CAPITAL ADVISORS

Overview
Fourth Quarter 2017

Key Points

- With many valuation benchmarks for the U.S. stock market near an all-time high, it seems safe to assume that *a lot* of optimism may already be baked into recent stock prices.
- Even so, stock market valuation tends to move inversely with interest rates, so it makes sense for stocks to approach a historical extreme on the upside at a time when global interest rates are near their own historical extreme on the downside.
- We believe the stock market *should* be making new highs in the face of today's combination of low interest rates, accelerating economic growth, rising earnings estimates and business-friendly regulatory environment.
- Further, we expect stocks can still deliver positive returns for long-term investors (i.e. next 5-10 years) even though today's starting point seems less than ideal from a valuation perspective.
- However, we expect most asset markets to deliver much lower returns over the next 5-10 years compared to the average experience of the past several decades.
- This expectation is driven by current conditions in the major equity and fixed income markets, which are characterized by elevated valuation multiples, near-peak profit margins in the corporate sector, and historically low interest rates.
- We believe most investors should keep their current exposure to risk markets at the low end of the appropriate range for their respective risk profile.
- The degree of caution warranted by any given investor may depend on their definition of a "sufficient" rate of return.

Market Outlook

Many valuation benchmarks for the domestic stock market are currently near an all-time high.[1] Corporate profit margins are also near a record high, suggesting unusual generosity for both the numerator and denominator in the price-to-earnings ratio (P/E ratio)[2] calculation that measures valuation in the stock market. It seems safe to assume that *a lot* of optimism may already be reflected in current stock prices.

However, conditions in the stock market cannot be viewed in isolation because they are influenced by other variables, particularly interest rates. The P/E ratio of the stock market tends to move inversely with interest rates, so it makes sense for this measure to approach a historical extreme on the upside at a time when global interest rates are near their own historical extreme on the downside.

Stock prices probably also reflect recent acceleration in economic growth throughout much of the world, an expected boost to corporate profits from tax reform, and anticipation of a business-friendly regulatory regime in the U.S. We suspect corporate tax reform might be particularly helpful to market sentiment in the near-term as analysts re-calculate their earnings estimates higher to reflect the new tax rates. For many high-tax industries these adjustments could be material – as in 15% to 20% increases in estimated earnings per share for some companies.

Our two managed equity strategies include 25 companies (out of 59 on both Buy Lists) with a recent effective tax rate of 25% or greater.[3] We expect a healthy boost to the reported earnings of these companies in 2018 as a lower tax rate works its way into their income statements.

Our greatest concern at this point is that current market conditions may be *too* favorable. When the fundamental drivers of value for the stock market are nearly ideal, like now, these favorable conditions are probably mostly reflected in stock prices. This leaves little room for future disappointment if conditions deteriorate even modestly.

To be clear, we believe the stock market *should* be making new highs in the face of today's combination of low interest rates, accelerating economic growth, rising earnings estimates and business-friendly regulatory environment. We do *not* believe stocks have entered a bubble, and we expect stocks can deliver positive returns for long-term investors from today's starting point. Our concern involves the magnitude of the upside potential from here now that future changes in market fundamentals may struggle to exceed today's buoyant expectations.

[1] Source: DShort.com https://www.advisorperspectives.com/dshort/updates/2017/12/05/market-remains-overvalued

[2] The P/E ratio is calculated by dividing price of a stock, or a stock market index by the earnings per share for that stock or index. It is a commonly utilized metric for comparing the valuation of stock market investments across time, or relative to alternative securities.

[3] Source: Bloomberg; Value Line

The Distinction between Positive and Sufficient Returns

The challenge for investors, as we have stated before, is navigating the distinction between *positive* returns and *sufficient* returns. If one accepts the notion that future returns from stocks may be materially lower than recent experience (more on this below), investors with different return objectives and risk tolerance can justify opposing views about what to do about it.

One view defines a "sufficient" return from investing as anything that justifies the risk that was assumed. When sufficient returns are defined this way, the logical response to the current outlook for the stock market is to take less risk. After all, stocks are still a risky asset class due to their inherent vulnerability to recessions, geopolitical accidents, inflation, major terrorist strikes, etc. When the likely "reward" for assuming these risks drops into the mid-single digits, these investors may feel compelled to reduce their commitment to stocks, and justifiably so, in our opinion.

Other investors define a "sufficient" return as the minimum threshold for meeting an annual distribution requirement or long-term principal obligation. For these investors almost any pickup in expected returns relative to fixed income may be worth pursuing. By this logic, a mid-single-digit return from stocks might be unattractive by historical standards, but with interest rates near historical lows, what choice do they have but to accept more risk to achieve a higher expected return? This is also a rational perspective, in our opinion.

The Logic for Low Expected Returns

Between any two points in time, the rate of return for the stock market is determined by three variables – earnings growth, dividends, and the change in the P/E ratio. When the P/E ratio goes up during an investor's holding period it adds to the sum of earnings growth plus dividends to improve the total return. When the P/E ratio declines over the measurement period it *subtracts* from the total return.

As of late December the cyclically adjusted P/E ratio (CAPE ratio)[4] of the U.S. stock market was higher than it has been in 97% of all monthly observations since 1881.[5] We suspect this is because the constellation of market conditions necessary to support such a premium valuation hasn't been sustainable for extended periods of time historically. This matters to the long-term outlook because *any* deterioration in market conditions – a down-tick in profit margins, up-tick in inflation, higher interest rates, etc. – might cause the future valuation multiple for stocks to be lower than today, creating a headwind for future returns from today's starting point. This is why many commentators, including us, expect no better than mid-single-digit returns from the equity asset class over the next 5-to-10 years.

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[4] The CAPE ratio is calculated by dividing the price of a stock market index by the average earnings per share for the index over the trailing 10-years. It is designed to smooth out the impact of the business cycle on short-term earnings for the index.

[5] Source: Robert J. Shiller http://www.econ.yale.edu/~shiller/data.htm ; The cyclically adjusted P/E ratio (CAPE ratio) of the U.S. stock market has been greater than or equal to its recent reading of 32.4 in 47 out of 1,644 monthly observations since January 1881.

Considerations for Asset Allocation

The table below is reprinted from the third quarter Overview, as our recommended asset allocations have not changed. Please note that this matrix 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 also influence the appropriate commitment to risk markets.

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%

Observations about Asset Allocation

- For all but the most conservative investors we believe the allocation to risk markets should be skewed toward the minimum threshold in the current market climate.
- We also believe that most investors – even those with the most conservative risk profile – would benefit from keeping *some* exposure to risk markets because the incremental return for doing so may be attractive relative to fixed income. Stocks can also provide diversification benefits to bonds, particularly during the early stage of a rising interest rate cycle.
- 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 future returns from risk markets may be materially lower than recent experience.

Current Design of Our Investment Strategies[6]

The remainder of this report addresses the current positioning of each of our investment strategies. These strategies are designed to complement one another when used in combination within a diversified portfolio.

Managed Equity Growth

The *Managed Equity Growth* strategy provides focused exposure to the domestic equity asset class to achieve long-term capital appreciation. The investment process for this strategy emphasizes three kinds of investments: 1) Long-term commitments to companies we believe can benefit from a sustainable competitive advantage in an expanding market opportunity; 2) Smaller commitments to companies seeking to revolutionize a market sector, or pioneer a new industry; and 3) Companies with a more event-driven investment thesis that we expect to retain for a shorter period of two years, or less.

As of year-end, seven of the 31 stocks on the Buy List for this strategy have been in the portfolio for five years or longer. The average price appreciation among these stocks has been approximately 328%, with just two stocks rising less than 100% since they were added to the Buy List, and two that are up more than 500%.[7] Several of these stocks pay a dividend, so total returns from this group have been even better when dividends are included.

[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.
[7] Source: Bloomberg; Capital Advisors records

Of course, not every stock we have added to the *Managed Equity Growth* strategy over the years worked out as well. Our misplaced patience with **General Electric (GE: ~$17)** is a recent example of a major disappointment.

Our reason for highlighting the success of the longest-held positions in this strategy is to remind investors that long-term wealth creation in the stock market requires patience and a tolerance for short-term volatility. Every one of the success stories referenced above experienced at least one decline of 20% or more from a recent high, while one of the most rewarding positions suffered a pull-back of nearly 50% at one point.[8] For select companies like these that we believe may be capable of long-term wealth creation for shareholders, we expect to ride out the inevitable ups and downs in the stock price along the way.

We seek to mitigate the volatility of this strategy's long-term commitments with complimentary positions in stocks with a more event-driven investment thesis. The most recent example of such a position is **Delta Airlines (DAL: ~56)**, which was added to the Buy List on December 26th. With Delta we believe a combination of materially higher earnings in 2018 – partially driven by tax reform – and a modest expansion of the stock's P/E ratio could produce a total return in the range of 17% to 40% over the next 12-18 months. If the stock achieves our upside target we expect to sell it.

We feel Delta can provide diversification benefits because it is the only pure-play transportation company in the portfolio, and the stock is priced at one of the lowest P/E ratios in the domestic stock market.[9] While a low P/E ratio cannot prevent a stock from dropping (particularly if the "E" comes up short of expectations), stocks with low P/E ratios frequently reflect low expectations among investors, which can be a source of resilience during market downturns (i.e. there can be less scope for disappointment when expectations are low to begin with).

At a time when the major stock market indexes are trading near an all-time high we expect to incorporate tactical opportunities like Delta into the *Managed Equity Growth* strategy to manage risk. We can also us cash as tool for risk management. Most portfolios invested in this strategy will enter 2018 with 10% to 15% of the strategy sleeve in cash.[10]

Managed Equity Dividend

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 with relatively stable cash flows. 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.

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[8] Source: Bloomberg

[9] Source: Value Line - As of Dec. 15 Delta Airlines stock had the 75th lowest P/E among the Value Line universe of 1,753 stocks, placing the DAL P/E ratio within the lowest 5% of all stocks in the comparison.

[10] Client-directed deposits and withdrawals can cause variability in the specific position weightings of each portfolio sleeve.

We like the outlook for high-dividend stocks as a way to maintain exposure to the equity asset class in an environment of low expected returns. As of late December the weighted average dividend yield for the *Managed Equity Dividend* strategy model was approximately 5.1%.[11] With interest rates near historic lows, and the valuation multiple of the stock market near an all-time high, we suspect the cash yield from this strategy may provide a competitive return compared to other major asset markets for the foreseeable future.

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.

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 in 2018 because it is specifically designed to reduce risk whenever market conditions deteriorate. As of year-end the strategy model was fully invested in its five risk market sectors, with just a 1.0% target weighting in cash reserves.

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 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 *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.

[11] Source: Orion

Tactical Global Strategies

The *Tactical Global Growth* and *Tactical Global Income* strategies participate in the long-term growth of the global risk 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 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 first quarterly holding period of 2018 these strategies will include over-weight positions in emerging markets, international small-cap and domestic large-growth, 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.

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. It seems reasonable to expect some upward pressure on interest rates further out on the yield curve as the Fed tightens policy, however, we don't expect a substantial increase because inflation expectations remain subdued, and interest rates throughout much of Europe and Asia are well below domestic levels.

By structuring our bond portfolios in a "ladder" with most maturities 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.

December 29, 2017

DISCLOSURES

This presentation is not an offer or a solicitation to buy or sell securities. The information contained in this presentation has been compiled from third party sources and is believed to be reliable; however, its accuracy is not guaranteed and should not be relied upon in any way, whatsoever. This presentation may not be construed as investment advice and does not give investment recommendations. Any opinion included in this report constitutes the judgment of Capital Advisors, Inc. as of the date of this report, and are subject to change without notice.

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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. Due to differences in portfolio timing and position weightings, the returns for any individual portfolio managed by Capital Advisors may be lower or higher than any performance quoted.

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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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.

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.