CAPITAL ADVISORS

Overview
Second Quarter 2018

Key Points

- We believe the potential for escalating barriers to global trade presents the most consequential near-term risk for the stock market.
- At this point it is impossible to know how this issue might evolve, so we seek to manage risk in our active strategies in a manner that balances exposure to potential negative *and* positive surprises.
- We suspect stocks may be more vulnerable to global trade tensions than the economy as a whole – particularly in the United States – due to the predominance of non-tradeable services as the main driver of household incomes.
- If the domestic economy demonstrates the resilience we expect (with or without a global trade war), we believe any pull-back in stocks could be short-lived.
- We also take comfort in the baseline earnings growth potential of domestic companies due in large part to the tax reductions that went into effect in January.
- After a frustrating adjustment to higher interest rates in the domestic bond market, fixed income investors can finally earn a respectable interest rate on high quality securities.
- We expect continued gradual increases in the Fed Funds rate over the next 1-3 years, but we believe much of the likely adjustment in longer-term interest rates (i.e. bond maturities of 10-years or longer) may have already occurred.
- One possible consequence of a substantial escalation in global trade friction could be a pause; or even an outright reversal in U.S. monetary policy – not our baseline forecast, but something to consider if the news cycle becomes more unsettling.

Handicapping the Impact of a Global Trade War on the Economy

Your next trip to the barbershop should not be impacted by a tariff. That's good news for the domestic economy. In the United States approximately 83% of private sector incomes are generated by service jobs like haircuts.[1] Indeed, the number of personal incomes tied to manufacturing and farming – whose output *can* be influenced by trade barriers – has been shrinking for decades. For example, the percentage of domestic workers employed in agriculture is estimated to be down by approximately 98.5% over the past 100 years, even though output from farming has never been greater.[2]

In addition to the economy's transition toward services, the vast majority of service-sector jobs are non-tradeable. Foreign nations could impose a 100% tariff on pizza delivery, tax preparation, teachers, cardiac surgery, software development, and bartending, among countless other services, and it would have almost zero impact on the domestic economy.

We are not suggesting that an outright trade war would go unnoticed on Main Street. However, assuming the baseline growth rate for the domestic economy is *at least* 2% per annum – and we believe it is – the headwind from trade restrictions seems unlikely to drag the economy into negative territory, even if tit-for-tat trade barriers escalate further from here.

Consider Soybeans For Example

It's no accident that China targeted soybeans among its primary weapons for retaliation against the Trump Administration. Soybeans are America's largest agricultural export by far.[3] Yet the number of private sector incomes that rely on the production and distribution of soybeans is a small fraction of what it was during the last global trade war in the 1930s.[4] Moreover, today's economic landscape includes many more two-income households, as well as government assistance programs that support household incomes during times of disruption. Resilience in household income promotes stability for the economy as a whole in ways that did not exist when the last global trade war was credited with extending and deepening the Great Depression.

[1] Source: Strategic Economic Decisions, Inc., May 2018
[2] Source: Strategic Economic Decisions, Inc., May 2018
[3] Source: U.S. Department of Agriculture
[4] The infamous Smoot-Hawley Trade Act of 1930 coincided with the worst years of the Great Depression

The Impact on Stocks Might be a Different Matter

Yet surely *someone* would be hurt by a trade war, otherwise, what's all the fuss? In the example of a soybean tariff, that "someone" is the owner of the *John Deere* tractor who would likely earn a lower-than-expected return on the capital employed to purchase it. In economic terms, the share of national income going to capital would decline relative to the share going to labor. This is bad news for owners of capital – i.e. land owners, business owners and ***stockholders*** – while it is less of a threat to the millions of workers whose income and spending comprises more than two-thirds of annual Gross Domestic Product (GDP).[5]

To the extent that global trade restrictions continue to escalate, the disproportionate burden sharing between capital and labor suggests that America's most noteworthy vulnerability might be the consensus earnings estimate for the *S&P 500 Index*.[6] Increasing trade barriers can be expected to disrupt global supply chains in unpredictable ways that would probably do more harm to corporate profits than household incomes. This may pose a greater threat to the stock market than it does to the economy as a whole.

Keep an Eye on Corporate Profits

A few signs of stress have already emerged in the form of profit warnings from companies like **Daimler (DDAIF: ~$65), Harley Davidson (HOG: ~$41)** and **Winnebago Industries (WGO: ~$42),**[7] each of which cited trade related issues as the cause for their tempered outlook. In another sign, nearly 65% of respondents to the latest quarterly survey of the *CNBC Global CFO Council*[8] said U.S. trade policy is likely to negatively impact their firms over the next six months, while roughly 20% of CFOs indicated the impact would be "very negative."

Fortunately, corporate profits may enjoy a greater than usual margin for error this year due to the tax cuts that went into effect in January. The latest consensus earnings estimate for the *S&P 500 Index* for the next 12-months is $163.49 per share,[9] a 24.8% year-over-year increase. Even if we assume this estimate gets cut by 10% due to trade frictions, stocks could deliver a positive total return of at least 5.0% over the next 12-months if the market can sustain a trailing P/E ratio of 19.0, or better one year from now (the average trailing 12-month P/E for the *S&P 500* over the past 30 years has been 19.2).[10] Note that ***if*** stocks drop materially between now and then, the recovery potential to a target P/E ratio of 19 would look even more attractive.

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[5] Source: St. Louis Fed; Personal Consumption Expenditures comprised 69.5% of U.S. GDP
[6] The S&P 500 Index measures the price and yield performance of the leading companies in the U.S. stock market. The index is maintained by Standard & Poor's.
[7] Source: Barron's; "As Tariffs Take Hold It's Corporate Crunch Time"
[8] Source: CNBC.com
[9] Source: Bloomberg
[10] Source: Bloomberg; Based upon a starting index level of 2705 as of June 25, 2018 plus a 1.9% dividend yield

Key Points on Trade

We will be tracking management commentary carefully when companies report their second quarter earnings in July and August. For now we wish to highlight two main points on this topic:

- First, we believe the stock market may be more vulnerable to a trade war than the overall economy.
- Second, due to the expected resilience of household incomes – and therefore the economy – stocks might recover rather quickly, even if they turn lower at some point in the next several months.

Bonds Have Been Frustrating in 2018…

Fixed income investors deserve to feel frustrated over the paper losses they incurred during the past six months when market yields adjusted notably higher. While painful, the interest rate adjustment was needed to accommodate a path toward normalization of monetary policy away from the "emergency" measures put in place to combat the financial crisis. Although we still expect continued gradual increases in the Fed Funds rate over the next 1-3 years, we 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.

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 3.64%, while the tax equivalent yield to maturity for the *Barclays Municipal Bond 10-Year Index* reached 4.19%[11] (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.

[11] 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.

…But the Future Looks Brighter

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 June 22, 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	1.68 (2.5 Years to 6-22-18)
6-22-18	3.33	??

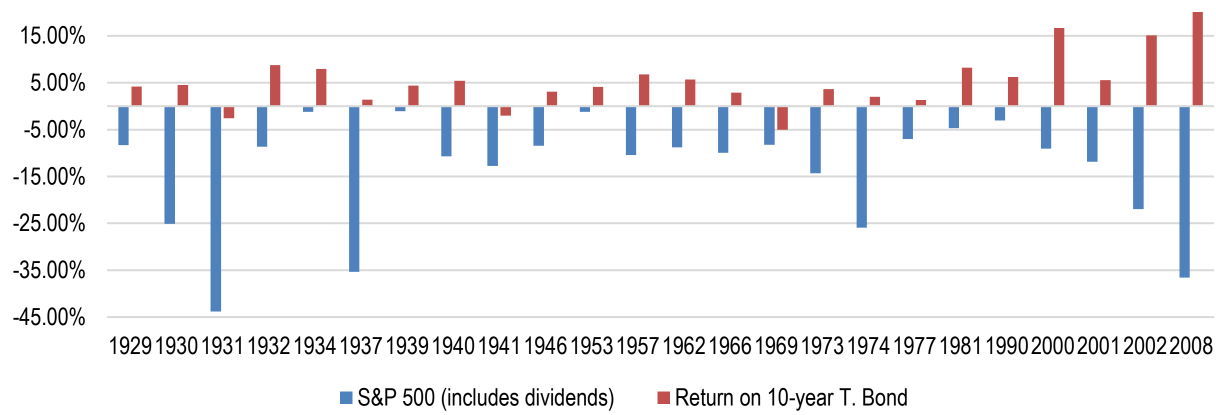
Source: Barclays plc 12/31/90 to 12/31/17; Bloomberg
It is not possible to invest directly in the index

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. Recent examples of this effort are described on page-9 of this report.

Bonds as a Hedge

We suspect bonds might also provide a valuable offset to stocks in the event of a negative shock from global trade. As discussed above, trade barriers seem more likely to disrupt the earning power of corporations rather than households. Although tariffs can put upward pressure on the price of certain goods, we believe the net effect of widespread trade restrictions, should they occur, would be to dampen economic vigor by disrupting corporate supply chains and capital spending plans. In such a scenario, the Fed seems likely to slow its pace of monetary tightening materially, if not reverse course and take rates *lower*. This would likely allow bonds to fulfil their typical role as a safe haven during times of stress in the stock market.

Bond Returns in (24) Years When Stocks Were Down
Jan. 1, 1928 to Dec. 31, 2017



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

Current Design of Our Investment Strategies[12]

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 1-3 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 to be the most consequential near-term risk factor for the stock market, but believe any correction might be short-lived if the overall economy proves to be resilient.
4) One possible consequence of a substantial escalation in global trade friction could be a pause; or even an outright reversal in U.S. monetary policy.

[12] The portfolio strategy discussions in this section are supplemental to a compliant presentation. A complete list of Capital Advisors' portfolio models and compliant presentations are available by contacting Capital Advisors.

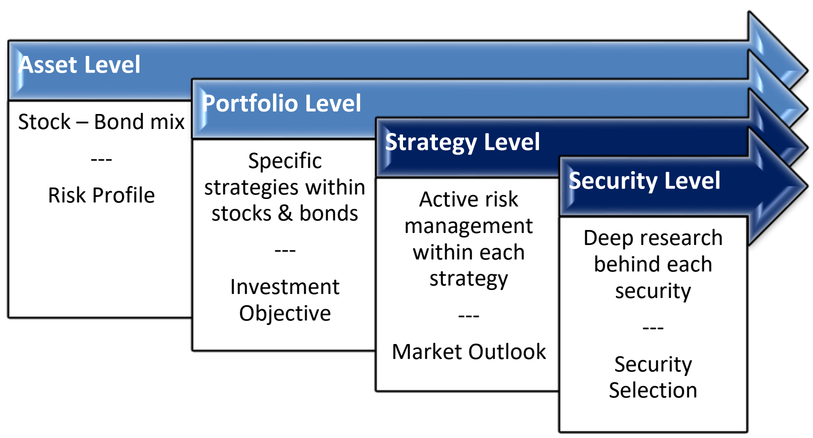
Managed Equity Strategies

Risk management is at the core of our investment process. We attempt to optimize returns while giving the strategies uniquely valuable risk attributes. Risk can enter a portfolio in multiple ways. Just because a stock has a high P/E ratio does not necessarily mean it is more risky than one that has a low earnings multiple. In addition to specific company attributes, much depends upon the stock's relationship to the broader market.

- How willing are investors to pay for earnings expected far into the future?
- Does the company have the ability to enter and disrupt additional industries?
- Does management have a proven record of constant innovation or operational excellence?
- Does the company have some other underappreciated intangible asset such as brand value?

The list goes on. Answers to these questions help us assess the durability of a company's earnings power, how the stock should behave in different market environments, and the stock's key sources for potential risk *and* reward.

Broadly stated, we manage risk at the Strategy Level as well as the individual Security Level (as illustrated below).



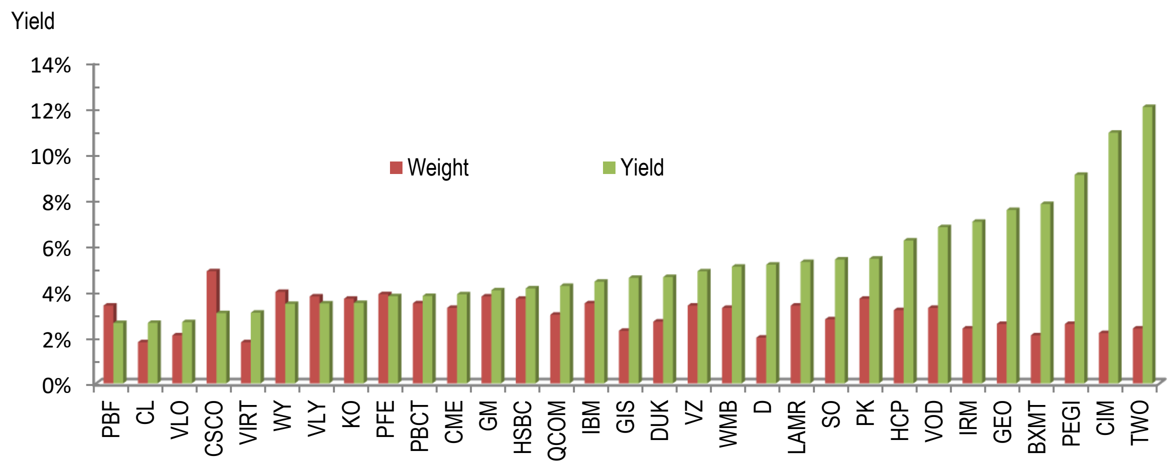
At the Security level, we start by identifying companies we believe should outperform the broader market over time. We perform in-depth research on each company, often involving conversations with management. We attempt to identify each company's key risk factors in light of potential market scenarios. We also clarify the investment thesis, and seek to identify what the consensus is missing or undervaluing.

At the Strategy level, we start with the pool of companies that have completed our security analysis. We then attempt to fit them together in a way that emphasizes attractive economic and market trends, while de-emphasizing key risks. Some companies may not make it through this process if their addition would contribute outsized risk given our market outlook.

The *Managed Equity Growth* strategy currently has about equal exposures to "Growthy" and "Value-type" categories. Within those, we carefully manage our exposures to what we call *Emerging Franchises, Core Innovators, Core Operators* and *Strategic Opportunities*. This more detailed management is key to balancing performance and anticipated risk in a transparent way.

We also manage the *Equity Dividend* strategy in four major investment categories: *Aggressive Yield, REITs, Utilities* and *Income & Growth*. We design the strategy to have a much higher-than-average dividend yield while carefully managing our exposure to any one factor (see the chart below).

Managed Equity Dividend Yield Distribution as of June 22, 2018



Source: Bloomberg; Dividend yields do not reflect the deduction of management fees

Given our individual stock selection strategies, and our expectation that each stock should perform well against the broader market – no matter its style category – our objective is to outperform the broader market over any foreseeable market environment.

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.

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 been purchasing Treasury bonds in certain mandates in lieu of higher yielding corporate bonds as the yield premium compresses. 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 and into Treasury and AAA-rated agency/mortgage backed securities. We also recently sold our exposure to senior loans rated below investment grade **(BKLN: ~$23)** and redeployed the proceeds into higher quality investment grade corporate debt **(IBDR: ~$23)**, while at the same time, not sacrificing income.

Tactical Global Strategies

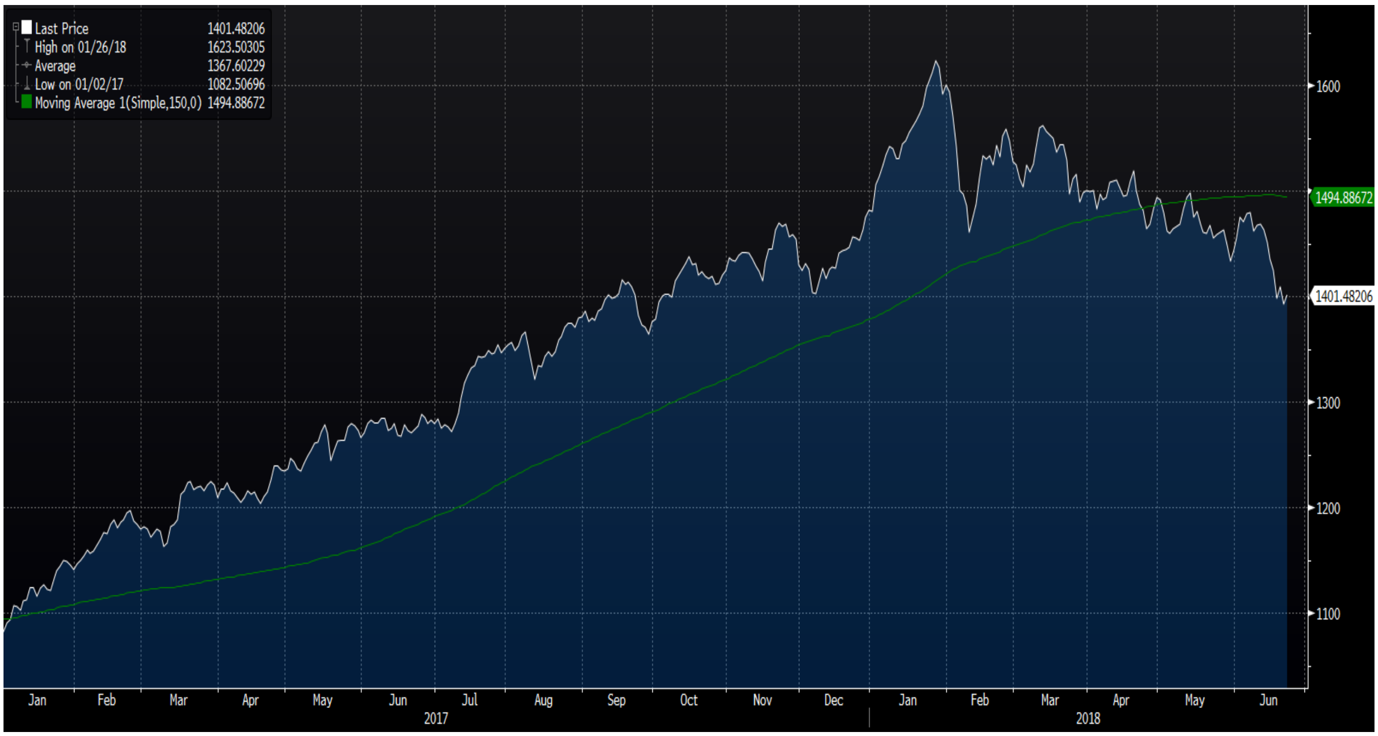
The *Tactical Global* strategies participate in the long-term growth of the global equity markets, including the U.S market. A discipline of systematically tilting the sector weightings toward relative strength incorporates a momentum effect into the portfolios. These strategies can serve as a core position 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. During the upcoming quarterly holding period these strategies will include over-weight positions in the large-cap growth, small-cap and natural resource sectors, while real estate, large-cap value and high-yield credit will be under-weighted.

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.

MSCI Emerging Markets Index
Daily Closing Price (white) vs. 150-Day Moving Average (green)
Jan. 2, 2017 to June 25, 2018



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

The chart above illustrates the recent condition of the emerging markets sector within the strategy model. The index for this sector (white line) traded well above its moving average trend line (green) for most of the past 18-months 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.

As of June 25th the strategy is invested in three of its five risk markets representing approximately 74% of the total portfolio, with roughly 26% invested in fixed income and 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 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 recent correction in emerging markets had a negative impact on this strategy during the second quarter. This was particularly true for value benchmarks within the emerging market sector. Emerging market value stocks are currently trading among the lowest valuation multiples within the broad universe of global equities. While a discounted valuation may be justified for this market sector to reflect near-term uncertainty, we remain optimistic about the long-term return potential for emerging markets in general, and the value component of this sector in particular.

June 26, 2018

DISCLOSURES

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 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 **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.

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.

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.

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.

Additional information, including management fees and expenses, is provided on Capital Advisors' Form ADV Part 2. **As with any investment strategy, there is potential for profit as well as the possibility of loss.** Capital 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. ***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. Presentation is prepared by: **Capital Advisors, Inc.** 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