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Dear Clients and Friends:

As we noted in our year end letter, it seemed to us at that time that the character of the stock market changed during the fourth quarter to something approaching normalcy. Technology price volatility slowed down a bit and in general our portfolios began to feel better with respect to our investment performance. This has now been confirmed in the first quarter of 2017 as our aggregate portfolio average return was comfortably ahead of the Lipper Balanced Fund Index and our equities alone are now ahead of all of our comparisons other than with the S&P 500 in most portfolios. The latter continues to be heavily influenced by social media stocks, but we expect these too to come back into line with their own fundamental progress over time. This is a much better environment for our style of investing.

	3 Months Ending 3/31/2017
<u>Benchmark Indexes</u>	
Lipper Balanced Fund Index	4.2%
S&P 500 Stock Index	6.1%
Russell 1000 Value Index	3.3%
Money Fund Average	0.01%
S&P-BGCantor-7-10-year-US Treas. Bond Index	1.1%
S&P-BGCantor Twenty Year+ US Treas. Bond Index	1.6%

Time to Sell?

On February 8 we passed the 10th anniversary of the beginning of the financial crisis that manifested itself in devastating financial and economic losses during 2008-2009. On that date in 2007, HSBC, a major mortgage lender and financial services company announced substantive issues with their sub-prime mortgage lending division that eventually required them to set aside $1.8 billion to offset potential losses. A day later, New Century, one of the largest stand-alone home mortgage lenders announced that they would need to restate 2006 earnings due to lending losses and insufficient reserve coverage. Though not evident at the time (it never is) thus began the largest financial debacle since the great depression. Yet, today, some of the same institutions that contributed to those problems are back making loans with only 5% down. The regulations and reserve requirements are now far more strict, but it seems some lessons are never learned.

The most frequent question asked by clients since the beginning of the year has been "is it time to sell?" This is asked in all kinds of ways with many different implications so it seems appropriate to review our general approach to asset allocation and how we deal with such issues.

Selling is both easy and difficult. It is operationally much easier today than it used to be because of all the technology at our disposal along with very low commissions. Schwab sets our standard by now offering a very low rate of under $12.95 for nearly all trades, and in large accounts, many trades are now completed at an industry low of just $4.95 per trade. So with the push of a button a trade can be completed at minimum cost and effort. Rates offered elsewhere are generally set at a certain number of cents per share fee with the rate declining as the number of shares increases.

It is the rest of the process that makes it difficult – namely what are the implications of selling on the long term performance and objectives of a client portfolio and where do we put the money that is raised?

Today, if just held in a money fund the earnings are near zero. Bond rates are also low and they have exposure to declining prices if interest rates (as we expect) continue to gradually rise. Stocks are generally far more volatile and not everyone has the fortitude to withstand substantive declines. The offset is that on a five year basis stocks have outperformed everything else in sight about 85% of the time since the end of WW II.

As a guide toward buying, holding or selling, we have a four pronged approach, each of which has both quantitative and qualitative aspects:

1. If the economy is good that is a plus. But if the economy is too strong the result is often rising inflation and interest rates which are not good. If the economy is too weak or in decline, corporate earnings suffer and that too is not good for stock performance.
2. Rising corporate earnings are also good assuming valuations are not too high. Today earnings seem to be decelerating as expectations for this year are being pulled back, but they are still going up. Valuations, however, are tricky. They are currently well above the historic norm of 15X earnings but interest rates are also extraordinarily low while earnings continue to go up. As long as that condition remains, high valuations are justified.

3. Bonds provide competition for stocks if interest rates are high enough. But today interest rates remain way too low given the current rate of inflation. As a result, interest rates are expected to continue to rise assuming the economy continues to grow. Rising interest rates have historically not been good for stocks as they often result in a decline in stock valuations that can more than offsets rising earnings.
4. The fourth leg is psychology. It has often been said that a bull market climbs a wall of worry. This is just another way of saying that bull markets, in spite of glitches along the way, can develop momentum that seems to have a mind of its own. This partly explains the extraordinary move upward in some of the social media stocks.

Most of the unease today seems to be based on the last point. The stock market has gone up a lot and valuations are historically high. In addition, many are very concerned about the Trump administration and project those concerns on the market – but the market doesn't listen and keeps going up. Is this the Wall of Worry?

If a client has a long term objective of, say, 70% invested in stocks and the market rises to the point that the percentage gets up to 75% in stocks, we will typically cut back to the lower number. Conversely, if the market declines to the point that stocks represent only 65% of assets, we will typically buy to get back to 70%. This approach is entirely consistent with long-term investing and over time has been proven to add to returns versus a simple buy and hold approach. It is a very simplistic but effective way to periodically "buy low and sell high".

But if sales are made with no change in circumstances and with the thought that we will buy stocks back cheaper somewhere down the road, this is short term in nature and often speculative because it is unrelated to a client's long term objectives and no one can predict the future of the financial markets over short time frames. And that is the rub. All of us are somewhat ill at ease today because of the above factors in some combination. Longer term we know that most of the time fundamental growth will out and stocks will eventually go higher. But when and with what pitfalls along the way none of us can tell.

In our portfolios a partial offset to short term selling is the lower price volatility that is exhibited by our portfolios relative to the general market. Our valuations are lower and our income yields are higher and both are consistent with lower volatility. Our best performance relative to the stock indexes typically occurs in down markets. So a question we ask ourselves is whether reducing stock positions is actually hedging again what we have already hedged through our higher yield and appreciation approach?

In our last letter, we changed our green light on stocks to yellow mostly because of the rise in interest rates but also reflecting the same uneasiness many of you have expressed. This still seems appropriate. In many accounts we have already eased cash positions higher as we have done our normal trading. Last summer we mentioned more internal portfolio "rebalancing" to reduce the size of individual stock holdings that have done exceptionally well. This program continues, though large capital gains slow our progress in a number of portfolios because of the tax implications.

If you remain uneasy with your equity exposure, give us a call and we will with you reexamine together your long term objectives and work on an action plan to bring your portfolio positioning more in line with your objectives if they have changed.

When we first meet with prospective clients and on an ongoing basis we draw assumptions on the ability and willingness of a particular client to absorb risk and volatility. The old adage of selling down to the sleeping point still holds true as a large part of the services we offer include creating a sense of comfort. Employment status matters as do outside reserve funds.

Top Twenty Update

There was not much turnover in our top twenty stocks since the end of the year. Abbvie and IBM were bumped out of the 18th and 19th slots with about average market performance.

Previous laggard Viacom was our best performer for the first quarter of 2017, providing a total return of over 33% to shareholders. While we did not actively buy shares over first three months of the year, the increase in price was enough to propel the stock back onto our top twenty list. From an operational standpoint, the smoke appears to be clearing at Viacom as new CEO Bob Bakish aims to refocus on the company's flagship brands (including Nickelodeon, Nick Jr., MTV, BET, Comedy Central and Paramount). Growth in earnings and cash flow appear likely to return this year, and as we look forward we are cautiously optimistic about Viacom stock.

VF Corp is the other company that broke into our top twenty list as we have now purchased a small to medium size position for most client accounts. It is likely you have never heard of VF Corp, but it is the largest publicly held apparel supplier in the US and owns many well-known brands including The North Face, Lee, Wrangler, Vans and Timberland. As an owner of multiple brands with minimal overlap, VF Corp has a great deal of diversity which provides some protection from brands as they (inevitably) go in and out of favor. Also, VF Corp is much less dependent on physical retail sales than many of its competitors. The company has the flexibility to sell online as well as through other distributors and retailers, and is not particularly dependent on brick and mortar storefronts.

With current prices of VFC stuck around 2013 levels, the shares have lagged the market for some time, and we believe the stock is now a bargain as it has been dragged down with other retailers. From a financial standpoint, VF Corp is as about as strong as they come. The company has raised its dividends for 44 years in a row, including a 14% increase in 2016. The current yield stands around 3% which is much higher than it has been historically, and the dividend is extremely well covered by earnings and cash flow. It is rare to find a company in the apparel industry with an "A" financial rating, but VFC fits the bill and we think it is a good addition to most portfolios.

Other Activity

In our Q2 2016 letter we highlighted the growing interim volatility in individual stocks (somewhat in contrast with the overall market) and our thoughts about how we can address it in portfolios:

> Over the past five years or so… individual stocks have rotated between over and under valuation in far shorter time frames (than they have historically). As the majority of the assets under our supervision are taxable, taxes (short term gains in particular) often get in the way of acting to maximize returns in personal accounts… Our solution going forward is that you will probably find us making smaller but more frequent trades over the course of time. This mitigates large tax costs in any one year but will allow us to take advantage of shorter term price movements. As part of this process, we will probably also be broadening the number of stocks held in portfolios to account for our lessor confidence in the price of any one stock at a given point in time. In the investment business this more active approach goes under the heading of "rebalancing" portfolios. There may be the appearance of greater activity, but in the end we don't expect annual turnover to increase. There will just be a greater number of smaller transactions.

Short term volatility showed no signs of letting up in the first quarter, as we counted more than ten of our core holdings with a greater than 5% daily move at some point over the quarter, and several stocks made the list more than once. Fortunately most of these short-term movements were to the positive rather than the negative, a change from previous periods.

This continued volatility has provided an ongoing opportunity for us to continue trimming back our largest and most successful holdings while adding a few new positions to our portfolios. There was no one size fits all approach, as the tax implications and holding sizes vary for all clients. We were generally able to do a bit more in retirement accounts where taxes are not an issue, but the general underlying principle was the same across the board. We aimed to rebalance and diversify portfolios by trimming back some of our winners and outsized positions in order to purchase market laggards with perhaps greater upside potential, including adding a few new names. Although in some cases the number of trades was higher than we have typically done in the past, the overall turnover was not particularly high in most cases. Among the list of stocks we actively trimmed back were Microsoft, Dow Chemical, Cisco, Caterpillar, Deere, Fastenal, Digital Realty, and IBM, all of which have outperformed the market over the last 1-2 year period.

There were also a few new holdings in addition to VF Corp, and again the purchases varied depending on what accounts already owned, but they included Amgen, Pfizer, Anheuser-Busch, Qualcomm, Public Storage, and Extra Space Storage.

Conclusion

Looking ahead, we have no crystal ball for what the rest of the quarter or the rest of the year might look like. But even in the context of a possible correction we generally feel good about the long term prospects for most of the companies we currently hold in portfolios. This gives us some ability to ignore any short-term noise that may occur. It also enables us to continue taking advantage of the volatility in individual stocks and to continue in our approach of trimming back some of our relative winners in order to add to some of the high quality and generally higher yielding laggards.

While we maintain our “yellow light” on the stock market due to many of the factors mentioned in this letter, there are at least a few items which could push the market higher from here. It is likely that remaining interest rate hikes for 2017 have already been telegraphed to the stock market well in advance of them actually occurring. Barring any big surprises, these increases should be largely baked into current market prices, and we welcome rather than fear a slow and steady return to anything that approaches a normal baseline for interest rates. Meanwhile earnings and the economy continue to chug along in a positive direction, though growth continues to be a bit slower than we would hope. Lastly, while serious corporate tax reform is by no means assured, even small changes could provide a positive tailwind for the market. Many US Corporations have huge sums of money parked overseas because the tax penalty to bring those dollars back to the US is simply too high. Any reform that addresses this would likely provide a boon for future growth in earnings and the market, and that could be accomplished even without the context of greater tax reform.

As always, we will continue to review the options and implications of financial change as we move forward. Don’t hesitate to give us a call if have questions.

Sincerely,

Loudon Investment Management LLC

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