Brexit — Our Prespective
Jared Kizer, Chief Investment Officer

Britain's decision to exit the European Union has brought with it all the expected trappings of a significant news event — projections of crazy market volatility, wild headlines and a fair dose of uncertainty about the long-term impact on the global economy and our individual financial lives here at home. Many questions immediately arise as we pay close attention to how the event will play out in the weeks and months to come. But our perspective is the same as it has always been in times like these. Your financial plan is built with diversification and your personal risk tolerance in mind — it's designed to weather the ups and downs that inevitably follow significant world happenings. Jared Kizer, Chief Investment Officer for the BAM ALLIANCE, reminds us of this below:

What did British voters decide?

To the surprise of many — including stock and bond markets — Britain voted to leave the European Union (EU) by a margin of 52 percent in favor of leaving (i.e., "Brexit") and 48 percent in favor of remaining. The general belief from the economic community is that this decision will weaken the British and European economies since Britain both imported and exported a significant amount of its economic consumption and production, respectively, to continental Europe.

How have markets reacted?

At the time of this writing, stock markets have fallen precipitously and bond interest rates have dropped as well. With the exception of precious metals, commodity markets are also generally down, and the British pound has dropped by about 8 percent against the U.S. dollar.

Why have markets reacted so violently?

Without question, the primary reason is that markets had incorporated a belief that Britain would remain in the EU. Stock markets had been up significantly over the last couple of weeks, and interest rates had started to move back up after being lower earlier in the month. These movements were generally believed to be an indication that the market expected Britain would remain in the EU.

Because the vote did not go as most expected, stock markets are giving back those gains and more, and interest rates are now falling instead of increasing. We emphasize, though, that while these market moves have been swift, this is normal market behavior when a significant event (like Britain leaving the EU) turns out differently than what the market had anticipated.

Why has the U.S. market reacted so strongly to Britain's decision?

We truly live in an interconnected, global economy at this point. Any decision by an economy that is the size of Britain's (fifth largest in the world) will impact markets elsewhere, including the U.S.

market. The European market is a significant trading partner for many U.S. firms, so it's not surprising to see U.S. stocks decline since Britain's decision is thought to be a net negative for Europe from an economic perspective.

Will Britain's decision precipitate a global recession?

It's impossible to say whether we are headed toward a recession, but Britain's decision likely increased the likelihood of a recession. However, the strong caveat here is that markets are forward looking and have already started to incorporate this likelihood, meaning you can't use this information to your advantage. This increased likelihood of recession is no doubt one of the reasons that stock markets have moved down sharply while bond prices have moved up sharply.

How did markets get this wrong?

While outguessing markets is difficult, in hindsight markets will always appear to have been overly optimistic or pessimistic, which means it's easy to critique them while looking in the rearview mirror. This particular vote was expected to be close, so markets weren't certain but were tending toward a "remain" vote.

What will markets do from here?

While it's very difficult to predict markets, it is highly likely markets will be volatile for some time to come. Stock market volatility has been relatively low over the last few years, but it can change quickly. The VIX, which is a measure of annualized stock market volatility, has gone from about 17 percent to 25 percent in reaction to the news, which is higher than the long-term average of about 20 percent per year.

It is important to remember, however, that higher volatility can work in both directions. While we could certainly see more days when stocks fall significantly, it's also possible we will have days when they rise significantly.

What should I do with my own portfolio?

Our guidance is the same that it has always been. If you have built a well-thought-out investment plan that incorporates your ability, willingness and need to take risk, you should not change your plan in reaction to market events. Doing so rarely leads to productive results.

Your plan incorporates the certainty that we will go through periods of negative market returns, and market reactions like this are also the primary reason we emphasize high quality bond funds and bond portfolios, which help buffer the risk of stocks. The early read on this bond approach is that it's doing exactly what we expect it to since high quality bonds have appreciated significantly in reaction to the Brexit vote.

How will this impact Federal Reserve interest rate policy?

As we have previously noted, interest rates have dropped dramatically in reaction to the vote. In early trading, the 10-year yield is at about 1.5 percent after having been at about 1.75 percent one day earlier. These early movements in interest rates indicate the market does not expect the Fed to increase interest rates at any point during the rest of the year. The primary ways this would likely change are either an unexpected increase in the rate of inflation or unexpectedly positive developments in the U.S. and global economy.

Do international and emerging markets stocks still deserve a place in a well-diversified portfolio?

International and emerging markets stocks comprise about half of the world's equity market value, so we continue to believe that a well-diversified stock portfolio should include a significant allocation to international and emerging markets stocks. While both have underperformed U.S. equities over the last five and 10 years, that does not mean they will continue to do so. We have seen periods in the past when international stocks have outperformed U.S. stocks for a long period of time only for that to reverse in the future. Further, international stocks are trading at significantly lower prices than U.S. stocks, indicating expected returns are higher for international stocks compared to U.S. stocks.

What role do currencies play in this situation and in my portfolio?

Initially, we are seeing the U.S. dollar and Japanese yen appreciate against most other currencies, while the British pound is falling precipitously. The international funds we use do not hedge foreign currency, so when the U.S. dollar appreciates relative to other currencies, this negatively impacts their returns. The long-run academic evidence, however, shows that hedging currency risk has minimal impact on an overall portfolio and that it can be beneficial to have exposure to currencies other than the U.S. dollar for a portion of an overall portfolio.

About Jared Kizer, Chief Investment Officer, The BAM ALLIANCE

Jared Kizer is the Chief Investment Officer for BAM Advisor Services and the BAM ALLIANCE. And while it may sound like his job is all about the numbers, what he likes most about his role is the opportunity for him to collaborate every day with advisors, clients and prospects, helping investors better understand the complicated concepts that will have a tangible effect on their financial lives.

He is also chair of the Investment Policy Committee, which evaluates findings from academic research and applies that learning to develop investment strategy recommendations for The BAM ALLIANCE.

Jared's passion for education doesn't end with The BAM ALLIANCE. In 2008, Jared co-authored the book "The Only Guide to Alternative Investments You'll Ever Need" with financial author Larry Swedroe. Jared has written several articles on a variety of topics, including retirement planning and investment policy. His work has been published in The Journal of Portfolio Management, Journal of Indexes, ETF.com, AdviceIQ.com, Morningstar.com and USA Today. He maintains a blog at MultifactorWorld.com. Jared has also made appearances on local and national television, including Bloomberg Television.

Jared holds a master's degree in finance from Washington University in St. Louis. He lives in Chesterfield, Mo. with his wife and children.