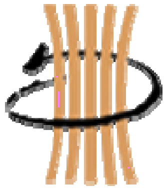

# Sheaff Brock

Innovative Portfolios for Intelligent Investors™

# MARKET UPDATE
## June 2016

8801 River Crossing Blvd.
Suite 100
Indianapolis, Indiana 46240

317-705-5700 or 866-575-5700
sheaffbrock.com

"Benign neglect, bordering on sloth, remains the hallmark of our investment process."

Warren Buffett

## In This Monthly Update

Date of publication 6/29/16

- Successful Investors and Sloths!
- Brexit Event Risk
- Portfolio Updates

Check out sheaffbrock.com for our latest column at abcnews.com. Also listen to recorded portfolio manager calls.

(continued from page 4)
Performance information of benchmark indexes is included for comparison purposes only. Two general types of benchmarks are provided with respect to the composites. The first type is a well-known and widely-recognized index, such as the S&P 500 Index (described previously), which generally is used to reflect the market for equity investments in large US companies), and the Barclays US Aggregate Bond Index (described previously), which generally is used to reflect the investment grade taxable bond market in the US). These types of indices are not selected to represent an appropriate benchmark with which to evaluate a composite's performance, 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 more narrowly-focused index selected based on one or more characteristics, such as asset class, style or strategy, geographic area, sector, tax characteristics, or volatility, for example, similar to characteristics of a composite. Although a more narrowly-focused index will 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 narrowly-focused index does not indicate that a composite will achieve returns, volatility or other results similar to those of the index. The composition of a narrowly-focused 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 the narrowly-focused index in an actual account.

Securities may be mentioned in a portfolio description, and if so a list of a transactions/recommendations for the trailing 12 months is available upon request. Any portfolio returns mentioned are composite 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. 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.**

## Successful Investors and Sloths

Given the current market volatility and all of the angst over Brexit, reread the quote on the front cover and see if that describes your investment philosophy. Go ahead, flip it over and read it.

If so, you would be the type of client who allocates a portfolio to a quality strategy, every now and then checks on the progress, and then just leaves it alone for a long, long time. Over a period of years, perhaps you move a bit of money from one strategy to another (either in response to your risk or income needs, or to take advantage of areas of the market that are great values) but mostly you do nothing. If this describes your mentality, you will retire and eventually die rich (morbid perhaps, but look on the bright side, your kids will be motivated to visit you in the nursing home). If patience and benign neglect describes your investing method, congratulations, you are a rare investor.

Successful long-term investors don't waffle around or change with the wind. For over half a century, Buffett has stuck to his long-term strategy, even through the 1980's and 90's when he was considered out-of-touch. He would never completely change from one strategy to another, a wholesale change, just because his value style was temporarily out of favor.

Unfortunately, very few retail investors (that would be you) adhere to a long-term philosophy. Over the years, we have talked to thousands of investors, and continue to daily speak to a lot of people who want to make portfolio changes for a myriad of dumb reasons such as, high interest rates, a market crash, low interest rates, bubbles, inflation, deflation, Japan, savings-and-loans, junk bonds, a currency crisis, dot-com, Y2K, China, "Cramer says…", demographics, QE, Eurozone problems, bad earnings, high P/E ratios, recessions, black swans, global debt, fiat currency, Brexit, blah, blah, and blah. There is always a reason to sell or change, based on news.

The other reason investors change is because they feel performance is not up-to-snuff, and they see that another fund, product, or advisor is doing better, so they move to the new shiny investment. Look at the below XYZ portfolio returns compared to the S&P 500. XYZ underperformed the market 60% of the time, underperformed over 1-year, 3-years, 5-years, and 7-years, plus never paid dividends or interest.

| History (05/31/2016) | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|
| XYZ Portfolio | 2.24 | 21.90 | -4.76 | 17.56 | 32.17 | 26.64 | -12.06 |
| S&P 500 TR USD | 26.46 | 15.06 | 2.11 | 16.00 | 32.39 | 13.69 | 1.38 |

It is obvious to anyone with any sense that this portfolio is a dog. If XYZ was one of our portfolios, this is the last thing a short-term oriented client may have said:

I put $1 million in XYZ at the bottom of the market in 2009. If I had just put it in an index fund I would have $600,000 more than you made me. $600,000!! You have underperformed, your investment method is not working, and hasn't for 7 years! **YOU'RE FIRED!!!**

By the way, XYZ's returns are Berkshire Hathaway's (BRK'B) returns from Morningstar. Yep, that's right, through 2015 Buffett had underperformed for 1, 3, 5, and 7 years. All well executed investment strategies underperform from time-to-time. Invest in appropriate strategies, and become slothful.

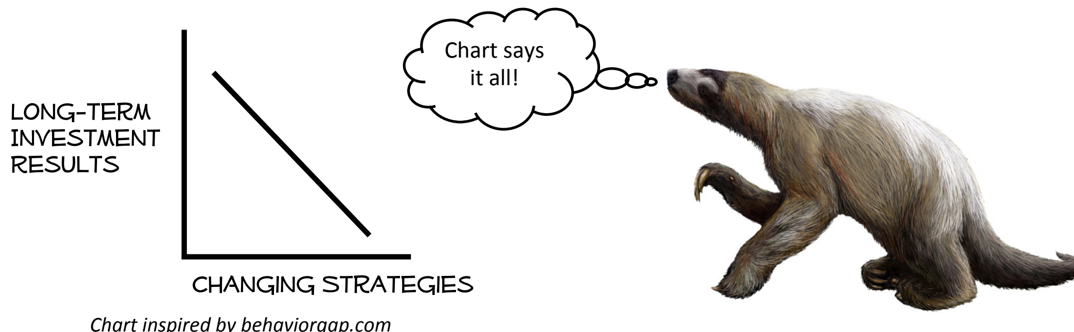


*Chart inspired by behaviorgap.com*

When is likely the best time to invest in a given strategy? When doing so makes you uncomfortable. On January 1st of this year it might have been uncomfortable to buy Berkshire-Hathaway with 7 years of underperformance staring you in the face. Year-to-date through 6/28 BRK.B is up for the year, while the S&P 500 is down.

As this is being written, a few days into the Brexit selloff, it is very uncomfortable to invest. A few years from now, one might look back at today's prices and ascertain that indeed, the Brexit selloff was a good time to buy US stocks.

## Brexit Event Risk

We have received an untold number of e-mails on the Brexit vote, and have sent a few out ourselves. Opinions are flying around like the pigeons in front of St. Paul's Cathedral. Below are a few bullet points of pertinent items we have gleaned:

- It now appears that the official process to exit the European Union will not be initiated until a new Prime Minister is chosen. It could be three to six months before they start the 2+ year process to exit.
- What is the impact to the US economy? Many reports have quoted that S&P revenues from the UK are less than 3% of total and the UK

is not a material US trading partner.

- Morgan Stanley estimated in a note today that the GDP impact in 2016 would be zero and in a base case the impact in 2017 would be a 30 bps hit to GDP
- Even in a "high stress scenario" the impact to US GDP would be only 60 bps.
- US companies could be the beneficiary of investment flows as the US economy remains relatively stable, commodity prices should remain in check due to the stronger dollar, and valuations do not look out-of-line in the context of bond yields.
- The US economy is the most insular of all major economies, so the damage to it should be less than other developed economies. For S&P 500 companies, 70% of sales are domestic.
- The early read seems to favor US equity markets near term.

Ned Davis Research recently put out a list of 51 market "events" spanning the last 110 years and showed how the stock market reacted after those events. The list begins with the Panic of 1907 and ends with the Boston Marathon Bombing. Included are events like the Crash of 1929, Pearl Harbor, JFK's assassination, various terror attacks, and Lehman's collapse. The net effect to the S&P 500 was:

| Fifty-one Market Events | | Subsequent S&P 500 gain over the following... | | | |
|---|---|---|---|---|---|
| | Loss During Event | One Month | Three Months | Six Months | Twelve Months |
| Average | -6.7% | 3.7% | 5.2% | 8.9% | 13.9% |

*Source: Ned Davis Research, Inc. www.ndr.com*

Thirty-six out of fifty-one times, 70% of the time, the market was higher 12 months later. Domestic investors may fare just fine in the next year. However, if you know a EU bureaucrat, you might drop them a hint to update their LinkedIn profile.

## Portfolio Updates

### Preferred Income

Preferred stocks have been the shining star of our portfolios, and have held up fairly well during the Brexit predicament. The recent "stress test" for the big US banks went so well it hardly made the news. All of the banks passed. Credit quality is pretty good in the banking world (at least in the USA).

For our preferred portfolio, January and February were difficult, but March, April, and May were generous. The current yield of the portfolio is a bit under 6% and the average call protection is about 4 years. Because the stocks are mostly at premiums to par value, the yield-to-call is a bit over 4%. Not a bad yield in today's world, especially compared to other products with a similar duration and credit quality. There have been several articles recently in *Barron's, Forbes*, and *The Wall Street Journal* singing preferred's praises. JR Humphreys, the portfolio manager, has been laddering the call dates so securities won't be called away all-at-once. JR has also been adding a few positions in "fixed-to-floating" rate preferreds. These types of preferreds should help mitigate the interest rate risk of the portfolio. You might want to go to the archives of the monthly portfolio manager calls on our website and listen to the most recent recording. JR did a nice job explaining some of the nuances of the portfolio. JR tore his Achilles while kickboxing. Painful, but he gets to ride around the office on this sweet scooter!

### IntelliBuilD Growth™

IntelliBuilD is the blend of up to 33 American stocks from *Investors Business Daily* lists. It is heavy in the mid-cap and small-cap portion of the market. During most periods of market stress, this portfolio experiences higher than average volatility. It is interesting however, that during the Brexit selloff, IntelliBuilD held up better than US large, mid, or small-cap indices. The portfolio has also held up better than the ETF that mimics the IBD 50 index (FFTY). That said, it has been a tough year for the portfolio and for *Investors Business Daily's* IBD 50 index. Momentum driven US growth stocks have struggled, and foreign growth stocks have struggled even more. For 2016 through 6/28, the IBD 50 index is down about 8.5%. We still have high hopes because the portfolio metrics are really strong:

| IntelliBuilD Portfolio Average | |
|---|---|
| Trailing Sales Growth | 14% |
| Return on Equity | 33% |
| Earnings Growth | 42% |
| Price to Sales | 2.2 |
| P/E Ratio | 19 |

Growth metrics are higher than the S&P 500, Mid-Cap 400, or Small-Cap 600.

And valuation metrics are lower.

*Source: William O'Neil & Co.*

It is a rare day when you can buy high growth companies and pay less for them than you pay for lower growth companies. Mr. Market is sometimes irrational and knocks at your door offering low prices on his stocks. This seems to be one of those times.

### Dividend Growth & Income

This is our flagship portfolio of high quality, dividend paying companies which have had a propensity to raise their dividends. The portfolio has a definite "value" bent to it. Recent diagnostics on it vs. the S&P 500 show our portfolio's valuation measures of price-to-sales, price-to-earnings, price-to-book and dividend yield are all better. And again, our earnings growth, sales growth, book-value growth, and dividend growth rates are all higher than the index. One thing that has hurt the performance relative to other "dividend" portfolios is our lack of exposure in the utility and consumer staple stocks. A couple of the research sources we use score those groups as too richly priced, with too much downside risk. We like to buy stocks when their P/E ratio is one or more standard deviations below their 5-year average P/E. Currently the above groups have very high P/E ratios, as much as 2 standard deviations above average, which is just too risky for our blood.

### Covered Call

The portfolios had a nice May, bringing them about even through May. Wally has been increasing the option writing activity, and generally using shorter dated calls. Also, larger-cap stocks dominate the new buy lists.

### Alternative

We haven't written about this for awhile, but this year it has been a good performer. It is commodity, currency, and emerging market heavy portfolio using mutual funds and ETFs. The narrow focus has made it a sort of boom-or-bust portfolio. It is going on 4 consecutive years of gains.

Out of room for the rest, but our most recent conference call, which is now archived on the website, has 30 minutes of scintillating conversation on a couple of unmentioned portfolios. Listen and learn!

It is important to be an intelligent investor. In June, we launched our Knowledge Builder Series, which is an ongoing monthly series of educational webinars focused on educating you about the investment issues most important to you. In our first webinar, we focused on the mechanics and fundamentals of using two alternative strategies to generate income in your portfolio—Covered Calls and Writing Puts. Feedback was very positive and clients appeared to have found the information extremely valuable.

In July, the Knowledge Builder Series will focus on Retirement Income Planning. Paul Coan, CFP®, ChFP, CES (we joke that Paul has more letters after his name than in his name) and Head of Financial Planning for Sheaff Brock, will be our guest speaker and he will offer insight on how to manage retirement and navigate some of the challenges retirees face today.

The webinars will be archived for later viewing in case you miss the live presentations. The schedule for the remainder of the summer is:

**July 19 and 21:** Retirement Income Planning: The Three Things You Need to Know
**August 23 and 25:** Portfolio Management: Building the All Weather Portfolio
**September 20 and 22:** Mind Games: Strategies for the Irrational Investor

Top Financial Advisers 2016

And finally, Sheaff Brock is pleased to announce it has been named to the *Financial Times* (the pink British financial paper) 300 Top Registered Investment Advisers, as of June 16, 2016. The list recognizes top independent RIA firms from across the U.S. The 300 top RIAs hail from 34 states and D.C. More than 1,500 prescreened RIA firms were invited to apply for consideration, and 300 were chosen. Everyone at Sheaff Brock here had a hand in this recognition.

The 2016 Financial Times 300 Top Registered Investment Advisors is an independent listing produced by the Financial Times (June, 2016). The FT 300 is based on data gathered from RIA firms, regulatory disclosures, and the FT's research. As identified by the FT, the listing reflected each practice's performance in six primary areas, including assets under management, asset growth, compliance record, years in existence, credentials and accessibility. Neither the RIA firms nor their employees pay a fee to The Financial Times in exchange for inclusion in the FT 300.

If you have any questions or comments regarding this letter, including any Portfolio or composite, please contact our Chief Compliance Officer, Dave Gilreath at daveg@sheaffbrock.com; you can also reach him, or any other Sheaff Brock representative, at 317-705-5700.

| Style | Performance Update<br>Portfolio | Thru May - 2016 | 2015 | 2014 | 2013 | 2012 | 2011 | 2010 | 2009 |
|---|---|---|---|---|---|---|---|---|---|
| Fixed Income | **Preferred Income** - Preferred stocks | 3.16 | 5.22 | 14.02 | -4.57 | 9.10 | | | |
| | **High Yield Bond** | 1.99 | -7.32 | -1.93 | 8.78 | 15.38 | 3.99 | 15.93 | 45.69 |
| Growth and Income | **Covered Call Income** - Quality stocks & covered calls | -0.17 | -1.20 | 6.39 | 23.56 | 11.56 | -10.25 | | |
| | **Dividend Growth & Income** - Dividend paying stocks | -0.53 | -7.16 | 5.20 | 36.09 | 12.36 | 5.36 | 17.09 | 24.08 |
| Growth | **IntelliBuilD Growth** - IBD growth stocks | -9.07 | 2.57 | 7.62 | 19.69* | *9/1—12/31/13, S&P 500 +12.9% | | | |
| | **Bulls of the Dow** - 10 strongest of the Dow 30 | 1.37 | 1.14 | 12.42 | 30.05 | 7.83 | | | |
| | **Mid-Cap 10** - Mid-cap growth momentum stocks | -16.10 | -12.68 | 11.84 | 24.32 | 23.55 | 21.88 | 21.26 | 38.15 |
| Tactical | **Technical Long/Short** - Long S&P 500, cash, or short | -10.23 | -27.13 | | | | | | |
| Alternative | **Alternative** - Metals, foreign currencies, commodities | 2.03 | -8.25 | -4.23 | -0.70 | 9.02 | -7.74 | | |
| | **Index** | | **2015** | **2014** | **2013** | **2012** | **2011** | **2010** | **2009** |
| | **S&P 500** | 3.57 | 1.38 | 13.69 | 32.39 | 16.0 | 2.1 | 15.1 | 26.5 |
| | **CBOE S&P 500 Buy/Write** | 1.26 | 5.24 | 5.64 | 13.26 | 5.20 | 5.72 | | |
| | **Barclays Aggregate Bond** | 3.45 | 0.55 | 5.97 | -2.15 | 4.2 | 7.8 | 6.5 | 5.9 |
| | **DB Commodity Index Tracking Fund (NAV Total Rtn.)** | 10.40 | -27.41 | -28.18 | -7.57 | 3.31 | -2.71 | | |

Composites include all (but not less than five) 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. Net-of-fee performance was calculated using actual management fees, except in the case of non-fee-paying accounts, where model fees have been imputed. 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. The securities mentioned in this report can be, and often are, owned by clients and employees SBIA. *Denotes partial year, with note reference. October 1, 2015 Preferred Income was sub-advised by Trust Investment Advisors, Indianapolis, IN. calculated. Past performance is not indicative or a guarantee of future results.

- 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 (agency fixed-rate and hybrid ARM pass-throughs), asset-backed securities and CMBS (agency and non-agency).
- The CBOE S&P 500 BuyWrite Index (the "BXM" or the "BXM Index") is a passive total return index based on (1) buying an S&P 500 stock index portfolio, and (2) "writing" (or selling) the near-term S&P 500 Index (SPX) "covered" call option, generally on the third Friday of each month. The SPX call written will have about one month remaining to expiration, with an exercise price just above the prevailing index level (i.e., slightly out of the money). The SPX call is held until expiration and cash settled, at which time a new one-month, near-the-money call is written. The premium collected from the sale of the call is added to the portfolio's total value. The expired option, if exercised, is settled in cash. 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 is designed to represent general trends for a hypothetical buy-write strategy.
- DB Commodity Index Tracking Fund (DBC) The PowerShares DB Commodity Index Tracking Fund seeks to track changes, whether positive or negative, in the level of the DBIQ Optimum Yield Diversified Commodity Index Excess Return™ (DBIQ Opt Yield Diversified Comm Index ER) plus the interest income from the Fund's holdings of primarily US Treasury securities less the Fund's expenses. The Fund is designed for those who want a cost-effective and 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. (continued pg 1)