WOODSTOCK

QUARTERLY NEWSLETTER

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As a client sometimes we have to reassure our investment adviser that yes, we understand the risks in the present market but we are still committed to the investment strategy we have agreed to. In the investor guide, Winning the Loser's Game, the ideal client/advisor meeting begins with reaffirming the existing strategy.[1] There may be reasons to change, but client and advisor should discuss and, if needed, spend the rest of the meeting getting to agreement on the change. The Loser's game analogy is to tennis where professionals try to hit winning shots and amateurs try not to hit losing shots. The double meaning is that even professionals in investment management have trouble deciphering the financial market's short-term direction. The attempt to predict the market's short-term direction using macro-economic thought processes, versus the micro-economic effort to determine the prospects for individual companies, has been called "the weather report".

One of our favorite investment manager quotes is that this particular manager has "never been wrong but often been early". The weather report is never "wrong". It will rain or snow or hail sometime; it just may not be when predicted. The advantage of having two other "late cycle" markets in the last 20 years is that we can reflect on what worked then. As the "weather" turned bad in 1999 and in 2007 what was the best advice given by investment consulting firms? Overweight high quality US stocks[2] and have enough cash for emergencies. The historical advice that most Woodstock clients already know well is "don't try to time the market". The timing requires two perfect decisions: when to get out and when to get back in. The missing of only a few key days in any market cycle means that an equity-like return disappears to become a bond-like return and negates much hard work.[3]

Tinker around the edges of an agreed investment strategy? Of course. Pick less than high quality companies? No. There are high quality companies in the growth sectors of healthcare biotech and information technology and in the stable and irreplaceable sectors of energy and consumer staples. Because of recent volatility the prices for these impressive companies sometimes drop to the right price. How you and your investment manager decide to utilize the resources you have at your disposal is very important.

In recent academic studies another reason for thinking long-term, instead of short-term has popped up. All investors try to follow the maxim "buy low and sell high". Hard to do anyway but especially true because it is counter-intuitive to whatever weather forecast is current. Now it turns out, in the very long-term, it may not matter. Very long-term studies over 120 years on world-wide markets show that "investors who bought after returns were high didn't do markedly worse in the long run than those who bought after returns were low".[4] Practically, it's good to remember we all have to live in a term shorter than that and decisions made will matter.

We know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow.

We thank you for your support and want you to know that we are dedicated to serving your best interest.

William H. Darling, Chairman & President — *Adrian G. Davies, Executive Vice President*

[1] *Winning the Losers' Game, C. Ellis, 2010, Appendix A; 1998 p.86*

[2] *Ask your investment manager for the source.*

[3] *Cambridge Associates, Standard & Poors and Thomson Datastream, 2011.*

[4] *WSJ 2/24-25/2018*

Realistic Investor Expectations for Late Cycle Conditions

Thomas C. Stakem

The bull market just passed its ninth anniversary and most investors have to be amazed at the 331% run in the S&P 500 from 667 (3/9/09) to 2,873 (1/26/18). This near 18% compound annual total return (CATR) performance is reminiscent of the spectacular back-to-back decade performances of 18% that occurred in the 1980's and 1990's. But just as that period was followed by a lower return decade – the 2000's -1% CATR, a bit of late cycle planning is prudent today. All the key resources (human, capital, raw material) are at rising rates of utilization, unemployment and productivity are low and commodities tend to come to life late in economic cycles. Together with higher interest rates these factors will combine to make existing operating margins more difficult to maintain let alone grow from the estimated 10.3% level of Q4 2017 (source: www.standardandpoors.com), the highest level seen in the S&P 500 data since at least 2006 (we would wager in history). For contrast, the only negative operating margin quarter ever was Q4 2008 (at -0.04%). This was in the quarter before the bull market began in Q1 2009 and surely no forecaster could have foreseen the magnitude of the margin expansion that lay ahead over the nine years. A ten percentage point operating margin improvement on S&P 500 revenues of over $1,200 per share (source: www.standardandpoors.com) has been a material driver of the earnings progression we've seen since and has been one of the two key supports under this nine year bull market. The other driver of course was the easy monetary policy the Federal Reserve adopted initially to stave off a larger panic than what occurred and then to nurture a weak, fragile economy for much of the last nine years.

For 2018 and beyond investors are now seeking total return clarity, if not certainty, at a time of great uncertainty. As always it is the outlook for the equity asset class return that is the most difficult to forecast. We're always either guessing or extrapolating inflation from recent experience which now is 2% plus or minus. We think we have a good handle on predicting cash returns, which typically do not have real return value and only occasionally match or exceed inflation by a small amount. Because of the Federal Reserve suppressing short-term yields to zero since Q4 2008, cash returns (money market or Treasury bill rates) have not kept up with inflation. But as the Fed normalizes rates going forward cash will likely trend up to at least a zero real return asset class providing a 2%-3% return (1.5% now, perhaps 3.5% two years from now). We know what five and ten year total bond returns will be at any given time, if held to maturity, from their yields-to-maturity (YTM). That leaves the heavy lifting in the asset class expected return exercise to be what will the total return be from equities? The interplay of dividend yield, earnings growth and P/E multiple change will determine the answer.

In the table below we pull together a range of returns for equities based on 5%-7% trend S&P 500 EPS growth expectations for the next five and ten years. A 2% dividend yield is also assumed. To isolate the return sensitivity to P/E multiple change we impose two further conditions: the ending P/E multiple rises 2 multiple points (+11%) and the ending P/E multiple declines 3 multiple points (–17%) from an assumed 18x level today. In the happy circumstance of P/E multiples widening further equities return 8%-11%, 5%-8% over bonds which is about in line with ninety years of history. In the P/E multiple compression case, equities return 4%-7%, 1%-4% more than bonds. While admittedly still in positive alpha territory, a 1%-4% return premia would be at the low end of a ten or twenty-five year average of equity-Treasury bond spreads.

What is eye-opening about this exercise is how these prospective equity-Treasury bond spreads prompt the question of whether one is being adequately compensated for the incremental risks of owning equities. In stable, low volatility stock markets 1%-4% may seem adequate but in periods of higher volatility and bungee jumping episodes in the S&P 500 it may seem small compensation for the volatility.

Monetary policy since the financial crisis (2007-2008) has been a tailwind for equities and this has produced a rising P/E multiple environment for the last nine years. Perhaps the biggest uncertainty in the equity return calculation over the next five to ten years will be the extent to which monetary policy is a

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Equity Returns Under Different Growth Scenarios

+2 point change in P/E

EPS Growth	5.00%	6.00%	7.00%
Yield	2.00%	2.00%	2.00%
P/E Change	11%	11%	11%
5 yr Equity Return	9.20%	10.20%	11.20%
10 yr Equity Return	8.10%	9.10%	10.10%
Cash	2.50%	2.50%	2.50%
Bonds	2.70%	2.70%	2.70%
Spread vs:			
5 Year Bonds	6.50%	7.50%	8.50%
10 Year Bonds	5.40%	6.40%	7.40%

-3 point change in P/E

EPS Growth	5.00%	6.00%	7.00%
Yield	2.00%	2.00%	2.00%
P/E Change	-17%	-17%	-17%
5 yr Equity Return	3.70%	4.70%	5.70%
10 yr Equity Return	5.35%	6.35%	7.35%
Cash	2.50%	2.50%	2.50%
Bonds	2.70%	2.70%	2.70%
Spread vs:			
5 Year Bonds	1.00%	2.00%	3.00%
10 Year Bonds	2.65%	3.65%	4.65%

headwind, acting in reverse to what investors have become accustomed during the last nine years.

A lot of educated guesses exist as to how many Federal Reserve rate increases will occur over the next two-three years. Will there be 3-4 in 2018, 2-3 in 2019, and 1-2 in 2020? There could be 6-9 increases which if 0.25% each would place the return proxy for cash at about 3.00%-3.75% in three years. Since the current 2, 5 and 10 year US Treasury YTMs are 2.30%, 2.60% and 2.80%, the prospect of a future inverted yield curve raises concerns regarding the impact of monetary policy headwinds on equity P/E multiples. In addition to impacting the Federal Reserve governors in their deliberations to adhere to the presently envisioned hike schedule, the performance of inflation data and real GDP growth will impact the shape of the yield curve while these interest rate hikes are occurring. If one believes that the economy has become "hooked" on free money then the prospect of these Fed hikes would incline one to believe the rate hike cycle will be short-lived because of its negative effects on the economy. On the other hand, if one holds the belief that rising rates will affirm the strength of the economy one would expect parallel moves up in 2-5-10 year yields and that a slowing economy would not necessarily follow. But like the Federal Reserve we are all "data dependent" and it's hard to imagine that the data over the next eight-to-twelve quarters will uniformly favor one direction. Thus, volatility in perceptions and expectations are likely.

But it is hard to see how a "late cycle" investment mindset isn't appropriate. And that entails the reality of monetary policy now being a headwind, that earnings growth will slow from the heady tax reform enhanced growth rate level of 20% in 2018 to a more sustainable trend growth rate of 5%-7% per year and downward pressure on P/E multiples. Late cycle earnings expectations are evident in the latest S&P sector earnings outlook below as Energy, Financials and Materials are prominent earnings outperformers. A late cycle investment strategy may need to allow for more defense over offense because of slowing earnings growth and P/E compression. P/E multiples have to rise for stocks to return more than 7%-9% over the next five and ten years. After a long bull market this seems unlikely. While this would still be a respectable absolute return it would be about half of the last five calendar years' equity return (15.8%) and about on par with the last ten calendar years' equity

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	---------Operating EPS---------					
	4Q Sum Delta Q4 2017 – Q4 2019E	Q4 2017	Q4 2019E	% Chg	% Chg Rank	3/23/18 Weighting
S&P 500 Energy	$14.81	$13.29	$28.10	111%	1	5.80%
S&P 500 Health Care	$21.45	$45.09	$66.54	48%	2	13.72%
S&P 500 Real Estate	$4.83	$10.18	$15.01	47%	3	2.75%
S&P 500 Financials	$11.98	$26.59	$38.57	45%	4	14.64%
S&P 500 Materials	$7.17	$17.18	$24.35	42%	5	2.87%
S&P 500	$47.98	$124.51	$172.49	39%	6	100.00%
S&P 500 Information Technology	$18.30	$50.58	$68.88	36%	7	24.95%
S&P 500 Industrials	$9.95	$30.29	$40.24	33%	8	10.21%
S&P 500 Consumer Discretionary	$10.47	$35.22	$45.69	30%	9	12.78%
S&P 500 Consumer Staples	$6.12	$27.35	$33.47	22%	10	7.54%
S&P 500 Telecommunication Services	$1.85	$14.53	$16.38	13%	11	1.90%
S&P 500 Utilities	-$0.14	$5.60	$5.46	-3%	12	2.84%

source: www.standardandpoors

return experience (8.5%). A lower 4%-7% equity return type experience is feasible if P/E multiples narrow as modeled above.

Corporate earnings growth over the next two years is also expected to come from sectors considered "late cycle". Thus including some sector exposure different from what worked during the nine year bull market may make sense if cash availability, tax sensitivity and overall investment objectives are supportive. Discussing this with your portfolio manager is always the prudent course of action.

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Tax Update

One of the things the new tax bill didn't lower is the percentage of the income tax paid by the highest earners. In fact the very "progressive" income tax became more so. According to Congress, the income tax is expected to raise 50% of the total federal revenue in 2018, which is the largest source of US revenue.[1] The highest earning 20% of taxpayers, those expected to earn $150,000 or more, will pay 87% of the income tax, up from 84% in 2017. The great leveler in the US tax system is payments for Social Security and Medicare made by all working Americans and their employers, almost regardless of income level. When those taxes are added to the income tax, the share of those combined taxes paid by the highest earners drops to 67%.

The US Federal Reserve Bank watches the risk in something called the "household financial stability" picture, comparing household wealth to disposable personal income and to household debt.[2] With household wealth approaching $100 trillion because of increasing stock market and real estate values which is seven times disposable personal income (at a high point) and, although household debt is increasing, it is not rising at as fast a pace as in 1999 and 2007 (so a "modest risk").

We are watching recent Congressional Republican efforts to make some of the "temporary" parts of the new tax law permanent. The "cost" of the "make permanent" law, according to congressional accounting, is estimated at $600 billion. The benefits? Perhaps, it makes more certainty for investors and businesses. However, provisions expiring in 2023 or beyond are several election cycles away anyway and our politics would appear to continue to be volatile even if this "permanent" vote passes. Certainty does not seem to be in the cards for investors or businesses. In looking at coming mid-term elections, a Washington DC political consultant reminded his audience that the last time Democrats controlled Congress they did so with the help of "blue dog" Democrats.[3] More than watching the generic, like-dislike, national ballot, the mid-term results will come down to who is running against who in individual races across the country, according to the consultant.

If you or any of your other advisors have questions about the issues raised here, please contact your investment manager or one of us.

William H. Darling, CPA - Chairman & President
Jeanne M. FitzGerald, CPA – Tax Manager

[1] *WSJ 4/7-8/2018 p.B5*
[2] *WSJ 3/9/2018 p.A2*
[3] *Ask your investment manager for the reference.*