INVESTOR NEWSLETTER Armbruster Capital Management, Inc. 4TH QUARTER 2017

The ACM Journal

Exemplary Conduct

One of my more interesting community activities recently has been as President of the Rochester Rotary Club. We're one of the largest clubs in the world, right here in Rochester. We also own and operate a fully-accessible camp for disabled and disadvantaged kids. In order to keep the camp going, we need to raise a lot of money each year.

One of our primary fund raisers is an evening at the Rochester Philharmonic Orchestra's Holiday Pops concert. It is a lot of fun, and gets you in the holiday spirit. However, this year it was particularly memorable.

I was in a position to appoint a guest conductor for part of the concert. The RPO is famous for their rendition of *Sleigh Ride*, so that is usually where the guest conductor sits in. If you recall the song, there are some notable whip-cracking sounds from the percussion section to mimic the sound of a horse-drawn sleigh.

Too bashful to do the guest conducting myself, I cajoled my oldest son Omar into doing the job. I gave him plenty of notice and told him he should start to become familiar with the song

continued on page 6

IN THIS ISSUE

Index Investing in 2017 3
Alternatives in Focus 4
Portal Launch 4
2018 Tax Facts 5
Compliance Corner 6

Current Thinking

With the exception of Donald Trump and Bitcoin, stock market valuations seem to be making the most headlines these days.

Bubble Territory?

Sure, by some measures the stock market is as expensive as it has ever been, with the exception of 1929 and 1999. I'm sure you know how things turned out then. However, we have written many times that past is not necessarily prologue. Unlike those prior periods, there is not the same speculative excess in the markets today, with the possible exception of Bitcoin.

Indeed, while today's stocks may be highly valued, they are all real companies. Back in the late 1990s, stocks weren't priced on earnings, since they didn't have any, but rather on sales figures. Then, late in the boom, some companies came public without any sales. We had to value them on a "price to clicks" basis, counting the number of hits they received on their web sites. Today's environment is staid by comparison. Even high-flying tech stocks generally have relatively sound financials and solid business plans.

Admittedly, there are a couple similarities to the 1990s. Lately, we've noticed that stocks can score significant run ups just by announcing that they are entering the cybercurrency space. An iced tea maker recently did so, boosting its stock by over 300%. Eastman Kodak did the same. In the two days since it announced the coming launch of KODAKcoin, the stock also increased by over 300%. This is similar to the early days of the internet, when stocks would shoot higher after announcements that the companies would be launching new websites. In fact, I remember when Zapata Corp, a purveyor of fish meal products, announced it was launching a web site and changing its name to Zap.com. The stock soared, despite the fact that its underlying business remained the same. However, the world was forever changed, as you could now buy your fishmeal over the internet. Lookout Amazon.

Today's boomtime environment will naturally have some parallels to earlier times when money was fast and loose, but otherwise, the economic environment appears quite robust. Historically low interest rates, tame inflation, and the prospect of higher corporate earnings have propped up stock returns. From the chart on page 2, you can see that 2017 was a very strong year for stocks, across all sectors. The S&P 500 earned over 20%, besting all but international stocks. Mid-cap and small-cap stocks lagged somewhat, though still with very solid gains.

A Global Expansion

The returns of international and

continued on page 2

CURRENT THINKING *continued from page 1*

emerging market stocks show that the current economic expansion is a global phenomenon. Despite political tensions seemingly everywhere in the world, there is still money to be made in virtually all corners of the globe.

Can the good times continue to roll? Probably. Corporate earnings could continue to grow, particularly as after-tax earnings recently received a boost from the passage of the new tax law. The rollback of Obama-era regulations also will likely lead to stronger earnings, at least in the near term. This could all lead to more capital spending by corporations, which have largely hunkered down the past ten years. Capital spending by one corporation leads to increased profits at another corporation, which could set up a virtuous cycle of increasing profits, economic growth, and stock market gains.

Look Out Below?

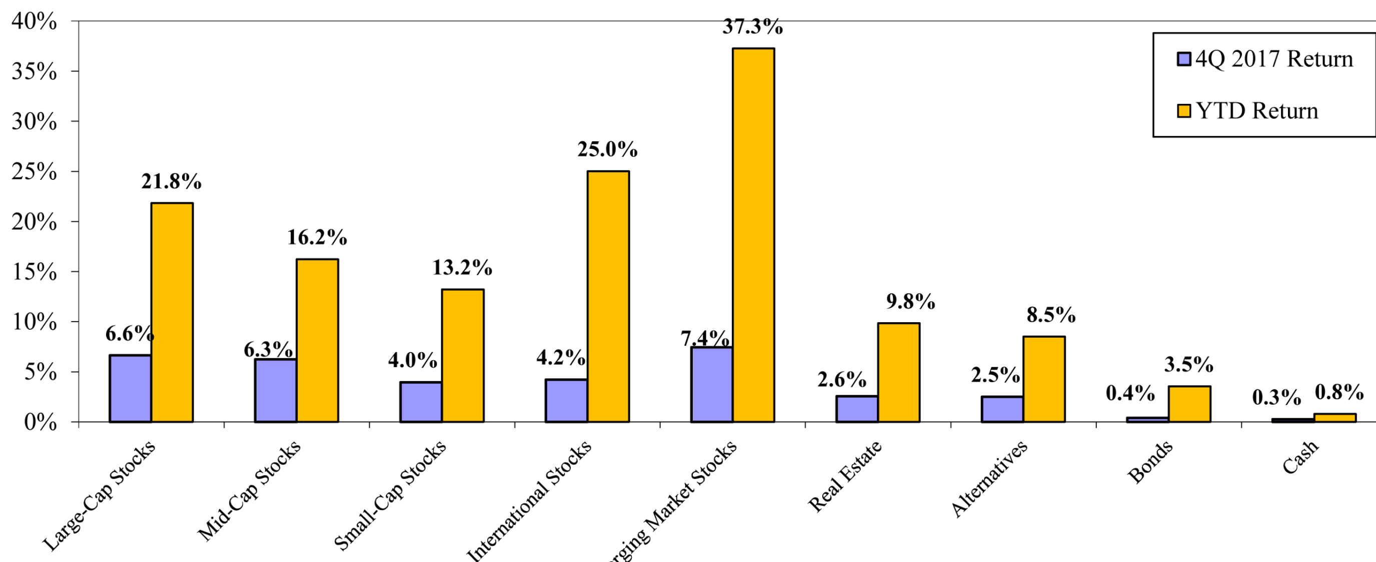
Of course, this can't go on forever. What happens when the music stops is anyone's guess. It largely depends on how the music stops. A gradual rise in interest rates could start to cool the economic engine, and bring us to a soft landing over several years with flat stock market returns. That's probably the best-case scenario. The worst-case scenario would look a lot like 2008. We're not forecasting either of those just yet, but there are always risks.

In fact, while we don't expect to see a major drop in the stock market, there likely will be more volatility in the coming year. That is a pretty easy forecast to make since the stock market has been unusually tranquil of late. Don't be surprised by a 10% to 15% drop in stocks at some point in 2018. This may be driven by higher interest rates, the threat of renewed inflation, the crash of cryptocurrencies, or any number of exogenous events (remember who our leaders are). Still, this type of decline is very normal, not cause for concern, and very healthy for an expanding market. In early 2016, the stock market declined over 11% from prior November highs. Yet, for the full year stocks earned almost 12%.

A periodic decline in stock prices, while not comfortable to endure, is actually positive for many investors. For younger investors who are still saving for retirement, a market correction is an opportunity to buy stocks on sale. For those already retired, a market decline can be a chance to realize tax losses, rebalance the portfolio, and get rid of low-basis legacy stocks that might have been too costly to sell previously.

This may sound overly optimistic, but periodic losses are part of investing. We either need to accept them and make the best of it, or we shouldn't be in the markets. We suspect we won't have to worry about deep losses for at least another couple years, but the threat is always there.

FOURTH QUARTER 2017 ASSET CLASS RETURNS



Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indices. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Alternatives are represented by the HFRI Fund Weighted Composite index. Bonds are the Barclays Aggregate Bond Index. Cash is the yield on the 30-day T-Bill.

Index Investing in 2017

Index investing was much in the news in 2017. An article in the Wall Street Journal in late November noted that U.S. index funds have seen cash inflows of around $1.7 trillion since 2009, compared with outflows of nearly $1 trillion for actively-managed mutual funds. Another article noted that investors had collectively invested $436.5 billion this year into index funds globally through December 20, according to EPFR Global.

Clearly a lot of investors are waking up to index funds, which attempt to mimic the returns and risk profile of a particular market, rather than trying to "beat the market" as actively-managed funds do.

That said, index funds have been derided as unamerican and Marxist. They have been accused of settling for average and overweighting overvalued stocks.

Yet, despite the criticism, index funds have hugely outperformed actively-managed funds in recent years. There is actually evidence dating back almost 100 years that index funds outperform active funds in just about every market environment. However, the past couple years have seen index funds truly dominate. A semiannual study from S&P (see nearby chart) shows the percentage of actively-managed funds that underperform their benchmark index. The news has not been good.

Over a one-year period, most actively-managed funds underperform, but many still beat their benchmarks. However, over time, as their higher fees compound, the vast majority of actively-managed funds trail the market. You can see from the data above that in most asset classes, over 90% of actively-managed funds fail to beat their benchmarks over 15-year holding periods.

Mutual Funds That Trail Benchmark Index

Fund Category	1-Year	3-Year	5-Year	10-Year	15-Year
Large-Cap	56.6%	81.9%	82.4%	85.1%	93.2%
Mid-Cap	60.7%	87.2%	87.2%	95.2%	94.4%
Small-Cap	59.6%	88.7%	93.8%	94.1%	94.4%
Real Estate	43.5%	72.0%	84.7%	85.2%	82.0%
International	77.8%	57.4%	71.9%	79.9%	91.5%
Emerging Markets	75.4%	80.2%	75.3%	87.9%	95.2%
Bonds	57.9%	76.2%	88.9%	83.7%	87.7%
NY Muni Bonds	81.5%	42.9%	55.2%	90.9%	92.3%

Source: Standard & Poor's, data through June 30, 2017

Yet, actively-managed funds charge higher fees, as they claim their superior performance justifies higher costs. In fact, it is these high fees that weigh on returns and make their performance so poor.

Index funds have outperformed for decades, with a fraction of the cost of active management. Still, most investors still utilize actively-managed funds. We have read studies claiming that indexing accounts for 20% of the overall stock market, but others suggest that number is as high as 35%. In either case, indexing is still squarely in the minority.

Critics claim that as indexing grows to be too large a part of the stock market, it could make investing less efficient. We agree, but the level at which that will occur is likely closer to 90% of the market. As long as there are active traders determining the prices of stocks and bonds, index investors can passively reap the rewards of the market in a low-cost, tax-efficient manner.

Interestingly, ultra-low-cost index funds became even cheaper to own and trade during 2017. Expense ratios for index funds and indexed exchange-traded funds (ETFs) offered by Vanguard, Charles Schwab, Fidelity, and others all fell during the year. While the average cost to hold an actively-managed mutual fund is around 1.0%, it is possible to own an index fund that invests in the entire U.S. stock market for 0.03%.

However, not all index funds are created equal. While it is possible to buy a fund that tracks the market for an annual cost of 0.03%, other S&P 500 index funds have expense ratios ten times as high, and some even charge up front sales loads of 5.75%. Also, most large index funds and ETFs are very tax efficient, but not always. The S&P 500 fund index fund offered by PNC Bank paid a capital gains distribution of over 20% last year. Many investors will have to pay tax on that gain, even if they don't sell their shares. By comparison, Vanguard paid no capital gains distributions on its S&P 500 fund. We don't want to be overly dramatic, but an index fund paying out a 20% capital gain should be punished by a long, slow, horrible death.

Trading commissions also declined during 2017. Our primary custodians, TD Ameritrade and Charles Schwab both reduced commissions on stock and ETF trades. However, many of the ETFs we use trade without any commission at all. This makes it all the more cost effective to use index strategies. And, remember, what you don't pay out to financial intermediaries stays in your account to grow and compound over time.

Alternatives in Focus

While 2017 was a great year for stocks, it was mediocre for alternative investments. The benchmark index we often look at, the HFRI Fund-Weighted Composite Index, earned 8.5% last year. While that isn't too bad, our alternative investments did not produce returns in that range.

Depending on the allocation within your alternative investment portfolio, your returns were likely between 1.5% and 7.5%. The performance gap between our alternative funds versus the HFRI index is mostly because of the way we invest. Our funds have very little exposure to the stock market. In fact, the correlation of returns between our funds and the S&P 500 is close to zero. The correlation of the HFRI index with the S&P 500 is close to 75%.

While this hurts our returns in a bull market, we believe it is a positive attribute over time. Alternative investments are much more expensive than stocks. So, it doesn't make sense to pay high fees for something that largely tracks the stock market. Also, tracking the stock market reduces diversification. We own alternative investment funds because they are different from stocks and bonds. We want them to behave differently to reduce risk in the overall portfolio, and hopefully lead to higher long-term returns.

We have some funds that performed very well last year, and others that were quite poor. That is the nature of our alternative portfolio. Because the funds all have low correlation of returns with each other, there will always be some funds that do well and others that stink. That doesn't mean we sell the stinkers. Today's losers are often tomorrow's winners. All investments go through cycles. Unfortunately, those cycles are largely unpredictable, so we find investments we are comfortable with for the long haul, and hold them through thick and thin. Over time we expect to get returns that are a bit higher than the bond market and a bit lower than the stock market, reflecting the risk we take on with alternative investments.

On the plus side, our private real estate funds and the funds using futures and options all performed quite well, earning double-digit returns. The multi-strategy fund and the alternative lending fund performed decently, earning low-to-mid single digit returns. On the negative side, managed futures and reinsurance both lost money in 2017.

We wrote earlier in 2017 about the reinsurance fund and the year of record insured losses for the reinsurance industry. That led to a loss of 11.2% in the fund we use. Our preferred managed futures fund lost 1.0%, but has had a string of bad years lately. That said, both of these funds have experienced very positive upcycles in the past, and we have every reason to believe they will be contributors to gains in future years.

The goal with our alternative portfolio is to smooth out volatility and to earn returns in excess of the bond market. Both of those objectives have been accomplished over the past 5-7 years, even if returns have been a bit below what we would like. We expect alternatives to really earn their stripes in the next volatile stock market phase.

Portal Launch

With the new technology we implemented last year, we have been able to offer clients a portal to log into their accounts to run various detailed reports on their portfolios. We believe this has been a great success.

Previously, detailed performance reporting was only available during meetings with us. Now, you can run your own reports every day if you want to (not that we encourage it).

Since the launch in November, we have received generally positive feedback, and the number of clients activating their portals has exceeded our expectations. There have also been a few less supportive opinions, and we realize that not everyone finds it intuitive to navigate through the various menus.

This is a tool that is there for those who want to dig a little deeper and get more robust reporting, but the old tools (such as our quarterly reports and the ability to log into the custodians' web sites) will continue. And, as always, you can call us with any questions or reporting request any time.

continued on page 5

Portal Launch *continued from page 4*

However, we feel the portal takes our ability to provide client service to a new level. The custodial web sites only provide balance and position data, but not performance reporting. You now have the ability to run your own performance reports for any time period, and to drill down to asset class-level and even fund-level performance.

While it isn't for everyone, the portal platform we use was awarded "Best Portal Solution" at the Wealth Management Industry Awards held recently in NYC. This honor for outstanding achievement in the industry is awarded by a panel of eleven independent judges who scored nearly 500 initiatives from more than 300 companies. So, we think we made a good choice.

We have also tried to make the portal more user friendly by creating our own user manual. Our resident technology expert, Craig Julien, wrote a very lengthy user manual with lots of pictures and screenshots. We realize this isn't exactly bedtime reading, but it should prove a handy reference if you have specific questions about the portal. You can also call Craig directly if you'd rather get answers from a human.

In addition to the reporting features, some clients are also using the portal's Document Vault to securely send and receive account documents that contain personal data. The vault can also be used to upload items such as estate documents, powers of attorney, health care proxies, tax returns, and anything else you would like to store in one place. Some will see this as a convenience, and some may be scared about putting these documents on line. The tool is there to use if you want it.

This is just the starting point. We are actively working on enhancements, including a soon-to-be released mobile app. This will allow you to view your portfolio and performance reports while on the go. Technology use is increasing in our industry, and all others. We'll continue to use it to enhance the client experience, and to improve our abilities and efficiencies.

We're always open to feedback (positive or negative), so let us know what you think about what we currently offer, and what you would like to see in the future.

2018 Tax Facts

1. $18,500 maximum salary deferral to a 401(k) or 403(b) plan (up $500 from 2017).
2. $6,000 catch-up contributions to 401(k) plans or 403(b) plans for individuals age 50 and older (same as 2017).
3. $12,500 maximum salary deferral to a SIMPLE plan (same as 2017).
4. $55,000 maximum contributions to SEP IRA accounts and Solo 401(k) accounts (up from $54,000 in 2017).
5. $5,500 maximum contributions to IRA accounts and $1,000 catch-up contributions for individuals age 50 and older (same as 2017).
6. $11,200,000 federal estate tax exemption (up from $5,490,000 in 2017).
7. $5,250,000 New York state estate tax exemption (same as 2017).
8. $15,000 per person annual gift tax exclusion (up $1,000 from 2017).
9. 2.0% cost of living adjustment for Social Security benefits.
10. Maximum contributions to Health Savings Accounts of $3,450 and $6,900 for single and family coverage respectively, with a $1,000 catch-up for individual age 55 and older.

Exemplary Conduct

continued from page 1

and get some practice. After all, he was going to be standing next to Jeff Tyzik, one of the most prominent pops conductors in the country, as well as in front of an audience of roughly 2,500. Omar is a good musician. He can sight read and play the guitar and clarinet, but like most typical teenagers, he procrastinated until the concert was getting near. I was a bit nervous since he would be visible to a large section of our community, and I didn't want to show any disrespect to the august RPO.

Even a couple nights before the event, he didn't really seem to know much about the piece. To his credit, he is busy with school, music, and sports, but he still finds time to squeeze in more video game time than I would prefer. I suggested he use some of that time to practice, but my "helpful" suggestions seemed to fall on deaf ears.

The night before the concert we had to attend a rehearsal. After an hour or so, Omar was called up on stage at the Eastman Theater by Jeff Tyzik himself. Jeff seemed a little bemused about the whole thing, but he was a good sport. He showed Omar how to keep time with his baton, and told him "don't worry if you screw it up…they've only played this song about 10,000 times".

With that, the music began and Omar did a serviceable, if somewhat stiff, job. Despite knowing the song so well, the orchestra did keep their eyes on Omar's conducting. In fact, just as the whip-cracking ensued, Omar gestured over to the percussion section to cue them. The entire orchestra, taken off guard that this kid knew what he was doing, burst into laughter. The mood lightened significantly at this point.

The next night was show time. We went backstage, and as the orchestra members passed by to take the stage, they all smiled and acknowledged Omar. He was nervous, but did a great job. He even got all the percussion cues. At the end of the show, he was like a rock star. Everyone who went by congratulated him. It was a big moment for him, and for his parents.

Compliance Corner

We are in a highly regulated business, which causes a few headaches, but is largely a good thing that offers our clients important protections. There are certain disclosures we are required to make regularly regarding our policies and procedures. A few of them are below:

The nature of our business requires us to obtain sensitive personal and financial information from our clients. As a registered investment adviser with the United States Securities and Exchange Commission (SEC), we must adopt policies and procedures to protect this nonpublic, personal information. Our policy mandates that ACM employees are prohibited from disclosing nonpublic, personal information to any person or entity outside of our firm, except as authorized by our clients or an appropriate regulatory institution. We also take all reasonable measures to ensure secure transfer and/or disposal of documents containing sensitive information about our clients.

Additionally, registered investment advisors are required to file Form ADV with the SEC or state securities regulators on an annual basis. A copy of our updated Form ADV is available at any time upon request. A copy of this brochure is also available on our website. We encourage each of our clients to read it. Please let us know if you would like us to send you a copy.

Armbruster
Capital Management, Inc.
(585) 381-4180

info@armbrustercapital.com
www.armbrustercapital.com

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