January 16, 2018

Dear Investor,

On average, client accounts with a 75% equity / 25% fixed income allocation rose eighteen percent for full year 2017*. During this period, the S&P 500 stock index rose 21.7% and the Barclays Aggregate bond index rose 3.5%. A similarly proportioned investment in the S&P stock and Barclays bond indexes (3/4 stock and 1/4 bonds) would have resulted in a quarterly return of 17.2%.

Account performance was helped by the good performance of a number of our holdings. Chief among these were the stocks of Alphabet (Google), Microsoft, Anthem, Aetna, Apple, Abbott, Constellium, Facebook, FMC Corp, and Visa.

Cable Television Investments

For the last few years one of your larger portfolio allocations has been to cable television companies, including holdings of Comcast, Charter Communications, Cable One, and Liberty Global. As a result of recent developments I have grown concerned about the future of the cable industry.

For some time, cable viewership has declined as the potential audience has chosen to watch more shows and movies over the internet. However, that negative operating trend has been more than compensated for by growth in cable's more profitable business of selling high speed internet access.

My concern is that the high speed internet business is becoming more competitive. While I think cable's high speed product may remain the fastest internet connection available to consumers, other broadband technologies are improving. Landline phone companies are already supplementing dated copper wire with high speed optical fiber, allowing them to offer faster internet speeds. Wireless phone providers plan to invest heavily in next generation ("5G") technologies which could vastly increase wireless broadband speeds. And satellite technology is making improvements that should make it a more credible competitor in a few years, particularly in rural areas.

Some of these developments may not hurt cable. For example high speed wireless technologies may rely on cable infrastructure, providing the cable companies with a new customer base. However the rapid technology change underway makes it hard to be confident that the cable industry will continue to grow. Despite this uncertainty, our cable investments are now priced near all-time highs. As a result, I have reduced our exposure to the sector at what I think are very fair prices, selling most of our holdings of Charter Communications and Cable One, and reducing our holdings of Comcast.

*****Performance information is unaudited, and is based on fully discretionary client accounts without significant intra-year contributions or withdrawals.

DSW Investment, LLC
878 Lawrenceville Rd, Princeton NJ 08540
P:(609) 430-8407 F:(866) 202-2204
www.dswinvestment.com

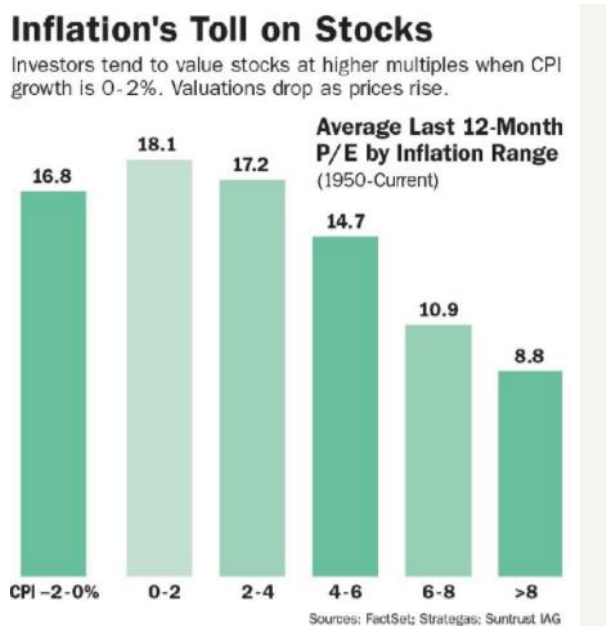
General Market Notes

Stock prices and returns continue to be supported by the combination of steady economic growth and low interest rates. Valuations remain high, but appear unlikely to contract until there is a significant decline in economic growth or a significant rise in interest rates.

Regarding economic growth, we are nine years into an economic recovery, an unusually long stretch without a recession. However typical precursors of recession, such as excessive consumer debt or rising unemployment are not imminent risks. The biggest immediate risks to global growth, and so to stock market values, would appear to be a destabilizing geopolitical event, such as worsening tensions in our relationship to North Korea.

Inflation, and in consequence interest rates, may well rise this year as a result of tightening labor markets. That said, unless inflationary pressures are stronger than anyone expects, they are unlikely to have a big impact on the stock market.

This chart published in Barron's gives a good sense of the historical relationship between inflation and stock prices. Note that stock multiples don't fall much until inflation exceeds four percent, a level well above most economic forecasts:



Source: Barron's (see their credited sources above)

More modest inflation and rate increases would likely be offset by continued earnings growth, which would allow stocks to move higher. This is particularly true for shares of American businesses which will benefit this year from lower tax rates.

A modest increase in inflation would be more problematic for low yielding longer term bonds than for stocks. The rates on these securities are so low that even modest increases in interest rates would require a downward revaluation. Investors in thirty year treasury bonds for example could see double digit market losses in the event of a one percent rise in thirty year interest rates. I am avoiding investments that, like long term treasuries, would lose substantial value in the event of modestly higher interest rates.

Portfolio adjustments

Since the financial crisis, I have tried to reduce the variability of clients' portfolios by investing roughly a third of portfolios in securities that are not overly sensitive to market movements. This has included higher yielding preferred stocks and short maturity bonds.

Over the last eighteen months our investments in stock have risen substantially while our fixed income investments have remained flat. As a result, our investment in stock as a percentage of total portfolio holdings has risen substantially, from roughly two thirds of holdings at the beginning of 2017 to more than seventy percent of holdings today. Given ongoing market risks, my preference is for your stockholdings to gradually move back towards two thirds of your portfolio. That will require some selling of stock as well as investing dividend and interest income in alternatives to stock.

The challenge for me is finding sound alternatives to stock. In the past preferred stocks helped in this effort, as they offered high single digit yields with relatively low price volatility and limited performance correlation to the stock market. Today, those yields have fallen to six percent or lower. While that is still a good-enough return relative to many alternatives, if interest rates rise substantially these securities will lose value (although not as much as even lower yielding bonds). As a result, I am searching for other ways to make portfolios less dependent on the direction of the stock market while still providing reasonable returns.

One possibility involves companies which have agreed to sell themselves for a known price, but are awaiting regulatory approval. For example, CVS has agreed to buy Aetna for roughly $206 per share, with most of that price fixed and payable in cash, but Aetna is only valued at $185 today due to concerns the sale will not be permitted by regulators. While regulatory concerns represent a very real risk, occasionally mergers have a high probability of avoiding regulatory censure and constitute good bets. This is particularly the case if the stock price of the selling company is fair even if the merger is never consummated. I will be alert to opportunities of this sort.

As always, please contact me with any questions.
Best,

DSW Investment, LLC
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