A Registered Investment Adviser

3rd Quarter 2017 Commentary

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Special points of interest:

- US economy continues to strengthen
- Traits and Emotions Affect Performance
- Uncertainty Over Foreign Policy Increases Risks
- Federal Reserve Pushes Interest Rates Higher
- You Can't "Buy Low" if you Don't "Sell High"
- Update Your Beneficiaries Before Going on Vacation

Inside this issue:

Overview

Market commentators expected the U.S. presidential election to be the catalyst for increased market volatility. Instead, calm best describes markets worldwide. In Europe, large price swings in stocks have largely subsided. In Asia equities are near their lowest volatility this century. The VIX, Wall Street's "fear gauge" has been trading near historic lows for much of the year. A very supportive Trump trade and accommodating central banks have led to a certain amount of complacency. With the Trump rally behind us and the US Federal Reserve Bank becoming more hawkish 2H17 may not be as tranquil. In the short-term surprise geopolitical events, soft economic data, or corporate earnings missteps could send investors for the exits as fear and the herd instinct pressures prices lower. Our view is that unless the economic outlook for 2017-'18 changes that stocks will trend higher. We'll continue to keep portfolios in balance, selling into strength and using market weakness as an opportunity to buy.

Broad Market Outlook

With the broader equity markets making new highs in June we have to be somewhat concerned about the potential for a pullback or sideways move in the short-term. However, over the next 6-12 months we remain constructive for a number of reasons. Companies have been reporting strong earnings. For the S&P 500, the percentage of companies beating consensus on EPS and sales moved up as did the percent of companies raising guidance. Analysts estimate S&P 500 EPS growth expectations at 8.8% for 2017. In addition, expectations are for a continued strong performance into 2018 for both small cap and large cap companies. Also, economists at Credit Suisse expect 2017 real GDP to come in at 2.2% on the year, and to increase to 2.3% in 2018. Only modest upside from Washington is baked into their estimates. Typically, stocks move up in this GDP range. Expectations regarding the Trump agenda are likely to remain a driver of stocks for some time to come. We do think that the release of details on the White House's goals for tax reform has reduced some of the political uncertainty that has been a headwind for equities. Recent investor surveys indicate that most expect corporate tax reform to get done by the end of 1Q18 with half anticipating a cut in the corporate rate by 24%. But there is still risk to equities on the tax front in terms of execution risk, timing, and the size of the cut. Valuations remain a key negative (the S&P 500 forward P/E is still around 18.8x, off its recent highs of ~19x, but not cheap yet).

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The Human Side of Investing

In the past decade, stocks as measured by the S&P 500, have more than doubled. Along the way we have experienced declines of more than -50%, -20% and -15%. Most investors who have a strategy that is 100% invested in stocks failed to match the market's returns. This despite the fact that there is a ton of valuable information available about how to invest. Perhaps too much. Usually the short-fall is basic human behavior. Incorporated within us are traits that have helped us survive, such as embracing those things that bring us security or pleasure and shunning what causes us pain. These traits can easily contribute into being terrible investors. It seems perfectly normal to make new investments at market highs (pleasure) and sell investments at market lows (pain). Pleasure needs to be controlled and pain needs to be managed. For most investors pain is best managed by recognizing that stocks are

risky and there will be periods of decline. How much of each decline you will experience (and can tolerate – your risk tolerance) is directly related your asset allocation; what percentage of your portfolio is invested in stocks vs. other assets. While a portfolio allocated to various asset classes is not likely to match the returns of a "stock only" portfolio over the long-term, it will probably outperform a portfolio driven by typical human behavior. It's no secret that money is emotional. Money is about your fears and dreams, goals and values. So, are you really surprised that when the train goes off the rails you make decisions that may be illogical? Human traits, and the fact that money is emotional, are two good reasons to have a well thought out, disciplined approach to investing. For many who have neither the experience nor desire to invest the effort necessary maximize their investment performance, the best solution is a professional investment adviser who cuts through the information overload, who has the knowledge and experience to assure that you have the optimum portfolio and who is an ever-present voice of reassurance.

Geopolitical Trends and Risks

There is considerable uncertainty about how the Trump administration's foreign policy strategy will ultimately coalesce. His policies have three competing strands, including: 1) an "aggressive America First" approach (e.g., threatening to leave NAFTA); 2) a traditional "America as leader of the global order" approach (e.g., strikes in Syria); and, 3) a transactional "America as deal-maker" approach (e.g., negotiating with North Korea). In general, the risk of a catastrophic or highly costly event, though still low, is higher under the Trump administration given the lack of a clear policy framework. Situations to monitor include Syria, Venezuela, the increasingly tense U.S./Turkey relationship, and the potential for regional trade deals in Asia. As for North Korea, since China and now South Korea (following the recent election) are unlikely to make major moves, President Trump will likely need to take some kind of action. However, the most the U.S. can hope to gain is for North Korea to agree to a freeze of its nuclear program (the nation has no rational incentive to give up the program entirely) and to stop the missile program (a concession the U.S. has never been able to get). With that said, the impact to financial markets from developments in North Korea is likely limited, provided most investors see China and the U.S. cooperating on the matter.

Fed Policy and Interest Rates

At its June meeting the Federal Reserve Bank raised short-term interest rates and provided greater detail about its plans to start shrinking its $4.5 trillion portfolio of bonds and other assets this year. The benchmark federal-funds rate was raised by a quarter percentage point to a range between 1% and 1.25%. Another increase is predicted later this year. Since Fed officials last met in early May, they have faced conflicting signals about the economy on two items that matter most: employment and inflation. Solid job gains have pulled down the unemployment rate to lower-than-expected levels, at 4.3% in May, but inflation has unexpectedly slowed. Officials also revealed plans for winding down their holdings of Treasury and mortgage securities. The Fed's plan would start reducing the holdings by allowing a small amount of net maturities per month ($6 billion in Treasury securities and $4 billion in mortgage bonds) and to allow that amount to rise each quarter. The Fed's previous purchase of securities and subsequent reinvestments have helped depress and to hold down long-term rates. Without reinvestment, long-term interest rates could rise. The moves made at its last meeting will test the economy's ability to stand on its own as the central bank dials back the extraordinary stimulus measures taken after the 2008 financial crisis. Recent policy changes signal that officials believe the economy will keep growing and the job market will stay healthy. Fed officials now see inflation reaching their 2% target by the end of 2018. They now predict unemployment of 4.3% for the end of 2017 and 4.2% at the end of 2018 and 2019. The Fed's median expectation for the federal-funds rate puts short-term rates between 2% and 2.25% at the end of 2018, and between 2.75% and 3% at the end of 2019. After years of pushing down on the gas pedal, the Fed's job now is to allow "the economy to kind of coast and remain on an even keel, to give it some gas, but not so much that we're pressing down hard on the accelerator," said Fed Chairwoman Janet Yellen in recent remarks. Rising interest rates present a risk to investors holding fixed income securities. There are various methods for managing interest rate risk including the size of total allocation to the sector, and the maturity and credit quality of the bonds.

Janet Yellen

Herding and Market Bubbles

Many individuals who lack conviction when faced with uncertainty, copy the behavior of others. This behavior can be observed in all markets. Take, for example, the Dutch Tulip bubble in the 1630s. In three months, prices soared 20-fold. At its peak, a bulb could sell for more than a luxury house. How about the DOT-com bubble of the 1990s? The Nasdaq rose from 500 in 1990 to a peak over 5000 in 2000 before it burst. Or the US housing bubble. House prices doubled between 1996 and 2006, before selling off. By 2009, the average home had lost 1/3 of its value. A great amount of volatility was caused in each market, both on the upside and the downside. Everyone wanted to get in, or out, at the same time. This type of behavior is called herding. Investors followed the behavior of other people they believed to be "industry experts," or people deemed prescient by the financial media. When investors herd, they override their common sense. They just want to "get in" or "get out" so they don't lose out and get left behind. On the upside, a bubble occurs when an increase in the price of an asset deviates from its fundamental, or real value, in a significant way. When the bubble bursts value develops when prices fall below their fundamental value. Unfortunately, investors often buy at peaks and sell at troughs. One easy way to guard against getting caught up in herding is to pay attention to valuations. A second way is to have an experienced and trusted adviser stand between you and your emotions. Like pruning and weeding a garden, a solid discipline of regularly taking profits, selling laggards and rebalancing the allocation, leads to a healthier portfolio over time. You can't "buy low" if you don't "sell high" – Rogers.

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Divorce and Beneficiaries

James was an employee of Fly High Airlines. He and Christina recently became divorced. In the division of marital assets, James kept his 401(k) benefits and IRA account. Then, James died on a wine tasting trip while on vacation. James had not been too concerned about paperwork and never updated his beneficiary designations. Christina was still named as the primary beneficiary. James's children were named as contingent beneficiaries. Now Christina and the children want to know, who gets the money? Since James never changed his beneficiary, and there is no federal law dictating that divorce revokes a beneficiary of an ex-spouse, unless the 401-k plan says otherwise (not likely), Christina is entitled to the money. If Christina signed away her rights in the divorce agreement, the children may be able to sue and get the money from her – but the divorce agreement is not binding on the 401-k plan. James's IRA is not subject to federal ERISA law that creates spousal rights in pensions and "pre-empts" state inheritance laws. Under many states' laws, divorce revokes a beneficiary designation in favor of the ex-spouse – the ex-spouse is deemed to have predeceased the IRA owner. But the question will be, which states law applies? The laws of the state of the deceased? The law of the IRA provider's state of incorporation? As you can see, ex-spouses and the children may have plenty to argue about. The confusion could have been avoided if James spent the time updating his beneficiary designations before going on vacation.

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