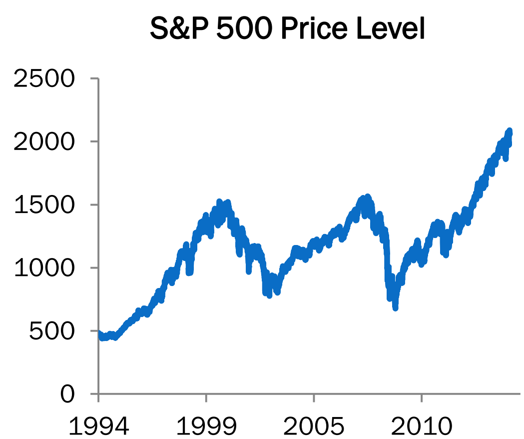
The Economy and Markets:

The U.S. stock market continues to perform in a band that represents a relatively high level of risk. As of the close of trading on January 2, the S&P 500 was at a level of 2,058.20, up around 5.8% from its 1,946.16 level at the time of our last newsletter. The Shiller "cyclically adjusted price ratio", the CAPE indicator we introduced in the last newsletter, is at about 27.02, again up modestly from our last report, and getting in to uncomfortable territory. The S&P 500 market volatility index (or VIX) is about 17.79, indicating that the market generally is a bit riskier than three months ago, although this is an unreliable indicator and is subject to change quickly. For example, the peak of the VIX this year was a level of 25.27, achieved this quarter in October. But as recently as early December, the VIX closed at a level below 12. At the risk of repeating myself from the last newsletter, the state of the market at the moment continues to suggest below average long-term performance (defining long-term performance here as in the academic literature – roughly a 10-year horizon). However, it is impossible for anyone to predict short-term market movements. Further, there are some fascinating circumstances currently affecting the market, in particular the decline of oil prices and the expected actions of the Fed in 2015.

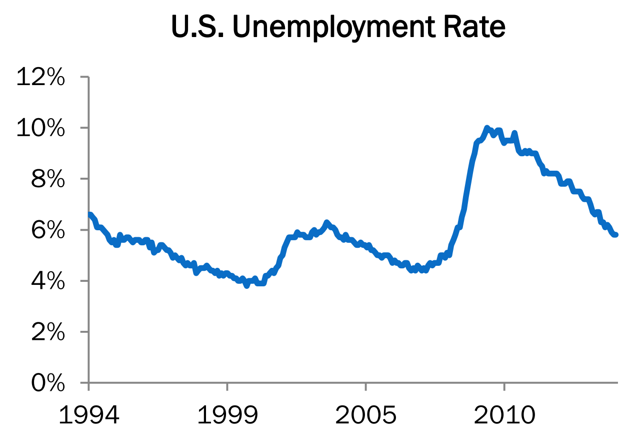
Markets at a Glance (January 2, 2015)	
S&P 500	2,058.20
Dow Jones	17,832.99
10 yr. U.S. Treasury	2.11%
3mo U.S. Treasury	0.02%
GDP Growth (last quarter)	5.0%
Unemployment Rate	5.8%

As of January 2, the 10-year U.S. Treasury yield is 2.11%. This is a very low level, and even lower than three months ago. The Federal Reserve has engaged in unprecedented bond-buying in an attempt to mitigate the lingering negative effects of the financial crisis. The unprecedented intervention by the Fed is diminishing, however. In October, the Fed ended the third round of its "quantitative easing" initiative, also known as QE3. This is an indication that the Fed believes the U.S. economy does not need the level of artificial intervention that was previously being provided. The recent upward revision of the 3rd quarter GDP growth to an incredible 5.0% appears to validate this belief. The unemployment rate now stands at 5.8%, down from 6.1% three months ago. This is also down dramatically from the October 2009 high of 10%, and provides an indication that the health of the economy is improving. In a further encouraging sign for the economy, the Fed also found that the underutilization of labor in the economy "is gradually diminishing." This is an indication that the Fed believes that labor market improvements are likely



One major economic variable that has changed since our last newsletter is the price of oil. The price of oil has notable effects throughout the real economy. The decline on oil prices, on net, is a positive, according to Federal Reserve Chair Janet Yellen. This is not necessarily obvious. For example, the fall in the price of oil will suspend economic activity associated with drilling in the United States, and will stymie energy production more broadly. However, the U.S. remains (for now) a net energy importer. As such, the national economy will experience an effective net income boost from the decline in energy prices. An interesting side note – the U.S. is quite close to becoming a net energy exporter (though the recent decline in energy prices will slow this down). Whenever this threshold is crossed, a decline in oil prices may actually be a net negative to the U.S. economy.

The decline in the price of oil will have a downward effect on inflation, which is already uncomfortably low. Janet Yellen has expressed the Fed stance that inflation reductions stemming from the decline in the price of oil are likely to be "transitory". In fact, she used that word several times in a recent speech to describe the effect of inflation, so clearly that was the word approved by the committee to illustrate their stance. The committee continues to believe that inflation will move up toward 2% through time, which is the Fed's goal. By way of comparison, imputation from market-traded inflation-indexed bonds indicates that the market expects inflation to average around 1.7% annually over the next ten years. This is down from about 1.9% three months ago, and this reduction is likely the result of the decline in the price of oil.



For the reasons discussed above, the real economy looks to be on solid footing. Consistent with what we saw in the last newsletter, this solid economy appears to be already reflected in the relatively high prices in the stock market. Right now, the economy is doing well and the market expects corporate profits to remain high. If something happens to change that expectation negatively, that change would be the driver of stock price declines. I am not one who believes it possible for anyone to "time" the market. Given the relatively high valuation currently in the market, academic indicators (here I am referring to the Shiller CAPE index whose value I provided above) point toward lower than average market returns over the next 10 years.

Quarterly Special Topic:
What exactly is the value added by finance professionals?

The finance industry constitutes approximately 6.4% of the GDP of the United States, generating about $1 trillion in output per year. The fees to the finance industry are derived from a great many sources. A large percentage of those fees come from various management fees charged by mutual funds, portfolio managers, financial advisors, and similar professionals paid to select securities on behalf of their clients. To what extent are these fees necessary or beneficial to the clients?

One of the most intensely debated notions of the last 40 years in finance is whether markets are "efficient." When economists discuss efficient markets, they generally are referring to them as "informationally efficient" – that all publicly available information is immediately reflected in current asset prices. A key implication of informationally efficient markets is that it is impossible to reliably predict the returns of assets with publicly available information – stock picking and market timing are matters of luck rather than skill, no matter how smart or well-researched the approach. Clearly, whether markets are informationally efficient is of crucial importance to several sectors of the finance industry, including financial advising.

In a previous newsletter, I discussed the work of Robert Shiller and Eugene Fama. These economists shared the Nobel Prize in 2013, and are the intellectual architects of (somewhat) opposing views on market efficiency. Eugene Fama argues that in the short run markets are efficient, and thus cannot be predicted. Most academic research supports this notion, with a few known systematic exceptions. Shiller argues that in the long run (time horizons of 8-10 years in the future) it is possible to predict market-wide returns with a modest degree of accuracy. These forecasts aren't as good, say, as hurricane forecasts, but they do better than just taking the historical average return. Most notably, with these forecasts it is possible to tell when market valuations are far out of line. There is less evidence that this predictability is possible for individual stocks. It is a reasonable logical extension of the finding that individual stock returns could be predicted at a long time horizon, but the individual variation in stock returns may cause the predictive "signal" to be swamped by the noise.

So, decades of academic research has found that in the short run asset returns are unpredictable. In the long run asset returns are mildly predictable, but this predictability is primarily possible at the market level. And yet, a large proportion of the economy is allocated to mutual fund managers, stock brokers, investment advisers, and other professionals who are primarily hired for the purpose of picking stocks to outperform the market in both the short and long run. In *A Random Walk Down Wall Street*, Burton Malkiel (a chaired professor at Princeton) claims that "a blindfolded monkey throwing darts at a newspaper's financial pages could select a portfolio that would do just as well as one carefully selected by experts." This statement is likely a bit harsh, but closer to reality than a lot of finance experts would prefer to admit.

It may be possible to reliably beat the market. But if this is possible, the expected improvement is small, and most of the returns would come from gathering proprietary information, which is a costly process. A study in 2013 found only 24% of mutual fund managers beat the S&P 500 over a 10 year period, and that while on average active managers outperform the index by 0.12% before fees, they charge more in fees than the value they create. Worse, those outperformers aren't reliable. Research by S&P Dow Jones Indices found that of funds in the top quartile of returns in March 2012, only 3.8 percent were still outperforming their benchmark by the end of March 2014. These statistics indicate that the outperformance is largely due to luck.

I would argue that some finance professionals exist not primarily because of their value-added to clients, but because of their sales ability. "Load" mutual funds, for example, have an up-front sales charge that is siphoned off from a clients' investment. This fee is large, usually around 5% (think about that, in an environment where the 10-year Treasury yield is far under 3%). The client is literally paying the mutual fund to advertise.[1] Why on earth would an investor ever agree to do this? Load mutual funds have never been shown to outperform the market consistently – quite the opposite, actually.[2] But people invest in them all the time. Sales ability trumps client value.

So what should be the role of finance professionals if, effectively, they aren't able to predict asset returns? This is the crucial question. All of these discussions about the inability to predict the market are geared toward predicting *returns*. But many variables that are important to investors are related to factors other than returns. And many of these other variables are predictable, or even known with certainty.

For example, the primary determinant of the financial profile of most individuals is defined by their life stage and tolerance for risk. If you are in your 30's, for example, it is far more important that you are contributing to your 401(k), saving money for emergencies, and paying down debt in an optimal way, than it is that you are a good stock or mutual fund picker. Indeed, acknowledgement that you *can't* forecast stock returns is an excellent place to start in forming an intelligent portfolio. It can save you from costly temptation. It can make you realize that you don't need to pay for the sales ability of your mutual fund adviser. It can allow you to resist the recommendation of your buddy that became a stock broker. Making the right decisions at this time in your life can save you tens, or even hundreds of thousands of dollars – maybe more. A financial adviser that can counsel correct decisions in this stage of life can be worth many times their cost.

Other finance professionals that can help you navigate the road to retirement, and the tax issues that are necessarily intertwined with retirement decisions, can be of particular value as well. Retirees and near-retirees are facing a historically difficult environment right now. At a time when reducing market exposure is (perhaps) prudent, the returns of safe assets are near all-time lows. Guidance on how to structure a portfolio to accommodate this difficulty, and the broader difficulty of selecting the right tradeoffs between risk and expected return, can mean the difference between comfort and concern in retirement.

Related to this, the most difficult to assess but somewhat predictable variable that professionals can assist clients with is the risk of an asset – and how that risk correlates with other assets a client may hold. While returns in the short run are difficult to predict, solid predictions of short and intermediate-run risk are possible for risk professionals with a sufficient statistical background (unfortunately, too many advisers don't have this background, but that is a different column altogether). Monitoring of this risk is a valuable task an advanced market professional can provide.

As a general rule, academic research has found that fees charged by finance professionals are a drag on the performance of investments. As such, they should be avoided whenever possible. Low-cost funds passively invested generally outperform funds managed by professional stock pickers. However, professionals that provide a detailed analysis of the financial situation and future of an individual or business can add a great deal of value to their clients - sometimes, life-changing value. What we can learn from the Nobel laureates above is what finance professionals *can't* do – and stop paying them for it.

[1] Variable annuities offered by many financial advisers work in a similar way.
[2] For a simple discussion of mutual fund loads, see http://www.fool.com/school/mutualfunds/costs/loads.htm

About Us

Madison Financial Research, LLC (MFR) is a registered Investment Adviser.[3] 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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