Communiqué

Droms Strauss Wealth Management

Celebrating a 20-year anniversary

With the close of 2014, we can look back with great satisfaction on completing our first 20 years in business.

We started the firm with the single goal of providing institutional quality financial and investment advice to a small group of our friends. Droms Strauss Wealth Management now provides that same level of expertise to over 240 clients that we consider our friends, across the U.S., Europe, the Middle East and Asia.

We remain committed to our mantra — ***meeting your objectives and exceeding your expectations.*** Our quarterly Communiqués are one part of our continuing efforts to effectively communicate to you what we're thinking about investments, financial planning issues, and the economy. We always welcome your questions, comments and feedback; please feel free to contact us at any time.

INSIDE THIS ISSUE

1 Celebrating a 20-year anniversary

Looking back at 2014

2 The Active/Passive investment argument

3 Looking forward to 2015

4 Referrals

Looking back at 2014

December is always a good time to look back on the year, take a look at where we have gone, and look forward to where we expect to go next year.

The Dow broke through 18,000 for the first time this December 22nd, and closed out the year at 17,823 on December 31. Looking down from 10,000 feet to get the bigger picture of where we ended up the year, U.S. large cap stocks provided a solid double digit return (13.7% for the S&P 500 Index), small caps finished up in positive territory albeit a meager 5% (measured by the Russell 2000 Index) while international stocks generally lost money this year (-4.9% as measured by the EAFE Index). In the alternative asset space, U.S. REITs was the clear winner returning 27% (FTSE NAREIT U.S. Real Estate Index) while international REITs returned a paltry 2.6% (Vanguard Global ex-U.S. Real Estate). Our positions in infrastructure helped portfolio returns with the Deutsche Global Infrastructure shares returning 18.3% while energy limited partnerships struggled to stay in positive territory with rapidly falling oil prices. In defiance of the economic consensus that interest rates would rise this year and push down bond prices, the opposite occurred and the Barclays Aggregate Bond Index returned 6.0% for the year.

"Solid GDP growth, reduction in unemployment and low inflation leave a lot to like about the 2014 economy."

The economy continued its expansion into a fifth year following the end of the Great Recession in June 2009. Signals of an accelerating pace of the recovery were seen toward the end of the year. According to a December 23 press release from the Department of Commerce, the final figure for third quarter GDP growth was revised upward to 5.0% from the previous estimate of 3.9%. This latest estimate is a significant increase from the second quarter GDP growth of 4.6%. According to the November release from the Bureau of Labor Statistics, unemployment was down to 5.8%, a significant improvement from the 6.6% at the beginning of 2014. Inflation is still tame, as measured by the 1.7% increase in the Consumer Price Index for 2014 over 2013. All in all, solid GDP growth, reduction in unemployment and low inflation leave a lot to like about the 2014 economy.

DROMS STRAUSS WEALTH MANAGEMENT

Registered Investment Advisors

The Active/Passive investment argument

This year proved to be a "win" year for passive investing as most active managers finished the year trailing their benchmarks. However, history has taught us that chasing the leaders or following the trends often produces less than desired results.

The active/passive debate has been ongoing since the first passively managed index fund was introduced in the early 1970's by the Vanguard Group. This issue really is a never ending debate that most likely never will be settled definitively. However, it is possible for active and passive approaches to logically co-exist in the context of what might be called "investment management in a nearly efficient market," which is the approach we take at Droms Strauss.

Passive management generally refers to the use of "index" funds, which simply are mutual funds constructed to track the performance of some stock index. The argument in favor of investing in index funds rests on the economic concept of "market efficiency," which essentially states that stocks in aggregate are priced efficiently such that their market prices fairly reflect the "intrinsic value" of the stock. If stock prices were perfectly efficient, there would be no sense in doing any kind of analysis to try to outperform the efficient market. This has been a hotly debated point in finance for nearly 50 years now and Warren Buffet, for one, has been famously quoted as saying that telling investors that markets are efficient is akin to telling bridge players that it doesn't do any good to look at the cards.

"The active/passive debate will no doubt continue in the future, but the core/noncore approach is a good way to take advantage of the best features of each argument."

Active management generally refers to a portfolio management strategy where the manager makes specific investments with the goal of outperforming an investment benchmark index in an attempt to produce above-average returns on a risk-adjusted basis. Active managers exploit market inefficiencies by purchasing securities that are undervalued or by selling securities that the manager believes are overvalued. Active managers many use a variety of factors and strategies to construct a portfolio including quantitative measures such as P/E ratios, attempting to anticipate long-term macroeconomic trends and/or purchasing stocks of companies that are temporarily out-of-favor or selling at a discount to the company's intrinsic value.

There is a deep well of academic studies to support the position that the market for large cap U.S. stocks is highly efficient, even if not perfectly efficient. However this market is close enough to efficiency that for most investors, the best returns will come from investing mainly in index funds in the large cap sector. This is a market segment where a "core/noncore" approach makes sense: index the core of your large cap investments in index funds and invest the rest in actively managed funds. For Droms Strauss portfolios, we index the core of our U.S. large cap investments and supplement the core with a specialty "satellite" fund like the Diamond Hill Long Short Institutional Fund. The Diamond Hill fund, as its name implies, employs a long-short philosophy which we use to reduce portfolio volatility. In higher return years we expect the fund to underperform the market index but in low return and especially in negative return years this fund should outperform thus reducing portfolio volatility and portfolio losses.

As one moves out of the large cap space into midcaps (generally $2 to $12 billion average market cap) and small caps (generally less than $2 billion average market cap), markets become less efficient and the probability of outperforming an index fund with actively managed funds increases. In this space, we generally invest in active managed funds. This active approach also works well in selecting international funds. Finally, in the "alternative investments" sphere, where the market becomes even less efficient, we invest mainly in active funds (real estate and infrastructure funds), although we do invest in one specialty Exchange Traded Note that is indexed to the Alerian Index of the 50 largest publicly traded energy limited partnerships.

This core/noncore approach takes advantage of market efficiency in the market segments that are most efficient and takes advantage of active management in the segments that are less efficient. The active/passive debate will no doubt continue in the future, but the core/noncore approach is a good way to take advantage of the best features of each argument.

Looking forward to 2015

We look to the *Livingston Survey*, published semi-annually by the Federal Reserve Bank of Philadelphia, as an excellent guide to what is most likely to work out in the economy next year based on the consensus of economic forecasters from industry, government, banking and academia.

According to the December issue of the Survey, economists expect to see GDP growth just shy of 3% for the full year, continued reduction in unemployment (5.6% by June 2015) and an even lower inflation rate at 1.4% for 2015 over 2014. Given that consensus forecasts are notoriously unreliable, we place little or no reliance on the point estimates for the economy, but, absent a major disruptive event (one of those "unknown unknowns") the direction is likely to be correct: growing GDP, falling unemployment and low inflation are likely to describe the economic environment for 2015.

"In expansion years, five and one-half years is just past middle age."

The current recovery period dates back to June 2009, so the current economic expansion is now five and one-half years old. In expansion years, five and one-half years is just past middle age: the last three expansion periods (1982 to 1990, 1991 to 2001 and 2001 to 2007) lasted for an average of about 8 years each, with 1991-2001 leading the pack with a 10-year expansion cycle. The fact that the current expansion is growing slowly, accompanied by both low interest rates and low inflation, bodes well for continuing expansion. There is much truth to the statement that no economic expansion in history has died of old age – they generally are murdered by the Fed through the process of raising interest rates to cool off an over-heated economy. There is certainly no current evidence of over-heating or inflation and the current Fed emphasis is on stimulating growth and avoiding disinflation so the current expansion should continue for the next few years.

Of course, the Fed is virtually certain to raise interest rates sometime in 2015. However, when the rate increases do come they are most likely to be fairly measured and gradual so as not interfere with the still-fragile economic expansion. No one can accurately predict exactly when the current bull will run out of steam, but given that the S&P 500 Index is the single best leading indicator of the economy, we can expect that the market will trend upward as long as the economy continues growing for the next few years. However, bull markets never go straight up without a pause and we have to expect some retreats, perhaps as much as 10 percent down (the usual definition of a correction) so stock market investors have to remain psychologically and financially prepared for stock market volatility.

All things considered, we hope to see the bull market run for the next two to three years, but perhaps with a good dose of volatility along the way. We expect that bond returns will be choppy as interest rates rise, with longer term bonds suffering larger declines than shorter term bonds. On balance, we are optimistic about 2015 and as we begin the New Year, we wish each and every one of our clients and friends a very healthy and happy New Year!

Referrals

Please take a moment to recommend us or share contact information for an individual, family or a business colleague you think could benefit from working with us. Be assured that we will regard your friends, family and business colleagues with the highest level of consideration.

Sincerely,

Droms Strauss Wealth Management

Contact Us

William G. Droms, CFA	bill@droms-strauss.com
Steven N. Strauss, CPA/PFS	steve@droms-strauss.com
Robert J. Hines, CFP®	bob@droms-strauss.com
Anthony Z. Gennaoui	anthony@droms-strauss.com
Michael S. Murphy	mike@droms-strauss.com
Rachel Strauss Rosen	rachel@droms-strauss.com
Dawn Presswood	dawn@droms-strauss.com