F.L.PUTNAM
INVESTMENT MANAGEMENT COMPANY

MARCH 31, 2018

QUARTERLY REVIEW

In our newly expanded Quarterly Review we will share our thoughts on tactical asset allocation and examine what is happening in the Equity and Fixed Income markets. See page 4 for highlights of recent market activity.

ASSET ALLOCATION UPDATE

While advisors largely agree that asset allocation is one of the primary drivers of portfolio performance, many clients may not have a clear understanding of proper asset allocation beyond the "don't put all your eggs in one basket" analogy. It may help to layer on another analogy…using a bigger basket. The basket in this analogy is a grocery shopping cart. Like most people we walk into the grocery store with a list that includes several categories: Fruits and veggies, meat and dairy, household items, snacks, wine, etc. Factored into our list is our budget – what's on sale, do we have coupons – and our priorities: milk over wine, for example. Before deciding what to put in our cart, we have a plan of how to allocate our budget across the various types of groceries. This decision is like the asset allocation decision. In general, we expect to allocate a portfolio across a spectrum of categories of investments. Large company U.S. stocks, small company U.S. stocks, international stocks, real estate, corporate bonds, government bonds, cash, etc. Each 'asset class' brings something different to the table. The objective is to select the right combination of assets given the level of risk we are targeting, as well as the prevailing economic conditions. Let's start there.

The dominant economic factor leading up to the first quarter was the level and direction of interest rates. To combat the effects of the great recession the Federal Reserve ("the Fed") took extraordinary measures to lower interest rates to stimulate the economy. Now that the economy is on solid footing, the Fed has begun the process of raising short term interest rates as shown in the chart below. Low interest rates have been a tailwind for both U.S. stocks and bonds. With rates ticking higher, or more accurately, with the expectation of higher rates, the tailwind has turned into a headwind. Other economic indicators like employment, industrial production, housing data, and GDP remain solid. However, the question is if these indicators will continue to improve or plateau at this point in the economic cycle.

Continued

In response to the changing economic climate and elevated valuation levels, we have started to tilt our asset allocation toward asset classes that have underperformed in recent years. Specifically, over the past several quarters we have trimmed the U.S. large cap stocks in favor of international stocks. The valuation gap between blue-chip U.S. stocks like Apple, Amazon, and Microsoft relative to large companies outside the U.S. continue to make this trade compelling. Recently we introduced some 'value' exposure to the U.S. stock portfolio that should offer more stability and higher dividends as volatility increases. We have also sought to add to U.S. small cap and mid cap stocks as appropriate. Relative to their larger, multi-national counterparts, these U.S. companies are more attractively valued, should benefit from changes to U.S. tax policy, and are less vulnerable to the impact of trade tariffs.

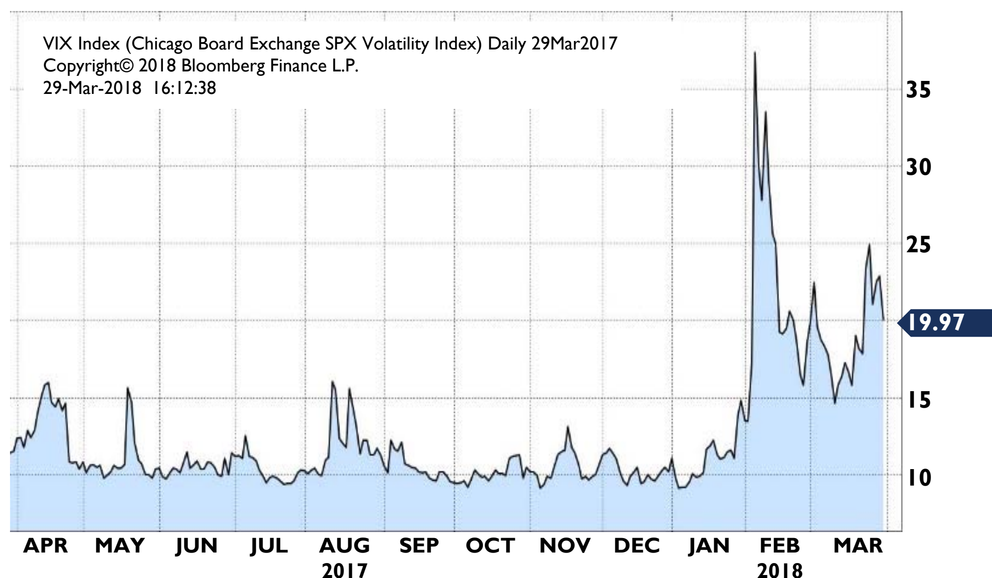
On the bond side of the ledger we have opted to reduce the maturity of our portfolios as longer-term bonds are more vulnerable in a rising rate environment. We continue to favor corporate bonds over government bonds given the solid economic trends, low default rates and yield advantage. We actively debate and monitor our bond exposure in our Asset Allocation meetings. The reason is simple…none of us has been here before. The Federal Reserve, and central banks around the world, are attempting to 'normalize' monetary policy as the global economy recovers. Our approach to our bond portfolios will be to continue to emphasize safety of principle and income over the potential for capital appreciation.

We hope this summary of our Asset Allocation positioning is informative and we welcome any questions on this important topic.

EQUITY MARKET UPDATE

Equity markets began 2018 with an acceleration of the steady gains experienced in 2017. The S&P 500 Stock Market Index returned 5.7% in January, which may not seem like much, but would represent an 85% return if it occurred each month for a year. While this pace of appreciation was unsustainable, few market participants expected it to end so quickly and violently. Over the next few weeks, the S&P 500 declined nearly 12% to the lows reached in early February. In some ways, the balance of the quarter was spent digesting the increase in volatility, which did not return to the prior lows and probably will not any time soon.

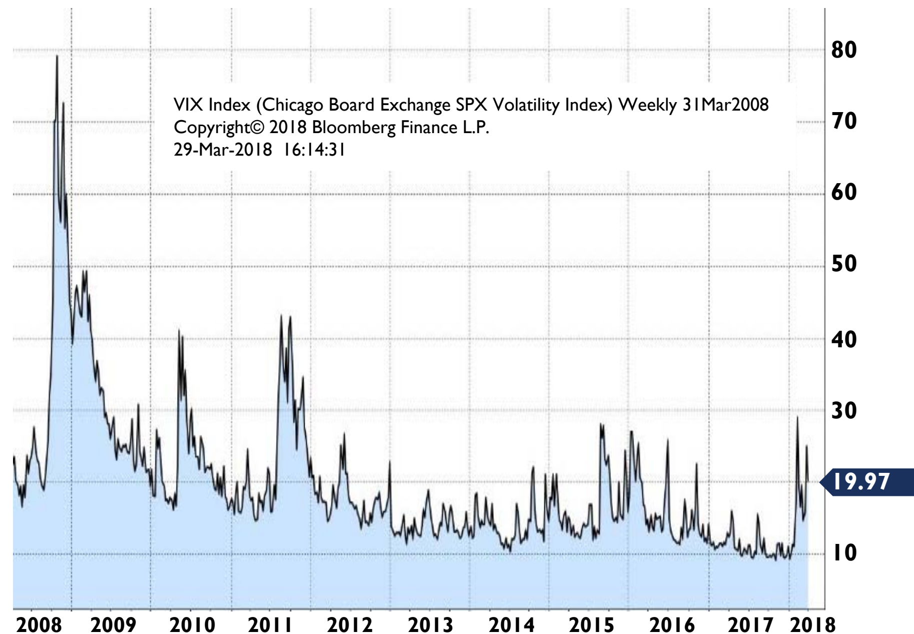
The initial jump in volatility was exacerbated by some complex investment products that track stock market volatility indices. While these products collapsed in spectacular fashion, the market didn't fully recover as additional concerns began to emerge. President Trump announced a series of tariffs, first targeting specific imported materials (steel and aluminum) and then targeting specific countries (e.g., China). Adding further fuel to the fire, Facebook's data privacy issues raised the specter of government interference with the large technology companies that have been stock market leaders in recent years (Google, Apple, Amazon, etc). As a result, volatility remained elevated as depicted by the one-year chart at right of the "VIX" index that is commonly used to track stock market volatility.



The result was a stock market that resembled a roller coaster ride in the first quarter: an initial rise to ominous heights, a sudden, scary drop, lots of twists and turns, and ending right where it started. While this wild ride has left many investors queasy, we are

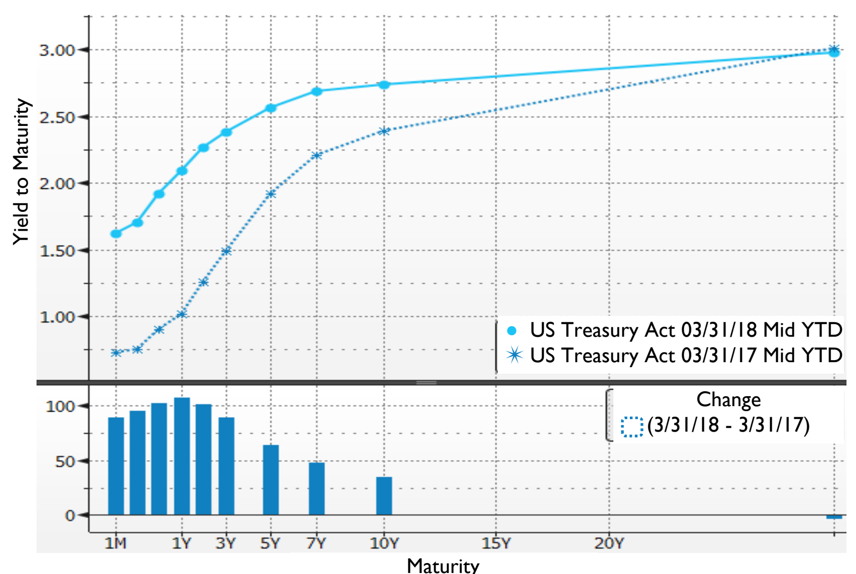
focused on the fundamentals in developing our market outlook. There are many reasons for optimism: corporate earnings are strong, valuations are less elevated than at the beginning of the year, interest rates have stabilized after a lurch higher in January, fiscal stimulus is adding to a strong economic backdrop, and wages have improved.

From a longer-term perspective, the recent level of volatility seems more normal. The chart of the VIX over 10 years at right illustrates that volatility at current levels occurs periodically and the unusual aspect of recent volatility was its sustained low level in 2017. The sudden return of volatility has us reassessing the probability of a more substantial market downturn, and there is some cause for concern. The economic cycle is well advanced, interest rates have been rising, and almost all investible assets seem expensive by historical standards. Economic and market data so far support a more constructive perspective, so we remain cautiously optimistic that recent volatility is creating new investment opportunities rather than serving as a warning of a larger systemic problem.

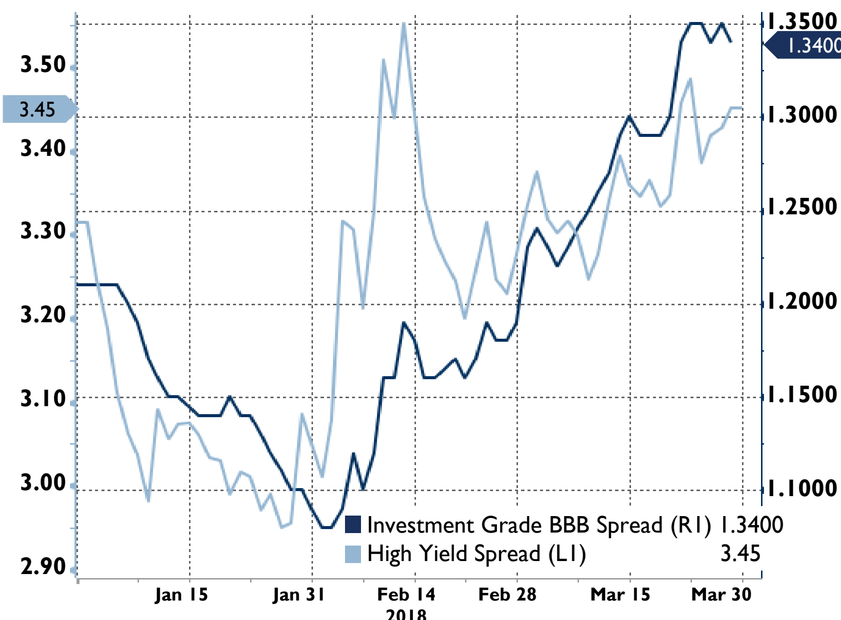


FIXED INCOME MARKET UPDATE

At the latest Federal Open Market Committee (FOMC) meeting in March, the Fed raised the Federal Funds rate for the sixth time since the 2008 financial crisis to 1.75%. The Federal Funds rate (the interest rate at which banks lend money overnight to other banks to maintain minimum reserve requirements) has a meaningful impact on short-term Treasury rates. In 2017, the 2-year Treasury rate rose from 1.19% to 1.88% as the Fed heightened rates three times. This trend has continued in 2018 and 2-year Treasury rates stood at 2.27% by the end of March. The Fed could potentially raise rates 2-3 more times during the remainder of 2018. Long-term rates have risen along with short-term rates, albeit at a slower pace, as illustrated in the chart at right that graphs interest rates available at various maturities today and a year ago. The chart at right shows a dramatic "flattening" of the yield curve, meaning the premium for holding long-term bonds has decreased relative to short-term bonds. This may imply lower growth and inflation expectations over the long-term. The quarter-end yield difference between the 10-year and 2-year Treasuries was 47 basis points, or 0.47%, which is the lowest level since late 2007. Equity market volatility may have had some impact on yields as well, as Treasury bonds are often thought of as safe-haven assets in times of market distress. The 10-year Treasury stood at a multi-year high of 2.95% in mid-February, and has since rolled back to 2.74% as of the end of March.



The corporate bond market had a strong 2017, but got hit alongside the equity market in early February. Higher quality investment-grade corporate bonds (-2.92%) underperformed their lower quality, higher yielding counterparts (-1.04%). As shown in the chart at right, the "spreads" or differences between investment grade and high-yield corporate bond yields and Treasury bond yields widened by +15 and +14 basis points, respectively. This volatility has stirred substantial ETF outflows; the two largest High-Yield ETFs (JNK/HYG) lost nearly $6.4 billion combined, and the largest investment grade ETF, LQD, saw outflows of $5.7 billion.



We maintain our laddered fixed income approach, which should allow us to take advantage of rising interest rates by rolling maturing bonds into higher-yielding securities. Buying short-to-intermediate term bonds protects us from large swings in bond prices, as longer-dated bonds are more sensitive to movements in interest rates. Additionally, our focus on higher-quality corporate bonds provides added income over treasuries, while not substantially increasing credit risk.

GLOBAL MARKET RETURNS

Source: Bloomberg Capital Markets

		Last 3 Months	Last 12 Months*
U.S. Equities	S&P 500 *(Large U.S. Companies)*	-0.76%	13.98%
	Dow Jones Industrials *(Selected Large U.S. Companies)*	-1.96%	19.39%
	Russell 2000 *(Small U.S. Companies)*	-0.08%	11.79%
	Russell 3000 *(All U.S. Companies)*	-0.64%	13.80%
International Equities	MSCI World Index ex-US *(Developed Markets)*	-2.07%	14.30%
	MSCI EAFE *(Developed Markets)*	-1.70%	14.60%
	MSCI Emerging Markets *(Emerging Markets)*	1.24%	25.14%
Fixed Income	Barclay's U.S. Int. Gov't/Corporate *(Intermediate Investment Grade Maturities)*	-0.98%	0.35%
	Barclay's U.S. High Yield *(Non-investment grade "junk")*	-0.86%	3.78%

* Includes dividends for equity indices

The Long Term Care Conversation

Long Term Care (LTC) is defined as "Services and supports necessary to meet health or personal care needs over an extended period of time."[1] Such care isn't necessarily medical in nature. Rather, it is typically associated with the performance of basic tasks of everyday living (like eating, dressing, and bathing). Long Term Care *insurance* (LTCi) is a type of insurance coverage designed to pay for some (or all) of the expenses associated with an LTC need.

And, as it turns out, "most Americans turning age 65 will need long-term care services at some point in their lives."[2] Bear in mind, LTC isn't just associated with old age. LTC needs can arise after automotive accidents, workplace injuries, or terminal illness. In other words, this topic probably matters to you.

Does that mean everybody needs to go out and buy a LTCi policy? Not necessarily. Depending on your situation, an insurance policy might be unnecessary or unaffordable. Insurance is just one way to plan for LTC. An examination of your own resources, support network, and care preferences are also key components of the process.

Family, friends, visiting nurses, in-home care, day programs, and a full spectrum of residential services can all fill the needs presented by an LTC event. Some of these cost money, some don't. Some can be insured against, and some can't.

[1] https://longtermcare.acl.gov/the-basics/what-is-long-term-care.html
[2] https://longtermcare.acl.gov/the-basics/who-needs-care.html

So what can you do to get started?

Have the conversation.
Talk to your parent or loved one about their coverage, needs, preferences, and their expectations of you or others.

Talking to an LTC professional can be informative and empowering. Even partially funding your LTC needs can provide substantial asset preservation – and an array of options and costs are available to consumers.

Examine your own circumstances.
Assets, current policy ownership (if applicable), risk tolerance, and legacy goals. Discuss this with us and insurance professionals to weigh the cost/benefit of various coverage types, exposure to risk, and the impact a long term care event may have on your financial plan.

The Long Term Care Conversation

Usage of Long-Term Care

6.3 Million:

The number of Americans who have a high long-term care need because they need help with two or more activities of daily living or are experiencing cognitive decline.

15 Million:

The number of Americans expected to have a high long-term care need by 2050.

52.3%:

The expected percentage of people turning 65 who will have a long-term care need during their lifetimes.

10%:

Percentage of Americans over age 65 who have Alzheimer's dementia.

35%: Projected increase in number of people with Alzheimer's dementia between 2017 and 2030.

Paying for Care

$30 Billion:

Long-term care expenditures in U.S., 1980.

$225 Billion:

Long-term care expenditures in U.S., 2015.

57.5%:

Percentage of individuals turning 65 between 2015 and 2019 who will spend less than $25,000 on long-term care during their lifetimes.

$5,518:

Median total household wealth for people who have lived in a nursing home for six months or more.

$0:

Median household wealth for people who have lived in a nursing home for six years or more.

State and Federal Funding

62.3%:

Percentage of long-term care services and supports that are provided through Medicaid.

20%:

Percentage of Medicaid funding that went to pay long-term care costs in 2016.

Long-Term Care Insurance

125:

Number of insurers offering standalone long-term care policies, 2000.

Less than 15:

Number of insurers offering standalone long-term care policies, 2014.

Excerpted from: *75 Must-Know Statistics About Long-Term Care*, Christine Benz, Morningstar, 08-31-2017

FLP-Financial Planning News

Jessie Butler from our Portland office has most recently become a Financial Paraplanner Qualified Professional™. Individuals who hold the FPQP™ designation have completed a course of study encompassing the financial planning process, the five disciplines of financial planning and general financial planning concepts, terminology and product categories.

Jessie is a senior account officer directing client administration and has over 18 years of industry experience.