

Begin forwarded message:

From: "Krause, Mitchel (Raleigh)" <mitchel.krause@[REDACTED].com>
Subject: **Managing Risk - capturing upside while protecting downside!**
Date: January 5, 2017 at 3:32:33 PM EST
To: "Krause, Mitchel (Raleigh)" <mitchel.krause@[REDACTED].com>

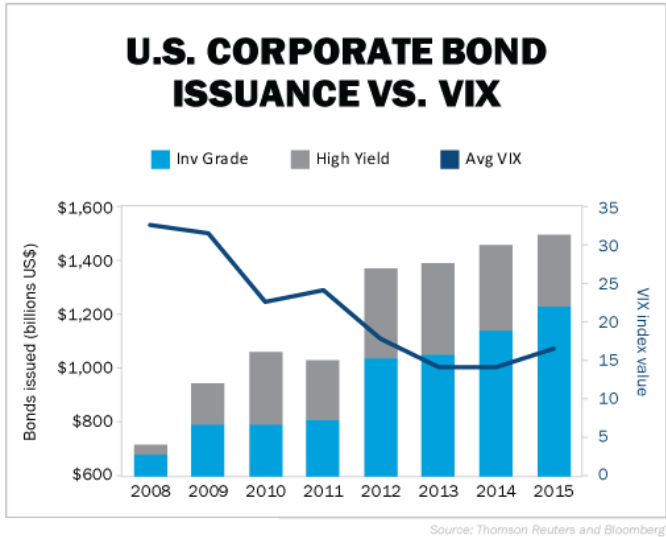
Great catching up with you today –

Per our discussion – When I initially left the private wealth side of the business so many years ago, the first few years of my time on the institutional side of the business was spent learning how little I actually knew about an industry I had been in for 8 years. It didn't take very long when working with Institutions, Hedge-funds, C-level execs in numerous capacities to learn the very "heart and core" of the industry. What dawned on me very early and I find to this day to be extremely important is that... *Most brokers, and investors, don't know what they don't know...* Brokers and investors alike, don't know how to sell – investors have "faith" in their "broker or friend"... but they don't know what they don't know.

After 20 years in this industry looking at it from all walks and angles, I am reaching out to pretty much everyone I know or care about to educate them a little on a few simple ways people can manage their risk more appropriately given the sheer volume of debt and leverage currently in financial markets.

In my 20 years, I don't believe there has never been a more lopsided environment in the financial markets between heavily leveraged companies with tremendous debt loads (and virtually no organic earnings) vs. obscenely low fear. Couple that with most not understanding how to manage or hedge their risk (individuals or professionals) and I believe we are staring in the face of some tremendously volatile times ahead. BUT... as I explained to you on the call – there are ways to mitigate this risk and protect ourselves.

From the graph below – combining information from Thomson Reuters and Bloomberg – back in 2008 the amount of Corporate debt issued to fear was nominal vs. today. While this chart includes 2015 – 2016 is omitted and you can see by the VIX (as I showed you today) is trading around \$12.98 – with even more debt having been issued.



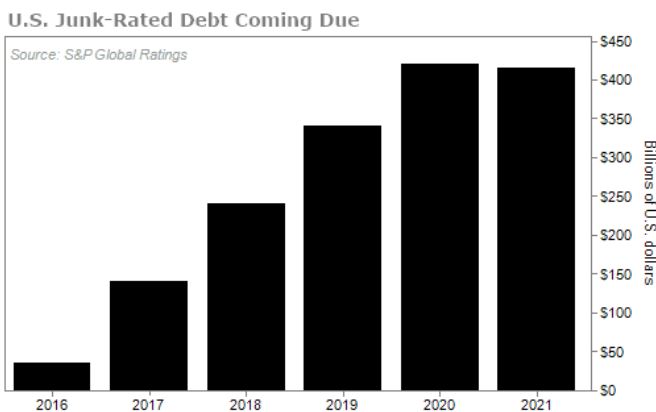
I don't believe there is a more opportune time to understand what I currently do and how it would be tremendously beneficial to you now. Today I manage risk more than anything (and teach investors how to do the same)...

As we discussed - the dislocation in the VIX and markets is giving individuals an opportunity to protect themselves with what I would consider "term financial life insurance" on their investments... This is an anomaly most individuals are simply unaware of.

Let's talk corporate debt for a moment...

More than 9.5 Trillion dollars' worth of Global Corporate Debt will be coming due over the next 5 years. Let's let that sink in for just a minute...

- **Roughly 2.3 Trillion of this is considered "High Yield" - "Junk Bonds"**



- **Roughly 1.5 Trillion of this debt is that of the United States**

Before the mid-2000s, US corporations had never borrowed more than \$1 trillion in a year. They did so twice in 2006 and 2007 and I believe everyone remembers 2008 and 2009 being the worst recession since

the Great Depression. However, during a six year period from 2010-2015, U.S corporations borrowed more than \$1 trillion dollars A YEAR from 2010 through 2013, capping it off with borrowing \$1.5 trillion in 2014 AND 2015. Of this debt, High Yield (a.k.a. Junk Bonds) made up more than 20% of the issuance in every year except for that of 2015.

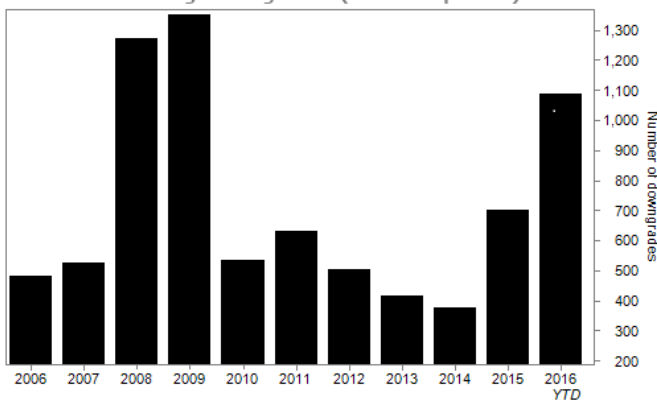
High Yield Bonds as % of Issuance 2010-2015

Year	% Junk
2010	25%
2011	22%
2012	24%
2013	24%
2014	22%
2015	18%

Source: Securities Industry and Financial Markets Association (SIFMA)

Historically, the debt cycle in the United States has rolled over as the Corporate debt to GDP ratio nears 45%. Defaults tend to rise, issuance tends to slow, and markets quietly begin to roll over; To date, rating agency Standard and Poors (S&P) has downgraded 1,088 companies in 2016, which is 55% more downgrades than in all of 2015

S&P Credit-Rating Downgrades (U.S. Companies)



Today, corporate debt is now roughly 45.4% of the country's GDP

Corporate Debt-to-GDP Ratio



Corporate bond analysts at Morgan Stanley anticipate the default rate among junk companies to reach 25% within 5 years. The lowest “rung” of high quality bonds or BBB Rated bonds used to comprise roughly 17% of the market now represents nearly 30% of all bond issuance. When adjusted for the amount of corporate debt issued, US equity markets are trading at record highs with outlandish valuations - though corporate earnings have fallen for five straight quarters.

What does this mean? It means BBB credits may not be investment grade credits anymore?! In a recent report from Bloomberg found [here](#) - both Moody’s and S&P have been “*cutting companies slack on mergers and acquisitions, an analysis of credit-ratings by Bloomberg News found.*”

cont...

“Over the past year and a half, both have bumped up their ratings by two, three or even six levels on a majority of the biggest deals, the analysis found.” (emphasis mine)

It also means that if you own the Equity or Stock of a company whose debt goes into default - the equity value will more than likely be wiped out as bond or debt holders take precedence over that of Equity holders.

As of the end of 2Q16 we’ve seen the 5th consecutive Quarter with declining corporate earnings, with an even longer drought of declining revenues. It’s anticipates we are in the midst of the 6th Quarter of declining earnings. Earnings continue to fall as profit margins have shrunk for more than 8 consecutive quarters.

I sent the below as an email to some prospects and clients a few weeks ago and this is what I am talking about...

The BIG QUESTION:

What have you done (or are you doing) **DIFFERENTLY**, to protect yourself should financial markets see another 2008/2009 crisis? ***What solutions have you implemented?***

Think about it... be HONEST with yourself. If your answer is anything close to:

- I’m with another broker
- I’m now in "Diversified Mutual Funds"
- I’m no longer in Mutual Funds - but Equities
- I’m using an “experienced” money manager now
- I’m doing things myself
- I leave it to the experts, that’s what I pay them for

If your answers "END RESULT" leads you to being long (owning) some form of an equity instrument; i.e. Stock or Mutual Fund... without addressing anything else, specifically your downside and risk, the reality is you’re most likely doing nothing differently and you should seriously re-evaluate your current situation. If you are currently invested in a “Bond Fund/s” - you very well *could* be doing more harm than good?!

During the 2008 crisis, there was a sarcastic “joke” that floated around cocktail parties that “**a 401k turned into a 201k**” - as the value of many 401k’s had fallen by roughly 50%. There are numerous reasons many individuals flock to mutual funds with their investable dollars, though; do they do so, under a guise of a false sense of security? Markets fell peak to trough from 2008/2009 by roughly 53% the value of many funds did so as well.

The reality is anyone can buy a Stock, Bond or Mutual Fund, that’s the easy part. Understanding and Managing RISK while maintaining a low expense structure is significantly more difficult.

Remaining invested while understanding the looming headwinds is also a challenge? “Guessing” is where people get into most trouble. Give a call - let’s talk about it.

Moving forward, I don’t believe we make money the same way in markets as we have over the last 30 years... The next 3-5 years are going to be tremendously interesting and we’ll have many chances to be opportunistic! Especially in bonds (yep, I just said that). As Bonds are downgraded from “Bank investment grade” to “junk” – and Banks and institutions are forced to sell them as they can no longer own them per bylaws – buying bonds (which rank higher in pecking order than common stock) will begin to offer yields and returns that far exceed that of a common stock, again, with less risk.

Many people are going to be hurt very badly by what is looming... Most are blind to it. The strategy that I laid out for you allows you to Participate in up markets with less risk. Protect your principal and manage your risk on an individual name basis and then purchase a “term financial life” policy on your investments for relative pennies on the dollar if the ultimate sell off comes... If I’m wrong, we’re still set up for significant upside. We are able to prepare for the vast majority of outcomes and while I can’t foresee things like Godzilla stomping all the central banks in the world on the same day – we can be significantly more prepared than most, including all those managers who said “who could have seen this coming?” bottom line - people won’t be prepared for this...

I’ve laid out a plan to profit well in good markets and insulate your downside in tough volatile ones. Then significantly insure yourself in catastrophic.

The reality is that regardless of what my Macro view is at this time – and while everyone loves to be right – the biggest impact on your portfolio moving forward will more than likely boil down to managing your risk... Given the scenario, I can be wrong with my Macro view and we can still do extremely well. But if I am right... very few will have you protected as you could be.

Be well my friends,

Mitchel