COLORADO FINANCIAL MANAGEMENT®

SEPTEMBER 2017

Economic & Market Review

by Brad Bickham, CFA, CFP®
Chief Investment Officer

Summary

As Of 8/18/17	YTD 2017	Last 5 Years (Annualized)
60/40 Balanced World Index	8.9%	7.4%
World Equity Index (ACWI)	12.7%	10.3%
U.S. Equities (Wilshire 5000)	8.7%	13.9%
U.S. Equities Small Caps (Russ 2000)	0.9%	12.5%
Foreign Equities (ACWI-ex U.S.)	17.3%	7.1%
U.S. Bonds	3.2%	2.1%
HFRI Fund of Funds Composite	1.4%	3.2%

Dear Clients and Friends,

A client I recently met with summed up a feeling I think many of us have. He said, "The economy and the returns look good, but I don't feel like it's been that good this year."

As several pundits have remarked, it seems the news flow is causing time to move in dog years. I have certainly never seen anything like this, and I don't think many people have. Especially now, since almost all of us have a smart phone that updates us every minute on news, I am on edge every waking minute about what the next crisis or controversy is going to be.

Yet, the economy keeps chugging along and the stock market is only a few percentage points from its all-time high. I have always believed that politics is a whole lot more important to politicians than it is to anyone else. I think this year is further proof of that thought. There are some important issues ahead that could affect the economy, and certainly the financial markets, and we will explore them in more detail in this newsletter. But suffice to say, we would probably be better off if we could get off the 24/7 rollercoaster of a news cycle.

Economy. The U.S. economy grew at about a 2% rate in the first half of the year, almost exactly the rate it has averaged during this recovery. With a strong labor market, rising median wage growth, and relatively healthy consumers, we see little reason to believe this trend will change. As we have often stated, market corrections can and do come often, but a prolonged bear market has never occurred outside the context of a recession.

The Fed, Inflation, & Interest Rates. Because we do not put much faith in the economy accelerating to a 3% growth rate sustainably, we do not see inflation accelerating much either. The low rate of inflation has surprised most economists considering the low unemployment rate. The idea that tight labor markets lead to increasing inflation was first introduced by Irving Fisher in the 1920s; but it was in 1958 that a New Zealand born economist William Phillips wrote a paper describing the inverse relationship between unemployment and inflation. It has since been known as the Phillips Curve. Economists today are trying to figure out why this relationship has changed, or whether it is just delayed.

We will leave it to the academics to debate and as practitioners, we simply observe inflation is running below the Fed's 2% target. Unless (and until) there is an accelerating in inflation, the Fed can be patient and slow in the process of raising rates. They have stated there will be one more increase in short term rates this year, and we take them at their word. Longer term rates are little changed this year, and baring a surprise increase in economic growth or inflation should remain little changed.

Earnings. In the long term, stock prices are driven by earnings and changes in valuation. According to Standard & Poors, earnings for the S&P 500 are progressing as follows:

	12 mo. Earnings	Year / Year change
June 2017	$116	+18%
Sept 2017	$120	+19%
Dec 2017	$127	+20%

While these estimates are likely to prove optimistic, they nevertheless are excellent growth rates even if they are somewhat reduced.

According to estimates from JP Morgan, international earnings growth will be even higher than in the U.S. They peg U.S. earnings growth at 10%, Japan at 13%, and Europe and Emerging Markets at 18%.

Valuation. The problem is the market already reflects these increases in earnings. By almost every measure we look at, the U.S. market is over-valued relative to history – not extremely so, but higher than average. It is possible to make an argument that at current levels of interest rates that valuations are normal, but with the Fed embarking on a tightening campaign (even a slow one) it would be risky to put too much faith in this argument. The average P/E ratio since 1988 (covering 115 quarters) is 18.8x. The current P/E is 20.9x.

Financial Stress. Those of you that have read our newsletters for a while will remember we added this to try and anticipate the next banking crisis. They tend to recur every decade or so. We see no indications of stress currently – even the yields in Greece are signaling relative quiet.

Politics. As alluded to in the introduction, the noise on the political front is LOUD, but it has not had much of an effect on the markets or economy thus far. But, there is the potential for more volatility in the near future. Some of what will come from Washington is substantive. In September, Congress has two important deadlines; First, late in September the government hits the debt ceiling. Without an increase, the Treasury cannot issue new bonds and could default. In other words, the Treasury may not be able to pay back a maturing bond. This is an insane, self-inflicted process. If the U.S. government defaults, even for a day, it will likely have long lasting and far reaching effects. Despite assurances from some, there is reason to worry this will come down to the last minute.

On September 30th, the government runs out of funding if Congress does not pass a budget, and the President signs it. There have been threats issued already that will only make agreement more difficult. Other less known funding deadlines in September are the Children's Health Insurance Program, the National Flood Insurance Program, and authorization of the Federal Aviation Authority.

After September, the Trump Administration and Congress are expected to take up tax reform. We have studied tax rates and their changes on past economic cycles, and we believe the impact is lower than commonly believed; but there has been a great deal of attention on this in the financial media over this year. Since health care reform failed, if tax reform were to also fail there would very likely be a further loss of confidence in the government causing volatility in the financial markets.

Strategy. Concerns about valuation and the political climate/calendar have led us to be slightly conservative this year. While we would like to over-weight equities during periods when they outperform, the risks we have outlined have led us to be neutral. There are indicators we follow that suggest an opportunity could present itself to increase equity allocations very soon. For example, Ned Davis' Trading Sentiment has moved into the 'Extreme Pessimism' zone, which has proven to be an excellent time to buy in the past. We would like to see more than the 2% correction we've seen so far, however, before increasing equity allocations. These events could change quickly and we are watching indicators closely.

Our view of fixed income is unchanged. We do not subscribe to the description by some of a bond bubble, but we expect returns to be modest at best. Therefore, we have diversified from investment grade bonds into 'alternatives' such as high yield, low volatility equity investments such as option income mutual funds; and we have lower than benchmark duration in both our individual bonds and bond funds.

Within the equity allocation, we have increased our international exposure and reduced the allocation to U.S. small and mid-cap mutual funds. Our style tilt still favors growth, which has outperformed by a wide margin this year. Our Model Equity group (individual stocks) is having an excellent year thus far, outperforming the S&P 500 by 4 ½ %.

So far… so good. If we can get through the next two months without too many surprises, then this should turn out to have been a pretty good year for you, our clients, and in turn for us too.

Data is the Key

Greg Francis & Jordan Kunz, CFA, CFP®
SRI Research Team

Every year, the Rocky Mountain Showdown reminds us that school has started around the state. Academia is in the air! Accordingly, this fall, our team at CFM will be crunching a new set of numbers. The last time we spoke about sustainable, responsible, impact (SRI) investing, our newsletter mentioned that data was key to understanding and implementing an SRI portfolio. Our firm has since made an investment in a data platform called *Eikon* from Thomson Reuters. With it, we can now track and analyze how thousands of public companies are performing against their peers on environmental, social, and governance (ESG) factors, which provide a framework to evaluate companies in the context of an SRI strategy.

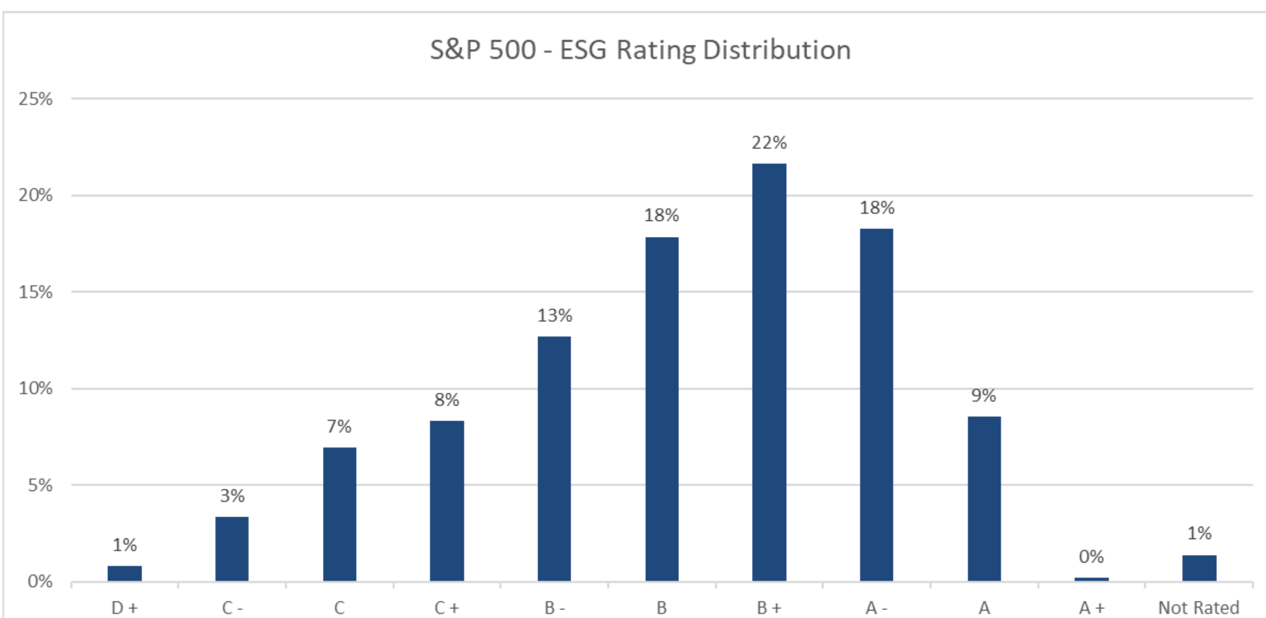
Eikon aggregates more than 400 data points for each rated company across ten ESG-related themes.

This information, which is disclosed in annual reports, websites, stock exchange filings, etc. can be used to produce scores for each theme on an annual basis. Cue the number crunching!

We've included a chart of the ESG rating distribution of S&P 500 companies broken down by letter grades in keeping with our academic theme. Many portfolio construction strategies can be formed to attempt to "beat the benchmark" and embrace or avoid selected, non-financial, characteristics. For example, a portfolio with a higher average ESG score, a portfolio with no D or C rated companies or, a portfolio with an A in each sector. The potential strategies are endless.

In future newsletters, we will keep you updated on how we are integrating *Eikon*'s ESG data into our investment process. If you would like any additional information, please don't hesitate to let us know.

P.S. GO BUFFS!



Source: Thomson Reuters

Men, Women, and their Finances – Is there a difference?

Barbara Lommen, CFP®
Advisor | Financial Planner

The financial industry has been and still is a male dominated world looking at money from a male perspective. Fewer than a third of financial advisors and only 23% of CFP® Certificants are women.

In preparation for CFM's *Financially Strong!* Workshop, which aims at empowering women investors, we have plowed through studies investigating gender roles in finance. It turns out that the good old Venus versus Mars cliché applies to our financial lives as well. There are some clear discrepancies between the male and female perspective on money.

Difference #1: Earnings and Savings

Women earn on average $0.83 for every $1 their male counterpart earns for the same job. Also, women are more likely to interrupt or scale down their careers to take care of children or parents, so their lifetime earnings, and therefore savings, are lower. According to Vanguard, men have about 50% more in their retirement savings accounts than women.

Difference #2: Financial Philosophy

By and large, women do not seek to accumulate money for its own sake. They tend to view it as a way to care for themselves and their families, improve their lives and – first and foremost – ensure security. For men money is often more about winning and losing.

Difference #3: Confidence

Many surveys and studies show that women have lower levels of confidence about money matters than men. There may be several factors that cause women to doubt themselves–how they were raised, the kind of education they received, their math-anxiety etc. But regardless of the underlying factors, low confidence and fear can translate into avoidance that results in not taking charge of one's financial future.

Difference #4: Investing Strategies

Any financial planner can tell you that you have to be willing to invest over the long haul if you want to reach your long-term goals.
Many women, though, don't see themselves as investors, but rather as "savers". And even when women do invest, they generally opt for more conservative investments.
Men, on the other hand, not only invest more aggressively but also often enjoy the "sport of investing."

All advisors at CFM are well aware there is no one-size-fits-all approach to wealth management. For women clients and their friends we offer our *Financially Strong!* workshops, where we provide you with tools to become more knowledgeable and confident in financial matters. If you are interested in learning more about the workshop, contact your advisor.

Last Word

Rick Lawrence
President & CEO

It seems, thankfully, that our newsletters of late are all about how long stocks might stay at these levels or how long and low interest rates can go before the inevitable correction. Still looking for warning signs, Brad's notes provide good color on today's somewhat confusing market conditions, and where we are looking for out-performance in the coming months.

Do you wish that you could have an investment portfolio that only holds assets in companies that are proven to be socially responsible, demonstrate a commitment to sustainability or are run by management teams and boards with commitments to responsible corporate governance? There is more data emerging all the time that supports the idea that a portfolio comprised of companies receiving high marks in these areas of social responsibility may perform favorably compared to the overall stock market. Jordan Kunz and Greg Francis have been working on implementing some new tools to provide monitoring and measurement of performance of these kinds of portfolios. "Socially responsible investing" has been a buzz word for years, but these disciplines are coming into their own now.

We are grateful that two of our financial advisors happen to be women, and three of the women in our firm have earned the Certified Planner Designation. Barbara Lommen has written a great piece in this newsletter about respecting and understanding the differences between men and women when it comes to financial planning and wealth management, and making sure that our firm is mindful of this when we get an opportunity to engage with women clients. If this sounds like it is worth looking into, and we hope it will, call Barbara or Meagan and see if you should meet them.

Thankfully, none of our staff has been directly affected by the calamitous weather in Texas, but I imagine many of us know someone who has. These major weather events can also have an impact on your investment portfolio.

Last year we looked into the risk of default on selected municipal securities associated with geographic areas that are particularly vulnerable to weather disasters. We changed the portfolios of several clients as a result of this work. No one is smart enough to do the right research at the right time, all the time; but this is the kind of diligence that you ought to be looking for from your investment manager, and I am glad we got this one right.

Our thoughts and prayers go out to families in Texas, and now Florida, who are having to deal with the physical effects of these hurricanes. We are grateful for the blessing of being able to focus on your well being, and truly thank you for giving us the opportunity to work for you.

Many happy returns,
Colorado Financial Management
www.colofinancial.com

COLORADO
FINANCIAL
MANAGEMENT®