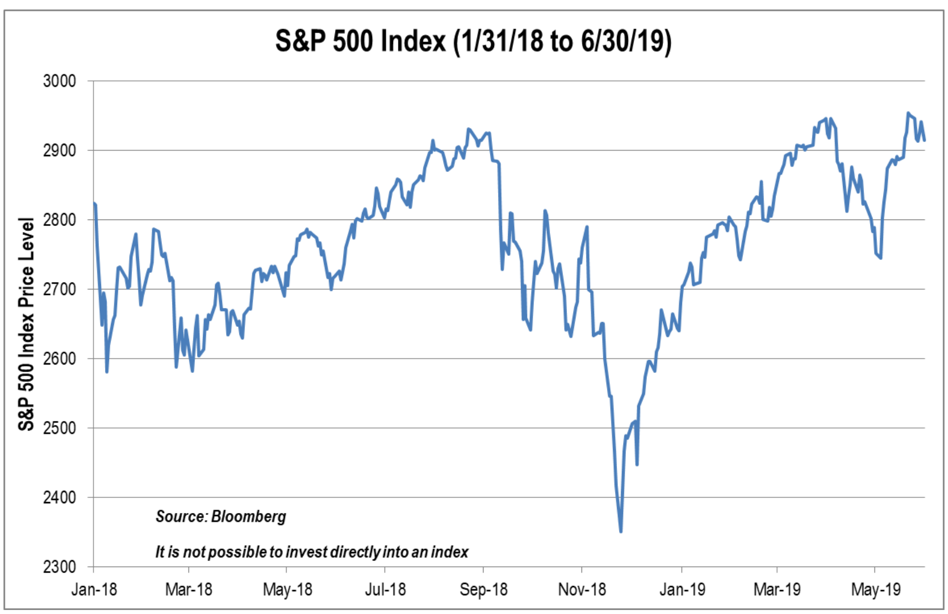
CAPITAL ADVISORS

Overview

July 2019

Key Points

- The longer-term outlook for all major investment assets will depend heavily on the future path of interest rates.
- We don't believe interest rates can go much lower on a sustainable basis, but we don't expect rates to rise materially either over the next three-to-five years.
- We believe the U.S. stock market is priced about where it should be within the context of this interest rate outlook.
- This perspective supports our recommendation that investors stay committed to the stock market, despite the logical temptation to "book some gains" after such a strong first half of the year.
- We also find it helpful to put the first-half performance of the stock market into context…even *after* jumping 18.5% over the first six months, the *S&P 500 Index* delivered a more "normal" total return of 10.4% over the 12-month period ending in June, and just 5.1% annualized between January 31, 2018 and June 30, 2019.[1]
- We believe security selection and careful portfolio design can still generate attractive long-term returns at acceptable risk levels in the financial markets.



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

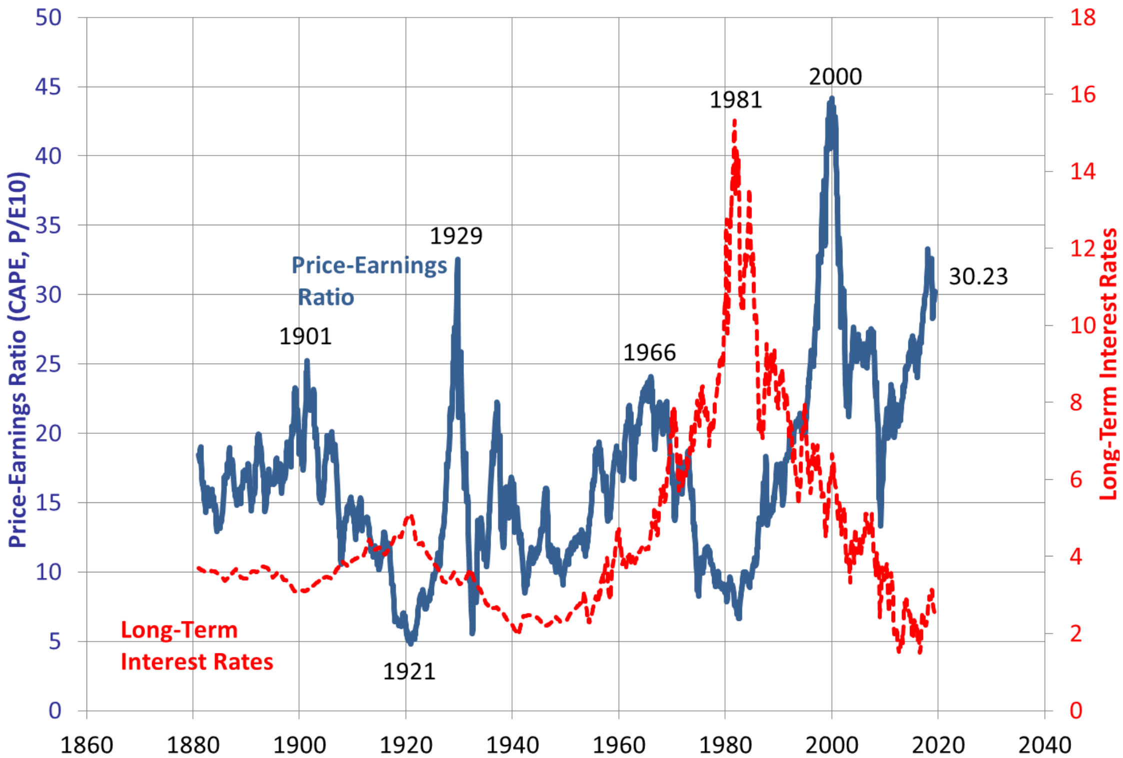
[1] Source: Bloomberg; Standard & Poor's; All returns assume reinvestment of dividends

Low Interest Rates Support Asset Prices

After such a sharp jump in the stock market it is natural to wonder if the market has come too far, too fast. We don't think so for two reasons. First, much of the price action in the first six months of 2019 might be viewed as catch-up from a lackluster year in 2018.

More importantly, the appropriate valuation level for the stock market goes hand-in-hand with interest rates. The chart below reflects a strong inverse correlation between interest rates (red line) and the valuation multiple of the stock market (blue line). Low interest rates support a higher valuation multiple, and vice versa. This relationship is grounded in first principles. The "risk-free" interest rate on government bonds is a key input in the valuation formula of virtually all investment assets, including stocks.

U.S. Stock Market Valuation vs. Interest Rates
Jan. 1881 to May 2019



Source: Robert J. Shiller

The importance of interest rates in the valuation equation for the stock market means that it is only partially accurate to say that stocks look "expensive" today. When measured against the historical range of outcomes, the current valuation level of the stock market falls within the most expensive 10% of all observations in the post-WWII era.[2] Thus, within this context, stocks are indeed expensive.

[2] Source: Robert J. Shiller - Jan. 1, 1950 to May 31, 2019: http://www.econ.yale.edu/~shiller/data.htm

However, when the historical comparison is limited to comparable periods of very low interest rates, the current valuation multiple no longer seems extreme. In fact, if one could be certain that interest rates would remain near current levels for the next 20 years, the stock market would be downright cheap by comparison based upon a prudently discounted present value of its estimated future cash flows.

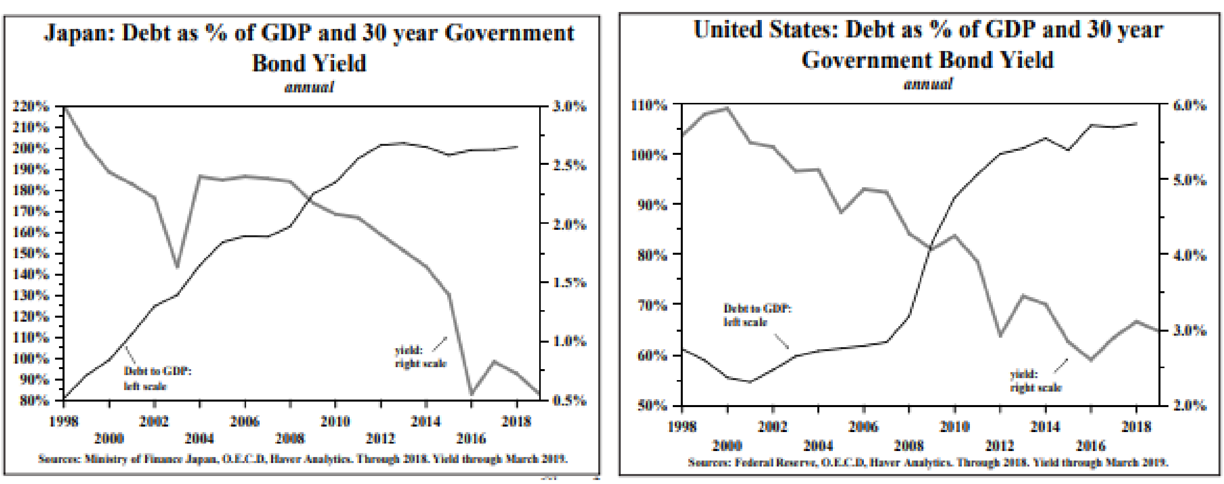
The Case for Low Rates

It is impossible to know what the 20-year path for interest rates might be, however, we feel reasonably confident that interest rates can remain low for at least another three-to-five years. Therefore, we do not find the recent valuation level of the stock market to be overly alarming.

In the very near-term the case for low rates is supported by accommodative monetary policy throughout the world. Central banks in the U.S. and the euro zone recently signaled a shift in bias toward lower policy rates. In Japan, interest rates out to 10-years on the yield curve have been anchored near zero for more than a decade, while 10-year yields have dropped below zero in seven countries beyond Japan.[3]

Longer-term, the case for low rates rests with the elevated level of government debt throughout the world. Economic theory and historical experience both suggest that government debt accelerations ultimately lead to lower, not higher, interest rates. Essentially, increased government debt levels tend to weaken economic activity and inflation, leading to lower interest rates.

Debt to GDP vs. Interest Rates
1-1-1998 to 3-31-2019



Source: Hoisington Investment Management – Market Review and Outlook – First Quarter 2019

[3] Source: Bloomberg as of June 30, 2019: Austria, Denmark, Finland, France, Germany, Netherlands, Switzerland

Consider the evidence – in the past 20 years gross government debt as a percent of gross domestic product (GDP) advanced dramatically in all of the major economic areas of the world – the U.S., Europe, Japan and the U.K.,[4] yet government bond yields are down sharply in all four regions over the same time period.

Debt to GDP vs. Interest Rates
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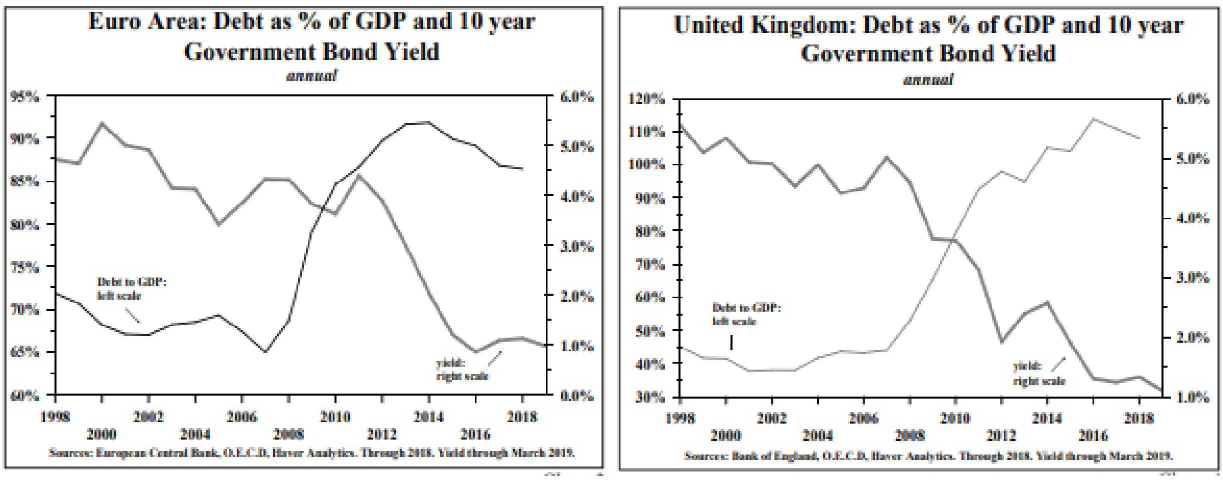

Source: Hoisington Investment Management – Market Review and Outlook – First Quarter 2019

An unfavorable combination of demographics and government policy commitments in each of these regions ensures that the debt-to-GDP ratio should continue to rise for all of them, potentially extending the downward influence on economic activity and inflation in these regions for at least the next few years.

Current Design of Our Investment Strategies[5]

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) Many risks remain unresolved, but our base case outlook assumes the economy will not enter recession for the foreseeable future and stocks can retain their gains from the strong first half.
2) We do not recommend that investors “lock-in” recent gains in the stock market by selling down their equity exposure.

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[4] Source: Hoisington Investment Management – Quarterly Review and Outlook – First Quarter 2019
[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.

3) The only possible exception to point #2 is any investor who learned that the downside volatility of their portfolio was out of sync with their risk tolerance during the fourth quarter downturn last year.
4) If our relative optimism is misplaced, we would not expect the resulting downside in the stock market to be materially worse than the fourth quarter in either magnitude, or duration. Investors who endured that experience with tolerable anxiety seem well suited for the full range of most likely outcomes over the next 12-18 months.
5) Principal areas we are watching closely for negative surprises include earnings estimates, credit spreads, trade policy, and the behavior of international markets, particularly China.

Managed Equity Strategies

Our managed equity strategies remain actively engaged in “owning” companies that lead sectors where economic value is being created, and stocks we believe are undervalued. While our outlook for the stock market remains constructive, we recognize that financial markets can change quickly. With this in mind, we have already taken several steps to tilt the risk profile of our Managed Equity strategies lower, as follows:

- We have been actively managing the stock weightings in each strategy for new money purchases to avoid over-committing to individual stocks that are close to our near-term price targets;
- We have rotated the stocks in both strategies towards higher-quality balance sheets. For instance, we added two companies to the *Dividend* strategy that have a blended average dividend yield of 5.5%, three-year dividend growth rate of 4%, and an average credit rating of A- (upper tier).[6]
- We have further diversified both strategies to help avoid over concentration to any single valuation factor. For instance, within *Growth* we trimmed certain outperforming Technology and Health Care positions, while redeploying those funds into a more diversified range of value drivers.

[6] Source: Bloomberg

Focus on Sustainable Leaders in the Most Attractive Markets

We seek to focus the Managed Equity strategies on mega-trends that seem likely to create significant value in the global economy. Within these mega-trends we seek to identify leading companies that help to shape the trend's development. We believe this is an important feature of active investment management because the leading companies and industries of tomorrow are frequently different from the past.

Top-10 S&P 500 Members

1980	2017
1. IBM	1. Apple
2. AT&T	2. Microsoft
3. Exxon	3. Alphabet
4. Standard Oil of Indiana	4. Amazon
5. Schlumberger	5. Facebook
6. Shell Oil	6. Berkshire Hathaway
7. Mobil	7. JP Morgan
8. Standard Oil of California	8. Johnson & Johnson
9. Atlantic Richfield	*9. Exxon Mobil*
10. General Electric	10. Bank of America
7 of 10 were Oil companies	**Top-5 are Tech companies**

Indices heavily weight yesterday's trends

Only one company made the transition from 1980 to 2017

Source: Standard & Poor's. As of December 31 in the year shown

For example, the *Managed Equity Growth* strategy currently includes dedicated exposure to the following mega-trends:

Robotics: The next leg of the Industrial Revolution's use of machines to make tasks more efficient. At present, we view Medical Robotics as the highest-value segment.

Artificial Intelligence: The next stage of the Computing Revolution, including data analytics, self-driving cars, intelligent homes, smart utility grids.

Cloud Services: Involves businesses shifting their technology and information assets to the cloud for better capture and analytics...technology is not Wal-Mart's core competency; retailing is.

Biotechnology: At the center in the fight against suffering and death - the knowledge, equipment and treatments that are sparking advances in cancer, heart disease, diabetes, arthritis, including…

> **Gene & Cell Therapy:** Treating DNA strands and cells to eliminate or treat the root cause of diseases.
>
> **Immuno-Oncology:** Supercharging the body's immune system to fight cancer.

Electronic-Payments: The shift from cash to card to button. E-payments can enable new business models and help make established ones become more efficient.

New Retail: Technology is transforming the shopping experience. Use a phone (or ask Alexa) to have food delivered to your doorstep in two hours; select items and check out of a store without stopping at the cashier; try on a blue item at a store and order a red one from the online kiosk...we believe technology has just scratched the surface of its potential impact on the shopping experience and profitability of "new retail" companies.

Social Change: The aging global population, the impact of connectivity technologies, the rise of two-income families, increasing financial power among women, changing generational expectations....

Emerging Consumer: In Asia alone, 525 million people have already joined the middle class - more than the total population of the European Union (EU). Over the next 20 years the middle class could expand by another 3 billion people, almost exclusively from the emerging world.[7]

Fixed Income

The Fed pivoted its policy stance this quarter to a more "dovish" outlook as inflation continued to fall short of expectations. Consequently, Treasury market yields marched lower along the yield curve leading to solid price gains across most fixed income securities. The futures market has now priced in a 100% chance the Fed will cut the Funds rate by 0.25% in July, and a meaningful 63% chance of an additional 0.50% by year end![8] We suspect much of the drop in intermediate to longer term market rates may be priced into these forecasts, while the shorter end of the yield curve may follow this downward trend should upcoming Fed's actions mirror market projections.

Our individually managed taxable (corporate focus) and tax-exempt (municipal focus) bond portfolios 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. We continue to prefer an "up-in-quality" bias across all bond portfolios.

By structuring bond portfolios in a "ladder" with maturities typically contained within the 1-to-10-year range, the cost of being wrong should be minimal unless rates rise significantly. 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, and the portfolio is supported by higher cash flow among the longer-dated bonds in the ladder.

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[7] Ernst & Young, "Middle class growth in emerging markets: Hitting The Sweet Spot," April 23, 2015

[8] Source: Bloomberg as of June 26, 2019

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. In all cases we will not reach for yield unless the merits of the underlying strategy prove worthwhile relative to the risk. With the continued rally in rates, we have positioned most of our clients' individual managed bond portfolios neutral to slightly lower duration (sensitivity to a change in interest rates) relative to their respective benchmark durations to manage risk.

Within our ETF bond models we continue to emphasize "defined maturity" ETFs. These funds include all of the features of a traditional fixed income ETF with one important difference: a specific maturity date. These funds are populated with bonds that all mature in the same calendar year. During that year the ETF terminates, and the fund's net assets are distributed to shareholders as cash, similar to what happens when an individual bond matures. After taking advantage of higher yields at the beginning of the year through the purchase of longer maturity ETFs, we have allowed each models' average duration to ratchet lower commiserate with the move down in rates to get slightly more defensive.

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.

This strategy has been frustrating in 2019. After a resilient performance during the stock market downturn late last year the portfolio was poorly positioned for the V-Shaped recovery that started in early January when the Fed signaled a pivot away from restrictive monetary policy. The portfolio re-entered its five risk markets between February and April as each ETF crossed above its respective moving average. Unfortunately, the strategy became fully invested just in time for the pull-back in risk markets that occurred in May.

After rebounding in June, the strategy has managed a modest gain for the year as of June 30. However, the opportunity cost from the short-term reversals that occurred in January and May has been meaningful.

We feel it is important to emphasize that *this is a known hazard* for moving average crossover strategies like Tactical Dynamic. The risk management discipline embedded in this strategy is designed to create the most value during two kinds of market environments – durable upward trends, and deep downturns. This characteristic distinguishes Tactical Dynamic from buy-and-hold strategies, which typically suffer during market downturns. This distinction can provide a material diversification benefit when Tactical Dynamic is paired with buy-and-hold strategies in the equity markets.

Tactical Global Growth

The *Tactical Global Growth* strategy participates in the long-term growth of the world equity markets by spreading 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 portfolio. This strategy can serve as a core position for investors seeking global diversification within the equity portion of their portfolio.

The strategy will see an unusual level of adjustment for the upcoming quarter, with three sectors moving up in weighting, and three sectors dropping lower. International equities and emerging markets will see an increased commitment after spending most of the past year at the lowest target weighting. The strategy will also have a maximum weight in two of the three diversifying asset classes in its mix – real estate and high-yield credit. The common theme among the under-weighted sectors is small market cap, with both domestic and international small-cap markets at the lowest target allocation.

International Focus

International equities have under-performed the U.S. stock market for the vast majority of the past decade. At this point there is a fairly wide valuation gap between the two global regions, implying a potential catch-up opportunity for international equities if conditions improve for the global economy in general.

The relative performance of international markets improved materially in the final two weeks of June after the Fed signaled a pivot toward easier monetary policy.[9] One potential consequence of this shift in monetary policy could be a trend-reversal in the U.S. dollar exchange rate, which had been strengthening for most of the past 18-months until the Fed's announcement on June 19th. A weaker U.S. dollar exchange rate frequently (though not always) supports relative out-performance for international stocks versus domestic benchmarks.

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, or "small-cap."

July 2, 2019

[9] Source: Federal Reserve press release, June 19, 2019

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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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