



VIEWPOINTS

3RD QUARTER 2019

ADVISORY NEWSLETTER

MARKET COMMENTARY

FREDRIC W. WILLIAMS

Everything Is Just Im-peachy...

One could almost be excused if the political theater emanating from our nation's capital this last quarter was mistaken for just another of the season's summer stock performances. But, as we've unfortunately come to expect these last few years, it was merely the latest episode in our spasm of partisan polarization whereby one side of the aisle is clamoring for impeachment and the other slings accusations of treasonous intentions. Gone are the days where our elected officials engaged in a civil discourse that could be viewed through the lens of "Leave It To Beaver" or "Mayberry RFD".

A possible roadmap to an antidote for this absence of conversational civility might be found in the content of The Beatles last studio album, the culturally iconic *Abbey Road*, which celebrated its 50th anniversary on September 26.⁽¹⁾ The tumultuous and eventful year of 1969 (*which gave us touchstones like the moon landing, Woodstock, the Stonewall riots, along with, of course, the Miracle Mets*) provided the backdrop for lyrics and melodies that are indelibly etched in many of our minds. Perhaps an apt description of our current political "process" could be found (*Mean Mr. Mustard, Maxwell's Silver Hammer, & She Came in Through The Bathroom Window*), as well as what we'd instead like to have happen (*Come Together*), so we could avoid continued chaos (*The End*) and arrive at a better place (*Here Comes The Sun*). Sounds so very '60s-ish, don't you think?

Outside the beltway in the real world, continuing tariff frictions were slowing top line global trade flows and beginning to trickle down a bit closer the concerns of Main Street, as was seen in the September non-farm payrolls coming in under consensus – the big picture was starting to show up in the little picture.

"World trade flows are set to increase at the weakest pace this year since the global financial crisis as tariffs rise and the global economy cools..."

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Releasing new forecasts, the WTO warned that slowing trade could hit investment and jobs, as surveys of purchasing managers from Asia and Europe pointed to continued declines in manufacturing activity linked to falling export orders.”

- *P. Hannon, WSJ 10/1/19*

“The picture that emerges from the data is an economy still that is growing, albeit more slowly since last year’s fiscal boost gave way to friction from tariffs. To those who made it through basic calculus, the first derivative still is positive, even if the second one is lower. English majors should understand things are getting better, albeit less rapidly.”

- *R. Forsyth, Barron’s 10/7/19*

And despite the Twitter-world’s assertion that everything is “great” economically, it appears that central bankers around the world have a different perspective, with 16 of them lowering rates in the 3rd quarter, and another two-dozen expected to follow suit during the 4th quarter of this year. These moves, of course, indicate that the denizens of the world’s monetary policy levers are less concerned about slowing an overheated economy down, than they are making sure they give it a stimulating java-like boost.

All of these factors have impacted a more muted market performance since the end of 2017, albeit with some significant moves down (Q4 2018) and up (Q1 2019) in between. Using the DJIA as a proxy, it closed 2017 at 24,719, dropped to 23,062 by the end of 2018, before rebounding back to 26,820 by the close of 2019’s 3rd quarter. So that overall round trip of approximately 8.5% over 21 months equated to around a 4.85% annualized price return during a period of significant political and market volatility and uncertainty.

The slowing of the growth and momentum sectors of the market is contributing to the resurgence of value stocks as investors look for less extended areas to ride out the head winds of a slowing economy. As measured by price earnings ratios, the value side offers much less expensive fundamentals:

“...value is cheaper than usual. The Russell 1000 Value Index trades at about 17 times trailing earnings compared with 27 times for the Russell 1000 Growth Index. That 10-point gap is one of the largest divergences since the global financial crisis.”

“Value dividend stocks wouldn’t produce positive returns in a bear market or recession. But the stocks should hold up better than growth stocks with steep multiples. And there are signs that investors are shifting to value over growth, based on the movement of money into and out of exchange-traded funds and other market trends.”

- *D. Fonda, Barron’s 9/17/19 & 9/28/19*

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With QT (quantitative tightening) reverting back to QE (quantitative easing) as the Fed pushes rates lower while simultaneously adding to bank reserves with their \$60 billion per month purchases of Treasury bills, we would expect a weaker dollar developing as another component of the central bank's most recent reflationary moves. OPA believes in that environment, value sectors overall, as well as international shares in general, with Europe in particular, will offer prudent long-term investors the prospect for favorable risk-adjusted returns, given the dividend-oriented cash flow that can help mitigate short term pricing volatility.

- (1) Although *Let It Be* was released the following year, in 1970, those tracks had been laid down prior to the original Fab Four's recording sessions the summer of 1969 on Abbey Road in North London

CAPITAL MARKETS OVERVIEW

Index Returns			
Equities	Percentage Change for the 3 rd Quarter	Percentage Change for the Year	Annualized 10-Year Returns
S&P 500	1.70%	20.55%	13.24%
Bloomberg Commodity Index	-1.84%	3.13%	-4.32%
MSCI EAFE*	-1.07%	12.80%	4.90%
MSCI Emerging Markets*	-4.25%	5.89%	3.37%
FTSE NAREIT Equity REIT Index	7.60%	26.96%	13.04%
Fixed Income			
Bloomberg Barclays U.S. Aggregate Bond	2.27%	8.52%	3.75%
Bloomberg Barclays U.S. Treasury Inflation-Linked Bond	1.35%	7.58%	3.46%
<p>Source: BlackRock, Bloomberg, FTSE™, NAREIT®. *Returns are calculated with net dividends in USD</p> <p>Index returns are for illustrative purposes only and do not represent actual performance of any investment. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.</p>			

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“I knew which shifts in the economic environment caused asset classes to move around, and I knew that those relationships had remained essentially the same for hundreds of years. There were only two big forces to worry about: growth and inflation.”

- Ray Dalio, Bridgewater Associates

The third quarter was marked by a continued slowdown in the global economic data, offset by further monetary easing from the US and Europe. Signs of growth and inflation (the major economic forces as defined by the founder of the world’s largest hedge fund) were hard to find. Manufacturing is contracting globally; trade is weakening, and corporate profits are under pressure. In the US, the Federal Reserve cut interest rates in July and September, attempting to jumpstart the economy.

The damage from slowing global trade has been contained mainly to the manufacturing sector and to nations dependent on export of finished goods. The US has fared better than most due to our emphasis on the service sector. American industrials have had to deal with a stronger dollar – up over 6% in the past 18 months – in addition to the weakness in global trade. Luckily, manufacturing accounts for only 11% of US GDP. The labor market and consumer spending, while softening, are still constructive. Estimates for the third quarter GDP growth suggest the U.S. economy will decelerate to 2.07% YoY from 2.28% in the second quarter.

The US equity markets continued to run in place in Q3 2019. Each attempt to make new highs retreated to the levels set back in January 2018. The large-cap S&P 500 gained 1.7% after a summer of rises and falls. Mid and small-cap stocks lost ground with the Russell 2000 down 2.5% and the S&P Midcap 400 dropping 0.3%.

The Euro sector economy continued to slow, largely in the manufacturing sector, which particularly impacts on export-based Germany. The European Central Bank cut interest rates further into negative territory. European equities rose 2.5% over the quarter. In the UK, Brexit drama continued. The EU waited for Britain to admit defeat on the Irish border while Boris Johnson suspended parliament, only for the suspension to be ruled unlawful. If Johnson cannot reach a deal, a contentious election is the most likely outcome. Another troubling sign was the collapse of UK-based Thomas Cook, a 178-year old travel giant with its own airline and hotels and 21,000 employees, after it could not find short-term financing. Despite the circus, UK equities delivered 1.0% over the quarter.

China saw slowing growth in industrial production and retail sales, though both remain well above the US. The Chinese threshold for pain is well beyond that of the US and given the election next year, it is questionable whether China will concede to US demands on trade. China cannot be seen to reward Trump for aggressive and unilateral protectionist moves and the president has a clear motivation to avoid a recession before the November 2020 election. Emerging markets felt the effect with equities declining 1.9%.

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Brent crude jumped 20% after drone and missile attacks on Saudi Arabian oil production. That gain was reversed as production quickly came back online. A slowing global economy requires less fuel, and Brent lost 8.5% for the quarter. Recession fears helped precious metals as gold gained 4.5% despite losing 3.2% in September.

It was another good quarter for government bonds, despite a sell-off in early September. Central bank easing, including the first cuts in the overnight fed funds rate in 10 years, along with the rising concerns about global growth helped US Treasuries gain over 2% in the third quarter while global corporate bonds rose 1.2%. The main story was the crisis in the overnight repo markets (where institutions lend to each other very short term). Rates spiked as demand outstripped supply, a sign that liquidity is substantially lower than believed. The US will see greater need for liquidity as the debt expands. The economy grew by \$830 billion over the past four quarters while the Gross National Debt grew by \$1.2 trillion. The U.S. yield curve is signaling that recession risks are increasing.

Recessions begin quietly as a loss of confidence leading to lower spending which causes reduction in production. The average length of economic growth without a significant downturn is about 39 months. At 120 months, the current cycle is very long in the tooth. No amount of federal interest rate manipulation or quantitative easing can hold back inevitable economic reality forever. This sets up buying opportunities. For the month ahead, investors should be prepared for another bumpy ride as October has historically been the most volatile month.

SECTOR OVERVIEW

RICHARD “CHIP” HARLOW

This last quarter has been highlighted by volatility, choppiness and noise for both the markets and sectors. In fact, looking over the last year, it's hard to see any sector leadership, as monthly sector fluctuations have been all over the place. The S&P500 only returned 1.7% during the most recent quarter and is up 20.6% YTD. Sector performance during the 3rd quarter ranged from -6.3% for Energy to +9.3% for Utilities.

Utilities

Utilities have benefited for multiple reasons. They are traditionally defensive in nature and tend not to be as volatile, so when choppiness hits, they act as a protected harbor. Lower interest rates also benefit utilities, and thus indications of further Fed cuts has led them to rally. Utilities were up 9.3% for the quarter and are up 25.4% so far this year. While current valuations are high, solid fundamentals (4% earnings growth and 7% revenue growth) and healthy dividend growth should allow this sector to continue higher. Utility stocks are also not really impacted directly by the trade war, as only 3% of their revenue comes from international sources.

Real Estate

Real Estate has also benefited from deriving most of its revenues from domestic sources. Low interest rates have helped by allowing real estate investors to buy property with “cheap” money, as well as being an attractive investment for investors looking for yield. Real Estate was up 7.7%

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for the 3rd quarter and 29.7% YTD. Real Estate's earnings growth is also healthy at 3.5%. Real Estate is tied to the health of the economy, unemployment rate, and GDP as they all directly correlate to the profitability of commercial real estate.

Technology

The tech sector has given back some of its gains as the trade war and rhetoric with China continues. The tech sector gets 57% of its revenue from foreign sources, making it more vulnerable to trade disputes. Technology was up 3.3% during the quarter and still leads on a YTD basis, up 31.4%. While balance sheets of the sector are strong, the sector is seeing year over year earnings decreases of 10% and a record high number of Technology companies are issuing negative EPS guidance. The trade disputes are starting to take their toll on the sector, so as positive or negative news flows about the trade talks, so will the performance of this sector and to a certain degree the market.

Energy

Energy rallied in September due to the attacks on the Saudi Arabia oil supply, but the rally was short-lived. Energy ended the quarter being down 6.3% but is still positive for the year at +6.0%. Oil prices are currently at the lower end of the range they have been in since the beginning of the year. 89% of Energy companies have seen a decline in Q3 EPS estimates since June 30th. This underperformance of the Energy sector has caused it to be the only sector that has a forward P/E ratio that is significantly less than its 5-yr and 10-yr averages.

FIDUCIARY CORNER

STEPHEN L. EDDY

Past Class Action Litigation Leads to Future Best Practices for Plan Sponsors...

Noted ERISA attorney Fred Reish recently reviewed four important landmark class action cases against plan sponsors and their service providers for 401(k) and 403(b) plans, and what plan sponsors should learn from the outcomes. The four cases were brought by noted retirement plan class action law firm Schlichter, Bogart & Denton out of St. Louis. Notably, the Schlichter firm does not only go after significant compensation damages in its class actions, but also demands to stay in the picture to oversee the corrective process and conditions requested of the plan sponsor in the settlement agreement (committee structure, benchmarking, and RFP results).

As the financial aftereffects of the 2008/2009 "Great Recession" receded, several significant lawsuits emerged regarding the fiduciary care of 401(k) and 403(b) plans. Many of the initial judgments supported plan participants and the outcomes of course, were appealed. Enough time has passed - many of the cases have progressed as far as they can up the appellate court ladder, and several of them settled out of court – to discuss and implement best practices from the resulting judgments.

- **The Anthem Case** – Anthem was accused of using a more expensive share class when less expensive shares of the same funds were available in their 401(k) plan. They were also accused of overpaying their recordkeeper. The judgment against them was for \$23 million and a

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requirement to put out an RFP for recordkeeping services. Noteworthy: Anthem was using Vanguard funds which are usually considered to be the least expensive funds. The share class issue is very important and extends to collected investment trusts and separately managed accounts, which the court points out may be less expensive.

- **The Vanderbilt Case** – Similar to the Anthem case, Vanderbilt was accused of using more expensive share classes versus what was available and not using its size to negotiate lower costs and better fund classes. Unique to this finding was a request that participants be given disclosure regarding their frozen annuity balances and allowed to transfer out of them, and also contractually prohibit the recordkeeper from using participant data to market products to the participants unless the participant initiates the request.
- **The BB&T Case** – the complaint alleged that BB&T didn't use the lowest cost share classes available and did not negotiate lower recordkeeping costs. Sound familiar? Also important to note, the fiduciaries were alleged to have imprudently selected and retained underperforming investment options. BB&T provided its own recordkeeping and investment consulting to the plan, so the potential conflicts over an independent consultant are more apparent.
- **The ABB Case** – apart from the fund share class argument that Schlichter uses to wedge the door open in most of its class actions, some unique conditions of the settlement agreement (outside of \$55 million of compensation) from the class action were a) that the plan sponsor needed to use a competitive bidding process to select its recordkeeper, and b) if ABB was a plan fiduciary, they should not use the recordkeeper to "provide any corporate services to ABB" (i.e. payroll or deferred comp plan services). As Fred Reish explains, the implication is that the recordkeeper was making so much money off the plan that they were able to offer other discounted services to ABB, which creates the obvious problem of participants in the plan funding non-plan expenses. This requires an ongoing review of plan expenses.

The Takeaways:

- Use the lowest fund share class available. This is not to be confused with using passively managed index funds (less expensive) over actively managed funds (typically more expensive). This is about using the lowest cost shares of the fund you select and not charging excess costs to the plan, or using the excess revenue to reduce plan sponsor fees
- Investment, Retirement and Fiduciary committees need to document that they have benchmarked\ and monitored investments and performed RFP's for plan service provider fees and deliverables. Negotiate, negotiate, negotiate.
- Hire independent investment and fiduciary consultants and listen to them. Many of these plans ignored recommendations from outside consultants.

Old Port Advisors provides comprehensive fiduciary investment services to 401(k) and 403(b) plans, and always acts as an advocate for plan participants and the plan sponsor.

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Evaluating Investment Risk Through Drawdown

There are many ways to quantify risk in the investment world. Alpha, Beta, R-squared, standard deviation and the Sharpe ratio are the most common. However, these measurements are only mathematical in nature as compared to an individual's risk tolerance which can have an emotional element. Just as an equity's risk profile may change with the economy or company-specific data, an individual's risk tolerance may change based on multiple factors as well. And quickly. This is one of the most overlooked issues when evaluating an investor's risk tolerance. The loss in one's portfolio is mathematical – only a number - but the emotion of that loss drives future decisions making it difficult to ascertain an investor's true risk tolerance. One way to measure that emotional pain threshold for risk is an investor's tolerance for something called maximum drawdown.

Maximum Drawdown and Risk Tolerance

Maximum drawdown is defined as the decline in value from the peak to trough over a specific time, usually quoted as a percent. As the drawdown increases so does the gain needed to get to break even. A 50% loss needs a 100% gain to get back to the starting point. The drawdown in the dotcom bubble, March 2002-October 2002 was -49%. It took almost 5 years to break even from that drawdown.

An individual's risk tolerance has emotional element to it during large market drawdowns. That emotion can be exacerbated depending on asset size as well. A \$500,000 portfolio losing 40% in 2008/2009 (\$200,000) changed many individual approaches to analyzing their personal risk tolerance. Investors compound the issue when they make sell decisions during the drawdown (inadvertently becoming market timers). It is emotionally easy to sell in a down market but much, much harder to get back in at the right time. Instead of taking four years to break even, people may have altered their allocations enough that it took seven years to get there. Once you identify someone's pain threshold or loss threshold, it can be used to determine a proper asset allocation.

Drawdowns and Volatility

Most people associate drawdowns with recessions. It is very common for the market to have large drawdowns on an intra year basis. Going back to 1928 and looking at 18 month rolling periods, the S&P was flat or down more than 27% of the time. So over a quarter of the time over the past 90 years, stocks have been flat or down for long periods. More recently:

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S&P 500 Corrections Since 2009

Peak	Trough	S&P 500 Peak	S&P 500 Trough	Drawdown
04/23/10	07/02/10	1,217	1,023	-16.0%
04/29/11	10/03/11	1,364	1,099	-19.4%
05/21/15	08/25/15	2,131	1,868	-12.4%
11/03/15	02/11/16	2,110	1,829	-13.3%
01/26/18	02/08/18	2,873	2,581	-10.2%
09/20/18	12/24/18	2,931	2,351	-19.8%

Table: Ben Carlson SOURCE: Yahoo! Finance

Since the recession in 2008, the market has had a few significant drawdowns. Though the market is up over the above years, there have been some significant fluctuations.

Drawdowns and Retirement

Identifying one's drawdown risk in retirement becomes very important. When a retiree starts to take distributions from their portfolio, a large drawdown can put it at risk. If a retiree has \$1,000,000 balance and uses a 4% withdrawal rate, they can historically safely withdraw \$40,000 a year for 25 years with a 60/40 equity/fixed income allocated portfolio. The issue is after a large market drawdown a 4% withdrawal on a portfolio that fell to \$700,000 turns into a 5.7% withdrawal rate. At that rate, using the 60/40 historical allocation returns, the portfolio may only last 18 years, shortening the portfolio's lifespan.

In the last 20 years investors have lived through two very large drawdowns, but they have become complacent with the current bull market, the longest in history. While we all hope the next downturn, correction, recession or bubble will not be as bad as the last, we don't know. It may be important to review your asset withdrawal plan and reduce your risk level. It may be easier to stomach when the next bubble bursts.

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Jake Kenyon - Jake joined Old Port Advisors as a Portfolio Manager Associate in August after working the last four years at various positions in the financial services and insurance industry. His experience as analyst and adviser in wealth management and planning will be an invaluable asset for the next generation of OPA's clients, as well as the numerous participants in our various employer-client retirement plans. A graduate of the University of Maine at Machias, and currently enrolled in the CFP Board Education Program at Bryant University, Jake and his new bride Isabel, recently married in her native Puerto Rico after a love-story meeting six years ago while working for Royal Caribbean, currently reside in Old Orchard Beach.

Save The Dates:

We're entering the time of year when a variety of non-profit organizations begin their annual fundraising efforts so they can continue to enhance the fabric of our community. Although by no means complete, the events below are but a sampling of the organizations that our firm, employees, colleagues and clients are involved with, should you want to consider supporting their missions.

St. Lawrence Arts – OPA has joined the host committee for SLA's October 16th annual Fall House Party fundraising concert, at the Barridoff Galleries in South Portland, featuring Maine's own Luke and Will Mallett to support Munjoy Hill's neighborhood art center. More information is available at <http://www.stlawrencearts.org/>

Maine Marathon – The 2019 Gorham Savings Bank Maine Marathon was held October 6th and benefited the Eastern Trail Alliance, Girls on the Run, Portland Community Squash, Rippleffect and Winter Kids. OPA was part of the sponsorship group, and had one of our own – Jason Foster – running this year in his first full marathon. Additional information can be found at <http://mainemarathon.com/>

The Community of Caring's "Pink Tie Party" – We again are part of the host group for the 4th annual event, on October 10th at Vinegar Hill Music Theatre in Arundel, to support The Maine Cancer Foundation. Additional information can be found at <https://www.eventbrite.com/e/pink-tie-party-tickets-68748858687>

Wayfinder Schools – We are sponsors of two events they will be holding during the 2018-2019 school year to benefit its mission of providing pathways to opportunities for all Maine high school students. On October 5th a tasting and vineyard tour will take place at Willows Awake Winery & Vineyard, while the School's annual author's event with Richard Russo will take place April 30th 2020 at USM's Hannaford Hall. Additional information can be found at <http://wayfinderschools.org/>

Dream Factory of Maine – This year we are kicking off the holiday season by being a segment sponsor for their Make Your Own Candy Cane Event at Haven's Candies Factory in Westbrook on Saturday November 30th between 9:30 and 10:00 AM. Our office has some tickets, so please contact us, while additional information and tickets can be found at <http://dreamfactoryinc.org/chapters/portlandmaine/>

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Gather Together

An Informative Celebration Of Our Anniversary

Old Port Advisors was founded 25 years ago this fall as Investment Management & Consulting Group (IMCG), with a vision to create a boutique independent investment management firm centered on the best interests of our clients.

Please join us for an evening of conversation and celebration as we toast our first 25 years in business. We'll look back at the past, as well as at the economic issues and policies that will take us into the future with a very special presentation by:

Jeffrey Kleintop

Senior Vice President, Chief Global Investment Strategist

Charles Schwab & Co.

Mr. Kleintop is a frequent contributor to The Wall Street Journal, the New York Times, Barron's and Financial Times, and is a regular guest on CNBC, Bloomberg, Fox Business News and ABC News.

Wednesday, December 11

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The Portland Country Club

Eleven Foreside Road, Falmouth, Maine

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Kindly R.S.V.P. by November 29 to

Mary Ellen Carignan

or

Erica Bly

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