SMITH & HOWARD WEALTH MANAGEMENT

Your family's *CFO Report*

A review of issues affecting your financial health

Second Quarter 2017

Market Recap: Calm and Yawns Amid Continued Gains

Brad Swinsburg, CFA, CAIA, BFA™ | Director of Investments

Relative calm and near complacency dominated markets during the 2nd quarter. There was no shortage of drama geopolitically, but both stock and bond markets continued to yawn and move higher. There were also no big revelations economically, although growth continues to accelerate nicely internationally and optimism for renewed GDP growth here at home persists despite limited hard evidence.

While the optimism surrounding renewed US growth prospects as a result of actions in D.C. may be showing some cracks, the actual earnings results (shaded blue area of chart, right) reflect a nice recovery and acceleration from the drop experienced in late 2015/early 2016. Those earnings have still not returned to 2014 levels though, yet the market continues to reach new highs (grey line of chart, right).

All that led to gains from both equities and bonds during the quarter. On the equity front, international and emerging markets continued to lead the way as they did during the 1st quarter. While there is a noticeable difference between the US and international arenas so far this year, the prior 12 month period (July 2016/June 2017) shows that investors have enjoyed strong equity returns globally.

Year to date, there has also been a rather stark difference between growth and value styles with growth handily outpacing value across the globe. This is a reversal from the prior year in which value stocks led the way. From a sector standpoint here in the US, Healthcare and Technology (two areas we've emphasized in portfolios) led returns while Energy and Telecom were the only negative sectors both for the quarter and year.

Bond returns were positive if not unspectacular. Given the fear around rising rates, this is likely a somewhat surprising result to many market participants. Despite another Federal Reserve rate hike and discussion around their balance sheet reduction later this year, longer maturity bonds have really not moved. Credit spreads and quality were also relatively stable during the quarter allowing investors to continue to enjoy clipping their coupons and waiting for any day of reckoning that would occur should either rates rise or credit spreads widen.

The one negative outlier among the major markets was in commodities.

Did You Know?

You should always check your transactions on a regular basis to be on the lookout for fraud. You can do this by logging into your Schwab account or by contacting Lisa Curles or Stephanie Roberts at 404-874-6244.

To be fair this is an area that had a strong 2016, so the weakness could be a retracement of part of that rally. It is also mostly a reflection of what occurred with energy prices as the index used for our graphic is the S&P GSCI which is heavily weighted toward energy. As many may recall, oil prices bounced from a low of around $26 in early 2016 to the mid $50s earlier this year. While still well off the lows of 2016, oil levels have dropped back to the low/mid $40s at quarter end. The weakness has been driven by the increase in oil production and the sustained high levels of oil already in storage. Not surprisingly the pullback in energy prices has resulted in a similar pullback in energy related equities as that is the worst performing sector in the S&P 500 for the year.

Market Outlook: Eight Areas to Watch

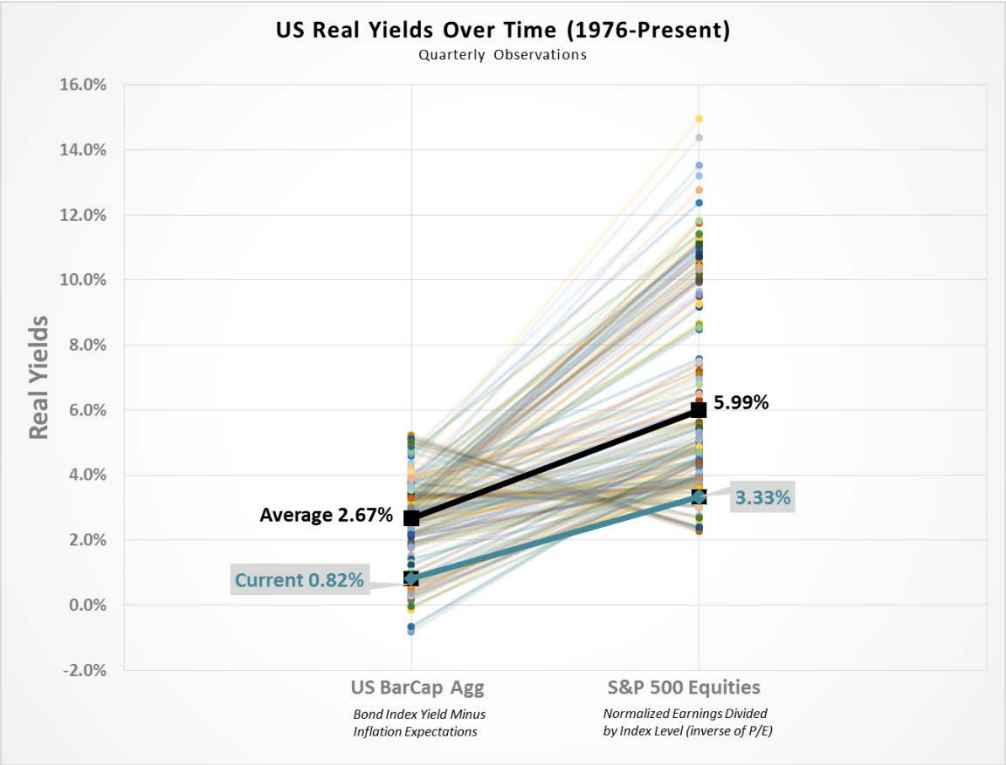
Brad Swinsburg, CFA, CAIA, BFA™ | Director of Investments

The big picture for Smith & Howard Wealth Management is always going to be framed by valuations. As long-term investors, we recognize that as interesting as it is to speculate and debate about near term events and breaking news, investment returns are ultimately driven by valuations. Shifting portfolios towards cheap assets and away from expensive ones "wins" over time. It not only generates a higher long-term return, but typically results in smaller drawdowns or losses along the way. Put more simply, it's the amazingly simple, but difficult to execute philosophy of "buy low, sell high."

The Market (Still) Isn't Cheap

While I look forward to the day that I can excitedly write about how cheap everything is, today is not that day. Generally speaking markets are expensive. Despite several rate increases by the US Federal Reserve bond yields remain near all-time lows and credit spreads remain tighter than average. Equities by most any metric are expensive, in particular here in the U.S. The chart on the following page, while a bit busy, helps provide clarity on just *how* expensive equities are. What we're attempting to show is the historical levels and relationship between bond yields (BarCap Aggregate Index) after subtracting out inflation expectations and normalized equity yields for the S&P 500 (as the graph indicates by yield we simply meaning earnings divided by the index

level). The larger black squares and line depict the average for each over the time period while the blue diamonds and line show the current level for each. As an example the average real bond yield has been 2.67%, but today is only 0.82%. As is obvious in the graph both bonds and equities are well below their historical averages.



There is Hope in the Slope

While both of those are sobering items of note, there is one rather interesting aspect to this graph. The line that is drawn between the two averages and the line between the current levels has roughly the same "slope". What that tells us is that equity valuations when compared to bonds are actually not "out of whack," for lack of a better term. What we expect to receive in "extra" return for investing in equities versus bonds is not all that different than normal. It is for this reason that when clients ask if we should reduce equities in favor of bonds that our answer is typically no.

This is a key difference between markets today and markets like the tech bubble. During the tech bubble this "slope" was actually negative. In that scenario bonds were yielding nearly 2x what equities were, yet investors continued to pile into equities! Equities may be expensive, but until bonds present an attractive alternative, they are likely to stay so.

International and Alternatives Bring Balance

Before anyone thinks we are too dire in outlook, the chart we just reviewed reflects valuations of US stock and bond markets. International stocks, of both developed and emerging countries, are fortunately more attractively

valued and are priced to return what investors have come to expect from their equities. While markets generally may be on the expensive side there are always pockets of opportunity and we're working hard to identify them and take advantage of them.

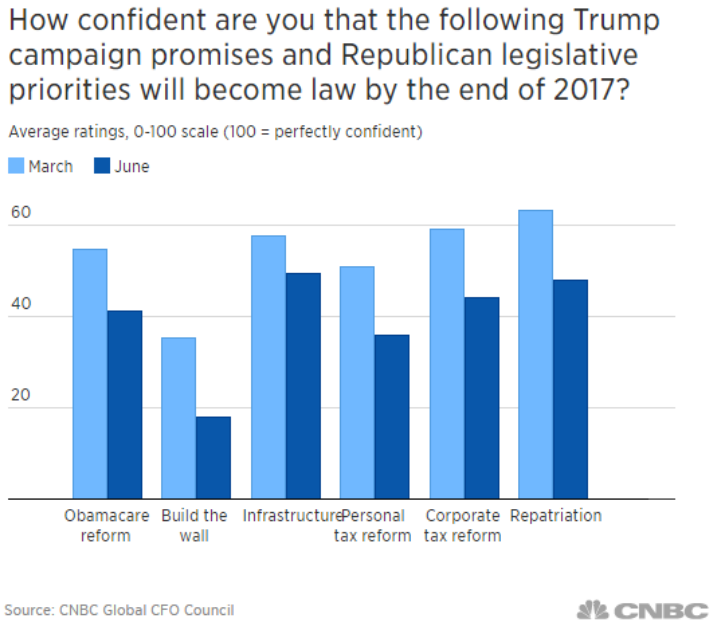
As most clients well know by now we have also emphasized the use of alternatives in our portfolios. The above chart hopefully helps make it obvious as to why. What "alternative" means is a topic for another discussion, but given the valuations present in the more traditional US markets it is a must for clients who want to simply do more than ride the public market roller coaster! Historically when equities were expensive bonds were cheap or vice versa. That is unfortunately not the world we live in today, so the traditional two-asset-class portfolio approach needs to be adjusted.

On the Horizon: Eight Areas to Watch

We know we painted a rather bleak long-term picture, but as discussed in our Market Recap much of the recent news has been positive. In addition to low bond yields, it is another reason why equities have remained at elevated levels and can remain there for quite some time. One downside that comes with positive current news, however, is that investors increasingly begin to expect the continuation of positive news. Expectations gradually build and are harder and harder to exceed or even meet the longer the period of time between disappointments.

Much of what happens over the next quarter and remainder of the year will be not just about whether the news is positive, but whether it is positive "enough". There will always be things out of left field that will get our attention, but there are also some areas that one can reasonably expect will provide market- moving developments. In this section we hope to highlight some of those areas and some brief thoughts on each:

1. **Washington D.C. –** There is no question that what happens in D.C. will have a large impact on markets for the foreseeable future. Some portion of the strong returns on the equity side since last fall can be attributed to the aggressive, pro-growth agenda espoused by the Trump administration. The initial euphoria has started to wear off, however, so any gains from here will be dependent on actual results and not just talk (or tweets!). As can easily be seen in the graph below, the confidence level among CFOs polled by CNBC as part of their CNBC Global CFO Council has dropped significantly in just the last 3 months regarding the passage of various campaign promises made by the President and Republicans.



2. **European elections, particularly in Germany –** this item could have potentially been a bigger hot button had the recent French elections turned out differently. Given the results in France and the sizeable lead the current German Prime Minister Angela Merkel holds, this is likely to be a non-event. Stranger things have happened though (and rather recently) and if her lead does narrow between now and the election in late September, speculation and volatility will likely pick up.
3. **Brexit –** does anyone remember the Brexit scare from June of last year? As "fun" as that selloff and immediate recovery were, the real risks to the UK and their economy are only beginning. The negotiation process for their withdrawal from the EU is likely to play out in the headlines and with the recent election results weakening the hand of Prime Minister May it may be very difficult for them to strike a deal that doesn't weaken their long-term economic prospects. That is obviously negative for the UK, but for EU supporters this would be viewed as a win as other countries are less likely to follow suit if the negotiations lead to a one sided, pro-EU deal.
4. **North Korea –** I've been in this business for 20 years and every year this is cited as a potential market disruptor. With that said, there is no question the rhetoric and stakes have been escalating and there doesn't appear to be any reason to expect them to deescalate. At best, we can hope that this remains mostly a war of words and gamesmanship.
5. **The Fed –** much like the North Korea mention above, this is likely to always be among the list of items to watch. The Fed has, however, been very deliberate and seemingly overly communicative. Surprises out of them are certainly not out of the question, but probably not likely.

The negotiation process for the UK withdrawal from the EU is likely to play out in the headlines, and with the recent election results weakening the hand of Prime Minister May, it may be very difficult for them to strike a deal that doesn't weaken their long-term economic prospects.

6. **Oil & Gas prices –** the recent pullback there could lead to some jitters around the health of the companies in that industry along with the banks that lend to them. Angst is likely to be somewhat contained though, as prices remain far above the prior year low and the breakeven level needed for most producers has also come down significantly in a short period of time allowing them to remain profitable at lower and lower energy price levels.
7. **China –** outside of the US, no country plays a bigger role in the global economy and strikes more fear in investment manager's hearts than China. China continues to work through a difficult process in which they are attempting to slow growth from an unsustainable rate earlier in the century and evolve from an export oriented economy to a domestically oriented one, all while trying to control the rapid growth of credit via banks and a shadow banking sector. Fortunately most agree they have the currency reserves and ability to withstand any near term hiccups. That doesn't mean the market might not experience intermittent periods of panic and doubt (remember August 2015?).
8. **Global Economy –** while there is still optimism for renewed growth in the US driven by the potential for tax reform and pro-business initiatives out of D.C., economic growth outside of the US has actually already seen a pickup. Markets will be watching closely for signs that this was either short lived or continues to accelerate. Obviously acceleration would cause good volatility!

To be clear, the items above are fun to speculate on and will certainly move markets over the short term, but trying to predict them and shift portfolios based on those predictions is essentially a fool's errand. Nobody has a clear enough crystal ball and if they did I suspect the market reaction to the news would still confound them.

My favorite example of this was in August of 2011 when S&P downgraded US government debt from AAA to AA+, a move that took the world by surprise. While stock markets declined precipitously as a result, US Treasury Bonds, which were the subject of the downgrade, actually rallied.

Deeper Dive: The Fear Index

Brad Swinsburg, CFA, CAIA, BFA™ | Director of Investments

In our new format each quarter, we will take a little deeper dive into a topic that is timely and interesting. We're certainly open to suggestions on topics that you'd like to understand better or hear more about, but this quarter, we thought we'd devote time to something that the industry and media refers to as the "Fear Index". It gets a lot of attention during market panics, but has recently garnered more mentions due to the fact that investing "fear" is at historic lows.

The "Fear Index" is also known as the VIX index or Volatility Index and is a measure of market expectations of near-term volatility conveyed by S&P 500 stock index option pricing. That is obviously a mouthful and the calculation of the actual index level is not for the mathematically challenged.

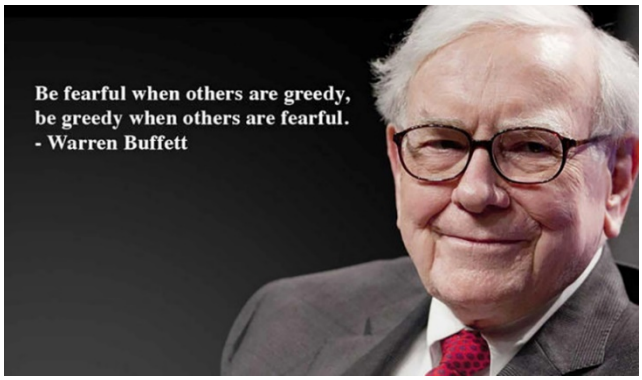
What it all boils down to is an attempt at quantifying the general mood or frame of mind of investors. Fortunately grasping the meaning of the index level is much more intuitive than the actual calculation – the higher the number the higher the expected level of volatility and the greater the fear, the lower the number the lower the level of expected volatility and fear.

We chose to write about VIX as our first "Deeper Dive" partly due to the media attention it has received more recently as it continues to sit at record low levels. As the following graph shows the VIX is currently well below its long term average of 20 (green line) with a reading of around 10 which has historically acted as an unofficial, arbitrary lower limit.

What does all this mean? If spikes in the VIX indicate fear and panic, then historically low readings must indicate a lack of both or a general feeling of complacency and comfort. The recent drop in the VIX indicates investors are not just unworried by the myriad of geopolitical concerns and high valuations, but their level of comfort is at unprecedented levels. While relatively low volatility levels existed for nearly a continuous 3 year period from 2004 through early 2007 what we are witnessing today is really extraordinary. From the beginning of 2003 through quarter end the VIX had closed below 10 only 9 times (out of 3,764 trading days). An amazing seven of those nine times have occurred just this quarter (actually since May 5th)!

Our purpose in discussing the VIX and its current level is certainly not to scare anyone and suggest a selloff is imminent. It is absolutely a note of caution, however, and a reminder that what we are experiencing is neither normal nor likely to last forever. We don't know what the trigger will be or how long it will last, but the probabilities certainly point to volatility picking up. Rather than assume we are in a new normal, it is better to prepare ourselves and our portfolios. As we've discussed with each of our clients over the last few quarters it is why we remain committed to the use of alternatives and have shifted equity exposure to more attractively valued parts of the globe.

Anytime the VIX reaches historic lows or highs, I'm reminded of one of Warren Buffett's more famous quotes:



Market and Investment Summary

Brad Swinsburg, CFA, CAIA, BFA™ | Director of Investments

Complacency in investing rarely ends well. As strong as the last 12 months have been, it is important not to extrapolate and assume that such a trend will continue. In the cartoon (right), that is clearly the "plan".

"Inform everyone that there will be no tweaking of this investment strategy until further notice."

I was fortunate enough a few months ago to participate in an investor conference at Brandes Investment Partners in San Diego. One of the presenters was from the Brandes Institute which focuses on Behavioral Finance and he shared what I thought was a comical example of the absurdity of extrapolation.

In 1977, at the time of Elvis Presley's death, there were 170 Elvis impersonators worldwide. In 2000, there were 85,000 Elvis impersonators. At this rate of growth, statisticians predicted by 2019 Elvis impersonators would make up 1/3 of the world's population.

Obviously that is not likely to happen, just as the strong equity market growth we've experienced the last 12 months on top of the prior 7 years is unlikely to continue indefinitely. Rest assured that we are not sitting on our hands counting on the trend to continue. Pockets of opportunity do still exist despite a strong run and we are positioning portfolios appropriately. We've mentioned some of those shifts already such as the increases to international equities and alternatives. We continue to evaluate the portfolio and look for additional opportunities where we believe we can improve the risk/reward characteristics in a tax efficient, cost effective manner.

Charitable Giving: Pen a Check or Gift Stock?

Lauren Starks, CFP™ | Senior Wealth Planner

If your charitable giving plan consists of making substantial cash donations to certain charities, there are alternative approaches to consider that could provide significant benefits to you over and above the achievement of your charitable goals.

Why Not Just Donate Cash?

A check or cash donation is often best for spur of the moment charitable requests, but for more substantial gifts that are part of your giving plan, cash can present disadvantages. Obviously, the most immediate is a reduction in your cash; a longer term and more substantial disadvantage is missing out on tax savings.

If Not Cash, What?

Instead of cash, we often advise affluent individuals to consider donating an appreciated portfolio position.

Consider a hypothetical client named Margaret, who bought $1,000 of Apple Computer stock as a young investor in 1980. That stock, which is now worth over $250,000, will generate a substantial taxable liability of almost $50,000 should she sell it. If instead, she gives some or all of the stock to her charity of choice, the gains on the donated stock become a charitable contribution and trigger no federal capital gains tax.

$250,000
($1,000)
$249,000
x 20%*
$49,800

* 20% is the Capital Gains tax rate for the highest income bracket

Margaret's contribution of the Apple stock must be a qualified donation, meaning that the donee is recognized by the IRS as a nonprofit. But her contribution of the stock to a qualified organization allows her to avoid the tax on the gain and take the fair market value of the donation as the deduction, subject to limits.

Alternatively, Margaret could gift the stock to one of three types of charitable giving "vehicles" that would be responsible for allocating the donation to qualified nonprofits that meet Margaret's giving goals. The three types of vehicles are:

- Private Foundations
- Community Foundations
- Donor Advised Funds

In this case, funds generated from Margaret's stocks can be distributed to qualified charities for the rest of her life and beyond by the foundation or fund itself.

In either case, gifting stock can bring a substantial tax benefit and has the added bonus of providing a concrete paper trail for tax time.

Which Planned Giving Approach is Right for You?

While there are a multitude of ways to accomplish your philanthropic goals, we'll focus on the three charitable vehicles mentioned above: private foundations, community foundations and donor advised funds. Please bear in mind that every family's situation is different; it is important to discuss your goals with your financial advisor before making any decisions about a charitable giving strategy.

With each of these options, you can take advantages of swings in the stock market by making a well-timed gift of stock, taking the tax deduction in the current year, and then distributing contributions over subsequent years.

Private Foundations

Private Foundations can be started with a relatively small gift of appreciated investment holdings and all contributions are tax deductible, subject to limitations. A private foundation allows you to build a family legacy and engage family members and others in the business of running the foundation. It gives donors more control over granting and investment decisions and can be funded with almost any kind of asset, including real estate, stocks, mutual funds, ETFs, tangible assets, and even intangible personal property, although these are much more complex and may have complications.

A disadvantage of a private foundation is that it's expensive. There can be significant management fees, administrative and reporting burdens, excise taxes, and a required minimum annual payout.

We generally advise this approach to families with higher net worth who are focused on establishing a family legacy and to those for whom passing funds on to the next generation is less of a concern.

Community Foundations

Community Foundations function similarly to private foundations but are operated by a group of like-minded donors focused on identifying and solving problems in a defined local geographic area. These foundations are directed by an advisory board which controls how, when and to whom donations are made.

For that reason, you have less control over how your gift is used. Donors usually have some degree of influence but the board makes the final decision. Those donors who sit on the board will have more influence than those who do not.

Like a private foundation, a community foundation requires filing tax returns and paying management and administrative fees, which can be expensive. It's usually best for families of lower net worth than those at the private foundation level and for those who would like to establish endowments that serve their local community.

Donor Advised Funds

Donor Advised Funds (DAF) provide a charitable giving vehicle for those with lower initial contributions than the typical Private or Community Foundation.

DAFs are similar to private and community foundations in that you can make a gift of almost any type of asset. While the ultimate decision on how the donation is used is in the hands of the custodian, the donee does have more power to suggest how the donation is used than they would through a Community Foundation. It is also significantly less expensive alternative to Community and Private Foundations.

And in a departure from our usual argument against market timing, this is one area where we consider timing a strategic advantage. For instance, if as part of your charitable giving plan, we know that you want to make a contribution to an undetermined organization in 2017 and we see that a specific stock in your taxable portfolio has reached a high mark, we may advise you to establish and make the stock transfer to your DAF immediately. In a DAF, the donee can be determined at a later date but you can take advantage of the tax savings of the transfer immediately. Unlike a community or private foundation, however, the IRS considers the stock liquidated upon transfer to the DAF.

While the custodian of a Donor Advised Fund makes the ultimate decision on how a donation is used, the donee does have more power to suggest how the donation is used than they would through a Community Foundation.

An example of a simple but smart use of a Donor Advised Fund comes from another hypothetical client, Richard. Richard considers tithing to this church an important part of his charitable giving plan. For years, he has regularly written checks to his church as part of his tithing commitment. At the same time, Richard owns a variety of stocks in his portfolio. After a review of his financial plan and a discussion about his charitable giving goals, we helped Richard establish a Donor Advised Fund strictly for the purposes of donations to his church to achieve his tithing goals. This allowed Richard to use existing stock that had appreciated significantly to fund his DAF, fulfill his financial commitment to his church and as a bonus, receive a tax deduction and save his cash to buy stock in his portfolio with higher basis.

While Richard was using his DAF for a specific and acknowledged nonprofit, gifts can be completely anonymous. No tax returns are required to be filed from the DAF and when it's tax time, donors have a statement from the firm (SHWM in Richard's case), showing the gift of to the DAF.

While the DAF does allow the charitable dollars to remain for one to two generations, it doesn't allow donors to leave a named legacy, but it is a good solution for many investors who have or would like to develop an annual gifting plan.

When to Donate Stock Directly to the Charity

Turning your stock over to a charity may be the best option in some situations, particularly with larger donations that are a one-time gift. This approach however requires more planning than making a gift of stock to a private foundation, community foundation or DAF.

If you want to take the deduction this year, for example, you'd need to complete the process of donating on or before December 31. You will also need to find out from the charity as well as the bank or investment firm what is required to transfer shares and any additional requirements for a direct stock donation. In addition, donors must allow ample time to complete the transfer before December 31. It is not necessarily a quick process. This approach also complicates timing the donation of stock to take advantage of swings in the market.

Let Smith & Howard Wealth Management Help You

We can guide you to develop the charitable giving approach that best suits your financial needs and charitable goals. Our investment and tax professionals coordinate directly with wealth planners to stay on top of your goals, market values and the best time to take action.

Your Family's CFO

Whether it's advice on the best way to plan for your future, minimize your tax bill, optimize the performance of your investment portfolio, or all of these, Smith & Howard Wealth Management serves as your family's CFO. We strive to support you in making the financial decisions designed to serve your family's situation and goals and bring you financial peace of mind.

If you have any questions about charitable giving vehicles – or any other aspect of your family's financial life, please contact me at lstarks@smithhowardwealth.com.

SHWM in the News

SHWM Ranked Among Top 150 Firms by AUM

Accounting Today, a leading publication of the accounting and financial industry, recently published its annual ranking of "Wealth Magnets," the Top Firms by AUM (Assets Under Management). Smith & Howard Wealth Management is pleased to have been included on this distinguished list in "The $500 Million-Plus Club" as designated by Accounting Today and Audit Analytics, the organization that performed the data analysis.

Tim Agnew, Managing Director of Smith & Howard Wealth Management said, "We are pleased and honored to be included on the Wealth Magnets list. We are able to be included because of the clients who entrust their financial lives to us and because of the hard work and commitment of our very smart team."

Lauren Starks Promoted to Senior Wealth Planner

Tim Agnew, Managing Director of Smith & Howard Wealth Management recently announced the promotion of Lauren Starks, CFP® to Senior Wealth Planner.

After spending four years in Smith & Howard's tax group, Lauren moved to Smith & Howard Wealth Management in 2010 as a Wealth Planner, working with affluent individuals and families. She became a Certified Financial Planner™ professional in 2016.

"The trust and confidence our clients have in Lauren's planning expertise, along with her genuine interest in helping them achieve their financial goals and peace of mind have made her an integral part of our team," said Tim Agnew. "We are happy to recognize her contributions to the firm with this promotion." Lauren's strengths extend beyond financial planning to include a focus on process and technology matters of the firm.

Lauren graduated from the University of Georgia with a Bachelors of Arts in Sociology and is currently working on her yoga teaching certification.

Thank you for reading this issue of Your family's CFO Report. If you have ideas for future topics, please call us at 404-874-6244 or email our marketing department at jbarnes@smith-howard.com.

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