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PERFORMANCE WEIGHTED ASSET ALLOCATION REPORT

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ADVISORS' THOUGHTS

2016 ended on a positive note for US stock investors as sharp declines in the 1st and 2nd quarter were erased in the back half of the year with gains. This was particularly impressive given the rancor around the US election and the general belief by many that electing Donald Trump would cause an immediate stock market decline. During this period of heightened anxiety, but no material economic change, we chose to maintain the stock exposure within your accounts. This proved beneficial as all of the stock market gains in the 4th quarter occurred after the election.

For the year, the S&P 500 increased 9.54%. This benchmark of large company US stocks showed solid returns. Outside the US, large company stocks did not fare so well. The **MSCI EAFE declined 1.59%** in 2016. Once again investors favored US stocks over their foreign counterparts.

Ironically, the higher risk segments of the stock market showed the most gains with the small company stock benchmark, Russell 2000 increasing 19.48% for 2016. It was a volatile year for these stocks as early in the year they were declining and by February 11th they were down 16% year to date. By Election Day the Russell 2000 had recovered its losses yet had only increased 5.22% for the year before jumping higher after the election.

Within the bond market, investment grade bonds ended with modest gains. The **Barclays Aggregate US Bond Index returned 2.79%**. This reflected a modest change for the 10 year Treasury yield. It began the year at 2.27% and ended the year at 2.45%. Lost in this minor change was a sharp decline in the middle of the year to 1.37% by July 5th just after the Brexit vote and the strong increase through year end back to 2.45%.

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BENCHMARK RETURNS THROUGH 12/31/2016

	3 Mo.	6 Mo.	12 Mo.
DJIA	7.94%	10.22%	13.42%
S&P 500	3.25%	6.67%	9.54%
Russell 2000	8.43%	17.81%	19.48%
MSCI EAFE	-0.74%	5.01%	-1.59%
MSCI Emerging Markets	-4.61%	3.32%	8.51%
Barclays US Aggregate Bond	-3.13%	-2.67%	2.79%
ML High Yield Bond	1.85%	7.46%	17.34%

Source: Wall Street Journal and Morningstar Principia
Does not include reinvestment of dividends

DJIA: A price weighted average of 30 stocks.

S & P 500: A market value weighted index of 500 stocks.

Russell 2000: A market value weighted index of 2000 stocks.

MSCI EAFE: A stock market index designed to measure the equity market performance of developed markets outside US and Canada.

MSCI Emerging Markets: A stock market which captures large and mid cap representation across 21 Emerging Market countries..

Barclays US Aggregate Bond Index: An index that measures the investment grade, US dollar-dominated, fixed-rate taxable bond market.

ML High Yield Bond: An index of non-investment grade corporate bonds.

Major tax changes are being discussed that would impact nearly every American if they become law. Both President Trump and the House Republicans have tax platforms they have stated to generally lower taxes for individuals and business. Typically during periods of a divided government, where the House, Senate and President are not all from the same party, we would not focus too closely on tax proposals. Today however, with the Republican Party having a majority in the House and Senate along with the Presidency, it appears more likely some tax changes will occur. Furthermore, both **President Trump and the House Republican plans are very similar** in many respects, **increasing in our minds the probability of tax reform**.

INDIVIDUAL INCOME TAX

During the campaign, President Trump proposed condensing the marginal tax rates for individuals to three brackets from the current seven. Based on how much taxable income you have, the **new 12%, 25%, and 33% tax rates, for most taxpayers are equal or lower** than the rates they are currently paying.

Aside from the changes being made to the tax rate one would pay on their taxable income, he is also proposing significant changes to how much one can deduct from their gross income to calculate their taxable income.

Currently everyone is allowed to take either a standard deduction or itemized deduction from their gross income to calculate their taxable income. If your expenses that can be classified as an itemized deduction (examples include: mortgage interest, charitable contributions, state taxes etc.) are greater than the standard deduction you may itemize. Using either the standard or itemized deduction will lower your taxable income.

Under **current tax law** the **standard deduction is $6,350 for individuals and $12,700 for married couples** as noted in the Income Tax Deduction Proposed Changes Table on the following page. The **proposal is to substantially increase the standard deduction to $15,000 for individuals and $30,000 for married couples**. This would have the impact of lowering the taxable income, and therefore taxes, for many taxpayers. For those who would still be able to take an itemized deduction they may face a limit as to how much they can deduct. **Itemized deductions would be capped at $100,000 for individuals and $200,000 for married couples**.

The **Trump proposal also eliminates the personal exemption of $4,050**. Currently each taxpayer may deduct, subject to phase out, $4,050 for themselves and each of their dependents from income. **When these provisions are combined**, the benefit from the increase in the standard deduction along with detriment from the loss of the personal exemption and applying the new tax rates is **projected to lower the tax bill for more taxpayers than it will not**. However, the impact of change is **not universal and some taxpayers will actually see an increase** in their taxes.

There are **numerous other proposed changes** to the individual income tax system, but one final one to mention here is the **elimination of the Alternative Minimum Tax (AMT)**. Many taxpayers with incomes above a certain threshold are required to calculate their taxes under an additional tax system called the alternative minimum tax. They then compare the tax due under the "standard" income tax system and the "AMT" income tax system and owe the higher of the two taxes.

Originally, the AMT Tax was enacted **to ensure that the super high income households paid a minimum amount of tax**. However, for many years the income thresholds were not indexed for inflation causing an increasing number of taxpayers to pay the tax. **Today** it has grown to where **nearly 4 million households owe the tax** and millions more must do the AMT calculation to determine if they owe the tax. For these taxpayers the **elimination of AMT would be welcome news**.

ESTATE TAX

Both the House Republicans and President Trump are **proposing to eliminate the estate tax**. This would be a monumental shift from the current wealth transfer system. Currently, individuals may leave an estate of $5,490,000 and a married couple $10,980,000 free from estate tax. Amounts above these thresholds are taxed at a 40% rate.

However, there is a new concept (actually a very old one that has been tried before) introduced in the Trump Plan. That is how **capital gains are treated due to death**. **Currently** when a person dies their **assets receive an adjustment in cost basis to the date of death value**. This is commonly referred to as a step-up-in-basis because typically assets appreciate in value. **Under the Trump proposal the adjustment of basis is not clear**. In reviewing, the campaign website for Trump/Pence at www.donaldjtrump.com/policies/tax-plan it says the following: "The **Trump Plan will repeal the death tax, but capital gains held until death and valued over $10 million will be subject to tax** to exempt small businesses and family farms."

The wording in that one sentence is awkward and vague without further elaboration. Does this phrase, "…capital gains held until death and valued over $10 million will be subject to tax…" mean there will be no step-up-in-basis and the heirs will owe capital gains tax later when they sell the asset? Or does this mean a capital gains tax will be due immediately during the estate settlement process? Is it referring to the entire estate being above $10 million and those assets within the estate that have a capital gain would be taxed? Or maybe it is referring to specific assets that are individually valued above $10 million that have a capital gain?

The **belief one will receive a step-up-in-basis** on their assets **has been prevalent so long** that **many do not have adequate records** of what they paid for their assets or the cost of improvements that have been made. In our experience, it has been very common for real estate owners to hold their property for their heirs knowing they will receive a step-up-in-basis and the heirs can sell the property free of tax. The **Trump proposal may flip that whole concept on its head**.

While it may not appear that this proposal will impact too many people because of the high threshold of $10 million, tax laws have a way of evolving to catch more and more taxpayers over time. Just as the Alternative Minimum Tax originally applied to very few taxpayers, today it hits millions. If there are changes to how capital gains are treated in the estate, it will be much easier to change (lower) the threshold amount in the future.

2017 may be a year of significant changes to the individual income tax system. We will be closely following these developments for planning opportunities to minimize your taxes. Furthermore, the major proposed change of the elimination of the estate tax and change of how capital gains are treated in estates would have a dramatic impact on many estate plans. **If this proposal should come to pass we will review your estate plans where applicable**.

INCOME TAX DEDUCTION PROPOSED CHANGES

	Current	Trump Plan
Standard Deduction		
Individual	6,350	15,000
Married Filing Jointly	12,700	30,000
Cap Itemized Deductions		
Individual	None	100,000
Married Filing Jointly	None	200,000
Personal Exemption	4,050	None

Over the **past couple of years** the **market has** seen plenty of volatility both up and down but has **more or less moved sideways**, see chart below. This is probably reflected in a number of factors, but **one major reason has been soft corporate earnings**.

Since the beginning of 2015 through the 3rd quarter of 2016 the earnings growth rate has been declining. According to Factset, "Earnings Insight" dated January 13, 2017, "For the **fourth quarter, companies are reporting earnings growth of 3.2% and revenue growth of 4.6%**. For all of 2016, companies are reporting earnings growth of 0.2% and revenue growth of 2.0%." These are rather modest gains, but most **importantly they are shifting from losses to gains**. Furthermore, analyst are projecting earnings growth of 11.4% and revenue growth of 6.0% for all of 2017. After **a lull in corporate profitability** for the past couple of years **analysts are now much more optimistic**.

Optimism for improving economic conditions have also spread outside of Wall Street analysts. The Conference Board **Consumer Confidence Index posted a gain in December after having increased considerably in November**. The survey showed a sharp increase in future expectations while present conditions declined. "Consumer Confidence improved further in December, due solely to increasing Expectations which hit a 13-year high (Dec. 2003 107.4)," said Lynn Franco, Director of Economic Indicators at The Conference Board. "The post-election surge in optimism for the economy, jobs and income prospects, as well as for stock prices which reached a 13-year high, was most pronounced among older consumers. Consumers' assessment of current conditions, which declined, still suggests that economic growth continued through the final months of 2016."

There is also a renewed optimism within parts of the business community. The **National Federation of Independent Business's Index surged in November to its highest level since the end of 2004**. More significantly, this was the **largest one month gain since 1980**. The NFIB report was based on a survey of 619 small-business owners. "We haven't seen numbers like this in a long time," said Juanita Duggan, president and chief executive of the NFIB. "Small business is ready for a breakout, and that can only mean very good things for the US economy. Business owners are feeling better about taking risks and making investments."

As **impressive** as these **sentiment indicators** have been they are still **based on what may happen** in the future as opposed to what will happen. We are carefully watching business and economic conditions and how they impact your investments. For now the **economy is continuing to expand modestly and your accounts are positioned for this trend to continue**.