# Sheaff Brock

Innovative Portfolios for Intelligent Investors™

# MARKET UPDATE

## October 2016

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**Invest 45 Minutes to Build your Knowledge and Skill as an Investor**

Look for our email invitations to our webinars, or call our office for a reservation.

In Sheaff Brock's November **Knowledge Builder** webinar, we'll talk about ***"Rate Risk: Understanding the Dynamic Nature of Interest Rates and Your Bond Portfolio."*** Our guest presenter is Leo Dierckman, Managing Director of Oppenheimer Investment Advisors, who will offer strategies to manage the fixed income portion of your portfolio both now and when interest rates begin to rise.

**November 16 and 17 from 7:00 to 8:00 pm EST**

Upcoming **Knowledge Builder** in December: Financial Planning 101: Planning for the New Year

"A bird that fears turbulence will never know how high it can fly."

Matshona Dhliwayo

## Monthly Update

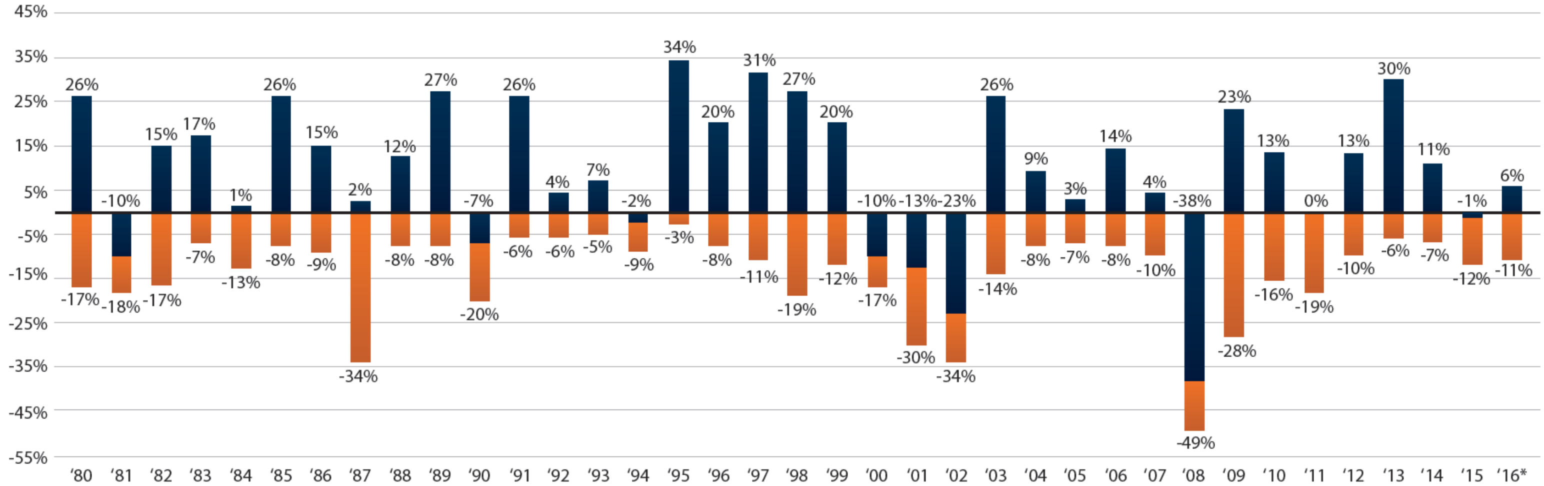
Publication date: 10/25/16

- Preflight Safety Information
- Election
- Portfolio Updates

Check out sheaffbrock.com for our latest column at abcnews.com.

## Intra-Year Declines vs. Calendar Year Returns

Volatility is not a recent phenomenon. Each year, one can expect the market to experience a significant correction, which for the S&P 500 has averaged approximately 14% since 1980. Although past performance is no guarantee of future results, history has shown that those who chose to stay the course were rewarded for their patience more often than not.




*YTD through 9/30/16.

Source: First Trust Advisors L.P., Bloomberg. The benchmark used for the above chart is the S&P 500 Index. The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges. Returns are based on price only and do not include dividends. This chart is for illustrative purposes only and not indicative of any actual investment. These returns were the result of certain market factors and events which may not be repeated in the future. Past performance is no guarantee of future results.

### Preflight Safety Information

You have all heard the following spiel countless times:

> *To fasten your seatbelt, insert the flat metal end into the buckle. To release, lift up on the top of the buckle. Seatbelts must be worn low and tight across your lap whenever the "fasten seatbelt" sign is turned on. Although we never anticipate a change in cabin pressure, should one occur, four yellow oxygen masks will drop from the ceiling compartment overhead. If this happens...*

Turbulence is an expected byproduct of a flight. And even though nearly everyone on the plane has heard the above speech many times and experienced some turbulence, a certain percentage of passengers still freak-out when turbulence shakes them around.

Volatility (turbulence) is an expected byproduct of the stock market. Before investing, a client is given all kinds of disclosures (preflight speech). And even though nearly every investor has seen the disclosures and witnessed many years of market volatility, some investors still freak-out when volatility shakes their account around.

The chart above shows 37 years of two things:

The **blue** bars show the annual return of the S&P 500 Index. The average annual return over the 37 periods is 9.7%. But look how often the annual gain was between 9 and 11%; only twice! So, even though the average is about 10%, in any given year the market almost never returns 10%. Ninety-five percent of the time, the stock market "flight" was not smooth, but way-up or way-down. When the market went down (about 20% of the time), it dropped an average of -13%. When the market went up (80% of the time), it gained an average of 16%! Returns have been volatile. Over the 37 year "flight", the fasten seatbelt light has been on almost the whole time and, a couple of times (1987 and 2008-2009), the oxygen masks fell out of the ceiling!

The **orange** bars show the corrections, the downdrafts. Every year there has been a downdraft. *Every year*! The average annual correction has been –14% and, more often than not, the pullback has registered double-digits. Even in the good years for the market, the intra-year correction has often been double-digits.

On a plane, a passenger might freak-out but they can't get off the aircraft. Instead, they close their eyes and sit white-knuckled until the pilot stops the plane, the little ding rings, and then they exit, safely, at their destination. Passengers can't get out until the pilot lets them.

When investing, the investor is both the passenger and the pilot. This dual-role can sometimes be a problem. For the undisciplined investor, volatility of returns, downdrafts, and falling yellow oxygen masks cause such angst that that they can't stomach the stock market. Even when shown over 100 years of historical data proving positive long-term investor results, the undisciplined bail-out, often near the bottom of a correction.

Regarding the stock market:

- Expect volatility and learn to use it to your advantage.
- Stay onboard until your final destination. Stay the course.
- Returns are almost never average, so don't expect them to be.

### Election

This letter will land in your mailbox very near election day. Talk about a bad flight! This campaign has required one barf bag after another. In preparation for potential turmoil, we have been raising some cash in most of our equity portfolios. Better safe than sorry and, if there is some volatility, we would like to be able to take advantage of it.

## Portfolio Updates

Besides the January - February market swoon, 2016 (at least through today, October 25th) has been fairly quiet and generally positive. Bonds have gained low single-digits. The stock market has been variable. The S&P 500 is up about 7%. The energy sector has been the best so far, up 16%, and the healthcare sector is wearing the dunce cap, down –3%. As this is being written, earnings season is in full bloom. About a month ago, many pundits were predicting another bad quarter for earnings. The "Doubting Thomas" crowd looks like they will be wrong. Of the companies reporting thus far, 80% have beat earnings estimates and two-thirds beat on revenues. Mergers and IPOs are percolating. Currently, the forward P/E ratio for the S&P 500 is 16.6. Stocks aren't cheap, nor are they very expensive.

### Preferred Income

As a group, preferred stocks are priced pretty close to where they started the year. Prices peaked in August and since then, have hit a couple of air pockets. The most recent turbulence surrounded the kerfuffle caused by Deutsch Bank. Our composite of accounts gave back a little in September but is still up 5.6% year-to-date, through September of 2016. Our portfolio's current yield is north of 5.7% and has a yield-to-worst call over 4%. The average call is about 4.75 years. The Fed's interest rate decisions in the next quarter will likely impact prices, although much of the potential effect is already baked into the cake. Single digit yield + decent stability > Poke in the eye with a sharp stick.

### High Yield Bonds

Our high-yield bond portfolios have had a great year by turning in a total return of over 10% through September 30th. Our offering is a diversified portfolio with about 50 different bonds. Some of the bonds are issued by companies you know, and some are from companies you might not know. This approach is different than a large ETF in which would have several hundred positions. Oppenheimer Investment Management runs the accounts for us and does very nice work. In fact, in November our ***Knowledge Builder*** webinar will feature Leo Dierckman, Managing Director for Oppenheimer. He will speak on interest rates and fixed income. Watch for an invite.

### Dividend Growth & Income

It's our flagship portfolio of high quality, dividend paying companies which have historically raised dividends. It is a value driven portfolio filled with mostly boring stocks. For the better part of a month we have been selectively selling stocks with higher downside risk numbers and building up cash. Currently the average account's cash position is 16%. We are taking the "bird-in-the-hand" approach before the election, and if we are mistaken we would rather err on the lower risk/sleep-at-night side of the coin. Including the heavy cash position, our portfolio's dividend yield is still over 3%. Through September 30, the composite's total return is 5.42%.

### Bulls of the Dow

In August and September, the ten Bulls gave back 1.5%, making their 9 month total return 4.95%. In early October we did our quarterly rebalance and two Bulls were replaced.

### IntelliBuilD Growth™

IntelliBuilD is the blend of up to 33 American stocks from *Investors Business Daily* lists, and is mostly mid-cap and small-cap stocks. It has been a tough year for *Investors Business Daily's* IBD 50 index, as well as for our IntelliBuilD portfolio. The portfolio characteristics are strong, really strong. The list has a reasonable P/E, high earnings growth, and low debt. Performance has always been in fits-and-starts, but it has been a tough year with the composite down –6.8%.

### Mid-Cap 10

This is a portfolio of ten mid-cap stocks chosen by a momentum based computer program out of a pool of 120 stocks. September was good at +1.44%, but 2016 has been difficult, down -8.65%. We are hoping for it to hit a bunch of 3-pointers (basketball lingo) in the 4th quarter. There is a lot of turnover in the portfolio because the quant-program is always seeking the best momentum.

### Alternative

Emerging markets and commodities are on the move, which is what this portfolio is all about. It has a nice year going, +9.04% through September 30th. Interestingly only 5 of the 9 months in 2016 have been positive for the portfolio, but the good months have been really good. The commodity beat-down was a long time in the making, so we might be in for a longer than normal recovery. If you don't have much exposure to emerging markets and hard assets, you should ask your portfolio consultant about moving some funds into this portfolio.

### Covered Call

This month, as stocks have been called away, Wally is letting the cash accumulate. Currently the Covered Call accounts have 13% cash. He has generally been using shorter-dated, closer to the money calls. If volatility picks up, we will likely sell longer dated calls in order to lock in higher option yields for a longer time. Today, across all accounts in the composite, the standstill-simple option yield (if the stocks are flat, the theta yield generated by the option time decay) is annualized at 6.5%.

*The following option overlay products are intended to be additive in return to other investments held in an account. Selling puts in* ***Put Income*** *generally adds cash, slowly-but-surely, to an account, however realized gains come in a very erratic fashion. Completed transaction-trails on a security can last many months.* ***Index Income*** *is a series of laddered, one through three month put credit spreads on an S&P 500 index ETF. There is no "trading" in either strategy as they are simply unleveraged, time decay strategies. Selling put options on equities or credit spreads on an index to generate cash-flow is an income strategy based on equity prices. A short put, below the strike price, carries the same risk as owning the stock or index. Historically, the cash-flow from overlays has been positive from year-to-year. However, realized gains and losses are very inconsistent. Generally speaking, when the stock or index is flat or rising, gains are realized. When prices fall, losses are realized. These are long-term strategies and may not produce capital gains over the short-term.*

## Put Income

Put Income accounts have improved in total return this year along with improvement in commodity type stocks. We have been active at taking gains in the last couple of months. Cash-flow generation has been below average for accounts over 18 months old, however newer accounts have seen reasonable cash-flow and realized gains. Some legacy positions (like WLL, FOXA, MU, WFL, BX, VIAB, and GILD) which were severely beaten-up, have regained some footing helping total return. Newer names (in the last year), generated through the "Downside Risk" analysis, have acted quite well. One change many of you will notice in November (probably post-election) is a position in index puts on the S&P 500. Options on the S&P 500 eliminate the single stock risk and have historically produced smoother results. It is common for a stock to drop 20% in price, but it is uncommon for the index to do that. And if so, recovery is normally months, not years. Also, over time some risk will likely be shifted from direct equities to indices. Lower risk, lower commission costs, and smoother historical returns. We have been studying this for well over a year, and it is time for the shift.

## Index Income

For several months we have launched a soft introduction to a more simple alternative to the regular Put Income (which has proven to be too complex for some people). We are discontinuing all of the aggressive strategies which use leveraged spreads or condor positions, and morphing those strategies into this. Not as exciting, but more consistent. The Index Income is simply an unleveraged put spread, where a put is sold on an S&P 500 Index ETF about 4% out-of-the-money, and that is paired with a long, insurance put 15% below. Spreads are staggered over three months. The insurance (think high deductible) is to protect an account against a "black swan" market collapse, like 1987 or 2008—09. By using the S&P 500 instead of individual stocks, diversification is higher but there is still market risk. So far, about $20 million of capital has migrated to this product. Because the S&P 500 ETF started trading over 25 years ago, it is easy to examine how many months a client would have had to roll out an index put position, in order to capture a realized gain. It is a simple, low trading volume, watching-paint-dry type of option overlay product.

If you have any questions or comments regarding this letter, including any portfolio or composite, please contact our Chief Compliance Officer, Audrey Kurzawa at audreyk@sheaffbrock.com; you can also reach her, or any other Sheaff Brock representative, at 317-705-5700.

| Style | Performance Update<br>Portfolio | Thru Sept - 2016 | 2015 | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|---|---|---|
| Fixed Income | **Preferred Income** - Preferred stocks | 5.58 | 5.22 | 14.02 | -4.57 | 9.10 | | |
| | **High Yield Bond** | 10.17 | -7.32 | -1.93 | 8.78 | 15.38 | 3.99 | 15.93 |
| Growth and Income | **Covered Call Income** - Quality stocks & covered calls | 2.51 | -1.20 | 6.39 | 23.56 | 11.56 | -10.25 | |
| | **Dividend Growth & Income** - Dividend paying stocks | 5.42 | -7.16 | 5.20 | 36.09 | 12.36 | 5.36 | 17.09 |
| Growth | **IntelliBuilD Growth** - IBD growth stocks | -6.80 | 2.57 | 7.62 | 19.69* | *9/1/13 inception date | | |
| | **Bulls of the Dow** - 10 strongest of the Dow 30 | 4.95 | 1.14 | 12.42 | 30.05 | 7.83 | | |
| | **Mid-Cap 10** - Mid-cap growth momentum stocks | -8.65 | -12.68 | 11.84 | 24.32 | 23.55 | 21.88 | 21.26 |
| Alternative | **Alternative** - Metals, foreign currencies, commodities | 9.04 | -8.25 | -4.23 | -0.70 | 9.02 | -7.74 | |
| Option Overlay | **Put Income** - Overlay of short equity puts | *-0.18* | *-9.17* | 0.56 | 5.92 | | | |
| | **Index Income** - Overlay of unleveraged put credit spreads | 2.19* | *4/30/16 inception date | | | | | |
| | **Index** | | **2015** | **2014** | **2013** | **2012** | **2011** | **2010** |
| | **S&P 500** | 7.84 | 1.38 | 13.69 | 32.39 | 16.0 | 2.1 | 15.1 |
| | **CBOE S&P 500 Buy/Write** | 4.31 | 5.24 | 5.64 | 13.26 | 5.20 | 5.72 | |
| | **Barclays Aggregate Bond** | 5.80 | 0.55 | 5.97 | -2.15 | 4.2 | 7.8 | 6.5 |
| | **DB Commodity Index Tracking Fund (NAV Total Rtn.)** | 12.61 | -27.41 | -28.18 | -7.57 | 3.31 | -2.71 | |

Composites include all fully discretionary, management fee-paying and, beginning on January 1, 2011, non-management fee-paying accounts, including those accounts no longer with the firm of reasonable size that are substantially invested in accordance with the composite strategy or style. Returns are presented net of management fees and all trading expenses, and the reinvestment of all income. Put income results are only realized gains and Index Income reflects the total return of only the option overlay. Net-of-fee results were calculated using actual management fees. Actual advisory fees and transaction fees will vary depending on, among other things, the portfolio, account size, and activity. Fees are described in SBIA's ADV Part 2A. *Denotes partial year, with note reference. Prior to 2015 Mid-Cap 10 was a model account. Prior to October 1, 2015 Preferred Income was sub-advised by Trust Investment Advisors, Indianapolis, IN.

Benchmarks: The S&P 500 Index is a market capitalization-weighted index comprised of the 500 stocks with the largest market capitalizations trading in the United States. This is not a managed portfolio and does not reflect the deduction of fees or expenses; returns include dividends. The Barclays US Aggregate Bond Index is a broad-based benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market in the United States, including Treasuries, government-related and corporate securities, mortgage backed securities, asset-backed securities and CMBS (agency and non-agency). The CBOE S&P 500 Buy-Write Index (BXM) is a passive total return index based on buying an S&P 500 stock index portfolio, and selling the near-term S&P 500 Index (SPX) covered call option, generally on the third Friday of each month. The SPX call will have about a one month expiration, with an exercise price just above the prevailing index level, slightly out of the money. The BXM Index does not take into account significant factors such as transaction costs and taxes and, because of factors such as these, investors should be expected to underperform passive indexes. The BXM Index represents a hypothetical buy-write strategy. DB Commodity Index Tracking Fund (DBC) The PowerShares DB Commodity Index Tracking Fund seeks to track changes in the level of the DBIQ Optimum Yield Diversified Commodity Index Excess Return™ plus the interest income from the Fund's holdings less the Fund's expenses. The Fund is designed for those who want a convenient way to invest in commodities. The Index is composed of futures contracts on 14 of the most heavily traded and important physical commodities in the world. The Fund and the Index are rebalanced and reconstituted annually in November. The Alternative portfolio is a commodity centric portfolio of ETFs and mutual funds whose constituents' profits are highly sensitive to general commodity prices. It may perform differently than DBC since the composite does not hold futures contracts. Indexes are unmanaged and unavailable for direct investment. Benchmark returns include reinvestment of income, but do not reflect taxes, or other fees that would reduce performance. Performance information of benchmark indexes is included for comparison purposes only. Two general types of benchmarks are provided.. The first type is a well-known and widely-recognized index, such as the S&P 500 Index (described previously), and the Barclays US Aggregate Bond Index (described previously). These types of indices are not selected to represent an appropriate benchmark, but rather to allow for comparison of a composite's performance to that of a well-known and widely recognized index. The second type of index is a narrowly-focused (NF) index selected on one or more characteristics, (continued page 1)

# year-end SHEAFF BROCK CHECKLIST

**Now may be an ideal time to consider year-end tax strategies that may benefit you and help you plan for the year ahead.**

**Questions? Call your Sheaff Brock Portfolio Consultant at 866.757.5700.**

Sheaff Brock

Innovative Portfolios for Intelligent Investors

## GENERAL STRATEGIES

### Offset Capital Gains and Defer Income

- ❏ Harvest your losses by selling taxable investments, keeping in mind short-term losses are most effective at offsetting capital gains. **Note:** wait at least 31 days before buying back a holding sold for a loss to avoid the IRS wash sale rule.
- ❏ Take your deductions this year (pay your Q4 state income tax payment, medical expenses, deductible interest and alimony payments before January 1st.)
- ❏ Evaluate if you should delay purchasing mutual fund shares until January 1st to avoid capital gains taxes on brand new investments.
- ❏ Defer your year-end bonus, the sale of capital gain property and receipt of distributions to delay income to 2017.
- ❏ Increase your W-2 federal income withholding amount in preparation of a significant tax bill or to avoid the under-withholding tax penalty.
- ❏ If you are subject to the Alternative Minimum Tax (AMT), or if you are close to being in the Alternative Minimum Tax, you should speak with your CPA or other tax advisor before implementing these strategies.

## RETIREMENT PLANNING

### Seize Opportunities and Avoid Missteps

- ❏ Confirm your retirement income is on track by speaking with your Sheaff Brock Portfolio Consultant (PC) to complete your Retirement Income Map.
- ❏ If you are 50 or older, take advantage of catching up on IRA contributions and certain qualified retirement plans.
- ❏ Maximize your IRA contributions.
- ❏ Consider converting from a Traditional IRA to a Roth IRA.
- ❏ Avoid taking IRA distributions prior to age 59 ½, otherwise a 10% early withdrawal penalty may apply.
- ❏ Consider increasing your 401(k) and retirement account contributions.
- ❏ Take your Required Minimum Distribution (RMD) if you are past the age of 70 ½ prior to December 31st.
- ❏ Determine the optimal time to begin taking Social Security benefits, which you can apply for between ages 62-70.
- ❏ Explore taking employer stock under favorable tax rules.

Sheaff Brock Investment Advisors, LLC, is not a custodian and does not render tax advice. All decisions regarding the tax implications of your investment should be made in consultation with your independent tax advisor. If applicable, only figures provided by the custodian should be relied upon for tax purposes.

## GIFTING

### Give to Loved Ones and Those in Need

- ❏ Gift up to $14,000 per individual in federal tax free gifts.
- ❏ Contribute to charities using appreciated stock in place of cash to reduce capital gains in your portfolio while generating an income tax deduction.
- ❏ Give an outright charitable gift of cash for an immediate income tax deduction.
- ❏ Set up a Donor Advised Fund for an immediate income tax deduction and provide immediate and future donor gifting to charity over time.
- ❏ Set up a Private Foundation for an immediate income tax deduction and provide complete control over current and future charitable giving.
- ❏ Make a will or trust bequest so that the estate can take both income and estate tax deductions.
- ❏ If you are over 70 ½ and would like to make a donation to charity from your IRA, you can donate up to $100,000 under favorable tax provisions as of 2016.

## PLANNING

### Set Yourself Up for Success in the Upcoming Year

- ❏ Discuss major life events with your Sheaff Brock PC, such as marriages or divorces, births or deaths in the family, job or employment changes, and significant elective expenses (real estate purchases, college tuition payments, etc.)
- ❏ Send capital gains and investment income information to your accountant for a more accurate year-end projection.
- ❏ Ensure your account paperwork, risk tolerance and investment objectives are up to date with your Sheaff Brock PC.
- ❏ Revisit contribution amounts to your 529 Plan college savings accounts; make contributions prior to December 31st.
- ❏ Review Medicare Part D plan, make changes during open enrollment, which begins October and ends December 7th.
- ❏ Double check your beneficiary designations and update as necessary with your Sheaff Brock PC or custodian.
- ❏ Check your Health Savings Account contributions and confirm you've spent the entire balance in your Flexible Spending Accounts.
- ❏ Remember, tax estimates are due January 15th.