QUARTERLY NEWSLETTER

2017 Fourth Quarter

Dear Client,

We hope this finds you doing well and your 2018 is off to a great start. Fourth Quarter and 2017 Annual reports along with our 2018 privacy policy are going out this week, so please watch for this information. Tax information is forthcoming (from TD Ameritrade) and as we do every year, will do our best to keep you informed on its availability. Remember to compare the information on your report to your account statements received from TD Ameritrade or other custodians, and promptly call the office to notify us of any material discrepancies (note that there might be slight discrepancies due to the timing of the credit of dividends or transactions at quarter end). Also, if you are not receiving account statements directly (either in print or electronically) from TD Ameritrade or other custodians, please notify us immediately.

Market prognosticators are making their 2018 market forecasts. It has been sometime since we've discussed the caution investors should exercise with regard to market predictions, but felt this to be a timely topic in lieu of equity markets that continue to push to all-time highs. For example, no one could have foreseen what happened in the markets this past year. Major financial institutions Goldman Sachs and Credit Suisse projected less than a 3% rise for the S&P 500 and poor bond returns in the face of rising rates for 2017. Good, bad, or indifferent, we now know how this story ended, and those who might have made decisions based in part on such forecasts missed out. The discussion topic below is a research piece from Dimensional Fund Advisors about market predictions. While written in late 2016, we updated some of the data with the thought that its' message is just as applicable now as it was a year ago. The piece exemplifies the benefits of sound long-term investment planning over the use of short-term information, like market predictions, to drive investment decisions. First, however, is a review of an unprecedented 2017 market.

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2017 – MARKETS IN REVIEW

2017 was certainly a remarkable year for equity markets around the globe, with all major world indexes not only closing in the black but posting significant gains. A breakdown of the MSCI All Country World Index revealed that 45 out of 47 countries posted positive returns for the year, great news for globally diversified portfolios. In the US, the S&P 500 Index returned 21.48% for the year. While one of its best calendar year finishes ever, the more notable fact is that it did so with record low volatility – it did not move up or down more than 2% from the prior days close at any point and had positive returns in every month, both firsts. Despite this unique performance, however, US returns ranked 35th out of the 47 countries in the index.

International and emerging markets were the real story this past year with emerging markets leading the way as measured by the MSCI Emerging Markets Index 37.28%, followed by the international developed markets, as measured by the MSCI EAFE index at 24.21%. Austria led developed countries with a return of 51.39%, with Poland besting all emerging economies with a return of 53.56%. There was significant disparity in the returns on both fronts, which again, emphasizes the importance of maintaining a disciplined and diversified global approach.

Performance of the small cap, value, profitability premiums (key components of your portfolio structure and long-term returns - each further defined below) around the world were mixed. The Small Cap premium (the return difference between small and large capitalization stocks) was positive in international developed markets, but negative in both US and emerging markets. The value premium (the return difference between those stocks with low relative prices - value, and those with high relative prices - growth) was negative across all markets. The little discussed but highly relevant profitability premium (the return difference between those stocks with high relative profitability and those with low relative profitability) was positive in US, international developed and emerging markets.

Though absolute global equity returns were positive for 2017, the overall premium effect across the global marketplace was negative, exactly the opposite of what happened in 2016. This should not be cause for concern. The diversification element of having multiple factors is beneficial for both long-term performance enhancement and diversification purposes, with well documented research that unequivocally supports the long-term benefits of exposure to these factors or premiums. This same research also reveals that the potential excess returns associated with them don't materialize every year, and like the market, they can't be "timed" as to occurrence. Remember, if the expectation is to outperform the broad market long-term, then there must be periods of under underperformance – such is the nature of investing. Staying disciplined by maintaining consistent exposure to these areas of the market, however, remains key to your long-term investment success.

There was not much drama in the way of global bond returns in 2017. The predicted headwind of rising rates at the beginning of the year did not materialize, creating a relatively smooth ride for bonds. Both US and

International bonds posted positive returns on the year, as noted in the return summary below. Upward sloping yield curves in developed markets for most of the year benefitted the returns of longer maturity bonds over shorter maturity bonds. The environment also proved beneficial for lower credit quality investment grade bonds, as they outperformed their higher quality counterparts. The rate curve in the US did begin to flatten out in US toward the end of 2017 with the Fed's action to raise short-term rates. As a result, yields on the 10 and 30-year Treasury, came down in the fourth quarter, although were positive for the year.

More detailed information and additional commentary on the markets can be viewed by going to our web-site. A summary of 4th quarter and 2017 annual returns is provided in the table below:

	US Stock Mkt.	International Dev. Mkts	Emerging Mkts	US Real Est.	US Bond Mkt.	Global Bond–ex US
Q4 '17	6.34	4.23	7.44	1.70	.39	1.10
2017	21.13	24.21	37.28	4.18	3.54	2.06

Source: Russell, MSCI, Wilshire, Barclays and Citigroup

PREDICTION SEASON

Investors are likely to be bombarded with predictions about what the future, and specifically the next year, may hold for their portfolios. These outlooks are typically accompanied by recommended investment strategies and actions that are aimed at trying to avoid the next crisis or missing out on the next "great" opportunity. When faced with recommendations of this sort, it would be wise to remember that investors are better served by sticking with a long-term plan rather than changing course in reaction to predictions and short-term calls.

PREDICTIONS AND PORTFOLIOS

One doesn't typically see a forecast that says: "Capital markets are expected to continue to function normally," or "It's unclear how unknown future events will impact prices." Predictions about future price movements come in all shapes and sizes, but most of them tempt the investor into playing a game of outguessing the market. Examples of predictions like this might include: "We don't like energy stocks in 2018," or "We expect the interest rate environment to remain challenging in the coming year." Bold predictions may pique interest, but their usefulness in application to an investment plan is less clear. Steve Forbes, the publisher of *Forbes Magazine*, once remarked, "You make more money selling advice than following it. It's one of the things we count on in the magazine business—along with the short memory of our readers." (*from presentation at the Anderson School of Management, University of California, Los Angeles, April 15, 2003.*) Definitive recommendations attempting to identify value not currently reflected in market prices may provide investors with a sense of confidence about the future, but how accurate do these predictions have to be in order to be useful?

Consider a simple example where an investor hears a prediction that equities are currently priced "too high," and now is a better time to hold cash. If we say that the prediction has a 50% chance of being accurate (equities underperform cash over some period of time), does that mean the investor has a 50% chance of being better off? What is crucial to remember is that any market-timing decision is actually two decisions. If the investor decides to change their allocation, selling equities in this case, they have decided to get out of the market, but they also must determine when to get back in. If we assign a 50% probability of the investor getting each decision right, that would give them a one-in-four chance of being better off overall. We can increase the chances of the investor being right to 70% for each decision, and the odds of them being better off are still shy of 50%. Still no better than a coin flip. You can apply this same logic to decisions within asset classes, such as whether to currently be invested in stocks only in your home market vs. those abroad. The lesson here is that the only guarantee for investors making market-timing decisions is that they will incur additional transactions costs due to frequent buying and selling.

The track record of professional money managers attempting to profit from mispricing also suggests that making frequent investment changes based on market calls may be more harmful than helpful. **Exhibit 1**, which shows S&P's SPIVA Scorecard from midyear 2017, highlights how managers have fared against a comparative S&P benchmark. The results illustrate that the majority of managers have underperformed over both short and longer horizons.

Exhibit 1. Percentage of US Equity Funds That Underperformed a Benchmark

Fund Category	Comparison Index	One Year (%)	Five Year (%)	Ten Year (%)
All Large Cap Funds	S&P 500	56.56	82.38	85.08
All Mid Cap Funds	S&P MidCap 400	60.69	87.21	95.16
All Small Cap Funds	S&P SmallCap 600	59.55	93.83	94.06

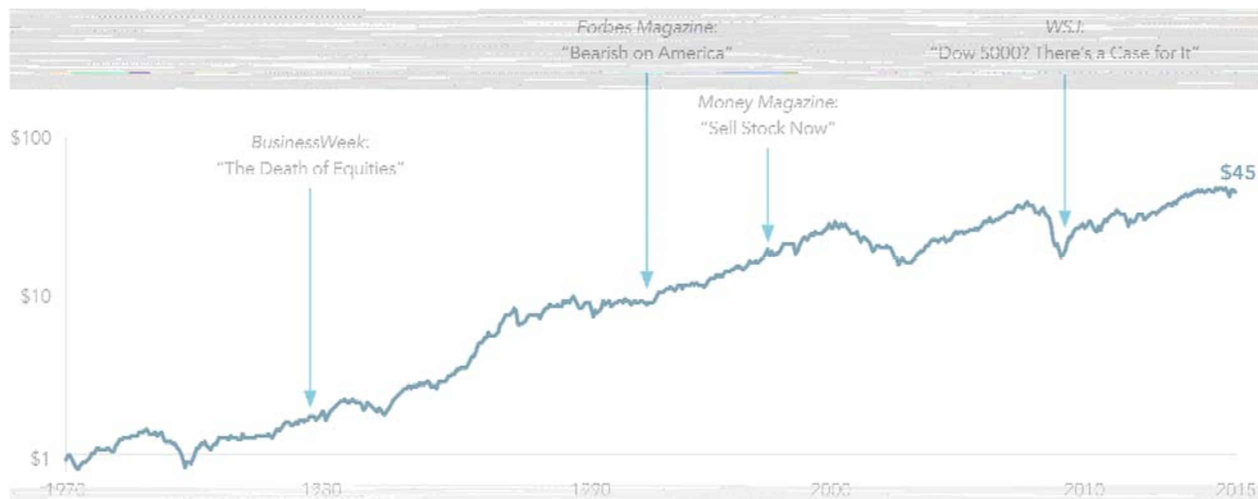
Source: SPIVA US Scorecard, "Percentage of US Equity Funds Outperformed by Benchmarks." Data as of June 30, 2017.

Past performance is no guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. The S&P data is provided by Standard & Poor's Index Services Group.

Rather than relying on forecasts that attempt to outguess market prices, investors can instead rely on the power of the market as an effective information processing machine to help structure their investment portfolios. Financial markets involve the interaction of millions of willing buyers and sellers. The prices they set provide positive expected returns every day. While realized returns may end up being different than expected returns, any such difference is unknown and unpredictable in advance.

Over a long-term horizon, the case for trusting in markets and for discipline in being able to stay invested is clear. **Exhibit 2** shows the growth of a US dollar invested in the equity markets from 1970 through 2015 and highlights a sample of several bearish headlines over the same period (*even more convincing when figuring 2016 and 2017 returns*). Had one reacted negatively to these headlines, they would have potentially missed out on substantial growth over the coming decades.

Exhibit 2. Markets Have Rewarded Discipline
Growth of a dollar—MSCI World Index (net dividends), 1970–2015



In US dollars. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results. MSCI data © MSCI 2016, all rights reserved.

CONCLUSION

As we transition into a new year, it is natural to reflect on what worked previously and what one may want to improve upon next year. Within the context of an investment plan, it is important to remember that investors are likely better served by trusting the plan they have put in place and focusing on what they can control, such as diversifying broadly, minimizing taxes, and reducing costs and turnover. Those who make changes to a long-term investment strategy based on short-term noise and predictions may be disappointed by the outcome. In the end, the only certain prediction about markets is that the future will remain full of uncertainty. History has shown us, however, that through this uncertainty, markets have rewarded long-term investors who are able to stay the course.

Source: Dimensional Fund Advisors LP. Diversification does not eliminate the risk of market loss. Investment risks include loss of principal and fluctuating value. There is no guarantee an investing strategy will be successful. All expressions of opinion are subject to change. This article is distributed for informational purposes, and is not to be construed as an offer, solicitation, recommendation, or endorsement of any particular security, products or services.

Our prediction for markets in 2018: …almost had you! We should know now that it is impossible to predict the direction of markets. Our advice for 2018 and beyond: …You probably guessed - maintain your disciplined approach by sticking with your plan. No matter what transpires, keep your focus on your long-term personal financial situation and goals, not the short-term movements of the markets.

Please provide us with your thoughts and feedback. As well, we look forward to visiting about your individual situation in the coming months. Thank you for your continued confidence and the privilege to serve as your Financial Advisor.

Sincerely,

Doug Babcock, CFP®