CAPITAL ADVISORS

Overview

First Quarter 2017

Key Points

- The so called "Trump rally" probably accounts for about half of the roughly 10% advance in the stock market since the November elections, with the remainder likely attributable to accelerating corporate earnings growth and improving economic data worldwide.
- Investor enthusiasm for the Trump administration's business-friendly agenda may have cooled with the recent failure of the American Healthcare Act (AHCA), however, this early defeat does not eliminate the possibility for tax reform, regulatory relief, or infrastructure spending, each of which has the potential to influence financial markets more directly than healthcare reform.
- Rising interest rates in the fixed income markets over the past nine months make it possible to generate a current yield of approximately 3.4%[1] in the bond market for investors willing to assume some duration risk.[2]
- We believe the domestic stock market can perform well in 2017, but we worry that a buy-and-hold approach to U.S. stocks over the subsequent 5-to-10 years may not perform substantially better than bonds, with much higher volatility and downside risk in the process.
- Because we believe the return premium for taking risk in the stock market may be modest over the next several years, we encourage virtually all investors to include fixed income in their asset mix, regardless of their time horizon or risk tolerance.
- International equity markets have under-performed the U.S. stock market substantially during the eight years since the financial crisis,[3] but we suspect current conditions might favor a reversal of this trend over the next 5-10 years (Please refer to page 11 of this report for a discussion of a specific investment strategy that can participate in this possibility).

[1] This estimate is based upon the recent yield of the Barclays 5-10 Year Credit Index, which tracks the price and yield performance of domestic investment grade corporate bonds with maturities between 5 and 10 years. As of March 30, 2017 the yield to maturity for this index was 3.4% (Source: Bloomberg).

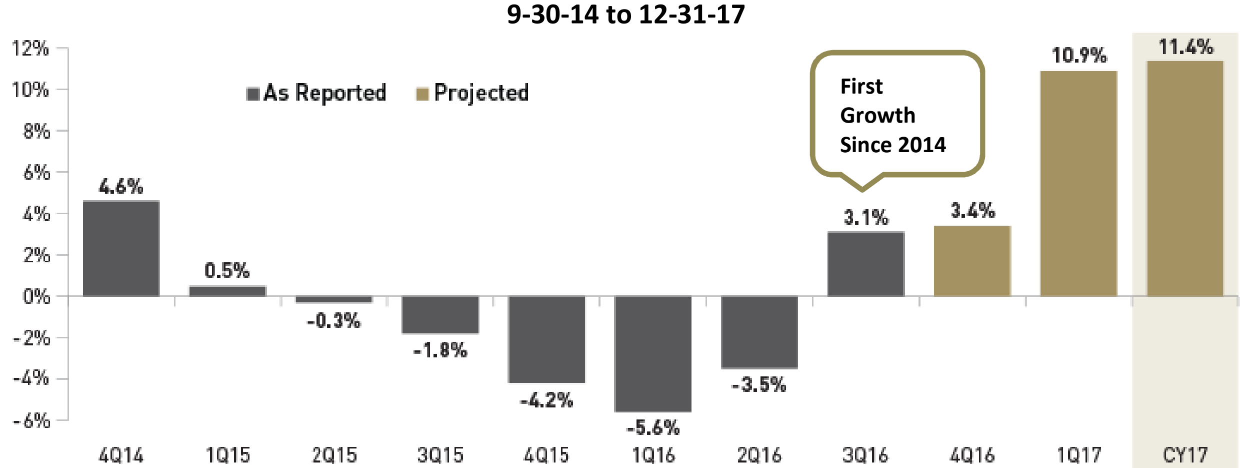
[2] Duration refers to the weighted average time period of the cash flows from a bond. The longer the duration, the more sensitive the bond price will be to changes in the general level of interest rates.

[3] Source: Bloomberg; From February 28, 2009 to February 28, 2017 the domestic S&P 500 Index outperformed the international MSCI EAFE index by approximately 150 percentage points.

Honeymoon Over?

The roughly 10% advance for the U.S. stock market since the November elections can probably be ascribed about equally to optimism for the business-friendly tone of the Trump administration, and solid fundamentals beyond Washington. Fortunately, the stock market has a lot more going for it than government policy alone. Specifically, corporate profits look healthy, while many economic indicators have improved throughout much of the world.

S&P 500 Index
Year-over-Year Earnings Growth
9-30-14 to 12-31-17



Source: FactSet Research; Data as of 1-20-17; It is not possible to invest directly in the index

In our last *Overview* we speculated that the stock market might perform best during the window of time when investors could dream about a pro-growth policy agenda in Washington without being interrupted by the reality of actual legislation. We wonder if the failed healthcare bill might represent the kind of "interruption" we were imagining in January.

Even so, we remain hopeful for the near-term because investors care more about tax reform, regulatory relief and infrastructure programs; and progress on each of these priorities remains possible in 2017. Some observers have even argued that a pivot toward tax reform should be viewed as a *positive* development for the financial markets.

Show a Little Respect for Bonds

Interest rates have been drifting higher since July. Rising interest rates can cause short-term pain for an existing bond portfolio, but higher rates also improve the *forward-looking* investment opportunities for the asset class.

With the change in interest rates that has already occurred since July, fixed income investors can now design a laddered portfolio of investment grade bonds with an average yield to maturity of approximately 3.4%.[4] We suspect that a 3.4% return might turn out to be unusually competitive relative to stocks over the next several years.

A Shrinking Risk Premium

Historically, fixed income investors have had to sacrifice several percentage points of annualized return compared to stocks over long-term holding periods of 10-years or more. For example, among 375 overlapping 10-year holding periods between 1976 and 2017, the *S&P 500 Index* outperformed the *Barclays Aggregate Bond Index* in 320 of them, an 85% success rate. The average outperformance for stocks across all 375 periods was roughly 7.2% per annum.[5]

Unfortunately, we believe current conditions in the asset markets make it unlikely that stocks will outperform bonds by anything close to this historical premium over the next 5-to-10 years. We won't repeat the rationale for this forecast in this report because our last *Overview* spent several pages on this topic.

The point we wish to emphasize here is that the *incremental* reward for taking risk in the stock market may be uncharacteristically low unless/until stock prices revert toward a more productive starting point in terms of valuation and dividend yield. This can occur in one of two ways – a sharp drop of 20% or more for stocks (this is not our forecast, just an ever-present possibility); or a multi-year stretch of two-steps-forward/two-steps-back behavior that allows time for corporate earnings and dividends to "catch up" with today's Stock prices. In either scenario, portfolio diversification with fixed income would be helpful.

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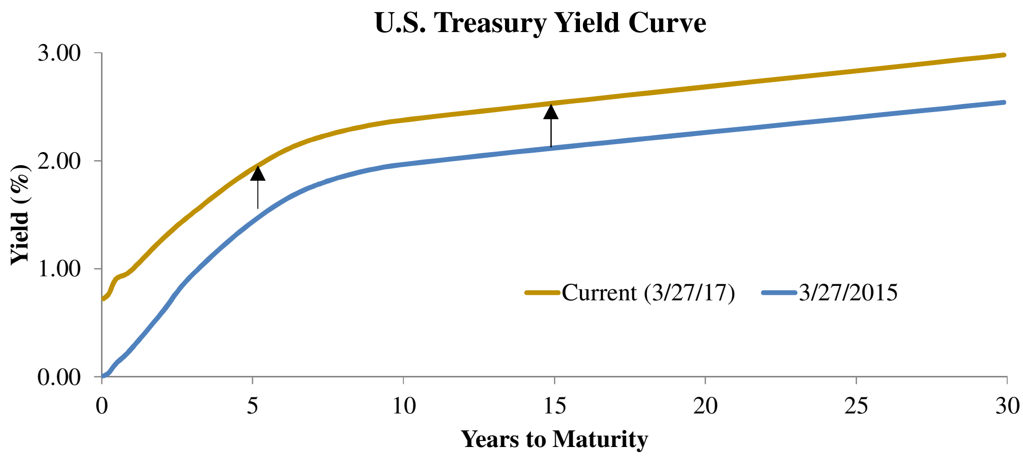
[4] This estimate is based upon the recent yield of the Barclays 5-10 Year Credit Index, which tracks the price and yield performance of domestic investment grade corporate bonds with maturities between 5 and 10 years. As of March 30, 2017 the yield to maturity for this index was 3.4% (Source: Bloomberg).
[5] Source: Standard & Poor's; Barclays Capital; Capital Advisors, Inc.; Jan. 1, 1976 to Feb. 28, 2017

Don’t Bonds Suffer When the Fed Raises Rates?

The recent period of near-zero interest rates throughout much of the world encouraged many commentators to view fixed income as a toxic asset class. The logic for this viewpoint is sound up to a point. After all, why would anyone want to own a security that provides a low return *and* has the potential to lose value if interest rates rise?

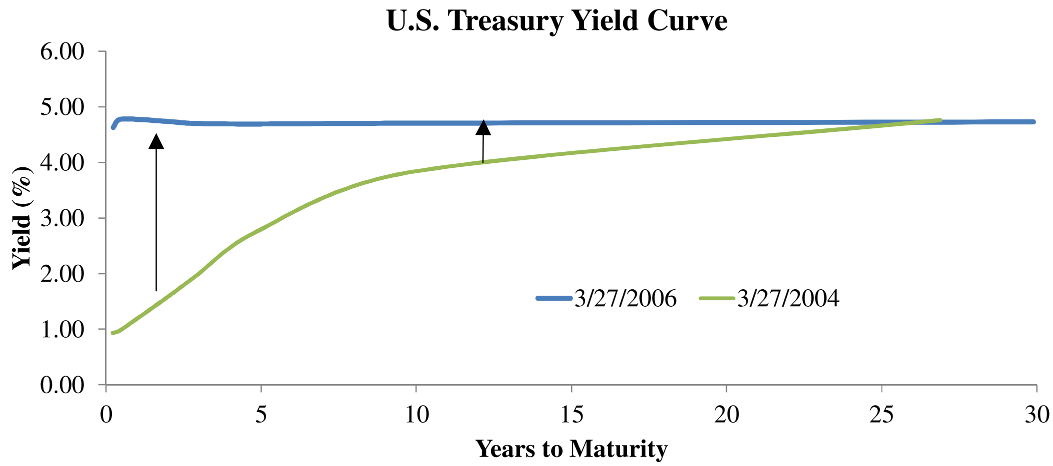
We say “up to a point” here because the argument against bonds breaks down quickly once interest rates lift off from zero, as has now occurred in the domestic bond market.



Source: Bloomberg; Capital Advisors, Inc.

The graphic above reflects a normal response to the early phase of a monetary tightening cycle. Typically, the first one or two rate hikes by the central bank echo across the entire yield curve, such that the initial increase in the policy rate is about the same as the change that occurs for 5-year, 10-year and 30-year bonds further out on the curve.

When the entire yield curve shifts upward, as illustrated above, *all* bond prices suffer. This is what happened in the U.S. bond market between July and December last year, when many investors experienced negative returns in the “safe money” portion of their investment portfolios.



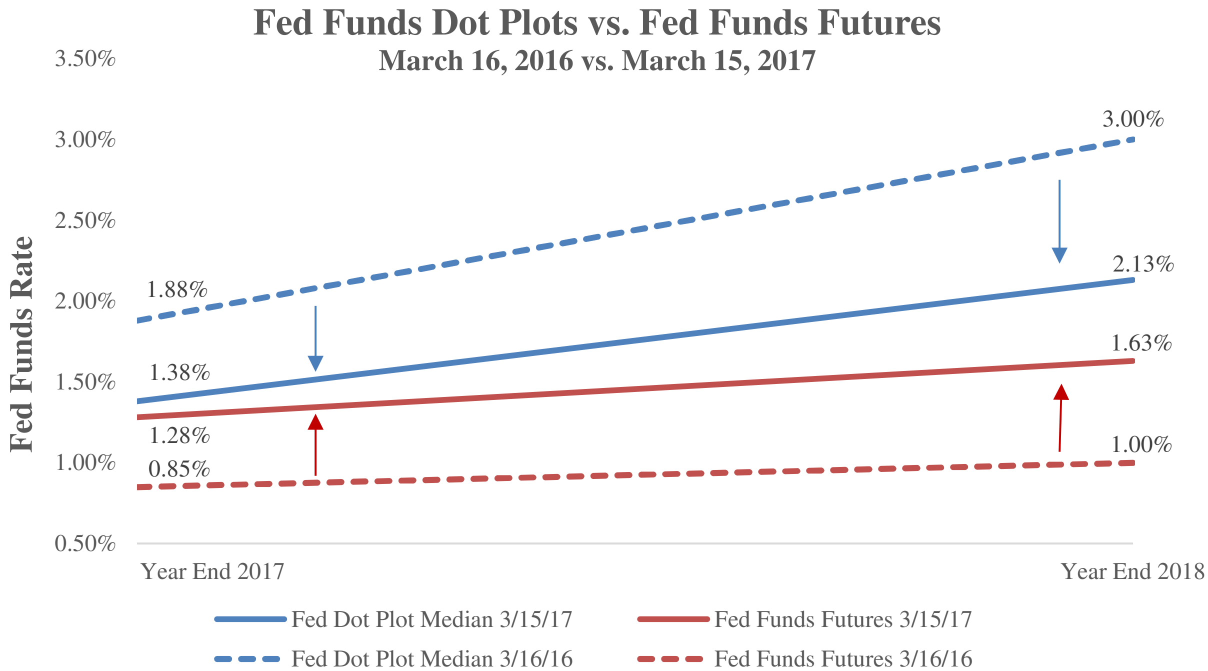
Source: Bloomberg; Capital Advisors, Inc.

The second chart above is more reflective of the later stages of a typical monetary tightening cycle, when the change in rates usually becomes less uniform across the yield curve. Note that over the two-year period reflected in the chart above, short-term interest rates increased significantly more than longer term rates. To be clear, no two monetary cycles are the same. Even so, it is appropriate to say that most tightening cycles have evolved somewhat like the pattern reflected above, with short-term rates moving more than long-term rates over the course of the entire cycle.

We suspect the domestic bond market may have already entered the latter phase of its adjustment to the Fed's current tightening cycle. Thus, we believe longer-term interest rates might rise less than short-term rates from this point forward, even if the Fed follows through on its recent forward guidance to raise rates two more times in 2017, with more hikes in 2018.[6]

This matters for investors because it suggests that a well-designed *portfolio* of bonds might perform just fine over the next few years, even if the Fed raises rates several more times.

[6] Source: Minutes of the Federal Open Market Committee (FOMC).



Source: Bloomberg; Capital Advisors, Inc.

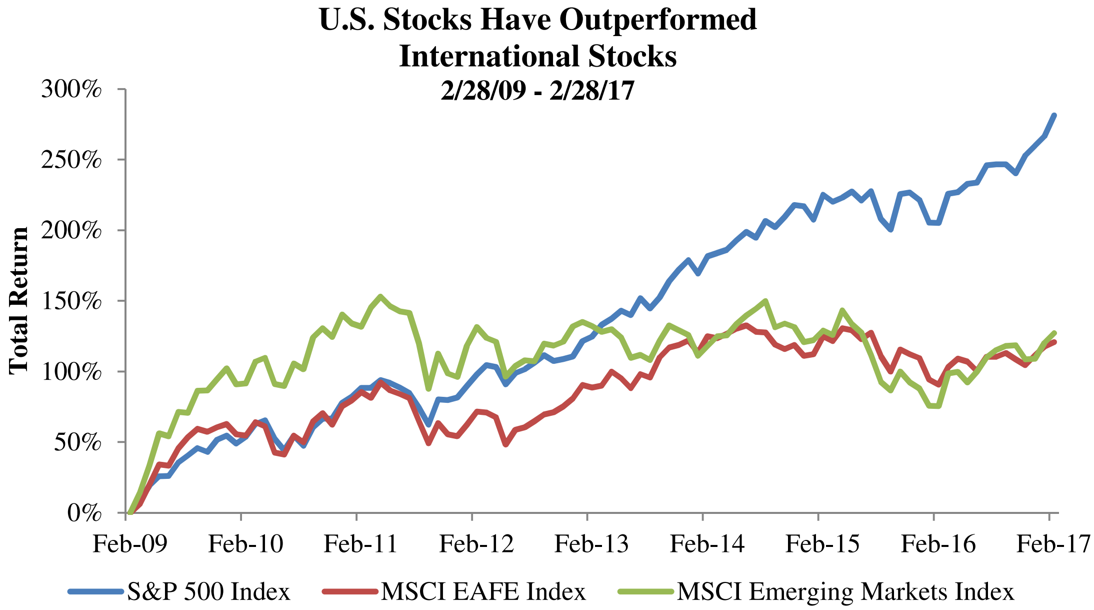
We offer one last chart to support our constructive outlook for the bond market. The graphic above compares a market-based view of the future path for interest rates (red lines) with the forward guidance provided by the Fed (blue lines). One year ago there was a wide gap between what the Fed was saying (dotted blue line) and what investors in the futures market expected (dotted red line). More recently, the expectations of the Fed and the futures market have converged (solid lines).

This convergence matters for fixed income investors because it suggests that longer-term bond prices might have already adjusted to the current monetary tightening cycle. If so, longer-term interest rates need not move higher in lock-step with the Fed Funds rate, even if the Fed raises rates several more times during this cycle.

This is *not* to say that long-term interest rates won't move higher over the next few years. Indeed, we believe they will. The point is that long-term rates might not move as much as short-term rates, and a laddered portfolio of bonds can perform reasonably well in that environment.

Making a Case for International Stocks

As the chart below reflects, domestic stocks have performed substantially better than international stocks since the financial crisis. Over the eight year period ending on February 28, 2017, the *S&P 500 Index* outperformed both developed international and emerging market stocks by more than 150 percentage points each.[7]



Source: Bloomberg, Capital Advisors, Inc.
It is not possible to invest directly in the index

The magnitude of this spread in relative performance is unusual by historical standards, and it has created an equally uncommon divergence between the current valuation levels of domestic versus international stocks.

The chart below reflects the recent valuation multiple of the same three indexes presented above. For each market we used a cyclically adjusted price-to-earnings ratio, or "CAPE ratio," to measure valuation.

> Note: A CAPE ratio uses trailing 10-year average earnings for the "E" in the P/E multiple. This is done to measure the earning power of a market index across an entire business cycle, rather than a shorter 12-month snapshot.[8]

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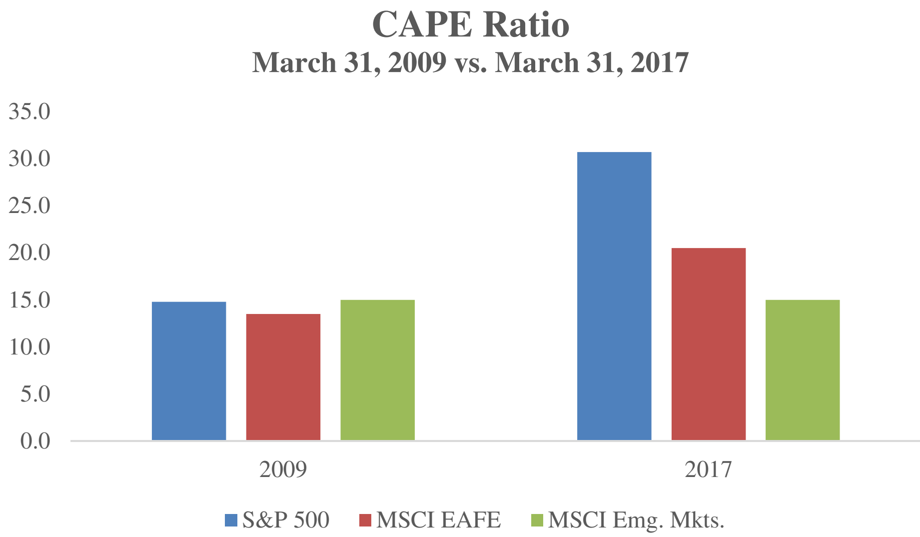
[7] Index returns listed here represent cumulative total returns including reinvestment of dividends; Source: Bloomberg

[8] For this report the CAPE ratio for all three indexes presented is based on nominal prices for the index and the underlying earnings. An alternative approach popularized by Robert Shiller uses inflation adjusted inputs.



Source: Bloomberg; MSCI; Capital Advisors, Inc.

We acknowledge that U.S. stocks probably deserve a premium valuation compared to most international markets. Relative to most countries, the U.S. economy scores favorably on measures of political stability, rule of law, and regulatory framework. In addition, many analysts expect corporate profits can grow faster in the U.S. compared to other regions of the world.

Even so, it is unusual for U.S. stocks to trade at such a substantial premium relative to other regions of the world. Notice, for example, that emerging markets currently trade at roughly the same valuation multiple as during the depths of the financial crisis. For investors with a time horizon of five years or longer, we believe an allocation to international equities could be productive within a diversified portfolio.

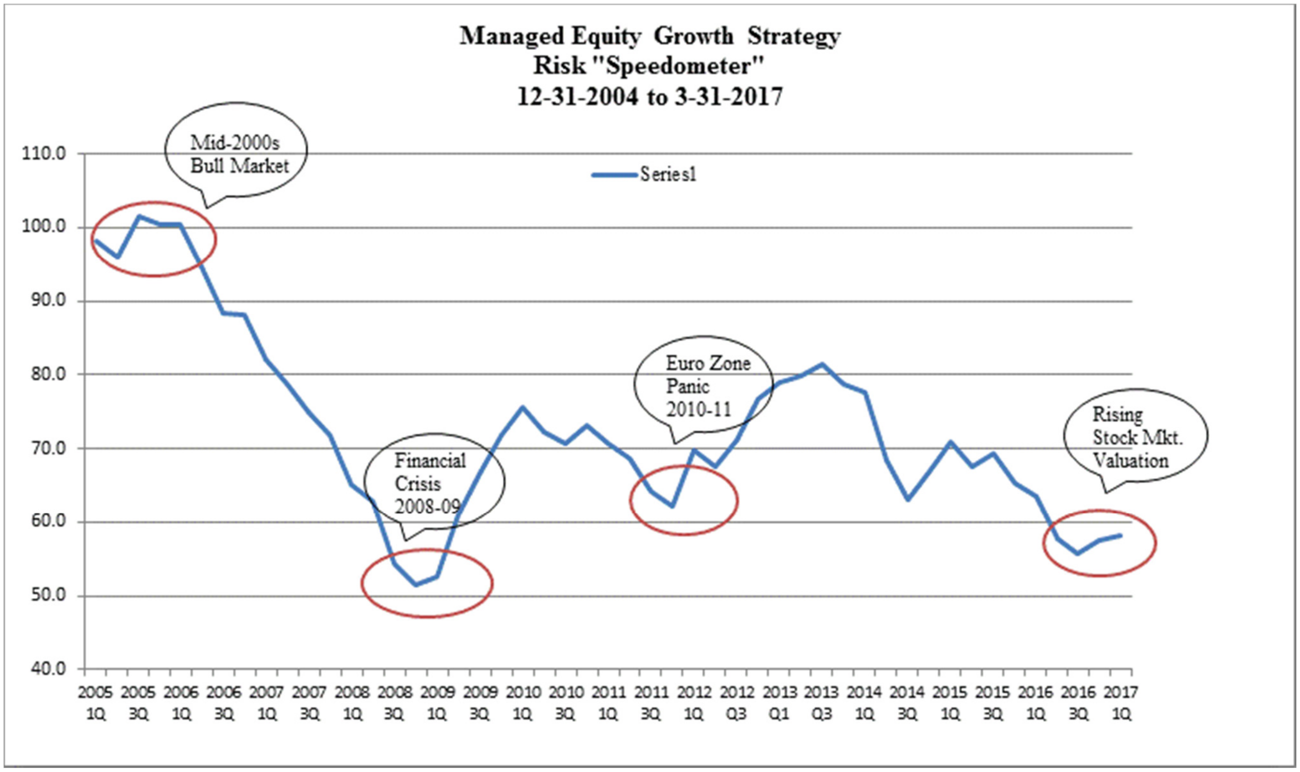
Current Design of Our Investment Strategies[9]

The remainder of this report addresses the current positioning of each of our investment strategies. We made a point to highlight the international equity exposure in strategies that include it. Please also note that we have a new strategy that is composed entirely of international stocks. It's called the **Tactical International Focus** strategy, and it is reviewed below.

[9] The portfolio strategy discussions in this section are supplemental to a compliant presentation. A complete list of Capital Advisors' portfolio models and compliant presentations are available by contacting Capital Advisors.

Managed Equity Growth[10]

The *Managed Equity Growth* strategy serves as a core allocation to the domestic equity asset class to achieve long-term capital appreciation. The graph below has been updated since the last *Overview* to reflect the recent risk profile of the portfolio model.



Source: Capital Advisors

The graph reflects the strategy's relatively cautious approach since the financial crisis. After taking the risk level higher during the recovery years of 2010-13, we began a downward shift in the risk level in the second half of 2013 in response to higher valuation multiples in the stock market following a strong advance that year.

We are comfortable with the current positioning of this strategy for now. We believe the portfolio includes plenty of exposure to stocks that ought to participate in a rising stock market trend, should such an outcome unfold. Conversely, if new fears emerge that translate into a correction for the domestic stock market, the steps we have already taken to dial-down the risk profile for this strategy might help to soften the damage.

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Managed Equity Dividend[11]

The *Managed Equity Dividend* strategy is designed to complement the equity and fixed income allocations of a diversified portfolio. For the equity portion of a portfolio this strategy provides a value tilt due to its emphasis on mature companies trading at low valuation multiples. For the fixed income portion of a portfolio this strategy diversifies the sources of cash flow to include dividend income in addition to interest from bonds.

We like the outlook for high-dividend stocks in 2017 because we believe the worst of the adjustment to higher interest rates may be over for now. Assuming the Fed follows through on its current forecast to raise the Fed Funds Rate two more times in 2017, it would not be surprising if interest rates drifted a bit higher throughout the year. However, we suspect longer-term interest rates may have already priced in another rate hike or two, and long-term rates provide the greatest competition for high dividend stocks in the marketplace.

Meanwhile, the weighted average dividend yield for the *Managed Equity Dividend* strategy model was approximately 4.7% (Source: *Fiserv APL*) as of March 31, 2017. As noted above, we suspect the long-term outlook for the broad domestic stock market may be no better than 4% annualized for buy-and-hold investors, with plenty of volatility in between. Within this context a cash yield of 4.7% makes a lot of sense to us.

Tactical Dynamic Allocation[12]

The *Tactical Dynamic Allocation* strategy is designed to be highly responsive to changing market conditions. By systematically responding to a quantitative indicator called a "moving average," this strategy is likely to be mostly exposed to risk assets when the recent trend in global markets has been positive, and mostly out of risk markets when the recent trend has been negative.

We use this strategy to complement a diversified portfolio of equity and fixed income assets because the variable portfolio mix within this strategy allows the overall risk exposure of the broad portfolio to react to changing market conditions un-emotionally. This strategy may be a particularly good match for the current stage of the market cycle because it is specifically designed to reduce risk whenever market conditions deteriorate. As of March 31, the strategy model included 89% exposure to risk markets and 11% in cash reserves. The only un-invested risk market as of quarter-end was real estate.

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International equities are a core component of this strategy. The investment universe includes a potential 24% allocation to developed international markets, and a 15% sleeve for emerging markets stocks. As of quarter-end both of these international sectors were invested within the strategy.

Tactical International Focus (NEW!)

The *Tactical International Focus* strategy delivers broad exposure to the global equity markets, excluding the United States. The strategy seeks to capture a return premium relative to common international equity benchmarks through disciplined exposure to three market factors that have demonstrated a long-term history of producing attractive risk-reward characteristics – value, momentum and low market capitalization.

The portfolio model is strategically diversified across five ETFs that provide broad exposure to international stocks and emerging markets. Two of the five ETFs use a quantitative discipline to overweight securities that exhibit characteristics of value such as low price-to-book, low price-to-earnings or low price-to-sales. Two ETFs apply a quantitative process to overweight securities that demonstrate recent price momentum. The fifth ETF focuses on small-cap and mid-cap companies outside the United States.

The *Tactical International Focus* strategy participates in the long-term growth of the global equity markets, excluding the United States. It can be used as a complement to domestic portfolio strategies to enhance the diversification of a portfolio's risk market exposure. By systematically overweighting securities that exhibit characteristics of value, momentum and low market capitalization, the strategy seeks to capture a return premium relative to common international equity benchmarks over time. Since the systematic adjustments that maintain the strategy's factor tilts occur within each ETF, rather than at the portfolio level, the strategy may be relatively tax efficient.

Tactical Diversified Strategies[13]

The *Tactical Global Growth* and *Tactical Global Income* strategies participate in the long-term growth of the global equity markets. A discipline of systematically tilting the sector weightings toward relative strength incorporates a momentum effect into both portfolios. These strategies can serve as a core position for investors seeking global diversification within the equity portion of their portfolio.

Both strategies spread investments among 10 broad sectors of the global asset markets using exchange traded funds (ETFs) for each market sector. The portfolio weightings change according to an objective measure for relative strength among the 10 sectors.

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Three of the 10 sectors invest beyond the U.S. border – developed international equities, emerging markets, and international small-cap stocks. The total allocation to these three sectors can be as high as 48%, or as low as 12%, depending upon the relative strength scores among the sectors at any given time.

We believe the global diversification inherent in these strategies may be helpful over the next several years because international equity markets might offer higher potential returns than the domestic stock market from today's starting point. Broadly speaking, the international equity markets trade at a lower price-to-earnings multiple, and a higher dividend yield relative to domestic market benchmarks. This difference in initial conditions might produce comparatively higher returns for international and emerging market equities over the next 5-to-10 years.

Fixed Income

Our Fixed Income strategies are customized according to three broad priorities – Liquidity, Income or Aggregate. A Liquidity portfolio invests exclusively in high credit quality securities and short-term maturities to ensure stability of principal and ready access to capital. An Income portfolio extends further out on the yield curve and includes a broader range of credit quality to generate a higher level of income. The Aggregate approach incorporates elements of both designs for a "core" exposure to the fixed income asset class.

Our fixed income portfolios are currently structured to withstand a possible increase in short-term interest rates associated with a gradual monetary tightening process from the Fed. It seems reasonable to expect some upward pressure on interest rates as the Fed tightens policy, however, we don't expect a substantial increase from here because rates already moved a lot in the second half of last year, and interest rates throughout much of Europe and Asia remain well below domestic levels.

By structuring our bond portfolios in a "ladder" with maturities typically contained within the 1-to-10-year range, the overall sensitivity to rising interest rates should be moderate unless rates rise much further and faster than we currently expect. Even then, a laddered bond portfolio provides opportunities to take advantage of higher rates by shifting near-term maturities further out on the yield curve. In February we purchased slightly longer maturities in many of our fixed income strategies to take advantage of higher cash flows.

We continue to emphasize "defined maturity" ETFs in our fixed income model portfolios. These funds include all of the features of a traditional fixed income ETF with one important difference: a specific maturity date. These funds are populated with bonds that all mature in the same calendar year. At the end of that year, the ETF terminates, and the fund's net assets are distributed to shareholders as cash, similar to what happens when an individual bond matures.

Most alternative fixed income strategies look relatively expensive to us, but we see potential opportunities in floating-rate bank loans, along with variable rate and trust preferred securities. In all cases we will not reach for yield unless the merits of the underlying strategy prove worthwhile relative to the risk.

April 3, 2017

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The **S&P 500 Index** is a stock market index based on the market capitalizations of 500 leading companies publicly traded in the U.S. stock market, as determined by Standard & Poor's. The index is calculated on a total return basis with dividends reinvested and is not assessed a management fee.
The **Barclays Aggregate Bond Index** is a broad base index, maintained by Barclays Capital, which took over the index business of the now defunct Lehman Brothers, and is often used to represent investment grade bonds being traded in United States.

Estimated portfolio yield represents the 12-month run-rate of interest and/or dividend payments in a strategy divided by the market value of the securities and cash reserves invested in the strategy. Estimated interest/dividend payments and market values are calculated by a portfolio accounting system from *Fiserv APL* using a single client portfolio that Capital Advisors believes to be representative of clients' portfolios invested in the same strategy. The actual portfolio yield for any single client portfolio may be lower or higher than the yield quoted. The underlying holdings of any presented portfolio are not federally or FDIC-insured and are not deposits or obligations of, or guaranteed by, any financial institution.

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