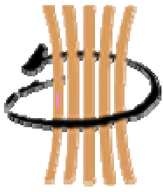

Sheaff Brock

Innovative Portfolios for Intelligent Investors™

MARKET UPDATE

August 2016

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"Normalcy is not interesting."

Lindsay Lohan

In This Monthly Update

Publication date: 08/18/16

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- Evolution
- Portfolio Updates

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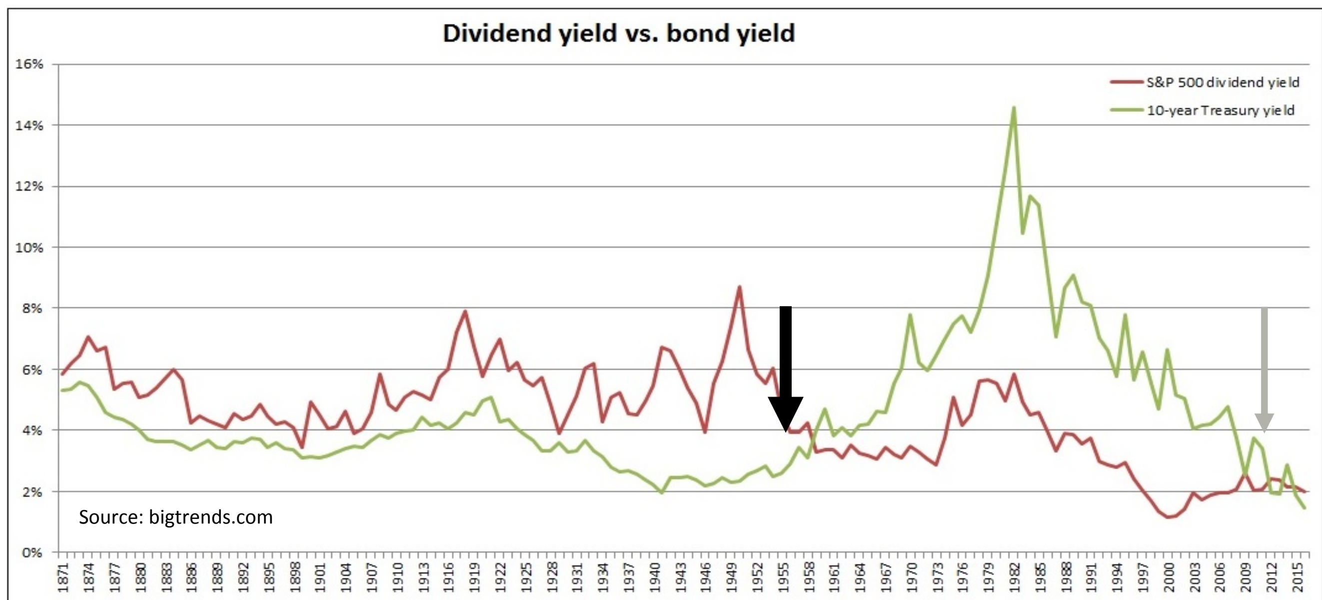
Performance information of benchmark indexes is included for comparison purposes only. Two general types of benchmarks are provided with respect to the composites. The first type is a well-known and widely-recognized index, such as the S&P 500 Index (described previously), which generally is used to 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.**



A Return to Normalcy

In 1920 Warren G. Harding was running for President under the campaign promise of a "return to normalcy", which meant a return to the way of life before World War I. Harding ran a "front porch" campaign, meaning he almost never left home, but instead made speeches from his front porch. No travelling around with an entourage, no secret service, no CNN or Fox News, just intelligent speeches. "Normalcy" worked, he won by a landslide. Sounds refreshing, doesn't it?

As we mentioned last month, the S&P 500 pays a higher dividend yield than 10-year bonds pay in interest. Currently the S&P 500 dividend yield is 2%, and the 10-year Treasury bond yield is only 1.57%. Because of this yield inversion, pundits are filled with wonderment, angst, bewilderment, and concern that stocks yield more than bonds. But, did you know that for about 90 years, from 1870 to about 1959, stocks yielding more than bonds was considered normal? Before 1959 (bold arrow above), dividend yields on stocks (red line) were reliably above those of bonds (green line). This made all the sense in the world insofar as stocks were seen as a riskier way to generate income. Since they don't come with the legal obligations that adhered to bond payments, dividend yields had to be higher as compensation for income risk.

In 1898 and in 1929, when bond yields came close to the dividend yield of stocks, bad things happened to the stock market which brought the "normal" relationship of stock yields and bond yields back. In 1959, when bond yields did finally cross through, the "stock market experts" warned of impending doom, perhaps a repeat of 1929 even. Back then they said, "Everybody knows stocks should yield more, so they have to drop in price." But, apparently nobody paid attention. From 1959 to 1969, the S&P 500 went up 110%.

For the next 55 years, from Buddy Holly's death in 1959 (dark black arrow) to Justin Bieber's 19th birthday in 2013 (light gray arrow, The Biebs' 19th only merits a light gray arrow), bonds paid more in interest than stocks yielded in dividends. Bonds yielding more has been the norm. Experts today say, "Of course bonds should pay more, they have to in order to compensate for the lack of growth."

During the last couple of years, bond yields have again dropped below stock dividend yields. Most pundits think bonds yields will pop back up to their "normal" higher level. But what if interest rates stay r-e-a-l-l-y low for a long, long time? What if the yield relationship goes back to the way it was for most of the last century? As implausible as all of that seems, never say never.

What this new low rate environment is doing is forcing savers to evolve, forcing them to be "investors" instead of "savers". What this has done is raise the prices of otherwise boring investments to record high prices. A lot of investors seeking income own electric utility stocks. One of the biggest and most popular holdings is Duke Energy. It is also the one I send a check to every month.

Duke (DUK) is over $80 per share. The stock price is up over 14% this year (through 8-18-2016) and the stock pays a nice dividend of a bit over 4%. The problem with Duke, and nearly all utility stocks, is that they are trading at the highest valuation (as measured by P/E) ever. Duke's P/E is higher now than at any time since going public! A company growing like a weed can justify a high P/E. Look at Amazon's earnings and future expectations by the analysts:

AMZN	Last year EPS	$1.25	
	This year estimate	$5.74	
	Next year estimate	$10.34	+730% in 2 years

Now look at Duke's earnings and future expectations by the analysts:

DUK	Last year EPS	$4.54	
	This year estimate	$4.61	
	Next year estimate	$4.74	+4% in 2 years

Amazon is growing like a newborn. Their growth is off the charts, and they commensurately trade at a high valuation. Did you know that through your lifetime your nose, ears, and feet continue to grow? Electric utilities only grow as fast as the population and GDP. Duke is growing like an 80-year-old man's ears, but they are trading at a teenager's valuation. We aren't specifically picking on Duke Energy, we're just trying to illustrate that some high-dividend paying stocks (utilities and consumer stocks) are trading at crazy-high valuations.

Will overvalued sectors in the stock market return to normalcy? Absolutely. Someday they will because the valuation pendulum *always* swings back the other direction. Will the relationship between bond and stock yields return to normalcy? Who knows? Maybe today's low interest rates are the investment world's return to normalcy.

Evolution

Just as income seeking investors are being forced to evolve, investment management is evolving. There are two schools of thought regarding the best way to invest in stocks; active management and passive management.

Active managers use some methodology to pick stocks. They believe that outperformance can be obtained through a discipline (be that value stocks, growth stocks, momentum investing, etc.). Over time, the good ones do just fine, although they all suffer years of underperformance, as well as enjoy years of outperformance. Warren Buffett is the current poster child of great active managers. Active managers think.

Passive managers, or indexers, figure the odds are against them being able to "beat the market", so they throw up their hands and buy everything in the index. An index investor will always be average. An index/passive manager doesn't think.

An evolution is now happening as evidenced by the below headlines posted over the last 30 days. As a group, active mangers have had a rough go over the last few years. Many of the best and brightest active managers start hedge funds. A successful hedge fund can make the manager rich, allowing them to afford the fancy house in the Hamptons, their 1st, 2nd, and 3rd wives, and private school tuition. But, even the best of the hedgies have been suffering.

Withdrawals Plague Once-Mighty Hedge-Fund Firms

Active managers have been struggling. Pre-2009, it was common for maybe 50% of all active managers to "beat the market". During the last 7 years it has been more like 25%, and this year it has been only 18%. Because of this underperformance slump, money has been flowing out of active management shops (American Funds, T. Rowe Price, Janus, Baron, etc.) and into passive index shops (Vanguard).

Summer Brings $54.6B in Active Equity Fund Outflows

Active funds see flows flood out

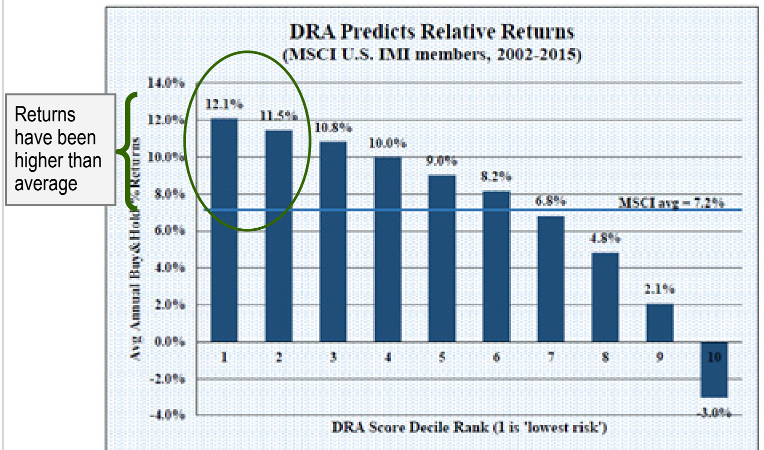
However, even the top-dog of indexing now sees the benefit of active management.

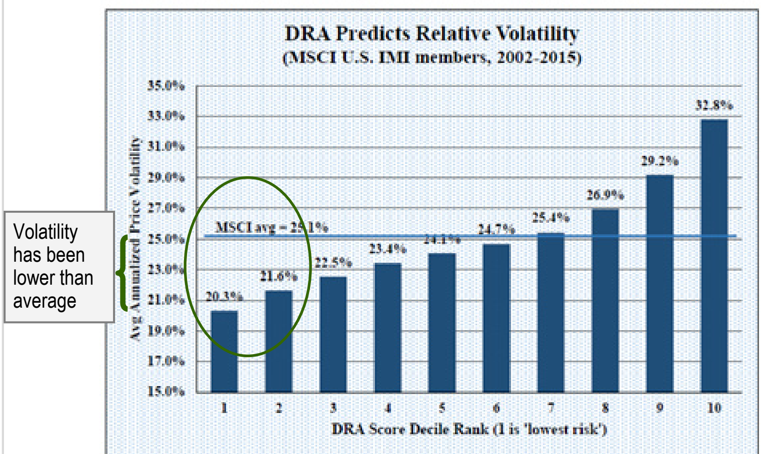
Vanguard, king of passive investing, joins the active ETF crowd

And, the brightest thinkers out there are moving more toward "quant" investing. This is where computer based screening is used for decision making, which removes some amount of human bias.

Quant investing is the biggest new trend for hedge funds

Sheaff Brock has been evolving too. We started moving to quant equity investing some time ago with Bulls of the Dow, IntelliBuilD Growth, and Mid-Cap 10 portfolios. Currently we are exploring prudent methods to make our Dividend Growth & Income model more quant driven. If there are ways to use the reams of available data to make better decisions, why not use them? And, if removing some of our human bias can improve results, we will swallow our pride and admit that maybe we aren't as smart as Watson. One quant research tool we have been leaning on for about nine months is from Revelation Investment Research, an institutional research firm. Revelation focuses on the downside risk a stock has based upon over 20 fundamental variables. By focusing on the downside risk vs. the upside potential, not only is volatility lower but, interestingly, it has also improved upside returns. In the next charts you can see the culmination of their work. The top couple of deciles of stocks, the ones with the fewest "downside risk" characteristics, since 2002, have returned 4 or 5% more per year (top chart) and have exhibited lower volatility (bottom chart).





This is the type of institutional quantitative data that we feel will improve all of our equity offerings.

Portfolio Updates

The stock market has been uncommonly quiet for the last month. Dog days of summer. Some technician types think this is a precursor to the next leg-up. Maybe an election rally?

Preferred Income

Preferred stocks keep on keepin' on. This bond/equity mash-up has been solid nearly all year. The space still offers a decent yield and yield-to-call. Recently the Fed has been hinting that they will likely raise rates later in the year. In December of last year, rates went up 25 basis points but preferreds held tight. Rising rates typically hurt fixed income prices, so one thing JR Humphreys, the portfolio manager, has been doing is slowly adding some floating rate preferred shares.

High Yield Bonds

High yields have had a great year. A recovering economy and especially rising oil prices have helped. High Yield bonds have been a stellar performer year-to-date. Good current yield of about 6% too.

Dividend Growth & Income

This is our flagship portfolio of high quality, dividend paying companies which have had a propensity to raise their dividends. We talked about the addition of the Downside Risk analysis on the previous page. July was quite good, which has brought our returns closer to par. The dividend yield is still over 3% and, of the 25 stocks in the portfolio, all but 1 have either raised their dividend or paid a special dividend in the trailing 12 months. The one stock that hasn't raised the dividend is yielding 4.75%, so they get a free pass….for now anyway. Good dividend income, rising income, and potential appreciation may be the new normalcy!

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. July was great, up about 6%. But this year, the *Investors Business Daily's* IBD 50 index, the base of the portfolio, has struggled to get back whole from January's swoon. IntelliBuilD has experienced much higher turnover in 2016 than it did in the previous two years, although has slowed down in the last couple of months. The portfolio stats are strong (sporting an average P/E of 21, and trailing earnings growth of 33%). As a comparison, the S&P 400 has an average P/E of 23 and average earnings growth of only 5%. A lower P/E with six-times the earnings growth. That is abnormalcy, in a great way.

Covered Call

The accounts had a great July; significantly better than the CBOE benchmark. We have generally been using shorter-dated calls because, with a low VIX, you don't want to lock in today's lower option yields for a long time. If volatility increases, expect a little longer option duration.

Alternative

This is our best performer YTD. Recent emerging market gains and metals prices gains have helped. Commodity prices could be turning up.

Mid-Cap 10

Had a big July, + 8%. Best rebound of all offerings. A great August would help catch back up, but we won't complain.

Bulls of the Dow

This is our #1 equity portfolio YTD. July was a rebalancing month and 2 of the 10 stocks changed. Quant is working!

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 Portfolio	Thru July - 2016	2015	2014	2013	2012	2011	2010	2009
Fixed Income	**Preferred Income** - Preferred stocks	5.97	5.22	14.02	-4.57	9.10			
	High Yield Bond	8.19	-7.32	-1.93	8.78	15.38	3.99	15.93	45.69
Growth and Income	**Covered Call Income** - Quality stocks & covered calls	2.18	-1.20	6.39	23.56	11.56	-10.25		
	Dividend Growth & Income - Dividend paying stocks	6.03	-7.16	5.20	36.09	12.36	5.36	17.09	24.08
Growth	**IntelliBuilD Growth** - IBD growth stocks	-2.79	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	6.54	1.14	12.42	30.05	7.83			
	Mid-Cap 10 - Mid-cap growth momentum stocks	-8.05	-12.68	11.84	24.32	23.55	21.88	21.26	38.15
Alternative	**Alternative** - Metals, foreign currencies, commodities	8.36	-8.25	-4.23	-0.70	9.02	-7.74		
	Index		**2015**	**2014**	**2013**	**2012**	**2011**	**2010**	**2009**
	S&P 500	7.66	1.38	13.69	32.39	16.0	2.1	15.1	26.5
	CBOE S&P 500 Buy/Write	3.24	5.24	5.64	13.26	5.20	5.72		
	Barclays Aggregate Bond	5.98	0.55	5.97	-2.15	4.2	7.8	6.5	5.9
	DB Commodity Index Tracking Fund (NAV Total Rtn.)	7.19	-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)