Quarterly Newsletter

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Brexit Update

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Uncertainty comes in many forms, and when it comes it is almost always a destructive force. A child not getting home by curfew or an impending surgery can throw us into a state of fear and anguish as we yearn for closure, for the truth of the matter. And so it has been with the United Kingdom's surprise exit from the European Union, also know as "Brexit".

I found it amusing, though not altogether surprising, that the pundits got it so wrong, once again. Even the bookmakers had the odds at 79% that the Brexit would fail and the U.K. would remain a member of the EU. But as I have chronicled for over 30 years in these pages, political pundits have about as good a success rate of predicting political outcomes as the market gurus have had at predicting stock markets or weathermen predicting the weather. Not very good. Yet, we still tune in, we still listen. Why? Because we so desperately want answers to our uncertainty.

Even I want to give you answers to your uncertainty, but I am certainly no pundit. It has been said that the worst sort of advisor is the one that "Doesn't know that he doesn't know". I know I don't know! Besides, it is much too early to tell. However, there are facts that we can consider in context together and that may help us all get a better handle on what this all means to us and our portfolios.

First of all, I empathize with the British people's decision to leave the EU. There was a general frustration with the EU leadership in Brussels dictating what residents of the UK could and could not do. From a wide open immigration policy that caused people to worry about their country's sovereignty to what sort of tea pot was approved for their use. It seems natural to me to be able to make one's own choices about how to run one's own country, one's life.

It is important to remember that the UK economy represents less than 4% of the world economy. While 4% is not insubstantial, it is not a huge player either. The UK economy could take a substantial hit as 1/2 of all exports from the UK are with the EU. The British pound sterling declined to its lowest point in three decades and S&P has downgraded their credit rating, which is really bad for business in the UK.

It is worth noting that the three weakest countries in the EU suffered the biggest post Brexit one-day stock market losses-Spain (-12.3%), Italy (-12.5%) and Greece (-13.4%). On top of that, France's National Front party has called for a "Frexit" and the Dutch populist Geert Wilders has called for a "Nexit". You can be sure that the EU's response to the UK's Brexit will not be very accommodating as they would naturally want to discourage other country's similar defections.

The second threat to a sustainable EU is the continuing tensions among members not only over the flood of incoming refugees and what do do with them, but the continuing friction between creditor and debtor countries within the eurozone. Italy's 12.5% loss the day after Brexit, for example, would seem to indicate a clear vulnerability to a banking crisis.

What does all of this mean for us? As I said above, I really don't know.

What I do know is that the media will announce the end of the world at least twice a week in the coming months. For more on this, see Heath's article on the coming pages.

For now, stay on course. We are ready for what comes our way. Of course your portfolio will feel the effects of this uncertainty, but it is sturdy and has been here before. So have you.

Rainfall in Ethiopia

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A meeting with a prospective client several weeks ago has stuck with me in a way that few meetings have in my career. As we learn about the goals and aspirations of the people with whom we work, we also hear about their frustrations with previous financial advisors. He explained, "A typical meeting with my current advisor involves an hour-and-a-half dissertation on how rainfall in Ethiopia impacts rice production in China which affects the US stock market by so-and-so."

Now besides the obvious silliness of this line of reasoning, it is frightening to think of how many advisors employ similar reasons to justify the investments they recommend to their clients. This is the most extreme example I've ever heard, but consider these less eccentric ones that are being discussed by countless financial advisors with their clients at this very moment, especially in the wake of the June 23rd "Brexit" vote:

"If Great Britain decides to leave the European Union, the market will respond by [fill in the blank]." Or "If Donald Trump/Hillary Clinton wins in November, the market will respond by doing [fill in the blank]." Or, "If the Fed decides not to raise interest rates in June, the market will surely [fill in the blank]." Or, "If OPEC decides to cut crude oil production, the market will react by [fill in the blank]."

They then use these predictions as the rationale for changes to clients' portfolios: Add an energy sector ETF, or trim the bond allocation, or increase exposure to dividend paying stocks.

Economist John Kenneth Galbraith once said of forecasting, "There are two kinds of forecasters: those who don't know, and those who don't know they don't know." Renowned financial theorist and author, William Bernstein, adds a third type of investor, "the investment professional, who indeed knows that he or she doesn't know, but whose livelihood depends upon appearing to know."

No one knows how any of these events will impact markets. No one. That includes financial advisors who have access to complex computer models and investment strategists in the home office with cool British accents. They don't know, but their livelihood depends upon appearing to know. Few of them are ever held accountable for the innumerable predictions they got wrong. They simply move on to the next prediction, the next tactical move.

If we come to the realization that this type of advice doesn't work, what then should we focus on? In our view, there are four things:

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1. **Risk**

   The way we manage volatility (translation: “downturns”) is by diversifying the portfolio across lots of investments that don’t act the same way at the same time. We create that allocation specifically to address the risk tolerance and risk needs of the individual client. More conservative portfolios hold more bonds. More aggressive portfolios hold more stocks. In this way, we can manage the level of risk that we take.

2. **Expenses**

   Keeping the internal expenses of a portfolio low is a huge predictor of future fund success. In a May 5th article, Morningstar provides an update to the already compelling data on this subject. We control these fees by using institutional mutual funds and ETFs with very low expense ratios.

3. **Taxes**

   No one likes paying taxes, even if they’re “feeling the Bern.” So we focus on keeping taxes to a minimum. For clients who have investments in taxable brokerage accounts, we minimize taxes by using ETFs and mutual funds with tax management as part of their mandate. We also take advantage of tax loss harvesting opportunities when they arise.

4. **Our Behavior**

   Most important of all, controlling our response to the news is the biggest determinant of investment success. If we allow our emotions to drive investment decisions in reaction to bad news or predictions about future market movements, our well-designed plan is for naught. As advisors, the most valuable thing we do for our clients is helping them avoid making behavioral financial mistakes.

Please don’t ever believe that anyone knows how rainfall in Ethiopia will impact the market. Instead, focus on what you can control, have patience and put your faith in a well-designed plan. If you do I’m confident you’ll have greater peace of mind and, in the long run, greater wealth.

Negative Interest Rates: How Do They Work?

MIKE MINTER, CFP®, CFS® | SHAREHOLDER, PORTFOLIO MANAGER

In recent months the European Central Banks and the Bank of Japan have instituted a policy of negative interest rates. But what does this mean, and how did it come about?

What are negative interest rates?

In simple terms, it means that the lender actually pays the borrower. So instead of getting paid interest for depositing funds with a bank, you would pay the bank for the privilege of depositing money with them. Obviously this is the exact opposite of what we're used to. So the logical question is, why on earth would anyone choose to pay the bank to deposit funds?

Well, the average consumer (You and I) would never voluntarily choose to do this. We have too many other options. Realistically, the chances of a negative rate situation in the U.S. dissuading you from depositing money in your bank is pretty low. This kind of scenario is usually reserved for the relationship between a country's central banks and commercial banks.

Central Banks

A country's central bank acts as the bank for all the country's commercial banks. In our case, the U.S. central bank is the Federal Reserve (Fed). The commercial banks all have accounts with the central bank, which enables them to operate efficiently, quickly moving money around on a daily basis.

The rate that is now negative in Japan and Europe, is the deposit rate. In these countries now instead of getting paid for depositing funds with the central banks, the commercial banks pay the central bank. Sounds pretty crazy, right?

So what is the purpose of a negative interest rate policy?

In theory, interest rates below zero should push down short-term rates on other lending products and reduce borrowing costs for individuals and companies across the board, which would then drive up demand for loans. They also punish banks that stockpile cash instead of extending loans or making investments. It's supposed to spur an economic boost.

The central banks want you to think negative rates sound ludicrous, so you'll go invest your money in more economically productive assets rather than putting it in a bank account or government bonds.

The central banks are kind of venturing into uncharted waters with negative interest rates. Hopefully some of the theories behind this experiment prove to be true.

The Annual End of the World

HEATH HIGHTOWER, CFP® | SHAREHOLDER, FINANCIAL ADVISOR

The date was December 31, 1999. I remember going to Wal-Mart to search the picked-over shelves for bottled water, canned food, and ammunition. Why? Y2K was coming! The world was about to end, and I was preparing for inevitable doom.

More recently the British voted to exit the European Union (EU) on June 23, 2016. And, in case you've been living under a rock the last couple of weeks, the vote decimated global stock markets and caused the British pound to fall to its lowest level in decades. It's as if the world is ending... But is it really?

Today, with the benefit of hindsight, we know that Y2K was not nearly as disastrous as our imaginations allowed us to think. But, I thought it would be interesting to turn back the clock to see how the market performed during other moments of crisis and then see if the market recovered in the years following the crisis. What I found may surprise you.

The Year	The Crisis (The Annual End of the World)	Calendar Year S&P 500 Return	S&P 500 Return After the Crisis*
2000	Y2K scare, technology bubble burst, mad cow disease	-9.1%	108.0%
2001	World trade center attack, Anthrax scares	-11.9%	136.1%
2002	Enron, Arthur Anderson, Tyco, Qwest, federal investigation & collapse	-22.9%	203.0%
2003	US invades Iraq (or Iran), Mutual fund after-hours trading scandals	28.7%	135.5%
2004	Multiple terrorist attacks in Spain, 3 hurricane's hit Florida in 2 months	10.2%	112.4%
2005	Hurricane Katrina & Rita, Pope John Paul II dies	4.9%	102.4%
2006	Iran successfully enriches uranium, Hezbollah attacks Israel	15.8%	74.8%
2007	Sub-prime mortgage crisis	5.5%	65.7%
2008	Banking crisis, stock market meltdown, severe economic recession, government bailouts	-37.0%	163.0%
2009	Swine Flu, unemployment at 16-year high, Bernard Madoff convicted, President Obama sworn in	26.5%	108.0%
2010	BP oil disaster, The Affordable Care Act (Obama-care) signed into law, upheld in 2012, Arab Spring begins	15.1%	80.8%
2011	Japanese earthquake, nuclear meltdown & tsunami, Egyption present overthrown in revolution	2.1%	77.0%
2012	Greece defaults, Eurozone debt crisis, US Ambassador killed in "Battle of Benghazi"	16.0%	52.6%
2013	Fiscal cliff, government shutdown, & sequestration	32.4%	15.3%
2014	Russian/Ukraine military standoff, Taliban prisoner swap for Sgt. Bowe Bergdahl	13.7%	1.4%
2015	Iran nuclear deal, Paris terrorist attacks	1.4%	TBD
2016	The British vote to exit the European Union...	TBD	TBD

In the year 2000, the world was ending because of the technology bubble, and mad cow disease. The stock market lost 9.1% that year. But, the S&P 500 went on to make a stunning 108% in the following 15 years (through Dec 2015).

In the year 2001, the world was ending because the world trade center was attached by terrorists. Thousands of Americans were killed and wounded. Anthrax packages riddled government buildings and dot.com stocks continued to plagued the US markets. The market lost about 12% for the year. But, the S&P 500 went on to make 203% in the following 14 years*.

In the year 2002, the world was ending because some of the largest and most trusted companies in America were under federal investigation. Enron, Arthur Anderson, Tyco and many others collapsed as a result of these investigations. The market lost 22% for the year, making it the worst calendar year return in 28 years. But, the S&P 500 went on to make 136% in the following 13 years (through Dec 2015).

I could go on, but the chart above speaks for itself. Over the long term, our market tends to be quite resilient. Since the year 2000 we've seen hundreds of terrorist attacks, natural disasters, nuclear meltdowns, political scandals, government defaults, corporate greed, International instability and all-out war. Each of these crisis seemed like Armageddon at the time. But we often forget how resilient our markets really are. It leaves me to wonder how the paragraph about the year 2016 will read. It's hard to say exactly what it will say, but here's my best guess…

> *In the year 2016, the world was ending because the British voted to exit the European Union. The _________________ crisis also surprised the markets. The market lost/made ________% for the year. The S&P 500 went on to make _________% in the years following the crisis.*

*S&P Return is the mentioned start date through December 31, 2015.

Sources: Morningstar Direct, Morningstar.com, Dimensional Returns Web, Investopedia.com, OnThisDay.com, JP Morgan's Guide to the Markets 2016

Announcements

We would like to welcome **Stacy Davis** to the team! Stacy was hired onto the operations team in June, as Client Service Specialist. Stacy is a native of Austin, TX and an alumna of the University of Houston. Stacy comes to us with six years of experience in the financial services industry as a marketing and client service professional. She is passionate about the Houston community and service to others - she is involved in many volunteer organizations including the Adult Reading Center, The Living Forward Alliance, and Yes Prep. We are so happy she became a part of the Financial Synergies family.

Congratulations to **Candace Cunningham**, who will be leaving Financial Synergies to pursue studies in medicine. Candace has been an integral part of our team and we wish her every success for her future endeavors.