Mid-Month Update 3/15/2020

Institutional Thinking for Individual Investors

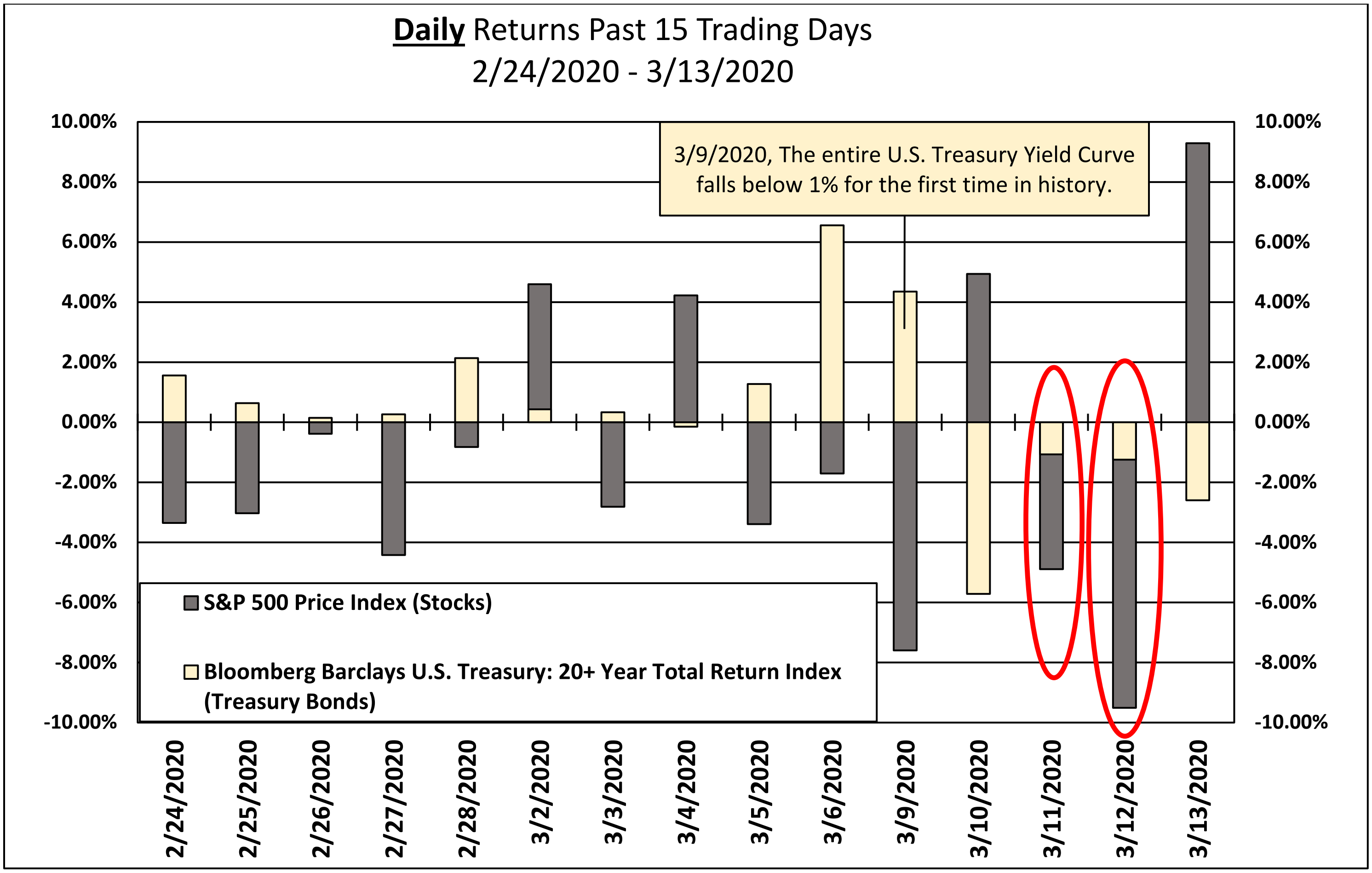
By: Dustin Latham, CFA, CAIA, CRPC

During the past few weeks, we have been proactive in rebalancing and reweighting assets to risk across portfolios. As we are all aware, over the past three weeks, markets have fallen more than at any other time since the financial crisis. This past Thursday, the market experienced the single worst one day loss since the October 19, 1987 crash (often referred to as Black Monday). We want to take the opportunity to acknowledge what has undoubtably been a period of heightened concern for many of you. Over the past weeks, we have been using our resources to take measurable actions to reweight your portfolios, which we believe will be favorable for your investments over the medium-term.

The two major global market shocks this year, with one more obvious than the other, have been the impact of Coronavirus and the following rout in oil prices. Our communication aims to provide you with our insight regarding the market moves, asset price action, and the actions we took in which we are accountable to you.

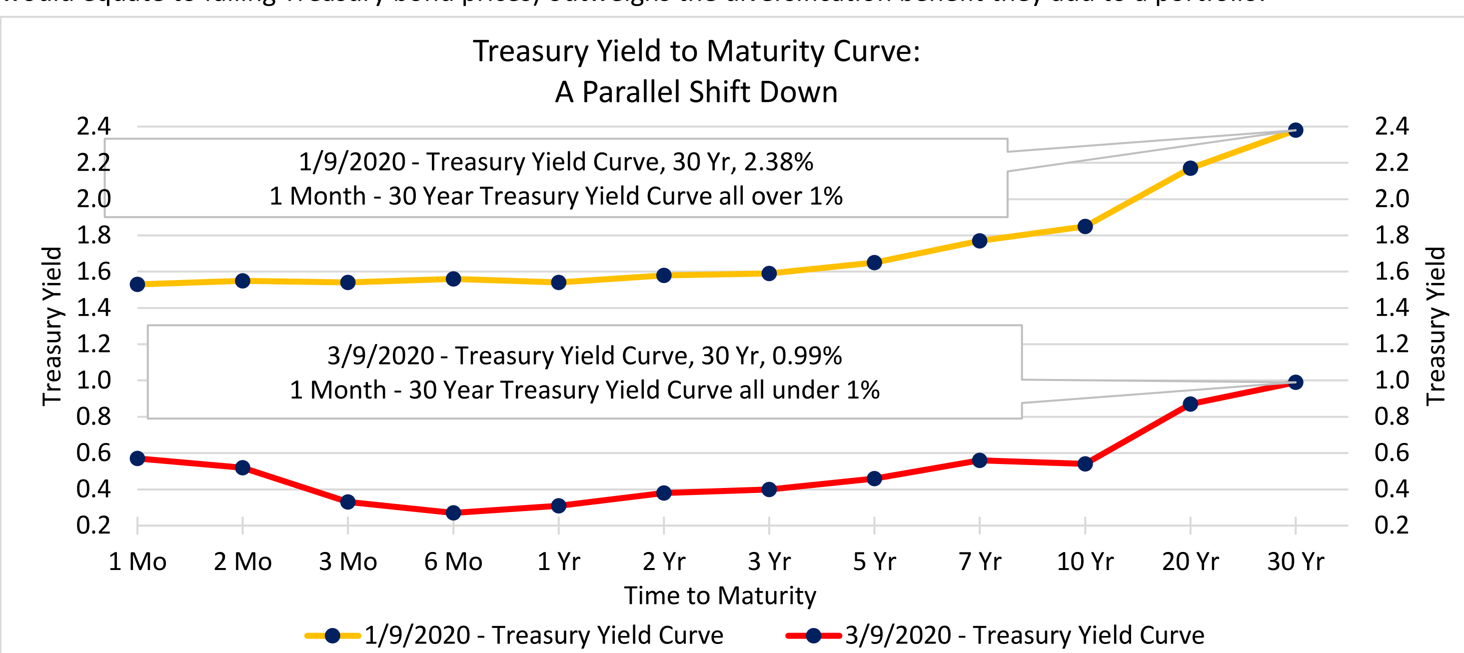
When markets become volatile, many investors try to guess when stocks will bottom-out. This past week, the behavioral finance concept of *loss aversion* prevailed. We witnessed this because uncertainty in the market moved investors to sell. As we have discussed, people are more fearful of losses than they are of equivalent gains. Many of you have seen this before, although the speed of the market moves was shocking to even the most seasoned investors. We have long advocated that we do not try to time the market, but rather invest differently over the market cycles (namely Risk-Off, Market Weight, Risk-On). Given the volatility this past week, we moved quickly. Our moves were in line with our target risk/reward framework, from Risk-Off to almost Market Weight (or Neutral) across the model strategies. The conviction trades came on Monday and Thursday (as you likely noticed when looking through your accounts), with the largest changes coming on Thursday during the record selloff (we were buying risk when, seemingly, most investors were heading for the exit). We enabled ourselves to buy risk this week in the face of adversity, as we had the ammunition and dry powder from our defensive posturing coming into the year. Importantly, Thursday's actions were **NOT** driven by a belief that we were "calling this the market bottom." I'll summarize below how jaw dropping these moves were and why we moved as quickly as we did this week.

The chart below is the daily percentage price movements over the last 15 trading days from 2/24/2020-3/13/2020. We chose two price indexes that are broadly representative of the U.S. stock market and longer maturity Treasury bonds: S&P 500 Price Index and Bloomberg Barclays U.S. Treasury: 20+ Year Total Return Index. As the markets were falling, we held a strategic overweight to longer maturity Treasury security exposures because of their safe-haven status and the extreme positive price moves in a real Risk-Off environment. As a reminder, when yields are falling, Treasury Bond prices are rising. We were able to ride the falling interest rate environment all the way into Monday, March 9, 2020.



Data sourced from: *S&P 500 Price Index (https://us.spindices.com/indices/equity/sp-500) and Bloomberg Barclays U.S. Treasury: 20+ Year Total Return Index (https://www.bloomberg.com/quote/LT11TRUU:IND).*

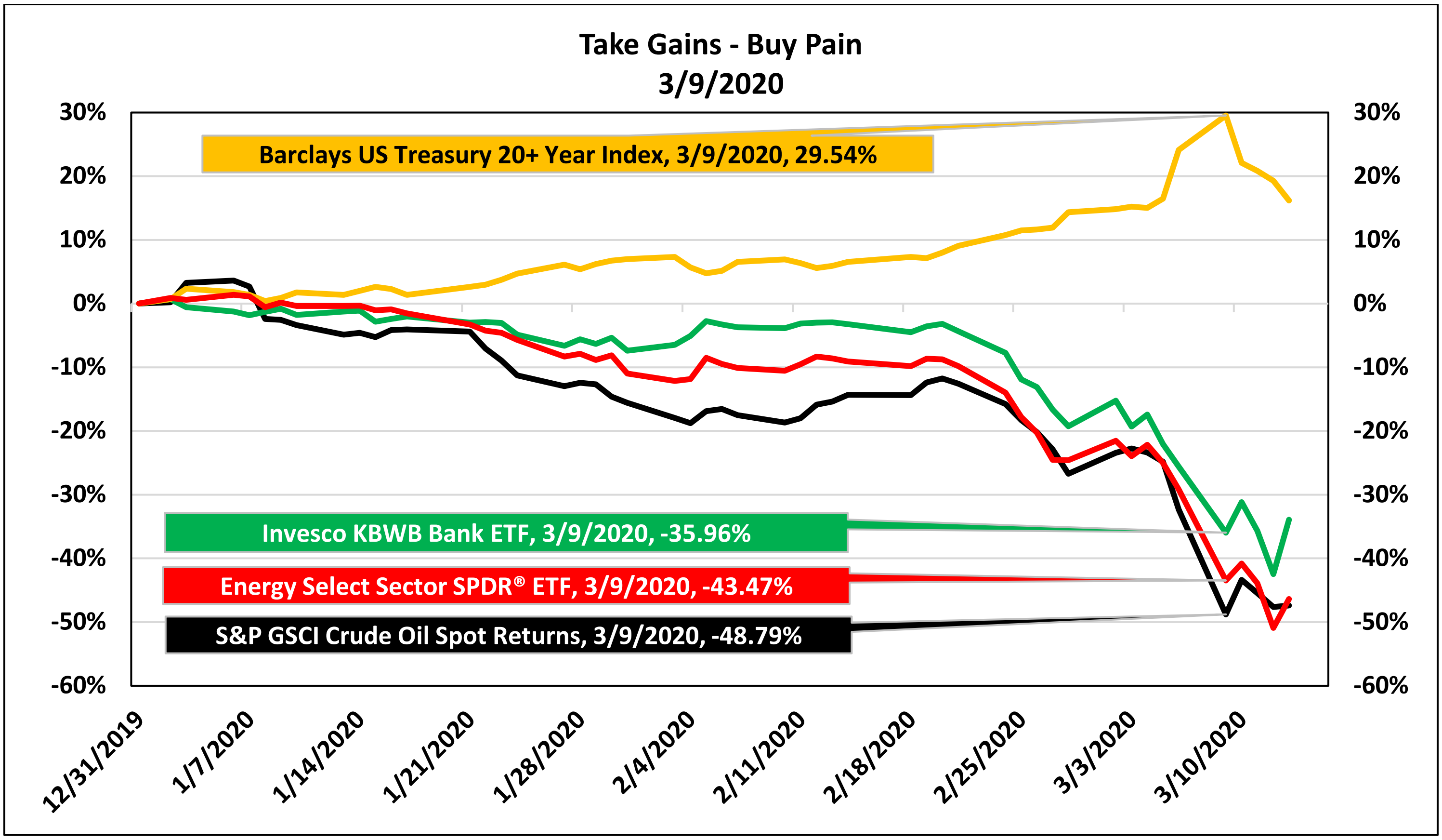
On Monday, March 9, 2020, the entire U.S. Treasury Yield Curve (all Treasury maturities from 0-30 years) fell below a 1% yield (see the chart below, which depicts the shift in the yield curve). This was the first time the entire yield curve was below 1% in U.S. history. To put this in perspective, for a brief moment there were market participants willing to buy a 30-year Treasury that would yield to maturity less than 1% per year (for the next 30 years). At some point, the risk of holding these longer maturity Treasury exposures become exacerbated when the risk of rising interest rates (which would equate to falling Treasury bond prices) outweighs the diversification benefit they add to a portfolio.



49.11% was the return on the Bloomberg Barclays U.S. Treasury: 20+ Year Total Return Index from 12/31/2018 - 3/9/2020. Included in that total period was a return of 29.54% from the start of the year through 3/9/2020. Fast forward from 3/9/2020 to Friday the thirteenth (3/13/2020), the index fell by -10.3% while the S&P 500 Price index only fell by -1.3%.... Wow.

On Monday March 9, 2020 we made the following material moves to the model strategies:

- Significantly lowered our longer dated Treasury exposures;
- Moved from a small overweight to a large overweighting to the Energy Sector (equity exposure);
- New allocation to large regional banks.



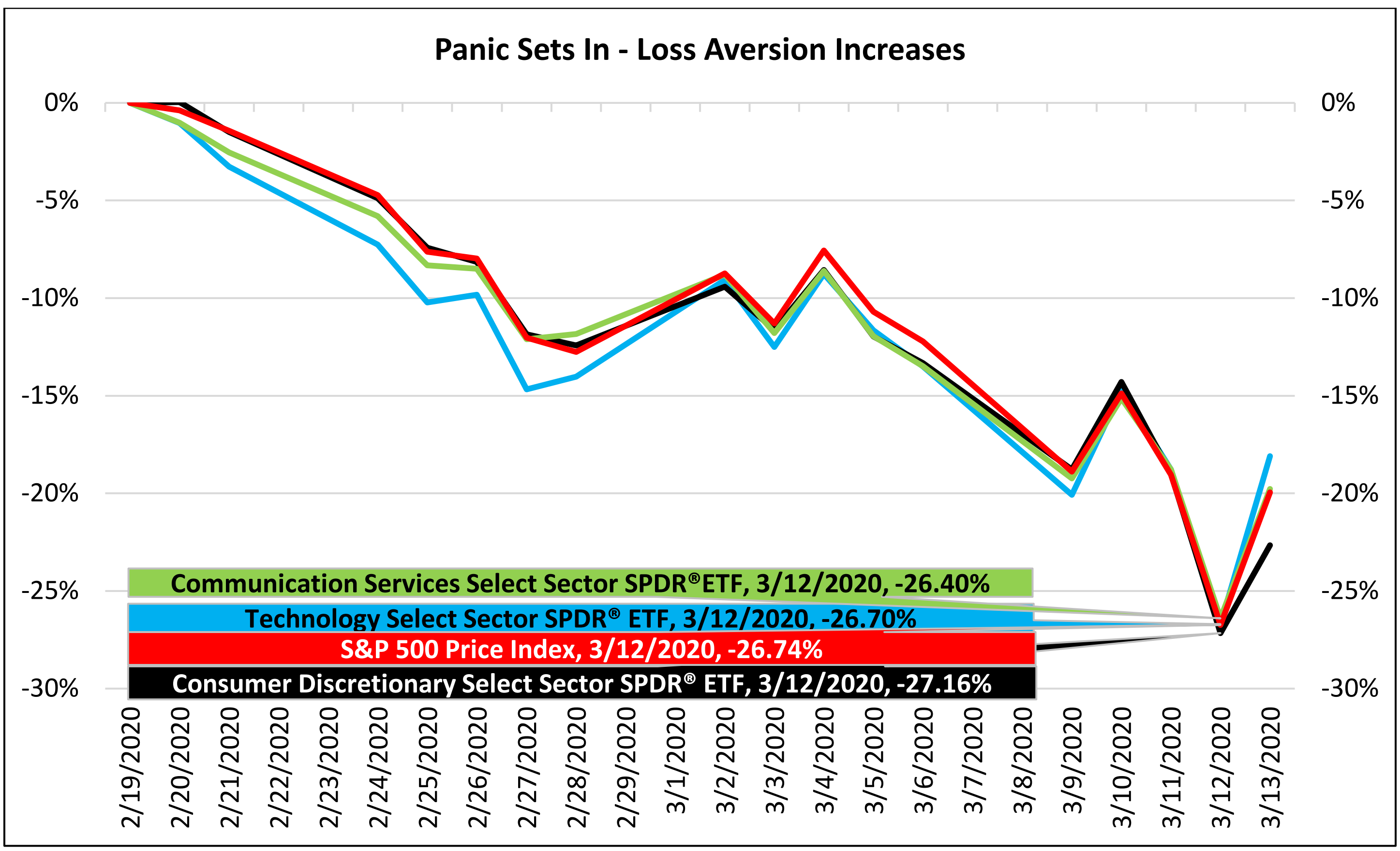
Both the level of interest rates and the slope of the yield curve play an important role in traditional banking profitability. Some might be wondering why we would buy banks in this environment, given how poorly they have done in past economic downturns. In past downturns, banks posed greater risk to the system than they do today. Given the increased scrutiny, regulation, and capitalization (reserve) requirements of the banking sector as a whole, the sector is a safer place than in past cycles.

Our large overweight to the Energy Sector comes at a point that we anticipate oil markets to self-correct over time. Over the short run, oil prices tend to move to extreme highs or lows, without remaining there for long periods, during supply or demand shocks. The selloff in oil started with a build in oil reserves (oversupply or oil “glut”), followed by a demand shock from the Coronavirus outbreak (reduced travel and transportation). The capitulation of the oil selloff came after a breakdown in the OPEC + meeting in Vienna. Russia shocked the cartel because of their unwillingness to jointly reduce production. Saudi Arabia, in a game of “Chicken,” for lack of a better metaphor, committed to **INCREASING** production. Oil production can only be profitable at certain prices for producers and for countries around the world. Increasing and decreasing production is not like turning on or off a hose. It takes time to ramp up and reduce production. With that said, at some point someone will have to reduce production or possibly both agree to come back to the table and negotiate a coordinated reduction in production (supply). U.S. oil producers are projected to take oil production levels down through year end 2020 through 2021. Historically, when energy prices have sold off at this magnitude, it has generally been rewarding for investors to add exposure to the sector. Energy prices can only go so low before companies and countries are forced to cut production. When this happens (if it has not already happened), we believe energy prices will mean-revert to their longer-term historical averages.

Preparing assumptions to see through the volatility:
Our communication is not intended to downplay the real risks that remain to individuals and capital markets. Capital markets are forward looking. Asset prices (with cashflows) are based on future expected returns based on the prices market participants are willing to pay at present. The rise of the quarantine and containment efforts will undoubtably negatively impact growth in the short term. Internally, we started running scenarios of the growth rates of the Coronavirus spreading in mid-January. By mid-February, we had increased our forecast to over 400,000 infections globally by mid-April. It is a quantitative and qualitative (discretionary) estimate with significant limitations. This is what a lot of market participants are trying to figure out. Countries that have moved quickly to effectively shut down and self-isolate for 2-4 weeks have seen the best containment results to date. Our assumptions for looking through a period of negative growth assume that the U.S. economy essentially loses an entire month of revenue (individuals and business spending) by people reducing their activities. This will unquestionably take more than a month to work itself out, but overtime, it will. The risk to this assumption is that many services-related (hourly pay) roles are potentially cut as businesses do not have the capacity to pay without their doors open (restaurants, retail, travel & leisure sectors, etc.). Further limitations are actual market contagion from default rates increasing in the energy sector if oil prices stay at historically low levels. We believe(d) this was the first time since the financial crisis that domestic fiscal stimulus was needed, and policy measures would likely be enacted to "bailout" individuals and organizations alike.

Full-blown, indiscriminate panic selling 3/12/2020:

Enter fiscal response (Government Stimulus…Insert Here) ______________________________.........?
Okay, so we thought we were getting this after the current administration hinted at in on Monday night (3/9/2020). With fiscal stimulus seemingly held hostage as of Thursday (3/12/2020), full-blown panic sets in.



Who can afford to make a mistake during an election year? Neither side of the aisle can. On Thursday, March 12, with markets in freefall, we made large moves to reduce areas in which we had alternative equity-like exposures and we **added to true equity sector exposures, as shown in the above chart**. The alternative equity-like exposures did not suffer the same drawdowns as the actual equity sector exposures shown in the chart above. For example, we were using Short-Term High Yield and Emerging Market Sovereign Debt for our alternative equity-like exposures, which are actually bond exposures that have similar correlations and lower betas than equites. With these rebalances, we went into the close of the trading day on Thursday with model strategies that had more market-neutral or market-like weightings consistent with each strategy's risk/reward profile. We left room in the model strategies with cash available to add to either fixed income and/or equites going forward, depending on how markets react over the coming days, weeks and months.

Markets have priced in a lot of the negative news that you will hear in the coming weeks. The number of infections will, in our view, likely capitulate over the coming weeks as self-isolation efforts increase and the reality of the disease sets in at home. Like a natural disaster, these are difficult and unpredictable times in the short run. As FDR said in his inaugural address, "So, first of all, let me assert my firm belief that the only thing we have to fear is...fear itself — nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance." This too shall pass, but it is a serious time in which serious measures still need to be taken. We believe the magnitude of these policy measures will now come sooner than later, and it will benefit both the physical and financial health of individuals over the longer run.

Dustin Latham, CFA, CAIA, CRPC
Founder, Investment Adviser Representative
DLatham@altcapialis.com
551-258-3476 (551-ALT-FIRM)

Alternative Capitalis, LLC

Alternative Capitalis, LLC
233 Harvard St, Suite 307
Brookline, MA 02446
altcapitalis.com
facebook.com/altcapitalis

As this release was getting set to be distributed to clients, the Federal Reserve announced it is cutting their policy rates to a target range for the federal funds rate to 0 to 1/4 percent as well as an additional $700 billion in another round of Quantitative Easing.

<u>Model Disclosure</u>

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Performance results shown include the reinvestment of dividends and interest on cash balances where applicable. The data used to calculate the model performance was obtained from sources deemed reliable and then organized and presented by Alternative Capitalis, LLC. The performance calculations have not been audited by any third party. Actual performance of client portfolios may differ materially due to the timing related to additional client deposits or withdrawals and the actual deployment and investment of a client portfolio, the reinvestment of dividends, the length of time various positions are held, the client's objectives and restrictions, and fees and expenses incurred by any specific individual portfolio. The performance calculations are based on a hypothetical investment of $100,000 for both the model and benchmarks presented. **Benchmarks:** The performance results shown are compared to the performance of the performance of a blended ETF (exchange-traded-fund) portfolio comprised of the following two ETF's symbols, SPY & AGG, are described below. The benchmarks used are investable ETFs and their performance calculation is inclusive of the highest fee charged to a client(s) account, 1.25% annually. This will reduce the total return of the investable benchmark by the annualized rate of 1.25%. The ETF symbol SPY (SPDR® S&P 500® ETF Trust) which seeks to provide investment results that, before expenses, correspond generally to the price and yield performance of the S&P 500® Index (the "Index"). Visit https://us.spdrs.com/en/etf/spdr-sp-500-etf-SPY for more information about the ETF. The S&P 500® Index results do not reflect fees and expenses and you typically cannot invest in an index. The ETF symbol AGG (iShares Core U.S. Aggregate Bond ETF). The iShares Core U.S. Aggregate Bond ETF seeks to track the investment results of an index composed of the total U.S. investment-grade bond market. (the "Index"). Visit https://www.ishares.com/us/products/239458/ishares-core-total-us-bond-market-etf for more information about the ETF. The index composed of the total U.S. investment-grade bond market results do not reflect fees and expenses and you typically cannot invest in an index. <u>The benchmark is blended representing a weighting of a percentage (%) to SPY and percentage (%) to AGG based on the respective model weights below.</u> Unless otherwise indicated, the benchmarks are not rebalanced to maintain their original weighting over the period measured. Instead, they are comprised of the starting allocation and will shift given the prevailing market environment over the period measured. **Return Comparison:** To benchmark the results, the ETF (exchange-traded-fund) symbol SPY (SPDR® S&P 500® ETF Trust) which seeks to provide investment results that, before expenses, correspond generally to the price and yield performance of the S&P 500® Index (the "Index"). The S&P 500 was chosen as it is generally well recognized as an indicator or representation of the stock market in general and includes a cross section of equity holdings. In addition, the ETF symbol AGG was chosen as a benchmark. The iShares Core U.S. Aggregate Bond ETF seeks to track the investment results of an index composed of the total U.S. investment-grade bond market. The total U.S. investment-grade bond market was chosen as it is generally well recognized as an indicator or representation of the bond market in general and includes a cross section of debt holdings. For each respective model benchmark the performance measurement weightings are as follows to SPY / AGG %: 20/80, 30/70, 40/60, 50/50, 60/40, 70/30, 80/20, 90/10 % respectively for Ultra Conservative, Conservative, Moderate, Balanced, Growth & Income, Growth, Aggressive, Ultra Aggressive. **OPTIONS TRADING RISK DISCLOSURE**: Options Trading – Both the purchase and writing (selling) of options contracts –involves a significant degree of risk not suitable for all investors. Investors should carefully consider the inherent risks and financial obligations associated with options trading as further detailed in the Options Clearing Corporate booklet "<u>Characteristics and Risks of Standardized Options</u>." 233 Harvard St, #307, Brookline, MA 02446 is Alternative Capitalis, LLC's client facing address. All books, records, receipts, correspondence (mailing address) and day to day operations are located at 1565 West St, Wrentham, MA 02093. Alternative Capitalis, LLC is a registered investment adviser. Information presented herein is for educational purposes only and does not intend to make an offer or solicitation for the sale or purchase of any specific securities, investments, or investment strategies. Investments involve risk and unless otherwise stated, are not guaranteed. The results presented before 12/31/2016 for model performance assume that the weights initially held on that date were held at the unset of any performance presented before 12/31/2016. This assumes results based on discretionary models that are not purely quantitative or rules based. **Global Benchmarks:** The performance results shown are compared to the performance of the performance of a blended ETF (exchange-traded-fund) portfolio comprised of the following three ETF's symbols, VT, BNDX & BND, are described below. The benchmarks used are investable ETFs and their performance calculation is inclusive of the highest fee charged to a client(s) account, 1.25% annually. This will reduce the total return of the investable benchmark by the annualized rate of 1.25%. Additionally, the ETF's that lack the track record to cover the entirety of the period presented have been backfilled with index data that Alternative Capitalis, LLC deems appropriate as a proxy of the chosen ETF's hypothetical track record. Below is the summary of backfilled data and time period:

ETF	Earliest Available Price Data for ETF	Backfill Index 1	Earliest Available Data for Index Backfill 1	Backfill Index 2	Earliest Available Data for Index Backfill 2
BNDX	5/31/2013	*<u>ICE BofAML Global Broad Market Index</u>*	9/22/1998	N/A	N/A
VT	6/24/2008	<u>MSCI All Country World Index TR</u>	12/29/2000	*<u>S&P 500 (TR) Index</u>*	9/22/1998
BND	4/3/2007	Barclays US Aggregate Bond Index	9/22/1998	N/A	N/A

The ETF symbol BNDX (Vanguard Total International Bond ETF). The Vanguard Total International Bond ETF attempts to track the performance of the Bloomberg Barclays Global Aggregate ex-USD Float Adjusted RIC Capped Index (USD Hedged). Visit https://investor.vanguard.com/etf/profile/BNDX for more information about the ETF. The ETF symbol VT (Vanguard Total World Stock ETF) seeks to track the performance of the FTSE Global All Cap Index, which covers both well-established and still-developing markets. Visit https://investor.vanguard.com/etf/profile/VT for more information about the ETF. The ETF symbol BND (Vanguard Total Bond Market ETF). The Vanguard Total Bond Market ETF attempts to track the performance of the Bloomberg Barclays U.S. Aggregate Float Adjusted Index and attempted to track the Bloomberg Barclays U.S. Aggregate Bond Index through December 31, 2009. Visit https://investor.vanguard.com/etf/profile/BND for more information about the ETF. The benchmark is blended representing a weighting of a percentage (%) to BND, percentage (%) to VT and percentage (%) to BNDX based on the respective model weights below. Unless otherwise indicated, the benchmarks are not rebalanced to maintain their original weighting over the period measured. Instead, they are comprised of the starting allocation and will shift given the prevailing market environment over the period measured. **Return Comparison:** To benchmark the results, the ETF symbol BNDX (Vanguard Total International Bond ETF) attempts to track the performance of the Bloomberg Barclays Global Aggregate ex-USD Float Adjusted RIC Capped Index (USD Hedged). The Vanguard Total International Bond ETF was chosen as it is generally well recognized as an indicator or representation of the global bond market, ex-U.S. bonds, and tracks an investment-grade, non-USD denominated bond index, hedged against currency fluctuations for U.S. investors. The ETF symbol VT (Vanguard Total World Stock ETF) seeks to track the performance of the FTSE Global All Cap Index, which covers both well-established and still-developing markets. The Vanguard Total World Stock ETF was chosen as it is generally well recognized as an indicator or representation of the global stock market and tracks a market-cap-weighted index of global stocks covering approximately 98% of the domestic and emerging market capitalization. The ETF symbol BND (Vanguard Total Bond Market ETF) attempts to track the performance of the Bloomberg Barclays U.S. Aggregate Float Adjusted Index and attempted to track the Bloomberg Barclays U.S. Aggregate Bond Index through December 31, 2009. The Vanguard Total Bond Market ETF was chosen as it is generally well recognized as an indicator or representation of the U.S. Domestic bond market, and tracks a broad, market-value-weighted index of U.S. dollar-denominated, investment-grade, taxable, fixed-income securities with maturities of at least one year. For each respective model benchmark the performance measurement weightings are as follows to BND/VT/BNDX %: 66/20/14, 57.8/30/12.3, 49.5/40/10.5, 41.2/50/8.8, 33/60/7, 24.7/70/5.3, 16.5/80/3.5 and 8.2/90/1.8 % respectively for the Ultra Conservative, Conservative, Moderate, Balanced, Growth & Income, Growth, Aggressive and Ultra Aggressive Global Benchmarks.