QUARTERLY NEWSLETTER • **2ND QUARTER 2018**

Praetorian Guard

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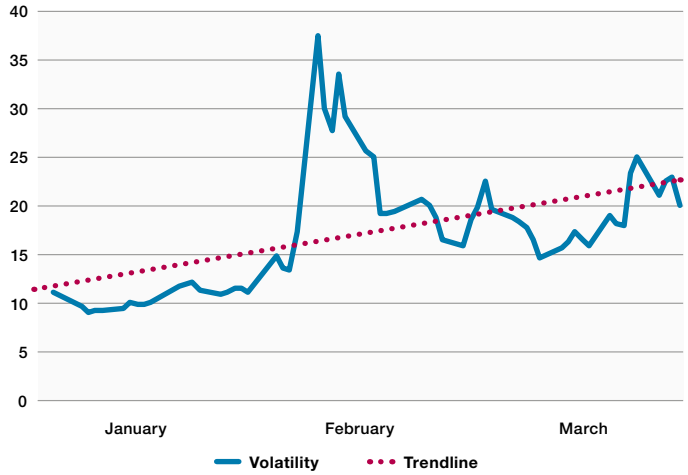
FIRST QUARTER 2018 MARKET REVIEW

By **RICHARD A. HEWITT**

THE RETURN OF VOLATILITY WAS THE OVERARCHING THEME FOR MARKET PERFORMANCE IN THE FIRST QUARTER OF 2018. The most common metric for volatility is the VIX (shorthand for the CBOE Volatility Index) which is calculated using the price of put and call options on the S&P 500 from the Chicago Board Options Exchange. Values greater than 30 are generally considered to be "high" and levels of 15 and below are considered "low" volatility periods.

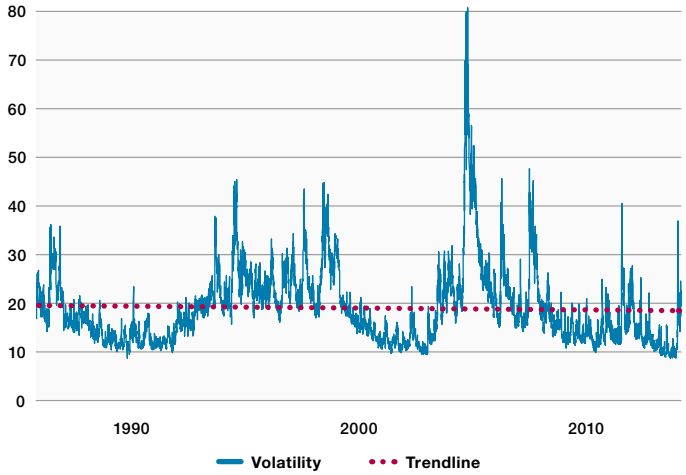
Historical analysis can help put in perspective what we recently experienced—2017 was an extraordinarily low volatility period, with the VIX averaging a mere 11.09. The first quarter of 2018 saw an average VIX of 17.4 but Graph 1 (below, courtesy of CBOE) shows the large increase in early February that skewed the data higher. However, what actually occurred was the trend of reversion towards historical levels.

CBOE Volatility Index (Graph 1)
Q1 2018



Source: CBOE.com

CBOE Volatility Index (Graph 2)
1990-Present



Source: CBOE.com

For a longer-term perspective, VIX data exists back to the start of 1990 and an average value of 19.4 over this period is visible with the red trendline (in Graph 2 above). We are not experiencing anything other than a return to more "normal" levels of volatility but our frame of reference is the unusual lows of 2017.

Market performance was slightly negative for the quarter for most indices. The economic struggle between increasing profitability of corporations and greater disposable income for most consumers are positives. However, tariffs (see accompanying article by Joe Clark in Political & Economic Environment) and economic uncertainty are a drag. The next two quarters will give us much more clarity.

SP 500 Large Cap	SP 400 Mid Cap	SP 600 Small Cap	Developed International	Emerging Markets
-1.22%	-1.15%	+0.23%	-2.35%	+0.93%

IN THIS ISSUE

POLITICAL & ECONOMIC ENVIRONMENT

By **JOSEPH P. CLARK**

TARIFFS AND THEIR POTENTIAL IMPACTS HAVE BEEN MAJOR DISCUSSION POINTS OF LATE. Recently, President Trump directed the U.S. trade representative to place tariffs on at least $50 billion worth of Chinese imports. This policy decision came on the heels of the administration's announcement to impose tariffs of 25 percent on steel and 10 percent on aluminum. How Americans will be impacted by these tariffs is not 100% clear, but as of this writing China has proposed a 25% tariff on $50 billion worth of U.S. exports that include over 100 products as diverse as soybeans, chemicals, aircraft, and automobiles (Source: www.money.cnn.com). In order to better understand the impacts of tariffs in general, we will focus on the steel and aluminum tariffs.

Tariffs are supposed to counter where foreign producers of aluminum and steel have flooded the U.S. market, putting American companies at a disadvantage. These tariffs are welcomed by firms that produce steel and aluminum. Parts of Pennsylvania, Ohio, and other Rust Belt states could see production jobs return as demand for American steel and aluminum increase. According to the Commerce Department, 90 percent of the aluminum and 30 percent of the steel used in America annually comes from overseas, and these tariffs could change that dramatically.

One argument against the tariffs is retaliatory tariffs from other countries on key American export industries. While it is unclear whether other countries will respond with their own retaliatory measures, Canada, China, and the European Union (EU) signaled that they would respond by increasing tariffs on American-made products, potentially curbing exports. The situation is very fluid and the administration elected to exempt Argentina, Australia, Brazil, Canada, Mexico, South Korea, and the EU countries from these tariffs. Effectively, the only countries really impacted (as of now) are China, Russia, and Japan. Excluding NAFTA countries was important because Canada and Mexico (together) supply 32 percent of U.S aluminum and steel imports. Michigan relies on NAFTA for more than 70 percent of its steel and aluminum products. These imports support the state's automotive and metalworking clusters, which together employ 230,000 workers. Illinois (the nation's second largest importer of steel products) imports 41 percent of its steel from Brazil. Illinois also imports 29 percent of its aluminum from China as aluminum is increasingly used as a substitute for steel in the U.S auto industry (Source: www.brookings.edu/blog/theavenue). Higher prices for steel and aluminum imports could also negatively impact industries such as brewing and construction. These industries would have to bear the higher cost of production or pass that additional cost on to the American consumer.

For every job created in steel and aluminum production, there is a potential for several jobs lost in industries using those metals as inputs to their production. These tariffs will (at a minimum) disrupt those firms, industries, regions, and states that rely on steel and aluminum imports. In the coming months, we will continue to monitor how these tariffs and further changes in economic policy impact the U.S. economy. It is important for investors to be patient as these changes are implemented rather than trying to react to each action in a 24 hour news cycle.

Our hope would be that these tariffs are primarily designed to gain negotiating leverage rather than the Administration actually thinking this is sound economic policy. While the "benefit" is concentrated in a few industries or companies, the overall negative impact on the economy hurts all of us—this is a circular firing squad exercise that virtually all Presidents have a compulsion to experience. All learn the same lesson.

PRESIDENT'S COMMENTARY

HISTORY (POLITICAL, MILITARY, BIOGRAPHICAL OR ECONOMIC) CAN PROVIDE INSIGHT THAT CAN HELP US AVOID BEING OUR OWN WORST ENEMY. Most of us intuitively believe we should "do something" because we fear inaction in the face of uncertainty. I learned from a wise man named Karl Johnson that applying the principal of "don't just do something, stand there" often allows for better decision making.

The last few years of financial markets have dimmed the memories of two events, both of which are important. The first is the Great Recession and market turmoil of late 2007 to February 2009—the main take away is that the world did not end. The second is the market recovery of March 2009 to December 2017—not always smooth or pleasant, but steady. I believe we are entering another period which will test our emotional equilibrium and recalling where we have been will help steer us to where we want to go.

FINANCIAL PLANNING – EFC & 529 PLANS

By **MARC A. WEHMEYER**

PARENTS AND GRANDPARENTS OFTEN HAVE DIFFICULTY RELATING TO CURRENT COLLEGE COSTS BECAUSE THE ENVIRONMENT IS SO MUCH MORE EXPENSIVE TODAY RELATIVE TO WHEN THEY WERE COLLEGE AGE. According to a 2017 CollegeBoard analysis of trends in college pricing, "published" tuition and fees for 2017-2018 after adjusting for inflation were 2.29 times higher at private nonprofit four-year institutions than 30 years ago, rising from $15,160 to $34,740 in 2017 dollars. Tuition and fees rose faster at public four-year institutions, growing 3.13 times from $3,190 in 1987-1988 to $9,970 in 2017-2018 in 2017 dollars. Families face even higher costs after accounting for room and board, books and supplies, transportation and other expenses. CollegeBoard calculated a total budget of $50,900 for a full-time on-campus student at a four-year private school for 2017-2018. In reality, few students are expected to pay the "published" rates for their college education. Sometimes a student's out-of-pocket costs might be lower at a school with a higher "published" price. Unfortunately, estimating how much of the costs will be borne by the student's family and how much will be covered by other sources can be a complicated task.

In order to reduce the uncertainty surrounding the question of "how much", it helps to understand the concept of Expected Family Contribution or EFC. EFC is a measure of your family's financial strength and is determined by a formula established by law. It is not the amount of money you will have to pay for college. To determine how much financial need-based aid you can get, a school will subtract your EFC from the cost of attendance (COA) for that school. Your official EFC is calculated when you fill out the federal government's Free Application for Federal Student Aid or FAFSA as part of the college application process. Your EFC amount changes from year to year and depends on multiple factors such as annual income, assets, and family circumstances (to include the number of children in college simultaneously). Fortunately, there are online calculators that will generate an EFC estimate so you can plan accordingly. We like the CollegeBoard EFC Calculator, which calculates two estimates of your EFC using the federal methodology from the FAFSA as well as an institutional methodology using information from the CSS PROFILE (which is required by approximately 400 institutions).

After you figure out your EFC, the next step is to consider the different options for funding college expenses not covered by need-based aid. If your EFC is high, students and families should make every effort to maximize available merit-based aid and/or scholarships. Other funding options include financing college expenses out of current income, liquidating assets in investment accounts or savings, having the student get a part-time job, taking out student loans, and/or going to a less-expensive college.

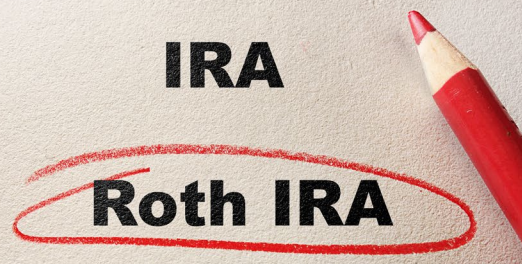
Families should also consider using 529 plans and/or Coverdell Education Savings Accounts (ESAs) to save and invest for some or all of their future college expenses. Both types of accounts have a named owner/custodian (typically a parent) as well as a beneficiary (typically the future college student). Contributions to 529 plans and Coverdell ESAs are not tax-deductible, but earnings grow tax-deferred and distributions are tax-free if used on qualified education expenses. 529 plans have much higher contribution limits than Coverdell ESAs and 529 plans can be front-loaded with five years of contributions in a single year. Anyone can contribute to a 529 plan, but the ability to contribute to a Coverdell ESA begins to phase out above certain income levels. Additionally, some states provide a tax benefit for contributions to their 529 plan. The Tax Cuts and Jobs Act expanded the utility of 529 plans and they are now able to be used for up to $10,000 per student per year for tuition expenses at public, private and religious elementary or secondary schools. In the event a beneficiary doesn't need all of the money in the account for qualified education expenses, you can make a non-qualified withdrawal in which case you would normally have to pay a 10% penalty on any earnings in the account in addition to regular income tax. However, you can qualify for an exception to the 10% penalty in the following situations: the beneficiary dies or becomes permanently disabled, the beneficiary receives a scholarship, the beneficiary attends a service academy, or the beneficiary receives employer-provided educational assistance.

It seems unlikely that the rate of increase in college costs will slow down any time soon. It also seems unlikely that the task of paying for college will become any less complicated.

It seems unlikely that the rate of increase in college costs will slow down any time soon. It also seems unlikely that the task of paying for college will become any less complicated. You can improve your situational awareness about how much you may be expected to contribute to a college education by using an EFC calculator. You can use these results as the starting point for a family conversation about how to pay for college and discussing all the various options.

STRATEGIES TO CONSIDER UNDER THE TAX CUTS & JOBS ACT OF 2017

By **EDWARD LESZYNSKI**

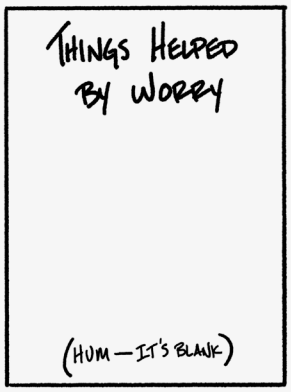


WITH TAX RATES REDUCED AT ALMOST ALL INCOME LEVELS THROUGH 2025, THERE WILL BE MORE MONEY IN TAXPAYERS' POCKETS AND SOME UNIQUE PLANNING OPPORTUNITIES. One is the conversion of traditional IRAs to Roth IRAs.

If you convert in 2018, you will pay today's lower tax rates on the extra income triggered by the conversion. You will completely avoid the potential for higher future rates on all the post-conversion income that will be earned in your Roth IRA account. This is because Roth IRA withdrawals taken after age 59½ are totally federal-income-tax-free, as long as you've had at least one Roth IRA account open for five years. Additionally, because Roth IRAs do *not* have Required Minimum Distributions you gain more control over cash flow during retirement—you need it, you take it, but it's your choice.

A second strategy is to take advantage of a deduction equal to 20 percent of "qualified business income," otherwise known as "pass-through" income (i.e., income from partnerships, S-corporations, LLCs, and sole proprietorships). The income must be from a trade or business within the United States. Investment income does not qualify, nor do amounts received from a S-Corporation (as reasonable compensation) or from a partnership (as a guaranteed payment for services provided to the trade or business). The deduction is not used in computing adjusted gross income (only taxable income). For taxpayers with taxable income above $157,500 ($315,000 for joint filers): (1) a limitation based on W2 wages paid by the business and depreciable tangible property used in the business is phased in, and (2) income from the following trades or businesses is phased out of qualified business income: health, law, consulting, athletics, financial or brokerage services, or where the principal asset is the reputation or skill of one or more employees or owners.

WORRY AS A STRATEGY



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CLOSING THOUGHT

"The real art of conversation is not only to say the right thing at the right place but to leave unsaid the wrong thing at the tempting moment."

—Dorothy Nevill

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