Sheaff Brock

Innovative Portfolios for Intelligent Investors™

# MARKET UPDATE

## July 2017

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 from page 4) such as asset class, style or strategy, geographic area, or sector, for example, similar to characteristics of a composite. Although a NF index may have characteristics similar to those of a composite, actual composite holdings will differ significantly from the securities that comprise an index. Consequently, use of a NF index does not indicate that a composite will achieve returns, volatility or other results similar to those of the index. The composition of a NF index will not reflect the manner in which a composite is constructed in relation to investment holdings, Portfolio guidelines, restrictions, sectors, correlations, concentrations, volatility or tracking error targets, all of which are subject to change over time. Comparison of a narrowly-focused index to a composite must be limited to the similar characteristics. Clients should NOT expect performance comparable to a narrowly-focused index in an actual account. (continued below)

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Any portfolio returns mentioned are composite total returns, and are net of fees and commissions. There is the chance that market conditions or portfolio performance may deteriorate in the future, and clients may experience real capital losses in their managed accounts. Portfolios are compared to the performance of various indices although the portfolio, which contains much fewer positions, may not reflect the securities making up these indices. None of the indices may be an appropriate comparison index as our managed accounts may own companies not represented in the benchmarks. All clients of SBIA who desire to participate in option transactions receive the option disclosure document, titled Characteristics and Risks of Standardized Options, which outlines the purposes and risks of option transactions. Despite their many benefits, options are not suitable for all investors. Individuals should not enter into option transactions until they have read and understood the risk disclosure document which can be obtained from their broker, any of the options exchanges, or OCC. All investment strategies carry risk, and transactions in options may carry a high degree of risk. Options derive their value from underlying equities or indices, and the derivative value is directly related to the underlying security, thus they carry many, if not more, of the same risks as the underlying equity or index. Sellers of options should familiarize themselves with the type of option (i.e. put or call) which they contemplate trading and the associated risks. You should calculate the extent to which the value of the options must increase for your position to become profitable, taking into account the premium and all transaction costs. Selling ("writing" ) an option generally entails greater risk than purchasing options. Although the premium received by the seller is fixed, the seller may sustain a loss well in excess of that amount. The seller will be liable for additional margin to maintain the position if the market moves unfavorably. Standstill option yield is calculated by dividing the aggregate annual option time decay by the aggregate account values. The yield is reflected gross of management fees. There were no other strategies employed to obtain the results portrayed other than those strategies disclosed in the SBIA ADV or other disclosure brochure. SBIA provides this Newsletter for general informational and educational purposes, and where appropriate, to assist in explaining the portfolios and composites. It is not investment advice for any person. Information is obtained from sources SBIA believes are reliable, however, SBIA does not audit, verify, or guarantee the accuracy or completeness of any material contained therein. The statements and opinions reflect the judgment of the firm, and along with the information from third-party sources and calculations, are made on the date hereof and are subject to change without notice. SBIA does not assume liability for any loss that may result from reliance by any person upon any material in this Newsletter. Clients or prospective clients are directed to SBIA's Form ADV Part 2A and to one or SBIA's representatives for individualized information prior to deciding to participate in any portfolio or making any investment decision. SBIA does not provide tax advice. Clients are strongly urged to consult their tax advisors regarding any potential investment. **Past performance does not guarantee future results, there is always a possibility of loss.**

# Sheaff Brock

**Innovative Portfolios for Intelligent Investors™**

## Monthly Update

Publication date: 7/17/2017

Google **sheaffbrock/in-the-news** for our latest columns posted on abc News and CNBC


> If you ever injected truth into politics, you would have no politics.
>
> Will Rogers

**Two random thoughts before a week in Brooklyn**

Yesterday, our second-oldest daughter delivered her first child (third grandchild for us) and my wife will be helping the new mom for a week or so. Mom and baby are doing well. I'm in New York doing a grandfather's role, holding the baby for an Instagram picture, at which time my job is done. While hanging with hipsters two random thoughts came to me:

1st random thought...interest rates are going up:

This snapshot shows the rates on U.S. Treasury bonds now, and a year ago. At every maturity, rates are higher by 60 to 95 basis points. The curve still slopes up, and the spread between the 1-month and the 30 year rate has increased.

| Date | 1 Mo | 3 Mo | 1 Yr | 3 Yr | 5 Yr | 10 Yr | 30 Yr |
|---|---|---|---|---|---|---|---|
| 07/10/17 | 0.95 | 1.04 | 1.23 | 1.59 | 1.93 | 2.38 | 2.93 |
| In the last year, interest rates are higher at every maturity | | | | | | | |
| 07/11/16 | 0.28 | 0.31 | 0.50 | 0.77 | 1.03 | 1.43 | 2.14 |

Source: US Treasury Dept. www.treasury.gov

Believe it or not, U.S. 10-year yields have now closed higher for 3 consecutive years (2014... 2.17%, 2015... 2.27%, and 2016... 2.44%), marking the longest annual consecutive streak since the early-1980s. Read that last sentence again; it is significant and could win you some money in a bar-bet. Rates are rising because the economy is still chugging along pretty steady. Also, an upward sloping curve means a recession is probably not in the near-term future.

Rising rates have hurt high quality, long-term bond prices. According to Morningstar, in the trailing 12 months the iShares 20+ Year Treasury Bond ETF (TLT) has lost –12.3%. Preferred stocks, which are still fixed income but more economically sensitive, are up in the last year. The iShares U.S. Preferred ETF (PFF) gained 4.1%. A 16% difference is significant! Rates will likely keep rising, so think twice before committing to a long-term investment that has high interest-rate-risk (high quality long-term bonds, fixed annuities). Rising rates in a good economy is not a bad thing for some income bearing strategies, ones that benefit from an improving economy. Preferreds, REITs, and floating rate investments should be OK.

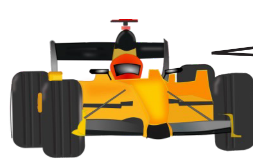
2nd random thought...Index funds are all you need. Really?

There are many people espousing the use of index funds, ETFs or other passive products, instead of using a firm like ours that provides active management of individual stocks, or our sister company, Salzinger Sheaff Brock that uses ETFs and mutual funds. It is a very one-sided debate, and many pundits are saying active management is deadsville. Psst...this argument has been made several times in history.

Would you buy this?

*"We have a portfolio that mirrors the S&P 500 and we take out a small annual fee to maintain the portfolio. When you invest with us, we don't think, we don't analyze anything or try to add money to the cheaper stocks. We don't hold back investing if the market is really pricey. We automatically put most of your money in the biggest companies, normally the stocks that have already gone up the most; the more expensive stocks. Right now, if you send us $1000, we will put $200 of it in ten stocks that have an average P/E of 35, and have already gone up 32% in the last year! We don't try to buy low and sell high, we just BUY! Isn't that great? Most importantly, Mr. Investor, I cannot guarantee performance, but I can guarantee we will never, ever, beat the market; and in fact year-after-year, as long as you are invested with us, you will always slightly underperform the S&P 500."*

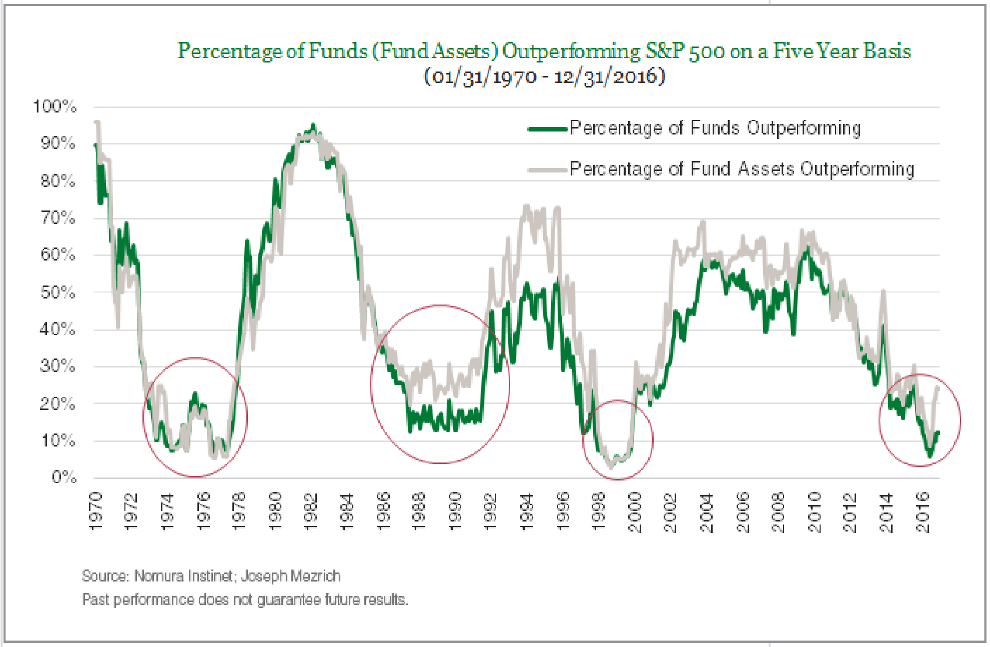
According to a Morningstar study released in June of 2015, *Morningstar's Active/Passive Barometer*, over 1, 3, 5 and 10 year periods, between 35% and 32% of managers beat their benchmark over the periods; so call it one-third beat and two-thirds don't. If you equate an index fund to the Indy 500, the index race car would finish 11th out of 33 cars every year, but earn a bigger headline than the winner in the sports page because they spent less than Roger Penske.




Successful long-term investing is about preserving capital during downdrafts and keeping emotions in check. During a bull market an index product is fine, easy, and cheap. But who is watching the store when there is a riot in the streets? You are.

In reality the most successful long-term equity investors have been the ones who stick to a solid discipline through hell-and-high-water, buy companies they understand and like, and don't get swayed by singing Sirens. Sir John Templeton, Mario Gabelli, Peter Lynch, Benjamin Graham, Carl Icahn, and Warren Buffett come to mind.

Many people feel Warren Buffett is considered the greatest living investor. He didn't get to $76 billion being average; and he is an active investor. Every quarter he reports buys and sells. The greatest should at least beat the market, right? Some years he does and some years he doesn't. According to Yahoo Finance, from September of 2008 (the beginning of the financial crisis) through June of 2017, almost nine years now, BRK-A has underperformed the S&P 500 by almost 30%!! Year-to-year, or over certain stretches he might underperform. But over longer periods, Buffett's discipline has shined.




Above is a chart that shows the percentage of funds that beat the market on a rolling 5-year basis. You can see that at the end of last year, the percentage hit another trough with only 10 or 15% of funds outperforming. Three previous times, the mid-70s, 1990, and 2000, active management was also declared dead, only to rise like the Phoenix again. Active managers' next time-to-shine may already have started. Look at this CNBC headline from July 6th (and our highlight).


CNBC

Active managers having best year since bull market began

- Active managers are having their best year since at least 2009, with 54 percent beating their benchmarks in 2017.

In the 1970s the crowd was buying the "nifty-fifty" stocks, in the 1980s it was tax shelters, fixed annuities, and oil stocks, and in the late 90s it was tech stocks. After the dot-com bust the crowd was in a frenzy about gold. Housewives were going to "gold parties" and selling Grandma's necklace. Unfortunately we won't know for a few years what today's crowd is wrongly focused on, and an index fund likely won't be a lamentable investment. It just seems there is an excited crowd at the index fund storefront window admiring average looking goods. There is a classic investment book written in 1841 by Charles Mackay about behavior, and not following the crowd, called *Extraordinary Delusions and the Madness of Crowds*. Just reciting the title makes you feel smarter. Good book too.

## Portfolio Updates

Speaking of CNBC, there is an insert in this month's letter of an article written by yours' truly about REITs in a rising rate environment. Our REIT portfolio is off and running. If you are looking for income with a potential for some long-term growth, give it a look. Once it has toddled longer, we will start posting performance numbers.

The halftime show for 2017 (July 4th holiday) is over, and with the little space left after the random thought diatribes, we will talk about a few portfolios. For the most part, portfolios had a good first half.

**Dividend Growth & Income**

Dividend Growth & Income had a solid first half, beating the Dow Jones Select Dividend Index's gain of 6.09%. The portfolio has 25 positions and is fully invested. Currently we have a position in all but one S&P sector; no telecom stocks make the grade. The portfolio's dividend yield is a bit over 3% and sports an average dividend growth rate of 15%, according to William O'Neil & Co.

**IntelliBuilD Growth™**

This is the growth equity portfolio based on *Investors Business Daily's* stock lists. Right now the portfolio is 55% mid-cap and 45% large-cap. It had a good first half, gaining 8.2% net-of-fees, compared to the same percentage blend of the S&P Mid-Cap 400 and S&P 500 Indices, which gained 7.3%. The portfolio's beta is 1.4, trailing earnings growth is 39%, and average P/E is 22.

**Bulls of the Dow**

The quarterly rebalancing swapped out 3 stocks, interestingly

We're warning you! **Soon, new management agreements will arrive in your mailbox. *They will need to be signed and returned.*** The Department of Labor's language requirement regarding fiduciaries is to blame.

**Knowledge Builder** webinars. They are 45 minutes long and are on various subjects. You can watch the recording of previous Knowledge Builders on our website. Invites come by email. For those of you who don't know-it-all, take a few minutes and learn something new.

all were technology companies. Overall through June, the big old Bulls were our best equity portfolio, beating both the S&P 500 and the Dow Jones Industrial Index.

### Covered Call

Covered call accounts stumbled a little in May, recovered in June, and delivered a decent first half. Low volatility is making it tough to get yield from the call options. That said, according to thinkpipes, the theta of the composite (standstill yield from option premium decay) is $330,000 per month, or an annualized yield of 9.3%. And that is higher than recent months. The reason is some of the stocks that had dropped in price (which made writing calls unworthwhile) have recovered in price, making them writable again.

### Preferred Income

Through June, the Preferred composite basically returned about a full year's expectation in only six months, +6.8% net-of-fees. Preferreds have been in the fixed income sweet spot, mainly due to their economic sensitivity, and perceived regulatory relief on banks. The portfolio's yield to call is still over 4%, and the dividend yield is over 5%.

*The following option overlay products are intended to be additive in return to other investments held in an account, and are not appropriate for all investors. Historically, the cash-flow from overlays has been positive from year-to-year. However, realized gains and losses are very inconsistent. These are long-term strategies and may not produce capital gains over the short-term.*

### Put Income Overlay

Unless you're a honey badger you should listen to the monthly portfolio calls. We are continuing to add index put spreads on the SPDR S&P 500 ETF (SPY) in all accounts with notional exposure wiggle room. The long-term goal is to have half of an account's risk on the index, and the other half of risk on individual stocks. Across the book we are halfway to our goal. Exchanging deep in-the-money puts on some old positions for puts on other larger-cap and higher quality stocks (that have a much higher statistical probability of expiring for a gain) has increased theta and increased probability of a gain, but at the expense of exposure. Before other repeal-and-replace swaps are made we need to wait for some of the first swaps to expire. At halftime, Put Income was excited at delivering it's best first half ever.

### Index Income Overlay

The simple overlay, which just keeps on keepin' on. We use put option credit-spreads on the SPDR S&P 500 ETF (SPY) staggered monthly, one spread expiring month, after month, after month. Since inception of this overlay, results have been consistent. Every month, the spreads have expired for gains, and clients have received a low-single-digit percentage *addition* in cash-flow and realized gains to their account, which was also invested in one of our strategies, or self-directed by the client.

August is usually hot and sultry. Historically, August has been a good month for equities. Sweaty but perhaps profitable!

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 | 2017 Thru June | 2016 | 2015 | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|---|---|---|---|
| Fixed Income | **Preferred Income** - Preferred stocks | 6.80 | 1.66 | 5.22 | 14.02 | -4.57 | 9.11 | | |
| | **High Yield Bond** | 3.09 | 11.63 | -7.32 | -1.93 | 8.78 | 15.38 | 3.99 | 15.93 |
| Growth and Income | **Covered Call Income** - Quality stocks & covered calls | 5.40 | 6.24 | -1.20 | 6.39 | 22.04 | 10.14 | -11.57 | |
| | **Dividend Growth & Income** - Dividend paying stocks | 7.14 | 11.22 | -7.17 | 5.20 | 36.47 | 12.46 | 5.80 | 16.94 |
| Growth | **IntelliBuilD Growth** - IBD growth stocks | 8.20 | -2.71 | 2.52 | 7.63 | 11.18* | *10/1/13 inception date | | |
| | **Bulls of the Dow** - 10 strongest of the Dow 30 | 10.45 | 9.65 | 1.14 | 12.42 | 30.05 | 7.83 | | |
| | **Mid-Cap 10** - Mid-cap growth momentum stocks | -0.95 | -7.90 | -12.68 | | | | | |
| Alternative | **Alternative** - Metals, foreign currencies, commodities | 10.31 | 4.37 | -8.25 | -4.23 | -0.70 | 9.02 | -7.74 | |
| Option Overlay | **Put Income** - Overlay of short equity puts | *3.37* | *0.48* | *-9.17* | 0.56 | 5.92 | | | |
| | **Index Income** - Overlay of unleveraged put credit spreads | 1.59 | 3.67* | *5/31/16 inception date | | | | | |
| | **Index** | | | | | | | | |
| | **S&P 500** | 9.34 | 11.96 | 1.38 | 13.69 | 32.39 | 16.0 | 2.1 | 15.1 |
| | **CBOE S&P 500 Buy/Write** | 8.09 | 7.06 | 5.24 | 5.64 | 13.26 | 5.20 | 5.72 | |
| | **Barclays Aggregate Bond** | 2.27 | 2.65 | 0.55 | 5.97 | -2.15 | 4.2 | 7.8 | 6.5 |
| | **DB Commodity Index Tracking Fund (NAV Total Rtn.)** | -8.78 | 18.50 | -27.41 | -28.18 | -7.57 | 3.31 | -2.71 | |

Composites include all fully discretionary, management fee-paying and 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 October 1, 2015 Preferred Income was sub-advised by Trust Investment Advisors, Indianapolis, IN. Please see additional disclaimers on the next page.

CNBC

June 15, 2017

# A portfolio diversifier for a rising rate environment

- REITs do better in rising rate conditions because they thrive under the very same economic conditions that prompt the rate raise.
- During the 2004–2006 rate raises, REITs posted cumulative total returns of 77.9 percent.
- REITs exhibit low volatility in general but do go through their own choppy periods.

DAVE GILREATH,
partner and founder of Sheaff Brock Investment Advisors

Investors seeking portfolio diversification and income as the Federal Reserve approved its second interest-rate hike of 2017 should be aware of the rate-hike-resistant history of real estate investment trusts.

As financial markets had anticipated, the policy-making Federal Open Market Committee increased its benchmark target a quarter point. The new range will be 1 percent to 1.25 percent for a rate that currently is 0.91 percent. This is the third time in the past six months that the Fed has followed through with an interest-rate hike.

REITs, investments in the equity of companies with real estate holdings and — in many cases — traded on major exchanges, have historically performed well in rising rate environments. Actually, they've usually done better during periods of rising rather than declining rates because the same improvements in macroeconomic conditions that prompt rate increases also lead to improved REIT performance.

During the 2004–2006 period of Fed rate increases, for example, REITs posted cumulative total returns of 77.9 percent, compared with 32.5 percent for stocks and 8.6 percent for bonds.

REITs own a broad array of property-ownership ventures, including apartments, hospitals, warehouses and commercial property such as hotels, shopping malls and office buildings. The game for direct investors is to assess shifting demand variables for these specific markets. These shifts are of less concern to long-term investors seeking exposure through actively managed mutual funds and passively managed index and exchange-traded funds. (Some REIT ETFS are actively managed.)

This is a small market, totaling only about $900 billion — not much greater than the market cap of Apple — and consists of only about 220 distinct property-owning entities.

Most REITs' income is from lease payments on property they own, so they generally have good cash flows to fuel earnings and dividends. Long-term, annual dividend yields have hovered around 4 percent.

Historically, REIT performance on average has not been correlated with that of the stock (or bond) market. But during some periods, it has. Between 1988 and 2015, REITs and the stock market both returned about 12 percent annually.

As a result of the dot-com boom, stocks outperformed REITs in the late 1990s, returning between 12 percent and 18 percent annually, compared with REITs' 9 percent to 15 percent. But since 2001, REITs have beaten stocks by 3 percent to 5 percent annually.

Though REITs have exhibited fairly low volatility in recent years, they occasionally go through distinctly choppy periods. The Dow Jones Wilshire REIT Index lost more than half its value in 2007–2008.

A key factor driving REIT performance in recent years has been the demand for residential, industrial and office space. Pent up since the financial crisis of 2008, this demand has been driving strong construction in all of these categories since 2015 and currently shows few, if any, signs of abating.

In the housing market, increasing wage and consumer confidence are intensifying this demand among consumers seeking 1.5 million new households of all types per year. The category is benefiting from an improving job market that allows kids to finally move out of their parents' homes, and from seniors seeking to downsize.

While residential REITs are still performing well, this category isn't among the top few performers. Currently, the fastest-growing categories are industrial space (including warehouses benefiting from the "Amazon effect" — the proliferation of online order fulfillment centers), data centers and office space, which grew 13 percent in 2016.

Among the poorest-performing REIT categories are those that own brick-and-mortar shopping centers, which have been losing business to said Amazon effect. While Macy's and Nordstrom may not need as much retail space, their online businesses, like those of strictly online retailers, are all about mega-warehouses.

Contrary to stock funds, REIT funds are creatures of millions, instead of billions, of dollars. The fund market is dominated by Vanguard, whose Vanguard REIT ETF (which currently owns about 160 REITs) is the largest, with only about $62 billion in assets in recent weeks. The other three funds in the top four all recently have totaled less than $10 billion. Recently, all four have had significantly overlapping holdings and all — particularly Simon Property Group, which owns shopping malls — have concentrations in retail REITs. Investors seeking to avoid retail exposure have little choice but to seek active management. But this shouldn't be a deal breaker for passive-management aficionados.

"In this small universe of potential holdings, the key to good returns for active managers isn't security selection but the timely weighting of select groups based on economic analysis."

In another reality reversal from the stock market, active REIT managers have over the past decade outperformed their benchmarks more often than not, and have done so twice as often as stock fund managers. In this small universe of potential holdings, the key to good returns for active managers isn't security selection but the timely weighting of select groups based on economic analysis. For example: What are the relative strengths of the near-term market for timber versus data centers?

Investors can evaluate active managers the same way they do for general equity mutual funds, with one key difference: There are so few — only 58 companies manage REIT funds — that investors can evaluate all of them.

As a practical matter, the Lilliputian nature of the REIT market relegates the product to a minor role, even in small portfolios. Professionals can't buy gobs of them incrementally without pushing up the price for their next purchase. And the best tack for most individual investors is to add REITs to their portfolios to serve as a tincture of alternative-asset diversification for the long term.

*— By Dave Gilreath, partner and founder of Sheaff Brock Investment Advisors*