FAIRPORT ASSET MANAGEMENT
A WealthTrust company

The Compass

Wealth management tips, trends and articles that provide confident navigation for high net worth clients.

December 2017

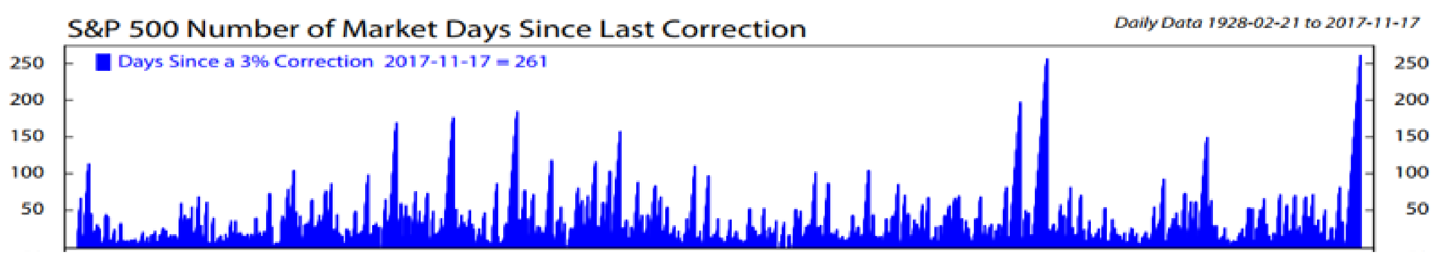
Happy Holidays! During this season of thanksgiving and celebration, we would like to express our gratitude to Fairport clients and friends. Whether you are a long-time client or you have started working with us this year, it is our privilege and honor to serve as your wealth manager.

Mid-Quarter Commentary as of December 1, 2017

John M. Silvis, CFA
Chief Investment Officer

As we head into the home stretch, it is important to point out that 2017 is approaching rarified air as the equity markets continue to establish all-time highs as we finish out the fourth quarter. With one month to go to the end of the year, the S&P 500 Index has registered a total return of 20.5%. While impressive, the MSCI All Country World Index, a global benchmark consisting of both U.S. and international equities, has totaled 22.6% since the beginning of the year fueled by markets overseas. Overall, the emerging markets have lead the way in 2017 with the asset class returning 32.9% year-to-date.

The S&P 500 Index has posted positive returns in each of the first eleven months of the year, a feat that hasn't happened since they started keeping records back in 1926. On top of that, volatility has been historically low. The index has not seen a decline of 3% or more all year (see chart below), with the last drop well over a year ago making it the longest streak in the last ninety years!



One of the drivers of performance so far this year has been an improving economic picture. After registering GDP growth of 3.3% in the recently completed third quarter, the domestic economy is on the verge of establishing a trend of above average economic growth. The current fourth quarter is likely to join both the second and third quarter and finish with GDP growth above 3%. The current forecast for the Atlanta Fed's GDPNow econometric model projects will finish the quarter with growth of 3.0%. The consumer is benefiting from a strengthening economy as well, with Consumer Net Worth as calculated by EvercoreISI expanding to all-time highs after bottoming in 2008 during the financial crisis. Like equity valuations, home prices are on the rise as well with the Case Shiller home price index rising 6.2% in September versus the same time last year. For most consumers, their homes and their retirement savings are the two biggest assets and both have benefited by higher prices over the last year.

The employment picture continues to improve with the unemployment rate dropping to 4.1%, the lowest reading since December of 2000. As we approach full employment, we will likely see some stress in the labor markets as we head into 2018 with wages coming under pressure. However, without the threat of higher inflation on the horizon, any increases in wages in the coming months should be manageable and not present a headwind to the overall economy in the New Year.

2018 will bring changes at the Federal Reserve as President Trump has nominated Jerome Powell to succeed Janet Yellen, whose term expires in February, as the new Fed Chairperson. Assuming he gets confirmed (you can't assume anything in Washington these days!) we would expect more of the same from the new Chair whose views closely align with Ms. Yellen. The Fed remains on track to gradually raise interest rates next year with the consensus being three hikes in 2018 along with further winding down of the already bloated balance sheet. Overall, there are no signs of an economic recession on the horizon which should be a positive for equity markets.

Large Cap equities within the U.S. have outpaced Small Caps for most of the year, a trend we think will carry over into 2018. Leadership has come from Information Technology, the largest sector within the S&P 500 Index, with returns over 40% so far this year. Health Care and Consumer Discretionary have also been leaders with both sectors posting returns near 20% in the first eleven months of the year. If there has been any area of weakness it's been in the retail space, where most brick and mortar stores are trying to figure out how to compete and not lose market share to Amazon as it continues to expand its footprint (it reached into the grocery business this year with its acquisition of Whole Foods). Earnings were up nearly 8% in the recently competed third quarter with revenues continuing to see growth over last year. Earnings tend to be a function of the economy and, as we pointed out, the economic expansions should continue in the New Year driving earnings up over the next few quarters forming a tailwind for equities. Because of this, we remain overweight cyclical sectors such as Industrials, Materials and Financials that should benefit from the economic tailwind.

Overseas, it's more of the same. The global economic expansion we have harped on over the last year continues to pick up momentum and will likely strengthen in the months to come. The Global Purchasing Managers' Index (PMI) remained strong in October climbing to a reading of 53.5 (any reading over 50 is considered in expansion) with all countries in expansion territory – a rare occurrence. International equity markets so far this year have been the leaders with developed markets such as Europe and Japan breaking out during the year and outpacing the markets here at home. Asian markets led by Japan, South Korea and China have seen strong growth led by improving economic growth and fueled by a weaker dollar. The Japanese Nikkei Index has broken out to multi-year highs as the Abe administration received a vote of confidence during the recent election, guaranteeing the country stays on the path of more fiscal and monetary stimulus.

Emerging Markets gets the prize as the best performing asset class, a trend we believe will continue in 2018. China continues its transition which it started a few years ago to a consumer-based economy. After its recent Communist Party meeting, leadership is in place for the next five years removing any political drama in the near future. China, the world's second biggest economic market, has steadied the ship with GDP growth at or near 7% for the last few quarters. The Dollar decline has been a positive for emerging markets with the greenback down nearly 10% for the year. This trend will likely continue in 2018 helping markets overseas.

We moved to an overweight in equities in our allocation models back in March of 2013 as we felt equities were attractive both using historical price to earnings multiples and relative to bonds. That proved to be the right call. While valuations are not as attractive as in the spring of 2013, we still believe given the current backdrop (low inflation, improving economy, higher earnings) that the current secular bull market likely has more room to run. We are historically overdue for a correction, and it's not a matter of "if" but "when" the next market pullback will happen. Given the extremely low volatility we have experienced in 2017, we are likely to see an increase in the coming months. While political drama both here and overseas may cause short term disruptions, the fundamental backdrop remains conducive to more gains in the New Year.

Fixed Income Commentary as of December 1, 2017
Rick D'Amico, CFA
Manager of Investments

At 2.39%, 10-year U.S. Treasury yields are hovering close to where they began the year (2.45%), and with only a month to go in 2017 appear to be falling well short of many analysts' year-end projections of 2.75%. There are several factors contributing to the depressed level of 10-year U.S. yields, including: (1) a low neutral rate, (2) low inflation and (3) a drop in the term premium. The neutral rate (i.e., the policy rate that is viewed as being neither stimulative nor restrictive to the economy) is anchored around 2.0% to 2.25%, well below its historical average. Since 2008, 10-year Treasury yields have tracked the neutral policy rate closely. In terms of inflation, the core personal consumption expenditures price index (PCE), at 1.3%, is well below the Fed's target level of 2.0%. There also seems to be some internal debate among some FOMC members as to whether the low level of inflation is transitory, or something more persistent. At the October Group of Thirty's Annual International Banking Seminar in Washington, Janet Yellen remarked that "the biggest surprise in the U.S. economy this year has been inflation." Finally, the term premium, or additional yield required by investors to commit to holding a longer-term bond, remains negative and continues to be heavily influenced by global central bank policy.

The slope of the yield curve also continues flatten causing some angst among investors, as an inverted yield curve (i.e., when 2-year yields exceed 10-year yields) has preceded the last 7 recessions dating back to the late 1960's. It should be noted that the yield curve can remain flat for some time without the economy falling in to recession. According to Strategas Research Partners, when the 10-2 year spread falls below 75 basis points, a yield curve inversion is typically at least one year away. Furthermore, the yield curve has flattened during 5 of the 6 last Fed tightening cycles, so some flattening is to be expected. It also remains to be seen how much distortion has been caused on the long end of the curve due to the unprecedented monetary policies of global central banks. It is quite possible that when the ECB and BOE begin to normalize policy, long-rates could gravitate higher, alleviating some of the flattening the yield curve has undergone.

The Barclays U.S. Aggregate Bond Index has posted modest returns in 2017, returning 3.07% year-to-date through November. Fairport remains defensively positioned in fixed income portfolios, short duration relative to the index. In our view, there is very little margin of safety in most sectors of the fixed income market, as credit spreads continue to grind tighter, with most sectors at or near historic lows.

Meet Katie and Michelle

Katie Sheehan, a CFA® charterholder, joined Fairport in September as Portfolio Manager. As a member of the Investment Team, Katie is responsible for helping set investment strategy and overseeing the implementation of the firm's impact investing models.

Katie joins us from PNC, where she was most recently responsible for providing fiduciary oversight for all discretionary fixed income securities. She received both her bachelor's degree and MBA from Cleveland State University. She has taught undergrad finance at her alma mater as well.

Katie is an active member of the CFA Society Cleveland, as well as a level 2 CAIA candidate. She resides in Westlake with her husband Jason and daughter. In her free time, she enjoys spending time with her family and playing volleyball.

Michelle Taylor joined the firm as Advisor in October and brings more than 20 years of wealth management experience to Fairport. In her role, she is responsible for client deliverables and relationship management. Michelle's experience and strategic skill set make her particularly adept at working within Fairport's women's division, Luma Wealth Advisors, to help grow its footprint.

Michelle worked at Charles Schwab & Co., most recently as Vice President and Branch Manager of the Legacy Village office, as well as Fidelity Investments in a number of roles. She is a CRPC designee and a graduate of the University Of Kentucky School Of Business.

Michelle lives in Lorain with her husband and daughter. In the warmer weather, she enjoys spending time boating on Lake Erie with family and friends.

Welcome to the Fairport team!

Charitable Giving

Peter P. DeVito, CPA, CFP®
Partner

It's that time of year when gifts are on everyone's minds, but for many of our clients, charitable giving plays a key role in their lives year-round. At Fairport, we advise clients on the many ways to be philanthropic *and* tax efficient.

Cash and Non-Cash Contributions
A charitable deduction is allowed if cash or property is donated. No deduction is permitted for services and a deduction can only be taken for donations to U.S. charities. To confirm whether a charity is a qualified organization, see www.irs.gov or www.guidestar.org.

In general, a charitable deduction counts for the year as long as the check is postmarked or credit card is charged by December 31st. If a benefit is received in return for a contribution, a deduction is only available to the extent it exceeds the value of the benefit.

Don't forget deductions for expenses related to a charitable activity:
- Unreimbursed expenses directly connected to providing services to the charity.
- Travel (if no significant element of personal pleasure).
- Charitable mileage (14¢ per mile).

The most commonly donated property is clothing and household items. The items need to be in "good used condition or better" and are usually deducted at thrift shop value. For any property donations worth $5,000 or more, you are required to obtain a formal appraisal from a qualified appraiser. There is an exception for marketable securities because they have a clear market value.

You must obtain required documentation for contributions over $250 before a tax return is filed. Additionally, cash and property deductions are limited up to 50% of Adjusted Gross Income (AGI) to public charities. Unused deductions can be carried forward up to five years.

Appreciated Stock Contributions
Appreciated stock is a powerful tool for charitable giving that is often overlooked. Some rules apply depending upon how long the stock is held. If the stock has been owned less than a year, the deduction is limited to the cost basis (what you paid for the stock). Stock held over a year can be deducted at its current fair market value, calculated by the average of the high and low price on the date of contribution.

You'll also avoid capital gains taxes on the increase in value over time, which you would have had to pay if you sold the stock then gave the cash proceeds to the charity. If the stock has lost value, it is better to sell the stock first and give the cash to the charity. You'll still be able to deduct your charitable donation if you itemize, but you'll also be able to take a capital loss when you sell the investment.

The IRS does mandate some limitations. Deductions for appreciated stock are limited up to 30% of AGI to public charities. Similar to cash contributions, there is a 5-year carry-forward for unused deductions.

Charitable IRA Distributions
The IRA charitable distribution allows individuals who have reached age 70½ to donate up to $100,000 to charitable organizations directly from their IRA. Congress made this provision permanent in 2015.

The gift, also known as a Qualified Charitable Distribution, does not count as taxable income to the IRA holder (provided they made the gift in the same taxable year) but does count toward their annual Required Minimum Distribution.

Charitable IRA distributions especially benefit those who do not itemize deductions, and therefore, do not receive a tax benefit for their charitable contributions. If charitable gifts already exceed the 50% / 30% AGI limits within the calendar year, this allows the donor to skip by these limits and give more.

By avoiding recognition of taxable income, the donor may have less of their Social Security income subject to tax and may minimize their Medicare Part B and D premium surcharges. Charitable IRA distributions also provide state tax savings if the donor is a resident of a state that provides no income tax break for charitable contributions.

The combination of estate and income taxes on IRA assets can produce an effective tax rate of up to 70%. The charitable IRA distribution exclusion gives individuals the opportunity to remove these assets from their estate with no tax consequences. Spouses can also directly distribute up to $100,000 if they are over age 70½.

Donor Advised Funds

The biggest trend over the last decade has been the creation of donor advised fund (DAF) accounts. They are simple to establish with minimal ongoing expense and effort. They are effective in helping individuals achieve their charitable mission without the overwhelming reporting and operating requirements of a private foundation.

When a donor transfers cash or appreciated stock into their DAF, they receive an immediate income tax deduction and are provided a contemporaneous written acknowledgement from the DAF administrator. Donors can make their charitable grant at a time that fits their schedule, in some cases years after the initial gift is made.

The donor also benefits from no capital gains tax on their gift of appreciated stock. Furthermore, any continued growth of those appreciated shares within the DAF will be tax-free. A DAF may also accept privately held stock, real estate and other complex investments.

Donors can add to their account over time with additional contributions when convenient and recommended grants to charity can be as low as $100. DAFs are also an effective way to build a charitable legacy for your family since you can name successor account owners.

CRATs and CLATs

There are various estate planning vehicles available for those who want to blend their philanthropic goals with their wealth shifting goals. A Charitable Remainder Annuity Trust (CRAT) allows a grantor to contribute property to a trust and receive payments for a term of years or for life. A CRAT pays a fixed percentage of the initial value of trust assets (i.e. 5% minimum) to the grantor annually, regardless of investment performance. Income distribution is mandatory and principal may be invaded to satisfy the requested payout.

Once the term expires, the remainder of the trust is transferred to the charity beneficiary. The grantor retains the right to change the designated charities during the term of the trust. A CRAT provides a charitable income tax deduction equal to the value of the remainder interest at the time of funding. Deferral of capital gains taxes on the sale of appreciated property and portfolio diversification inside the CRAT are additional benefits.

A charitable lead annuity trust (CLAT) is the inverse of a CRAT. The charity receives an annuity payment from the trust, with the remainder passing to a non-charitable beneficiary. Like a CRAT, a CLAT is also an example of a split interest trust because their value is broken into a “lead” interest and a “remainder” interest.

At the time a CLAT is implemented, the donor specifies the term, the income beneficiary (charity) and the remainder beneficiary (typically the donor’s heir(s) or the donor himself if structured as a grantor CLAT). If the remainder interest passes to non-charitable beneficiaries, the transfer will be subject to gift tax but is reduced by the net present value of the income stream granted to the charity.

CLATs work well in a low interest rate environment because if the trust’s investment performance exceeds the “7520 Rate” (minimum interest rate required by the IRS), then the excess earnings and growth at the end of the term pass to the remainder beneficiaries tax free. The lower the 7520 Rate, the larger the potential gift to the family.

CLATs are typically designed to reduce gift taxes on shifting assets to family members, not usually to obtain a charitable income tax deduction. If a charitable income tax deduction is claimed, the CLAT’s income is taxable to the grantor throughout the term of the trust.

Summary

There are many different ways to make charitable gifts and we’re here to help. Donating appreciated stock could make sense to avoid paying capital gains taxes. Further, if you are in a higher tax bracket this year than you might be next year, it could be beneficial to accelerate gifts to this year. If the numbers are large enough, you might consider a donor advised fund, or even a private foundation. Finally, estate planning can be carefully interwoven with your giving plans through the use of charitable trusts. As always, please reach out to a member of your Fairport team to discuss which strategies would work best for you and your family.

Fairport News
Read about our most recent community involvement, awards and accolades, conferences and continuing education.

Fairport team members volunteered for our Community Beacon sponsor, Cleveland Museum of Natural History, at two festive community events – Owls and Howls in October and CircleFest in December. **Emily Shacklett, Paul Zappala, Kristen Lucas** and **Tia D'Aveta** helped museum guests paint pumpkins, take spooky selfies and make dog and cat toys to celebrate Halloween and **Andrew Connors, Paul Zappala, Kristen Lucas** and **Michelle Taylor** worked with museum guests of all ages to create beautiful, one-of-a-kind snowflakes for winter. We encourage you to visit and support the museum – email kristen.lucas@fairportasset.com for complimentary tickets while supplies last!

The advisors of **Luma Wealth** were out and about in our local community celebrating girls and women this fall. Some inspirational events included YWCA Circle of Women, College Now Greater Cleveland Bag Lady Luncheon and STEAM Inspiration day at Laurel School.

Ken Coleman is an inaugural member of the Board of Directors of the National Center for NonProfit Enterprise helping nonprofit organizations make wise economic decisions.

Andrew Connors, Heather Ettinger and **Kristen Lucas** joined the industry's largest gathering of experts and forward-thinking advisors at Charles Schwab's annual IMPACT conference in November (below).

Heather Ettinger was a featured "Pivots & Pathways" speaker at the Female Entrepreneur Summit presented by Contempo Communications. Her advice to female entrepreneurs was dream BIG, get stuff done and have fun! Short promo video here. She was supported at the event by colleagues **Callie Cornett, Rachel Margulis, Emily Shacklett, Michelle Taylor** and **Joyce Zak** who enjoyed a day of learning, inspiration and networking.

Heather Ettinger participated in two other panels— Oswald Women's Leadership Forum: The Business of Uplifting Others and *InvestmentNews'* Women Advisor Summit. She was also quoted in a *Barron's* article.

Chris Isabella will be attending the OSCPA 2017 MEGA Tax Conference later this month.

Rachel Margulis attended the Tax Club of Cleveland State and Local Tax Update, BSA Estate Planning Seminar and an AICPA conference – Sophisticated Tax Planning for Your Wealth Clients.

Fairport supported Beech Brook and partner **Tom Seifert** (first photo below, far right) as a sponsor of the 5k Run /1 Mile Walk. A leading behavioral health agency, Beech Brook serves more than 15,000 of our community's most vulnerable children and families.

Katie Sheehan passed Level I of CAIA exam and is scheduled to take the level II exam in March. She attended the BlackRock Factor Client Council in early October and the Vanguard Symposium in early November. She is pictured above at the NYSE in New York City.

John Silvis attended the Morningstar ETF Conference to keep current on the latest developments in the exchange-traded fund space and the Hightower Fall Forum in New York City.

Paul Zappala attended the 2017 Compliance Solutions National Conference in Florida. This short video recaps the conference and includes a cameo from Paul.

Newsletter Disclosures
This newsletter represents an assessment of the economic and market environment at a specific moment in time and is not intended to be a forecast of future events or any guarantee of future results. It is for informational purposes only and should not be relied upon as research or investment/financial planning/tax advice. It should not be considered as a solicitation or recommendation by Fairport to buy, sell or continue to hold securities or other investments. Past performance is not a guarantee of future results, and is not indicative of any specific investment. It should not be assumed that the investment process and strategy discussed herein has been or will prove to be profitable.