Investing in the Unknown

By Montgomery Taylor

Two of the most renowned investors who've ever lived—Warren Buffett and Peter Lynch—have followed a "keep it simple" philosophy in building their fortunes. As Lynch famously put it, "Know what you own, and know why you own it." Those who study the so-called "Oracle of Omaha" say that Buffett's preference has been for businesses that can be explained in a single sentence.

Whether or not you're big on value investing, these nuggets of wisdom ring true. If you don't understand the investments you own, or you can't easily explain how they work, then you may be opening a door to some unwarranted risk (and regret).

What was the great lesson of the bear market of 2008 to 2009? If some investments grow so complex that even banks and brokerages didn't fully comprehend their risks, doesn't it follow that it might not be right for ordinary investors? Unfortunately, as memories of bear markets fade, memories of the pain and folly associated with such investments fade as well.

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How understandable are your investments?
Shouldn't they be transparent and liquid? Few individual investors need non-traded or illiquid investments. Even so, a notably optimistic market climate can inspire investment in those options. These investments may have their merits, but they also have their drawbacks. Here are some examples.

Life settlements. These investments have been pitched as having the potential for double-digit returns with no stock market correlation. That sounds great, but what about their downside? At the root, a life settlement occurs when a person sells his or her whole life insurance policy to a third party, as he or she can't make the premium payments any longer or just needs cash for retirement. The result? A lump sum that's somewhere between the policy's cash surrender value and its death benefit. The buyer of the policy (the financial institution) keeps it in force by taking over the premium payments.

When you invest in life settlements, you basically invest in the life insurance policies of senior citizens. The institutional investor who owns these policies is betting, more or less, that these seniors will die before they're supposed to. If they live longer than expected, the institutional investor loses the actuarial bet. Creepy? Yes, and these investments are unregulated in some states (they're regulated in California). Due to bad underwriting and/or increasing longevity, you could end up with a much lower return than advertised or even a loss. Moreover, do you need an illiquid investment with an undefined time horizon?

Non-traded REITs. Real estate investment trusts (REITs) offer "small" investors a chance to buy fractional ownership shares of a real estate portfolio as well as the potential for solid annual returns and tax advantages—but not all REITs are traded on national securities exchanges. Investing in a non-traded REIT has its hazards. Many are structured so there will be a "liquidity event" in their future: Either they go public or liquidate at that time. Until that time, however, an investor in a non-traded REIT faces illiquidity risk, no guarantee of a distribution and the possibility of major fluctuations in the per-share price. Front-end fees on them may also be higher than those for exchange-traded REITs and dent the return so it ends up being lower than that of an exchange-traded REIT.

Mortgage-backed securities. Yes, they're still being offered as potentially high-yielding alternatives to Treasuries. These securities are akin to bonds, and they're created through a multiphase process. First, banks sell groups of home loans to issuers. The issuers pool the home loans together into mortgage-backed securities—that is, securities collateralized with residential mortgages. In selling these securities to institutional investors, the issuers are essentially selling portions of the mortgage pool featuring different levels of risk and expected return. These portions (or "tranches") are known as derivatives, and the derivatives feature different levels of prepayment risk: The risk that the borrowers in the given "tranch" will make more than the minimum mortgage payment per month, thereby lowering the interest on their loans. After all these steps are taken, residential mortgage payments end up being the revenue stream for the institutional investor.

When you have a strong housing market (and low interest rates), a mortgage-backed security may seem attractive. When homeowners start to miss payments or default on their mortgages...well, think back to 2008. If you lack the stomach to try and understand embedded options, option-adjusted spreads, zero-volatility spreads and other mortgage-backed securities jargon, then stay away from that market and explore more liquid ways to invest in this sector.

Many of the horror stories I hear from people concerning their investing include investments such as those discussed here. I suggest you protect your nest egg by investing in what you understand yourself or through a wealth adviser who's interested in helping you understand.

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