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3rd Quarter 2020 Market Commentary

Premise Investors,

There is a benefit to tactical management that can't be seen when looking at returns at the end of the year or only looking at a wiggle that goes the wrong way. Considering a few wiggles, the fact that we were able to keep diversified baskets near the comparable risk tolerance basket since 2012 is a function of tethering the max portfolio to the same diversified basket and making a limited set of decisions to only remove risk at a predetermined level.

It is nice to be able to look at it in terms of return, but it is not really a comparison that answered the question "who did better?" because they were being managed for completely different reasons. The benefit is that we had removed risk at times when the market looked like something might start to get out of hand. While each time the market bounced back and we got back in higher (wiggled), the market was down substantially more AFTER our exit, giving a sense of security that the predetermined portion of equity exposure was no longer taking that risk.

- Not all market selloffs are equal. A trend following tactical system can provide a benefit in a prolonged selloff but performs poorly in a fast drop from a high and subsequent rally. There is no free lunch. Using a tactical system to help in one case doesn't mean it will work in all cases.

- There is value beyond the numbers as not being fully invested in down moves can give peace of mind and prevent impulsive actions when markets are the scariest.

- Talking with clients how all these parts interchange with each other and setting up a disciplined system beforehand is the best way to handle market volatility.

- While having a tactical slice can help with prolonged drawdowns, without derivatives event driven risk requires an adjustment to the equity fixed income ratio of the portfolio (a lower overall risk tolerance). This of course will lower returns in up markets. A possible solution would be to identify another slice of equity that you might remove during these periods (like before the election).

- But always make decisions beforehand and follow a process. Never in the heat of the of the panic!!

We have a group of people that sold out before the election or have been on trade hold during the rally without getting back into the equity markets. As the market shoots up after the election, all these investors have essentially been "wiggled". At some point in the future they will re-enter the markets but the longer they wait, the harder it will be if the market continues up to new highs.

So, while looking at this move through time, these customers will be trailing a basket that would have just stayed in. They essentially just tactically managed their own accounts. My main point is that even if they get back in higher, they actually received a benefit from not being in. The benefit is that they were not in when things looked like they could have gotten ugly.

At the end of the year, no one that exited the market due to the election should look back at the end of the year and feel like they made a mistake. They may be behind their "benchmark", but they also were not exposed to the markets at a point in time that volatility was increasing and event driven risk was at a high point. It's nice to look back at "what they would have made" if they didn't get out, but that completely ignores the reduction of risk at a time when risk was high. Essentially, you are comparing two different investment strategies that have a completely different purpose. They are similar when they are both in because the portfolios at the "in" time are the same, but they are completely different in terms of style and purpose.

This is why we created the Diversified Tactical portfolios. We acknowledge that there is a place for buy and hold as well as tactical, and this tool gives the ability to customize the amount that is appropriate for each investor. The only difference is that while the clients decided based on a feeling, we have looked back at the history of market movement, identified times when a large prolonged drop may occur., and implemented an objective, disciplined process to react. During this up move, we have been invested as the price action was not signaling a second drop, so by definition, we would have outperformed someone that exited or never got back in after the lows. So even though staying in the Diversified Tactical portfolios beat someone that got out, it doesn't mean getting out was not the right decision for some investors. It just comes down to the desire to try and make money by taking risk vs. the desire to say "I'm going to just sit this out for a while. I don't care if it goes back up and I miss out on some gains. I don't want to take the risk at this point."

If you took the risk-aversion position, then looking back after the fact and identifying the decision that was the 'winner' does not consider the "benefit" of not having to sit through the tumultuous period at all. It only looks like the right decision because you have the benefit of knowing the outcome.

I wrote this because I believe having a piece of Diversified Tactical combined with a buy and hold portfolio is the right thing to do. It takes a predetermined amount of equity exposure and removes it when there is a possibility of a substantial drop. We always knew that as a trend following system, we would take a large drop if it happens very quickly as it did earlier this year. We exited when the market was down 20% and it continued down to 36%. If the early projections for deaths would have come even close to true, the economy and the market would be a mess. The amount that was in Premise, or tactical in any of the models, had attempted to put the floor under that drop. We also allowed the investor to have money "out" as the market began marching upward. That amount was predetermined and removed. Looking back now on the market behavior earlier this year completely undervalues the benefit to the portfolio in the same way looking at removing the exposure over the election does.

If moving 20-30% of your investments to cash when the market was down 20% prevents a panic sell of everything when the market is down 35%, then there is an incalculable value in having a piece managed tactically.

Despite EVERYONE calling for a total market meltdown, there was an unbelievable rally from the lows, without ever revisiting those lows! For the most risk tolerant investors, with very long time horizons, perhaps stomaching 100% invested portfolios in this environment is tolerable. But for most (even slightly) risk-adverse clients, having 20-30% of your money on the sidelines as the unbelievable rally ensued, provided a huge value to the client, even if it trails a portfolio not getting out at all.

Making these decisions beforehand about an amount to move in and out is part of creating the right portfolio for the client. Looking at the return afterwards is only one way to judge the strategy. You don't remove a class from a diversified basket because it doesn't perform as well as another, i.e. international equities v domestic large cap. The same goes with style. Customers that sold everything may have a different view of tactical now.

As customers consider when to get back in, it would be good to have that conversation. Diversified Tactical will do what it is supposed to do if there is a prolonged down move in the markets. The buy and hold will stay in no matter what. The customers pain tolerance should be identified in advance if there is reason to believe they may panic and sell everything. Making all these decisions upfront is what is important. They all have a place.

Additionally, 'Buy and hold' must have an equity fixed income ratio that the customer is comfortable with no matter what happens. They are meant to hold on because over time, bounces will occur, and that style will prevail. We have always said most money should be in a strategic portfolio. Any customers that didn't get back in or sold before the election need to reassess their risk tolerances.

Tactical provides some portion of equity exposure to move in and out. We have always said it is extremely beneficial in times like 2000 and 2008 but not very good in 1987 and now 2020. We now have two periods where the initial drop signaled a longer term sell off, and two that bounced back quickly. (2020 faster than 1987).

When looking at actions, it seems that some investors have expressed a desire to have a third section of the allocation carved out. It is an 'anticipation' slice that states "I don't like the potential event risk coming up and I want to sell". This is the toughest spot of all because it leaves you open to emotional decision making without any reason to reverse the decision. The strong uptrend after the election will leave people in the same position as the people that never got back in after 2008.

As stated earlier, having Diversified Tactical can help alleviate the panic, but it is the job of the advisor to lay out this plan before hand to not fall to emotional decision making. If an investor will get out, then the 'buy and hold' portfolio needs to be adjusted for that purpose. You can hold less equities or identify an amount that you will sell, which creates the third slice. If you make it clear at the beginning, then they will still have a basic core allocation that will stay invested.

That's what we are trying to do with Diversified Tactical. Have an amount predetermined that will exit when the next prolonged sell off occurs. Knowing that it will react poorly in a fast moving sell off as we just went through doesn't mean a prolonged. yearlong pullback won't occur.

If you identify each piece, then you won't have to explain why the investor needs to hold on to some equities when they want to sell. In practice you could simply hold a growth basket with Diversified Tactical. Let this piece do the job it is supposed to do but change the 'buy and hold' from growth to moderate. Knowing that Diversified Tactical would eventually get out again might have been a way to keep people in the market instead of selling out of everything.

Building a portfolio with some Diversified Tactical along the 'buy and hold' model might be a way to get clients to go back in as well.

Additionally, we discussed in our second quarter commentary the modifications to our Diversified Tactical portfolios. Please visit http://www.premisecapital.com/files/2020_Quarterly_Summary_Q2.pdf for the full commentary. Here are the highlights regarding the modifications:

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We did extensive research into a way to keep the potential benefit of tactical management in a 2000 or 2008 scenario but also 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 upgrade to the system is 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.

- In addition to re-entering the markets earlier, we also took a mathematical approach to limit the risks that exist, specifically the fast drop from a market high, which is the biggest risk in trend following systems. The net effect is a quicker partial exit if the downturn is extreme relative to the current trend.

- The third thing we looked at was to add some more risk-taking behavior that was still in line with our current methodology. Rather than own the entire S&P500, we now can split the index into its 11 component sectors. Instead of just holding SPY for large cap equity exposure, we now use the ETF representing each sector in a tactical rotation. This modification could overweight stronger sectors while underweighting weaker ones holding equity exposure the same. (Think overweighting technology while underweighting energy, for example.)

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 outcome, so we believe it is best to employ components that react differently in various market environments.

As always, thank you for investing
with Premise Capital.

- The Premise Capital Team