CAIRN INVESTMENT GROUP

Newsletter and Quarterly Update

December 2016

Inside This Edition:

- Elephants, Where?
- Upward Interest Rates
- ETFs & Indexed Funds
- Household Summary
- Individual Account Reports

Important Reminders

NYSE Closed—No Checks, Deposits or Settlement on:

- 1.16.17 – MLK Day
- 2.20.17 – President's Day
- 4.14.17 – Good Friday
- Expect 1099 Forms Mid February
- Form 1099-R Late January
- Schedule K-1 Various

CAIRN INVESTMENT GROUP

121 SW Morrison Street
Suite 1060
Portland, Oregon 97204
Phone: 503.241.4901
Fax: 503.241.5699
E-mail: info@cairninvestment.com

Greetings from the Northwest.

We've had a wonderful 2016. Not that it necessarily turned out the way we expected; little ever does. But it has turned out to be a good year for our investors, and a good year for Cairn Investment Group. It is kind of fun to say this — have you noticed the elephant in the room? Yes, I know the elephant is in the room. Over the decades we've seen a lot of changes in the political front, just as we've seen a lot of evolution in our business, from ticker tapes to computerization. Probably the most frequent question asked of me since November is: What can we expect going forward? Quite candidly, it may be that we can expect quite a few reasonable and unpredicted agreements being made. Inevitably, there will be lots of talk about federal tax code — probably a reduction of corporate tax rates. There will be conversations about eliminating personal exemptions and maybe putting a cap on itemized deductions. Lawmakers may eliminate the individual and corporate AMT, and possibly the 3.8% net investment income tax. And a lot of conversations around the idea of eliminating the federal estate tax could occur.

There may be some relief on the horizon regarding the thought that global stagnation and deflation fears are giving way to somewhat better growth, with possibly modest inflation and rising interest rates. 2017 will inevitably bring degrees of uncertainty about the economy, markets, politics and change. As I'm so fond of saying, we're going to ignore a lot of the noise and focus on individual companies. I think that's what we need to do, particularly since the initial optimism about some of the tax changes in the Trump agenda will likely fade away in light of the fact that the legislative process is historically slow, slow, and slow.

Here in Portland we've experienced continued growth. 2017 could be the seventh year in a row of positive job growth in the state. We're beginning to bump into the problem of not enough qualified workers, which could cause wage inflation and we'll see how the economy takes that. As many of you know, we strive to maintain a certain amount of income in most of our portfolios. This is continuing to be a challenge and will be fascinating, since it may be that we are in the early stages of a change in the interest rate cycle. We haven't seen a prolonged period of upward interest rates since the Carter administration.

Cairn Holiday Selfie

Patrick Mason, CFP :: Investment Analyst

The potential market reaction to the recent presidential election is currently a hotly debated topic. While we agree there could be significant changes in government policy and spending, we have little confidence in our ability (not to mention anyone else's) to correctly predict every minute detail and the corresponding effect that will have on each sector of the market. What we can say with confidence is that changes don't happen in a vacuum and don't happen overnight. The debate over tax law, infrastructure spending, and trade policy will be extensive. What we can hope for is that our lawmakers focus these debates so the outcome is positive for many companies, countries, and individuals.

I want to address a current debate in the investment world regarding active vs. passive management, and specifically ETFs and index funds. As our clients are aware, we are a strong proponent of owning individual securities through active management. Our approach focuses on an in-depth understanding of a company's fundamentals and operating performance, combined with price discovery and strict valuation principles. This approach requires patience, and yet we feel it produces superior long-term results with less potential risk of permanent loss of capital.

A research report by Credit Suisse published on 1/4/17, titled "Looking for Easy Games," discusses the large influx of assets that ETFs and index funds have received over this current market cycle and potential risks going forward. This report is one among many expressing a risk that we at Cairn believe a substantial number of market participants do not fully understand. A particularly alarming quote from this research report states (emphasis mine): "Active funds tend to trade the same stocks as passive funds, but those stocks that are held more by passive investors are less informationally efficient than those that are held more by active investors. **In mid-2016, passive index funds and ETFs owned 10 percent or more of 458 of the 500 companies in the S&P 500. In 2005, that was true for only 2 of the 500**."

The index fund market has grown to over $2 trillion as of 2016 – up from about $3 billion 25 years ago. When purchasing an index fund or ETF an investor now owns an interest in a large basket of stocks that make up a particular index. The inherent issue with this is that the more investors buy passive index products, the greater the chance the larger positions within those indices could become potentially overvalued. This is caused by the index fund/ETF manager's having to buy shares in those companies **regardless of price**. We believe this is a risk that many investors are ignoring at present. Many risks are not inherent when everything is working well and prices are rising, but will become clear when times are not as euphoric as they are today. We will continue to touch on this topic throughout the year when we feel a shift is starting to take place, causing value conscious, active strategies to be more in favor as broad market valuations continue to be on the expensive side of historical averages.

Across the investment landscape we feel opportunity is not rampant at this time so we continue to be patient in our allocation of new investments. The good news is that select companies do continue to meet our strict criteria. As always, thank you for trusting us to manage your wealth and know that we will weigh the risks when considering the reward of any investment we make. — *Patrick Mason*

My desk has been flooded the last few weeks with all sorts of information from all sorts of sources. Sometimes I find it personally satisfying and maybe even a little calming to go back to the NW's Agricultural weekly paper, the *Capital Press*. I chuckled when I read the front page of the *Capital Press* last week, and I'm going to quote the headline as it was appropriate: "Water, workers, trade and Trump among the many issues facing agriculture in 2017." Followed by Rose Hayden-Smith, former county extension agent, "I think we're going into a very uncertain period for producers and the food system, because the new administration coming in will be a little less predictable, perhaps." I think "perhaps" is going to be the word I end all my sentences with in 2017, perhaps. I am looking forward to the New Year partly because we're in the process of remodeling an adjacent office space into a new conference room at Cairn. We're looking forward to utilizing additional technology to bring the information about your investments into sharper focus with more Star Trek tools. Perhaps.

2016 was also notable for the people who passed away. I thought I'd say goodbye to two of them in this letter. For young men growing up in Portland, it was almost a rite of passage in your life to visit a very small shop at the corner of SE 82nd and Ankeny, and to be fitted for a pair of Danner Boots. Bill Danner and Danner Boots were legends in the Portland Metro area for wonderfully built men's footwear. I still enjoy my original pair. And to Merle Haggard. For those of you who have a cassette or CD player in your automobile, you could swing by the music store and pick up the Best of Merle Haggard. Get a good cup of coffee, point your car down the road and tune in Merle's "Silver Wings". And at this point I'm going to enjoy the memory of that song *shining in the sunlight*, and as has happened to 2016, we're *slowly fading out of sight*.

Happy Trails,

Jim

Jim Parr, Principal