DSA Communiqué

December 2013

With the turn of the year, we will celebrate the beginning of our 20th year 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. DSA now provides that same level of expertise to over 200 clients that we consider our friends, across the U.S., Europe, the Middle East and Asia. We are 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 welcome your questions, comments and feedback; please feel free to contact us at any time.

Looking back at 2013

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. Do you remember the "fiscal cliff" that haunted us as we were about to enter 2013? We've come a long way since way back then. In 2013 the stock market was on a tear, the labor market went nowhere and Wall Street and Main Street had come to terms with the "New Normal."

DSA made three major portfolio changes during 2013. First, late last winter and in early spring, given widespread concern about rising interest rates, we shortened the duration of our fixed income holdings. (Duration is a measure of the expected price change in a bond given a change in interest rates; the higher the duration, the more the price of a bond will fall if rates rise.) We sold our highest duration bond fund and replaced it with a very low duration fund. At the same time, we also altered our mix of U.S. and international bond funds, moving from approximately 20 percent of our fixed income allocation in international bonds to approximately 25 percent. Thus, for the overall bond allocation, approximately 75 percent of the bond allocation is now invested in U.S. bond funds and 25 percent in international and global bond funds.

The second major change we made was to replace our commodity allocation with a global infrastructure fund. We first added commodities to our portfolios to protect against high inflation which often accompanies economic recoveries. Commodity performance in the current low inflationary environment has been disappointing, so we decided to rotate entirely out of that asset class. The global infrastructure fund that we invested in (DWS RREEF Global Infrastructure Fund) focuses on the "pure play" portion of the infrastructure universe, that is, investing in companies that are involved solely with global infrastructure projects such as owning and managing oil and gas pipelines,

owning and managing communication facilities, or building and/or managing roads, bridges, tunnels and other infrastructure projects.

Finally, our third major tactical change was to invest in a new class of fixed income investments, a fund that invests in global reinsurance companies. Reinsurers sell insurance to insurers around the world. Reinsurers hold more remote risks than insurers and typically hold a far more diversified set of risks across geographies and perils. For several years institutional investors have gained access to the reinsurance risk premium through hedge fund investments in catastrophe bonds ("cat bonds") and quota share notes. Our investment in Stone Ridge Reinsurance Risk Premium fund offers our clients the same access to these investments as institutional investors. The risks and returns of cat bonds are linked to clearly defined natural catastrophes such as earthquakes and hurricanes. Historically, cat bonds have provided attractive returns, low volatility and low correlation with other asset classes, minimal credit risk and minimal duration risk. Quota share notes allow investors to participate side-by-side with a brand-name reinsurer, taking a portion of the premiums and bearing a portion of the expenses and losses.

Looking forward to 2014

Looking forward to next year, the consensus U.S. forecast for GDP growth is in the 2.5 to 3.0 percent range for 2014. The current recovery period dates back to June 2009, so the current economic expansion is now four and one-half years old. In expansion years, four and one-half years is just entering middle age: the last three expansion periods (Dec. 1982 to July 1990, March 1991 to March 2001 and Nov. 2001 to Dec. 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 so 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 emphasis is on stimulating growth and avoiding disinflation so the current expansion should continue for the next few years.

The market cheered the Fed announcement on December 18 that they will begin tapering by scaling back monthly bond purchases to $75 billion from $85 billion – both the Dow Jones and S&P indexes closed at new highs at the end of the day. It appears that Mr. Market is amenable to the Fed message: tapering is not tightening and the economy is strong enough to begin phasing out quantitative easing. The Fed has also said that short term rates will be kept at or near zero for until at least 2015.

Just a few days ago the third quarter GDP figures were revised upward from 3.6 percent to a whopping 4.1 percent. This revision was due to a big jump in consumer spending. This rise in consumer consumption adds credibility to the growing consensus that we

are most likely in the middle of a long-term secular bull market and are likely to experience positive stock market returns over the next few years. The bull market for equities began in mid-2009 along with the recovery of the economy so is now about four and one-half years old. No one can accurately predict exactly when the 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 20 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 expect 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 2014 and as we get ready for another 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 ADVISORS, INC.

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