KOVITZ INVESTMENT GROUP
Intrinsic Values®

Market Insights
Winter 2018

Many investors greeted 2017 with apprehension, but it turned out to be a very good year for risk-based assets. In what likely would have been a surprising outcome to most prognosticators, the stock market[1] returned nearly 22% in 2017 and continued its nine year bull run. This streak of years with returns in the black has been notable for its duration, but even more so for the lack of volatility throughout the climb to its current height. The past year took that lack of volatility to a new low with annualized daily volatility for the year coming in at a meager 6.7%. It may be difficult to picture what that number means, but it is stunningly low. The same measure over the prior 20 years was 19.6%, and the 2017 reading marks the second lowest for a calendar year on record.

In a year where most seemingly important world and economic events were met with a collective shrug from investors, the most market-moving development was undoubtedly the changes to the tax code enacted in Washington in December. The most prominent feature of the new law was the reduction in the statutory corporate tax rate from 35% to 21%. The new law, through a variety of changes, also provides for temporary tax cuts for most individuals and large increases in exemptions that will prevent many taxpayers from falling under the Alternative Minimum Tax or the estate tax. These sweeping changes to the tax code are likely to offer a number of opportunities and strategies for tax minimization. If you haven't already, we highly recommend consulting with your tax adviser and discussing the topic with your Kovitz financial adviser, as needed.

Regarding the effect on the economy and the stock market, there is much debate over whether or not these tax cuts will create enough incremental economic growth to counteract the additional deficits they create over the next ten years. However, the focus of our analysis has been mainly on the change to the corporate tax rate. For any company that generates most or all of its income in the United States, and was thus paying the full 35% federal tax rate, the new law will result in an immediate 21.5% increase in net income starting in 2018 and every year thereafter, all else equal.

It's possible that this bounty will be diminished by rising wages resulting from increased competition for workers or increased investment. Indeed, several companies announced they were paying their employees special bonuses as a direct result of the tax overhaul, but these were one-time payments that amounted to a small fraction of one year's worth of tax savings under the new rate. At least in the near-term, we expect the tax savings to predominantly flow to shareholders in the form of increased dividends or share buybacks. While we offer no grand predictions of what the overall, long-term effect the changes to the tax code will have on the US economy, the corporate tax reduction is unequivocally good for stocks, and thus owners of stocks.

[1] As represented by the S&P 500

While tax rates fell, interest rates have continued to rise. The Federal Reserve raised the overnight fed funds target rate another quarter of a percent in December. Including the increases that took place in June, March, and December of 2016, the fed funds target range now stands at 1.25%-1.50%, up from 0.25%-0.50% a little over a year ago. Meanwhile, long-term rates ended the year pretty much where they began. This combination has produced the narrowest gap between short-term and long-term rates since 2007, and that was when the Fed was aggressively raising rates to slow down an overheating economy being fed by the housing and credit bubble.

Current Portfolio Positioning

Despite the fact that our clients' equity portfolios have returned 304%[2] since the last market bottom in March of 2009, we remain steadfast in our commitment to only buy when the value we are getting is materially more than the price we are paying. We further commit to invest client assets as if they were our own and to invest alongside our clients whenever possible. Honoring these commitments is second nature to us, even if adhering to the former has remained challenging in this environment. Nevertheless, we continue to pursue every opportunity across asset classes for our clients even if we end up passing on many more than we choose to invest in. Across our strategies, we are positioned as follows:

1. Equities: We remain defensively positioned with above-average cash balances, although these were reduced throughout the latest quarter as we added three new positions to client portfolios. These are discussed in detail in the accompanying Core Equity Commentary.
2. Fixed Income: Given the reduced incremental yield currently obtained by purchasing long-term bonds relative to short-term bonds, we continue to slightly overweight short-term bonds in our clients' bond ladders. This decision, the interest rate environment, and other topics are discussed in more detail in the accompanying Fixed Income Commentary.
3. Alternatives: We continue to recommend the inclusion of some alternatives, such as hedged equity and real estate, in client portfolios as these assets may improve the overall risk/reward profile of a client's total portfolio, if suitable.

As always, these are general comments that do not apply to all KIG clients. Please discuss your particular situation with your KIG Financial Advisor for more information on these topics.

Best Regards,

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[2] As represented by the KIG Equity Composite net-of-fees return between February 28, 2009 and December 31, 2017. Individual client portfolio returns will differ from Composite returns based on variations in account holdings, cash position, and other client-specific circumstances.

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