FINANCIAL SYNERGIES®
WEALTH ADVISORS

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★ Quarterly ★ Newsletter

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Retirement Myths

MIKE BOOKER, CFP®, CHFC®, CFS®

SHAREHOLDER, FINANCIAL ADVISOR

Retirement is a time of great celebration and great trepidation. By and large, our clients have had successful retirements, but they usually mention that it was a bit different then they had imagined. Some differences good, some not so good. As the old Holiday Inn adage goes, "The best surprise is no surprise." Let's dive into some of the more popular myths and misconceptions about retirement.

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MYTH 1: I'll never make it to age 90. You just might. According to the Retirement Income Reference Book, 25% of 65 year-old men in average health will live to 93, 25% of women in that category will live to 96. All retirement plans should take into account that we are living longer. To plan on dying sooner could cause you to run out of money.

MYTH #2: Medicare will cover my health costs in retirement. Nope. Generally, Medicare covers a bit more than ½ of a retiree's medical bills. The typical annual out-of-pocket expense for a retiree is $5,500. Any good retirement plan will address this expense item.

MYTH #3: A conservative portfolio is best for retirees. Well, yes and...no. Most retirees should expect 30+ years of retirement. As you may have heard me say before, inflation is the biggest reason retirees run out of money. That's because their expenses increased with inflation, but their portfolio didn't. It is critical that retirees invest a substantial portion of their portfolio in equities. A "no risk" portfolio of bonds and CDs is ripe for the destructive and insidious nature of inflation and a prescription for disaster.

MYTH #4: It's best to claim Social Security benefits at age 62. The decision is specific to each person's situation, but the odds are against that decision. If a retiree must have Social Security benefits at age 62 to pay bills, then taking these benefits early is not a choice, it's a necessity. But, based on life expectancy, claiming at age 62 offers just a 7% to 9% chance of receiving the highest cumulative Social Security Benefits.

MYTH #5: My taxes will be lower in retirement. If retirees need as much income in retirement as they did during their working years to maintain their lifestyle, it is unlikely their tax burden will be less. Why? A couple of reasons: Most retirees must withdraw from retirement plan savings that are 100% taxable at ordinary income rates. Additionally, rates are currently at the lower end of the tax spectrum and to think those rates will continue or go lower is not credible.

MYTH 6: I will need less money in retirement. This is probably true, but there are factors that could increase income need in retirement and should be considered in advance:

- More time to travel can make travel expenses go up dramatically.
- Pursuing an expensive hobby that you didn't have time for when in the workforce.
- Retiring early will cause you to have to pay for medical expenses out-of-pocket prior to age 65.

Retirement is a time to do those things you always wanted to do and can be a time to quit doing those things you don't want to do anymore. Dispelling retirement myths and planning well in advance could make the difference between a great retirement, a not-so-great retirement or going back to work.

Welcome Steven Ha!

As part of our commitment to providing the highest level of service to our clients, we've added a new financial advisor to the team – Steven Ha. Please join us in welcoming Steven to the Financial Synergies Team!

Steven graduated from Mays Business School and the Financial Planning program at Texas A&M University. Having completed the core curriculum in the program, he is currently pursuing the CERTIFIED FINANCIAL PLANNER™ certification in order to best serve the needs of our clients. When away from the office, Steven and his wife, Jennifer, enjoy serving with their church, Bayou City Fellowship, taking road trips, and venturing the outdoors.

Steven comes with experience from another reputable advisory firm in the Houston area. He will be learning our wealth management business from the ground up, and will no doubt prove to be an invaluable asset to our team and clients for years to come!

Should You "Take a Flyer" on Boeing Stock?

BRYAN ZSCHIESCHE, CFP®, MS, MBA | SHAREHOLDER, FINANCIAL ADVISOR

We've received a handful of phone calls from clients asking if they should purchase some Boeing stock in the wake of the recent grounding of the 737 MAX 8 aircraft. The stock price declined nearly 12% over a two-day period from Monday, March 11th through Tuesday, March 12th, falling from $422.54/share to $375.41/share.1 The stock price has since experienced a roller coaster ride ranging from $362.17 on March 22nd to $395.86 on April 4th back down to $370.16 as of this writing on April 11th.

It is only natural for bargain-hunting investors to ask if it is a good time to buy. The broader question is, should investors take a risk and buy Boeing stock, or any other individual stock that experiences a dramatic decline?

I always answer this question with a set of my own questions:

Where does the investment fit into the overall portfolio strategy?

As our clients already know, our portfolios are built using institutional mutual funds and exchange traded funds to help us achieve a truly diversified investment mix. So, in general, we don't include individual stocks in our portfolios.

Boeing's decline provides a great example of the risk associated with holding a large position in a single company's stock. Prior to the grounding of these aircraft, I think most market observers would say that Boeing is a strong, stable, financially sound company. That may still be the case. But events like this highlight the fact that even strong, stable, financially sound companies can be negatively impacted by unpredictable events.

This is where mutual funds and exchange traded funds have the advantage. Even if Boeing stock is held in a fund, its decline won't sink the whole ship.

So we start by acknowledging that an individual stock doesn't really fit into the overall portfolio strategy. Rather it is a speculative purchase aimed at taking advantage of a (hopefully) short-term loss in value. If an investor wants to own a stock as a speculative purchase, then we must ask the second question:

How much do you plan to buy?

Most clients who ask about buying an individual stock are thinking about a relatively small investment when compared to their total investable assets. They usually recognize the that the purchase is speculative in nature, and there can even be an element of entertainment in the buy. I've had many people say things like, "I'd just kinda like to buy a stock and see what happens."

If that is the case, our recommendation would generally be to buy a very small amount relative to the overall portfolio value. This means that the stock won't have a huge impact on the investor's net worth, for good or for bad.

What is your exit strategy?

Most serious stock pickers try to arrive at an estimate of a stock's "intrinsic value," or worth based on fundamental analysis. They will then plan to sell the stock once its market price reaches that intrinsic value. This requires an analysis of a company's prospects for earnings and dividends and some fun math:[2]

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...Boeing, continued

$$Value\ of\ Stock = \frac{Div_1}{(1+r)^1} + \frac{Div_2}{(1+r)^2} + \cdots + \frac{Div_n}{(1+r)^n}$$

Where:

Div = Dividends expected in one period

r = Required rate of return

Most casual investors don't have the time, experience or expertise to perform such an analysis on the stock they're considering. Even then, unpredictable events (like the grounding of an aircraft) can throw the assumptions off. Absent such analysis, what is your exit strategy? When will the time be right to sell the stock, whether things improve and the stock goes up, or, horror of horrors, things go wrong and the stock continues to slide?

In summary, I really don't know if investors should "take a flyer" on Boeing stock. I don't think anyone can honestly say they know how this situation will play out. Here the wisdom of Mark Twain may be instructive:

"There are two times in a man's life when he should not speculate: when he can't afford it, and when he can."

[1] https://www.cbsnews.com/news/boeing-stock-price-value-has-sunk-28-billion-since-ethiopian-air-crash/

[2] https://www.investopedia.com/articles/basics/12/intrinsic-value.asp

Are Index Funds Distorting Prices?

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

Over the last several years, index funds have received increased attention from investors and the financial media. Some have even made claims that the increased usage of index funds may be distorting market prices.

For many, this argument hinges on the premise that indexing reduces the efficacy of price discovery. If index funds are becoming increasingly popular and investors are "blindly" buying an index's underlying holdings, sufficient price discovery may not be happening in the market. But should the rise of index funds be a cause of concern for investors? Using data and reasoning, we can examine this assertion and help investors understand that markets continue to work, and investors can still rely on market prices despite the increased prevalence of indexing.

MANY BUYERS AND SELLERS

While the popularity of indexing has been increasing over time, index fund investors still make up a relatively small percentage of overall investors. For example, data from the Investment Company Institute shows that as of December 2017, 35% of total net assets in US mutual funds and ETFs were held by index funds, compared to 15% in December of 2007. Nevertheless, the majority of total fund assets (65%) were still managed by active mutual funds in 2017. As a percentage of total market value, index-based mutual funds and ETFs also remain relatively small. As shown in Exhibit 1, domestic index mutual funds and ETFs comprised only 13% of total US stock market capitalization in 2017.

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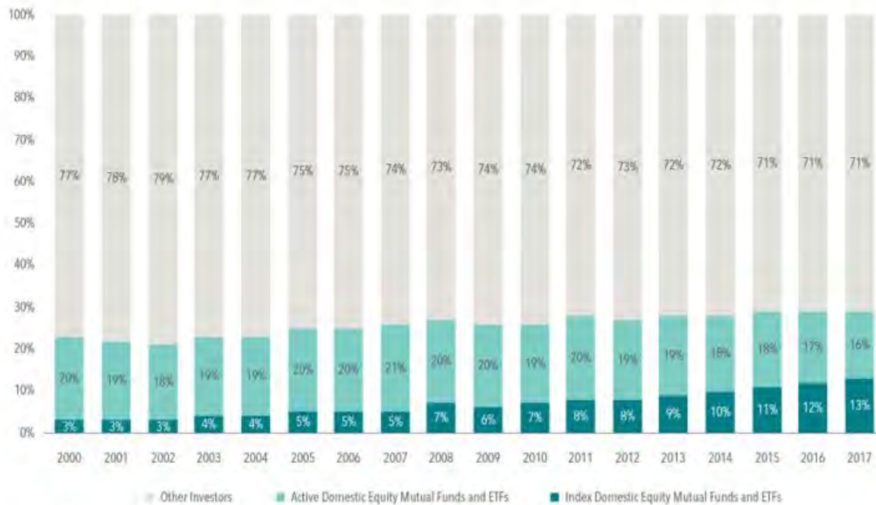


All totals may not equal 100% due to rounding. Sourced from the 2018 ICI Fact Book: ici.org/pdf/2018_factbook.pdf

In this context, it should also be noted that many investors use nominally passive vehicles, such as ETFs, to engage in traditionally active trading. For example, while both a value index ETF and growth index ETF may be classified as index investments, investors may actively trade between these funds based on short-term expectations, needs, circumstances, or for other reasons. In fact, several index ETFs regularly rank among the most actively traded securities in the market.

Beyond mutual funds, there are many other participants in financial markets, including individual security buyers and sellers, such as actively managed pension funds, hedge funds, and insurance companies, just to name a few.

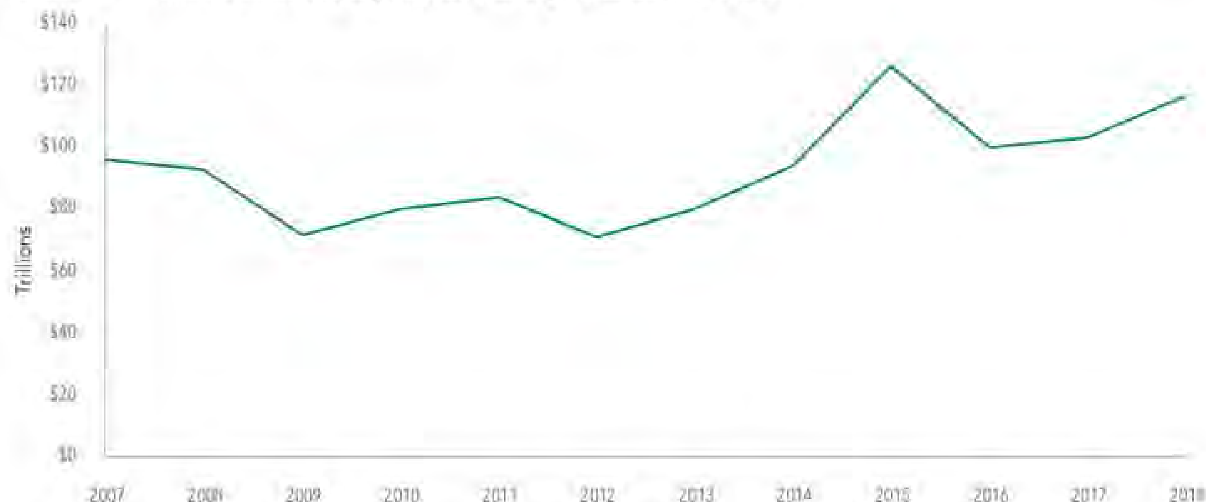
Security prices reflect the viewpoints of all these investors, not just the population of mutual funds.

As Professors Eugene Fama and Kenneth French point out in their blog post titled "Q&A: What if Everybody Indexed?", the impact of an increase in indexed assets also depends to some extent on which market participants switch to indexing:

"If misinformed and uninformed active investors (who make prices less efficient) turn passive, the efficiency of prices improves. If some informed active investors turn passive, prices tend to become less efficient. But the effect can be small if there is sufficient competition among remaining informed active investors. The answer also depends on the costs of uncovering and evaluating relevant knowable information. If the costs are low, then not much active investing is needed to get efficient prices."

WHAT'S THE VOLUME?

Trade volume data are another place to look for evidence of well-functioning markets. Exhibit 2 shows that despite the increased prevalence of index funds, annual equity market trading volumes have remained at similar levels over the past 10 years. This indicates that markets continue to facilitate price discovery at a large scale.



In US dollars. Source: Dimensional, using data from Bloomberg LP. Includes primary and secondary exchange trading volume globally for equities. ETFs and funds are excluded. Includes 2017 total returns for constituent securities in the S&P 500 Index as of December 31, 2016. Excludes securities that delisted or were acquired during the year. Source: S&P data ©2019 S&P Dow Jones Indices LLC, a division of S&P Global. For illustrative purposes only. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

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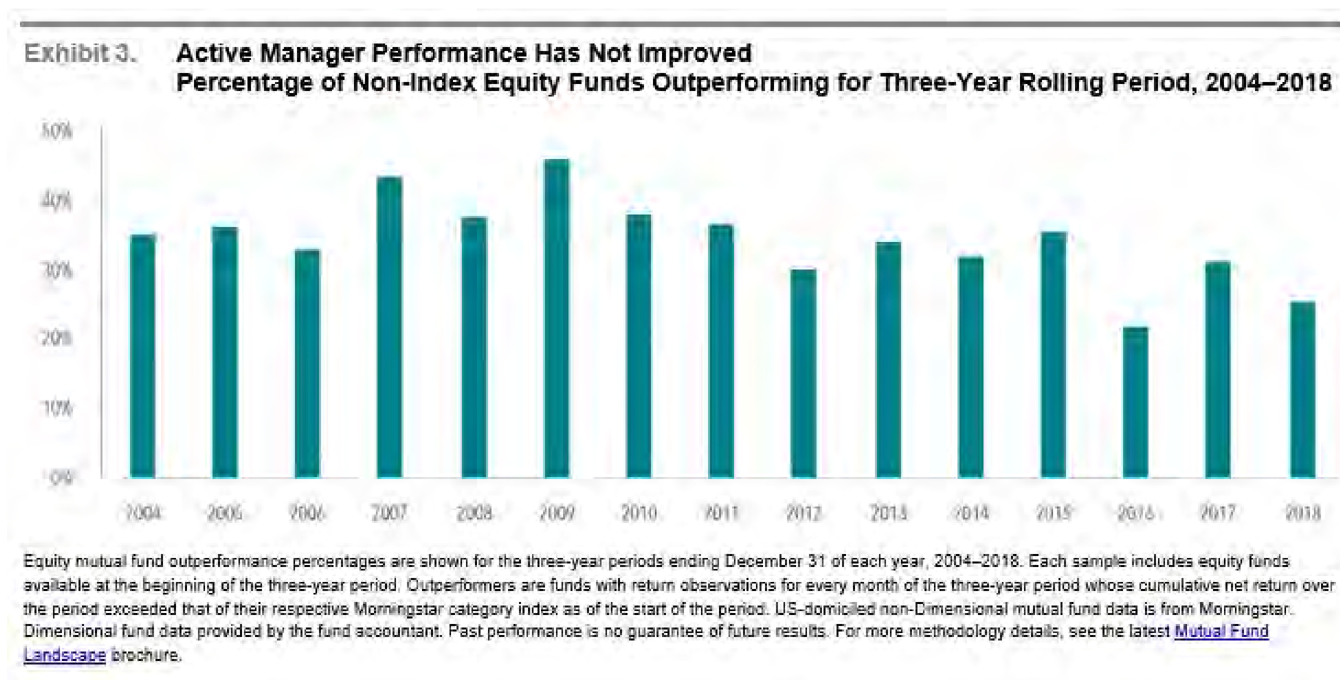
Besides secondary market trading, there are also other paths to price discovery through which new information can get incorporated into market prices. For example, companies themselves can impact prices by issuing stock and repurchasing shares. In 2018 alone, there were 1,633 initial public offerings, 3,492 seasoned equity offerings, and 4,148 buybacks around the world. The derivatives markets also help incorporate new information into market prices as the prices of those financial instruments are linked to the prices of underlying equities and bonds. On an average day in 2018, market participants traded over 1.5 million options contracts and $225 billion worth of equity futures.

HYPOTHESIS IN PRACTICE

Even though the historical empirical evidence suggests that the rise of indexing is unlikely to distort market prices, let's consider the counterargument that the rise of indexing does distort markets, and in turn causes prices to become less reliable. In this scenario, wouldn't one expect stock-picking managers attempting to capture mispricing to have an increased rate of success over time.

Exhibit 3 shows little evidence that this has been the case. This chart shows the percentage of active managers that survive and beat their benchmarks over rolling three-year periods. These data show that there is no strong evidence of a link between the percentage of equity mutual fund assets in index funds and the percentage of active funds outperforming benchmark indices.



Equity mutual fund outperformance percentages are shown for the three-year periods ending December 31 of each year, 2004–2018. Each sample includes equity funds available at the beginning of the three-year period. Outperformers are funds with return observations for every month of the three-year period whose cumulative net return over the period exceeded that of their respective Morningstar category index as of the start of the period. US-domiciled non-Dimensional mutual fund data is from Morningstar. Dimensional fund data provided by the fund accountant. Past performance is no guarantee of future results. For more methodology details, see the latest Mutual Fund Landscape brochure.

Lastly, in a world where index funds bias prices, we should expect to see evidence of such an impact across an index fund's holdings. In other words, there should be more uniformity in the returns for securities within the same index as inflows drive prices up uniformly (and outflows drive prices down). Taking the S&P 500 Index as an example, however, we see that this has not been the case. The S&P 500 is a widely tracked index with over $9.9 trillion USD indexed or benchmarked to the index and with indexed assets comprising approximately $3.4 trillion USD of this total.

Exhibit 4 shows that in 2008, a year of large net outflows and an index return of -37.0%, the constituent returns ranged from 39% to -97%. This exhibit also shows that in 2017, a year of large net inflows and a positive index return of 21.8%, the constituent returns ranged from 133.7% to -50.3%. We would also expect that constituents with similar weighting in traditional market cap-weighted indices would have similar returns. In 2017, Amazon and General Electric returned 56.0% and -42.9%, respectively, despite each accounting for approximately 1.5% of the S&P 500 Index.

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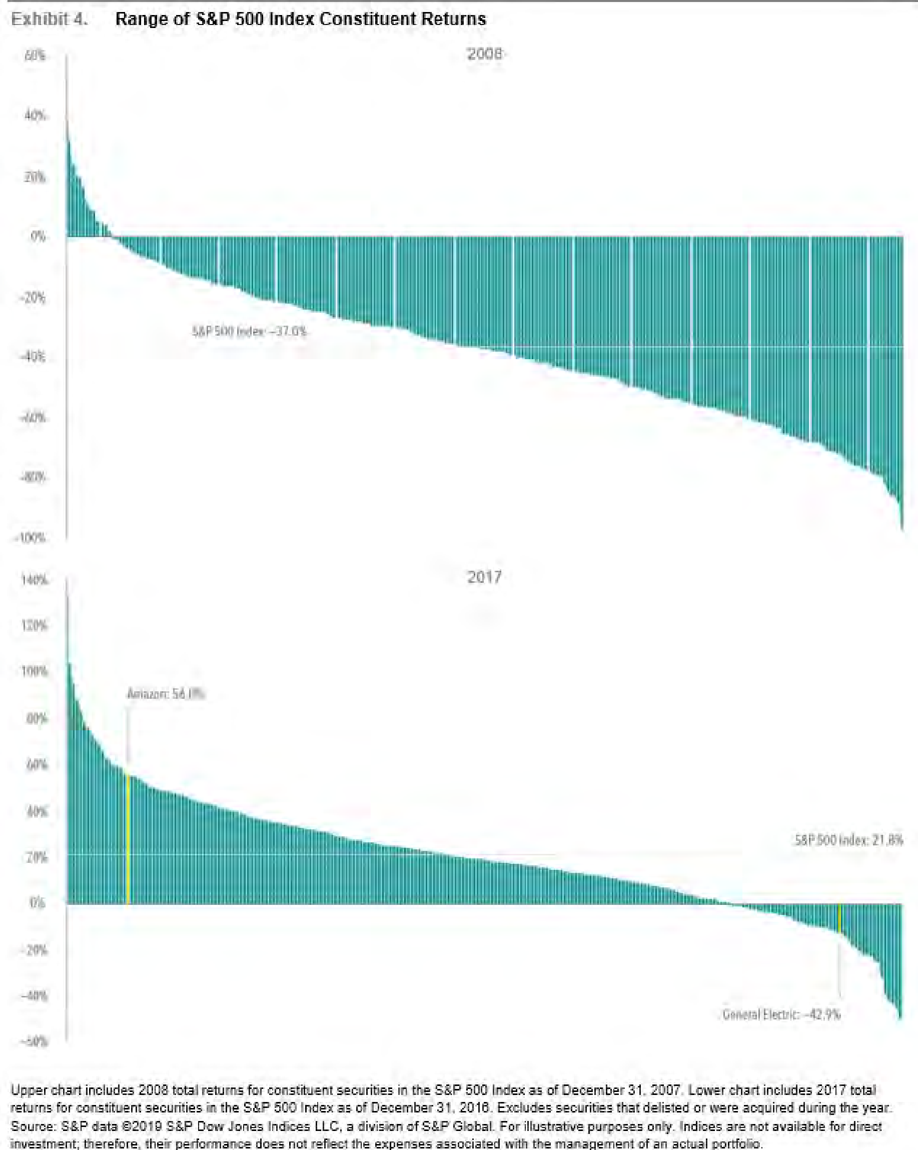


Upper chart includes 2008 total returns for constituent securities in the S&P 500 Index as of December 31, 2007. Lower chart includes 2017 total returns for constituent securities in the S&P 500 Index as of December 31, 2016. Excludes securities that delisted or were acquired during the year. Source: S&P data ©2019 S&P Dow Jones Indices LLC, a division of S&P Global. For illustrative purposes only. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

CONCLUSION

Despite the increased popularity of index-based approaches, the data continue to support the idea that markets are working. Annual trading volume continues to be in line with prior years, indicating that market participant transactions are still driving price discovery. The majority of active mutual fund managers continue to underperform, suggesting that the rise of indexing has not made it easier to outguess market prices. Prices and returns of individual holdings within indices are not moving in lockstep with asset flows into index funds.

Lastly, while naysayers will likely continue to point to indexing as a hidden danger in the market, it is important that investors keep in mind that index funds are still a small percentage of the diverse array of investor types. Investors can take comfort in knowing that markets are still functioning; willing buyers and sellers continue to meet and agree upon prices at which they desire to transact. It is also important to remember that while indexing has been a great financial innovation for many, it is only one solution in a large universe of different investment options.

GLOSSARY

Derivative: A financial instrument whose value is based on an underlying asset or security.

Options Contract: An options contract is an agreement between two parties to facilitate a potential transaction on an underlying security at a preset price.

Futures: A financial contract obligating the buyer to purchase an asset or a seller to sell an asset at a predetermined future time and price.

Source: Dimensional Fund Advisors LP

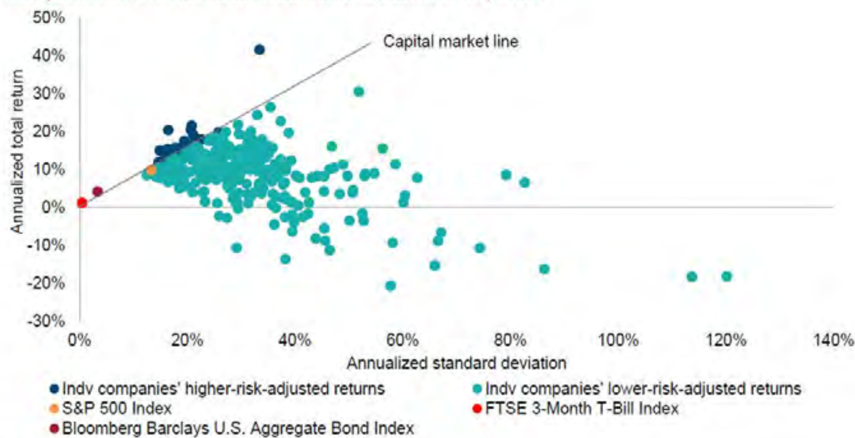
Concentrated Stock Can Be Hazardous to Your Wealth

KEVIN NELSON, CFP®, CDFA™ | FINANCIAL ADVISOR

First, we must ask "What do we consider a concentrated stock position?" The rule of thumb is 10% of your investable net worth. Now rules of thumb can sometime get us in trouble, but the risk should be looked at from a holistic prospective.

For example: If you are in your 40's you may be comfortable holding a bit more of company stock because your time horizon for retirement may be many years away. If your company stock under-performs you still have time to make up with additional savings. If you are near or at retirement you may want to not hold any individual stock at all, as now you are "playing for keeps" and don't have time to make up the difference. Another factor you might consider is your overall net worth. If you have sizable assets but small expenses, you may be able to be more aggressive with certain portions of you portfolio.

The chart below shows how risky individual stocks in the S&P 500 were from 2003-2017. First, let's note that when the period begins there were 500 companies to choose from, but at the end there were only 314 companies. Companies leave an index for a variety of reasons, including the company going out of business, severely under-performing and being forced out of the index, or some sort of merger/acquisition happened in that company. So just some simple math: 314/500=63% are left after that 15-year period.



Next, we should look at returns over that period. The S&P 500 Average Annual Return over that time period was 9.9% with a standard deviation of about 16%. Standard Deviation represents risk in this chart, and it is basically how much the price has swung over one year periods around the average price. You can see that few stocks beat the annualized return of the S&P 500 and the "Capital Market Line" shows that very few stocks beat the index on a risk-adjusted basis.

What do these numbers mean? Well, trying to identify great individual companies is very hard to do. That's why we like to own the index and broad market funds. Individual stocks could outperform the market with a much higher risk level. Alternatively they could be one of the 186 stocks that are not even in the S&P 500 anymore. We believe taking calculated risks with a solid long term investment philosophy is the way to go.