

★ Quarterly ★ Newsletter



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Investors Save the World

MIKE BOOKER, CFP®, CHFC®, CFS®

SHAREHOLDER, FINANCIAL ADVISOR



Most people look at the stock market as a way of funding retirement or securing their financial futures while on the way to retirement. Investing in the market has worked out very well - individual investors have made lots of money. Since World War II, the market has returned roughly 10% per year! (Source: Morningstar)

We all know the two components to dealing with stocks - the buy side and the sell side. We don't often consider the third component which goes hand-in-hand with the buying and selling of stocks, the incredible benefits that stock investing provides the world. In fact, I submit that the stock investor has done more good for this world than anyone else. Read on.

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When ideas get organized and expanded, they often become companies. When companies are interested in expanding their ideas even further, they will issue shares of stock. The sole purpose of stock issues is to facilitate capital investment by individual stock investors.

Throughout the history of the stock market, these investors have helped grow many ideas we encounter everyday like the radio, the personal computer, the airplane, antibiotics, vaccines, the automobile, the internet, and cell phones. None of these ideas would have been possible without the capital provided by investors which, in turn, breathe life into those ideas, those dreams. Can you imagine what a different world we would be living in without the wonderful ideas and the inventions that stocks have funded?

And there is this. When a company expands there are more jobs to be had. More jobs typically lead to more consumer spending. More consumer spending means more capital flows to consumer goods and other companies that sell goods and services. The capital these companies receive allows them to keep their operations going and allows them to expand, leading to even more jobs and even more consumer spending.

Charities benefit when stocks are purchased, too. Gifting appreciated shares is an effective and popular method for many investors who give their stock or mutual fund shares to a charity after it has increased in value, in lieu of writing a check. This is a true win/win as the donor, who may have paid only \$10,000 for their stock, gives their charity the full value of the \$20,000 stock. The charity gets financial help it needs, and the donor gets a nice tax deduction, which, in turn, puts those tax saved dollars back into the economy.

There is so much more to investing than merely the buying and selling. Without the stock market, dreams would die on the vine, ideas that start out as a drawing or a word on paper would stay there, never reaching the outside world. When investments and capital are deployed around the world, new industries are created, problems are solved, and economies around the world grow and benefit mankind.

The Inflation Factor



KEVIN NELSON, CFP®, CDFA™

FINANCIAL ADVISOR

Ever so slowly, the cost of purchasing goods and services goes up and, if you're not careful, it can catch up to you. It's like the old parable of the frog in the pot of water: the premise of the story is that if a frog is put suddenly into boiling water, it will jump out, but, if the frog is put in tepid water which is then brought to a boil, slowly, it will not perceive the danger and will then be cooked to death. That's where inflation measures come in.

When we create retirement plans for our clients, we always account for increases in inflation. While the increase in the cost of living might seem miniscule (you may not even know it's creeping up on you!) we adjust for this annually to make sure you can have a fruitful retirement. And while you may not ask for an increase in your recurring withdrawals in Retirement Salary®, over time the balance of checking accounts might go lower and may be replenished by a one-time distribution, or you may need to make a large purchase. The adjustments are designed to handle those situations.

So, how do we measure the increases in inflation? There are plenty of data points we look at, but the main one is consumer price index (CPI). The CPI is a measure calculated by the government, where they take an aggregate of prices of goods and services all over there country and then average them. (There is an interesting podcast that follows a man named George whose sole job is to go out as a 'secret shopper' to price items. You can find the episode by searching "Planet Money Episode 222: The Price of Lettuce in Brooklyn".)

The government has been collecting this data since 1913, and it provides us with history as to what's happened in the economy and gives us a baseline trend to follow for adjustments. Since 1913, inflation has averaged 3.25%, but a more modern time frame used by experts is the past 77 years, where inflation rate averages 3.82%. The last 30 years averaged 2.65%, and the last 5 years averaged 1.26%

So where does that leave us in our retirement planning projections? We agree that somewhere between 3.82% and 2.65% is a good number to use for our clients. It may not seem like a big difference, but over 30 years, it can make a big impact year over year. For example, using the inflation rate of 3.82%, your current living expenses will double every 18.8 years. If you have 3% inflation it doubles every 24 years. If you have 2.65% it doubles every 27 years. A little difference each year makes a big difference in the long run.

Market Highs and Expected Returns

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



We've had a nice run in the stock market the last couple of years, so inevitably there has been much discussion in the news recently about new nominal highs in benchmark indices like the Dow Jones and S&P 500. So, when markets hit new highs, is that an indication that it's time for investors to cash out?

History tells us that a market index being at an all-time high generally doesn't provide actionable information for investors. Just observe the S&P 500 Index for the better part of the last century. **Exhibit 1** shows that from 1926 through the end of 2016 the proportion of annual returns that have been positive after a new monthly high is similar to the proportion of annual returns that have been positive after any index level. In fact, over this time period almost a third of the monthly observations were new closing highs for the index.

Looking at this data, it's clear that new index highs have historically not been useful predictors of future returns. Given that the level of an index by itself does not seemingly have a bearing on future returns, you may ask yourself a more fundamental question: What drives expected returns for stocks?

POSITIVE EXPECTED RETURNS

One way to compute the current value of an investment is to estimate the future cash flows the investment is expected to deliver and discount them back into today's dollars.

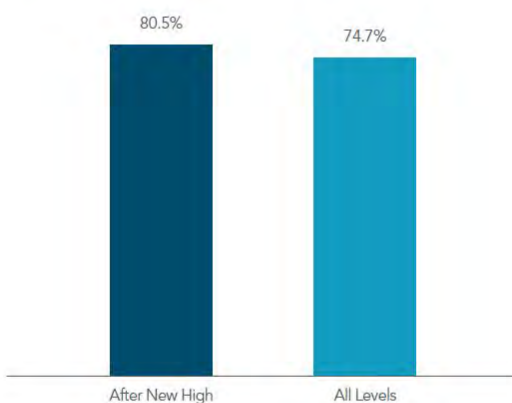
Stock prices are the result of the interaction of many willing buyers and sellers. It is extremely unlikely that in aggregate, those willing buyers apply negative discount rates to the expected profits of the firms they are purchasing. Why? Because there is always a risk that expected profits will not materialize or that the price might decline because of unanticipated future events.

If investors apply positive discount rates to the cash flows they expect to receive from owning a stock, we should expect the price of that stock to represent a level such that its expected return is positive. Unless the expected cash flows are persistently biased downward or upward, we can expect this to be the case.

There is little evidence, though, that the aggregate expectations of investors that set market prices have been persistently biased downward or upward. Many studies document that professional money managers have been unable to deliver consistent out-performance by outguessing market prices. In the end, prices set by market forces are difficult to outguess. The market does a good job setting prices, and we can assume that the expected return investors have applied when setting prices are not biased.

Therefore, it's reasonable to assume that the price of a basket of stocks like the S&P 500 Index, should be set to a level such that its expected return is positive, regardless of whether or not that price level is at a new high. This explains why new index highs have not, on average, been followed by negative returns. At a new high or a new low, expected returns are positive.

Exhibit 1: S&P 500 Total Return Index Highs: 1926–2016
Percent of Months with Positive Return Over Next 12-Month Period



From January 1926–December 2016, 319 months, or approximately 29% of monthly observations, were new closing highs.

Note: 1,081 monthly observations.

The S&P data is provided by Standard & Poor's Index Services Group. For illustrative purposes only. Index is not available for direct investment. Past performance is no guarantee of future results.

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RETURNS AND HOLDING HORIZONS

Today's prices depend on expected returns and expectations about future profits. If either expected returns or expectations about future profits change, prices will also change to reflect this new information. Changes in risk aversion, expectations about future profits, or the quantity of risk can all drive changes in expected returns. All else equal, an increase in expected returns is reflected through a drop in prices. A decrease in expected returns is reflected through a rise in prices. Thus, realized returns can differ from expected returns.

This means there is a probability that the realized return on any stock, an index like the S&P 500, or the market as a whole can be negative even when expected returns are positive. But what can we say about the relation between the probability of a negative realized return and an investor's holding horizon?

Exhibit 2 shows rolling 10-year performance of the equity market premium (equity returns minus the return of one-month US Treasury bills, considered to be short-term, risk-free investments). In most periods, it was positive, but in several periods it under-performed.

There is uncertainty around how long periods of under-performance like this may last. Historically, the probability of equity returns being positive increases over longer time periods compared to shorter periods.

Exhibit 3 shows the percentage of time that the equity market premium was positive over different time periods going back to 1928. When the length of the time period measured increases, so does the chance of the equity market premium being positive.

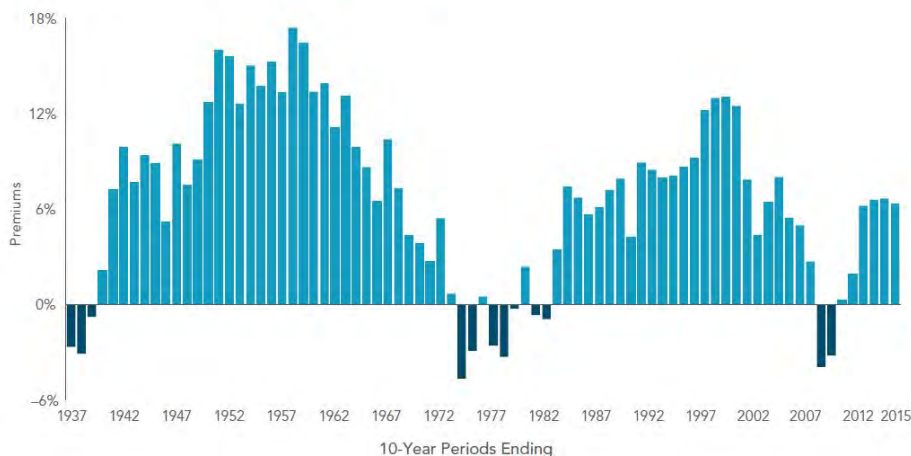
So, to answer our question from before: as an investor's holding period increases, the probability of a negative realized return decreases. This is why it's important to choose a level of equity exposure that you can stay invested in over the long term.

By themselves, new all-time highs in equity markets have historically not been useful predictors of future returns. While positive realized returns

are never guaranteed, equity investments have positive expected returns regardless of index levels or prior short-term market returns.

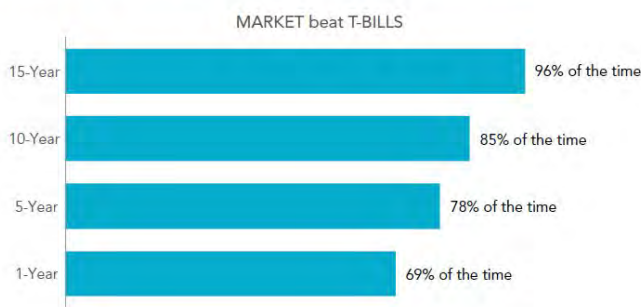
Historically speaking, over longer time horizons, the odds of realized stock returns being positive have increased. This is one reason why investors should consider investing a long-term commitment: Staying invested and not making changes based on short-term predictions increases your likelihood of success.

Exhibit 2: Historical Observations of 10-Year Premiums
Market minus one-month Treasury bills: US markets



Information provided by Dimensional Fund Advisors LP. In US dollars. The 10-year rolling equity premium is computed as the 10-year annualized compound return on the Fama/French Total US Market Index minus the 10-year annualized compound return of the one-month US Treasury Bill. Fama/French indices provided by Ken French. Index descriptions available upon request. Eugene Fama and Ken French are members of the Board of Directors for and provide consulting services to Dimensional Fund Advisors LP. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results.

Exhibit 3: Historical Performance of Equity Market Premium over Rolling Periods
US markets overlapping periods: January 1928–December 2015



Market is Fama/French Total US Market Index. T-Bills is One-Month US Treasury Bills. There are 877 overlapping 15-year periods, 937 overlapping 10-year periods, 997 overlapping five-year periods, and 1,045 overlapping one-year periods.

Information provided by Dimensional Fund Advisors LP. Based on rolling annualized returns using monthly data. Rolling multiyear periods overlap and are not independent. This statistical dependence must be considered when assessing the reliability of long-horizon return differences. Fama/French indices provided by Ken French. Index descriptions available upon request. Eugene Fama and Ken French are members of the Board of Directors for and provide consulting services to Dimensional Fund Advisors LP. Indices are not available for direct investment. Past performance is not a guarantee of future results.

Homeowners' Insurance Best Practices

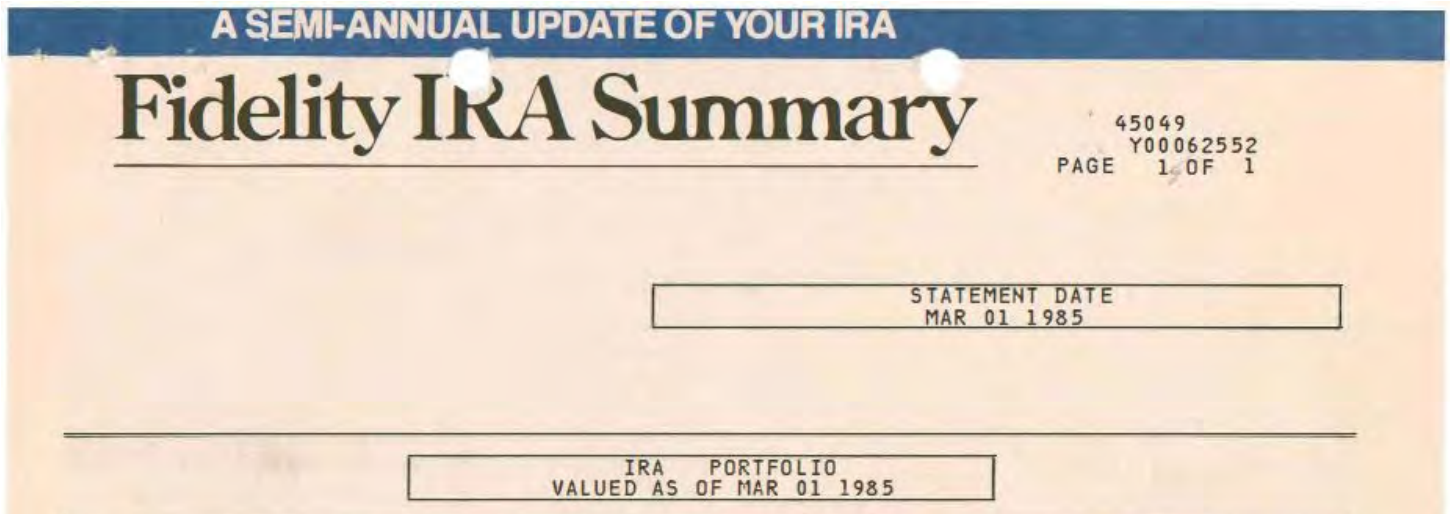
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With summer officially here, most people are focused on taking vacations, enjoying their kids being out of school, or planning outdoor barbeques. Reviewing one's homeowners' insurance is probably not high on the priority list. However, if it's been awhile since you last reviewed it, there is a good chance you may be paying too much or lack adequate coverage. The dog-days of summer make for the perfect time for a policy audit. To get you started, here are a few tips to ensure you're getting the best coverage for the best price.

- 1) Review your coverage amounts.** We call inflation the “silent killer.” The costs of goods and services increase over time, and building costs are no exception (take a look at Kevin's article for more info). If you bought your house 10+ years ago and haven't increased the replacement cost coverage, you may want to review it. Some policies have inflation guards, but it's a best practice to review the replacement cost in your policy to make sure it's keeping up with current building costs. This is also important if you've done any major renovations to your property. The existing coverage may not factor in such improvements.
- 2) Watch for premium increases.** This may seem obvious but pay attention to increases in your premiums. Insurers often promote low initial rates to attract new customers. After the first year, they may dramatically increase the premium amounts, even when the coverage stays the same. They're banking on the fact that people either forget or don't pay attention!
- 3) Look for discounts.** Many insurers provide discounts for bundling home and auto insurance or signing up for paperless billing and/or online payments. You may also receive a rebate for having a monitored security alarm. Make sure you taking full advantage of all available discounts.
- 4) Reduce unnecessary coverage.** Many homeowner policies are written with standard coverage amounts. For example, it's common for a policy to offer up to 10% coverage for damage to “other structures.” This includes fences, gazebos, fully detached garages (those that don't share a roofline with the main structure), out buildings, etc. If your property does not contain many of these other structures, reducing the coverage amount could reduce your annual costs.
- 5) Consider an umbrella policy.** Accidents happen so it's important to prepare for worst-case scenarios. Many homeowners' policies contain liability insurance but the coverage may top out at \$300,000. If your assets exceed this amount, it would be wise to consider an umbrella policy, which will extend coverage beyond the base amount in your policy. It's also important if you have potential safety hazards like a swimming pool. Umbrella coverage typically starts at \$1,000,000 and is relatively inexpensive.

I once heard an insurance agent say “in the insurance business, inertia is a powerful force.” People tend to set up their policies on the frontend and never revisit them. It's a good idea to check your homeowners' policy each year and make sure no adjustments are needed. A good property & casualty insurance agent can do a lot of the heavy lifting so considering finding someone in your area who can help. The small amount of time needed to review items such as these can lead to peace of mind and big potential savings!



How Long Should I Keep This?

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



Recently, I finished reading a book called *The More of Less* by Joshua Becker. The book promotes the idea that most of us own more “stuff” than we really need or even want and that this clutter can “distract us from the very life we wish we were living.” This topic has increasingly gained my interest, and it has very practical applications for our clients, especially when it comes to paper clutter.

While helping a family member de-clutter her paper files last year, I found records that were nearly as old as I am. I found utility bills, insurance renewals, and tax records dating back to the early 1980s. In addition, I located an original trust document from 1983 which still had a \$5 bill stapled to it, which was used to open the trust. I also found stacks of trade confirmations and brokerage account statements, including the one pictured above: a Fidelity IRA statement from 1985 - quite the find for an investment geek like me!

So, in the interest of living with less clutter, which documents should you keep and which ones can you safely discard?

Let's start with brokerage statements. Charles Schwab and many other custodians now retain electronic copies of account statements and trade confirmations for up to ten years. A law passed in 2012 requires custodians to track cost basis on securities purchased within the account, which further diminishes the need to keep trade confirmations. For any securities purchased in taxable brokerage accounts prior to 2012, you may wish to hold on to trade confirmations until you sell those securities.

Financial Synergies also distributes a quarterly report. Half of our clients already receive the report electronically, but the other half still get paper statements. While we're glad to continue sending the paper version, please let us know if you'd like to try electronic delivery. A PDF copy of the statement will be saved in your online document vault for future retrieval should you ever need it.

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How about tax records? The IRS website states that individuals should keep tax records and receipts for three years unless 1) you don't report income that you should have reported, 2) you don't file a return, or 3) you file a fraudulent return. I sure hope none of these exceptions applies to you, but if so, please see the IRS Publication 17, Section 26 for more detailed rules on recordkeeping.¹

For utility bills, such as cellular, cable TV, phone, water and electricity, I recommend holding no more than 12 months' worth of statements and discarding the oldest statement as you receive new ones. Almost all utility companies now provide online delivery of statements and many retain electronic copies for 12 - 24 months.

You may also wish consider a program called **FileThis**. The service links up to your online accounts and pulls in the statements automatically. You can use this program to store utility bills, credit card statements, and health insurance Explanations of Benefits (EOBs) so you can avoid receiving any paper statements, (ahem, clutter!), in the mail. The app uses 256-bit encryption (the same security level as banks) and integrates with other productivity apps such as Evernote, Dropbox, or Google Drive.²

As our world continues to become increasingly complex, I find myself searching for ways to reintroduce simplicity into my life. If you do, too, start simplifying by decluttering the paper.

¹ IRS Publication 17; https://www.irs.gov/publications/p17/ch26.html#en_US_2016_publink100022796

² <https://filethis.com/>

Congratulations to Al & Simone Jones!

We'd like to congratulate Pathway Clients Al & Simone Jones on opening their first **Marble Slab & Great American Cookie Company** location. We had the honor of touring the location back in June, and chowed down on some delicious cookies and ice cream while we were there!



Their store is located at 6630 Spring Stuebner Road, #505, Spring, TX 77389 - stop by if you're in the neighborhood!

They have been working on this venture for quite some time, and we are happy their dreams have come to fruition. We wish them all the best in their endeavors!