THIRD QUARTER REPORT 2016

LUCIEN, STIRLING & GRAY ADVISORY GROUP[SM]

"Smart Decisions About Serious Money"

MEET OUR TEAM

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A MESSAGE FROM THE PRESIDENT

Thomas G. Twombly

I confess that I've spent more time than I care to admit over the last couple of weeks struggling to come up with something thoughtful to say about this confounded election. Like a lot of people, I find myself opting between two candidates, each of whom I regard as flawed, and facing a choice that's driven much more by who I don't want to lead and represent this country than who I do. It's a disconcerting feeling for me to define such an important decision in such "negative" terms, and it's been challenging at times to hold onto a sense of purpose and optimism about the outcome.

My colleague Cass Grange wrote an insightful article for our October newsletter that touches on this. (You can find it on our website – I recommend it.) She reminds us just how crucial it is for all of us to lift up our heads, take stock of ourselves and what is going to happen in our lives irrespective of who ends up in the White House, and to decisively take charge of those inevitable changes. In thinking this way, perhaps you will find, as I have, that your sense of purpose, drive and optimism return.

In four years I'll be 59. Four years after that I'll be 63. And I fully expect to be engaged in this business for ten years beyond that. (I've always had a goal since starting in this profession at the age of 23 that I'd have a 50-year career, and retire at 73.) But this firm and I must still be taking purposeful steps now to prepare not only for that eventual transition, but all the others that will take place in the interim. We are doing just that, so it seemed a worthwhile time to touch on some of that work here, and to illustrate some of the substantial investments we're making for our future, and for yours.

People – the development of human capital – are the most important investments we're making, by far. Our long-term success as a firm depends on our continued commitment to attract, develop and retain bright, energetic, like-minded, younger professionals to grow into leadership positions over the coming years. Though one of our team's greatest strengths is the stability, trust and longevity of our professional relationships with each other, we cannot neglect to welcome new talent to the fold, and to enthusiastically embrace the unique strengths, abilities and perspectives they bring with them.

Culture – the constant reinforcement of beliefs, values and behaviors that ensure a fiduciary mindset – has always been a central investment theme of mine. "Honest, hard-working, fun-loving, self-effacing professionals whose primary orientation is towards the care of others" are the character traits I look for in members of this team. At every opportunity we emphasize sharing the best that each of us has to offer for the ultimate benefit of our clients, each other, and the company as a whole. Our culture is what makes Lucien, Stirling & Gray the #1 Best Place to Work, and we believe it also helps to make us a great company to work with. There is no doubt in my mind that preserving and growing this culture is our most valuable competitive advantage.

Technology - and the operational efficiency and productivity it eventually yields - is another crucial area of investment. Cloud-based computing, data aggregation and so-called artificial intelligence are bringing huge changes to the world, and especially to our profession. The thoughtful acquisition of new tools and, more importantly, the commitment to grow, learn and integrate these new resources into our daily operations is central to our long-range plan. Though another of our team's strengths is the emotional bond we enjoy with our clients, we must augment close relationships with technical expertise. At Lucien, Stirling and Gray, technology is not put in place to try to replicate or replace the personal bond that we have with our clients, but instead to further supplement our relationship and allow us to better serve you.

We have been fortunate in each of these areas. The newest members of this team, Chris Vasquez, Chaney Barton-Nichols, and Preston Neumann have all joined us in the past two and a half years. Young, enthusiastic, tech-savvy, digital natives with a warm confidence, a commitment to teamwork, and a reassuring sense of humility, each has already made a lasting impact. Each also has demonstrated an impressive commitment to investing in themselves, into each other, and into the success of this entire team. Chris is enrolled in the CFP certification program, and has provided superb leadership in our successful transition to a cloud-based CRM system. He's also a brand-new Dad. Chaney has taken all our marketing efforts to an entirely new level, and is responsible for all changes you see to these reports, our website, and much more. She and her husband just celebrated their first anniversary and just put down an offer on their first home. Preston has already passed level 1 of the CFA exam and is working on level 2, while also mastering trading and interface operations with multiple custodial relationships and becoming the most recent member of our Investment Policy Committee. All I can say is "wow."

Investing in anything is a statement of faith. Whether it's getting married, buying a house, bringing children into the world, building a business, or plowing effort into a new career, one cannot make a true long-term investor out of anyone whose fundamental view of the future is negative. I think you'll agree with me, these three should give anyone a sense of long-term optimism.

Changing gears, you'll note that we've changed our look. After a lot of self-evaluation, and after getting some thoughtful input from a number of our favorite clients, we decided it was time for an upgrade – both for this report, and especially the Personal Portfolio Review that accompanies it. We hope you'll let us know what you think, good or bad, because the best ideas keep coming from clients, and we appreciate the opportunity to respond to your suggestions.

We're most proud of what we've done to improve and streamline the Personal Portfolio Reviews. The first thing you'll note is that the date is now featured prominently on the cover page. (You'd think this should have been a no-brainer, but one of our clients actually had to point out that its absence up until this point was particularly confusing.) Pages 2 & 3 now feature a kind of executive overview in graphic form, including activity for the most recent quarter, and a brand new multi-colored pie chart that offers an instant view of the most recent asset allocation of your aggregate portfolio, while the next section provides a long-range perspective of portfolio results since inception. (Thanks to another client, we changed the print density to conserve ink – excellent suggestion!)

Pages 4 and beyond provide the underlying details. The most valuable improvement in this section was in re-ordering the columns so the information makes more sense sequentially. We completely eliminated the Table of Contents and the Firm Comments sections, as a number of clients pointed out that we could conserve paper and printing. Several also gently suggested that my comments were already sufficient with what's included in these Quarterly Reports. Please do let us know what you think.

Thank you for your confidence and trust

Thomas G. Twombly

President

INVESTMENT COMMENTARY

From a longer-term economic perspective, one of the most significant revelations of the third quarter of 2016 was the release in September of the 2015 Census Bureau's report. (Yes, it was nine months after the fact… the wheels of government do turn slowly.) It showed that, adjusting for inflation, median household income in the United States rose by +5.2% last year. Please note, this was the largest increase on record in the almost 50 years since the annual survey began in 1967. So it would seem that however gradual and halting this recovery may have been to this point, it continues to gain steam.

Even more significantly, the report also showed that it was the bottom 20% of all income earners in the United States who actually enjoyed the largest percentage increases in their incomes. In fact, 2.4 million people gained full-time employment in 2015, building upon several years of accelerating employment growth.

Additionally, approximately 3.5 million people pulled themselves above the poverty line as the overall rate of poverty in the U.S. declined from 14.8% in 2014 to 13.5% by the end of last year.

These developments are notable for at least two reasons. Most importantly, from a human perspective they mean that many of the people who have struggled the most during the last number of years are finally beginning to benefit from the long slow recovery we've experienced since 2009. Number two, since most of these income gains are more likely to be spent rather than saved, from a macro economic perspective they provide an almost immediate boost to growth in the overall economy.

And it's not just data from last year that have showed improvement. More recent evidence suggests that the contemporary job market continues to improve on these results. In fact, J.P. Morgan reports that the weekly unemployment numbers for the final week of September of this year were the lowest ever for the 2386 weeks going back to 1971. If it weren't for the over-arching negativity of the elections pulling our attention away, surely this news would have been greeted with more enthusiasm.

In other words, be careful of buying into the pessimistic narrative that claims that the U.S. economy is on the brink of a precipice. As was mentioned in last quarter's report, we may in fact be on the cusp of accelerating growth, and the difference between those two outlooks can have significant implications for the appropriate positioning of an investment portfolio. With still more than $12 trillion parked on the sidelines in cash earning almost nothing, and with household debt-service ratios at their lowest levels in over 40 years, even a subtle change in the inflationary psychology of the investing populace could result in a flood of cash seeking a different place to be invested. It's certainly not the time to throw caution to the winds, but neither is it the time to be gripped by fear. We remain cautiously optimistic, and convinced that patience and discipline will continue to be rewarded.

So far in 2016, emerging market equities have proven to be the top-performing asset class in broadly-diversified portfolios. After four years of negative results, overall year-to-date returns of 16.4% have caught many skeptics by surprise, and shown the value of patience and a long-range view in portfolio construction. The modest allocations we have maintained in this area have been quite beneficial to many of our clients, especially as we began adding to those holdings earlier in the year when prices were particularly low. Also beneficial have been select holdings in high-yield debt, Real Estate Investment Trusts, small-cap equities and commodities, all of which have managed, finally, to show strength after the extended dominance of large-cap U.S. stocks over the last five years.

U.S. fixed income markets also showed positive results during the recent period as interest rates on the benchmark 10-year U.S. Treasury Bond declined overall for the quarter. Despite being near the lowest yields in history, continued negative interest rates in the sovereign bonds of many of the world's most developed economies have created an environment where foreign investors feel compelled to buy ours instead. While this situation offers some degree of protection in a world of continued slow growth, yields in this sector are so low that even a slight uptick in expectations for inflation could be more damaging than many bond investors suspect. As a result, we remain cautious and alert.

Developed market equities have lagged many other asset classes recently, and our allocations to these areas have provided a drag on overall results for the year so far. Nevertheless, we continue to believe that these holdings offer some compelling long-term opportunities, and we encourage patience and a long-range perspective. Comparatively speaking, the domestic economy is more likely to encounter some structural impediments to growth going forward, as our labor markets tighten and the long-term effects of our underinvestment in infrastructure (both by our corporations and our governing bodies) become more evident. On the other hand, many developed-market economies, especially in Europe, have much more room to expand. With higher unemployment rates and therefore a greater supply of labor readily available, weaker currencies versus the U.S. dollar, much more attractive equity market valuations, and only fairly recent indications that corporate earnings are on the rise, we think the next several years could see a reversal of more recent trends. Keep your eyes on the far horizon.

Upcoming Events

Join Us for Our Annual Holiday Party
Thursday, December 8, 2016
3:30 – 7:00 PM

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General Market Results

	3rd Quarter	YTD	One Year	Three Year	Five Year	Ten Year
CPI	-0.08 %	1.83%	1.22%	0.95%	1.20%	1.73%
Barclays Agg Bond	0.46 %	5.80%	5.19%	4.03%	3.08%	4.79%
S&P 500	3.85%	7.84%	15.43%	11.16%	16.37%	7.24%
DJI	2.78%	7.21%	15.46%	9.23%	13.77%	7.39%
S&P 400	4.14%	12.40%	15.33%	9.35%	16.50%	9.11%
Russell 2000	9.05%	11.46%	15.47%	6.71%	15.82%	7.07%
NASDAQ	9.69%	6.08%	14.97%	12.09%	17.07%	8.93%
MSCI EAFE	6.50%	2.20%	7.06%	0.93%	7.88%	2.30%
MSCI EM	9.15%	16.36%	17.21%	-0.21%	3.39%	4.28%

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