July 8, 2016

Brexit Fallout & Interest Rate Worries

"A difference between a democracy and a dictatorship is that in a democracy you vote first and take orders later; in a dictatorship you don't have to waste your time voting."

-Charles Bukowski

Brexit

As I'm sure you are aware, the citizens of the United Kingdom have voted to terminate their membership with the European Union. While there have been numerous takes by various talking heads, it's very much a mystery as to what this will mean for the UK, EU, US, and global markets in the future.

The exit vote precipitated two days of steep market declines followed by four days of hearty gains that brought the domestic stock markets back to or near their pre-vote levels[1]. Much of the reason for this dramatic volatility may have been due to the result of the vote being unexpected. Market participants had made a determination prior to the vote that a referendum to leave was unlikely, so the turbulence felt in the days after seemed to be a development of traders coming to grips with an unforeseen outcome.

I wanted to share with you the letter Dimensional sent out to us in response to the Brexit which echoes much of our feelings on the potential implications of the UK's decision:

> *On June 23, citizens of the United Kingdom voted to leave the European Union. While there has been much speculation leading up to and since the vote, many of the longer-term implications of the referendum remain unclear, as the process for negotiating what a UK exit may look like are just beginning.*
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> *Dimensional has nearly 35 years of experience managing portfolios, including during periods of uncertainty and heightened volatility. We monitor market events—including their impact on trading and trade settlement—very closely and consider the implications of new information as it comes to light. We are paying close attention to market mechanisms and they appear to be functioning well. Our investment philosophy and process have withstood many trying times and we remain committed to them.*
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> *We urge caution in allowing market movements to impact long-term asset allocation. Long-term investors recognize that risks and uncertainty are ever present in markets. A drop in prices is generally due to lower expectations of cash flows, higher discount rates, or both. In some cases, a drop is also due to investors demanding liquidity. In the current situation, some investors and economists may expect lower cash flows due to possible trade barriers that may not be implemented. Higher discount rates may be occurring due to uncertainty about changes in the economic landscape and regulations. We have seen markets increase discount rates in times of uncertainty before, resulting in lower prices and increased expected returns. However, it is difficult to know when good outcomes will materialize in the future. By attempting to time the right moment to invest or redeem, one risks not enjoying the potential benefits of such*

materializations. Many of those who exit the markets miss the recoveries. What we have often seen in the past is that investors who remained in well-diversified portfolios were rewarded over time.

The UK will have up to two years to negotiate a withdrawal, during which time it remains subject to EU treaties and laws. Any potential operational changes depend on what path the UK and EU decide to take.

Leading up to and since the vote, we have worked with our counterparties, including custodians, brokers, and dealers, regarding potential operational implications resulting from the UK's leaving the EU.

Dimensional remains committed to helping our clients in the UK, other parts of Europe, and around the world have a good investment experience.

Despite the red you may have seen if you tuned in to CNBC on the 24th, the domestic, real estate focused, and some of the international mutual funds we employ are positive for the year. The big losers in the wake of Brexit vote were the equities of the United Kingdom and Europe at-large. As always, we believe a well-diversified portfolio focused on responsibly allocating assets globally is an effective approach for most individuals.

Fund Name	**Symbol**	**YTD Return (as of 6/30/16)**
Dimensional Global 60/40 Portfolio	DGSIX	3.66%
Dimensional US Large Cap Value	DFLVX	4.10%
Dimensional Emerging Markets Core	DFCEX	9.64%
Dimensional Real Estate Securities	DFREX	13.32%
Dimensional Investment Grade Fixed Income	DFAPX	5.76%
Dimensional United Kingdom Small Company	DFUKX	-14.60%
Dimensional International Core Equity	DFIEX	-1.82%

**Source: Dimensional Fund Advisors*[2]

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Interest Rate Blues

The conventional wisdom concerning asset allocation is that as we approach and live in retirement it is often wise to reduce exposure to equites and shift assets to comparatively less volatile fixed income investments. Most debt instruments offer consistent interest payments to the investment-holder which retirees can conveniently use to supplement their retirement income. Today, fixed income investors searching for yield face additional challenges accomplishing this goal.

The yield on a 10 year U.S. government bond at the end of June came in at 1.49% after briefly dropping during the Brexit crisis to 1.385%. The yield on a 30 year government bond is about 2.25%[3]. If we look internationally, the yields on the Euro yield curve are *negative* for the 10 year, and the 30 year is offering less than half of one percent[4]. That's for thirty years!

It's important to understand the role fixed income plays in a portfolio and from where end-income to an investor comes from. An investor can hold bonds to serve a variety of purposes - for example, to provide income as we've discussed, to reduce portfolio volatility, or to pursue higher returns. Simply because many fixed income investments are currently offering yields well below historic levels, does not mean fixed income cannot serve an important role in a portfolio.

A retiree could look at fixed income more through the lens of how a pre-retiree might. The income on the instrument is not where we are focused. We are instead concerned with the volatility dampening aspects of bonds. Equity exposure creates sometimes intense volatility to a portfolio and bonds can serve as a limiter to the overall volatility risk an investor can expect to experience. If interest rates remain low for longer periods of time, retirees may be unable to count on coupon payments alone to provide income for retirement. Coupons are not (and never have been) the only source of income for a balanced portfolio. Appreciation on equities and dividends could provide income just as readily as bonds can. As equity exposure may rise in importance to a retiree, this further creates a need for bonds to smooth out short-term returns.

Income in retirement may be more complicated than it has been in the past which is all the more reason to develop a robust income plan that coordinates investments, social security, annuities, pensions, and other sources.

On a more positive note regarding interest rates, depending on when you took out a mortgage on your house, it could be a fantastic time to consider refinancing. We'd be happy to review your current mortgage and provide an analysis on the benefits and costs of a refinance.

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New Team Member

Our firm is growing! We'd like to introduce our newest employee, Andrew Payne.

Andrew comes to us as a recent graduate from the University of Maryland where he earned a degree in Economics. He plays for a local softball team on weeknights and enjoys taking care of his two golden retrievers when not at the office. Andrew will primarily be assisting the firm through research, analytical, and administrative activities.

If you happen to catch him answering the phone in the next few months, give him a hearty welcome!

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It's certainly been an exciting year so far, but we're looking forward to what we hope is a milder second-half to 2016. However, with a presidential election on the horizon we may be in for a few more surprises before the year comes to a close. We wish you a pleasant and fun-filled summer.

John, Derek, Jon, Stacie, and Andrew

[1] Harlan, Chico. “After steep drop, markets make up losses of Brexit within a week.” The Washington Post. July 1st, 2016.

[2] Data Source: Dimensional Fund Advisors as of 6/30/16

[3] Data Source: US Department of the Treasury as of 6/30/16

[4] Data Source: European Central Bank as of 6/30/16

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Investing internationally carries additional risks such as differences in financial reporting, currency exchange risk, as well as economic and political risk unique to the specific country. This may result in greater share price volatility. Shares, when sold, may be worth more or less than their original cost

Neither Asset Allocation nor Diversification guarantee a profit or protect against a loss in a declining market. They are methods used to help manage investment risk.

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