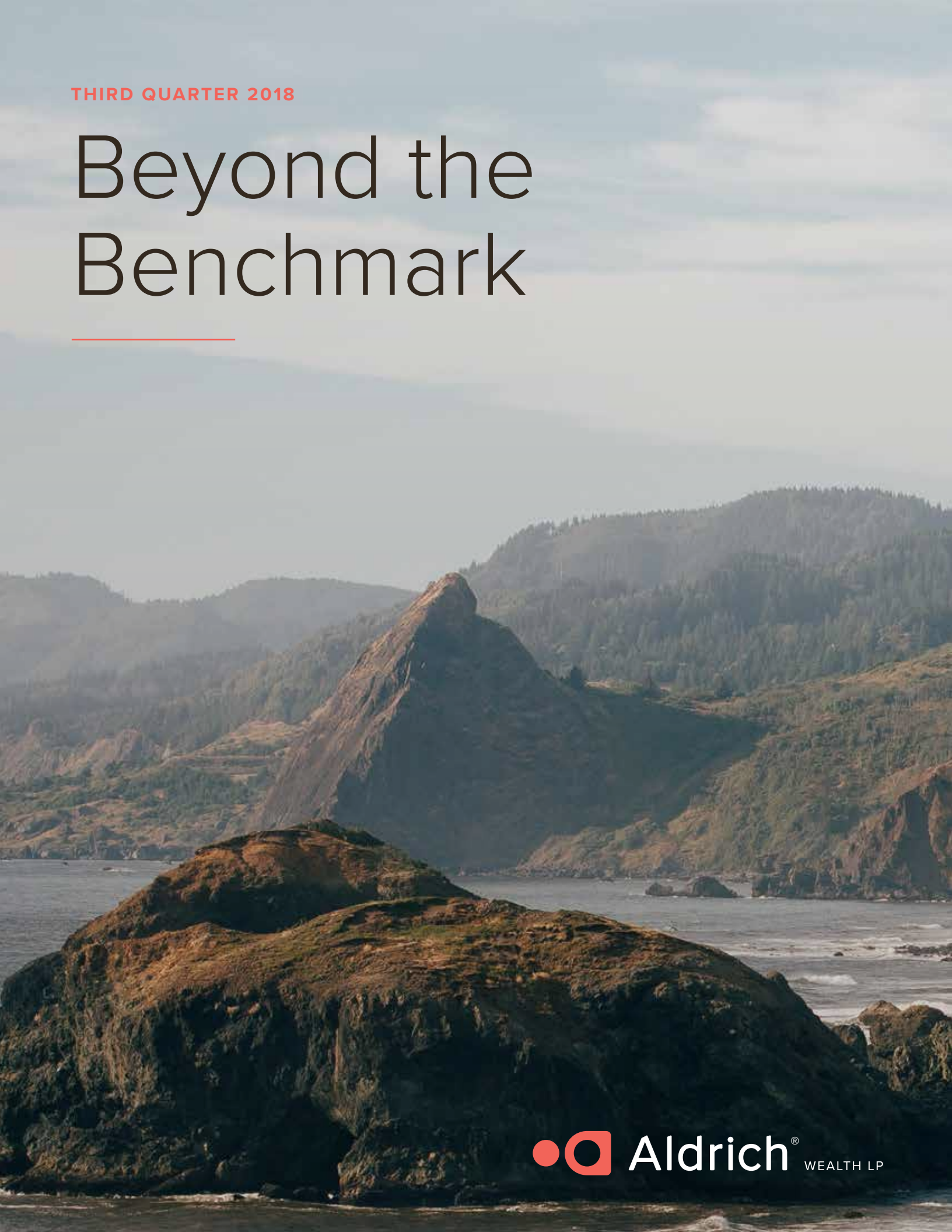
THIRD QUARTER 2018

Beyond the Benchmark



Aldrich® WEALTH LP

QUARTERLY MARKET SNAPSHOT

	VALUE	CORE	GROWTH
Large	5.70%	7.71%	9.17%
Medium	3.30%	5.00%	7.57%
Small	1.60%	3.58%	5.52%

This matrix illustrates U.S. equity benchmarks provided by Russell with the exception of Large Core, which is the S&P 500 Index.

	VALUE	CORE	GROWTH
Global	3.98%	4.28%	4.56%
Non US	1.18%	1.35%	1.53%
EM	3.44%	-1.09%	-5.38%

This matrix illustrates international equity benchmarks provided by MSCI.

	SHORT	INTER	LONG
Gov	0.20%	-0.57%	-2.82%
Corp	0.70%	0.97%	1.32%
Hi-Yield	2.21%	2.44%	3.05%

This matrix illustrates the fixed income benchmarks provided by Bloomberg Barclays Indices and BofA Merrill Lynch.

Executive Summary

A backdrop of solid economic activity and strong corporate earnings, particularly in the U.S., bolstered global equities throughout the quarter. Tax cuts continued to support corporate profits, but ongoing Federal Reserve interest rate hikes and U.S.-China trade tension have placed notable pressures on the go-forward investment narrative. The U.S. topped regional equity-market results for the third quarter in a row. Large cap stocks outpaced their small cap brethren while growth bested value. Trade tensions reverberated overseas as well, inflicting the greatest damage on the emerging markets.

Non-U.S. markets, as measured by the MSCI EAFE Index, increased 1.4% amid strength in Japan. Emerging markets, as measured by the MSCI Emerging Markets Index, declined 1.1% with significant weakness emanating out of Asia. With trade retaliation between the U.S. and China heating up, China's currency and stock market continued to weaken. Emerging market currencies, stocks and bonds have faced headwinds in 2018, particularly those in the most vulnerable countries that have large current account deficits and foreign financing needs. The Fed hiked rates again during the period and increased its forecast for economic growth to 3.1%. Meanwhile the European Central Bank (ECB) announced it would stop bond purchases by year end, signaling the end of an era of unconventional monetary policy. More economically sensitive bond categories such as high-yield corporates fared well, though higher interest rates held back other categories as the yield on the 10-year Treasury rose to its highest levels since 2011.

Domestic Equities

This quarter marked the longest bull market on record for the S&P 500 as a strong economy, modest inflation, surging corporate profits and favorable employment data buoyed consumer optimism. Each of the 11 underlying sectors of the S&P 500 Index turned in positive results last quarter, as the benchmark advanced 7.7%. The strong economic and earnings environment seemed to compensate for the persistently turbulent geopolitical backdrop.

During the period, the Communication Services sector was unveiled within the S&P 500 Index, replacing the antiquated Telecommunication Services sector. The new sector includes a number of well-known technology and media stocks from the Information Technology and Consumer Discretionary sectors. After reporting better than expected earnings, Apple became the first $1 trillion publicly listed U.S. company. Although all sectors rose in the quarter, much of the strong performance was driven by a few high-flying stocks, including Apple.

While the Fed's increase in the overnight lending rate in September was largely anticipated, sectors that are sensitive to such moves, including Real Estate and Utilities, struggled in the quarter. The U.S. market was led by Healthcare, Industrials, Communication Services and Technology. The S&P 500 Index companies posted earnings growth exceeding 25% in the second quarter. In total, 80% of the companies beat earnings expectations with a similar percentage reporting better than expected revenue figures.

International Equities

Burgeoning trade issues, a persistently strong U.S. dollar and mounting political concerns in Italy put a damper on investment markets overseas. International equities weathered the volatile quarter fairly well considering the troubling backdrop with the MSCI EAFE Index advancing 1.4% in the third quarter. Performance was better in local terms as the Index added 2.4%. The Japanese market led the quarterly advance with the MSCI Japan Index increasing 3.7%. Japanese Prime Minister Shinzo Abe easily won reelection, extending his tenure for another three years. The Bank of Japan kept its accommodative monetary policy in place with only modest tweaks to its annual purchasing of exchange-traded funds (ETFs) and real estate investment trusts.

Meanwhile, European stocks struggled as Brexit concerns continue to weigh heavily on investor sentiment in the region. Italy's coalition government agreed to a wider than expected 2019 budget deficit goal of 2.4%, triple what the previous government had planned. The decision essentially puts the country on a collision course with the European Union (EU), which had urged Italy to rein in its spending.

After leading the way in 2017, the MSCI Emerging Markets Index has been the worst performer over the subsequent two quarters, dropping 1.1% in the period. Emerging market stocks were negatively impacted by escalating tariff fears, U.S. interest rate hikes, a stronger U.S. dollar and higher oil prices. The Chinese market continues to feel the effects of trade tensions as monthly indicators have recently provided evidence of slowing growth on the mainland. During the quarter, the U.S. formally implemented tariffs on $200 billion in Chinese goods with reports that tariffs on another $267 billion are on the docket. The Chinese yuan fell for eleven-straight weeks, its longest losing streak since China created its current exchange rate regime in 1994.

Emerging market currencies faced headwinds in 2018, particularly those in the most vulnerable countries that have large current-account deficits and foreign financing needs. Turkey was in the headlines during the quarter as rising inflation, extensive U.S. dollar debt, and a dramatically falling currency raised the prospect of a default. Several other countries, including Argentina and South Africa, saw their currencies tumble in the quarter.

Fixed Income

Policymakers raised the federal funds rate by another 0.25% in September and are expected to make another 0.25% hike in December, recording four 0.25% hikes for the year. The Fed increased its forecast for economic growth this year to 3.1% and outlined plans for three more rate hikes in 2019 as economic activity and unemployment data remain robust. The Fed expressed its favorable view on the economy, noting that solid gains in employment, household spending, and business investment could continue. For the quarter, the yield on the 10-year Treasury marched higher from 2.85% to 3.05%. Leading up to the Fed meeting in late September, the yield on the benchmark 10-year Treasury note broke through the 3% threshold and remained above that psychologically significant level through quarter-end. For the first time since 2008, the rate on the three-month Treasury exceeded 2%.

The Barclays Universal Bond Index ended the third quarter up just over 0.2%, but the year-to-date return remains in negative territory. Yields across all maturities increased in the quarter and short-term bonds were the best performers since they are less sensitive to rising bond yields. Municipal bonds have performed well year-to-date, exceeding the returns of both U.S. Treasury and corporate bonds. The relatively strong results of the municipal bond market have centered on continued supply constraints and ample demand. High-yield and floating rate bank loans turned in some of the best returns in this rising interest rate environment. With the ability to reset rates quarterly, bank loan investors are able to benefit from interest rate hikes.

The European Central Bank kept short-term rates unchanged. Post-meeting remarks by ECB President Mario Draghi were slightly more hawkish than they have been in the past. The ECB also confirmed that it will reduce the monthly amount of bonds it buys by half, to €15 billion from €30 billion, under its quantitative easing program through 2018. The Bank of England (BoE) raised its key short-term interest rate from 0.50% to 0.75% mid-quarter. Despite recent soft economic data, the move was largely expected.

Economy

The U.S. economy, as measured by the change in the Gross Domestic Product, increased 4.2% during the second quarter—the fastest pace in nearly four years. The positive effects of corporate tax cuts and deregulation led to a solid increase in business spending, which helped boost an already strong economy. U.S. unemployment dropped to 3.7%, marking the lowest reading since December 1969. Meanwhile, wage growth grew 2.9%, the highest since June 2009. The University of Michigan's consumer sentiment index topped 100.0 for only the third time since January of 2004. Consumer spending was strong in the quarter as confidence was near all-time highs.

Global growth has moderated somewhat amid currency headwinds and escalating trade war rhetoric. However, most economists are projecting global GDP will accelerate further in the back half of the year and that the moderating trend isn't worsening. Growth across much of Europe, Japan, and emerging Asia has been encouraging and has exceeded expectations. Interest rates remain very low globally and this has contributed to increased business and consumer spending, but thus far hasn't notably increased inflationary pressures. Therefore, governments across the globe are maintaining low interest rates and are more focused on generating growth rather than taming inflation. The pro-growth posture of so many countries and regions has contributed to the global rebound in growth and is projected to provide additional fuel in 2019.

Market Outlook

Burgeoning trade tensions continue to weigh heavily on the overarching investment narrative, despite a healthy economic backdrop. The recent imposition of tariffs out of the White House on China has increased downside risk to global trade. The recently implemented tariffs on $200B of goods at 10% could increase to 25% in 2019 and expand in coverage. China represents the second largest economy in the world and China is a major importer of goods, particularly among other emerging market countries. A major slowdown in China would arguably have negative ripple effects across the globe. Thus far the Chinese government has been able to take some measures to limit the impact of tariffs, including encouraging banks to lend more and allowing local governments to spend more on infrastructure projects. A long-term trade war could hurt global growth and increase inflation in the U.S. Although this seems like an unlikely outcome, investors appear to be pricing in the negative consequences, particularly in emerging market equities. A resolution in the coming months could potentially unlock a significant amount of value in emerging market equities trading at historically low valuations.

After strong performance in August and September, U.S. equity valuations moved back above their long-term averages. Meanwhile, developed market equites are trading slightly below their long-term average and emerging markets equities are trading well below their long-term average valuations. The latest estimates suggest that S&P 500 earnings could surge 19% in the quarter and over 20% for all of 2018. The Tax Cuts and Jobs Act increased earnings expectations for domestic stocks and is projected to add about 8% to earnings in 2018. There is some concern that the economy is peaking and that margins will begin to deteriorate as interest rates rise. A more aggressive Fed would likely weaken equity investor enthusiasm and negatively impact returns. Nonetheless, strong earnings growth should be supportive of modest gains in 2018 and into 2019. Historically, post mid-term returns have been very good for stocks and could boost returns in the back half of the fourth quarter.

Based purely on relative valuations and given that the U.S. is likely farther along in its economic recovery, international equities could outperform domestic stocks going forward. Although domestic and international developed market equity returns were similar in 2017, nearly half of the performance for international stocks was attributable to currency appreciation, particularly the Euro. Therefore, valuation metrics for equity indices in the Eurozone actually improved relative to domestic levels. However, investor sentiment turned negative toward international stocks this year after the asset class experienced a surge in inflows in 2017. Until sentiment improves, international stocks may continue to struggle to keep pace with their domestic counterparts.

U.S. interest rates increased in the third quarter as relatively strong economic growth prompted the Fed to raise the overnight rate by 0.25% in September. The Fed is projecting a fourth 0.25% hike this year in December. The corporate tax cuts have further strengthened an already strong economy. We believe strong global growth will help push interest rates higher as inflation increases. Given this outlook, we continue to emphasize shorter duration bonds and floating rate bonds, which generally perform relatively well when interest rates rise.

A Lesson on Attitude

By Carl Pinkard, CFP®

In my role as a wealth manager, I have the opportunity to work with a diverse group of clients that have very different backgrounds and unique personalities. It always amazes me how, regardless of circumstances, people have the ability to forge their own path in life. In being exposed to and working with so many successful people over the years, I have observed they tend to have one shared personality trait...a positive attitude. That's not to say that I haven't seen at least a few grumpy folks find success, but that is generally the exception.

A few years back a client sent me a handwritten letter that included a quote about attitude. She has a gift for sharing valuable information she's learned during her life and passing it on to others. That following quote resonated with me, and I keep it visible on my desk to this day.

"Attitude is more important than facts. It is more important than the past, than education, than money, than circumstances, than failures, than successes, than what other people think or say or do. Attitude is more important than appearance, giftedness, or skill.

Attitude will make or break a company, a church, a home. The remarkable thing is, you have the choice every day regarding the attitude you will embrace for that day.

You cannot change the past...you cannot change the fact that people will act a certain way. You cannot change the inevitable. The only thing you can do is play on the one string you have...and that is your attitude.

Life is 10% what happens to you and 90% how you react to it. And so it is with you...you are in charge of your attitude." — Charles Swindoll

What I take from this each time I read it is that I am in control of my attitude. We all face daily challenges and even times of great loss or sadness. How we respond and react is purely in our hands. This is a lesson that my clients have taught me, and it impacts how I approach each day. If I can pass on that message and lead by example, then I get to perpetuate the "gift" that my client gave to me with that note. She happens to be 88, lives independently, volunteers 30 hours a week, and continues to spread wisdom to those around her. She may be on to something...

CARL PINKARD, CFP®
Partner, Aldrich Wealth

As a leader of our Private Wealth group, Carl helps shape our comprehensive and integrative service model that provides investment management, financial planning and tax services to our clients in San Diego. Carl specializes in working with high net worth families, business owners and medical practitioners, providing financial planning and consulting services. He also works with pension committees and assists with a number of non-profit organizations.

Saving When Giving at Year-End: Using a Qualified Charitable Distribution

By Stephen Nelson, CFP®

The last quarter of the year is typically a season of expectation and service. The scent of pumpkin spice candles readies our stomachs for warm Thanksgiving pie. Fall-themed couch pillows are a sign that friends and family will soon be visiting and making memories with us (brownie points from the better half for saying I like couch pillows?), and during this time-off over the holidays we also think of those who are less fortunate.

This is also the time of year that can delight those over 70 ½ with Traditional IRA balances as they'll be receiving the IRS mandated Required Minimum Distribution or RMD. Most people like receiving the extra "bonus" at the end of the year but can be disheartened knowing the amount distributed will be fully taxed come April of next year.

What if there was a strategy that allowed you to give to charity, satisfy your RMD, and didn't cost you any income taxes? Well, Santa Claus did come early in the form of what's called a Qualified Charitable Distribution or QCD that's even more powerful now with the new tax law in place.

How it works is rather straightforward once you know the steps. Instead of distributing your RMD to yourself, have the amount made payable to the charity (or charities) of your choice. This will satisfy your RMD requirements but exclude the distribution from your income. Just be sure you receive confirmation from the charity that the gift was accepted – like any other charitable gift.

As a result of the tax law causing the standard deduction to double to $24,000 (for married couples), fewer people will itemize and therefore, won't receive

a deduction for their charitable giving. But by utilizing a QCD, essentially, you get a double advantage. You can take the standard deduction and exclude the RMD given to charity from your income, effectively gaining a charitable deduction.

Because a QCD is not included in income as a distribution, using this strategy is better than taking a taxable IRA distribution and trying to offset it with a charitable contribution deduction. A QCD does not increase AGI (adjusted gross income) unlike a taxable IRA distribution. As an older taxpayer, it would be wise to limit your AGI because that is what determines the income tax on your Social Security benefits and your Medicare premiums.

Even if you aren't quite at age 70 ½, it might make sense to delay making charitable contributions until you become eligible to use QCDs.

What kind of tax savings are we talking about? Say a client is in the new 24% tax bracket and makes a $10,000 gift using a QCD. If the client is taking the standard deduction where charitable contributions are not deductible, this $10,000 QCD will reduce their tax bill by $2,400 ($10,000 x 24% tax rate) compared to giving the old way without the QCD.

Clients who take the standard deduction have the most to gain, but there are plenty of tax savings for those who will still itemize.

There are a few things to remember when dealing with QCD's. The funds must come out of your IRA by December 31st for it to satisfy the RMD requirement. They must be made payable to the charity rather than you, the IRA owner, which would then cause the withdrawal to not qualify as a QCD. There are some charities that do not qualify for QCDs, mainly private foundations or donor-advised funds. The annual QCD limit is $100,000 per person.

For those of you who already have plans to give and are in the RMD stage of life, it stands to reason that the most effective and tax smart way to go about it is to utilize the QCD strategy.

STEPHEN NELSON, CFP®

Wealth Manager

Stephen assists individuals, families, and businesses plan for their financial future through prudent and values-based advice. Trust, stewardship, integrity, and excellent service are the bedrock of every interaction with his clients. His experience prior to joining the firm includes investment management, financial planning and advising. He aims to educate, serve and strategize for meeting clients' financial objectives while always upholding a fiduciary standard.

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Recognized as Financial Times Top 300 Financial Advisors

The 2015 Financial Times Top 300 Registered Investment Advisors is an independent listing produced by the Financial Times (June, 2015). The FT 300 is based on data gathered from RIA firms, regulatory disclosures, and the FT's research. Applications were solicited from more than 2,000 independent RIA firms that had $300 million or more in assets. The 630 RIA firms that applied were then graded on six criteria: AUM; AUM growth rate; years in existence; advanced industry credentials; online accessibility; and compliance records. To make sure the list was relevant to Financial Times readers, the paper required that no more than 75% of a practice's assets be institutional. Only those who completed an application were considered. Neither the RIA firms nor their employees pay a fee to The Financial Times in exchange for inclusion in the FT 300. This is the second annual FT 300 list, produced independently by the FT in collaboration with Ignites Research, a subsidiary of the FT that provides business intelligence on the investment management industry.

Recognized Five Star Professional's "Five Star Wealth Managers"

Five Star Professional, as a third-party research firm, identified pre-qualified award candidates based on industry data and contacted all identified broker dealers, Registered Investment Advisor firms and FINRA-registered representatives in the Portland area to gather wealth manager nominations. Award candidates were then evaluated against 10 objective eligibility and evaluation criteria: 1) Credentialed as an investment advisory representative (IAR), a FINRA-registered representative, a CPA or a licensed attorney; 2) Actively employed as a credentialed professional in the financial services industry for a minimum of five years; 3) Favorable regulatory and complaint history review; 4) Fulfilled their firm review based on internal firm standards; 5) Accepting new clients; 6) One year client retention rate; 7) Five-year client retention rate; 8) Non-institutionalized discretionary and/or nondiscretionary client assets administered; 9) Number of client households served; 10) Educational and professional designations. 1,107 wealth managers in the Portland area were considered for the award. 224 were named 2015 Five Star Wealth Managers which represents approximately 21 percent of the total award candidates of the area. Wealth managers do not pay a fee to be considered or placed on the final list of 2015 Five Star Wealth Managers. The Five Star award is not indicative of the wealth manager's future performance. For more information on the Five Star Wealth Manager program and the research/selection methodology, go to www.fivestarprofessional.com/wmsummaryandresearch.pdf. To view AKT Wealth Advisors, LP award document, go to http://www.pageturnpro.com/Five-Star-Professional/64888-PORWM15-Heather-Wonderly/puredefault.html.

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