Droms Strauss Wealth Management Communiqué

June 2016

We review three timely topics of interest in this quarter's Communiqué. First, we provide our take on the newly released fiduciary standard for investment management from the Department of Labor that has been prominently featured in the press over the last two months. Secondly, we are encouraged by the recent return of value investing dominating growth investing, validating decades of investment research results on this issue. Finally, we take a look at the general consensus for the economic and investment outlook for the next year or two.

The "New" Fiduciary Standard for Investment Managers

Wall Street is all abuzz this month with the new application of the so-called "fiduciary rule" to stock brokers and other investment professionals who are compensated by commissions. The new fiduciary standard applies to investment advice for retirement accounts, including employer-sponsored retirement accounts and Individual Retirement Accounts (IRAs), and is imposed by the Department of Labor under its authority granted by the Employee Retirement Income Security Act (ERISA) of 1974. The DOL rule requires more retirement investment advisers to put their clients' best interest first by expanding the types of retirement investment advice covered by fiduciary protections. Simply stated, the fiduciary standard holds advisers to the requirement to put their clients' interests first and act in the best interests of their clients rather than the former so-called "suitability standard" (required mainly of commissioned based sales persons) that simply required an adviser to have a "reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer."

This rule will have a big impact on commission based brokers because they now have to be able to demonstrate that their recommendations meet the fiduciary standard rather than the much looser suitability standard. As a simple example, suppose your stock broker is evaluating several similar investment options that have similar objectives but different fee structures. Under the suitability standard the broker is free to select any option that is suitable for your account even if it is highest commission option. Under a fiduciary standard, the broker must be able to verify that the highest commission option is in your best interest, not just suitable for your account.

The "new" fiduciary standard doesn't change anything for us at DSWM because as Registered Investment Advisors we always have been held to the fiduciary standard both by the SEC and the standards imposed by the governing bodies for the CPA, CFA and CFP certifications that various professionals at DSWM have earned. This fiduciary standard really embodies the way we prefer to do business: we put our clients first and

always act in the best interests of our clients. In 1992, two years before DSWM started in business, Bill Droms had published a paper in the Financial Analysts Journal (published by the Institute for Chartered Financial Analysts) entitled "Fiduciary Responsibilities of Investment Managers and Trustees" and partially because of that paper has appeared as an expert witness in court cases alleging breach of fiduciary responsibility. So, we have been well acquainted with our fiduciary responsibilities since the first day that Droms Strauss began operations over 20 years ago.

Note also that the fiduciary standard as administered under ERISA applies only to retirement accounts. The suitability standard still applies to non-retirement accounts so even with the new standard, stock brokers need only recommend a "suitable" investment for their non-ERISA accounts. All of our actions for all of your accounts at Droms Strauss now and always have been subject to the fiduciary standard imposed on RIAs. So the "new" standard is not new to us or to your investments.

Value Makes a Comeback

Decades of investment research results have demonstrated that over most long time periods, "value investing" outperforms "growth investing." The value/growth paradigm is shorthand for two different stock market investing philosophies. Value investing generally refers to investing in stocks that are considered to be trading below their "intrinsic value" as determined by standard stock valuation models anchored in the discounted present value of future cash flows or earnings. Value stocks typically trade at below-market price/earnings ratios and usually have above market dividend yields. The concept behind value investing essentially is that value stocks are mispriced by the market and will appreciate over time as the market valuation comes into line with the stock's intrinsic value.

Growth stocks, on the other hand, typically trade at above-market P/E ratios and below market (or no) dividend yields, usually because of the market perception that growth stocks will experience higher than normal growth. This higher growth will in turn propel rapid growth in the stock's intrinsic value and provide higher than market-average returns.

While it generally is true that value stocks outperform growth stocks, nothing works all the time, and the last few years have been difficult for value investors, with growth stocks generally outperforming value stocks. In our practice, we have always had a value bias in our stock market investing, but tempered with the knowledge that there can be relatively long periods when growth outperforms value. All of the portfolios that we manage have a moderate "value tilt" to take advantage of the value effect. We are happy to report that the value tilt is once again paying off – for the year-to-date period (through 5/31/16) we have experienced a dramatic reversal of the dominance of growth over value: since the first of the year, the S&P 500 Index returned 3.57%, with the S&P 500 Value Index returning 5.21% and the S&P 500 Growth Index returning 1.86%.

The U.S. large cap index funds that we own in all of our portfolios are a good illustration

of our value tilt in that sector. While the iShares S&P 500 ETF (ticker IVV) tracked the S&P 500 Index at 3.54% return, the Schwab Fundamental Index Fund (SFLNX), which has a value tilt, outperformed IVV with a 5.77% return. SFLNX is a large cap U.S. fund that uses stocks in the FTSE (Financial Times London Stock Exchange) RAFI U.S. 1000 Index as its investment universe and weights the allocation to each stock in the index according to a weighted average of four fundamental factors: book value, income, sales and dividends. The fact that SFLNX holds twice as many stocks as the S&P 500 also is responsible for some of the performance differential. Regardless of the sources of outperformance, it is encouraging to see value stocks making a comeback in the volatile markets we have experienced over the last few years.

Economic Outlook

After yet another moribund first quarter, it looks like - - despite predictions of doom and gloom from both parties this presidential season - - the economy is picking up steam in the second quarter. Very sluggish first-quarter growth followed by a second quarter rebound has been fairly common over the course of the long expansion that began in 2009. In mid-May, the Federal Reserve Bank of Atlanta published its estimate of second quarter growth in real (inflation-adjusted) GDP at 2.5%. The Fed's preferred measures of inflation, the inflation index for personal consumption expenditures which normally make up about two-thirds of Gross Domestic Product, was up 1.6% for the past year, still below the Fed's target of 2.9% but picking up nonetheless. The continued housing recovery has also contributed to economic growth over the past couple of years.

The second quarter 2016 "Global Investment Outlook" published by the BlackRock Investment Institute, a subsidiary of the world's largest (over $4 trillion) investment manager, notes that "U.S. corporate executives show little concern about recession risk" and that "we are in the midst of a long, shallow economic recovery - - and we do not see a recession in the near-term horizon." One of the BlackRock outlook's major themes is that we should expect to see relatively low returns ahead. This certainly is in line with forecasts we have seen in many places over the last few years, particularly in the Pimco (another trillion dollar investment manager) "new normal" scenario. Pimco's 2016 Asset Allocation Outlook, entitled "Altitude Adjustment," notes that Pimco believes that "investors need to 'altitude adjust' their return expectations lower and volatility assumptions higher."

As for their economic outlook, Pimco is in general agreement with the BlackRock outlook which they express as an outlook for "sideways growth with an uptick in inflation." To put a number on it, their outlook for the global economy is an overall growth rate in the 2.25% to 2.75% and an expectation that the U.S. economy will expand at a rate between 2.0% and 2.5%, "in line with its stable post crisis recovery." These views from the Fed, BlackRock and Pimco are pretty well in line with what we reasonably could call the consensus economic outlook from most major U.S. investment firms. Our takeaway from

what we see as a reasonable forecast of the most likely future economic outcome, is to stay invested in both U.S. and international equities and maintain a commitment to a consistent asset allocation plan that aligns with your long-term financial objectives.

Thanks for sharing

We would like to thank our clients and friends that have shared our Communique' with their friends and family members and ask those of you that haven't to think about forwarding the Communique' to your friends, family or a business colleague you think could benefit from working with us.

We would welcome the opportunity to discuss the services we offer and our investment philosophy with others as we continue to grow our business.

Sincerely,

Droms Strauss Wealth Management

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