

PREPARING CLIENTS AND THEIR PORTFOLIOS FOR HIGHER MARKET VOLATILITY

by Matthew Pasts, CMT, Chief Executive Officer, BTS Asset Management
Isaac Braley, President & Co-Portfolio Manager, BTS Asset Management



*Taming the Cycle of
Emotional*

Overreaction



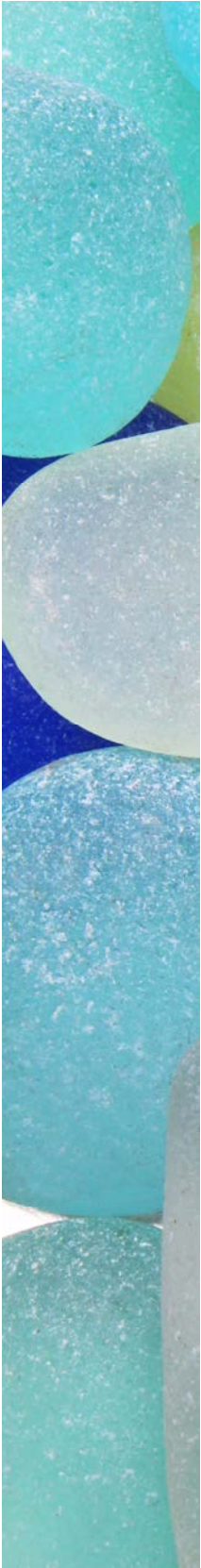
A BTS Asset Management Special Report for
Investment Advisors, and Their Clients

Find Opportunity

Preparing Clients and Their Portfolios for Higher Market Volatility — *Taming the Cycle of Emotional Overreaction*

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History's Lessons on Trying to Catch the Last Year of a Bull Market

HELPING CLIENTS MENTALLY PREPARE FOR VOLATILITY

HISTORY'S LESSONS ON TRYING TO CATCH THE LAST YEAR OF A BULL MARKET

by Isaac Braley, President & Co-Portfolio Manager, BTS Asset Management



When people say “there might be one more year left in this bull market,” we think there’s a good chance fear of missing out on potential gains might be leading to over-risked portfolios.

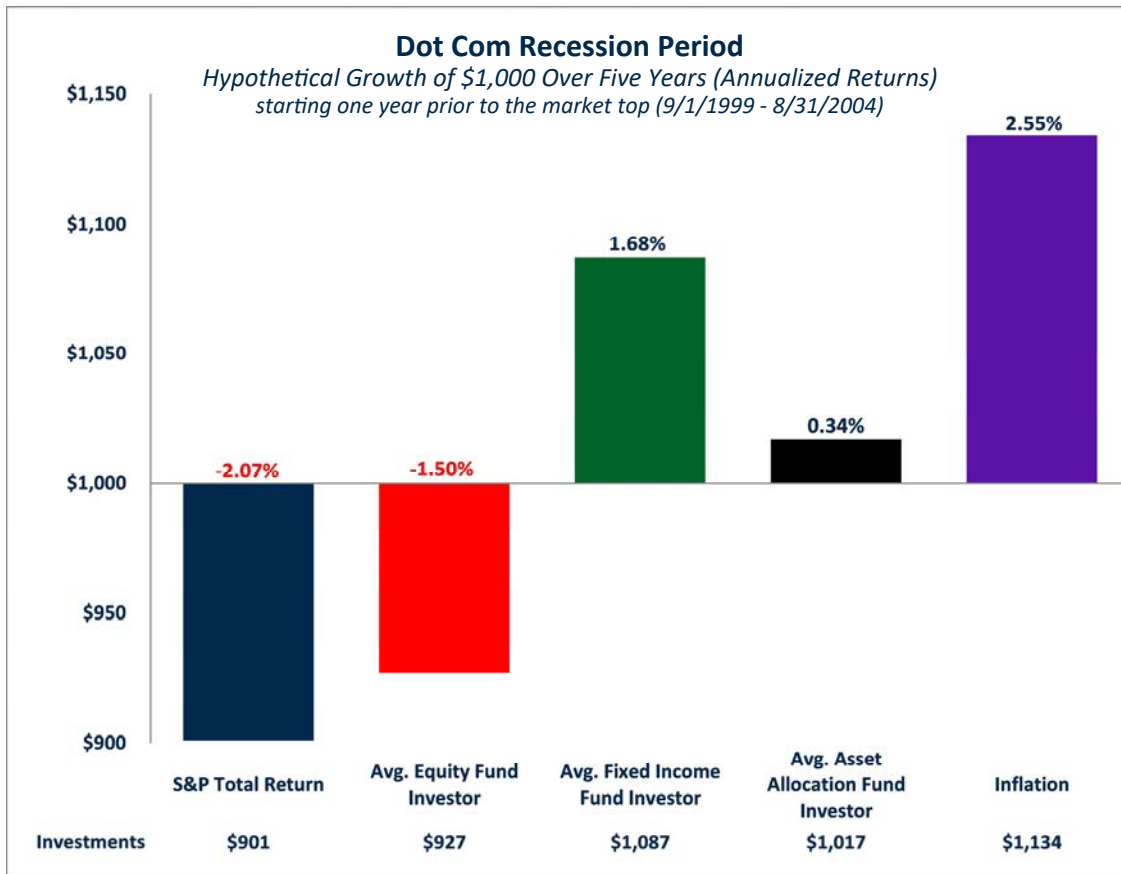
Many investors experienced intense loss aversion after the last two recessions and under-risked their portfolios. Over the course of a long bull market, it’s not surprising that loss aversion would eventually succumb to a frustrated sense of having missed out on much of the current bull market’s gains. The result, in our view, is taking on too much risk in a hope to capture “one last great year.”

Our observation is investors who are carrying this hope tend to fall into two broad categories:

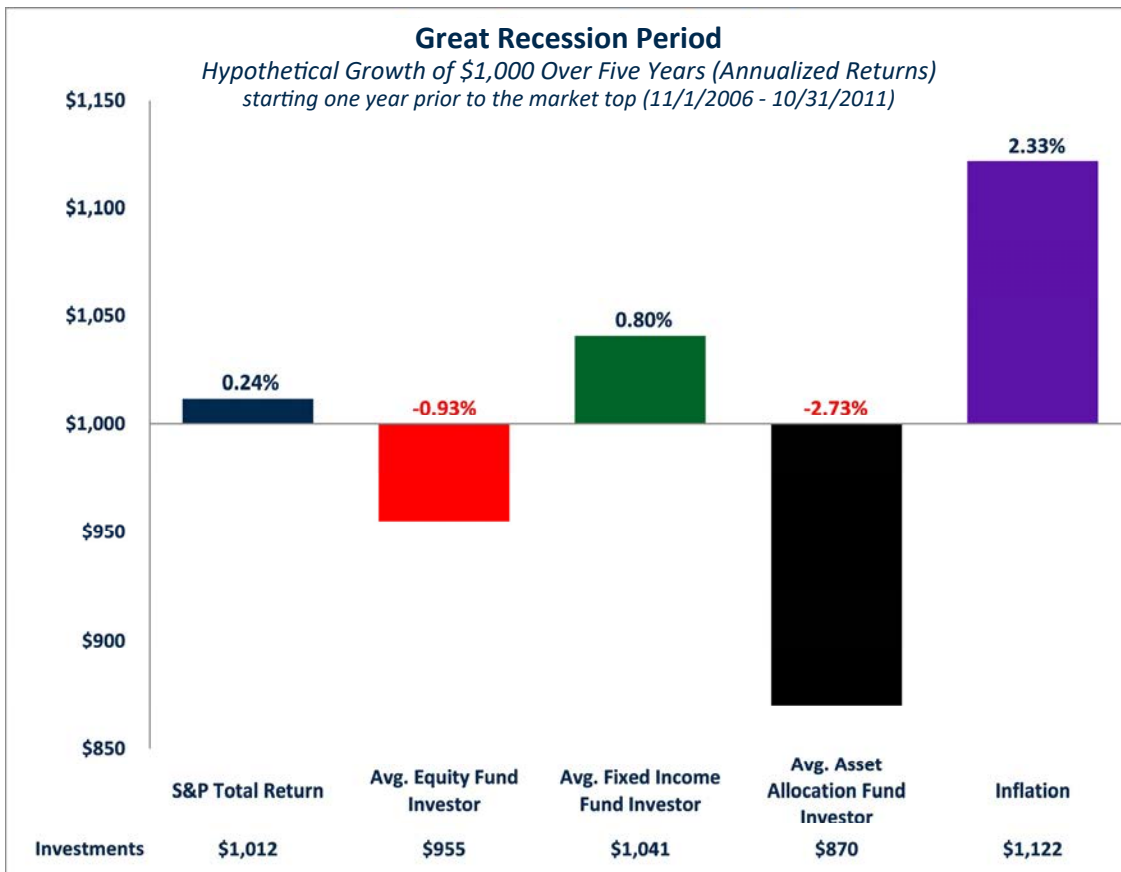
- ◆ “ First, those who plan to attempt stepping to the sidelines *after* the start of a major drawdown event. This is, of course, highly difficult to do given how fast prices can fall, not to mention investor psychology that takes over. That psychology leads first to a desire to “break even” and, later, to a kind of frustrated capitulation and “going to cash”—the very attitude that, unfortunately, cost so many investors returns in the initial phases of the current bull market due to their non-participation.
- ◆ “ And second, those who recognize they may be unable to avoid a downturn but hope to “weather it” by achieving offsetting positive performance in the year prior to a downturn and the two or three years afterward. At first glance, this may seem like a reasonable strategy—especially taking into account the very real psychological pressure that manifests as “fear of missing out.” But unfortunately, history suggests that a hope for offsetting positive returns before and after a downturn isn’t well founded. This paper explores these ideas further.

Failure to Match the Rate of Inflation

First, consider the Dot Com recession period. The chart on the following page shows the hypothetical growth of \$1,000 over a five-year period that began one year before the market top and continued, therefore, through the downturn and into part of the following recovery. The S&P 500 Total Return Index performance—reflective in this case of an “over-risked” portfolio—was negative for the period. But even more dramatically, the average fixed income fund investor failed to match the level of inflation. Taking portfolio risk into account, investors across both equities and fixed income may have been better served to play defense.



The figures for the Great Recession period tell a similar story. Here, too, all returns substantially trail the inflation rate for the period.



For more information, including definitions for the terms used in the graphs above, please see page 36.

Recessions and Investment Prices Do Not Move Together

Many investors believe that recessions and investment prices move together. However, market tops and bottoms do not match up with the beginning and end of recessions.

- ◆ The market top and bottom of the Dot Com Bubble era were 9/2000 and 10/2002, while the recession ran from 03/2001-11/2001.
- ◆ The market top to bottom of the Great Recession era were 11/2007 and 3/2009, while the recession ran from 12/2007-6/2009.

As implied by these dates, markets often lead economic contractions *but don't always lead expansions*. For example, when the S&P 500 TR Index finally reached break-even with the Dot Com Bubble top, it was already November of 2006. Then, sadly, just 12 months after breaking even the market turned south again. These types of recessions can lead to lost decades of performance, while inflation continues to claw at investors' principal.

Positioning a Portfolio Properly Means Getting Ahead of the Crowd

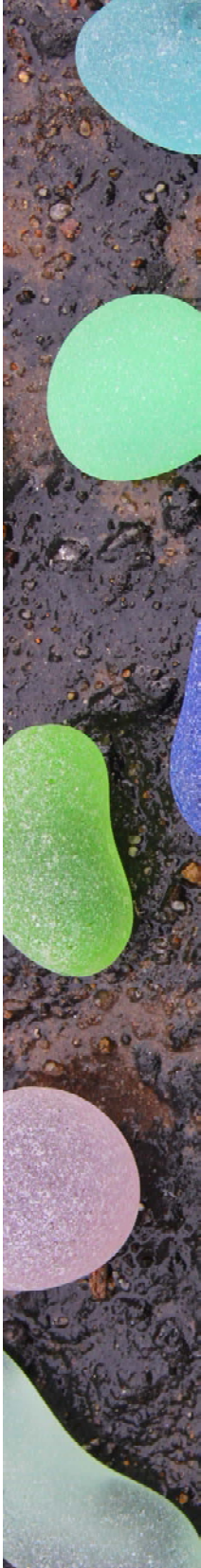
A market blow-off occurs when investments rise in a rapid and steep upward trend. This late-stage market phenomenon often happens when investors become behaviorally euphoric and do not want to miss out on performance. Sadly, the performance they are often seeing has already happened. The temptation is strong to look into the recent past to find what has done best and then allocate to it.

Instead, investors should focus on what has the opportunity to potentially outperform in the coming years. Doing so begins with an analysis of previous time periods during which market events transpired that have the highest chance of occurring in the future—and then looking for an investment that has done well through that period. Of course, past performance of any investment strategy is no guarantee that it will achieve the same or similar results in the future, or that it will work as intended in all market environments, but we believe seeking to position a portfolio correctly ahead of major “down” events occurring is absolutely crucial.

Let's return briefly to the argument that an investor might try to begin moving allocations to a defensive posture once down events start to occur. Sounds great—but is it feasible? Once market declines start to occur, investor psychology starts to kick in. At first, people are in denial and just want to break-even. Then, the next thing you know, there's panic and a desire to sell everything and go to cash.

BTS believes our Tactical Fixed Income Fund may help in smoothing out the emotions of an investor and potentially give them the opportunity to receive the financial outcomes they are looking for.





The Cycle of Emotion

HELPING CLIENTS MENTALLY PREPARE FOR VOLATILITY

THE CYCLE OF EMOTION

by Isaac Braley, President & Co-Portfolio Manager, BTS Asset Management

- ⊙ *Over the past 37 years, the S&P 500 gained 12.01% annually.*
- ⊙ *The average equity investor? About half that.*

For investment professionals, there's probably no more familiar number than 8% when it comes to long-term returns. Coming out of academia, the 8% assumption for long-run annualized returns has taken hold even among many individual investors.

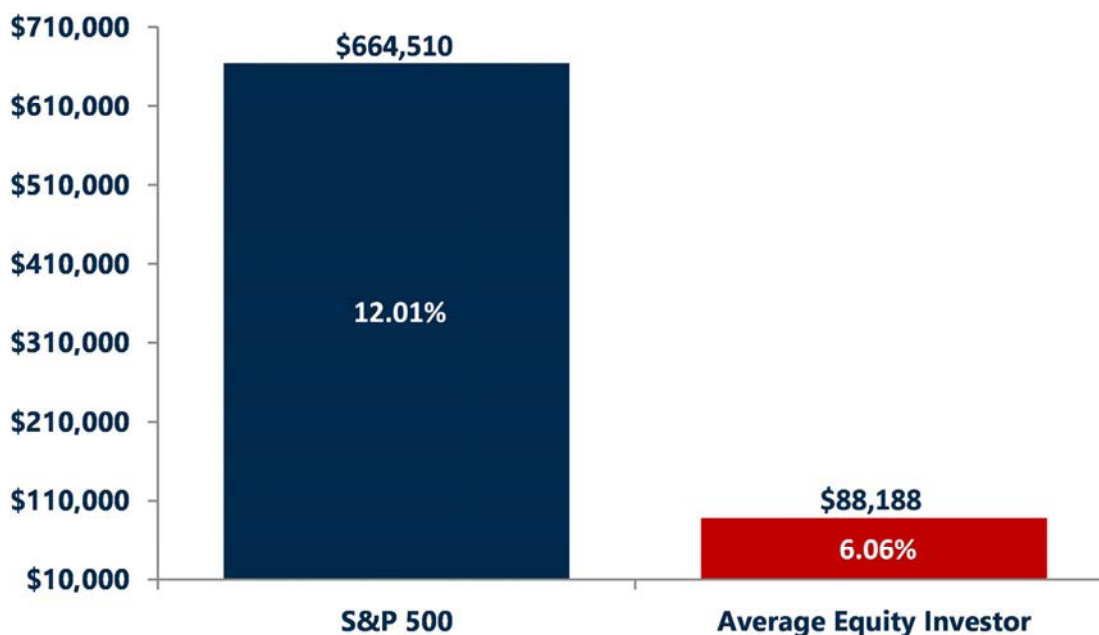
Many advisors use a more conservative assumption, such as 6%, when building financial plans, to accommodate potentially lower market returns in the coming decades.

*But there's a problem with that 6% assumption, just as much as the 8%:
Neither figure takes into account actual investor behavior.*

Consider these figures, over the 37-year period ending December 31, 2021:

- ⊙ The S&P 500 Index achieved an average annual return of about 12.01%
- ⊙ The average equity investor, according to DALBAR, earned only 6.06%

Hypothetical Growth of \$10,000 Annualized Returns 1/1/1985 - 12/31/2021



Past performance is no guarantee of future results. Investors cannot directly invest in an index and unmanaged index returns do not reflect any fees, expenses or sales charges.

The second theme is an application of the fact that losses can be hard to recover from. Here, when people discuss “sequence of returns risk,” they are likely doing so with respect to a particular point in time that’s relevant to an individual investor.

The classic example is a planned retirement date. For someone approaching retirement, the conventional wisdom about long-term average rates of return won’t be much comfort in the event a portfolio’s value crashes with too little time to make up the loss before funds are needed to meet living expenses.

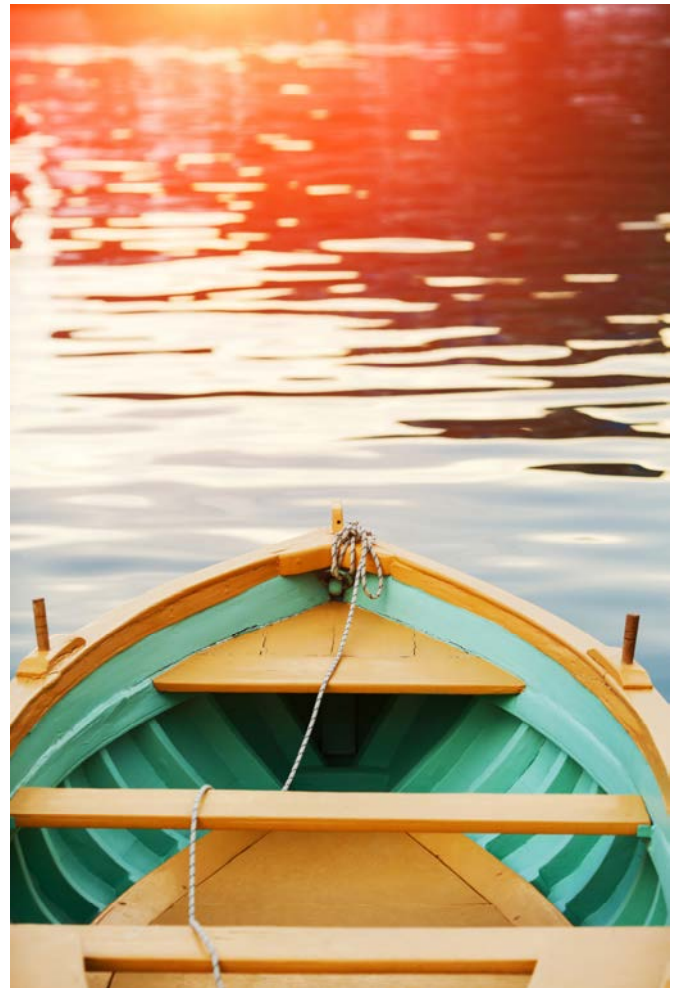
Consider, for example, the calendar-year returns shown below for each of the past 22 years. They are for a broad basket of bonds, and a 50/50 portfolio of stocks and bonds. Traditional wisdom characterizes bonds as the safer portion of a portfolio...but take a look at the years with negative returns, remembering that for investors with more than 50% equities, those negative returns would have been even lower. It's no wonder that many would-be retirees around 2008 had to stay in the workforce—or return to it, at lower-paying jobs than the ones they retired from.

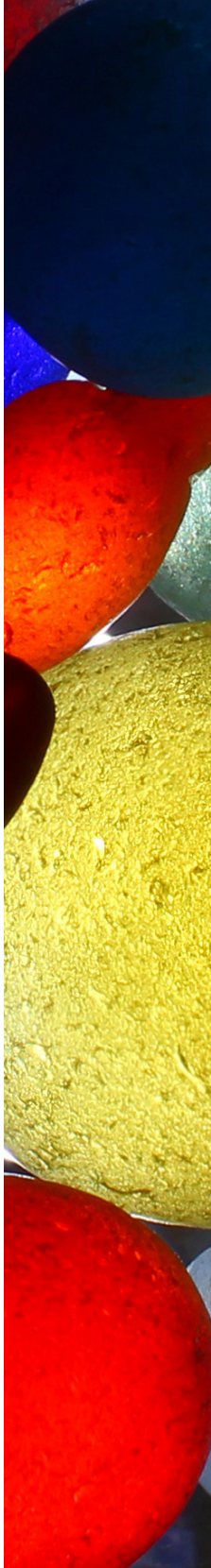
| Year | Bloomberg Aggregate Bond Index | S&P 500 & BBg Agg. 50/50 |
|------|--------------------------------|--------------------------|
| 2000 | 11.63% | 0.96% |
| 2001 | 8.42% | -1.29% |
| 2002 | 10.27% | -6.25% |
| 2003 | 4.11% | 16.17% |
| 2004 | 4.34% | 7.70% |
| 2005 | 2.43% | 3.70% |
| 2006 | 4.33% | 9.99% |
| 2007 | 6.96% | 6.34% |
| 2008 | 5.24% | -17.48% |
| 2009 | 5.93% | 16.41% |
| 2010 | 6.56% | 11.36% |
| 2011 | 7.86% | 5.58% |
| 2012 | 4.23% | 10.21% |
| 2013 | -2.02% | 14.26% |
| 2014 | 5.94% | 9.77% |
| 2015 | 0.57% | 1.13% |
| 2016 | 2.66% | 7.29% |
| 2017 | 3.55% | 12.42% |
| 2018 | 0.02% | -1.81% |
| 2019 | 8.72% | 19.82% |
| 2020 | 7.51% | 14.31% |
| 2021 | -1.54% | 12.91% |

Past performance is no guarantee of future results. Investors cannot directly invest in an index and unmanaged index returns do not reflect any fees, expenses or sales charges.

There's another important subtlety about sequence of returns that comes into play during retirement itself, as withdrawals of principal are made from the portfolio to cover expenses. This period is often assumed to be relatively low-risk—but in fact it may not be whatsoever. Due to compounding effects, a “poor” sequence of returns in retirement (e.g., low or negative returns early in the retirement period) can have a drastic impact on account balances after 10 or 20 years of retirement.

The bottom line is that sequence of returns risk is a clear and present danger to everyone but those with truly long time horizons.





The Difference Between “Volatility” and “Risk”

HELPING CLIENTS MENTALLY PREPARE FOR VOLATILITY

THE DIFFERENCE BETWEEN “VOLATILITY” AND “RISK”

by Matthew Pasts, CMT, Chief Executive Officer, BTS Asset Management

- ⊙ *People often use volatility as a shorthand way to talk about risk—whereas actually volatility can be friend or foe.*
- ⊙ *Investors may have an easier time avoiding emotion-based decisions during volatile periods if they are clear about the difference between volatility and risk.*

“Volatility” is a charged word when it comes to market action. And yet in actual fact it’s essentially a neutral concept—a mathematical expression of the magnitude of price changes (both up and down) within a reference time period. There is no inherent reason why low volatility is “good” and high volatility is “bad” when considered at the individual-investor level. It all depends on that investor’s goals, portfolio positioning and time horizon.

Furthermore, most investors don’t mind volatility to the upside; it’s just the downside they’re concerned with. That’s one reason why we consider risk statistics that focus on the downside—such as Downside Deviation and the Sortino Ratio—more practically useful to more investors than risk statistics that focus on both upside and downside variance, such as Standard Deviation and the Sharpe Ratio.

In fact, we believe investors can substantially benefit from internalizing the difference between, say, the Sortino Ratio and the Sharpe Ratio. Even if they don’t dig into the math behind the calculations, they can benefit in our view by becoming aware of how volatility is neither inherently good or bad...*because this awareness can help people maintain a rational approach to investment decisions during turbulent times.*

Unlike volatility, “risk” is not a neutral concept. Risk means, essentially, the chance that investors will not meet their goals—or, worse, that their capital will be lost. In this way, risk has a ‘real-

life” sense that’s fundamentally different from volatility. Risk needs careful, constant attention.



In the real world, volatility and risk are very different things

In a *Wall Street Journal* article titled “The Real Risk Is Believing That Volatility Is Risk” (April 30, 2018) journalist James Mackintosh gets at the heart of the difference between volatility and risk for investors and their portfolios. Here are two brief excerpts:

- ⊙ “Volatility matters a lot if you have a short-term investing horizon, because it is a proxy for how much money you might make or lose over a short period. If you can lose a lot because volatility is high, it is quite reasonable to demand a lower price as compensation.... But if you have a long-term horizon, volatility is an opportunity.”
- ⊙ “When the word ‘risk’ is used investors should question what it means, because one person’s risk is another’s opportunity. Consider the risk categories into which financial advisers attempt to lump assets. A high-risk portfolio has more equities and fewer bonds, while a very-low-risk portfolio might be mainly cash and Treasuries. Used like this, risk amounts to little more than volatility, as history shows.”

And clients need reassurance about the portfolio-management philosophy mechanisms in place that are designed to help against loss of capital. In our case, that philosophy focuses on mitigating risk of loss first and foremost—even when it means a willingness to forgo some potential gains—and the mechanisms in place include stop-losses.





Remember that Losses
are
Twice as Painful as
Gains are Pleasurable

HELPING CLIENTS MENTALLY PREPARE FOR VOLATILITY

REMEMBER THAT LOSSES ARE TWICE AS PAINFUL AS GAINS ARE PLEASURABLE

by Isaac Braley, President & Co-Portfolio Manager, BTS Asset Management

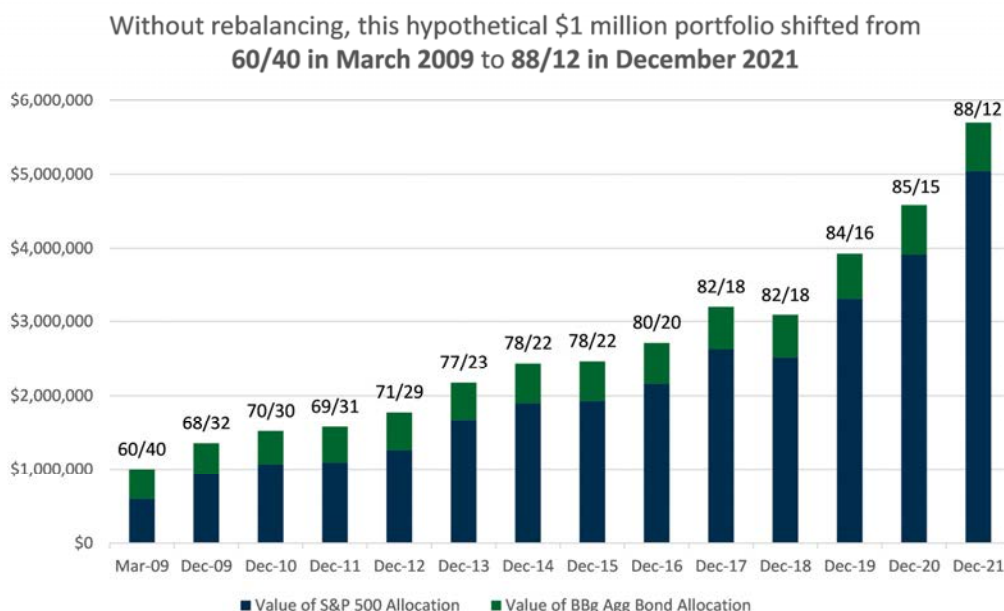
- ⊙ *Fear of missing out can lead to dramatic distortions in an investment plan if investors give into the temptation to let rebalancing go by the wayside.*
- ⊙ *A 60/40 portfolio in 2009 could be an 88/12 portfolio as of December 31, 2021, if not rebalanced.*
- ⊙ *One way to address the problem . . . combat psychology with psychology.*

There's much talk in the financial media of "fear of missing out," which of course is no surprise this many years into a bull market. When this kind of fear takes over, investors become loath to de-risk their portfolios and, therefore, potentially miss out on further gains.

That's completely understandable—and very dangerous, in our view. Fear of missing out can lead to risk profiles far from the original investment plan. For example, without rebalancing, a 60/40 portfolio in 2009 could be an 88/12 portfolio as of December 31, 2021.

That's an extreme case. But even a 10-percentage-point deviation from the investment plan's risk tolerance could represent a huge shift in risk exposure. During a bull market, the investor doesn't mind a bit—and may even resist an advisor's counsel to de-risk. But once the market turns, so does the psychology.

That's why, in our view, it helps even in bull markets to keep the emotions of bear markets clearly in mind. Most advisors are probably familiar with the concept that people "feel" losses approximately twice as intensely as they "feel" gains. (This is a central aspect of "prospect theory," developed by Nobel Prize-winning economist Daniel Kahneman and Amos Tversky.)



Investors cannot directly invest in an index and unmanaged index returns do not reflect any fees, expenses, or sales charges.



Because people “feel” losses more than gains, they are sometimes irrationally conservative—as demonstrated in Kahneman and Tversky’s famous coin-flip experiments. In fact, many advisors probably use exactly this type of thought experiment to help investors avoid the mistake of bailing out of a bear market and failing to reenter.

But there’s another slant to these ideas—one that applies in a vital way when times are good.

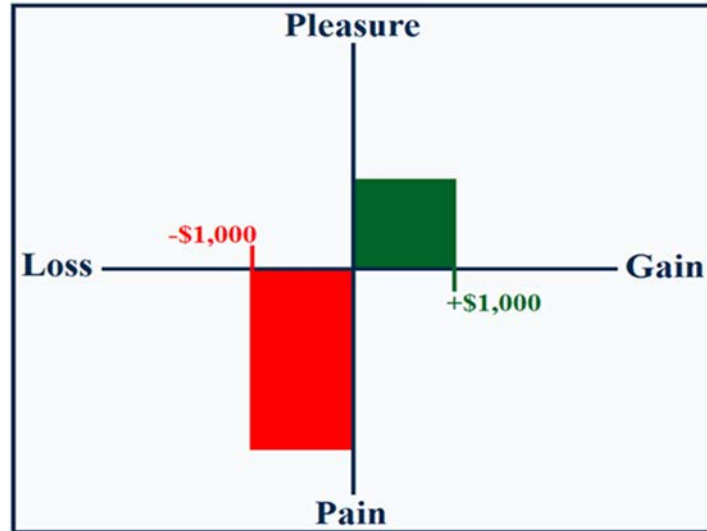
Simply this: *If an investor can simply remember that losses “feel” twice as painful as gains are pleasurable, investors are more likely, in our view, to avoid the mistake of over-risking a portfolio during bull markets.*

Of course, it’s possible that during especially high-flying emotions (the “euphoria” stage) that investors won’t quite be able to imagine the possibility of that future pain. In that case, we can only hope automatic rebalancing is in place!

Emotion is a powerful factor. Usually, the goal is to dispense with it as much as possible. But in this case, it may be useful to combat one kind of emotion with another kind of emotion, if the ultimate result is a more rational investment program.

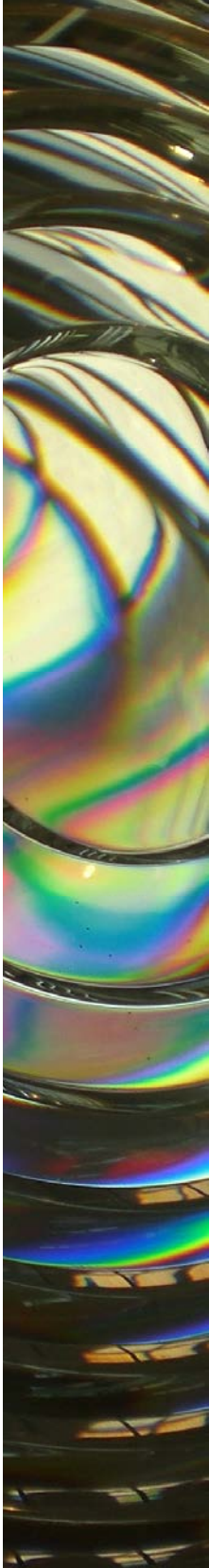
Loss Aversion

Losses are Twice as Painful as Gains are Pleasurable



Source: Amos Tversky & Daniel Kahneman, “The Framing of Decisions and the Psychology of Choice”





How Good is Twice as Good as Average?

HELPING CLIENTS MENTALLY PREPARE FOR VOLATILITY

HOW GOOD IS TWICE AS GOOD AS AVERAGE?

by Isaac Braley, President & Co-Portfolio Manager, BTS Asset Management

- ⊙ *In baseball, a batting average twice as good as average puts a player into superstar territory—and then some.*
- ⊙ *In investing, not so much. Just 4.82% annually was all it took to do twice as well as the average asset-allocation investor over the past 37 years.*

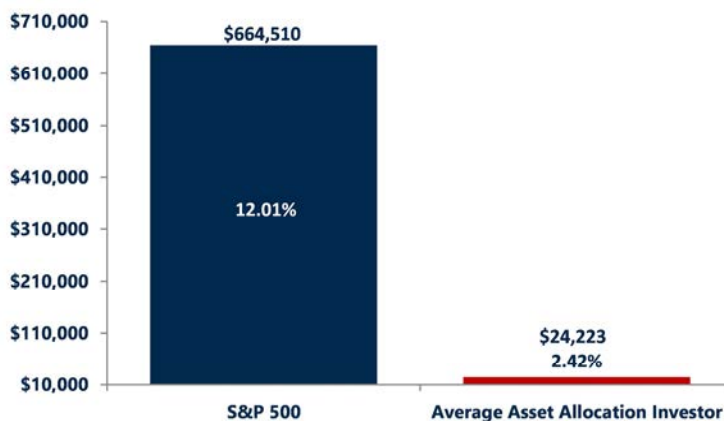
In most walks of life, “twice as good as average” is a solid outcome. There are exceptions, of course: leaping twice as far as the average person won’t win you a long jump medal at the next Olympics. And throwing a baseball twice as hard as the average person won’t put you on the mound in Fenway Park.

But by and large—and certainly when it comes to investing—we believe most people would be thrilled to achieve a long-term outcome that’s twice as good as average.

But Maybe Not, When They Find Out How Bad “Average” Actually Is

According to DALBAR, the average asset allocation investor earned only 2.42% annually over the 37-year period ending December 31, 2021. That’s a staggeringly low number for a category that’s intended to serve as a proxy for a so-called balanced portfolio.

Hypothetical Growth of \$10,000 - Annualized Returns by Asset Class
1/1/1985 - 12/31/2021



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The problem isn’t with stock or bond-index returns. Over that period, the S&P 500 Index advanced about 12% per year. The Bloomberg Bond Index earned about 6.59% annually.

So, a big part of the problem lies with investor behavior.

As advisors know firsthand, it’s extremely difficult for investors to overcome the Cycle of Market Emotions and stay the course over the long term. The temptation to step to the sidelines—perhaps never to return—lures many investors away from a path that might otherwise lead to a comfortable retirement.

We believe clients desperately need advisors’ help in overcoming such pitfalls—and that many advisors add tremendous long-term value by doing so.

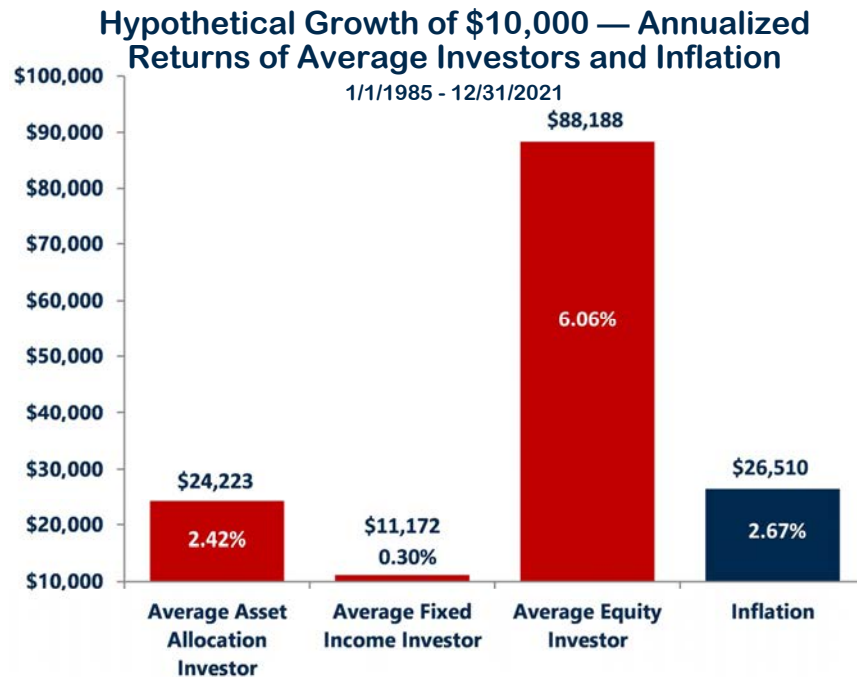
But is that enough? Say a client, with an advisor’s help, rationalized his or her investment behavior and, furthermore, benefited from the advisor’s planning and allocations to such a degree that the investor did twice as well as average over that same 37-year period.

In this hypothetical, how much would this client have earned? Unfortunately, twice the average return is still painfully small on an absolute level: just 4.82% per year.

Here, then, is where we think clients may get into some trouble. Because even a twice-as-good return is so low, the temptation may be strong to allow a portfolio to become over-risked as a way to attempt to “make up” the gap between individual and market returns.

That might work fine for a while. Maybe even a long while, if a bull market stretches out far enough. But eventually markets turn. From our experience working with investors, we believe that over-risked portfolios tend to catch up with investors eventually.

That’s why we believe the prudent course, even when times seem good, is to maintain a portion of a portfolio in strategies designed to embrace playing defense when called for.



*The data presented in the chart above is for illustrative purposes only.
Past performance is no guarantee of future results.*





Should “Out of Favor” Mean “Out of Portfolio”?

HELPING CLIENTS MENTALLY PREPARE FOR VOLATILITY

SHOULD “OUT OF FAVOR” MEAN “OUT OF PORTFOLIO”?

by Matthew Pasts, CMT, Chief Executive Officer, BTS Asset Management

- ⊙ *In recent years, the phrase “out of favor” has commonly been associated with value-stock investing.*
- ⊙ *There’s a larger sense of the phrase “out of favor” that applies more widely — and may help investors steer a straight course ahead of and through volatile markets.*

The phrase “out of favor” is a common market discussion, whether in reference to a particular company’s stock or a whole investment style.

For example, in recent years, the phrase “out of favor” has been commonly applied to value-stock investing. As an investment style, “value” has done reasonably well over the decades, but in the current bull market, “growth” has dominated.

| Year | S&P 500 Growth TR USD | S&P 500 Value TR USD |
|------|-----------------------|----------------------|
| 2000 | -22.08 | 6.08 |
| 2001 | -12.73 | -11.71 |
| 2002 | -23.59 | -20.85 |
| 2003 | 25.66 | 31.79 |
| 2004 | 6.13 | 15.71 |
| 2005 | 4.00 | 5.82 |
| 2006 | 11.01 | 20.80 |
| 2007 | 9.13 | 1.99 |
| 2008 | -34.92 | -39.22 |
| 2009 | 31.57 | 21.18 |
| 2010 | 15.05 | 15.10 |
| 2011 | 4.65 | -0.48 |
| 2012 | 14.61 | 17.68 |
| 2013 | 32.75 | 31.99 |
| 2014 | 14.89 | 12.36 |
| 2015 | 5.52 | -3.13 |
| 2016 | 6.89 | 17.40 |
| 2017 | 27.44 | 15.36 |
| 2018 | -0.01 | -8.95 |
| 2019 | 31.13 | 31.93 |
| 2020 | 33.47 | 1.36 |
| 2021 | 32.01 | 24.90 |

In fact, growth has dominated value to such an extent that we suspect many investors have let price appreciation in their growth sleeves drive down the overall percentage of a portfolio allocated to value.

In our view, that might be entirely appropriate—we are tactical managers, after all—as long as the portfolio stays true to the investor’s risk tolerances. Value managers may be correct that their “out of favor” style will eventually swing back into favor, but that doesn’t *necessarily* imply an allocation to value should remain fixed in the meantime.

The relevant question, in our view, always comes down to this: ***what is the purpose of the “out of favor” investment in the larger portfolio?***

If the purpose is, for example, “long-term stock price appreciation,” then it might be reasonable to let the value allocation slip relative to growth, if that’s what market trends suggest. After all, both value and growth may fulfill that broad-based, long-term purpose.

But what if an out-of-favor investment has a fundamentally different purpose from other asset classes in a portfolio? The simplest example is bonds vs. stocks. Most investors conceive of the bond portion of a portfolio as more conservative than stocks. During a strong bull market in stocks, the bond portion of a portfolio may shrink substantially relative to the stock portion, unless the investor rebalances. That could be a serious problem, in the event a sharp downturn arrives and the portfolio is over-risked.

Past performance is no guarantee of future results.
Investors cannot directly invest in an index and unmanaged
index returns do not reflect any fees, expenses or sales
charges.

The same way of thinking can, and in our view should, also be applied at a more granular level, within the overall bond sector. Our flagship strategy at BTS, for example, focuses on tactical management of high-yield bonds and government bonds. If high-yield bonds are sufficiently “beaten up” — or “out of favor”—it’s likely that we’ll be on the sidelines (in money markets), due to our risk controls. In that scenario, we may identify opportunities to pursue gains in Treasuries, during flight-to-quality periods. At times, these Treasury allocations may help “pay for” the defensive posture of stepping away from “out of favor” high yields.

But stepping back from these potential tactical allocations, we’d offer this larger point: regardless of whether we’re investing in high yields, Treasuries or money markets, we believe the ***purpose of the strategy in the investor’s larger portfolio remains consistent.***

It all comes back to investors’ individual risk tolerances. No matter how “out of favor” assets potentially used by an investment strategy may be, if the strategy’s presence in a portfolio is to mitigate risk or otherwise differ from other allocations, then beware of letting what’s “out of favor” drive allocation decisions.





Beware of Thinking of Bonds as the “Safe” Portion of a Portfolio

HELPING CLIENTS MENTALLY PREPARE FOR VOLATILITY

BEWARE OF THINKING OF BONDS AS THE “SAFE” PORTION OF A PORTFOLIO

by Isaac Braley, President & Co-Portfolio Manager, BTS Asset Management

- ⊙ *The “60/40 portfolio” is conceptually useful—but also dangerous if investors mistakenly assume the bond portion of a portfolio is its “safe” portion.*
- ⊙ *Bonds vary in risk factors and therefore, correlations. There is no generic “bond market” with respect to risk analysis.*
- ⊙ *Most investors active today have never seen an extended bear market in bonds.*

The “60/40 portfolio” has endured for decades as the basic reference point for portfolio allocations. What’s so appealing about “60/40” (or “70/30” or other ratios) is their ability to compress vast markets’ worth of risk factors into a single, simple expression.

But there’s a conceptual danger in the reductive nature of “60/40”—especially on the bond side. Here’s why:

- ❑ With respect to stocks, even modestly experienced investors generally have a sense for variation in risks, from the “bluest of the blue chips” down to highly speculative penny stocks.
- ❑ But with respect to bonds, even relatively experienced investors often lack a basic conceptual framework for how bonds “work” and how different classes of bonds vary relative to each other—and relative to stocks.

What can happen is this: a hypothetical investor might think: “OK, I understand that 60% of my portfolio is invested in stocks, which I know are risky but offer better returns. I’m comfortable with that, because I know that 40% of my portfolio is invested in bonds, which are safe.”

A dangerous conceptual reduction

That hypothetical investor is making what we believe to be a dangerous conceptual error by genericizing “bonds” in that way. Sure, most bonds are less risky than most stocks, most of the time.

But when investors talk about “the bond market” as if it were a unified entity, they are lumping together asset classes that are every bit as diverse as blue-chips and penny stocks. Therefore, it is simply not helpful, in our view, to generically refer to bonds as “safer” than equities. To help investors grapple with this important point, the following two illustrations may be helpful.

First is a table showing correlations among two types of bonds—high yield corporate bonds and 10-year U.S. Treasuries—plus large-company stocks. As shown below, high-yield bonds and Treasuries tend to move in *opposite* directions. So much for “the bond market” as a generic construct!

10-Year Correlations as of 12/31/2021

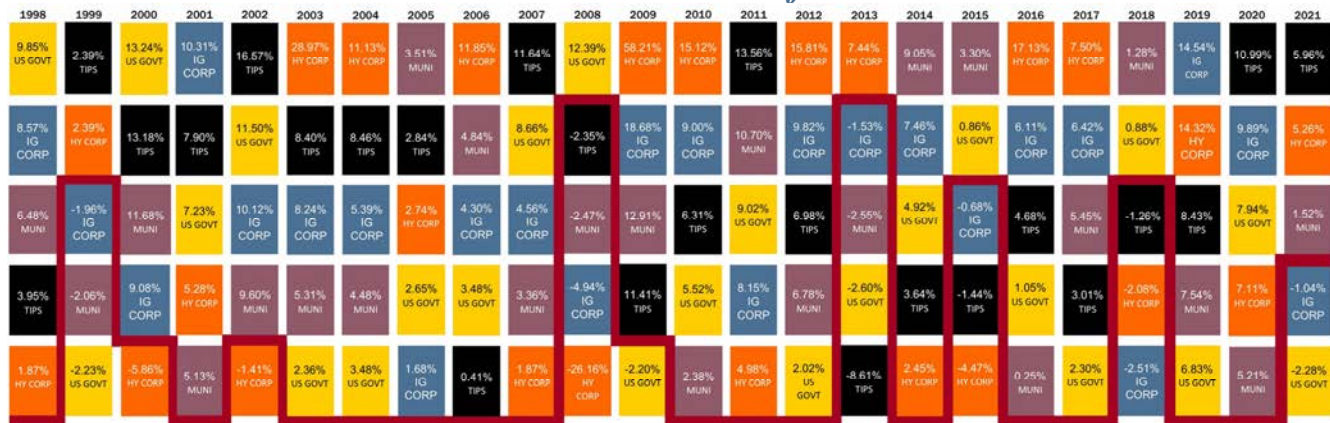
| Benchmark | High Yield ¹ | Treasury ² | S&P 500 ³ |
|-------------------------|-------------------------|-----------------------|----------------------|
| High Yield ¹ | 1.00 | -0.10 | 0.73 |
| Treasury ² | | 1.00 | -0.28 |
| S&P 500 ³ | | | 1.00 |

1- ICE BofAML US High Yield TR USD 2 - Citi Treasury Benchmark 10 Yr USD 3 - S&P 500 TR USD

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Second is a table showing annual performance for various segments of the bond market. As illustrated, year-to-year performance for a given segment can vary widely. So can the segments' performance ranking versus each other.

Fixed Income Sector Performance



LEGEND

| | |
|--|--|
| ■ HY Corp | Bloomberg US Corporate High Yield TR USD |
| ■ IG Corp | Bloomberg US Corp Bond TR USD |
| ■ MUNI | Bloomberg Municipal TR USD |
| ■ TIPS | Bloomberg Treasury US TIPS TR US |
| ■ US Gov't | Bloomberg US Government TR USD |

■ Demarcation between positive and negative returns



Past performance is no guarantee of future results. Investors cannot directly invest in an index and unmanaged index returns do not reflect any fees, expenses or sales charges.

Yet another word of caution

The two illustrations, the one above and the one on the previous page, can help investors understand the need for care when evaluating the “safety” of a bond allocation. But investors should take yet another conceptual leap as they grapple with their individual risk tolerances and study the risks that may be lurking in their portfolios.

Namely this: **Most investors active today have never seen an extended bear market in bonds.** The overall trend, for decades now, has been lower yields (and therefore higher prices). Yields are in part a function of prevailing interest rates, and today most observers expect interest rates to gradually move upwards from historically low levels.

Consider again the hypothetical investor who thinks the bond portion of his or her portfolio is the “safe” portion. That investor may be in for a painful surprise if yields were to jump higher—let alone double—and therefore drive bond prices down accordingly.

“The right bond at the right time”

For years at BTS, we have espoused the importance of seeking “the right bond at the right time.” Our general impression at the current time is that many investors underestimate the risk inherent in the bond portion of their portfolios. We believe a good way to grapple with those issues is the two-step approach described in this short paper:

1. Beware of the temptation to “bucket” bonds together and call the overall allocation “safe” or “safer.”
2. Be willing to humbly recognize that no one knows the future—and therefore a potentially negative future for the bond market (such as sharply rising yields and sharply falling prices) needs downside risk management.



Be Clear About What's "Tactical" and What Isn't

HELPING CLIENTS MENTALLY PREPARE FOR VOLATILITY

BE CLEAR ABOUT WHAT'S "TACTICAL" AND WHAT ISN'T

by Matthew Pasts, CMT, Chief Executive Officer, BTS Asset Management

- ⊙ *In our view, a strategy must be able to truly “play defense” to be considered tactical*
- ⊙ *Managing exposure to the margin hasn’t been enough historically speaking to mitigate an investor’s risk from substantial downturns*

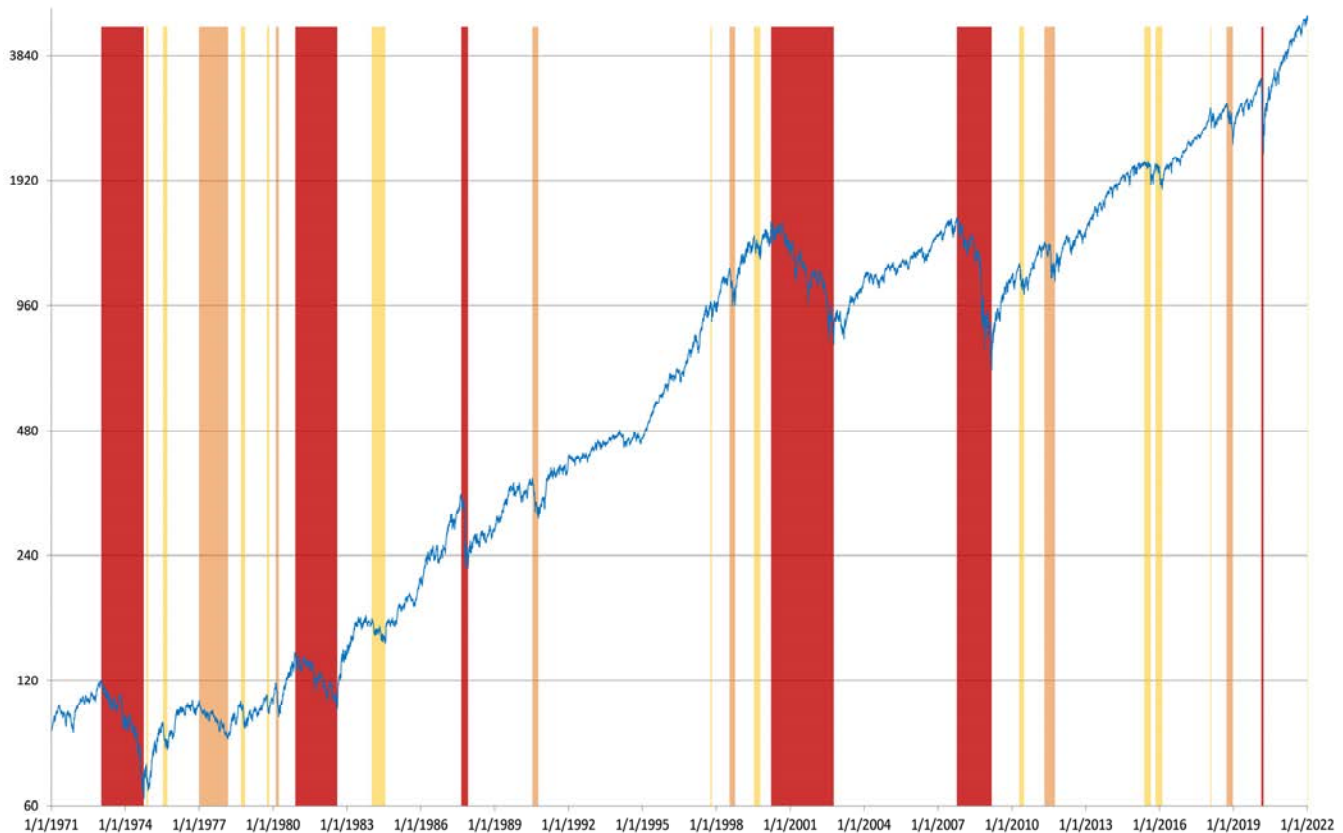
We believe the word “tactical” is mis-applied when used in reference to strategies that don’t have the ability to go to cash or otherwise “play defense” in an attempt to avoid substantial losses, such as:

- ❑ **1973-1974 | STAG FLATION & OIL SHOCK:** Stock prices came to reflect a worst-case scenario view of economic depression. Many investors who were heavily weighted to stocks sold positions and took massive losses. Peak to trough, the S&P 500 Index lost 48.20%
- ❑ **1987 | BLACK MONDAY:** Starting with the bull market that began in 1982, people came to presume stock prices would go up every year. A three-day drop of 33% cured them of this assumption.
- ❑ **2000-2002 | TECH BUBBLE COLLAPSE:** The recession at the time was relatively light, but the stock market experienced a massive correction (S&P 500 down 48.92%) because valuations were so high to begin with.
- ❑ **2007-2009 | GREAT RECESSION:** In general, investors were overweight stocks. After the S&P 500 fell 56.78%, many had to take losses and exited the stock market, never to return.
- ❑ **2020 | COVID-19 PANDEMIC:** With investors already jittery due to increasing tensions in the trade wars between the U.S. and China, the coronavirus pandemic led to unbridled global fear of the virus’s spread, the threat of economic lockdowns, and a precipitous drop in oil prices. In just over a month, the S&P 500 Index lost nearly 34%.

These five episodes are among the red-shaded “major declines” of more than 20% highlighted in the chart on the following page, which plots the S&P 500 Index level since January 1972. (The orange and yellow-shaded periods show major declines of more than 15% and 10% respectively. See tables further below for details on the numbers).



S&P 500 Index, 1972-2021 (Logarithmic Scale)
 Highlighted Bands Show Periods of Major Declines
 >20% (red); >15% (orange); >10% (yellow)



For illustrative purposes only. Past performance is no guarantee of future results.

To us, these periods show why it's essential to maintain flexibility. If an investor gets too overweight risk assets—without downside risk management elements such as stop losses and the readiness to “go to cash”—it's possible that a downturn will force an investor out of the market due to significant loss of capital.

That's fundamentally different from so-called tactical management that hugs a benchmark while seeking to generate marginal gains around that position. Traditionally, that's the kind of approach taken by most mutual funds—even those that refer to themselves as “tactical.” Hedge funds, on the other hand, have been more likely to be truly tactical in their decision-making.

Late in a business cycle—when investors are starting to worry about recession risk but the economy still appears reasonably strong—traditional “benchmark-hugging” strategies may appear more attractive than strategies designed to play defense. That's because when a truly tactical manager steps to the sideline, there's always a risk of missing further upside gains.

That risk of missing out may seem accentuated during late-cycle periods, because until a point of capitulation—typically followed by an asset-price plunge—there may be a reasonably quick “bid” in place that keeps prices from falling far.

In our view, one of the hallmarks of a truly tactical manager is the willingness to miss out on some gains as part of an effort to be “right” when it matters most . . . Ahead of the of price-level drops seen in 1973-1974, 1987, 2000-2002, 2008, 2020, and others.

We believe that most investors—especially those without decades to make up potential losses from such events—may benefit from risk-aware strategies that refuse to hug a benchmark, even if it means giving up potential gains during volatile periods.

S&P 500 Index Major Declines, 1972-2021

Declines >20%

| DATE | PERCENTAGE |
|--------------------|------------|
| 1/11/73 - 10/3/74 | -48.20% |
| 11/28/80 - 8/12/82 | -27.11% |
| 8/25/87 - 12/4/87 | -33.51% |
| 9/1/00 - 10/9/02 | -48.92% |
| 10/9/07 - 3/9/09 | -56.78% |
| 2/19/20-3/23/20 | -33.93% |

For illustrative purposes only.
Past performance is no
guarantee of future results.

Declines >15%

| DATE | PERCENTAGE |
|--------------------|------------|
| 12/31/76 - 3/6/78 | -19.13% |
| 2/13/80 - 3/27/80 | -17.07% |
| 7/16/90 - 10/11/90 | -19.92% |
| 7/17/98 - 10/8/98 | -19.15% |
| 4/23/10 - 7/2/10 | -15.99% |
| 4/29/11 - 10-3/11 | -19.39% |
| 9/20/18 - 12/24/18 | -19.78% |

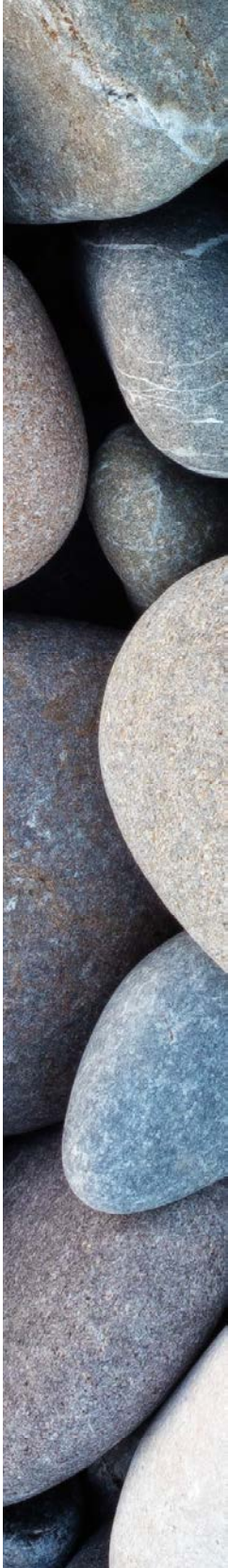
For illustrative purposes only.
Past performance is no
guarantee of future results.

Declines >10%

| DATE | PERCENTAGE |
|------------------|------------|
| 11/7/74-12/6/74 | -13.56% |
| 7/15/75-9/16/75 | -14.14% |
| 9/12/78-11/14/78 | -13.55% |
| 10/5/79-11/7/79 | -10.25% |
| 1/6/84-7/24/84 | -12.68% |
| 10/7/97-10/27/97 | -10.80% |
| 7/16/99-10/15/99 | -12.08% |
| 3/24/00-4/14/00 | -11.19% |
| 5/21/15-8/25/15 | -12.35% |
| 11/3/15-2/11/16 | -13.31% |
| 1/26/18-2/8/18 | -10.16% |

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Past performance is no
guarantee of future results.





Don't Underestimate Sequence of Returns Risk

HELPING CLIENTS MENTALLY PREPARE FOR VOLATILITY

DON'T UNDERESTIMATE SEQUENCE OF RETURNS RISK

by Matthew Pasts, CMT, Chief Executive Officer, BTS Asset Management

- ⊙ *Many investors are familiar with long-run average returns, such as the common expectation for 8% average annual returns on U.S. stocks.*
- ⊙ *But for investors with shorter time horizons, long-run averages have little practical meaning.*

When people talk about “sequence of returns risk,” they may be getting at one of two broad themes.

The first theme is that a steady, positive sequence of returns may better support long-term success than a more volatile sequence of returns—even when the latter includes “higher highs.” The key concept here is that growth comes from the absence of loss. The following table walks through a hypothetical example of the basic mathematical facts that can make losses difficult to recover from.

Hypothetical Example: 4 Year Returns*, Initial Investment of \$10,000

| | INVESTOR A | INVESTOR B |
|--------|-----------------|-----------------|
| Year 1 | +20% | +10% |
| Year 2 | +20% | +10% |
| Year 3 | (-20%) | +10% |
| Year 4 | +20% | +10% |
| | \$13,824 | \$14,641 |

*This table is intended for illustrative purposes and is not intended to indicate that BTS Asset Management returns 10% a year, nor imply that BTS can't lose money.

The second theme is an application of the fact that losses can be hard to recover from. Here, when people discuss “sequence of returns risk,” they are likely doing so with respect to a particular point in time that’s relevant to an individual investor.

The classic example is a planned retirement date. For someone approaching retirement, the conventional wisdom about long-term average rates of return won’t be much comfort in the event a portfolio’s value crashes with too little time to make up the loss before funds are needed to meet living expenses.

Consider, for example, the calendar-year returns shown on the next page for each of the past 22 years. They are for a broad basket of bonds, and a 50/50 portfolio of stocks and bonds. Traditional wisdom characterizes bonds as the safer portion of a portfolio...but take a look at the years with negative returns, remembering that for investors with more than 50% equities, those negative returns would have been even lower. It’s no wonder that many would-be retirees around 2008 had to stay in the workforce—or return to it, at lower-paying jobs than the ones they retired from.



There's another important subtlety about sequence of returns that comes into play during retirement itself, as withdrawals of principal are made from the portfolio to cover expenses. This period is often assumed to be relatively low-risk—but in fact it may not be whatsoever. Due to compounding effects, a “poor” sequence of returns in retirement (e.g., low or negative returns early in the retirement period) can have a drastic impact on account balances after 10 or 20 years of retirement.

The bottom line is that sequence of returns risk is a clear and present danger to everyone but those with truly long time horizons.

| Year | Bloomberg Aggregate Bond Index | S&P 500 & BBg Agg. 50/50 |
|------|--------------------------------|--------------------------|
| 2000 | 11.63% | 0.96% |
| 2001 | 8.42% | -1.29% |
| 2002 | 10.27% | -6.25% |
| 2003 | 4.11% | 16.17% |
| 2004 | 4.34% | 7.70% |
| 2005 | 2.43% | 3.70% |
| 2006 | 4.33% | 9.99% |
| 2007 | 6.96% | 6.34% |
| 2008 | 5.24% | -17.48% |
| 2009 | 5.93% | 16.41% |
| 2010 | 6.56% | 11.36% |
| 2011 | 7.86% | 5.58% |
| 2012 | 4.23% | 10.21% |
| 2013 | -2.02% | 14.26% |
| 2014 | 5.94% | 9.77% |
| 2015 | 0.57% | 1.13% |
| 2016 | 2.66% | 7.29% |
| 2017 | 3.55% | 12.42% |
| 2018 | 0.02% | -1.81% |
| 2019 | 8.72% | 19.82% |
| 2020 | 7.51% | 14.31% |
| 2021 | -1.54% | 12.91% |

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“Rebalancing Problems” in a Bull Market’s Extra Innings

HELPING CLIENTS MENTALLY PREPARE FOR VOLATILITY

“REBALANCING PROBLEMS” IN A BULL MARKET’S EXTRA INNINGS

by Matthew Pasts, CMT, Chief Executive Officer, BTS Asset Management

- ⊙ *Too much stocks relative to bonds is an obvious concern if investors resist rebalancing to reflect their true risk tolerances.*
- ⊙ *But another problem may be lurking as well: more risk than presumed in the bond portion of the portfolio.*

Because asset allocation is necessarily dependent on individual goals, risk tolerance and investment time horizon, any significant variation from an agreed-upon risk profile is natural and important to address as part of an advisor’s fiduciary responsibilities to clients.

But the reality is that investors are often resistant to rebalancing, perhaps especially during a long bull market, because they fear missing out on gains. That’s a challenge familiar to many advisors in what’s now the longest bull market on record.

The Problem Isn’t Just Stocks

The most obvious likely “rebalancing problem” is too great a concentration of stocks relative to presumed-to-be-safer bonds. But for many people, there could be a second significant problem as well: too much risk lurking in the bond portion of the portfolio.

Just as many equities (e.g. growth, value, large, small domestic and international) and commodities (e.g. agricultural, minerals, energy, and gold) react differently to economic stimuli, bonds, too, are not alike. Each bond class reacts in its own way to stimuli.

Different Bonds Have Different Risk Characteristics

| Bond Sector | Interest Rate Risk | Default Risk |
|----------------------------|--------------------|--------------|
| 10 Year U.S. Treasury | High | None |
| Municipal | High | Low |
| Investment Grade Corporate | High | Low |
| High Yield | Low | High |

Interest rate changes are the primary, though not the only, factor affecting values of highly rated bonds, such as Treasuries bonds and Investment Grade Corporate bonds.

The values of lower-rated bond classes, on the other hand, may be significantly affected by business factors, and less so by interest rate changes. For a few bond asset classes interest rates are not the major risk—in High Yields, for example, default risk has been more important to historical performance.

It’s critical to keep in mind the key risk characteristics of various bond asset classes—not just the volatility of each. Otherwise, an overall bond allocation has the potential to become too sensitive to one type of risk...which could be antithetical to the common use of bonds as the “safer” part of an equities-dominated portfolio.

Be Aware of Correlation

Because High Yields and Treasuries have different primary risk factors, their historical performance shows negative correlation.

10-Year Correlations as of 12/31/2021

| Benchmark | High Yield ¹ | Treasury ² | S&P 500 ³ |
|-------------------------|-------------------------|-----------------------|----------------------|
| High Yield ¹ | 1.00 | -0.10 | 0.73 |
| Treasury ² | | 1.00 | -0.28 |
| S&P 500 ³ | | | 1.00 |

1-BofAML US HY Master II TR USD 2-City Treasury Benchmark 10 Yr USD 3-S&P 500 TR USD

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DISCLOSURE

DISCLOSURE:

S&P 500 TR USD includes 500 leading companies in leading industries of the U.S. economy and is a proxy for the total stock market.

Average Equity Fund Investor is comprised of a universe of both domestic and world equity mutual funds. It includes growth, sector, alternative strategy, value blend, emerging markets, global equity, international equity, and regional equity funds (<https://www.dalbar.com/QAIB/Index>).

Average Fixed Income Investor is comprised of a universe of fixed income mutual funds, which includes investment grade, high yield, government, municipal, multi-sector, and global bond funds. It does not include money market funds (<https://www.dalbar.com/QAIB/Index>).

Average Asset Allocation Investor is comprised of a universe of funds that invest in a mix of equity and debt securities (<https://www.dalbar.com/QAIB/Index>).

BBg Agg Bond Index refers to the Bloomberg Aggregate Bond Index, which is comprised of government securities, mortgage-backed securities, asset-backed securities and corporate securities with maturities of one year or more to simulate the universe of bonds in the market.

S&P 500 BBg Agg 50-50 is a blended benchmark made up of 50% S&P 500 TR and 50% Bloomberg Aggregate Bond Index and uses indexes to represent a stock/bond allocation that a conservative or moderate investor might have.

HY Corp - The U.S. Corporate High-Yield Index measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds.

Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt.

IG Corp - The U.S. Corporate Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers that meet specified maturity, liquidity, and quality requirements.

MUNI - The U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prerefunded bonds.

TIPS - The US Treasury Inflation-Linked Bond Index measures the performance of the US Treasury Inflation Protected Securities (TIPS) market. Federal Reserve holdings of US TIPS are not index eligible and are excluded from the face amount outstanding of each bond in the index.

US Gov't - The U.S. Government Index is comprised of the U.S. Treasury and U.S. Agency Indices. The U.S. Government Index includes Treasuries (public obligations of the U.S. Treasury that have remaining maturities of more than one year) and U.S. agency debentures (publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The U.S. Government Index is a component of the U.S. Government/Credit Index and the U.S. Aggregate Index.

ICE BofAML US HY Master II tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and minimum amount outstanding of \$100 million. In addition, qualifying securities must have risk exposure to countries that are members of the FX-G10, Western Europe or territories of the US and Western Europe. The FX-G10 includes all Euro members, the US, Japan, the UK, Canada, Australia, New Zealand, Switzerland, Norway and Sweden.

Citi Treasury Benchmark 10 Yr tracks the 10 Year Treasury.

Each of these asset classes has its own set of investment characteristics and risk and investors should consider these risks carefully prior to making any investment decisions.

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The value of the fixed income securities will fluctuate with changes in interest rates. Defaults by fixed income issuers could also harm performance. Lower-quality bonds known as "high yield" or "junk" bonds, present greater risk than bonds of higher quality, including an increased risk of default. An economic downturn or period of rising interest rates could adversely affect the market for these bonds.

Downside Deviation - Considers returns that fall below the minimum acceptable return. 0% is used for the minimum acceptable return. Standard Deviation - Measures the degree of variation of returns around the average return; the

DISCLOSURE (continued):

higher the volatility, the higher the standard deviation. Sortino Ratio - A risk-adjusted performance measure (the incremental average return over the minimum acceptable return - represented as 0% - divided by risk), where risk is defined by downside deviation. A higher Sortino ratio may indicate higher risk-adjusted returns. Sharpe Ratio - A risk-adjusted performance measure (the incremental average return over the risk-free rate - represented as 3% - divided by risk), where risk is defined by standard deviation. A higher Sharpe ratio may indicate higher risk-adjusted returns. Inflation: US BLS CPI All Urban SA 1982-1984. Correlation measures how two securities move in relation to one another.

Dalbar, Inc QAIB report uses data from the Investment Company Institute (ICI), Standard & Poor's, Bloomberg Barclays Indices and proprietary sources to compare mutual fund investor returns to an appropriate set of benchmarks. Covering the period from January 1, 1985 to December 31, 2021, the study utilizes mutual fund sales, redemptions and exchanges each month as the measure of investor behavior. These behaviors reflect the "average investor." Based on this behavior, the analysis calculates the "average investor return" for various periods. These results are then compared to the returns of respective indices.

Average investor performance results are based on a DALBAR study, "Quantitative Analysis of Investor Behavior (QAIB), 2021." DALBAR is an independent, Boston-based financial research firm. Using monthly fund data supplied by the Investment Company Institute, QAIB calculates investor returns as the change in assets after excluding sales, redemptions and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses and any other costs. After calculating investor returns in dollar terms, two percentages are calculated for the period examined: Total investor return rate and annualized investor return rate. Total return rate is determined by calculating the investor return dollars as a percentage of the net of the sales, redemptions, and exchanges for the period.

This commentary has been prepared for informational purposes only and should not be construed as an offer to sell or the solicitation to buy securities or adopt any investment strategy, nor shall this commentary constitute investment advice. This commentary may contain opinions and assumptions that are forward-looking in nature. To the extent this material constitutes an opinion or assumption, recipients should not construe it as a substitute for the exercise of independent judgment. This material has been prepared from information believed to be reliable, but BTS Asset Management, Inc. makes no representations as to its accuracy or reliability. Past performance is no guarantee of future results. The views and opinions expressed herein are subject to change without notice and are the authors own and not necessarily that of BTS Asset Management, Inc.

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