Investment Commentary

September 30, 2017

Signs of accelerating economic growth in the U.S. and other parts of the world, combined with hopes of pro-business and tax reforms, have been a second wind for stock prices. Stocks are rising in the most pleasant manner: U.S. stocks haven't sustained even a four percent drop from top to bottom so far in 2017. The lack of volatility this year is historic, and perhaps surprising considering the volatile news headlines of 2017.

We continue to closely watch developments on tax reform in the U.S. The GOP's recent proposal lacked details, but it articulated an overhaul to the tax code lowering the overall tax rate on most corporations and lower individual earners. Some highlights include:

- Lowering corporate tax from 35% to 20%
- Lowering business income on personal returns at 25% (who qualifies for this is unknown)
- Limits on deductions for interest for corporations
- One-time tax on foreign profits held overseas and tax-free earnings repatriation going forward
- Collapses seven tax brackets into three: 12%, 25% and 35%
- Doubles the standard deduction for many households
- Eliminates deduction for state and local taxes
- No changes to capital gains and dividend tax rates
- Repeals the estate tax and the alternative minimum tax

Many details need to be written, and quickly, if the GOP is to pass tax changes through the budget process. It is not known exactly who will ultimately pay more tax or less, where the income break points are for tax brackets, which business owners can claim business income versus wages, and how interest deduction by corporations will be limited, among other questions.

While corporate tax reform has many proponents, including Democrats, many take issue with other provisions in the plan, especially eliminating the deduction of state and local taxes. Upper middle income to high earners in high tax states such as California, New York, Oregon, and Hawaii would likely see higher tax bills.

Tax reform's details and ultimate fate should be known within the next month or two.

Defense Stocks

During the quarter we increased our bullish bet on the defense industry. Defense companies are premium businesses—well-managed oligopolies, actually—but without premium prices. Years of deferred maintenance and deferred replacement, GOP leadership, and increasing procurement globally should benefit this part of our portfolio. We also believe defense stocks help hedge geopolitical risk in a portfolio.

Notable Trades

The following summarizes major buys and sells placed during the quarter in our Core strategies (conservative, asset allocation-driven and absolute return-focused portfolios representing a majority of our clientele). Note that not all clients or portfolios participate in every trade idea due to clients' circumstances, account size or other factors. Some portfolios are managed primarily, or exclusively, with exchange traded funds.

New Buys:

Bristol-Myers Squibb Company (Ticker: BMY)

The pharmaceutical industry has been plagued in recent years with expiring patents and fewer successful new drugs. Fears the federal government will finally negotiate tough pricing have also put pressure on drug stocks like Bristol-Myers. We thought a lot of the bad news was "priced-in," leaving a lot of upside potential when the company begins making blockbusters again. Its *Opdivo* immuno-oncology drug will generate over $4.5 billion in sales in 2017 and could eventually peak at $12 billion. We also liked its pristine balance sheet with no net-debt and near-3% dividend yield. We paid almost 19 times earnings.

iShares Core MSCI Total International Stock ETF (Ticker: IXUS)

We increased our international stock allocation again this quarter with this broadly diversified exchange traded fund holding stocks of developed and emerging markets. (See our June 30, 2017 Commentary on our views on international investing.) Dividend yield: 2.3%.

General Dynamics Corporation (Ticker: GD)

This well-run defense contractor makes nuclear submarines, ships, defense technology, combat systems, and Gulfstream jets, among other products and services. Like other current holdings Raytheon, Lockheed Martin, and Northrup Grumman, revenue and earnings should accelerate going forward under Republican control and heightened global tensions. We expect the market to continue rewarding the company's earnings visibility. A rebound in the important Gulfstream unit should also give the company and stock price a boost, especially given its rare valuation discount to peers. Years of smart financial stewardship and share repurchases at cheap prices mean shareholders receive a bigger share of rewards going forward. Dividend yield: 1.6%

SPDR Dow Jones Industrial Average ETF (Ticker: DIA)

We added this exchange traded fund holding the 30-member index to raise overall equity exposure quickly. Given our outlook, we thought the Dow's relatively higher industrial and financial exposure was more attractive than the S&P 500 Index. Dividend yield: 2.2%.

Sells:

We sold or reduced holdings in **Hubbell (Ticker: HUBB)**, **Rio Tinto (Ticker: RIO)** and **SDPR S&P 500 ETF Trust (Ticker: SPY)** to temporarily reduce equity exposure or to reallocate capital in higher-conviction ideas.

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