

Free research report

For readers of undervalued-shares.com

Dear Readers and Members of Undervalued Shares,

Having been an undervalued-shares.com member and reader myself for years now, I am in regular contact with Swen.

Swen inspired me with his two blogs to start my own one. I did so a few months ago.

After showing Swen my research report about Butterfield, we found out coincidentally that he also had this stock on his radar and was ready to write his own report.

So we decided that I would show you, as readers of undervalued-shares.com, my report about this bank for free, as an add-on to Swen's latest weekly dispatch.

Thank you Swen for your inspiring work and also the possibility to present my work!

On my blog financial-engineering.net, I am publishing two sets of writings:

1. free columns, every Thursday on a weekly basis (*I call them „Weeklies“*). A free newsletter with alerts when a new Weekly is due, is available on my site.
Plus, subscribers receive as a bonus a free research report about a company with a market leading position that benefits from high volatility. The higher the “*vola*“, the disproportionately favorable for their earnings.
2. 8 exclusive research reports (*so far two published, Butterfield being one*) plus updates to my reports, if something noteworthy comes around, for my Premium Members (*99 EUR per year*).

If you are curious to find out more about my work, please feel free to visit my site:

financial-engineering.net

All the best,



Alan Galecki

Founder of Financial-Engineering.net

FINANCIAL ENGINEERING

TOMORROW'S INVESTMENT NEWS ALREADY TODAY

08 October 2022

Research Report – Issue #2

Bank of N.T. Butterfield & Son Going offshore with a stock investment!



Photo by Tim Evans on Unsplash

WHILE MANY BIG BANKS ARE LEAVING THE STAGE, THIS BARELY KNOWN INSTITUTE FOCUSES ITS ACTIVITIES ON OFFSHORE JURISDICTIONS.

What sounds like a very speculative and unserious business, in fact is the strength of the company.

Where there are less competitors, there is more pricing power and thus more to be earned! Not in vain is Warren Buffett preferably looking for businesses with strong moats that typically can be found in less competitive sectors.

While banking per se is very competitive in many parts of the world (*see Europe*), this bank earns very healthy margins.

As a big plus, it has also a quite conservative balance sheet with less leverage than many US banks.

The big driver will be rising interest rates. Like hardly any other bank, this financial institute will profit from higher rates due to its mostly variable loans.

While waiting for massively growing earnings and a probably higher share price, you can collect a sound 5.3% dividend yield.

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About simplicity

To the point – from proven successful people

“Behind every stock is a company. Find out what it's doing.”

&

“All the math you need in the stock market you get in the fourth grade.”

&

“If you're prepared to invest in a company, then you ought to be able to explain why in simple language that a fifth grader could understand, and quickly enough so the fifth grader won't get bored.”

(Peter Lynch)

“That's been one of my mantras – focus and simplicity. Simple can be harder than complex: You have to work hard to get your thinking clean to make it simple. But it's worth it in the end because once you get there, you can move mountains.”

(Steve Jobs)

“I am suspicious of thick and overly detailed reports. What is good is usually also quite simple, so lengthy explanations should not be necessary.”

(Marc Faber)

“I don't look to jump over 7-foot bars: I look around for 1-foot bars that I can step over.”

(Warren Buffett)

„Simplicity is the ultimate sophistication“

(Leonardo da Vinci)

Why do I write short reports and not long, extensive ones?

Short answer: It's about simplicity, comprehension and your time in today's information overloaded world.

Long answer: For me the big goal (and challenge) is to be clear and on point with my investment theses. For every aspect I look at, the aim is to write down the main points cleanly on a single page.

The research I am doing beforehand is not reduced, however, quite the opposite. My research process is extensive. I am spending several hours of time to crush together what is necessary into an easily comprehensible and digestible format for you.

It is a service from me and also my philosophy to be spot on.

Because I value your time!

Foreword

NTB is THE play on rising interest rates in the banking sector!

HAVE YOU EVER BEEN LOOKING FOR A BANK THAT OFFERS STABILITY, SECURITY AND GOOD RETURNS FOR SHAREHOLDERS?

I have good news for you!

The Bank of N.T. Butterfield & Son Ltd. (from here on in short either "Butterfield" or by its ticker NTB) is barely known, even among people more familiar with stocks.

Certainly, one of the main reasons is the fact that the relatively small Butterfield solely operates in offshore markets that for many ordinary people at best are opaque and at worst have something criminal to them.

In my [current Weekly](#), I gave you a first rough introduction from the perspective of a small private investor, like you and me. There is nothing criminal to it to having a bank account offshore. You just have to be tax-compliant.

What I didn't write about are the indeed way more opaque and discussable practices of some groups with deeper pockets. I highly recommend to [watch this video](#) about Britain's "second empire" (should it be deleted in the meantime, drop me a line).

This is the market NTB is operating in over several tax-havens.

That alone wouldn't be a firm enough investment thesis for me, though. Actually, I find Butterfield so interesting, because it has everything to turbo-charge its operating performance in the current environment:

- conservative, stable balance sheet with lots of liquidity
- Low delinquency and charge-off rates
- A customer base that consists mainly of high net worth individuals (HNWI) that are financially way more stable than indebted „small fish“
- The markets NTB operates in are decoupled from larger economies
- Its loan portfolio mainly consists of variable loans; it quickly adapts to rising interest rates, while many big banks „locked in“ low interest rates on their loans
- A stable dividend and some share buybacks
- An acceptable valuation

One of the critical questions is whether central banks, especially the Federal Reserve, will continue with their recent pace of interest rate hikes. I think the FED will do so, at least for some time. The current narrative in the markets is that Jerome Powell (*the FED chair*)



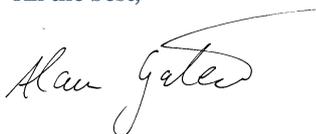
will get soft when markets fall too much. But this is a misconception, I think.

He will raise rates, because the FED has two mandates: A low unemployment rate and a low inflation (around 2%). It is NOT their task to make sure that stocks go up or stay high! If they stop raising rates, they will be blamed for too high inflation. If they overshoot, they will be blamed, too, for crashing the markets. Hence, there's no reason to stop, at least for now. They'll be blamed anyway.

NTB is the perfect stock to profit from rising interest rates, parking money offshore, already with small sums and collect a dividend of more than 5% in the meantime.

I hope you enjoy this new report.

All the best,



Alan Galecki

Founder of Financial-Engineering.net

The investment case in a nutshell

What you need to know on one page – because I value your time

CURRENTLY, I WOULD NOT TOUCH ANY BANK WITH EVEN A TWO METER LONG PAIR OF NIPPERS.

But with Butterfield I can imagine of making an exception.

There are several things I really like about this offshore bank:

- fully restructured since the crisis of 2008–2009 (*that even lasted longer in its home markets*)
- re-focussed its operations on offshore banking services
- All its markets are fully tax-compliant and participate in the CRS since 2017, respectively 2018
- Conservative balance sheet with high liquidity
- Barely any credit write-offs and small delinquencies only
- Firepower for more acquisitions like the recently announced addition of the trust business of Credit Suisse
- 82% of its loan portfolio is on variable interest rates; this makes it THE bank for a rising interest rate environment
- Its customer base mainly consists of high net worth individuals (*HNWI*) that are less likely to default on loans
- Nearly 70% of Butterfield's loan book consists of mortgages that are fully recourse; should the debtor go belly up, NTB will become the property owner

While waiting for higher interest rates that the FED is delivering on a fast pace (*and regularly confirming in the media*), you can collect a dividend of around 5.3%. Not bad.



source: Markus Winkler on Pexels

There is even a chance that it will be risen in the next few months, because I expect earnings to go up massively. The payout ratio just recently already fell slightly below the target range of 50%.

Plus, the management has a share buyback program running that could repurchase around 4% of shares outstanding. This is not massive, but management showed especially during 2020 that they understand cycles and are willing to act in case share prices get lower for a certain time. Now is a good time to be ready to act!

This investment case will certainly not be for everyone, but I think it is interesting to read about such an opportunity, anyhow.

[Read on for the whole story...](#)

Brief overview of the stock

Key facts and longterm chart



BUTTERFIELD

The Bank of N.T. Butterfield & Son Ltd.

ISIN / ticker	BMG0772R2087 / NTB
Home bourse	New York (USA)
Share price (as of 07 October 2022)	33.28 USD
Market Cap / enterprise value	1.6 bn. USD
Average 3 month daily volume	0.1 million shares / 3.3 million USD

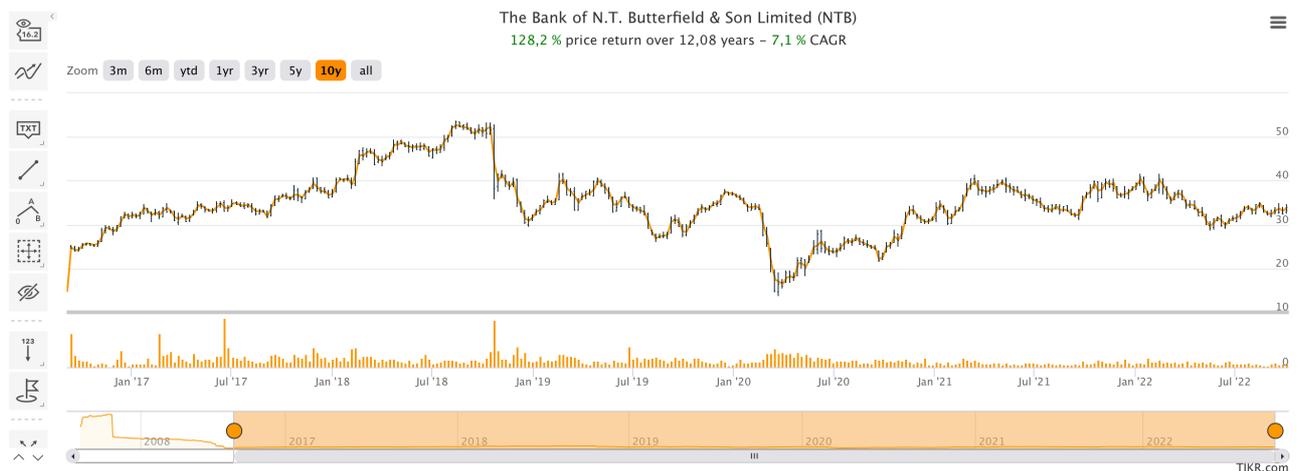
The Bank of N.T. Butterfield & Son Limited (NTB)

33,28 \$

-0,84 \$ (-2,46 %)

7. Oktober 2022 Close

USD



Source: TIKR.com

The business model

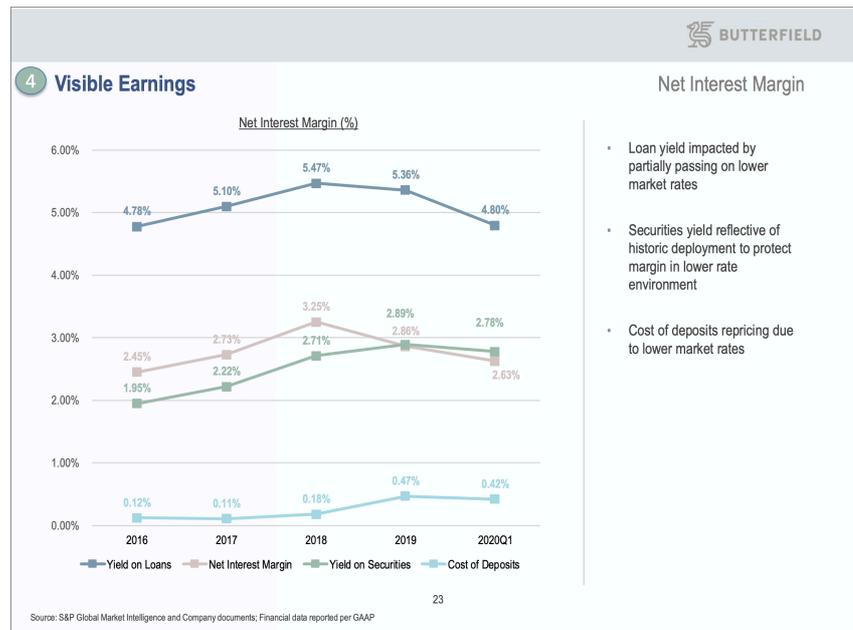
What is the company doing?

BUTTERFIELD IS A HOLDING COMPANY, DOMICILED IN BERMUDA, WITH SEVERAL OFFSHORE OPERATIONS.

Besides Bermuda where Butterfield is already active since 1858 (*the first bank registered there*), NTB has also operations in the Cayman Islands, the Bahamas, Singapore, the Channel Islands (*including Guernsey*) and Switzerland. Butterfield offers financial services like mortgage loans, commercial and consumer loans as well as trust and asset management.

Despite the reputation of being centers of crime and tax-evasion, offshore banks like NTB have to be compliant to international tax laws. Especially the smaller banks like NTB. Otherwise they would be cut out from the financial system. Besides HSBC which had several scandals in the past, Butterfield is among the cleaner banks in this sector. Thanks to its comparatively lower regulatory burden (*so-called "protection of consumers"*), offshore banks like Butterfield can offer their clients more privacy and more financial services, often even at more attractive conditions due to lower bureaucracy costs and taxes.

The two most important markets for NTB are Bermuda and the Cayman Islands from a revenue perspective. Very interesting is the development in the banking sector. While many bigger banks are separating from offshore banking, Butterfield is buying some of these unloved, but highly valuable assets! In 2018, NTB could gobble up its private banking operations in the Channel Islands which it bought from the Dutch bank ABN AMRO. It also bought some businesses from HSBC and Deutsche Bank.



Source: *Investor Presentation June 2020*

With the most recent acquisition, announced in September 2022, Butterfield will strike again and buy the international Trust business of Credit Suisse which is said to be in trouble (*the bank, not the assets; probably at favorable conditions, no specifications were given*).

Butterfield has a more than 30% market share of deposits in its two biggest markets, Bermuda and the Cayman Islands. This means, every third Dollar there is under the custody of NTB.

Another interesting fact is that the Cayman Island are effectively the 5th largest financial center of the world with ca. 80.000 registered companies and hosting over 75% of all hedge funds. The population of the Cayman Islands is only around 60.000 people – this is roughly the

estimated equivalent of homeless people in New York alone!

As you can see from the graphic above, NTB's yield on loans and net interest margin (NIM) both went up from 2016–2018, only to fall afterwards. This was exactly the same time when the FED raised interest rates from 0.25% to 2.5%. The takeover of the Channel Island operations also played a role, due to lower average rates there.

Currently, we are again in an up-cycle. However, I think, this time it will not only be way higher, but also stay on a higher base.

Per their latest annual report, Butterfield had a big 82% of its outstanding loan portfolio in floating rates. With higher rates, this will be adjusted up – much more income for NTB!

Leadership & capital management

What is the company doing with stockholders' money?

BUTTERFIELD SUFFERED MASSIVELY DURING THE FINANCIAL CRISIS STARTING IN 2008.

The first reason is that the economies of Bermuda and the Cayman Islands took way longer to recover. Bermuda only posted a positive growth rate for 2015 (*the first after 2007!*), while the Cayman Island at last got healthier again in 2011.

The second reason is that NTB was a wholly different business back then. Not only was it involved into the garbage of US property „securities“, the share of loans given to the very cyclical hospitality and tourism business at home was also much higher than today.

After a tough cure with painful losses and capital raises, Butterfield restructured and put a new management team in charge by 2015. Both the CEO and CFO are still with the company. The CFO, however, recently took over the role as risk officer.

Interesting side-fact: Banks in Bermuda, NTB's biggest market, are not supported by a central bank. This means, management must act wisely and conservatively, because no one will come to rescue a failed bank, unlike you certainly are aware of the USA and Europe!

After the crisis of 2008–2009, NTB started to focus on the operations it has today. Besides growing slowly organically, management actively pursues opportunities by acquiring unloved assets from other banks that want to sell what is non-core for them. You can imagine that there is not much competition for buying these unloved assets, hence NTB will likely always be in a good

Quarter	Avg Equity	Net Income	Perc
2019 Q3	2,092,847,856,000	57,360,053,000	10.96
2019 Q4	2,088,127,077,500	54,845,181,000	10.51
2020 Q1	2,111,159,399,000	18,489,351,000	3.50
2020 Q2	2,127,599,354,000	18,459,832,000	3.47
2020 Q3	2,161,678,041,000	51,116,384,000	9.46
2020 Q4	2,203,166,849,000	59,133,463,000	10.74
2021 Q1	2,236,625,310,000	76,773,316,000	13.73
2021 Q2	2,274,963,132,000	70,011,251,000	12.31
2021 Q3	2,321,415,861,000	69,487,467,000	11.97
2021 Q4	2,338,757,797,000	64,026,347,000	10.95
2022 Q1	2,294,134,408,500	59,754,343,000	10.42
2022 Q2	2,231,691,578,500	64,409,252,000	11.54



Source: Bankregdata.com

position for negotiations. How do I know? They have barely any goodwill on their balance sheet (*premiums paid during takeovers*).

The performance of a bank is evaluated by its return figures. Here, unsurprisingly, NTB shows its strengths.

- Returns on assets: most banks have less than 1%, especially in Europe. Only the best of bread like JPMorgan achieve around 1% (*NTB currently has 1.4% per Q2 2022*) – more to come
- Returns on equity, respectively on tangible common equity: NTB posted an awesome 27.8% last quarter – rates only just started to rise! At its top, JPM had only 18.3% last year!

Don't forget that JPM is one of the best managed banks in the world!

Both metrics show that Butterfield is way more profitable. Look at the graphic above that shows average returns on equity for the whole US banking sector. Even during times of zero interest rates, NTB mostly

had better returns on equity (*the low was 15.5% in Q2 2020*) than its peers during their best times!

To be fair, one reason is also that NTB doesn't pay corporate taxes in Bermuda – there are no such taxes. But why not taking this advantage?

Since 2017, the management team has bought back 10% of its own stocks outstanding. They were very active especially during 2020 when prices were low and most other companies stopped buybacks. Well done! That's what I like!

The other component is the dividend which shall take around 50% of earnings through the whole up- and down-cycle. It was maintained even during 2020 and 2021 when earnings were weaker. Currently, the payout ratio sits even under 50%. A raise in the next quarters is likely, supported by higher rates and earnings.

More on the management quality in the next section about the balance sheet and some other core figures.

The financials

Cash flow statement, balance sheet, income statement

EVERY WELL MANAGED BANK HAS TO HAVE CERTAIN FIGURES AND METRICS IN ORDER.

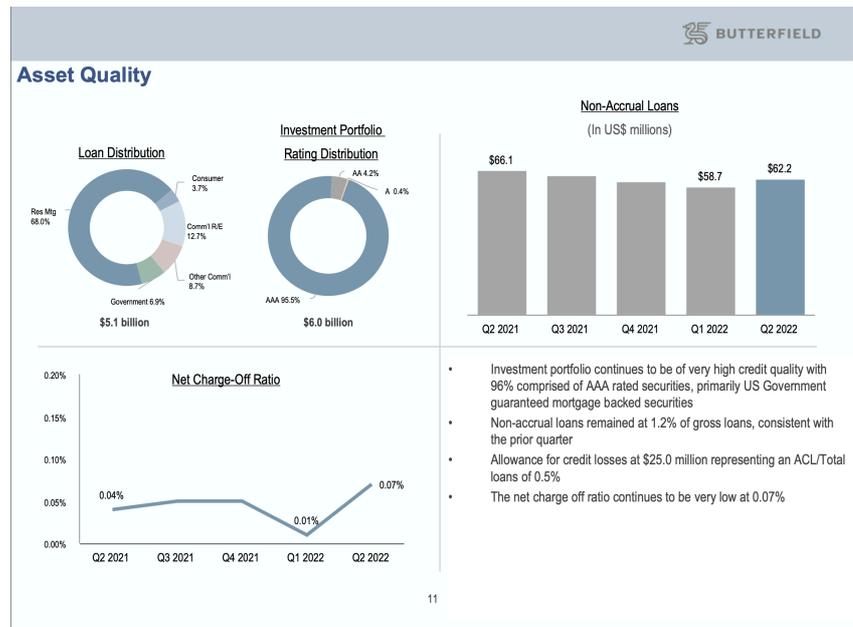
Among these are the costs, the overall strength of the balance sheet, the bank's delinquency and charge-off rates (*loans paid too late or written off*) and of course the net interest margin (*NIM*).

Butterfield has an efficiency ratio (*think of costs to income, the lower the better*) of around 60%. It is not superb, but not bad, nonetheless.

Its balance sheet is conservative due to the following facts:

- less than 40% of deposits are given out as loans; this is a very conservative ratio; Scandinavian banks often have more loans outstanding than deposits!
- of total assets, around 60% are cash and securities (*mainly US treasuries*) held by NTB; the bank is highly liquid and ready for acquisitions
- its regulatory capital ratios are solidly above the requirements and higher than at US banks
- of loans outstanding, only 0.07% have been written off, as of Q2 2022 – and this was already higher than in the past. Only around 0.5% of loans are „*non-performing*“, hence late in repayment. [Here](#) and [here](#) you can see that the average for US banks is nearly double of that for non-performing loans and two different worlds when it comes to complete charge-offs

It is important to understand the structure of a loan portfolio of a bank. For one, we have the geographies of the tax-havens where the customers typically are



Source: Butterfield Q2 2022 [presentation](#)

high net worth individuals (*or above*), not average Joes. The risks for loans failing are way smaller, because these people use loans for investment purposes and are way more diversified than those that use much more expensive consumer loans and pedal in a hamster wheel.

The majority of loans (68%) given out by Butterfield consists of residential mortgages. All loans are recourse, this means that in the case of a collapse of a debtor, the bank receives the underlying properties. Only less than 4% are consumer loans. The other loans are to government and commercial.

NTB earns fees (*e.g. in its trust and asset management business*), but the backbone of its operations still is interest income. What defines the ability to earn money for a bank is

the difference between interest earned and interest paid. This is the net interest margin (*NIM*). Due to its high share of variable loans and zero interest rates in the recent past, the NIM was under pressure, falling slightly below 2% at the low. Per Q2 2022, it already recovered to 2.3%. I expect 3%, soon.

The other thing to look at is the investment portfolio of Butterfield. They have parked around 6 billion USD (*or around 40% of their total assets*) in US government bonds. Unfortunately, this is not optimal. With rising rates, bonds lose in accounting value (*higher rates = lower bond prices*). NTB will post losses due to impairments from its holdings, but there will be no money flowing out. In the end, they will receive their money back, inclusive of interest payments.

Valuation and what to expect

Valuation always matters!

BANKS ARE TYPICALLY VALUED USING TWO OR THREE METRICS.

We have the:

- P/E ratio (*price to earnings*)
- Dividend yield

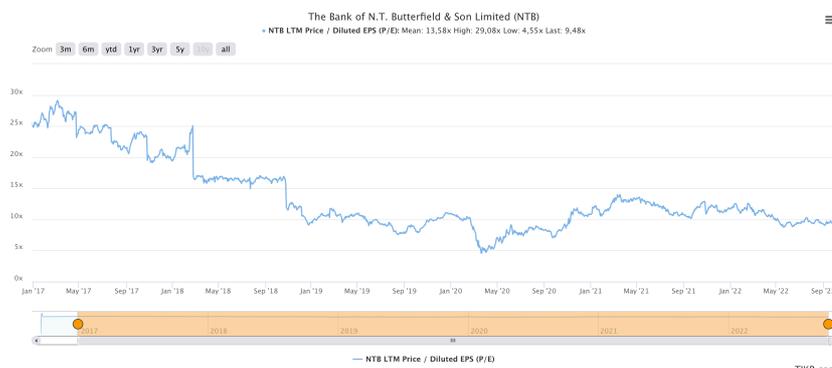
You know that I'm big proponent of using cash flows and not earnings for valuations. But in the case of banks, cash flows don't make sense, because during an expansion they give out loans (*cash flows out*) while during economical stress new loans shrink and repayments stay roughly the same. Hence we have an inverted cash flow cycle.

This is important to understand. Always use cash flows, except with banks / credit businesses!

To have a more complete picture, make sure to always think about the growth prospects of a bank and look at its dependence on business cycles as well as the state of the current cycle. Of course every bank with a loan portfolio will be cyclical.

In the case of Butterfield, I think you can add a valuation premium for the reason of the flight to safety by many people who can afford it. Being honest, the Eurozone is not a respected safe place for storing big amounts of wealth. Hence, I'd expect at the very minimum no shrinking deposits, but even slightly rising ones in Butterfield's offshore territories. The amount of new loans could stay flat or even shrink slightly, but the average interest on its mainly variable outstanding loans is rising!

Mix into that the fact that due to its acquisitions, Butterfield's loan book is 25% bigger today than in 2018 (*mainly due to the acquisition of its Channel Island operations*).



Source: TIKR.com

During the last high in 2018, the yield on loans reached 5.5% and resulted in net interest income after costs of 350 million USD. Plus, NTB had fee based non-interest income of 170 million USD for total revenues of 518 million USD. The share price reached 50 USD (*nearly 50% upside from today!*)

Per Q2 2022 (*last published results*), Butterfield announced a yield on loans of 4.5%. I have a gut feeling that the potential of NTB is somewhat underestimated. The yields of 2018 were reached while the FED funds rate stood at 2.5%. However, we are already a third above the last high with the FED funds rate currently at 3.25% (*probably 4% during October*).

To be conservative, I would factor in the same yields like four years ago, but with the higher loan book and the same non-interest income. This translates to interest income of ca. 450-500 million USD annualized for the next twelve months. Non-interest income should be 20% higher than back in 2018 and reach 200 million USD. Say 650 million USD in total revenue and a net margin of 35%

(*they had 37.7% in 2018*) leads us to an expected net income of 227.5 – 245 million USD.

This would be before almost certain impairments on NTB's longterm bond investments. But like I said on the last page, this will be only an accounting figure and not represent any cash outflow from the business.

The dividend currently costs Butterfield 87 million USD. It is safe and very well covered. At least a small increase should be possible.

Management currently runs a share buyback program. Instead of having announced a USD-figure for which they will be repurchasing stock, the program has a volume of 2 million shares. This results in a bit more than 4% of outstanding shares (*last announced figure was 49.8 million shares outstanding*).

As it stands, we have expected earnings per share of 4.20-4.50 USD for this year (*3.50 USD in 2018*). This gives us a not expensive P/E ratio of 8x (*12.5% earnings yield*). Keep I mind that this bank is highly liquid and has among the safest customers.

Investment risks

Important to think about – what could go wrong?

EVERY STOCK HAS POTENTIAL RISKS. SO DO BANKING STOCKS LIKE BUTTERFIELD.

The main risks I can think of are:

- the economies of the Caribbean islands depend besides the financial sector heavily on tourism (*est. 20–25% of GDP*) which was non-existent or muted during the last two years; currently it seems to have revived at least somewhat
- Forex risks due to exposure to the declining GBP (*20% of deposits*)
- During the financial crisis 2008–2009, NTB suffered losses due to weak and only slowly recovering economies on the Caribbean islands and financial losses on US mortgage backed securities. But NTB had also a far higher share of cyclical loans in its portfolio back then. Plus, there is no US-exposure anymore
- Higher interest rates on loans can lead to lower demand for new borrowings however the variable interest rates on loans outstanding should compensate for that
- Higher interest rates could potentially bankrupt some lenders, though not so likely (*customers are mainly HNWI*)
- Harder regulation; however all jurisdictions where NTB is active, are already participating in the CRS, I wrote about in my [current Weekly](#). Bermuda, the Cayman Islands, the Channel Island since 2017 and the Bahamas, Singapore and Switzerland since 2018. Fully compliant on this front



Source: Drew Rae on Pexels

- The company has no long history as a publicly listed company in the US (*since 2016*); however it is already listed on the Bermuda Stock Exchange since 1971 and its operations are more than 100 years old
- Due to inflation the cost basis of the bank could increase; yes, higher costs, but also higher earnings

All in all, I think that the risks are non unreal, but should also not be exaggerated.

I really like the focus on its core operations and the conservative management of its balance sheet and liquidity.

Sources

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