FIRST QUARTER
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DEIGHAN
WEALTH ADVISORS

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23 Years
Deighan Wealth Advisors
1994-2017

MARKET COMMENTARY

Imagine you`re really hungry, and you`d like to make a nice meal for yourself. So, you put together a shopping list and head over to your local grocery store. On the ride there, you can`t stop thinking about how great your meal is going to taste. It`s going to be savory, a little fatty, and maybe just a tad sweet.

However, upon entering the grocery store, you become dismayed. The meat is really expensive! And so are the potatoes! Nearly everything in the store is priced much higher than normal. You`re indignant. "I`m not going to pay this!" you exclaim. Then your belly rumbles. You try to ignore it, but it rumbles again. Begrudgingly, you put a few necessary items into your cart. "Gee," you think, as you walk your cart to the front of the store. "This isn`t going be the meal I was hoping for after all."

We all need to eat, and we all need to save and invest. One way to invest, of course, is to buy stocks. Sometimes, shopping in the stock market can be expensive, just like shopping at the supermarket. But you still need to shop there, and this can be aggravating. Unfortunately, now is one of those times. Of course, this isn`t entirely bad. As prices have risen, portfolio values have risen. Over the past five or six years, investors have enjoyed the opportunity to put a little extra "meat" on their bones. But when prices are higher, staying well-fed starts getting harder.

Why is this? Well, let`s say you go to the store and buy a dozen eggs for $1.20. That`s $0.10 per egg. Now, let`s assume the price for a dozen eggs goes up to $1.44. Suddenly, you`re paying $0.12 per egg. It`s the same-sized egg, but with a bigger price tag. The result is decreased value for you, the buyer. You would only continue to realize the same value if the eggs were to grow in size by 20%.

When you buy a single share of stock, you`re paying for a piece of ownership. This is your "egg." But what are you really buying, when you buy a piece of ownership? You`re buying the right to a slice of earnings. In essence, when shopping for stocks, you`re shopping for earnings.

If a company doesn`t grow its earnings, but its share price increases, then this is like paying a higher price for the same-sized egg. Of course, a well-run company should be able to increase its earnings year-over-year. Therefore, stock prices and earnings, unlike egg prices and eggs, tend to increase in size together.

However, sometimes a company`s stock price rises faster than its earnings. Both might increase, but earnings might increase at a lesser rate. When this happens, it results in decreased value for the stock buyer. Fortunately, we can measure this relationship with a financial ratio known as the Price-to-Earnings Ratio, or

P/E Ratio for short. Using this ratio is no different than using other common household ratios, like price-per-dozen or price-per-gallon. In this case, we`re simply comparing a stock`s price per share to a stock`s earnings per share.

A higher P/E Ratio means a company`s shares aren`t value priced; the buyer is paying more for a smaller share of earnings. For any company with positive earnings, we can calculate its P/E Ratio. This helps us determine whether its stock is a buy or a sell.

We can also aggregate P/E Ratios across the entire stock market, to get an idea whether the stock market, on average, is a buy or a sell. Right now, if we were to do this, we`d find that the Forward P/E Ratio for the S&P 500 Index, based on consensus estimates for future earnings, is 17.56. This means that the average investor investing in the average company is paying $17.56 for every $1.00 in expected earnings.

By comparison, over the past 145 years, the P/E Ratio for the S&P 500 Index has averaged 15.64. In other words, for nearly a century and a half, the average investor investing in the average company has paid just $15.64 for every $1.00 in expected earnings.

> "The stock market has certainly taken Trump's promises to heart and priced in political wins on many of these fronts."

This implies that stocks are about 12% pricier than average. While this isn`t a terribly high premium, it does illustrate that stocks aren`t on sale. It`s also important to note that the Forward P/E Ratio is exactly that, forward looking. It`s based on the average analyst`s best estimate of future earnings. If we were to instead look at the Current P/E Ratio for the S&P 500 Index, which is based on actual earnings in the most recent period, we`d see that it`s 21.72. In other words, investors are currently paying $21.72 for every $1.00 in known earnings. That`s a 39% premium above the average historical P/E.

> "A higher P/E Ratio means a company's shares aren't value priced; the buyer is paying more for a smaller share of earnings."

This begs the question: Are analyst expectations realistic? Based on the above numbers, analysts are expecting earnings to grow nearly 24% over the next twelve months. That`s generally in-line with the average earnings growth rate over the past ten years. However, markets rarely exist at the average. Over the past ten years, year-over-year growth rates have been as low as -78% and as high as 243%. If we were to narrow our look-back period to the most recent five-year period, which excludes the financial crisis and therefore excludes these extreme outliers, we`d find an average growth rate in earnings of just 5% per year. If earnings were to grow just 5% over the next year, then this would imply a Forward P/E Ratio of 20.69. This would mean stocks are 32% more expensive than they have been historically, not 12% more expensive.

What would it take for earnings to grow at a 24% rate this year? The Trump administration has indicated a desire to jump-start the economy through tax cuts, health care reform, and infrastructure spending. If these initiatives were to become reality, then the end result could be a meaningful increase in earnings. The stock market has certainly taken Trump`s promises to heart and priced in political wins on many of these fronts.

However, with the failure of the American Health Care Act and Obamacare reform, Trump`s ability to spearhead significant fiscal stimulus and legislative change has come into question. Further, even if Trump were to succeed with tax reform, or infrastructure spending, or both, there would be a lag between approval and implementation. Effects would unlikely be felt in any meaningful way this year.

Still, the economy is doing well. The U-3 unemployment rate, which is the rate typically associated with unemployment, is at 4.5%. This means we`re at full employment. The U-6 unemployment rate, which includes workers marginally attached to the labor market and workers in part-time jobs who would prefer full-time work, has also improved. It now stands at 8.9%, slightly off the lows of prior economic cycles, but nowhere near recent highs. This bodes well for the American consumer, and, indeed, consumer confidence is near its highest point in 15 years.

Another positive is GDP growth. Unlike many other countries, the U.S. economy has been growing slowly and steadily. The consensus expectation is for annual GDP growth of around 2.2% in coming years. Given the unemployment numbers and steady economic growth, it`s no surprise, then, that the Federal Open Market Committee (FOMC) voted to increase interest rates by 0.25% at is March meeting. The effective federal funds rate, the base interest rate in the U.S. economy, now stands at 0.91%.

> "Unlike many other countries, the U.S. economy has been growing slowly and steadily."

This is all good news, which could support positive earnings growth in the coming year. But let`s think about these numbers in the context of a 24% estimated earnings growth rate:

We`re in the late innings of the economic cycle, the FOMC is raising interest rates, and it`s uncertain whether tax reform and infrastructure spending are actually coming. Meanwhile, companies have already slashed whatever costs they could in response to the prior recession, and they`re running pretty lean cost structures. Yes, the economy is steady and people have jobs, but, on the whole, this is a bit of a mixed bag in terms of future earnings.

In order to fuel earnings growth of 24%, the average company would need to deliver a return on equity of 35% in the coming year, likely a tall task in this economic and political environment. Think of return on equity as the "interest rate" a stock investor requires on a stock investment. Then think about how far away 35% is from the base federal funds rate of 0.91%, or the 10-year yield on an A-rated corporate bond, which is currently 3.38%.

Since 2001, the average annual growth rate in earnings for companies in the S&P 500 Index has been 7.64%, implying a long-term return on equity of roughly 11%. This kind of number makes sense. Numbers of 24% and 35%, however, do not. And if those numbers don`t make sense, then it`s less likely the stock market is only 12% overvalued. It`s probably more expensive than that.

We know that you, our clients, need stock exposure in your portfolios just like you need vegetables with dinner. So we can`t, and won`t, refrain from filling up our cart at the stock supermarket. However, that said, you can be sure we`re paying careful attention to stock prices, and we`re avoiding the priciest of companies. We`re shopping in the discount aisle when we see good deals there. Our goal is to shop for values and to stretch your dollars, so we can build the best basket of investments possible in this challenging investing climate.

PORTFOLIO CHANGES

REMOVED

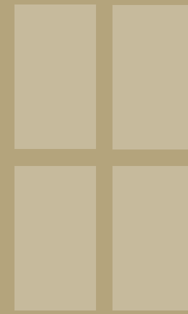
SPDR Dow Jones Global Real Estate ETF (RWO)
This exchange traded fund (ETF) corresponds with the Dow Jones Global Select Real Estate Securities Index, which is comprised of the securities of publicly traded global real estate companies. Most of the fund`s holdings are domestic Real Estate Investment Trusts (REITs). REITs have been popular for yield-seeking investors for several years, but we saw that valuations were getting stretched well beyond historic norms and took the opportunity to lock in gains this past quarter. Since REITs are often heavily financed by debt, we are concerned that increasing interest rates will cause downward pressure on share prices due to their higher debt-financing costs.

BREAKING NEWS FOR ALL INVESTORS!

The new "Fiduciary Rule" promulgated last year by the Department of Labor (DOL) was to go into effect on April 10, 2017. It has now been delayed 60 days to June 9, in terms of advice given, and to January 1, 2018, with respect to providing clients with written disclosures designed to ensure that investment professionals are acting in their clients` best interests. We are happy to report that we`re ready, and are disappointed at the delay.

We expect most investors might respond to the news flash with, "Really? I hadn`t heard. How will this new rule affect me as an investor, and what is a fiduciary anyway?" If you are a client of Deighan Wealth Advisors, there will be no impact because this firm adopted the fiduciary standard twenty-three years ago at inception. In fact, it was the reason Jenifer Wilson and Jean Deighan founded the firm as a Registered Investment Advisor choosing to be regulated by the Securities and Exchange Commission (SEC) under the Investment Advisors Act of 1940. Additionally, under the Investment Advisors Act, acting as a fiduciary means being held to deliver the highest level of loyalty and trust, always putting the clients` best interests first. We take it a step further: to us, acting as a fiduciary goes back to the term`s Latin derivation, i.e., it means acting in loco parentis or like a parent to a child who must be protected at all cost.

Unfortunately, not all investment firms and professionals are held to the fiduciary standard. Brokerage firms are regulated by the Financial Industry Regulatory Authority (FINRA) and are currently held to a lesser "suitability standard." The suitability standard requires that recommendations made to clients must be suitable in terms of the client`s financial needs, objectives and unique circumstances. While this is good; in our view, it does not go far enough. The suitability standard does not require that the financial professional place his own interests below that of the client, and this shortfall has led to the pending but now delayed DOL regulations. As one might imagine, there has been some strong resistance on



SOUNDBYTES

Tyler Hoxie joined Bangor Area Breakfast Rotary and looks forward to being an active member of the club.

Lucie Estabrook has joined the board of directors of Wellspring, Inc., and is eager to help the organization in its efforts to deal with the growing addiction crisis in our community.

Jenifer Wilson enjoyed being a panelist for Maine Public's "Maine Calling" radio show in January to answer caller questions about personal finance.

Jean Deighan and Jenifer Wilson will meet with Professor Jia Liu's Personal Financial Planning class at Husson University on April 13, 2017 to discuss their financial planning and investment management career paths and to answer questions students may have about this career choice.

behalf of major financial firms to extending implementation and enforcement of the fiduciary standard. Most cite the anticipated excessive cost of implementation. For Registered Investment Advisors, however, the cost is not a concern because we are already operating under the standard.

It is interesting to note that the proposed Fiduciary Rule was promulgated by the DOL and has a narrow focus. As now drafted, the rules are designed to protect only clients in qualified retirement plans and IRAs funded by those retirement plans. The intent of the DOL laws and regulations is to protect vulnerable investors from losing important savings designed to help them live a sustainable retirement. Since, in the past, some financial professionals may have been incentivized to sell products and services with high costs that benefit the financial professional more than the client, most of the rules focus on clear disclosure of cost. While we are pleased that the fiduciary standard is being expanded to cover all financial services professionals, we have some concerns about cost being the primary focus. Cost is only half the story. Benefits are important too, but they are not addressed in the disclosure requirements. Consequently, like many laws and regulations, the new DOL rule is a blunt instrument. Perhaps this could be an area improved during the period of delay. In the meantime, we applaud this first step as awkward as it might be, and hope the rules will go into effect and not be derailed.

To conclude, Deighan Wealth Advisors was ready for the April 10 implementation of the Fiduciary Rule and will employ the written disclosure requirements regardless of the implementation of the rule. We have always been committed to serving as a fiduciary to our clients. Each morning, we start our day by placing our coffee on a coaster that contains our firm mission:

"We provide thoughtful financial advice to people who want better lives, making customized recommendations based solely on what`s best for our clients."

So for us and for our clients the Fiduciary Rule is nothing new. Our clients` best interests always come first and always will! In the meantime, we will keep you posted on the fate of the Fiduciary Rule.

The highest level of *service* and *respect*

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