



Johnston Investment Counsel

Gregory A. Johnston, CFA, CFP, QPFC, AIF
President & Chief Investment Officer
2714 N. Knoxville
Peoria, IL 61604
309-674-3330
gjohnston@jicinvest.com
www.jicinvest.com

February, 2017

Tax Tips for the Self-Employed

Grandparents Can Help Bridge the College Cost Gap

Can the IRS waive the 60-day IRA rollover deadline?

What's the difference between a direct and indirect rollover?



Johnston Investment Counsel
LIFE THE WAY YOU PLANNED IT.

Johnston Investment Counsel

LIFE THE WAY YOU PLANNED IT.

Should You Auto-Enroll Employees in Your 401(k) Plan?



According to the Plan Sponsor Council of America (PSCA), more than half of all 401(k) plans enroll employees automatically. Yet just 19% of plans with fewer than 50 participants have

this feature.¹ Might automatic enrollment be right for your organization?

What is automatic enrollment?

Simply put, automatic enrollment means that employees are automatically enrolled in the retirement plan upon hire (or at some other specified date) unless they specifically opt out. A designated percentage is then deducted from employees' paychecks each pay period and invested in a default investment on their behalf. According to the PSCA, the most common default contribution percentage is 3% (51% of plans), and the most common default investment is a target-date fund (75% of plans). Target-date funds are mutual funds that invest based on a targeted retirement year (e.g., 2035). As the date approaches, the asset mix in the fund typically becomes more conservative.²

What are the advantages to automatic enrollment?

The IRS reports that about 30% of workers who are eligible to participate in a retirement plan at work fail to do so. According to behavioral economist Richard Thaler, one of the primary reasons people don't participate is inertia — they simply don't get around to signing up. In Thaler's 2008 book *Nudge*, he describes the experience of one company that adopted automatic enrollment and saw its plan participation rate skyrocket from 65% to 98%. In the years since, similar results have been widely reported.

The benefits of automatic enrollment may have an even greater impact on those who need it most. One study found that more than 80% of college graduates with access to a 401(k) plan actually enroll, compared with only 69% of high

school graduates and 61% of those without a high school diploma.³

"The lesson from behavioral economics is that people only save if it's automatic," Thaler said in a 2015 interview.⁴

Another potential benefit: Automatic enrollment can help employers pass their nondiscrimination tests (testing designed to ensure that a company's retirement plan does not favor key employees over the rank and file).

Are there any drawbacks?

Costs were cited as a concern by 18% of companies that do not offer automatic enrollment, according to the PSCA survey. Consider that your obligation to make matching contributions, if offered, would rise with participation rates. In addition, average deferral rates may remain low, as inertia-prone participants may not change from the default rate.

For more information, consult the IRS and Department of Labor [publication Automatic Enrollment 401\(k\) Plans for Small Businesses](#).

¹ 58th Annual Survey of Profit Sharing and 401(k) Plans, PSCA, 2015

² The target date is the approximate date when an investor plans to withdraw the money. The principal value of a target-date fund is not guaranteed at any time, including the target date, nor is there a guarantee that a target-date fund will meet its stated objectives. The fund's return and principal value fluctuate with changes in market conditions. Shares, when sold, may be worth more or less than their original cost. No two funds with the same target date are alike. *For more information, investors should request a prospectus, which contains details about holdings, fees, and expenses, and should read the prospectus carefully before investing or sending money.*

³ "The 401(k) Is Wreaking Havoc on Retirement," *Employee Benefit News*, August 24, 2016

⁴ "Behavioral Economist Richard Thaler on the Key to Retirement Savings," *The Wall Street Journal*, November 29, 2015



Self-employed individuals make up 10.1% of the total U.S. workforce.

Source: U.S. Bureau of Labor Statistics, March 2016

Tax Tips for the Self-Employed

Being self-employed has many advantages — the opportunity to be your own boss and come and go as you please, for example. However, it also comes with unique challenges, especially when it comes to how to handle taxes. Whether you're running your own business or thinking about starting one, you'll want to be aware of the specific tax rules and opportunities that apply to you.

Understand the self-employment tax

When you worked for an employer, payroll taxes to fund Social Security and Medicare were split between you and your employer. Now you must pay a self-employment tax equal to the combined amount that an employee and employer would pay. You must pay this tax if you had net earnings of \$400 or more from self-employment.

The self-employment tax rate on net earnings (up to \$127,200 in 2017) is 15.3%, with 12.4% going toward Social Security and 2.9% allotted to Medicare. Any amount over the earnings threshold is generally subject only to the Medicare payroll tax. However, self-employment and wage income above \$200,000 is generally subject to a 0.9% additional Medicare tax. (For married individuals filing jointly, the 0.9% additional tax applies to combined self-employment and wage income over \$250,000. For married individuals filing separately, the threshold is \$125,000.)

If you file Form 1040, Schedule C, as a sole proprietor, independent contractor, or statutory employee, the net income listed on your Schedule C (or Schedule C-EZ) is self-employment income and must be included on Schedule SE, which is filed with your Form 1040. Schedule SE is used both to calculate self-employment tax and to report the amount of tax owed. You can deduct one-half of the self-employment tax paid (but not any portion of the Medicare surtax) when you compute the self-employment tax on Schedule SE.

Make estimated tax payments on time

When you're self-employed, you'll need to make quarterly estimated tax payments (using IRS Form 1040-ES) to cover your federal tax liability. You may have to make state estimated tax payments as well.

Estimated tax payments are generally due each year on the 15th of April, June, September, and January. If you fail to make estimated tax payments on time, you may be subject to penalties, interest, and a large tax bill at the end of the tax year. For more information, see IRS Publication 505, Tax Withholding and Estimated Tax.

Invest in a retirement plan

If you are self-employed, it is up to you and you alone to save sufficient funds for retirement. Investing in a retirement plan can help you save for retirement and also provide numerous tax benefits.

A number of retirement plans are suited for self-employed individuals:

- SEP IRA plan
- SIMPLE IRA plan
- SIMPLE 401(k) plan
- "Individual" 401(k) plan

The type of retirement plan you choose will depend on your business and specific circumstances. Explore your options and be sure to consider the complexity of each plan. In addition, if you have employees, you may have to provide retirement benefits for them as well. For more information, consult a tax professional or see IRS Publication 560, Retirement Plans for Small Businesses.

Take advantage of business deductions

If you have your own business, you can deduct some of the costs of starting the business, as well as the current operating costs of running that business. To be deductible, business expenses must be both ordinary (common and accepted in your field of business) and necessary (appropriate and helpful for your business).

Since business deductions will lower your taxable income, you should take advantage of any deductions to which you are entitled. You may be able to deduct a variety of business expenses, such as start-up costs, home office expenses, and office equipment.

Deduct health-care expenses

If you qualify, you may be able to benefit from the self-employed health insurance deduction, which would enable you to deduct up to 100% of the cost of health insurance that you provide for yourself, your spouse, your dependents, and employees.

In addition, if you are enrolled in a high-deductible health plan, you may be able to establish and contribute to a health savings account (HSA), which is a tax-advantaged account into which you can set aside funds to pay qualified medical expenses. Contributions made to an HSA account are generally tax deductible. (Depending upon the state, HSA contributions may or may not be subject to state taxes.)





Assets in 529 plans reached \$266.2 billion, spread over 12.7 million accounts, as of the second quarter of 2016.

Source: College Savings Plans Network, 529 Report: An Exclusive Mid-Year Review of 529 Plan Activity, September 2016

Note: Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing, along with each plan's specific investment options, underlying investments, and investment company. More information can be found in the plan's official disclosure statements and prospectus, which should be read carefully before investing. As with any investment, there are generally fees and expenses associated with participation in a 529 plan. There is also the risk that your underlying investments may lose money or not perform well enough to cover college costs as anticipated. Finally, be aware that your ability to take advantage of any 529 plan state tax benefits may be contingent on your enrollment in your own state's 529 plan.

Grandparents Can Help Bridge the College Cost Gap

For many families, a college education is a significant financial burden that is increasingly hard to meet with savings, current income, and a manageable amount of loans. For some, the ace in the hole might be grandparents, whose added funds can help bridge the gap. If you're a grandparent who would like to help fund your grandchild's college education, here are some strategies.

529 college savings plan

A 529 college savings plan is one of the best vehicles for multigenerational college funding. 529 plans are offered by states and managed by financial institutions. Grandparents can open a 529 account on their own — either with their own state's plan or another state's plan — and name their grandchild as beneficiary (one grandchild per account), or they can contribute to an existing 529 account that has already been established for that grandchild (for example, by a parent).

Once a 529 account is open, grandparents can contribute as much or as little as they want, subject to the individual plan's lifetime limits, which are typically \$300,000 and up. Grandparents can set up automatic monthly contributions or they can gift a larger lump sum — a scenario where 529 plans really shine.

Contributions to a 529 plan accumulate tax deferred (which means no taxes are due on any earnings made along the way), and earnings are completely tax-free at the federal level (and typically at the state level) if account funds are used to pay the beneficiary's qualified education expenses. (However, the earnings portion of any withdrawal used for a non-education purpose is subject to income tax and a 10% penalty.)

Under rules unique to 529 plans, individuals can make a lump-sum gift of up to \$70,000 (\$140,000 for joint gifts by a married couple) and avoid federal gift tax by making a special election on their tax return to treat the gift as if it were made in equal installments over a five-year period. After five years, another lump-sum gift can be made using the same technique. This strategy offers two advantages: The money is considered removed from the grandparents' estate (unless a grandparent were to die during the five-year period, in which case a portion of the gift would be recaptured), but grandparents still retain control over their contribution and can withdraw part or all of it for an unexpected financial need (the earnings portion of such a withdrawal would be subject to income tax and a 10% penalty, though).

What happens at college time if a grandchild gets a scholarship? Grandparents can

seamlessly change the beneficiary of the 529 account to another grandchild, or they can make a penalty-free withdrawal from the account up to the amount of the scholarship (though they would still owe income tax on the earnings portion of this withdrawal).

Finally, a word about financial aid. Under current federal financial aid rules, a grandparent-owned 529 account is not counted as a parent or student asset, but *withdrawals* from a grandparent-owned 529 account are counted as student income in the following academic year, which can decrease the grandchild's eligibility for financial aid in that year by up to 50%. By contrast, parent-owned 529 accounts are counted as parent assets up front, but withdrawals are not counted as student income — a more favorable treatment.

Outright cash gifts

Another option for grandparents is to make an outright gift of cash or securities to their grandchild or his or her parent. To help reduce any potential gift tax implications, grandparents should keep their gift under the annual federal gift tax exclusion amount — \$14,000 for individual gifts or \$28,000 for joint gifts. Otherwise, a larger gift may be subject to federal gift tax and, for a gift made to a grandchild, federal generation-skipping transfer tax, which is a tax on gifts made to a person who is more than one generation below you.

An outright cash gift to a grandchild or a grandchild's parent will be considered an asset for financial aid purposes. Under the federal aid formula, students must contribute 20% of their assets each year toward college costs, and parents must contribute 5.6% of their assets.

Pay tuition directly to the college

For grandparents who are considering making an outright cash gift, another option is to bypass grandchildren and pay the college directly. Under federal law, tuition payments made directly to a college aren't considered taxable gifts, no matter how large the payment. This rule is beneficial considering that tuition at many private colleges is now over \$40,000 per year. Only tuition qualifies for this federal gift tax exclusion; room and board aren't eligible.

Aside from the benefit of being able to make larger tax-free gifts, paying tuition directly to the college ensures that your money will be used for education purposes. However, a direct tuition payment might prompt a college to reduce any potential grant award in your grandchild's financial aid package, so make sure to ask the college about the financial aid impact of your gift.



Johnston Investment Counsel
LIFE THE WAY YOU PLANNED IT.

Johnston Investment Counsel

Gregory A. Johnston, CFA, CFP,
QPFC, AIF
President & Chief Investment
Officer
2714 N. Knoxville
Peoria, IL 61604
309-674-3330
gjohnston@jicinvest.com
www.jicinvest.com

IMPORTANT DISCLOSURES

Broadridge Investor Communication Solutions, Inc. does not provide investment, tax, or legal advice. The information presented here is not specific to any individual's personal circumstances.

To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances.

These materials are provided for general information and educational purposes based upon publicly available information from sources believed to be reliable—we cannot assure the accuracy or completeness of these materials. The information in these materials may change at any time and without notice.



Can the IRS waive the 60-day IRA rollover deadline?

If you take a distribution from your IRA intending to make a 60-day rollover, but for some reason the funds don't get to the new IRA trustee in time, the tax impact can be significant. In general, the rollover is invalid, the distribution becomes a taxable event, and you're treated as having made a regular, instead of a rollover, contribution to the new IRA. But all may not be lost. The 60-day requirement is automatically waived if all of the following apply:

- A financial institution actually receives the funds within the 60-day rollover period.
- You followed the financial institution's procedures for depositing funds into an IRA within the 60-day period.
- The funds are not deposited in an IRA within the 60-day rollover period solely because of an error on the part of the financial institution.
- The funds are deposited within one year from the beginning of the 60-day rollover period.
- The rollover would have been valid if the financial institution had deposited the funds as instructed.

If you don't qualify for this limited automatic waiver, the IRS can waive the 60-day requirement "where failure to do so would be against equity or good conscience," such as a casualty, disaster, or other event beyond your reasonable control. However, you'll need to request a private letter ruling from the IRS, an expensive proposition — the filing fee alone is currently \$10,000.

Thankfully, the IRS has just introduced a third way to seek a waiver of the 60-day requirement: self-certification. Under the new procedure, if you've missed the 60-day rollover deadline, you can simply send a letter to the plan administrator or IRA trustee/custodian certifying that you missed the 60-day deadline due to one of 11 specified reasons. To qualify, you must generally make your rollover contribution to the employer plan or IRA within 30 days after you're no longer prevented from doing so. Also, there is no IRS fee.

The downside of self-certification is that if you're subsequently audited, the IRS can still review whether your contribution met the requirements for a waiver. For this reason, some taxpayers may still prefer the certainty of a private letter ruling from the IRS.



What's the difference between a direct and indirect rollover?

If you're eligible to receive a taxable distribution from an employer-sponsored retirement plan [like a 401(k)], you can avoid current taxation by instructing your employer to roll the distribution directly over to another employer plan or IRA. With a direct rollover, you never actually receive the funds.

You can also avoid current taxation by actually receiving the distribution from the plan and then rolling it over to another employer plan or IRA within 60 days following receipt. This is called a "60-day" or "indirect" rollover.

But if you choose to receive the funds rather than making a direct rollover, your plan is required to withhold 20% of the taxable portion of your distribution (you'll get credit for the amount withheld when you file your federal tax return). This is true even if you intend to make a 60-day rollover. You can still roll over the entire amount of your distribution, but you'll need to make up the 20% that was withheld using other assets.

For example, if your taxable distribution from the plan is \$10,000, the plan will withhold

\$2,000 and you'll receive a check for \$8,000. You can still roll \$10,000 over to an IRA or another employer plan, but you'll need to come up with that \$2,000 from your other funds.

Similarly, if you're eligible to receive a taxable distribution from an IRA, you can avoid current taxation by either transferring the funds directly to another IRA or to an employer plan that accepts rollovers (sometimes called a "trustee-to-trustee transfer"), or by taking the distribution and making a 60-day indirect rollover (20% withholding doesn't apply to IRA distributions).

Under recently revised IRS rules, you can make only one tax-free, 60-day, rollover from any IRA you own (traditional or Roth) to any other IRA you own in any 12-month period. However, this limit does not apply to direct rollovers or trustee-to-trustee transfers.

Because of the 20% withholding rule, the one-rollover-per-year rule, and the possibility of missing the 60-day deadline, in almost all cases you're better off making a direct rollover to move your retirement plan funds from one account to another.



Johnston Investment Counsel
LIFE THE WAY YOU PLANNED IT.

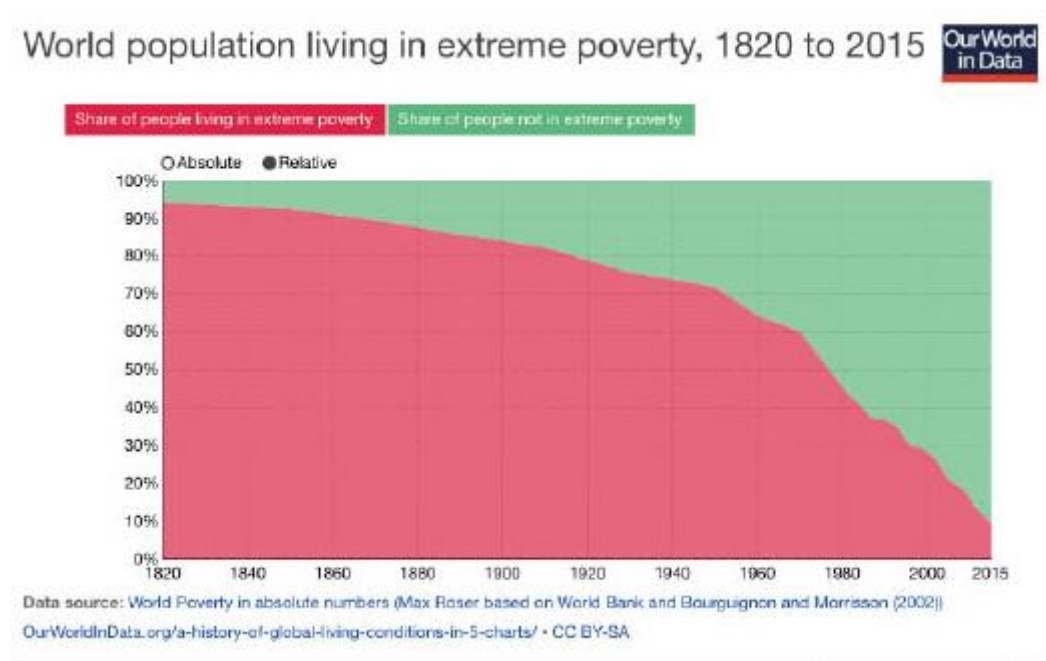


The Uptrends We Never See

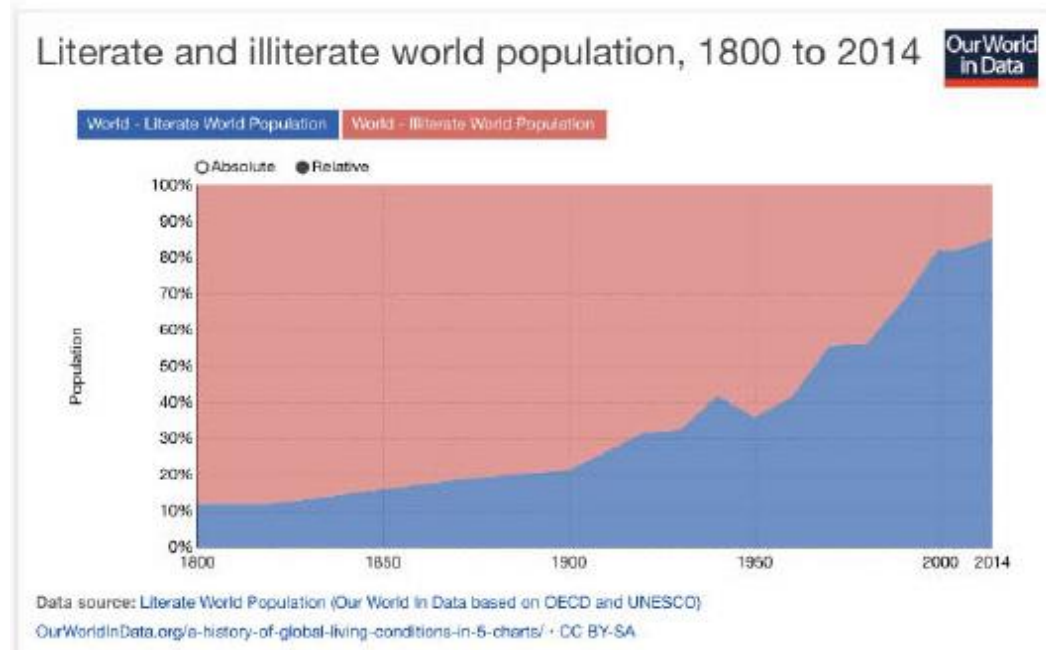
Many people suspect that the world is going to hell in a handbasket—or at least getting worse over the long term. In the U.S., only 4% of respondents will tell you that our world living conditions are improving.

If you're in the majority, the website "Our World in Data" (<https://ourworldindata.org/a-history-of-global-living-conditions-in-5-charts/>) has posted some charts that might change your mind. Looking back over the long-term, it finds that we're living at the very peak of world living conditions. And the trend still seems to be upward.

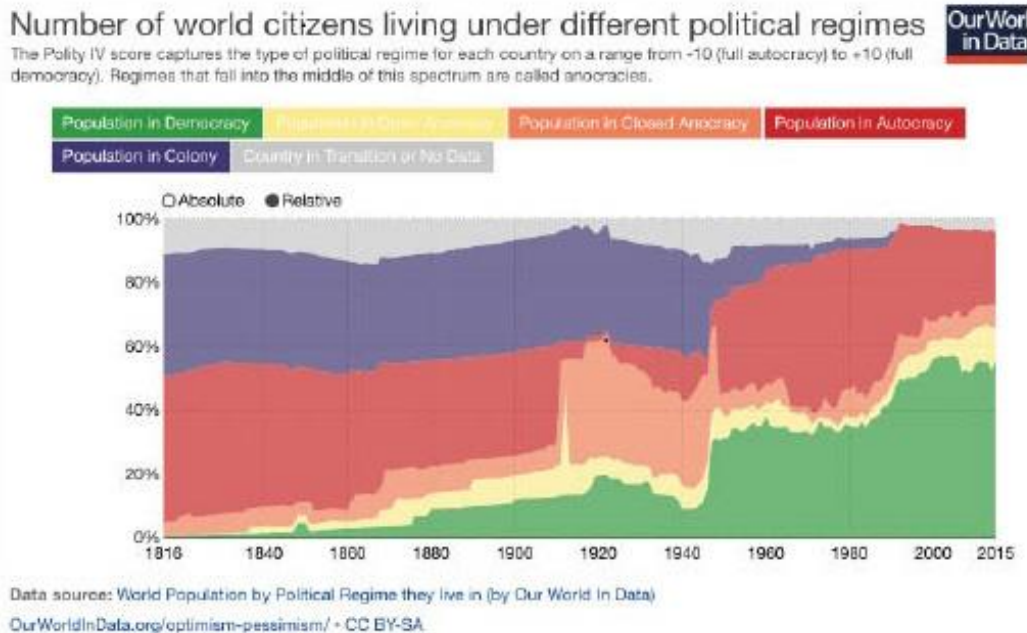
Consider global poverty. The accompanying chart shows the share of the world population living in extreme poverty—and you can see that this was a very high percentage in 1820, when the dataset begins. Since then, the share of extremely poor people has fallen dramatically and steadily, as more world regions have embraced industrialization, created social safety nets and slowly built a middle class. Today only about 10% of the world's citizens live in extreme poverty.



Take another example: literacy. In 1800, only around 10% of the human population could read. Today, as you can see from the chart, the number hovers around 80%. If you believe that science, technology and political freedom are important to solving the world's problems, then it helps if more people can read and write and therefore participate.



Finally, there have been dramatic changes in the percentage of people around the world who live in a democratically free vs. closed totalitarian society. The accompanying chart shows that virtually no people live in colonies any more, and closed autocracies are becoming scarce. Meanwhile, the green-shaded area shows the percentage growth of individuals who now live in a democratic society—more than half currently, up from nearly zero in 1816.



What does all this mean? If we take a longer-term perspective than, say, the recent presidential election cycle or last quarter's earnings reports, we begin to see that all the time and energy and labor that all of us are putting in every day to improve the world, are actually paying off with substantial—if sometimes incremental--results. Other charts show that we're healthier, better-educated and better off than our ancestors.

Let's hope we can keep it up. The trends say we will.



Get Ready for Weird Food

Are you ready to start eating bugs? Or or goldfish muscle dipped in fetal bovine serum? Scientists point out that people 100 years ago probably would have barfed at the sight of a Twinkie and would have had trouble comprehending a Dorito. So, looking ahead 100 years, they're predicting that the food people typically consume will get weird in ways that are surprisingly predictable.

For example? Consider insects in your diet. You can already buy pasta and food bars made with cricket flour that adds extra protein, and roasted crickets are sold whole at the website www.bonanza.com. Grasshoppers are equally nutritious, and mealworms and black soldier flies are, we are told, a great source of dietary fat. There's some debate about whether eating insects is more environmentally-conscious than eating chicken or beef, but reports suggest that the insects can survive on diets that you wouldn't feed to your pig.

What about hamburger that is made in the laboratory? Companies like Memphis Meat and Mosa Meat are patterning stem cells into animal tissue, which can be converted into synthetic meat that looks like ground beef. The process uses 7-45% less energy than raising animals for slaughter, and produces 78-96% fewer greenhouse gas emissions—and, as you might guess, it involves 99% less land use than conventionally produced steak. Along the same lines, NASA researchers created fish fillets by dipping goldfish muscle into fetal bovine serum, while New Wave Foods is looking for ways to create synthetic shrimp out of red algae.

Farmed fish are already part of our diet, and history suggests that it will totally take over the fish market. Raising cattle takes up a lot of land, but raising cultivated fish as livestock takes place where people don't live (in the ocean), and fish require only a fraction of the amount of feed that cattle do in order to produce the same amount of protein. In case you think this is far-fetched, the former director of Aquaculture at WorldFish Corp. says that most aquatic food now comes from farming rather than fishing. That shouldn't be surprising, since virtually all the beef, pork and chicken we consume now comes from farmed animals, rather than hunted ones.

You already eat vegetables and other plant life. Why not micro-algae as well? The microscopic plants feed off carbon dioxide in the atmosphere, and are rich in proteins, fats and carbohydrates—including a high concentration of omega 3 fatty acids.

Not ready for the brave new world of exotic (and disgusting) foods? Don't worry; over time, your kids or grandkids will eat these future delicacies with the same nonchalance that you now give to Doritos and Twinkies.

Source:

- <http://gizmodo.com/eight-futuristic-foods-youll-be-eating-in-30-years-1790570240>



Investments to Avoid

Every year, the Morningstar mutual fund tracking organization releases a list of the worst new ETF investments—and generally, these tend to be trendy new offerings that are designed to catch the eye of investors who are responding to yesterday's headlines rather than their long-term economic future.

This year's top nomination is something called the VelocityShares Leveraged Crude Oil ETN, closely followed by the VelocityShares 3x Inverse Crude Oil Fund.

What do you get when you invest in these shares? Every day, the VelocityShares products give you three times the daily movements of the price of oil on the global markets. The first fund gives you three times the amount that the price changes in the same direction, while the second gives you three times the movement in the opposite direction.

Set aside the fact that there is no conceivable reason why you would want daily exposure to an investment as volatile as crude oil. For the moment, ignore the fact that the typical portfolio already has plenty of oil exposure, since energy companies are among the largest of the large caps, and just about every U.S. and global organization uses energy as one of its major expense items.

The bigger problem with these shares is that the more volatile an investment is, the lower its long-term performance will tend to be in dollar terms. When a stock or ETF goes down 50% and then back up 50%—and this could happen in a week with these shares—the round trip delivers you a 25% loss. Lather, rinse and repeat, and you're looking at an underperforming asset—at three times the normal velocity.

What else did Morningstar single out? You might also consider avoiding the Whisky & Spirits ETF. Not only is this portfolio concentrated on a small component of a much larger business sector, it is even highly-concentrated within the small realm of alcoholic beverages. A single stock accounts for 23% of the portfolio, and its top 10 holdings comprise 79% of the total dollars invested. And for this absurd lack of diversification, you pay 75 basis points a year—as much as you might pay for a diversified international fund. Why not just buy your own distillery instead?

Source:

- <http://www.thinkadvisor.com/2016/12/28/the-best-and-worst-etfs-of-2016-morningstar?page=2&slreturn=1483222427>

Capital Market Review and Outlook

January, 2017

Visit us online
jicinvest.com

Office
2714 N. Knoxville
Peoria, Illinois 61604
t 309.674.3330
tf 877.848.3330
f 888.301.0514



Johnston Investment Counsel
LIFE THE WAY YOU PLANNED IT.

Executive Summary

In response to stagnant wages and rising inequality, the electorate is upending the political establishment.

Nationalism, expanding fiscal policy, and de-regulation appear to be the new themes.

New directions bring uncertainty. Investors need to prepare for a wider range of potential outcomes.

In the U.S., we believe there will be a modest uptick in economic growth, inflation, and interest rates.

We are emphasizing economically-sensitive sectors. Broad market valuation remains a concern.

We expect future returns to be below normal.

JIC's Investment Outlook

2016 will go down as a year in which the people spoke. I'm not sure too many people predicted the U.K. would vote to leave the European Union, the U.S. would elect Donald Trump, Italy would vote no to reform, and the markets would respond favorably – and in some cases very favorably.

The middle class has finally had enough. As a result of stagnant wages, rising inequality, declining purchasing power, and general economic malaise, they let their fury be known to the political establishment. The challenge for us is to decipher this changing environment.

We believe the following broad themes may dominate not only here in the U.S. but, to different degrees, globally:

1. A change toward nationalism and away from globalism
2. A changing emphasis toward fiscal policy and away from monetary policy, and
3. A shift towards de-regulation from regulation.

In the U.S., while we may have a very general framework on policy direction of a Trump presidency, there are many details that are unanswered. Moving in a new direction certainly has risks -- some known and some unknown. In short, these new directions will lead to increased uncertainty and a wider range of possible outcomes (both positive and negative).

During the past few years, markets have been relatively stable – not exhibiting significant levels of volatility (at least by historical standards). As markets attempt to interpret new policy initiatives and directions, we believe investors should be prepared for higher levels of volatility.

JIC's Base Case Scenario

JIC's normal investment process is to evaluate general macroeconomic conditions and trends, fundamentals and valuation, and technical characteristics. Using that information as inputs, we then develop the various strategies that influence our investment decisions.

The election of Donald Trump as President has both

positive and negative implications for the U.S. economy. On the positive side, Trump has promised to reduce regulations, cut corporate taxes, and increase infrastructure and defense spending. On the negative side, his protectionist and anti-immigrant proposals threaten to stem the free flow of goods, services, and labor.

JIC thinks reducing regulation and corporate tax reform will have beneficial effects on the economy and are the policy ideas most likely to be implemented. While an infrastructure spending bill would also be beneficial (and is needed), there are budget deficit concerns. Those concerns may reduce the size, and therefore the impact, of any infrastructure package.

We are hopeful that the President will back away from his campaign rhetoric and not actively use permanent trade tariffs, but other approaches, to advance his trade agenda. Negatively impacting trade will probably be counterproductive to his goal of stimulating economic growth.

These themes generally suggest an uptick in U.S. economic growth, inflation and possibly interest rates (over time). Currently, we view the risk of recession as low. We believe equity prices already reflect some of these pro-growth changes. But there may be more room for stocks to appreciate.

With that said, valuations here in the U.S. are more extended compared to other parts of the world. The U.S. will likely act sooner on its reflation policies and, for the time being, we would favor U.S. stocks over developed market stocks. However, at some point, reflationary policies will probably start in other large international economies. At that time, given more attractive valuations, we could reasonably see leadership change to the developed international markets.

Since improving economic growth is one of the new administrations major economic goals, the fiscal and de-regulation changes we expect will likely have more benefits to specific sectors of the economy, namely the economic sensitive sectors. As such, we expect value stocks to outperform.

In terms of company size, we remain tilted toward large company stocks mainly as a risk control measure (we are concerned about the valuation levels of small company stocks). With that said, a more domestic-focused economic strategy, at the margin, tends to favor small company stocks. We are closely monitoring these developments and may, at some point in the future, increase our small company allocation.

Our sense is that we have seen the low in bond yields and believe that, over the next few years, interest rates may rise across the maturity spectrum. On a short-term basis we do not believe the FED will aggressively move to raise interest rates – unless wages, inflation, and/or economic growth start to rise well above expectations. A couple of interest rate increases during the next year or so are reasonable to expect.

We have increased our allocation to shorter-maturity bonds. In addition, with the risk of recession low, we have taken credit exposure in both the investment grade and high yield segments of the market.

While predicting short-term stock returns is a fool's errand, against the backdrop of higher than average equity valuations and low (but possibly rising) bond yields, we see longer-term investment returns (both stock and bond) as below average.

So what are the risks to our outlook?

The reality may not live up to the forecasts. Perhaps Congress will not be able to execute tax reform or develop a meaningful fiscal stimulus package. Maybe deregulation is not as successful as the markets hope. It could be that miscalculations on trade lead to an all-out trade war. International events could also have an impact.

It is entirely possible that the markets are overestimating the benefits of tax reform and fiscal spending and underestimating the impact of protectionist trade policies. If that were to materialize, that could be a catalyst for a correction.

In addition, if interest rates were to suddenly rise, due

to a rapid increase in expected inflation, that could have a negative impact on asset prices.

Lastly, during 2017, Europe faces general elections in France, Germany, the Netherlands and possibly Italy. The potential for meaningful populist gains is a significant risk – particularly at a time when European cohesion appears fragile. Concerns about a Eurozone breakup could lead to stalled business and investment decisions while driving increased volatility in financial markets.

2016 Capital Market Performance

To the surprise of many, stocks returned 12.8% during 2016, although a good portion of the increase was concentrated during the post-election period. Bonds returned 2.7% for the year but lost -3.0% during the fourth quarter as interest rates rose. Commodities finally rebounded returning 11.8% after several years of poor returns. Inflation remained below 2.0%.

In terms of stock returns, mid- and small-company, value, and commodity-related were the best performing during 2016. High yield bonds returned over 17%. Laggards for 2016 included short-term, municipal, and developed market bonds although there were very narrow performance differences.

One way we use to identify the attractiveness of market segments is to compare their yields (higher yields

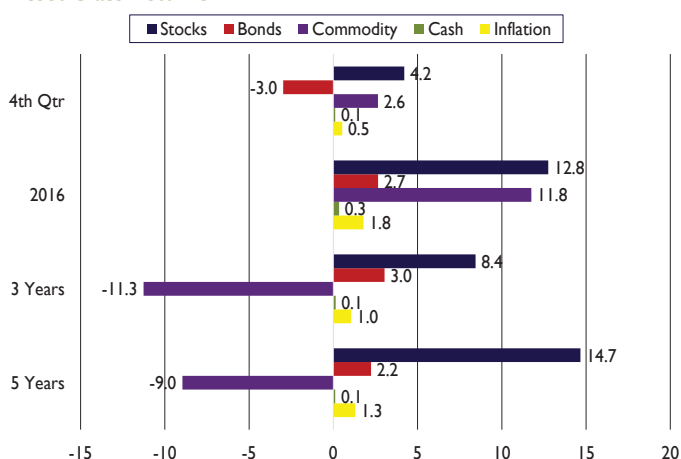
are better). On this measure, stock yields (currently at 4.5%) are still more attractive than investment grade bonds, but have significantly declined during the past several years (as stock prices have risen). A-rated bonds yield around 3.0%. High yield bonds are yielding a little more than 6%.

2016 Stock Market Results

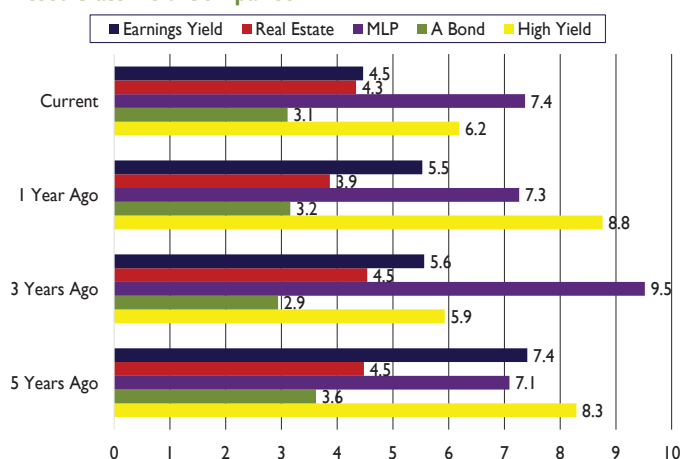
Having any international stock allocation detracted from returns during 2016 but, in particular, developed market stocks which returned 1.6% (compared to the U.S. return of 12.8%). Emerging market stocks returned 10.7%. Emerging market stocks led for a good portion of the year, but fell during the fourth quarter on concerns about the trade policies of a Trump administration.

Small stocks rocketed 21.3% during 2016 ahead of

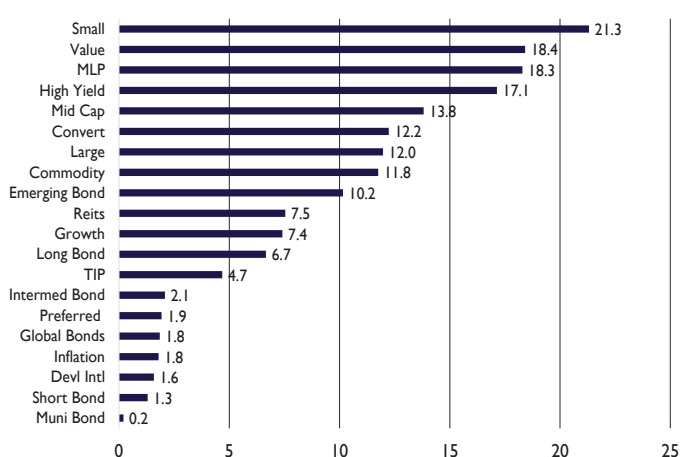
Asset Class Returns



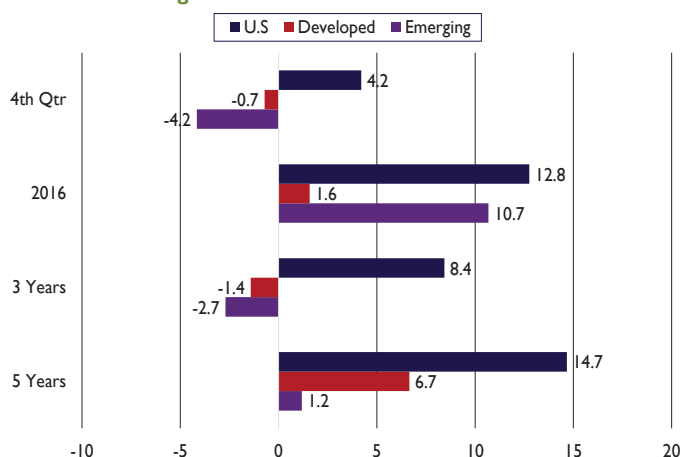
Asset Class Yield Comparison



2016: What Worked



Stock Market Segment Returns



the 12.0% large- and 13.8% mid-cap returns. Nearly all of the small-cap outperformance occurred during the post-election period. Value stocks returned 18.4% during 2016 compared to the Growth stock return of 7.4%. Similar to small company stocks, a disproportionate amount of the performance advantage was concentrated to the post-election period.

The three S&P 500 sectors with the best 2016 performance included Energy (27.4%), Telecommunications (23.5%), and Finance (22.8%). The three worst performing sectors included Healthcare (-2.7%), Consumer Staples (5.4%), and Consumer Discretionary (6.0%). The remaining sectors (Industrials, Materials, Technology, and Utilities) had returns that ranged from 13.8% to 18.9%. The best performing sectors generally were more economically sensitive. It is noticeable that the performance difference between the worst and the

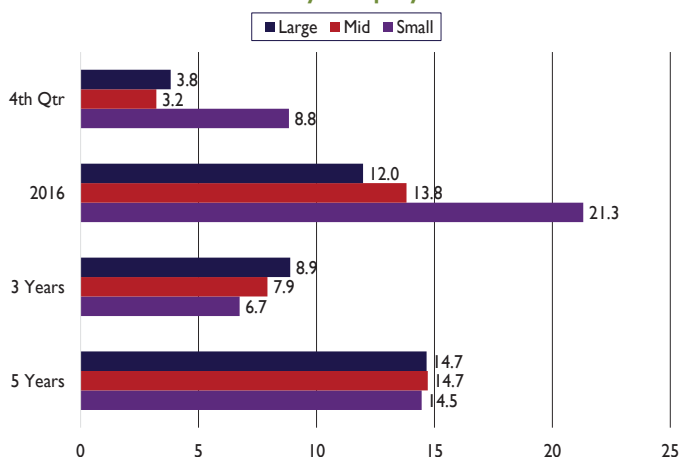
best sector was approximately 30%.

Valuation metrics clearly have increased. Compared to five years ago, the price to sales ratio has increased 33% while the price-earnings ratio has increased 36%. While there has been earnings growth during this time, price appreciation has been significantly greater than earnings growth. At present, the price-earnings ratio stands at 22.4x which is clearly above its long-term historical average, but is not near the Internet bubble levels of the late 1990's.

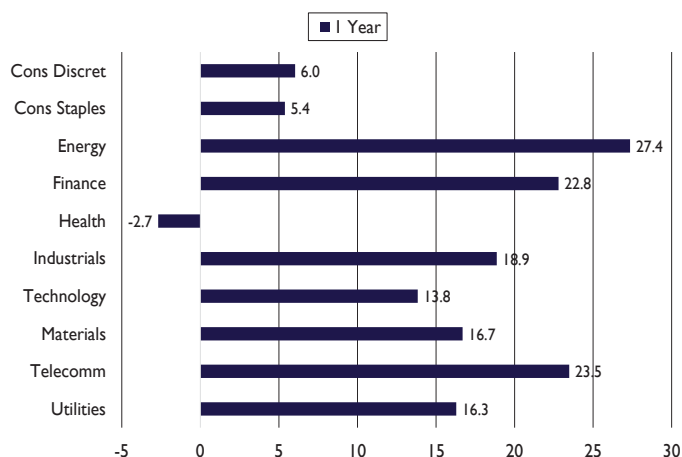
By company size, there is also a significant price / earnings difference between large (22.4), mid (28.8), and small (36.0) company stocks.

Not surprisingly, comparing valuation characteristics to the developed and emerging markets, the U.S. is

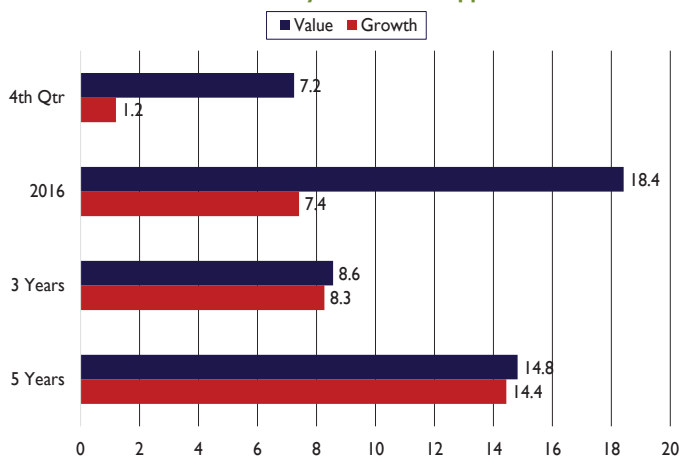
U.S. Stock Market Returns: By Company Size



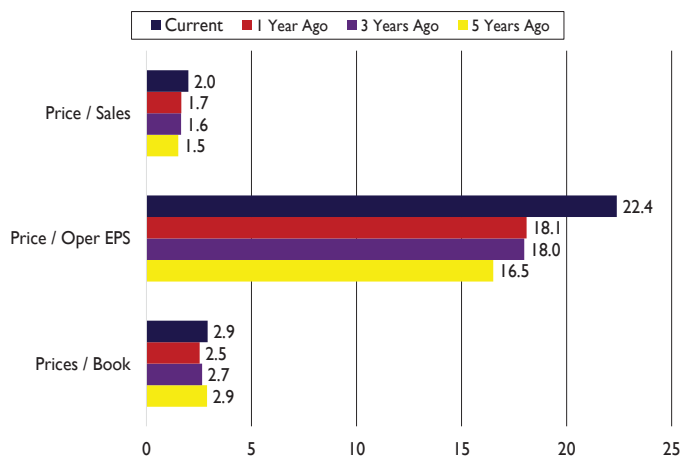
S&P 500 Sector Returns



U.S. Stock Market Returns: By Investment Approach



S&P 500 Valuation Characteristics



generally more expensive. At present, emerging markets offer the most attractive valuations.

2016 Bond Market Results

With the exception of high yield and dollar-denominated emerging market bonds, bond returns were modest during 2016. Municipal bonds had the lowest return of 0.2% while inflation protected securities (known as TIPS) returned 4.7%. The broad U.S. market returned 2.7%. It is interesting to note that, for the traditional bond segments, returns were negative during the fourth quarter when interest rates significantly increased after the election.

By maturity, long-term bonds returned 6.7%, intermediate-term bonds returned 2.1%, short-term bonds returned 1.3%, and money markets returned 0.3%. While the long-term bond return is accurate its per-

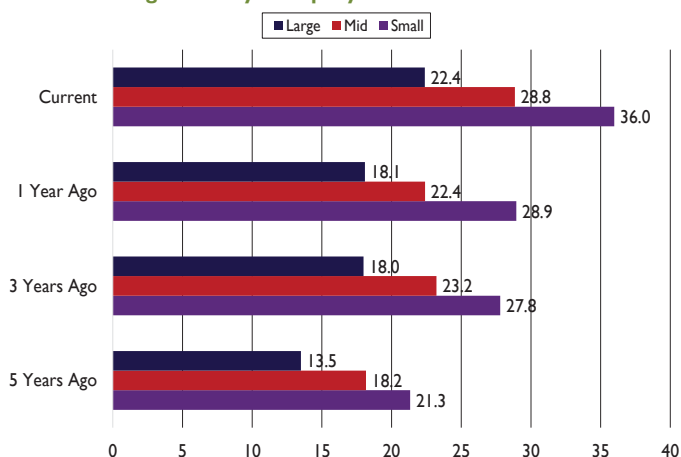
formance is almost entirely attributable to the corporate bond segment of the index.

Corporate bonds returned 5.6% during 2016, mortgages returned 1.7%, and government bonds returned 1.0%.

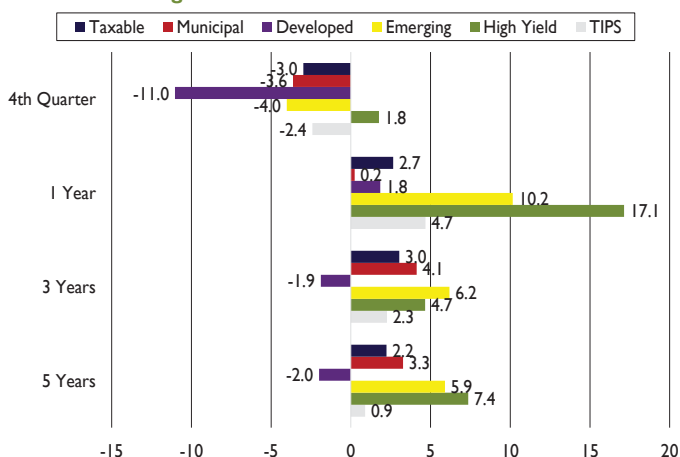
As a result of the fourth quarter rise, bond yields are higher (compared to one year ago) across the maturity spectrum. The shape of the yield curve has remained similar compared to a year ago (gradually upward sloping).

Not surprisingly, high-yield bonds offer a significant yield premium compared to other bond market sectors. With that said, the yield premium received has declined during the past year. In other words, investors are not being as well compensated for taking on

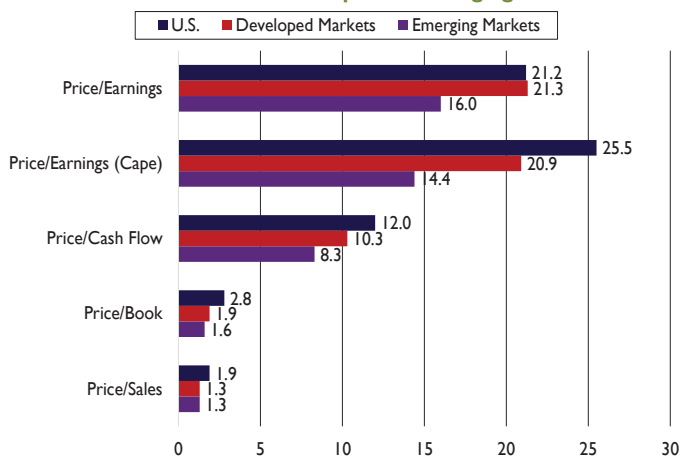
Price / Earnings Ratio by Company Size



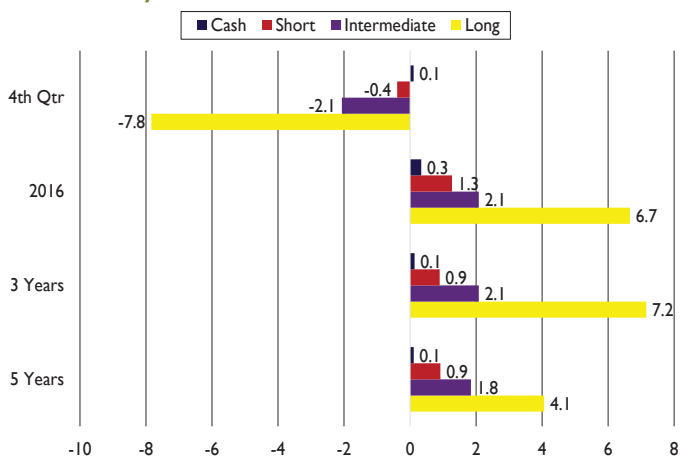
Bond Market Segment Returns



Valuation Characteristics: Developed vs. Emerging



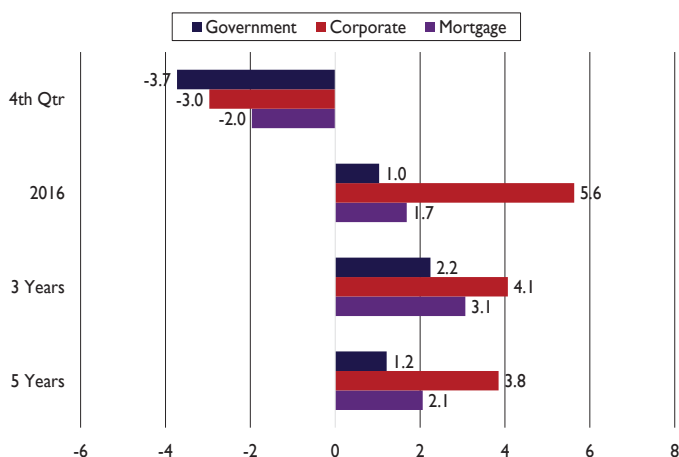
Bond Maturity Returns



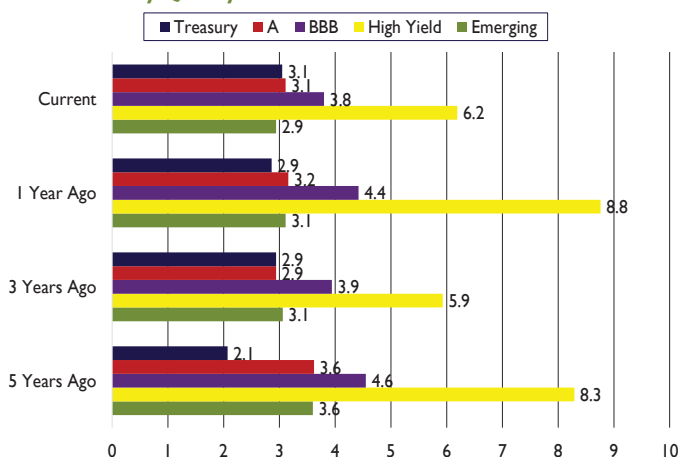
the additional risk of high-yield bonds compared to a year ago.

In terms of our bond allocation, we have established a short-term bond allocation with the expectation of rising interest rates. We also have allocations to both investment and non-investment grade credit as well as preferred stocks and emerging market bonds.

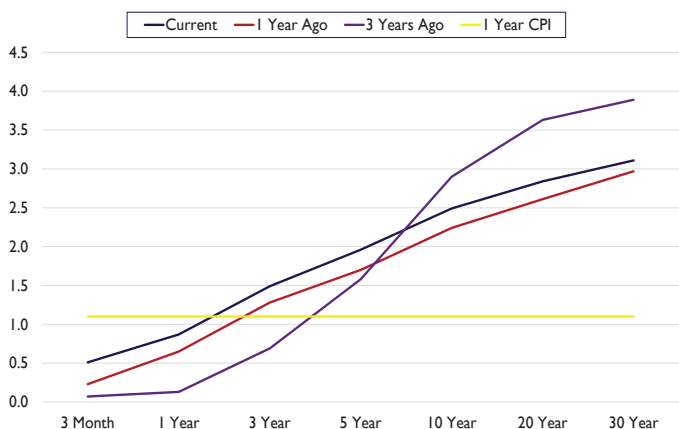
Bond Sector Returns



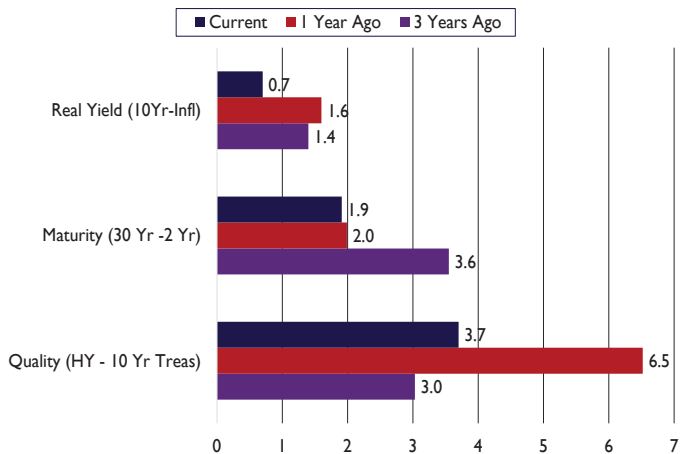
Bond Yields By Quality



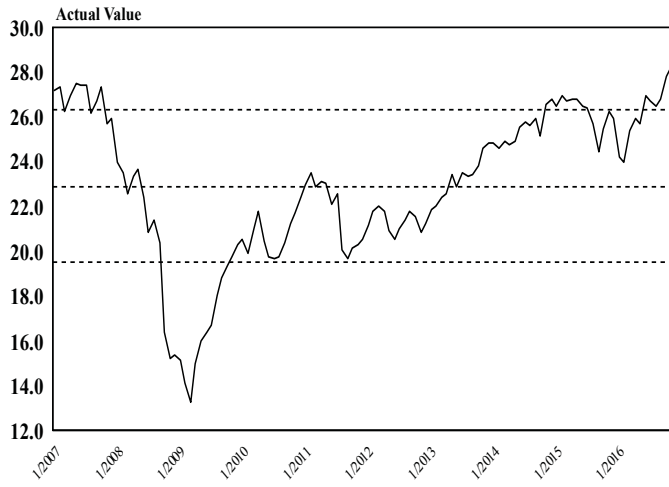
Treasury Yield Curve



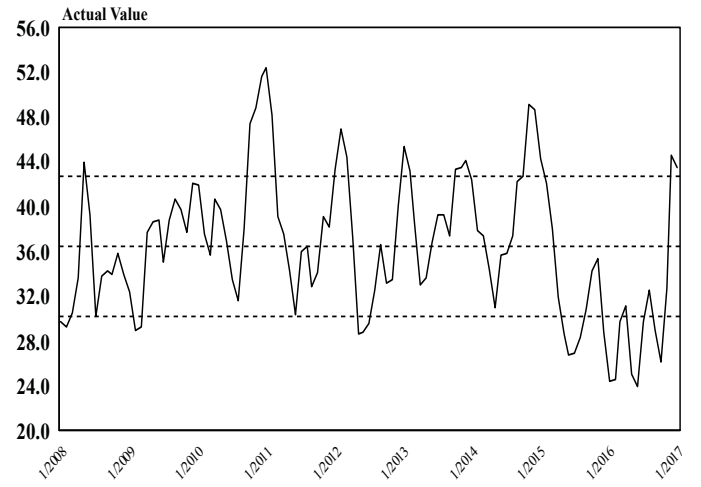
Inflation, Maturity & Quality Spread



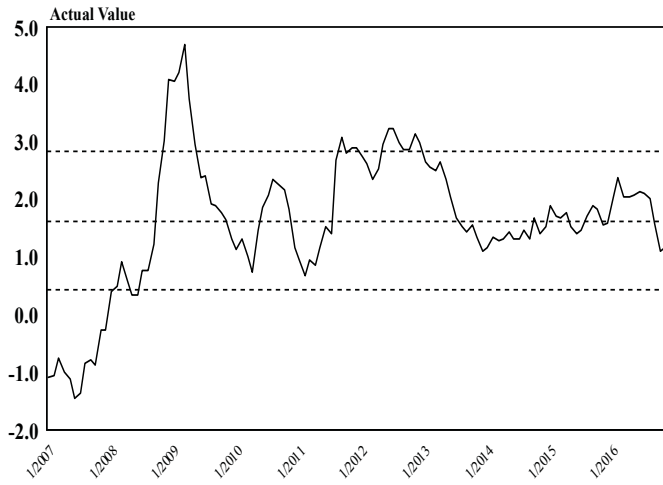
S&P 500 PE Using 10-Year Average Real Earnings



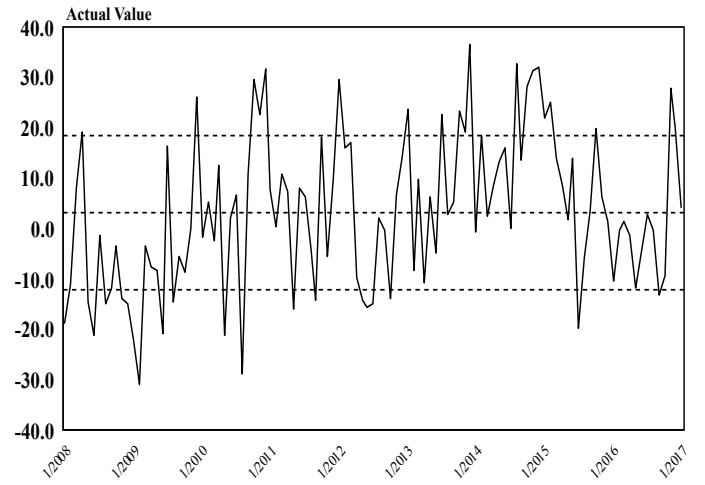
AAII Percent Bullish 8-Week Average



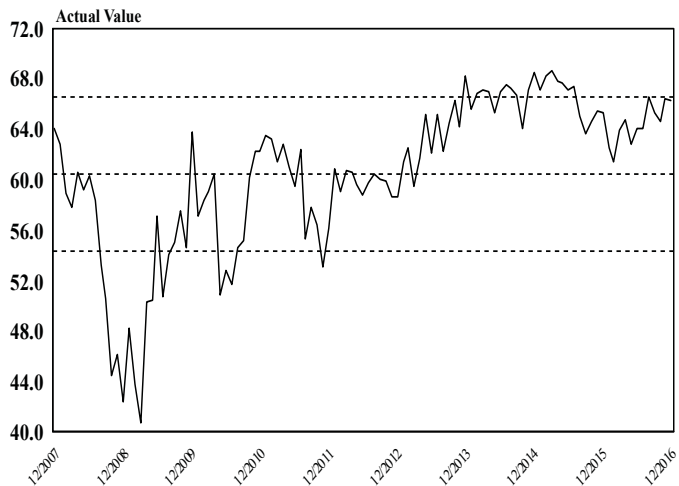
S&P 500 Earnings Yield Using 10-Year Average Real Earnings Less 10-Year Treasury



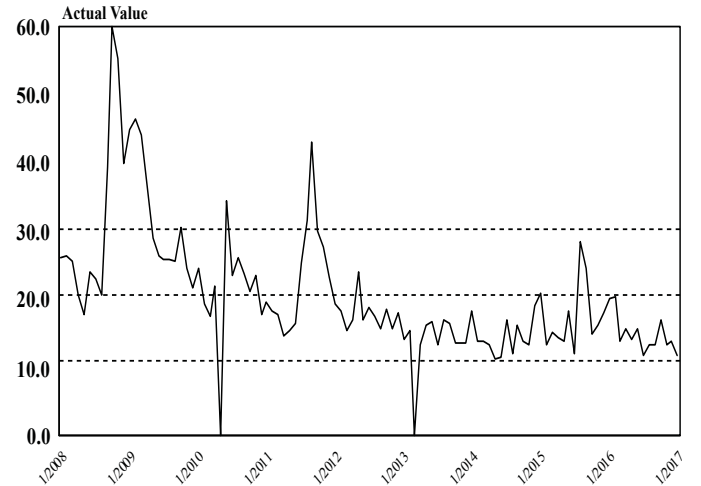
AAII Bull/Bear Investor Sentiment Spread



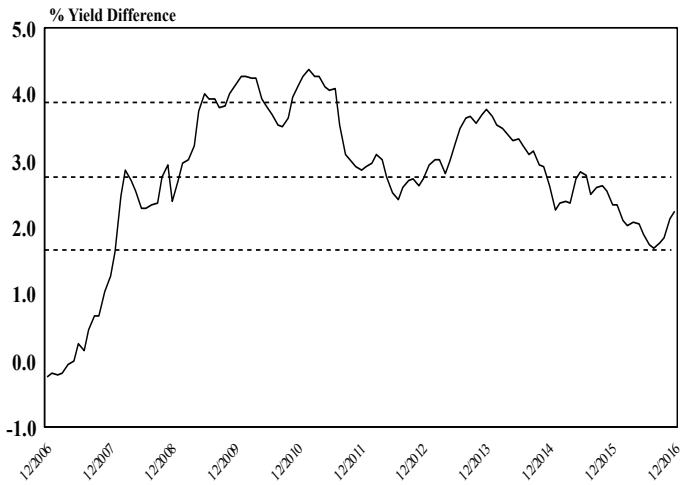
AAII Survey: Stock Allocation



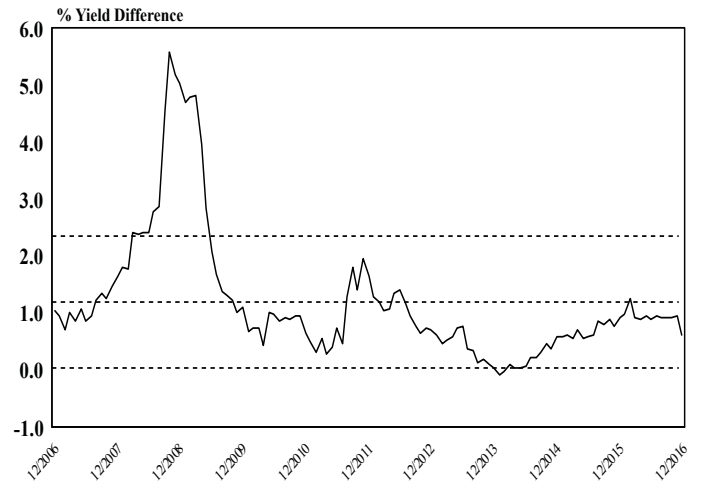
CBOE Volatility Index



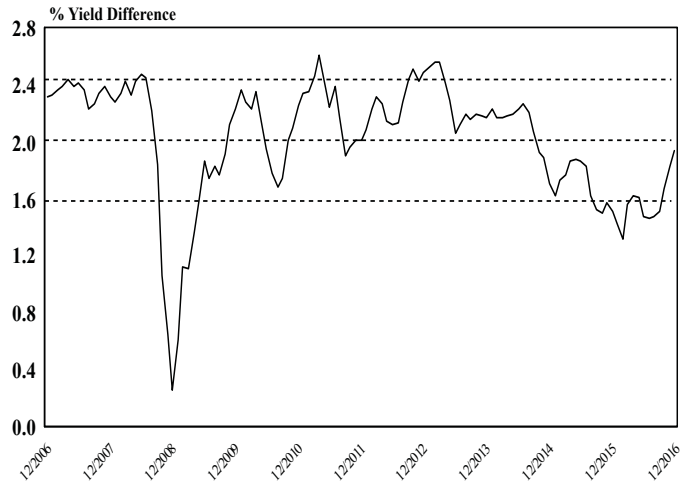
30 Year Treasury Less 1 Year Treasury



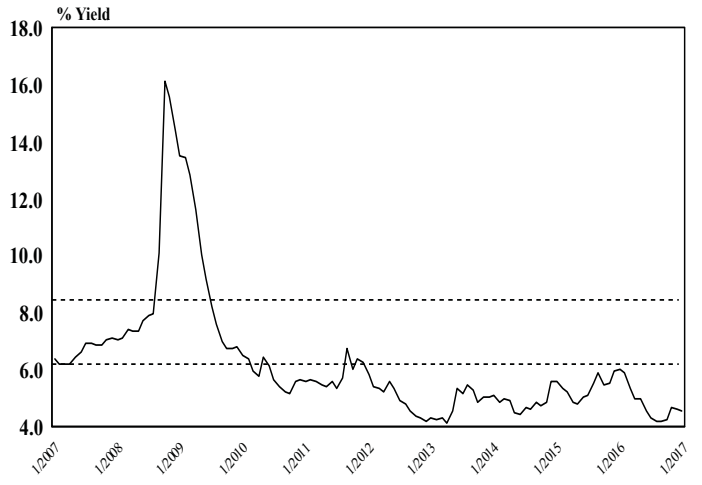
MLA Less 10 Year Treasury



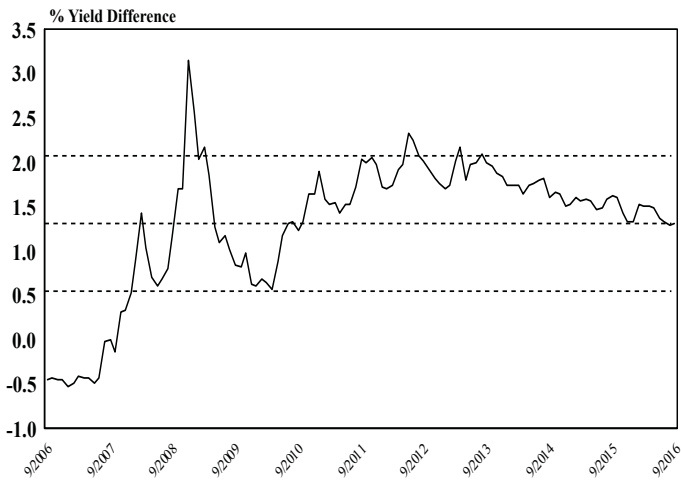
10 Year Treasury Less 10 year TIP



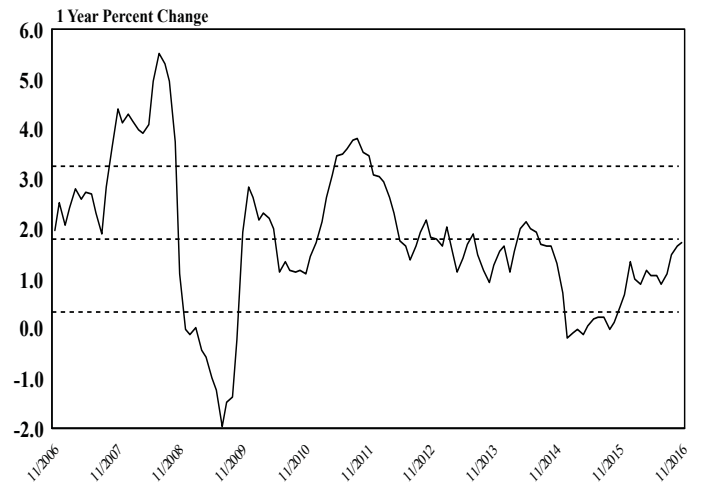
ML Emerging Market Corporate



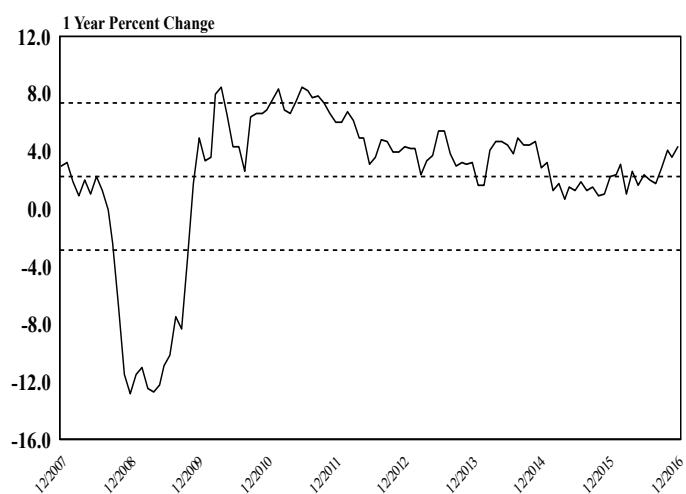
Bond Buyer 20-Bond Municipal Bond Index Less 10 Year Treasury



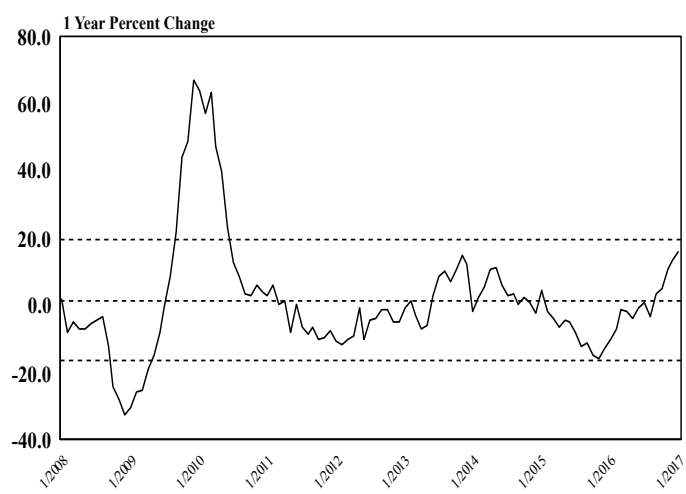
Consumer Price Index



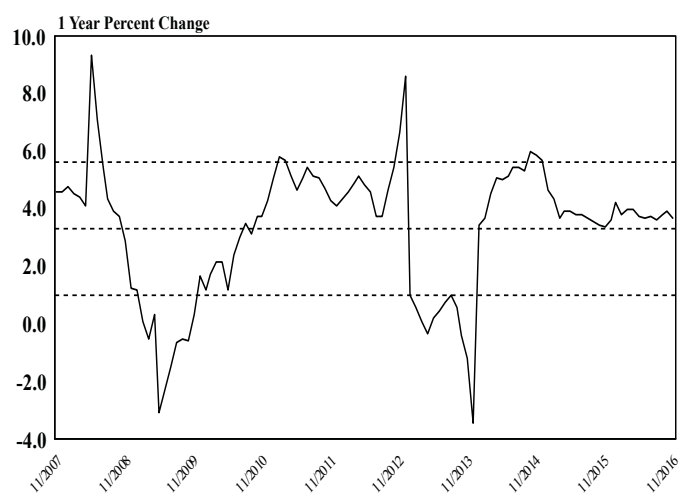
Retail Sales (Excluding Food Service)



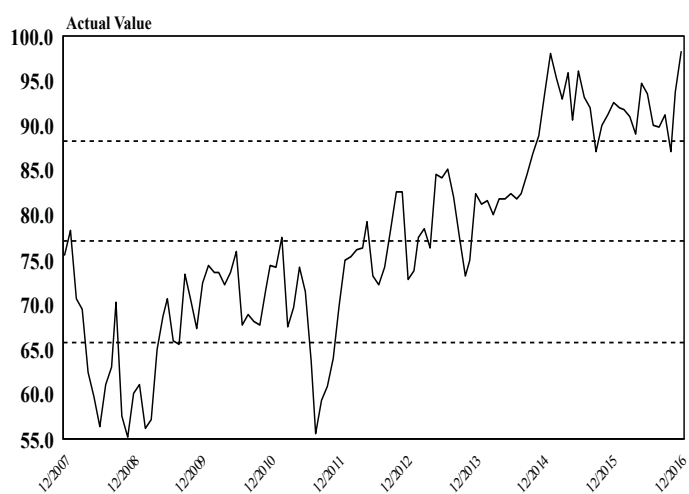
ISM Purchasing Managers Index



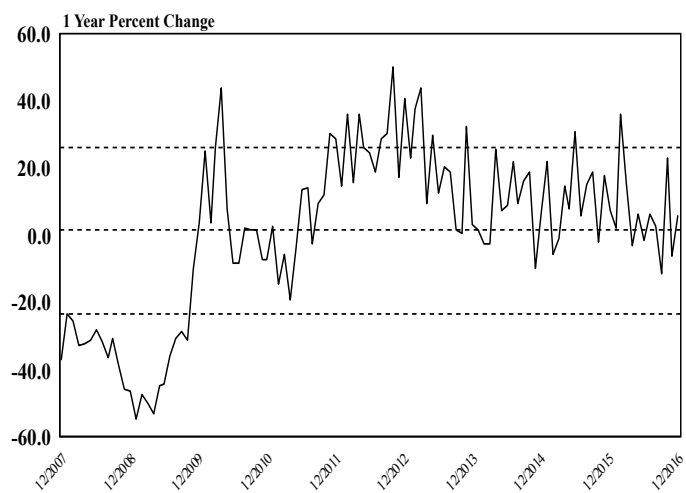
Disposable Personal Income



Consumer Sentiment



Housing Starts



U.S. Dollar to Euro Exchange Rate

