Quarterly Overview

Third Quarter 2019

CAPITAL ADVISORS

Key Points

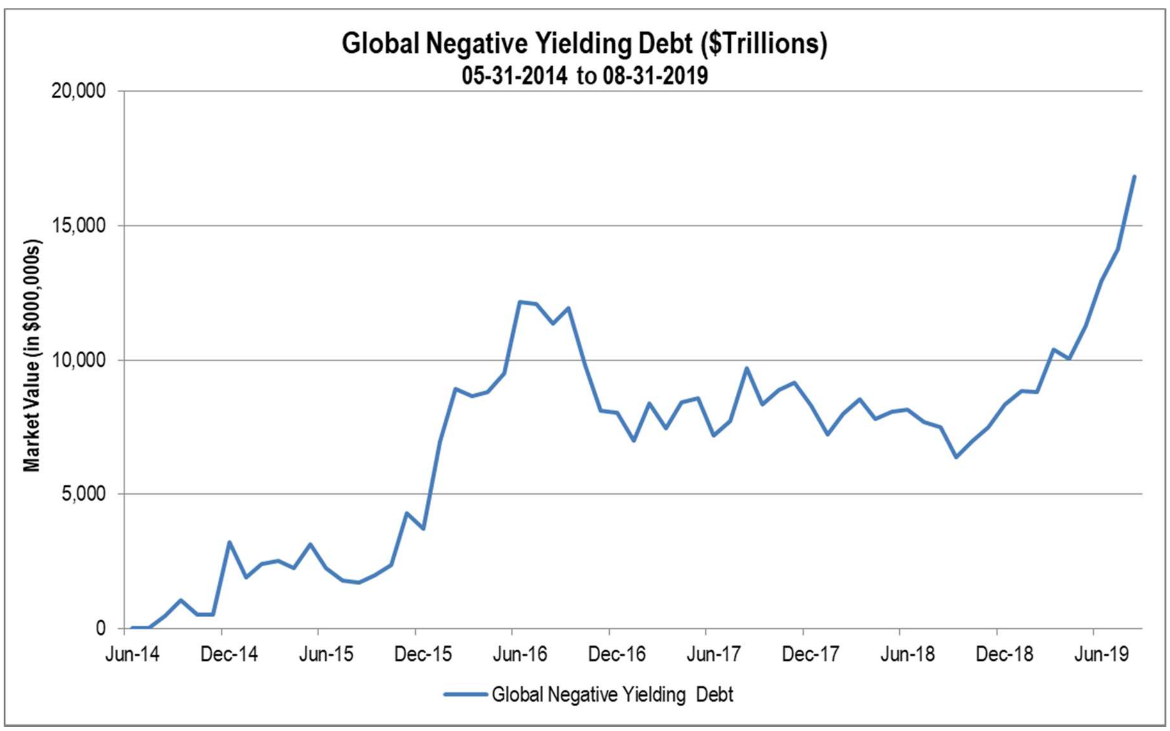
- We believe the current macro environment calls for a flexible balance from investors between caution and opportunity.
- Caution seems justified by the recent deterioration in certain economic indicators, the startling step-move lower in interest rates worldwide, and elevated uncertainty from global trade frictions and the 2020 elections.
- We have already taken a number of actions to manage risk within our investment strategies, which we describe in more detail below.
- We also recognize that a key driver of recent economic deceleration – U.S. trade policy – seems likely to trigger intermittent rallies in risk assets whenever progress is reported.
- More importantly, the potential for a trade agreement between the U.S. and China (eventually) makes it risky to become *too* careful with one's investments, in our opinion.
- This perspective supports our recommendation to stay committed to risk market investment strategies, while taking actions within these strategies to manage risk downward.
- We consider the recent surge in the number of bonds trading at negative-yields around the world to be a particularly troubling development.
- The total market value of bonds trading at a negative yield-to-maturity recently exceeded $16 trillion worldwide, mostly throughout Europe and Japan.[1]
- Investors have no playbook for navigating such an environment because nothing even remotely similar has ever happened before.
- We describe our interpretation of this important topic below.
- The 2020 elections can also be expected to trigger bouts of volatility for certain industries as investors adjust their expectations with the ebb and flow of the campaign cycle – the introduction of an impeachment inquiry elevates the uncertainty around the elections even further.
- We do not anticipate substantial portfolio activity for purely political considerations in the near-term, but the election does factor into our risk management strategies for certain positions in our portfolios.
- Despite prevailing uncertainties related to U.S./China trade relations, the 2020 elections, impeachment, negative interest rates, and the ever-present possibility of a geopolitical surprise, we believe careful security selection and thoughtful portfolio design can still generate a reasonable long-term return at an acceptable level of risk in the financial markets.

[1] Bloomberg as of August 31, 2019

Assume We Have a Can Opener…

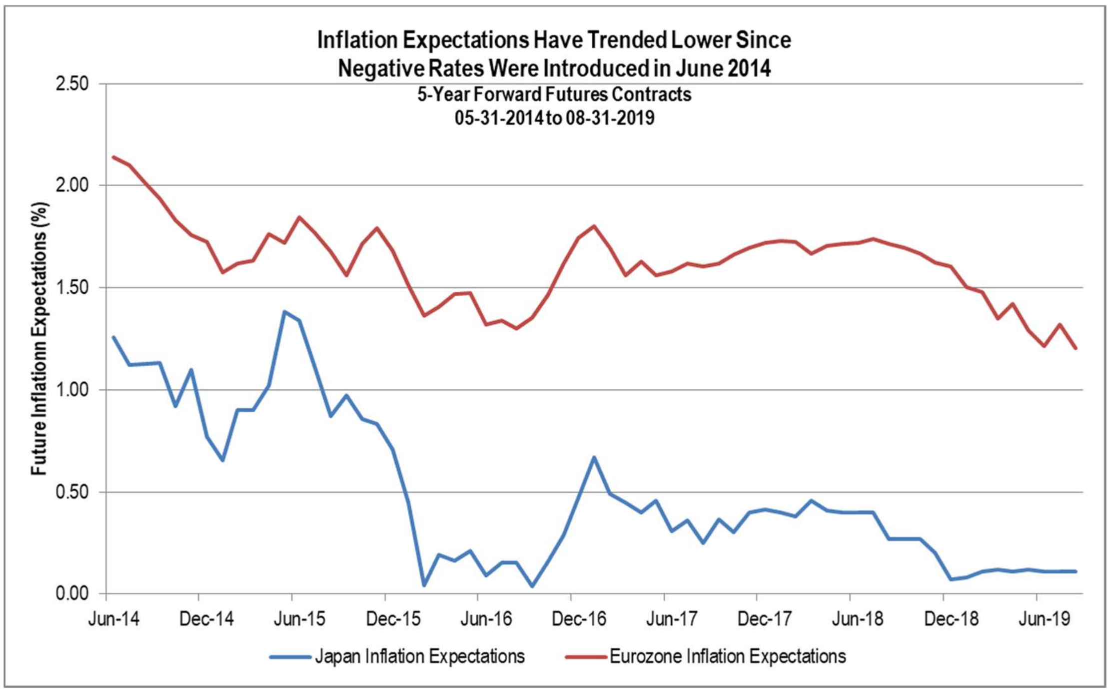
There is a classic joke about economists that goes like this…A physicist, a chemist, and an economist are stranded on an island when a can of soup washes ashore. Troubled by how to open the can, they compare ideas. The physicist suggests dropping the can from a palm tree onto a rock. The chemist suggests heating the can with fire until it pops open. The economist explains his idea saying, "First, assume we have a can opener…"

We suspect this joke might capture a critically important – and little discussed – feature of negative interest rates…that they are supposed to be *temporary*. We say "supposed to be" because the theoretical support for negative interest rates assumes their implementation will be short-term. Indeed, the use of negative interest rate policy arguably *must* be short-lived because the policy carries widely recognized side effects that grow stronger with time. Potential side effects include artificially incentivized risk-taking, market distortions, inequality, penalization of savers, and material stress on the business models of banks, pension funds and life insurance companies.



Source: Bloomberg

Unfortunately, we are now five-years into the first real-world experiment with negative interest rates and the affected economies have yet to respond the way the economists' models predicted they would. According to theory, the shot of adrenaline to spending and investment from negative rates is supposed to raise peoples' expectations for future inflation, resulting in *higher* long-term interest rates. Yet five years into the current test of this theory we find the opposite has occurred – long-term interest rates have *dropped* throughout the Eurozone and Japan, while inflation expectations have shriveled based on pricing in the futures markets.



Source: Bloomberg

Assume No One Hoards Cash...

We believe there is a reason for this disconnect between theory and reality. The "can opener" in our current economic story is cash. The economic models that support the efficacy of negative interest rates work best when they *assume* that no one can hoard cash.[2] This assumption is typically achieved through a make-believe environment with no paper currencies. In a hypothetical world where all currencies are stored electronically, negative interest rates can be imposed on all units of the currency equitably, and no one can avoid negative rates through hoarding.

[2] Reference: Andrew Lilley and Kenneth Rogoff, "The Case for Implementing Effective Negative Interest Rate Policy," April 4, 2019, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3427388

Of course, such an economy does not exist, and there are substantial legal and operational barriers to creating it. All of the current experiments with negative interest rates represent a diluted version of the theoretical ideal because hoarding is an option. Since consumers and companies have alternatives to negative rates (cumbersome as they may be), banks are reluctant to pass negative rates on to their depositors for fear of losing customers. This substantially dilutes the potential stimulus from negative rates because banks are the primary transmission mechanism between central bank monetary policy and the economy. Moreover, negative rates squeeze the profit margins of the banking system, which diminishes its capacity to lend. Needless to say, this dis-incentive in the banking system runs counter to the objectives of the policy.

Err on the Side of Caution

Based upon the evidence to date throughout the Eurozone and Japan, we do not expect negative interest rates to achieve the goals they were designed for. This raises the possibility of an eventual unwinding of these policies in an environment where economic vitality was never restored in the regions where the policies were applied.

No one knows whether the eventual extraction from negative interest rate policies will go smoothly or not. There is no playbook for it because it has never happened before. For now, we are choosing to err on the side of caution, without assuming the worst. This involves deliberate risk management at the strategy level, without wholesale changes in the recommended mix between risk markets and stable assets. Details of these actions are provided below.

Current Design of Our Investment Strategies [3]

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) Despite numerous prevailing uncertainties, we believe careful security selection and thoughtful portfolio design can still generate a reasonable long-term return at an acceptable level of risk.
2) We believe risks to the global economic outlook have increased in recent months, but we continue to expect the U.S. economy to avoid recession.
3) We feel it is appropriate to manage risk lower in this environment, while avoiding excessive caution that might diminish the impact of potential positive developments like a favorable breakthrough on U.S./China trade relations.

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[3] 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.

4) We suspect the growing balance of negative yielding debt throughout the world – and the central bank policies that support it – may be the most important development for investors to monitor for the foreseeable future.
5) We recognize the *possibility* for central banks to unwind their negative rate policies smoothly someday, while remaining vigilant for signs of unintended consequences.
6) The 2020 elections factor into our risk management strategies for certain positions, and we stand ready to make further adjustments as the election cycle evolves.

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. Multi-layer risk management and strategy balance are the focus. In the current environment, slight changes to the factors that control global money flows – such as interest rates, central bank policies and political events – can generate sharp swings in the types of securities that are in and out of favor. We expect the wide policy divergence between President Trump and his key potential opponents to continue overhanging certain groups near term.

The following highlight our third-quarter actions:

- We are 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 continue to rotate towards higher-quality balance sheets.
- We developed a cash reserve within the Managed Equity Growth strategy to cushion short-term volatility and create a resource for potential future opportunities.
- We selectively took profits on companies that have stable, slowly-expanding earnings after the valuations exceeded our targets.
- The wide policy differences between President Trump and his likely 2020 opponents should continue to overhang certain groups near term due to increased uncertainty. We proactively trimmed selected holdings that have direct exposure.
- We continued to take selective profits on "FANG"[4] and certain mega-cap technology stocks. We expect some of these companies to remain under a global regulatory cloud as the competitive landscape evolves with emerging competitors. So far this year, we have diversified FANG exposure into the following areas:
  - Gene editing technologies
  - Robotics
  - Regulatory complexity
  - 5G & the Internet of Things (IoT)
  - Geopolitical Uncertainty
  - Rapid economic change

[4] The "FANG" acronym is commonly used in reference to leading technology companies like Facebook, Apple, Amazon, Netflix and Google.

Managed Equity Growth

Broadly stated, our *Managed Equity Growth* strategy has four primary segments:

- Emerging Franchises: Companies that are pioneering what we believe could become very large markets.
- Core Innovators: Companies that should continue leading large, attractive markets, and could enter and disrupt additional markets. We believe these management teams can innovate at a pace that helps these companies shape the development of multiple markets.
- Core Operators: Companies that have proven abilities to lead large, attractive markets through economic cycles. These are companies we believe can not only endure economic challenges but also emerge in stronger positions, for instance by acquiring troubled companies that have attractive assets.
- Strategic Opportunities: We believe these companies are temporarily undervalued due to either an overreaction to a recent negative event, or under-appreciation of a potential future development.

Near-term capital flows typically rotate among the above categories as global market conditions change. We link that framework into our market outlook to further manage risk while targeting expected, longer-term returns. Portfolio balance helps manage near-term volatility and prevent over-exposure to any narrow group.

Among the core holdings in this strategy we seek to identify companies that are helping shape the development of highly attractive markets. The leading companies and industries of tomorrow are frequently different from those of the past – a key difference between passive and active investing. While we actively manage exposure to these positions to keep the strategy in balance given our market outlook, we tend to give these companies a longer leash to build wealth over time.

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

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

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.

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.

Connectivity Technologies: We believe the rapid development of information and communication technologies is helping change the way value is created. These changes to the way people interact with each other and interpret large amounts of information present significant investment opportunities, in our view. How companies, consumers and societies use cell phones, social media and electronic commerce are just some examples.

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.

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.

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....

Managed Equity Dividend

Our *Managed Equity Dividend* strategy retains exposure to some (not all) of the above trends. It maintains a cash yield of 4%-5% and an active focus on relatively lower-risk, higher-quality balance sheets.[5] During the quarter, we added to aerospace & defense, global telecommunications and 5G, consumer staples, and alternative investments.

The most recent approximation of the strategy's beta versus the S&P 500 Index is 0.69.[6] This statistic represents the amount of a portfolio's movement that is explained by (directly related to) the overall stock market over the past year. Prices can move significantly due to factors not directly related to the market. That said, beta is one of the statistics we can use to get a sense of strategy risk levels. All else equal, a higher beta, above 1.0 say, is typically associated with more risk.

[5] Source: Capital Advisors Inc., Junxure

[6] Source: Capital Advisors Inc., calculated as the sum of each position times its aggregate holding weight

Fixed Income

In July the Fed cut its interest rate target for the first time since the financial crisis in 2008. After a second 0.25% reduction in September the Fed Funds range now stands at 1.75%-2.00%, with an easing bias. The futures market is currently pricing in a roughly 65% probability the Fed will cut rates by another 0.50% by year end.[7] Consequently, Treasury market yields continued their trend lower in recent months, leading to solid price gains across most fixed income securities. 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 actions from the Fed 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. <u>We continue to prefer an "up-in-quality" bias across all bond portfolios</u>.

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 nearer-term 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 flows among the longer-dated bonds in the ladder.

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 <u>neutral to slightly lower duration</u> (sensitivity to a change in interest rates) relative to their respective benchmark durations to manage risk.

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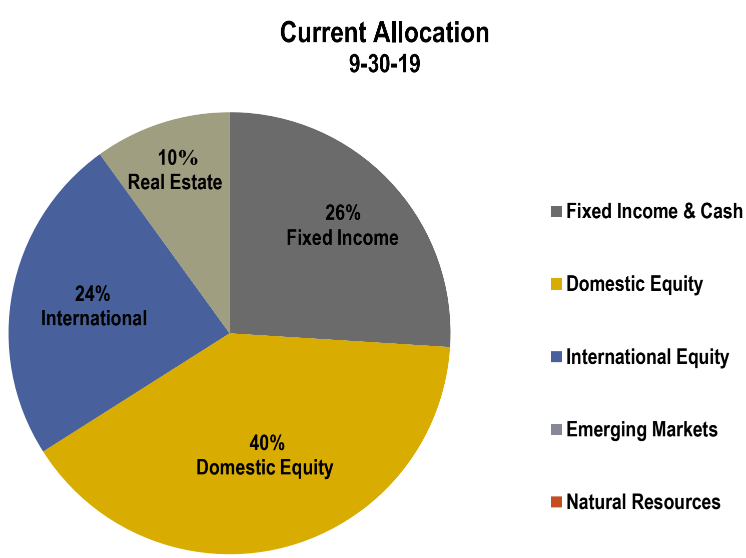
[7] Source: Bloomberg as of September 25, 2019

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.

The strategy shifted incrementally toward caution in August with the sale of the Emerging Markets sector on August 15th, and Natural Resources on August 23rd. As of the end of September the strategy model was committed to three of its five risk market sectors – Domestic Equity (40%), International Equity (24%) and Real Estate (10%), with approximately 26% set aside in short-term U.S. Treasury securities and cash reserves.



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 has been reasonably well positioned for the recent market environment. Since the mid-year re-balance of sector weightings on July 1st, the relative performance rankings for the three over-weighted sectors has been 1st, 3rd and 4th, while, the rankings for the three under-weighted sectors has been 10th, 8th and 5th.[8] In other words, the strategy has successfully directed more money to the market sectors that have performed relatively better, and less into the sectors with lower returns.

Perfection is a pipe dream for the quantitative trading discipline employed by this strategy. However, we estimate a success ratio of just 60% across all of the tactical adjustments that occur over a multi-year time period should be sufficient to add value over a buy-and-hold approach.

Asset Class	**Current Weighting (9/30/2019)**
Large-Cap Growth	Overweight (16%)
Real Estate	Overweight (16%)
High-Yield Credit	Overweight (16%)
Large-Cap Value	Neutral Weight (10%)
Mid-Cap	Neutral Weight (10%)
International	Neutral Weight (10%)
Emerging Markets	Neutral Weight (10%)
Small-Cap	Underweight (4%)
Natural Resources	Underweight (4%)
International Small-Cap	Underweight (4%)

[8] Source: Bloomberg, measured from June 30, 2019 to September 25, 2019; Overweight sectors are Large Cap Growth, Real Estate and High-Yield Credit; Under-weight sectors are Natural Resources, Domestic Small Cap, and International Small Cap

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, or "small-cap."

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.

Unfortunately, valuation is nearly worthless as a tool for market timing. Investors seeking to participate in a potential improvement in the relative performance of non-U.S. equities should be willing to make a long-term commitment to these markets. International equities also offer diversification benefits to a balanced portfolio. These markets can be particularly helpful during periods of weakness for the U.S. dollar exchange rate.

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