TUFTON CAPITAL
MANAGEMENT

VIEWPOINT

WINTER 2018

In this space, a bit over twelve months ago, I admitted that I didn't have a clue what sort of market 2017 would bring. "Perhaps the economy will thrive...buoyed by the message that America is now 'open for business'," I wrote. "Or perhaps...our new president-elect will prove uniquely problematic, unduly influencing the market one late-night 'tweet' at a time."

On Wall Street, however, where confidence is king, well-paid prognosticators were obliged to issue a more definite outlook. And as you may recall, that outlook was rather bleak. On January 3, 2017, CNBC reported that Wall Street's collective annual forecast was the most bearish it had been in over a decade. The following day, Goldman Sachs warned clients of "downward pressure" on U.S. equities. With sociopolitical tumult and a bull market that was officially long in the tooth, it seemed as though worrying over a slowdown was the respectable analyst's only prudent move.

What happened next is history. Over the last twelve months, that bull market has grown even longer in the tooth, surmounting the Street's "wall of worry" (and continued sociopolitical tumult) in truly rare form. In 2017, while volatility sat at historic lows, the S&P 500 rose 22% (total return), posting its largest yearly gain since 2013. Not to be outdone, the Dow Jones shot up 25%, its second-biggest annual gain of the last decade. With this increase, it turned in nine consecutive months of growth, its longest streak since 1959. So much, it would seem, for those January jitters.

Yet, pleasant as the market's surprises were in 2017, one question still looms large. What should investors expect in the year ahead? Given the strong start U.S. equities have already had in 2018, it's no surprise that many once-dour pundits have taken on a sunnier tone. Open the morning paper, and you're likely to read about the market's "record run," spurred on by an encouraging global economic outlook. As Goldman Sachs' asset management arm now succinctly puts it, "We think equities will continue to outperform in 2018."

We certainly hope Goldman Sachs' prognostication will prove to be the case. However, all good things must eventually come to an end, and we at Tufton Capital will continue to implement a bottom-up, value-driven investment philosophy that delivers performance in a strong market—and perhaps more importantly - provides peace of mind when things take a turn for the worse. For twenty-two years, this approach has kept our clients in good stead from the "Great Recession" of 2008 throughout the "great gains" of 2017.

As we charge into 2018, I will again forgo a firm "outlook". Instead, I offer this simple assurance. Above all else, your team of investment professionals at Tufton Capital remains honored by your trust and committed to your interests. From all of us here at Tufton Capital, Happy New Year.

Chad Meyer, CFA
President

Inside This Issue

The Fourth Quarter of 2017: Consistent Returns, Low Volatility

Eric Schopf
Director Of Research/Partner

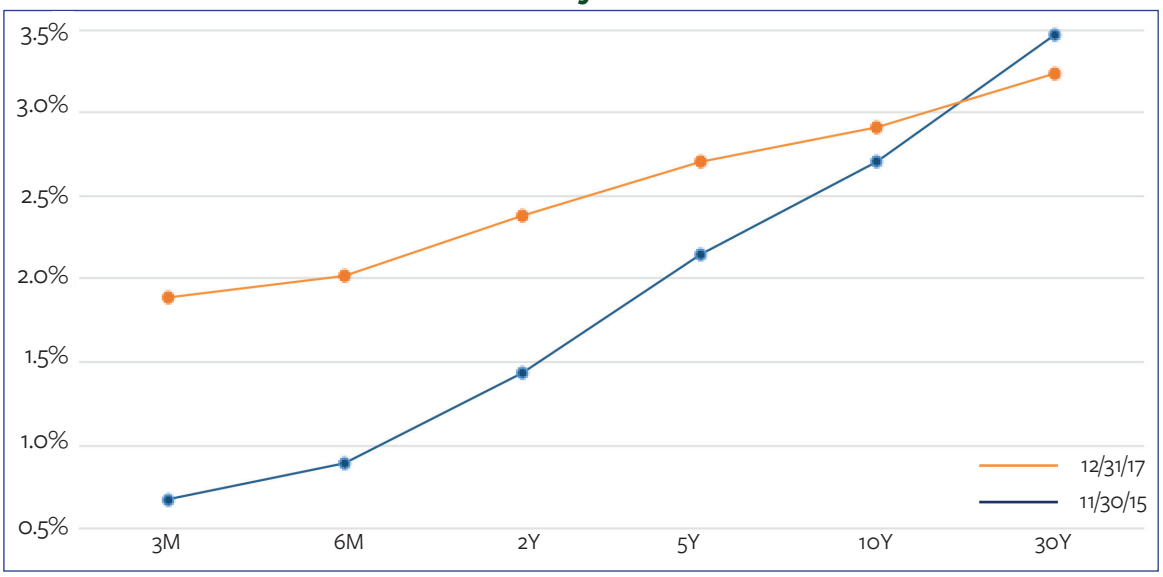
The frigid weather that ushered in the New Year has been no match for the red hot stock market. The Standard and Poor's 500 delivered a total return of 6.6% for the fourth quarter and 21.8% for the year. As many expected, the fourth quarter continued the trend of consistent returns with little volatility. Although technology stocks led the way with returns in excess of 38%, the rally was broad with most sectors posting double-digit returns. This widespread improving economy, combined with low interest rates and benign inflation, continues to attract investors to the equity market.

Interest rates were once again on the move, with the Federal Reserve raising the Federal Funds rate to 1.5% in December. This rate increase was the fifth since the Fed began tightening two years ago. Despite the increases, interest rates are not yet attractive enough to entice investors to move out of stocks and into bonds. Longer-term interest rates continue to be a challenge. Although the Fed has raised the Fed Funds rate from .25% to 1.5% since the tightening cycle began in 2015, longer-term rates (maturities of 10 years or greater) have essentially remained unchanged. Although the business cycle is approaching maturity, which would normally suggest some shift to bonds, we thus have little appetite for the longer-term instruments that offer returns that are just slightly higher than the rate of inflation. Higher rates on the short-end are a welcome relief. It is nice to actually earn something greater than zero on cash held in money market funds.

While lower corporate taxes are a good thing, there is no such thing as a free lunch.

The major news headline in the quarter was tax reform. The Tax Cut and Jobs Act was passed along party lines in late December and provides some tax relief for many individuals. However, the lion's share of the law was designed to reduce corporate taxes. Although the corporate rate has been reduced to

U.S. Treasury Yield Curve



Source: FactSet

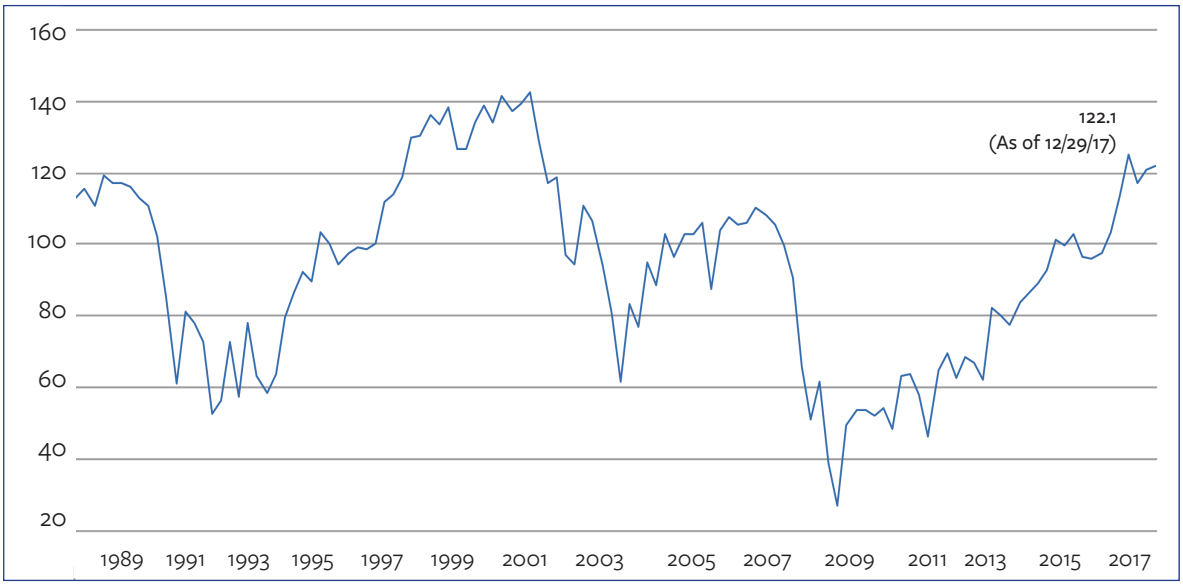
21% from 35%, the impact will vary from company to company. Legions of accountants are employed to minimize corporate taxes, so most corporations have not been taxed at the 35% level. Nonetheless, extra cash generated through any tax savings may be deployed in a shareholder-friendly fashion. Investment in plant and equipment made to produce future earnings or reduce costs, share buybacks, and higher dividends are all potential uses of the extra cash. President Trump and his administration expect the lower tax rate to help "make America great again" by attracting more business back to our shores from abroad and igniting economic growth.

While lower corporate taxes are a good thing, there is no such thing as a free lunch. Unless spending is reduced or economic growth truly does generate enough incremental tax revenue to allow the tax cuts to be self-funding, the Treasury will need to issue a lot of debt to cover the expected expansion of our nation's deficit. The Congressional Budget Office estimates that the deficit will grow by $1 trillion over the next decade. The issuance of debt to cover the deficit will come at a time when the Federal Reserve is winding down their balance sheet amassed during quantitative easing. The end result will most likely be higher interest rates.

Low interest rates have not been the only pillar of the soon-to-be nine year old bull market. The economy has improved, which has had a tremendous impact on the equity market. Gross domestic product grew in excess of 3% in the second and third quarters. This is the first time our economy has grown at these rates for consecutive quarters since 2014. Additionally, consumer confidence has bubbled higher. Confidence hasn't been this high since the dotcom era of 1997 to 2000, and it may further improve once individuals feel the impact of lower taxes. Corporate earnings growth has also provided a stable footing for the stock market. Wall Street estimates going forward are strong, and the rebound in energy prices should drop to the bottom line for a wide range of companies that support the industry.

(Continued on page 7.)

U.S. Consumer Confidence Index



Source: FactSet

How The New Tax Plan Affects You

Neill Peck
Marketing Associate

Just before Christmas, President Trump scored his first major legislative victory when he signed the Tax Cuts and Jobs Act. The bill dramatically reworks the U.S. tax code and promises to immediately alter the financial lives of families across the economic spectrum.

The Tax Cuts and Jobs Act represents the largest one-time reduction in the corporate tax rate in U.S. history, lowering it from 35% to 21%. The 503-page bill also lowers taxes for a majority of American households, as well as for small business owners – at least until the personal tax cuts expire after eight years. The bill lowers taxes for top income earners. Prior to its passage, couples earning over $470,000 per year paid 39.6% in federal income taxes. The GOP bill drops that rate down to 37% and increases the threshold at which that rate kicks in to $600,000 for married couples. This new break for millionaires is intended to ensure that wealthy earners in highly taxed states such as New York, Connecticut, and Maryland don't end up paying substantially higher taxes. Moving forward, taxpayers will only be able to deduct $10,000 in state, local, and property taxes.

The final tax plan lowers taxes for most Americans until 2026, since it will decrease rates for every income level. Even though the personal exemption is being scrapped going forward, the plan nearly doubles the standard deduction. It also doubles the child tax credit that parents receive to $2,000, and it increases the credit's income threshold from $75,000 to $200,000.

The bill also creates a new $500 temporary credit for non-child dependents (children 17 or older, a disabled adult child, or an ailing elderly parent). Moving forward, the new plan lowers the cap on the mortgage interest deduction on a first or second home. Now, homeowners will only be allowed to deduct interest on the debt up to $750,000, down from $1 million today. While early versions of the bill had proposed repealing deductions on medical expenses and student loan interest, these changes did not make it into the final version.

Republicans in Congress had originally wanted to do away with the estate tax entirely but ended up settling on increasing the taxable threshold from $5.5 million per person to $11 million. Going forward, a wealthy couple will be able to pass $22 million on to their heirs tax free. Small businesses are getting a big tax break under the new plan. Pass-through companies (LLCs, S corps, partnerships, etc.) will receive a 20% reduction under the new tax code.

Investors saving for retirement will not expect many changes under the new tax plan, since it makes no changes to the tax-free amounts they can put into 401(k)s, IRAs, and Roth IRAs. ■

2018 Income Tax Brackets

Rate	Individuals	Married Filing Jointly
10%	Up to $9,525	Up to $19,050
12%	$9,526 - $38,700	$19,501 - $77,400
22%	$38,701 - $82,500	$77,401 - $165,000
24%	$81,501 - $157,500	$165,001 - $315,000
32%	$157,501 - $200,000	$315,001 - $400,000
35%	$200,001 - $500,000	$400,001 - $600,000
37%	Over $500,000	Over $600,000

How The New Tax Code Affects Your Portfolio

Ted Hart
Research Associate

The new tax plan promises to cut taxes for corporations. The companies in which we invest our clients' funds have various options for the new-found savings.

As stated in the preceding article, the corporate tax rate will be revised from 35% to 21% this year. On a global basis, the tax reduction takes the United States from the highest in the industrialized world to the middle of the pack – quite competitive for businesses in the world's largest economy. One of the largest benefits that has flown under the radar is the provision that allows businesses to deduct the cost of their equipment immediately. Previously, these companies were required to deduct the cost over a period of several years.

Despite the tax break, not all businesses will find the new plan beneficial. Companies will no longer be able to fully deduct their interest expenses on their debt. Instead, companies can deduct up to 30% of their EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) through 2021. Thereafter, companies will be able to deduct up to 30% of their EBIT (Earnings Before Interest and Taxes). This will ultimately hurt companies that carry a lot of debt and that have low profitability. Fortunately, a large majority of companies in our portfolios are highly profitable and have affordable amounts of debt.

What will the big multinational companies and other large U.S. businesses do with their tax savings? The answers have varied. AT&T has stated that it will increase its capital investments in the United States by $1 billion over the course of the next year. Additionally, it will provide a bonus of $1,000 to approximately 200,000 people. Boeing, the largest manufacturer of airplanes, says that it will make an additional $300 million in investments, with the idea of allocating one third of the investment to facility improvement, one third to employee training, and one third to corporate giving. In the banking sector, Wells Fargo and Fifth Third Bancorp both stated that their companies would increase their minimum wage to $15 per hour. Fifth Third also said they would reward some 3,000 employees with a $1,000 bonus.

In addition to capital investments and bonuses, many companies plan on additional share buybacks and dividend increases, which should drive investor returns higher. However, the lack of management voices claiming more capital investment implies that their production capacity is not that restrained. Furthermore, the prevalence of bonuses versus wage increases is also somewhat concerning. The lack of wage increases implies that the tax bill may not remain in effect if the Democrats gain control of the House and Senate in the 2018 Midterm Elections or if the Democrats win the White House in 2020. (Although the former is highly unlikely.) Overall, the tax overhaul should be positive for companies in our portfolios. ■

2018 Corporate Taxation

	Former	New
Corporate Tax Rate	35%	21%
Expensing	50%	100%
Interest Expense Deduction	No Limit	30% of EBIDTA
One-Time Repatriation Tax	None	15.5%

Company Spotlight: International Business Machines (Ticker: IBM)

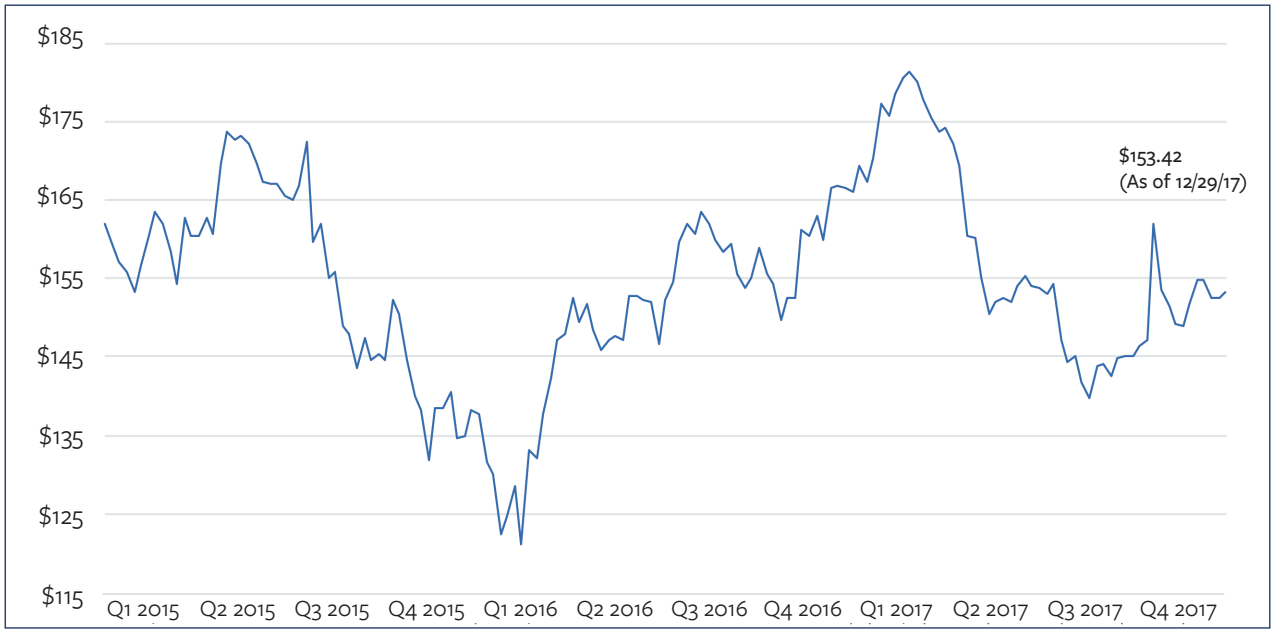
John Kernan
Research Analyst

International Business Machines (IBM) reinvented itself before. Now it is looking to do it again. In the tech boom of the late 1990's, IBM developed a technology services business that became the envy of all the other big tech names. Meanwhile, the company started to move away from the hardware businesses that defined it for a generation. Now, it seeks to make a new name for itself in the burgeoning field of artificial intelligence.

The impressive defeat of all human challengers on Jeopardy was remarkable for sure, but IBM's powerhouse artificial intelligence system Watson is more than a quiz show smarty-pants (or smarty-motherboard, as the case may be). It is powering industry-specific solutions as the world's businesses move to hosting their data on the cloud. Companies that have turned to Watson to solve problems in security, healthcare, and automation have seen productivity gains significantly beyond what human engineers could accomplish.

But the great-sounding story of Watson comes on the back of revenue numbers that came in under consensus in 14 of the last 20 quarters. Wall Street is waiting for evidence that IBM has truly turned a corner. As it does, we have stock that is yielding almost 4% and trading at attractive multiples. Technology is a fast-paced, quickly changing industry, and the timing of IBM's turn is far from certain. But Big Blue has been investing in this change for years. Now we have a company with a strong balance sheet, good customer relations, and a history of success that has a solvable problem affecting the stock price - the value investor's ideal. ■

International Business Machines (Ticker: IBM) Stock Chart



Source: FactSet

(Fourth Quarter of 2017...Continued from page 3.)

Our optimistic outlook for the near term reflects the mosaic of earnings growth, low inflation and interest rates, along with the continuation of a strengthening economy. We temper our enthusiasm knowing that the business cycle is not extinct. The five interest rate hikes initiated by the Federal Reserve have not put a damper on the economy.

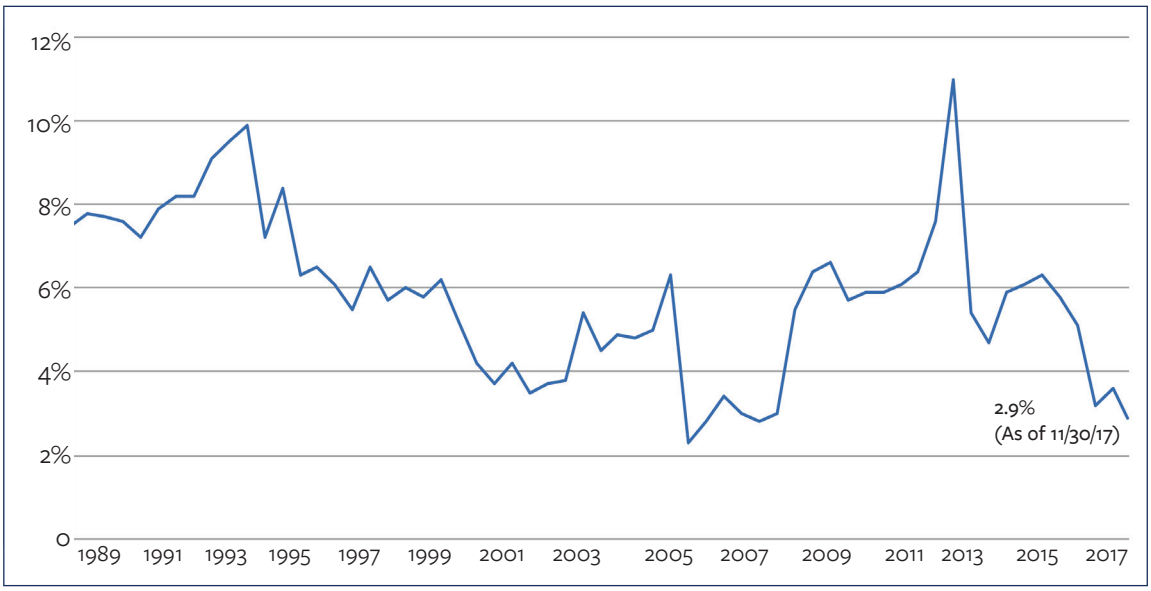
Soaring consumer confidence and dwindling personal savings leave little room for future improvement.

However, with three or four more hikes potentially in the cards for this year, the impact may be more apparent. We must also pay attention to the fact that the growth in share prices has been much greater than underlying earnings. Stocks are just more expensive. It is becoming increasingly difficult to find quality investments at reasonable prices. Finally, consumers are very confident and are spending freely. The U.S. savings rate has dipped below 3%, the lowest levels since 2005 – 2007, prior to the Great Recession.

Soaring consumer confidence and dwindling personal saving leave little room for future improvement. It may seem that all these factors together suggest imminent recession. However, history has proven that these conditions may persist for many years.

Although we turn the calendar to a new year, our investment style and strategy remain consistent. We continue to seek quality companies that are trading at temporarily depressed levels. We place a premium on above-average dividends and sound balance sheets. Portfolios are maintained within asset allocation guidelines spelled out in our clients' investment policy statements. This consistent and disciplined approach has served Tufton's clients well over the numerous business cycles throughout our firm's twenty-two year history. ■

U.S. Personal Savings Rate



Source: FactSet

"Stocks In The Future": Investing in Students

Tufton Capital Management is pleased to announce our firm's involvement with the Baltimore-based charitable organization "Stocks in the Future." This non-profit partners with schools in downtown Baltimore and provides a three-year financial literacy curriculum for middle school students in under-served communities.

"Stocks in the Future's" mission is to develop highly motivated middle school students who are eager to learn and dedicated to attending class. The financial literacy program introduces Baltimore City students to business concepts, expansion possibilities, reasons for taking a company public, and ways to compare company performance. As students progress through the program, they can earn money in an investment account by attending school regularly and improving their grades. Their money can be used to purchase shares in a publicly traded company. When they graduate from high school, their hard work pays off, since they are able to keep the shares that they have purchased.

Tufton's associates have been actively volunteering with the Program. Our employees have taught middle school math classes and have worked with teachers to help them better understand the Program's curriculum.

Tufton Capital is happy to support the "Stock in the Future" organization, and we believe its incentive-based curriculum can make a difference in students' lives.

To learn more about "Stocks in the Future's" mission, visit the organization's website: www.sifonline.org ■

Tufton Capital Management Team

Standing: Ted Hart, Gina Jackson, Rick Rubin, Eric Schopf, Chad Meyer, Scott Murphy, LaShawn Jenkins, John Kernan
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