TRIVANT

CUSTOM PORTFOLIO GROUP, LLC

April 2016

Quarterly Insights

EXECUTIVE SUMMARY

US Stocks and Oil Have Wild Ride In Q1

In the First Quarter, the domestic S&P 500 Index was up a modest 1.35% and oil prices rose a mere 0.87%. However, it was a wild ride. The S&P 500 Index fell more than 10% by February 11 before rising to positive territory, and oil prices fell 28% by February 12 before recovering 41% by quarter end. Other developed markets were negative. While Emerging Markets was positive (+5.71%), it was led by Brazil (+28.48%) and Russia (+15.75%) rather than China (-4.80%) and India (-2.50%). The Barclay's bond index rose 2.78%, a stark contrast to 2015 which was up only 0.57%.

Should Dividends Drive Stock Selection?

The dividend yield for the S&P 500 Index is 2.11%, a rate that exceeds recent market returns and the 1.83% yield on a 10-year US Government Treasury. Should dividends drive stock selection in these conditions? Our short answer is "no".

While a high dividend yield may appear attractive, a dividend is not guaranteed and can be cut anytime. Dividend-paying stocks are sensitive to interest rates. Decisions regarding style rotation, total return and tax efficiency should take precedence.

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First Quarter 2016

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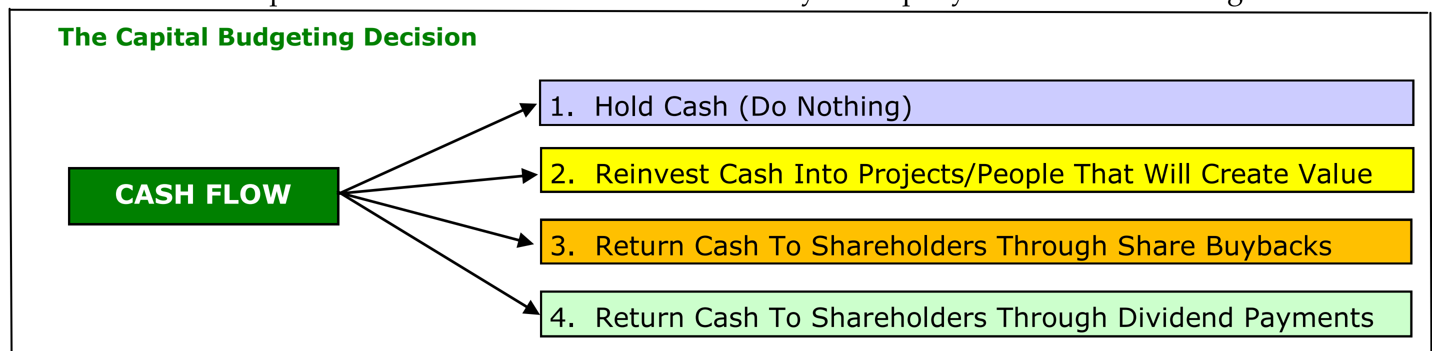
Should Dividends Drive Stock Selection?

Dividends Can Appear Attractive Amidst Flat Market Returns And Low Interest Rates

We have faced flat market returns for over a year after a spectacular multi-year recovery that started in early 2009. The S&P 500 Index rose 1.38% in 2015 and was up 1.35% in the First Quarter. To complicate matters, we have also faced historically low interest rates on high-quality bonds. For retirees, it is especially challenging to meet cash flow needs from portfolio income alone.

The dividend yield for the S&P 500 Index is 2.11%, a rate that exceeds recent market returns and the 1.83% yield on a 10-year US Government Treasury. Should dividends drive stock selection in these conditions?

Before addressing this question, let's briefly review the mechanics of a dividend. When a company generates cash flow, its management is faced with a capital budgeting decision as to where to deploy the funds. Dividends do not represent additional wealth but are one way a company can share its existing wealth.



It's Important To Distinguish Dividend Yield, Dividend Growth Rate, And Total Return

"Dividend Yield" indicates how much a company pays out in dividends each year relative to its share price.

Dividend Yield = Dividends Per Share For The Previous 12 Months / Current Price Per Share

When a stock's price falls, its dividend yield (assuming a constant dividend) increases, and vice-versa.

The "Dividend Growth Rate" is the annualized percentage increase in company dividends. To maintain an investor's purchasing power, it is important to know whether the growth rate is keeping up with inflation.

The "Total Return" for a stock considers both its cash payment (dividend) and appreciation (capital gains).

Dividend Relevance Is Inconclusive From An Academic Standpoint

1. Dividend Irrelevance Theory

The Franco Modigliani / Merton Miller "dividend irrelevance theory" states that there is no effect from dividends on a company's capital structure or stock price. Why? An investor can replicate desired dividend cash flow by selling company stock and is therefore indifferent between dividends and capital gains.

2. Bird-In-The-Hand Theory

The Myron Gordon / John Lintner "bird in the hand theory" states that dividends are relevant and preferred by investors. In this theory, a "bird in the hand" (dividends) is worth "two in the bush" (capital gains).

3. Tax-Preference Theory

The "tax preference theory" considers different potential tax rates for dividends and capital gains. Depending on their individual tax bracket, some investors may prefer capital gains to dividends, and vice versa.

There Are Pitfalls With A Dividend-Centric Approach To Stock Selection

Many think the total return (dividends and capital gains) of a dividend paying stock will be higher than that of a non-dividend stock. They are often wrong. A dividend-centric approach to stock selection has pitfalls.

1. Don't Be Fooled By High Yield: Dividends Can Be Cut In Adverse Market Conditions

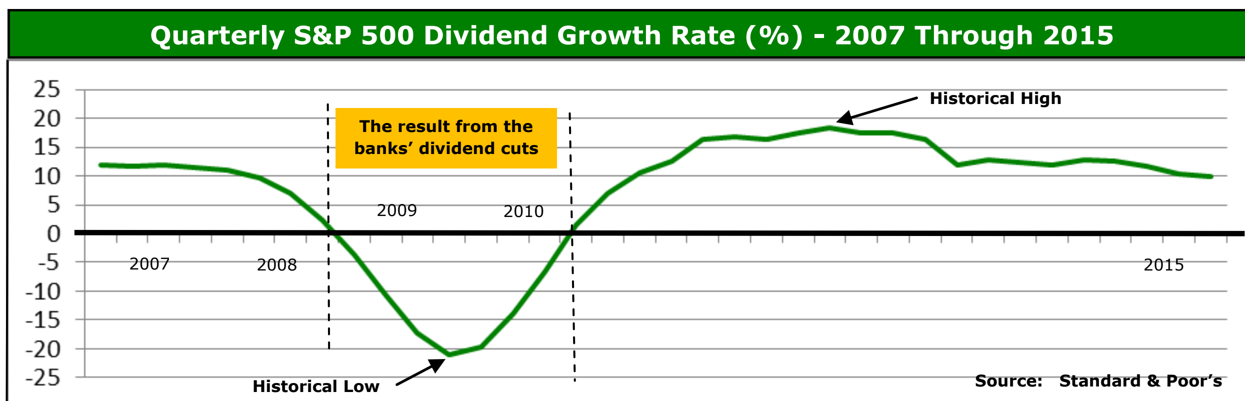
Recall the definition of dividend yield:

Dividend Yield = Dividends Per Share For The Previous 12 Months / Current Price Per Share

Imagine a company pays a quarterly dividend of $1.00 per share and its stock price is $80.00. Its dividend yield is 5% ($4.00 / $80.00). Let's further imagine the company faces adverse market conditions and its stock price falls to $40.00. Assuming a constant dividend, the dividend yield rises to 10% ($4.00 / $40.00). The adverse market conditions likely necessitate that the company reduce its quarterly dividend to $0.50 to meet pressing cash obligations. Assuming a constant stock price, the dividend yield returns to its original 5% ($2.00 / $40.00). The investor has had a loss in income (dividends) and share price (unrealized capital losses). The interim rise in dividend yield (5% to 10%) was a value trap rather than a positive stock indicator.

Dividends are not a guarantee: they can be cut. Indeed this is what happened during the financial meltdown in 2008-2009. All the major banks either slashed or eliminated dividends. Dividend growth was decimated.

Quarterly S&P 500 Dividend Growth Rate (%) - 2007 Through 2015



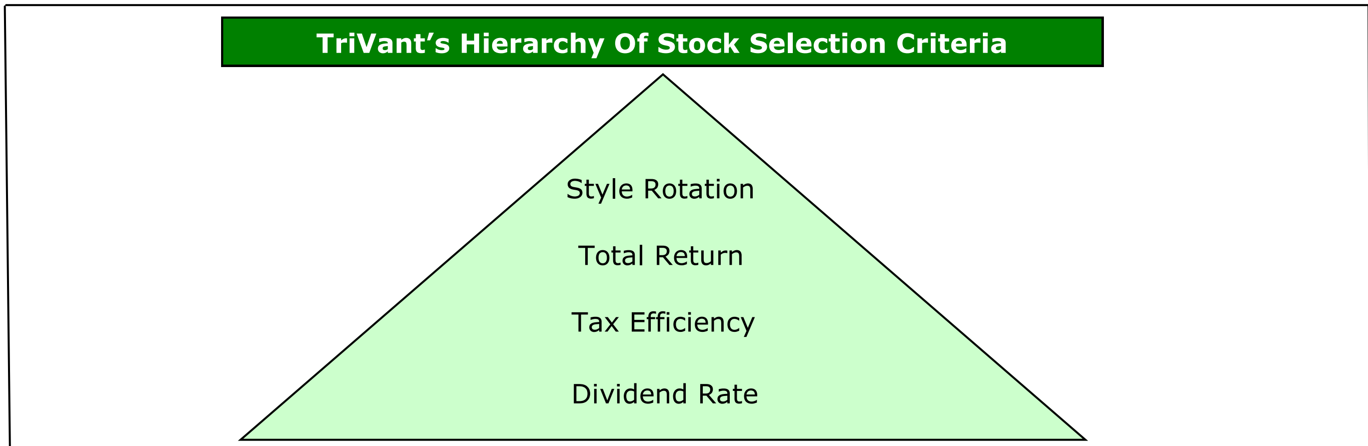
Williams Partners L.P. (symbol: WPZ) owns, operates, develops and acquires natural-gas assets. WPZ got hit hard with falling commodity prices. While net income was roughly 20%-25% of revenues from 2012-2014, there was a net loss of $1.9 billion on revenues of $7.3 billion in 2015. To meet operating needs and $2.7 billion dividend payments, WPZ raised $7.4 billion from debt issuance in 2015, and now has "long term debt" at 40% of total assets on its balance sheet. While its stock was down 30% in Q1 and 60% over the last year, WPZ still met its stated quarterly dividend of $0.85 a share over the last four quarters. The dividend yield as of March 31 was 16.63% ($3.40 / $20.45), which looks quite enticing. Can WPZ meet its stated dividend going forward given its operating pressures and debt load? This could be a high-yield company that will fool investors.

2. Dividend Stocks Are Sensitive To Interest Rates

Many investors see conservative dividend stocks as a substitute for fixed income securities. Consequently, dividend stocks are highly sensitive to interest rates. If rates rise, the dividend yield becomes less attractive as compared to other fixed income alternatives, and the stock price falls. If rates fall, the stock price rises. Look at what happened the first six months of 2015. This period had rising interest rate risk with an improved labor market and economy, as well as comments from the Fed that interest rate hikes were on the horizon. While the S&P 500 Index was +2%, high dividend yielders such as Utilities (-20%) and REITs (-15%) fell hard.

We Do Not Prioritize Dividends Regarding Stock Selection Criteria

We do not prioritize dividends regarding our criteria for portfolio stock selection. Why? We believe style rotation, total return, and tax efficiency should take precedence (and in that order).



1. Style Rotation

Dividend payers tend to be more mature companies in industries such as Utilities, Consumer Goods, and Energy. While they typically provide stability to a portfolio, they have slower growth prospects and fewer profitable reinvestment opportunities (see Capital Budgeting Decision, page 2). Faster-growing companies tend to retain their earnings and reinvest them into their business. Simply said, the higher-dividend stocks have a value focus and the low/no dividend stocks have a growth focus. Regarding style rotation, we currently have a growth focus that stresses high quality US companies. Consequently, the dividend yield of our model portfolio (1.56%) lags both the dividend yield of the S&P 500 Index (2.11%) and the MSCI EAFE (Foreign) Index (3.01%). One of the biggest downsides to chasing dividends is "concentration risk": the top-yielding securities are concentrated in sectors which tend to grow less in rising markets.

2. Total Return

The total return of a stock is the important consideration (income and appreciation). In general, dividend-paying companies see less price appreciation than growth stocks. Therefore, our relative bias to dividend-paying stocks will depend on where we believe we are in the market cycle. At a time where we favor growth stocks in our style rotation framework, we place less priority on dividends and more priority on gains.

3. Tax Efficiency

Price appreciation (capital gains) may be more valuable than dividends. Why? Dividends are taxed when paid (in a taxable account). Capital gains are taxed when realized. Delaying taxes and letting untaxed returns compound will likely be a more tax-efficient strategy. Step-up cost basis also favors price appreciation.

4. Dividend Rate

As long as the first three components of our hierarchy are satisfied (style rotation, total return, tax efficiency), we would rather receive a dividend than not receive one. Dividend growth is a more important consideration than dividend yield. A company can cut its dividend at any time. Dividend yield considers the past year of dividend data - it is not forward-looking. The dividend growth rate provides more answers as to where the stock is heading. Reliability is more important than a high yield.

Stock Market Spotlight

US Stocks And Oil Have Wild Ride In Q1

In the First Quarter, the domestic S&P 500 Index was up a modest 1.35% and oil prices rose a mere 0.87%. However, it was a wild ride. The S&P 500 Index fell more than 10% by February 11 before rising to positive territory, the first time a double-digit recovery has happened within a quarter since Q4 1933. Oil prices fell 28% by February 12 ($36.59 to $26.21 per barrel) before recovering 41% by quarter end ($36.91 per barrel). Other developed markets were negative. While Emerging Markets was positive (+5.71%), it was led by Brazil (+28.48%) and Russia (+15.75%) rather than China (-4.80%) and India (-2.50%).

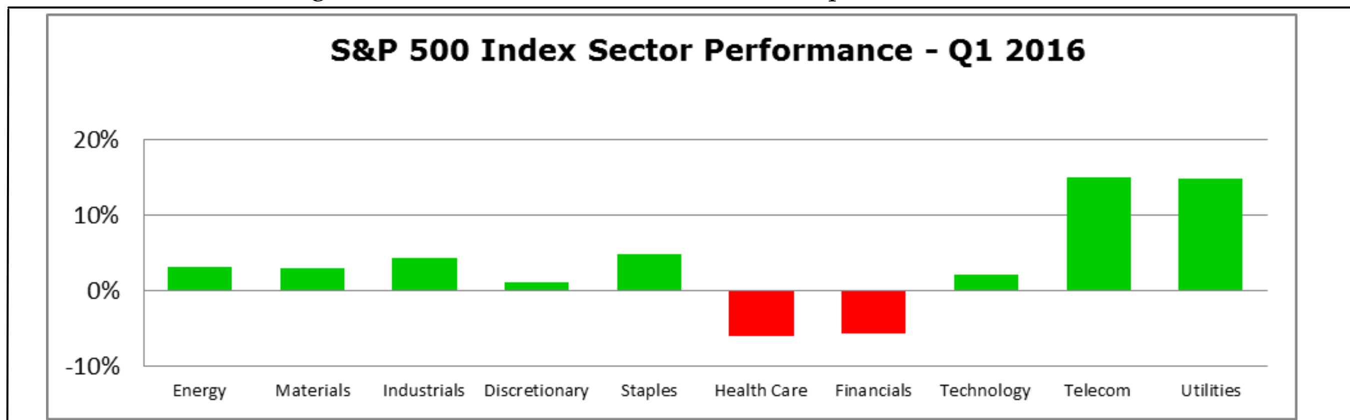
Equity Index Performance

Index	Q1 2016
S&P 500 (Domestic)	**1.35%**
MSCI EAFE (Foreign) *	**(3.01%)**
MSCI Emerging Markets	**5.71%**
MSCI EMU (European Monetary Union)	**(2.09%)**
MSCI Japan	**(6.52%)**

* Europe, Australia and the Far East

Sector Performance Was Wide-Ranging In Q1

Seven out of 10 sectors out-performed the S&P 500 Index, the most dramatic being Telecom and Utilities (the smallest sectors, each weighted less than 3%). Two sectors under-performed: Health Care and Financials.



We Lagged Our Benchmark In Q1

Our Q1 portfolio positioning was not optimal. The “high yield” dividend sectors of which we have minimal exposure (Telecom and Utilities) benefited from reduced expectations of a Fed rate hike. Financials suffered from fears of energy company loan exposure. Healthcare fell due to headline risk from the Valeant scandal and election rhetoric regarding the high cost of pharmaceuticals. We did not benefit from European foreign exposure and we had no Emerging Markets exposure. Having said this, we are comfortable with our current positioning: we expect a rate hike, bank loan and pharma fears are exaggerated, and Europe is improving.

Performance Attribution Q1 2016 Highlights	Positive Attribution	Negative Attribution
Sector Selection	(Nothing Notable)	Financials & Telecom
Stock Selection	Financials & Technology	Discretionary & Industrials

Bond Market Spotlight

Bonds Rise In Q1

The Barclay's Capital US Aggregate Bond Index, a broad-based representation of bond performance, rose 2.78% in the First Quarter. This is a stark contrast to 2015 when the index was up 0.57% for the entire year. The yield curve effectively shifted downward as it slightly tightened. A tightening yield curve is less favorable for banks as they make less money on their lending spread.

Key US Interest Rates	Dec. 31, 2015	March 31, 2016	Change
Federal Reserve Board Funds Target Rate	0.25%	0.25%	0 basis points
5-Year Treasury (Constant Maturity)	1.80%	1.26%	- 54 basis points
10-Year Treasury (Constant Maturity)	2.31%	1.83%	- 48 basis points
30-Year Treasury (Constant Maturity)	3.04%	2.65%	- 39 basis points

Note: 100 basis points (bp) = 1.00% Source: Telemet

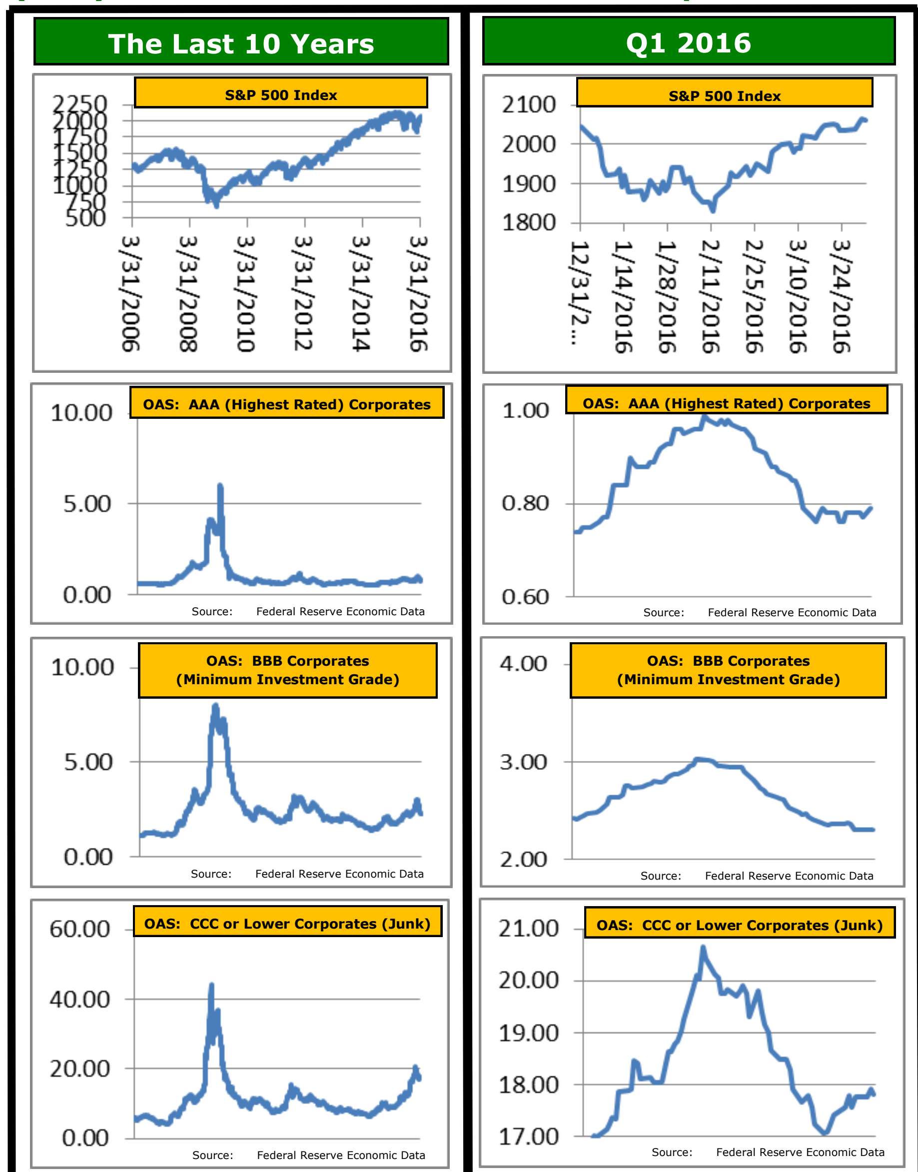
The Option Adjusted Spread (OAS) Measures The Risk Premium Of Corporate Bonds

The Option-Adjusted-Spread (OAS) is the differential yield (%) of a corporate bond versus a risk-free Treasury bond with the same maturity.

In times of perceived market risk, the OAS will increase as investors "flee to quality" (less risky bonds). The magnitude of the OAS increases as the corporate bond quality rating decreases (from AAA to CCC).

In 2008-2009, there was a huge spike in OAS as investors fled to Treasurys during the crisis. The OAS for junk (CCC) bonds exceeded 40% (5X the BBBs).

In Q1 2016, the OAS spiked as the stock market fell through early February. Note the very high OAS (17.76%) for the junk (CCC) bonds primarily tied to the highly risky Energy sector. Don't get fooled by high yield!



Your Portfolio

The First Quarter can best be described as a roller coaster. From January through February 11, the S&P 500 Index fell roughly 10%. You may recall the letter we sent to you on February 8 stating why we felt this was a normal market correction versus heading into a bear market and, if true, our experience was that "knee jerk reactions" prove detrimental. We don't have a crystal ball, but fortunately the market more than recovered by quarter end. Thank you for the confidence you had in us during a very uncomfortable time.

During the quarter, we bought Allergan PLC (symbol: AGN), a pharmaceutical company whose products (most notably Botox) are not susceptible to insurance pricing pressure because they are not covered. We also bought Equity Commonwealth (symbol: EQC), which is a real estate investment trust (REIT). On August 31, the S&P 500 Index is adding a new REIT category, so we jumped ahead of the curve by adding an exciting REIT turnaround led by legendary industry leader Sam Zell.

We sold Johnson Controls (symbol: JCI), an industrial company that concentrates in three areas: auto parts, commercial property HVAC servicing, and batteries. While the auto industry has done well lately, JCI did not keep pace. We also sold PNC Financial Services Group Inc. (symbol: PNC) in order to reduce our bank exposure.

Over the next few months, we anticipate further adjustments to both the stock and bond components of your portfolio. Stay tuned for updates.

We will continue to closely monitor the market and adjust your portfolio as needed. Please feel free to contact us anytime to discuss questions or comments you may have. We will keep you informed of portfolio progress.

Respectfully submitted,

TRIVANT

CUSTOM PORTFOLIO GROUP, LLC

John Barber, CFA	Dan Laimon, MBA	Michael C. Harris, CFA
Chief Investment Officer	Managing Member	Vice President

Disclaimer

The information presented herein is intended for informational purposes only. All views are subject to change based on updated indicators. The recommendations made in this publication are made without regard to individual suitability. Investors should consider their own needs and objectives before making any investment decision.

Commentary in this review reflects our portfolio strategy. Many of our clients have different objectives and circumstances which are reflected in unique portfolio considerations. Please note that accounts may not contain all elements of the strategy discussed here. Additionally, individual client customizations and start dates may preclude certain elements of this strategy from being implemented.

Past performance is no guarantee of future results. A risk of loss is involved with investments in stock markets.