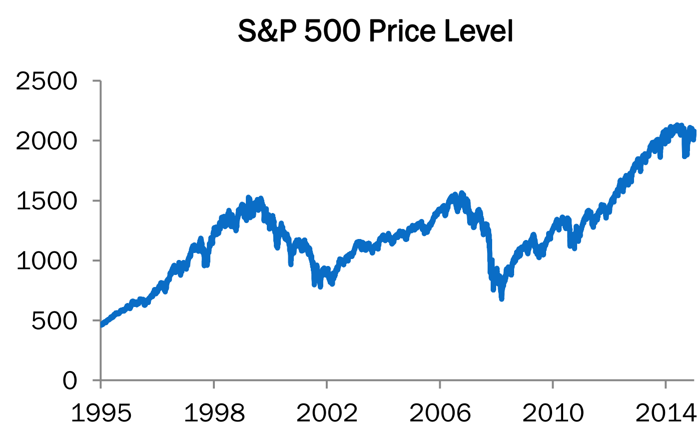
The Economy and Markets:

U.S. markets continue to exhibit a similar profile to our last few newsletters – modestly high risk in the stock markets, coupled with solidity in the real economy. On Dec. 31 the S&P 500 closed the year at a value of 2,043.94, which is 6.45% above the 1,920.03 level at which it closed last quarter, but 0.72% below the 2,058.90 level at which it closed 2014. The increase in stock prices this quarter largely offset the decline near the end of the third quarter, and provided yet another reminder that reacting to short term stock market movements can be financially detrimental. However, this was the first down year for the S&P 500 since 2011.

Markets at a Glance (December 31, 2015)	
S&P 500	2,043.94
Dow Jones	17,425.03
10 yr. U.S. Treasury	2.27%
3mo U.S. Treasury	0.16%
GDP Growth (last quarter)	2.0%
Unemployment Rate	5.0%

The two measures of stock market risk I tend to reference have moved in opposite directions since the last newsletter. This provides some mixed signals, but is interesting in that the two measures capture fundamentally different forms of risk. The VIX index, which is estimated from S&P 500 options trading, closed the year at a level of about 18.2, which is a bit above its historical average. When stock prices are “moving around” a lot, the VIX measure is high. It began the quarter at an elevated level of roughly 24.5. This measure changes rapidly, but provides a reasonable short-term reading of the degree of uncertainty in the market.

By comparison, the Shiller CAPE ratio is a measure that tries to ascertain the “value” of the market (we have explored this measure in detail in our June 2014 newsletter). The higher the CAPE value, the more “expensive” the market. The long-term average level of the CAPE ratio is about 16.6, and it closed this year at a level of 25.89, so it is evident that the market is relatively expensive. This measure changes more gradually than the VIX, and this elevated value tends to imply lower long-run returns going forward. However, this measure can deviate from its historical mean significantly (its all-time high is over 40). It is at best a weak measure of future stock market performance, but is nonetheless one of the best we have.



The state of the real economy is quite interesting at the moment. The domestic economy continues to grow at a steady rate – gross domestic product (GDP) growth in the 3rd quarter was an annualized 2.0%. Economist forecasts indicate that the U.S. economy is expected to grow at a similar rate for the next few years (expectations, of course, are not always met). The U.S.

unemployment rate has fallen further to 5.0%, a low rate in the range of what economists consider to be stable and healthy.

Globally, however, the economy appears to be on much shakier footing. Eurozone GDP continues to increase at an anemic rate close to 0.5% annually. GDP growth in China continues to be reported in the 6-7% range, but that rate has dropped steadily since 2010, and there are many who question the officially reported numbers. Japanese economic growth appears unsteady in the range of 0.5% to 1.0%.

Confidence in the strength of the U.S. economy recently allowed the Federal Reserve to raise the federal funds rate to a target range of 0.25% to 0.5%. Consistent with our discussion in previous newsletters, this modest increase in interest rates is the first in a decade, and suggests that a prolonged era of Federal Reserve support of the economy may be drawing to a close. In a mid-December press release, the Federal Reserve issued the following statement:

Information received since the Federal Open Market Committee met in October suggests that economic activity has been expanding at a moderate pace. Household spending and business fixed investment have been increasing at solid rates in recent months, and the housing sector has improved further; however, net exports have been soft. A range of recent labor market indicators, including ongoing job gains and declining unemployment, shows further improvement and confirms that underutilization of labor resources has diminished appreciably since early this year.

Federal Reserve Chair Janet Yellen stated in her press conference that "There are pressures on some sectors of the economy, particularly manufacturing, and the energy sector…but the underlying health of the U.S. economy I consider to be quite sound." She stated several times that the modest health of the U.S. economy implies that further increases in rates would take place at a gradual rate. Being Fed Chair requires a certain degree of ambiguity of speech, and she made no effort to define "gradual."

Inflation rates in the United States remain low. Market trading implies an expected inflation rate in the United States of about 1.3% over the next five years. This is below the Fed's target of about 2%, so if rates continue to remain at this level, "gradual" is likely to mean very infrequent indeed. Low inflation rates appear to be largely tied to weakness abroad, particularly in the Chinese market. Lower Chinese demand than previously expected for commodities of all types is putting downward pressure on prices (this was discussed at length in our last newsletter, and the same effects continue to appear evident). Energy prices seem to be particularly soft as a result of this effect.

This dichotomy – strength of the domestic economy but economic weakness abroad – is likely to drive the economic narrative for a time. When we see this kind of split, the world economy can be a drag on the U.S. economy and the U.S. economy can improve the world economy. What is unknown is which side will "win" the tug-of-war and have the greater effect on the other.

Quarterly Special Topic: When is Financial Advice Most Useful, and When is it Actually Sought?

According to the Bureau of Labor Statistics, the number of financial advisers is expected to boom in the coming years, increasing more than 30% between 2014 and 2020. By comparison, overall job growth in the U.S. over that time is expected to grow by about 14%.

So why is the financial advisory business growing so fast? It appears to come down to a combination of demographics and the structure of the industry. According to the U.S. Census Bureau, the population of the U.S. aged 65 and older will increase from 46.2 million in 2014 to 56.4 million in 2020 – a greater than 20% increase. The U.S. population aged 45 to 64 is projected to remain almost constant. So an increase in the number of individuals entering retirement age is seen to be driving an increase in the demand for financial advisory services. The population aged 18 to 44 is expected to grow a bit, by 4% over that time period, but they generally haven't accumulated enough wealth by that point in their life for the financial industry to care too much about them yet.

More new retirees implies a greater demand for financial advisers. Why is that? It turns out, securing new clients is a difficult thing to do for a new financial adviser. This should surprise absolutely no one. But the difficulty is more than might commonly be realized. Roughly 90% of financial advisers (I've seen some statistics that go as high as 95%) don't last more than 3 years in the profession. If they don't bring in enough new money to their firm, they get fired. Period. Most financial advisory firms work in the same way: their advisors are tasked with bringing in new money, for which the firm charges clients a percentage of assets: usually 1 to 1.5% every year. The financial advisors get a fraction of that payment, and work on commission. So naturally, financial advisors making their way in the world care first and foremost about securing as many assets under management as quickly as possible, to ensure their survival. As I have mentioned in this space before, in many financial advisory firms, firms salesmanship is THE prized skill among advisers.

So who has the assets that can keep a fledgling financial advisor afloat? The rich, and those nearing retirement. And here we reach our first concern: the financial industry is addressing the needs of many people, or at least the middle and upper-middle class, too late.

The AARP in 2013 found that the average 401(k) balance for individuals age 55 and older, who had been at their job at least 10 years, was about $255,000.[1] By comparison, according to the census bureau, the median *entire net worth* of a household headed by an individual under the age of 35 is about $6,600. These are the kind of statistics that an enterprising would-be financial adviser is well aware of – at least if he or she wanted to remain in the profession. Financial advisers cater to the wealthy of all ages. But they cater to the older part of the population generally, because 1% of their assets every year are simply more valuable than 1% of the assets of a 30 year old.

But who would actually benefit more from time with a financial adviser? Without question, the answer is usually the younger worker. It is obviously important for retirees to get the basics right with their nest egg that they now have accumulated – this should in no way be minimized. But during the ages of 30 to 60, workers should be accumulating their nest egg, and a failure to do so effectively can have devastating consequences later in life. This is even more the case for Generation X and subsequent generations than those that preceded them. Company pensions are a rarity, 401(k)s are the norm. The risk of retirement shortfall lies squarely on the shoulders of that 30 year old, and small adjustments can make enormous differences.

Let's take a concrete example with some very rough numbers. Consider as a base case, a hypothetical, employed 30-year old that has their entire net worth ($6,000) in their 401(k). Assume they have no professional guidance, as is typical. Imagine that under these circumstances they contribute $6,000 per year to their 401(k) until 67 (full retirement age). If they earn 5% on their assets, they will retire at 67 with about $650,000 in assets – enough to allow them to live on about $26,000 per year in retirement.

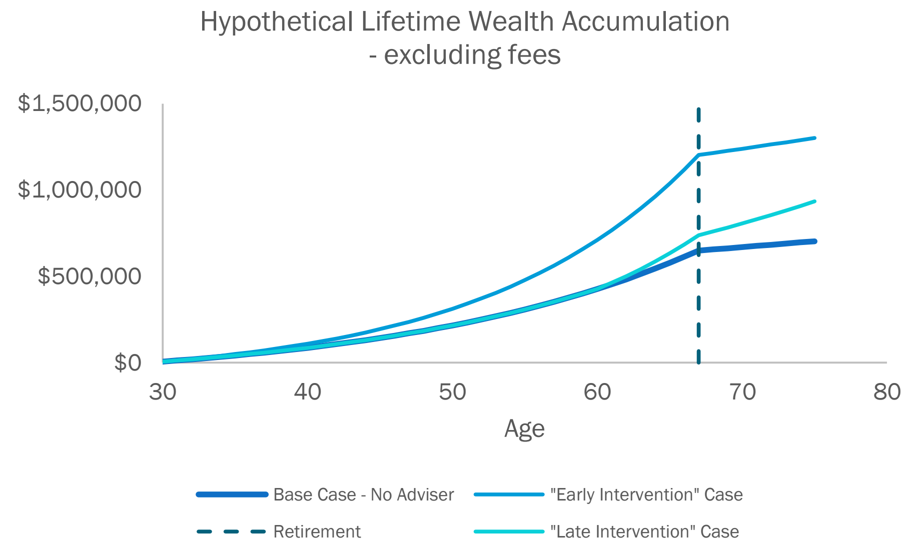
By comparison, consider as an alternative a 30 year old in the same circumstances who consults a financial advisor, and increases their financial effectiveness as a result (for now, ignore the fees for the financial advisor, we'll return to this later – it's an important topic). If the financial adviser they consult convinces them to save just $1,000 more every year, and can manage a 7% return on their assets (by increasing their risk exposure – remember we have a 40 year horizon at this point), they will retire with $1.2 million – enough to generate about $48,000 per year. This small push from an experienced financial planner, because it takes place so early, can almost double their retirement income from assets.

Finally, imagine instead that this 30 year old follows the base case (without consulting professional help) until they are 60, and then consults a financial adviser. After this consultation, let's assume that the client then saves the additional $1,000 and increases their return (again for the moment, ignore the associated fees). By the age of 67, they will have accumulated $737,000, which would allow a retirement income of $29,400. Better than nothing for sure, but clearly they would have been better off if their needs had been catered to earlier!

All three of these scenarios are illustrated in the figure at the top of the next page. The difference that comes from "early intervention" is clear, and it is driven by compounding returns. Better and greater investment early can make a large difference, and professional advice can help spur this.

[1] Now, even this amount is far too low for retirees to maintain their pre-retirement lifestyle, and it is a subject of much concern among academics that study this issue.

Ok, but it turns out fees are also important – critical, really. Financial planners are expensive, but the way in which they can be expensive is subtle. Most planners charge a fixed percentage of assets, which they deduct quarterly from your financial statements. A "typical" fee for such planners is 1-1.5% per year.



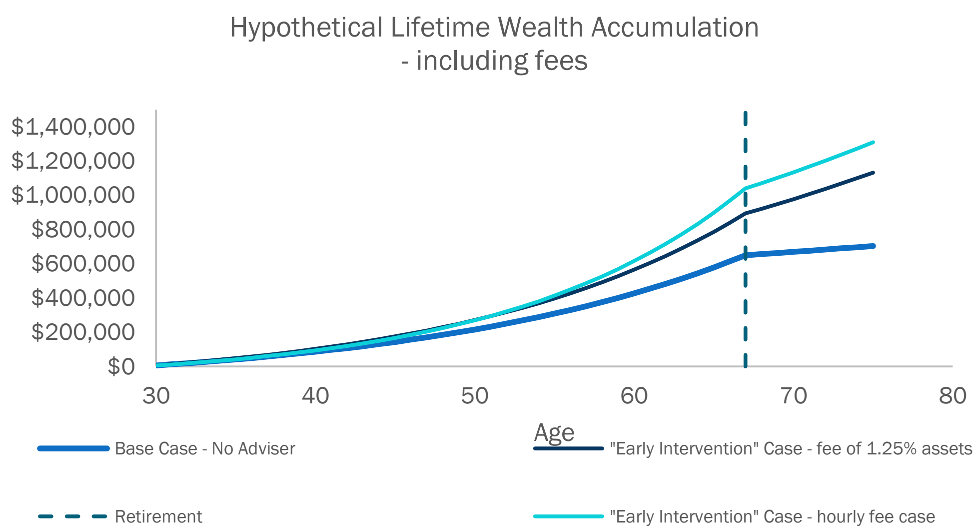
Consider an "early intervention" of the sort that we described above. If the 30 year old went to a financial adviser who charged a 1.25% fee (this is a bit of a contrived example, as most advisers that operate this way wouldn't bother with someone with $6,000 in assets, and the assets are in a 401(k), so they really wouldn't be able to charge a percentage of those assets, so they'd be even less interested in helping our stalwart 30-year old). By the time the investor were retiring at age 67, they'd have accumulated about $893,000, implying a $35,700 income to live on in retirement. This is still better than the base case, and even better than the "late intervention" case that was (hypothetically) free of charge, but the fees have certainly taken a bite.

Most people who seek an adviser early in their career seem to go this route – although they usually along the way end up buying variable annuities at higher fee levels (why do they do this? I'm not sure, but most everyone I speak with seems to have picked a couple of these variable annuities up along the way). But it is not the most efficient way. Most of the work of a financial adviser is early in the relationship with the client. They have to figure out the entire situation - what products the client may already own, what their budget looks like, etc. But the percentage of assets model is set up such that 20 years after the hard work is done, a financial adviser is still earning 1 – 1.5% of the clients assets. It doesn't make sense.

An alternative way for a financial adviser to function is with a set fee. Not too many advisers do this, because it ultimately results in lower fees for the adviser. There are a few ways this could be structured. Many (such as Madison Financial Research) simply charge an hourly fee for their time.

Consider this case for our hypothetical 30 year old. At first, the client pays a relatively hefty up-front fee for financial advice. $300 per hour is a typical fee for a well-qualified financial adviser on an hourly basis. Five hours of work, which is about what is necessary to set up a financial "plan" for a young adult, will run therefore about $1,500. An annual review taking three hours or so will cost about $900. For our 30 year old with $6,000 of net worth, there is some sticker shock associated with this!

But look at the benefit. By not extracting a fixed percentage through time, the accumulation in this scenario is far better than in the "fixed percentage" of assets case. After taking out the fees, by retirement in this case the investor has accumulated about $1.04 million, corresponding to a roughly $41,500 retirement income – about $6,000 a year more than the person who went the route of paying the fixed percentage of their assets every year. These clear differences in the effects of fees can be seen in the figure to the right.



But again, most people seem to go the route of hiring an adviser with a fee that is a fixed percentage of assets, and even then typically not until later in life. Why is this? My best guess is that the hourly fee approach results in a sticker shock that frightens off many individuals. Your typical 30-year old, trying to support a family, is very likely to balk at a $1,500 fee for financial advice that won't really show much of a benefit for 20 years. Further, for those who do seek out financial planning at all, percentage fee financial advisers are far easier to locate (though those that cater to such small accounts tend to have higher fees than those in our example). Finally, the percentage fee appears quietly on a bill with other large numbers, and seems to be less traumatic for people. But the difference over a lifetime from this decision can literally be hundreds of thousands of dollars, even in the relatively modest scenario presented here.

About Us

Madison Financial Research, LLC (MFR) is a registered Investment Adviser.[2] 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 Professor and Wachovia Securities Faculty Fellow 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.

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 financial 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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[2] Madison Financial Research is registered in the states of Florida and Virginia. Registration does not imply any certain level of skill or training. So, always ask your adviser about their skill and training – it's important.