Droms Strauss Wealth Management Communiqué

December 2015

More rankings news for Droms Strauss Wealth Management

In addition to the exciting news about our CNBC rankings earlier this year, Droms Strauss Wealth Management also was listed this year in Financial Advisor magazine's rankings of the 500 largest wealth management firms in the United States. Out of a total of more than 10,000 registered investment advisor firms in the U.S., Droms Strauss was ranked number 364 by size of assets under management in the annual Financial Advisor rankings. This ranking puts Droms Strauss within the top 4% of firms in the U.S. by dollar amount of assets managed.

The Financial Advisor ranking follows on the CNBC 2015 ranking of the Top 100 Fee-Only Wealth Management Firms in the United States, with Droms Strauss Wealth Management listed at number 10 on the 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.

Investment Returns Outlook

Some really interesting and interrelated articles published by Morningstar caught our eye over the last few weeks. The most recent article needs to be discussed first, just to keep the second article in perspective.

The first article was an interview with Jack Bogle, the founder of the Vanguard mutual fund family and the keynote speaker at this year's "Bogleheads" Conference. One big topic covered every year at the conference is Mr. Bogle's forecast of expected returns for various investment asset classes. Bogle breaks down his expected equity returns for the U.S. market into two components: the "investment return" and what he calls the "speculative return." He measures the investment return on equities as the average market dividend yield plus the average earnings growth, currently running at about 2% and 6%, respectively, for a total investment return of approximately 8%.

Bogle then adjusts investment return by the expected speculative return, which he measures as the expectation of whether stock price/earnings ratios will increase (thus increasing stock prices and increasing total return) or decrease (thus decreasing total return). Bogle notes that P/E ratios, however measured, are at the high end or even above the historical range of P/E ratios, and thus more likely to decrease rather than increase. He estimates the impact of declining P/E ratios to be a drag of about 3% per year on future stocks returns, bringing the expected total return on stocks to about 5% per year. Bogle qualifies this forecast further by stating that he does not think earnings growth will actually reach 6%, so he reduces earnings growth by a point, bringing estimated total return to 2% for dividends plus 5% for growth minus 3% for declining P/E ratios or a net of 4% per year total return. As for bonds, Mr. Bogle opines that based on the 2.2% current yield to maturity of 10-year Treasuries, if we mix in some higher yielding (and riskier) corporate bonds, we can get to a 3% return on bonds to go along with the 4% return on stocks. This is a pretty dreary outlook and actually a good bit lower than most other prognosticators, but it is a useful lower limit that can be used to test your portfolio and see if you can still meet your objectives with the (much) lower than long-term average returns – in other words, how will this impact your ability to reach your goals if in fact we have these lower returns over the next five years or perhaps even longer.

Implications for Portfolio Management

Bogle also has been quoted elsewhere recently (in the Journal of Portfolio Management) as predicting a 6% return for stocks and 3% return for bonds. A follow up interview with Russ Kinnel, Morningstar's director of fund research, uses the (lower) range of 4% to 6% for expected future stock returns and 3% for bonds in a discussion of the implications of Bogle's forecasts for managing investor portfolios. Kinnel makes the important point that we should not take Bogle's predictions literally but to use them as a guide to thinking about how we should plan for our future growth of capital and income needs. In particular, Kinnel suggests that we plan our future retirement spending so that if returns do turn out to be 4% rather than 6% or 7%, that we make sure our plans are not derailed by a lower than expected return on our investments.

In thinking more broadly on the implications for return expectations on asset allocation planning, we were struck by an issue that surfaced during our recent participation in an asset allocation discussion with a multi-billion dollar investment fund and the fund's outside investment consultants. After discussing the asset allocation recommendations resulting from a set of fairly high return assumptions (starting with an assumed 7.5% return for U.S. equities over the next ten years), the question was raised as to what the impact of working with lowered return expectations would be. The consulting firm had anticipated this question and had already prepared a second set of calculations predicated on a 4% return on U.S. stocks. In hindsight, the results of the lowered return expectations model should have been "intuitively obvious:" returns for all asset allocation models were lower across the board, but the optimal combination of assets in each asset allocation model did not change. As long as we assume that the interrelationships among asset classes will not changes (e.g., stocks will have higher returns that bonds, bonds will

have higher returns that money market instruments, etc.) the "scale" will slip up and down (i.e., the return on an optimal asset mix may slip from 6% to 4%), but the optimal asset mix will not change.

The independence of asset allocation from return expectations is a really important point: given that no one can predict future returns with accuracy, it is important to know that the best asset allocation model is the one that fits your individual financial situation and risk tolerance. Whether or not we can know what returns the future will bring is not a relevant decision variable in designing the distribution of investment assets that best fits your individual situation. The choice really comes down to: "do I invest or not invest?" Once the decision to invest is made, the best distribution of assets for you to invest in is independent of anyone's forecast of future returns. Obviously, actual returns earned in the future will be the driving variables controlling growth of wealth or income derived from that wealth, but the best combination of assets for your situation will be the same regardless of the level of future returns.

As a final note, we have to recognize reality - - various market prognosticators have been talking about the "new normal" of lower security returns since Pimco first coined the phase in 2010. Over the past five years, the new normal school of thought could not have been much farther off - - the actual return on the S&P 500 for the five years ended November 30, 2015 was 14.4% per year. That's about three times the forecast of the new normal school. Bond returns have been much closer to expectations at 3.0% over the last five years roughly in line with returns predicted by new normal. So, once again, we have to acknowledge that no one can accurately predict the future returns on the market, but we can build our plans around the most likely scenario and be prepared to adjust these plans as reality unfolds.

To us, the big lesson from all of these investment planning issues is the importance of keeping our future plans up to date and revising these plans as the future unfolds. By assessing what has actually transpired over the last two or three years compared to what we based our plans on and revising our future plans based on updated assumptions, we can make sure that we are not blindsided by some major "black swan" event and have a contingency plan if such an event does occur. If you have not recently had us update your long-term plan or if you would like to review your personal asset allocation and investment results, please contact any one of us at any time to arrange a meeting to review your situation.

What's happening at Droms Strauss?

The most exciting "new" news is that Anthony and Silke Gennaoui delivered their second child on November 28. Their second son, Mason Joseph Gennaoui, came into this world at 10:18 AM, weighing in at 8 pounds, 12 ounces. Mom, Dad, son Michael and Michael's new brother, are all healthy, happy and looking great.

On a professional note, November also was an important month for the Gennaoui family as Anthony passed all seven sections of the examination qualifying him for the Certified Financial Planner (CFP®) designation. Congratulations to Anthony - - you can now use your former study time to stay up with the baby.

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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