CEDAR HILL
WEALTH MANAGEMENT

A VIEW FROM THE HILL™

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Tax-Efficient Investing: It's What You Keep – Not What You Make – That Matters

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We discuss our approach to mitigating tax liabilities and maximizing total after-tax returns.

What is tax-efficient investing?

As part of our investment strategy, we attempt to proactively limit the amount of taxes our clients pay each year, without jeopardizing total return potential or increasing risk. Maintaining low turnover, harvesting tax losses and selecting asset location are just a few of the strategies we employ to help reduce the tax bite.

Our strategies largely generate long-term capital gains, which are typically taxed at a preferential rate (23.9% for upper-income earners). Short-term capital gains are taxed at the client's current income tax rate, which could be 45% or higher, when including federal and state taxes. Hence, an equity strategy with high turnover may need to generate a 40% greater return to produce the same after-tax return for taxable investors!

We also work closely with our clients' accountants and estate planners to ensure we are invested appropriately, taking advantage of carried-forward losses and maximizing the value of a client's estate plan.

Do tax-efficient investment strategies increase risk?

We do not believe we are increasing risk by attempting to maximize after-tax returns. Take fixed income securities as an example: Municipal bonds — which generate tax-free income — typically have lower default rates than taxable investment grade corporate bonds. Additionally, equity market risk is neither increased nor decreased by a strategy's tax efficiency.

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How do taxable and tax-advantaged accounts factor into investment decisions?

Tax-advantaged accounts — including IRAs, Roth IRAs and other retirement plans — play an important role in our investment process. We prefer to hold the most tax-inefficient strategies in retirement accounts to shelter the investments from taxes. On the other hand, fully taxable personal or trust accounts hold more tax-efficient strategies. If we identify an attractive strategy that generates significant current income, we review the opportunity for an individual's tax-exempt or tax-deferred accounts first, and are very selective when using the strategy in fully taxable personal accounts.

What is tax-loss harvesting?

We periodically sell underperforming investments to generate losses, which help offset realized capital gains from investments that have performed well. This strategy is called tax-loss harvesting. Whether we are investing in individual stocks and bonds or exchange traded funds (ETFs), the sold investments are often replaced with near-equivalent securities that should not reduce upside potential, while also helping our clients lower their overall tax bills. We look for these losses throughout the year to maximize after-tax results.

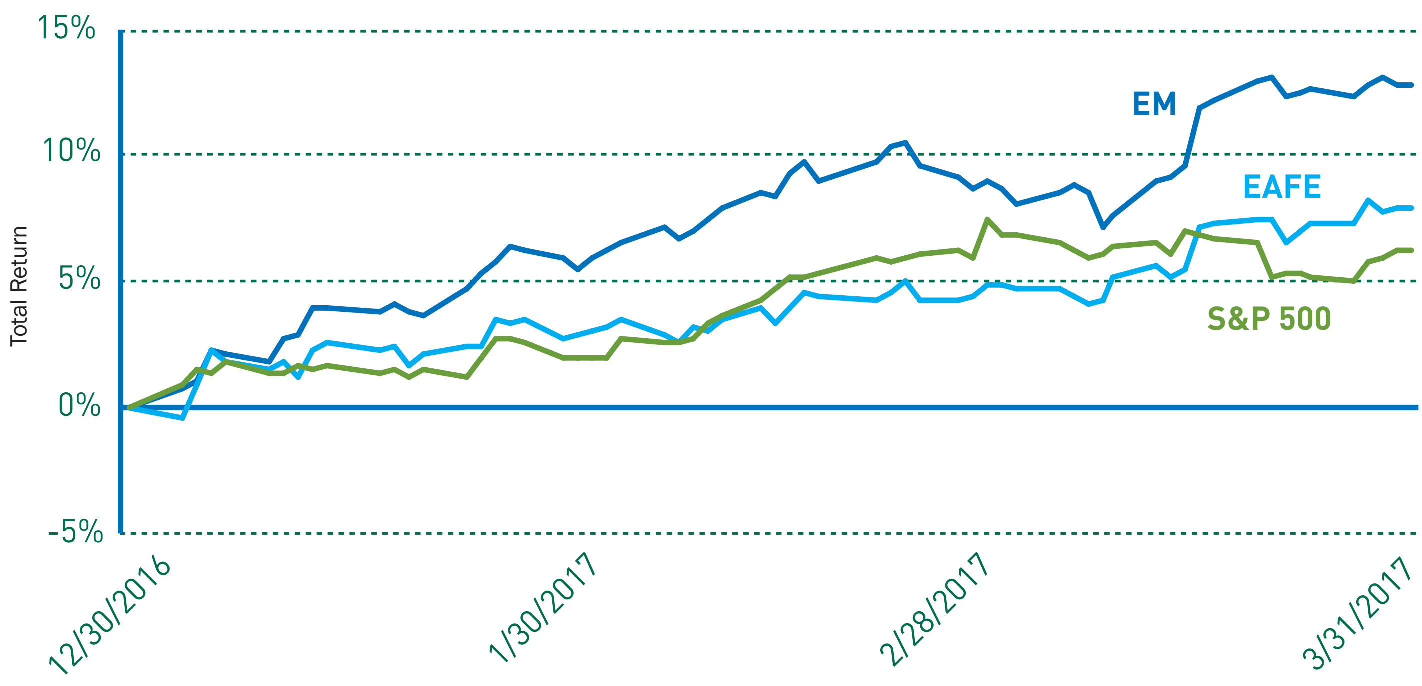
Final thoughts

While taxes don't dictate our investment decisions, we are able to maximize after-tax returns for our investors by integrating tax strategies into our broader investment process.

Market Outlook

Global equities began 2017 in encouraging fashion, as each of the major indices posted mid-single-digit returns or better for the first quarter. Domestic stocks extended their post-election rally, with the S&P 500 Index climbing an additional 6.3% in the first quarter. Overseas equity returns proved even more robust: The international developed market index (MSCI EAFE) posted a first-quarter gain of 7.2% and the emerging market index (MSCI EM) increased 11.4%.

YTD Equity Market Returns

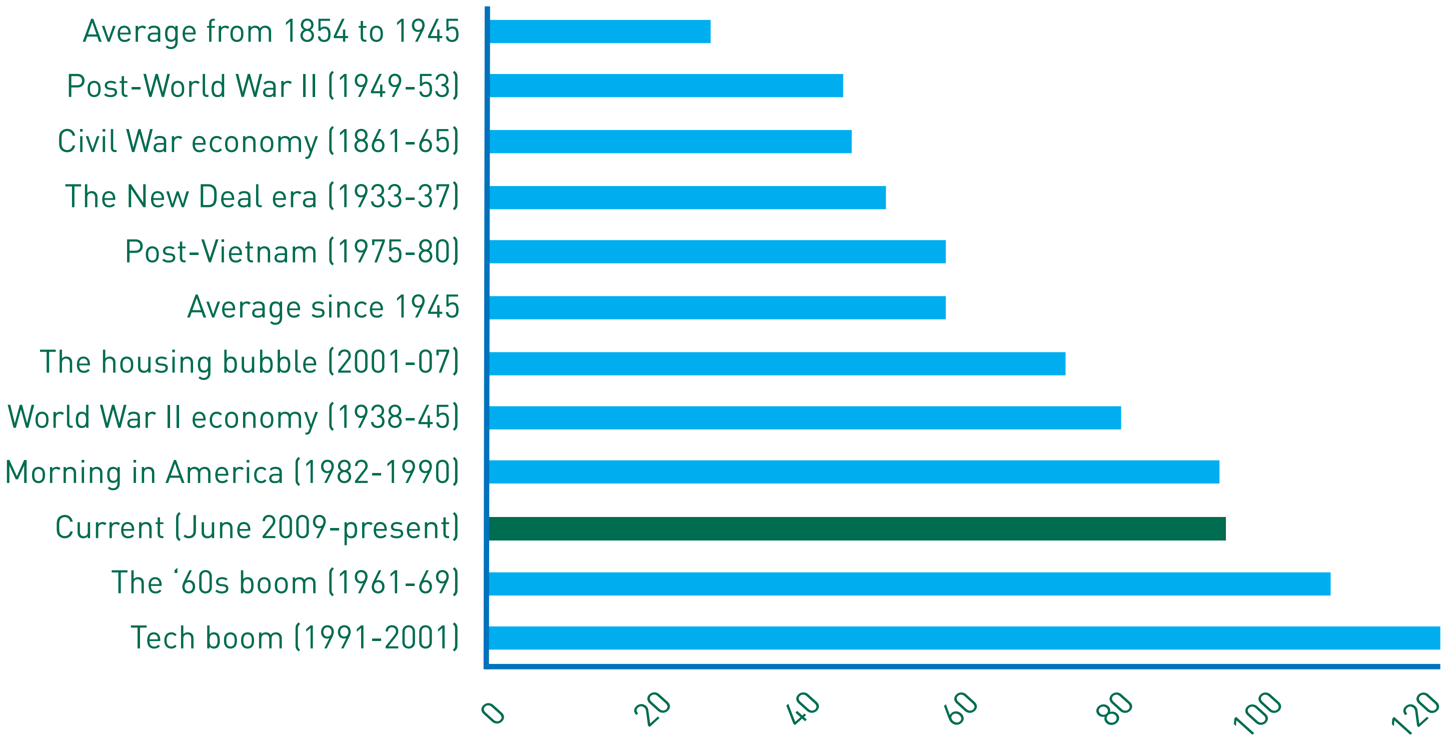


Source: Bloomberg

Several factors have lifted the equity markets, but the most important has been broad-based global economic expansion. Latin America's largest economies (Brazil and Argentina) are recovering. All European economies are poised to grow this year for the first time in a decade, and gross domestic product (GDP) growth in China and India remains above 6.5%. On the domestic front, the U.S. economy marked its 93rd month of expansion in March — surpassing the 92-month expansion of the 1980s — making this the third-longest economic recovery in U.S. history.

Longest Economic Expansions in U.S. History

(# of months)



Source: National Bureau of Economic Research, Wall Street Journal

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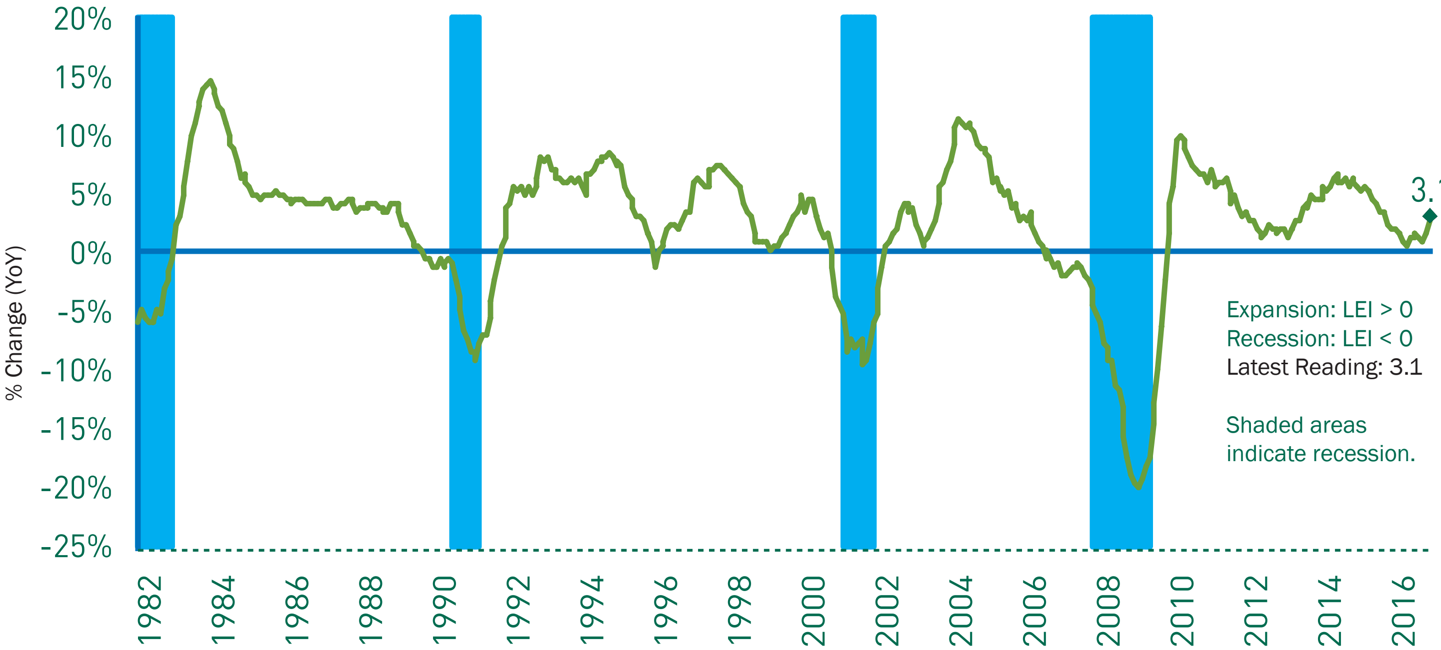
In our view, one of the best measures of the economy's health is the Conference Board Leading Economic Index (LEI). The U.S. LEI looks at 10 diverse economic indicators that have historically provided early warnings of recession and the start of equity bear markets. When year-over-year (YoY) growth in the LEI turns negative, a recession typically follows within the next 14 months. The latest LEI reading accelerated to 3.1% YoY growth, signaling that a recession occurring in 2017 would be unlikely.

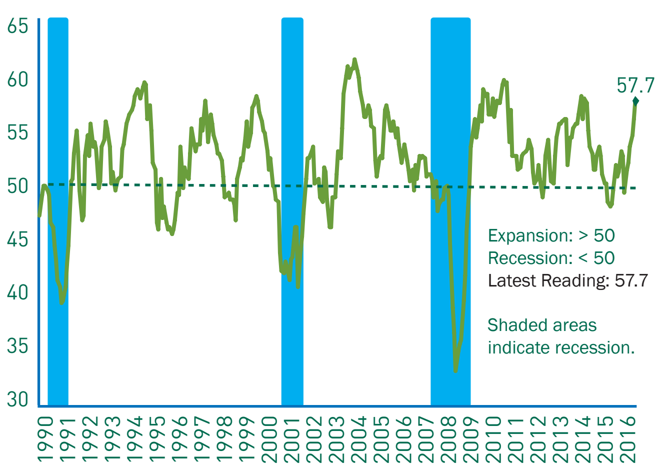
U.S. Leading Economic Index (LEI)



Source: Bloomberg

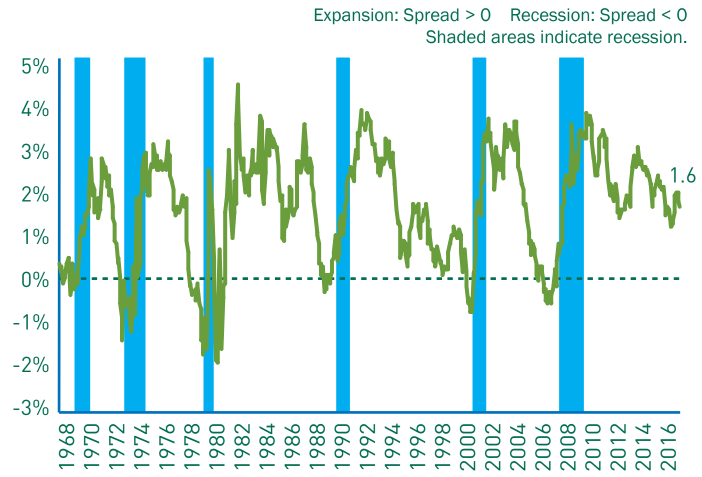
We also follow the ISM Manufacturing Index (which typically falls below 50 prior to a recession) and the spread between 10-year and 3-month U.S. Treasuries (which typically turns negative ahead of a recession). At present, both readings remain well above their recession danger-zone levels, reinforcing our belief that the economy is likely to remain in an expansionary mode for the next several quarters.

ISM Manufacturing Index



Source: Bloomberg

U.S. Treasury Spread: 10-Year Minus 3-Month



Source: Bloomberg

Economic stability in the U.S. provides a supportive foundation for continued expansion of corporate earnings. During the fourth quarter of 2016, S&P 500 earnings growth increased 6.4%, beating expectations — and analysts are forecasting 10% earnings growth for full-year 2017. While we believe mid- to high-single-digit growth is more likely for the year, approval of potential pro-growth policies coming out of Washington by late 2017, such as tax reform, infrastructure spending, and deregulation, could drive similar earnings expansion in 2018.

Given this encouraging economic and earnings backdrop, we maintain our constructive outlook for equities. We are not, however, complacent about the prevailing risks as U.S. equity valuations are elevated on the back of broadly positive investor sentiment. The S&P 500 closed the quarter at a forward price-to-earnings (P/E) multiple of 18.3x, compared to a historical 30-year median of 16.3x. A string of unanticipated economic disappointments or poor earnings announcements could trigger a quick reversal of this positive disposition.

Investors could also become more cynical about the prospects for pro-growth legislation if the typical dysfunction in Washington postpones or threatens the ratification of these initiatives — as demonstrated by the Republicans' failed health care bill. Additionally, the risk of a monetary policy mistake could escalate now that the Federal Reserve (Fed) has adopted a more hawkish position on inflation with its forecast for multiple interest rate hikes this year. Finally, North Korea's incessant saber rattling via nuclear tests could have unsettling geopolitical effects on the markets.

Given this encouraging economic and earnings backdrop, we maintain our constructive outlook for equities.

While each of these looming concerns warrant continued attention, we still believe risks for equities are skewed to the upside. With the positive momentum in economic data, the U.S. could be on the cusp of a new growth paradigm. Underlying fundamentals are the strongest they've been for some time and show no signs of cracking. Even if sentiment declines due to waning political optimism, we expect economic growth to remain on track and supportive of valuations. A short-term pullback or correction would not be unexpected at this point in the market cycle, but we believe stocks will continue to outperform bonds and cash over the next year.

Investment Overview

Core Portfolio

During the quarter, we established a new position in Mylan.

Mylan is a global generic and specialty pharmaceuticals firm. Its generic business is the largest in North America, and third-largest in the world. Mylan's specialty pharma segment — which focuses on the development, manufacturing and marketing of branded prescription drug products — is best known for producing EpiPen.

During 2016, Mylan came under intense criticism for its EpiPen price increases. Ultimately, management chose to launch its own generic version of the branded product at half the price. EpiPen headlines grabbed the lion's share of investor focus and put significant pressure on Mylan's stock price. We viewed the selloff as an opportune time to purchase shares of a high-quality pharmaceutical firm trading at an attractive valuation. We believe the EpiPen concerns will prove overblown, though they will likely be a modest drag on near-term growth. With Mylan deriving 80% of operating profit from products other than EpiPen, the company's strong generic franchise should continue to drive sustainable earnings growth. More significant growth is possible if the company succeeds in its plans to launch generic alternatives for blockbuster branded drugs Advair and Copaxone.

We exited our holdings in Whiting Petroleum and Quanta Services during the first quarter.

Whiting is an independent producer of oil and natural gas. We continue to believe energy prices will move higher over the intermediate to long term, which should benefit petroleum exploration and production companies. Whiting's highly-leveraged balance sheet, however, makes the company more susceptible to short-term price swings, which could threaten its viability. As a result, we decided to exit our position in the firm and concentrate our energy exposure in higher-quality portfolio holdings, such as EOG and Apache, coupled with our more diversified investment in the Oil & Gas Exploration SPDR Fund.

Quanta Services is a leading energy infrastructure solutions provider. It designs, constructs and repairs transmission and distribution assets for the electric power industry, in addition to large diameter pipelines for the natural gas industry. The company has benefitted from investments to upgrade the electrical grid in the U.S. It has also capitalized on the expansion of natural gas pipelines into new production markets (such as shale basins) and underpenetrated gas delivery markets (such as the Northeast).

While we believe both businesses will continue to generate attractive growth in the coming years, we concluded Quanta's valuation got ahead of itself, thanks to speculation about the new administration's lofty infrastructure spending proposals. We were concerned that investors had become overly optimistic about prospects for additional spending measures and could ultimately be disappointed. We liquidated our position in the company and redeployed the capital into more attractively valued opportunities.

Equity Income

Income-producing equity investments, such as mortgage Real Estate Investment Trusts (mREITs) and Master Limited Partnerships (MLPs), reported another quarter of positive gains.

Despite the much-anticipated Fed interest rate increase in March, mREITs delivered an impressive 10.8% total return during the quarter. While volatile spikes in interest rates are detrimental for the sector, mREITs can post solid returns in a gradual and well-telegraphed rising rate environment, which is expected over the near term.

MLPs posted a total return of 4.0% for the first quarter. Though less robust than other equity benchmarks, MLP performance was rather impressive given several headwinds facing the sector in the quarter, including a pullback in oil prices, a wave of equity raises to shore up balance sheets and/or fund growth projects, and rising interest rates. Going forward, we believe MLPs should benefit from increased transportation volumes as U.S. government policies are promoting energy independence and U.S. energy producers are expanding capital spending and production relative to last year's depressed levels.

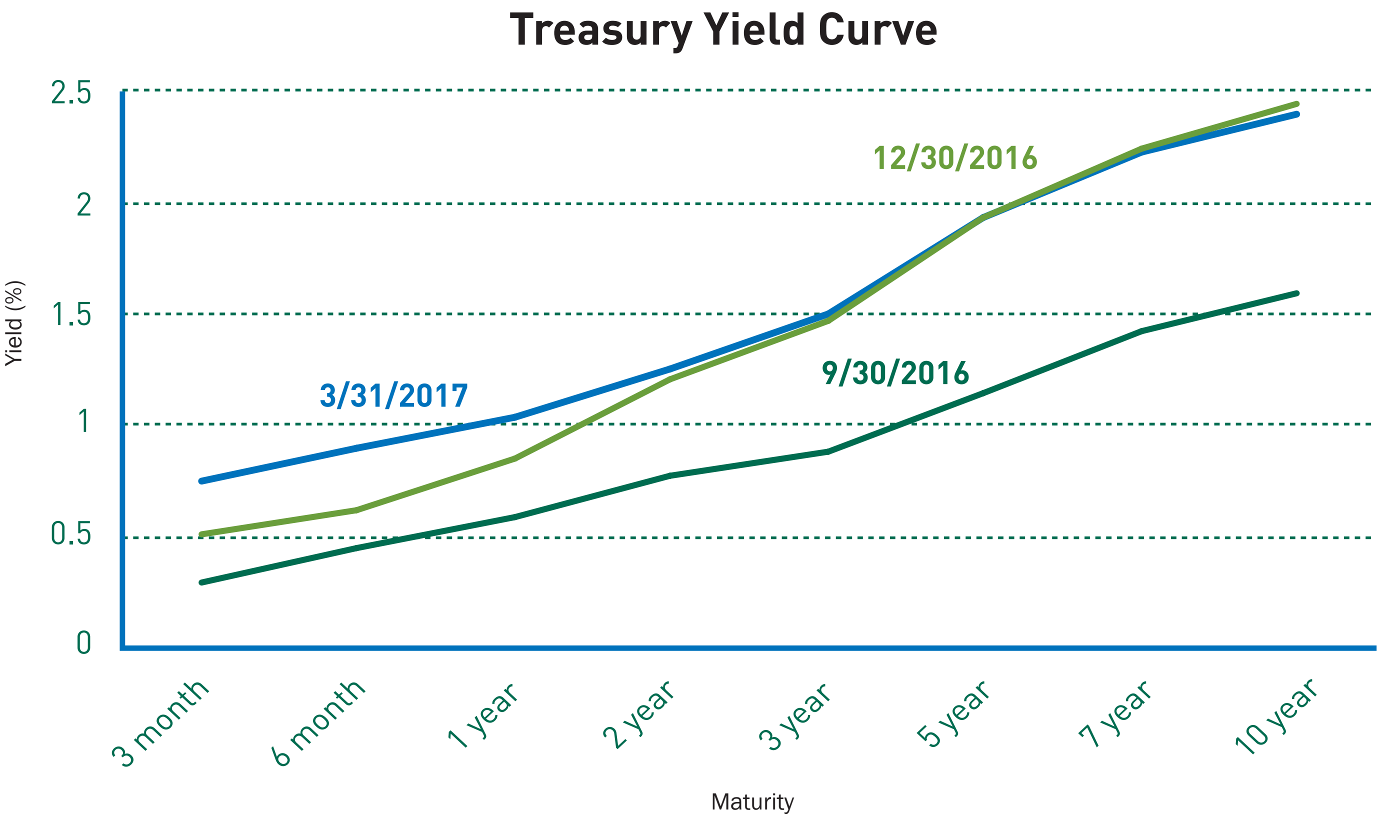
Corporate bonds benefitted from tightening credit spreads as investors were unconcerned about a recession-driven increase in bankruptcies.

Fixed Income

The yield curve flattened during first quarter.

Yields on lower-risk short-term Treasury notes jumped higher in anticipation of the 0.25% Fed rate hike in March, while yields on 10-year and longer-maturity bonds declined slightly. Ending the quarter at 2.4%, the yield on the benchmark 10-year Treasury note is back at the lower end of the 2.3% to 2.6% range it has been stuck in since late November. We believe stabilization in the 10-year Treasury note reflects the bond market's expectation for steady, albeit slow, economic growth, coupled with a benign inflation outlook and a more clearly communicated rate-hike narrative from the Fed.

Corporate and municipal bonds also posted positive results during the quarter. Corporate bonds benefitted from tightening credit spreads as investors were unconcerned about a recession-driven increase in bankruptcies. Municipal bonds were pressured late last year as investors speculated that a personal income-tax cut could reduce the attractiveness of tax-exempt interest income. Sentiment reversed during the first quarter as adoption of a comprehensive tax reform package doesn't appear to be happening anytime soon.



Source: Bloomberg

Other Cedar Hill News

We are working vigorously on implementing a new investment reporting platform for our clients. We believe the new platform will allow us to better customize our reports to your needs, including creating an online portal for more immediate access to your portfolio. We also plan to open a second office in downtown Chicago during the summer, while keeping our presence in Rosemont. We will update you on these initiatives as we move closer to fruition.

Emergency Contact

As a reminder, our website (www.cedhill.com) has an “Emergency” link under the Contact Us tab. In the event of an interruption to normal business operations at our office, this link will redirect users to a web page that will provide updates and alternative phone numbers for communications with clients and interested parties. In such an event, updates will be provided continually until operations are fully restored to normal.

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