CAPITAL ADVISORS

Overview
First Quarter 2018

Key Points

- Volatility returned to the global asset markets in a major way in February and March.
- In addition to persistent political unease, recent tensions in global trade, U.S. monetary policy and the technology sector have justifiably rattled investor confidence in three important pillars of the bull market: 1) Coordinated global growth, 2) Low and stable interest rates, and 3) The boundless growth potential of certain technology platforms like Facebook.
- These developments create a dilemma for investors because their potential to trigger a meaningful decline in the financial markets seems clear, yet it is equally plausible that these risks might come and go without inflicting their worst-case potential.
- Should recent trade skirmishes escalate into an outright trade war, the impact on global asset markets could be quite negative.
- Investors who do nothing to prepare for such an obvious risk might look foolish in hindsight if it comes to pass.
- Yet it is also possible for the “fools” to be those who prepare for a trade war, or a surge in interest rates that never materializes, potentially missing out on a good run for stocks.
- For now, we believe our investment strategies are appropriately positioned for the outlook we deem to be most likely.
- Specifically, we feel it is premature to position for a worst-case scenario on global trade or inflation.
- Even so, we suspect that valuation multiples and corporate profit margins may have peaked for this cycle, resulting in average returns from stocks over the next few years that may be well below the experience or the past several years.
- We have tried to position our investment strategies accordingly with a conservative tilt.
- In the pages that follow we hope to describe the current positioning of each of our investment strategies in sufficient detail to allow investors to determine if they agree with our approach.
- If the world view we have incorporated into our investment strategies feels out of sync with your own, please give us a call…We stand ready to work with you to adjust your asset allocation toward your comfort zone.

Please see important disclosures at the end of this document.
Supplemental to a fully compliant presentation.

A High-Risk Approach to Trade Policy

We believe investor anxiety over the growing friction in global trade is justified, but we also see merit in some of the Trump administration's objectives. This results in a conflicted view of how to react as an investor.

We feel that an outright trade war could do material harm to global asset markets by pressuring inflation and interest rates higher and economic growth lower. Such an outcome cannot be ruled out, which justifies a conservative tilt to portfolio construction, in our opinion. We explain what we have done on this front below.

Yet we do not recommend a drastic response to the risk of a trade war because it seems quite possible that the recent trade skirmishes initiated by the Trump administration might never deteriorate beyond the negotiating tactics we believe they are intended to be. We agree with the conclusion of many economists that the U.S. and its allies have been harmed by abusive trade behavior from China, particularly in the field of intellectual property. We also acknowledge that the tactics that have been tried thus far to improve China's behavior have not worked.

The Trump administration's new approach to China is high-risk to be sure, but the objective is valid, in our opinion. From an investment perspective, we believe it makes sense to let this issue play out further before assuming the worst.

The Importance of Interest Rates

Rising interest rates are nearly always a headwind for financial markets due to their impact on the discounted present value calculation that forms the foundation of all asset prices. However, the specific drivers of higher interest rates can be either benign or threatening. The distinction is critical for investors.

Until recently, the upward trend in interest rates was ascribed to a benign combination of monetary policy normalization and accelerating economic growth. On the policy front, investors have been comfortable – so far – with the central bank's gradual approach to unwinding its emergency policy measures. This may be because monetary policy remained highly stimulative through the first five hikes in the Fed Funds rate, as indicated by a target rate for Fed Funds that remained lower than the rate of inflation, even after five rate increases.

With the latest hike in the Fed Funds rate on March 21st the policy target reached parity with inflation, suggesting an end to the era of "emergency" interest rates. This represents a noteworthy transition for monetary conditions in the U.S. because future policy actions are likely to push short term interest rates above the rate of inflation for the first time in a decade.

The crossing of this policy milestone may have contributed to the stock market's negative reaction to the Fed's rate decision on March 21st, which included an update to the committee's Summary of Economic Projections (SEP). The latest SEP suggested a higher terminal rate for the Fed Funds target than many investors had been expecting according to prices in the Fed Funds futures market ahead of the Fed announcement.[1]

Investor concerns around trade policy can echo into the interest rate outlook as well. Considering that the primary objective of a trade war is higher prices for the disputed products, investors assume – correctly in our opinion – that one of the consequences of a trade war would be higher inflation. Such a scenario would almost certainly put upward pressure on interest rates for all the wrong reasons.

While we recognize the potential for future disappointment on the inflation and/or interest rate front, our baseline expectation is that longer-term interest rates (i.e. bond maturities of 10-years or longer), may have already completed most of the necessary adjustment to account for continued, gradual increases in the Fed Funds rate over the next couple of years. While uncertainty around this outlook justifies a cautious investment approach, the gradual pace of rate increases we expect should not pose a major threat to global financial markets, in our opinion.

A "Lehman Moment" for Tech?

With the benefit of hindsight it is tempting to point to the bankruptcy of the investment bank, Lehman Brothers, in September of 2008 as the moment that changed the global banking industry forever. The reality of the financial crisis was obviously much deeper and more complex than the failure of one large investment bank, but Lehman's collapse was a signature moment nonetheless.

Today, investors may be asking themselves if the consumer privacy scandal at Facebook might signal a similar *structural* shift in the future path of dominant tech companies like Amazon, Apple, Netflix and Google (in addition to Facebook). To be clear, nothing about the Facebook awakening should trigger a global financial crisis, in our opinion. However, like the Lehman bankruptcy, Facebook may represent a signpost for a lasting structural change.

As was the case before Lehman's collapse, change has been bubbling beneath the surface of the technology sector for some time now. Politicians, regulators and tax authorities around the world have signaled increasing concern for the magnitude of resources and influence that the largest technology platforms have accumulated. Prior to the Facebook scandal these signals had gone largely unnoticed – occasional tax disputes, regulatory actions, or policy proposals, for example. Yet the shift in sentiment has been clear, in our opinion.

[1] Source: CME

As one concrete example of the changing landscape for tech, consider the General Data Protection Regulation (GDPR), which is scheduled to go into effect throughout the European Union (EU) in May. The GDPR seeks to bring a new set of "digital rights" for EU citizens to reflect the increased economic value of personal data in the digital economy.

For flavor on the potential impact of GDPR on the technology sector, certain violations carry a potential penalty of the *greater* of $25 million, or 4% of trailing 12-month revenue.[2] Had GDPR been in place prior to Facebook's recent missteps, the potential fine might have been approximately $1.6 billion (4.0% of $40.7 billion in revenue). It will be interesting to watch the legal and regulatory ramifications of the Facebook controversy in the months to come.

We remain optimistic about the long-term growth potential of the technology sector, including many of the dominant platform companies. Indeed, we may even take a position in Facebook at some point. However, we also believe the days of the "FAANG" stocks – i.e. Facebook, Amazon, Apple, Netflix and Google – representing the dominant element of each stock market advance may be over for the foreseeable future.

Portfolio Design: Asset Allocation

Our recommended asset allocations have not changed since the last Overview. Please note that the matrix below represents a *generalized starting point* for framing the asset allocation discussion. Unique client circumstances may justify deviations from this framework, while material differences in the risk management process of our various investment strategies can influence the appropriate commitment to risk markets as well. We note the following observations:

- We believe the allocation to risk markets should be skewed toward the minimum threshold in the current market climate for most investors.
- Even so, we expect stocks to outperform bonds over the next 5-10 years, justifying continued commitment to equities for even the most conservative investors.
- At the other end of the spectrum, we believe even the most aggressive investors would benefit from a meaningful allocation to stable assets to reflect the possibility that *incremental* returns for risk markets relative to fixed income may be more modest than usual.
- If the major uncertainties of the moment can be resolved without lasting harm to the outlook, we expect investors to eventually reorient their attention to a U.S. stock market poised to earn approximately $156 per share for the *S&P 500 Index* in 2018.[3]
- By this time next year if the *S&P 500 Index* can trade at an un-demanding price-to-earnings (P/E) ratio of 18.0, the implied target for the index would be approximately 2,808, enabling a total return with dividends of about 9.2% from here to there.

[2] Source: www.EUGDPR.org
[3] Source: Bloomberg consensus estimate for 2017 earnings per share for the S&P 500 Index.

Asset Allocation Matrix: Risk Markets vs. Fixed Income and Cash

Investor Risk Profile	Suggested Risk Market Range	Current Recommendation
The **Preservation** risk profile is designed for the cautious investor. It is the most conservative profile for investors with a low risk tolerance and/or a short time horizon. The primary objective is investment stability and liquidity. Long-term growth of principal is expected to be limited as a tradeoff for safety of principal and limited fluctuations in portfolio value.	0% to 35%	20%
The **Conservative** risk profile is the second most conservative category. This investor will have a slightly higher risk tolerance compared to the most conservative profile. While this range is still designed to preserve the investor's capital, fluctuations in the value of the portfolio may occur from year to year due to moderate exposure to more volatile asset classes like equities.	35% to 55%	35%
The **Moderate** risk profile is best suited for the investor who seeks relatively stable growth from their investable assets through a balance of fixed income and equity market exposure. An investor in the moderate risk range will have a higher tolerance for risk, and/or a longer time horizon compared to more conservative profiles. The main objective for this profile is to achieve steady portfolio growth while limiting fluctuations in portfolio value to less than the overall stock market.	50% to 70%	50%
The **Moderately Aggressive** risk profile is designed for investors with a relatively high tolerance for risk and a longer time horizon. These investors typically hold more than half of their portfolios in risk assets like equities, with a smaller allocation to fixed income to reduce volatility. The main objective of this risk range is capital appreciation. These investors should be able to tolerate fluctuations in portfolio value.	65% to 85%	65%
The **Aggressive** risk profile is appropriate for investors who have both a high tolerance for risk and a long investment time horizon. It is the most aggressive investor profile. The main objective for this investor is long-term growth, with limited concern for current income. Portfolios in this range may have substantial fluctuations in value from year to year, making this category unsuitable for those who do not have an extended time horizon.	80% to 100%	80%

Current Design of Our Investment Strategies[4]

The remainder of this report addresses the current positioning of each of our investment strategies. To the extent possible within the structure of each strategy, we have positioned these portfolios for the following broad perspectives:

1) Average returns in the global equity and fixed income markets seem likely to be well below historical trends over the next 5-10 years.

[4] 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.

2) We expect continued gradual increases in the Fed Funds rate over the next 1-3 years, but believe that much of the likely adjustment in longer-term interest rates (i.e. bond maturities of 10-years or longer) may have already occurred.
3) We consider negative surprises on global trade policy or inflation to be the most consequential risk factors threatening the financial markets in the current environment, but believe it is premature to position portfolios for a worst-case scenario for either risk.
4) We expect the attitude of consumers, regulators and policy makers toward certain technology platform companies may be undergoing a structural shift that could make life more difficult for these companies going forward, but we remain optimistic about the technology sector in general, including several of the major platform companies.

Managed Equity Growth

The *Managed Equity Growth* strategy provides focused exposure to domestic equities with the objective of achieving long-term capital appreciation. The investment process combines long-term commitments to Core Holdings and Emerging Franchises with more event-driven positions we categorize as Tactical Opportunities. We may shift weights between categories, depending upon anticipated market conditions. The risk management process can also involve temporarily holding cash as a tool for investing after the market overextends to the downside. The table below shows the portfolio model's current design:

	Core Holdings		
Emerging Franchises	**Innovators**	**Operators**	**Tactical Opportunities**
CRISPR Therapeutics	Alibaba	Apple	Bristol-Myers Squibb
Editas Medicine	Alphabet	Blackrock	CarMax
Intellia Therapeutics	Amazon.com	Bright Horizons Fam.	Citigroup
	Booking Hldgs.	Brookfield Asset Mgt.	Celgene
	PayPal	Check Point Software	Coherent
	Salesforce.com	Laboratory Corp.	Continental Resources
		Microsoft	Delta Airlines
		PepsiCo	Exxon Mobil
		Procter & Gamble Group	Gilead Sciences
		UnitedHealth	Merck
		Visa	Sensata Technologies
			XPO Logistics

We select each company based upon positive short- and long-term outlooks, while our risk management process acknowledges the different market forces that can affect performance. By managing diversification between these forces, we seek to achieve some protection against visible and unforeseen risks, while gaining exposure to multiple attractive value drivers.

Broadly stated, we would expect the left side of the above grid – Emerging Franchises and Core Innovators – to perform best when investors are optimistic and willing to discount potential of future earnings. Tactical Opportunities, which include most of our valuation-oriented investments, tend to get a tailwind when investors are cautious and more focused on very near-term earnings, or tangible asset value.

Around mid-last year, we added several names to the Core Operator segment. Later in the year we focused upon Core Innovators and Emerging Franchises. These moves have helped the strategy significantly year to date. So far in 2018 we have emphasized the Tactical Opportunity category to prepare for higher market volatility.

Investors in this strategy should expect a relatively patient sell discipline for the stocks characterized as Core Holdings and Emerging Franchises, while activity may be greater among the Tactical Opportunities.

Managed Equity Dividend

The *Managed Equity Dividend* strategy is designed to provide healthy income generation in addition to equity market exposure. It can be a complement to the equity and fixed income allocations of a diversified portfolio. Each of these objectives might be considered relative to a different performance benchmark.

- For the portfolio's equity market participation objective, this strategy provides a value tilt due to its emphasis on mature companies with relatively stable cash flows.
    - Unlike growth stocks, dividend-oriented companies usually deliver a meaningful portion of their total return through near-term cash payments. As an asset class, this attribute can make these stocks less reliant upon investor risk sentiment and more directly exposed to near term interest rate changes.
- As a complement to fixed income, this strategy diversifies the sources of cash flow to include dividend income in addition to bond interest.
    - Equity dividends can help diversify inflation risk. We seek companies for this strategy that we believe can raise their dividend payments over time at a pace equal to, or higher than inflation. Investors should be willing to accept equity-like risk with dividend stocks, which makes the strategy best suited to a medium- to longer-term portfolio role.

Our investment and risk management process for this strategy includes the active management of style segments. We combine long-term commitments to Consistent Dividend Growers with more event-driven positions we categorize as Tactical Opportunities. Within these broad groups, we actively manage exposures between utilities, real estate investment trusts (REITs) and aggressive yielding companies in line with anticipated market conditions.

The Managed Equity Dividend strategy continues to generate an above-market income stream. As of quarter-end the weighted average dividend yield for the *Managed Equity Dividend* strategy model was approximately 4.9%.[5] Most recently, we have focused on companies that we believe should outperform during times of economic uncertainty and market volatility.

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 these markets has been positive, and mostly out when the recent trend has been negative.

Schwab U.S. Broad Market Index
Daily Closing Price (white) vs. 180-Day Moving Average (green)
Jan. 3, 2017 to March 28, 2018

Source: Bloomberg **It is not possible to invest directly in an index**

The chart above illustrates the recent condition of the domestic equity sector within the strategy model. The equity index for this sector (white line) has been trading well above its moving average trend line (green) for most of the past 15-months. At each monthly review for this sector, when the current price of the index is higher than its moving average, the ETF for that index stays in the portfolio for another month. When the current price drops below the moving average as of a monthly review date, the ETF is sold and replaced with cash reserves and an ETF for investment-grade fixed income.

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[5] Source: Orion

As the chart reflects, the recent volatility in the domestic stock market brought the current price of the index much closer to its trend line. Should market conditions deteriorate a bit further, we would expect the index to drop below its moving average, triggering the removal of the domestic equity ETF from the strategy model for as long as it takes until it rises back above its trend line.

Investors in this strategy should know that as of the end of March, each of the four risk market sectors currently invested within the portfolio is close to its moving average threshold, similar to the illustration above. As such, we would expect one or more of these risk market ETFs to be replaced with cash and fixed income reserves should market conditions evolve unfavorably from recent levels. The real estate sector came out of the portfolio in January, so the model became moderately conservative (11% cash reserves), before recent market volatility kicked into higher gear in February and March.

We use this strategy to complement a diversified portfolio of equity and fixed income assets because its variable portfolio mix allows the overall risk exposure of a balanced portfolio to react to changing market conditions un-emotionally. This strategy may be particularly useful for investors who wish to sustain a material commitment to risk markets because it is specifically designed to reduce risk whenever market conditions deteriorate.

International Focus

The *International Focus* strategy delivers broad exposure to the global equity markets outside 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 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 *International Focus* strategy participates in the long-term growth of the global equity markets. It can be used as a complement to domestic portfolio strategies to enhance the diversification of a portfolio's risk market exposure. 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 Global Strategies

The *Tactical Global Growth* and *Tactical Global Income* strategies participate in the long-term growth of the global equity markets, including the U.S market. 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 ETFs for each market sector. 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.

During the upcoming quarterly holding period these strategies will include over-weight positions in the international equity, international small-cap and domestic large-cap growth sectors, while real estate, natural resources and high-yield credit will be under-weighted.

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.

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.

Our fixed income portfolios are currently structured to withstand a likely increase in short-term interest rates associated with a gradual monetary tightening process from the Fed. We believe that much of the likely adjustment in long-term interest rates (i.e. bond maturities of 10-years or longer) may have already occurred because inflation expectations remain subdued, and interest rates throughout much of Europe and Asia are well below domestic levels.

In addition to interest rate risk management, we have been focused on "up-in-quality" trades across many of our portfolios. For example, we have begun purchasing Treasury bonds in certain mandates in lieu of higher yielding corporate bonds as the yield premium compresses further. Within the Income Bond Model specifically, the actively managed ETF within the strategy **(TOTL: ~$48)** is already doing this through an active sector rotation out of High Yield and Emerging Markets debt into Treasury and AAA-rated agency/mortgage backed securities.

March 28, 2018

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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 **MSCI World Index** is a stock market index of 1,650 global stocks, and is used as a common benchmark for 'world' or 'global' stock funds. The index includes a collection of stocks of all the developed markets in the world, as defined by MSCI.
The **Morningstar® Dividend Yield Focus Index** is designed to track high-yielding, qualified dividend paying, U.S.-based securities screened for companies with superior quality and financial health. The Index represents the top 75 high yielding stocks that meet the screening requirements.
The **Bloomberg Barclays Intermediate Government/Credit Bond Index** seeks to track the investment results of U.S. dollar-denominated government, government-related and investment-grade U.S. corporate bonds with remaining maturities between one and ten years.
The **Bloomberg 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.

Real Estate Risk Disclosure: Portfolios concentrated in real estate securities may experience price volatility and other risks associated with non-diversification. While equities may offer the potential for greater long-term growth than most debt securities, they generally have higher volatility.

Real Estate Investment Trust (REIT): A corporation or business trust which owns, manages, and/or leases commercial real estate properties, and/or invests in real estate related securities, such as mortgaged-backed securities or whole loans. Created by Congress, REIT legislation was initially passed in 1960 and was amended in 1986 to enhance and increase ownership and management focus on the underlying asset operations. REITs are exempt at the entity level from federal (and usually state) corporate income taxation, subject to meeting certain IRS requirements for real estate investment and ownership, real estate income, and dividend levels (i.e., dividend payout requirements for REITs require that 9O% of taxable income be paid as a dividend). REITs must invest at least 75% of total assets in real estate assets and derive at least 75% of gross income from rental or management of real estate or interest from mortgage activities. The REIT Modernization Act of 2001 provides that REITS may now have up to 20% of assets consist of stocks in taxable REIT subsidiaries. (Source: Bloomberg)

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 *Orion* 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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The information provided is supplemental to a fully compliant presentation. A complete list of Capital Advisor's portfolio models and compliant presentations are available by contacting Capital Advisors at the number listed below. The actual return and value of an account fluctuate and, at any time, the account may be worth more or less than the amount invested.

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