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212.287.3111
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February 27, 2018

Brexit: A Tempest in a Teapot?

By Maria Vassalou, Ph.D. and Thomas Cooley, Ph.D.

In June of 2016, the UK held a referendum on its membership in the European Union (EU). Despite the many warnings and reports about the disastrous effects Brexit may have on the country, to the surprise of many, the people voted to exit the EU.

Prior to the vote, Her Majesty's Treasury issued an in-depth analysis of the consequences Brexit would have on the UK economy. The conclusions of their analysis were ominous:

> "The analysis in this document comes to a clear central conclusion: a vote to leave would represent an immediate and profound shock to our economy. That shock would push our economy into a recession and lead to an increase in unemployment of around 500,000, GDP would be 3.6% smaller, average real wages would be lower, inflation higher, sterling weaker, house prices would be hit…"[1]

These were the projected immediate consequences. A separate Treasury Study estimated the long term consequences, depending on what course of action the UK followed. It concluded that "[t]he UK would be permanently poorer if it left the EU and adopted any of these [alternative trade] models."[2]

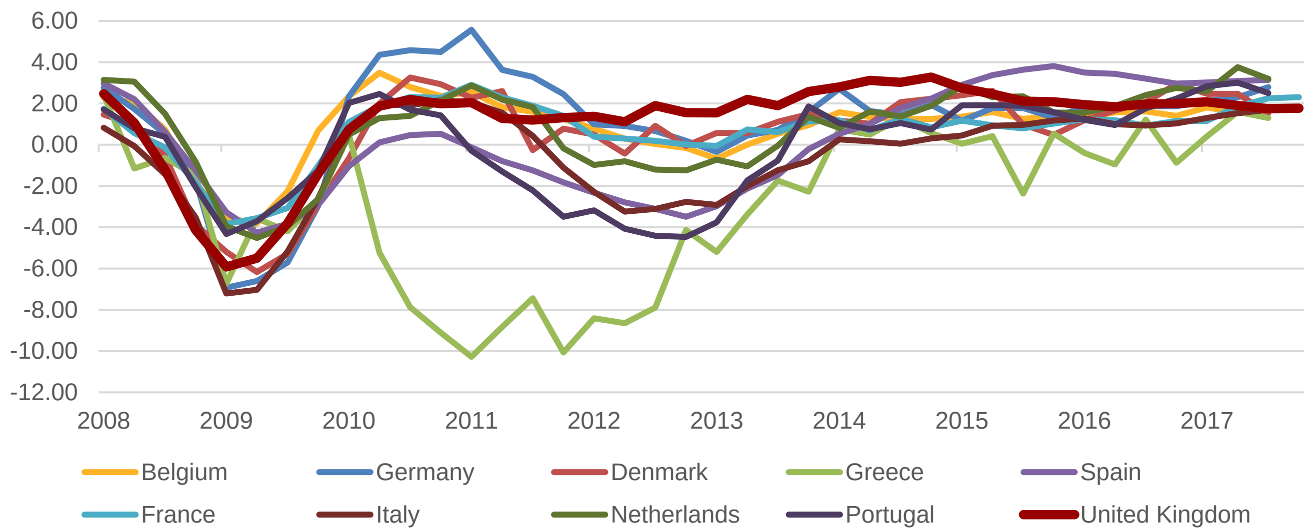
In all fairness, the Treasury was not alone in predicting catastrophic effects of Brexit. Many other respected economists predicted a dramatic collapse in investment and growth.[3]

The Dog That Didn't Bark

Contrary to the predictions above, the UK economy has continued to grow. Figure 1 below shows the real GDP growth rates of various EU countries since the financial crisis. While the real GDP growth rate for the UK has somewhat slowed down in recent years, this slowdown started well before the Brexit vote and the rate of GDP growth did not materially decelerate after the referendum. Furthermore, other European countries experienced similar behavior in their GDP growth rates despite not having had a referendum to exit the EU.

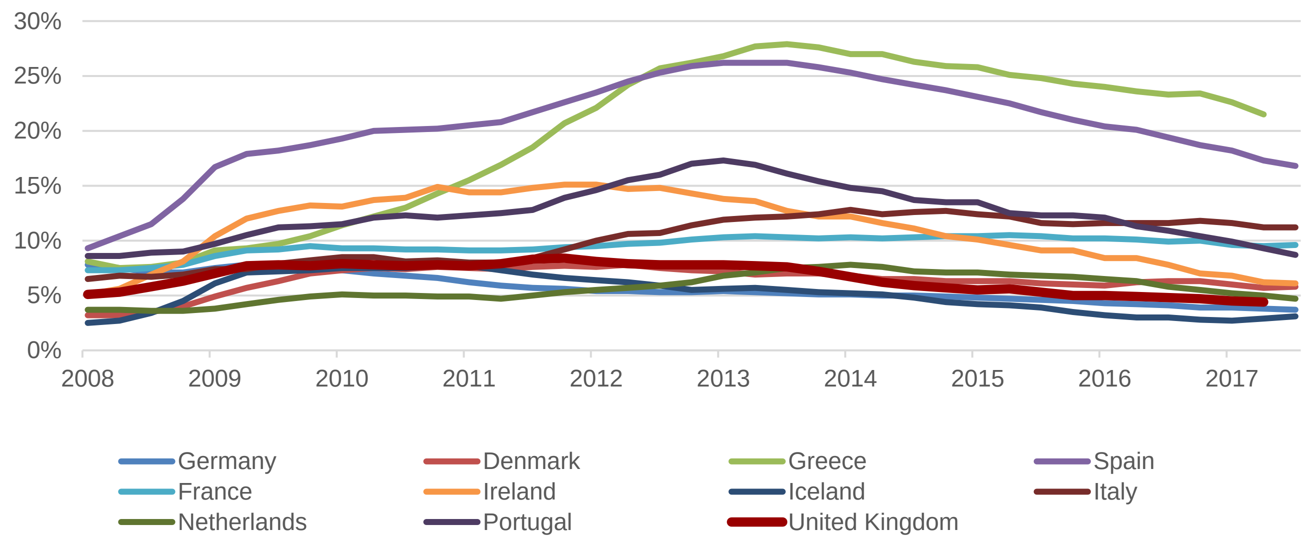
[1] HM Treasure analysis: the immediate economic impact of leaving the EU. Forward by George Osborne.
[2] HM Treasury analysis: the long term economic impact of EU membership and the alternatives, April 2016.
[3] Dhingra, S, H. Huang, G. Ottaviano, T. Sampson, and J. Van Reenen, "The consequences of Brexit for UK trade and living standards, April, 4, 2016, VOX CEPR's Policy Portal.

FIGURE 1: REAL GDP GROWTH - YEAR-ON-YEAR, INDEX: 2008Q1



Source: OECD/FRED

FIGURE 2: UNEMPLOYMENT RATE - SEASONALLY ADJUSTED

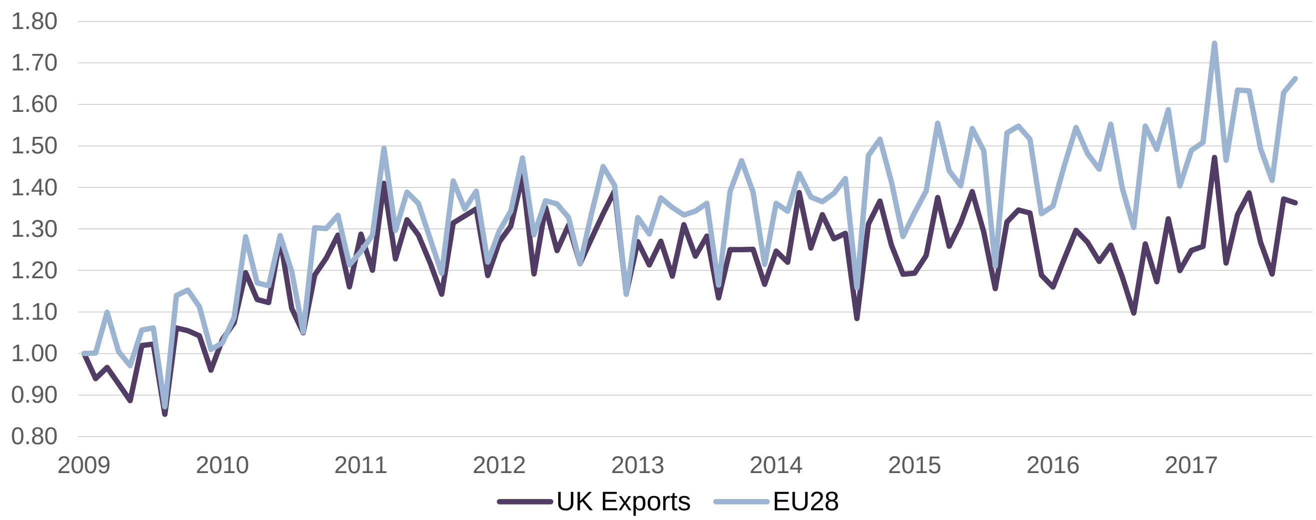


Source: OECD/FRED

Figure 2 shows the evolution of the unemployment rate in the same European countries since the financial crisis. Again, we observe that the UK unemployment rate has fallen over time and has continued to do so after the Brexit vote. In fact, Governor Carney stated after the recent Bank of England decision that the central bank may have to tighten its monetary policy faster than initially expected because the slack in the economy is diminishing and unemployment is falling, resulting in a rise in inflation that cannot be solely attributed to the decline in the value of the British pound.

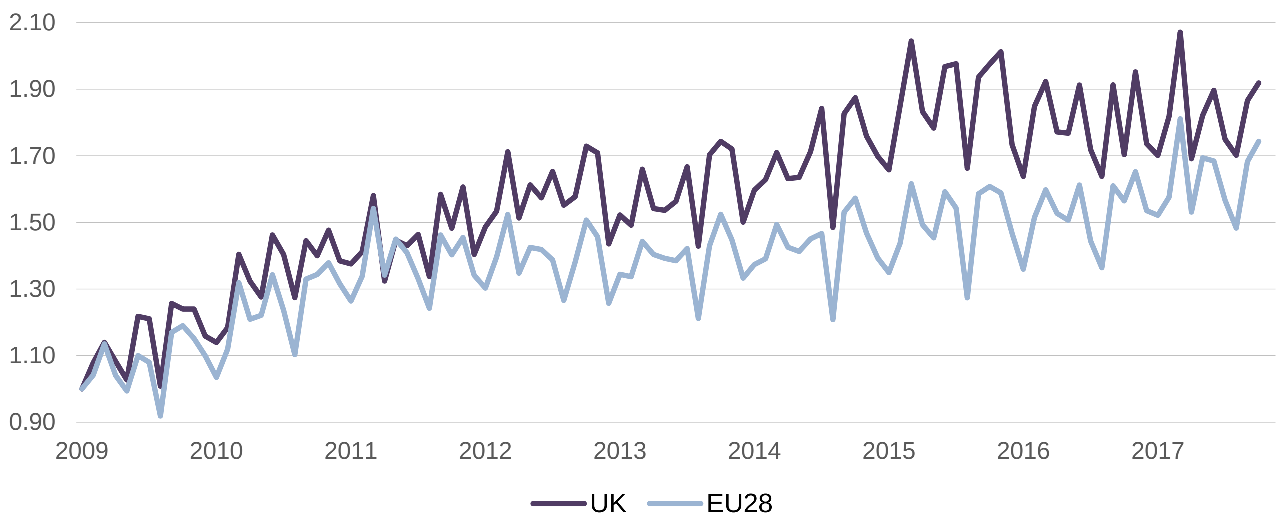
When it comes to the UK's trade with the EU, we observe again that nothing has changed since the results of the referendum. As Figures 3a and 3b show, imports and exports of the UK with the EU, normalized by their 2009 levels, remain largely the same and they continue to follow the same seasonal variation pattern they always did. Furthermore, the imports and exports of other EU-28 countries with the EU tend to follow a similar pattern to those of the UK. In short, we find no discernable change in the trade of the UK with the rest of the EU since the referendum that will differentiate it from what we observe for the other EU countries.

FIGURE 3A: EXPORTS TO EU-28



Source: Eurostat

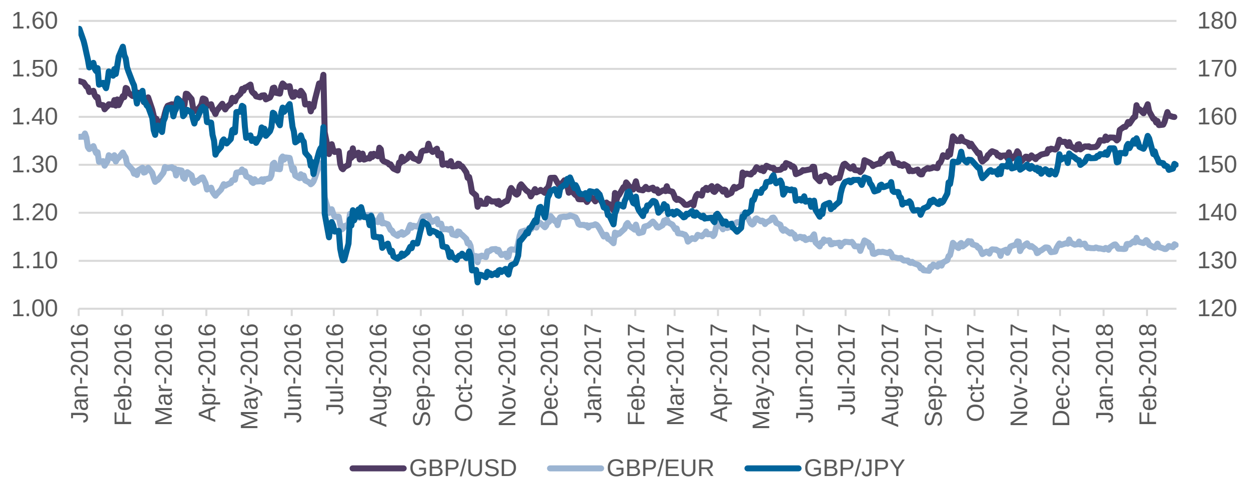
FIGURE 3B: EU-28 IMPORTS



Source: Eurostat

One of the biggest shocks from the Brexit vote was experienced by the British pound that fell approximately 18% against the USD in the aftermath of the referendum results. However, as Figure 4 shows, much of that decline has already been recovered, partly aided by the weakness in the USD. Similarly, the value of GBP against the JPY has also recovered most of its lost ground. That is less the case for the GBP/EUR exchange rate, but that's partly due to the strengthening of the euro as a result of the improved economic growth and inflation dynamics in the currency area.

FIGURE 4: GBP AGAINST SEVERAL MAJOR CURRENCIES



Source: Bloomberg

The above discussion shows that the Brexit vote did not have the immediate catastrophic consequences that many had expected. This does not mean that it will not have adverse effects going forward. To a large extent, the consequences of the Brexit decision will be a function of the trade deals the UK strikes with the EU and the rest of the world, as well as the exact relation it will maintain with the EU in other matters that may affect growth, such as regulations, migration and legal matters.

What Is at Stake for the UK and the EU?

It is safe to say that nobody was expecting the Brexit negotiations between the UK and EU to be easy or smooth. The past year and a half has certainly validated this view. Sticky points in moving forward include the transition period, the UK's contribution to the EU budget, the UK's trade status including that of the financial sector in London, immigration controls and the border with Ireland, as well as whether the UK will be subordinated to the European Court of Justice going forward. The maladroit handling of the talks with the EU by PM May's government have certainly not helped the process.

The risks for the UK are intimately related to the type of trade deal the country strikes with the EU. Several studies have considered the effects of various alternatives. Specifically, they have tried to estimate the impact of deals that resemble those with Sweden and Norway, the bilateral agreement with Switzerland or the application of WTO rules such as those used in trade between the EU and the US and Canada, for instance.[4]

The average estimate across these studies and scenarios is that Brexit would cost the UK 3.5% of GDP by 2030. The uncertainty attached to these estimates is particularly large, as the scenarios considered are significantly different from one another. While costs in terms of future economic growth can be large for the UK, there are also a number of facts that argue for a more contained impact.

On the trade front, we should consider the following:

1. Trading relationships exist because they are mutually beneficial. Unless the eventual agreement that is reached forces costs much higher, they will continue to be beneficial.

[4] HM Treasury analysis: The Long-Term Economic Impact of EU Membership and the Alternatives", April 2016, and Ebell and Warren, "The Long-Term Economic Impact of Leaving the EU", National Institute of Social and Economic Research (NIESR), May 25, 2016.

2. A lot of the barriers to trade don't change whether the UK is in the EU or not.
    a. Physical distance and transportation costs don't change.
    b. The UK was never going to adopt the single currency, so that won't change.
    c. The language advantage remains the same.

In addition, it is worth considering that outside the EU, the UK will have the ability to strike agreements with other countries that may be more beneficial for the UK than those it would have to follow as a member of the EU. The premise here is that the agreements that the EU enters can be assumed to be, at least in principle, beneficial for the average member state. To the extent that the UK is not the average member state, such agreements may be suboptimal for the country. The ability of the UK government to enter agreements that are tailor-made to the UK's comparative advantages and also take into account the country's potential weaknesses, may result in positive benefits for growth in the future, beyond those considered by the above studies.

A recent study by McGratten and Waddle[5] focuses on the impact of Brexit on Foreign Direct Investment (FDI) and production. Their study is based on a modeling approach that examines the consequences for FDI of increased barriers between the UK and the EU. Countries that remain open enjoy the benefits of new ideas and the knowledge of others embodied in technology capital without undertaking the investment themselves. In other words, they enjoy positive spillover effects from technological advancements from other countries. Barriers have the effect of limiting those spillovers as they affect FDIs. It is possible the UK will enjoy fewer technological transfers or synergies from the EU if access to Europe is limited, which it may not be able to substitute with domestically undertaken R&D. However, the same may be true for Europe, especially since the UK has established research centers and universities that compare favorably with those in Europe. In addition, a UK outside the EU may be able to benefit from closer trading relations with the US, Canada and Japan that may result in increased inward UK FDI and possibly significant increases in the welfare of UK citizens.

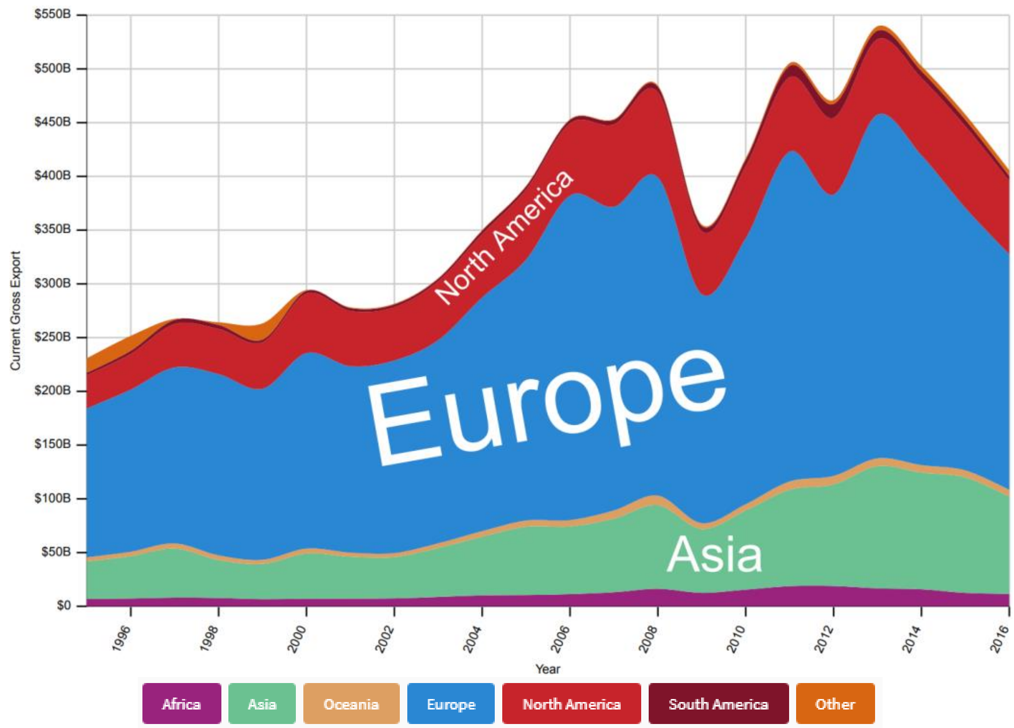
The Center for International Development at Harvard University, in cooperation with MIT, has developed and maintains the Atlas of Economic Complexity which allows the exploration of global trade flows across markets, the tracking of trade dynamics over time and the growth potentials of each country.[6] The Economic Complexity Index (ECI) they construct captures the diversity and complexity of a country's exports. A country that ranks high in the index has a high diversity of productive and specialized know-how, and therefore a high ability to produce a diverse set of sophisticated products. It is also shown that ECI provides a useful measure of economic development and is predictive of future economic growth.

Based on the ECI rankings, over the period of 2011-2016, the UK ranks 8th in the world, just behind the United States. And while Germany ranks 5th and Sweden 6th, all other EU countries rank below the UK—in many cases, significantly so. For instance, France ranks 13th, Italy 17th and Spain 28th. Clearly, while the UK can benefit from some technological and know-how spillovers from Germany and other EU countries, the EU has also much to benefit from similar spillovers from the UK, especially given its relative advantage in key industries such as electronics, machinery and chemicals.

Figures 5a and 5b provide a visual representation of UK's exports and imports over time and the relative importance of its various trade partners.

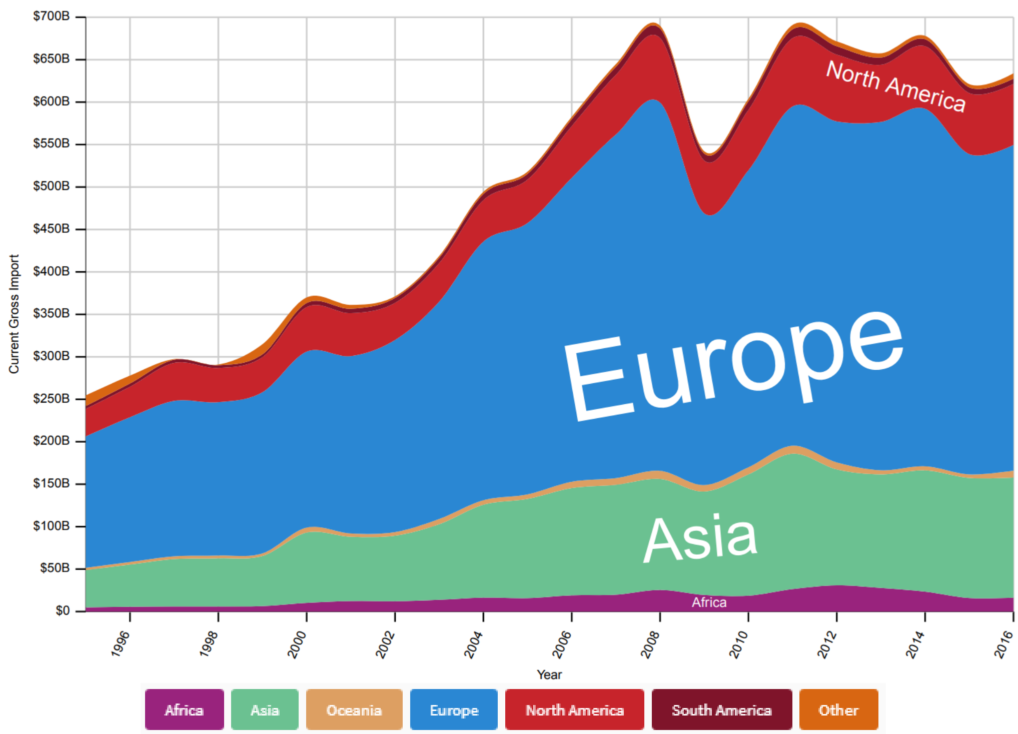
[5] Ellen R. MGratten and Andrea Waddle, "The Impact of Brexit on Foreign Investment and Production, Staff Report 542, Federal Reserve Bank of Minneapolis, 2017.
[6] http://atlas.cid.harvard.edu/rankings/ and https://atlas.media.mit.edu/en/rankings/country/eci/

FIGURE 5A: UK EXPORTS



Source: Atlas of Economic Complexity – Center for International Development at Harvard University

FIGURE 5B: UK IMPORTS



Source: Atlas of Economic Complexity – Center for International Development at Harvard University

In addition, Table 1 shows goods exports and imports between the UK and Germany, France, Spain and Italy for 2015 and 2016.

TABLE 1: UK GOODS TRADE WITH MAJOR PARTNERS (IN BILLION USD)

	2015				2016			
Partner	**Germany**	**France**	**Spain**	**Italy**	**Germany**	**France**	**Spain**	**Italy**
UK Imports From	94.3	38.7	21.6	25.0	88.0	35.9	21.2	24.1
UK Exports To	46.6	27.2	13.3	12.8	43.7	26.4	13.0	13.1

Source: UN Comtrade Database

Clearly, the above EU countries benefit enormously from goods traded with the UK and a more punitive trade arrangement than the one currently in existence would not be in their interests. In other words, the risks of a hard Brexit followed by hostile trade relations are high for both sides, and certainly no less for the EU, at least for selected key EU member states.

Are Financial Services in the UK Doomed after Brexit?

Financial services is the biggest part of the services trade in the UK, and the one most at risk. Specifically, financial services accounted for 11.8% of the GDP in the UK economy in 2016 and generated a trade surplus with the rest of the world of about 3% of GDP.[7] Fifty percent of that value is generated in London. In addition, financial services is an important contributor to employment with about 1.1 million people working mostly in the banking and insurance industries.

Given the importance of financial services for the UK economy, it is no wonder that much attention has been paid to the costs it will bear after Brexit. The predictions have again been overwhelmingly negative for the sector. However, there are good reasons why the impact may not be as catastrophic as it is presumed to be.

TABLE 2: INTERCONNECTIONS BETWEEN UK AND EU FINANCIAL SERVICES

	Total	**Banking**	**Asset management**	**Insurance and reinsurance**	**Infrastructures and others**
UK financial service revenues (GBP bn)	190-205	108-117	20-23	39-42	22-26
UK financial services revenues (% of GDP)	11%	6%	1%	2%	1%
UK financial services revenues related to the EU	23%	22%	26%	10%	44%
UK market shares in the EU	24%	26%	41%	22%	-

Source: EGOV based on figures by TheCityUK, LSE, New Financial, Oliver Wyman
Note: market shares relate to revenues (whole sector), bank lending (banking), value of assets under management (asset management) and insurance premiums (insurance and reinsurance).

Table 2 shows that only 23% of the UK financial services revenues are related to the EU.[8] While this is a significant percentage, it translates to about 2.5% of UK's GDP. In the event that much of this activity is transferred to continental Europe, the financial services industry will still remain a dominant sector of the UK

[7] M. Magnus, A. Margerit and B. Mesnard, "Brexit: the United Kingdom and EU financial services", Briefing, Directorate-General for Internal Policies, European Parliament, 9 December 2016.
[8] See: Magnus, M., A. Margerit and B. Mesnard, "Brexit: the United-Kingdom and EU financial services", Briefing, Directorate-General for Internal Policies, Economic Governance Support Unit, 9 December 2016.

economy although it may lose its top spot in the Global Financial Centers Index (GFCI) to New York.[9] However, the transfer of such activity to continental European centers will not be an easy task.

TABLE 3: GFCI 22 RANKS AND RATINGS

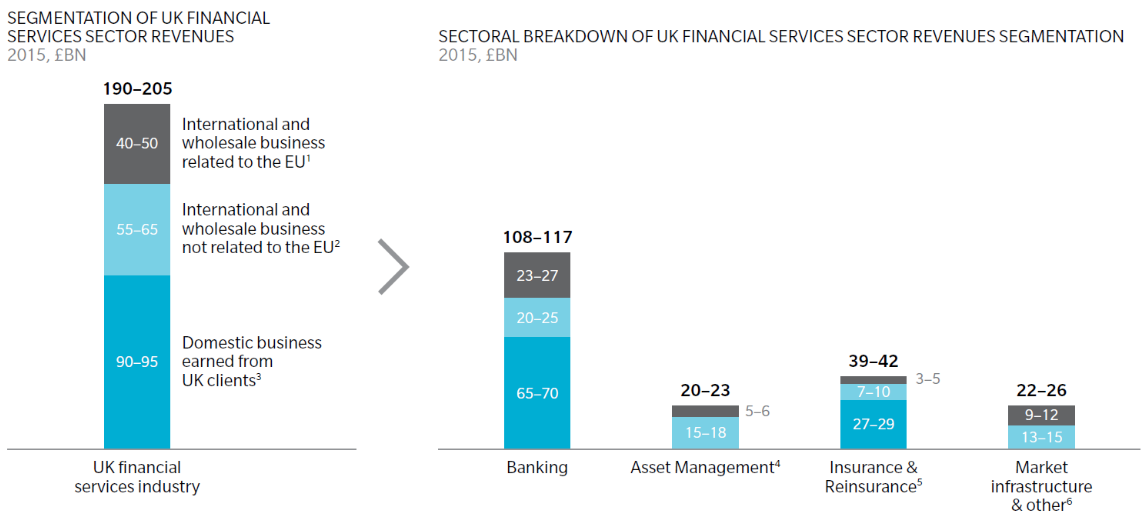
Centre	GFCI 22		GFCI 21		Change in	Change in
	Rank	Rating	Rank	Rating	Rank	Rating
London	1	780	1	782	0	▼2
New York	2	756	2	780	0	▼24
Hong Kong	3	744	4	755	▲1	▼11
Singapore	4	742	3	760	▼1	▼18
Tokyo	5	725	5	740	0	▼15
Shanghai	6	711	13	715	▲7	▼4
Toronto	7	710	10	719	▲3	▼9
Sydney	8	707	8	721	0	▼14
Zurich	9	704	11	718	▲2	▼14
Beijing	10	703	16	710	▲6	▼7
Frankfurt	11	701	23	698	▲12	▲3
Montreal	12	697	14	713	▲2	▼16
Melbourne	13	696	21	702	▲7	▼6
Luxembourg	14	695	18	708	▲4	▼13
Geneva	15	694	20	704	▲5	▼10
San Francisco	16	693	6	724	▼10	▼31
Vancouver	17	692	17	709	0	▼17
Dubai	18	691	25	696	▲7	▼5
Boston	19	690	9	720	▼10	▼30
Shenzhen	20	689	22	701	▲2	▼12

Source: The Global Financial Centres Index, 22 – September 2017 – Financial Centre Futures

In the GFCI rankings shown above in Table 3, the only financial centers located in the EU and ranked in the top 20 globally, pending Brexit, are Frankfurt in 11th followed by Luxembourg in 14th. The rankings of the GFCs are based on five key factors of competitiveness: business environment, financial sector development, infrastructure, human capital and reputational factors. While existing and aspiring financial centers in the EU can aim to enhance their standing with respect to the above factors, it will likely take them a long time to attain levels comparable to those currently present in London. Some of these European financial centers, such as Luxembourg, are likely to also face physical constraints. Others may be negatively affected by limited infrastructure and language constraints. In that sense, the erosion of the financial services sector in the UK due to Brexit may be much slower and of a lesser degree than currently feared. The EU will likely still need London after Brexit.

[9] The Global Financial Centres Index, 22, September 2017.

FIGURE 6: SEGMENTATION OF THE UK FINANCIAL SERVICES INDUSTRY



Source: Oliver Wyman

Figure 6 above details the breakdown of the UK financial services sector revenues by sub-sectors and sources of revenue. The biggest source of revenue at risk is that from banking related to the EU, which accounts for about 23% of total banking revenue and 13% of revenue of the total financial services sector. This also explains why passporting banking services in the single market is such a significant negotiating chip for the EU. However, the downside for the UK in the event that EU refuses to grant it passporting rights will not be catastrophic for the UK economy, or even its financial services sector, although the loss will be nontrivial.

Concluding Thoughts

Brexit can be costly both for the UK and the EU and it will be as costly as both sides make it. The patterns of trade between the UK and EU that have been developed over time reflect the comparative advantages of both sides. In simple terms, continental Europe exports mostly goods to the UK and the UK exports mostly services, and indeed financial services, to continental Europe. There is no sound economic reason why these trade patterns should be disrupted because of Brexit. However, even if negotiations turn out for the worse, the economic impact for the UK will likely be much smaller and contained than it is made out to be. Furthermore, in such an adverse scenario, the negative economic impact on the EU and specific member states will also be nontrivial.

Most of the commentary and analysis over the past two years has focused on the negative economic consequences of Brexit for the UK. The projections for the catastrophic immediate effects of the exit vote have not materialized, but some may still appear in the years to come. In this note we highlight that any negative economic effects from the eventual post-Brexit agreement are bound to be shared by both sides. In other words, it is unlikely that the economic costs of Brexit will only fall on the UK. However, the problem with Brexit is that it is primarily a political event, and one of particular importance for the EU. In that sense, the EU may be willing to forgo economic benefits from a non-punitive trade arrangement with the UK to deter other member states from venturing to exit the union in the future. The goal for the EU in such a scenario would be primarily to exert and assert its power over other member states rather than maximize its economic benefits from the Union. For the UK, forgoing the pre-Brexit trade benefits of its membership makes sense if the benefits of increased flexibility of self-determination in areas of importance to the country, including but not limited to its ability to negotiate bilateral treaties, and set up its own laws, regulations, and immigration policies, exceed the costs of any trade barriers with the EU. Post-Brexit, the UK is expected to save 33bps of its GDP per annum which amounts to the difference between the contributions and benefits it currently has from its membership in the EU. A post-Brexit agreement with the EU would be punitive if it ends up costing the UK more than 33bps to maintain access to the single market and passporting for UK-based financial institutions.

While Brexit has been presented over the past two years as a major political event with severe economic and political consequences, Europe may be more susceptible to another risk: technology. Europe has been relatively slow in adopting automation technologies and embracing artificial intelligence (AI). The McKinsey Global Institute report on Europe's economy estimates that for Europe's five largest economies—the UK, Germany, France, Spain, and Italy—62 million workers perform technically automatable activities.[10] As those jobs disappear, and to the extent that the governments fail to retrain the displaced employees and redeploy them in other jobs within a year, unemployment and income inequality issues in Europe can be amplified significantly. Governments will have to respond creatively to these challenges. Automation and AI will be bigger threats to free labor mobility and European integration than Brexit. Ultimately, Brexit may be more of a "tempest in a teapot"—the biggest risks may well lie elsewhere.

[10] Europe's economy: Three pathways to rebuilding trust and sustaining momentum, McKinsey Global Institute, January 2018.

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Maria Vassalou, Ph.D.

Partner & Portfolio Manager, PWP Global Macro

Maria Vassalou is Partner and Portfolio Manager for the PWP Global Macro strategy. Dr. Vassalou joined Perella Weinberg Partners from MIO Partners, a subsidiary of McKinsey & Company, where as a Portfolio Manager she managed a similar global macro investment strategy in a dedicated legal entity, and as Head of Asset Allocation she provided counsel on allocation for liquid assets within MIO's portfolio. Prior to joining MIO, Dr. Vassalou was a Global Macro Portfolio Manager at SAC Capital Advisors, LP. She joined SAC from Soros Fund Management where she was responsible for global quantitative research, as well as the development and management of global quantitative trading strategies. Prior to her career in asset management, Dr. Vassalou was an Associate Professor of Finance at Columbia Business School which she joined in 1995 and where she established many of the investment principles she employs today. Dr. Vassalou is a Past President of the European Finance Association and was the Chair of the 2008 European Finance Association Meetings. She has also served as a Research Affiliate of the Centre for Economic Policy Research (CEPR) in London for many years and is a past member of the Academic Advisory Board of the Vienna-based Guttmann Center of Competence in Portfolio Management. Her research focus has been on the interrelation of the macro-economy and financial markets with applications in hedge fund strategies. A frequent speaker to both academic and practitioner-oriented seminars and conferences, Dr. Vassalou has published in leading academic journals, such as the Journal of Finance, Journal of Financial Economics, Journal of Financial and Quantitative Analysis, Journal of Business, Journal of International Money and Finance, and the Journal of Economic Dynamics and Control. While she was on the faculty of Columbia University, she also served as a consultant to many premier hedge funds and asset management institutions in the U.S. and Europe. Dr. Vassalou received a Bachelor of Arts in Economics from the University of Athens and she holds a Ph.D. in Financial Economics from London Business School.

Thomas F. Cooley, Ph.D.

Paganelli-Bull Professor of Economics at the Leonard N. Stern School of Business, New York University

Thomas F. Cooley is the Paganelli-Bull Professor of Economics at the Leonard N. Stern School of Business at New York University, as well as a Professor of Economics in the NYU Faculty of Arts and Science. He served as Dean of the Stern School from 2002 to January 2010. Cooley is known for his scholarly work in the areas of macroeconomic theory, monetary theory and policy, and the financial behavior of firms as well as for his commentary in many economic and business publications. Responding to the financial crisis of fall 2008, he spearheaded a research and policy initiative that yielded 18 white papers by 33 NYU Stern professors, published as *Restoring Financial Stability: How to Repair a Failed System*, (Wiley, 2009). Together with Stern colleagues he edited and wrote a second book, *Regulating Wall Street, The New Architecture of Global Finance*, which was published by Wiley in 2010. His book, *Understanding Business Cycles*, Princeton University Press 1995, is a widely cited reference on macroeconomic fluctuations. Cooley is a Research Associate of the National Bureau of Economic Research and a member of the Council on Foreign Relations. He is also the former President of the Society for Economic Dynamics, a Fellow of the Econometric Society, holds an honorary doctorate from the Stockholm School of Economics. In the corporate sector, Cooley has been a senior advisor and member of the board of Managers of Standard & Poor's, served on the Board of Directors of Thornburg Mortgage and has been an advisor to Ameriprise, eTrade Securities, and Cedar Consulting. Cooley received his Ph.D., and M.A. in Economics from University of Pennsylvania. He received his B.S. in Engineering Science from Rensselaer Polytechnic Institute. Before joining Stern, he was a Professor of Economics at the University of Rochester, University of Pennsylvania, and UC Santa Barbara.

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