CROWELL WEEDON ASSET MANAGEMENT

MONTECITO INVESTMENT PORTFOLIOS

January 1, 2017

Dear Fellow Investors,

We've outlined the major topics & takeaways of this year's letter in an easy to follow format. Those sections are:

Main Message Highlights

- ***A Lost Generation:*** the past 16 years was pretty dreadful for the stock market. Major market crashes sandwiched around fear of the financial system collapsing have turned off many to investing. While history doesn't repeat itself, it quite often rhymes. We believe the 2000 - 2016 time frame is amazingly similar to the 1966 - 1982 time frame. If this rhyme holds true we could be at the beginning of the next major move in growth & productivity that will lead to higher prices for the stock market over the next 5, 10, 15 year time period.
- ***Proof of Absolute Pessimism – Negative Interest Rates:*** human emotion can be difficult to measure. However, we believe the Summer of 2016 will go down in history as proof of how much fear and negativity was in the markets as investors were willing to lock in a known loss on certain government & corporate bonds.
- ***News – fact or fiction?*** With fabricated news becoming every bit as prevalent as 'real' news, discovering the truth is more difficult and nearly impossible for the average person. Recent political elections showed news can be fabricated & not always true. Our industry is not immune. There are countless investment opinions these days with many founded on human emotions of greed and fear. Today's brief, 140 character Twitter world entices reaction as opposed to investigation. As long term investors we believe fundamental research, identifying a company's long term catalysts, and having an investment thesis are essential to making sound investment decisions.
- ***Doing More with Less – Changes in Working Capital:*** we highlight a metric we utilize when analyzing a company. Digging in to Working Capital reveals how efficiently a company runs their operations. Ideally, a business wants to shorten their Working Capital cycle by collecting money that is owed to them as quickly as possible and delaying money they owe to others for as long as possible.

Forecast Review for 2016 - As forecasting goes we did pretty well with credit for ***8 out of 11 correct.*** We had a couple of forecasts that once again were spot on, a couple we got half right, and a couple that didn't come close, but that's just the nature of predicting the future! And frankly you all know at this point we like to put a few forecasts in that are totally outside conventional thinking – just to be sure we are looking in as many directions as we can.

Thoughts & Forecasts for 2017 **–** Never learning our lesson we will forecast the future once again!

- ***US equity market sees continued volatility but ends 2017 approaching 2,500 on the S&P 500 before year end – an approximate 10% rate of return***
- ***Short-term rates: 2 to 3 Fed hikes with 1% - 1.5% on the Fed Funds rate by year end***
- ***Long-term rates: up in line with the Fed discount rate hikes – the 10 year ending the year at a yield of around 3.25%***
- ***Oil prices: see $50 to $65 as range where supply and demand equalize and cost of recovery becomes main driver of supply equilibrium***
- ***Inflation: remains in check and below 3% for 2017 but signs of acceleration begin***
- ***Commercial real estate – Cap rates will come under pressure, but with the glide path to rate increases being slow, rental increases should allow most properties to retain most of their value. The spread between cost of capital and Cap Rates will become all important to get deals done. Defensive sectors with solid fundamentals, REITs with unique growth propositions, & REITs that can expand their portfolios and increase Funds from Operations on an accretive basis should be the best performers. Still a preferred alternative to a buy and hold of long term bonds, but underweight in an all equity portfolio.***
- ***Residential real estate –much the same as last year - smaller homes still the spot to be and in states that are tax-friendly or retiree friendly – the Millennials will start buying more houses.***
- ***Three more forecasts that are not entirely investment related***

Conclusion – 2016 was a rewarding year in the markets. Our disciplined investment approach was well rewarded and we are pleased with returns in our portfolios. Don't lose sight of the long-term goals and the long-term potential. We remain extremely excited for the US economy!

Main Message

A LOST GENERATION OF INVESTORS

Planning for financial goals is usually a long-term process. Retirement, a second home, college, weddings, etc. are goals that can be years or even decades into the future. Not too long ago, investing in the stock market was accepted as a great way to achieve your long-term goals. However, a younger generation has had a completely different experience with investing. To show just how different this experience has been, we wanted to check in on a hypothetical investor whose financial awareness started in the not too distant past (year 2000) and see what their investing journey has looked like.

> ***1999: Up, Up, & Away!!*** *- The stock market has enjoyed a decade of phenomenal returns. Returns so good that "Day Trader" is an actual career. People are euphoric. Virtually everyone has made money in the stock market with technology companies leading the way. Friends of mine have invested in several .com IPOs and seen the stock double on its first day of trading! Everyone knows the internet will transform our lives. The future looks so bright investors are willing to pay over 2 times historic valuations because growth expectations are that robust.*
>
> ***2000 - 2002: OUCH!!*** *Turns out that stocks can actually go down in price too. Not only can they go down, but they can go bankrupt. Many of those .com companies turned out to be little more*

than a cool name and suspect business plan. Also, two significant companies – Enron & WorldCom, wiped out billions of dollars of wealth with their bankruptcy filings. Three straight down years in the market which has now lost over 40% of its value. Times have certainly changed. I no longer get stock tips from my waiter at lunch. Day Trader isn't really a career choice anymore. People are afraid now. Life has certainly changed after 9/11.

2003 - 2006: House Hunting *– The losses caused by 3 straight down years from 2000 to 2002 have now been recovered. Stocks are doing well led by financial companies who are seeing a boom in profits driven by the housing market. Much like Day Trader was a career choice in the late 1990s, House Flipper is now a career choice for today. Home prices have gone up so dramatically that many have been tapping the equity in their home like a personal piggy bank to buy all the toys they desire. Virtually anyone can get a loan. There are even loans where you don't have to pay the full amount of interest each month! The accepted thought is you buy the house today, through any means possible, knowing that you'll be able to refinance it next year when the home price is much higher. Stocks have done OK but nothing like the returns you've seen in the Real Estate market.*

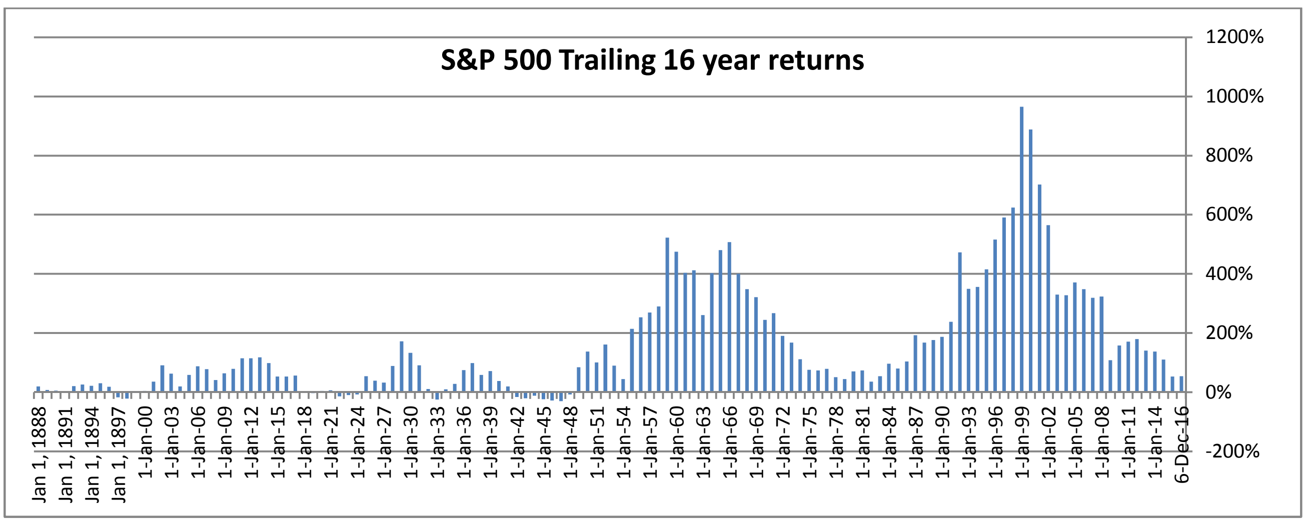
2007 – 2009: GET ME OUT!! *Turns out home prices can go down too. Drive through most neighborhoods and the streets are covered with For Sale signs. A lot of people's equity has vanished and those ridiculous loans are causing people to not be able to afford their house. Due to this negative equity, some are choosing to walk away as they see it unlikely their home will recoup its value any time soon. Losses in the real estate sector translated into losses at some huge financial institutions. A couple of really big firms went bankrupt and now the government has stepped in to save others. There is a severe lack of trust for Wall Street. It's no wonder when you consider one of their supposed brightest minds in Bernie Madoff turned out to be a criminal operating the biggest private Ponzi scheme in American History!! Fear & Panic gripped the entire financial system with certain markets temporarily ceasing to operate. The stock market had one of its worst declines in history losing over half its value. Even "safe" investments don't seem safe today. I know what the supposed experts say, but I'm now questioning if owning stocks is good for anything at all. I'd rather stop the bleeding and am going to sell everything. At least my hard-earned savings won't go down any further sitting in cash.*

2010 – 2016: I don't buy it *– Since witnessing the dot com collapse, real estate bubble, & financial system nearly breaking, a lot of people don't want anything to do with the stock market. The market has been up, but from what I hear it's going to crash again any day now. I somewhat regret selling everything back in 2009. If I would've hung in there I would probably be back to where I started. Yet, I feel torn because there are so many issues out there. Economic growth is hard to come by which is why Central Banks around the world have cut interest rates to near zero – in some cases government bonds are actually yielding a negative interest rate!! The United States had their credit rating cut, oil prices have plunged, fast growing China is now stalling, governments are buying their own bonds in an attempt to kick start their economy, & the market has seen something called a flash crash where the Dow went down by nearly 1,000 points intraday. The list of worries is too long to ignore yet the market is now hitting all-time highs. I doubt this time will be any different. I think I'd prefer to hold onto my cash or maybe invest in something safe like a CD or government bond. At least then I know that I won't lose anything.*

This is of course an example of a hypothetical investor and not indicative of what everyone experienced. However, we can say that we talk to many people from all walks of life and the narrative expressed during these time periods was very common. ***Our takeaway from this is that we have an entire generation of recent investors whose experience with investing in the stock market has been below expectations.*** Looking back, if you had the mental strength to stay invested you received a reasonable rate of return. However, many were overcome by emotion and didn't even receive the approximately 4.5% annualized rate of return from the S&P 500. Instead of viewing the stock market as a good way to save for long-term financial goals, they have memories of 2 major market crashes sandwiching a real estate collapse that shook the entire financial system to its core. In our opinion, worry, fear, & pessimism have plagued the market over the past 16 years and truly jaded an entire generation of investors.

HOW BAD WAS IT?

As proof of just how bad the market has been over the past 16 years we did a historical study. We calculated the trailing 16 year returns for the S&P 500 going back to the 1880's. We then plotted the trailing 16 year returns on a bar chart to be able to visualize where we currently stand from a historical perspective.



DATA COMPILED FROM [WWW.MULTPL.COM](http://www.multpl.com) DATES INCLUDE 1/1/1871 TO 12/31/2016

A couple of takeaways from the study:

- The 16 year period we just experienced saw the lowest returns since 1982
- The highest 16 year period on record ended with the dot com blow-up in 1999
- There has been a boom / bust pattern to trailing market returns that generally coincides with each generation experiencing both
- The fact that we are currently at a trough for trailing 16 year returns gives us confidence that the next 16 years could look very different

WHAT'S NEXT

We've reviewed the torturous emotions our hypothetical investor experienced. We've shown proof of just how lousy the past 16 years has been for investors from a historical perspective. Now, we must look forward and see what might be next. Like any successful coach will tell you, it all starts with the fundamentals.

Fundamental #1 – Earnings provide the foundation for stock prices

Historical evidence shows long-term stock market returns are highly correlated to earnings. This makes sense. ***If a company makes more money, the business is worth more, & the stock price should be higher.*** It doesn't always happen instantaneously, but in general this simplification holds true. Even the past 16 years shows this fundamental truth:

	Earnings Per Share of the S&P 500	***S&P 500 Price Index***
2000	$50	1,458
2016	$109	2,239
Growth	2.2 times	1.5 times
Annualized Rate	4.7%	2.4%

SOURCE: FACTSET 1/1/2000 – 12/31/2016

Earnings increased by 2.2 times & the S&P 500 increased by 1.5 times. This period of time saw the market go from overvalued to undervalued, & now to somewhere near fair value in our opinion. This was a needed period of P/E compression. *(P/E compression – when the Price to Earnings ratio of an investment declines significantly over a period of time. In 1999 the P/E of the stock market was 30. Today we stand at approximately 17.)* Yet, in the end, absolute value of the stock market followed earnings higher.

We believe the next 10 – 15 year time period will look vastly different for earnings. The past 16 years saw some major sector declines. We started by seeing significant losses in the technology sector, followed by significant losses in the financial sector, followed by significant losses in the energy sector. These huge sector declines coupled with general economic sluggishness led to below average earnings growth & an extremely volatile environment. ***Based on our calculations, the volatility of earnings for the past 16 years was the highest in market history!*** We feel change in earnings from the S&P 500 companies will regress to the mean resulting in a higher growth, less volatile environment. Higher earnings growth will be driven by technological advancement which is happening at an accelerating pace. Unlike the 1990s, technological advancement isn't limited to just the technology sector. This time virtually every industry should see a benefit from advancements in communication, manufacturing, connectivity, automation, robotics, artificial intelligence, genetic research, & more. Innovation drives future earnings and we can't recall a time period with more potential. This gets us excited which leads to our next fundamental.

Fundamental #2 – Investor emotion can drive significant changes in returns

Emotion is a confusing yet undeniable part of investing. Humans are not robots. Life is full of ups and downs and these emotional swings also spill into investing. At certain times, investors feel excited, optimistic, hopeful, & euphoric. Other times, investors feel nervous, afraid, worried, and outright defeated. Believe it or not, the emotional mood of investors plays a big role in the short-term pricing of the stock market. What someone is willing to pay for something depends on a number of factors – investing in stocks is no different. We've been through a prolonged period of time where the stock market has endured negative emotion. We believe the next 10 – 15 year time period will see this change. Amazing technology will lead to products & services that seemed like science fiction just a decade ago. As this evolution happens we believe investors will once again feel excited about the future. So, what does this mean for potential returns from the stock market? ***Tying our fundamental outlooks together gives us a forecast of accelerating earnings growth coupled with improving investor sentiment over the next decade.*** What does this look like in regards to the major indexes?

Forecast #1 – accelerating earnings growth with historic market multiple

	Growth	*Multiple*	*S&P in 2030*	*DJIA in 2030*	*Cumulative Return*
EPS growth #1	7%	15	4,699	41,600	108%
EPS growth #2	10%	15	6,732	59,600	198%
EPS growth #3	12%	15	8,509	75,200	276%

Forecast #2 – accelerating earnings growth with expanding market multiple

	Growth	*Multiple*	*S&P in 2030*	*DJIA in 2030*	*Cumulative Return*
Multiple #1	7%	18	5,639	49,800	149%
Multiple #2	10%	20	8,976	79,400	297%
Multiple #3	12%	22	12,480	110,400	452%

Obviously, forecasting more than 10 years into the future can involve a great deal of uncertainty. We're presenting a simplified forecast based on straight line returns. We assure you, short-term emotions will continue to create market volatility and see many market gyrations during this time period. However, the long-term potential is what we want to emphasize. Looking out more than a decade, we believe you can fundamentally make the case for excellent stock market returns with the ***Dow Jones average being somewhere in the range of 50,000 to 100,000 points by 2030.*** Because of these reasons today's market being at all-time highs does not scare us. We know the journey the market endured to arrive at where it is today. It's a backstory filled with negativity, crashes, & pessimism. Hardly the type of behavior witnessed at a true market top.

NEGATIVE INTEREST RATES – PROOF OF ABSOLUTE PESSIMISM

Emotion can be tricky to measure. Humans are complicated with each of us expressing ourselves in uniquely different ways. However, we feel recent actions with interest rates gives us a resounding emotional picture that doesn't take a lot of guess work to figure out. Just over 5 months ago the world experienced something new. Interest rates on numerous government & even corporate bonds yielded less than zero. What this means is investors were willing to lock in a known loss. Why would anyone in their right mind invest money accepting a known loss?? A logical way this can be explained as a rational decision is if you believe losses in the future will be even worse than what they are today. If everyone loses 50% and I only lose 5% I'm feeling pretty good about myself.

Whether we're talking about 15% interest rates or negative interest rates, what was rampant in both situations was a question of the solvency of our country because of money. Record high interest rates were put in place by Volker to kill inflation. Record low interest rates were put in place in as a desperate attempt to stimulate demand and kill deflation. In about a 40 year time span the pendulum has completed its move swinging from one extreme to the other. What existed at each arch's peak was a great deal of fear and uncertainty related to the financial system.

In our opinion, the negative interest rates in the Summer of 2016 will go down as historical proof of just how pessimistic the market was. The interest rate peak of 1981 turned out to be the bottom for the stock market before it made a nearly 2 decade bull run. In our weekly investment committee meetings we recount memories of when the 10 year U.S. treasury rate touched 15%. It is difficult to hide the dumfounded look on our faces as we utter "That's INSANE". In about 10 – 20 years from now we believe the same reaction will happen when discussing with our next junior partner that investors actually bought bonds with negative interest rates. "That's INSANE!!

NEWS – FACT OR FICTION?

This past year's political elections reminded us just how much "news" is put in front of us. Virtually everywhere you turn news is available. 24 hour news channels, websites, social media, magazines, e-mailed links, & more would make most believe that we are a well-informed society. However, too much of anything can be a bad thing. Today, we enjoy instant information at our fingertips. However, this instant information is often times a tangled mess of facts, misinformation, and opinions designed to elicit reactions from consumers. Take a look at some recent headlines & see how they make you feel:

Ebola: "The ISIS of Biological Agents?" – CNN 10/6/2014

How to Prepare for the Coming Stock Market Crash – FORBES 7/29/2016

Reality Check: Is US System a Disaster for Democracy? – BBC 11/15/2016

NAACP Joins Soros army plotting DC disruptions, civil disobedience, mass arrests – DRUDGE REPORT 4/5/2016

This year Facebook was blamed as part of the reason Donald Trump was elected President. Critics argued that if legitimate news stories were shared on the site the results could have been different. Barack Obama went so far as to call Facebook "a dust cloud of nonsense." Facebook founder Mark Zuckerberg responded by saying it was a crazy idea to believe fake news on Facebook played any part in the election. Why has reporting the news become such a controversial topic?

We believe the answer is simple at its core yet difficult to change. Reporting the news is big business. ***As long as it remains a business there will always be an inherent conflict of interest between presenting facts and attracting the biggest audience possible.*** For whatever reason, people like drama. It is why the news usually leads with stories such as murders, car crashes, natural disasters, & death, – all bad stuff. This drama keeps us watching, listening, sharing, & coming back for more. As long as we keep coming back "News" companies have a captive audience to then show perspective advertisers just how valuable their target market is.

The financial industry news sources are no exception. However, the consequences for listening to the news can be far greater. The past decade has been filled with supposed financial gurus calling for the next great market crash and where you need to be invested to protect your wealth – not news stories, merely someone's opinion. The consequences for listening to these stories can be detrimental to your financial health. As long term investors we believe fundamental research, identifying a company's long term catalysts, and having an investment thesis are essential to making sound investment decisions. Remember to keep perspective. Investing in the stock market should be a rather boring, unemotional, disciplined process. Yet, there are so many out there that want to convince you otherwise. ***Today, it is paramount to take time to investigate fact from fiction which at this point has become a full-time job.***

CHANGE IN WORKING CAPITAL – DOING MORE WITH LESS

Each year we like to provide some insight into some of the analysis that goes into our research process at a detailed level. This year we highlight one of many metrics we use to get a sense of how efficient a business is running their operations – Change in Working Capital.

Analyzing a company's Working Capital gives us a sense of their efficiency & short-term financial health. The definition is rather straightforward: Working Capital = Current Assets – Current Liabilities. In general, we want to see a company with current assets greater than current liabilities to see near-term financial strength. A declining figure might signal trouble with a company's ability to meet near-term liabilities. Further analyzing the accounts that make up Current Assets & Current Liabilities and the way in which they change, gives us a detailed look at a company's operations.

When operating a business you'll have Current Assets such as Accounts Receivable, Inventory, Prepaid Expenses, & various Other Current Assets. From a Current Liabilities standpoint you'll have Accounts Payable, Deferred Revenue, Taxes Payable, & various Other Current Liabilities as well***. Ideally, a business wants to shorten their Working Capital Cycle by collecting money that is owed to them as quickly as possible and delaying money they owe to others for as long as possible.*** This allows the business to hold on to capital for as long as possible allowing them to put it to the best use they see fit. Holding on to cash for an extra day or two may seem insignificant when thinking about a small business, but when we're talking about billion dollar corporations, holding on to cash for a day or two can be very significant. Earning 1% on $1 Billion dollars is $10 Million dollars or approximately $27 thousand dollars per day which pays for an awful lot of corporate finance salaries!

To analyze a company's efficiency, we monitor change in the Current Accounts. An increase in a Current Asset account is a use of cash, a decrease is a source of cash. The opposite is true for the Current Liability accounts. An increase in a Current Liability account is a source of cash & a decrease is a use of cash. If you think about it, this makes sense. If a cabinet maker buys wood, that would be considered an increase in Inventory under Current Assets & a use of cash. Likewise, if a cabinet maker is able to receive cash up front to build some cabinets that will be delivered at a later date, that is a source of cash and we would see an increase in Deferred Revenue which falls under Current Liabilities. Remember, the most efficient companies are able to hold on to capital for as long as possible thus getting maximum use out of it. Let's look at a real world example to get a glimpse into their operational efficiency.

Apple has had a spectacular run over the past 10 years driven by innovative products & the growth of the Apple ecosystem. This run has allowed them to gain quite the negotiating leverage when dealing with other companies dying to get into the Apple supply chain. To see proof of this we can dig into the Working Capital numbers and note a couple of items:

- 8 out of the past 10 years Apple has seen an increase in their Change in Working Capital numbers. This means when going through all of the Current Asset & Current Liability accounts, Apple has consistently been able to increase (source of cash) their Current Liabilities more than their Current Asset accounts.
- Some of the biggest increases in Apple's Current Liabilities can be seen in Accounts Payable & Deferred Revenue. This means Apple is receiving parts from a supplier now and taking longer and longer to pay them. It also means Apple is receiving cash now for sale of finished goods that are then delivered at a later and later date.

They have been masterful in managing working capital needs. As it stands, Apple is one of a handful of dividend paying companies with the ability to receive cash now & delay sending it out – this is the ideal position to be in for a Corporate Finance Manager. It may sound like a small item, but when we're talking about a company that does $200 Billion in annual sales, the ability to hold on to cash for even a couple of extra days can have a significant impact on results.

To summarize:

- Increase in a Current Asset account: use of cash
- Increase in a Current Liability account: source of cash
- Decrease in a Current Asset account: source of cash
- Decrease in a Current Liability account: use of cash
- Positive Change in Working Capital: increase in cashflow
- Negative Change in Working Capital: decrease in cashflow
- Ideally, we want a business that can shorten the amount of time to collect cash and lengthen the amount of time to pay cash. This way they maximize the use of their Working Capital.

Our Working Capital analysis is only one piece of the puzzle when it comes to analyzing a firm's financial statements. It can provide meaningful insight into a company's financial health & operating efficiency yet must be considered with many other metrics before making an investment decision.

FORECASTS

This is the section of the annual letter that most readers turn to first – that foolish section where we actually make forecasts for the future! We enjoy using "What If" in our thought process as it allows us to think outside-the-box and challenge our (and your) assumptions. As a reminder, these forecasts are our thoughts as of the writing of this annual letter. Markets are dynamic and ever-changing. When change occurs, so too must our thoughts to adapt to the current market environment. This is similar to our health. We get check-ups on a regular basis and develop a plan to maintain or improve ourselves. However, should we get sick we must be flexible enough to alter our plan to adapt to the new diagnosis we're dealt.

We remind everyone our portfolios are managed substantially from the bottom up. This means we look at individual investments themselves and the long-term value they represent, knowing that quality companies at the right price represent value. With this reminder out of the way let us review our forecasts from 2016's annual letter and make some new and bold (and perhaps foolish given our longer term perspective) forecasts for 2017.

First, let us check and see how we did last year.

2016 Forecasts

- ***US Equity Market*** – The growth rate of Earnings Per Share has been significantly impacted by the losses seen in the Energy market – reminiscent of 2008 when 3 Financial companies losses wiped out a significant portion of the earnings for the entire S&P 500. Current forecasts call for EPS growth of 7.7% for 2016 & 12.5% for 2017 for the S&P 500. We do believe the way EPS calculations are done for the S&P 500 Index overstates the effect of losses as the EPS calculation is not done on a market weighted basis. To illustrate this let's consider a 2 stock index:

	Company A		***Company B***
Market Cap:	$150 Billion	Market Cap:	$10 Billion
Earnings:	$10 Billion	Earnings:	-$9 Billion
P/E:	15 x	P/E:	None due to losses
Weight in index:	94%	Weight in index:	6%

If we calculated EPS the way S&P does this for this simplified index we would sum the earnings of the 2 companies. In this case, this would be $1 Billion. With a combined market cap $160 Billion, the P/E ratio of our index would be 160! If you were to instead weight the earnings by the respective market cap of each company, this portfolio would have earnings of $8.813 Billion which would give you a P/E ratio of 18.2 – certainly a much different view of valuation than a P/E of 160! This leads to our conclusion that during times of severe losses for several of the index constituents the market should trade at a higher multiple because of the dramatic effect significant losses have on the index.

In an attempt to counter this negative bias we've witnessed, we looked at constituent earnings & earnings estimates on a market cap weighted basis. Doing so leads to EPS growth that would actually be closer to 12% for 2016 & 14% for 2017 – both rather respectable growth rates and certainly better able to justify an earnings multiple of 16 – 18 times. With this said, we do believe the market remains in "fair value" range. We do believe volatility will remain heightened from previous years and see a strong possibility for another intra-year significant correction (greater than 10%) during 2016. We believe the earnings yield of the market has been a good predictor of real future returns. With the market trading around a 17 multiple, this implies a return of 5.8%. Based on our forecast of muted inflation we would target a total return for the S&P 500 in the range of 5% - 9% for 2016 or 2,174 – 2,256 on the Index level. If anticipated earnings growth does not materialize this year we do believe there is the risk of multiple contraction with the market trading above its long-term average. In this scenario another volatile year with minimal return could materialize

   - ***Volatility was once again the mantra of the year. As outlined in another part of this letter we have been experiencing volatility of earnings and the markets for quite some time. We also got the direction of the market for the year correct. While many were forecasting a decline in earnings and the Price to Earnings level of the market this past year because of a lift off in short term interest rates, we saw the ability of the Federal Reserve to raise interest rates as a positive indicator for corporate profits. As of writing this the magnitude of the gain this year was exaggerated by a shift in positive outlook for business with the election of Trump. We feel we deserve a point for staying invested while many panicked in the first half of the year - Full point.***

- ***Short term rates*** – We believe the Fed will continue their interest rate hike plan on a gentle glide path in 2016 with 4 – 5 hikes. We see 1% – 1.5% on the Fed Funds rate by year end. More hikes would surprise us but fewer would not due to presidential politics and the lack of international growth.

   - ***While the Federal Reserve did raise rates again in December of 2016 by another 25 basis points, there were not the multiple increases we anticipated. Headline employment numbers improved all throughout the year, but this was as much to do with how and who are calculated into the number more than the actual strength of the employment. The inflation rate was muted and with the rancor of the political process the Federal Reserve tempered their own forecast of rate hikes in favor of continued "easy money" policy to support the slow motion economic recovery. We had the direction right, just not the quantity - Half of a point.***

- ***Long term rates*** – We see long-term interest rates being slightly influenced by the Fed but more influenced by the US and global economies and depressed commodity prices. We see a potential tug-of-war with continued moderate growth from the US offset by sluggishness & slower growth from Europe, China, India, & other emerging economies. Because of this, we predict a flattening of the yield curve with the long-end of the curve rising less than the short-end.

    - ***While all of the factors were correct in the macro economy, this is a great example of how quickly things can change. The yield curve was indeed flattening up until the US Elections were over. Then the markets anticipated a change in business sentiment (to the positive) based on Republican control of Washington politics (at least for the next two years). That anticipation lead to a very positive steeping of the yield curve in the last 8 weeks of the year - No Point here.***

- ***Oil prices*** – Oil above $100 is too expensive. Oil below $40 is too cheap. In our view, $60 oil is equilibrium where demand is largely at “normal” levels. At these prices one can justify the cost of developmental exploration but not speculative drilling, hence replacing the reserves but not expanding reserves. We feel prices will move higher because of the underlying facts about energy - worldwide demand continues to grow & worldwide depletion is a real factor. With US energy production run by for-profit companies and the US now a swing producer, it takes longer for these companies to adapt to the economics of prices. Therefore the recovery of oil we saw going to $60 plus last year didn’t materialize. US companies could not shut down production fast enough to bring supply and demand back in line. With 2016 Capital Budget estimates now half of what they were in 2014 and the specter of some bankruptcies in the sector in 2016, we believe equilibrium will be found in the oil markets and see the price once again slowly trend to above $50 and as high as $60 or more by year end. And of course there is always the wildcard of political instability surrounding the balance of power in the Middle East that could disrupt supply and send prices higher.

    - ***Toward the latter half of the year OPEC (and Saudi Arabia) came to the realization that the lower revenue was causing economic and social pressures in their own countries. At two meetings they came together to try and reverse the glut of supply and balance forward supply with a continuing growth in demand. In anticipation of this, as of this writing, Oil has indeed regained the $50 to $60 range - Full point.***

- ***Inflation*** – remains in check for most of the year until energy prices begin to rebound. Otherwise, we see continued strength in the dollar which should keep inflation low as imports remain down in price in dollar terms. We see moderate economic growth along with moderate wage increases. In our opinion, another year of benign sub 3% inflation.
    - ***Spot on here - Full point.***

- ***Sub investment grade bond defaults –*** We see another difficult year for high yield corporate bonds led by a rise in defaults from overleveraged oil & gas companies with inadequate capital reserves. After a few bankruptcies, we believe this will most likely mark the bottom in oil. Likewise, we recommend investors steer clear of any banks or finance companies with heavy exposure to the oil & gas sector. We see too much potential risk in the sector if oil prices recover slower than expected

  - ***In the first six months of 2016 there had already been $50.2 billion in Defaults, which topped the entire year of 2015 amount of $48.3 Billion. And more defaults have occurred since then, but the rate is declining. The price of oil declining to its lows in the first half of the year caused some companies to be forced into drastic action and there being some surprise bankruptcy filings by companies that appeared to have the cash to stay afloat and weather the price cycle. But banks and lenders were quick to seek remediation and recover what they could. We were spot on with this forecast as well - Full Point.***

- ***Commercial real estate –*** Will face a strong headwind in a rising interest rate environment. Because of this we recommend staying away from triple net lease properties unless they have inflation or automatic rental increase clauses – otherwise we feel they will respond very similar to 15 to 30 year bonds which will see weakness with rising interest rates. However, we still prefer to own select REITs instead of a 10 year bond as higher yields coupled with the possibility of an increasing dividend that make them more attractive and better able to insulate against a price decline due to rising rates. Because of this we recommend a slightly underweight exposure to REITs in general and see outperformance in the sector coming from Health Care, Data Storage, & Residential (both apartments & manufactured housing).

  - ***According to REIT.com the four highest returning sub sectors of Real Estate through November 2016 were Residential (Single Family Homes), Industrial, Data Centers, and Specialty. We get a full point here as our money was where our mouth was and in addition to getting the right sectors, and overweighting REITs (which performed nicely on a total return basis), our individual selections did nicely - Full Point.***

- ***Residential real estate*** – Will rising mortgage rates create a spike in demand as buyers look to get in before it's too late? We're not sure about this as we have a couple forces at play that may offset this. 10,000 baby boomers retiring every day and looking to either downsize or move to a senior living community could offset some of the spike along with millennials embracing the sharing economy and less likely to see the need to buy a house. In our view, the McMansions will have trouble selling. We still favor the small end of residential housing in states that are tax friendly or retiree friendly. Prices which start the year still below peak levels of 2006 – 2007 should continue to climb near 5% for 2016 and potentially those peak levels of 2006- 2007 should be realized again nationwide.

  - ***The S&P/Case Shiller National Home Price Index has increased form 175.23 on Sept 30, 2015 to 184.80 on September 30, 2016 – a 5.46% increase. It eclipsed the July 2006 high of 184.62. With interest rates not rising substantially during the year, the potential of higher mortgage rates to temper the price recovery in housing did not materialize - Full Point.***

In the past we've tried our forecasting knowledge at everything from a World Series match-up to glaciers breaking apart. In 2016 we had a couple more out of the box forecasts to add to the list – and as in years past it may just be the opportunity to bring a subject to light that may otherwise fly below the radar:

- ***Climate change is real –*** While we will avoid the political debate surrounding climate change (whether it is man-made or merely a cyclical process the Earth goes through) we cannot ignore the fact that the planet is warming. We predict 2016 will end with the highest or second highest average temperature since being recorded!

    - ***NASA/GISS (Goddard Institute for Space Studies) have confirmed that through November 2016 this is the hottest year on record. Many months during the year have been records or second highest readings for those months in the last 136 years. It should be noted that the Arctic ice is melting at three times the rate that the Antarctic ice is increasing. The ocean currents surrounding the Antarctic and colder winds have allowed ice increases in South – but not enough to offset the North's decline - Full Point.***

- **Republican Convention** – With many qualified candidates still in the race and plenty of cash left in campaign war chests, we believe this year will be the first since 1976 where a Republican candidate does not enter the convention as the "Presumptive nominee" with enough delegates to win on the first ballot. 1948 was the last time Republicans actually had more than one ballot and Dewey was selected on the third ballot. Absent some last minute, very high level compromises, we believe this convention may take a couple of ballots to determine who will represent the party.

    - ***One of our more fun forecasts. The election did prove to be tense, hard fought, and on the Democratic side, close to a brokered convention. Trump surprised many by capturing the mood of the dissatisfaction of many of the voters who were tired of Washington insiders. He certainly is not a typical politician! - No point here.***

- **Saudi Arabia begins to lose its grip on power in the Middle East**. – Western allies have had a strong tie to the House of Saud since it was invested with the Kingdom of Saudi Arabia in 1932. 150 years ago Muhammad bin Saud and Muhammad bin Adb al-Wahhab formed a pact that eventually led to Wahhabism becoming the official form of Sunni Islam in 21st century Saudi Arabia. While there are fewer than 5 million Wahhabis in the Persian Gulf region (compared to 28.5 million Sunnis and 89 million Shia) Wahhabism has been linked to inspiring the ideology of the Islamic Sate of Iraq and the Ilenat (ISIL) and labeling Muslims who disagree with the Wahhabi definition of monotheism as *takfir* – thus paving the way for their execution for apostasy. The petroleum dollars since the 1970's has allowed the House of Saud to support the ultra-conservative movements within Islam financially and behind the scenes without having it appear to impact their Kingdom. We see the connection as becoming more transparent in 2016 and the international backlash against Saudi Arabia start to gather force.

    - ***There really is no way to quantify this other than to note that Iran's influence has expanded dramatically in the region. Iran appears to be the power broker in Iraq and***

Syria along with a bolder Russian influence in the area. In addition, the recent OPEC agreements would not have happened without Iran obtaining the concessions they wanted. There were pages of reports on the 9/11 attacks that had been redacted that came to light where there was direct blame back to Saudi Arabia as well. Their continued involvement in the military conflict in Yemen has shown their military may not be as vaunted as many had previously thought. So, while there is an obvious lessening of their influence in the region, no direct backlash has begun based on their ultra conservative Islamic religious backings - we think ½ a point is in order here.

2017 Forecasts

- ***Economy*** **–** Psychology impacts the markets considerably as it is the marginal trade (that last trade as a small percentage of an entity) that is so influenced by the fear and greed of the traders. And that in turn sets the valuation of all the shares of a company. But psychology is as important in the corporate boardroom as anywhere else. The corporate boardrooms have had to deal with a political system that was regulation and tax friendly for the past 8 years. Now there is a new mood, one of hope and expectations of a more business friendly environment. Less regulation and lower taxes combined with additional infrastructure stimulus initiatives by the government create a perfect storm for the C suites to be positive and invest in the future. Rather than buying back stock, perhaps they will invest in Research and Development and capital equipment. While there will be a lag effect of the change in corporate mentality, the growth rate of the economy should be better in 2017, and much better in 2018. We see ***GDP for 2017 at the 3% level***, and the momentum being higher as the year progresses.

- ***Stock Market –*** Earnings drive markets over the long term. Expectation of future earnings drive markets in the short term, along with some event driven emotional volatility. We forecast that earnings will be up for 2017 over 2016. While the consensus earnings estimate for the S&P 500 is around $130, we think it does not factor in a potential relief on corporate taxes and the number could come in a bit higher. The headwinds of potential interest rate increases, the offset of potential fiscal stimulus, along with the competiveness in the world economy based on our currency, are all wild cards to the perception of those earnings and how the markets will value them. Additionally, the potential for isolationism to disrupt global trade is a "Grey Swan" type of event that could derail the pro-business climate. We have a much longer viewpoint that the growth of earnings year after year will drive the Dow Jones average over the years to 30,000, 40,000, 50,000 and higher. The question is when. As these forecasts are for next year we are assuming the market will be anticipate 2018 earnings by the end of 2017. Applying a reasonable multiple on those future earnings we would expect the ***S&P 500 to end the year at 2,500 which is approximately 10% higher than today's levels.***

- ***Short term rates –*** The Federal Reserve has released its "Dot Plot" that anticipates 3 rate hikes in 2017. They anticipated 4 last year and we believed them. This coming year we will have potential economic stimulus coming from Washington at a time in the economic cycle when normally you would expect none. That coupled with potential adjustments to the tax code could lead to monetary policy and fiscal policy being in direct conflict with one another. We believe it will take the better part of the year to get any meaningful fiscal changes done, so the impact of those changes would not be felt in the economy until 2018. However, the anticipation of those policies very well could be reflected in the markets well before they impact the economic numbers. As a result we feel ***2 to 3 rate hikes will be the actual number for the year*** but language and rhetoric will be talking rates higher rather than lower.

- ***Long term Rates –*** One of the main indicators of the health of the economy has been the shape of the yield curve over time. When it goes inverted it traditionally signals a recession. When it has a normal slope with long term rates being higher than short term rates, it signals the proper relationship of the cost of capital to the length of the use of that capital. In the past few years we have seen a fairly flat yield curve. Since the election it has steepened considerably. We see this as another indicator of a positive outlook for the economy. We feel that as the Fed raises the discount rate we should see a like increase in the yield curve – all the way along the yield curve. Therefore with our forecast of 3 rate hikes for a 75 basis point increase in the Federal Funds rate, ***we anticipate the 10 year bond yield to rise to 3.25% by year end 2017.***

- ***Oil –*** During the attempt by Saudi Arabia to try to capture/or protect their market share by forcing the price of oil lower, the oil industry had to adapt once again to lower prices. That meant delaying development, capping wells, reducing expenses wherever possible, and paying attention to their balance sheets. In doing so the production cost for a barrel of oil has declined significantly. Bad news for anyone who wants to see a rapid return to triple digit oil prices. The United States has become the defacto swing producer in the world oil supply market. As the price increases, so will our production. Maybe not as quickly as an OPEC meeting in Vienna, but the free market will regulate the price of oil more going forward. If congress gives the oil industry the ability to ship oil overseas in addition to LNG, then we may see the United States buildup production and finally become a net exporter of oil. Given our outlook that the price of oil will be based on profitable economics going forward, our forecast is for the ***price of oil to be range bound between $50 and $65 a barrel in 2017***. Because of the lag in putting on production as the price rises, there is a chance the upper end of the range may be pierced for short periods of time. On a longer term basis we feel the adoption of alternative fuels will slow the growth of consumption of oil and may cause this range to actually slide lower in the ensuing years.

- ***Commercial Real Estate -*** Rising interest rates can have a dampening effect on commercial Real Estate. The value of these properties is based on the income they generate and then applying a rate of return that is acceptable to the purchaser of the property – or the Capitalization Rate. While rents can rise with inflation clauses in many rental contracts, if the rate of the increase in the Cap Rate out paces the income increase, the value of the properties will decline. The only way that you can overcome that is by adding value in other ways on the property, either through development or revenue enhancements. ***The REIT sector will probably be challenged next year as rate rise. Defensive sectors with solid fundamentals, REITs with unique growth propositions, & REITs that can expand their portfolios and increase Funds from Operations on an accretive basis should be the best performers. If mortgage rates increase and affordability becomes an issue, Manufactured Homes could also do well.***

- ***Residential Real Estate –*** Jobs drive real estate prices more than any other factor. Scarcity of land and housing supply is a second driver. Third is the cost of mortgage financing. Then there is the demand side of the equation. For a number of years the Millennials have not been following the traditional trend of launching their households as soon as they have their first jobs. They have either lived at home, or chosen to rent as they have a mobile outlook for jobs. With the remote job capabilities becoming more accepted, and as they reach the point where children are part of the equation, we feel Millennials will begin to seek that "nest" they will call home. They will be entry level purchasers shopping for condos and town houses in urban areas, & houses in more remote locations. The trend toward larger and larger homes since the 1950's we see as reversing in the years to come as more of life will be experienced outside the walls of the house. So once again we will forecast that ***entry level homes will do well in 2017 and the larger "mega" homes will continue to be under pressure. With more demand and sales driving the starter home end of the market the net result will be for an increase nationwide in the price of a home.*** Yes, as the 10 year treasury increases in yield mortgage rates will rise. The affordability of a $200 - $250 thousand dollar home will be marginally affected, but not enough to counteract the demographics. If there is tax reform and the mortgage interest deduction is impacted, then again the larger priced homes will suffer more in price.

- ***<u>SPECIAL FUN FORECASTS</u>***

- ***US Government issues 50 or 100 Year bonds –*** Most borrowers will match off borrowings with the life of the project they are funding – or the expected length of time borrowed funds will have an economic usefulness to the entity. The US Government has a time horizon measured in centuries, not decades. As such, we feel they should be borrowing money long term to fund long term infrastructure and other investments. With business people in the Executive branch we feel they will realize the cost of infrastructure projects being financed at lower rates available now should be done over the very long term. And common sense will be part of the economics of the country for this administration – you borrow long when rates are low and expected to rise; you borrow short when rates are high and expected to come down. To accomplish this, ***we think the US treasury will issue 50 or 100 year bonds.***

- ***Shifting International Balance of Power -*** International tensions will become more of the front page news as the world deals with two things simultaneously. ***Issue #1: the apparent retrenchment of America from the role of world policeman will create a perceived vacuum that China and Russia will try to fill.*** This will be accomplished either with China continuing to assert dominance and control over the South China Sea, or with Russian expanding its influence in the Middle East and coming to a mutual friendship agreement with Ukraine. ***Issue #2: the solidarity of the three major superpowers to combat the destabilizing influences of terrorism worldwide.*** Yes, the three will be US, China, and Russia. Germany will see their place in the influence of the geopolitical world wane as continued pressures to maintain the Eurozone prove increasingly more expensive – both in money and prestige.

- ***Disruptive technology –*** technology is the advancement of any field, not just computer science. The assembly line was once advanced technology. Today the advances are happening at ever increasing rates across all industries. ***If an industry thinks it is immune then it is going to get disrupted.*** The most recent example is the concept of a "driverless car". The car for hire business will be disrupted. The need for multiple vehicles in a family will be reduced. Delivery drones may not fly through the air, but be driverless cars with delivery robots that place the package on your front doorstep. Machine Learning and Artificial Intelligence will be the buzzwords of 2017 as the ethics and disruptions impact many industries.

CONCLUSION

As long-term investors we see a constructive environment for the stock market looking out over the next 5 – 10 years. We are fairly certain the stock market will continue to gyrate based on short-term emotional inputs. However, with solid fundamental research based not just on past but future catalysts as well, we feel the stock market will continue to be a long-term wealth creator for patient investors. Remember, it can be difficult to look through the real-time & constant bombardment of negativity put forth by the media. However, we believe if you do, your mental & financial health will be greatly rewarded.

As always we want to thank you for your continued confidence and the opportunity to manage your investments. We take very seriously our responsibility and will always endeavor to be responsive to your questions and concerns. We welcome and encourage your comments as well.

Montecito Investment Portfolio's Mission: To provide diversified, disciplined long-term investment solutions, service and guidance to help our clients achieve their "Financial Independence".

Sincerely,

Blake Todd, AIF®, CWS
Portfolio Manager

Jarrett Perez, CFA
Portfolio Manager

Disclaimers

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Real estate investments may be subject to a higher degree of market risk because of concentration in a specific industry, sector or geographical sector. Real estate investments may be subject to risks including but not limited to declines in the value of real estate, risks related to general and economic conditions, changes in the value of the underlying property owned by the trust and defaults by borrower.

The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

The Standard & Poor's 500 Index is a capitalization weighted index comprised of 500 widely-held stocks on US stock exchanges. Companies included in the index are selected by the S&P Index Committee, a team of analysts & economists at Standard & Poor's.

S&P 500 Total Return Index is a measure of the price movement of The Standard & Poor's 500 index and including the dividends paid by the companies in the index.

S&P Case Shiller Index – a group of indexes that tracks changes in home prices throughout the United States. Case-Shiller produces indexes representing certain metropolitan statistical areas as well as a national index.

GDP – the monetary value of all the finished goods & services produced within a country's borders in a specific time period.

The MSCI US REIT Total Return Index is an index that broadly represents the price and income movement of the equity REIT universe in the United States. The Index represents approximately 85% of the US REIT universe.

The Barclay's Aggregate Bond Index – includes government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturities of the bonds in the index are more than one year.

P/E Ratio is a valuation ratio of the company's current share price compared to its per-share earnings.