CAPITAL ADVISORS

Key Points

- 2022 delivered the largest decline for stocks since the 2008 financial crisis and the worst annual return for bonds on record, resulting in a dismal loss of 16.02% for the common industry benchmark for balanced portfolios of 60% stocks/40% bonds.[1]
- The corresponding loss of household net worth in 2022 was also the largest on record.[2]
- Capital Advisors' investment strategies performed relatively well in this difficult environment, even though this meant losing less than the benchmark for most strategies.
- The primary driver of these negative returns was a massive increase in interest rates engineered by central banks throughout the world.
- Interest rates matter to markets because they form the bedrock of the valuation equation for every asset – stocks, bonds, houses, oil wells, office buildings, etc.
- Unfortunately, the relationship between interest rates and asset values is inverse…higher rates produce lower asset prices, and vice versa.
- We suspect most of the downside in stocks and bonds last year was a necessary valuation re-set to reflect a more-than-doubling of the interest rate environment during the year.
- Looking forward, we believe the negative valuation re-set *due to interest rates* has mostly run its course.
- We suspect the primary influence on asset markets in 2023 will shift from interest rates to the performance of the economy and corporate earnings.
- Regarding the economy, it is hard to guess how the stock market might respond to a possible downturn because an army of economists, CEOs, billionaires, and pundits have been predicting a recession for months.
- Consequently, if there is a recession in 2023, it will be the most widely anticipated economic downturn in history, suggesting that *some* degree of recession risk must surely be reflected in asset prices already.
- The more impactful source of uncertainty in 2023 may be corporate profits, where the likelihood for negative earnings surprises may be elevated by whatever weakness transpires in the economy.
- Based upon the framework above, we expect fixed income markets to deliver productive risk-adjusted returns in 2023 built upon the mid-single-digit yields on offer for high-quality bonds across the maturity spectrum.
- Stocks are a harder guess in the short-term, particularly if there is a recession or a geopolitical shock, but we are encouraged by the investment opportunities available in some individual stocks, and we expect even more attractive entry points could emerge if markets get spooked in the early months of the New Year.

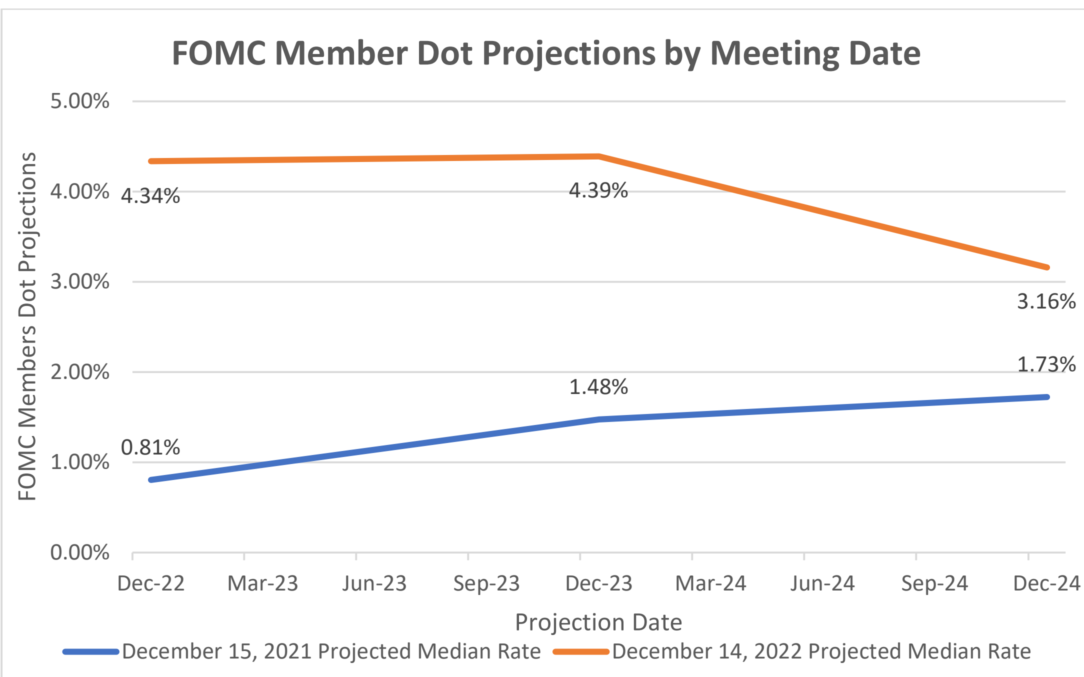
[1] Source: Bloomberg; Wall Street Journal; Bond history based on the inception of the Bloomberg Aggregate Bond Index in July 1973; 60/40 balanced index represents 60% S&P 500 Index and 40% Bloomberg Aggregate Bond Index
[2] Source: Alpine Macro; represents "real," or inflation-adjusted net measure of U.S. household assets minus liabilities

“Prediction is difficult, especially about the future”
-Danish Proverb

It seems ironic that the consensus forecast for corporate earnings was spot-on last year, and yet stocks delivered their worst performance in more than a decade. At this time last year, the consensus earnings estimate for the *S&P 500 Index* for calendar year 2022 was within $1.00 of the current estimate now that the year is over.[3] According to *Refinitiv IBES* this was the most accurate annual earnings forecast since 1995.

Such is the nature of financial markets…. even a flawless forecast for corporate earnings was unhelpful for predicting how stocks would behave in 2022. The primary reason for the big miss was the historic surge in interest rates that caught investors by surprise. Investors whiffed on their forecast for interest rates because the central bankers who manipulate interest rates for a living also whiffed…badly.

One year ago, the Federal Reserve (Fed) was guiding market participants to expect three interest rate hikes of 0.25% each in 2022. This was expected to lift the target rate for Fed Funds to a range of 0.75%-1.00% by the end of 2022. The actual Fed Funds target as of year-end 2022 turned out to be 4.25%-4.50%. Whoops.



Source: Bloomberg; 12-1-2021 to 12-31-2022

[3] Source: Refinitiv IBES; Bloomberg; Wall Street Journal

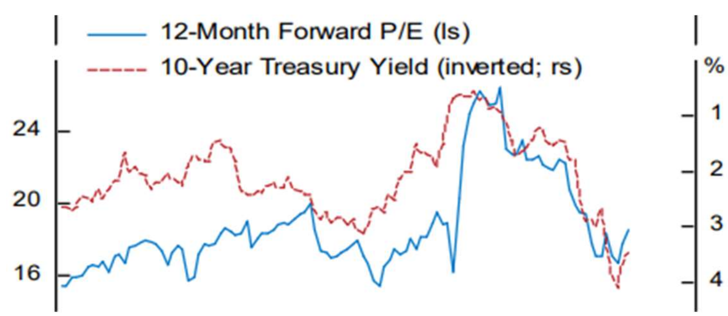
Interest rates are a primary input in the valuation formula of all assets, including stocks and bonds. The impact on the fair value of an asset priced with a 4.25% interest rate versus a 0.75% interest rate can be like the difference between the value of the Toledo Mud Hens versus the New York Yankees.

Last year at this time most assets were priced like the New York Yankees because interest rates had been anchored to zero for the better part of 14 years and the Fed was guiding investors to expect a *very gradual* glide path toward interest rate normalization. However, the Fed proceeded to move the goal posts at every successive meeting of its policy committee throughout the year, such that by December the Fed's interest rate target was more than 4X higher than its original guidance. Consequently, the price of virtually all assets needed to adjust lower, and most everything did.

That Was Then…

We suspect that most of the valuation adjustment related to higher interest rates is behind us. Going forward we expect the performance of the economy and corporate earnings to have a greater impact on the behavior of stocks and bonds.

S&P 500 Price-to-Earnings Ratio (P/E)
1-1-2014 to 12-27-2022



Source: Alpine Macro

As it relates to the stock market, if we assume the Fed achieves its objective of cooling the U.S. economy in 2023, if not tipping it into recession, we should expect more companies to fall short of their earnings expectations as the year unfolds. Unlike interest rates, which influence the value of everything, the impact of corporate profits is more company specific.

When a given company falls short of its earnings expectations, the stock market reaction can be harsh in the short-term. However, companies that achieve their earnings targets might perform just fine, regardless of the latest economic headline or earnings miss from elsewhere in the marketplace. In this environment, the performance of the overall stock market, as measured by an index like the *S&P 500,* may depend upon the relative balance between companies that fall short of their earnings expectations versus those that don't within the index.

For active investment managers like us, the challenge is to avoid as many negative earnings surprises as possible within our stock portfolios. Although we will inevitably step on a few banana peels, there is a silver lining whenever earnings disappointments become widespread during an economic downturn – it causes stocks *we don't own* to go down, sometimes by a lot.

The stock market is notorious for pushing prices too far in both directions in response to good or bad news. We believe some stocks are already trading at attractive entry prices on the heels of last year's steep declines. We suspect at least a few opportunities may become even more enticing in the wake of an earnings miss, or a geopolitical flare up in the early months of the New Year. We are tracking these opportunities carefully, and we have room to act as conditions warrant (more in the Managed Equity strategy commentaries below).

A *Much* Better Environment for Bonds

Interest rates have an inverse relationship with all asset prices, but in the case of bonds the connection is straight math. For any given change in interest rates, the price of an existing fixed income security will adjust up or down by whatever amount is necessary to match the market rate for bonds of a similar structure, duration, and credit quality. It stands to reason then, that in a year when the Fed engineered a more-than-quadrupling of short-term interest rates, bonds delivered their worst annual performance on record.[4]

However, now that interest rates have adjusted substantially higher across the entire spectrum of security types and maturity levels, the outlook for fixed income seems quite encouraging from here forward, in our view. With the starting yield for a high-quality bond portfolio sitting in the mid-single-digits today, the risk-reward consequences of future interest rate scenarios tilts in favor of the investor.

Note in the chart on the following page that interest rates could increase by another full percentage point (100 basis points) in 2023 and the downside for the *Bloomberg US Aggregate Bond Index* would be less than 2%. On the other hand, if interest rates decline by 100 basis points – quite realistic if there is a recession – the index would return nearly 11%. Note as well that an environment that might be troubling for stocks – recession – could be helpful for fixed income returns in 2023.

As described in the fixed income strategy sections below, our portfolios have been structured relatively defensively to reduce their sensitivity to rising in interest rates relative to the illustration below. This was helpful for each of our fixed income strategies in 2022.

[4] Source: Bloomberg; Wall Street Journal; Bond history based on the inception of the Bloomberg Aggregate Bond Index in July 1973

Bloomberg US Aggregate Bond Index Yield
As of November 30, 2022

A Higher Starting Point for Bond Yields Can Act as a Cushion Should Interest Rates Continue Higher

10-Year Treasury Yield Change (bps)	Agg Index Yield (%)	12-Month Return
100	5.56	-1.7%
75	5.31	-0.1%
50	5.06	1.5%
25	4.81	3.0%
0	4.56	4.6%
-25	4.31	6.1%
-50	4.06	7.7%
-75	3.81	9.2%
-100	3.56	10.8%

Source: DoubleLine; Period 1-1-1992 to 11-30-202

Current Design of Our Investment Strategies[5]

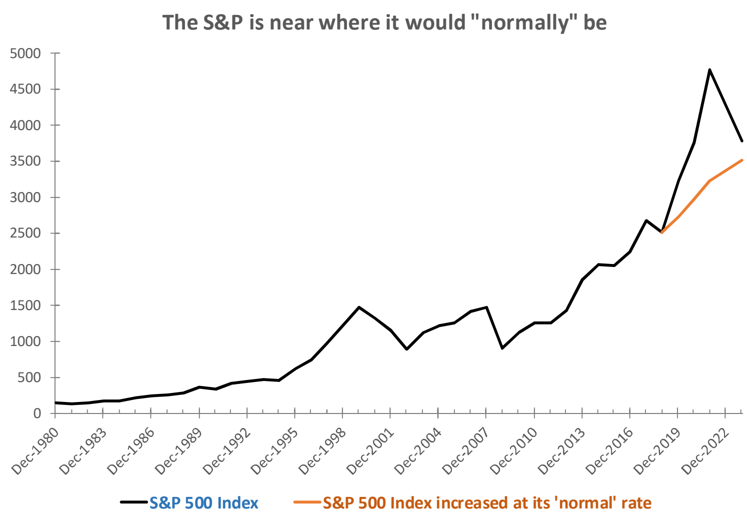
The remainder of this report addresses the current positioning of each of our investment strategies under current macro conditions. The specific design of *your* portfolio is customized to match your return objectives and risk tolerance. **For a refresher on how your portfolio is designed, and why, please reach out to your Wealth Advisor any time.**

ASSET LEVEL	Based on your investment objectives and risk tolerance, we set parameters for an optimal stock/bond mix. Instead of keeping your portfolio at a stagnant allocation, we have the ability to change the stock-to-bond-to-cash ratios as market conditions change.
PORTFOLIO LEVEL	By understanding the types of portfolios/accounts we're managing, we structure each portfolio to fit its stage in the investment life cycle (accumulation vs. distribution). We also take into account legacy positions and/or outside assets.
STRATEGY LEVEL	By understanding your optimal asset allocation range and the types of portfolios being managed, we determine how our specific strategies should be combined. We utilize both fundamental and tactical strategies to help take diversification one step further.
SECURITY LEVEL	Our team of CFA charter holders performs deep research behind each security selected and provides rationale for trades. We strive to position your portfolio for prevailing market conditions to participate in long-term trends.

[5] 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

Liquidity-driven asset inflation essentially pulled investment returns forward during the Covid response period of 2020-21, in our view. Longer-term equity returns have been rather consistent since the Korean War in the 8%-11% range. For perspective, had the equity market returned (the more conservative version of) its "more typical" annual growth rates since 2018, the *S&P 500* would be just below where it is now.[6] Point-to-point, from 2018 through 2022, stocks are still up at an 11% annual rate, despite the recent round trip of excess returns in 2020-21 and bear market in 2022.[7]



Just because 2022 was a down year for asset prices does not mean global economic innovation has stopped - far from it - innovation typically thrives in times of stress and necessity, often clearly visible in hindsight. Those times also help to separate weak companies from the great ones that can emerge stronger than before. In the current financial climate, we are looking for great companies whose stocks have been "thrown out with the bathwater," and well-managed leaders of trends that could grow strongly as the global economy evolves.

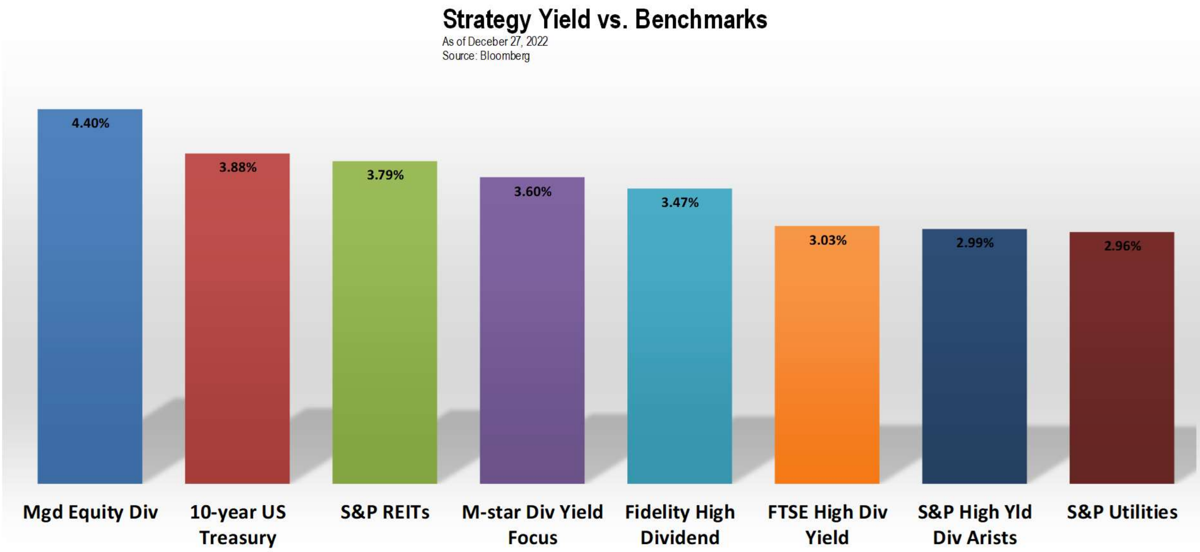
[6] The "normal" line increases the year-end 2018 S&P 500 Index level by 9% per year, which is the average annual S&P 500 Index increase since 1950. The median increase (since 1950) is 11% by annual calendar year and 10% by weekly calendar year. As of December 27, 2022

[7] Source: Bloomberg, Orion. From December 31, 2018 – December 30, 2022. "The market" is represented by the S&P 500 Index. For consistency, the calculations and chart exclude dividends.

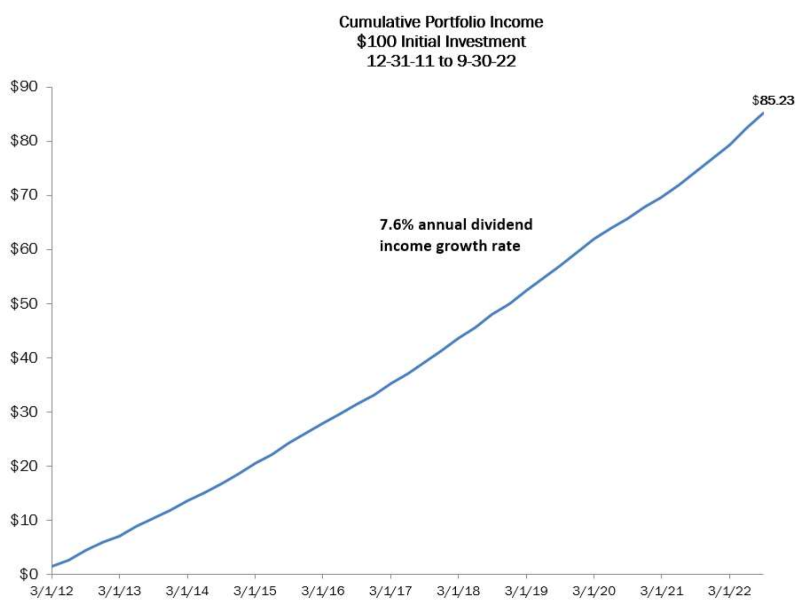
Managed Equity Dividend

The *Managed Equity Dividend Strategy* has several attractive attributes for the current market climate:

- Approximately four percentage points of the *Strategy's* total return comes from consistent cash payments from dividends.



- The amount of cash the *Strategy* has returned to shareholders has grown nicely over time. For instance, assuming no withdrawals, the strategy has expanded its dividend cash flows at more than 7% annually since inception.[8]



Source: Orion

[8] Source: ORION

- The *Strategy* returns are linked to the stock market, which over the long term, is generally regarded to be a solid inflation hedge. We expect inflation to decline in 2023 but remain above the pre-Covid levels.
- The *Strategy's* beta vs. the *S&P 500* is approximately 0.7, suggesting it has been meaningfully less volatile than the broader market.[9] In 2022, that lower volatility held true while the strategy significantly outperformed "the market."[10]

We purposefully manage the *Strategy* to mitigate risk within the confines of focused exposure to higher dividend paying stocks. While that focused exposure has multiple benefits, there are times when market conditions do not favor that factor. Our risk management process seeks to mitigate this risk but cannot fully avoid it. In 2022, the *Strategy* posted a gain despite the broader equity market being down materially.[11]

Managed Equity Growth

The *Managed Equity Growth Strategy* slightly outperformed the *S&P 500 Index* in 2022, while retaining its growth style and a 0.9 beta (signifying lower volatility risk than the index). We are particularly pleased with this outcome because it was achieved in an environment that was very hostile to growth-oriented equity strategies like this one. For example, the *Russell 1000 Growth Index* underperformed the *S&P 500* by roughly 11.0 percentage points last year (1,100 basis points), while the *Morningstar* mutual fund category for Large-Cap Growth (our peer group according to *Morningstar*) underperformed the *S&P 500* by approximately 11.9 percentage points (1,190 basis points) in 2022.[12]

We are looking to take advantage of 2022's market weakness by identifying high-quality "bathwater stocks," as well as price-depressed leaders of highly- attractive, long-term economic growth trends. Management and asset quality take precedence in this approach. We believe there are opportunities to pick up excellent companies at attractive prices when viewed over the long term. Since the *Strategy* is already constructed around this philosophy, we also intend to use some cash to strengthen selected positions.

We retained a moderate cash reserve over 2022, so we do not have to sell good stocks to take advantage of these opportunities. Just a brief reminder: Cash serves a dual role in the *Managed Equity Growth Strategy*. One is to balance risk taken elsewhere in the portfolio. A second is to take advantage of excellent opportunities during volatile periods without having to sell the stocks of great companies at depressed prices.

[9] The market as reflected by the S&P 500 index's total return
[10] Source: Bloomberg as of December 27, 2022. The market is represented by the S&P 500 Index.
[11] Source: ORION; Bloomberg
[12] Source: ORION; Bloomberg; Morningstar

Managed Credit Strategies

Within our *Managed Credit Strategies*, we have continued to tilt the portfolios toward better credits, with roughly 70% of our clients' exposure in companies currently rated A- or better, on average.[13] We believe our BBB exposure has better balance sheets than the broad market, but we are willing and able to further reduce this exposure should we see specific situations worsen. We have also increased our allocation to U.S. Treasuries, as applicable, to provide further credit diversification from a potential slowdown in the economy. Our overweight to investment grade corporate credit performed well versus Treasuries this quarter, while our relatively defensive duration posturing provided some guardrails to interest rate volatility. On a go forward basis, portfolios are now yielding between 4.7% and 5.1%[14] depending on one's yield curve positioning.

Municipal Bonds

Our *Municipal Bond* portfolios are still focused on "A" and above credits with strong debt coverage and liquidity profiles. We have also intentionally over-weighted essential service revenue bonds (water & sewer, utilities, etc.), and general obligation bonds with an average portfolio credit quality of "AA." Citing stretched valuations up to this point, portfolios have been generally positioned with less interest rate sensitively to rising rates relative to the benchmark. Looking forward, portfolios are now yielding between 2.8% to 3.2% tax free *(between 4.4% and 5.0% at the 37% highest marginal tax rate)*[15] depending on one's yield curve positioning, providing solid levels for tax-sensitive bond investors.

ETF Bond Models

Our *Aggregate Bond* (ETF) strategy continues to be 100% invested in "defined maturity," investment-grade corporate bond ETFs. Today, there is a relatively even laddered maturity structure of ETFs ranging between 2024-2028, thus remaining relatively conservative from an interest rate sensitivity perspective. Corporate debt performed well this quarter after facing extreme rate volatility on a year-to-date basis through the end of the third quarter. With the increase in market yields over the year, the model now carries an average net acquisition yield close to 5%[16]. Thankfully, our overall defensive stance relative to the benchmark has provided some downside protection from rising rates in 2022. The same can be said for the upcoming discussion on the *Income Bond* (ETF) strategy.

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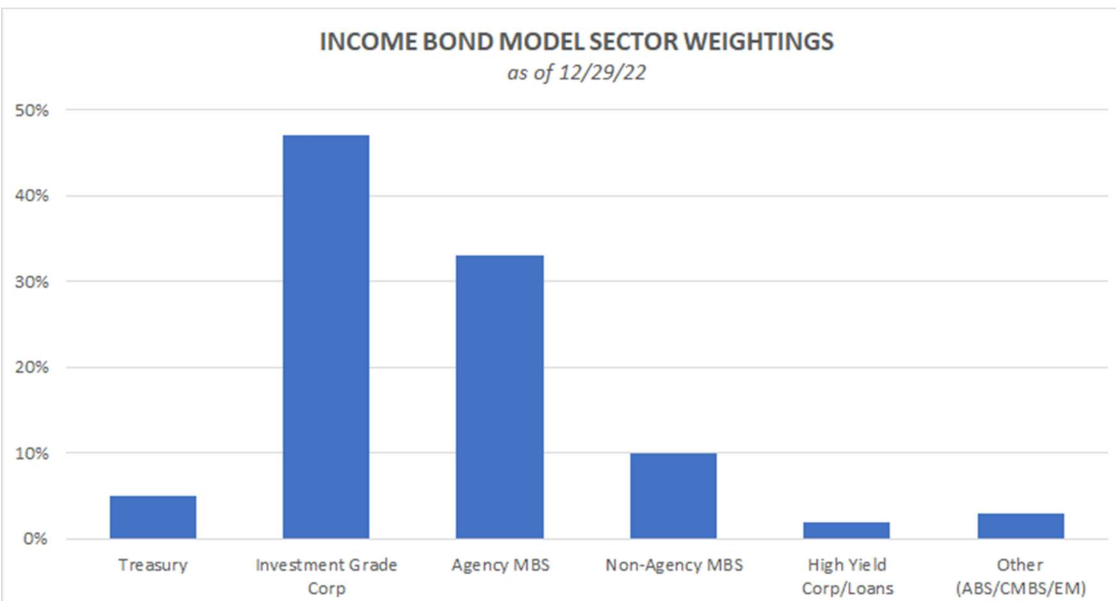
[13] Source: ORION
[14] Source: ORION; Bloomberg
[15] Source: ORION, Bloomberg
[16] Source: Bloomberg, iShares, State Street

The *Income Bond* (ETF) strategy has focused on maximizing cash flows within the construct of balancing risks. For many quarters now, the model has been defensively postured relative to the benchmark from both an interest rate and credit risk perspective. In addition, we have been grateful to have over 50% of the model's exposure invested in active managers (**SPDR Doubleline Total Return ETF (TOTL: ~$40) and Janus Henderson Mortgage-Backed Securities ETF (JMBS: ~$45)** that both attempt to avoid many pitfalls in times of market stress along with taking advantage of pricing inefficiencies when prudent. The second half of this year highlights such an environment within the mortgage-backed securities (MBS) marketplace, where 30-year rates rose to their highest levels since 2008 in September, but then subsequently fell sharply heading into December.

We continue to look for opportunities to add yield in this volatile market, but until we can see some stability in either inflation and/or rates, retaining dry powder seems to be the right bet until the trend changes. The good news from this point going forward is that the model now yields approximately 5.2%[17] on an annualized basis, with an overweight to high quality corporates and "AAA-rated" MBS.



Source: ORION, iShares, State Street

[17] Source: Bloomberg, iShares, State Street

Tactical Global Growth Strategy

Tactical adjustments to the asset allocation in this strategy have been helpful of late, allowing the strategy to outperform global equity market benchmarks in 2022. The most notable change for the upcoming quarterly holding period is an increase in the allocation to international equities for the first time in several quarters. The strategy spent most of last year with the minimum possible weighting in non-U.S. assets. Starting this month there will be an increase for both **Emerging Markets** and **International Developed Markets**. Another noteworthy change is a two-stage reduction for **U.S. Large-Cap Growth** from overweight to underweight. This change is interesting because Large-Cap Growth has been overweighted for most of the past *decade*.

Tactical Global Growth Strategy
Asset Allocation for the Upcoming Quarter

Asset Class	Current Weighting (1/3/2023)
U.S. Large-Cap Value	Overweight (17%)
U.S. Mid-Cap	Overweight (17%)
High-Yield Credit	Overweight (17%)
U.S. Small-Cap	Neutral Weight (11%)
International Developed Markets	Neutral Weight (11%)
Emerging Markets	Neutral Weight (11%)
International Small-Cap	Underweight (5%)
Real Estate	Underweight (5%)
U.S. Large-Cap Growth	Underweight (5%)

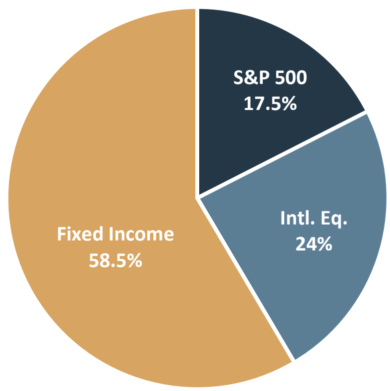
The *Tactical Global Growth* strategy provides a strategic allocation to nine major risk markets globally. Broad diversification across multiple geographies, factors, asset classes and market caps support the risk-adjusted return profile of the strategy. We strive to further enhance long-term returns by systematically adjusting the weightings among the nine sectors to overweight markets that demonstrate relative strength, while reducing the allocation to markets that exhibit relative weakness.

Dynamic Allocation Strategy

This strategy entered 2022 in a relatively conservative position with 40% of its allocation in short-term Treasuries and cash reserves. It became more conservative at the end of January when the allocation to short-term reserves increased to 60%, and then shortly after the Russian invasion the portfolio reached its maximum defensive position with 90% of its assets set aside in short-term reserves.

These tactical adjustments helped to truncate the downside for the strategy relative to most equity market benchmarks. The defensive positioning of the portfolio would have been even more helpful were it not for the historic rise in interest rates during the year. Rapidly rising interest rates caused the fixed income out-position in the portfolio to decline by nearly 4% in 2022.[18] While this is dramatically better than the equity sectors that were sold from the portfolio, it is unusual historically for short-term U.S. Treasuries to deliver a negative total return of this magnitude.

Current Allocation
January 3, 2023



Last year we adjusted the trading rules for re-entering the equity market (following an exit) for the two largest equity sectors in the strategy – *S&P 500 Index* and *MSCI EAFE Index* (developed international markets). The change incorporates a secondary metric for re-purchasing these sectors that we expect can be triggered at a deeper point in the drawdown whenever these two markets experience anything close to a "V-shaped" bottoming process.

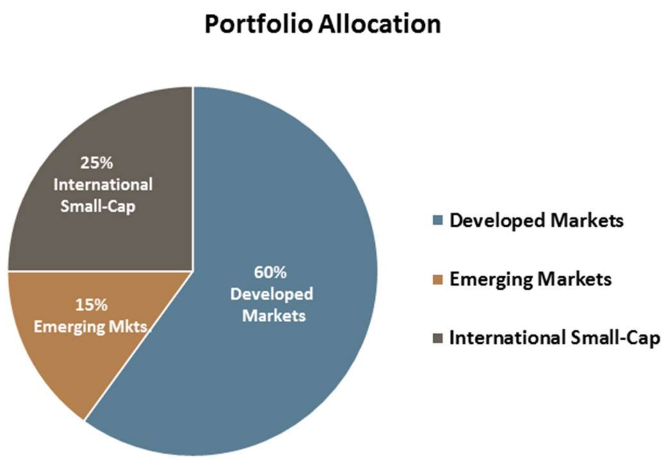
Specifically, the strategy will repurchase one-quarter of the amount that was sold upon achieving a 25% drawdown for either of these two sectors. If these sectors reach a drawdown of at least 35%, the strategy will re-purchase a second tranche to bring the allocation to one-half of its fully invested target. The final 50% of the allocation will not be re-purchased until the ETF for that sector crosses back above its moving average trend line, which is the primary decision metric for all sectors in the strategy.

The introduction of this secondary trading rule seeks to hedge against the risk of missing substantial early gains in a stock market recovery whenever external events – like central bank interventions – trigger a V-shaped reversal in the equity markets. This decision metric was triggered for the International Equity sector in June, resulting in the purchase of a 6.0% allocation to the *MSCI EAFE Index* on June 16th, and for the *S&P 500 Index* on October 10th, when a 7.5% allocation was purchased. Both actions proved to be helpful for the strategy's performance last year.

[18] Source: Morningstar

International Focus Strategy

International equities performed very well in the fourth quarter, delivering substantial outperformance relative to domestic equity markets during the period. This comes after an extended period of under-performance for international equities relative U.S. stocks that has produced an unusually large valuation discount for these markets based upon common valuation metrics like price-to-earnings ratio, price-to-sales ratio, and dividend yield.[19] This valuation support may be at work in the recent market environment, where the relative performance of international equities has been resilient despite a weak economic outlook and greater exposure to the negative effects of the war in Ukraine. The International Focus strategy has been further supported by its factor tilt toward value. The value sub-sector of the strategy includes numerous stocks in industries like energy, natural resources, pharmaceuticals, and telecommunications, which performed relatively better in 2022.[20]



The *International Focus* strategy provides a strategic commitment to international equities to expand the universe of companies for investment beyond the U.S. market within a diversified portfolio. To enhance the potential diversification benefits of this expansion, the strategy seeks to capture a return premium relative to common international equity benchmarks through disciplined emphasis on three market factors that have demonstrated a long-term history of attractive risk-reward characteristics: Value, Momentum and Low Market Capitalization, or "small cap."

[19] Source: MSCI; Standard & Poor's
[20] Source: Bloomberg

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 **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 **Russell 1000 Growth Index** seeks to track the investment results of an index composed of large- and mid-capitalization U.S. equities that exhibit growth characteristics.
The **Russell 1000 Value Index** seeks to track the investment results of an index composed of large- and mid-capitalization U.S. equities that exhibit value characteristics.
MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S.
MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.
MSCI EAFE Small-Cap Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of small- and mid-cap stocks in the developed markets, excluding the U.S.

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.

Additional information, including management fees and expenses, is provided on Capital Advisors' Form ADV Part 2, available upon request or at the SEC's Investment Adviser Public Disclosure site,

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