Droms Strauss Wealth Management Communiqué

June 2015

Some exciting news for Droms Strauss Wealth Management

On Wednesday, June 3, CNBC published its list of the Top 100 Fee-Only Wealth Management Firms in the United States for 2015. We were very pleased to learn that Droms Strauss Wealth Management was listed at number 10 on the CNBC list. The link below contains the complete list and the methodology used by CNBC to compile the list.

CNBC Top 100 Wealth Management Firms

The criteria for the CNBC ratings are detailed at the end of the CNBC list. These ratings are not indicative of any single client's experience with Droms Strauss Wealth Management (DSWM) and not indicative of either past or future performance of DSWM accounts under management. The survey was conducted by the CNBC Digital Editorial Team and Meridian-IQ, an unaffiliated financial services research and marketing firm that maintains databases on registered investment advisors and other financial services organizations. DSWM had no contact with either CNBC or Meridian-IQ related to this rating and DSWM is not aware of the total number of wealth management firms assessed. DSWM did not fill out any surveys, pay any fees or in any way participate in the ratings project.

Economic Outlook

The rather abrupt slowdown in the economy last quarter has caused investors to reconsider their expectations for the growth trajectory of the U.S. economy for 2015. And, in fact, the slowdown was actually worse than the original estimates of 0.2% GDP growth in the first quarter of 2015. The Commerce Department revised estimate of Q1 growth showed an actual decline in GDP with the revised growth figure at –0.7%. At least some of the decline can be traced to the economic impact of the harsh winter weather, the dockworkers' strike and the strong dollar making U.S exports more expensive, all taking a toll on the first quarter economy.

In a recent Wall Street journal article (5/27/15), the author, Greg Ip raised the provocative question: "Did the U.S. recovery just die without warning?" We are persuaded by his conclusion that "the answer is very likely no, not with all the contrary evidence out there, from buoyant stock prices to strong hiring." Mr. Ip points out that inflation is low, oil prices are down, the unemployment rate continues to decline, yet there is plenty of spare labor capacity when involuntary part-time workers are factored in.

One also has to consider the activities of the Federal Reserve. Because the economy has continued on a slow growth path and inflation is low, the Fed has been reluctant to raise interest rates. It seems unlikely (but not impossible) that the Fed will increase rates at the June meeting but it is also unlikely that we won't see rates rise sometime before the end of the year, most seem to think this will occur in September. Independent of the timing of rate increases, it is most likely that rates will be increased slowly in small increments because of the low growth and low inflation scenario.

Finally, we should note that this is the third time since the current recovery began in 2009 that the first quarter of the year experienced a decline in GDP (the other two years are 2010 and 2014) and the recovery has not been derailed. The general consensus of economists is that the economy will snap back next quarter, just as it did in 2011 and 2014. On balance, we expect to see the continued slow growth (in the two percent range) of the overall economy to persist for the next few years.

Active/passive investing trends

Last December, we commented on the continued movement among retail investors to a higher level of passive fund investing and a lower level of active fund investing. These funds flows followed the general trend in 2014 of an off year for active management, particularly among U.S. funds where approximately 75% of active managers have trailed their benchmarks. For those keeping score, points went to the passive side of the active/passive debate, at least for 2014.

The trend has reversed so far in 2015. Through the end of April, nearly half of actively managed funds outperformed their benchmarks, more than double the percentage of funds that outperformed in 2014. Active equity managers largely attribute this change to the more volatile market environment this year, an environment that allows active equity managers to outshine passive investments that simply mimic their underlying benchmark. Active managers note that a low volatility environment compresses the performance spread between the best performing stocks and the worst performing stocks, making it much more difficult for active managers to add value by undertaking any kind of analysis designed to identify and invest in the stocks that will outperform the market.

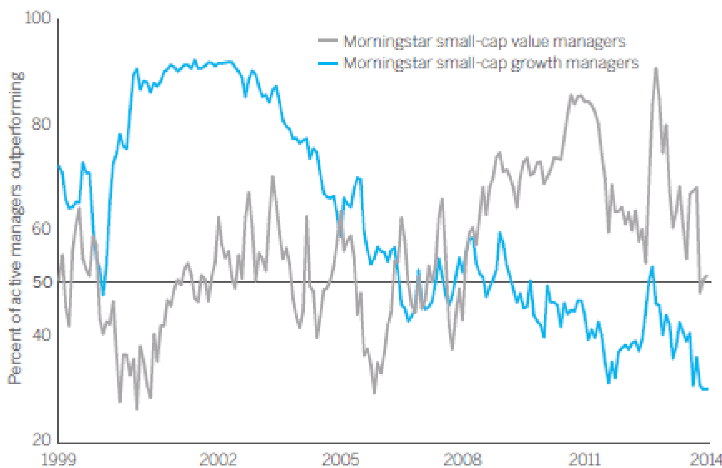
It is also true that the spread between active and passive investing tends to move in cycles. The graph below, from RS Investments, shows the percentage of active

small cap value and small cap growth managers that outperformed their benchmarks (Russell 2000 Value and Russell 2000 Growth, respectively) over the preceding five years over the 1999 to 2014 period. Over 50 percent of active small cap growth funds in all but one rolling five-year period from 1999 to 2007 outperformed the Russell 2000 Growth Index. Similarly, active small cap value funds outperformed their benchmark from 2008 to 2014. This cyclicality is one reason that we use a mix of active and passive management for our client portfolios – simply stated, nothing works all of the time.

PASSIVE DOESN'T ALWAYS WIN

Percent of active managers outperforming Russell category indexes

January 1999–December 2014



History has shown that the performance of active versus passive management is highly cyclical, even in the least efficient segments of the market. This underscores the importance of choosing the right manager.

The chart shows the number of active managers within the Morningstar Small Value and Small Growth categories outperforming the Russell 2000® Value[1] and Russell 2000® Growth[2] indexes over rolling 5-years periods. Above 50% indicates the majority of active managers have outperformed and below 50% indicates the majority of active managers have underperformed. There are 452 funds in the Morningstar small cap value category and 760 funds in Morningstar small cap growth category, January 1999–December 2014.

Sources: Morningstar, Russell, 12/31/2014.

Indexes are unmanaged and not available for direct investment and do not represent the performance of a single fund or any of the RS Investments Funds.

Performance quoted represents past performance and does not guarantee future results.

Note that the above graph refers to small cap stocks. Small caps are a less efficient market sector than large caps and offer more opportunity for active management to add value than do large cap stocks. In fact, in our opinion, outperforming the large cap U.S. equity market offers so low a probability of outperforming the large cap market benchmark that we do not invest in large cap U.S. active funds, other than specialty large cap funds such as long/short funds or high dividend funds. In less efficient markets, such as emerging market equities, real estate and infrastructure, we invest solely in actively managed funds.

As we commented in December, the active/passive debate will most likely never 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. We follow a "core/noncore" approach where we use passive management for the core investment in efficient markets such as the large cap U.S. equity market and supplement the core with specialty active funds. In less efficient market segments, we use little or no passive management where the probability of outperformance trends in our favor.

The 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 compromise is a reasonable way to take advantage of the best features of both worlds.

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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