Praetorian Guard

QUARTERLY NEWSLETTER • 1ST QUARTER 2017

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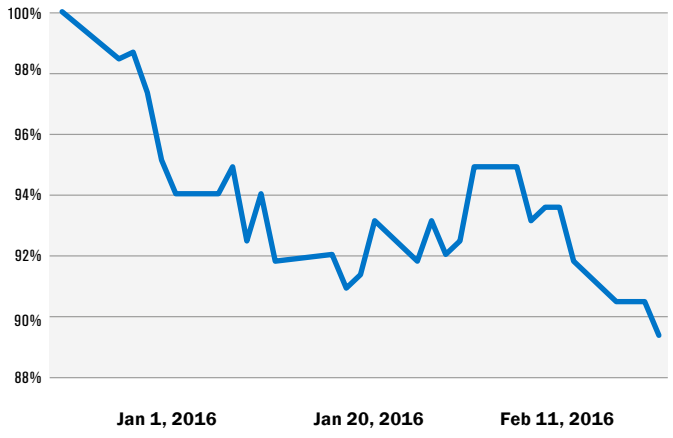
First Quarter 2017 Market Review and Discussion

As we close out 2017, a review and discussion of two human traits that work against us as investors is worthy of discussion. The first is *recency bias*, which translates to our tendency to remember and therefore give more weight to an event or news that is most recent. In January 2017, the stock market declined approximately -10% in the first 12 trading days of the year (left graph). Today, that seems to be ancient history, but during that first month it was easy to talk oneself into being "certain" the wheels were coming off the market.

S&P 500 First Trading Days of 2016



Source: S&P

S&P 500 From Low of 2016

Source: S&P

Had you reacted in January to reduce the stock exposure in your portfolio, your timing would have been exactly perfect... if you were trying to sabotage yourself. The lesson to keep in mind in times of market downturns (as well as rapid rises) is the trend won't continue that far, that fast for that long. Markets, made up of individuals who ALL experience *recency bias* will over-shoot to both the down and upside.

The second mental bias to be aware of is *anchoring*. This impacts investors by using an initial piece of information or data (for example the purchase price of a stock) as the "anchor" and then all subsequent decision making is made in relation to the anchor value. Being aware of this cognitive bias is useful when you are trying to make a decision to sell an asset *(continued on pg. 3)*

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PRESIDENT'S COMMENTARY

Swing… and a miss! I missed the Presidential Election call in our last newsletter so I must apologize for not seeing one of the larger political upsets of the last 60 years. America has some degree of political accountability for at least the next two years. I do not see the electorate becoming more hospitable to "business as usual" so we should expect a significant change in direction in numerous areas from the last eight years.

Accountability is a good thing—you know who to fire after assessing the blame. Our political system won't get more unified in the near-term but my hope is that it can be more functional.

We expect that the incoming administration is going to expend its political efforts in three areas: repeal of the Affordable Care Act (ACA), overhauling both the Corporate and Individual Tax Code and increasing the size, lethality and capabilities of the U.S. Military. None are easy or inexpensive. Repealing the ACA is a promise to keep to those who voted for the incoming administration so it will happen concurrently with the replacement legislation.

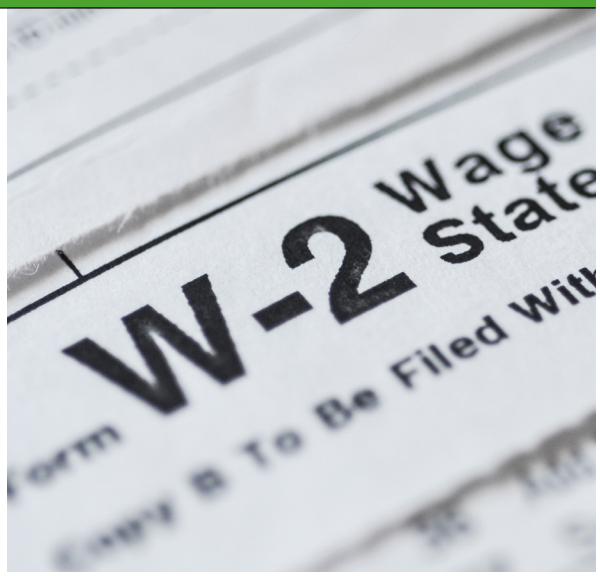
TAX REFORM IN THE NEW YEAR

Standing at the intersection of opportunity and necessity is where we find ourselves today. The last large tax reform was completed in 1986. Since that time of simplification and streamlining, every Congress has made things more complicated and cumbersome. We believe this is the most economically significant action Washington D.C. can take *now* to get the economic engine out of the stagnation of 2% annual growth rates.

INDIVIDUAL TAX BRACKETS: 7 TO 3

We do see a streamlining of brackets for individual taxpayers from the current seven (ranging from 10% to 39.6%) down to three: 12%, 25% and 33%. Those numbers may move around a bit but expect the individual taxpayer will see simpler and flatter brackets. We are confident the three big deductions for mortgage interest, charitable contributions and state/local income taxes will remain in the Tax Code but many other items added over the past 30 years will be eliminated.

Congress is (we pray) smart enough to realize that many individual taxpayers are really businesses. The S-Corporations, LLCs, etc. are all pass-through entities. A percentage of the income for these business owners is W-2 income and a percentage is corporate earnings. There will be a separate tax rate, which we expect to mirror the final C Corporate rate, on those business earnings.



Items We Expect To Die a Well-Deserved Death

The Alternative Minimum Tax (AMT) came into being in 1969 after Congress learned that 155 high earning families paid $0 income taxes on their 1967 returns. Those families were using the tax code as written and Congress enacted a second tax system, the AMT, to address the issue rather than applying first principles. Things have become more complicated ever since. Another item we expect to die is the 3.8% net investment income tax. It will go away with the repeal of the ACA.

Finally, although there is political disagreement, the House GOP is suggesting the elimination of virtually all individual tax deductions except the mortgage and charitable deductions (paired with an expanded standard deduction). However, President Trump would keep all the current itemized deduction rules, but cap itemized deductions (at $100,000 for individuals, or $200,000 for married couples) while also expanding the standard deduction even more.

First Quarter 2017 Market Review and Discussion

(continued on pg. 1) (stock, house, investment) and the market is telling you the economic value is less than your anchor value. The stock does NOT know what you paid for it nor does it feel any obligation to return to that price so you don't realize a loss and feel badly. The true question to ask: would you buy it *today* at the market price? If yes, likely worthwhile to continue to hold; if no, time to sell and reposition the funds to better opportunities.

For the year, all indices with the exception of the Developed International Markets were positive with the Large Cap Stocks (S&P 500) returning 9.5%, Mid Cap U.S. Stocks (S&P 400) returning 18.7% and Small Cap US Stocks (S&P 600) coming in at 24.7%. This illustrates why we always want diversified portfolios and accounts to have exposure to all market cap segments.

Our investment overweighting changed somewhat as we moved out of Energy and repositioned those dollars into Industrials. The top performing sectors of the U.S. economy for 2016 were Energy (+28%), Financials (+22%) and Industrials (+19%). Technology returned +14%.

CORPORATE TAX REFORM: TWO COMPONENTS

The U.S. Corporate tax rate of 35% is among the highest in the developed world and will be reduced—we expect 25% to be the final rate. We do not believe the "math" works to bring this down to 15% but a flat rate of 25% would be significant. Additionally, the worldwide tax system we have had in the past will be modified to reflect a territorial system. This means that profits would be taxed where earned but NOT taxed a second time at the difference between the U.S. rate and the foreign rate if repatriated back to the U.S. Given that U.S. corporations currently have in excess of $2 trillion overseas, this could bring a large portion of that capital back to the U.S. and be invested or distributed to shareholders.

WHAT TO EXPECT IN 2017: ECONOMICS AND MARKETS

Crystal Balls are inherently cloudy but there are some areas where we at Praetorian Guard feel confident sharing our reading of the tea leaves:

Federal Reserve: 3 rate hikes this year, each .25% so that we end 2017 at a Fed Funds Target rate of 1.50%.

U.S. Unemployment Rate: 4.7%... because any decline in the rate will be offset by workers returning to the labor force. Therefore this number will be better than it appears.

Oil Price (WTI): $50-52 per barrel on average for the year. OPEC's production restraint will be internally tested and fail by the summer. In addition, Russia's need for funds will spur output higher than desired by non-U.S. producing nations. This will keep gasoline and related petroleum products very affordable in the U.S. The savings will enable the consumer to spend freely in the summer and into the fall.

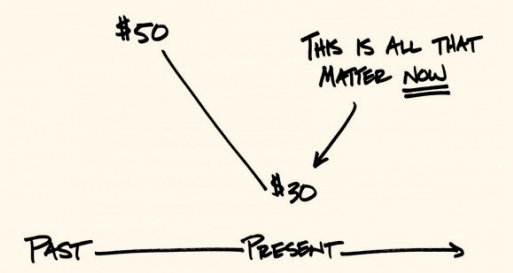
U.S. Markets: There will be a pullback likely in the first 6 months of the year as markets react to the slower than desired legislative progress on tax and regulatory reform. However, by year-end we will experience a rise of 7-9% for the S&P 500.

CLOSING THOUGHT

"Although we speak loosely of production, man neither creates nor destroys matter, only transforms it."

—Thomas Sowell

ANCHORING



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