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FINANCIAL MANAGEMENT, INC.

January 16, 2017

Dear Client,

Subject: 2016 Year End Review / 2017 Outlook / Performance Review and Tax Reporting

2016 Review

2016 can best be described as the tale of two halves with Brexit in the middle. The year began with a broad selloff in equity markets over fears that a slowing economy in China would lead to a recession in the U.S. Oil and commodity prices declined with the prospect of slowing global growth and supply outstripping demand, and global bond yields declined (some into negative territory) as investors sought the safety of bonds. By February 11, 2016, the S&P 500 had declined 10.5%.

But the economy and equity markets proved to be resilient. As we articulated in our 2016 outlook letter and in client meetings, the fundamentals of the U.S. economy were intact and a recession did not appear to be in the offing. Ultimately investors were too pessimistic and the underlying U.S. economy was quite stable, global economies less so, U.S. markets recovered and by June 22nd were up a modest 3.14%.

Brexit – Britain's vote to exit from membership in the Euro zone occurred on June 23rd and the outcome came as a surprise to markets. But after a brief three day selloff, which DBFM used as a buying opportunity, markets resumed their upward trend. The vote however, could portend future exits from the Euro zone and remains a risk that bears watching moving forward.

The second half of 2016 provided the majority of the gains. A rebound in corporate earnings, accelerating U.S. growth (3.5% GDP in the 3rd qtr) and stabilizing oil prices ignited investor's appetite for stocks. The election of Donald Trump in November further ignited the rally as investors bet that the new administration's policies would usher in a period of looser regulation, lower taxes and the possibility for fiscal stimulus (government spending on infrastructure). All told in 2016 the S&P 500 was up 11.96% with dividends reinvested, the Dow 16.5% and the Russell Small Cap index 21.31%. U.S. equities continued their dominance over their international counterparts and bonds moved inversely to stocks all year. Bonds started the year strongly and peaked in early July returning 6.38%. Yields increased over 1% from that point thereby reducing return to a modest 2.79% by year end as measured by the Barclays Aggregate Index.

2016 provided some reminders as well. Specifically, the fundamentals of the economy still matter despite assistance from the FED. Diversification still matters, large caps led most of the year before small caps took over. Finally, as we have often reminded clients, it is difficult if not impossible to time exits or entries into the market successfully. Those that considered exiting the market in mid February or prior to the election would have missed out on significant gains.

2017 Outlook

We enter 2017 with a fundamentally strong and growing U.S. economy and with an improved global outlook. Europe appears to be seeing signs of growth and moving away from a risk of disinflation. Also fears of a slowing China are subsiding but still present. In the U.S., decent employment gains, slowly rising wages and a modestly growing economy should provide a decent backdrop for corporate earnings progress. Further signs of a strengthening US economy include:

- 2016 stock market rally occurred in spite of outflows of $63 billion from stock funds. The US stock market is yet to be loved in this secular bull market.
- 3rd quarter Gross Domestic Product (GDP) accelerated to 3.5% vs. 1.4% in the 2nd qtr. Gains in consumer spending, business fixed investment, inventories and exports were offset by a decline in housing and an increase in imports.
- 3rd quarter profit growth was positive for the first time in six quarters, as oil and commodity companies were less of a drag.
- The U.S. economy added 156,000 jobs in December and 2.2 million jobs in 2016 (183,333 jobs/month average). Average hourly earnings for all employees are up 2.9% over the last year. Source BLS 1/6/2017.
- First time claims for unemployment (a forward looking indicator) were 235,000 for the week ending December 31. The four week moving average is now 256,750. This marks the 96th consecutive week with claims below 300,000, the longest streak below 300,000 (a key level) since 1970.

From a market perspective the recent improvement in earnings will need to continue to see stocks move higher in 2017, but it is possible. From a valuation standpoint stocks aren't cheap, trading at about 20 times their last 12 months of earnings. The midpoint for fair value is 16. That said, an improvement in the earnings picture, perhaps propelled by lower tax rates, could improve the valuation picture and propel stocks higher. Bonds aren't cheap either and will face increasing risks from higher inflation and rising interest rates.

One risk to the market appears to be the uncertainty of the new administration and their ability to deliver on the promises that have propelled markets higher. Specifically, the administration's policy on trade will need to be watched carefully. Policies that promote protectionism have the potential to incite a trade war and could reduce growth.

The improving U.S. economy has also increased the prospect for higher inflation and in turn higher interest rates. Modestly higher interest rates can be tolerated by stocks, but rapidly rising rates could slow overall U.S. growth. The same can be said for a stronger U.S. dollar, which makes U.S. made goods more expensive abroad. Keeping the dollar in check versus other currencies will be critical to maintaining our growth prospects.

Additionally, the FED has expressed a desire to raise the FED Funds rate three times in 2017. While higher inflation is desired, the FED will surely have to keep an eye on inflation and the dollar so as not to slow the economy.

Finally, overseas we will be watching elections in Denmark, France and Germany to see if rising populist movements in these countries will increase the likelihood that they will seek to exit the Euro zone and end the long experiment with the Euro. At this juncture in time, further separations from the Euro zone do not appear to be in the cards.

In sum, 2017 like its predecessor will prove unpredictable. As such, we recommend that clients continue to control what you can control. Manage your budget. Increase income where possible and remain cognizant of the impact of taxes on portfolio distributions. We will continue to remain vigilant in identifying the risks that have the potential to affect your portfolio, as well as remain focused on maintaining investment diversification and a long term view of the economy and securities market.

Performance Review and Tax Reporting

The remainder of this letter is intended to review your portfolio results relative to the market through year end 2016. Additionally, tax reporting notices are at the end of the letter.

Attached you will find a summary perspective on the market and your personal portfolio reports including: Performance Analysis from December 31, 2015 through December 31, 2016, Index results for the same period, and a Position Performance Summary.

Stock Perspectives / Growth vs. Value

A. Stock Market Valuations: By the end of 2016 valuations as measured by price/earnings ratios were above the historical fair value level in large, mid and small cap stocks.

B. Small Caps (21.3%) outperformed Large caps (11.96%) and Mid caps (13.8%). Domestic U.S. equities bested the International World Ex US Index by 8.67%.

C. In 2016 Value stocks outperformed Growth stocks by a large margin, over all market caps (small, mid and large). Our focus on value allowed us to comfortably beat each respective equity benchmark. Additionally, our individual stock portfolios with a focus on dividends performed admirably and in most cases exceeded the return for the S&P 500.

Bond Market:

D. In spite of a year that ended with the Federal Reserve increasing interest rates a notch (0.25%) without justifiably meeting either of their dual mandates of full employment and price stability, bonds eked out a small gain. Despite the rise in rates Corporate bonds were up 5.96%, the Barclays Aggregate Bond Index was up 2.79% and the Lipper Short Term Investment Grade Bond index was up 2.08%.

E. Our client bond portfolios held their own in 2016 thanks largely to our shorter duration bonds and floating rate, high yield bond holdings. We remain focused on protecting against interest rate and credit risk. By historical standards bonds remain over-valued.

Tax Reporting:

F. **IRS Form 1099** – You will soon receive IRS Form 1099 from your custodian, Charles Schwab & Co. or Fidelity Investments. IRS Form 1099 summarizes all dividend and interest income, proceeds from broker transactions (sales), and capital gain distributions from mutual funds paid in tax year 2016. Additionally and if applicable, you will also receive Form 1099-R, which summarizes all *retirement account distributions* recorded in 2016. **As a reminder, due to frequent adjustments and changes to the 1099 reporting information including the re-classification of dividends after year-end, it is generally a good idea to wait until mid to late March to prepare your federal and state income tax returns. Delaying the filing of your tax return will enable more accurate reporting of your tax information and avoid future amendments to your return.**

G. **2016 Expense Report** - For those of you that pay all or a portion of your DBFM management fees via a *non-retirement account, your management fees will be listed on the 1099. If you paid your management fees by check* a **2016 Expense Report** is enclosed. The Expense Report details the management fees deducted from your account during the year, which may be deductible on Schedule A of your Federal tax return.

H. **Indiana 529 Plan Investments** - As a reminder Indiana residents who made contributions to the Indiana College Choice 529 College Savings Plan in the year 2016 are eligible for a state tax credit. Please do not forget to apprise your accountant of the amount of any contributions so you may claim the corresponding credit on your Indiana tax return.

I. Clients wishing to make a **2016 IRA contribution** have until April 15, 2017 to make the contribution. If you plan to make a contribution for the year 2016, please make your check payable to Charles Schwab & Co. or Fidelity Investments and write the tax year on the memo line of your check. Please mail the check to us so that we receive it no later than April 7, 2017. We will ensure that the check gets deposited into the correct account.

Please feel free to contact us with any questions, or if you would like to schedule a meeting.

Thank you,

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