Davenport Asset Management
Quarterly Update | Q4 2018

December 31, 2018

2018 brought investors a number of twists and turns. In the end, the S&P 500 Index finished the year down 4.4%. This was the first down year for the S&P since the sharp swoon we experienced in 2008. Losses were concentrated in the fourth quarter, when the Index dropped 13.5% and experienced its worst December since 1931. Meanwhile, the Russell 2000 Index declined 20.2% in the fourth quarter and ended the year down 11.0% as a "risk off" mindset disproportionately impacted shares of smaller companies.

Let's take a look back at how the year progressed. We started the year still on a sugar high from the 2017 Trump tax cuts. Then, we finally saw volatility return to the market in February following an extended period of uninterrupted calm. Volatility persisted, but markets managed to climb higher through the year. The S&P's 7.7% gain in the third quarter was particularly impressive (and somewhat surprising), as it came in the face of numerous headwinds including trade tensions, rising interest rates and signs of cracks in a few areas of the economy. It seemed hopes for still-reasonable economic and corporate earnings growth were enough to keep investor optimism alive.

Market Returns	Q4 2018	YTD
U.S. Large Caps	-13.5	-4.4
U.S. Mid Caps	-15.4	-9.1
U.S. Small Caps	-20.2	-11.0
International Developed Markets	-12.5	-13.8
Emerging Markets	-7.5	-14.6
Intermediate Term Bonds	1.7	0.9

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

That changed in the fourth quarter, when we reached somewhat of a tipping point. Fears of moderating growth moved to center stage and were supported by evidence of weakness in economically sensitive areas such as housing and transportation. Concurrent with a pervasive bout of "peakitis," investors began to pay more attention to monetary policy, suddenly fearing the Federal Reserve may be raising interest rates too far in light of slowing growth. Equity markets swiftly rolled over and the S&P finished 14.5% off its intra-year high. Interestingly, a number of momentum-oriented stocks, particularly within technology, fully participated in the downside. We had noted this group's leadership was getting long in the tooth and this proved to be the case.

The forecast has certainly become cloudier. Investors need to consider a number of abating tailwinds as well as potential headwinds. In the category of abating tailwinds, bear in mind the following: 1) employment gains aren't likely to continue at recent levels with unemployment at a record low, 2) consumer credit quality can't get much better, 3) corporate borrowings are unlikely to expand much from already elevated levels and 4) corporate earnings growth will likely slow in 2019 given the waning impact of corporate tax reductions. Potential headwinds include: 1) pressure on profit margins from higher freight, labor and interest costs, 2) ongoing trade battles and 3) tighter Fed policy and rising interest rates after years of ultra-loose monetary policy.

However, we don't think the sky is falling. The economy still seems healthy, rates are still low in absolute terms and inflation remains subdued. Also, some areas of the market have already gone quite far in discounting a slowdown (albeit maybe not a full blown recession) and equity valuations broadly look reasonable. The S&P now trades at 14.9x forward earnings estimates, down from 16.7x at mid-year and below an average of 16.5x over the last 25 years. Current levels seem to offer an attractive risk/reward proposition even if earnings estimates need to be revised downward a bit. In addition, negative investor sentiment could give way to a rally. As we write this, the CNN Fear & Greed Index has a reading of 12 versus 63 a year ago (scale of 0-100 with 0 representing extreme fear and 100 showing extreme greed).

All told, we continue to think investors need to be expecting worthwhile but more moderate returns. As a reminder, the S&P generated annualized returns of 15.8% from 2013-2017. Such returns are far above historical norms and indicate to us that the market borrowed from the future. It makes perfect sense to expect more subdued returns over the next five year period and results for 2018 seem to be a step in that direction (although the near-term outlook has certainly improved with stock prices now lower). We think this type of environment will make stock selection more important. Further, it could cause investors to place added emphasis on sound capital allocation by corporate management teams. In recent years, cheap money and rising asset values have coalesced to make even marginal corporate investment decisions look good. This could change in an environment with a rising cost of capital and increased risk aversion. Thank you for your trust and read on for a discussion of Portfolio themes and ideas.

Bond Market Update

As we entered 2018, it was the first time in many years that global economies were growing together. The investment outlook was favorable and optimism was wide spread. Fast forward to the end of the third quarter; stocks were at new highs and the bond market was relatively mundane. Boy, what a change took place as the fourth quarter was ushered in. Stocks dropped and 10-year Treasuries, kissing 3.25% for much of the summer, ended the year at 2.69% - a 37 basis point drop.

Our base premise at the beginning of the year was that the economy would continue to grow at around 3% and the Federal Reserve would gradually raise rates to their theoretical "normalized" level of 3% with Fed Funds as we closed in on 2020. We believed the yield curve, the difference between short and long-term rates, would shrink and that floating rate notes would be an attractive investment as we moved forward in time. We were spot on through the end of the third quarter – then the financial landscape took a dramatic turn and virtually every asset, other than Treasury securities, were no longer producing positive returns.

We, like most asset managers, are now looking into a very hazy future to decide what course to take. The challenge being that we are in an arena where there is no clarity other than the fact that volatility, in stocks and bonds, will be present for the immediate future. Thus, it is difficult to assign value to a 2-year Treasury that was just shy of 3% at the beginning of November that is now at 2.5%.

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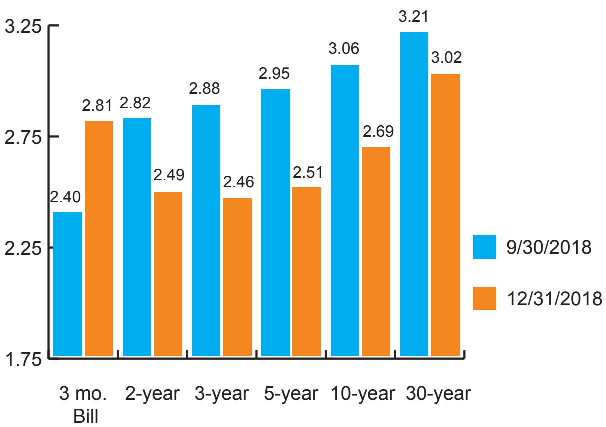
Bond Market Update Continued

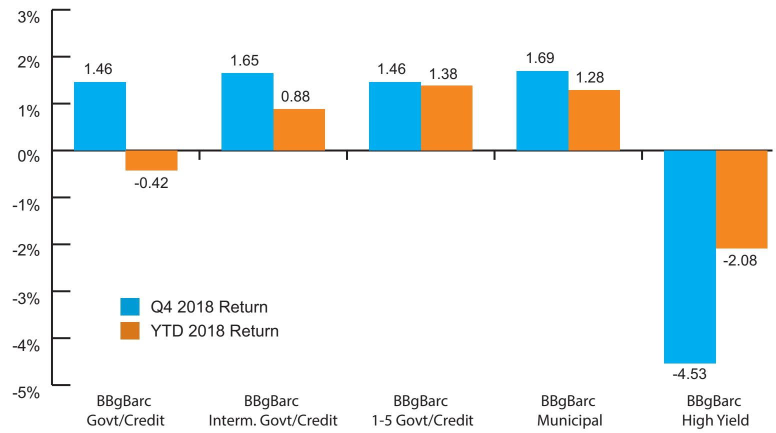
Our view is the U.S. economy will grow at a moderate 2.6% GDP rate for 2019 and the Federal Reserve will continue to raise short term rates. In light of this view, our strategy for 2019 is to continue to take advantage of opportunities to upgrade the credit quality of our portfolios. This effort started in September in anticipation of a challenging year for corporate credit quality. Additionally, proceeds from floating rate notes maturing during the first quarter of 2019 will be invested in attractive fixed rate securities of varying maturities. We continue to believe conservative structures are appropriate as we enter 2019 and the uncertainty surrounding the global investment environment with many countries showing signs of economic deceleration.

Q4 2018 Treasury Yield Changes



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

2018 Index Returns



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

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, representing approximately 8% of the total market capitalization of the Russell 3000. The **Russell 1000® Value Index** measures the performance of the Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. 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, Russell 1000® Index and Russell Midcap® Index are trademark/service marks of the Frank Russell Co. Russell® is a trademark of the Frank Russell Co.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 U.S. 1-3 Year Government/Credit Index** includes all medium and larger issues of U.S. government, investment-grade corporate, and investment-grade international dollar-denominated bonds that have maturities of between 1 and 3 years and are publicly issued. The **Bloomberg Barclays U.S. 1-5 Year Government/Credit Index** measures the performance of U.S. dollar-denominated U.S. Treasury bonds, government related bonds (i.e., U.S. and non-U.S. agencies, sovereign, quasi-sovereign, supranational and local authority debt) and investment grade U.S. corporate bonds that have a remaining maturity of greater than or equal to one year and less than five years. **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.