QUARTERLY PERSPECTIVE
January 8, 2018

"There is nothing that cannot happen today."
-Mark Twain

Happy New Year! Something about a new year brings out renewed determination to get that project, goal, or item on our personal bucket list done *this* year. We hope this new year's energy surge carries you through to a happy and productive year.

We enter 2018 with a brand-new tax bill and we have done our best to summarize the primary changes pertaining to individual taxpayers. In addition, we have enclosed a review of 2017's index returns and a recap of last year's market performance.

Also in this mailing, you will find 2017 performance reports for the portfolio we manage for you, as well as a step-by-step guide on how to read them. If you have any questions about these reports, please don't hesitate to give us a call.

Thank you for the trust you have placed in us. It is our sincere pleasure to serve you.

Karen, Joe, Brooke, and Noel

The Tax Cuts and Jobs Act of 2017

On December 22, 2017, President Trump signed into law one of the most extensive tax reform changes since President Bush's tax cuts of 2001 and 2003. The Act's full title is *An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018* but was introduced to Congress as the ***Tax Cuts and Jobs Act of 2017*** **(TCJA).**

Similar to the last round of major tax law changes, this Act includes a "sunset" provision that all of the individual tax law changes will lapse after the year 2025. However, the corporate tax law changes are permanent, as is the shift to use chained CPI for indexing tax brackets, and the repeal of the individual mandate of the Affordable Care Act (ACA).

Below is a summary of the new rules as they pertain to individuals. The bill is hundreds of pages—we have only touched the surface here.

INDIVIDUAL PROVISIONS	
EFFECTIVE DATE	GENERALLY, TAX YEARS BEGINNING AFTER 12/31/17 AND BEFORE 1/1/2026. (Which means most changes are subject to *another* sunset provision after the year 2025.)
INDIVIDUAL TAX RATES	**10%,12%, 22%, 24%, 32%, 35%, and 37%** (Prior brackets: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%.) **IMPOSES HIGHEST RATE AT $600,000 MFJ AND $500,000 SINGLE AND HOH.** (The highest tax bracket of 37% brings back the marriage penalty for upper income individuals.)

STANDARD DEDUCTION	**INCREASES TO $12,000 SINGLE, $18,000 HOH, AND $24,000 MFJ.** (An additional $1,250 for a blind individual, or one over age 65 will continue to apply.)
PERSONAL EXEMPTIONS	**SUSPENDED THROUGH 2026** (This suspension takes the Personal Exemption Phaseout income surtax along with it.)
MEDICAL DEDUCTION	**ALLOWS A DEDUCTION FOR MEDICAL EXPENSES IN EXCESS OF 7.5% OF AGI FOR 2017 AND 2018.** (This was expanded retroactively for the just-ended 2017 tax year, and the upcoming 2018 tax year. After 2018, the medical expense deduction reverts back to the 10%-of-AGI threshold.)
STATE AND LOCAL TAXES	**SUSPENDS ALL SCHEDULE A INDIVIDUAL STATE AND LOCAL TAX, SALES TAX, AND PROPRTY TAX DEDUCTIONS ABOVE $10,000.** (This is a $10,000 limit on the *combined* total of property, sales, and income tax, not $10,000 each.)
MORTGAGE INTEREST	**REDUCES DEDUCTIBLE ACQUISITION DEBT FROM $1,000,000 TO $750,000 FOR DEBT INCURRED AFTER 12/15/17 AND SUSPENDS HOME EQUITY DEBT INTEREST DEDUCTION.** (It is important to note that 'home equity debt' is based on how the mortgage proceeds are used. A HELOC that is used to build, or substantially improve a primary residence is still treated as acquisition debt and deductible, while a cash-out to repay credit cards, for example, is equity debt and not deductible.)
CHARITABLE CONTRIBUTIONS	**INCREASES THE 50% AGI LIMITATION ON CASH CONTRIBUTIONS TO PUBLIC CHARITIES AND CERTAIN PRIVATE FOUNDATIONS TO 60%.** (This increase may help to 'release' existing carryforward deductions under the new higher limit.)
MISC. ITEMIZED DEDUCTIONS	**SUSPENDS ALL MISC. ITEMIZED DEDUCTIONS THAT ARE SUBJECT TO THE 2% OF AGI LIMITATION EXCEPT FOR PRESIDENTIALLY DECLARED CASUALTY LOSSES.** (This means that all unreimbursed employee business expenses, hobby expenses, tax preparation expenses, and investment advisory fees will no longer be deductible starting in 2018.)
PHASEOUT OF ITEMIZED DEDUCTIONS	**SUSPENDS THE PHASEOUT OF ITEMIZED DEDEDUCTIONS.** (This suspends the limitation that phased out 3% of taxpayer's itemized deductions once income crossed a certain threshold in 2017, those with more than $261,500 of AGI as individuals, or $313,800 as married couples.)
SECTION 121 HOME SALE EXCLUSION	**RETAINS AS IN CURRENT LAW.** (If primary home is owned and used for at least two of the five years prior to sale, section 121 allows exclusion of $250,000 Single and $500,000 MFJ.)
MOVING EXPENSE DEDUCTION	**SUSPENDS MOVING EXPENSE DEDUCTION EXCEPT FOR MILITARY.** (This means in 2018 and beyond, reimbursed moving expenses for employees will be taxable income to employees.)
ALIMONY DEDUCTION	**SUSPENDS THE ALIMONY PAID DEDUCTION FOR AGREEMENTS EXECUTED AFTER DEC. 31, 2018. THERE IS A CORRESPONDING REPEAL OF THE PROVISIONS PROVIDING INCLUSION OF ALIMONY IN GROSS INCOME.** (Good news for the recipients who will not be taxed on the alimony they receive.)
EDUCATOR DEDUCTION	**RETAINS AT $250.**
CHILD TAX CREDIT	**INCREASES FROM $1,000 TO $2,000 ($1,400 REFUNDABLE) FOR CHILDREN UNDER 18 AND ADDS $500 FOR OTHER DEDPENDENTS—PHASEOUT INCREASED TO BEGIN AT $400,000 MFJ.** (Examples of 'other dependent' is an elderly parent you take care of or a disabled adult child.)
ADOPTION ASSISTANCE CREDIT	**RETAINS.** (The amount changes each year to adjust for inflation. For 2017 the maximum credit and exclusion was $13,570 per child. Phase-out range $203,540-$243,500.)

CAPITAL GAINS & QUALIFIED DIVIDENDS	**RETAINS THRESHOLDS.** (Preferential rates for long-term capital gains and qualified dividends will continue to use the old thresholds; however, with the adjusted tax brackets, these rates will no longer line up with the ordinary income tax brackets.)
3.8% SURTAX ON NET INVESTMENT INCOME	**RETAINS.** (This is not indexed for inflation and kicks in for single people with AGI over $200,000 and $250,000 for MFJ.)
ALTERNATIAVE MINIMUM TAX (AMT)	**RETAINS AMT BUT INCREASES EXEMPTION AMOUNT TO $109,400 MFJ, $70,300 SINGLES AND HOH. PHASEOUT OF EXEMPTION INCREASED TO $1,000,000 MFJ AND $500,000 SINGLE AND HOH.** (Today the AMT commonly impacts those with around $150,000 to $600,000 of income, in the future AMT exposure will be much smaller, and it will be extremely difficult for taxpayers to be impacted at all, especially given more limited deductions.)
KIDDIE TAX	**A CHILD'S UNEARNED INCOME WILL BE TAXED USING TRUST TAX BRACKETS RATHER THAN PARENTS' TOP MARGINAL TAX RATE.** (This tax generally applies to children, under the age of 19, or full-time students under age 24, with unearned income above a modest threshold—just $2,100 in 2017.)
529 TUITION SAVINGS PLAN	**ALLOWS A QUALIFIED DISTRIBUTION FOR K-12 TUITION UP TO $10,000.** (This includes public, private, or religious schools for up to $10,000 in distributions *per student* each year.)
ROTH IRA RECHARACTERIZATION	**SUSPENDS RECHARACTERIZATION RULE.** (The rule only limits Roth recharacterization of Roth conversions—not Roth *contributions*, permitting those who discover they're over the income limits to recharacterize it back to a traditional IRA. Notably, this provision should *not* affect the ability to make the so-called "backdoor Roth" contribution. However, once the IRA contribution is converted, that conversion can no longer be undone.)
ACA INDIVIDUAL MANDATE PENALTY	**REDUCES PENALTY TO ZERO AFTER 2018.** (The requirement that people have health insurance, qualify for an exemption, or pay a fine is repealed for post-2018 years. Keep in mind, this mandate *continues to apply for 2018*.)
FEDERAL ESTATE TAXES	**DOUBLES EXEMPTION TO ABOUT $11,000,000—BUT DOES NOT REPEAL.** (At the Federal level, this will eliminate estate taxes for all but the small subset of ultra-high-net-worth families who are over the $11.2M exemption or $22.4M for couples. However, state estate taxes could still be a problem for the 15 states (WA being one of them) that still have a state level estate tax that is not "coupled" to the Federal estate tax exemption.)

The new tax rules are complex enough that it may take months or even years for new tax strategies to emerge; however, we acted on the first (of probably many) strategies with this quarter's billing. With the loss of the investment advisory fees deduction, it is substantially more appealing to have your investment advisory fees deducted directly from your IRAs rather than a taxable account. Fees paid from a pre-tax IRA are, by definition, 100% pre-tax (the equivalent of making those fees a deductible expense). All traditional IRA fees that were previously being paid through a taxable account were changed to be directly deducted from the IRA.

For Roth IRAs, it is still preferable to use taxable accounts to pay investment advisory fees—given that it's not pre-tax money, there is no tax benefit to using Roth dollars to pay fees.

As we continue to digest the implications of all the tax changes going into effect this year, we will keep you apprised on any additional tax strategies that may help bring about the best possible tax results.

2017 Returns

As you can see from the chart below, 2017 posted healthy returns. The figures below are total returns; not just the price movement of the index, but the return generated via reinvested dividends or interest as well.

Index	Tracks	2017 Return	3 Year Annualized	5 Year Annualized	10 Year Annualized	Since Inception	Standard Deviation (10 Year)
Russell 3000 Index	Broad US stock market	21.13%	11.12%	15.58%	8.60%	11.95%	15.60%
S&P 500 Index	US large cap stocks	19.42%	9.10%	13.39%	6.18%	5.73%	15.08%
Russell 2000 Index	US small cap stocks	14.65%	9.96%	14.12%	8.71%	11.73%	19.90%
MSCI EAFE Index	Foreign stocks	21.78%	4.93%	5.04%	(0.94%)	6.50%	18.48%
Dow Jones US Select REIT Index	Real estate stocks	3.76%	4.97%	9.09%	7.07%	9.16%	25.77%
S&P GSCI	Commodities	5.77%	(7.52%)	(12.16%)	(10.16%)	6.99%	23.05%
Barclays US Aggregate Bond Index	Investment grade taxable bonds	3.54%	2.24%	2.10%	4.01%	7.45%	3.24%
3-month T bill	Ultrashort govt debt (proxy for cash)	0.97%	0.45%	0.29%	0.34%	4.00%	0.16%
Consumer Price Index (through Nov)	Inflation	2.23%	1.45%	1.38%	1.62%	3.51%	1.10%

2017 Year-End Investment Market Report

The bull market continued for another year, causing market indices to soar to new heights—pushing most valuations above their long-term averages.

A breakdown shows that just about everything gained in 2017. The Wilshire 5000 Total Market index, the broadest measure of U.S. stocks, rose 6.39% for the 4th quarter, finishing the year up 20.99%. The comparable Russell 3000 index was up 21.13% for the year.

Looking at large cap stocks, the Wilshire U.S. Large Cap index gained 6.70% in the fourth quarter, providing a 21.84% return for the year. The Russell 1000 large-cap index finished the year with a similar 21.69% gain, while the widely-quoted S&P 500 index of large company stocks gained 6.12% during the year's final quarter and overall returned 19.42% gains in calendar 2017.

Meanwhile, the Russell Midcap index finished the 2017 calendar year up 18.52%.

As measured by the Wilshire U.S. Small-Cap index, investors in smaller companies posted a 3.56% gain over the final three months of the year, to stand at a 13.45% return for 2017. The comparable Russell 2000 Small-Cap index gained 14.65% for the year, while the technology-heavy Nasdaq Composite index rose 6.27% in the final three months of the year, to finish up 28.24%.

International stocks are also participating in the bull run. The broad-based EAFE index of companies in developed foreign economies gained 3.90% in the recent quarter, and ended the year up 21.78% in dollar terms. In aggregate, European stocks were up 22.13% in 2017, while EAFE's Far East index gained 23.37%. Emerging market stocks of less developed countries, as represented by the EAFE EM index, rose 7.09% in dollar terms in the fourth quarter, giving these very small components of most investment portfolios a remarkable 34.35% gain for the year.

Looking over the other investment categories, real estate, as measured by the Wilshire U.S. REIT index, posted a meager 1.70% gain during the year's final quarter, yet finished the year up a respectable 4.18%. The S&P GSCI index, which measures commodities returns, gained 9.90% in the 4th quarter, to finish the year up 5.77%.

In the bond markets, coupon rates on 10-year Treasury bonds have risen incrementally to 2.41%, while 30-year government bond yields have fallen slightly to 2.74%. Five-year municipal bonds are yielding, on average, 1.70% a year, while 30-year municipal bonds are yielding 2.62% on average.

This was a year when investors ignored the dire headlines, North Korean missile threats, investigations of the presidency, hurricane devastation, and a rapidly-growing national deficit to produce one of the smoothest investment rides in the past century. In October, the S&P 500 index broke its all-time record of consecutive days without a 3% drawdown. The biggest single-day drop in 2017 was just under 2%.

How long can this continue? Nobody knows for sure. The S&P 500 is now trading at around 18 times forward earnings, which is above the historical average of 16, which, loosely translated, means you aren't getting a bargain when you buy stocks today. At the same time, we are experiencing low unemployment rates and solid profits for American companies. The U.S. economy is growing at a 3% rate. And the psychology of the markets doesn't match what you traditionally see at market tops: people still seem to be suspicious about how long the market rally will last, unlike the normal buying frenzy that often presages the next sharp downturn.

Indeed, not all stocks have prospered despite the rise in indices. Firms you've heard of incurred significant drawdowns, including General Electric (-43%), Mattel (-43%), Advance Auto Parts (-42%) and the Apache oil and gas company (-34%).

Eventually, there will be a broader bear market which will see most stocks lose value. It will be impossible to spot by forecasters, but will seem inevitable with the benefit of hindsight. The important thing to remember is that few people have ever become extremely wealthy by timing the market and jumping out because they think they can predict the next downturn. Many have gotten significantly wealthier by holding on whenever the raft hits the rapids. We missed the rapids in 2017, but everybody knows they're coming—someday, though perhaps not soon. Let's make sure we have a tight grip anyway.

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