Market Commentary

A Tactical Strategy for Current Volatility

From basketball to tennis or chess to tic-tac-toe, winning a game involves strategic decisions, probability analysis and math. The best teams and players are not passive, generating the same moves over and over, but tactically adjusting to make the next best move. Investing is much the same.

Any investment choice represents trade-offs between risk and opportunity. Risks can come from any direction at any time. But how to prepare for the unpredictable?

Many investors believe that by taking on more risk, they will benefit with more reward. That is not always the case. Let's look at four major traditional asset classes:

- U.S. stocks
- High yield corporate bonds
- Preferred stocks
- Municipal bonds—investment grade as well as high yield (below investment grade)

Primer on Several Traditional Asset Classes

As a short primer, **the S&P 500** is a market-capitalization-weighted index of the 500 largest public companies. **High yield corporate bonds** are often referred to as "junk" bonds because of higher risk of default and therefore offer a high interest rate than investment-grade rated corporate bonds. **Preferred stocks** are often considered a hybrid of stocks and bonds as they represent company ownership (like common stocks) and also have a mandatory fixed dividend

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Invest wisely. Rest easy.

(like bonds). **Municipal bonds** are typically issued by a city, state, or related entities to fund projects like building schools or highways, and the interest that is paid to the bond holder is tax-exempt by the federal government.

Does More Risk Always Deliver More Return?

Most may expect that U.S. stocks have the most risk and therefore can also be expected to deliver the best return. On the other hand, municipal bonds are frequently deemed as very conservative and downright boring, perhaps best suited for widows and orphans. Sound familiar?

Turning to the other, perhaps less understood asset classes, high yield corporate bonds and preferred stocks would perhaps fall somewhere in between the risk and return for U.S. stocks and municipal bonds. These expectations are rooted in a fundamental belief and “rule” that risk and return are intricately and efficiently related. That is, the best returning asset classes are the riskiest and vice versa.

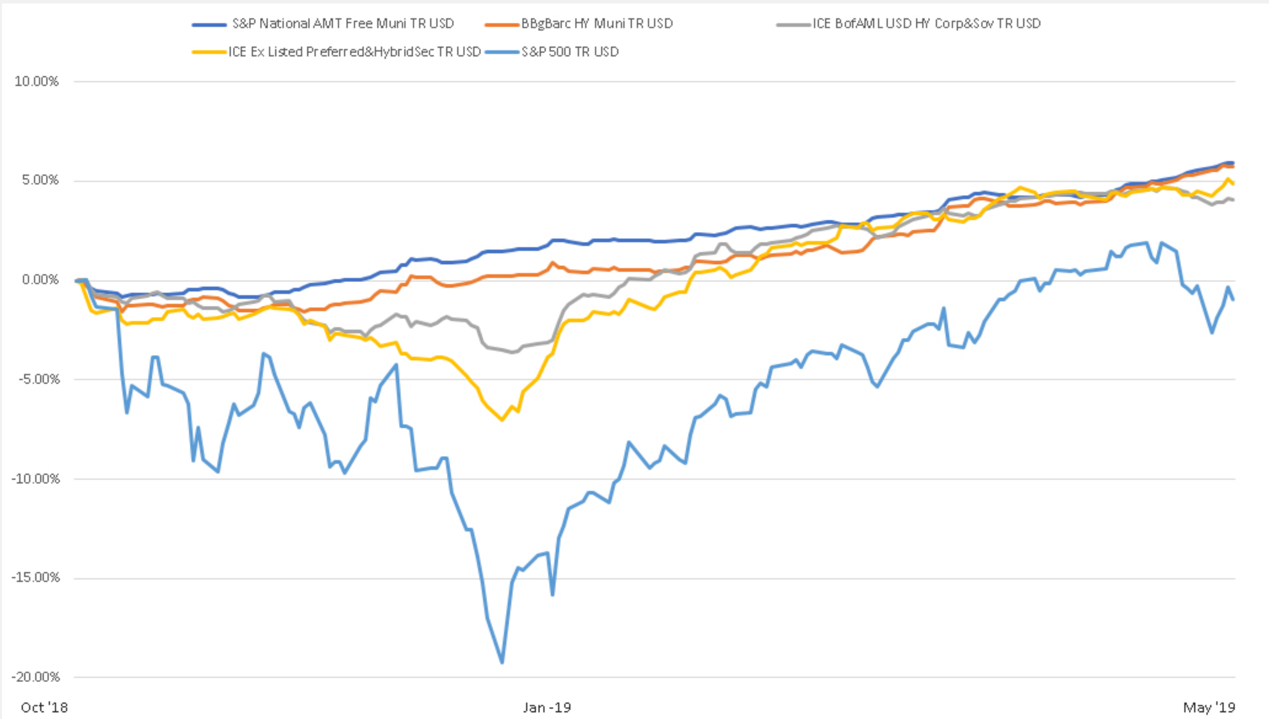
This makes sense, but is it always true?

We studied the past seven months, from the start of the fourth quarter 2018 until the close of trading on May 17, 2019. This small recent sample captures the periods of significant stock market decline during the fourth quarter and the v-shaped recovery that followed.

The chart on the next page shows the hard facts. The top two lines represent two major municipal bond sub-asset classes, investment grade and high-yield (below investment grade). In fact, high yield corporate bonds and preferred stocks are also nicely positive. By far the worst performing asset classes during this period is U.S. stocks, as measured by the S&P 500.

Equity vs. Bond Performance

Index performance October 1, 2018–May 17, 2019



Source: Morningstar Direct, Reuters, Sierra Investment Management

As can be seen, the muni bond index (the top line) ended this period with the best performance (so far), while the S&P 500 index (the bottom line) ended with a loss.

A Tactical Approach to Traditional Asset Classes

Surprised? We aren't. For our diversified portfolios, when we have cash, our quantitative, rules-based process steers our asset allocation tactically into a diversified mix of holdings that are not highly correlated with each other, giving preference to lower-risk assets that are in attractive uptrends. Our rules adjust to what the market is saying. That's why our largest allocations are currently in municipal bonds and high yield corporate bonds. At times this group of assets will demonstrate very different behavior and can line up in another way. Our tactical, rules-based approach drives our next purchases.

Rather than playing the investment game with a static portfolio, our diversified strategies adapt to the changing investment environment. Your life isn't passive. Your investments shouldn't be either.

Definitions

Correlation is a statistic that measures the degree to which two securities move in relation to each other. Correlations are used in portfolio management, computed as the correlation coefficient, which has a value that must fall between -1.0 and +1.0.

A drawdown is a peak-to-trough decline during a specific period for an investment, trading account, or fund. A drawdown is usually quoted as the percentage between the peak and the subsequent trough.

The S&P National AMT-Free Municipal Bond Index is a broad, market value-weighted index designed to measure the performance of the investment-grade tax-exempt U.S. municipal bond market. Bonds issue by U.S. territories, including Puerto Rico, are excluded from the index.

The Bloomberg Barclays High Yield Bond Index is designed to measure the performance of publicly issued U.S. dollar-denominated high yield corporate bonds with above-average liquidity.

The ICE Bank of America Merrill Lynch U.S. High Yield Master II Index tracks the performance of U.S. dollar denominated below investment grade rated corporate debt publicly issued in the U.S. domestic market.

The ICE Exchange-Listed Preferred & Hybrid Securities Transition Index tracks the performance of U.S. dollar-denominated preferred and hybrid securities.

The Standard & Poor's 500 Index (S&P 500) is a market-capitalization-weighted-index of the 500 largest U.S. publicly traded companies. It is widely regarded as the best gauge of large-cap U.S. equities.

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

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