

**Droms Strauss Advisors, Inc.**  
**February 2011 White Paper**

**“Heading Toward the Teen Years: Investment Outlook for 2011 and Beyond”**

As was our first White Paper (“Investing for 2009 and Beyond”) two years ago, this 2011 White Paper is our view on the investment fundamentals that will guide how we invest for the next year or two and a look back over the past two years, the actions we took and how they worked out. From the perspective of 2011, we now appear to have survived the near economic implosion kicked off by the bankruptcy of Lehman Brothers in September 2008. At this time, the economy continues to expand (albeit slowly), private sector employment appears to be showing signs of life, inflation remains low but likely above what could lead to a devastating blow from widespread deflation, and the stock market has recovered from the March 9<sup>th</sup> 2009 bottom when the Dow closed at 6547.

When we published our January 2009 White Paper, we were only four months past the economic “tipping point” of September 2008. In that month alone, Merrill Lynch was acquired by Bank of America, Lehman Brothers filed for bankruptcy protection and was subsequently acquired by Barclays Bank, AIG was rescued by a federal bailout, Goldman Sachs and Morgan Stanley converted to commercial bank status so that they could lean on the credit guarantee of the FDIC, Washington Mutual was taken over by the FDIC and subsequently acquired by JP Morgan, First Reserve Fund “broke the buck” for the first time on a money market fund, and the federal government launched the \$700 billion TARP bailout. We were as shaken as anybody by the “Black Swan” events of 2008, but we based our January 2009 paper on the premise that “letting our emotions and fears drive our investment decisions undermines everything we know about investing.” We concluded the first paragraph of that White Paper with the comment from Charles Schwab’s Chief Investment Officer that “panic is not an investment strategy.”

Looking back at the last two years since the January 2009 White Paper, we think there are a few key “points of inflection” that have some powerful lessons as we move forward into 2011 and beyond. When the Dow closed out 2008 at 8,776, down 38% from its all-time high of 14,165 in October 2007, we fervently hoped the worst might be over. December 2008 was our “tipping point” where we had to decide whether we would follow conventional wisdom and rebalance portfolios back to their normal asset allocations. The problem we faced was clear: a portfolio that was 60% invested in stocks at the end of 2007 would now be approximately 50% invested in

stocks after the crash. Although firmly convinced that we cannot and should not try to time the market, we did have a sense that rebalancing at the end of 2008 essentially would require selling bonds into a bond market where prices had been irrationally beaten down in order to reinvest in a stock market where no one seemed to know where the bottom was.

Our bottom line was that we made two key decisions at the end of 2008. First, we thought it was of critical importance that we not sell stocks into the weakest market since the Depression and that we would do everything we could to encourage each of our clients and friends to “stay the course” with their stock investments. Secondly, we believed that it would be imprudent to make new equity investments by selling bonds because, although we could hope the market had bottomed, there was really no way to know. We had a sense at the time that the market bottom was somewhere in the 7,000 to 8,000 range on the Dow, but even that pessimistic estimate proved to be too high by subsequent events. The net effect was that we decided to hold our existing equity positions but hold off on rebalancing until we could see some “green shoots of prosperity” on the horizon.

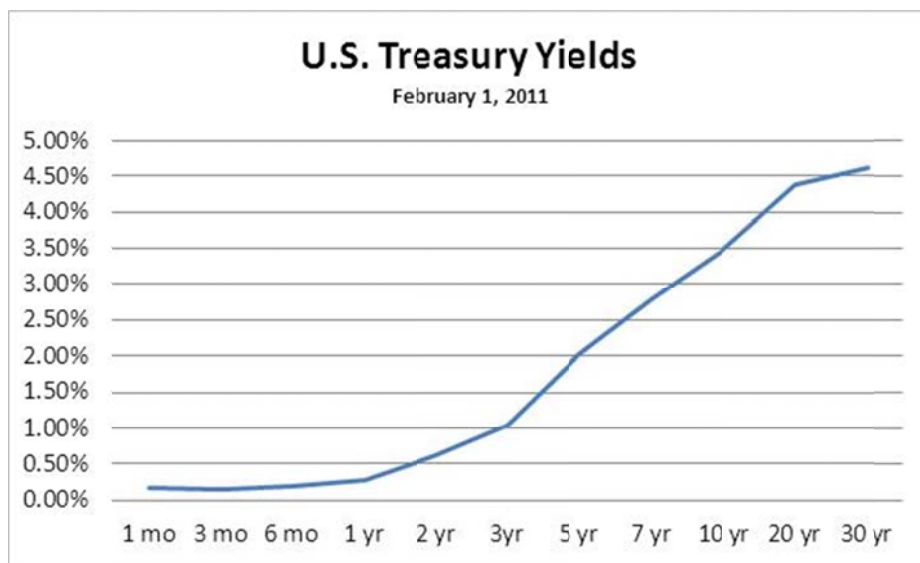
We all know now that the Dow eventually bottomed out at 6,594 on March 9, 2009 and recovered all the way to 10,428 by the end of 2009. Based upon our premise that “it was better to get to the station early than to miss the train,” we slowly began the process of rebalancing portfolios in late March and early April of 2009. As it turned out, our timing couldn’t have been better. In our second quarter 2009 newsletter, we noted that “Calendar year 2008 was a market crash of truly epic proportions, but we are beginning to see the seedlings of an economic recovery and we do know that economic recoveries generally are led by a turn up in the equity markets.” This statement laid out our justification for the rebalancing we had begun during the second quarter that would continue through the third quarter. We closed out the year with the Dow at 10,428 on December 31, 2009. Subsequent developments have been even more positive. We closed out 2010 with the Dow at 11,578, up 11% over the previous December and a truly remarkable gain of 75.6% from the March 2009 low.

We believe that one of the lessons we all should have learned is that taking a long-term perspective and working hard to not overreact to difficult, even frightening, times is much more important than trying to call the tops and bottoms of the stock market. We are not aware of any firm or individual that sold out at the market top in October 2007 and then bought back in at the bottom on March 9, 2009. But we do know that staying the course with equities when times were tough, holding off on any precipitous moves during the downturn, and carefully rebalancing back to target asset allocations as we saw signs of life in the economy, stood us in good stead during the worst economic situation that any of us have lived through over the past 40

years. As we go forward, we intend to take this lesson to heart and continue our two-decade long policy of broad diversification across asset classes, diversification within asset classes, and avoiding ultimately futile attempts at market timing.

In the spirit of looking forward, we have several tactical changes that we have either begun to implement or will be implementing as we rebalance portfolios over the next few months. First, an easy call: for portfolios that hold significant amounts of money market funds, we have already reduced our money market targets in favor of adding an “ultra-short bond” target. With money market fund yields continuing to hover near zero, it makes sense to divide our old money fund targets into two sections: a small percentage to money market funds and the balance to an ultra-short bond fund. Ultra-short funds are not the equivalent of money markets in that their share values can and do fluctuate, but they normally do not fluctuate much. For example, even with the recent muni market volatility, the ultra-short muni bond fund that we use (Wells Fargo Ultra Short Municipal Fund), currently trading at \$4.80 per share, fluctuated between the limits of \$4.81 and \$4.82 per share over all of calendar year 2010. The fund has a current yield of 1.20% and paid \$0.058 per share in dividends in 2010.

The “800 pound gorilla” in the room is, of course, interest rates. The consensus expectation for future rates by bond market investors can be seen in the current shape of the U.S. Treasury yield curve – the graph that shows bond yield to maturity as a function of years to maturity. The spread between 30-year Treasuries and 2-year Treasuries (the 30-year rate minus the 2-year rate) hit 4.01% at the beginning of the year. This is the highest spread over the last 25 years that Bloomberg has been publishing this data. So, what does this mean to us?



With the Fed funds target rate at 0.0% to 0.25%, we believe it is obvious that Treasury rates cannot go lower, so if we ask ourselves where rates are likely to head as the recovery continues, there is only one possible answer: they have to go up. The “known unknowns” out here, of course, are how much and how soon? We are in agreement with the evolving opinion of many leading economists that it is likely that we will see a rise in interest rates once the recovery gathers steam. However, predicting the timing and magnitude of interest rate increases is at best a highly inexact art. Nonetheless, just as we felt in late March of 2009, the penalty for getting to the train station a little early (and positioning our portfolios for rising rates) is far better than missing the train altogether.

The most useful risk measure for bond price reaction to changes in interest rates is called “duration.” Duration is actually a fairly simple mathematical estimate of the percentage change in bond prices given a one percent change in interest rates. Duration is directly related to maturity: longer maturity bonds have higher durations than shorter maturity bonds. Since rising rates drive down bond prices, we can think of duration as the percentage decrease in bond prices for a one percent increase in interest rates. Duration is not a perfect measure of price change because as interest rates rise, duration decreases – in effect, as interest rates go up, prices and duration both go down because bond prices decrease at a decreasing rate. The key point is that duration is the best available measure of the impact of interest rate changes on bond prices, but is only an accurate measure for fairly small changes in interest rates. For our clients who majored in math or engineering, duration is just the first derivative of the bond price with respect to interest rates divided by the bond price – simple, eh?

So, what changes will we be making in the portfolios we manage? The obvious and easy first step is to decrease the duration of our aggregate fixed income holdings. Since duration is directly related to maturity, this means we are decreasing the average maturity of the bond funds that we own. We are doing that this quarter as we rebalance client portfolios. Within our taxable bond holdings, we are replacing one of the three funds we own (Vanguard Total Bond Index Fund) with a lower duration fund (Pimco Low Duration Fund). Within our tax exempt bond funds, we are replacing the Vanguard Intermediate Term Tax Exempt Fund with the Vanguard Short-Term Tax Exempt Fund.

The world of fixed income investing is actually a good bit more complicated than simply observing that rising rates result in falling prices. Obviously, the managers of the bond funds that we use are well aware of the impact of rising rates on their bond portfolios and we have invested a good bit of time in meeting with and conference calling with our bond managers. The Investment Summit that we organized last October featured speakers representing major bond

management firms, including both Pimco and Blackrock, the two largest bond managers in the world. We also attended a Pimco presentation on fixed income management in a rising interest rate environment at the AICPA Personal Financial Planning Conference we attended last month. Finally, we have held discussions with representatives of both Pimco and TCW (the two intermediate term taxable funds that we own) during the last two weeks to better understand how each firm and their fund managers are trying to mitigate interest rate risk. These managers have the ability to actively manage the durations and maturities of their portfolios as conditions in the bond market change and we are maintaining contact with them to make sure we are consistently aware of what actions they are taking in their funds.

The obvious question is why not move all of our funds to short-term funds? First of all, we should note that we do not own any long-term funds. We own short term (average maturity less than three years) and intermediate-term funds (average maturity less than 6 to 7 years). Short and intermediate term bonds have smaller reactions to interest rate changes than long-term bonds. Secondly, the answer to the question lies in seeking to manage total return rather than simply reacting to expected changes in interest rates. Consider what happens to a bond portfolio when interest rates go up. If the bond portfolio's average interest yield is, say, 4% per year, if prices decline by less than 4%, then the fund would have a low return year but not a loss year. We must be willing to live through low return or even loss years if we are to focus on long-term total return. We own intermediate term bonds because their interest yields are higher than shorter term bonds (at the extreme, money market fund yields right now are barely above zero). The reinvested interest yield in our intermediate bond funds contributes to total return. And, in a rising rate environment, as bonds in the existing portfolio mature, the proceeds can be reinvested in higher-yield bonds that become available because interest rates are rising. In fact, one of the presentations we attended at the AICPA Conference did the math to show that, because we currently are in such a low interest rate environment, the positive impact of reinvesting and compounding in a rising rate environment may result in higher returns for long-term investors than would be obtained in a stable or falling rate environment. Total returns would be lower in the first one to three years after the interest rate increase, but reinvested coupon interest and the opportunity to buy higher yielding bonds after the interest rate increase would drive longer term total returns to be higher than what would have been earned in a stable or falling rate environment.

A change that we began to implement in the second half of 2010 was to add a global bond fund to our asset allocation guidelines to act as a supplement to our two existing international bond funds. The fund we added, the Templeton Global Bond Fund, is rated five stars by Morningstar and is one of their "analysts pick" funds (fund favorites identified by Morningstar's fund

analysts). Templeton Global generally avoids what they consider to be overleveraged developed economies, including Japan and most of the euro zone. They invest primarily in bonds and currencies in countries they consider to have low debt levels and good growth prospects, such as Norway and Poland in Europe and South Korea and Australia in Asia.

As we all learned during 2008 and 2009, market volatility has increased dramatically over the last several years and we have and will continue to manage portfolios around this increased volatility. In virtually all but the smallest portfolios that we manage, we have made structured notes and long-short funds an integral part of each portfolio. We have been successfully using structured notes for the past three years to reduce downside equity risk and, at the same time, to offer enhanced positive returns in moderately increasing markets. We will continue to enhance our use of these investments by “laddering” the notes in client portfolios and by adding the use of structured investments in the real estate (REIT) asset class. We have also made long-short funds a permanent part of our portfolios. Most long-short funds purchase those stocks that the fund manager believes are undervalued “long” and sells “short” those stocks that the manager believes are overvalued. The aim is to provide equity like returns with significantly less volatility. In addition, long-short funds can take advantage of volatile market conditions: as the market rises and falls, so do opportunities to go long and short.

As we noted above, all indications are that the global recession ended 18 months ago and the recovery is now well underway. However, as we are all aware from reading the headlines, storm clouds remain over much of the global economy preventing “green shoots” from taking root. Unemployment is a lingering problem in the U.S., Europe continues to have sovereign debt issues and Japan continues to battle deflation. These dismal predicaments in industrialized nations stand in sharp contrast to what is unfolding in the world’s emerging markets. China’s concern is growing too quickly and Malaysia is attempting to curb inflation as GDP has been growing at double-digit rates. Last summer the International Monetary Fund released an assessment of the global economy drawing some interesting distinctions between developed and emerging economies:

- The average gross debt-to-GDP ratio for developed economies was projected to rise from 91% at the end of 2009 to 110% in 2015
- Among the G-7 nations, the debt-to-GDP ratio is rising to levels exceeding those that existed following World War II
- In emerging economies, debt-to-GDP ratios are projected to resume a gradual decline in 2011 thanks to sustained growth and low interest rates

- In emerging G-20 economies, public debt in 2015 is projected to be almost 5 percentage points of GDP lower than before the crisis

As a result of this assessment, and as noted previously, we added the Templeton Global Bond fund which is heavily invested in emerging market debt and we are adding an explicit allocation to emerging market equities in our international stock allocations.

We are also implementing changes to our “alternative investments” category this year. For the past year we have been tracking the performance of the Cohen & Steers Global REIT fund and comparing that to our separate positions in U.S. REIT funds and international REIT funds. After the meeting that we had in October 2010 with Marty Cohen, Co-Chairman of the Cohen & Steers organization, we decided to combine our domestic and international REIT positions into the Cohen & Steers Global REIT fund. This move to what in the investment business is called a “global mandate” effectively relies on the worldwide analysts and portfolio managers at Cohen and Steers to manage the country weighting of the portfolio rather than manage the country weights by setting a predetermined mix of international and U.S. REIT funds. Over the long run, we expect the global mandate to enhance performance of our REIT investment.

Many economists believe that as the current recovery builds momentum, we will experience an increase in commodity prices and we have already seen this price pressure in the prices of oil, gold, and other precious metals. We are continuing our commodity exposure in the alternative investment area to provide a hedge against inflation. Rather than invest in only one commodity class, we have been investing in actively managed mutual funds that have exposure to a broad based index of many commodities, including energy, precious metals, and agricultural commodities.

One of the disadvantages of investing in exchange-traded commodity index funds is what is referred to as “contango”, a market condition where futures contracts are priced higher than current cash contracts. During the October Investment Summit that we organized in New York, we had the opportunity to meet with both an active commodity fund manager and Asjlyn Loder, a Bloomberg Business Week reporter who had published an article last summer on the pros and cons of commodity investing. Ms. Loder, in explaining the title of her article, “*Amber Waves of Pain: Do Not Buy Commodity ETF,s*” argued that since ETFs have to roll over their futures contracts on a specified date, they often are placed in the position of closing out existing contracts at prices that are lower than the prices of the new futures contracts they are buying. One example in the Bloomberg article cited the case of the U.S. Oil Fund, an oil ETF that declined by 7.4% in the same month that crude oil went up by 7.4%. The active manager (from Credit Suisse Commodity fund) explained that an active manager is not constrained by these pre-defined “rollover” dates and can often avoid this significant problem. This reinforced our

original decision some two years ago to gain exposure to commodities in client accounts through the use of actively managed mutual funds rather than indexed ETFs.

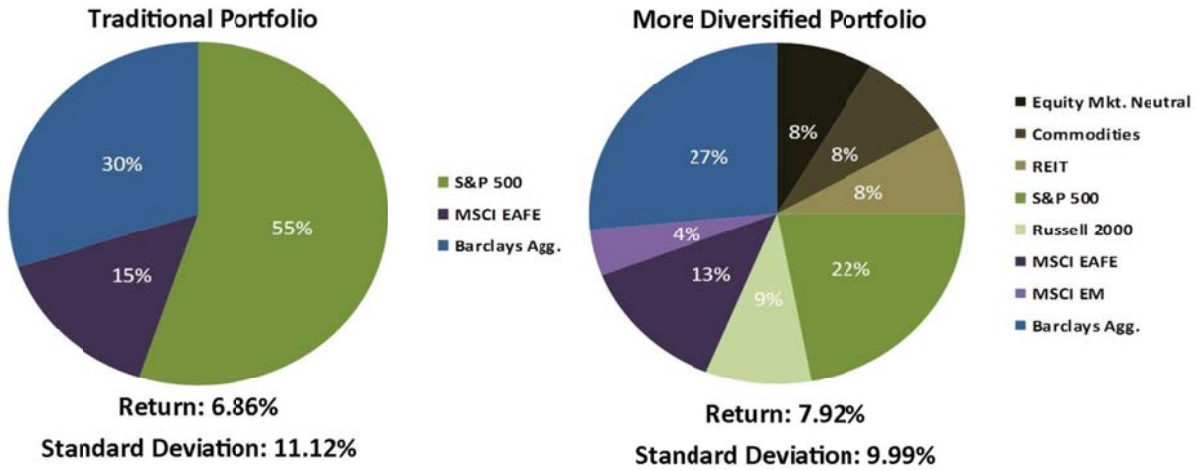
Finally, and again for the purpose of reducing portfolio volatility, we are making a second change in our alternative investments for 2011. We have added a new investment to the alternative asset space – JPMorgan Alerian Master Limited Partnership (MLP) Index Exchange Traded Notes (ETNs). The Alerian ETNs are designed to track the performance of the energy MLP sector. The index components are selected by Alerian Capital Management, an investment advisor that exclusively manages portfolios focused on midstream energy MLPs. The majority of the MLPs in this index currently operate in the energy infrastructure industry, owning assets such as pipelines that transport crude oil, natural gas and other refined petroleum products. MLPs generate fee-based revenues which generally tend not to be directly tied to changes in the commodity prices – in essence, the MLPs are the “toll-road” that the oil companies must use to transport their products. Since the MLPs are paid based on the physical volume of products shipped rather than their dollar value, their revenues tend to be much more stable than they would be if they were linked to commodity prices. A major benefit of investing in MLPs include a relatively low correlation to equity and commodity prices (thus reducing portfolio volatility) and attractive income yields compared to fixed-income investments.

A “new old” or “old new” change is that in order to make certain that portfolios are structured to be as tax efficient as possible, we are continuing our implementation of state of the art technology in portfolio rebalancing software which will allow us to make our rebalancing adjustments to investment portfolios as tax efficient as possible. Although it is virtually impossible to predict the government’s tax policy, making sure that we can be as tax efficient as possible will enhance our portfolio “after-tax” returns. We participated in both the “alpha testing” and “beta testing” of this software and we were the first firm in the country to place an order for this new technology.

Finally, drawing one last time on last month’s AICPA Conference, we were impressed with the presentation by David Kelly, the chief market strategist at J.P. Morgan. We are in agreement with the overall thrust of Dr. Kelly’s economic outlook that there is a real opportunity for GDP growth of as high as 4 percent in 2011 and that we should all position our portfolios in anticipation of rising interest rates this year. We were particularly struck by one of Dr. Kelly’s charts showing the impact of broader diversification on investment return and risk.



## Maximizing the Power of Diversification, 1994 - 2010



Source: J.F. Morgan Asset Management

The data show returns and standard deviation of returns since 1994 for two contrasting portfolios: one invested only in U.S. stocks (S&P 500), international stocks (EAFE), and U.S. bonds (Barclays Aggregate) and the second widely diversified across these three categories plus REITs, equity market neutral funds (e.g., long-short funds), mid and small cap stocks, commodities, and emerging markets. Since we diversify our portfolios across all of these categories we were obviously interested in his results. The data show that the portfolio with only three asset categories earned an average annual return of 6.9% over this period with a standard deviation of 11.1% (remember standard deviation measures variability of returns; statistically, in any given year, returns are expected to fall within one standard deviation of the average about 68% of the time and within two standard deviations about 95% of the time). For the more broadly diversified portfolio, not only did return go up (to an average of 7.9%) but risk, as measured by standard deviation, went down (to 10.0%). This result is pretty much the definition of a win-win outcome and we were very pleased to find yet more statistical evidence supporting the diversification posture we have been following since we started our practice in 1994.

In conclusion, we see no reasonable alternative to adherence to our underlying investment philosophy that has anchored our investment strategy since we began our practice 17 years ago. As we noted in our last White Paper, we had the rare privilege and pleasure to attend a dinner in January 2009 with Dr. Harry Markowitz, the 1990 Nobel laureate in economics and the father of modern portfolio theory. One of the points we took away from “Dinner with Harry” was that statistically, the market meltdown of 2008 can be expected to occur approximately once in 40 years. He explicitly stated that he does not believe that market timing will help investment performance and that the best response to market turmoil is to hold a broadly diversified portfolio that is anchored in equity investments. In short, it does not make sense to build your

long-term investment strategy on the basis of a scenario that has never occurred before and has a probability of reoccurrence of less than two percent. We continue to focus on the investment approach that we have consistently recommended for ourselves and all of our clients:

- Broad diversification across asset classes and within asset classes
- Maintenance of adequate liquidity to meet expected cash flow needs
- Adherence to an agreed-upon asset allocation and invest policy
- Avoidance of market timing

For 2011 and beyond, although we will be adding some new tactics to help implement our investment strategy, our strategy will continue to be anchored in these foregoing principles. We believe that long-term success at investing requires discipline and a consistent commitment to an underlying investment philosophy. We will continue to exercise that discipline and commitment on your behalf and look forward with confidence to the future growth of the U.S. and world economies.