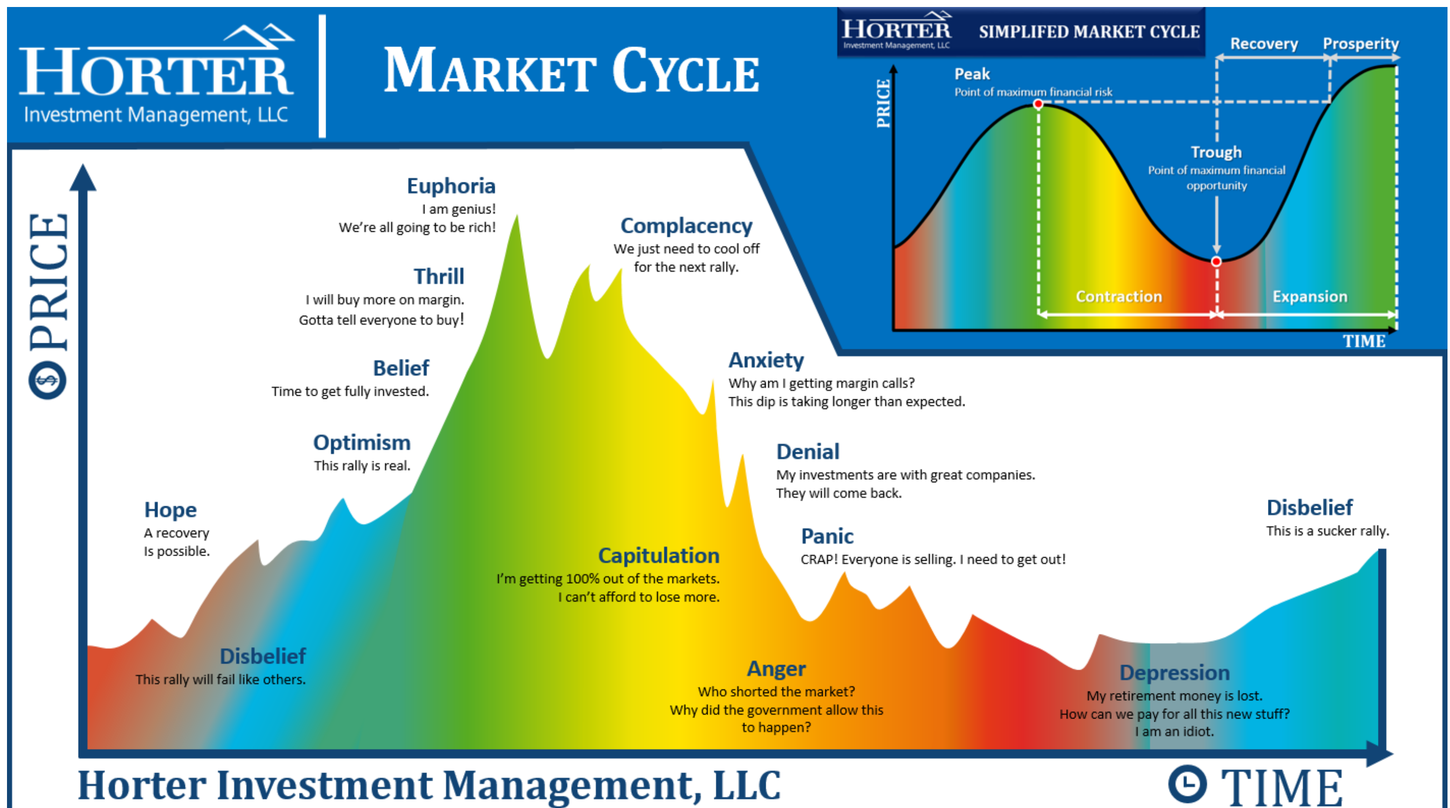
HORTER
Investment Management, LLC

Investing Principles of Tactical Portfolio Management And Wealth Protection

Protecting wealth through short term risk managed investing is at the core of the Horter investment style. We believe that proactively managing downside investment risk in a portfolio, to mitigate large potential declines in portfolio values, is a key to long-term investment success. Why? Large declines can discourage investors from staying the long-term investment course and it motivates them to exit the market just when they should be doing the opposite as they succumb to human nature letting their emotions drive their decision-making. Below are examples of the highs and lows investors go through during different Market Cycles.



These investment experiences can negatively impact their wealth long term, disrupt their quality of life and shorten the time horizon in which they were expecting to be able to enjoy the fruits of their life's work.

Like all professional endeavors, these types of important decisions should be systematic, disciplined, fact based and executed as unemotionally as possible. It is our contention that not enough attention is paid to risk management, the

likelihood of investment losses, the potential size of those losses and the human reaction to them. As a result, we believe based on their risk tolerance that a small or large part of investor capital should always be allocated to strategies dedicated to protecting against these downside risks along with tactics flexible enough to produce positive returns, even smaller ones, regardless of market conditions. The time, effort and skill required to identify, research, assess and monitor investment managers that use these types of tactics is a considerable and expensive ongoing endeavor. Our fees reflect this additional work. However, we feel that effort (and expense) is what differentiates Horter strategies – we focus on protecting against loss but also incorporate concepts that could produce positive outcomes regardless of market conditions.

How much of a portfolio should be allocated to this type of approach depends on a wide variety of investor factors including other investments in their portfolio, their time horizon, risk tolerance, investment experience, personal experience with non-traditional investment strategies, savings rate, cash flow needs, etc. While this allocation is a personal decision based on the need for downside protection, it is also in our opinion a matter of common sense safety for any person's investment journey.

Over the years, and in particular from 12/31/1999 to the present (17+ years), we observed the negative effects of mixing human emotions with a lack of investment discipline. Accordingly, we have incorporated guiding principles in our portfolio strategies. These principles do not guarantee investment success but we believe they help create more risk awareness and investment discipline that has the potential to mitigate short-term losses that often discourage investors from sticking with a long-range approach to financial success. Of course, investing is both a science and an art and there is no ironclad guarantee that this downside protection will be accomplished with certainty; however, we believe it is important to dedicate enough capital to these types of strategies so that there is a focused effort to do just that. Additionally, by actively managing for downside risk protection there is the potential that upside investment opportunity could be limited. And, it is also true that the severity of downside market periods that we have experienced in the past may or may not happen again.

The three principles we try to incorporate into our portfolio management process include:

1. Risk Awareness – *we define risk as loss of principal at <u>any</u> point in time*
2. Manager screening, selection and due diligence – *we carefully select and monitor non-traditional investment strategies employing dedicated risk-aware techniques*
3. Prudent portfolio construction and management – *we combine non-traditional management techniques that diversify risk exposures and investment tactics*

1. Risk Awareness

Stock and bond markets are volatile and unpredictable in the short term. It is that uncertainty about tomorrow's price, the value of future prices and the day to day variation in price that provides investors with the opportunity for premium returns versus purely guaranteed investments – *IF*, investors have the tolerance to stay invested to endure that volatility and see their portfolio values change that much. The table below takes a look at three specific bear market declines.

// A LOOK AT PREVIOUS S&P 500® BEAR MARKETS

Bear Market	Year	Peak to Trough[1]	5 Yr Stock Return[2]	FIA 5 Yr Return[2]	Return Difference between Stock and FIA Returns	Shiller P/E 10: Bear Market Indicator[3]
Wall Street Crash of 1929: Black Tuesday	1929	-86.10%	-71.63%	6.25%	77.88%	32.56
Crash of 2000: The Dot Com Bubble	2000	-49.10%	-20.32%	9.16%	29.48%	43.77
Crash of 2007: The Great Recession	2007	-56.40%	-6.61%	23.60%	30.21%	27.55
January 1st, 2017	2017	?	?	?	?	28.33
Average		-63.87%	-32.85%	13.00%	45.86%	33.05

The Shiller P/E ratios were calculated from top months in the year of the market correction. In this case September 1, 1929; January 1, 2000 and May 1, 2007.

The average bear market indicator, expressed as a Shiller P/E 10 Ratio, on the S&P 500® over the last 137 years is 16.72. Are we approaching a correction to the mean bear market indicator?

BEAR MARKET INDICATOR:[4]

The Shiller P/E 10 ratio is a valuation measure, generally applied to broad equity indices, that uses real per-share earnings over a 10-year period. The P/E 10 ratio uses smoothed real earnings to eliminate the fluctuations in net income caused by variations in profit margins over a typical business cycle. The ratio was popularized by Yale University professor Robert Shiller, who won the Nobel Prize in Economic Sciences in 2013. It attracted a great deal of attention after Shiller warned that the frenetic U.S. stock market rally of the late-1990s would turn out to be a bubble.

This is the 3rd most expensive stock market[5]

1. "11 Historic Bear Markets," NBC News, accessed March 17 2017, <http://www.nbcnews.com/id/37740147/ns/businessstocks_and_economy/t/historic-bear-markets/#.WMmCbFUrJhE>.
2. See: Drew Dokken and Wade Dokken, "A Client's Perspective on Best Interest", for information on how these returns are calculated <https://wealthvest.com/white-papers>.
3. Robert Shiller, "Online Data - Robert Shiller." Online Data - Robert Shiller, accessed March 23, 2017, <http://www.econ.yale.edu/~shiller/data.htm>.
4. Elvis Picardo, "P/E 10 Ratio," Investopedia, June 1, 2016, <http://www.investopedia.com/terms/p/pe10ratio.asp#ixzz4YtmafJaB>.
5. "Shiller PE Ratio,"Accessed June 12, 2017,<http://www.multpl.com/shiller-pe/.>

Source: WealthVest Marketing.

More recently the past 17+ years have been very volatile with two significant drawdown periods 12/31/2000 through 2002 and October 2007 through early March 2009. The graph below shows it took more than 12 years for investors in December 1999 to make a return on investment in 2013.

The total return from 12/31/99 through 8/21/17 is 68% or roughly 3.9% for just our 17.5 years. That is significant risk and volatility for the Buy and Hold S&P 500 portfolio. With the market at all-time highs, could a significant correction be in store? With Horter Tactical Investment portfolio management style, investor assets could have much less draw down.

S&P 500 from January 1, 2000- August 21, 2017

Source: Yahoo Finance

The next cycle up in interest rates may be sooner than later with the previous cycle (1945-1982) and the current one lasting 35 to 36 years. Current investors in the Bond Market could be in for portfolio losses if interest rates start climbing (see chart below).

Interest-Rate Cycles Tend to Be Very Long

Source: Bloomberg

When discussing risk and market cycles, it is important to understand how investors' emotions and poor decisions can cause harm to their portfolio. Below are the Key Findings from the 2017 DALBAR Study.

> "Since 1994, DALBAR's **Quantitative Analysis of Investor Behavior** (QAIB) has measured the effects of investor decisions to buy, sell and switch into and out of mutual funds over short and long-term

timeframes. These effects are measured from the perspective of the investor and do not represent the performance of the investments themselves. The results consistently show that the average investor earns less – in many cases, much less – than mutual fund performance reports would suggest."

KEY FINDINGS FROM 2016

- In 2016, the average **equity mutual fund investor** underperformed the S&P 500 by a margin of 4.70%. While the broader market made gains of 11.96%, the average equity investor earned only 7.26%.

- In 2016, the average **fixed income mutual fund investor** outperformed the Bloomberg Barclays Aggregate Bond Index by a margin of 0.19%. The broader bond market realized a slight return of 1.04% while the average fixed income fund investor earned 1.23%.

- Equity fund retention rates decreased materially in 2016 from 4.10 years to 3.80 years.

- Fixed Income retention rates increased by almost 2 months in 2016, inching up from 2.93 to 3.09, eclipsing the 3.0 year mark for the first time since 2012.

- Asset allocation funds experienced a significant decline of retention rates in 2016. The average retention rate shortened by over 5 months, decreasing from 4.53 to 4.09.

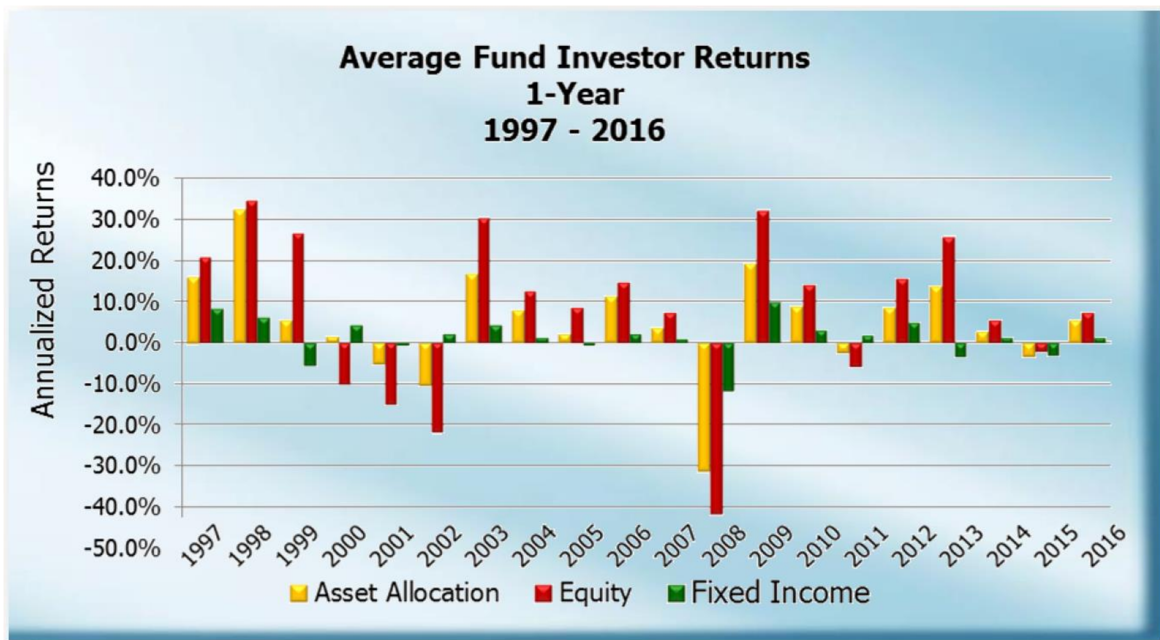
- In 2016, the 20-year annualized S&P return was 7.68% while the 20-year annualized return for the Average Equity Fund Investor was only 4.79%, a gap of 2.89% annualized.

- The gap between the 20-year annualized return of the Average Equity Fund Investor and the S&P 500 continued to contract in 2016 (from 3.52% in 2015 to 2.89% in 2016).

	Investor Returns[1]					
	Equity Funds	Asset Allocation Funds	Fixed Income Funds	Inflation	S&P 500	Bloomberg Barclays Aggregate Bond Index
30 Year	3.98	1.85	0.57	2.65	10.16	5.99
20 Year	4.79	2.29	0.48	2.13	7.68	4.96
10 Year	3.64	1.78	0.40	1.83	6.95	3.97
5 Year	9.83	4.85	0.05	1.40	14.66	1.21
3 Year	3.42	1.45	-0.23	1.25	8.87	2.29
12 Months	7.26	5.48	1.23	2.07	11.96	1.04

1. **Returns are for the period ending December 30, 2016**. *Average equity investor, average bond investor and average asset allocation investor performance results are calculated using data supplied by the Investment Company Institute. Investor returns are represented by the change in total mutual fund 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 each period.*

- In 5 out of 12 months, investors guessed right about the market direction the following month. While "guessing right" 42% of the time in 2016, the average mutual fund investor was not able to keep pace with the market, based on the actual volume and timing of fund flows.
- The Average Equity Fund Investor outperformed a hypothetical Systematic Equity Fund Investor on an annualized basis for the period 1997-2016 (4.79% vs. 4.15%).
- For the period 1997-2016, the Systematic Fixed Income Investor outperformed the average fixed income investor by a wide margin (2.29% vs. 0.48% on an annualized basis).

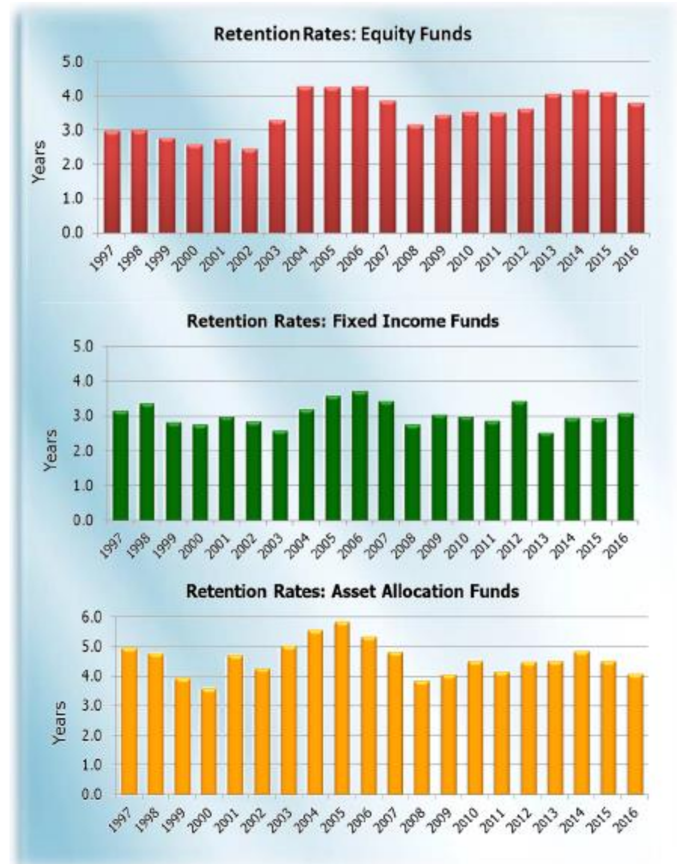


Short-Term Focus and Market Timing

Investors so often cost themselves money because the behaviors elicited by short-term focus are almost always irrational. While many investors set a course of action that is based on a well-planned rationale and considers the full time horizon, those plans can take a back seat when fear or exuberance sets in. The best way to avoid irrational behavior is to employ a strategy that instills confidence in the outcome. This can be achieved by stating goals and analyzing the probability of achieving those goals. The markets can have a bad day, week, or even a bad year, but investors who can see that their probability of success is within an acceptable level are less likely to overreact.
The data shows that the average mutual fund investor has not stayed invested for a long enough period of time to execute a long-term strategy. In fact, they typically stay invested for just a fraction of a market cycle.

Retention Rates

Over the past 20 years, **equity mutual fund investors** have seldom managed to stay invested in their funds for more than 4 years. When they have done so, it has generally been during periods of bull markets. Equity fund retention rates surpassed the four year mark from 2004-2006 and would have a similar three-year streak in 2013-2015. In 2016, equity fund retention rates broke their current streak of exceeding four years, dipping from 4.10 years to 3.80 years.



Fixed income mutual fund investors saw their highest retention rates since 2012 (3.09 years), which surpassed the 3.0 year mark for just the second time since 2009.

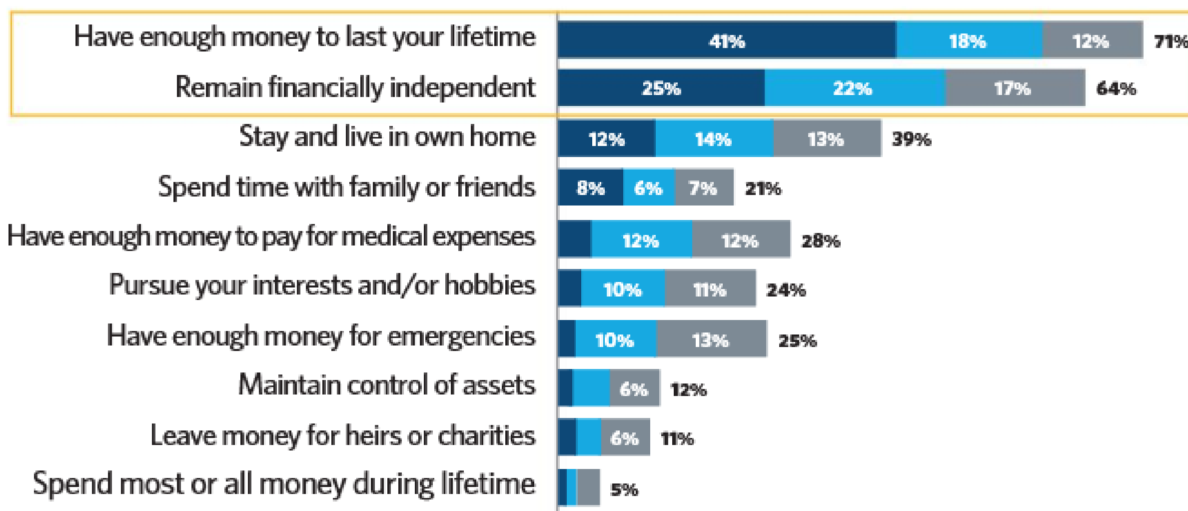
Asset allocation mutual fund investors have generally stayed invested longer than their equity and fixed income investor counterparts. Asset allocation fund retention rates have stood above the four-year mark for eight straight years. This year, asset allocation fund retention rates decreased to 4.09 years, nearly falling below the 4.0 year mark for the first time since 2008.

Longevity Risk and Portfolio Management

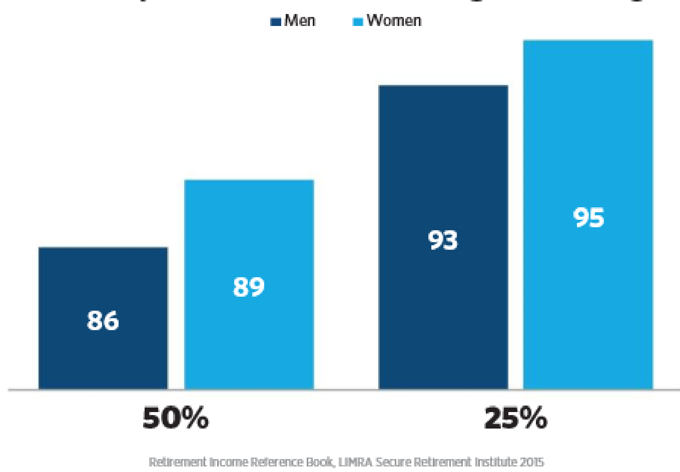
HIM's primary objective is to minimize the potential for large unintended investment losses at any point in time that would throw investors off course from their long-term financial plan.

Longevity Risk is a real risk and is the number one concern of retirees, **the "fear of running out of money."** With stock market declines happening generally every 7 to 8 years and bond market risk (rising interest rates) financial lives can be in jeopardy if retirees live too long.

Below are longevity statistics.



Source: Insurance News Magazine – June 2017



The Longevity risks that could significantly impair ones retirement are 3 possibly 4 major stock market declines of 30%, 40% or 50%. So having the ability to go risk off to cash during turbulent times is attractive to conservative investors, pre-retirees and retirees.

So, attempting to assess investment risk and the tradeoff with return is an important day-to-day consideration in trying to reduce the prospects of large drawdowns or losses in their portfolio. We believe an effective way to achieve this objective is to emphasize the use of rules based and or quantitative solutions that replace day to day professional judgment of a Buy and Hold money manager. This approach attempts to take emotions out of investing as well as to incorporate broad investment mandates that give specialty non-traditional, non-correlated investment managers the flexibility to respond to market conditions as they emerge. And so, we look to find strategies that are:

1. **Non-correlated portfolio as much as possible for client assets.**
2. **Dramatically reduce market risk in a portfolio by going to some or all cash; minimizing portfolio drawdowns**
3. **Short a market that appears too risky to own and or the manager believes is apt to decline. Shorting can provide potential gains when an asset goes down in value.**
4. **Invest opportunistically by reducing or increasing risk exposures based upon perceived opportunities or lack thereof.**
5. **Provide combinations of several non-correlated managers to minimize losses.**

By combining specialized, flexible and more quantitative investment approaches that can exercise some or all of these tactics into Horter's non-traditional strategies, we enhance the focus on avoiding large drawdowns. An overall investment strategy designed for wealth protection that fails to account for the potential negative effects of downside risk could severely handicap an investors' ability to achieve their financial goals.

Over the past 17+ years, we are keenly aware the investors do not understand risk or downside volatility pertinent to their portfolio often times. What they desire when they take a Risk Tolerance test is that many investors desire lower risk when their portfolio actually has a risk score that is significantly higher.

2. Selecting Specialized Investment Managers

The universe of specialized managers with the kind of experience and demonstrated track record we seek is not large in relation to the entire investment industry. The tools and resources to do this kind of work have not been available for that many years and the industry's focus on downside protection has only increased since 2008. We have built a proprietary screening tool to help us identify such firms and apply a number of common sense criteria to sort the list of available candidates worthy of further research. We look for:

1. **Managers with auditable track records that go back to at least to the most recent large market decline (2011); some go back as far as 1/1/2007.**
2. **Firms that have demonstrated business seasoning, organizational maturity and staying power**
3. **Firms with investor friendly compliance records**
4. **Firms with performance records that exhibit the kind of risk management we seek in a down market.**

Once these firms and their strategies have been identified we work at getting to know its management team, understanding their approach and assessing their ability to reliably execute on their strategies going forward. We take a balanced approach to selection and ongoing due diligence placing emphasis on both quantitative and qualitative factors.

Not only do we have ground rules for screening and selection but we also at times disengage with a manager we previously thought highly of. The considerations that go into removing a manager from a Horter portfolio include:

1. **Perceived ethical lapses**
2. **Negative legal or regulatory events**
3. **Sustained inferior performance relative to expectations**
4. **Organizational disruptions**
5. **Strategies that become untimely and are expected to remain untimely for the foreseeable future**

3. **Prudent Portfolio Construction and Management -** *We combine non-traditional management technologies that diversify risk exposure and investment tactics.*

Since 2008, the evolution and the art and science behind combining various types of tactical portfolio managers has been very dramatic. When looking at "sleeves" or combinations of various tactical management styles, asset classes, algorithms, and time horizons, we find there are five primary drivers to minimize losses and attain good rates of return over time.

1. Asset Class Diversification
2. Non-Correlation Of Portfolios
3. Minimize Drawdown (Maximum period of loss during a specific time period)
4. Time Horizon
5. The ability to be invested Long, Short or in Cash

By integrating different asset classes with manager algorithms, non-correlated is enhanced to minimize clients' losses/drawdowns.

Different managers have different time horizons built into their models which further diversifies the portfolio management and enhances the non-correlation element of portfolio design.

The ability to be Long (own the asset), Short (believing the asset will go down in value) or Cash are important as well.

Conclusion

Achieving long-term investing success is challenging and requires vigilance, discipline, and skill. While it is not possible to predict future returns or market movements, we believe it is possible to develop strategies that attempt to mitigate risk tactically when prudent. By attempting to sidestep the negative impact of large losses on portfolios, HIM portfolios attempt to place prudent investors in a better position to achieve long-term reasonable rates of returns.