Davenport Asset Management
Quarterly Update | Q2 2016

June 30, 2016

Equity markets gave us another interesting ride in Q2, with excitement capped off by the “Brexit” vote at quarter end. This surprise initially caused a market swoon, but stocks were able to bounce back nicely in the closing days of June. Ultimately, the S&P 500 Index managed a modest gain of 2.5%, which puts it up 3.8% on a year-to-date basis. Note that the S&P 500 has now traded sideways for roughly 18 months.

“Brexit” took center stage as the quarter came to a close. Residents of the United Kingdom shocked the world by voting to leave the European Union. This unprecedented event gave way to numerous questions: What is the impact on the U.K. economy? Will other countries follow suit? How do policymakers respond? Will this event tip the globe into recession? It’s hard not to construe this event as a negative and it certainly seems supportive of a “lower for longer” global growth picture. The U.K.’s exit may be a lengthy and complicated process that could yield less change than people expect.

This event has also furthered a “fear bubble.” Investor sentiment has generally remained dour, with many bracing for the next crisis and few seeming to bet on improving global growth. According to a recent edition of Barron’s, the average Wall Street strategist’s recommended stock allocation fell to its lowest level in 15 months at the end of May. The reading of 51.6% was even lower than it was at the market bottom in March 2009. The article went on to note that markets have generally been higher 12 months later when this indicator slips to these levels. In other words, it has traditionally been a positive sign when Wall Street strategists are bearish.

Government bonds, utilities and quality companies in defensive areas such as consumer staples are commanding premiums for their perceived safety. Don’t get us wrong, we love safety and quality, but the price paid for these attributes may be getting stretched. Put differently, many of these ostensibly safe/quality investments look more popular but could exhibit more downside than expected. Just because a food company or utility possesses below average business risk doesn’t mean its stock will continue to possess below average risk. This could be especially true in an improving economic climate, which would support companies with more cyclical exposure.

It may sound contrarian, but we are inclined to invest on the world getting a little better. The prices we can pay for more economically sensitive companies have become relatively attractive versus those for many defensive issues. We remind investors that many domestic indicators continue to show signs of improvement. The housing market, which seems to be recovering nicely, is a prime example. As you will read in our individual portfolio write-ups, we have recently added to positions with housing exposure.

In sum, there are always things to worry about and “Brexit” adds another layer of uncertainty. We aren’t ignoring obvious headwinds, but think it’s important to not cave in to negative headlines. We are attempting to plant seeds for future value creation and think more cyclical names could get back on track if global growth improves. Further, many large investors remain underinvested in stocks given the anxiety we highlighted. This could also be a plus for markets should conditions prove better than generally anticipated.

Market Returns	YTD	Q2 2016
U.S. Large Caps	3.8%	2.5%
U.S. Mid Caps	5.5%	3.2%
U.S. Small Caps	2.2%	3.8%
International Developed Markets	-4.4%	-1.5%
International Small/Mid	-3.6%	-3.0%
Emerging Markets	6.6%	0.8%
Interm. Term Bonds	4.1%	1.6%

Source: Morningstar Direct. Please see Important Disclosures at the back of this document for index definitions.

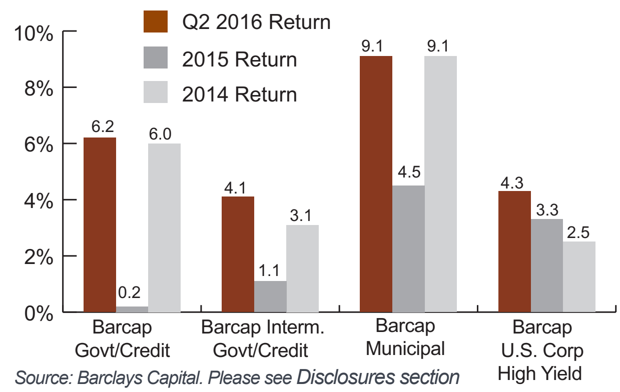
Treasury rates continued their decline during the second quarter in response to continued uncertainty about US and global economic strength. Domestic GDP slowed during Q1 and economic data for the beginning of the second quarter showed weakness in both the manufacturing and the retail sales sectors. These factors, plus aggressive quantitative easing by the European Central Bank, precipitated a flight to quality that led to drops in rates for three year Treasuries of 16 basis points to a yield of 0.69%, ten year rates by 30 basis points to 1.47%, and thirty year rates by 33 basis points to 2.29%.

Rate changes led to significant price gains for most bonds during the quarter. The table to the right compares 2016 returns for major bond indexes to returns for 2015 and 2014. The drop in rates was not limited to domestic rates. Global rates fell during the quarter to historically low levels as over $10 trillion of non US sovereign debt traded at negative yields.

Expectations are that the Federal Reserve may pause its tightening until stabilization of the global economies is apparent. Complicating the Federal Reserve's decision is the "Leave" vote by Britain which has added to the uncertainty surrounding global growth. The British vote has the potential of destabilizing the European Union further as other EU countries have discussed their own referenda. Should additional countries consider leaving the union, the probabilities for significant disruption of global economic activity increases.

Portfolio structures were slightly extended during the quarter in anticipation of a less aggressive Federal Reserve. This was accomplished by purchasing high quality corporate bonds in the 5 to 7 year maturity range. We expect to continue this strategy for the immediate future.

Q2 Bond Index Returns



Source: Barclays Capital. Please see Disclosures section for index definitions.

Important Disclosures

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. Investing in securities carries risk including the possible loss of principal. 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. Performance is shown net of fees.

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**. Bonds represented by the **Barclays Capital Intermediate Government/Credit Index**. International Developed Markets represented by the **MSCI EAFE Index**. Emerging Markets represented by the **MSCI EM Index**.

The **Barclays Capital U.S. Corporate High Yield Index** covers the universe of fixed rate, non-investment grade debt, including corporate and non-corporate sectors. Pay-in-kind (PIK) bonds, Eurobonds, and debt issues from countries designated as emerging markets are excluded, but Canadian and global bonds (SEC registered) of issuers in non-emerging market countries are included. Original issue zero coupon bonds, step-up coupon structures, and 144-As are also included. The reported returns reflect equities priced in U.S. dollars and do not include the effects of reinvested dividends. The **Barclays Capital 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 **Barclays Capital Municipal Bond Index** is a market value weighted index of investment grade municipal bonds with maturities of one year or more. The **Barclays Capital U.S. Government/Credit Bond Index** measures the performance of U.S. dollar denominated U.S. Treasuries, government-related and investment grade U.S. corporate securities that have a remaining maturity of greater than one year. The **Lipper Equity Income Funds Index** is an unmanaged index of the 30 largest funds in the Lipper Equity Income Fund category. The **Lipper Large Cap Growth Funds Index** is an unmanaged index of the 30 largest funds in the 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 **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 **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 2000 Index is a trademark/service mark of the Frank Russell Co. Russell® is a trademark of the Frank Russell Co. 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 Midcap Index is a trademark/service mark of the Frank Russell Co. Russell® is a trademark of the Frank Russell Co. 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. **An investor cannot invest in these indices and their returns are not indicative of the performance of any specific investment**.