



## Key Points

- This being the prime of summer, we will keep things brief for now.
- Although this report is mercifully succinct, it is not light.
- Readers should consider this *Overview* as part-one in a longer-term discussion about a critically important subject we believe may define the investment landscape for at least the next decade – punishingly low returns.
- Most investors have lived their entire working lives during a three-decade stretch of above-average returns for stocks and bonds in the United States and Western Europe.
- Many of the factors that drove these exceptional returns have run their course, or in some cases, reversed direction.
- Investment returns over the next 10-20 years seem likely to fall well short of the experience that has come to feel “normal” to all of us over the past 30 years.
- Many conventional investment strategies that worked well during the past three decades may be less effective in an environment of much lower average returns.
- We anticipate a more dynamic approach to asset allocation may be necessary to extract acceptable returns from an otherwise low-opportunity environment.
- The dynamic approach we envision represents a departure from conventional investment practice, which typically relies upon a more passive, buy-and-rebalance approach to portfolio design.
- We welcome the opportunity to make a positive difference in peoples’ lives by helping them navigate the more hostile investment landscape we envision over the next decade or longer.

## The Long-Term Case for Low Returns

We hope this *Overview* can serve as an introduction to a more enduring dialogue about the challenging investment landscape we expect ahead, which will likely be characterized by abnormally low returns from stocks and bonds throughout the developed world. We have drawn from numerous sources to inform our current perspective on this topic, but today's report relies most heavily on a recently published white paper from the *McKinsey Global Institute* called "Diminishing Returns: Why Investors May Need to Lower Their Expectations."<sup>1</sup> For those interested in a deeper dive into this topic we have included a link to the *McKinsey* report in a footnote below. The key points of the *McKinsey* analysis are as follows:

- For 30 years between 1985 and 2014 total returns from stocks were considerably higher than their 100-year average in the U.S. and Western Europe.
- Total returns from bonds exceeded their 100-year average by an even wider margin than stocks over this same time period.
- The confluence of economic and business conditions that drove these exceptional returns will not be repeated in the decades to come because most of these factors have already run their course, or in some cases, reversed direction.
- For example, the sharp decline in inflation and interest rates from the elevated levels of the late-1970s and early 1980s cannot be repeated now that inflation is already below desired levels throughout much of the world, and approximately one-third of government bonds from developed nations offer a *negative* yield to maturity.<sup>2</sup>
- A potent combination of steady population growth, increasing productivity, and sustained double-digit expansion in China drove an era of rapid growth in global GDP<sup>3</sup> between 1985 and 2014; but changing demographics among working age adults, a secular downshift in productivity, and slowing growth in China seem likely to deliver much slower growth from the world economy for the foreseeable future.
- Corporate profits grew even faster than the economy over the past 30 years as new markets opened up around the world, corporate taxes and debt servicing costs drifted lower, and profit margins benefited from dramatic advances in automation and global supply chain management.
- These trends are now reversing as the geopolitical mood seems to have shifted against further globalization, higher taxes are increasingly contemplated among cities and nations desperate for tax revenue, interest rates can seemingly fall no further, and corporate investment toward innovation has taken a back seat to financial engineering via mergers, acquisitions and share repurchases, frequently funded with increased debt.
- Over the next 20 years *McKinsey* expects real returns (i.e. net of inflation) from stocks could be around 3.0 percentage points lower *per annum* compared to the past 30 years, while bond returns may fall short by around 4.0 percentage points *per annum*.

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<sup>1</sup> The McKinsey Global Institute is a division of McKinsey & Company, one of the world's largest management consulting firms. A copy of the full report can be obtained through the following link:

<http://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/why-investors-may-need-to-lower-their-sights>

<sup>2</sup> Source: Bloomberg - <http://www.bloomberg.com/news/articles/2016-06-26/brexit-adds-380-billion-to-global-negative-yielding-bond-pile>

<sup>3</sup> "GDP" refers to Gross Domestic Product, a common measure of economic output.

## Quick Comment on “Brexit”

There are far better sources than us for analysis of the historic vote of the U.K citizens to leave the European Union. The only point we wish to include here is that the long-term fallout from the Brexit decision seems likely to reinforce the trend toward lower asset market returns outlined above.

At its core, the Brexit decision represents a move away from globalization. From an economic perspective, globalization has historically favored stronger economic growth and lower inflation, suggesting Brexit may have the opposite effect over time. From a psychological perspective, uncertainty causes business leaders to defer decisions to the detriment of economic vibrancy, while uncertainty among investors leads to lower price-to-earnings ratios, all else being equal.

## The Implications of Low Asset Returns Are Sobering

For a hypothetical portfolio comprised of the institutional “default” asset allocation of 60% stocks and 40% bonds, the difference between the actual returns of the past 30 years and *McKinsey’s* estimate for the next 20 years is staggering. A domestically focused portfolio with a 60-40 asset allocation would have generated an average annual return of approximately 9.2% over the past three decades. If we apply the estimated future returns for stocks and bonds from the *McKinsey* study to a similar asset allocation, the annualized return would sink to approximately 4.5% per annum going forward.

Over a 20 year holding the difference between a 9.2% return and 4.5% return is pretty shocking. For every \$100,000 invested at these respective returns the cumulative *difference* in wealth creation after 20 years is approximately \$340,000. If the starting balance is increased to \$1.0 million, the cumulative difference would be \$3.4 million. With a \$10 million starting balance the cumulative shortfall for the lower return is approximately \$34 million...etc.

Despite a 30-year tailwind of above-average returns from stocks and bonds, the vast majority of public pension plans are woefully under-funded today, many retirees and institutions that rely on earnings from an investment portfolio have been over-spending their principal, and the majority of consumers in the U.S. and beyond have not saved enough for retirement.

Imagine how these circumstances might look after 10 or 20 years of meager returns in the global asset markets. This is the challenge facing investors today. We expect the ramifications of chronically low asset returns could become THE story in the financial markets over the next decade as the realization of low returns begins to reveal itself in state and federal budget deficits, funding shortfalls among retirees and institutions like colleges and insurance companies, and strains on various social services facing greater demand from an aging and under-saved population.

## **Doing Better Requires Surviving the Downturns**

Asset markets never glide smoothly toward a long-term average outcome. Rather, they lurch their way through booms and busts that settle into a historical result that only looks “average” in hindsight. We believe the key to extracting more out of the asset markets in the years to come lies in preserving as much principal as possible during the periodic downdrafts that will inevitably occur.

Of course, this is much easier said than done. No one should expect magic from Capital Advisors on this front. The best we can hope for is to position clients’ portfolios more conservatively when the risk-reward tradeoff in the asset markets seems unfavorable, while tilting more aggressively when opportunities look more plentiful. We will have more to say on this subject in future commentaries.

## **Current Design of Our Investment Strategies<sup>4</sup>**

The remainder of this report addresses the current positioning of each of our seven investment strategies. For context, the recent fallout from the Brexit surprise triggered a pullback in all of our equity focused strategies. Fortunately, all five of our equity strategies are performing well this year relative to appropriate benchmarks, but returns are fairly low on an absolute basis, nonetheless.

Our baseline assumption at this time is that global risk markets can regain their footing in the second half of the year. We will be tracking credit spreads in the bond market, the U.S. dollar, commodities, and European bank stocks to either confirm this baseline forecast, or discard it if these indicators suggest we should.

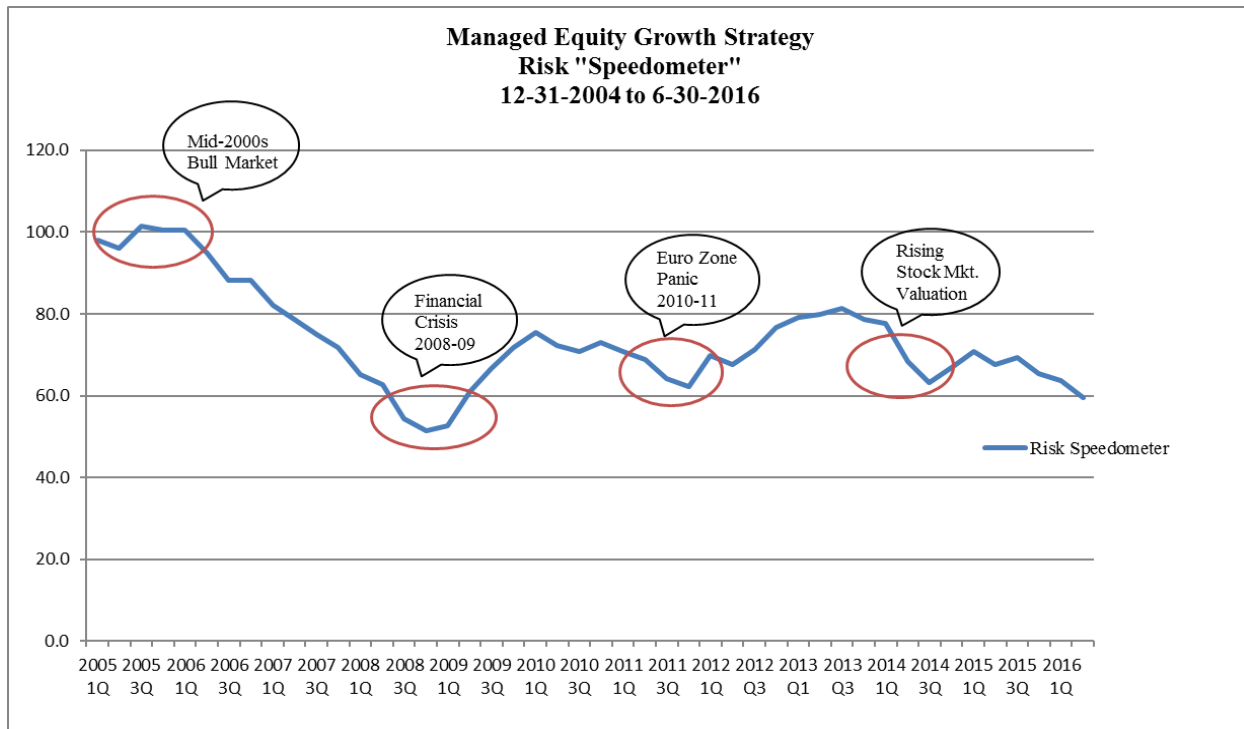
We offer the standard reminder that our seven investment strategies serve different roles within a diversified portfolio. The strategies are designed to complement one another when used in combination.

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<sup>4</sup> 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

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.

The strategy entered the Brexit decision in its most conservative position since the financial crisis based on this "Risk Speedometer" metric. Although this cautious positioning was helpful during the fallout from the Brexit vote, the strategy suffered a pullback nonetheless in the days immediately following the UK referendum.

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 recovery scenario for the stock market, should such a recovery unfold in the second half of the year.

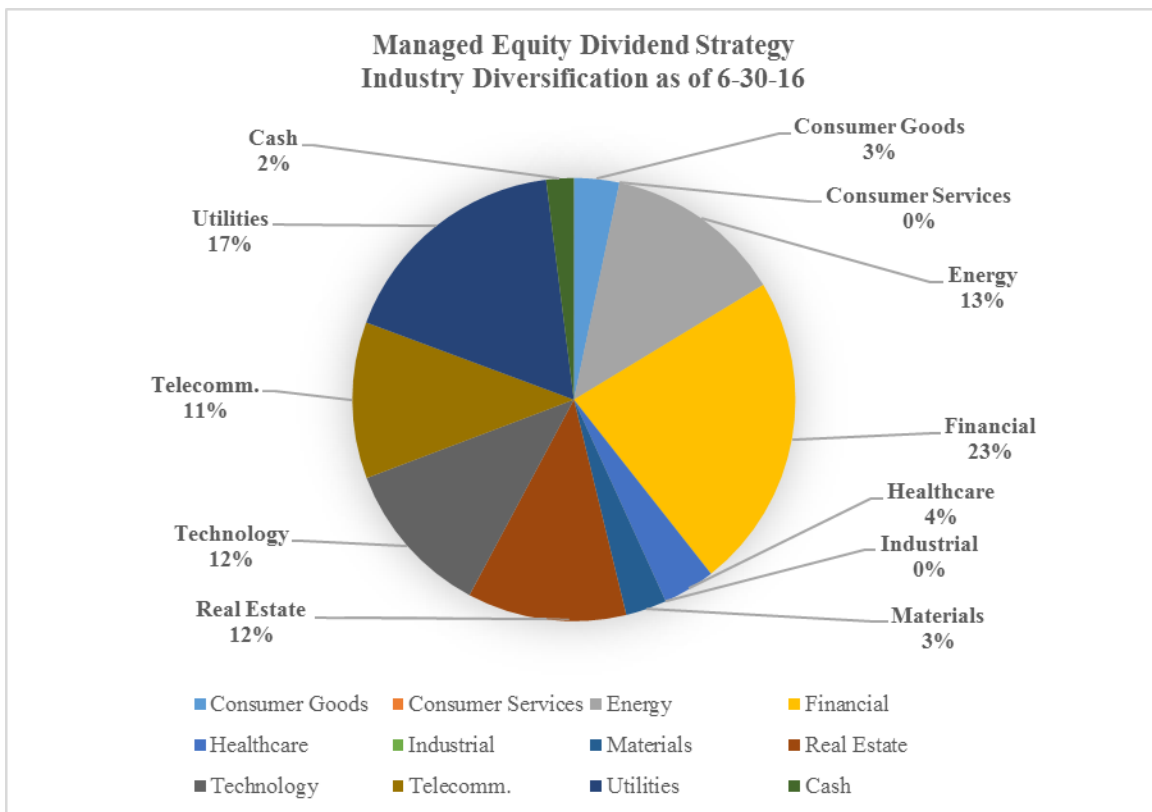
Conversely, if the Brexit surprise cascades into a deeper problem for the domestic stock market, the steps we have already taken to dial-down the risk profile for this strategy might help to soften the damage.

## Managed Equity Dividend

The *Managed Equity Dividend* strategy complements 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 the second half of 2016 because the threat of higher interest rates in the fixed income markets may have been pushed back by the Brexit decision. Recent prices the Fed Funds futures market<sup>5</sup> reflect an expectation for *at most* one rate increase between now and the first quarter of 2017.

Meanwhile, the weighted average dividend yield for the *Managed Equity Dividend* strategy model was 5.1% (Source: *Fiserv APL*) as of June 30, 2016. In a competitive global marketplace, a diversified yield of 5.1% looks out of place in relation to historically low interest rates in virtually every developed economy in the world. We believe this yield premium can narrow throughout the year if interest rates remain reasonably stable, as futures markets are currently predicting.



<sup>5</sup> Source: CME Group - <http://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html>

As the pie chart above reflects, attractive dividend yields can still be found across a broad spectrum of industries. Although the strategy model includes a healthy dose of “standard” dividend payers in the utility, telecommunications and real estate sectors, these three traditional dividend sources represent less than half of the total portfolio allocation.

## **Tactical Dynamic Allocation**

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 broader portfolio to react to changing market conditions un-emotionally.

This strategy performed admirably during the sharp downturn in global risk markets at the start of the year because it had become defensively positioned by the fourth quarter of 2015. Unfortunately, the rewards from this early success were largely given back in the aftermath of the Brexit decision.

Global risk markets rallied broadly in the weeks leading up to the UK referendum vote, presumably reflecting the consensus expectation (at the time) for a stability-inducing “remain” outcome from the vote. This up-trend triggered a positive moving average reading for all of the risk market sectors in the strategy model, leaving the portfolio fully exposed to the negative shock that followed the vote. Despite this setback, the strategy model performed better than global equity benchmarks through the first half of the year.

## **Tactical Diversified Strategies**

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. This discipline was particularly helpful during the recent correction because the most resilient sectors during the Brexit fallout – real estate and high-yield bonds – were both over-weighted at the time of the vote, while the most vulnerable sectors – international equities and emerging markets – were under-weighted.

For the upcoming quarterly holding period these strategies will be over-weighted in large-cap growth, large-cap value and real estate, while the under-weighted sectors will be emerging markets, Japan and natural resources.

## 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 *very gradual* monetary tightening process from the Fed. As mentioned above, the timing for the next rate increase from the Fed has probably been pushed back to the end of 2016, if not 2017, based on the macro uncertainties introduced by the Brexit decision, among other reasons.

It seems reasonable to expect some upward pressure on longer-term rates whenever the Fed finally tightens policy, however, we don't expect a substantial increase because interest rates throughout much of Europe and Asia are even lower than domestic levels. This implies a likely “flattening” of the yield curve, where the spread between short-term and longer-term interest rates narrows.

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.

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. During 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.

We will be watching the trend in high-yield corporate credit (i.e. “junk bonds”) carefully in 2016. We feel it is too soon to establish a position in high-yield debt because credit conditions for many sub-investment grade companies may not have improved as materially as the recent rally in junk bond prices suggests. However, if junk bond yields are still attractive when signs of sustainable improvement in business conditions have materialized, we may tip-toe back into high-yield bonds in one or more of our fixed income model portfolios.

July 1, 2016



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