STRATEGY FINANCIAL GROUP

Quarterly Commentary: Q3 2018

STRATEGY financial group

Market Commentary | October 2018
As of September 30, 2018

Q3 2018: An Investor's Internal Trade War

At first glance, the third quarter of 2018 seemed to reward investors who held on to risk. The S&P 500 Index had its best quarterly advance in 5 years. But the rally of perhaps overly exuberant expectations pushed equities to just barely surpass their peak, set more than 8 months ago in January 2018. Understandably, the widely published S&P 500 Index finally recovering from a 11% drawdown that began in January, generated some excitement in casual market watchers. However, the enthusiasm of being up 10.56% thru the end of Q3, was short lived with the S&P quickly giving back the majority of its 2018 gains to be up only 4.48% by October 11, 2018. This type of volatility has reflected the on-going tug of war between robust corporate earnings driven by strong U.S. economic data and geopolitical drama fueled by international trade disputes and tariffs. Investors seem to be struggling with their own tradeoffs including which headline to trade, resulting in an emotion driven see-saw of chasing returns then capitulation.

S&P 500 Index Price Returns: Emotional Investor Thought Process

Sources: Bloomberg, Redwood. Data as of 10/11/18. For illustration purposes only. An investor can not invest in an index. Annotations are opinions of the author and should not be construed as facts.

Equities: What's Really Happening?

The world of investing is a constant enigma, with market participants all looking for a way to crack the code using different indicators. For example, the Fed generally focuses on economic output in the U.S. and so far, economic indicators remained strong. Annual GDP surged 4.2% in the second quarter vs. 2.2% for the first quarter and unemployment continued to decline to the lowest level since the 60's at 3.9%. Inflation has also been hitting the Fed's targets, prompting the Fed to remain confident in the U.S. economy to gradually raise rates. However, outside the U.S. where not every country may enjoy the rosy economic data, international markets have still diverged to the downside, often pricing lower due to trade anxiety. Emerging markets led the slide with the MSCI Emerging Market Index falling into a technical bear market (losing 20% from the last peak). Trade tensions between the U.S. and China specifically have been in watch. The U.S. increased tariffs on Chinese imports from the initial $50B in goods to include an additional $200B of goods and threatened an additional $267B in tariffs. If all tariffs are fully implemented covering a grand total of $517B in Chinese goods, this would essentially cover the entire value of all products imported to the US from China ($505B in 2017 according to U.S. Census Bureau). These trade tensions contributed to both the Shanghai Composite

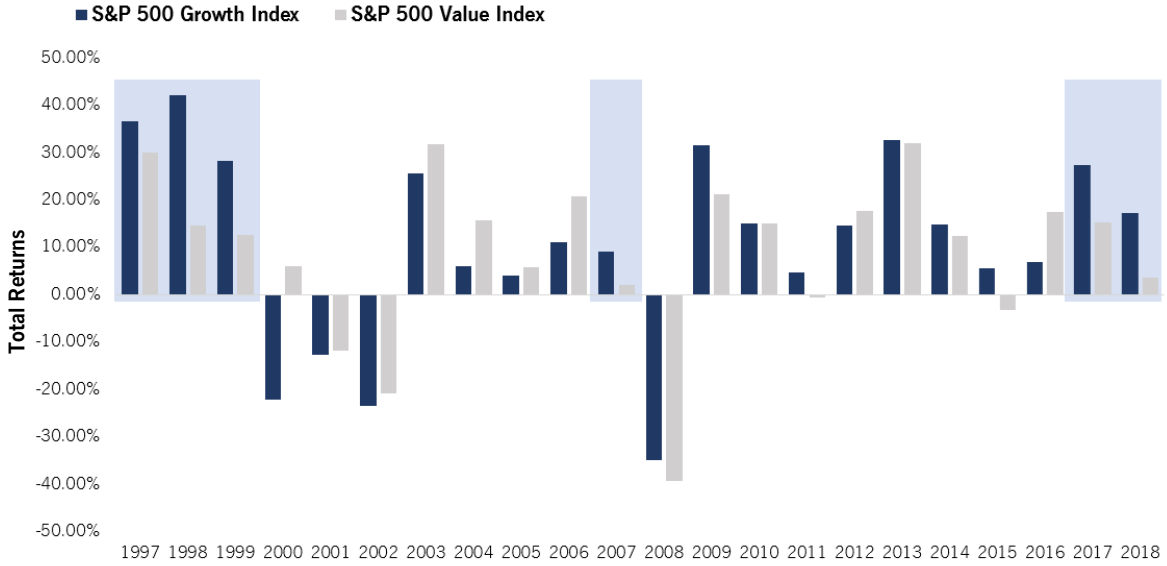
and the Hang Seng Index suffering their fourth consecutive quarterly decline. Granted, as international stocks sell off, valuations may look more attractive relative to their domestic (U.S.) counterparts.

Domestic Equity and International Equity Divergence – U.S. Earnings Strong Enough to Offset Trade Dispute?

Sources: Bloomberg, Redwood. Data as of 9/28/18. For illustration purposes only. An investor can not invest in an index.

Divergences don't only exist in domestic vs. international equities. They also exist within U.S. domestic stocks as well. Growth stocks have performed better than value stocks so far in 2018, perhaps a function of investors embracing the greater inherent risks associated with growth stocks in search of potentially greater returns. For experienced investors, this period of narrow growth stock outperformance may feel like déjà vu. Growth doesn't always outperform as investors learned after previous periods of growth outperformance such as in 1999. Over the last two market cycles, relative strength in growth preceded the large market declines of 2000-2002 and 2008. Having too much in growth, although relatively successful in the last two years, could add more unintended risk to a long-term asset allocation portfolio.

Strength in Growth Historically Preceded Major Market Declines



Sources: Bloomberg, Redwood. Data as of 9/28/18. For illustration purposes only. An investor can not invest in an index.

Many investors may not recognize the imbalances of their portfolios, believing that they aren't particularly tilted toward either growth or value, especially in today's age where many rely on the S&P 500 Index as "the" U.S. equity benchmark. This problem is exacerbated by the index being highly televised as a gauge of the equity markets. While the index, perhaps, does make an excellent gauge of investor sentiment, investors should recognize that the S&P 500 Index, is a strategy itself – just like dividends, value, growth, volatility, etc. The S&P 500 Index includes 500 companies, determined by the index board of members (from Standards & Poor's) that are leading companies and captures approximately 80% coverage of available market capitalization, market cap weighted. Like any equity strategy, this means that the S&P 500 can overperform or underperform other strategies. Another problem is that due to the market capitalization weighting (vs. equal weight), a small handful of companies can become large drivers of the index, a phenomenon described as narrow leadership. During these periods, strong performance of a small number of stocks may overshadow the majority of stocks, which may not be doing as well. As of 9/30/18, the top 10 stocks in the S&P 500 contributed 53.64% of the index's total returns – the highest level since 2007 where 10 stocks contributed 75%.

Majority of stocks within the S&P 500 Index are not performing as well or better than the S&P 500 Index

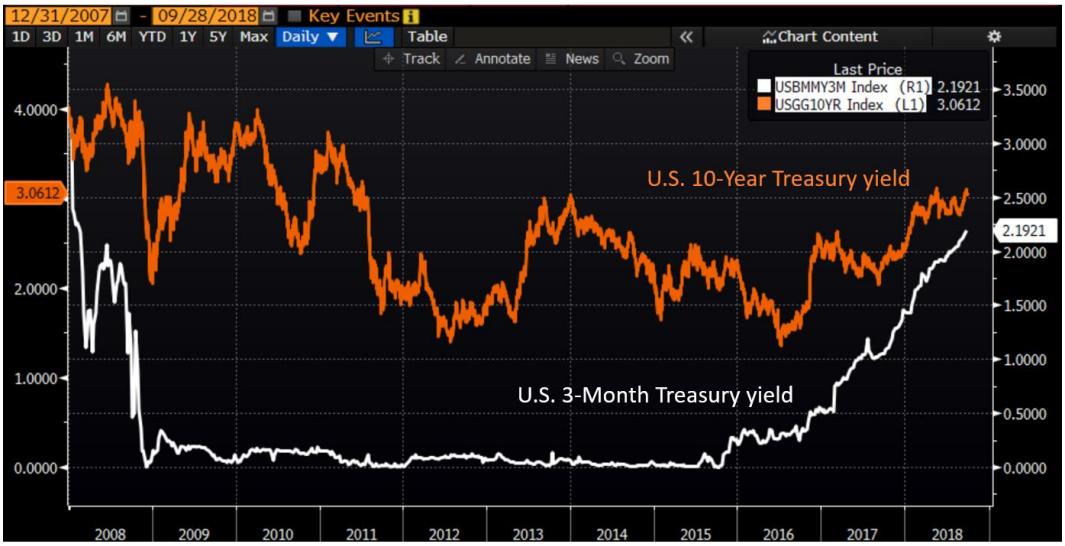
Sources: Bloomberg, Redwood. Data as of 9/28/18. For illustration purposes only. An investor can not invest in an index.

A fully diversified portfolio of equities in reality should have exposure not only to growth stocks, but to value, and various size as well (in addition to style). Therefore, investors should not gauge equities as a whole with a single index, and thus should also not expect portfolio performance to always match or outperform a single index. To put things in perspective, simply looking at performance of each of the S&P 500 Index stocks equally thru 9/30/18 indicates 7.27%, represented by the S&P Equal Weight Index. Adding an allocation (25%) to international equities indicates the returns would have been 4.78%. A respectable return given no global crisis (yet), but not quite the 10.56% that can drive investors to question whether they are missing out.

Sources: Bloomberg, Redwood. Data as of 9/28/18. For illustration purposes only. An investor can not invest in an index.

Fixed-Income: Nothing's Changed – Or Has it?

Perhaps one of the more interesting divergences in the investment universe is between equities and fixed-income, or stocks and bonds. While stocks (at least domestic stocks) are having a field day, traditional bonds have been trending towards what would seem like an inevitable environment with higher interest rates. The U.S. 10-Year Treasury yield for the majority of the year had been fluctuating around 3%, seemingly poised to go higher. The risk-free rate, however, has consistently been moving higher. The 3-Month Treasury yield is now near 2%, up from almost 0% just 4 years ago creating the smallest gap between the 3-Month Treasury yield and U.S. 10-Year Treasury Yield since 2008.



Sources: Bloomberg, Redwood. Data as of 9/28/18. For illustration purposes only. An investor can not invest in an index.

The constant pressure of rising rates has finally realized the risk that investors have been worried about since 2013: that a rising rate environment is bad for investment grade bonds. The Barclays Aggregate Bond Index, the most commonly used fixed-income benchmark slipped down to -1.60% in total return (includes dividends) so far in 2018 through the end of Q3 2018. The benchmark index is down -1.49% since 7/8/16 (date U.S. 10-Year Yield hit a bottom) in one of its longest slumps.

Portfolio Recap: Diversification vs. Betting

Performance is a function of what's ultimately available in the market place. We cannot manufacture returns. At SFG, the two things we **can** control are process and risk. Any strong investment process constantly compares how portfolios are doing; not against the best return available, but against the **objectives** of the portfolios set forth prior to putting a dollar at risk. As an objective, the Dynamic Risk-Budgeted (DRB) portfolios are designed within a risk budget. We start there. Although it's been a frustrating market period (surge in January from equity chasers, a correction of more than 10% in February, finally breaking even to highs in August-September, and selling off again in October), our portfolios are trending comfortably within their objectives.

Investing is about being allocated to different securities or strategies and markets to receive some type of economic benefit. As such, we observe and manage the individual components of the DRB portfolios to what each of those respective strategy objectives are attempting to achieve. Our fixed-income portfolios are still allocated to non-traditional strategies which seek higher yields, but have a tactical risk management overlay that can go 100% risk off. Our tactical international equity portfolio went risk-off in May, so far avoiding a lot of the downside (and upside) volatility in international markets. Should international equities seem to recover, we would expect the strategy to be invested again, albeit potentially at a higher price. Markets are unpredictable however, and this of course can always change.

As the portfolios are Dynamic, we are constantly evaluating how to enhance our asset allocation and diversification. We use a quantitative and systematic approach that seeks to minimize subjective, emotional decision making. One of the challenges we saw in real time, is that the quantitative nature of the equity strategies has been tilting the portfolios more and more toward value. While we do recognize the potential alpha generation of value-based investing on our own, and other academic research, the under-exposure to growth can also create a drag on the equity portfolio in shorter time periods. This can especially be noticeable if growth runs another 1, 2, or even 3 years before we hit another economic slowdown.

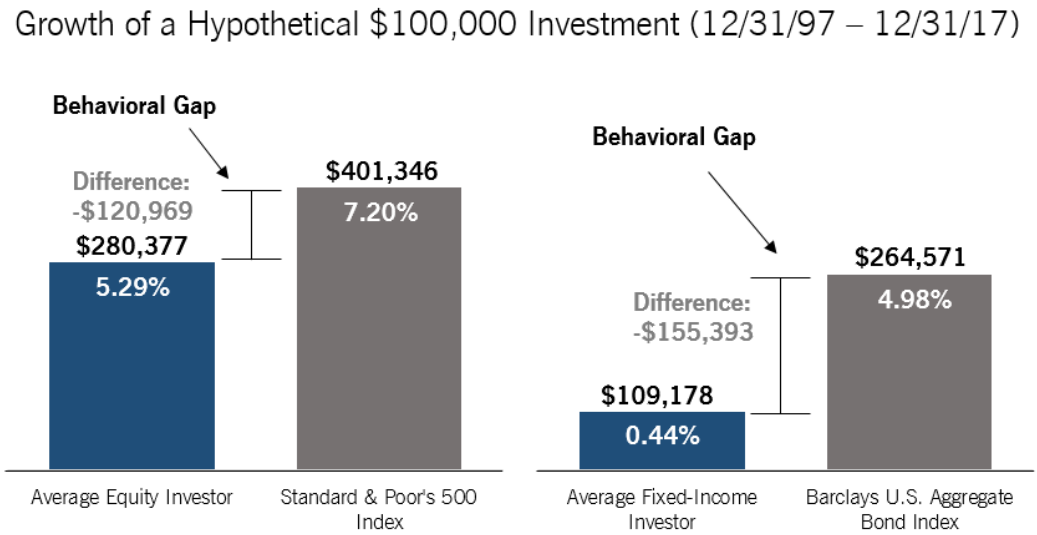
Can Growth Keep Running?

Sources: Bloomberg, Redwood. Data as of 10/12/18. For illustration purposes only. An investor can not invest in an index.

At the end of the day, our portfolios are designed to be diversified, and not to make directional bets. We will continue to monitor the portfolios and make adjustments based on quantitative research.

Conclusion

Investors constantly feel challenged by the markets, or themselves, to make large changes to their portfolios. Unfortunately, these decisions often use data that may not be fully relevant to the investor (such as only measuring equities by the S&P 500 Index) and arbitrary time frames (such as full calendar quarters). This type of recency bias overlooks efforts of well thought out longer-term plans. After posting double digit returns of 10.56%, in time for 3rd quarter reviews, the S&P 500 Index fell -6.31% during the first weeks of October within ***days***. Plagued by short term expectations, investors often focus on the small battles, rather than winning the war. A study by DALBAR is perhaps one of the most interesting illustrations of common investor behavior, such as, selling stocks after an equity market downturn, or buying stocks late in an equity market upturn.



Returns for average equity and fixed-income investors calculated by DALBAR. DALBAR 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. 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 indexes. Ending values for the indexes and hypothetical equity and fixed-income investor investments are based on average annual total returns. Standard & Poor's 500 Composite Index is a market capitalization-weighted index based on the results of 500 widely held common stocks. Barclays U.S. Aggregate Index represents the U.S. investment-grade fixed-rate bond market and consists of U.S. Treasury and government-related bonds, corporate securities and asset-backed securities. Figures shown are past results and are not predictive of results in future periods. The market indexes are unmanaged and, therefore, have no expenses. Their results include reinvested distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or taxes.

In the same sense, we believe it is important to let quantitative strategies benefit from non-linear characteristics. Any model, however, should be dynamic and not static. We recognize that adjustments to our Dynamic Risk-Budgeted models need to be made over time. At SFG, identifying potential enhancements is done first by sorting through the noise of the markets to identify areas of structural and/or secular change. This is done with research, research, and more research so that we don't succumb ourselves to emotional investing. Research results and potential enhancements are then subjected to rigorous testing to identify efficacy and levels and timeliness. We focus on risk first – accepting that risk, and accepting the fact that there will always be a variability of return outcomes. As long as risk is diversified, allocated wisely, monitored daily, and managed actively within a disciplined process, then we believe investment success is sure to come.

Perhaps the over exuberance of bullish prices will come to a screeching halt, or perhaps valuations can become even richer on the back of a strong economic landscape stretching the bull market 2 years longer. Maybe the traders willing to take the risks and make those bets will get paid handsomely and brag, but for the rest of us investing with a plan, we prefer to stay diversified, dynamic, and focused on our longer-term goals.

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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. **Drawdown** is a measure of peak to trough loss in a given period. **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. **Federal Reserve (Fed)** is the central bank of the United States that raises or lowers interest rates. **Bear Market** is a market condition in which the prices of securities are falling, and widespread pessimism causes the negative sentiment to be self-sustaining. A **Growth Stock** is a share in a company that is anticipated to grow at a rate significantly above the average for the market. These stocks generally do not pay dividends, as the companies usually want to reinvest any earnings in order to accelerate growth in the short term. Investors then earn money through capital gains when they eventually sell their shares. A **Value Stock** is a stock that tends to trade at a lower price relative to its fundamentals, such as dividends, earnings and sales, making them appealing to value investors. **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. **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. An **Investment Grade Bond** is a bond with a credit rating of BBB- or higher by Standard & Poor's or Baa3 or higher by Moody's. It is judged by the rating agency as likely enough to meet payment obligations that banks are allowed to invest in it. **Alpha**, often considered the active return on an investment, gauges the performance of an investment against a market index or benchmark which is considered to represent the market's movement as a whole. The excess return of an investment relative to the return of a benchmark index is the investment's alpha. **Recency Bias** is the psychological phenomenon of people allowing more recent event to influence their decision-making process, while not taking account of events that may have happened further in the past. **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. **MSCI Emerging Markets Index** captures large and mid-cap representation across 23 Emerging Markets countries and the index covers approximately 85% of the free float-adjusted market capitalization in each country. **Shanghai Composite Index** is a market composite made up of all the A-shares and B-shares that trade on the Shanghai Stock Exchange. **Hang Seng Index** is a market capitalization-weighted index of the largest companies that trade on the Hong Kong Exchange. **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. **S&P 500 Value Index** measures the performance of the large-capitalization value sector in the US equity market. It is a subset of the S&P 500 Index and consists of those stocks in the S&P 500 Index exhibiting the strongest value characteristics. **S&P 500 Growth Index** tracks the growth companies of the S&P 500 Index. **S&P 500 Equal Weight Index** is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total at each quarterly rebalance. **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. **U.S. 3-Month Treasury** is a short-term debt obligation backed by the Treasury Department of the U.S. government with a maturity of 3 months. **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.

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