Davenport Asset Management
Quarterly Update | Q2 2018

June 30, 2018

Equity markets picked up steam in the second quarter. Volatility cooled following a first quarter spike and investors were generally encouraged by economic data and corporate earnings reports. The S&P 500 Index gained 3.4% while the small cap-oriented Russell 2000 Index advanced an impressive 7.8%. Year-to-date, the S&P and Russell finished the quarter up 2.7% and 7.7%, respectively.

Economic growth in the U.S. seems to be outpacing the rest of the world, causing investors to shun foreign markets and favor companies with a domestic bias. This helps explain the significant outperformance of the Russell 2000 Index, which houses a number of smaller U.S.-centric companies. We've also seen strength in the U.S. dollar, which has created a headwind for large U.S. multinational companies that generate much of their revenue from outside the U.S. and must translate foreign earnings back into dollars at less favorable exchange rates. All the while, protectionist talk from the Trump administration and ongoing fears surrounding trade wars have put a further damper on international markets as well as U.S. stocks with significant foreign exposure.

Market Returns	Q2 2018	YTD
U.S. Large Caps	3.4	2.6
U.S. Mid Caps	2.8	2.3
U.S. Small Caps	7.8	7.7
International Developed Markets	-1.2	-2.7
Emerging Markets	-8.0	-6.7
Intermediate Term Bonds	0.0	-1.0

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

Dollar strength, slower growth abroad, cost pressures and trade fears have also prompted a case of "peakitis." In other words, investors seem to think economic growth may be close to peaking. This fear has been fueled further by the Federal Reserve's recent interest rate hikes. After years of ultra-loose monetary policy, some fear rising interest rates could crimp cyclical areas like construction and housing. These are valid fears and we are indeed many years into an economic expansion. On the other hand, we point out rates are still low by historical standards and corporate capital expenditures are finally beginning to accelerate. At the same time, the federal government is rolling out massive fiscal stimulus (both spending and tax cuts). This stimulus may be goosing near-term growth at the expense of long-term growth, but the market may be underestimating how much gas is left in the tank. Lastly, we've already seen significant damage inflicted on shares of many cyclical companies, suggesting a great deal of worry has already been discounted.

Fears of slowing growth have also fueled ongoing outperformance for the technology sector. The tech-heavy NASDAQ Composite Index gained 6.6% in the second quarter. Put simply, worries about a growth scarcity brought about a renewed willingness to pay a premium for companies with above average growth. We own a number of tech names and appreciate their attributes, especially the seemingly unassailable dominance of the large cap tech leaders. However, we continue to think the group's leadership is a little long in the tooth and expect it could start to lose some momentum. Of note, technology now represents 25.96% of the S&P 500 Index versus 24.87% in the first quarter of 2018.

It's hard not to mention technology without also referencing the dramatic outperformance of "growth" versus "value" investing. This quarter alone, the Lipper Large Cap Growth Index was up 5.9% versus a meager 1.9% gain for the Lipper Large Cap Value Index. Including 2018, value investing has now lagged growth investing for 10 of the last 11 years. Investors' recent tendency to gravitate towards momentum has coincided with an unwillingness to look at businesses facing headwinds, even if they are short-lived in nature. As a result, some sectors/companies have been neglected and seem to offer favorable risk/reward profiles. There are many cases where businesses are being materially disrupted (oftentimes by the aforementioned technology juggernauts) and should be avoided. However, there are also cases where good businesses are underpriced and worth a look. Recently, we've pinpointed a couple opportunities in the downtrodden consumer staples sector.

Finally, we note valuations still look reasonable with the S&P 500 Index trading at 17.1x earnings estimates for this year. Although we continue to expect moderating returns following the heady returns of 2013-2017 (the S&P annualized at 15.8%), we don't think investors are overpaying for stocks right now barring a recession. It may be difficult for stock valuations to expand with a backdrop of tighter monetary policy; however, earnings growth, dividends and large corporate buyback programs could still produce decent results for investors. Thank you for your trust and please see our Portfolio letters for a discussion of specific ideas.

Bond Market Update

The bond market experienced increased volatility during the second quarter as domestic and international issues took center stage. The catalysts for the increase in volatility were concerns over global growth, uncertainty surrounding the new Italian government, potential trade wars resulting from Trump's erratic tariff threats, and the Federal Reserve's decision to raise the federal funds rate.

Treasury rates were slightly higher at the end of June. The two-year Treasury rose 26 basis points, the five-year treasury rose 18 basis points, the ten-year treasury rose 12 basis points and the thirty-year sector rose two basis points. The yield curve, which is the difference between short and long-term rates, continued to flatten during the quarter as the difference between 2-year treasuries and 10-year treasuries was 33 basis points at the end of June. At the end of March, the difference was 48 basis points. The quarterly yield range for the ten-year Treasury was a low of 2.7%, a high of 3.1%, and a close of 2.9%.

2018 Yield Curve Change

Security	Q1 2018	Q2 2018	Change
3 Mo. LIBOR	2.31	2.34	0.02
2 Year Treasury	2.27	2.53	0.26
5 Year Treasury	2.56	2.74	0.18
7 Year Treasury	2.69	2.82	0.14
10 Year Treasury	2.74	2.86	0.12
30 Year Treasury	2.97	2.99	0.02

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

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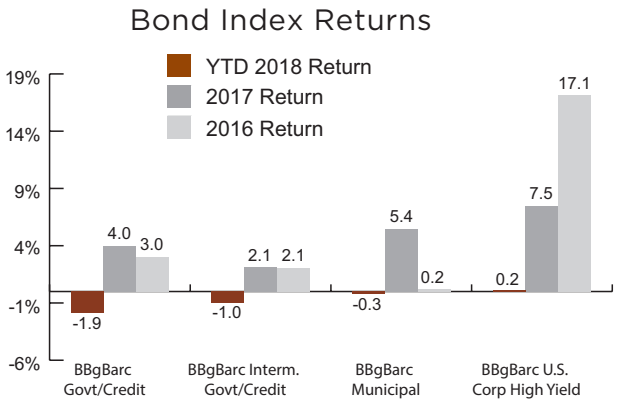
Bond Market Update Continued

The Federal Reserve acted to raise the federal funds rate by 25 basis points on June 13th to a range of 1.75%-2.0%. The move, widely anticipated, is consistent with the Fed's move towards normalized rates – ultimately with a 3% target for Federal Funds. There is no specific time line associated with reaching their stated level but it is expected that the Fed may raise the Fed funds rate two more times in 2018. Low unemployment at 3.8%, inflation close to their stated policy level of 2% and an expected Q2 GDP of close to 4% provided the backdrop for the rate increase.

The political uncertainty in Italy raised concerns about the viability of the European Union as a separatist party won the majority of the seats in their general election. The new Italian government recommended a new finance minister, an advocate of leaving the union, and this created a temporary flight to treasuries as fears of the breakup of the union escalated. Adding to the uncertainty of the union was the initiation of significant tariffs by Trump on our trading partners. The tariffs, if imposed, could lead to the destabilization of global economies and raise the costs of many products imported for U.S. consumers. There is already concern about the continuation of the global economic expansion as the stocks of emerging markets showed weakness for the quarter.



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

Overall, we are encouraged by the bond market stabilization we saw in the second quarter of 2018. Looking forward, we continue to believe market volatility should persist which bodes well for investors seeking stability and income within the bond market. In the current environment, we continue to believe a defensive positioning is warranted as the Fed continues to raise rates. We still prefer a short duration bias while trading up in quality and taking advantage of floating rate notes. As the year progresses, coupon income will accumulate and hopefully make up some of the lost ground from the first half of 2018. For investors putting fresh capital to work, the good news is that you can now achieve over 3% even in the 1-5 year corporate credit space.

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 **NASDAQ Composite Index** is a broad-based capitalization-weighted index of all common stocks listed on the Nasdaq. 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 **Lipper Large Cap Growth Funds Index** is an unmanaged index of the 30 largest funds inthe Lipper Large Cap Growth Fund category. The **Lipper Large Cap Value Funds Index** is an unmanaged index of the 30 largest funds in the Lipper Large Cap Value Fund category. 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 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.