JULY 2016

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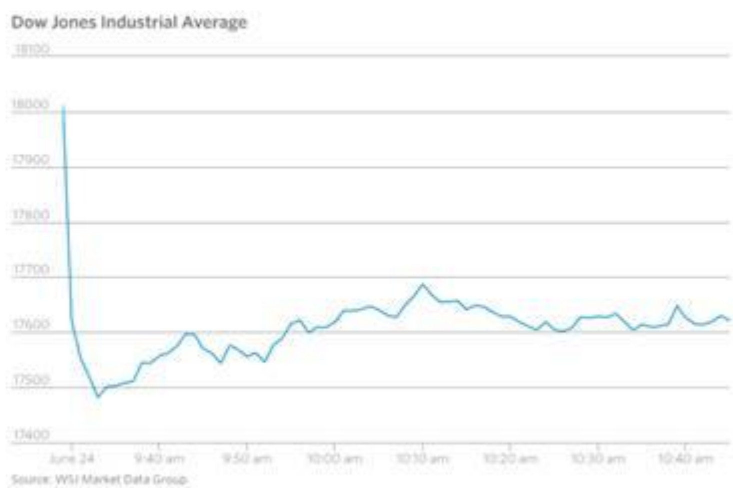
Brexit and the Media Frenzy

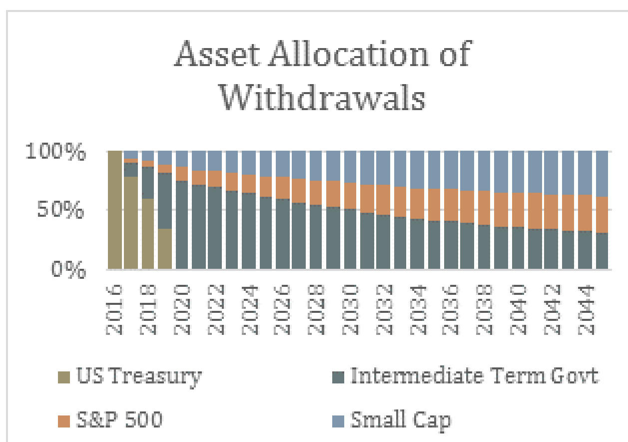
Once again, the media has not only overblown a news item, but distorted it as well. Shocking headlines reflected a wave of anxiety that hit immediately after the United Kingdom announced the result of the referendum was to leave the European Union. The top story on CNN.com read "UK Brexit vote triggers global financial, political havoc," and a WSJ.com headline said "'Brexit' Vote Wreaks Havoc in Markets." Even more dramatically, the WSJ.com Markets page was decorated with a giant chart showing the plunge of the Dow Jones Industrial Average (see at right).



But there's one thing all these headlines miss. US bonds simultaneously had an enormous rally. The IShares II Treasury Bond 7-10 year ETF was up about 9% midday, far more than the 2% decline in the Dow. Nobody pointed out that a diversified 60/40 blend of the S&P 500 and intermediate term US Treasury bonds was actually up about 2%. Nobody mentioned how terrific a day it was for many investors. This may come as a shock, but the media didn't tell the whole truth.

How can you be best prepared for situations like this? By using a strategically diversified portfolio. When stocks are down, bonds often go up, and vice versa. Such a strategy should utilize cash and bonds for short-term investments and stocks for long-term investments, as shown at right. This seems obvious, but given that few financial plans and no target date funds implement this path, apparently it is not.

The chart at right shows an example asset allocation of each future payout for a moderate risk investor who is retiring immediately. The first column is the allocation of the money that will be spent immediately, the second column is the allocation of the money to be spent in one year, and so on. You can see that money used immediately is held entirely in US Treasuries (similar to money market funds or cash). The money to be used in one year is mostly cash plus a pinch of intermediate-term government bonds (the bonds that gained 9% this morning), and a small pinch of stocks. The allocations quickly shift away from cash to bonds over four years, but then shift from bonds to stocks until the 15th year.



This strategy gradually shifts the overall allocation of the remaining funds from bonds to stocks. *This is exactly the opposite strategy from traditional planning*, which gradually shifts the allocation to bonds over time. The traditional approach effectively makes stocks the short-term investment and bonds the long-term investment. Such an approach increases the risk and reduces retirees' likely retirement income. Target date funds operate this way, which is why we do not recommend them.

All this said, we aren't suggesting that bonds don't go down. Bonds were decimated during the high inflation years of the 70's and 80's and immediately after WWII. Therefore, it's important to use a pessimistic projection for returns, so that you can achieve your goals even during poor market conditions. The risks are real, though, and no plan is fool proof.

Several other steps that will help to mitigate risk:

1. Utilize domestic funds. We love international funds, but they have a very short track record. None of the funds were around during the Vietnam war, WWII, the Great Depression, and many weren't around for the 70's and 80's. Luckily, the S&P 500 is effectively a global fund, with over half its revenue coming from overseas.
2. Watch out for tools based upon Monte Carlo. Monte Carlo is common with planners and online planning calculators, and it can suffer from a substantial optimistic bias (see Why Monte Carlo Analysis is Optimistically Biased). If you have a professionally created plan or use an online planning tool, assume the risk number is significantly higher than what you've been told and/or that your future income will be significantly lower. Whatever the plan is telling you to save, save more.
3. Use low-cost, no-load index funds. Reducing costs is free money. This lowers risk while improving likely returns. Avoid sales commissions, loads, and 12B-1 fees for your investments. If you're not sure, read your funds' prospectuses. Each one has an easy to read table that describes the funds fees. Many of these fees never show up on your statements, so reading the prospectus is important. Alternatively, just invest using Vanguard index funds.
4. Utilize a dual layer investment approach. This ensures that there is a low risk that essential needs will be met, while allowing higher risk for discretionary needs. This further reduces the possibility of dire consequences during severe market turmoil while allowing for upside potential during bull markets.
5. Invest for the long-term and don't worry about the short-term market. Retirements can last 30-50 years. Investing to minimize the potential short-term downturns can seriously increase your long-term risks and reduce your likely income.
6. Hold emergency reserves. The markets can always be worse than even pessimistic projections, so it's important to always maintain sufficient emergency cash.

If there's anything we can do to help, please let us know. You can also read our previous newsletters on the subject of market turbulence: What to Do When the Stock Market Swings, Riding Out Turbulent Seas, and More Market Turmoil. You can see that this is a recurring theme, and to be continued…