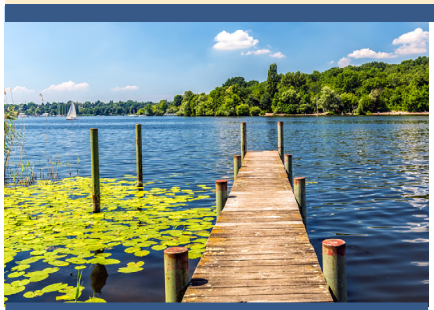
Cabot Quarterly Review

WEALTH MANAGEMENT

2ND QUARTER | 2017



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216 Essex Street | Salem, MA
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Blog

Dear Friends,

It was November of 1983 when I set out to start a new company called Cabot Money Management, Inc. I was 27 years old and only a few years out of receiving my MBA from University of Massachusetts in Amherst. Like a great many people, I followed in my Dad's footsteps (Carlton G. Lutts) and entered the investment business. Thirty-four years later I find myself thinking about the coming years and developing plans for the next phase of growth for Cabot Wealth Management, Inc.

After considerable research and thought, I have decided to begin a Succession Phase that will take ten years or longer, but will insure the company will long outlive me and will continue to thrive and prosper in the coming years. Effective July 1, 2017, I have sold 30% of Cabot Wealth Management, Inc. to the three senior principals of the firm: Jim Gasparello, Greg Stevens and Sonia Ernst. I continue to be the primary shareholder and will own 70% of the shares and will continue to work actively in the business as I have done for 34 years; however, we have begun a process of transition to the next generation of leaders.

I selected these three individuals because they are all very competent, hardworking, honest people who care deeply about our clients and about providing quality services for them. I am thrilled to now call them my partners in business ownership. For those of you who do not know, Jim Gasparello has had the longest tenure with the firm— more than 21 years, while Sonia Ernst has been running our operations and trading team for more than 17 years and Greg Stevens has been with the firm more than 13 years. During this time, they have all demonstrated extraordinary skill, talent, good judgement and a strong desire to help clients achieve their goals. Jim and Greg work with many of our clients on a regular basis and Jim supervises the Wealth Management team. Greg acts as the Compliance Officer of the firm and helps many clients with more complex retirement and planning cases. Sonia is the firm's ace operations expert who has lead the firm's trading and operations team quite skillfully for many years.

We do not expect to make any significant changes to the company or our services in the near term; however, I do expect the next generation of leaders may bring new and better ideas than I have had over the years. I can assure you I will be open-minded enough to listen and act on all of the great ideas. I want you all to know I enjoy our investment research work in the firm a great deal and will continue to research and explore new ways to grow our clients' wealth. I expect to continue my regular emerging markets travels and will continue to lead the firm's investment team for many years. When you see Jim, Greg, and Sonia please congratulate them on their new Shareholder title and wish them luck as they undertake new challenges and opportunities in the coming years.

We take our mission of preserving and building your family's wealth seriously. We appreciate that you've selected the Cabot team for this important job. Happy summer!

Rob

Robert T. Lutts
President, Chief Investment Officer

Robert T. Lutts
President &
Chief Investment
Officer

Innovation Takes Center Stage

Similarities to World's Electrification in 1888.

I read a great book this summer titled The Last Days of Night, by Graham Moore (Random House). It is set in 1888 in New York City and is in fact a novel, but is based almost entirely on real historical events at a fascinating period of technological progress in our country. The book places the reader right in the middle of NYC in 1888 during the period of time when electricity was first developed and implemented in our country, thus driving us into the fast-paced Industrial Revolution.

The novel's central character is Paul Cravath, a lawyer who represented George Westinghouse (the founder of the Westinghouse Inc.) regarding his competition with Thomas Edison in the race to electrify our country. The battle revolves around direct current versus alternating current, its technology and patent rights. The book exposes Thomas Edison as a devilish character who would do anything to advance his inventions. Moore has great insight into the unique relationship Edison had with Westinghouse and Nicola Tesla (the inventor of alternating current).

Besides being a fascinating, entertaining, and educational book, I found it very useful in understanding where we are today in terms of innovation. Innovation in 2017 revolves around artificial intelligence and smart software, solar and wind power, new forms of energy efficiency, electric and autonomous automobiles, genomic information in healthcare, and many more digital innovations. These innovations in aggregate possibly pose an even bigger impact to our economy and wellbeing than the development of electricity. I believe all of these innovations have the potential to catapult the United States even further ahead in the economic global race.

Companies like Alphabet (Google), Amazon, Apple, Facebook, LinkedIn, Tesla, Salesforce.com, Microsoft, Illumina, and Nvidia all dominate their respective fields in the digital world and all have one thing in common – they are all developed and grown right here in our country. The United States is leading the digital innovation in the technology world and its impact to industry and our economy is tremendous today. I believe one needs to fully consider the impact of all this new innovation and what this could mean to corporate profits and commerce in our country (likely very positive in many industries for some time).

We may be experiencing a period of time like the 1920s (the roaring twenties) when our economy was experiencing fantastic growth and innovation. Please do not set your sights too low for our country because we all may be surprised at how long the good times last!

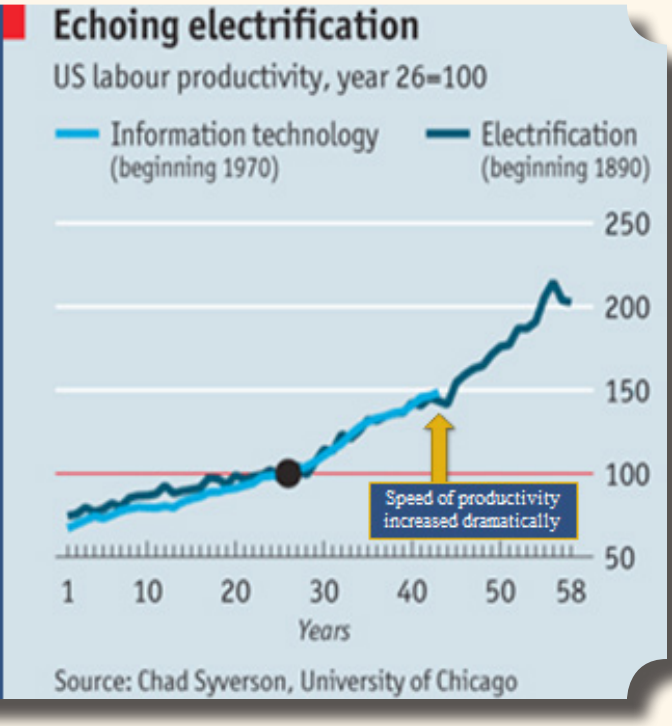
This chart (from Chad Swenson at University of Chicago) highlights the tremendous impact innovation can have on our economic progress. Our economy really grew fast in the early part of the 1900s....from 1907 to 1917 we doubled our Gross Domestic Product, then we doubled it again from 1917 to 1928.

Innovation really wound the stem of our economy at the turn of the century. Today we are in a similar period with extraordinary advances in transportation, new energy technologies, healthcare, communication tools, artificial intelligence and more.

Can we exceed the fantastic productivity gains since electricity was developed with the innovation from the digital world? My bet is YES. Stay tuned as wealth creation and great progress is right around the corner.

Benefits of information technology can take us a long way!

I believe Internet and IT will have **much larger impact on productivity** than electricity.



Markets Continue an Eerily Calm Trek Higher

Craig Goryl, CFA
Portfolio Manager

US and international stocks posted another quarter marked by positive returns and historically low volatility. An awful lot has been written about the quiet strength that currently pervades stock exchanges, so I thought I'd share a few thoughts on that topic.

How quiet has it been? There are a number of ways to measure market calmness… Most common is the standard deviation (SD) of daily market fluctuations- lower is less volatile. By this yardstick, the S&P500 has had 2 consecutive quarters with annualized SD below 8%, a feat not seen since 1993. The global "all country world" index SD has been under 7% for two quarters, which last occurred in 1996. Another measure is the VIX, known as the "fear index" which reflects the cost to buy insurance against a market crash. The VIX had its lowest average in over ten years in 2Q, signaling very few investors are seeking "protection."

What is causing this subdued volatility? There are a number of factors at play here. The popularity of low-cost index investing means that most money entering the markets is being allocated proportionally and mechanically (some might say indiscriminately!) by size, resulting in stocks moving together. Another theory has to do with the global economic cycle being in a "Goldilocks" state: not too hot, not too cold. The Financial Crisis is now almost a decade behind us, global economic growth is stable, corporate profits are rising, inflation is benign, and money is widely available to borrow at low interest rates. If economic seas are calm, it makes sense that markets would be, too. Finally, it is clear from the comments of global central banks, including our Federal Reserve, that they keep a close eye on equities and are likely to increase money supply whenever the market gets rattled. The result is that traders have the confidence (possibly unfounded) that a safety net awaits, and they can buy on even the shallowest decline.

What does it mean for investors? Does calm beget calm, or portend turmoil? Volatility will return for sure, but no one knows when, or even in which direction. Rather than trying to time the next crash or rally, it is important to stay properly allocated. The dangerous side effect of easy money and low volatility is complacency; do not allow yourself to be lulled into thinking the current dull stock markets will stay that way.

Asset Classes

Index	2nd Qtr Return	YTD Return	1 Year Return	3Y Ann. Return	Index Description
US Equities					
Dow Jones Industrial Average	4.0%	9.3%	22.1%	11.0%	US Large Cap Stocks (30 select large US corporations)
S&P 500 Index	3.1%	9.3%	17.9%	9.6%	US Large Cap Stocks (top 500)
Russell 1000 Index	3.1%	9.3%	18.0%	9.3%	US Large Cap Stocks (top 1000)
Russell 2000 Index	2.5%	5.0%	24.6%	7.3%	US Small Cap Stocks (2000 small public companies)
Global Equities					
MSCI All Country World Index	4.3%	11.5%	18.8%	4.8%	Combination of major global markets: United Stated, Foreign Developed, and Emerging Mkts
MSCI EAFE (Europe, Australia, Far East)	6.1%	13.8%	20.3%	1.1%	Large and mid-sized companies in mature foreign markets like Japan, Europe, Australia, etc.
MSCI Emerging Markets	6.3%	18.4%	23.7%	1.1%	Large and mid-sized companies in developing economies like China, India, Brazil, Russia, South Africa, etc
MSCI Frontier Markets	6.1%	15.6%	19.2%	-3.4%	Large and mid-sized companies in the world's least advanced economies like Kuwait, Argentina, Kenya, etc
Fixed Income					
Merrill Lynch 1-10 year A or better	0.8%	1.4%	-0.5%	1.9%	High quality US bonds maturing in 10 years or less
Bloomberg Barclay's US Aggregate Bonds	1.4%	2.3%	-0.3%	2.5%	US Bond Market: government, corporate, and mortgage bonds
Bloomberg Barclay's US High Yield	2.2%	3.9%	12.7%	4.5%	Higher risk, higher yeild "junk" bonds
"Alternative" Assets					
GOLD SPOT $/OZ	-0.6%	7.7%	-6.1%	-2.2%	Gold bullion
NYSE Arca Gold Miners Index	-2.9%	5.4%	-19.6%	-4.7%	Companies that mine precious metals
Crude Oil	-9.0%	-14.3%	-4.7%	-24.1%	The price of a barrel of oil
Bloomberg Commodity Index	-3.2%	-5.6%	-7.0%	-15.0%	Commodities like gold, copper, natural gas, corn, etc
Dow Jones REIT Index	2.3%	4.9%	0.2%	9.0%	REITs: Real Estate Investment Trusts
Alerian MLP Infrastructure Index	-6.9%	-3.1%	1.2%	-9.9%	MLPs: Energy infrastructure assets such as pipelines

Nick Burwell
Portfolio Manager

Is the Great Unwind Approaching?

Even occasional financial market observers have become familiar with the term quantitative easing. This unconventional monetary policy tool, in which central banks buy government securities in order to drive interest rates lower and increase money supply has clearly had a profound effect on the price of all types of assets. It is impossible to know where this economy and the stock, bond, real estate and labor markets would be without this unprecedented intervention. I can hardly recall a discussion centered around markets that did not include at least a mention of the all-powerful QE. Personally, I believe rates have been kept too low for too long. But like everyone else, I'm just plain tired of speculating as to what the final outcome will bring. Of course, there is some bias here, as some of us dream of the day we can pick up 4-5% yielding bonds with short maturities and solid credit fundamentals. The $64,000 question that we face today is, Can the Fed actually reverse some of this stimulus and will this potentially give us the attractive bond yields the world so desperately craves?

At the last Federal Open Market Committee meeting, the board released something called the "Addendum to the Policy Normalization Principles and Plans"—essentially a process to reduce the size of its $4.5 trillion stockpile of Treasury, Agency and mortgage-backed securities. The committee has hinted it would like to begin this process this year but has not set a formal date. The general idea is that the committee will gradually stop reinvesting principle payments as the securities it holds reach maturity. They will initially cap this amount at $6 billion per month for Treasuries and will increase in steps of $6 billion every three months until the cap maxes out at $30 billion per month. For its Agency and mortgage-backed securities, the committee will start with a $4 billion cap, increasing every 3 months until it reaches $20 billion per month. The addendum goes on to point out, "the Committee would be prepared to resume reinvestment of principal payments received on securities held by the Federal Reserve if a material deterioration in the economic outlook were to warrant a sizable reduction in the Committee's target for the federal funds rate."

For now, we still have Europe and Japan instituting massive quantitative easing programs but in the case of Europe at least, as the economy there continues to show signs of life, many market participants are expecting an announcement this fall detailing plans to taper European QE mid-year 2018.

So what will the future hold once the QE lever is pulled the other way? Hard to say for sure, of course. We continue to keep our interest rate risk defensively positioned against the broad index. We do expect, however, interest rate volatility to pick up in the coming months and will continue to pursue trading opportunities along the way.

An important key to this grand plan to unwind the Fed's balance sheet will be the time factor remaining for the current economic expansion. The history book is far from written regarding the post-financial crises central bank QE episode. Some say all the money printing creates perverse incentives and misallocation of capital. Some say it indiscriminately punishes savers of financial capital. And then there are those who think this program saved us from an economic environment rivaled only by the Great Depression of the 1930s. Whether or not the monetary authorities can successfully pull off the reverse side of this grand experiment will have implications for future generations of worker bees all across the globe for years to come.

To be continued…

ROTH IRA Contributions vs. IRA Conversion

Greg Stevens, CFP®, CRPS®
Sr. Wealth Advisor

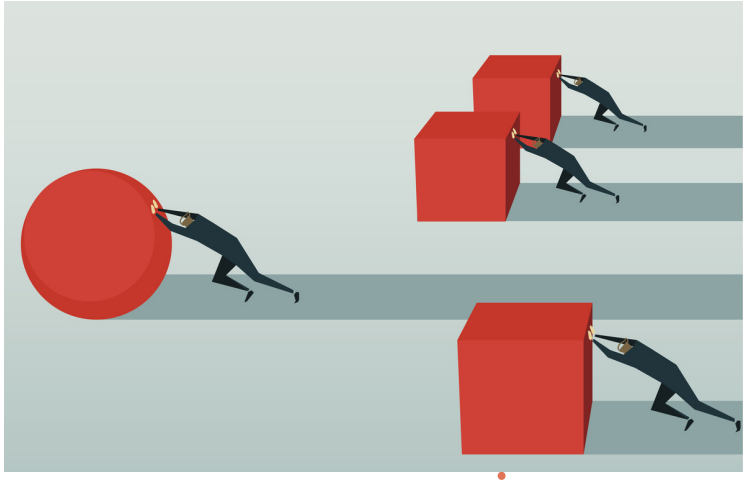
The tax-free growth component of ROTH IRAs make them a compelling tool to consider when saving for retirement. It is important to be aware of certain limitations to funding a ROTH and, more importantly, how to work around them.

The biggest hurdle to overcome are the income phaseouts. For the 2017 tax year, a married couple with an adjusted gross income (AGI) above $196,000 ($133,000 for single filers) cannot make a contribution directly to a ROTH IRA. However, anyone with earned income can contribute to a traditional IRA. Those who are active participants in a company sponsored retirement plan who also happen to be high income earners aren't eligible to take a tax deduction for their IRA contribution but they can still contribute.

Since there are no income limits on ROTH conversions, taxpayers that fall into both scenarios (high earners with an employer-sponsored plan) can still contribute to a ROTH simply by making an IRA contribution and then converting that money to a ROTH.

IRA Aggregation Rule

Keep in mind, though, that there is a catch…the IRA Aggregation rule. In the eyes of the IRS, all IRA accounts (including traditional IRAs, SIMPLE and SEP IRAs, Rollover IRAs but NOT employer sponsored plans or inherited IRAs) per individual are considered as one asset for the purposes of calculating taxable distributions. This creates a problem for tax payers hoping to convert their non-deductible IRA contribution to a ROTH. For example, if an individual has a $250,000 IRA rollover (pre-tax contributions) and just made a $5500 non-deductible IRA contribution, only $121 (2.2%) of the contribution could be rolled over tax free ($5500/$250,000). The remainder of the distribution would be taxed as ordinary income.



Another potential road block lies in the fact that a taxpayer must be able to prove to the IRS that the contribution and conversion were separate and distinct transactions and that the intent of making the IRA contribution was not to fund the ROTH. In other words, make sure that the conversion to the ROTH happens well after the IRA contribution (give it a quarter). There are no hard and fast guidelines relative to timing of the conversion but it's better to be safe than sorry. If a conversion is deemed to be an ineligible ROTH contribution, the transaction will need be reversed and the IRS will assess a 6% over-contribution penalty.

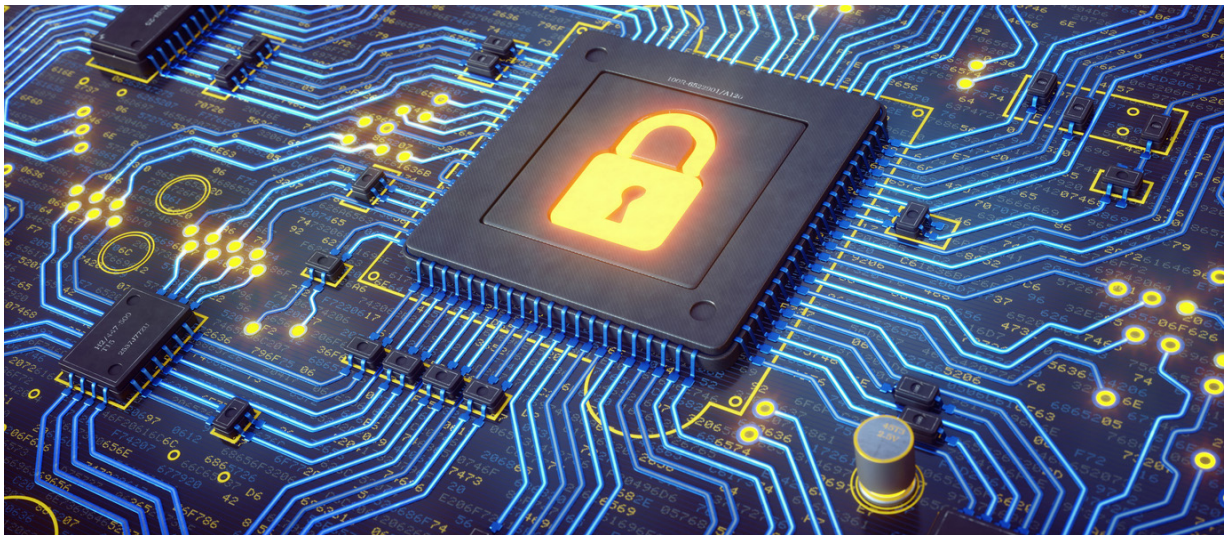
Allocating a portion of retirement savings to a ROTH is a great way to provide tax planning flexibility in the future. Since ROTH IRA distributions are tax free when made after age 59.5 (as opposed to IRA distributions which are taxable), investors can manage the tax impact of their retirement income. It may even make sense to convert pre-tax dollars and pay the tax if you expect to be in a higher tax bracket in later years.

The points mentioned here should be discussed in more detail with your advisor or tax professional to determine if a ROTH conversion is appropriate for you.

Tax Reform Coming?

Congress and President Trump are hoping to agree on a tax reform bill in the near future, perhaps before the end of 2017 or during 2018. While the timing and details of any potential tax law changes are mostly unknown at this time, we will be closely watching for any new developments as they take place.

Sonia Ernst
Manager of Trading & Operations



How to Respond to a Data Breach

Take immediate action to minimize the impacts.

Being the victim of a cybercrime is a frightening and stressful experience. Time is of the essence, whether your personal data has been compromised as part of a larger, targeted cyberattack, or you are the victim of an individual cybercrime. You'll need to take imediate action to minimize the impacts. Cabot proactively supports clients who experience identity theft and fraud by providing them detailed instructions for responding to such an event. Download our latest report, *How to Respond to a Data Breach*, for steps you should take within specified timeframes after discovering your data has been breached.

It's not a matter of if, but when.

- **17.6 MILLION** people experienced identity theft in 2014.
- **63%** of confirmed data breaches involved weak, default, or stolen passwords.
- Identity fraud is a serious issue. Fraudsters have stolen $112 billion in the past six years, equating to **$35,600** stolen per minute.

What to do within the first 24-48 hours of a data breach.

- ☐ Call your advisor so they can watch any suspicious activity in your accounts.
- ☐ Call the Social Security Administration's fraud hotline at (800) 269.0271.
- ☐ Contact the Federal Trade Commission at 877-IDTHEFT or identitytheft.gov.
- ☐ Visit the IRS website if you're the victim of tax fraud.
- ☐ Call Schwab's Fraud Prevention & Investigations hotline at (877) 566-7984.
- ☐ Call Schwab's Identity Theft hotline at (877) 862-6352.
- ☐ If appropriate, close any compromised or unauthorized accounts.
- ☐ Run reputable anti-virus/anti-malware/anti-spyware software to clean your computer.
- ☐ Change passwords on your accounts.

DOWNLOAD FULL REPORT: HOW TO RESPOND TO A DATA BREACH

Call (978) 745-9233 or email mikki@ecabot.com to request a hard copy.

Andrew Wulf, SHS Assistant Principal for Teaching and Learning, far left, SHS seniors Xhoralgo Gjinaj and Victor Acosta, and Bryan Boppert, SSU Associate Director of the Student Navigation Center, pose with the Reality Fair wheel of fortunate.

Mikki L. Wilson
Director of Marketing & Business Development

Students Get Real About Financial Future

Reality Fair equips seniors with tools to manage finances.

In May, Salem High School's Class of 2017 participated in their third annual "Reality Fair", a simulation of the financial obstacles students will face throughout their lives. Students had the opportunity to learn everything from managing their budget to using credit cards wisely. In our current economic climate, it is more important than ever that our youth be equipped with the knowledge and tools to manage their finances effectively.

Students were provided occupational scenarios that described their individual lives at age 25. They completed a one-month spending plan by visiting various booths in which they interacted with professionals from the business, non-profit, and public sectors to learn about the costs of living and the financial decisions they will make when they are adults. Booths included Career Counseling, Charity, Clothing, Credit/Lending, Education, Food, Luxury, Furniture, Housing, Insurance, Investments, Retirement, Savings, Transportation, and more. Additionally, each student received credit counseling throughout the process.

"What I learned while talking to students is that many of them were already paying their own personal bills, such as food and cell phone. One student acknowledged that he needed to save consistently and hoped the fair would teach him how to better manage his money so he could afford to buy his own car," shared Mikki Wilson, Cabot's Director of Marketing and Business Development, who is part of the high school's Reality Fair planning team.

The event was hosted by Salem State University at the Bertolon School of Business with strong support from Cabot Wealth Management as well as other local businesses. At the end of the three-and-a-half-hour fair, students walked away with a realistic understanding of building a budget for themselves as well as an understanding of real life challenges, such as choosing whether to save for retirement or book that trip to Cancun.

STAY CONNECTED to our latest insights, commentary and updates. Visit the Cabot Advisor Blog!

- Winding the Stem
- Sole Proprietors and Small Business Owners
- Paper vs. Paperless Statements
- Advisers on Front Lines Against Financial Abuse of the Elderly
- Why Average Investors Earn Below Average Market Returns

28th Annual Wealth Management Conference

Friday, September 29, 2017 | 8AM-3PM

Registration is open for our annual wealth management conference held on Friday, September 29, 2017. This half-day conference is held annually at the Hawthorne Hotel, one of the North Shore's most historic hotels. Clients and attendees will gain access to insights and perspectives on the economic landscape, investment opportunities, cybersecurity education and strategies for managing wealth.

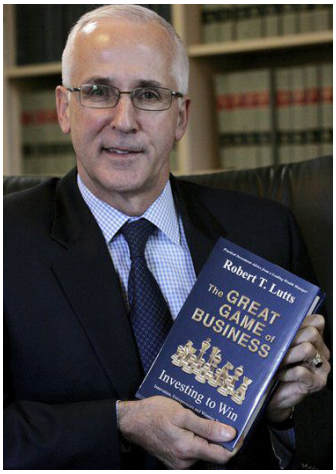
The day is rich with networking opportunities among clients, trusted partners and business professionals, who seek valuable insights and fresh ideas from our distinguished team of thought leaders and advisors. Through a series of expert presentations and panel discussions, we examine the issues likely to have the biggest impact on your wealth, lifestyle and the legacy you are building for future generations.

This year, we look to explore timely topics, including, but not limited to, estate and retirement planning techniques, transferring wealth to the next generation, sustainable investing concerns, and identity theft protection strategies.

Contact Mikki Wilson at mikki@eCabot.com or call (978) 745-9233 to register for this year's conference. We encourage our clients to mark their calendar so they can plan travel arrangements accordingly. If you need assistance with booking hotel accommodations for your stay, please contact your wealth advisor directly.

Great Game of Business: Investing to Win

2017 Lecture Series Recap



We saw June conclude with the fourth and final lecture in the Great Game of Business book lecture series, hosted by Rob Lutts and Cabot Wealth Management.

During this lecture series, author Robert Lutts, president and chief investment officer of Cabot, explained his personal passion for investing and why he founded Cabot Money Management, Inc. in 1983, which originally began as an investment advisory firm. Rob shared some of the key economic sectors that Cabot Wealth Management considers promising in the coming years and highlights possible future leaders within these up-and-coming sectors.

Attendees became familiar with the term "stemwinders", who Rob describes as successful leaders that understand and are constantly improving every part of the business. Rob shared insights on the key differences between growth and value investing as well as the global markets. Moreover, he explained the importance of investors diversifying for long-term success.

LECTURE PRESENTATIONS INCLUDE:

- Winding the Stem (March 2017)
- Rules of the Game (April 2017)
- Game Changers (May 2017)
- The Spirit to Win (June 2017)

Contact Mikki Wilson, Director of Marketing and Business Development, at (978) 745-9233 or email mikki@eCabot.com to request electronic PDFs or hard copies of any presentation booklet.

Cabot WEALTH MANAGEMENT

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