Premise Capital
STAY ON THE CURVE™

2nd Quarter 2020 Market Commentary

Premise Investors,

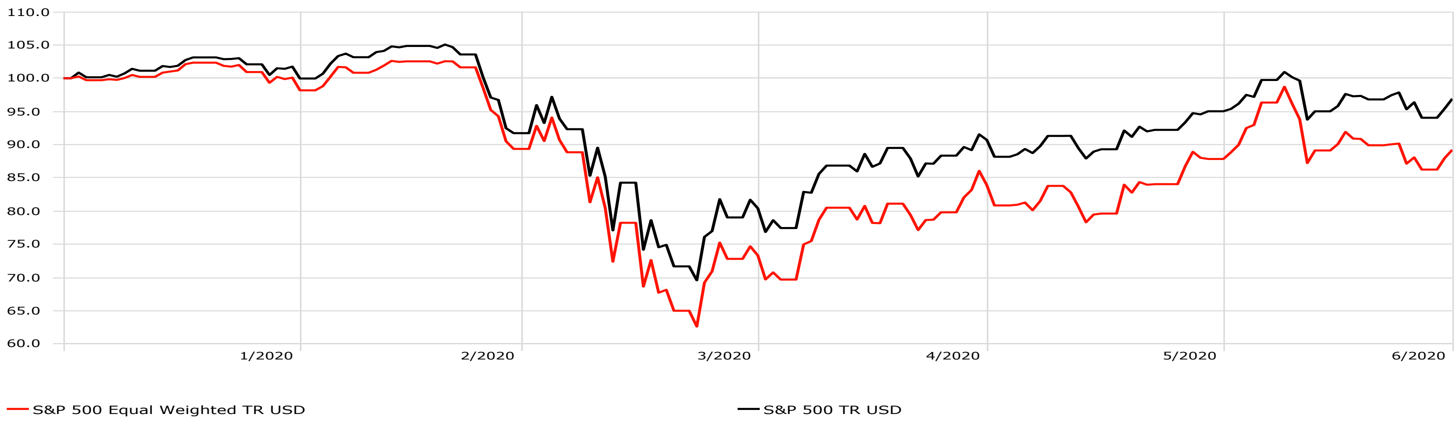
And just like that that, the market doesn't care about Covid-19. The fear of the unknown virus in the first quarter that caused the historic 36% drop in the S&P 500 at a record pace, was followed by the fear of missing out rally in the second quarter that matched the velocity of the down move but in the opposite direction. The initial stay-at-home / healthcare stock rally bled into other sectors and markets have moved sharply up.   The economy, while showing some signs of stabilizing, is still a big unknown going forward as the government debates even more stimulus to keep it from imploding. As the number of cases goes up, so does the market, leaving market analysts regretting their calls for a test of the bottoms.

The disconnect between the stock markets movement and the economic troubles in employment and growth is at a level that has investment professionals scratching their heads. The price to earnings ratio of the S&P 500 is reflecting a return to normal, but at some point, company earnings will have to match these lofty levels for the fundamentals to make sense. As companies remove all future guidance, markets have given companies a pass on any shortfalls caused by the virus shutdowns and reflect an expectation that all things will be back to normal over the next 12 months. So, while the fundamentals seem disconnected, the momentum of the stock market cannot be ignored.

Another growing issue is the effect of a small number of companies on the returns of the S&P 500. The market cap weighted index is showing large gains off the bottom, but that does not represent the return of the average stock. The chart below is the return of the S&P 500 vs. the equally weighted S&P 500 and shows that the average equity has not seen the same level of returns when adjusted for market cap, which may indicate weakness in the markets and economy that isn't being reflected in the upward march of the major indices.

Investment Growth

Time Period: 1/1/2020 to 6/30/2020



Risk

Time Period: 1/1/2020 to 6/30/2020   Calculation Benchmark: S&P 500 TR USD

	Return	Std Dev	Max Drawdown
S&P 500 Equal Weighted TR USD	-10.77	60.88	-38.99
S&P 500 TR USD	-3.08	55.53	-33.79

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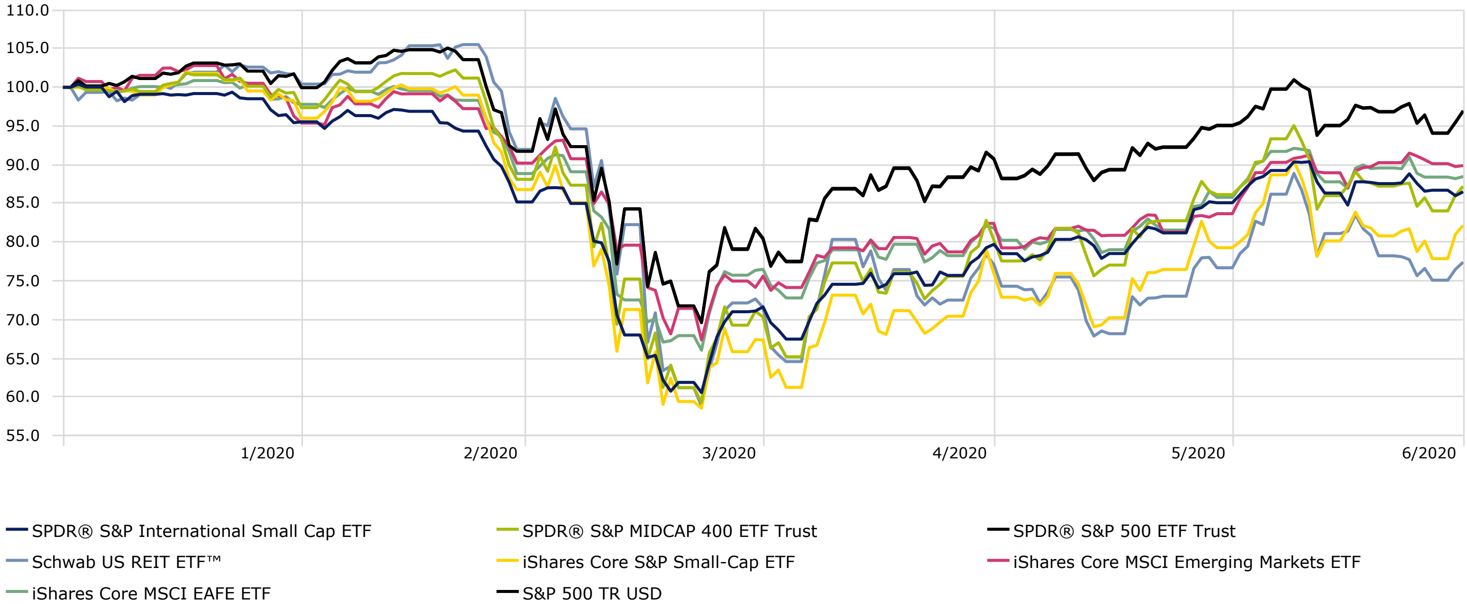
This can also be seen in the return of the S&P 500 vs. other equity classes, both domestic and international. The following chart shows the return of the S&P 500 vs. the other major asset classes used in a diversified portfolio. CHART

Investment Growth

Time Period: 1/1/2020 to 6/30/2020



Risk

Time Period: 1/1/2020 to 6/30/2020 Calculation Benchmark: S&P 500 TR USD

	Return	Std Dev	Max Drawdown
SPDR® S&P International Small Cap ETF	-13.50	37.04	-39.69
SPDR® S&P MIDCAP 400 ETF Trust	-12.80	65.51	-42.02
SPDR® S&P 500 ETF Trust	-3.02	55.37	-33.70
Schwab US REIT ETF™	-22.59	71.05	-44.25
iShares Core S&P Small-Cap ETF	-17.84	70.04	-42.61
iShares Core MSCI Emerging Markets ETF	-10.11	37.43	-34.49
iShares Core MSCI EAFE ETF	-11.52	37.23	-34.54
S&P 500 TR USD	-3.08	55.53	-33.79

Source: Morningstar Direct

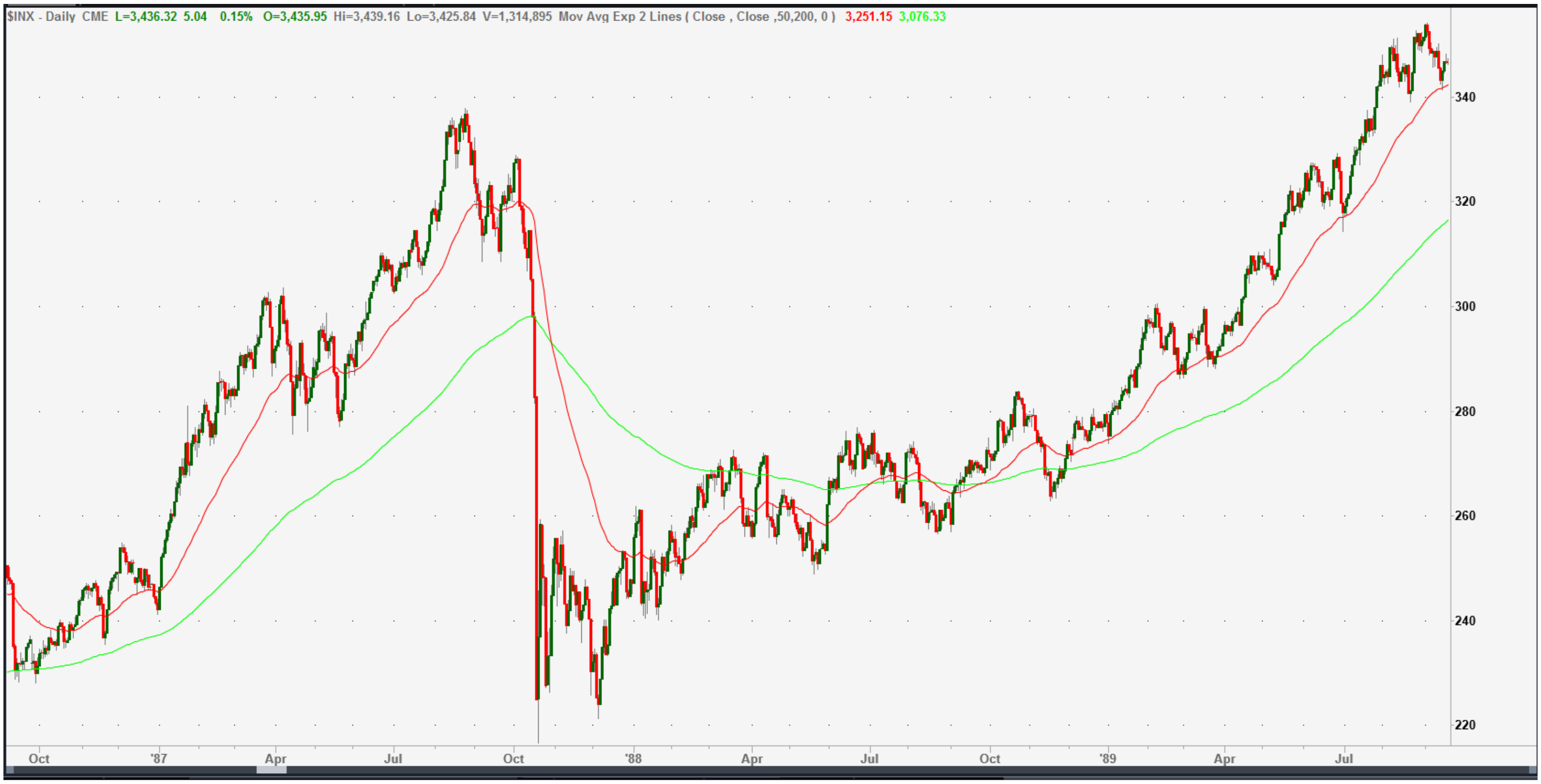
As you can see, other equity classes, whether domestic or international, do not have the benefit of the inclusion of the big tech names and therefore are not seeing the same level of bounce back. Unfortunately, this keeps advisors in the same tough spot they have been for the past few years as nightly financial newscasts continually report return numbers for stocks like Amazon and Apple that are unattainable by advisors' diversified portfolios. Doing what has long been considered 'the right thing' and keeping investors in a diversified portfolio at a risk tolerance is being outpaced by simply holding the S&P 500, and it is being trounced by investors that take the risky bet of concentrating their holdings in the FAANG stocks.

As the second quarter proceeded, trend following systems could not ignore the strength of the up move no matter how many people still feel like another shoe will drop. As the markets strengthened, our models started increasing equity exposure and finished the quarter off their respective low equity targets, but still below their maximum exposure levels. If markets move back to highs, we would expect to increase the equity exposure accordingly, but it is important to note that the situation is very different then it was at the beginning of the year. Trend following systems are most at risk from sudden down moves and large pullbacks from strong markets as they were at the beginning of the year. After the price action we just experienced, the signals are much weaker and reversing and exiting the equity markets would be done with much less of a down move. One caveat as always is that the move could occur in a very short time and we would be unable to exit, as the portfolio you are holding at any time defines the risk you have that day.

While a big drop from highs and a subsequent bounce is the worst-case scenario for tactical management, a prolonged economic downturn that might get a kickstart from the shutdowns is more likely a scenario that would act in our favor. This uncertainty and elevated risk are reasons tactical should be included in a diversified portfolio. As we march toward highs, eventually you must reenter the markets, thus having a mathematical process to exit is of heightened importance. We are not trying to time short term market movement but are attempting to avoid the longer and larger market pullbacks that we have seen in the last 20 years. Tactical is not meant to be a standalone portfolio but works as a part of a diversified group. Just as adding various equity and fixed income classes will see certain classes outperform others, so too will different management styles. The object is not to bet everything on which class or style will be the best, but to make purposeful decisions on how to allocate amongst them to provide a reasonable return and control the level of risk. A decision is made in advance that some portion of the equity exposure will get out and some portion will stay in. Money will be allocated to fixed income as well as various equity classes This is done knowing that there will be times that getting out will be very effective and times that it will not. It is done knowing that stocks can outperform bonds, or the reverse might be true.

Our risk tolerance based model allocations with a portion of the equity exposure being tactical have been able to provide returns that were very similar to a buy and hold basket at the same risk tolerance from our inception in 2012 until February of 2020. This even as each tactical risk-off move was reentered at a higher price. We also created a tactical model that allowed the amount of diversified tactical to be customized to an individual's needs. There are both favorable and unfavorable price actions for all classes and styles and extra care needs to be taken in the creation of the portfolio without knowing what the future brings. We caution against loading up on what has been in favor recently as concentrating everything into one stock, class, or style only looks like the right thing to do when the bet pays off. It can be disastrous when it doesn't.

One thing that we can do is look at the new information we get from price action and adjust the way we manage our models going forward. The sell off and bounce are a type of unprecedented price action that we do not see looking back at historical data of major asset classes. It is sometimes seen when looking at individual equities as shockingly bad news could be misunderstood and a huge sell off can reverse with the stock moving back to its previous place. In asset classes, we can see large and fast sell offs like the one experienced in 87, but that chart below shows the rebound was much slower, taking about two years to reach old highs. We also note the 2000 and 2008 sell offs took much longer to reach their bottoms, giving trend following systems time to react, and took years to regain old highs making trend following an extremely productive management style during that 20-year stretch.



Over the last few months, we looked at this new price action and made some decisions on how we could adjust our methodology to address new information. This is not done lightly and is an extremely difficult balancing act between getting out earlier in sell offs and getting wiggled more often. Looking at the S&P 500 index sell off in 2000 shows that investing only in SPY has the potential for a 50% sell off 2 times and an almost 13 year drought for the index to go back to highs. This just happened. It isn't ancient history. We also see a 1987 crash that occurred so quickly, trend following models would have all gotten stuck long and suffered losses. We looked at both of these scenarios and decided some portion of the core equity portfolio should be reduced knowing that we would lose ground to a buy and hold portfolio in a1987 type sell off, but come out vastly ahead in price action similar to 2000 or 2008 .

Realizing these possibilities was also a reason we decided to keep the portfolio diversified and use a risk tolerance-based baseline. This leaves open the possibility that different equity classes could see individual bear markets while others could still be positive, which hasn't happened as world markets have moved together but is a possibility as certain countries and regions could see trouble while others reap the benefits.

We now see something that we haven't experienced and quite frankly is a very dangerous precedent. We had a very quick sell off which began like the 1987 crash, giving back recently acquired strong gains, followed by an equally sharp rise in the S&P 500. The reason this action is dangerous is that the 35% sell off represents a large amount of volatility that is expected to be taken without signaling a change in trend. Over the last 40 years, we had seen many 10 to 15% drawdowns followed by a bounce back with few approaching 20% without turning into life changing 50% or greater prolonged sell-offs. You never know in advance whether it is a wiggle, or a true downtrend, and we had done a good job of keeping wiggles to a minimum and returns near an equivalent buy and hold portfolio with some portion of the equity exposure being tactical. Wiggles of greater than 30% that bounce back make everything more difficult. It's easy to say 'just buy and hold because it always comes back' , but we have just seen a scenario that took 13 years to get back to highs and extending that recovery period to 20 years isn't too far of a stretch under a global recession. That is a long time for an investor with a fixed investment horizon to not see new highs in a portfolio and is disastrous if one is withdrawing money for living expenses during that period.

This means a pullback of 35% becomes the proverbial frog sitting in a pot of water that slowly boils. By the time you realize the market is going to be in serious trouble, it's too late. You are already cooked. In the last sell off, we exited near 20% and the markets continued down about another 15%. We had limited further equity losses, but that left us with little exposure to the fast rebound that no one believed in. Many investors were happy that we were out of equities through this troubling time and that is how it is designed. We always recommended having core assets in a strategic buy and hold diversified portfolio with a predetermined amount that would move to the sidelines if things got scary. For years we had been saying that looking at returns vs the diversified basket was a good way to see if we are keeping up, but it isn't really the way we are managing money. We are trying to be out when it might get ugly and never position assets riskier than the diversified portfolio. For the fourth time since our inception, we exited markets and they continued lower.

As each wiggle occurs, we know it gets harder to remain allocated to tactical, but we need to make some points clear.

1. From our inception in June of 2012 to February of 2020, our risk tolerance-based models with a portion of equities being managed tactically, we were able to provide returns very close to a comparable buy and hold portfolio at a similar risk tolerance. A comparable diversified basket IS NOT the S&P 500. Advisors everywhere have been having the same conversation with clients about returns of a diversified basket vs. the S&P 500 as the S&P 500 has outperformed all other riskier asset classes. This has nothing to do with tactical as our baseline was the diversified basket and our overweight to the S&P 500 over the period is what helped us stay in line with comparable baskets while removing equity exposure in 2015, 2016 and 2018. Each of those exits saw that market move lower with us in a reduced equity position which could have gotten worse but instead bounced back. Each time we got wiggled and entered the markets higher, but over the entire period, we kept up to a portfolio that didn't get out at all.

2. 2020 has now shown us something different. It expanded the amount of leeway needed before a turnaround in trend is identified and that makes investing in equities a riskier proposition all around. This, at a time when interest rates are so low that some are recommending equities as a reasonable substitution for low yielding fixed income products. I have seen pundits saying managing equities tactically is a good substitute for fixed income since you can reduce risk. We welcome him to the arena, but we all know it isn't that simple.

3. We created the tactical model so that individuals could use as much or as little tactical exposure as they and their advisors felt needed. Our models have a set amount of equities moving, but we gave advisors the tools to customize based on need. Obviously after a large wiggle like we just experienced, it's easy to think you need less but you never know what the next market turmoil will bring. It could be a 1987 or a 2020 which are not ideal, or it could be like 2000 or 2008 which are. Of course, It could also be something completely different. When this all settles down, people may rethink their exposure to tactical, but looking at 2020s experience and pretending 2000 and 2008 didn't happen is giving too much credence to recent past and not looking at other equally probable scenarios.

From our standpoint, we did extensive research into a way to keep the potential benefit in a 2000 or 2008 scenario but perform better during market wiggles. We needed to keep to our basic tenets of diversification and systematic portfolio creation. We also needed to balance the increased potential for wiggles caused by getting out faster vs. the benefit of taking less downside before an exit. The first potential upgrade to the system would be a signal to re-enter the markets earlier than just waiting for the long term trend to reverse from negative to positive. The use of an 18 month to 3 year trend indicator may not be as efficient in re-entering, and we studied shorter term signals to identify a new potential uptrend. This allows us to partially 'step into' equities earlier, and then move back to full exposure once the uptrend is confirmed by our existing signal.

This of course is a balancing act as there is never a free lunch in the markets. The downside of this would be stepping into equities in a 2000/2008 type sell off. After each successive small up-move, an entry into equities markets would need to be reversed as the downtrend continued with small losses as each buy is made into the downtrend. When looking back, we needed to find a way to get earlier equity exposure in the wiggles in an uptrend without it costing us the downside protection we also need in the downtrend. What we have seen is that the slightly worse performance in the downtrend markets is outpaced by the gains we see when entering markets earlier in the wiggles. This makes sense because there are more periods of time when the market is up trending and increased equity exposure is a benefit, versus times when the trend is negative, and the increased exposure is a negative.

Another thing we looked very hard at is accounting for the speed of a down move regardless of the status of the overall trend. No matter the trend direction, a significant move in the opposite direction could be a signal that the trend will soon turn and waiting for the signal would just cause more damage. This is much tougher than entering earlier as increasing the amount of theexit trades and their potential wiggles becomes a factor. We did this while erring on the side of caution and making incremental moves that would not contradict our existing system. The net effect is a quicker partial exit if the downturn is extreme relative to the current trend.

By looking at the mathematics in detail, we could determine a quantifiable difference in the 1987 and 2020 time periods. Adding this was considered in the past and while it would have performed well in 2020, it would neither have been beneficial nor detrimental in 1987 and thus was never implemented. We are always looking for a mathematical way to limit the risks that exist and the fast drop from a high is the biggest one in trend following systems. A simplified way to think about this would be to acknowledge that if it drops over-night, there is nothing you can do, but if it falls quickly over a few days, it will give us a chance.

The third thing we looked at was to add some more risk-taking behavior that was still in line with our current methodology. We did this by looking at splitting the S&P 500 into its component sectors. Instead of just holding SPY for large cap equity exposure, we looked into using the ETF representing each sector in a tactical rotation that could overweight stronger sectors while underweighting weaker ones holding equity exposure the same. This model will also be made available as a separate account and will give investors a way to take advantage of strong sectors like technology while underweighting weaker sectors like financials or energy. That model is only tactical in the rotation of the sectors and always remains fully invested in equities. In our current risk tolerance-based models, the amount of large cap exposure is determined first in the efficient frontier calculations, and then the SPY holding is adjusted into the component sectors ETFs. We believe this will add value over just holding SPY but will remain very close to the return of the index.

This model is purposely designed to track closely to the S&P 500 with a slight tactical bend to add value. It should never be dramatically different than the index as the methodology only allows for small to medium deviations and is always holding only components of the index.

Overall, we think these changes will strengthen our portfolios and lead to better risk adjusted returns for our investors. The portfolios will continue to pair with a buy and hold basket to keep risk at a predetermined level and act as a buffer during certain types of market sell-offs. Portfolios are created before knowing the

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outcome, so it is best to employ components that react differently in various market environments. For almost eight years, we were able to use our tactical management combined with a buy and hold component to control risk and give returns much like a portfolio that only remained invested. While the numbers after the current quarter will be lower then if we had just stayed in, there is a value that must be seen beyond the return numbers. At a time that looked as if the world as we knew it was coming to an end, a portion of your portfolios was taken off the table to protect from the potential disaster that was being touted by some of the brightest minds in the financial industry. The reduced equity exposure would give a buffer if those predictions had come true and provided comfort at a very uncomfortable time. Many of our investors still don't want to be in as we start increasing equity exposure but as the future is always uncertain, we will rely on the system going forward to take the emotion out of the decision.

Thank you,
The Premise Team