

## Equity Risk Complacency

### Equities

This year, equity gains have been steadily increasing with unprecedented low volatility, as the markets again reached new highs in the third quarter. The S&P 500 Index, a measure of U.S. large-cap market performance, returned 4% for the quarter, displaying resilience in the face of numerous market moving headlines such as geopolitical tension in North Korea and a series of destructive hurricanes. Even with volatility, as measured by the VIX Index, rising more than 50% at a point in August, the S&P 500 Index suffered a drawdown of only 3% (small by comparative standards), before bouncing back through the end of September to make a new all-time market high.

#### S&P 500 Index – Minimal Relative Drawdowns in 2017

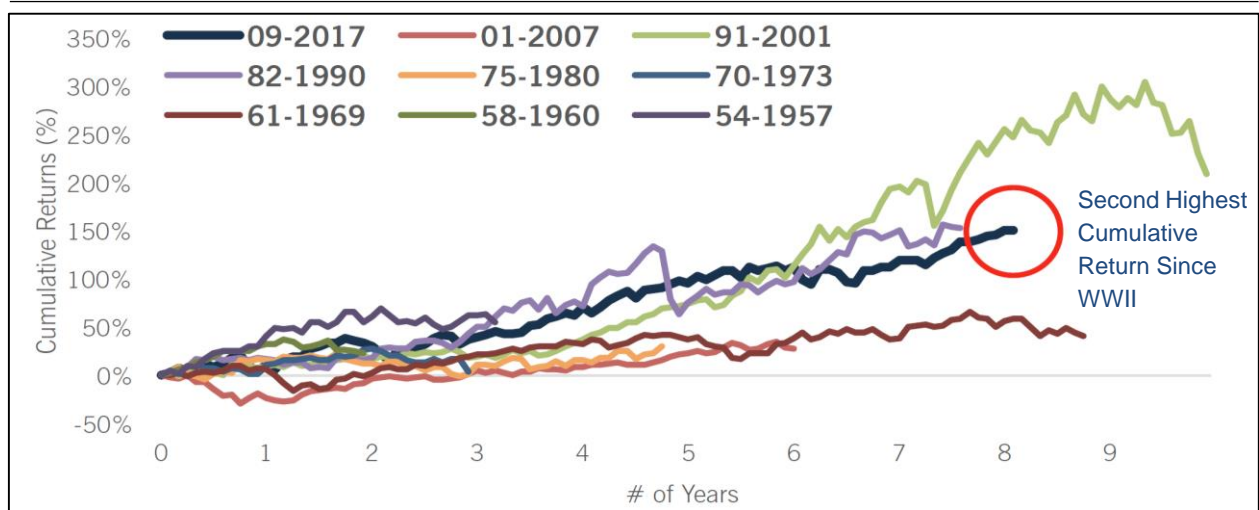


Sources: Bloomberg, SFG. Data represents 2017 through 9/29/2017. For illustration purposes only. Past performance is not a guarantee of future results. An investor cannot invest directly in an index. Please see disclosures at the end of this commentary for additional important information.

This uptrend in equities has been supported by strong economic data, underscoring the resilience of the U.S. economy. U.S. factory orders accelerated in August at their fastest pace of expansion in six years, while U.S. second quarter growth also reached its fastest pace in two years. In addition, consumer sentiment climbed to a three-month high amid an improving outlook on household finances and the economy, according to a University of Michigan Report. However, it is worth noting that 8+ years since the financial crisis bottomed out in March of 2009, the S&P 500 has had its second highest cumulative return during an economic expansion since World War II.

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### S&P 500 Index – Second Highest Cumulative Return Since WWII



Sources: Bloomberg, SFG. Data is from 1/1/1954 to 9/15/17. For illustration purposes only. Past performance is not a guarantee of future results. An investor cannot invest directly in an index. Economic Expansion periods are using NBER. Expansion in 1980-81 omitted. Please see disclosures at the end of this commentary for additional important information.

The end of the third quarter investors experienced one of the longest daily stretches of the S&P 500 Index trading less than 0.30% either up or down in history. The chart below illustrates the dramatic decline and unprecedented lows in S&P 500 Index volatility.

### S&P 500 Index Volatility



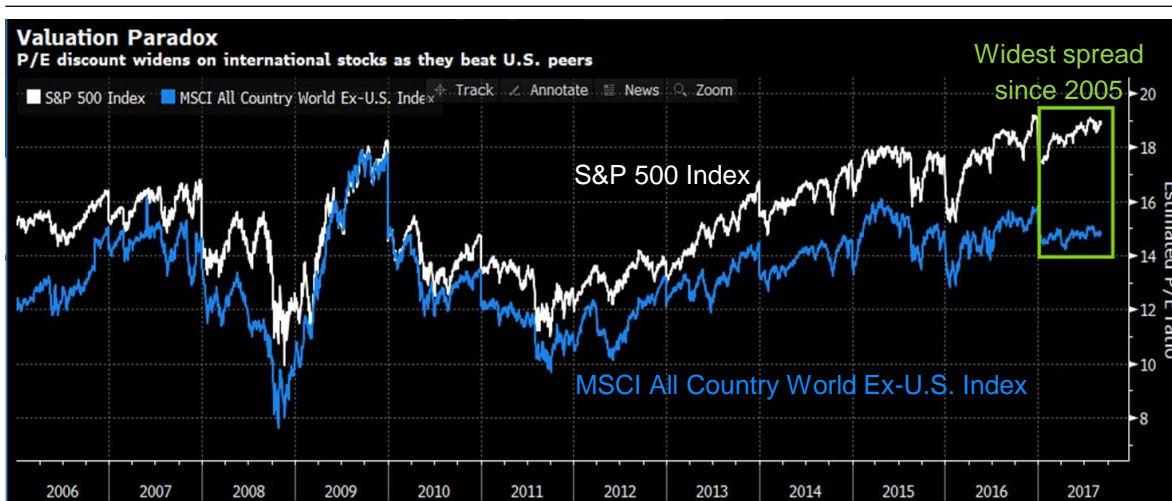
Sources: Bloomberg, SFG. Data is from 12/31/09 to 9/30/17. For illustration purposes only. Past performance is not a guarantee of future results. An investor cannot invest directly in an index. Please see disclosures at the end of this commentary for additional important information.

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## International Equities

The strength in equity markets extended abroad with international equities outperforming domestic equities this year. Surprisingly, even though international stocks have had a stronger recent rally, they have also become cheaper in terms of valuation. The following chart displays the spread between estimated price-to-earnings ratios on the MSCI All Country World Index excluding the U.S. and the S&P 500 Index. The spread is the widest since 2005. This suggests that international equities could continue to outperform domestic equities even if both see more upside.

**Valuation between the S&P 500 Index and the MSCI ACWI ex US Index**

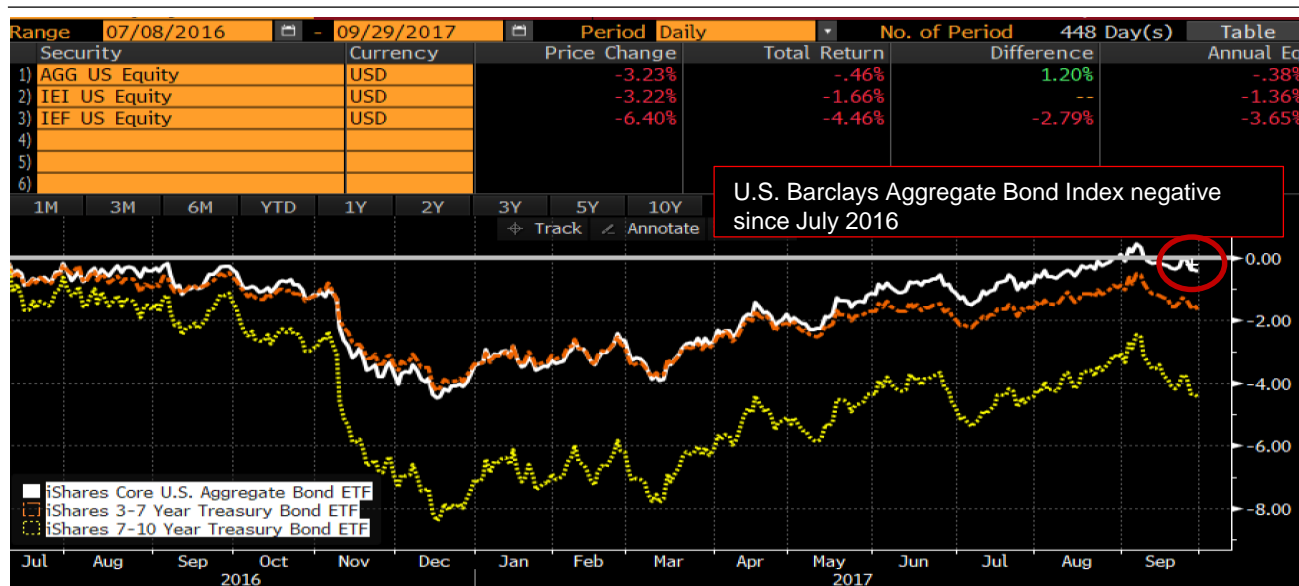


Sources: Bloomberg, SFG. Data as of 9/15/17. For illustration purposes only. Past performance is not a guarantee of future results. An investor cannot invest directly in an index. Please see disclosures at the end of this commentary for additional important information.

## Fixed-Income

Although stocks continue to set new records, bond investors still face the conundrum of how to generate satisfying returns in the current environment. After more than a year in the red following the bottom of the U.S. 10-Year Treasury yield at 1.35% in July of 2016, the U.S. Barclays Aggregate Bond Index finally broke even when tensions between the United States and North Korea led investors to seek safety in U.S. Treasuries. After hitting a low point for the year near 2% in early September, the U.S. 10-year Treasury yield reversed course to find itself back at 2.3%, thus causing the U.S. Aggregate Bond Index to fall back into negative territory again, extending the losses out to NEARLY 450 days.

**Traditional Investment Grade Back in Red from 2016**



Sources: Bloomberg, SFG. Data is from 7/8/16 to 9/29/17. For illustration purposes only. Past performance is not a guarantee of future results. An investor cannot invest directly in an index. AGG is the iShares Core U.S. Aggregate Bond ETF. IEI is the iShares 3-7 Year Treasury Bond ETF. IEF is the iShares 7-10 Year Treasury Bond ETF. AGG, IEI and IEF were chosen due to their wide use and familiarity of representing the respective asset classes and not to discuss the merits of the funds. Please see disclosures at the end of this commentary for additional important information.

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However, not all fixed-income asset classes are created equal. Higher yielding asset classes such as high-yield corporate bonds continued to push higher. The Barclays Corporate High Yield Index returned close to 7% for the year through the end of the third quarter, with most of its upside attribution coming from yield accrual (versus price appreciation). With that said, yield spreads have been trading primarily sideways and in a range near historically low levels.

### High-Yield Spreads Trading in a Range this Year



Sources: Bloomberg, SFG. Data represents 2017 through 9/30/2017. For illustration purposes only. The line above represents High-Yield Option Adjusted Spread for the Markit CDX North American High Yield Index. Please see disclosures at the end of this commentary for additional important information

## Portfolio Recap

As it pertains to the Dynamic Risk-Budgeted Portfolios, we remained fully invested across all sub-strategies as the underlying trends are still intact. Furthermore, our fixed-income strategies have also been able to participate in higher relative yields. International equities have remained strong with an attractive valuation comparison relative to domestic equities, suggesting that international equities could continue to be a strong segment of the global market. Previously, at the end of the second quarter, our Tactical Equity Dividend sub-strategy tilted towards international exposure. While these shifts are subtle, the goal is to have the Dynamic Portfolios positioned to be diversified in both asset classes and investment strategy style, while seeking to participate in upside capture and minimize downside risk.

## Conclusion

To the novice investor, recent positive performance with low volatility, especially in the short-term, can be a huge lure. When chasing returns, perhaps one of the biggest mistakes investors can make is changing their previously established risk tolerance. With the recent equity markets seemingly handing out gains without much volatility, why wouldn't they? However, the potential for higher returns always come with the potential for higher risk. As investors pile into a rising equity market with greater momentum, they also face heightened risk in a larger reversal when that momentum changes.

Unfortunately, investors aren't always rational and this illusion can cloud one's judgement. We utilize a quantitative approach, aiming to minimize the subjectivity of investing. This approach employs multiple factors that seek to stay invested while markets are appreciating, but also seek to be defensive in a "risk-off" position if markets are depreciating. Whether markets are going up or down, our bias is to be ready when things change.

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## Definitions and Indices

Indices are shown for informational purposes only; it is important to note that SFG's strategies differ from the indices displayed and should not be used as a benchmark for comparison to account performance. While the indices chosen represent broad market performance of each asset class, there are report limitations as to available indices and blends, which index can be selected, and how they are presented. **Equity** is a stock or any other security representing an ownership interest. **Volatility** is used to describe uncertainty or risk in terms of statistical measure of dispersion (variation in prices) – realized volatility is based on historical volatility while expected volatility is based on a market estimate of future volatility. **Large Cap** refers to a company with a market capitalization value of more than \$5 billion. Large cap is a shortened version of the term "large market capitalization." Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share. **Drawdown** is a measure of peak to trough loss in a given period. **Bull Market** is a market condition in which prices are rising or are expected to rise. **Spread** generally refers to the difference between two prices or interest rates. The **Price-to-Earnings Ratio** is the ratio of a company's stock price to the company's earnings per share. The ratio is used in valuing companies. **Fixed-Income (Bonds or Investment Grade Bonds) Security**, commonly referred to as a bond or money market security, is an investment that provides a return in the form of fixed periodic payments and the eventual return of principal at maturity. A bond price falls as its yield rises. **Federal Reserve (Fed)** is the central bank of the United States that raises or lowers interest rates. **Yield** is the income return on an investment. This refers to the interest or dividends received from a security. Yield shown may represent different yield types and calculations and varies from index (or asset class) to index determined by availability of data. **Yield Accrual** is the accumulation of yield of an investment over a period of time. **Price Appreciation** is an increase in the price of an asset over time. **U.S. 10-Year Treasury** is a debt obligation issued by the United States government that matures in 10 years, backed by its full faith and credit. A Treasury bond is a marketable, fixed-interest U.S. government debt security with a maturity of more than 10 years. **Investment Grade Corporate Bond** is defined as a bond with a credit rating that indicates that the bond has a relatively low risk of default. **Options Adjusted Spread** is defined as the flat spread which is added to the treasury yield curve in a pricing model (that accounts for embedded options) to discount a security payment to match its market price. **Downside Risk** is the financial risk associated with losses. That is, it is the risk of the actual return being below the expected return, or the uncertainty about the magnitude of that difference. **Quantitative** refers to economic, business or financial analysis that aims to understand or predict behavior or events through the use of mathematical measurements and calculations, statistical modeling and research. **S&P 500 Index** is a stock market index based on the market capitalization of 500 leading companies publicly traded in the U.S. stock market, as determined by Standard & Poor's. **VIX Index** is the Chicago Board Options Exchange S&P 500 Volatility Index, which reflects a market estimate of future volatility based on the weighted average of the implied volatilities for a wide range of strikes. **MSCI ACWI ex USA Index** is a market-capitalization-weighted index maintained by Morgan Stanley Capital International (MSCI) and designed to provide a broad measure of stock performance throughout the world, with the exception of U.S.-based companies. The MSCI All Country World Index Ex-U.S. includes both developed and emerging markets. **Barclays U.S. Aggregate Bond Index** is an index that consists of investment grade U.S. Government bonds, investment grade corporate bonds, mortgage pass-through securities, and asset-backed securities. It is often considered representative of the U.S. investment-grade fixed rate bond market. **iShares Core U.S. Aggregate Bond ETF (AGG)** is an exchange-traded fund that seeks to track the Bloomberg Barclays US Aggregate Bond Index. The fund invests in securities within the total U.S. investment-grade bond market. This includes Treasuries, government-related and corporate securities, MBS, ABS and CMBS. **iShares 3-7 Year Treasury Bond ETF (IEI)** is an exchange-traded fund that seeks to track the investment results of an index composed of U.S. Treasury bonds with remaining maturities between three and seven years. **iShares 7-10 Year Treasury Bond ETF (IEF)** is an exchange-traded fund that seeks to track the investment results of an index composed of U.S. Treasury bonds with remaining maturities between seven and ten years. **Barclays U.S. Corporate High Yield Index** is a market value-weighted index which covers the US non-investment grade fixed-rate debt market. **Markit CDX North American High Yield Index** is composed of 100 non-investment grade entities, distributed among 2 sub-indices: B, BB. All entities are domiciled in North America.

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