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Dear Clients and Friends:

Last year was one of great controversy, emotion and turmoil on the political side but quite good in terms of economic progress and nothing less than great for the stock market, technology stocks in particular.

There is always a mix of good and bad as we look back over any 12 month period, but the differences in 2017 were about as extreme as they have ever been. This is why we try to stick to the facts rather than emotion. At its core, our approach to selection is very simple – ignore the noise and buy good companies when their stock prices are depressed and, as a result, their income yields are historically high. Sell or reduce if something major goes wrong or a stock becomes by our measures, grossly overvalued. More on this later but to set the stage, the market returns are below:

	12 Months Ending 12/31/2017	3 Months Ending 12/31/2017
Benchmark Index Returns		
Lipper Balanced Fund Index	14.2%	3.6%
S&P 500 Stock Index	21.8%	6.7%
Russell 1000 Value Index	13.6%	5.3%
High Yield Div. Aristocrats	16.3%	6.8%
Money Fund Average	0.1%	0.2%
S&P-BGCantor-7-10-Year-US Treas. Bond Index	2.7%	1.9%
S&P-BGCantor Twenty Year+ US Treas. Bond Index	9.1%	2.6%

Looking at the above, it may reasonably be said that a good time was had by all, but particularly by those invested in common stocks. Perhaps the most interesting thing that happened last quarter was the narrowing of the performance differentials between the equity benchmarks. This mirrored our experience as our common stocks have come a long way in narrowing the gap between our aggregate equity performance and that of our benchmarks. A number of stocks purchased over the past several years at what appeared to be very good prices have finally started to perform. As a result, we came in ahead of all benchmarks except the S&P 500. We expect this trend to continue.

As is often the case, the S&P performance was extremely unbalanced. As expected, U.S. tech stocks led just about everything in the world returning almost 37% for the year. In fact, S&P Tech stocks were number one in the world amongst over 100 financial return numbers reported in the year-end summary from the Wall Street Journal. As many of these stocks don't pay dividends, we just didn't own enough of them, though what we did own did well. At the other end of the spectrum, energy and telecoms showed negative returns although a number made progress with respect to earnings and dividend growth.

The five largest companies in the S&P 500 at year-end were Apple, Alphabet (Google), Microsoft, Amazon and Facebook – all classified as technology stocks. On average these stocks returned about 44% last year. In combination with technology stocks in general, this is what made it so difficult for diversified investors to beat the S&P in 2017. Diversification is considered a good thing for long term investors but in any given year it can be a real drag on performance. But over time, safety and diversification go hand in hand.

We would characterize valuations today as high but not in bubble territory as earnings have also done very well. However, we will keep our yellow light on for equities as risk has undoubtedly risen over the past year.

In any event, our aggregate equity holdings did better than two of our three equity benchmarks. Last year the S&P 500 came in first in the performance derby but there have been other years when it has been last. We should all remember that at some point that will happen again. Our total account returns were just about equal to the Lipper Balanced Account Index.

The Economy

If it was difficult to fault equity returns last year, it was also difficult to fault the economy. From a starting annual growth rate of a little over 2% it apparently ended the year with the same number over 3% and it looks to move higher this year. Tax cuts should help, but after GDP reaches a certain point, it also starts to feed on itself. More people working and earning and spending leads to expansion to meet growing demand leading to even more people working, etc. in a virtuous circle. After years of slow growth, this process now appears to have begun.

And with interest rates remaining very low, there is not much friction to slow things down. Of course if growth continues to accelerate, at some point production can't keep up with demand eventually leading to inflation and higher interest rates. This is typically how the cycle ends with a decline in the stock market as a leading indicator followed by recession or slower growth.

But for now, things look good and we continue our green light on the economy. Inflation and rising interest rates are the things to watch if you are concerned about the stock market.

The tax plan

Much has been written about the passage of major tax legislation. Because of this and the many technicalities that apply to each return, we will not try to run down all the real implications on the one hand, and how they differ from the demagoguery from both sides of the political aisle on the other. But if we concentrate on the important things the changes are large and they are real.

The most important for individuals is the fact that the vast majority of U.S. citizens will be getting a tax break. It is easy to get caught up in what may appear to be relatively small individual numbers or perceived inequalities, but in aggregate there will be a lot more money in people's pockets this year when compared to 2017. This should have a significant impact on spending and debt reduction, both of which are good for the economy. However, this stimulative effect may also shorten the period between now and when inflation will become an issue and the Fed is forced to raise interest rates more aggressively.

On the corporate side, we should not get too excited about near term corporate earnings as the initial impact may very well be negative. Adjustments that will need to be made because the new tax law moves us to a "global" system means that taxes due for those with significant overseas retained earnings will move considerably higher in the fourth quarter of 2017 and into 2018. This means near term earnings will be lower. On the other side, the benefits of the lower tax rates will only accrue over time making it very difficult to predict what earnings will do this year. We do believe that many earnings estimates for 2018 will prove, as is generally the case, to have been too high.

For those who wish to dig deeper, we have attached a reasonable summary of the tax changes for your review.

Trading activity

There was not much turnover in our top twenty holdings over the quarter. General Electric dropped out of our top 20 list due to poor performance combined with tax loss selling. It was replaced by Fastenal which moved 20% higher in the last quarter after not doing much performance-wise for the first nine months of the year. These are the kinds of shifts that occur on a regular basis as the stock market continuously sorts itself out based on a number of typically short-term factors rather than fundamental change.

GE, however, does deserve some additional discussion. This has always been a highly visible company and even more so today as it works to restructure itself for the future. We regard much of the Wall Street research that has been done on the company's future as short sighted as it ignores some very positive facts about the company's future. The most important is that when the restructuring is completed GE will likely be the number one or two most important company in the areas it elects to compete within.

A new CEO always accelerates change, particularly if write-offs can be blamed on a predecessor – damn the near term earnings consequences. The fourth quarter of 2017 will see many charges against reported earnings but regardless of what is reported, they will probably begin to generate cash beyond their immediate needs shortly. The first quarter of this year may very well be the same. But coupled with what looked like a classic selling climax at the end of last year, this may very well have laid the ground work for a much better performing stock. As such, there will likely be a point in 2018 when we will again be buying.

Taking a look at what is available today, there are two names that have come up that are selling at very low historic valuations. We have been adding CVS and Hanesbrands to portfolios as we trim back some of the stocks that were very successful last year. These include Microsoft (+41%), Intel (+31%), Abbvie (+60%), and Ameriprise Financial (+56%).

It is very unlikely that these stocks will perform as well in 2018. The reason is that stock prices went up much faster than earnings and this cannot go on indefinitely. Microsoft, for instance, saw its earnings grow by about 10% while the stock was up more than 40%. To some extent this was true of all of these stocks setting up much higher valuations that may or may not be sustainable. But they are all very good companies. This is why we reduce rather than sell them in their entirety. Over time realism outperforms wishful thinking.

CVS Health got its start in 1963 as “Consumer Value Stores”, a chain of health and beauty stores. Since then it has grown to become one of the nation’s top healthcare companies, filling over one billion prescriptions per year in nearly 10,000 locations across the U.S. But as with many successful growth companies, CVS has never been one to rest on its laurels, particularly when there is a risk to their existing business. That risk has revealed itself in the form of Amazon, which has considered entering the prescription business. Partly as a result, the company recently announced plans to acquire health insurer Aetna, though it still needs to pass the some significant regulatory hurdles in order to get the deal done. CVS stock has fallen since the announcement as there have been concerns that it was overpaying for Aetna and that the company will need to take on some significant debt to complete the deal.

The CVS vision is that after the merger they will be able to provide a full range of services and benefits for everything in healthcare outside the hospital. CVS has a strong history of successful expansion through acquisitions, and we believe that this is one case where the threat of Amazon is overblown. Because of the above, CVS does carry some risk but we believe it is outweighed by the opportunity that will show itself once the merger is complete. And importantly, the company looks cheap with or without Aetna should the merger be blocked.

Hanesbrands has been on and off our radar screen since it started to pay a dividend in 2013, but this is the first time we have followed through to buy the stock. The company designs, manufactures and sells clothing globally, and its portfolio includes many well-known brands: Champion, Playtex, Bali, Just my Size, L’eggs, Wonderbra and Maidenform among others. While it is heavily dependent on retail sales (only about 10% of sales are online), the company is moving forward with a major push to expand its online operations. As part of this push, the company is also aiming to cut costs and expand its brand to more premium products. Meanwhile, Hanes' portfolio of brands is sold across many store names so it is not dependent on any particular retailer. While many retailers have struggled in recent years, Hanes has continued to increase sales and cash flow as well as its dividend. The 2.8% dividend yield is covered several times over by the excess cash generated by the business each year.

While their products may not be particularly exciting, Hanesbrands is a great company with a solid brand name that can perform well in all market cycles. The stock appears to have been pulled down with other retailers, which has provided us with a great entry point and a solid income yield.

Summary

There will be many moving parts within the economy and the stock market in 2018. Where we end up is anyone's guess but a repeat of 2017, in our view, is highly unlikely. We are not yet active sellers of stocks but we are beginning to accumulate rather than reinvest cash. Based on recent momentum for both the economy and the stock market, the first half of the year will likely be better than the second as the cumulative effect of rising interest rates begins to take hold and expectations begin to be reined in by investors.

The Federal Reserve has a nearly impossible charge. It is supposed to support strong growth at the same time that it restrains inflation, two objectives that are often in conflict. 2017 was what has been called a "Goldilocks" economy - low inflation, low interest rates and accelerating growth. While we are not negative on the financial markets, the forces in play make us increasingly nervous.

Our reaction is to reexamine client objectives and needs for cash and to return to the level of equity exposure implied by each client's long term needs. We are currently in the process of doing this.

Please give us a call if you have any thoughts or questions.

Sincerely,

Loudon Investment Management, LLC

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