THIRD QUARTER 2017

# Beyond the Benchmark

Aldrich℠ WEALTH LP

# Executive Summary

The overarching investment narrative remained notably upbeat during the quarter on the back of robust corporate earnings and a strong undercurrent of economic data. Global equity markets pushed higher during the quarter despite increased political uncertainty, rising tensions with North Korea and the ongoing inability of the administration to realize its policy goals. Both economic data and forward-looking activity indicators deteriorated towards the end of the quarter, though, in the wake of hurricanes Harvey and Irma. However, the market viewed any potential negative impact to be transitory. The Federal Reserve (Fed) took a similar stance in its statement following the latest Federal Open Market Committee (FOMC) meeting as they left rates unchanged. That said, Fed Chair Janet Yellen announced plans to commence the reduction of the Fed's balance sheet at a rate of $10 billion per month beginning in October. Against a backdrop of positive economic data, European equities advanced sharply during the quarter, led by gains in France and Germany. Emerging markets bested their developed market brethren with a 7.9% quarterly return, led by gains in China and Brazil.

## QUARTERLY MARKET SNAPSHOT

| | VALUE | CORE | GROWTH |
|---|---|---|---|
| Large | 3.11% | 4.48% | 5.90% |
| Medium | 2.14% | 3.47% | 5.28% |
| Small | 5.11% | 5.67% | 6.22% |

This matrix illustrates U.S. equity benchmarks provided by Russell with the exception of Large Core, which is the S&P 500 Index.

| | VALUE | CORE | GROWTH |
|---|---|---|---|
| Global | 4.59% | 5.18% | 5.76% |
| Non US | 5.87% | 5.40% | 4.94% |
| EM | 5.47% | 7.89% | 10.19% |

This matrix illustrates international equity benchmarks provided by MSCI.

| | SHORT | INTER | LONG |
|---|---|---|---|
| Gov | 0.24% | 0.38% | 0.59% |
| Corp | 0.59% | 1.34% | 1.97% |
| Hi-Yield | 1.62% | 1.98% | 2.46% |

This matrix illustrates the fixed income benchmarks provided by Barclays and B of A Merrill Lynch.

# Domestic Equities

The S&P 500 Index, a broad measure of the U.S. equity market, advanced for the 18th time in the last 19 quarters. S&P 500 companies posted earnings growth of 10.3% in the second quarter. This was the second highest earnings growth rate for the Index since the fourth quarter of 2011, and the first time the Index has recorded consecutive quarters of double-digit earnings growth since 2011. Ten out of the eleven underlying sectors within the S&P 500 Index posted gains for the quarter, with growth-oriented segments besting value. As has been the case all year, the Technology sector recorded the highest return with a gain of 8.7% in the quarter and over 27% so far this year. Investors continued to prefer the cyclical growth sectors of the equity market in contrast to the defensive sectors.

Small cap stocks outperformed large caps during the quarter for the first time this year as investors reassessed their timeline for the arrival of corporate-friendly tax policies following Republican-led tax legislation proposed in September. Smaller cap domestically focused companies are projected to benefit the most if corporate taxes are reduced.

# International Equities

International developed market equities, as measured by the MSCI EAFE Index, advanced 5.4% in the third quarter, marking the third quarter in a row of outperformance relative to the S&P 500 Index. European equities were the strongest performers, with major indices in France and Germany producing 8.4% and 7.7% returns, respectively. Earnings across Europe grew 16.4% during the quarter as sales grew at 4.1%. Energy had the fastest growth as oil prices recovered from last year's sharp decline. The euro advanced over 3.4% versus the U.S. dollar in the quarter, placing its year-to-date increase to 12.1%. ECB President Mario Draghi noted that the volatility in the currency markets is a source of uncertainty and needs monitoring, while reiterating that substantial policy accommodation is still needed.

Emerging market returns, as measured by the MSCI Emerging Markets Index, accelerated 7.9% during the quarter as China, Brazil, and Russia posted gains in excess of 14%. The Chinese economy advanced 6.9% year-on-year in the second quarter, the same pace as in the previous period, besting market expectations of a 6.8% expansion. Growth remained at its strongest level since the third quarter of 2015, as industrial output and retail sales picked up while fixed-asset investment remained strong. Strong growth in Asia is propelling earnings higher and equity prices have followed. Emerging market equities have been out of favor for several years and modest valuations reflected this. As earnings have improved and valuations around the globe remain elevated, emerging markets have attracted investor attention. The 28% gain in the MSCI Emerging Markets Index this year hasn't gone unnoticed and capital flows have increased into this once unloved space.

# Fixed Income

The Fed left interest rates unchanged at the September meeting but indicated it plans to raise rates one more time by year-end. In a long-anticipated move, the Fed also announced it will slowly downsize its huge $4.5 trillion balance sheet starting in October. The central bank said it would start by letting $10 billion in bonds mature each month, slowly ratcheting up that number until it reaches $50 billion. Despite the large numbers, it will take many years for the Fed to return the balance sheet to its pre-recessionary level. Unusually soft inflation even with a tight labor market has caused the Fed to take a fairly cautious approach to removing fiscal stimulus. Janet Yellen's tenure as chairwoman expires in February and President Trump is still considering whether to retain or replace her. The White House also has to fill four other positions on the Fed's rate-setting board, giving the President the power to dramatically reshape the central bank's leadership.

The Barclays U.S. Universal Bond Index, a broad measure of U.S. fixed income markets, increased 1.0% during the period. The yield on the 10-year Treasury bond moved narrowly higher during the quarter from 2.31% to 2.33%. The entire advance occurred in the final two weeks of September following the tax reform proposal and Fed announcement. High-yield bonds produced the best returns with a 2.0% advance during the period as strong economic data with continued stability across the energy complex helped boost returns. Robust demand for corporate bonds continued to push credit spreads (incremental yield above Treasuries) lower with spreads below their long-term averages across traditional fixed-income sectors.

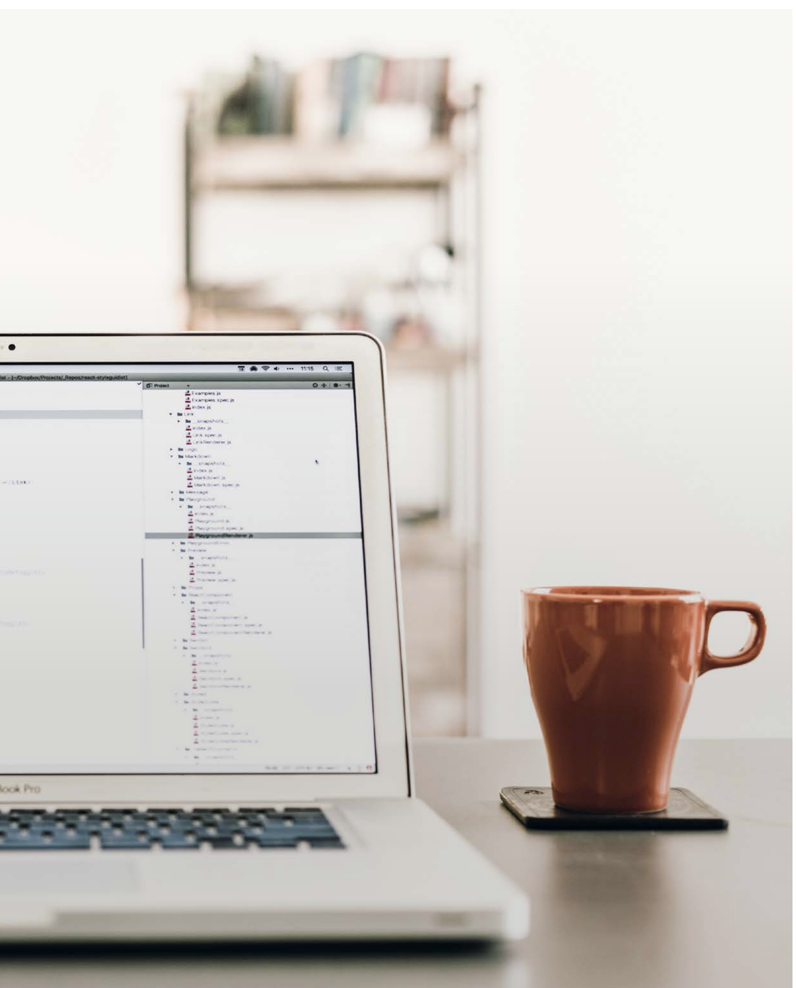
# Economy

The U.S. economy expanded 3.1% in the second quarter, driven by positive contributions from both consumer spending and business investment. Buoyed by a rise in new orders and production, the manufacturing segment of the economy, as reported by the Institute of Supply Management, expanded at the fastest pace since May 2004. Consumer inflation rose in August due in part to the impact from Hurricane Harvey, which increased gasoline and shelter costs. The unemployment rate in the U.S. fell to 4.2% in September, which marked its lowest level since February 2001. Consumer confidence dipped a little in September due to the impact of the hurricanes, but it remained near a 10-year high. The resilience of consumers has again been demonstrated as concerns about the impact of the hurricanes on the national economy have quickly faded.

The Eurozone continued its slow recovery, with GDP growth of just 0.6% in the second quarter. Growth was mainly boosted by household consumption, fixed investment and exports. Among the Eurozone's largest economies, GDP growth picked up in Spain, was unchanged in France and Italy, and slowed modestly in Germany. The seasonally adjusted unemployment rate in the Eurozone came in at 9.1% in August, the lowest reading since February 2009. Although GDP growth is fairly low in absolute terms, the growth is coming off of lower levels and the trend is moving higher. In addition, European companies have been able to extract solid profits from even modest sales growth as they have continued to operate more efficiently.

# Market Outlook

The recent improvement in economic data, strong earnings, a post-Brexit recovery, and reduced political uncertainty should provide a solid backdrop for equities to keep moving higher. However, the strong performance for U.S. stocks so far this year may be difficult to maintain in the coming quarters. If economic data remains robust, it's likely that inflation will increase and the Fed will need to increase rates. Higher inflation, particularly wage inflation, will put downward pressure on profit margins while higher interest rates will increase borrowing costs and may entice investors to move money away from stocks and into bonds. Companies are unlikely to maintain their current double-digit earnings growth pace at this stage in the domestic recovery, but a modest reduction in growth is still supportive of reasonable returns given the strength of the global economy.



U.S. equity valuations are generally above their long-term averages and developed market equities are trading near their long-term average, while emerging markets equities are trading below their long-term average valuations. The U.S. is further along in its recovery relative to the other developed countries and was the first developed country to start raising interest rates. So far this year, international equities (both developed and emerging) are outperforming their U.S. counterparts. Heightened valuations and strong economic data in the U.S. are indicative of an economy that is maturing and may offer less attractive growth opportunities going forward. Many international economies are still recovering as indicated by very accommodative central banks, low inflation, above-average unemployment, and rising profit margins. Historically, equity returns are the highest during an economic recovery and tend to decline as the recovery matures. At this stage, it seems increasingly likely that equity returns offered by international equities will outperform those of domestic stocks.

The Fed has raised the Fed funds rate twice so far this year and indicated that another hike is likely in the last quarter of the year. The Fed also announced a policy to begin shrinking its balance sheet starting this October. Clearly, this is not a supportive environment for fixed-income investors as rising interest rates push down prices of existing bonds. Although it doesn't appear that interest rates will rise quickly, even modest increases are detrimental to bond returns. Investors should expect below-average returns in bonds and should be wary of buying higher yielding bonds as the incremental yield for the level of risk is very low. Bonds with shorter maturities are less sensitive to interest rate increases and offer better protection from rising rates compared to longer maturity bonds. Given this and the fact that longer maturity bonds only offer slightly higher yields, a lower duration bond portfolio seems prudent.

# The Hidden Risks That Could Derail Your Retirement

## By Kayla Cook, CFP®

Watching recent coverage of the disasters created by hurricanes, earthquakes and wildfires reminded me of the importance of good planning. While natural disasters may be difficult to predict or plan for, there are other risks that can be mitigated with proper planning.

One of these is the risk of not having enough money to meet your retirement goals. Most of us dream about having all the money we'll need to accommodate our creature comforts, recreational interests and charitable pursuits during retirement. However, we may not consider the hidden risks that could derail our retirement dreams.

### Gauging Your Risk

Ask yourself these questions as you gauge your potential financial retirement risk:

- Does my lifestyle afford the opportunity to set aside savings consistently?
- Am I overly conservative with my investments such that I hinder the portfolio growth I need to achieve my goals?
- Are my assets diversified enough to protect me from adverse conditions that impact specific investment vehicles, industry segments and/or geographies?
- How would I be impacted in the event of a job loss or other life-changing tragedy?
- Am I doing everything possible to prepare physically, mentally and financially for living a really long life?
- Do I have the expertise and knowledge to adequately manage my financial affairs?

If the answers to these questions unveil hidden financial retirement risks, this shouldn't dampen your enthusiasm for your golden years. To the contrary, when you take stock of your current circumstances, prioritize your financial goals and make provisions for mitigating risks, you increase the chances of realizing your retirement dreams and reduce the chances of potentially facing risks you aren't prepared for.

## On the Income Side

You might take comfort in the prospect of receiving a steady paycheck. However, you must consider the risk of uneven income and/or unemployment at one or more points in your life, and your retirement investing strategy needs to be sensitive to this reality.

If your profession yields predictable income and ready access to employment opportunities (such as a physician), you'll be able to sustain more investment risk than someone whose livelihood depends on commissions (such as a real estate broker) or a cyclical business (such as a construction firm owner). This is because the high probability of a consistent income reduces the need to potentially dip into your retirement investments to support current living expenses. It also allows you to cruise through down markets without the need for untimely withdrawals.

If, on the other hand, your income is unpredictable or variable, you may need to periodically dip into income from your investments. In this scenario, you may want a more conservative portfolio that holds up well when the overall economy struggles.

## On the Expense Side

If you have a high percentage of fixed expenses — such as home mortgages, car loans and rental property debt — this will limit your ability to reduce spending and might force the sale of assets at depressed prices to meet cash flow requirements. If you are unable to quickly reduce or defer monthly expenses, you may want to employ a more conservative investment approach that is less susceptible to drawdowns.

Without the ability to cut spending when the financial markets decline, you may be forced to reduce your portfolio balance. Excessive spending in a down market magnifies risk as the ability to recover losses declines as the portfolio balance drops. This is why it's important to establish a robust emergency fund and/or restructure household finances to provide flexibility to weather unforeseen storms.

## Diversify Your Investments

Risk also increases when you put too many investment eggs in one basket. For example, real estate investors often concentrate their investment properties in local markets. As we saw in 2008, real estate can decline in value, making it very difficult to sell properties for their prior values as all sellers face the same dilemma. In this scenario, price reductions can wind up causing substantial losses.

A similar but less obvious risk can occur when investors focus exclusively on holding income-producing assets. The correlation is very high among high-income producing investments, and investors stretching for income can inadvertently take on significant interest rate risk as values tend to drop significantly when interest rates rise and investors flee such holdings.

## Plan for a Long Life

Life expectancy rates are continuing to move higher in the U.S. While living longer is certainly good news, we need to consider the consequences of this on retirement saving. If you live to age 95 and retire at 65, you will need to have enough assets to generate income to support your lifestyle for 30 years after you draw your last paycheck.

If you are too conservative with your investments and don't earn enough to support your projected income needs, you will be faced with a shortfall at a time when you might not have the option of going back to work.

## Identify, Mitigate and Understand Risk

The last thing you want is to reach your golden years without a pot of gold. With proper planning and risk identification, you will significantly increase the odds of achieving your retirement financial goals.

Keep in mind that risk doesn't have to be a bad thing. Without risk, many of us wouldn't be able to earn the types of returns we need to achieve our financial goals. However, it's important to identify and mitigate unnecessary risks while understanding when taking on risk is appropriate. Don't let risks sneak up on you and undermine your financial well-being.

**KAYLA COOK, CFP®**

WEALTH MANAGER

Kayla specializes in personal finance, financial planning and investments and has completed the Series 7 and Series 63. Kayla graduated from the University of Montana with a Bachelor of Science in Business Administration with an Option in Finance. She also has her Masters of Business Administration from Eastern Washington University.

# Tax Bracket Management: A Great Way to Boost After-Tax Returns

**By Elizabeth Hutchison, CPA, CDFA™**

Regardless of whether your investment objective is growth or capital preservation, maximizing your after-tax return should be a primary goal. One of the best ways to increase after-tax returns is to implement tax bracket management. This is a strategy utilized to reduce taxes in high-income years by possibly realizing additional income in lower income years if you expect to receive higher income in future years.

Currently, there are seven tax brackets (ignoring the alternative minimum tax, net investment income tax, Medicare surtax and long-term capital gain rates). President Trump has indicated he would like to simplify the tax code and reduce the current seven tax brackets to just three. Regardless of whether tax reform occurs, tax bracket management is still a great tool for helping develop a tax-efficient withdrawal strategy to boost your after-tax returns.

With tax bracket management, you usually aren't eliminating income, but simply deferring income into another period. So it's crucial that you consider when and how the realization of the deferred income will be taxed. If done poorly, short-term decisions may actually result in higher taxes at a later date. Therefore, we believe it is important to work with your CPA or tax advisor to develop a long-term plan that optimizes your cash flow while minimizing your tax liability.

## Strategies During High-Income Periods

In general, we recommend considering the following strategies during high-income periods.

Take necessary withdrawals from after-tax asset accounts. These include Roth IRAs (if the five-year and age tests are met), savings and individual or joint investment accounts. Generally, you are not taxed on the money withdrawn from these accounts. However, you could be taxed on any net realized gains, taxable interest income and dividends. Therefore, it is important to generate the funds for withdrawal as tax-efficiently as possible.

Note that long-term capital gains tax rates are usually lower than ordinary income tax rates in higher income years. If you are subject to high-income tax, it should be more tax-efficient to realize long-term gains than withdraw funds from pre-tax accounts.

Sell positions whose current value is below the purchase price first to realize a loss. Commonly referred to as tax-loss harvesting, this strategy can be used to offset realized gains and potentially eliminate any taxes due on sales. If you have capital gains, especially gains that are taxed in the highest bracket and subject to the net investment income tax, harvesting losses reduces your tax liability. Note that if you repurchase the stock too close to the sale date, the loss could be deferred, so you should discuss this with your investment advisor before taking action.

Estimate the potential capital gains and income distributions from mutual fund investments. These distributions, which usually occur toward the end of the year, represent taxable income even if the shares aren't sold. Mutual funds don't pay taxes and all realized gains and income are passed to the shareholders who are responsible for paying the associated taxes. The projected taxable distribution may justify selling the fund prior to the distribution if the current unrealized gain is less than what is projected to occur. Generally, mutual fund companies provide distribution estimates in November and the distributions occur in December.

Defer discretionary income and avoid taking gains. One of the easiest ways to defer income is to delay a distribution from an IRA or 401(k) account, as long as you have satisfied the Required Minimum Distribution (RMD) rules for the year.

Self-employed individuals may also have the ability to defer collection of income or withdrawal of funds from their business. Delaying income could be beneficial if income in the following year is projected to be lower than the current year. Keep in mind that when you receive a check, that amount is considered to be income during the year it is received — even if the check is not deposited or cashed until the following year.

Meanwhile, if you have stock options that are expiring and must be exercised in a specific year, it may be advisable to increase retirement plan deferrals or pre-tax contributions to a deferred compensation plan. In these situations, it is better to defer income if you will be in a lower or similar tax bracket when the income is eventually realized.

Maximize efficiency with your charitable donations. Consider donating appreciated securities that have been held for more than one year, rather than selling securities and donating cash. You will still receive the benefit of a tax deduction of the security's full fair market value, while the charity is not subject to capital gains tax upon sale. In situations where a large one-time gain occurs, it may be advisable to establish a foundation to receive the tax benefit of the donation in the high-income year while making distributions to charities over many years.

Another strategy to consider is making a qualified charitable distribution from an IRA. If you are going to make charitable donations consider directing all or a portion of your annual RMD directly to charity. This allows fulfillment of your charitable desires without taxation on the income that is withdrawn.

Accelerate deductible tax payments. Consider paying real estate taxes in full during high-income years and delaying the second or third payments to the following year if income is expected to be low. This will maximize your deduction during the years in which it is most beneficial. Paying estimated state income taxes prior to year-end may also provide additional benefits, depending on your specific tax situation.

## Strategies During Low-Income Periods

In general, we recommend considering the following strategies during lower income periods.

Perform a Roth IRA conversion. This might make sense if you have substantial tax-deferred holdings and want more flexibility with respect to generating tax-free income or bequeathing appreciated accounts. A well-timed Roth IRA conversion is a great way to increase your non-taxable portfolio, especially if you have substantial pre-tax retirement balances.

Note that there is a five-year waiting period after the conversion before you can withdraw the funds fully tax-free. But if this time frame fits into your retirement withdrawal strategy, a Roth IRA conversion can be very advantageous. In addition, unlike a traditional IRA, you are not required to take RMDs from Roth IRAs since the accounts include after-tax dollars.

Make withdrawals from traditional IRAs or 401(k) accounts. These withdrawals can be made to fulfill spending needs or simply to move funds tax-efficiently from a pre-tax account to a post-tax account. Distributions taken during low-income years will be taxed at a lower rate and can be utilized in the future with little or no tax implications.

Taking distributions could potentially reduce the balance of the tax-deferred accounts and may lessen the RMDs that must be taken in the future. This is particularly advantageous if you experience a lower income year, but expect income to increase in the future and are over or near the age when RMDs commence (70½).

Harvest long-term capital gains and rebalance your portfolio. Rebalancing and harvesting long-term capital gains is a good way to take gains in lower income years as well as possibly increase the cost basis of holdings and reduce taxes on sales in future years. If you have a position you don't want to sell but it has a large gain, you may consider selling a portion of the position and buying it back. This increases the cost basis but doesn't reduce exposure to the holding. In addition to the lower tax brackets allotted to long-term capital gains (15% or 20%), there is also the elusive 0% rate. If your highest tax bracket is 10% or 15%, then long-term capital gains could be taxed at the 0% rate.

## Short- and Long-Term Planning Are Essential

Determining which of these strategies might be most useful for you will depend on your specific financial circumstances. Engaging in both short-term and long-term planning should help yield the most advantageous after-tax results. By proactively managing your tax bracket, you can be sure that you are keeping as much money as possible and proactively managing your cash flows.

**ELIZABETH HUTCHISON, CPA, CDFA™**

SENIOR TAX MANAGER

Elizabeth goes beyond compliance and is a problem solver and strategic tax planner. Her expertise allows her to help clients navigate the complex nature of tax laws. With her most recent designation as a Certified Divorce Financial Analyst, she has the ability to help her clients understand their financial picture during significant life changes.

## Aldrich Locations

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## About Aldrich Wealth

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## Recognized as Financial Times Top 300 Financial Advisors

The 2015 Financial Times Top 300 Registered Investment Advisors is an independent listing produced by the Financial Times (June, 2015). The FT 300 is based on data gathered from RIA firms, regulatory disclosures, and the FT's research. Applications were solicited from more than 2,000 independent RIA firms that had $300 million or more in assets. The 630 RIA firms that applied were then graded on six criteria: AUM; AUM growth rate; years in existence; advanced industry credentials; online accessibility; and compliance records. To make sure the list was relevant to Financial Times readers, the paper required that no more than 75% of a practice's assets be institutional. Only those who completed an application were considered. Neither the RIA firms nor their employees pay a fee to The Financial Times in exchange for inclusion in the FT 300. This is the second annual FT 300 list, produced independently by the FT in collaboration with Ignites Research, a subsidiary of the FT that provides business intelligence on the investment management industry.

## Recognized Five Star Professional's "Five Star Wealth Managers"

Five Star Professional, as a third-party research firm, identified pre-qualified award candidates based on industry data and contacted all identified broker dealers, Registered Investment Advisor firms and FINRA-registered representatives in the Portland area to gather wealth manager nominations. Award candidates were then evaluated against 10 objective eligibility and evaluation criteria: 1) Credentialed as an investment advisory representative (IAR), a FINRA-registered representative, a CPA or a licensed attorney; 2) Actively employed as a credentialed professional in the financial services industry for a minimum of five years; 3) Favorable regulatory and complaint history review; 4) Fulfilled their firm review based on internal firm standards; 5) Accepting new clients; 6) One year client retention rate; 7) Five-year client retention rate; 8) Non-institutionalized discretionary and/or nondiscretionary client assets administered; 9) Number of client households served; 10) Educational and professional designations. 1,107 wealth managers in the Portland area were considered for the award. 224 were named 2015 Five Star Wealth Managers which represents approximately 21 percent of the total award candidates of the area. Wealth managers do not pay a fee to be considered or placed on the final list of 2015 Five Star Wealth Managers. The Five Star award is not indicative of the wealth manager's future performance. For more information on the Five Star Wealth Manager program and the research/selection methodology, go to www.fivestarprofessional.com/wmsummaryandresearch.pdf. To view AKT Wealth Advisors, LP award document, go to http://www.pageturnpro.com/Five-Star-Professional/64888-PORWM15-Heather-Wonderly/puredefault.html.

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