2019 Year End: Why Hindsight Should Not Be Your 2020

Hindsight should never be the reason for adjusting an investment portfolio. Period. Positive or negative performance of the past has come and gone; it cannot be changed. Even more importantly, recent past performance, either positive or negative, does not provide any guidance regarding outcomes in the future. Simply recalling the state of the markets a year ago at the end of 2018, when the S&P 500 had just experienced almost a 20% loss in a single quarter, reinforces the unpredictability of future returns after any period. Seems simple, right? Yet for most investors, resisting the temptation to chase yesterday’s returns after the rally or to sell out after the market sell-off is much easier said than done. Psychology takes over, and changes are consistently made, often at the least optimal times.

Surprising many, equities and bonds both rallied in 2019. Contrary to the pessimistic sentiment at the beginning of the year following losses suffered in the 4th quarter of 2018, the S&P 500 Index, one of the most popular gauges of U.S. large cap stocks, returned 31.48%. This was fueled by optimism surrounding the prospects of a US-China trade deal. Meanwhile, U.S. fixed-income also surprised most investors as they were convinced that yields would go higher in 2019. Instead, the U.S. 10-Year Treasury yield fell 77 basis points from 2.69% on 12/31/18 to 1.92% on 12/31/19. As a result, the Barclays U.S. Aggregate Bond Index, a popular gauge of U.S. investment grade bonds rose 8.72%.

At first glance, those performance numbers appear very strong. However, whether or not equities were really that strong, is a matter of perspective (and time frame). Most investors didn’t buy on exactly 12/31/18. Investors invested from different periods can have different experiences. From the previous S&P 500 Index peak of October 3, 2018 to the end of 2019, the Index was up 13.24%. This could be a more realistic gauge of S&P 500 performance given that a lot of the 2019 rally was just recouping losses at the tail end of 2018. In this same time frame, U.S. investment grade bonds were outperforming U.S. large cap equities for most of the period until later in December (as illustrated in the chart below).

Matter of Perspective: Slow and Steady Can Win a Race

![Chart showing performance of Barclays U.S. Aggregate Bond Index and MSCI ACWI ex US Index](chart.png)

Sources: Bloomberg, Redwood. Dates from 10/3/18 – 12/31/19. For illustration purposes only. An investor can not invest directly in an index.

Large Risk = Large Return = Large Risk?

The S&P 500 Index has continuously hit new records, perhaps inviting investors to be more optimistic about taking on more risk, while ignoring other factors. For one, the market has been rallying for 11 years -- the longest expansion and bull market in history -- virtually quadrupling off the lows of March 2009. Granted, the S&P 500 Index almost hit a technical bear market (peak to trough drawdown of 20% or more) in 2018, being down -19.78%, one of the largest drawdowns in 7 years. Even if the market can continue to go higher (overpriced securities can certainly

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become more overpriced), there are mounting risks that threaten portfolios of investors without a risk management discipline going forward. Our 2019 Q3 commentary showed how drastically different an investor’s experience can be with and without active tactical risk management.

Yes, The Rally Was Still Not Quite Enough For The Risk

In addition, the S&P 500 Index is becoming less diversified. In fact, the index gauge was so concentrated as of the end of 2019, that only the top five companies of the S&P 500 Index made up almost 18% of the total market capitalization of the entire index. This is out of five hundred of the largest U.S. companies! This is the most concentrated the S&P 500 Index has been since 1999. Meanwhile, the overall profitability of these five companies as a percent of net income of the Index, has decreased from 2018.

Party Like It’s 1999?

Top Five Companies in S&P 500 Index Hold Highest Share Of Total Market Cap

Sources: Bloomberg, Redwood. For illustration purposes only. An investor can not invest directly in an index.
This is not to say that the rest of the market didn’t rally with the top 5 in a systematic positive trend. Actually, almost 85% of the S&P 500 Index’s members closed above their 200-day moving average by the end of 2019. However, positive momentum may be at risk of stalling out. The gauge of market breadth is at its highest level since early 2018. This type of cyclical peak in momentum, as indicated in the chart below by previous similar peaks in 2018, 2017 and 2016, has historically been followed by heightened volatility.

**Can Equities Keep The Momentum?**

![Chart showing market breadth at its highest level since early 2018, with previous similar peaks in 2018, 2017, and 2016 indicating historical follow-up by heightened volatility.]

Compounding the need for caution is the fact that investors overall have been exiting equity fund vehicles. Almost $200 billion left equity mutual funds and ETFs (exchange-traded funds), despite the market rally in 2019. This is a strange phenomenon given supply and demand typically dictates prices rise with fund inflows, and fall with fund outflows. So if all the flows are going out, how can prices be rising? Perhaps investors are leaving diversified equity funds to favor individual stocks, such as mega-cap technology names, and in turn, causing the index to become more concentrated as shown above.

**Where’s The Real Demand? Equity Funds Experience Outflows**

![Chart showing 12-month cumulative equity fund flows and S&P 500 index, with equity prices having been rising despite equity funds experiencing outflows overall.]

Sources: Bloomberg, Redwood. For illustration purposes only. An investor can not invest directly in an index.

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Despite all of these heightened risk factors, this liquidity driven rally could continue. Bullish investors may argue that fund outflows signify that there may still be more money on the sidelines to purchase back into equities. Afterall, 2019 had some positive developments regarding trade, and economic data has been steady. In addition, despite a strong year, the most recent decade was only the 4th best of the 7 decades since the end of World War II. However, as the chart below indicates, decades with strong annualized returns have also been followed by the subsequent 10 years having more muted returns. For example, following the strong returns of the S&P 500 during the decade of the 1990’s, the decade of 2000-2010 produced a negative annualized return. This means that even risk seeking investors, willing to endure large drawdowns can lose money after holding for 10 years.

**Silver Lining? One Decade Equity Rally Only 4th Fastest – But More Corrections Can Be Coming**

<table>
<thead>
<tr>
<th>Decade</th>
<th>Annual Return</th>
<th>Annual Return (Including Dividends)</th>
<th>Number of Corrections (Drop 10% or More)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950s</td>
<td>13.60%</td>
<td>19.30%</td>
<td>6</td>
</tr>
<tr>
<td>1960s</td>
<td>4.40%</td>
<td>7.80%</td>
<td>5</td>
</tr>
<tr>
<td>1970s</td>
<td>1.60%</td>
<td>5.90%</td>
<td>7</td>
</tr>
<tr>
<td>1980s</td>
<td>12.60%</td>
<td>17.50%</td>
<td>9</td>
</tr>
<tr>
<td>1990s</td>
<td>15.30%</td>
<td>18.20%</td>
<td>5</td>
</tr>
<tr>
<td>2000s</td>
<td>-2.70%</td>
<td>-0.90%</td>
<td>11</td>
</tr>
<tr>
<td>2010s</td>
<td>11.20%</td>
<td>13.50%</td>
<td>6</td>
</tr>
</tbody>
</table>

Sources: Bloomberg, Redwood. Equities represented by S&P 500 Index. For illustration purposes only. An investor cannot invest directly in an index.

**Are Bonds Suggesting More Risk Ahead?**

Further supporting the thesis that the market could potentially continue to go higher is that the Federal Reserve has been relatively supportive. The Fed lowered benchmark interest rates and kept them steady toward the end of the year despite economic data showing a continued expansion. This is in contrast with the last two secular rate drops where the Federal Reserve responded to an adverse economic environment, where the U.S. ended in a recession. Historically, the Fed has lowered rates when the U.S. 10-Year Treasury Yield and the Fed Funds Rate converged, a trend that has been consistent through the last decisions. The last time the Fed lowered rates during an expansion was in the mid to late 90’s, where the market subsequently rallied.

**Is The Fed Just Following Their Own Historical Trends?**

Sources: Bloomberg, Redwood. For illustration purposes only. An investor cannot invest directly in an index.
Corporate bonds however, may be painting a different picture. Corporate bonds are typically traded by more institutions than retail investors, leading Wall Street to often refer to the corporate credit market as the “smart money.” Not surprisingly, when it comes to debt instruments, investors need to calculate the risk of a company not being able to pay the interest and principal of its debt. Overall ratings by Moody’s dropped in 2019. Over the past decade, corporate bonds rated BBB, which are the lowest rated in the investment grade category and just one step away from becoming “junk” bonds, have been climbing steadily as a percentage of the investment grade corporate bond universe. BBB credits now make up almost 50% of all investment grade corporate debt. This is an indication of greater risk in the investment grade corporate bond universe.

### Investment Grade Ratings Concentrated on Lower End (BBB)

![Graph showing BBB as % of Investment Grade over time](image1)

Over the past decade, debt rated BBB (lowest rated investment grade) has gone to record proportion vs. the broader investment grade corporate universe.

Sources: Bloomberg, Redwood. For illustration purposes only. An investor cannot invest directly in an index.

The high-yield corporate bond (junk bond) yields are close to their historic lows, showing that investors are currently demanding a smaller and smaller premium for holding riskier assets, perhaps a sign of complacency. The Barclays High-Yield Corporate Bond Index Yield-To-Worst dropped to its lowest level since 2014. Yields historically have not held near these lows for long periods of time – and when yields are rising, that means prices are falling.

### High-Yield Corporate Bond Yields Close To Historic Lows

![Graph showing Barclays High-Yield Corporate Bond Index Yield-To-Worst](image2)

Barclays High-Yield Corporate Bond Index Yield-To-Worst

High-yield corporate bond yields are close to the low set in 2014.

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Portfolio Recap

We approach portfolios grounded by the simple fact that no one can predict the future, and that no one can control performance. Therefore, we must focus on what we can control, which is process and risk management. Our portfolios are designed to be dynamic, driven by our disciplined, research guided, systematic approach that seeks to reduce discretionary biases. This dynamic approach seeks to take exposure in different asset classes during “risk-on” environments and remove exposure to reduce overall drawdown during “risk-off” environments. Our portfolios have not made any changes in the last quarter of 2019 and have been fully invested in risk assets, capturing the majority of market beta during the 4th quarter of 2019.

As of 12/31/19, our portfolios are still fully invested, and should the market continue to move higher, the portfolios are positioned to capture upside in the respective invested asset classes. However, we do not attempt to predict market movements. If markets stall and begin to pose higher risk of incurring larger drawdowns, we would expect our tactical risk-managed strategies to become defensive, similar to the end of 2018.

Conclusion:

If hindsight is not important, why analyze data in the marketplace at all? The reason is to manage risk of the portfolio. And that means real risk – which to us is measured by drawdowns. It isn’t the risk of missing out. Historical data helps put the variability of the market into proper context, which helps the investor stay within their risk objectives so they don’t capitulate and sell when investment losses are “too much” for them to handle. Consider the following: From data going back to 1928, following a calendar year where the S&P 500 Index returned over 20%, the average return in the next calendar year was a respectable 10.54%. But when viewing the distribution of those calendar years, there were actually a lot of years that were negative.

S&P 500 Index Total Returns in Years after 20% Plus Gains

<table>
<thead>
<tr>
<th>Average Gains</th>
<th>Number of Occurrences</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year of 20%+ Return</td>
<td>Following Year</td>
</tr>
<tr>
<td>30.44%</td>
<td>11</td>
</tr>
<tr>
<td>10.54%</td>
<td>3</td>
</tr>
<tr>
<td>&lt; 0%</td>
<td>0% - 10%</td>
</tr>
<tr>
<td>0% - 10%</td>
<td>10% - 20%</td>
</tr>
<tr>
<td>10% - 20%</td>
<td>20% - 30%</td>
</tr>
<tr>
<td>20% - 30%</td>
<td>&gt; 30%</td>
</tr>
<tr>
<td>9</td>
<td>7</td>
</tr>
<tr>
<td>4</td>
<td></td>
</tr>
</tbody>
</table>

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Fortunately, we utilize a disciplined, quantitative, RiskFirst® approach, that focuses specifically on isolating and reducing downside risk. This means combining different investment styles such as: low cost beta, smart beta, and active alpha strategies (tactical risk-management) that are dynamically managed with the sole focus on drawdown risk. All things equal, markets should rise…eventually. However, we have to be prepared for whatever bumpy road may lie ahead.

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Why do so many investors achieve results that are non-satisfactory? Often, investors may react irrationally toward what they perceive as a negative, rather than a positive, which can be counterproductive to their original investment goal. For example, if investors held risk assets for the duration of 2019 and enjoyed what they believe are satisfactory returns, they're likely to continue holding until prices fall below their risk tolerance. However, if an investor felt like they missed out, they're more likely to change their position, due to negative stimulus, into something that has already performed well. Investing by hindsight is not an investment strategy - having a disciplined investment process is.

At Redwood, we believe that any investment strategy that has a goal of protecting against significant loss of principal must have a mechanism that seeks to sidestep unfavorable investment environments.
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Definitions and Indices

S&P 500 Index is a stock market index based on the market capitalization of 500 leading companies publicly traded in the U.S. Stock market, as determined by Standard & Poor’s. Large Cap refers to a company with a market capitalization value of more than $5 billion. Large cap is a shortened version of the term “large market capitalization.” Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share. Fixed-Income (bonds or investment grade bonds) Assets, commonly referred to as a bond or money market security, is an investment that provides a return in the form of fixed periodic payments and the eventual return of principal at maturity. A bond price falls as its yield rises. U.S. 10-Year Treasury is a debt obligation issued by the United States government that matures in 10 years, backed by its full faith and credit. A treasury bond is a marketable, fixed-interest U.S. Government debt security with a maturity of more than 10 years. is a measure of peak to trough loss in any given period. Bloomberg Barclays Aggregate U.S. Bond Index is an index that consists of investment grade U.S. Government bonds, investment grade corporate bonds, mortgage pass-through securities, and asset-backed securities. It is often considered representative of the U.S. Investment-grade fixed rate bond market. MSCI ACWI ex USA Index is a market-capitalization-weighted index maintained by Morgan Stanley Capital International that captures large and mid cap representation across developed markets countries (excluding the US) and emerging markets countries. Bear Market is when market condition in which the prices of securities are falling, and widespread pessimism causes the negative sentiment to be self-sustaining. Investment Grade Bond is a bond with a credit rating of BBB- or higher by Standard & Poor’s or Baa3 or higher by Moody’s. It is judged by the rating agency as likely enough to meet payment obligations that banks are allowed to invest in it. Drawdown is a measure of peak to trough loss in a given period; a maximum drawdown is a measure of the maximum peak to trough percentage loss in a given period. Mega cap is a designation for any company with a market capitalization in excess of $200 billion. Fund flow is the net of all cash inflows and outflows in and out of various financial assets. Federal Reserve (Fed) is the central bank of the United States that raises or lowers interest rates. Volatility is used to describe uncertainty or risk in terms of statistical measure of dispersion (variation in prices). Federal Funds Rate is the interest rate at which depository institutions like banks lend reserve balances to other banks on an overnight basis. Defensive is a tactical strategy that may be used in response to adverse market, economic, political, or other conditions, where a portfolio may temporarily invest up to 100% of its total assets without limitation, in high-quality short-term debt securities, money market instruments and cash. High-Yield Corporate Bonds typically seek high levels of current income by investing in lower credit quality fixed income securities with varying maturities.

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