CAPITAL
ADVISORS

RESEARCH UPDATE
February 2, 2018

Market Comment

Global asset markets are in the midst of a material adjustment higher in interest rates. Although rates have been grinding upward since the summer of 2016, the trend accelerated in late December with the passage of the tax reform bill in the U.S.

Since interest rates are a foundational input into the valuation formula for all investment assets, the recent behavior of rates can be expected to echo throughout the global asset markets in various ways. During the first few weeks of 2018 the most significant effect occurred in the fixed income markets and among stocks with high dividend yields like utilities and real estate investment trusts (REITs). These markets are particularly sensitive to changing interest rates, so their recent behavior is not surprising in light of the magnitude of the move in rates.

Tough Stretch for Interest-Sensitive Assets
12-31-17 to 02-01-18

Asset Class	Index	Total Return
Fixed Income	Barclays Aggregate Bond Index	-1.42%
Utility Stocks	Dow Jones US Utilities Index	-4.67%
Real Estate	Dow Jones US Select REIT Index	-6.11%

Source: Bloomberg; Barclays Capital; Dow Jones; It is not possible to invest directly in the index

As the table above reflects, investors with a meaningful allocation to fixed income and/or dividend-paying stocks have had a frustrating start to the New Year. These investors are justified to feel out-of-sync with a stock market that hit multiple new highs in January. We share your frustration! However, please know that we consider the recent performance of interest-sensitive assets to be a normal reaction to a sharp move higher in rates. More importantly, we believe investors can recover from the recent setback by exploiting opportunities that can be created whenever interest rates rise.

As this note was being written the stress from higher interest rates seems to have spread to the entire stock market. We may have more to say on this next week. For now we will limit our comments to the strategies that have been impacted most directly by higher interest rates – Fixed Income and Managed Equity Dividend.

Fixed Income

Our ETF bond models – *Aggregate* and *Income* – have been positioned for a possible rise in rates for some time. This positioning includes a shorter-than-benchmark duration for both strategies and a significant allocation to investment grade corporate bonds, which can be purchased with a higher starting yield than their Treasury bond counterparts, potentially providing some downside protection to rising rates.

Please see back page for disclosures

The *Aggregate* strategy is able to create tighter control over the sensitivity to interest rates through the investment of four **BulletShares/iBonds ETFs** with maturities in 2020, 2021, 2022 and 2023. As time passes the average duration of the underlying bonds in each ETF will shorten systematically. This portfolio structure should be ideal for a gradual rise in interest rates over the next several years.

The *Income* strategy holds an allocation to the **PowerShares Senior Loan Portfolio ETF (BKLN: ~$23),** which invests in floating rate senior secured corporate loans. As opposed to fixed rate bonds, floating-rate securities can help to protect against rising interest rates because the coupons from these loans adjust upwards if/when short-term interest rates rise, based primarily on the 90-day LIBOR[1] interest rate. In addition, the portfolio holds the **SPDR DoubleLine Total Return Tactical ETF (TOTL: ~$48)** which provides active interest rate risk management.

Clients invested in our *Managed Credit* and *Managed Municipal Bond* strategies generally hold a laddered maturity portfolio of individual bonds. Assuming a given security does not default, its expected return to maturity is measurable within a narrow margin *at the time of purchase*. However, the price of the bond can take a varied path between the purchase date and maturity. It is important to note that in both cases, the interim price move has no effect on the outcome at maturity. In addition, as market rates rise, the reinvestment rate for coupon payments and maturing bonds improves, thus potentially enhancing the longer term return profile of the portfolio.

Managed Equity Dividend

While the recent behavior of high-dividend stocks has not been surprising, the more critical question for investors is how bad might it get? It is the nature of asset markets to overshoot their fundamentals in both directions from time to time, so no promises on this forecast in the short-term. However, from a longer-term perspective we believe the current level of *relative* yields among high-dividend stocks has already reached a threshold that can provide fundamental support for the *Managed Equity Dividend* strategy.

For example, it has been normal historically for the dividend yield of the *Dow Jones US Utility Index* to be lower than the yield of the 10-Year U.S. Treasury Note. Prior to the financial crisis, utility yields only exceeded Treasury yields for a brief time in the early 2000s in the wake of the Enron collapse. Yet the recent relationship between these two markets shows a 0.70% premium for Utilities relative to the 10-Year Treasury (3.5% vs. 2.8%).[2]

A similar dynamic holds true for real estate securities, where the recent yield for the REIT Index is materially higher than the 10-Year Treasury yield, and higher than the long-term average for the relationship between these two markets.

These relative yield dynamics offer two potential sources of comfort. First, there should be room for high-dividend stocks to recover lost ground if interest rates stabilize near current levels. Such a move would merely return the relative yield of these stocks closer to their long-term average. Second, should interest rates continue rising, high-dividend stocks might find greater resilience for the same reason – there is room for the relative dividend yield to improve.

Please see back page for disclosures

[1] LIBOR is an acronym for the London Interbank Offered Rate, and serves as the first step to calculating interest rates on various loans throughout the world.
[2] The Source for all data in this paragraph is Bloomberg and Dow Jones.

Disclosures

Security Recommendations: The investments presented are examples of the securities held, bought and/or sold in the Capital Advisors strategies during the last 12 months. These investments may not be representative of the current or future investments of those strategies. You should not assume that investments in the securities identified in this presentation were or will be profitable. We will furnish, upon your request, a list of all securities purchased, sold or held in the strategies during the 12 months preceding the date of this presentation. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of securities identified in this presentation. Capital Advisors, Inc., or one or more of its officers or employees, may have a position in the securities presented, and may purchase or sell such securities from time to time. Additional information, including management fees and expenses, is provided on Capital Advisors' Form ADV Part 2.

Items of Note Regarding Exchange Traded Funds
An Exchange Traded Fund (ETF) is an investment company that typically has an investment objective of striving to achieve a similar return as a particular market index. The ETF will invest in either all, or a representative sample of the securities included in the index it is seeking to imitate. Like closed-end funds, ETFs can be traded on a secondary market and thus have a market price that may be higher or lower that its net asset value (NAV). If these shares trade at a price above their NAV they are said to be trading at a premium. Conversely, if they are trading at a price below their NAV, they are said to be trading at a discount.

Investment Risk
Market Price Risk: The market price of ETFs traded on the secondary market is subject to the forces of supply and demand and thus independent of the ETF's underlying Net Asset Value (NAV). This can result in the market price trading at a premium or discount to the NAV, which will effect investment value.
Market Risk: The market prices of ETFs and mutual funds can fluctuate as the result of several factors such as security-specific factors or general investor sentiment. Investors should be aware of the prospect of market fluctuations and the impact they may have on the market price of ETF and mutual fund securities.
Sector Funds: Investing exclusively in one sector or industry involves additional risks. The lack of industry diversification subjects the investor to increased industry-specific risks.

The **Bloomberg Barclays US Aggregate Bond Index** is a market capitalization-weighted index representing most U.S. traded investment grade bonds. The index includes Treasury securities, Government agency bonds, Mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S.

The **Dow Jones US Utilities Index** tracks the price and yield performance of domestic utility stocks.

The **Dow Jones US Select REIT Index** is designed to measure the performance of publicly traded real estate securities. The index is designed to serve as a proxy for direct real estate investment, in part by excluding companies whose performance may be driven by factors other than the value of real estate.

As with any investment strategy, there is potential for profit as well as the possibility of loss. Capital Advisors does not guarantee any minimum level of investment performance or the success of any portfolio or investment strategy. All investments involve risk (the amount of which may vary significantly) and investment recommendations will not always be profitable. The investment return and principal value of an investment will fluctuate so that an investor's portfolio may be worth more or less than its original cost at any given time. 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.

Past performance is not a guarantee of future results. Capital Advisors, Inc. does not provide tax or legal advice and recommends you consult with your tax and/or legal adviser for such guidance.

Please contact Capital Advisors for a list and description of all firm composites and/or copy of our most recent Form ADV Part 2:
1-866-230-5879

Presentation is prepared by: **Capital Advisors, Inc.** and is considered to be supplemental to a compliant presentation. **Copyright © 2018, by Capital Advisors, Inc.**
www.capitaladv.com

2018.02.02R