CAPITAL ADVISORS

Overview

Third Quarter 2018

Key Points

- A lot of ink will be spilled in coming weeks to project the impact of the midterm elections on the economy and the financial markets.
- If history is any guide, investors would be better served to worry about something else.
- U.S. stocks have pushed to new all-time highs in 2018 at the same time that international equities and interest rate-sensitive assets have languished.
- The primary drivers of under-performance for international stocks and interest rate-sensitive markets – U.S. dollar strength and rising interest rates, respectively – seemed to stabilize toward the end of the third quarter.
- It these dynamics persist through year-end it would not be surprising to see some of the laggard asset markets close the gap with U.S. stocks during the fourth quarter and beyond.

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

Midterm Elections

The perception of a "good" or "bad" outcome in the midterm elections depends upon who you ask. Fortunately, Capital Advisors can remain comfortably neutral because it shouldn't matter much to the financial markets, at least in the short-term.

From a fundamental perspective, midterm elections have very little influence on the business cycle, which limits their impact on financial markets at the macro level. Federal government policy tends to be most influential on the asset markets when it changes the overall level of taxation or spending in a major way. In this particular presidential cycle, significant tax reform was implemented before the midterms, so the outcome in November has less of an opportunity to change investors' expectations, or behavior.

One area where the midterms might have a near-term impact on investor expectations is trade policy. For example, congress has the ability to challenge the president's ability to impose Section 301 tariffs, and congressional procedure could influence the administration's approach to negotiating with major trade partners. A flip to Democratic control of the House or the Senate could influence the tone of global trade negotiations, although there seems to be bilateral support for addressing China's longtime trade abuses, one way or another.

From an empirical perspective, both sides of the political spectrum can feel hopeful about the stock market because the third year of the Presidential election cycle tends to be the best of the four, regardless of political outcomes throughout the cycle. According to *The Stock Trader's Almanac*, the *Dow Jones Industrial Average* has gained an average 10.4% in the third year of the election cycle, compared to just 2.5% and 4.2% in the first and second years, respectively. The average gain in the fourth year has been roughly 6%, for what it's worth.

Even more hopefully, the U.S. stock market has been positive in the 12-months following the midterms in every election cycle since 1946.[1] The average return for all periods was 16.8%. However, it may be prudent to view this data with skepticism in 2018, because the current cycle has not conformed to historical patterns. For example, the second and third quarters of a midterm election year have historically been the weakest of the entire four-year election cycle.[2] Yet *this* year, the *S&P 500 Index* was up 11.4% during these two quarters.

For those insistent on fretting about a victory by the "other side," whatever that means for you, a study of all midterm elections since 1930 found the frequency of negative returns for the stock market was the same for both parties whenever one side or the other picked up seats in the midterm elections. Both political outcomes (i.e. a pickup in seats by one party or the other) preceded a market decline after 3-months 20% of the time, and a negative return after 12-months 10% of the time.[3]

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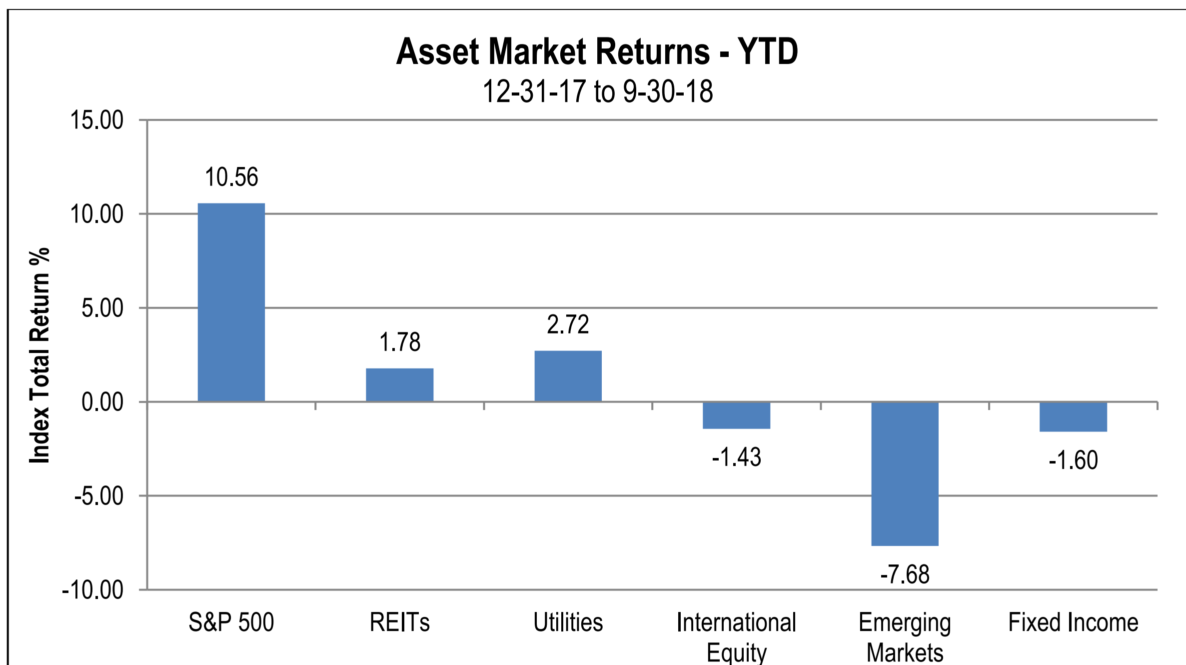
[1] Source: S&P Capital IQ; CNBC
[2] Source: Kirr Marbach & Co.
[3] Source: Forbes; Martin Fridson; Note the negative years occurred before 1946, as there has not been a decline since that year

U.S. Stocks Running a One-Horse Race

Media reporting of "the stock market" has made for pleasant reading in 2018 because major U.S. benchmarks like the *S&P 500* are up double-digits, and trading near all-time highs. Unfortunately, the U.S. stock market has been running a one-horse race thus far in 2018, as many of the other major asset markets have been stuck in the starting gate, or worse. The table below reflects two common themes among the lagging asset markets so far this year:

1) **Rising Interest Rates** – Higher bond yields have hurt rate-sensitive assets like bonds and high-dividend stocks in sectors like utilities and real estate investment trusts (REITs)
2) **Strong Dollar** – A rising U.S. dollar relative to most foreign currencies has been a headwind for international equities this year, particularly emerging markets



[4]

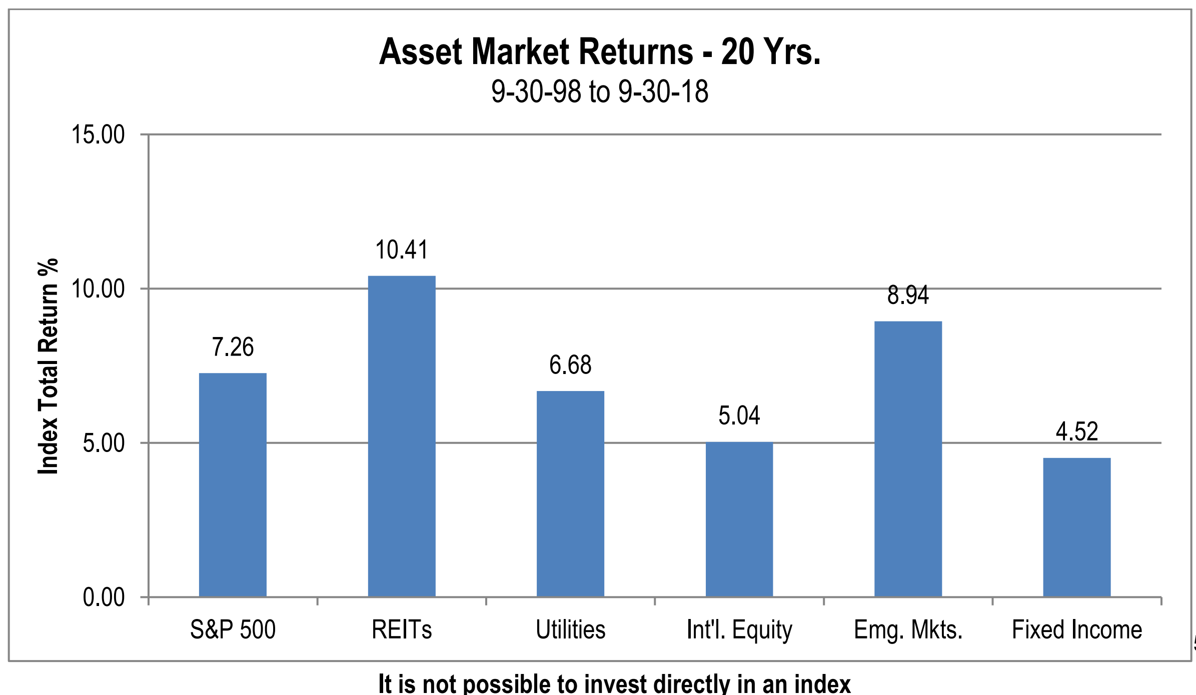
It is not possible to invest directly in an index

The performance of Capital Advisors' investment strategies has mirrored this dynamic in 2018, with the *Managed Equity Growth* strategy performing very well due to its core exposure to domestic growth stocks, while the remaining strategies are running a distant second place due to their exposure to one or more of the less rewarding asset markets shown above.

[4] Source: Standard& Poor's; FTSE NAREIT; MSCI, Inc.; Bloomberg Barclays

Market Divergence is Normal

We include the chart below as a reminder that nine-months is not a representative sample-size for global asset markets, particularly among volatile markets like equities. This data reflects the same six markets as the prior chart, measured over the past 20-years, instead of nine months. It is worth highlighting that the message would be similar for a wide range of holding periods that might be chosen. Specifically, all risk assets tend to reward their investors appropriately over time, even though the sequence of outcomes can diverge widely in the short-term, as it has in 2018.



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It is not possible to invest directly in an index

Diverging market returns are a common source of anguish for investors with a broadly diversified portfolio because it is irresistible to imagine what might have been if we held more of whatever has been working, and less, or none at all of the laggard holdings. This feeling may be relevant to investors in certain portfolio strategies at Capital Advisors. Our *Fixed income* and *Managed Equity Dividend* strategies have been held back by the upward shift in interest rates this year. A sizable allocation to domestic equities within our *Tactical Strategies* has been rewarding this year, but the benefit is diluted by lackluster results among international equities and interest rate-sensitive assets like REITs and fixed income.

Although frustrating in the short-term, higher interest rates are *very* helpful for future returns in the fixed income markets. Meanwhile, quarterly dividends have been paid without interruption within the *Managed Equity Dividend* strategy, even if price appreciation has been restrained by rising rates. We believe returns for each of these strategies can improve materially if recent stability in domestic interest rates and the dollar can be sustained through the end of the year.

[5] 5 Source: Standard& Poor's; FTSE NAREIT; MSCI, Inc.; Bloomberg Barclays

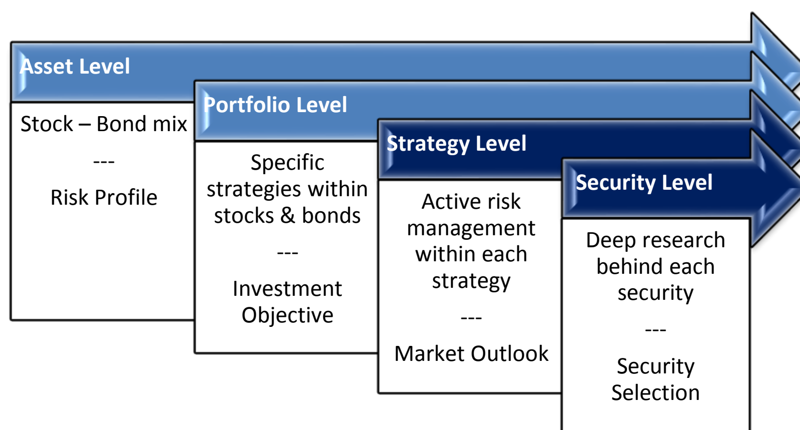
Current Design of Our Investment Strategies[6]

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.
2) We expect continued gradual increases in the Fed Funds rate over the next 1-2 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) The principal areas we are watching closely for negative surprises include interest rates, trade policy, U.S. dollar strength, emerging markets/China, and the legal/regulatory climate for platform technology companies like Alphabet, Amazon.com, Apple, and Facebook.

Managed Equity Strategies

Risk management remains at the core of our investment process. We attempt to optimize returns while closely managing the attributes that drive value on the security and strategy levels. Our risk management processes are designed to work harmoniously on several levels to enhance customization. Within Managed Equity portfolios, risk management covers the Strategy as well as the individual Security levels, as illustrated below. We believe that much of a company's risk profile relates to the durability of its competitive advantages and changing market conditions. Recurring revenue, intangible asset value, profit margin trends and management conversations are just a few of the items we use to help gain insight.



[6] 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.

The *Managed Equity Growth* strategy currently has about equal exposures to "growthy" and "value-type" categories centered by a midsection of companies we believe should retain leadership of attractive markets into the foreseeable future. This more detailed investment management is key to balancing performance and anticipated risk in a transparent way.

- We categorize the "growthy" portfolio segments as *Emerging Franchises* and *Core Innovators*. Certain near-term valuation ratios, such as price-to-earnings (PE), do not easily capture the true value of these stocks due to the ability to consistently expand earnings over the long term … as long as they retain the ability to pioneer new markets or disrupt additional ones. When market optimism is healthy, and investors tend to be more willing to discount earnings expectations far into the future, we would generally expect these stocks to outperform.
- We categorize the strategy's "strong midsection" as *Core Operators*. We expect these stocks can outperform the broader market over time, as long as these companies retain their ability to innovate and lead attractive markets.
- Most of our value-type stocks fit into the *Tactical Opportunities* category. The investment thesis for these stocks typically involves a specific catalyst for value creation, and we expect to exit the position once the expected value is realized. We also expect these stocks as a group to hold up relatively well when market optimism wanes and investors focus on near-term earnings or asset valuations.

The table below shows the current design of the *Managed Equity Growth* strategy within this framework of categories:

Managed Equity Growth

	Category Weight	Category Description
Emerging Franchises	3%	Typically smaller companies we believe could pioneer a potentially significant market. That CRSPR gene editing commentary you see on the screen at the head of Jurassic Park movies; that is the type of stock here.
Core Innovators	17%	Companies we believe have the ability to continually enter and disrupt additional markets. Amazon is an example.
Core Operators	45%	Companies we believe have the ability to consistently innovate at the head of large, attractive markets and retain significant competitive advantages.
Tactical Opportunities	21%	We believe the broader market is temporarily misvaluing at least one key attribute. Once the market comes around to seeing these attributes, and the stock price reflects this, we intend to exit the position.
Cash	14%	We view cash as a risk asset. If the market declines, we would deploy this cash to take advantage of new opportunities without having to sell good companies at what could be the wrong time.

The *Managed Equity Dividend* strategy is somewhat unique in its ability to deliver a healthy income stream from the equity asset class. The benchmark for this strategy is not a broad market index like the *S&P 500*, rather it is a comparable, higher yielding stock index. Due to the interest rate sensitivity of high dividend stocks, we expect this strategy to perform best when the general level of interest rates is stable or falling, while a rising interest rate environment – like 2018 – presents a headwind for the strategy.

Fortunately, the strategy includes a natural "hedge" against rising interest rates because the stocks within the portfolio typically raise their dividends *faster* than the pace of inflation. For example, over the past 12-months approximately two-thirds of the stocks in the strategy increased their quarterly dividend payment. The aggregate dividend increase for the portfolio as a whole – including the companies that did not raise their dividend – was roughly 4.5%.[7] By comparison, the latest reading of the Consumer Price Index (CPI) showed an annual inflation rate of 2.7%, while the "core" rate, excluding the volatile food and energy components, was 2.2%[8].

We categorize stocks in the *Managed Equity Dividend* strategy across three characteristics: *Dividend Income & Growth, Tactical Opportunities* and *Aggressive Yield*. We design the strategy to sustain a substantially higher dividend yield compared to most "equity income" mutual funds and ETFs, while carefully overseeing exposure to each of these factors.

Managed Equity Dividend

	Category Weight	Category Description
Dividend Income & Growth	**48%**	These companies have consistently raised their dividends over the past several years, preferably through economic cycles. We believe they can continue to do so into the foreseeable future. This tends to be the strategy's lowest-yielding category.
Tactical Opportunities	**30%**	These stocks offer attractive dividend yields and, we believe, currently have supportive fundamentals If those fundamental trends change significantly, or management shows an inability to retain competitive advantage, we would exit the position.
Aggressive Yield	**15%**	Companies that pay most of their available cash flow to shareholders. We do not expect these companies to consistently raise their already-high dividend payments.
Cash	**7%**	Cash is typically 2%-4% for a mature account. The strategy's objective is to deliver high income streams and some equity market exposure. We intend to stay fully invested in that range at most times. The current level is temporarily high due to a recent position sale.

[7] Source: Company dividend information in this paragraph was sourced from Bloomberg
[8] Source: Bloomberg

The recent market climate has not been kind to high-yield stocks, as the table below reflects. The data show that within the broad universe of dividend-paying stocks, companies with the highest yields performed materially worse than lower-yielding stocks during the third quarter. This was true for the *Managed Equity Dividend* strategy and its primary benchmark.[9] Unfortunately, since our approach strives for a much higher aggregate portfolio yield relative to the benchmark, the *Managed Equity Dividend* strategy includes a much higher allocation to the top line in the table, with less exposure to the bottom two lines compared to the index. We believe this design can serve the strategy very well over the long-term.

Average third-quarter 2018 returns
as of September 27, 2018

	Capital Advisors Managed Equity Dividend	Morningstar Dividend Yield Focus Index
> 4.0% yield	-2.2%	0.0%
> 3.0% yield	8.4%	1.1%
< 3.0% yield	10.3%	8.6%
Overall	1.2%	7.3%

Source: Bloomberg

Supplemental to a fully compliant presentation

Fixed Income

Our Fixed Income strategies are customized according to three broad priorities – Liquidity, Income or an Aggregate of the two. 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.

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. By structuring 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.

[9] Source: Morningstar; Bloomberg

Looking forward, we believe capital allocated to the fixed income market can once again earn a respectable cash flow after nearly a decade of paltry yields anchored to zero. Consider that the yield-to-maturity for the *Barclays U.S. Intermediate Credit Bond Index* recently hit 3.70%, while the tax equivalent yield to maturity for the *Barclays Municipal Bond 10-Year Index* reached 4.38%[10] (for investors in the top income tax bracket).

This is significant because the starting yield for a laddered bond portfolio (like the indexes above) accounts for the vast majority of its expected return over the subsequent 4-6 years. This happens because the staggered maturity schedule of a bond "ladder" creates periodic liquidity events that allow the portfolio to adjust to changing market conditions. If interest rates rise the ability to reinvest bond maturities into a higher rate environment helps to offset the negative price change among the longer term bonds in the ladder (over time….not month-to-month). When interest rates trend lower, price gains at the long end of the ladder serve to offset the lower reinvestment rate from maturing bonds.

The table below illustrates the resilience of "bond math" for laddered portfolio structures. Note how the starting yield of the index correlates with its subsequent 5-year total return. This dynamic held true regardless of the subsequent path of interest rates over each 5-year measurement period:

Barclays Aggregate Bond Index
Starting Yield vs. Subsequent 5-Year Return
Dec. 31, 1990 to September 28, 2018

Start Date	Beginning Yield	Subsequent 5-Yr. Return
12-31-90	8.52%	9.48%
12-31-95	6.01	6.46
12-31-00	6.43	5.87
12-31-05	5.08	5.80
12-31-10	2.97	3.25
12-31-15	2.71	1.65 (2.75 Years to 9-28-18)
9-28-18	3.46	??

Source: Barclays, Bloomberg
It is not possible to invest directly in the index

We seek to enhance the benefit of the laddered portfolio structure with active management. By deliberately emphasizing certain maturities, and diversifying across different sub-sectors and credit profiles, we hope to optimize the risk and return profile of our fixed income strategies.

[10] Source: Bloomberg; Barclays; The Barclays U.S. Intermediate Credit Bond Index measures the yield and return of a diversified basket of investment grade corporate bonds with maturities in the 1 to 10 year range; The Barclays Municipal Bond 10-Year Index measures the yield and return of a diversified basket of investment grade municipal bonds with an average maturity of 10 years.

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.

The chart below shows the recent behavior of emerging markets to demonstrate the investment process. The index for emerging markets (white line) traded well above its moving average trend line (green) early in the year before crossing below the moving average in late-April. 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. The emerging markets ETF was sold from the strategy model in May as a result of this discipline.

MSCI Emerging Markets Index
Daily Closing Price (white) vs. 150-Day Moving Average (green)
Jan. 2, 2018 to Oct. 1, 2018

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

A similar exercise triggered the removal of the international equity sector in July. This "dynamic" exposure to risk markets like international and emerging market stocks can serve as a tactical complement to "strategic" commitments to risk markets that are expected to be held for many years – if not decades. By pairing a dynamic strategy with strategic commitments to major asset markets, the overall risk profile of a portfolio can react upward or downward as market conditions change, while maintaining core exposure to the major risk markets that drive long-term returns.

As of September 30 the strategy is invested in three of its five risk markets representing approximately 60% of the total portfolio, with roughly 40% invested in fixed income and cash reserves. The risk market sectors included in the portfolio are domestic equity, real estate and natural resources.

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 smaller companies outside the United States.

This strategy has not been immune to the weakness in international markets in 2018. Exposure to value stocks and emerging markets has been particularly challenging for the strategy, as these two subsectors of the international equity universe have suffered disproportionately of late. While frustrating, this is a good time to remember that the rewarding long-term track record for both of these asset markets includes numerous periods of similarly poor results. We suspect the current setback may prove equally irrelevant to the long-term success of international equity markets, *particularly* the value and emerging market subsectors that have performed so poorly in 2018.

Tactical Global Strategies

The *Tactical Global* strategies participate in the long-term growth of the world equity markets, including the U.S market. Both strategies spread investments among 10 broad sectors of the global asset markets using ETFs for each market sector. A discipline of systematically tilting the sector weightings toward relative strength incorporates a momentum effect into the portfolios. These strategies can serve as a core position for investors seeking global diversification within the equity portion of their portfolio.

We are in the process of consolidating the *Tactical Global Growth* and *Tactical Global Income* strategies into a single approach by top-grading the ETFs for each market sector into the best option from each portfolio. The end result will be a single strategy with a lower underling expense ratio among the 10 ETFs in the portfolio, and greater trading liquidity.

We hope this process can be complete by year-end, but the exact timing is dependent upon the natural changes that occur within the strategies. We prefer to wait until a particular sector needs to trade anyway (due to its systematic over/under-weight discipline) before consolidating that sector into a common ETF for both strategies.

During the upcoming quarterly holding period these strategies will include over-weight positions in the domestic large-cap growth, mid-cap and small-cap sectors, while international equities, emerging markets and high-yield credit will be under-weighted.

October 2, 2018

DISCLOSURES

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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 **Morningstar Dividend Yield Focus Index** is a subset of the Morningstar US Market Index, a broad market index representing 97% of U.S. equity market capitalization. The Morningstar Dividend Yield Focus Index represents the top 75 high- yielding stocks that meet the screening requirements.
The **S&P 500 Utilities Index** comprises those companies included in the S&P 500 that are classified as members of the GICS® utilities sector.
The **MSCI Emerging Markets Index** seeks to track the price and yield performance of emerging market equities, as determined by MSCI. The index is calculated on a total return basis with dividends reinvested and is not assessed a management fee.
The **FTSE Nareit All Equity REITs Index** is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs. Constituents of the index include all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property.
The **Barclays U.S. Intermediate Credit Bond Index** measures the yield and return of a diversified basket of investment grade corporate bonds with maturities in the 1 to 10 year range.
The **Barclays Municipal Bond 10-Year** Index measures the yield and return of a diversified basket of investment grade municipal bonds with an average maturity of 10 years.
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.
The **Consumer Price Index (CPI)** is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them.

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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