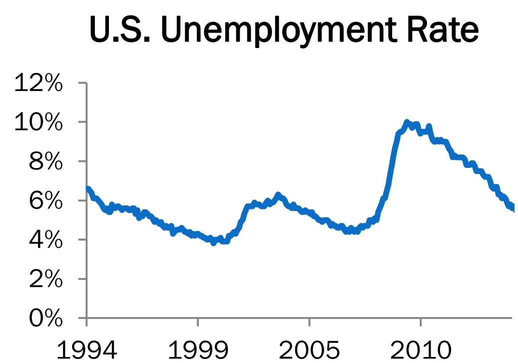
The Economy and Markets:

The U.S. stock market continues to exhibit a relatively high level of risk. As of the close of trading on March 31, the S&P 500 was at a level of 2,067.89, up about 0.4% from its 2,058.90 level at the time of our last newsletter. The Shiller "cyclically adjusted price ratio", the CAPE indicator we've discussed in the past, is at about 27.17, down very slightly from our last report, and well above it's long-run mean of 16.59 – indicating a likelihood of long-term market underperformance. The S&P 500 market volatility index (or VIX) is about 15.29, a bit lower than on January 1st. Both the VIX and the Shiller CAPE indicator provide indications that the market has a very similar risk profile compared to three months ago.

Markets at a Glance (March 31, 2015)	
S&P 500	2,067.89
Dow Jones	17,776.12
10 yr. U.S. Treasury	1.92%
3mo U.S. Treasury	0.02%
GDP Growth (last quarter)	2.2%
Unemployment Rate	5.5%

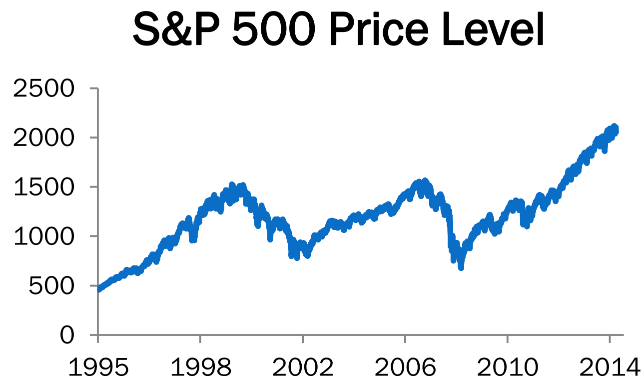


As of March 31, the 10-year U.S. Treasury yield is 1.92%. This is a very low level, and even lower than three months ago. This low level is largely the result of Fed behavior, in pursuit of its dual mandate to maintain a stable price level (the Fed targets an inflation level of around 2%), and to facilitate maximum employment. When the Fed lowers rates, it has the effect of increasing the availability of credit in the economy. This tends to increase economic activity, which helps the labor market, at the eventual cost of higher inflation. This tension gives rise to the perpetual balancing act of the Fed's policy choices.

According to Fed press releases, labor market conditions continue to improve. In February, the unemployment rate fell to 5.5%, the lowest rate in about 7 years. This easing of the underutilization of labor has positive ramifications for the efficiency of the economy. One crucial consideration for the Fed is the level at which the unemployment rate gets low enough to put upward pressure on the inflation rate. Because the Fed has impenetrable acronyms for everything, this level of employment is called NAIRU (Non-Accelerating Inflation Rate of Unemployment). When unemployment rate falls below this level, the Fed will typically begin to raise interest rates. The level of NAIRU is debatable, but most estimates tend to be around 5%.[1] You can see in our employment graph above that the unemployment rate seems to drift back to roughly this level following macroeconomic shocks.

[1] For example Atlanta Federal Reserve Bank President Dennis Lockhart stated on March 26 "I think the natural rate of unemployment is probably around 5 percent and it may be lower than that." Other prominent economists believe it may be a bit higher. For example, Martin Feldstein, Harvard Professor and for Chairman of the Council of Economic Advisors under President Reagan, argues in the Wall Street Journal on March 31 that the current unemployment level is low enough to spur inflation.

The economy appears to be functioning well, but there exist potentially significant risks. Export growth has weakened, and the recovery in the housing market remains slow. The fragile state of the global economy relative to the U.S. economy makes the former risk particularly important to monitor. However, the improving labor market has strengthened to the point that the Fed has begun to discuss (circumspectly, it is the Fed after all) the contingencies under which it may begin to raise rates. However, projected inflation rates are currently well under the Fed's desired rates of roughly 2%. Currently, market-implied expectations of inflation for the next five years are about 1.6% per year. As long as inflation expectations remain this low, there is little reason for the Fed to raise rates and dampen economic activity. One reason for such low inflation expectations is low energy prices. The Fed believes that this effect is transitory, and inflation expectations will gradually increase to their target level over the coming months. If this scenario plays out, a reasonable expectation is that the Fed will begin increasing rates some time in the latter part of this year. Inflation expectations are up modestly since our last newsletter, so this is certainly a plausible scenario.



So while the real economy continues to perform reasonably well, significant risks from the global economy remain. A continued expected recovery appears to be already reflected in the relatively high prices in the stock market. If something happens to change that expectation negatively, that change would likely be the driver of stock price declines. The high CAPE ratio (which looks at the prices of stocks compared to the long-run earnings of publicly-listed firms) and the modestly high volatility of the market imply that stock prices may have limited capacity to absorb negative market information.

Quarterly Special Topic: Fiduciary Responsibility

Finance is one of the most heavily regulated industries in the United States. This is natural, as financial practitioners of all stripes have the ability to affect the financial well-being of their clients in potentially very positive or negative ways. There is a strong public interest in maintaining a viable, trustworthy finance sector.

One of the legal mechanisms used to protect individuals in the financial arena is the legal assignment of "fiduciary responsibility" to some professionals.[2] The definition of fiduciary responsibility, and the behavior it requires of those assigned it, is an important notion for anyone

[2] If you wish to fully understand this topic, please have a discussion with a legal expert. This is only meant to be a rough sketch of the environment and how financial practitioners engage with clients. This discussion is for educational purposes. Importantly, this is not legal advice.

that enters the financial arena – which is pretty much everyone, since it directly relates to the quality of advice you can expect from a financial professional. Today, I'd like to discuss the basics of fiduciary responsibility, which financial practitioners have such responsibility, and importantly to whom they have this responsibility. In some cases, the answers may surprise you. The first and most important distinction in the investment arena is in the difference of responsibility of *investment adviser representatives* versus *broker*s. Both groups of professionals are regulated, and must register with either the SEC or individual states (the determination of which they register with is primarily just a matter of the size of the business).

The conduct of investment brokers is primarily regulated under the Securities Exchange Act of 1934. A broker is "any person engaged in the business of effecting transactions in securities for the account of others…" The primary responsibility for an investment broker is getting you to buy and sell securities through the firm that employs them (*dealers* engage in trades on their own account, and while an interesting subject, I am going to focus here on brokers). Since the role of an investment broker is purely sales, they can't possibly fulfill that role for their employers to the best of their ability, and simultaneously meet a legal obligation to act in their client's best interest at all times. It is almost always in a broker's employer's best interest to sell a bit more to the client, but it is only in their client's best interest to own the "best" allocation of securities for the client. The two interests are inherently in conflict.

Accordingly, the legal obligation of a broker is *not* that they must act in their client's best interest. They do have professional obligations, however. Certainly they are not permitted to engage in fraud. Importantly, a broker "must have a reasonable basis to believe" that their recommendations to buy or sell are suitable to the client. Brokers are obliged to undertake reasonable diligence to understand their customer in order to determine this suitability. But these recommendations do not need to meet a standard any higher than simple suitability. For example, a broker is able to recommend a "suitable" investment to a client, even though he or she may be aware of a similar investment with a lower fee. The broker may (and probably does) receive a fee for recommending the higher cost investment. This simple example shows that it is both possible and legal for a broker to have a conflict of interest in making a recommendation to a client, and yet not be required to disclose this conflict of interest or address it in any way.

By contrast, an *investment adviser representative* is bound by law to put their client's interest ahead of their own.[3] This is referred to as a fiduciary responsibility. Investment advisers are primarily regulated under the Investment Advisers Act of 1940.[4] Further, investment advisers are required to disclose any material conflicts of interest they may have with their client. To use our example above, an investment adviser would not be allowed to recommend a particular fund if he or she were aware of a similar fund with a lower fee, unless there was a reason that the high-fee fund

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[3] The "representative" part of the name exists because we are talking about an individual who is representing a firm that is an *investment adviser*. For example, Jason Fink is a registered investment adviser representative, and Madison Financial Research is a registered investment adviser.

[4] The words "fiduciary responsibility" in defining the role of investment advisers don't appear in the Investment Advisers Act of 1940. This role was clarified by the U.S. Supreme Court in the interpretation of the act in *SEC v. Capital Gains Research Bureau*.

was particularly in the best interest of the client. Further, if an investment adviser were to receive a fee for recommending a fund, this fact would need to be disclosed to their client in advance.

The differences in the responsibilities of brokers and advisers are clearly important, and can very well affect the financial well-being of an investor. But, the differences can be hard to uncover, since many financial professionals operate under names that blur the lines about what they do. For example, an individual may be a registered broker, but operate under the title of a "financial advisor." If such an individual is a registered broker, that individual need only follow the suitability rule. They are not a fiduciary. In their 2015 *Regulatory and Examination Priorities Letter* to members, FINRA (the self-regulatory agency that oversees brokerage firms), stated "A central failing FINRA has observed is firms not putting customers' interests first. The harm caused by this may be compounded when it involves vulnerable investors (e.g., senior investors) or a major liquidity or wealth event in an investor's life."[5] Despite the recognition by FINRA that this is a problem in the financial community, it isn't a legal requirement that brokers actually put their client's interests first.

Further confusing the fiduciary issue here is a phenomenon known as dual registration. Many financial advisers are registered as both investment adviser representatives *and* as brokers. Almost 90% of investment adviser representatives are also registered as representatives for broker-dealers. Brokerage firms routinely offer investment advising, and investment advisory firms routinely provide brokerage services. This gives rise to tortured legal situations and legal notifications such as this one from Fidelity Investments:

> *"It is important for you to understand that our brokerage services and investment advisory services are separate and distinct. Fidelity's brokerage products and services are covered under different sets of laws and regulations from our investment advisory products and services, and our obligations and duties to you are different for each. Although your Fidelity Representative may serve as your primary point of contact for many of the services you receive from Fidelity, when you receive multiple services from Fidelity, each service will be governed by the specific agreement, laws, and regulations applicable to that type of service — and therefore may be different from service to service."*[6]

This kind of statement is not at all uncommon. But certainly, this situation makes it, at best, unclear to the investor what standard the individual with whom they are working is acting under.

Fiduciary responsibility has other important ramifications throughout the financial world. For example, variable annuities, which are sold to many individuals as a product to help pay for retirement, are often sold by *insurance agents*. Variable annuities are de facto investment products, but are only allowed to be issued by insurance companies, which must register as such at the state level. Variable annuities have notoriously high fees that are difficult to identify, and they are often sold by individuals who are not legally required to put client interests first. Insurance *agents* (who represent an insurance company) have a fiduciary responsibility, but not to their clients. They are

[5] You can find this letter in its entirety at: http://www.finra.org/Industry/Regulation/Guidance/P122861
[6] From "Guide to Brokerage and Investment Advisory Services at Fidelity Investments" which can be found here: http://personal.fidelity.com/accounts/services/BD-IA-Dscls.pdf

required by law to act in the best interests of the insurer whose products they sell.[7] By contrast, an insurance *broker* has a fiduciary responsibility to the client seeking insurance. Again, the titles used by various professionals can often make it difficult to immediately discern the responsibilities of the financial professional in question. It is therefore crucial to determine the specific level of responsibility of financial professionals that are offering you products or advice.

The regulatory environment designed to protect retail investors in the United States is well developed. However, there are aspects of this environment that are not apparent to retail investors, and some firms inevitably use that ambiguity to their advantage. Understanding who has a legal obligation to protect your interests, and who does not, is an excellent first step toward a successful investment strategy, that has nothing whatsoever to do with market performance.

[7] This implies, among other things, that when an agent assists a policy holder in filing a claim, the agent is required to consider foremost the best interests of the insurance company.

About Us

Madison Financial Research, LLC (MFR) is a registered Investment Adviser.[8] Jason Fink provides all of the investment advising offered by MFR. Dr. Fink has a PhD in Economics from the University of Virginia, and is the Chandler/Universal Eminent Professor of Banking at James Madison University. He has over two decades of industry and academic experience, including previous positions at First Union Capital Markets, Fannie Mae, the University of Virginia and Florida State University.

What is Madison Financial Research?

MFR exists to provide *unbiased* answers to any financial questions its clients might have, and any help that its clients might need. We are comfortable working with a wide range of clients. For example, we are happy to explain the process of constructing an inexpensive and effective portfolio to novice investors, and to walk them through this process. We want to help you become comfortable with and understand your investments - not leave you mystified by them.

In the finance industry, almost all the people an individual can go to for advice have something they are trying to sell. A bank tells you why you need a mortgage. A financial adviser tells you why you should buy an annuity. An insurance agent tells you why their insurance product is ideal for you.

We are designed differently. We have nothing to sell but our time, which we use to convey knowledge to you. Whatever financial questions you might have, we will work to provide a solution.

These questions can be simple –

> "Is a particular mutual fund a good investment?"
> "Can you help me get started in understanding online brokerages?"
> "Is purchasing this particular annuity a good idea?"
> "Is my financial adviser charging me a lot for what he or she is providing?"

They can be complicated –

> "When can I retire, and how can I optimally construct my portfolio?"
> "Can you provide an overall assessment of my portfolio, including insurance, 401 (k), and other major holdings? How can I improve my approach? Should I diversify internationally?

We have the expertise to handle virtually any question, and the patience and teaching experience to provide understandable and actionable answers and guidance to novice investors. And outside of our time, *we have no products to sell* - our advice is unburdened by an alternate agenda.

As an investment adviser, we have a fiduciary responsibility to put our clients first. Investment brokers, insurance agents, mortgage lenders – none of these have such an obligation to you. We do, and we embrace it.

The financial world is complex. We can simplify it.

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[8] Madison Financial Research is registered in the states of Virginia and Florida. Registration does not imply any certain level of skill or training. So, always ask your adviser about their skill and training – it's important.