THIRD QUARTER
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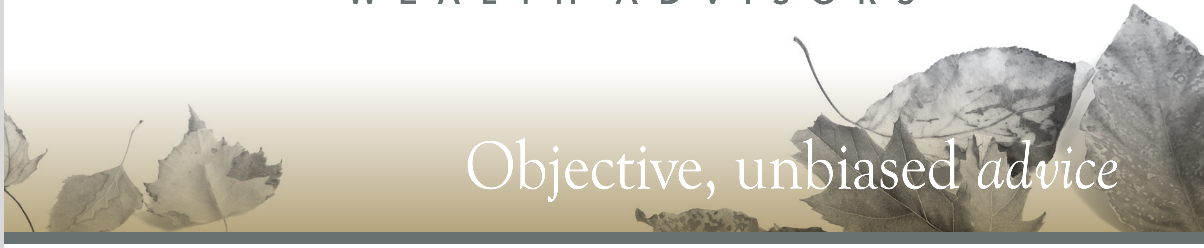
DEIGHAN
WEALTH ADVISORS



"Autumn asks that we prepare for the future — that we be wise in the ways of garnering and keeping. But it also asks that we learn to let go..."
– Bonaro W. Overstreet

MARKET COMMENTARY

For all of its vibrant color, autumn is a sober season. We might love it for its beauty, but we respect it for its brevity and for the change it portends. Autumn asks much of us. It is distinctly unlike the heady spring and summer seasons, which dare us to dream. Rather, autumn compels us to choose between that which we'd like to accomplish with that which we can actually accomplish. It's a season that forces us to be pragmatic, to prioritize our time and our goals before the snow flies. In short, autumn is a time to reconcile our wants with our needs.

Thus, if ever there were a season made for portfolio managers, it would be autumn. Investment management and financial planning are all about preparing for the future and juggling competing objectives. Think back to the last time you came in for a portfolio review, and you'll likely recall us discussing the difference between needs and wants. A need is something you can't live without, whereas a want is a luxury you'd like to have if possible.

For example, you might want to travel the world throughout your retirement years. But, at the same time, you need your money to last. These two competing objectives must be reconciled, if you're to have a retirement that's both enjoyable and lengthy.

In terms of asset management, an example of a process that reconciles competing needs and wants is rebalancing. What is rebalancing? Well, there's a general misconception that rebalancing is the act of trimming your winners and reinvesting in your losers. This is a somewhat crude assessment, because no one intentionally selects "loser" investments.

Rather, rebalancing is a way to sell high and buy low. It's a way to discipline yourself to lock in gains and maintain a target risk profile. When you rebalance, you sell your overweight investments, which are often overweight because they increased in value. You then put the proceeds into your underweight investments, which might be underweight because they decreased in value, but might also be underweight because they simply didn't grow as much.

Rebalancing is inherently uncomfortable for many investors. They think, why would I want to sell something that's doing well and reinvest the proceeds into something that's doing not so well? Such investors want to remain in investments that are performing the best right now.

The problem with this is that all investments are volatile. This means investment prices fluctuate over time and often without warning. Just because an investment is up today doesn't mean it will be up tomorrow. It does an investor no good to ride a stock's price upward just to ride it back down again.

And so investors need to rebalance periodically. They need to trim their winners. An investor might not want to rebalance, but he needs to rebalance. The need to rebalance isn't just about trimming winners and locking-in gains, however. The true purpose of rebalancing is to maintain a consistent risk allocation over time. Each investor has a certain level of investment risk that they're willing and able to take. This risk level is tied directly into their financial goals and investment time horizon.

Let's compare Jane and Bob. Jane is in her mid-30's and has a large appetite for risk. She's gainfully employed and is able to save a significant portion of her paycheck each month. She doesn't plan to retire for another 30 years. In this case, Jane has both the ability and willingness to take on significant investment risk. Her portfolio might be anywhere from 80% to 100% invested in stocks, with very little invested in bonds.

Bob, by contrast, is 67. He retired a couple years ago and lives off the combination of his retirement assets and his modest social security benefits. Bob doesn't particularly like taking risks, but he'll take risk as warranted. In this case, Bob's ability and willingness to take investment risk could be described as limited-to-moderate. He's likely to have just 40% to 60% of his portfolio invested in stocks, with the remainder invested in lower-risk investments like bonds.

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Now, what if Bob were to never rebalance his investment portfolio? At the outset, let's assume Bob has a portfolio that's allocated 60% to stocks and 40% to bonds. Further assume that stocks return 10% per year and bonds return 5% per year. In this scenario, after 10 years, Bob's investment allocation would be 70% stocks and 30% bonds. After 20 years, it would be 80% stocks and 20% bonds. This means that, at the age of 87, Bob would have an asset allocation on par with someone like Jane, a risk-taker in her 30's!

Bob clearly needs to rebalance, in order to keep his asset allocation near the 60/40 mix that's appropriate for his situation. Otherwise, he runs the risk of being overexposed to risky investments, which could significantly hurt his nest egg should stocks enter into a downturn.

Rebalancing is a bit like going to the dentist to get your teeth cleaned. You don't need to do it all the time (and you don't want to do it all the time), but you should do it at least once or twice per year. Our policy is to rebalance client portfolios every six months if needed. We'll also rebalance when clients have a change in circumstance, such as large cash inflows or outflows.

Just recently, we rebalanced client portfolios across the board. Despite all of the negative headlines, from health care, to North Korea, to natural disasters, equities have continued to march steadily upward. While this has been welcome, it's thrown asset allocations out of whack. Year-to-date, the S&P 500 Index has returned nearly 16%, and other major equity indices have performed similarly. The MSCI Europe Australasia Far East (EAFE) Index, for example, is up over 20% on the year. Therefore, we deemed it prudent to trim stock holdings, bank gains, and reinvest proceeds into less expensive asset classes.

The result, aside from locking-in gains, has been a modest reduction in risk. Although there's a part of us that would like to keep equity allocations elevated in an attempt to eke out every little gain, the current market cycle is getting quite long in the tooth. The average postwar business cycle expansion has lasted 58.4 months, whereas we're 99 months into the current expansion. Thinking back to Overstreet's quote at the start of this Commentary, we "...must be wise in the ways of garnering and keeping."

That's not to say we expect a recession anytime soon. Inflation remains contained and corporate earnings have been solid. But all business cycles do eventually end. If we were expecting a recession, then we'd consider pulling equity allocations down below target to protect clients from declining equity prices. As it stands, however, we've simply pulled equity allocations back to target. In short, we've returned to a neutral allocation while the economic cycle continues to mature.

Looking forward, it's difficult to know what to expect. Geopolitical risks abound, and American society appears more vulnerable and divided than it has in a long time. Financial markets have thus far done a good job shrugging off such worries, but the risk of a black swan event is probably higher than normal.

Last month, the Trump administration revealed an outline of its tax plan, which was met with mixed reviews. It remains to be seen whether tax reform will get passed, and to what degree. But there can be little doubt that equity markets have priced in some level of tax reform already. Indeed, the promise of lower corporate tax rates has helped drive strong equity returns since Trump's election win. So there's some risk that stock prices could fall, should tax reform stall similar to health care.

We must also be conscious of interest rate policy. The Federal Reserve has signaled that it intends to embark on "quantitative tightening" after nearly a decade of quantitative easing. This is Fed lingo for "interest rates are going up." When interest rates go up, borrowing costs rise for businesses and consumers, which has a cooling effect on the economy. Given that economic growth has remained below trend for much of the current expansion, the Fed will need to tread lightly so as not to cool the economy too much, too soon.

As always, our job is to weigh these various factors to position client portfolios for a variety of potential outcomes. Our decision to rebalance and take some money off the table reflects our recognition that the future, while uncertain, is certain to be eventful. After years of relatively stable markets, we would remind clients that investing involves risk. We wouldn't be surprised if a confluence of events were to lead to increased volatility in the coming months and years.

Our advice is to remain confident in what is still a strong economy, yet be watchful for cracks around the edges. Every year, we know generally that autumn will transition into winter, but we never know exactly when that switch will get flipped. Some years it's early November, while other years it's late December. Likewise, we don't know exactly when this market cycle will peak, but we do know it's maturing. Therefore, we must be sober and pragmatic. We must prioritize our goals and reconcile our wants with our needs, as we protect what we've earned against an uncertain future.

We extend our sincere gratitude to our friend and colleague, Matthew T. Skaves, for so thoughtfully articulating our Market Commentary this quarter.

Thank you, Matt!

– Deighan Wealth Advisors

PORTFOLIO CHANGES

ADDED: Chubb Ltd. (CB)

REMOVED: Guggenheim S&P 500 Equal Weight Financial ETF (RYF)

Chubb Corp. (CB) was acquired by ACE Ltd. In January of 2016 to form Chubb Ltd, a specialty insurer that provides commercial insurance and reinsurance coverage. We appreciate the high quality and diversity of CB's product line, which includes coverage for fine art, wine, cyber threats, and a wide range of other specialty insurance. Exposure to property and casualty losses resulting from recent weather-related events has driven the share prices of most insurers down. This represented an opportunity to purchase CB's quality shares at a discount to their intrinsic value, and to better diversify financial sector holdings for clients that hold individual equities in their portfolios. Shares of RYF, purchased as a placeholder for the financial sector while we searched for an attractive replacement, were sold.

ADDED: Honeywell International Inc. (HON)

REMOVED: General Electric Co. (GE)

GE has been in the process of restructuring its business for several years and has consistently underperformed the market and its industrial sector peers, leading to our decision to replace the shares with Honeywell International Inc. Adding to its restructuring struggles, GE has seen ongoing weakness in its oil and gas operations with no clear sign of a positive catalyst for change under new CEO John Flannery. We think that Honeywell's earnings and dividend growth trajectory is far more attractive than GE's and are particularly encouraged by the prospects for HON's Automation and Control Solutions segment, which is a leading global producer of environmental and combustion controls, HVAC, scanners (including bar code and RFID scanners), and building controls and information systems.

COLLEAGUE CORNER

Qualifying Charitable IRA Distributions

Thank you to Michele Depew, CPA, of Tate-Fitch, PA for providing this article. We enjoy working with our colleagues to provide relevant and timely topics for discussion. If this piques your interest, we are happy to further the conversation with more details and guidance!

If you are age 70 ½ or older, then you are required to take annual IRA distributions that are taxable to you at ordinary income tax rates. Here we talk about how IRA distributions can be made directly to a qualified charitable organization thereby reducing your taxable income, and ultimately the income tax owed.

The deduction for charitable giving has been part of the tax code since the early 1900s. Over the past few years, proposals at the federal level have sought to either cap or eliminate the deduction. The State of Maine has already made changes that in some cases either do away with or reduce the tax benefit of charitable giving. One way to preserve the tax benefit amid these proposed and enacted changes is to use a qualifying charitable IRA distribution (QCD).

QCDs have been a part of the tax code for several years. The provision was initially temporary, but was made a permanent part of the code in 2015. There are several requirements:

1. the distribution must come from an IRA;
2. it must be transferred directly from the IRA custodian to the charity;
3. the IRA owner must be at least 70 ½ years old; and
4. the contribution must be made to a qualifying charitable organization.

If all of these requirements are met, the IRA distribution is excluded from gross income, which provides a tax benefit for taxpayers with modest to high incomes. It can also be used to satisfy the annual required minimum distribution (RMD) of an IRA. Following are examples of the impact that structuring your gifting as a QCD can have:

Example 1: Joe and Mary have $600 of interest income, $42,000 of qualified dividend income, and $42,000 of social security benefits. They have an IRA with a required minimum distribution of $10,000. Let's assume that they have chosen a relatively simple life and have few itemized deductions such as mortgage interest and real estate taxes, and they wish to make a $10,000 charitable gift. If they use a QCD for the $10,000 gift, then the IRA distribution is entirely excluded from their income, and their income tax would be $500.

Example 2: Now, let's say that Joe and Mary were not aware of the QCD provision. Their total income tax would be $4,150. Why is the increase in tax so much given that the charity received the same amount of money?

Below is a summary:

	Example 1 (QCD)	Example 2 (Regular Donation)
Interest	$ 600	$ 600
Dividends	42,000	42,000
Taxable Social Security	22,660	34,263
Taxable IRA Distribution	0	13,650
Total Income	65,260	90,513
Standard Deduction	(15,200)	(15,200)
Personal Exemptions	(8,100)	(8,100)
Taxable Income	41,960	67,213
Tax Due	$ 500	$ 4,150

A number of factors increased the tax due. First, in Example 1, the $10,000 IRA distribution is completely excluded from the computation of taxable income. In Example 2, you'll notice that the IRA distribution is $13,650 rather than $10,000 because Joe and Mary chose to increase the distribution amount in order to pay the taxes owed on it, creating even more taxable income.

Second, the amount of taxable social security benefits increased. Since a QCD is not used in Example 2, the IRA distribution is included in taxable income. This increases taxable social security benefits since up to 85% of social security benefits may be taxable depending on other taxable income. As taxable income increases, more and more of the social security benefits become taxable until a taxpayer has reached the maximum of 85%. In Example 2, Joe and Mary had $11,603 more of their social security benefits taxed because of the increased income from the IRA distribution.

Finally, in Example 2, the $10,000 charitable donation does not result in any tax savings because Joe and Mary used the standard deduction instead of itemizing. The tax code allows taxpayers to take either a standard or an itemized deduction, but not both. The standard deduction is a set amount that every taxpayer can subtract when computing taxable income. Itemized deductions include charitable donations, mortgage interest, real estate taxes, state income taxes, medical expenses to a certain extent, and several others. Normally taxpayers only itemize deductions when the total is higher than the standard deduction. Since Joe and Mary have no other itemized deductions the $10,000 charitable donation does not exceed the 2017 standard deduction amount of $15,200. They will use the standard deduction and not get any tax benefit from the $10,000 donation.

Though the savings may differ, higher income earners can also benefit from a QCD. The following examples illustrate Alice and Pat earning $10,000 of interest income, $90,000 of qualified dividend income, $50,000 of other ordinary income, and $42,000 of social security benefits. They have an IRA with a required minimum distribution of $50,000 and wish to make a $50,000 charitable donation. Again, the assumption is that they have few itemized deductions.

	Example 3 (QCD)	Example 4 (Regular Donation)
Interest	$ 10,000	$ 10,000
Dividends	90,000	90,000
Taxable Social Security	35,700	35,700
Other Ordinary Income	50,000	50,000
Taxable IRA Distribution	0	57,500
Total Income	185,700	243,200
Standard Deduction	(15,200)	0
Itemized Deduction	0	(62,331)
Personal Exemptions	(8,100)	(8,100)
Taxable Income	162,400	172,769
Tax Due	30,500	38,000

In this case, the tax savings created by using the QCD is $7,500. In Example 4, the IRA distribution was increased to $57,500 in order to provide the funds to pay for the taxes due. Unlike Joe and Mary in Example 2, Alice and Pat did not see an increase in the amount of taxable social security benefits. This is because they were already at the 85% limit given their other income. Alice and Pat will receive a benefit from their $50,000 charitable contribution because the contribution alone puts them over the standard deduction amount. The itemized deduction total of $62,331 includes the $50,000 charitable deduction and the state income tax due of $12,331.

For comparison, let's go back to Example 2 (average income) and compare it to Example 4 (high income). In Example 2, Joe and Mary chose to increase their IRA distribution by 36.5% to cover the taxes owed on it. In Example 4, Alice and Pat only needed to increase their IRA distribution by 15% to cover the taxes. This illustrates that not only is the QCD beneficial for high income earners, but greater savings are also enjoyed by average income earners. It should be noted that it is not a requirement to increase the IRA withdrawal to cover the taxes owed on it, but it is a fairly common practice.

For those who qualify, using a QCD from an IRA is a good option for charitable giving. It is one way to support charities and continue to enjoy a tax benefit despite any legislative changes to itemized/charitable deductions at both the federal and state levels.

Note: Why is the tax due in Example 1 so much lower relative to income than Example 2? Good question. This has to do with the character of the income and the different rates for each. In example 1, the $500 of tax is actually all state tax. The federal tax is $0 because Joe and Mary qualify for the 0% tax rate on their qualified dividends/capital gains. In Example 2, the same $42,000 of dividends qualify for the 0% rate however the remainder of the taxable income is taxed at ordinary rates. So, in Example 2 not only are we increasing taxable income but we are increasing it with income that is taxed at a higher rate than in Example 1.

DEIGHAN
WEALTH ADVISORS

TELEPHONE 207-990-1117

www.deighan.com

DEIGHAN WEALTH ADVISORS
455 HARLOW STREET
BANGOR, ME 04401

JEAN M. DEIGHAN, JD, CFP®
CHIEF EXECUTIVE OFFICER
jeandeighan@deighan.com

JENIFER L. BUTLER, CFA, CFP®
PRESIDENT
CHIEF INVESTMENT OFFICER
jeniferwilson@deighan.com

LUCIE E. ESTABROOK, CTFA
VICE PRESIDENT
CHIEF OPERATING OFFICER
lucieestabrook@deighan.com

TYLER D. HOXIE
PORTFOLIO ADMINISTRATOR
ASSOCIATE ANALYST
tylerhoxie@deighan.com

KAREN S. MITCHELL, CAP
OFFICE MANAGER
karenmitchell@deighan.com