Davenport Asset Management
Quarterly Update | Q1 2018

March 31, 2018

The first quarter brought some long overdue volatility to equity markets. Indeed, the S&P 500 Index's relatively modest decline of 0.8% belies the underlying tumult during the quarter. Markets started the year where they left off in 2017, with the S&P 500 Index gaining 5.7% in January and cruising to new all-time highs. However, things quickly changed in February as the S&P 500 Index declined 3.7% and snapped its longest monthly winning streak since 1959 according to CNBC.

At one point, the S&P 500 Index was down 10.3% (intraday) for the month in early February. On February 5th, the Dow Jones Industrial Average experienced its largest percentage decline since 2011 (down 4.6%). We suspect ground zero for this correction was money flows centered around volatility. Betting against volatility, mainly through derivatives, has been an increasingly popular "easy money" trade over the last few years as markets have steadily ascended. When volatility began to dramatically increase, it triggered margin calls and covering, ultimately creating a supernova moment for these levered players on Monday, February 5th. As we noted at year-end, some turbulence was to be expected following an extended period of uninterrupted calm. Still, the violence of this event was no doubt unnerving.

Market Returns	Q1 2018	2017
U.S. Large Caps	-0.8	21.8
U.S. Mid Caps	-0.5	18.5
U.S. Small Caps	-0.1	14.7
International Developed Markets	-1.5	25.0
Emerging Markets	1.4	37.3
Intermediate Term Bonds	-1.0	2.1

Source: Morningstar Direct. Please see last page for index definitions.

March wasn't quite as wild; however, stocks remained under pressure. The trifecta of tighter Fed policy (the Federal Reserve raised interest rates on 3/21), Trump-induced fears of a trade war and troubles in the momentum-fueled tech sector created more uncertainty and pushed the S&P 500 Index down 2.5%. Interest rates remain low, and while stocks have been floating on cheap money for years, we don't think we're at a point where rates threaten economic growth. On trade, history shows that trade battles and tariffs are negative for global economic growth. We aren't dismissive of recent headlines, but hope the President's bark is bigger than his bite (as has been the case on some other issues). Finally, on technology, the weakness was prompted by user privacy concerns at Facebook (FB) and more recently the President's comments targeting Amazon (AMZN). As noted in our last writing, tech stocks appeared somewhat overbought; hence, all it took was one misstep for the sector to crack.

So now what? With the recent weakness, stocks are trading at levels seen prior to tax reform. In fact, the S&P 500 Index is trading for 16x Earnings Per Share (EPS) estimates over the next 12 months, which looks quite fair in the context of low interest rates and improving growth. While wage inflation and rising transportation costs are partly offsetting the benefits of lower domestic taxes, corporate earnings are nonetheless improving and we continue to see signs that lower taxes may help prompt an uptick in corporate capital expenditures. We aren't dismissive of recent negative headlines and acknowledge an outright trade war would be very problematic, but we also don't think the economy is signaling a downturn.

All told, it may actually be a plus for the market to take a breather after last year's gains. This period of consolidation could be setting the stage for further gains given what now appear to be reasonable valuations. That said, we maintain our view that forward returns should be more moderate following annualized returns of 15.8% for the S&P 500 Index from 2013-2017. Thank you for your trust and please see our Portfolio letters for a discussion of recent investment ideas.

Bond Market Update

The fixed income markets faced a reality check during the first quarter of 2018. Following 2017, where most assets trended upward, the increase in volatility shook the markets to the downside. Across the treasury complex, yields rose dramatically through mid-February, with the most drastic moves taking place in the front end of the yield curve. 2-year treasuries continued their rise from 2017, selling off with yields rising 37 basis points ending the quarter at 2.26%. 10 yr treasuries sold off as well, ending Q1 2018 at 2.74% after starting the year at 2.41%. The treasury sell off, accompanied by corporate spreads widening, resulted in negative returns for the quarter. To put this all in perspective, the Bloomberg Barclays Intermediate Government/Credit posted -0.98% for the quarter and the Bloomberg Barclays Intermediate Corporate index returned -1.50%. The lone bright spot within the high-grade credit market, where the only positive returns lived, was the Bloomberg Barclays FRN <5yr index, which posted a 0.47% return for the year.

2018 Yield Curve Change

Security	12/31/17	3/29/2018	Change
3 Mo. LIBOR	1.69	2.31	0.62
2 Year Treasury	1.89	2.26	0.37
5 Year Treasury	2.21	2.56	0.35
7 Year Treasury	2.33	2.69	0.36
10 Year Treasury	2.41	2.74	0.33
30 Year Treasury	2.74	2.97	0.23

Source: Bloomberg Barclays. Please see last page for index definitions.

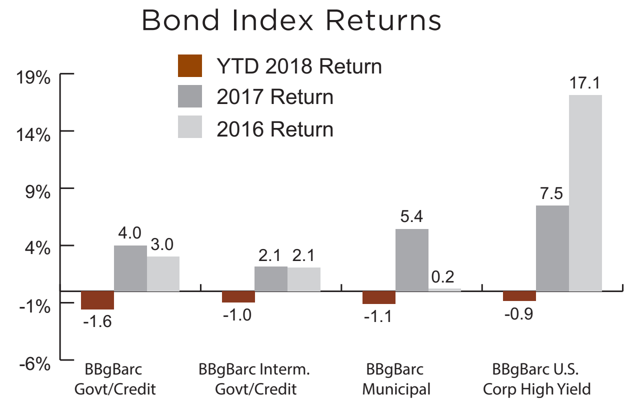
The start of 2018 was somewhat of a perfect storm in the bond market. The byproducts of President Trump's tax reform, while positive for equities, are overall negative for credit markets. Yields in the treasury market, especially in the front end, repriced higher because of the increased supply from the Treasury. To fund this increasing fiscal deficit, the U.S. treasury will have to issue double the amount of debt as in previous years, north of $1 trillion.

At the same time, the repatriation of foreign corporate cash has created more supply in the market as well. Corporations use US treasuries and USD investment grade credit as placeholders for their foreign assets. To repatriate this cash, we saw corporations

Bond Market Update Continued

selling bonds into the market. Overall, the market struggled to digest this new excess supply, while the demand for USD bonds was lacking two of the largest buyers (historically, Corporations and Central Banks). This imbalance was one of the causes of the swift move up in rates for Q1 2018. The good news is that this move has taken place and now the market seems to be on firmer ground going forward. We feel that the risk is still to the upside in yields, but may be less severe for the remainder of the year.

Also in Q1 ’18, under new chairperson, Jerome Powell, the Federal Reserve continued their normalization process in March, raising the Federal Funds Rate by 25 basis points to a range of 1.50%-1.75%. This marks the 6th rate hike since the Fed began hiking in December of 2015. The market expected this move along with at least two more hikes this year and potentially three hikes in 2019.



Source: Bloomberg Barclays. Please see last page for index definitions.

Overall, the pullback in the first quarter of 2018 was frustrating. However, we believe the dramatic move in yields from the new supply/demand imbalance are mostly in the rear view mirror. We still feel that rates may rise over time but will be less drastic as the market faces further Fed hikes, political tensions, inflation expectations and funding the increasing deficit…just to name a few potential headwinds. While these possible downside risks warrant a more defensive positioning in our portfolios, we have shortened our duration across the board and increased our allocation to floating rate notes to take advantage of the rise in LIBOR (London Inter-bank Offered Rate). Looking to the remainder of 2018, we feel market volatility may continue, but moves will be contained to a narrower range. In this environment, coupon income may eventually help total returns and chip away at some of the damage that was done in the first quarter.

Important Disclosures

Any opinions expressed here are statements of judgment on this date and are subject to future change without notice. This information may contain forward looking predictions that are subject to certain risks and uncertainties which could cause actual results to differ materially from those currently anticipated or projected. The information contained herein has been compiled from sources believed to be reliable; however, there is no guarantee of its accuracy or completeness. There is no guarantee that a company will continue to pay a dividend. The investment return and principal value of an investment will fluctuate. Small and mid cap company stocks may be more volatile than stocks of larger, more established companies. The portfolios may invest in foreign securities which are subject to additional risks such as currency fluctuations, political instability, differing financial standards and the potential for illiquid markets.

Performance shown is historical and is no guarantee of future results. Investing in securities carries risk including the possible loss of principal.

Index Definitions: U.S. Large Caps represented by the **S&P 500 Index**. U.S. Mid Caps represented by the **Russell Midcap Index**. U.S. Small Caps represented by the **Russell 2000 Index**. International Developed Markets represented by the **MSCI EAFE Index**. Emerging Markets represented by the **MSCI EM Index**. Intermediate Term Bonds represented by the **Bloomberg Barclays Intermediate Government/Credit Index**. The **S&P 500 Index** is comprised of 500 U.S. stocks and is an indicator of the performance of the overall U.S. stock market. The **Russell 2000® Index** measures the performance of the 2000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market. The **Russell Midcap® Index** measures the performance of the 800 smallest companies in the Russell 1000, which represent approximately 25% of the total market capitalization of the Russell 1000. The Russell 2000® Index and Russell Midcap® Index are trademark/service marks of the Frank Russell Co. Russell® is a trademark of the Frank Russell Co. The **Lipper Equity Income Funds Index** is an unmanaged index of the 30 largest funds in the Lipper Equity Income Fund category. The **Morgan Stanley Capital International Europe, Australia and Far East (MSCI EAFE) Index** is an unmanaged index composed of the stocks of approximately 1,000 companies traded on 20 stock exchanges from around the world, excluding the U.S., Canada, and Latin America. The **Morgan Stanley Capital International Emerging Markets (MSCI EM) Index** is a capitalization-weighted index of stocks from 26 emerging markets that only includes issues that may be traded by foreign investors. The reported returns reflect equities priced in US dollars and do not include the effects of reinvested dividends. The **Bloomberg Barclays U.S. Corporate High Yield Index** measures the U.S. dollar-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody’s, Fitch and S&P is Ba1/BB+/BB+ or below. The **Bloomberg Barclays Intermediate Government/Credit Index** is an unmanaged index composed of debt securities with maturities from one to ten years issued or guaranteed by the U.S. Treasury, U.S. Government agencies, quasi-federal corporations and fixed rate dollar denominated SEC-registered corporate debt that are rated investment grade or higher by Moody’s Investors Service and Standard and Poor’s Corporation or Fitch Investor’s Service, in that order. The **Bloomberg Barclays Municipal Index** covers the U.S. dollar-denominated long-term tax exempt bond market. The **Bloomberg Barclays U.S. Government/Credit Bond Index** measures the non-securitized component of the U.S. Aggregate Index. It includes investment grade, U.S. dollar-denominated, fixed-rate Treasuries, government-related and corporate securities. **The Bloomberg Barclays Capital US FRN < 5 Years Index** is a subset of the US Floating-Rate Note (FRN) Index, which measures the performance of USD denominated, investment-grade, floating-rate notes across corporate and government-related sectors. This index has a maximum maturity of 4.9999 years and is not part of the US Aggregate Index, which is a fixed coupon index. **The Bloomberg Barclays Intermediate Corporate Index** The Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

An investor cannot invest in these indices and their returns are not indicative of the performance of any specific investment.