Fourth Quarter Report 2017

LUCIEN, STIRLING & GRAY ADVISORY GROUP℠

"Smart Decisions About Serious Money"

MEET OUR TEAM

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A MESSAGE FROM THE PRESIDENT

Thomas G. Twombly

We are pleased to provide you with our report for the period ending December 31, 2017.

It was an extraordinary year. Any number of disturbing events, awful attacks and unpleasant revelations roiled our sense of safety over the last twelve months. Horrible outcomes were both realized and imagined as social tension and political vitriol pitted people of different nations, parties and races against each other. Yet virtually none of it was revealed in the financial markets. Volatility and uncertainty instead seemed to disappear from those fronts. Bonds experienced yet another year of calm on the inflation front, and equities of all types jumped up and went on a steady, year-long tear.

To understand the uniqueness of 2017, it's worth noting a couple of interesting statistics. First, 2017 was the first year in the history of the index when the S&P 500 climbed in every single month. That's right, at no point did we close a single month with the index lower than at the beginning of the month. What's more, the largest pull-back we experienced during the year was a mere -3%. That's far below the average intra-year decline of -13.8% during the last 38 years, and ties calendar year 1995 (22 years ago) for the lowest draw-down in the entire timeframe of my professional life.

There are two important points I'd like to raise as a result. The first is that it is (and always has been) a terrible mistake to allow one's political leanings to dictate one's investment policy. Despite deeply felt emotions (trust me, I have them too) there is still no evidence to support the idea that Presidential politics are meaningfully correlated with financial market performance. To their chagrin, many Republicans discovered this during the Obama administration. Now many Democrats are discovering the same thing during the Trump administration. Instead, investment policy should be guided by your personal time horizon, your resources, your needs, your individual tolerance for uncertainty and ambiguity, and an informed understanding of the long-term behavior of various asset classes.

The second, and perhaps more important, point I'd like to make is that this calm will eventually pass. I don't know when, but volatility will return. Uncertainty will revisit us. Anxiety, doubt and fear will come back to financial markets – possibly sooner rather than later. Unlike Presidential politics, there is a great deal of evidence to support the belief that financial markets eventually revert to their long-term mean. Knowing that, it's best to be prepared in advance – both financially and emotionally. If you believe you're not, or if you'd just like to revisit your game plan for reassurance, please come see us. We'd love to talk it over.

We live in a world of immense complexity, where even well-educated and successful people are confronted with constant change and mind-boggling choice. Our lives change. Our needs change. Tax rules and regulations change. The economy changes. Choices abound, and we are hammered daily with conflicting messages about how to address them. Change and choice can create anxiety and fear – which at best can lead to paralysis. At worst, they lead to horrible mistakes. Few have the requisite skills to go it alone, and fewer still have the desire. That's why we're here.

During 2017 we celebrated our 25th anniversary, and we continue to grow and improve. I believe we've succeeded because we've deliberately created a fiduciary culture here. Everyone on this team embraces the position that we will always act in the best interests of our clients, each other, and in the long-term success of this company as a whole – in that order. We promise never to place our individual interests ahead of those we serve, or those with whom we serve. Though we can never promise superior results, we do promise to provide impartial advice, and to act always with skill, care, diligence, and good judgment – treating you the same way we would wish to be treated. We promise to provide full and fair disclosure of all key facts, including all compensation we receive for the services we offer, and we promise to fully disclose and fairly manage, in **your** favor, any unavoidable conflicts that might arise. It's that simple.

Our greatest value lies not in the creation and maintenance of a brilliant investment portfolios for our clients, but in providing them personally with attention, accountability and expertise. Our goal is to give you the sense of comfort that comes with being organized and informed, and the confidence that whatever changes and challenges you eventually face, we will face them together. Competent, caring, trustworthy professionals who are willing to place other people's interests first are valuable. I believe that people willing to act as true fiduciaries are rare.

We wish you a very happy, healthy and prosperous 2018. And if you happen to know of someone else who deserves to be served in that manner, we would gladly welcome an introduction.

Thank you for your continued confidence and trust.

Thomas G. Twombly

President

INVESTMENT COMMENTARY

As mentioned earlier, 2017 was an unusually one-directional year for global financial markets; one that saw virtually every major asset class, almost every sector of the domestic stock market, and every sector of the domestic bond markets produce positive results. Based on those measures alone, the U.S. investor class has truly experienced a Goldilocks economy.

Economic activity in the U.S. continued the upwards trajectory we've experienced for many years now, and large company stocks undertook yet another impressive run for 2017. Led by a powerful technology sector that surged a full 9% in the final three months to finish the year at +38.8%, the S&P 500 produced a total return for 2017 of +21.8%. Perhaps in anticipation of the passage of significant corporate tax cuts in the closing days of the year, the consumer discretionary sector also jumped by a whopping 9.9% in the closing quarter, a further sign that economic optimism has been increasingly widespread. Even the notable laggard sectors for 2017 displayed a kick in the final quarter. Telecommunications stocks, the worst performer of the S&P 500 index for 2017, rose by +3.6% to finish the year at -1.3%. Energy stocks, too, rose by an impressive 6%, whittling down their 2017 loss to an even -1.0%.

More impressive still for all of 2017 were the results for foreign equity markets. Aided by strengthening foreign currencies relative to the Dollar, U.S. investors benefitted greatly from international diversification. The MSCI All-Company World Index – ex U.S., which rose by a very impressive +27.8% in U.S. Dollar terms, and the large-cap Europe Asia Far East(EAFE) Index, which was up by +25.6% illustrated these benefits. Somewhat more narrowly, and in a sign of how much economic conditions have improved throughout Europe in the recent past, the oft-maligned eurozone of several years ago also showed remarkable strength during 2017. Europe ex-U.K. alone provided total returns of +27.8% in U.S. Dollar terms, equaling fully the results of the MSCI.

Most impressive of all for 2017 were results for emerging markets equities, where, once again, long-term investors who had the patience and discipline to remain invested throughout prior years were well-rewarded. Broadly measured, emerging markets stocks were up by a whopping

+37.8% for the year, far outstripping their results for 2016. Notable strength came from the large and growing economies of China and India. Major indices in these countries rose by +54.3% and +38.8% respectively for 2017. They replaced Brazil and Russia as the previous year's leaders, demonstrating that broad diversification and a long-range time horizon are crucial principles for investors in this asset class.

On the more conservative end, fixed income investments also provided reasonable results for the year, though nowhere near the level of equities. The 10-year Treasury bond finished the year with a yield of 2.4%, almost identical to the 2016 closing yield of 2.45%. The Barclay's Aggregate Bond Index, too, provided total returns of 3.54% for the year, reflecting similar calm and stability in the broader fixed income markets. Finally, corporate high yield bonds as a sector generated total returns of +7.5%, reflecting continued economic stability and providing reasonable rewards to those willing to loan money to less-than-investment-grade enterprises.

Finally, despite the long bull market in equities, we believe it's worth noting the large balances in cash that remain on the sidelines – earning very little. According to the chart below from J.P. Morgan, as of 9/30/17 there was approximately $15.5 trillion in cash instruments overall. Fully $9.5 trillion of that sits in savings accounts and small-time deposits; another $2 trillion in checking accounts; and $1.5 trillion in plain old "bury it in your backyard" or "stash it under your mattress" currency. For perspective, that aggregate is greater than 150% of all outstanding mortgage debt in the U.S. Contrary to the broadly disseminated notion that we may be entering another euphoric bubble, this suggests to us that perhaps a great deal of caution still lingers – and that would be a healthy indicator.

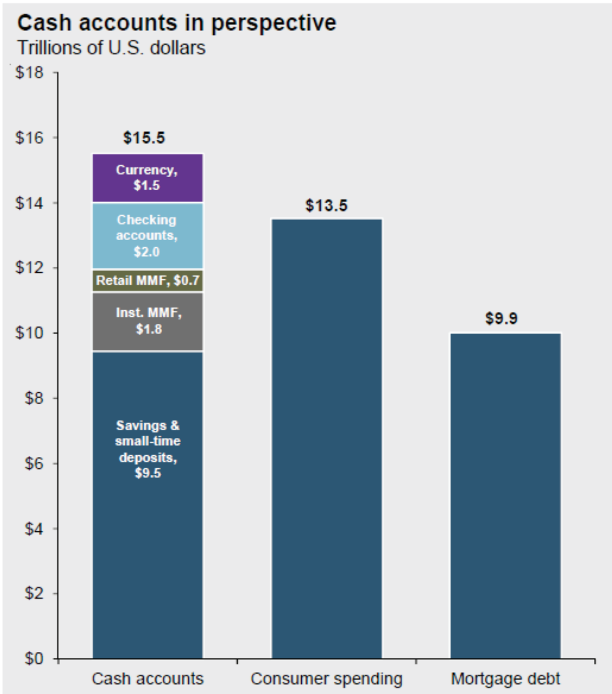
Looking forward, a lot appears to be right about the economy, both domestically and globally. But there are also a lot of people who are nervous. After a 295% increase in the S&P 500 since March 9, 2009, and the second-longest (so far) domestic economic expansion since WWII, the forward price / earnings ratio of large-company U.S. stocks finished 2017 at 18.2. That level is well above the 25-year average of 16.0, and has been sufficient to cause more than a few seers to opine that a sharp downdraft must be imminent.

While we should all acknowledge that this possibility exists, and while we should certainly temper our expectations about the continuation of the returns we've seen from this asset class in recent years, we believe that trying to predict (much less time) such an event is foolish. Furthermore, especially relative to bonds, we still believe U.S. stocks offer reasonable value. Earnings have increased for six years in a row, and they continue to show growth. Employment numbers continue to improve. Interest rates remain near historic lows. And more than 40% of earnings in the S&P 500 come from overseas – where economies and consumers continue to gain steam.

More compelling on balance, we believe, are opportunities in international equities, where price / earnings ratios are still a good deal lower than in the U.S. The MSCI All-World Index finished 2017 with a P/E of 14.3, which is still below its long-term average of 14.5, and it sports a dividend yield of 3.1% compared to a U.S. dividend yield of 2.0%. Reasonable allocations to emerging market equity investments also continue to look attractive to us in the long run. With lower debt / GDP ratios, younger populations, and a much larger consumer base and available workforce, long-range prospects for these economies look promising.

As always, we continue to maintain broad allocations across multiple asset classes for virtually all our clients, and we've been particularly pleased with the results we've witnessed in 2017. If you would like to discuss our perspective or your personal situation, please give us a call.

According to the chart below from J.P. Morgan, as of 9/30/17 there was approximately $15.5 trillion in cash instruments overall.



Source: FactSet, J.P. Morgan Asset Management; Federal Reserve System, BEA.
Money supply, consumer spending, and mortgage debt are as of 9/30/2017. M2 includes M1 (currency in circulation and checking accounts) plus savings deposits, small-denomination time deposits and retail money market mutual funds. Institutional money market funds are considered memorandum item, not included in M2. Annual income is for illustrative purposes and is calculated based on the 6-month CD yield on average during each year and $100,000 invested. Past performance is not indicative of comparable future results. Guide to the Markets – U.S. Data are as of December 31, 2017.

Please Join Us for a Fireside Chat
The New Tax Cuts & Jobs Act
from a CPA's perspective

Thursday, March 1, 2018
6:30 – 8:00 PM
At our offices at 4005 Guadalupe Street | Austin, TX

Presented by Sherrill Morales, CPA & Melinda Oster, CPA of
Atchley & Associates, LLP - a full-service CPA firm, located in Austin, TX

Wine, cheese, and other refreshments will be provided. Feel free to bring a friend.

RSVP: 512 – 458 – 2517 | info@lsggroup.com | lsggroup.com/resources/programs-and-events/

General Market Results

	4TH Quarter	YTD	One Year	Three Year	Five Year	Ten Year
CPI	-0.06%	2.17%	2.17%	1.66%	1.44%	1.62%
Barclays Agg Bond	0.39%	3.54%	3.54%	2.24%	2.10%	4.01%
S&P 500	6.64%	21.83%	21.83%	11.41%	15.79%	8.50%
DJI	10.96%	28.11%	28.11%	14.36%	16.37%	9.28%
S&P 400	6.25%	16.24%	16.24%	11.14%	15.01%	9.97%
Russell 2000	3.34%	14.65%	14.65%	9.96%	14.12%	8.71%
NASDAQ	6.27%	28.24%	28.24%	13.38%	17.98%	10.04%
MSCI EAFE	4.27%	25.62%	25.62%	8.30%	8.39%	2.42%
MSCI EM	7.50%	37.75%	37.75%	9.50%	4.73%	2.02%

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