February 2018

Dear Clients,

According to the zodiac cycle of the Chinese calendar, 2017 was the Year of the Rooster. That seems pretty apropos since market performance last year really was something to crow about. Oh, and 2018 is the Year of….the Dog. The Dog is described as loyal, honest, amiable, kind, cautious, and prudent, which also sounds pretty good. But since we don't typically rely on astrology or other types of fortune-telling, let's review 2017 by looking at the facts and then give some thought to where we find ourselves at the beginning of 2018.

Stock market gains in 2017 were astounding. The S&P 500 was up 21%, US Mid-Caps did well at 18% (Russell Midcap® Index), and small caps were up 14% (The Russell 2000® Index). A weakening US dollar helped international investments outperform US markets, with the broader international market (MSCI EAFE International Index) up 25% and emerging market stocks up more than 35% (MSCI Emerging Markets Index). Bonds did not fare as well, with international bonds up more than 9% (JPM GBI Global ex-U.S. Index), US corporate bonds returning 3.5% (Bloomberg U.S. Aggregate Bond Index), and U.S. Treasuries only 2.3% (Merrill Lynch U.S. Treasury Index). Commodities were up a paltry 1.7% (*The Bloomberg Commodity Index)*.

Earnings growth is one of most closely correlated indicators of stock market returns, and strong earnings were a key component of these lofty returns. It's pretty simple – as companies earn more, they are worth more. After years of slow, almost anemic global economic growth, the International Monetary Fund estimates that world GDP may have risen as much as 3.6% in 2017 and projects 3.7% growth for 2018 *(Source: IMF)*. This growth suggests that the global economy may finally be regaining its footing after making very slow progress following the Great Recession of 2008–2009.

So the natural question is, where do we go from here? Annual gains of 20% are not as uncommon as you might think. The Dow Jones Industrial Average has gained 20% or more in 34 of the past 121 years, or 28% of the time (*source: Bloomberg).* Suzann Pennington, Chief Investment Officer at Foresters Asset Management, notes, "The sun is shining. We have synchronized global growth for the first time since the Great Recession" *(Source: The Washington Post)*. However, as you know, we tend to be somewhat contrarian by nature, and too much of a good thing begins to give us pause. We are confident, however, that the market will continue to be more volatile in 2018 than it was last year, as we have already seen. On average, the market has one or two 5% pullbacks each year, a 10% decline once every two years or so (defined as a correction), and a 20% decline (defined as a bear market) every three or four years (*Source: American Funds*).

And since we're now in the second-longest bull market in history, we'd like to offer a few thoughts on what's referred to in our industry as "behavioral finance," which is just a fancy way of saying that human beings are programmed to do things that are against their long-term interest out of short-term fear, anxiety, exhaustion, or even "irrational exuberance."

A few years ago we saw some of the negative impacts of behavioral finance on investors during and after a down market, as investors become skittish and react reflexively. In January and February of 2016, the market had the worst-ever start to the year, with many global indexes down more than 20%.

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Investors had flashbacks to the Great Recession of 2008–2009 and wanted to pull out of the market "just until things settle down." Similarly, industry data tell us that many investors sold out prior to the presidential election in the fall of 2016. Those who exited the market abruptly ended up missing the tremendous gains that we've seen.

And right now, we're just beginning to see some of the behaviors that can result from positive "recency bias." After a market downturn, investors are eager to discuss risk and define their risk tolerance. After a long bull market, investors sometimes forget about their investment planning parameters because the possibility of risk and loss seems so much more remote. As a result, investors may make decisions that are outside of their actual risk tolerance because recency bias causes them to over-emphasize the recent positive performance to the exclusion of poor market performance, which is nonetheless still inevitable.

Risk is easier to evaluate when you're not in the midst of a volatile situation. That is why we apply goals-based investment planning, to help clients maintain a steady course. We have found that the earlier in the investment process you define your risk tolerance the better able you are to remain rational about what may lie ahead. The discipline of setting and adhering to your goals and rehearsing what you are investing for, rather than going it alone, can enhance the rational brain's ability to deal with challenges before the emotional brain hijacks the decision-making process out of fear, anxiety, exhaustion, or unwarranted exuberance.

Preparing for these responses ahead of time can keep you on track and on pace to meet your goals. Our approach stays constant. Define *your* goals – not market goals. Understand your time frame. Evaluate your risk tolerance and your ability to withstand downturns. Together, we select an investment portfolio that meets your goals, your time frame, and your risk tolerance. Then, together we monitor your progress and keep investments aligned with your goals. When we review portfolios with you, we again discuss risk and any changes in your life or in your thinking that affect how we define your risk profile. We want you to have confidence that regardless of what's going on in the market, the primary driver will always be working toward *your* financial goals.

As usual, this letter is when we announce the winner of our "Guess the Dow" contest. Our 2017 winner was Harry B., who, with six friends, will enjoy a meal at Landini Brothers – on us! The Dow closed at 24,719, and Harry's guess was 24,566. Of the several hundred guesses that we received, Harry's was the fifth highest. As usual, your guesses were generally conservative, although mostly positive, which suggests that you continue to take the balanced, measured approach that we have been advising for so many years. Please let Lichelle know your 2018 "Guess the Dow" entry by March 31st, at lichelle.yalung1@wellsfargoadvisors.com or 703-739-4540, and you and your friends may be the lucky winners of dinner with us – while basking in our unqualified admiration for your investment savvy.

A word about forecasting the market is in order here – there is a reason why we call the contest "*Guess* the Dow." We have written about this many times, but even the most famous stock market prognosticators are simply guessing when they discuss where the market is headed. If we knew for certain what the market was going to do (go up or down), we'd say so. Lacking that magical power, if you fear you'll be affected in a way that keeps you up at night (by missing gains or experiencing losses), then protect yourself by adjusting your equity exposure. And don't forget that the macro is what you see, but the micro (the professional management below the surface) is happening on your behalf 24/7. As always, we will give you our best, objective, and unbiased counsel. If we have not already discussed with you the year ahead and any changes needed or desired in your investment planning, please email or call Lichelle for an appointment.

In other important news, we would like to introduce you to our newest Financial Advisor, Ivana McNeill. Ivana joins us by way of an innovative program at Wells Fargo Advisors designed to cultivate the next generation of financial advisors. We now have some fourth generation clients, so a next-generation advisor is a perfect way to let us continue to deliver comprehensive investment advice and service to you and your family. Before joining us, Ivana was an economics major at the University of Virginia and a consultant at Accenture. You can find more information on Ivana and the rest of our team on our website, www.CaudronMegaryBlackburn.com.

In closing, we hope that you know how much we appreciate your trust and willingness to allow us into your lives. Much of our job satisfaction comes from the opportunity to know and serve you and your family. We strive to meet the individual needs of each of you, providing sound financial advice and investment planning and making sure we're here when you need us. On behalf of the entire team – Tristan Caudron, Matt Megary, Laurie Blackburn, Ivana McNeill, JoAnne Dorris, Jessica Jackson, Laura Newton, Lori Polonsky, Chalee Ricciardi, and Lichelle Yalung – thank you for affording us the honor and great pleasure of working with you. We wish you a wonderful 2018, filled with health, happiness, and prosperity.

Very truly yours,

Laurie Blackburn

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The views expressed by the authors are their own and do not necessarily reflect the opinion of Wells Fargo Advisors and its affiliates.

Stocks offer long-term growth potential, but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations. Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility.

Investments in fixed-income securities are subject to market, interest rate, credit and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and/or principal. This risk is heightened in lower rated bonds. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Diversification does not guarantee profit or protect against loss in declining markets.

The Dow Jones Industrial Average is a price-weighted index of 30 "blue-chip" industrial U.S. stocks.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

Bloomberg Barclays U.S. Aggregate Bond Index is unmanaged and is composed of the Bloomberg Barclays U.S. Government/Credit Index and the Bloomberg Barclays U.S. Mortgage-Backed Securities Index. The Bloomberg Barclays U.S. Government/Credit Bond Index is an unmanaged, market-weighted index generally representative of intermediate and long-term government and investment grade corporate debt securities having maturities of greater than one year. The Bloomberg Barclays Mortgage Backed Securities Index is an unmanaged index of mortgage pools of the Government National Mortgage Association, Federal Home Loan Mortgage Corporation and Federal National Mortgage Association.

The MSCI Europe, Australasia and Far East ("MSCI EAFE") Stock Index is an unmanaged group of securities widely regarded by investors to be representations of the stock markets of Europe, Australasia and the Far East. Source: MSCI. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.

MSCI Emerging Markets Index: The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The Index consists of the following 23 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey. Source: MSCI. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.

Russell Midcap® Index: The Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000® Index.

Merrill Lynch U.S. Treasury Index: The Merrill Lynch U.S. Treasury Index tracks the performance of the direct Sovereign debt of the U.S. Government. It includes all U.S. dollar-denominated U.S. Treasury Notes and Bonds having at least one year remaining term to maturity and a minimum amount outstanding of $1 billion. Additional sub-indices are available that segment the Index by maturity.

The Bloomberg Commodity Index is a broadly diversified index that allows investors to track commodity futures through a single, simple measure. The index is composed of futures contracts on physical commodities and is designed to minimize concentration in any one commodity or sector. It currently has 22 commodity futures in seven sectors. No one commodity can compose less than 2% or more than 15% of the index and no sector can represent more than 33% of the index.