



CAPITAL INVESTMENT SERVICES

Investment Stewards Since 1981

The Difference Maker: A Profession of Investment Stewardship

111 E. Wisconsin Avenue | Suite 1310 | Milwaukee, WI 53202
(800) 345-6462 | Capinv.com | Info@Capinv.com

Capital Investment Services of America, Inc.

The Difference Maker

Your Capital Team

Paul A. Muzzey, CFA
President

Jeffrey N. Allsop, CFA
Chief Investment Officer

Blaine E. Bancker, CFP®
Principal

Ruth A. Benben
Principal/CCO

Mitchell W. Carlson, CFA, CFP®
Principal

Ameet L. Kamath
Principal

Mia K. Potter
Principal

Brett M. Aarestad
Associate

Steven L. Muzzey
Associate

Investors today are confronted with a dizzying array of investment management options. Investment managers come in a multitude of different sizes, shapes and styles going by a variety of designations, titles and pedigrees. Despite this overwhelming menu, we believe a critical difference between

Stewardship: *"The careful and responsible management of something entrusted to one's care."*

— Merriam Webster Dictionary

investment managers primarily rests within a single, crucial factor. What is the all-important difference maker?

It is perhaps best captured by the following observation of a long time industry veteran:

*"Investment management used to be a **profession of stewardship**. Now it's become a **business of salesmanship**."*

— John Bogle, founder of The Vanguard Group

The *business of salesmanship* is marked by such developments as:

- ✓ Bigger – as in more assets under management – has often become the primary objective of the asset management firm. This has created an *asset gathering institutional imperative*.
- ✓ Investment *style-boxes* that restrict investment managers' ability to exercise care and judgment.
- ✓ Costly closet indexing (portfolios that essentially mirror market indices, but with high fees).
- ✓ A *product* mindset that detracts from the focus on delivering an essential service.
- ✓ Unnecessarily complex, wide-asset-allocation portfolios. These portfolios are often characterized by potentially ineffective diversification, tax inefficiencies and opaque fee structures.
- ✓ Increased complexity. Complexity often means less transparency and higher investment management fees.

*"Investment management used to be a **profession of stewardship**. Now it's become a **business of salesmanship**."*

— John Bogle, Founder
The Vanguard Group

We believe these developments create incentives that often subordinate investor interests to the business considerations of the investment firm.

Misalignment of incentives creates potential conflicts of interest between the *business of salesmanship* and the investors the profession is intended to serve.

The *profession of stewardship* by contrast, minimizes potential conflicts of interest. It does so by aligning investment managers' incentives with those of their clients. Incentive alignment increases the probability that investment decisions are made solely for a client's benefit.

We believe the profession of stewardship can offer clients relatively **simple** solutions driven by a **sophisticated** investment process that critically examines all of the investment issues affecting clients. We believe this approach offers the highest probability of providing **effective** outcomes for clients over an investing lifetime.

Objectivity, healthy skepticism and independence of thought are essential characteristics of good investment stewards. To this list a quality must be added that is harder to describe, but what is informally known as having *backbone*.

For at its core, stewardship is about doing the *right thing* for a client, even when doing what's right is not popular or easy. Going against the prevailing conventional wisdom – not for the sake of being contrary or because of inflexibility of thought, but because circumstances of good stewardship necessitate it – requires *backbone*.

Stacking Investment Probabilities

The primary role of a good investment steward is to maximize the probability that each client will achieve investment success. Whereas conventional wisdom typically defines success relative to market indices, for many clients such benchmarking is either too narrow of a success yardstick, or not even relevant to their circumstances.

Proper stewardship defines success according to each client's specific (and typically, multi-faceted) investment objectives. These objectives usually include questions like:

- ✓ Will I outlive my portfolio?
- ✓ Am I going to have enough money to live on?
- ✓ How much income can my portfolio generate?
- ✓ Who can I trust to look out for the interests of my family when I'm gone?

Answers to these types of questions constitute *real-world* definitions of investment success for many clients. While there are few, if any, assured outcomes in investing, a good investment steward strives to stack probabilities within an uncertain world in the favor of each client.

Stewardship Actions

To achieve client success, good investment stewardship adds value by:

- ✓ Focusing on client-specific investment objectives
- ✓ Avoiding emotionally driven investment decisions
- ✓ Managing the investor's *ride along the way*
- ✓ Providing dynamic market and portfolio evaluation



These four critically important actions will, to a large degree, affect the investment returns achieved by investors. And, as illustrated in the graphic above, it is through these actions that managers can help clients achieve returns consistent with *their* definition of success.

Structures that foster good stewardship:

- ✓ Transparent, reasonable and explicit fees based upon market value of assets managed
- ✓ Investment management firm owned and run by investment professionals – the notion of good stewardship is little more than bluster unless promoting the interests of clients is a pervasive attitude and is embedded in the culture of the firm
- ✓ Managers that *eat their own investment cooking* by investing their own assets as they do clients'¹
- ✓ Built in checks and balances (separated custodial and investment management functions) that protect investors/clients
- ✓ Active promotion of long-term thinking
- ✓ A low turnover investment approach that can provide the benefits of compounding and keeps costs associated with investing (transaction costs and taxes) relatively low

Investment Returns



The point of investing, of course, is earning rewarding returns. A good steward assists clients in a process of attaining investment returns *a client may not have been able to achieve otherwise*. Viewed within the context of long-term investing, which typically encompasses

multiple decades and perhaps multiple family generations, the value of achieving returns above what would have been earned otherwise can be massive.

The return dimension, therefore, resides at the center of the value of good stewardship. As a result, rate of return statistics receive much attention in the evaluation and selection of an investment manager. This is appropriate – up to a point.

There are two salient issues that must be considered regarding return statistics. First, despite the appearances of all-encompassing precision, rate of return statistics are more nuanced than generally believed. (Some of the more important nuances are discussed in the *ride along the way* section that follows.)

Second, rate of return statistics are often *too narrow of a measure* to assess client success. A more encompassing view is necessary; one that considers elements that define client success that often are not captured by numbers alone. As Einstein once noted, ***"What counts can't always be counted; what can be counted doesn't always count."***

Good stewardship encompasses many of the hard- to-count aspects of investing. This is where the other aspects of good stewardship noted earlier come into play.

Focusing on Custom Objectives



The goal of many investors is likely something along the lines of:

Capture the rewards of long-term investing while limiting the risks involved.

Such a statement is elegant in both simplicity and reasonableness of intent. A good steward can certainly play an important role in assisting a client in achieving this goal.

But even this broad statement often understates the many facets that represent client objectives.

Other considerations that often are essential elements of a client's goals include:

Peace of Mind

Wouldn't you think being the richest person in the world would inherently bring financial peace of mind? Yet when Microsoft cofounder Bill Gates hired an investment steward some years back, financial peace of mind was a key reason.²

With a steward managing his fortune, Gates can spend his time pursuing other activities he deems better suited to his talents and interests. And in the event something happened to him, Gates wanted a steward in place to take care of his family's investment interests.

If *financial peace of mind* is an important aspect of the investment objectives of a Bill Gates, it is probably high on the priority list of investment objectives for many other investors as well. A good steward can play a fundamentally important role by managing a client's assets in the manner they would themselves if they had the interest, talent, training and time to do so.

Will I outlive my assets?

A concern of most clients is sufficiency and sustainability of their accumulated nest-eggs. This issue is relevant to charitable foundations and endowments as well. Will their fund assets support future commitments, obligations and intentions?

A steward can help guide clients through the asset sufficiency assessment process. Today there are many seemingly sophisticated software programs designed to address the *"will I outlive my assets"* question. A good steward understands the limitations and often misleading implied precision of these software programs and can assist in the planning process on more effective and realistic terms.

In some situations the probability of outliving a nest-egg is indeed a very real threat. In these instances, stewardship *backbone* will be required to help a client comes to grips with the unpleasant potential reality of such an assessment and help manage within such a situation.

What about tax efficiency, gifting and estate planning?

Since taxes are a relevant issue to most investors, good stewards emphasize tax efficiency as another client objective component. The power of long-term investing

means that substantial capital gains will likely accrue within taxable assets.

Managing assets in a tax-efficient manner will therefore be important. However, a good steward should not allow tax issues to dominate investment decisions. Wall Street's *business of salesmanship* has a long history of designing and promoting *tax sheltered* products that proved to be detrimental to investor financial health.

The sole basis for all investment decisions—even when they create tax liabilities—should be a client's economic benefit. Selling past winners when shifting circumstances require action, and/ or rebalancing portfolio asset allocations often are difficult decisions (and require that *backbone* quality once again). Such actions are a routine part of good investment stewardship.

Tax efficiency is a by-product of a relatively low portfolio turnover investment approach. This may be supplemented by periodic tax loss harvesting.

For those whose objectives include gifting intentions, coordinating investment, gifting and tax efficiency may provide powerful benefits. Where appropriate, a good steward can help facilitate a strategy throughout a given tax year by gifting appreciated securities that may otherwise be sold for investment reasons.

A good steward is ready and willing to work with a client's tax and estate planning professionals to manage these and related issues on an all- encompassing basis.

In summary, *the* fundamental role of a good steward is to stack the probability of success of achieving each client's specific, broad-perspective investment objectives in an investor's favor.

Avoiding Emotional Decisions



Buy low, sell high may be a well know investing maxim, but studies repeatedly show emotions often cause investors to engage in the exact opposite – *buy high, sell low* – behavior.

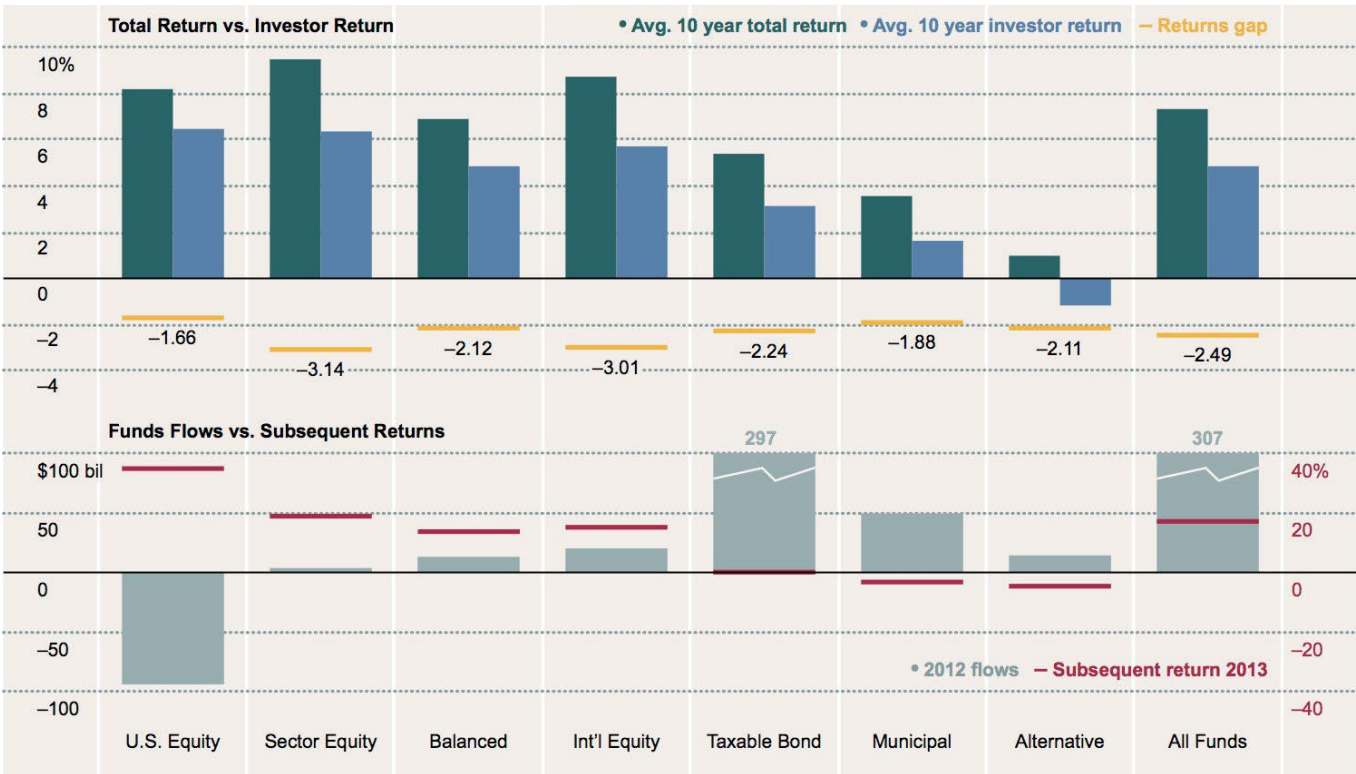
Chasing what's *hot*, pouring money in near peaks, and bailing out of investments near critical turning points are widespread behavioral investment patterns. So common are these patterns research suggests that *emotions often are one of the primary factors driving investor returns*.

Mutual fund researcher, Morningstar, produced the following graphic quantifying the costs, in terms of foregone return, due to emotionally-based decision making patterns.

Emotional Investing

The negative impact on returns

The chart's top panel suggests the cost of market timing often trims annual returns by 2% to 3%.



Source: Morningstar 2014

The bottom panel reflects how investment flows typically reflect *shooting where the duck was* behavior on the part of investors. Money commonly flows into investments that did well recently and away from those that did not. A hunter doesn't bag many ducks by aiming where a duck was; nor is such an approach likely helpful to investors.

Morningstar's findings are supported by other research as well.

DALBAR Data

For the past few decades, the financial consulting firm, DALBAR, has also noted the presence of a significant gap between returns on various investments and actual returns achieved.³ DALBAR estimates that investor annual returns are nearly 50% lower (3-5% in foregone returns per year) than respective market returns over meaningful periods of time.

Fidelity Experiences

Mutual fund investors frequently earn returns well below the return of the funds in which they are invested. Market timing on the part of investors is the primary reason for this phenomenon.

One study notes that legendary Fidelity fund manager Peter Lynch generated an annual return of nearly 22% per year over the 1981-1990 period as manager of the Magellan Fund. Because of market timing decisions on the part of fund investors, however, actual investor returns within Magellan during this period were 13% per annum – a good return no doubt, but significantly below that of the fund itself.⁴

The temptation by investors to exercise control with their Magellan funds proved costly.

Vanguard Research

Vanguard estimates good stewards can potentially make an estimated +3% improvement in investor annual returns over time,⁵ in part by minimizing emotional investment decision making.⁶

Academic Studies

Emotional behavior is not limited to individual investors. Pension plan sponsors, overseers of trillions of dollars of assets and ranking themselves as having considerable investment expertise, routinely terminate investment managers that subsequently go on to generate better investment results than the committee's hand-picked replacements.⁷

Similarly, their asset allocation changes also exhibit the *shooting where the duck was* tendency noted earlier. Sponsors exhibit a pattern of increasing allocations towards investments that did well over a relatively short past period (3 years typically). These asset decisions subsequently produce results *below* those experiencing plan-sponsor allocation reductions.⁸

Why do emotions often confound investment decisions? In part, the siren song of euphoria/ overconfidence and despair/uncertainty are typically the loudest near investment extremes, when the cost of poor decisions looms largest.

Both the *business* of investment management and the popular financial media are often the most seductive of voices in the emotional siren song.

Hype surrounding hot products/funds/investments is often the greatest and most believable after trends are well established, exploited, and vulnerable to meaningful reversals. As one long-time investment industry observer noted:

"Hastiness and superficiality are the psychic diseases of the century; and more than anywhere else this disease is reflected in the press."

— Aleksandr Solzhenitsyn
Russian novelist & historian

*"[Emotional] behavior is encouraged by investment firms that, to increase sales, concentrate their advertising on funds selected clearly because recent results—over selected time periods—make good results look even better. And, some fund managers have several hundred different funds, apparently so they will always have at least some documented winners to sell."*⁹

The popular media is of little help in this regard. Their objective is viewership. Attributes of good stewardship – doing the right thing for each client, low portfolio turnover and striving to maintain a longer-term investment horizon – are often little match for high-profile and often charismatic, financial gurus offering overly confident calls to action (*get out, get in, short this, use triple longs to get exposure to that*). Much that is offered in sound bites likely has little relevance to a specific investor's situation.

Market analyst Michael Mauboussin notes an interesting relationship between the media profile of *experts* and the accuracy of their forecasts. Mauboussin cites research suggesting the higher the pundit's profile, the worse their predictions.¹⁰

A good steward understands that emotions can be the arch-enemy of the investor. Whether it was imprudently piling into tech stocks during the *new era* of the New Millennium, or the conventional wisdom that house prices *never go down* in the 2000s, or that *peak oil* means oil prices can only go higher, stewardship *backbone* is necessary to guide investors away from actions that may cause serious harm to their net worth.

Managing the Ride Along the Way



Is it possible that two distinct investments could have an *identical compound annual rate of return* over a meaningful time period, yet *deliver significantly different results* for an investor?

The answer is YES!

The explanation for this apparent paradox reflects an important nuance about returns and represents another dimension where a good investment steward may be of significant value to a client.

An article published by researcher Craig Israelsen provides a vivid **real-world** example about the importance of what we call *the ride along the way* within an investment journey.¹¹

Israelsen identified two mutual funds that generated the exact same compound annual returns over a recent 10-year period. The funds, however, delivered very different year-by-year returns as the following table reflects.

ANNUAL RATES OF RETURN	MORE VOLATILE FUND	LESS VOLATILE FUND
year 1	-18.6%	9.2%
year 2	-23.1%	5.1%
year 3	-23.9%	7.9%
year 4	36.8%	4.5%
year 5	18.6%	3.2%
year 6	32.4%	2.2%
year 7	47.2%	4.4%
year 8	27.7%	3.4%
year 9	-52.8%	-0.1%
year 10	78.1%	10.2%
Conventionally measured compound annual return:	4.9%	4.9%

The extreme variability of year-by-year returns of the more volatile fund creates a situation ripe for the type of emotional *buying high and selling low* behavior we

discussed earlier. As a result, it may well be that average investor returns within the volatile fund were much different (likely lower) than the fund's 10-year compound annual return – much like the Magellan/Peter Lynch experiences noted before.

But Israelsen uses these two funds to make a different, very profound, point. He notes that if real-world investor objectives are imposed on the situation, a much different return experience may well emerge than that suggested by the conventionally measured rate of return statistics.

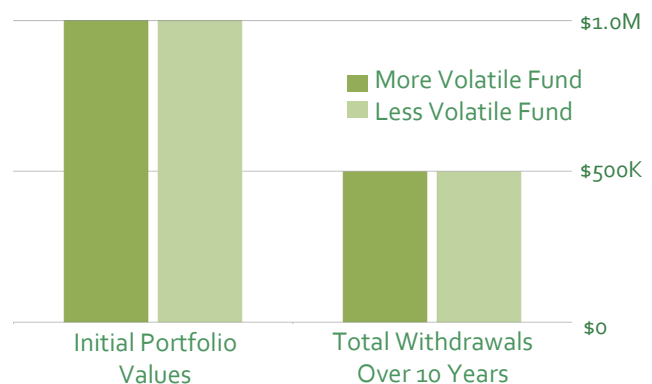
For example, consider the following examples of real world investor objectives:

- ✓ \$1,000,000 invested in each of the two funds at the start of the specified 10-year period
- ✓ An annual withdrawal of \$50,000 is required from each of the mutual fund portfolios
- ✓ Year-by-year returns for each of the portfolios are as depicted in the previous table

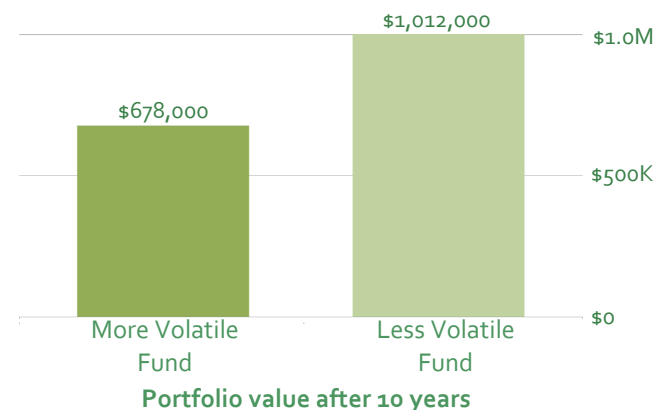
The situation *and the related outcomes* are summarized in the following two charts:

Two Portfolios:

Same initial values, same withdrawals...



Same conventionally measured 10-year compound annual return: 4.9%. But significantly different “real world” investment outcomes



The second chart reflects the difference in the value of the two portfolios at the end of the 10 years would be over 30% (\$300,000+). Quite a real world difference!

Two investments with the same annualized rates of return may provide very different real-world results when the outcomes are recast in dollar terms.

A good investment steward understands the importance of the investment ride along the way for many clients – particularly those living off an accumulated nest-egg. Managing the nature of *the ride along the way* represents yet another dimension where a good steward can add significant value to a client.

Providing Dynamic Evaluation



Earlier it was noted that low portfolio turnover and maintaining a longer-term investment horizon are attributes emphasized by good investment stewards. It is important to point out that this is not an endorsement of a *buy and hold* investment strategy. A

dynamic world requires an *invest and continuously evaluate* approach.

Inherent dynamism

Dynamism within the private sectors of economies creates near-constant fundamental change and alters investment prospects. Consider:

Eastman Kodak has gone from blue chip to extinction in a short period of time. Former retail titans Kmart, Sears, and JC Penny likewise appear to be fading into oblivion as Walmart has ascended, with the latter itself now under serious challenge by Amazon and other competitors.

In just a few years, investors have witnessed cellphone leader Motorola largely displaced by Nokia which in turn ceded significant market share to Blackberry. The latter has since been upended by Apple whose innovation saved itself from a near-death experience of its own at the turn of the New Millennium.

In 2005 Blockbuster had to abandon a takeover of rival Hollywood Video because antitrust officials asserted the merger might create a *monopoly*. By 2010 they declared bankruptcy, as Netflix disrupted Blockbuster's business model.

These are not simply *cherry picked* examples. According to financial news provider, Thomson Reuters, only 60% of companies in the S&P 500 Index a decade ago are still in the index currently.

And the speed of change in today's profit-and-loss market system

appears to be *accelerating*. Additionally, about *half* of the top 100 U.S. companies ranked by revenues have changed *every decade* since 1985. This is about *double* the speed of change that occurred in such rankings during the decades from 1955-85.¹²

Similar dynamism is also reflected by the changing composition of the Forbes 400 Richest American list. On the first Forbes list in 1982, inherited wealth represented over 20% of the constituents (14 Rockefeller's, 28 Du Pont's and 11 Hunt's). By 2006, *only 2%* of the list members were those that inherited their wealth^{13 14} as *old wealth* was displaced by that created by new entrepreneurs.

Invest and constant evaluation is clearly an important operating mode for good stewards. But the need for constant evaluation does not stop at the company specific level.

Markets don't always recover

Much as *real estate prices never go down*, and *oil prices will only go higher*, *depressed markets always come back* may be a dangerous investment mantra.

While it is true the significant declines registered by the Dow Jones Industrial Average and the S&P 500 market indices in both the 2000-02 period and 2008 were recovered in relatively short subsequent periods, it is not always the case that depressed markets either recover or do so in timely fashion. The Japanese Nikkei 225 stock index hasn't come close to its 1989 peak - a quarter of a century later.

Here in the U.S., the NASDAQ Index has

"Since 1980, over 320 companies were deleted from the S&P 500 for business distress reasons. This should not be a surprise: capitalism is based on competition, creative destruction and reinvention."

— Michael Cembalest

J.P. Morgan Asset Management

It is not always the case that depressed markets either recover, or do so in timely fashion. The Japanese Nikkei 225 stock index hasn't come close to its 1989 peak - a quarter of a century later.

only recently surpassed its year 2000 peak on an absolute basis. It remains significantly below in inflation-adjusted terms.

And in the case of the 2008 decline, in the midst of the panic, many pundits were making a plausible case that a Great Depression rerun was ahead and that stock prices may not recover for decades. Constant evaluation of unfolding events enabled good stewards to assist clients through this period of great uncertainty.

Correlations change

Changes also occur which may impact the effectiveness of diversification within a portfolio. Correlations, which measure the extent to which different portfolio assets move together, are not static variables.

In prior decades, it was not uncommon that the economies around the world were operating in different phases of their respective business cycles. If the U.S. was suffering a recession while other economies were not, the inclusion of international stocks in a portfolio may well have provided diversification benefits.

As many investors painfully learned in the 2008 Panic however, the *flat world* of increased globalization drove many asset correlations to 1. Stock prices (and many bond prices) around the globe all moved the same direction (down!) and in similar, or greater, magnitudes.

As a result, *diversification*, assumed to be an intrinsic feature within many wide asset allocation portfolios, proved ineffective. Having more investment eggs does little good if they all crack when the basket falls. To make matters worse, 2008 showed that the ineffectiveness occurred when diversification was needed the most.

Will these latest correlation patterns persist, or will they change yet again? Will high-quality bonds, which displayed such effective diversification properties in 2008 and the subsequent period, remain negatively correlated to stock price movements (bond prices rise when stock price fall)? Or will this correlation change? What are the implications of any of these correlation changes for portfolio construction and effective diversification?

Yet another value-added dimension of good investment stewardship is the constant evaluation and management of these issues.

The investment world continues to be marked by increasing complexity, rapid change and the *business of salesmanship*. Against this backdrop, the need for simple

solutions and sophisticated vigilance to provide effective outcomes from the *profession of investment stewardship* has perhaps never been greater.

While no one can guarantee success, a good steward – whose interests are aligned with the investor, that does the *right things* even when doing so is neither easy nor popular – can help stack the probability of success in an investor's favor. For most investors, good stewardship can be a powerful difference maker, adding value to an investor's financial life that is considerable and, perhaps, immeasurable.

At *Capital Investment Services*, it is our mission to take a simple, sophisticated and effective approach in service as good stewards for our clients.

Sources & Notes

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About Capital

Founded in 1981, Capital Investment Services of America, Inc. is an employee-owned Milwaukee-based investment advisor that serves high net worth individuals, trusts, businesses, and charitable organizations. We build custom tailored investment portfolios to achieve our client's individual financial objectives.

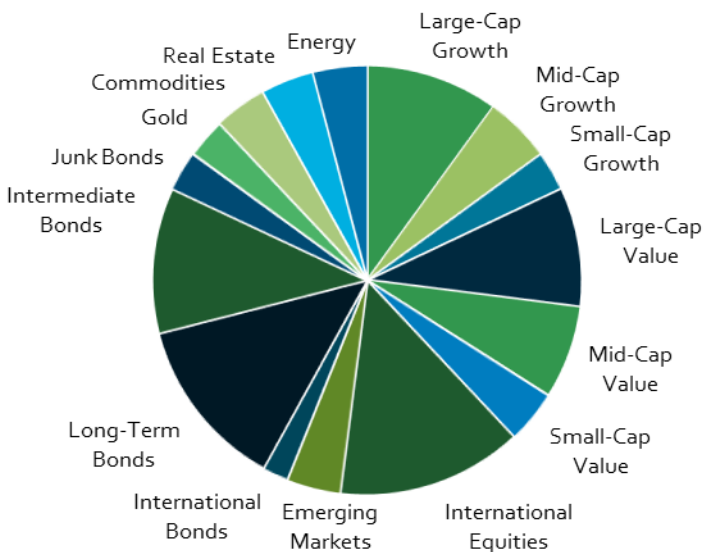
"Simplicity is the ultimate sophistication."
- Leonardo da Vinci

Complex Product-Driven Mindset vs. Simple Client-Driven Solutions:

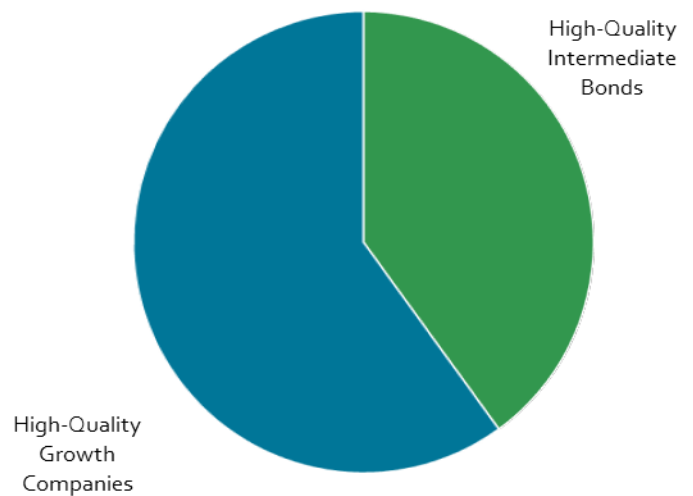
The financial industry continues to add more products and asset classes intended to offer new investment opportunities and less risk from the added diversification. But having more eggs in a portfolio basket accomplishes little if all the eggs crack during a fall.

Conversely, a simple portfolio of high-quality, consistent growth businesses, selected through a sophisticated investment process, coupled with the right type of bonds can achieve the results sought by many investors today.

Unnecessary Portfolio Complexity



Simple Blended Portfolios



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