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Investment Management

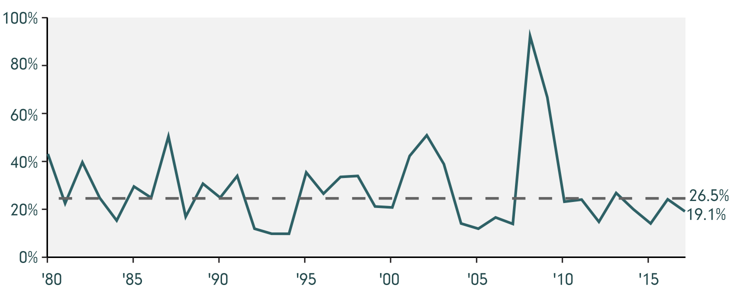
Market Review

Fourth Quarter 2017

Global equities performed spectacularly in 2017, with the S&P 500 Index returning 21.83% and foreign markets, as measured by the MSCI EAFE Index, posting a return of 25.03%. Emerging markets stocks, after several years of underperformance, were the star performers, returning 37.28%. The S&P 500 generated gains every single month last year, marking 2017 the first calendar year in history with no monthly losses in the key equity index. Markets were also characterized by low levels of volatility and minimal drawdown throughout the year (See chart: *S&P 500® Annual Price Volatility*). Growth stocks across the market-cap spectrum significantly outperformed value stocks in 2017, the opposite of what occurred in 2016. By sector, technology and health care stocks outperformed energy stocks in particular.

S&P 500® Annual Price Volatility

Annual high minus low (as percent of low)

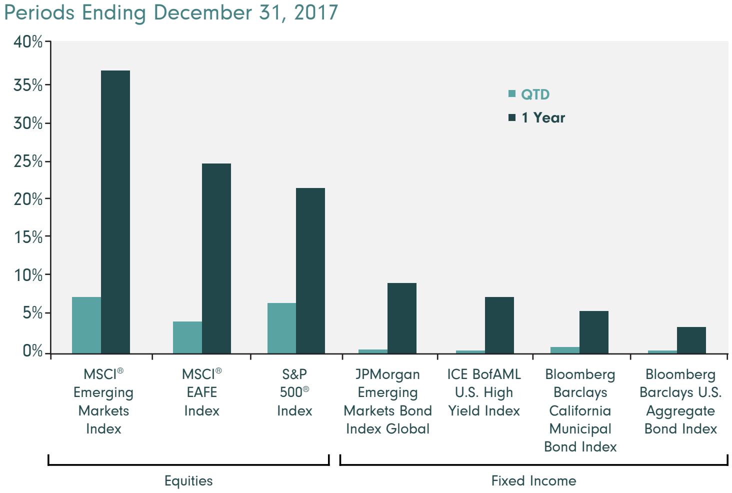


Data is obtained from Strategas and is assumed to be reliable. Past performance is no guarantee of future results.

Bonds continued to inch up through the end of the year, with the Bloomberg Barclays U.S. Aggregate Bond Index capping off the year with a gain of 3.54%. Emerging market debt was up 9.32%, high yield was up 7.48% and California municipal bonds returned 5.63% (See chart: *Index Returns*). Despite the Federal Reserve's raising short-term interest rates three times in 2017, the 10-year U.S. Treasury yield remained relatively steady, dipping slightly from 2.44% at the beginning of the year to 2.40% to end the year. The 30-year bond yield fell from 3.07% to 2.74%

Index Returns

Periods Ending December 31, 2017



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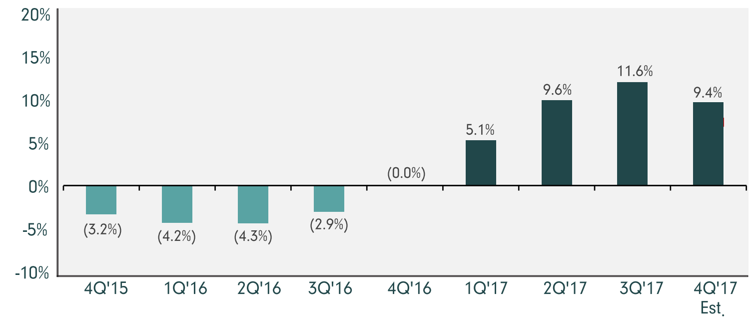
Here are the key factors that fueled superb returns for global equities:

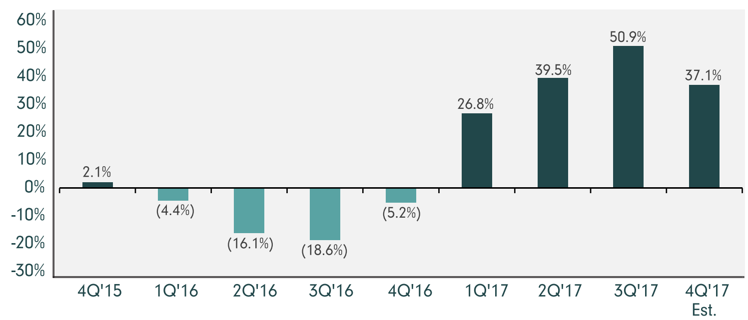
1. Corporate earnings grew solidly, with growth rates accelerating in the U.S., Europe, Japan and many emerging markets countries (See charts: *Global Earnings Growth Accelerated*). This is the first time since the financial crisis that earnings were improving across the board, not just in the U.S.

Global Earnings Growth

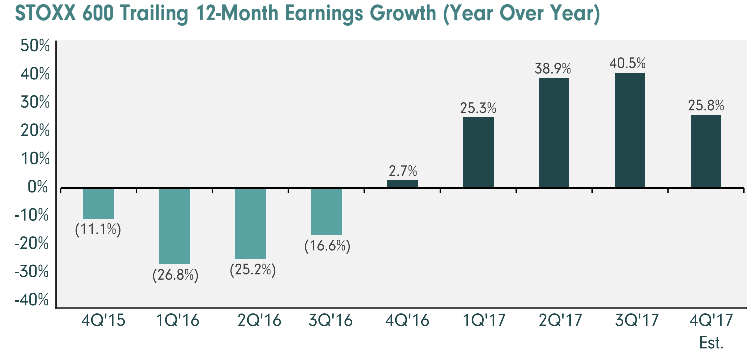
S&P 500® Trailing 12-Month Earnings Growth (Year Over Year)



Nikkei 225 Trailing 12-Month Earnings Growth (Year Over Year)



STOXX 600 Trailing 12-Month Earnings Growth (Year Over Year)



Data is obtained from Strategas and Bloomberg and is assumed to be reliable. Past performance is no guarantee of future results.

2. Inflation remained very much in check despite the improvement in global growth rates. Wage growth has been tepid, oil prices are still down materially from 2014, and global business competition continues to be fierce. Inflationary expectations are the key determinant of longer-term interest rates.

3. Despite the poor approval ratings, President Trump has so far created a more pro-business environment by rolling back numerous regulatory burdens in many industries, particularly in banking. Optimism among small businesses has dramatically improved over the course of the year (See chart: *NFIB Small Business Optimism Index*). Additionally, corporate America is a clear winner in the tax reform act passed in late 2017.

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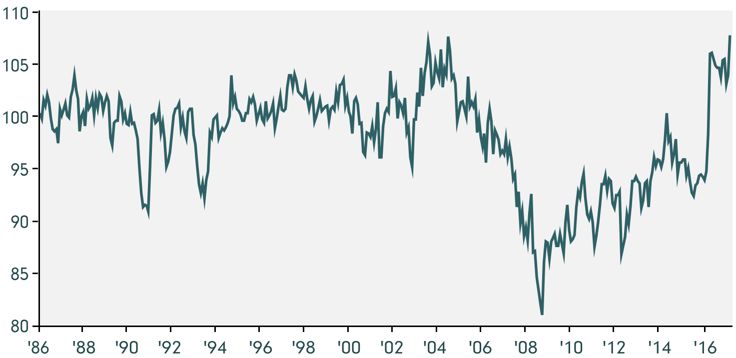
NFIB Small Business Optimism Index



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Impact of Tax Reform Legislation

There is little doubt in our minds that the corporate tax cut to 21% is beneficial to business overall. Companies will, for the most part, have increasing free cash flow, which can be applied to more capital spending, stock repurchases, increased dividends and/or acquisitions. Any of these choices made wisely should benefit shareholders in the future. Additionally, repatriation of foreign cash could lead to a significant increase in merger and acquisition activity in coming years.

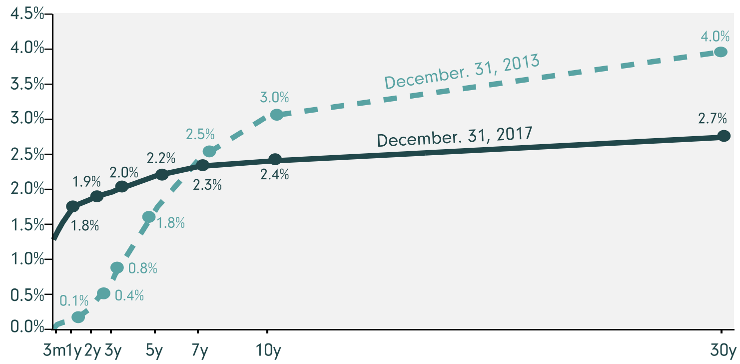
However, Wall Street analysts are simply making accounting adjustments to corporate tax rates and applying them to S&P 500 earnings-per-share growth expectations for next year across all industries. It is doubtful it will work this way. Industries like trucking, airlines, apparel, hardware, energy and banking, which are very fragmented and almost perfectly competitive, are likely to pass these savings right back to their customers. This may not happen immediately but should over time, as one or more of the participants choose to go for market share and force the competition to follow price declines or risk losing out. It is likely that only businesses with proprietary protections and unique innovative products will be able to retain the free cash flow benefits of tax reform. In other words, tax reform isn't going to result in making a commodity business a better one over time. Clearly, some of the future benefits of the tax overhaul have already been priced into the equity market, but not all.

What's Next?

After a year of stellar returns for equities, the question on many investors' minds is: "How long can this continue?" No one knows the answer for sure. But it is difficult to see any significant impediments to growth over the next year or two. We are keeping a close eye on the flattening of the yield curve into 2018 (See chart: *Yield Curve*). If the curve continues to flatten this year and ultimately invert, equities would likely experience at least a meaningful correction. If wage growth and/or oil prices were to accelerate considerably, that could also upset the longer end of the bond market and prove to be a catalyst for at least a correction.

Bitcoin and other cryptocurrencies are surrounded by massive enthusiasm and speculation, but even a potential meltdown in that speculation seems unlikely to have any substantial fundamental impact on more traditional asset classes, such as stocks and bonds.

Yield Curve



Data is obtained from FactSet Research Systems, Federal Reserve and J.P. Morgan Asset Management and is assumed to be reliable. Past performance is no guarantee of future results.

What Should Investors Do?

Investors should review their asset allocation and make sure they can "sleep at night" with their current equity exposure. The outlook for 2018 is favorable overall, but to expect another 2017 would be unreasonable. More volatility and drawdowns are anticipated in 2018 as markets return to more normal conditions. 2018 should continue to provide investors with mid-to-high single-digit equity returns but most likely not without a bumpy ride along the way.

We will continue to own high-quality businesses that can shine in good and bad times and have competitive protections. We thank you for your continued trust and support and wish you all a healthy, happy and prosperous new year!

Douglas S. Foreman, CFA
Chief Investment Officer
Douglas S. Foreman, CFA is Chief Investment Officer, Portfolio Manager, and a member of the Executive Management Committee. He has approximately 31 years of investment experience.

The S&P 500® Index is a market capitalization weighted index which includes 500 of the largest companies in leading industries of the U.S. economy. The MSCI® EAFE Index is a free float-adjusted market capitalization index that measures developed foreign market equity performance, excluding the U.S. and Canada. The MSCI® Emerging Markets (EM) Index is a free-float adjusted market capitalization index tracking the equity performance of global emerging markets. The Bloomberg Barclays U.S. Aggregate Bond Index is a market value weighted index that tracks the daily price, coupon, pay downs and total return performance of fixed-rate, publicly placed, dollar-denominated and non-convertible investment grade debt issues with at least $250 million par amount outstanding with at least one year to final maturity. Performance is calculated on a total return basis with dividends reinvested. The JPMorgan Emerging Markets Bond Index Global is a benchmark index for measuring the total return performance of international government bonds issued by emerging market countries that are considered sovereign (issued in something other than local currency) and that meet specific liquidity and structural requirements. The ICE BofAML U.S. High Yield Index tracks the performance of U.S. dollar denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market. The Bloomberg Barclays California Municipal Bond Index is a market capitalization-weighted index of California investment-grade municipal bonds with maturities of one year or more.

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