Investment Commentary

December 31, 2017

In a good year for stocks, client portfolios participated nicely, especially on a risk-adjusted basis. As always, investment success is not just about the return figures; it's also about the risks assumed. Over the past year, we were pleased overall on both fronts.

We remain bullish heading into 2018, due mostly to encouraging global economic data and the recently passed tax package. Debate is plenty about the longer term effects of such sweeping tax changes—deficits, GDP growth, wealth equality, etc.—but the shorter term effects are clearer and more instructive to investment strategy. In our view, the tax changes (1) give an immediate and measurable boost to the intrinsic value of many assets; and (2) offer plenty of stimulus and incentives that should raise economic output and investment in the near term.

Corporate Tax Changes

The corporate tax rate cut is a big deal, especially for companies doing business entirely in the U.S. as they tend to pay the full federal tax rate of 35%. (Many global companies pay an effective tax rate much less than 35% because they have been able to defer taxes owed from international subsidiaries indefinitely.)

Until 2018 these domestic companies "kept" $0.65 of every dollar in pre-tax income. The new 21% corporate income tax rate means that companies will now keep $0.79 for every pre-tax dollar, a 21.5% increase. This means profitable domestic companies now have 21.5% more earnings for shareholders' benefit.

More earnings means more value. Markets have been rising, so one could argue that some or all of this value has been reflected in prices. But while we see the prices of many assets exceed levels we think represents "fair-value", we think the tax changes haven't yet been fully discounted into stocks. The tax package's overall stimulus for individuals and businesses also raise the probability of higher economic growth and corporate profits.

Capital Allocation

All of this boost in after-tax profits means it is as crucial as ever to review a key function—perhaps the most important—of any company's management team: *capital allocation*, or deciding between re-investing in the company, paying down debt, paying a dividend, buying back stock, acquiring another company, and/or building reserves. What management does with earnings once made is an overlooked driver of investors' returns.

Some companies like Berkshire Hathaway and Amazon have huge capacity to re-invest in their businesses and shouldn't elect other capital allocation options like paying a dividend. Amazon investors have been best served by Amazon reinvesting 100% of its earnings to build what has become an increasingly formidable and valuable network. Same with Berkshire Hathaway, a household name today precisely because it has excelled at capital allocation. Both stocks' prices would be a small fraction of what they are today had they paid dividends all along.

But few companies have such capacity (or ability) to reinvest at a high rate of return. For most companies, a higher dividend is probably best for shareholders. For example, Home Depot has already fully built its retail network; there simply isn't a need for more store locations. Every year, after allocating some earnings to maintain its 2,250 stores, Home Depot has billions in excess earnings. We anticipate and appreciate further dividend hikes here. Though some companies will squander their windfall in unwise ventures or nonsensical acquisitions (we will be vigilant against companies that do this), we expect most will elect for dividend increases.

During the quarter, we added equity exposure, including areas that have lagged the overall market over recent years but now look to be relative winners with tax reform and higher economic growth. We increased exposure to banks, materials, transports, energy, and industrials stocks while lowering exposure in bonds and large cap "growth" stocks.

<u>Personal Taxes</u>

Finally, a short reminder to take a look at the new personal tax changes in effect. While tax rates overall have declined (see *Appendix*), a number of other changes have been made, including reducing or eliminating certain deductions. Tax relief for pass through entities may benefit small business owners. Your tax professional may have some new strategy advice. Please pass it along to us. As always, we're eager to learn what you learn and help in any way we can.

With all the changes going on, we realize you might have questions. (We are not embarrassed to admit we still have many.) Please don't hesitate to call with them or with anything else.

<u>Notable Trades</u>

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:

<u>Ross Stores, Inc. (Ticker: ROST)</u>
Discount retailer Ross Stores is winning as overall "brick and mortar" retail face escalating competitive and existential threats. The company generates eye popping growth, 35%-plus returns on capital, and lots of free

cash flow—so much that management has been able to open new stores, pay higher dividends and meaningfully reduce shares without increasing debt. Equally important to us, Ross will be a prime beneficiary of tax reform as it pays maximum tax. Dividend yield: 0.8%

iShares S&P 500 Growth ETF (Ticker: IVW)

When tax reform looked more certain, we added this ETF to quickly increase equity exposure. The index leans toward higher growing companies and is comprised largely of technology-related companies (40%), which we believed complemented our other holdings well. We planned on this being a short term holding, used in the future as a source of cash for higher conviction ideas after the specifics of tax reform are known. Dividend yield: 1.3%

Hubbell, Inc. (Ticker: HUBB)

We returned to this well-run U.S. maker of lighting and electrical components. Hubbell is levered to construction and general economic growth and a prime beneficiary of tax cuts. We paid 19 times forward earnings. Dividend yield: 2.3%.

SPDR S&P 500 Bank ETF (Ticker: KBE) and Financial Selector Select SPDR Fund (Ticker: XLF)

We increased exposure to U.S. banks and other financial institutions through these ETFs. Besides being maximum tax payers getting a boost from the tax package, financials are gaining from regulation rollback and higher economic growth. Banks' relatively cheap prices are also a plus.

Amgen Inc. (Ticker: AMGN)

The world's largest biotechnology company seemed too cheap to pass up. While not the biggest winner from tax reform, and being perhaps a future target of the Trump Administration, investors get a well-run company at 13 times earnings with no net debt. Dividend yield: 3.0%.

Exxon Mobil Corp. (Ticker: XOM)

Earnings are on the rise again at Exxon, which we believe is the world's best run energy company. A lot of pessimism is built in the energy sector, understandable since energy has been the worst performer over the past five-plus years. We have no oil price forecast, but like Exxon's risk/reward proposition and the diversification it brings. Exxon is also a maximum tax payer that should see an earnings jump from tax cuts. We paid 20 times forward earnings. Dividend yield: 3.7%.

iShares Transportation Average ETF (Ticker: IYT)

With this ETF we gain exposure in 20 companies that move goods in the U.S. With trucks, trains, planes, and logistics, investors get a basket of domestic operators paying high tax rates and levered to economic growth. Dividend yield: 0.9%

Vale S.A. ADR (Ticker: VALE)

Vale is a Brazil-based global metals and mining company and the world's largest producer of iron ore and nickel. We include this low-cost producer in our materials play and like its risk/reward prospects. Dividend yield: 3.6%

Sells:

We sold bonds holdings (iShares U.S. Treasury Bond ETF and a Treasury note expiring in June, 2019) and iShares Core MSCI Europe to fund higher equity exposure. We sold iShares S&P 500 Growth ETF to reallocate to more attractive investments.

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APPENDIX

New Individual Income Tax Rates for 2018:

Tax Rate	Single	Married Filing Jointly	Head of Household
10%	0 - 9,525	0 - 19,050	0 - 13,600
12%	9,525 - 38,700	19,050 - 77,400	13,600 - 51,800
22%	38,700 - 82,500	77,400 - 165,000	51,800 - 82,500
24%	82,500 - 157,500	165,000 - 315,000	82,500 - 157,500
32%	157,500 - 200,000	315,000 - 400,000	157,500 - 200,000
35%	200,000 - 500,000	400,000 - 600,000	200,000 - 500,000
37%	Over 500,000	Over 600,000	Over 500,000

What Taxpayers Would Have Paid in 2018:

Tax Rate	Single	Married Filing Jointly	Head of Household
10%	0 - 9,525	0 - 19,050	0 - 13,600
15%	9,525 - 38,700	19,050 - 77,400	13,600 - 51,580
25%	38,700 - 93,700	77,400 - 156,150	51,850 - 133,850
28%	93,700 - 195,450	156,150 - 237,950	133,850 - 216,700
33%	195,450 - 424,950	237,950 - 424,950	216,700 - 424,950
35%	424,950 - 426,700	424,950 - 480,050	424,950 - 453,350
39.6%	Over 426,700	Over 480,050	Over 453,350

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