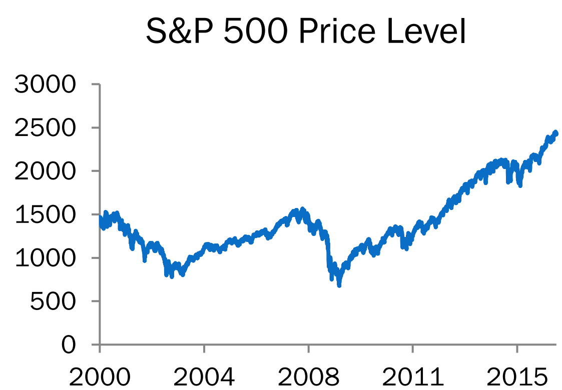
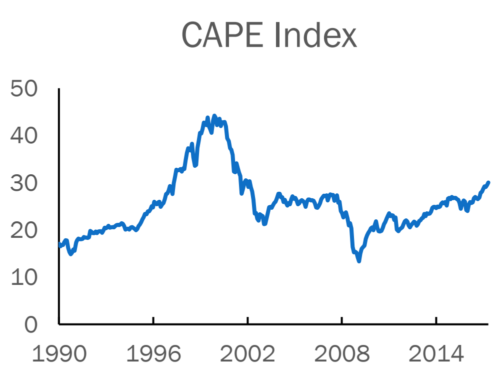
The Economy and Markets:

U.S. stock market continued its steady-return, low-volatility march upward this past quarter. The S&P 500 closed this quarter at a value of 2,423.41, which is 2.57% higher than its value of 2,362.72 on March 31. The S&P 500 once again hit its all-time high this quarter, doing so on June 19, at a level of 2,453.46. Current index levels are off that mark, but only a bit. For the index, this is quite a run from its value of 676.53 on March 9, 2009. The 9-year rise has not been without its hiccups (the Flash Crash, the Euro crisis and Brexit come immediately to mind), but it has been quite consistent. It has been a remarkable advance.

Markets at a Glance (June 30, 2017)	
S&P 500	2,423.41
Dow Jones	21,349.63
10 yr. U.S. Treasury	2.30%
3mo U.S. Treasury	1.03%
GDP Growth (last quarter)	1.4%
Unemployment Rate	4.3%



There are two broad risk metrics that we at Madison Financial Research tend to keep an eye on (bearing in mind that no one metric, or even two metrics, can alone tell the entire story), both of which we have discussed in detail in past newsletters.[1] The first is the VIX risk measure. The VIX measure comes from the price of options traded on the S&P 500, and is a market-derived measure of the expected variability of price movements in that index. The VIX ended the quarter at a level of 11.04. This is a remarkably low level. Indeed, the low for the VIX this quarter was 9.75, on June 2. This is not far off the all-time low of the VIX, which is 9.31 - registered all the way back in December of 1993.[2] For reference, the long-run average of the VIX is around 18, and its all-time high of 80.86 was reached in November of 2008. The VIX measure effectively reports how much the market expects stock prices to "move around." By contrast, the CAPE measure (CAPE is an acronym for "cyclically adjusted price to earnings") is a measure of the "value" of the stock market. It measures the price of the S&P 500 index compared to its earnings over the past decade. When the CAPE measure is high, long-term (7 – 10 years) future stock returns tend to be low. When the measure is low, long term future stock returns tend to be high. Coincidentally, the average for the CAPE measure is also around 18 or so. Currently, the CAPE measure stands at a level just shy of 30. There is some

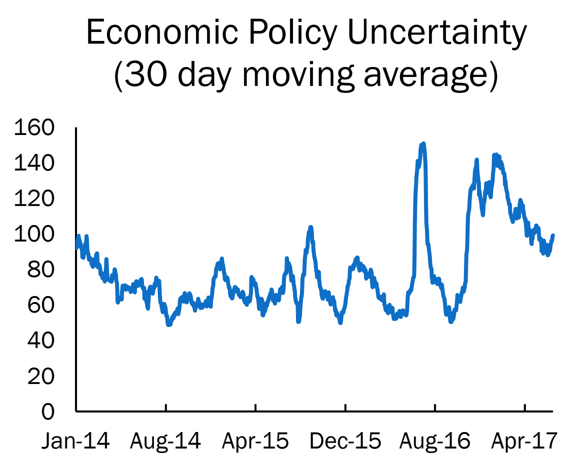


[1] All past newsletters, and some other useful resources, may be downloaded at http://www.madisonfinancialresearch.com/Resources.html.

[2] The CBOE slightly changed the way the VIX is calculated back in 2014. However, both the value and date of the all-time low remain the same under both methods of calculating the index.

debate about the best way to compute CAPE (the debate is about the various ways to compute the earnings portion of the ratio). Regardless of the method of computation, by this measure the market is relatively expensive by historical standards. Indeed, most measures of market valuation currently indicate that the market is currently "expensive." This tends to imply lower than expected returns going forward. The low reading of the VIX and the high reading of CAPE are not necessarily contradictory. The VIX suggests that prices are unlikely to change rapidly, and the CAPE suggests lower than average expected returns. The picture they paint jointly is a stock market that returns less than its historical average, while not moving around too much. That isn't too unreasonable forecast at the moment, given the economic environment (that we will discuss further below). However, it should be clearly noted: forecasts from either the VIX or CAPE are notoriously difficult to provide with any accuracy. But then again, we don't really have anything that does a better job, either.

Since politics has been at the forefront of so many people's minds recently, we have begun to track another form of uncertainty, the Economic Policy Uncertainty (EPU) Index developed by economists at Northwestern, Stanford and the University of Chicago.[3] This measure relies on aggregation of keywords from news stories to develop a measure of policy uncertainty, and was discussed in detail in a previous newsletter.[4] This measure was only recently developed, but provides an interesting quantification of policy uncertainty – a notoriously difficult notion to capture. As can be seen in the figure to the right, EPU remains at an elevated level, as it has been since the presidential election. However, this political uncertainty measure has steadily declined since February.

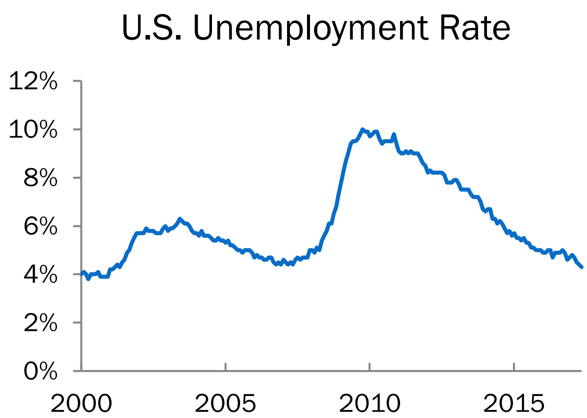


The U.S. economy continues to appear to be in solid shape, producing yet another quarter of steady growth. The most recent estimates of 1st quarter 2017 GDP (the latest available) show that the U.S. economy grew at an annualized 1.4% rate. The unemployment rate is particularly strong, and now stands at 4.3%, down from 4.7% reported last quarter. Although there is some debate (isn't there always?), it is fair to say that most economists expect that an employment level this low will eventually lead to inflation.

[3] The development of their index can be found here: http://www.policyuncertainty.com/media/EPU_BBD_Mar2016.pdf

[4] You can find that discussion here: http://www.madisonfinancialresearch.com/files/2016_Q4_Newsletter.pdf

There are several ways to estimate U.S. inflation, but current estimates from market trading are about 0.70% over the next year, and 1.66% per year over the next 5 years. These are quite low levels of inflation, particularly given the low unemployment levels. Inflation expectations had been increasing for a couple of quarters before this, and the reversal is significant. Even at a 10 year horizon, markets appear to expect a very low level of inflation, about 1.74% per year, which is below the Federal Reserve target rate of inflation. This level is higher than in 2016, but still very low given current economic conditions.



In June, the Federal Reserve raised the federal funds target rate again, from a targeted range of 0.75% - 1.00% to a new range of 1.00% - 1.25%. This is the third time since December that the Federal Reserve has increased the federal funds rate. The federal funds rate is an overnight rate, and so most directly affects short-term lending rates. Consistent with this, three-month Treasury yields are now at 1.03%, up from 0.75% last quarter. Interestingly, and consistent with the decline of inflation expectations, 10 year Treasuries are currently yielding about 2.30%, down a bit from last quarter. Interest rates increasing for short maturity bonds, while decreasing for long-maturity bonds referred to as a "flattening of the yield curve." If the yields on the long-dated bonds ever dip below the yields on the short-dated bonds, this creates a "yield curve inversion," which is usually seen as a potential warning sign for a recession. The last time the yield curve inverted was in 2006/2007, and before that in 2000. It is important to note that we are not currently observing an inverted yield curve, but that the slope of the yield curve has been drifting in that direction. This drift was noted in our previous newsletter, and the effect is slightly more pronounced this quarter.[5]

Quarterly Special Topic: The State of Financial Adviser Fiduciary Responsibility and Retirement

On June 9, the Department of Labor "Fiduciary Rule" went into effect for assets covered under the Employee Retirement Security Act (typically referred to as ERISA). This rule is potentially very important in shaping the investment landscape for those of us that hope to retire one day, as well as for those already retired - anyone not in one of those two categories can probably ignore the rule altogether. It also has an interesting history, and that history is still being written. I have written about financial

[5] For a retirement allocation strategy that incorporates inverted yield curves, see https://www.onefpa.org/journal/Pages/SEP16-A-Dynamic-Yield-Curve-Based-Approach-to-Retiree-Portfolio-Allocation.aspx , written by a pair of particularly insightful finance professors.

adviser fiduciary responsibility in the past. However, this new rule is potentially of such importance that the topic bears revisiting.[6]

How important is the rule? In first proposing the rule, research put out by the Council of Economic Advisers for the Obama administration estimated that the cost of American retirement-portfolio investors receiving "conflicted advice" was about *$17 billion* per year. For a sense of perspective, this is about the annual budget for NASA, or a little less than the annual GDP of Iceland. What is conflicted advice? It is advice given to a client, from a financial adviser, in which the adviser has a conflict of interest. Quite often, financial advisers receive commissions on mutual funds, insurance products, and so forth that they recommend to clients. Quite often, their clients have no idea that they are receiving these commissions. They reduce the return on said mutual funds, insurance products, etc., dollar for dollar. And it turns out there are about 17 billion of those dollars out there, up for grabs, each year – in IRA (Individual Retirement Asset) portfolios alone.[7]

We have discussed fiduciary responsibility in this newsletter previously, specifically in our 2015 first quarter newsletter.[8] If you don't remember the details of how fiduciary responsibility works, I strongly recommend that you look that section over once more. The comically-abridged version is this: *Brokers* and *Investment Adviser Representatives (IAR)* are both financial professionals that must register with either the SEC or the state(s) in which they practice. Both routinely call themselves "financial advisers." However, fundamentally, their job descriptions are different. The job description of brokers is to sell financial products. The job description of investment adviser representatives is to render financial advice. Investment adviser representatives are held to a "fiduciary" standard in dealing with clients – they must put client interests before their own. Among other responsibilities, this obligates an IAR to disclose any conflicts of interest he or she may have relating to the advice being given. So, if the IAR is going to receive a 5% commission on the product they recommend to you, they are required to let you know about it. And probably, they aren't going to recommend it, unless there is no cheaper alternative available for you. Brokers, since they are primarily obliged to sell to you, have no such obligation.

Since there are no rules about what a broker or IAR can call themselves, both end up generically calling themselves financial advisers, and the end result is that many individuals don't know if their financial adviser is obligated to act in their best interests. Muddying the waters, many financial advisers are registered as both brokers and IARs – and they transition into and out of each role without necessarily (or even typically) informing the client as to when they are acting in which capacity. Confused yet? Many are. Almost half of Americans apparently believe their financial advisers are

[6] 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 current financial landscape. This discussion is for educational purposes. Importantly, this is not legal advice.

[7] The complete report can be found here:
https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf

[8] You can find that writing in the quarterly special topic of this newsletter:
http://madisonfinancialresearch.com/files/2015_Q1_Newsletter.pdf

legally obligated to act in their best interests, which is decidedly not the case.[9] And the conflicted advice that they receive, that almost half apparently didn't know they were receiving, cost them about $17 billion a year.

Into this state of affairs, the Department of Labor "fiduciary rule" rule was introduced by the Obama administration. This rule roughly states that all financial advisers are bound by a fiduciary responsibility if they advise on retirement-related assets (those covered under ERISA). After a several month comment period in 2016, the Department of Labor chose to enact the rule, and it was originally intended to go into effect on April 10, 2017. However, prior to its enactment, on Feb 3, 2017, President Trump signed a memorandum ordering a review of the rule.[10] The result of this memorandum was a delay of the rule until June 9, when it went in to effect.

However, the rule does not fully go in to effect until Jan 1, 2018. The Labor Department has indicated that enforcement will be nonexistent or minimal until that time. Further, there appears to be strong indication that the intention of the current administration is to modify the rule going forward. Writing in the Wall Street Journal recently, Labor Department Secretary Alexander Acosta stated:

> *Today there are several regulations enacted by the Obama administration…another example…is the Fiduciary Rule. Although courts have upheld this rule as consistent with Congress's delegated authority, the Fiduciary Rule as written may not align with President Trump's deregulatory goals. This administration presumes that Americans can be trusted to decide for themselves what is best for them…*
>
> *The Labor Department has concluded that it is necessary to seek additional public input on the entire Fiduciary Rule, and we will do so. We recognize that the rule goes into partial effect on June 9, with full implementation on Jan. 1, 2018…*
>
> *We have carefully considered the record in this case, and the requirements of the Administrative Procedure Act, and have found no principled legal basis to change the June 9 date while we seek public input…*
>
> *The Labor Department will roll back regulations that harm American workers and families. We will do so while respecting the principles and institutions that make America strong.*[11]

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[9] You can see the full report here: https://www.personalcapital.com/assets/email/2017-Personal-Capital-Financial-Trust-Report.pdf

[10] This memorandum can be found here: https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-memorandum-fiduciary-duty-rule

[11] The full text of this piece may be found in the May 22, 2017 edition of the Wall Street Journal. Viewing the article requires a subscription, so I will not provide a link here. However, the title of the article is "Deregulators Must Follow the Law, So Regulators Will Too" for those with a subscription or a motivation to find the article.

The primary argument put forth by those who oppose the fiduciary rule is that financial advisers who abide by the fiduciary standard are too expensive. This argument is made by many financial institutions that oppose the rule. The increased cost of their services will price some advice-seekers out of the market, and this is an outcome to be avoided. I am sympathetic to this argument to some extent – it is an effect that will occur, and it is a shame that some savers will not get helpful advice.

But step back and think about what that claim really means. Right now, advisers' unwillingness to act in the best interests of their retirement-portfolio clients are costing those clients $17 billion per year. Presumably, most of that cost is being transferred to the advisers. And, because the advisers who aren't fiduciaries are not required to disclose back-door payments, the clients do not know they are paying it to them. (Again, recall the survey that finds that about half of retirement investors already incorrectly believe that financial advisers have a legal obligation to put their clients' interests ahead of their own.) So the argument is really that the only way many people can afford retirement advice is under a system in which they pay more than they think they are paying! It is a system built around deception, and this rule provides a welcome relief from the practice.

We will see how the future of the rule unfolds. Mr. Acosta's article sounded many ominous notes. Further, assets that do not fall under ERISA will not fall under the rule. But for the moment, the rule is in effect, and that appears to be a small positive outcome, however tenuous.

If you are interested, the following are a few more articles on the subject that I think you may find interesting:

A new rule on retirement savings advice is in your best interest – by Michelle Singletary

http://www.deseretnews.com/article/865681792/Michelle-Singletary-A-new-rule-on-retirement-savings-advice-is-in-your-best-interest.html

3 Reasons You Should Care About the Fiduciary Rule – by Arielle O'Shea

http://www.ajc.com/business/consumer-advice/reasons-you-should-care-about-the-fiduciary-rule/vAbOwGdiEcrBJEutQDfUpK/

And finally, lest my advocacy for the fiduciary law lull you into thinking it is a panacea, be sure to read this, which notes that it is still possible to sign away your legal protection:

Don't roll over for this 401(k) and IRA rip-off – by Ken Fisher

http://www.msn.com/en-us/money/retirement/dont-roll-over-for-this-401-k-and-ira-ripoff/ar-BBCsIEy?li=BBnbfcN

About Us

Madison Financial Research, LLC (MFR) is a registered Investment Adviser.[12] 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 a 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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[12] 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.

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