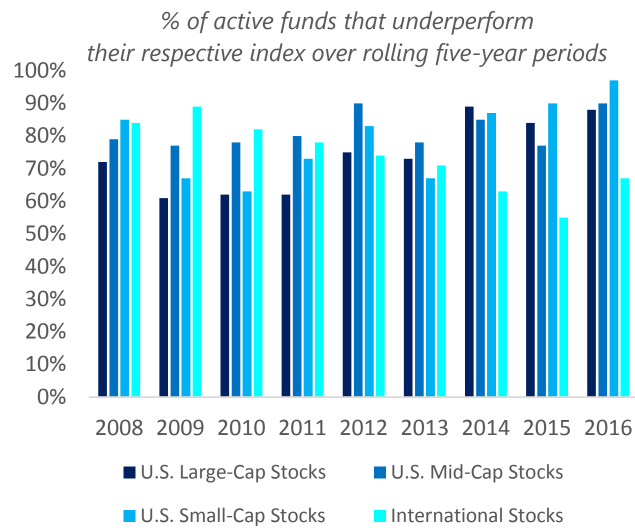
TARBOX FAMILY OFFICE

Third Quarter 2017

In 2007, legendary investor Warren Buffett publicly wagered $500,000 that the S&P 500 Index would beat actively managed hedge funds over a 10-year period. Hedge fund manager Ted Seides, the only one to take the wager, has already conceded the bet that technically ends this December. Seides should have more carefully examined the facts before taking the bet. Almost **all** active funds fail to beat the index over any recent time period examined. Through June, 2017, the 10-year annualized return of the S&P 500 Index was 7.2%, as compared to the hedge fund index return of 0.9%.

> **Buffett in his 2016 annual shareholder letter:** *"I sat back and waited expectantly for a parade of fund managers ... to come forth and defend their occupation. After all, these managers urged others to bet billions on their abilities. Why should they fear putting a little of their own money on the line?"*

Tarbox has managed investments employing various approaches over the past 30+ years. In 2001, after much research on professional managers' consistent inability to outperform the markets, we began to implement a value-added indexing approach. Tarbox was one of the very first firms to invest in low-cost indexed ETFs, thus ensuring its clients achieve the market return. It's icing on the cake to have what we've known for years proven by the "Oracle of Omaha's" bet!

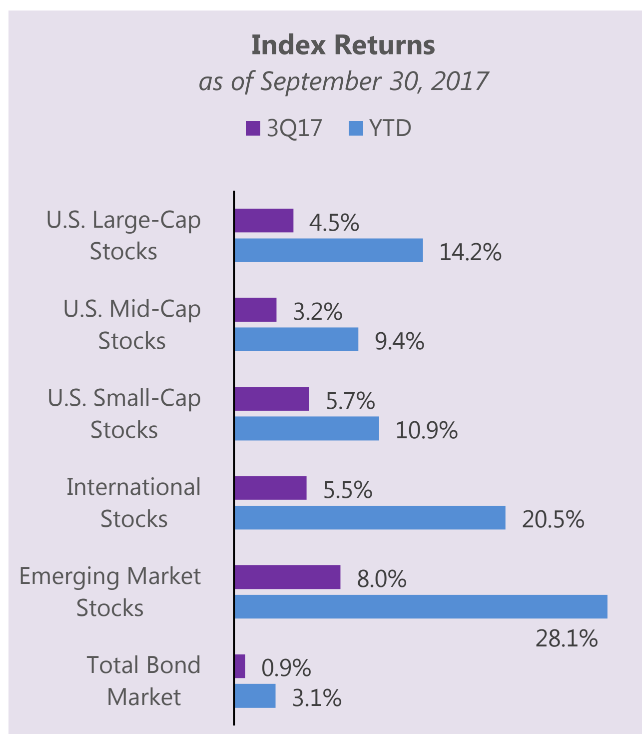


Market Recap

It's been a strong quarter for global stocks, with the data continuing to point to healthy economies worldwide. U.S. stocks continued their ascent, with the S&P 500 Index posting its eighth straight quarter of gains.

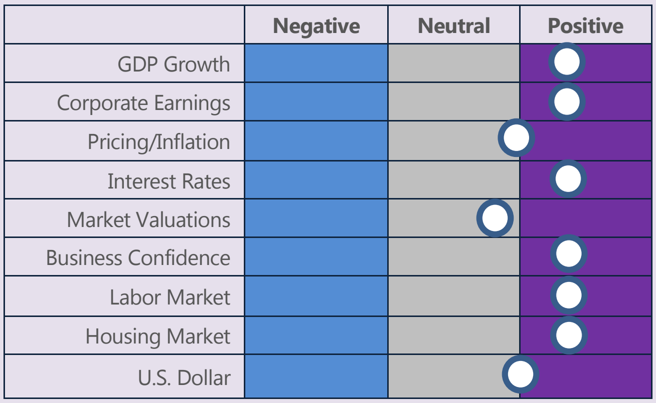
The weaker U.S. dollar and rebounding earnings helped emerging market stocks deliver strong returns. Underlying fundamentals appear solid for core international stocks as well, propelling solid investment results.

Bonds performed well during the third quarter as a blip of volatility kept interest rates low while the yield curve flattened, as evidenced by declining intermediate and long-term bond rates. Healthy fundamentals supported corporate credit spreads.



Tarbox Barometer

Global markets showed resilience during the quarter, despite a lackluster August. U.S. labor market data continues to support further tightening in monetary policy, while inflation and volatility remain contained. Corporate earnings continue to support further price appreciation.



- **GDP Growth:** GDP growth surprised to the upside at 3.1% for the second quarter, bringing the first half growth figure to 2.1%, following a bleak first quarter. Consumer spending is being supported by a strong labor market and wealth generated by home price appreciation, alongside further gains in the markets.
- **Corporate Earnings:** Corporate earnings were stronger than expected for the second quarter, and when combined with the first quarter, offered the first back-to-back periods of double-digit growth in six years. The retail sector has seen decreased consumer spending and industry changes with the growing e-commerce market.
- **Pricing/Inflation:** While inflation has yet to reach the 2% target, the Fed believes that the strong labor market will eventually get it there.
- **Federal Reserve**: The Fed reiterated its plans to hike once more in 2017, most likely December, while also beginning to unwind its $4.5 trillion balance sheet in October.
- **Market Valuations**: Comparing the yield on BAA bonds to the earnings yield on stocks, stocks still look attractive, with other measures, like the S&P 500 price/earnings, looking slightly elevated.
- **Business Confidence**: The initial heightened optimism over favorable business legislation has subsided, but the outlook remains positive. Concerns remain over the retail sector's competition with growing e-commerce.
- **Labor Market**: Unemployment moved higher off a 16-year low to 4.4% during the quarter. Wage inflation remains troublesome, given such a tight labor market.
- **Housing Market**: The housing market has continued to strengthen as home prices increase. Analysts suggest that a lack of available homes is causing the shortage. As property values outpace wage growth, first time home buyers have not felt this positive economic boost.
- **U.S. Dollar**: The U.S. dollar continued its downward trajectory during the third quarter as hope of progress on the political front diminished. A hawkish federal reserve, alongside stronger U.S. growth, could propel the dollar higher in the coming months.

"... as irrationally as possible."

Richard Thaler was recently awarded the Nobel Prize for his pioneering work in the field of behavioral economics where he established that people are predictably irrational – that they consistently behave in ways that defy economic theory.

The appreciation of global stock markets, credit, and property over the last eight years hasn't always felt rational. Markets have been rising against a backdrop of loose monetary policy, with central banks keeping short-term interest rates close to zero and helping depress long-term rates by purchasing $11 trillion worth of government bonds through quantitative easing. Central banks are now beginning the process of unwinding these policies.

The U.S. Federal Reserve is trimming its balance sheet and raising interest rates and the European Central Bank is tapering its quantitative easing program. They are both taking these actions in anticipation of higher inflation brought on by more competitive labor markets. We are seeing signs that the simple relationship between low unemployment and rising inflation is improving, at least in the U.S. In other parts of the world, notably the U.K. and Japan, the labor markets have become increasingly tight, yet there is little wage pressure. If central banks move too aggressively in anticipation of inflation, the impact of their actions on financial conditions could undermine the bull market in stocks.

Look at the broader picture, and you **can** see rationality in the ongoing rise in asset prices. The world economy is improving, with second quarter global GDP growing at the fastest pace since 2010. After an oil-driven decline caused by slowing growth in emerging markets, most notably China, the more steady gains in 2017 have come amidst the broadest global economic growth in 10 years, with no major economies in recession.

The GDP of many emerging markets has been lifted by higher exports. In the first half of 2017, the four biggest emerging economies known as the BRICs (Brazil, Russia, India and China) all grew simultaneously for the first time in three years. Of the MSCI emerging market countries which publish GDP growth (21 out of 24 countries), all have reported positive quarter-over-quarter growth figures so far this year, a phenomenon not seen since 2009.

As this economic expansion matures, we remain positive on the outlook for global stocks. We expect a gradual rise in inflation and a measured, well-communicated removal of monetary stimulus. The fourth quarter is typically active, and we don't have reason to think this one will be any different. Solid economic growth and good corporate earnings should allow for continued market growth, but we may experience bouts of volatility and/or pullbacks.

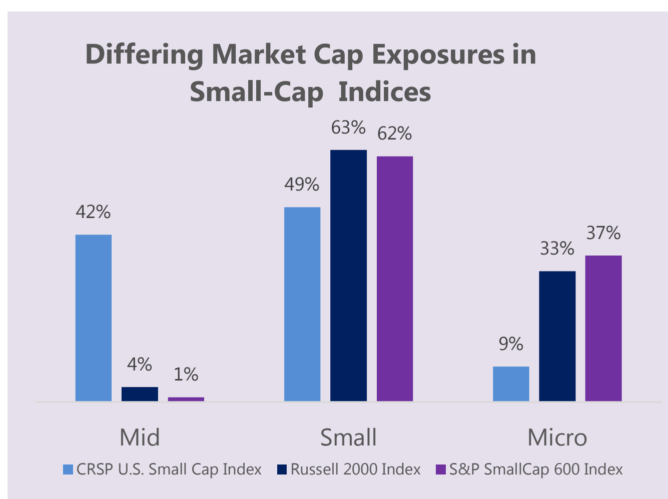
Dr. Thaler won the Nobel Prize, in part, for helping to identify investor biases based on irrationality, such as loss aversion – seeking to avoid losses more than seeking gains – and anchoring (a bias for the status quo). These and other irrational behaviors seemingly offer opportunities that many (irrational?) investors attempt to exploit. But, as Dr. Thaler himself says, *it's not easy to beat the market*; Thaler personally chooses index funds for his own investments. However, when asked how he will spend the $1 million prize money Dr. Thaler quipped, "I will try to spend it as irrationally as possible!"

Investment Spotlight – U.S. Small Cap Stocks: Don't Judge a Book by its Cover!

At Tarbox, we differentiate ourselves by investing in U.S. large-, mid- **and** small-cap index ETFs. To achieve pure asset class exposure, it's important to select ETFs that truly represent that segment of the market. In our review of U.S. small cap index providers, we discovered some startling results, such as – some of the so-called small-caps aren't really small-caps!

On the surface, indices that track an asset class look similar. For instance, the most widely recognized U.S. small-cap index, the Russell 2000, tracks performance of approximately 2000 U.S. small-cap companies. The S&P 600 Index also tracks the domestic small-cap market and the CRSP (Center for Research in Security Prices) U.S. Small-Cap Index performs a similar function.

Based on our analysis, we concluded that the S&P 600 Index not only provides the most concise exposure to the U.S. small-cap asset class, it also has provided superior returns over time (with lower volatility), when compared to the other leading small-cap indices. The S&P indices rebalance continuously throughout the year, versus the Russell which does so annually. Continuous rebalancing aids in smoothing out the volatility of changing index constituents, whereas annual rebalancing forces selling and buying at inopportune times. Furthermore, the S&P index criteria incorporates quantitative measures such as financial viability (positive earnings) and increased liquidity (active trading and publicly available shares) whereas the Russell does not.



Micro-cap: $50 million to 300 million
Small-cap: $300 million to $2 billion
Mid-cap: $2 billion to $10 billion

With the proliferation of "index ETFs", it's more important than ever to dig deep and uncover the idiosyncrasies of the wide array of index ETF offerings and how they differ.