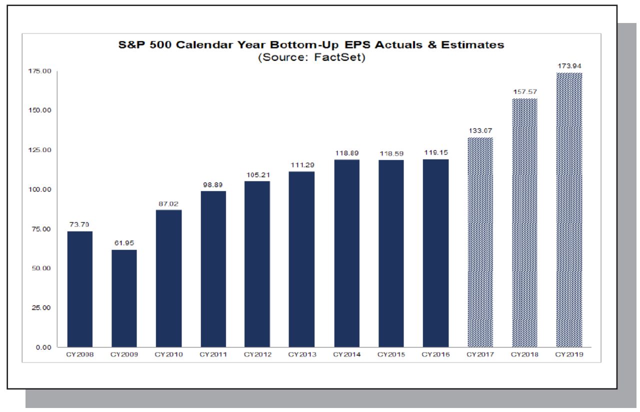
Hemenway Trust Company LLC

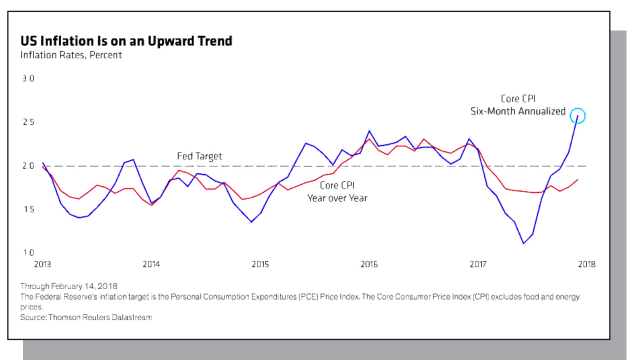
Winter 2018 Investment Report

2017 was an extraordinary year for equity investors, with the S&P 500 up 21.6%, and international and emerging markets up 25% and 37% respectively. Not only were the broad market returns strong from an absolute level, in the US we saw all sectors (with the exception of energy) post double digit returns with little volatility. In fact, the S&P 500 posted gains in all 12 months for the first time in history and there were only eight days when the index lost or gained 1% or more. A key driver to last year's lack of volatility was a continuation of the "Goldilocks economy," where growth wasn't too hot, causing inflation, nor too cold, creating a recession.



We've seen some of this complacency erode in 2018, and strong equity gains in January were quickly given back in the first week of February. That pullback stemmed from a positive report on wage growth and a string of corporation earnings above expectation. All of this good news quickly sparked fears of inflation and pushed interest rates up (10 yr treasury up 0.4%) and stock valuations down. Technical factors further exacerbated the sell-off and forced many leveraged investors to unwind positions.

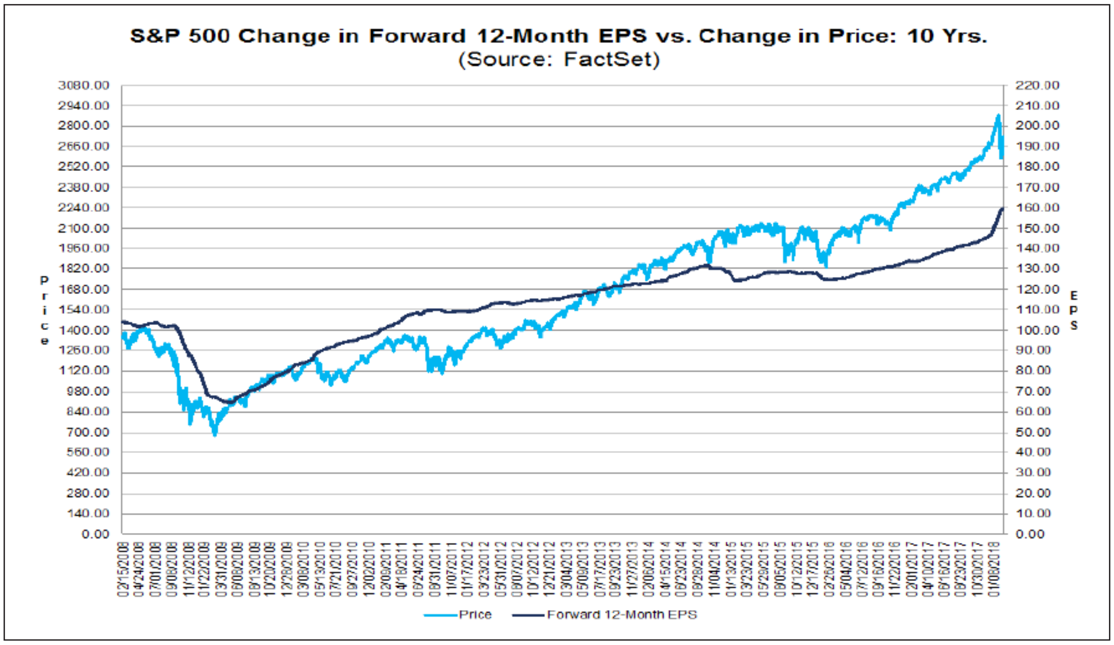
For most of the last three years, the financial world has questioned the low inflation rate. Even Federal Reserve Chair Janet Yellen recently said the low inflation was a "mystery" given the positive economic data. We believe there is a lagged effect with inflation data and the positive momentum in the global economy will lead to higher inflation over 2018 and beyond. This should be viewed as a positive sign for the economy and allow the Federal Reserve, and ultimately other central banks, to move away from their ultra-accommodative monetary policy.



But are we in a bubble?

US equities are up over 400% (including dividends) since the market bottomed in March 2009, but we do not believe the stock market is in a "bubble." As a whole, the S&P 500 currently trades at 17.6x next year's earnings. While this is above the 10-year average of 14.2x, it is still far below the 25x multiple seen in the tech bubble. As we saw in the late 90's tech bubble, there are pockets of stocks that have generated tremendous returns by growing revenue without earnings. We generally avoid these stocks, which has proven to protect our client portfolios in major market corrections. However, as the economy continues to improve, we are seeing Wall Street analysts increase price targets more than underlying earnings growth would seem warranted. As investment managers, and more importantly as trustees, we need to be disciplined in managing the risk in portfolios. As valuations and growth expectations become too optimistic, we must decide (1) if the stock is appropriate for new accounts, and (2) how aggressively we should reduce positions with large embedded gains. These are difficult decisions and vary by client and account.

Winter 2018 Investment Report (continued)



While we've been comfortable maintaining an overweight to equities for most of this bull market, we've started to increase our capital gains budget both to reduce oversized and high-valuation positions. We continue to find stocks trading at attractive valuations, but many are slower growing companies or companies undergoing a change to their businesses. We will need to be more patient with some of these names, but a recent Goldman Sachs note put it well: "Despite the strong macro outlook, it is worth remembering that it is typically better to buy when the news is poor and valuations are low than when all news is good and valuations are high."

In closing, we believe the US economy is on solid footing and will continue to benefit from positive employment and business spending data. This should be beneficial to equity investors over the intermediate-term, but we expect to see more volatility in the markets as interest rates and inflation data rise. We know that last year's performance will not likely be replicated in 2018, but we continue to see a well balanced portfolio of high-quality stocks as the best solution to building wealth and preserving purchasing power over the long term.

Overview of Tax Bill for Corporations

At year end, Congress passed a sweeping tax bill. While the impact to high-bracket individuals is mixed, the impact to corporations is largely positive. The new law reduces the top corporate tax rate from 35% to 21%, which allows 100% expensing for capital equipment purchases for five years and repeals the corporate alternative minimum tax (AMT). The corporate tax code will also move to a territorial tax system in order to reduce double-taxation of foreign profits for US companies and sets a one-time mandatory tax of 8% on illiquid assets and 15.5% on cash and cash equivalents.

We expect some of this cash will be used for capital expenditures and lowering debt, but expect most will be used for acquisitions and repurchase of stock. We will also be focusing on unintended consequences of the tax bill and any changes to the recognition of foreign profits by companies.