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Also in This Issue

Third Quarter 2017 Review & Outlook

by Whitney Brown

INVESTMENT OUTLOOK

- Stocks rise again in 3rd quarter.
- Broad advance includes small cap and international markets.
- Market valuation becoming a concern.
- Fundamentals still supportive for stocks.

Stocks logged another quarter of gains over the summer months. Across the board nearly all sectors and regions saw gains. Commodities fared well with a notable rebound in crude oil prices. Even bonds saw some price appreciation as yields slipped throughout most of the quarter. For the July-September period U.S market indexes such as the S&P 500, Dow Jones Industrial Average, and the NASDAQ Composite picked up gains of 4% to 6%. Year-to-date increases for those indexes were comfortably in double digits by the end of September. Small capitalization issues making up the Russell 2000 experienced similar appreciation in the quarter but lag the large caps for the year. Developed international markets of Europe and Asia as represented by the MSCI EAFE index tacked on 4.3% for the period and lead the S&P 500 and Dow with a year-to-date return over 16%.

Defying calls for a major correction, markets quietly and persistently worked to new highs. Investors can often get mixed signals from hearing what investment pundits say the market *should be* doing compared to what it actually *is* doing. In our practice we pay close attention to the latter and try to ignore the former. What the market *is* doing is continuing to move higher and getting stronger as it does. Even during the seasonally weak month of September, objective measures of market strength improved. Technical measures of supply and demand for stocks show demand increasing as supply contracts, a perfect recipe for a rising market. There is little data-based evidence of an impending market top. In fact, market breadth has been expanding as small cap and mid cap stocks have rejoined the market advance.

Market Measures	3rd QTR	YTD
S & P 500 (price)	4.0%	12.5%
Dow Jones Industrial Average	4.9%	13.4%
NASDAQ Composite	5.8%	20.7%
Russell 2000	5.3%	9.9%
MSCI EAFE	4.3%	16.6%
Barclays Capital Inter Gov't/Credit Bond Index	0.7%	2.4%
	9/30/17	9/30/16
10-Year U.S. Treasury Bond Yield	2.33%	1.60%
Three-month U.S. Treasury Bill Yield	1.06%	0.28%

Market breadth is an indicator measuring the number of individual stocks participating in a market advance. At times, advances by only the largest stocks may disguise underlying market weakness as market indexes are carried higher by just a handful of stocks.

Concerns about the market being richly valued are valid, and overvaluation can be one of multiple factors in most significant market corrections. A look at the historical record shows that equity markets can remain overvalued (or undervalued) for extended periods of time until other factors come into play. Most analysts would agree that based on measures of long-term absolute valuation, stocks are at best fully valued. Yet, measures of relative valuation that adjust stock prices for interest rates and inflation and compare them to other asset classes generally indicate that stocks are very reasonably valued at present.

Equity markets continue to focus on the supportive trends in the economy, corporate earnings, and inflation. At the same time, the market has avoided being distracted by the heavy flow of gloomy news on politics, natural disasters, and world affairs. While a bullish mood can be taken to extremes, the current focus on fundamentals helps keep sentiment grounded. One need not look far to find examples of individual stocks that have been punished for missing earnings estimates or violating the public trust. This is hardly a time when one could say we're suffering from "irrational exuberance". Sentiment in the equity markets is constructive but not at historical extremes. Any long running market advance will inevitably experience corrective periods when weak holders are flushed out and value reestablished. In our view, we are not yet at that point, and the next major market correction could come from higher levels.

Dealing with the Equifax Breach by Ted Feinour

The recent hacking of sensitive data and information of over 143 million U.S. consumers from credit bureau Equifax is a huge headache and major concern to both those affected individuals and the company itself. Birth dates, social security numbers, drivers' license numbers, addresses and names were or could have been stolen. All of this information can possibly be used for identification purposes to initiate loan applications and credit cards, or even file false tax returns to seek bogus refunds.

The Federal Trade Commission has suggested steps that consumers may want to follow to protect themselves in case of breached information. Visiting Equifax's website ***www.equifaxsecurity2017.com*** is the place to begin. Once you are into the site, click on the "potential impact" tab and follow directions to see if your data has been compromised. Even if one has not been affected, one should check credit reports at Equifax, Experian, and TransUnion, which are all free services by using ***www.annualcreditreport.com*** to view possible recent activity. One should also consider freezing or initiating fraud alerts on your credit data files. Doing this may help to protect your assets, but understand that elimination of all potential risks may not be assured.

It is also important to realize that Equifax has no reason to call you. If you do receive a telephone call from an individual stating that they need information from you in regard to the credit breach, it is purely a "phishing" call. The call should be terminated immediately without any private information given. One should also be sure to monitor credit cards and monthly bank statements to see if false or unauthorized charges have been made.

If you find that your data has been stolen, you may visit www.identitytheft.gov to learn more about the situation.

Ransomware by Jonathon Grace

In the July 2017 newsletter, we included an article about steps and best practices you could take to protect your data, privacy, and identity. As a follow-up, here are more suggestions and additional information to help keep your private data safe, in this case from Ransomware attacks. As the article above demonstrates, very little is safe these days. Constant diligence and ongoing education regarding new and emerging threats are required.

Ransomware is the technique of using a computer virus to hold data hostage. For it to work, a virus is delivered, usually by tricking the end user into clicking on a link. Imagine that you are sitting at your computer and you receive an email that pretends to be from UPS. It claims that UPS tried to deliver a package and the delivery guy is still in the area, and if you click on the link, another attempt to deliver the package will be made in two hours. Two items about this sneaky attack are noteworthy: 1) it appears to be real, and 2) it creates a sense of urgency. Ransomware can also be spread by clicking on an attachment to email.

Ransomware attacks are escalating. While using a computer virus to hold data hostage has been around for decades, massive attacks have spread around the world recently and taken the threat to a whole new level. In many cases, people and companies simply pay the ransom, usually in Bitcoins.

Here are steps you can take to minimize the risk of ransomware:

1. Always install software updates immediately and make it a regular habit. Turn on auto-updaters where available (e.g. Windows Update) to keep your operating systems patched and current against the latest vulnerabilities.
2. Make sure you have anti-virus, anti-spam and web filtering software installed on your computer. Set up regular scans. Keep the subscription active and ensure it is regularly updating itself.
3. Start a backup routine of your critical files, photos, and documents to external media, such as a thumb drive. If your machine gets infected and you are locked out due to Ransomware, you do not have to pay the ransom to get to these important files.
4. Always stay alert. Do not click on links you do not recognize, or accept downloads from people or vendors that you do not know personally.

Active Asset Allocation: Risk vs. Return by Stebbins Hubard

Most investment objectives are driven by risk vs. return decisions, investment time horizon, and cash flow needs. These goals must be identified and prioritized in order to determine an appropriate mix between different types of investments, such as stocks, bonds, and cash (the asset allocation decision). Establishing the appropriate asset allocation for a portfolio may be the most important factor in determining whether or not investment goals will be achieved. In fact, academic studies have determined that more than 90% of the variability in a portfolio's return can be attributed to the asset allocation decisions.

The risk vs. return tradeoff is the principle that potential return rises with an increase in risk. Low levels of uncertainty or risk are associated with low potential returns, whereas high levels of uncertainty or risk are associated with high potential returns. According to the risk vs. return trade-off, invested money can render higher profits only if the investor is willing to accept a certain higher level of risk. The table below provides an illustration of the historical trade-off between risk vs. return for various stock and bond mixes. It illustrates that greater exposure to stocks is generally consistent with stronger absolute returns.

For example, over the long run, a 25% stock/75% bond allocation has historically provided an annualized return of 6.92% since 1926 vs. 9.36% for a 75% stock/25% bond portfolio. In addition, historical quarterly return data indicates that a greater allocation to equities increases the likelihood of preserving purchasing power. For example, while a 25% stock/75% bond mix has failed to provide an annualized return of inflation plus 5% in 62% to 68% of rolling three, five, and ten year time periods since 1926, a 75% stock/25% bond allocation failed to provide such returns in only 40% to 45% of these same time periods.

There have been long periods of time when actual risk vs. return relationships have deviated widely from long-term averages. Therefore, market environment has a clear impact on the ability to achieve expected returns going forward. It is important to adopt an investment approach that allows for the flexibility to adjust a portfolio's asset allocation in response to changing market and economic conditions. The current historically low interest rates are an example that investors should recognize that they may have difficulty achieving returns consistent with their long-term goals without adjusting their allocations.

There is no single, fixed mix of assets that is likely to meet an investor's goals in every market environment, and some level of active decision-making is appropriate in the asset allocation process. These allocation decisions can be the key to lowering the risk of failing to meet long-term investment objectives.

1926 — 2016

% U.S. Large Cap Stock/ % Intermediate Treasury Bond	0/100	25/75	50/50	75/25	100/0
Annualized Return	5.26%	6.92%	8.29%	9.36%	10.12%
% Periods With Less Than Inflation +5% Return					
Rolling One Year Periods	67.42%	57.22%	46.18%	42.78%	42.49%
Rolling Three Year Periods	75.65%	62.03%	47.83%	43.77%	39.71%
Rolling Five Year Periods	79.53%	65.58%	50.45%	45.10%	43.92%
Rolling Ten Year Periods	83.60%	68.45%	49.21%	40.69%	35.96%

Source: Morningstar, Standard & Poors

Quantitative Easing and the Fed by Watt Dixon

After the Great Recession of 2008, the Federal Reserve began a massive bond buying program. By buying U.S. treasury and mortgage-backed bonds , the Fed hoped to drive down interest rates. Lower rates would encourage consumers to borrow money and spend, thus stimulating the economy. The Fed responded to the crisis by cutting its benchmark interest rate to nearly zero and by purchasing huge quantities of bonds. The Fed increased its balance sheet from about $900 billion in assets to $4.5 trillion in assets.

By most measures, the Fed's bond buying program, known as Quantitative Easing or QE has shown positive results, at least in the short term. Consumer and business borrowing costs have fallen. Home mortgage rates have dropped, helping prop up the housing market. The stock market has also recovered nicely since its massive sell–off in 2008. Inflation has remained low, and the number of unemployed workers has decreased as well.

Now that the economy seems to be on more solid ground and the Fed believes the slow but steady growth should continue, the Fed announced in mid-September that they are going to begin to unwind their bond portfolio.

In hopes of not disrupting the financial markets, the Fed has promised to move slowly and publish a detailed schedule of its intentions. There are several questions that remain that could play a role in the outcome of the Fed's actions. The Fed has not said exactly how large it would like its balance sheet to eventually be. Also Janet Yellen's term expires in early February and President Trump has not announced if he will nominate her for another term.

The Fed has said it will cut $10 billion per month for the first three months, divided 60%-40% between Treasuries and mortgage bonds. It will then raise the pace by $10 billion every three months. While the U.S. Fed is reducing bond holdings, The European Central Bank and the Bank of Japan continue to buy bonds. This buying should help keep rates low despite the Fed's actions.

Some people are worried that the Fed will move too quickly in reducing its bond portfolio. Perhaps the real worry should be if the Fed moves to slowly. If the Fed's bond portfolio is too large and another recession occurs, the Fed may not have the tools it needs to stimulate the economy. The Fed is trying to get back to higher interest rates and a more normal balance sheet so it can deal with any future crises.