WOODSTOCK

QUARTERLY NEWSLETTER

In This Issue:

A New Regime

-

Tax Update

Winter, 2017

The first nine months of 2016 for the financial markets were characterized as "boring".[1] The fourth quarter showed a steady upward trend. Perhaps a longer look back at the US economy would help determine what the future might hold. An economist's view of the US economy brought forth both statistics on our economy and comparisons with other developed economies.[2] In general, the insular view showed both high income mobility, with over half of both the top 20% and bottom 20% of earners growing up in families who were not in those categories, and an improving individual earnings environment, with over 80% of respondents reporting earning more than their parents. The global view shows, in comparison to other G-7 countries, that, compared on a per capita gross domestic product scale, the US is 140% as rich as the next closest economy. Our work force is more industrious (hours worked per week), mobile (out of a 150-million-person work force, 62 million were hired and 60 million were separated in the year ended October 2016), and welcoming (being the only G-7 country where the unemployment rate for immigrants is lower than for native-born). This is a platform designed for steady, upward growth. How does Woodstock intend to take advantage of that? With a steady, complex, perhaps "boring" approach. We are reminded of a famous investment consultant who described investing as a continuous process.[3] He also said a cookie factory is a continuous process. If you tour it and "find something interesting, you've found something wrong". That doesn't mean that the individual stocks are not interesting but the process of finding them is more perspiration than inspiration.

What about our "style"? We keep looking for good descriptions of "investing in high quality US stocks". In the Summer 2016 newsletter, Adrian gave a description of what to look for in such a stock. Looking at a company's total revenue minus basic expenses, or something close to gross margin may be a way to determine "quality" or when a "company's goods and services take in a lot more money than they cost to produce".[4] These companies' bottom lines, or earnings per share, may be negatively affected by R&D spending which could portent strong earnings in the future, or alternatively, they could be wasting money. The analysis around these questions is the hard work that investment managers at Woodstock do.

Two recent articles on looking out for investors, one a peer review system and the other a new regulatory approach in Canada, illustrate the complexity of the task. The peer review system was for clients with $10 million in investable assets and involved a defense before peers of one's investing activities.[5] The recommendations were for simplifying and streamlining, keeping sufficient cash on hand, and beginning the processes of gifting to adult children, putting assets in trust, and creating a charitable vehicle, perhaps a charitable foundation, now rather than later. The advice from peers was to concentrate on things you can control like spending and fees.

The new regulatory approach in Canada, Client Relationship Model, Phase 2, would cover all investment managers and broker dealers.[6] While the US system is "rules based", this

Continued on Page 2

[1] WSJ 9/3-4/2016
[2] WSJ 12/29/2016: Pew Report 2012 and OECD Report 2014
[3] WSJ 9/3-4/2016; Charles Ellis
[4] WSJ 3/4/2013
[5] WSJ 12/19/2016
[6] IAA Newsletter November 2016

Canadian system would be "principles based", leaving more leeway for individual firms to meet the required presentation guidelines. The Canadian research indicated that clients want to know: How am I doing? And what is it costing me? Transparency around fees and conflicts of interest were desired. From a regulatory point of view at least in Canada, we believe Woodstock would meet this transparency criteria as we are held, and hold ourselves, to a fiduciary standard. From a peer review perspective, most of the work needs to be by the client, however, we believe Woodstock or through its related entities, can offer the analysis tools that various above-mentioned strategies require in collaboration with a client's other professional advisors.

Although we encourage readers' comments, we rarely receive them, so a three-page "Thanksgiving reflections" caught our attention. The first comment that we are "too promotional", we will take in stride. The purpose of the page one of our newsletter is to explain why you, our clients, should be at Woodstock. We believe it strongly and believe it bears repeating. The second comment was about the Monte Carlo method which we were erroneously assumed not to believe in. We do believe in it and our software program for financial analysis of individual situations utilizes it.[7] What we do not believe in is "risk" defined as volatility. If you plug an erroneous definition of risk into the Monte Carlo method, for example, the volatility of US stocks calculated as a class, without regard for the individual company's stability or, obversely, speculative nature, there is an error. The volatility of high quality US stocks, whose movement coincides with other equities, is not a mark of their risk because they mostly return to their fair market value over time while other equities may never recover. At the other end of the volatility scale, private equity's placidity and low volatility belie the high-risk nature of that asset class. The third and final comment we'll respond to was Exchange Traded Funds (ETFs) as the wave of the future. We believe that a 30 to 40 stock portfolio of high quality US equities held in a separately managed account in the client's name will outperform, on a risk adjusted basis, a pooled investment in street name, actively/passively managed including several hundred to thousands of stocks of varying quality. We believe that what we are doing well will continue into the future.

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, CFA
Executive Vice President

---

[7] Ask your portfolio manager about it.

A New Regime

Adrian G. Davies

The US stock market turned in a very solid year in 2016. The S&P 500 Index returned 11.96% including dividends, with over half of the point return coming after the election. Fourth quarter rallies are not uncommon, nor are rallies following presidential elections, even if they aren't entirely explicable by modern financial theory. The election of Donald J. Trump as President was the proximate cause, with investors anticipating that Trump's policies will accelerate economic growth and improve corporate profitability. Interest rates also seem to have risen in response to the election. The 10-Year US Treasury yield bottomed in July at 1.36% and rose to 1.86% on Election Day, but then jumped to 2.44% by year end. It may surprise some that the back-up in rates did not prevent stocks from rising — to the contrary, both stocks and interest rates rose on the outlook for improved growth. The trade-weighted US Dollar also rallied 4.3% from the election through yearend.

As we start the new year, investors seem preoccupied with what will be different under a Trump Administration. Although few details are known about Trump's plans, he has espoused several agenda items with a view to accelerating economic growth and improving the availability of jobs:

Continued on Page 3

cutting taxes, eliminating burdensome regulation, and investing in infrastructure. It remains to be seen how more detailed plans will be received in Congress and what tradeoffs they will entail. Cutting income tax rates, a form of fiscal stimulus, while simplifying the tax code and eliminating deductions, could have a big impact on consumer confidence, spending, and hiring. One of the more direct positives for stocks would be if Trump were able to cut the nominal 35% Federal corporate tax rate. A Citigroup analyst estimated that cutting the corporate tax rate could increase S&P 500 earnings by as much as 9%.[1] That may be an optimistic scenario, with the elimination of tax deductions offsetting much of the tax cut.

While there could easily be more upside to stocks if these policies are enacted as envisioned, the prospect of new, pro-growth policies also entails new risks. The devil will be in the details. An important point of contention with many in Congress is likely to be the degree of deficit spending that tax cuts and infrastructure spending will generate. Deficits are likely to grow. Corporate taxes constituted only 13.4% of Federal revenue, so it's possible to cut them by a meaningful amount without a large impact on the deficit. In contrast, with personal income taxes accounting for 46.7% of Federal revenue,[2] a smaller reduction in income taxes would have a larger impact on the deficit. The balance of Federal revenue comes from Social Security, excise taxes, and other sources. Tax cuts could impact the economy as soon as they get through Congress, but infrastructure spending probably wouldn't impact the economy until 2018 or 2019.

Trump's proposals on trade and immigration are perhaps the most vexing. Several of Trump's proposed White House advisors, including Peter Navarro, Robert Lighthizer, and Wilbur Ross want to take a harder line against China. They appear to support the type of managed trade negotiations which occurred during the Reagan Administration – unofficial import quotas. However, these agreements would now violate World Trade Organization rules. These advisors believe trade deals such as NAFTA can be renegotiated so that fewer US manufacturing jobs will be lost to overseas workers. This view is contrary to economic orthodoxy. Most economists believe that countries are better off economically when they focus on their comparative advantages and trade to make up for their comparative disadvantages. That's not to say that some Americans have not been left behind by trade agreements. We should consider ways of improving the prospects for those left behind. Managed trade negotiations end up favoring one interest group over others. For instance, asking China to accept quotas on steel exports would benefit domestic steel producers at the expense of car manufacturers as buyers of steel and consumers as buyers of cars. It's unclear that the results would translate into more jobs across the economy. Trump further believes that stricter immigration terms will benefit US workers, but deporting large numbers of immigrants could be economically disruptive as well.

Countervailing Forces

The market is focusing on the potential for economic growth to accelerate, but there are also factors which may serve to moderate stronger growth. Despite a recent focus on those left behind, the job market overall has been fairly strong. The unemployment rate ended the year at 4.7%. The economy created 2.16 million non-farm payroll jobs last year, in spite of the economy only growing 1.6%. Wages have begun to creep up, culminating in 2.9% year-over-year growth in December. These employment statistics speak to a fairly healthy economy, giving the Federal Reserve confidence to continue raising interest rates. The Fed raised short-term interest rates one quarter of one percentage point in December, following on their first rate increase in nine years in December 2015. The Fed seems intent on "normalizing" interest rates, where normal short term rates could be in the three percent range, considerably higher than the current 0.50% - 0.75% Federal Funds rate.

Continued on Page 4

[1] Kim, Tae, www.cnbc.com, "Trump, GOP tax plan could raise S&P 500 earnings by 9%, Citi says," 11/16/16.

[2] www.gpo.gov

US interest rates have risen on expectations of faster economic growth and larger Federal deficits. Higher deficits will increase the supply of bonds relative to demand. As previously mentioned, the prospects for faster economic growth and higher interest rates have also driven the US Dollar higher. Greater energy independence in the US and decelerating growth in China may further serve to strengthen the greenback. Other reasons the US Dollar may stay strong have more to do with economics and politics elsewhere in the world. Britain is still trying to negotiate its exit from the EU, and a "hard exit" – faster, more disruptive – is looking more likely than a "soft exit." There are forces within the EU which want to make an example of Britain so as to discourage others from leaving the union. Populism and nationalism are on the rise not just in the United States and Britain, but elsewhere. There are important elections in France and Germany this year, with elections likely in Italy and the Netherlands as well. Issues within Europe include immigration, trade, regulation, deficit spending, and the very structure of the European Union itself. The Italian banking industry needs to be restructured, if not bailed out. Prior to the creation of the Euro, Southern European countries were in the practice of stimulating growth by devaluing their currencies. In the Eurozone that is no longer an option, creating tension among EU members that yearn for this more flexible past. Any or all of these elections could be further tests of commitment to the European Union. With the existence of the EU possibly in question, the outlook for the Euro is far less certain, and the uncertainty could further cause businesses to defer their capital spending plans.

On the other hand, stock markets might react to European elections the same way the US market reacted to the election here and the same way the British market reacted to Brexit. So far stock markets are up, suggesting little disruption. Fear or uncertainty before these votes can prove to be a greater overhang on stocks than the actuality realized by the votes themselves.

As we've seen in the US, changes in government have the power to shift the outlook for interest rates. With the realization that negative rates are counterproductive, and German inflation recently hitting 1.7%, the European Central Bank (ECB) is likely to return rates to positive territory. Higher rates in Europe would further reduce downward pressure on US rates, as sovereign rates in developed economies have tended to move together.

Rising interest rates in the US could moderate strong demand for housing and cars, two important sectors for the US economy. A stronger US Dollar may moderate demand for exports while increasing demand for imports. The US Dollar rallied in the second half of 2014 and into 2015, contributing to declines in S&P 500 earnings which lasted through midyear 2016. S&P 500 earnings returned to growth in the third quarter of 2016. The US Dollar has since rallied to its highest level since 2003 however, providing a renewed headwind to manufacturing and earnings growth.

Conclusion

The baseline case is that economic growth accelerates. The consensus among economists as compiled by Bloomberg is that the US economy grew 1.6% in 2016 and will grow 2.3% this year. One risk to stocks is that Trump's growth-inducing proposals don't materialize as envisioned. At the same time, it would be positive for stocks if fears surrounding Trump's trade and immigration policies weren't realized. If Trump's policies avoid economic disruption, stocks could move higher.

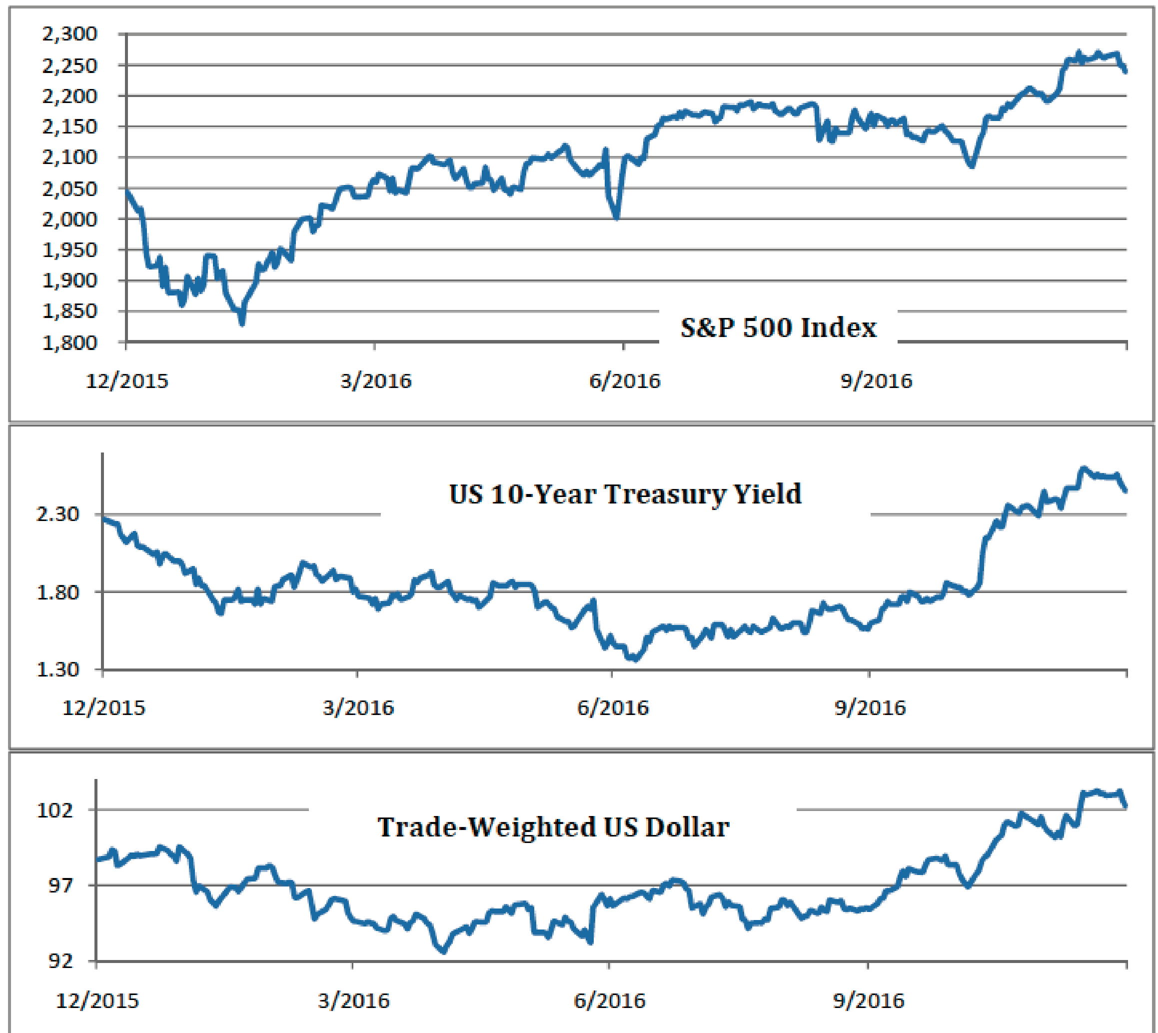
At seven and a half years, the current economic recovery is one of the longest in recent history, but it has also been one of the most anemic. Some economists are questioning if this is an appropriate time for fiscal stimulus. The risk is that too much stimulus will result in inflation. Although incipient wage inflation may cause inflationary pressures to tick up temporarily, we believe the dampening effects of higher interest rates and a stronger US Dollar, as headwinds to housing and industrial production, will serve to moderate inflationary pressures, allowing favorable market conditions to continue.

In 2016, we overcame fears of rising interest rates, a pause in earnings growth, Brexit,

Continued on Page 5

slowing growth in China, and a contentious election the outcome of which many did not predict. There are issues outstanding and surprises are inevitable in 2017. The market will likely be volatile, but it rises more often than it falls in spite of concerns, or possibly because there are concerns to overcome. In that regard, it is reassuring that there's still much doubt. If investors are reluctant to buy stocks, there's buying power that could enter the market. We feel that a diversified portfolio of high quality stocks, with reliable cash flow and savvy managements, is well positioned for these uncertain and volatile times. We also believe it is the best way to invest for the long term.

Adrian G. Davies is Executive Vice President at Woodstock Corporation. You may contact him at adavies@woodstockcorp.com.



We are growing and accepting new clients!

The best clients are the ones that come from a referral. Please consider recommending us.

What would seem to be inconceivable, although it happened for one year in 2010, is an end to the estate tax. Planning around "taxable estates" has engaged lawyers, accountants, life insurance salesmen, not to mention taxpayers, for 100 years since 1916.[1] However, a confluence of political opposition and the fact that the estimate for 2017 is that only about 5,200 people are expected to have taxable estates makes it likely. However, a taxable estate is only one of three major pieces to planning. The other two are what happens to the taxability of gifts made during one's lifetime, the gift tax, now integrated with the estate tax, and the so called "step up in basis" now granted for appreciated property held at death. Both their fates are unknown. If one believes that final estate tax modification needs to be "revenue neutral", in Washington, DC budget parlance, then windfalls for the wealthiest Americans may not occur.[2] The "trust" as a planning vehicle has been used in common law countries since before any imposition of an estate tax. The probability is high that planning for a "complex" end of the estate tax will utilize the same tools previously used (such as trusts) to help taxpayers navigate the new rules and regulations. Our favorite piece of tax advice is "just don't be greedy".

A recent study by the Tax Policy Center in Washington, DC highlighted who benefits under our social security system.[3] The work illustrates that more generous benefits are paid to lower wage workers. With many assumptions made to simplify the work, the estimates of lifetime taxes paid and projected benefits for couples retiring in 2020 showed: 1. a one-earner couple with earnings of $22,500 in 2015 would have paid in $129,000 in employee and employer taxes over a working lifetime and is estimated to receive $309,000 in benefits and 2. a two-earner couple hitting the social security "cap" each year would have paid in $1,358,000 and is estimated to receive $1,020,000. Only two-earner couples earning more than approximately $60,000 a piece pay in more than they would receive. No one-earner couples do. Some of the nuances of how the system actually runs are not part of the study. Over two-thirds of beneficiaries take social security pay-outs when they are first eligible rather than wait for the full retirement payout. The gain for waiting is approximately 8% per year from age 62 to 70 years of age. A useful tool to understand if one needs to maximize payouts during retirement, if other resources have not been accumulated sufficiently.

William H. Darling, CPA - Chairman & President

Jeanne M. FitzGerald, CPA – Tax Manager

[1] WSJ 12/10/2016
[2] Ropes & Gray Tax Alert 11/15/2016
[3] WSJ 10/29-30/2016