Market Commentary

Fourth quarter investment returns were divided by asset class into winners (domestic stocks) and losers (virtually every other market segment). The 2016 election has dramatically changed investor expectations for economic growth with anticipated lower regulatory burdens, increased infrastructure spending, and reduced corporate tax rates. As a result, the S&P 500 rose 3.8% this quarter for a total return of 12.0% for 2016. Small company stocks, whose businesses are more domestic in nature, rose sharply, returning 10.1% in the fourth quarter and 21.3% for the full year. Foreign stocks declined 1.3% in the fourth quarter largely due to the U.S. dollar strengthening 7.1% against a basket of foreign currencies, thereby lowering these foreign stocks in terms of U.S. dollars.

Interest rate-sensitive investments also performed poorly this quarter, with bonds and publicly traded real estate both dropping 3.0%. In December, the Federal Reserve increased the federal funds rate by 0.25% to a target range of 0.50%-0.75% and surprised the market by signaling three 0.25% rate increases in 2017 instead of the prior consensus of two. This policy shift, along with Trump's pro-growth agenda, reset the market's expectations of future interest rates and contributed to ten-year Treasury yields increasing by 50% to 2.45%.

Major Tax Reform on the Horizon

In our last quarterly newsletter, we observed that unless the president and both branches of Congress are controlled by one party, tax policy will be slow to change. We now find ourselves with a Republican president and Republican-controlled Congress, making tax reform highly likely. While President-elect Trump and Congress have some differences in their tax plans, they are very similar.

Tax Provision	Current	Proposed	Notes
Ordinary Income Tax	10%, 15%, 25%, 28%, 33%, 35%, 39.6%	12%, 25%, 33% (Trump) 12%, 25%, 33% (House)	A simplified tax code will likely reduce tax receipts, increase federal debt, and repeal 3.8% surcharge
Capital Gains Tax	0%, 15%, 20%	0%, 15.0%, 20.0% (Trump) 0%, 12.5%, 16.5% (House)	The House would tax all investment gains at 50% of ordinary income rates
Bond Interest Tax	Taxed as ordinary income (see above rates)	12%, 25%, 33.0% (Trump) 0%, 12.5%, 16.5% (House)	Implies up to a 58% reduction in rate under the House plan for interest earned on taxable bonds

Shift Toward Index Investing Continues

This past year exemplified the difficulties of making short-term stock market predictions as many investors incorrectly forecasted the outcome of the election and its impact on financial markets. Increasingly, investors are shunning stock pickers who claim market-beating abilities for low cost, tax efficient index funds. According to S&P Dow Jones, only 8% of traditional mutual fund managers focused on large company stocks outperformed their benchmark over the past five years. This poor performance contributed to investors moving an additional $285 billion out of traditionally managed funds and investing $429 billion into index investments over the first eleven months of 2016.

Comparative Returns

	Q4 2016 Returns	Annualized Performance			
		1 Year	3 Years	5 Years	10 Years
Large Cap U.S. Stocks(1)	3.8%	12.0%	8.9%	14.7%	7.0%
Small Cap U.S. Stocks(2)	10.1%	21.3%	6.7%	14.5%	7.1%
International Stocks(3)	-1.3%	4.5%	-1.8%	5.0%	1.0%
Real Estate(4)	-3.0%	8.5%	12.9%	11.8%	5.2%
U.S. Bonds(5)	-3.0%	2.7%	3.0%	2.2%	4.3%

1. *Measured by the S&P 500 index, which includes 500 of the largest U.S. companies in all sectors of the economy*
2. *Measured by the Russell 2000*
3. *Measured by the MSCI ACWI ex-U.S. index, which includes large and mid-capitalization stocks from developed and emerging international markets*
4. *Measured by the MSCI U.S. REIT index, which includes domestic publicly traded real estate stocks*
5. *Measured by the Barclays Aggregate Bond index, which includes a representation of the performance of the entire U.S. investment grade bond market*

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