FOURTH QUARTER 2017

Matt's Market Update

IN THIS REPORT

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Market Review

Global equity markets continued to surge in Q4 to finish off a truly extraordinary 2017. Large-cap growth companies, led by the likes of Facebook and Amazon, posted the best gains among U.S. equities and powered the major indices to all-time highs. The NASDAQ, home exchange to these leading technology stocks, gained +28.24% for the year and posted a +6.17% gain in Q4. The Dow Jones Industrial average wasn't far behind with a gain of +28.11% for the year, just falling short of the 25,000 price level. As 2018 began, the Dow quickly broke above 25,000 only to incredibly surge above 26,000 eight trading days later. Completely remarkable in light of the fact the index took 77 years to hit the 1,000 point level for the first time! Not to be outdone in terms of records, the S&P 500 rose in each month of 2017, the first time the index has logged a positive result in each month of any calendar year. In fact, the index has risen in 21 of 22 trailing months ending in Q4. Finally, small-caps as represented by the Russell 2000 index, posted a gain of +14.65%. Good on an absolute basis, but lagging far behind the large-cap indices for the year. The fact that smaller companies lagged in performance shouldn't come as a total surprise given that they led the market in 2016. Investors clearly have rotated to the largest and most liquid stocks. Much of this can likely be attributed to the ongoing surge of assets into index funds and ETFs. As these vehicles take in record amounts of investor assets, the largest index holdings see a continual demand for their shares, thus driving prices higher.

In terms of U.S. equity valuations, the S&P 500 ended the year with a trailing P/E ratio of 23x and 18x forward earnings. This is very high in terms of historical readings. Other valuation measures flashed caution as well with the Price to Sales ratio of 2.1x, just below the peak reached during the dotcom bubble of 2000. Finally, the Price to Book ratio on the S&P 500 was 3.4x, with readings higher only 7% of the time historically according to the investment firm Gluskin Sheff. Market valuations certainly have received a boost over the past year from the better earnings performance and especially the passage in late December of a tax cut plan very friendly to corporate America. There is talk of potentially massive new federal infrastructure program in the coming year as well. But one wonders how much of this potential good news is already priced into the stock market? While valuations are a poor short-term timing indicator, the very elevated levels we're witnessing does indicate that investors should likely temper their expectations from here.

While U.S. markets enjoyed a record year, foreign markets performed even better. The MSCI ACWI index of large-cap stocks returned +27.19% in 2017, while small-caps overseas did even better. The Morningstar fund categories covering Small-cap Value, Blend and Growth strategies returned +28.23%, +32.82% and +35.79% respectively for the year. Further on in this report we highlight why foreign small-caps have been a favored asset class in our portfolios. Emerging market funds were also very strong last year with the average fund in the Morningstar peer group returning +34.25%. Despite the strong performance of overseas stocks, the indices generally trade for lower valuations than their U.S. peers and have longer-term trailing returns that lag as well.

Combined with the fact

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that many foreign economies are earlier in their growth cycles than the U.S., we believe there continues to be a better relative growth opportunity in overseas companies. From our own anecdotal observations, it would seem that most investors remain very under-invested in foreign stocks.

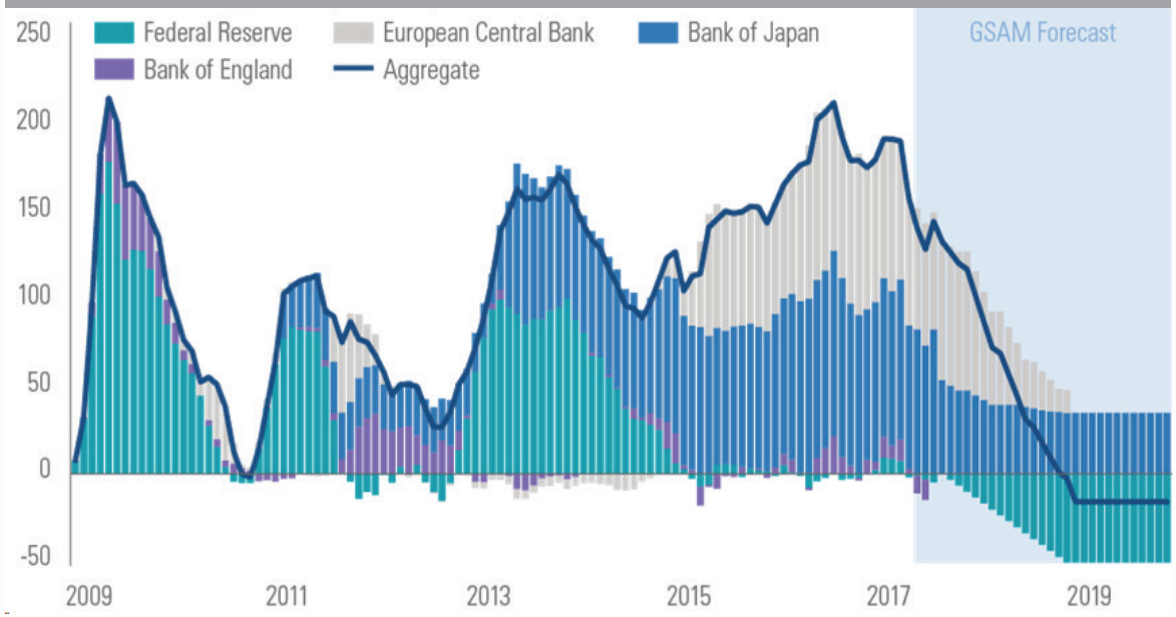
Central Bank Changes in 2018

Per usual, market movements this year are expected to be heavily influenced by a variety of factors related to central bank policy around the world. From an overseas perspective, the Bank of Japan has hinted at upcoming shifts in its approach to targeting interest rates, with the result being a slightly less accommodative stance towards stimulus. The European Central Bank (ECB) is expected to start reducing its asset-buying program to start the year. These are first steps towards more restrictive policy and less support for asset markets worldwide. In addition, the ECB is expected to name a new President this year and it's likely it will be someone in favor of tighter rate policy (less market friendly).

Here in the U.S., major changes are at hand as well with Jerome Powell taking over for Janet Yellen as the new Fed Chair at the end of January. In addition, due to the expiring terms of certain Fed committee members, a combined 43 years of Fed experience is leaving the committee with the retirements of voting members Yellen, Dudley, Fischer and Tarullo. These retiring members are mostly viewed as "dovish" (in favor of a low interest rate policy), while the new members coming on to the committee would seem to be more of the "hawkish" persuasion (in favor of tighter monetary policy and higher interest rates). What we're left with is the most inexperienced Fed in more than three decades. Depending on your viewpoint, this much turnover and loss of experience at the Fed may be a significant cause for concern, especially at such a key point in time where markets trade at all-time highs and when global monetary conditions are expected to tighten in 2018. As you'll note from the chart on this page, central bank asset purchases, which have arguably been the biggest driver of global equity returns recently, are expected to slow considerably starting this year.

Two final points to consider here. First, based on estimates from Gluskin Sheff, global central banks may be providing an estimated $1.8 trillion less liquidity (aka QE) to the markets this year than last. How will global equities react to this loss of buying power? Second, many have tagged new Fed Chair Powell as a clone of Janet Yellen who will continue to enact her same easy money policies. We're not so sure. Combined with the other new members joining the Fed, we think its reasonable to believe this group will pivot in new directions from a policy perspective. For the past few years it's been fairly predictable to bet on the Fed hiking rates less than they forecast at the beginning of the year. With the market consensus now at three rate hikes for 2018, what if this newly configured Fed does more?

CENTRAL BANK PURCHASES ($BILLIONS PER MONTH)



Source: Goldman Sachs

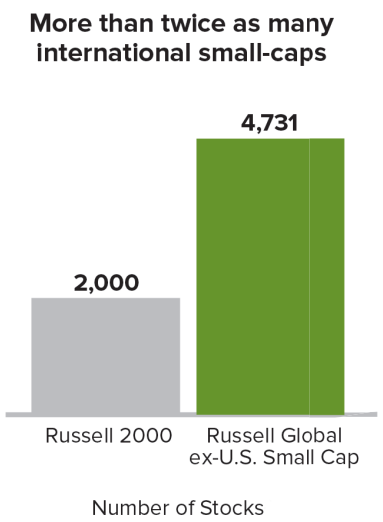
Intro to Foreign Small-Cap

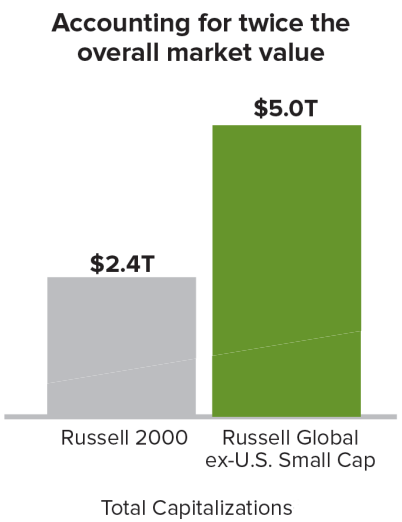
Our best peforming individual manager last year within our managed portfolios focused on small and mid-cap stocks from overseas. Not emerging markets mind you, but simply growth companies of smaller size domiciled in mostly developed nations outside the U.S. This particular strategy returned 38.54% in 2017 and still only ranked in the 35th percentile of managers for the year! The average fund in the peer group returned 36.19%. In fact, the fund that ranked worst in the peer group last year returned 26.10%, beating the S&P 500 by a wide margin. While this type of strong performance is unlikely to be repeated (although 2018 is off to another great start), there are several reasons for investors to consider foreign small companies for a place in their portfolio.

The first reason to be interested in this asset class is simply the large opportunity set. As you can see from the chart on this page, there were over 4,700 foreign small cap companies to invest in as of 9/30/17. More than double the number of small-caps in the U.S. Plus the value of these companies in aggregate market cap was also more than double the size. It's easy to believe that a talented manager or team could screen through these companies to develop a portfolio of winning stocks. A number of well-respected fund companies offer strategies that specialize in this market segment. A second reason for investors to be interested is the inefficiency of the asset class. Sounds like a bad thing right? Not really. What this refers to is the lack of analyst coverage and widely available information that exists for these companies. According to a recent white paper from Royce & Associates, more than 34% of the companies in the Russell Global ex-U.S. Small Cap index had either just one or no equity analysts formally covering the company. In other words, 1/3 of the group is essentially unknown and undiscovered. This presents a great opportunity for talented managers and analysts to find strong firms to invest in before these great companies become well known.

The next reason for consideration involves diversification. It should be no surprise that adding foreign companies to an all domestic equity portfolio enhances diversification through exposures to new companies and geographies. Most investors look to achieve this through the simple addition of a foreign large-cap fund or index. While this certainly adds diversification, the greater benefits accrue to those adding the foreign-small cap asset class. Again turning to the research from Royce, they looked at a foreign small-cap proxy, the Russell Global ex-U.S. Small Cap index, and evaluated the correlation (or tendency to move together) vs. other major asset classes. A correlation between asset classes of 1.0 means perfect correlation and no benefit of diversification. In other words, you want a reading below 1.0 (the lower the better) to show low correlation and thus provide greater potential diversification. In looking at the long-term corrrelation of monthly returns from 7/31/96 through 9/30/17, Royce found that foreign large-caps had a 0.86 correlation to U.S. large-caps, but that foreign small-caps registered a 0.74 correlation. Again, lower the better. Fourth, while the perception of smaller companies in general, and especially foreign, is of a risky asset class, the long-term numbers don't bear this out. Over the same time period from 7/31/96 through 9/30/17, foreign small companies demonstrated less volatility (standard deviation of returns) in comparison to U.S. small caps (as measured by the Russell 2000 index) and only marginally higher volatility than than the foreign large-cap index

COMPARED WITH U.S. SMALL-CAPS, THERE ARE:





Source: Morningstar, FactSet as of 9/30/17, Royce & Associates

(Russell Global ex U.S. index). Finally, what about returns? The news is good here too. The reseach from Royce showed the Russell index for foreign small-caps outperforming it's foreign large-cap peer index in 75% of rolling three-year periods, 88% of rolling five-year periods and 97% of rolling ten-year periods. When you add it all up, we feel that foreign small-cap is a compelling investment to consider for long-term investors and we've taken steps to make sure our managed portfolios have some exposure.

Wealth Management Corner

As the New Year gets underway, we wanted to introduce a new segment to our Quarterly Market Review. This segment will be dedicated to your individual wealth and financial planning. To that end, we will keep it brief, succinct, yet aim to be informative and constructive.

So, after the quick introduction, we begin with a recent event that will have an impact on all of us, the newly minted Tax Cut and Jobs Act bill. There are a plethora of resources that will explain to you how this bill will impact your taxes. We are first to admit that we have not read the 1,000 plus pages of the bill, yet we have the access and resources to boil it down to a couple of points that may impact you as an investor.

Diving in, some investment pundits that have studied the bill think it will provide a modest boost to the U.S. economy over the next few years. Interestingly as part of the bill, companies will be allowed a one-time repatriation of their foreign reserves at a lower tax rate. What this means is that companies are being incentivized to bring the cash sitting on their balance sheets back to the states at a reduced tax rate. There is thought to be over $2 trillion in cash on corporate balance sheets overseas. This could provide a waterfall of cash to further our domestic growth. Interestingly, prior tax reforms have tended to favor smaller companies that are usually focused on domestic operations versus their larger corporate counterparts. Smaller companies may again be lined up to benefit from this migration of capital back to the states if domestic spending were to accelerate and thus benefit smaller home-based businesses.

In terms of stock investments, lower corporate tax rates will generally lead to higher earnings. As earnings rise, valuations tend to follow suit. By some accounts, these profit expansions look to favor more consumer oriented companies, such as the financial sector. The financial sector's business model usually benefits from a rising interest rate environment. When higher interest rates are coupled with lower taxes, financial organizations tend to report higher net interest and operating margins. Part of the bill is associated with limiting a company's ability to deduct interest paid on debt in the future. When combined with potentially higher rates, this environment may prompt companies to rely less on debt to finance operations. This could also adversely impact lower quality borrowers, hence junk bonds and higher yielding investments.

Somewhat related, there has been a rush to issue certain municipal bonds before the end of the year due to the uncertainty of municipal tax reform. Thus, tax free bond issuance may be tempered this year. So, due to these changes, companies that have tended to own municipal bond investments for their Alternative Minimum Tax relief and favorable overall tax benefits may be so inclined to demand less of them in the future.

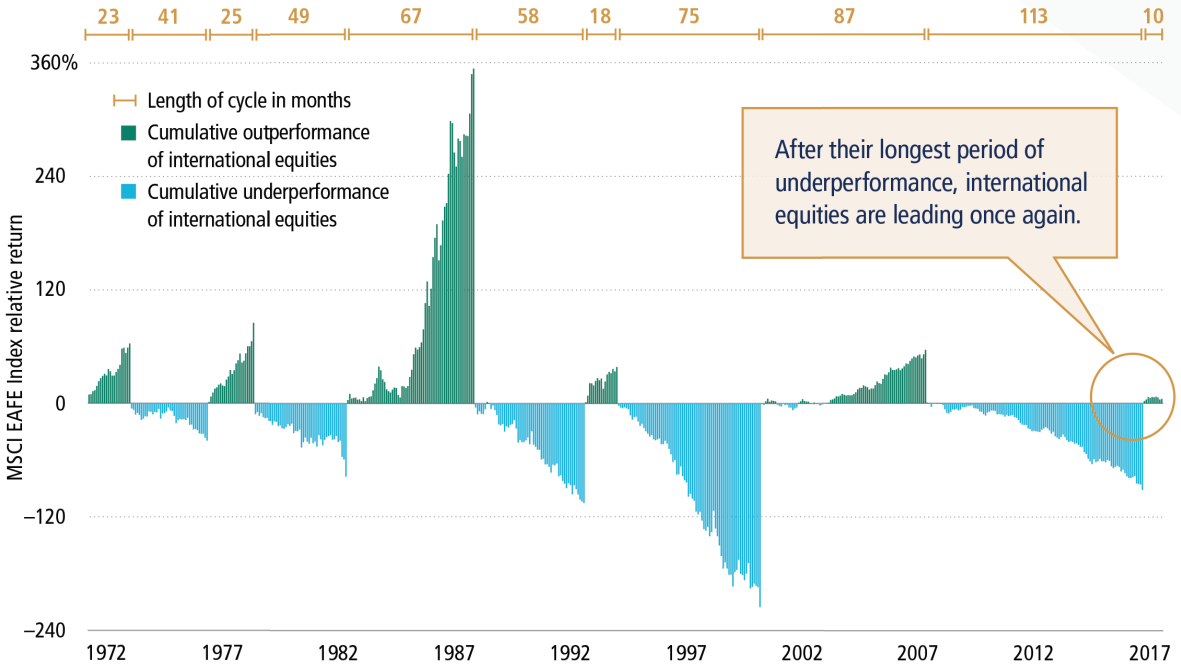
Overall, though challenging, there could be opportunity in these areas for companies and thus investors to increase their profits in the coming year. We will keep tabs on this as the year progresses. Welcome to our Wealth Corner. We look forward to hearing from you.

Our Portfolio Strategy & Allocation Outlook

We made no changes to our wealth management client portfolios in Q4, but we expect some minor adjustments to unfold in Q1. Here are some current thoughts on each of our main portfolio segments as we head into 2018:

Fixed-Income: Bond holdings today are best viewed as portfolio diversifiers that will add stability when equities struggle. Total return expectations for core fixed-income categories should remain low due to the continued low interest rate environment and the prospect for both future rate hikes from the Fed and potential inflation pressures from higher economic growth. The best opportunities are likely in individual sectors and countries. In other words, an environment best suited for

CUMULATIVE RELATIVE PERFORMANCE OF THE MSCI EAFE INDEX AGAINST THE S&P 500 INDEX



Source: Morningstar

active bond management. We'll be increasing our allocations to active bond managers in Q1 and would expect these allocations to potentially increase further over the course of the year.

U.S. Equity: We maintain our combination of a core large-cap index holding with active managers focused in the mid-cap space. Overall, we're still slightly underweight to our long-term strategic U.S. equity allocation due to concerns over valuations. Particular to mid-caps, the difference in performance between growth and value strategies was extreme in 2017. While the Russell Midcap Value Index returned 13.34% last year, the Russell Midcap Growth Index posted a 25.57% gain. Similar disparities in performance were seen in the Large and Small-Cap sectors as well. We suspect this gap in relative performance will narrow in 2018.

Foreign Equity: We remain overweight in this segment to our long-term strategic targets. We presented a similar chart to the one on this page last year which demonstrates the alternating leadership between U.S. and Foreign equities. While certainly not predictive, the chart does demonstrate that these asset classes tend to have multi-year periods where they outperform. 2017 was the first year since the financial crisis where foreign stock sectors outperformed in aggregate. Also considering the more favorable valuations (though not cheap) exhibited by foreign equities, we continue to favor this asset class.

Alternatives: Very quietly, the price of gold had a solid, yet unspectacular, year with a gain of 12.7% in 2017. We continue to maintain a position in our portfolios as a low correlating asset with good hedging potential should other markets finally face a correction. The fact that it's generally unloved by the investment masses also appeals to us. Strategies that attempt to hedge equity downside or make outright bets against certain stocks or sectors struggled last year. The incredibly strong equity market momentum completely neutralized these types of strategies in 2017. While we still believe these strategies have a place in a diversified portfolio, they were net detractors from performance last year.

Please let us know if you'd like to discuss your personal investing and financial planning needs.

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Market Scoreboard

Index Returns (%)	Q4 2017	YTD	1 Year	3 Year	5 Year	10 Year
S&P 500	6.64	21.83	21.83	11.41	15.79	8.50
DJIA	10.96	28.11	28.11	14.36	16.37	9.28
NASDAQ	6.27	28.24	28.24	13.38	17.99	10.04
Russell 2000	3.34	14.65	14.65	9.95	14.12	8.71
MSCI ACWI Ex USA	5.00	27.19	27.19	7.83	6.80	1.84
Barclays Aggregate Bond	0.39	3.54	3.54	2.24	2.10	4.01
Bloomberg Commodity TR	4.71	1.70	1.70	-5.03	-8.45	-6.83

Source: Morningstar

S&P 500 TR: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the large-cap segment of stock market.

Russell 2000 TR: Consists of the smallest 2000 companies in the Russell 3000 Index, representing approximately 7% of the Russell 3000 total market capitalization often used as a proxy for the small-cap segment of the stock market.

Barcap Aggregate Bond TR: The Barclays Capital Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most U.S. traded investment grade bonds are represented. The index includes Treasury securities, Government agency bonds, Mortgage-backed bonds, Corporate bonds, and a small amount of foreign bonds traded in U.S.

MSCI EAFE NR USD: Widely accepted as a benchmark for international stock performance, the EAFE Index is an aggregate of 21 individual country indexes that collectively represent many of the major markets of the world.

DJ US Industrials TR USD: Computed by summing the prices of the stocks of 30 U.S. companies and then dividing that total by an adjusted value--one which has been adjusted over the years to account for the effects of stock splits on the prices of the 30 companies.

NASDAQ: Measures the performance of all issues listed in the Nasdaq Stock Market and is often used as a proxy for the large-cap technology segment of the U.S. stock market.

DJ/UBS Commodity: The DJ-UBSCI is composed of futures contracts on physical commodities and is often used as a proxy for broad-based exposure to the commodity markets.

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