OVERVIEW

Third Quarter 2021

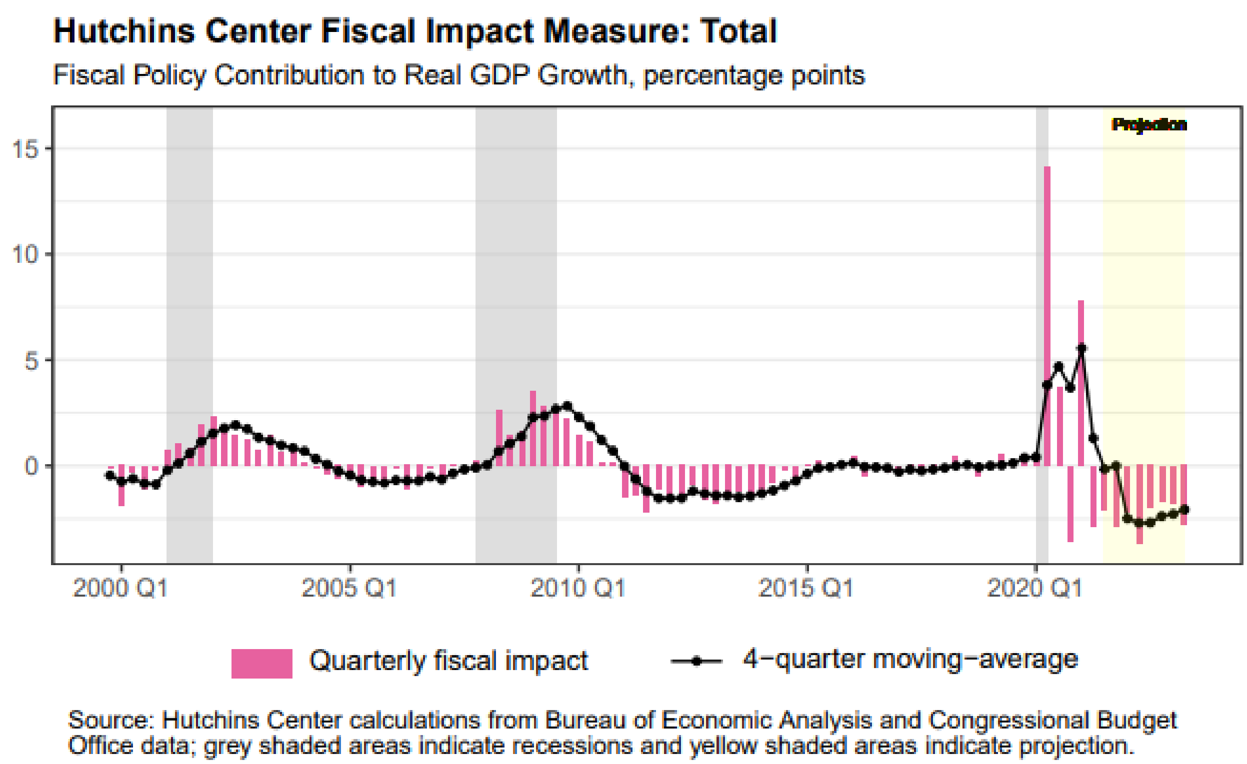
CAPITAL ADVISORS

Key Points

- For investors, the cost of safety has been extraordinarily high for most of the past dozen years due to aggressive monetary policies that helped to push interest rates below the rate of inflation in most of the developed world.
- The prospect of guaranteed losses after inflation for high quality bonds has only worsened in the post-Covid environment due to a substantial uptick in inflation and a doubling-down on aggressive monetary policies by the world's central bankers.
- High quality bonds have an important role to play for risk management in an investment portfolio, but most investors have been forced to move further out on the risk spectrum to pursue the returns they need for retirement spending and/or accumulation of long-term savings.
- Asset markets offer no free lunch, so higher returning assets necessarily expose the investor to a multitude of near-term uncertainties that can break against them.
- The list of potential problems is always evolving, but it is ever-present.
- We suspect the next several months might be particularly interesting in the financial markets because the makeup of the primary risk factors influencing asset prices seems to be shifting.
- We highlight the following risk factors, in approximate order of significance, as the most likely triggers for risk market volatility in the coming months:
    1. A pending "Fiscal Cliff"
    2. China
    3. Inflation
    4. Tax Reform
    5. A pending reduction in monetary stimulus (the "Taper")
    6. Covid
- Note that the ONE issue that mattered most, by far, over the past 18 months – Covid – is last on our list….this is a material change.
- We will elaborate on each of these risk factors in turn below, and describe their influence on our portfolio positioning, as applicable.
- Our hope for this report is to convey our emphasis on risk management during a time when most investors must assume more risk than they prefer to achieve a long-term return that meets their needs.

The Pending Fiscal Cliff

The primary debate among economists this year has been about how transitory the recent surge in inflation will turn out to be. We suspect it might be time to question how transitory the post-Covid economic boom might turn out to be. This is in large part do to the so called “fiscal cliff” that describes the pending return to “normal” budget deficits in the range of 4%-5% of Gross Domestic Product (GDP) beginning in 2022. This represents a step-down in fiscal stimulus on the order of 10% of GDP compared to deficit spending of roughly 15% of GDP in 2020, and 14% this year.[1]



Jan. 1, 2000 – Sept. 30, 2021

The graphic above seeks to measure how much local, state, and federal tax and spending policy adds to, or subtracts from overall economic growth. According to this analysis, the fiscal impact on economic growth crossed from additive to subtractive in the second quarter of this year, and the impact is projected to become deeply negative for the next several quarters as the unprecedented surge in temporary spending programs to combat the pandemic drops out of the year-over-year comparisons.

[1] Source: St. Louis Fed

China

The collapse of China's largest property developer, *China Evergrande*, dominates the headlines today, but the real story in China is much broader than this, in our opinion. For the past decade China has tried repeatedly to rebalance its economy away from debt-driven construction and property development toward greater consumption and services. Progress has been bumpy, and every time there was a hint of trouble the government backed away from policy restrictions and provided support for troubled companies.

This process has repeated itself enough that global investors have become conditioned to expect it again this time, but we believe there are two important wrinkles to consider. First, President Xi has already allowed the *Evergrande* collapse to progress much further than previous disruptions, possibly signaling a greater tolerance for risk this time around.

Second, President Xi recently expanded the scope of his ambitions for reshaping Chinese society to include tamping down the excesses of capitalism and taming the potential influence of business tycoons.

Our sense of the China situation was recently captured well by the Chief Global Strategist at Morgan Stanley, Ruchir Sharma, who said:

> *"What we are likely to witness over the coming months is an epic clash between a leader with supreme powers determined to change the course of his nation, and the economic constraints imposed by gargantuan debts."*

We do not believe the sky is falling in China. The central government has many levers it can pull, and we expect it will use them. However, the Chinese economic model needs rebalancing because it is incompatible with the ambitions of its supreme leader. It will be difficult to navigate the necessary adjustments without setbacks and mistakes, and when these happen, we suspect it to be felt globally.

Inflation

We dedicated a special report to the topic of inflation in May (https://www.capitaladv.com/wp-content/uploads/2021/05/RESEARCH-UPDATE-Inflation-05.24.21.pdf) so we will keep it brief here.

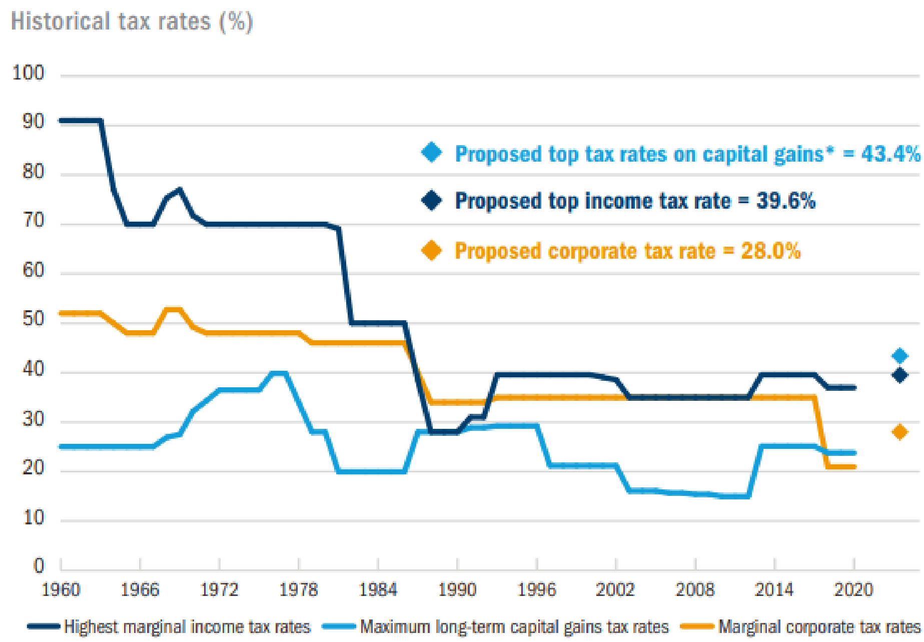
- We believe a sustained acceleration in inflation is one of the most important risks facing financial markets over the next few years.
- We have already reflected the possibility of a deteriorating inflation outlook in some of our portfolio choices, and we stand ready to do more if conditions warrant.
- We believe near-term headlines on inflation might improve as baseline effects from the depths of Covid fade from the year-over-year inflation metrics.
- However, for any improvement to be sustained, broken supply chains need to heal, energy prices need to come off the boil, and housing costs (apartment rents and "owners equivalent rent") need to stop accelerating…time will tell.

Tax Reform

We suspect most investors believe tax reform is likely, even though the specifics have yet to finalized. The proposed increase in corporate taxes may have the most direct impact on financial markets. Policies under consideration would raise the corporate tax rate by five-to-eight percentage points, while increasing domestic taxes on certain foreign profits. If enacted, these changes are expected to reduce after-tax corporate profits by 5%-7%,[2] implying a negative adjustment for stock prices in the same range, all else being equal.

Capital gains taxes also influence asset prices directly, although their impact is diluted by the preponderance of assets held in tax-deferred retirement accounts and non-profit endowments and foundations. For this reason, we do not expect an increase in the capital gains rate – viewed in isolation – to have a material impact on stock prices.

Jan. 1, 1960 - Sept. 30, 2021



Source: Tax Policy Center

*The proposed capital gains tax is levied for households earning more than $1 million per year and includes the 3.8% net investment income tax.

The broader question involves the various tax proposals *in aggregate*. As the chart above reflects, the general trend in tax rates has been lower for more than 60 years, with intermittent increases in one or another of the three major tax categories – capital gains, personal income and corporate. The prospect of a material *and simultaneous* increase in all three tax rates represents a substantial change in a major input for economic decision making. The consequences are uncertain.

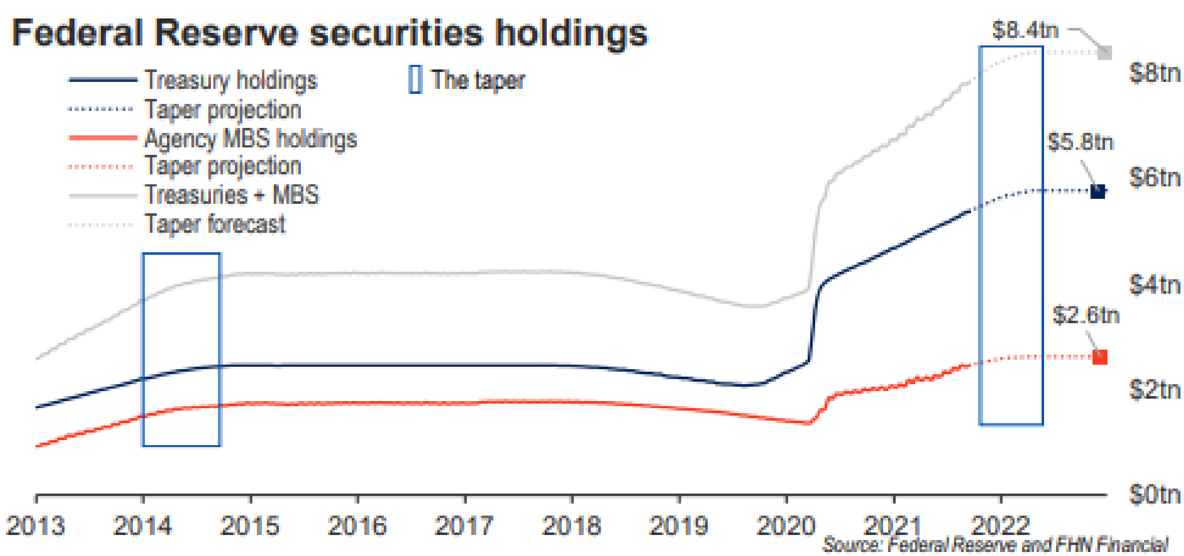
[2] Source: Goldman Sachs correlates a 25% corporate tax rate with a 5% reduction in corporate earnings; I/B/E/S data from Refinitive estimates a 28% corporate tax rate would reduce earnings by 7%.

Monetary Policy and the "Taper"

Barring an unforeseen calamity between now and the next meeting of the Federal Open Market Committee on November 3rd, the Fed is widely expected to begin tapering its monthly asset purchases in either November, or December. The Fed expects to complete the tapering process by mid-2022, at which point the central bank will own approximately $8.4 *trillion* of U.S. Treasury and mortgage-backed securities.[3]

It is widely noted that tapering is not tightening. Between now and mid-2022 the Fed will continue adding liquidity to the global financial system, just at a slower pace. Moreover, when the taper is complete the Fed plans to maintain its balance sheet at its terminal level around $8.4 trillion by reinvesting future bond maturities and coupon payments into new securities. In addition, the Fed has been adamant that the first move to normalize interest rates will not be considered until after the taper is complete, so short-term interest rate should remain anchored to zero until *at least* the second half of next year.

Jan. 1, 2013 – Sept. 30, 2021



Based on the latest guidance from the Fed, nothing about monetary policy will be "tight" for quite some time. Even so, the rate of change for monetary stimulus is poised to shift downward for the first time in 18-months, so it matters.

If the playbook from past tapering cycles holds, investors should anticipate a modest "flattening" of the yield curve in the months to come, which refers to a decline in the spread between the yields on short-term bonds relative to longer-term bonds. Rather than torture the reader with the specifics of a flattening yield curve, suffice it to say it is nothing to fear, and we're on it.

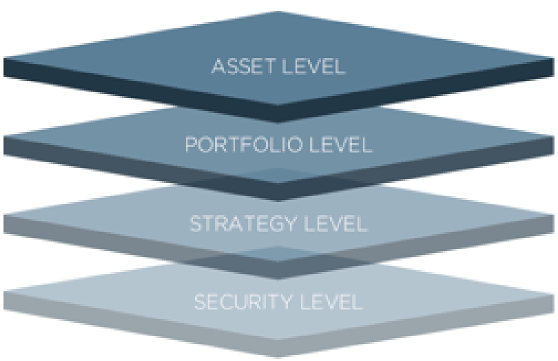
[3] Source: FOMC press release and press conference, Sept. 22, 2021; FHN Financial

Covid

We believe investors and policy makers are approaching acceptance that Covid has become the new normal for life on earth. We do not diminish the tragic implications of this reality for humanity, but this is a discussion of investment strategy. Among market participants, we suspect the investment ramifications of Covid are well enough established to diminish its importance to "just" one of several risks to monitor and respect, rather than the only thing that matters.

Current Design of Our Investment Strategies[4]

The remainder of this report addresses the current positioning of each of our investment strategies. Broadly speaking, we have continued adjusting to a changing market climate within our *Managed Equity* strategies. Our *Fixed Income* strategies are positioned toward the shorter end of the maturity spectrum (relative to their respective priorities) to soften their sensitivity to rising interest rates. The *Tactical ETF Strategies* have reduced exposure to international equities relative to domestic markets, and the *Dynamic Allocation* strategy has shifted approximately 40% of its portfolio to short-term U.S. Treasuries and cash reserves.



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.

<u>Managed Equity Growth</u>

The strategy remains invested in a diversified set of "growth" and "value" stocks. We recently increased the strategy's cash level off a relatively low position. The strategy uses cash for risk management, and as risk capital to be deployed into new opportunities. We took some profits in "deep finance" (or shadow banking), as well as growth-style investments that receive a particular boost from COVID vaccine manufacturing.

[4] 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.

We believe it is important to remain focused upon highly talented and proven management teams that can navigate a variety of significant challenges, including supply and logistics bottlenecks, labor shortages, expense pressures, and fluctuating demand patterns, particularly from China.

The strategy's core objective remains to identify the key areas of sustainable global economic growth and innovation and identify management teams and business models in the best position to help shape these trends' long-term development paths. These companies tend to have management teams with proven operational track records and business models that have pricing power. Following is a representative framework of the strategy's current positioning:

Health Care Innovation
- Danaher
- Thermo Fisher
- SPDR Biotech ETF

Genomics
- Beam Therapeutics
- CRSPR Therapeutics
- Intellia Therapeutics

Robotics
- Intuitive Surgical
- Stryker

Business Model Disruption & Digitization
- Accenture

(Quantum Computing)
- Honeywell

Financial Disruption
- PayPal
- Sea
- Lemonade
- (Visa)

"Emerging Market" Innovation
- Sea

EVs
- NXP Semiconductors
- Magna International
- General Motors

Internet of Things - Connectivity

Cloud A.I. & Video
- NVIDIA
- Alphabet

Wearables
- Apple

Managed Equity Dividend

Our objective continues to emphasize a cash dividend yield in the range of 3.5% to 4.5% during the foreseeable financial market environment. As part of our risk management strategy, we deliberately balance leaders of mature industries (such as Energy and Pharmaceuticals) with leaders of longer-term, higher-growth economic trends (such as 5G and biotech innovation).

Market interest rates rose after the Federal Reserve completed its most recent meeting and announced a more formal intention to slow the rate at which it buys bonds. Historically, "tapering" has at least temporarily supported interest rates. We have taken action to support the strategy's yield in-line with an economy that remains flush with liquidity while experiencing significant supply and logistical challenges.

We believe there is medium-term risk to Chinese property and construction activity as well as Chinese funded "Belt & Road" investments in emerging markets. The Chinese central government has long balanced its support of the innovation that spurs lasting economic growth and the influence of billionaires and other activities that such open innovation creates.

Municipalities have supported the finance of construction and other activities that have boosted local economies, raising significant debt in the process. Chinese authorities have long recognized the problems growing systemic debt would create, in our view. The Evergrande situation's more lasting impact could be a shift in behavior among Chinese lenders (including municipalities) that restrains liquidity flows towards certain new projects, especially speculative ones. We have trimmed the strategy's exposure to "deep finance," or shadow banking, as well as stocks that have direct exposure to Chinese construction demand.

Early in the quarter, we boosted investments in Finance and Utilities. Banks can directly benefit from higher longer-term interest rates and stable economic activity. Utilities could benefit, over time, from the transition to an electric-based global economy – for instance cars shifting from gas stations to plug-in recharging. Utilities are exposed to regulatory changes (particularly carbon pricing legislation) and the costs involved in transitioning to a lower-carbon energy generation infrastructure. We therefore favor management teams who recognized and acted upon this structural shift relatively early. Regulated utilities typically pass through, to customer bills, the costs of investments and higher operating expenses.

During the 2020 economic shutdown we took advantage of opportunities to add iconic companies at what we viewed as highly discounted valuations and uncommonly high dividend yields – examples include **Home Depot (HD ~$328)** and **Texas Instruments (TXN ~$192)**. As the 2021 economic recovery has matured, these stocks have recovered nicely, and consequently their dividend yields have declined. We continue to actively manage these positions and carefully rotate the gains into higher-yielding investments. One example is the sale of **UPS (UPS ~$182)** – which reached a sub-2% yield – and purchase of **Broadcom (AVGO ~$485)** a wireless and networking semiconductor leader that also has a significant cyber security business and yielded over 3%.[5]

Fixed Income

The third quarter experienced a moderate reversal in the level of interest rates after market yields dropped in the second quarter. Most of Capital Advisors' fixed income portfolios performed slightly negative due to declining bond prices. The bond market continues to flesh out transitory versus longer-lasting inflationary pressures, and while many of the key components to inflation appear to be rolling over, many factors may have yet to see the peak. In addition, the Fed has all but said a tapering of its bond purchases will occur sometime between the 4th quarter of this year and mid-2022. As such, within all our fixed income strategies, we remain defensively postured to a rise in interest rates.

[5] Source: Bloomberg

Individual Bond Management

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.

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. 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.

Managed Credit Strategies

Within our *Managed Credit Strategies*, we have attempted to tilt the portfolios toward better credits, with roughly 70% of our clients' exposure to companies currently rated A- or better, on average.[6] Although the growth outlook for corporate America seems to be supportive in what is still an accommodative, low borrowing cost environment, we want to remain well balanced and under-exposed to lower quality credits. We do believe our BBB exposure has better balance sheets than the broad market, and we are willing and able to further reduce this exposure should we see specific situations worsen.

Municipal Bonds

Within our *Municipal Bond* portfolios, we continue to focus 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." The municipal bond market has proven to be extremely resilient to rising rates in 2021 and holds the honor of being the best performing investment-grade asset class year-to-date[7]. Markets are closely watching proposed tax reform packages being discussed in Washington to help determine the magnitude to which any changes would incrementally add to/detract from the demand for tax-exempt securities.

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[6] Source: Orion

[7] Source: Bloomberg

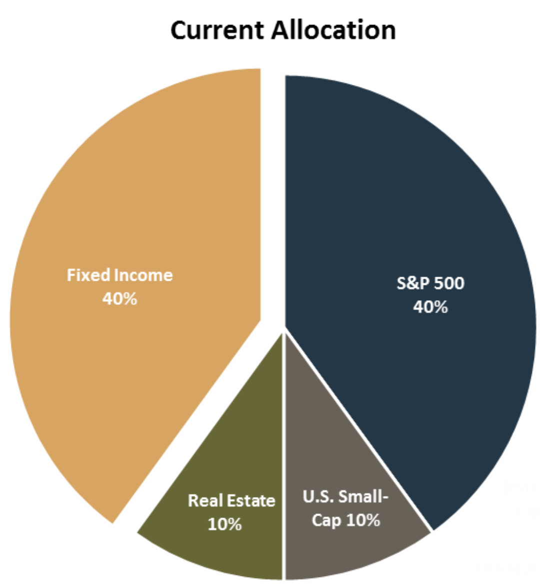
ETF Bond Models

Within our *Aggregate Bond* (ETF) strategy we continue to emphasize "defined maturity," investment-grade corporate bond ETFs. Today, there is a relatively even laddered maturity structure of ETFs ranging between 2023-2027, thus remaining somewhat conservative from an interest rate sensitivity perspective. Combining the higher yield of corporate debt with a lower duration profile has provided some downside protection from rising rates in 2021.

Within our *Income Bond* (ETF) strategy we have focused on maximizing cash flows within the construct of balancing risks. Within the quarter, we added to our strategic exposure to the **SPDR Blackstone/GSO Senior Loan ETF (SRLN: ~$46),** a limited duration, senior secured, floating-rate portfolio of corporate loans, has performed extremely well in a supportive credit market and rising rate environment. Alternatively, we sold the **SPDR Bloomberg Barclays Emerging Markets Local Bond ETF (EBND: ~$25)** which underperformed expectations due to its reliance on currency trends in various emerging economies, headlined by China. Lastly, the strategy maintains sector and quality balance with over 40% exposure in "AAA" government guaranteed agency mortgage bonds and Treasuries via our investments in the **iShares Mortgage-Backed Securities ETF (MBB: ~$108)** and the **SPDR DoubleLine Total Return Tactical ETF (TOTL: ~$48).**

Dynamic Allocation Strategy

The strategy recently implemented a second defensive step with the removal of the **International Equity** sector from the portfolio at the end of September. This follows the removal of **Emerging Markets** in August. With these changes the strategy reduced its allocation to risk markets to approximately 60% of its assets, with the remainder in short-term bonds and cash reserves. These adjustments reflect relative weakness among emerging markets and international equities sufficient to push these sectors below their moving average trend lines.



The *Dynamic Allocation* strategy can be incorporated into a diversified portfolio to systematically adjust the equity-to-fixed income mix in the portfolio based upon prevailing market conditions. Portfolio changes are driven by a quantitative marker called a "moving average." Each of five risk market sectors is retained in the portfolio whenever they demonstrate a positive price trend, and they are removed when the trend turns negative. The strategy is designed to complement the core of a diversified portfolio by delivering tactical adjustments to market exposures unemotionally.

Tactical Global Growth Strategy

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.

Tactical Global Growth Strategy
Asset Allocation for the Upcoming Quarter

Asset Class	Current Weighting (10/1/2021)
U.S. Small-Cap	Overweight (17%)
U.S. Mid-Cap	Overweight (17%)
Real Estate	Overweight (17%)
Large-Cap Value	Neutral Weight (11%)
Large-Cap Growth	Neutral Weight (11%)
International Small-Cap	Neutral Weight (11%)
High-Yield Credit	Underweight (5%)
International	Underweight (5%)
Emerging Markets	Underweight (5%)

Five market sectors will see an allocation change for the upcoming quarterly holding period. Real Estate and Large-Cap Growth will see an increased target weighting, while Emerging Markets, International, and International Small-Cap will see a reduction. These changes reflect the recent weakening in relative performance for international markets relative to the U.S., most notably emerging markets. The strategy is performing well in 2021 on both an absolute basis, and relative to benchmark indexes.

In addition to normal quarterly rebalance activity, we have elected to change the investment vehicle we use to access the high-yield credit sector to take advantage of a higher distribution yield and lower expense ratio for the new fund. Effective with the current quarterly rotation, the new fund for high-yield credit will be the **SPDR High Yield Bond ETF (SPHY: ~$27),** replacing the **iShares iBoxx High Yield Corporate Bond ETF (HYG: ~$88).**

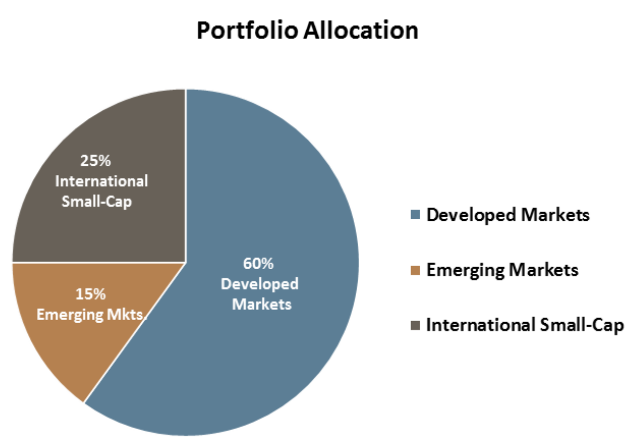
We consider these two funds to be substantially similar regarding industry diversification and credit quality. The primary differences relate to distribution yield and expense ratio. The new fund compares favorably on both fronts, in our opinion.

The net indicated distribution yield for the new fund is 4.84%, compared to 3.76% for the fund it replaces. Importantly, SPHY has an underlying expense ratio of 0.10% (10 basis points), versus 0.49% for HYG (49 basis points). The lower expense ratio for SPHY can reduce the annual friction costs for the strategy by a range of 2-to-7 basis points, depending on whether the high-yield credit sector is under- or over-weighted. Every little bit helps.

Please use the following link to access more detailed information about the SPDR High Yield Bond ETF, including important disclosures:
https://www.ssga.com/us/en/intermediary/etfs/funds/spdr-portfolio-high-yield-bond-etf-sphy

International Focus Strategy

The International Focus strategy provides a strategic commitment to international equities to expand the universe of companies for investment beyond the U.S. market. 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."



Emerging markets performed poorly during the third quarter, led by declines in Chinese equity markets, which have a material weighting in most benchmark indexes for the sector. Emerging markets may face continued headwinds related to Covid, inflation, commodity costs and a rising dollar. Compelling valuation provides an offset to these challenges for long-term investors, in our opinion. The relative valuation of emerging market equities compared to the U.S. stock market has rarely looked better since the inception of organized metrics for emerging markets in 1989.[8]

[8] Source: Bloomberg; MSCI

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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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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, https://adviserinfo.sec.gov/firm/summary/104643

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