WHAT IF A RECESSION IS STILL A YEAR AWAY?

by Henry Pasts, Executive Vice President and Analyst, BTS Asset Management, Inc.

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BTS® ASSET MANAGEMENT

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Even when a recession is made to seem inevitable by news headlines, major market participants, and pundits, there is still uncertainty as to when it will officially begin.

In these periods, some investors prefer to 'wait out the storm' and remain allocated to cash and other investors prefer to participate in relative returns by buying the S&P 500 or similar market index.

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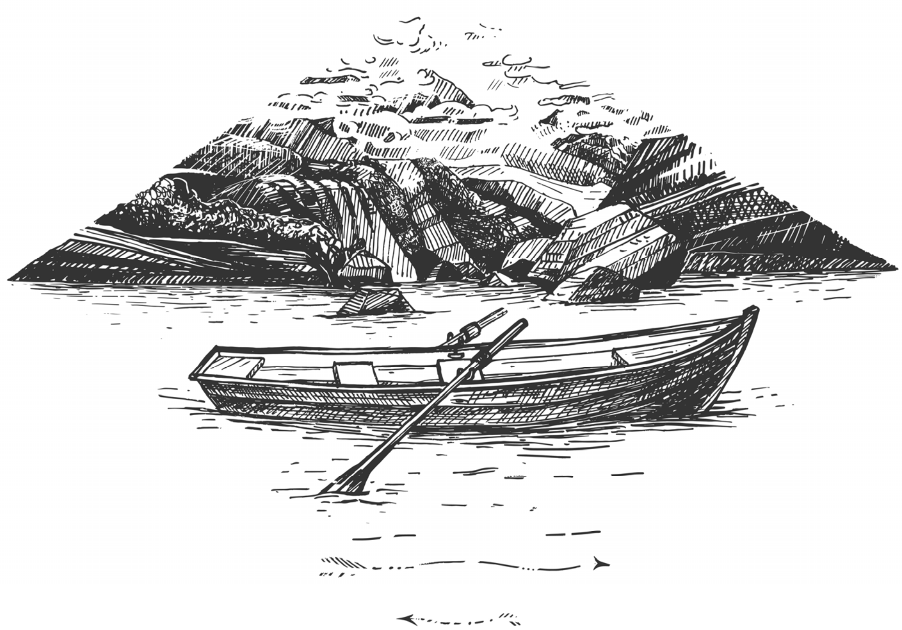
$$\textit{Internal Growth Rate (IGR)} = \frac{\textit{Return on Assets x Retention Ratio}}{\textit{1 - (Return on Assets x Retention Ratio)}}$$

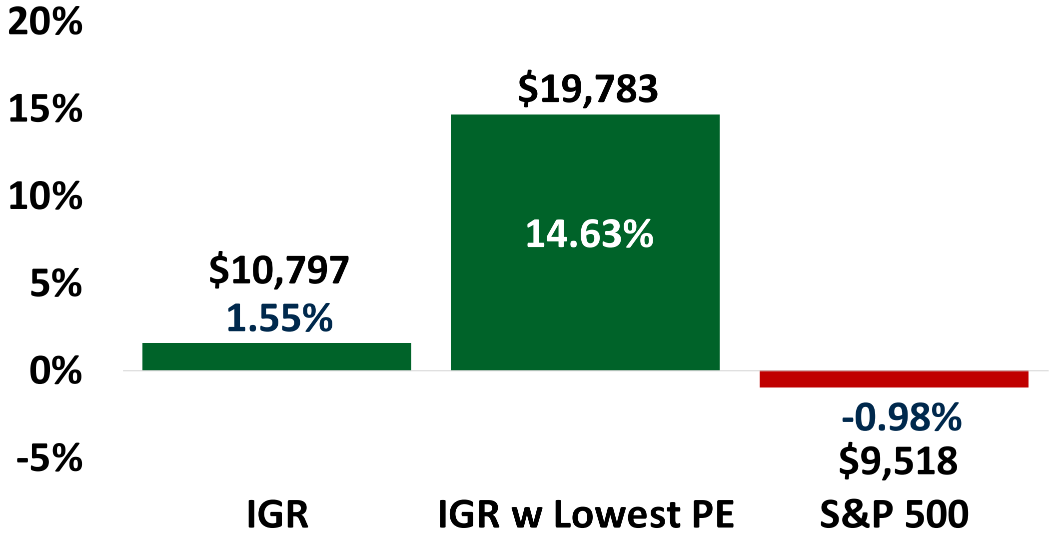
Trying to 'time' the equity market before a recession is difficult and prevents a client from participating in gains leading in and out of a recession. Buying and holding a market index product is easy but offers no ability to select specific securities with strong value propositions that are more likely to hold up in a recession and rebound strong from oversold price levels.

In case a recession is still over a year away, let's see how a strategy that selects the top quartile of stocks based on the highest IGR and a strategy that picks stocks with the highest IGR and lowest Price to Earnings Ratio does compared to the S&P 500 over a period of five years, starting one year before the official beginning of recessions since 2000.



DOT COM RECESSION PERIOD

Hypothetical Growth of $10,000 Over Five Years (Annualized Returns)
Starting one year prior to recession (03/01/2000 - 02/28/2005)



For informational purposes only. The performance shown above is not a recreation of any BTS Portfolios or products. IGR performance constitutes backtested hypothetical performance formulated by selecting the top quartile of stocks in the S&P 1500 with a market capitalization greater than 3 Billion based on Internal Growth Rate at the end of each year with data available as of 12/31 of each year and holding those securities until the end of the following year. IGR w Lowest PE performance constitutes backtested hypothetical performance formulated by selecting the top quartile of stock in the S&P 1500 with a market capitalization greater than 3 Billion based on an average ranking of highest IGR and lowest Price-to-Earnings ratios at the end of each year with data available as of 12/31 of each year and holding those securities until the end of the following year. The S&P 500 index is the benchmark for comparison. An investment cannot be made directly in an index. Internal Analysis.

Index	Sharpe Ratio
IGR	**0.06**
IGR with Lowest PE	**0.87**
S&P 500	**-0.10**

Performance shown is for discussion and illustration purposes only. An investment cannot be made directly in an index. Internal Analysis.

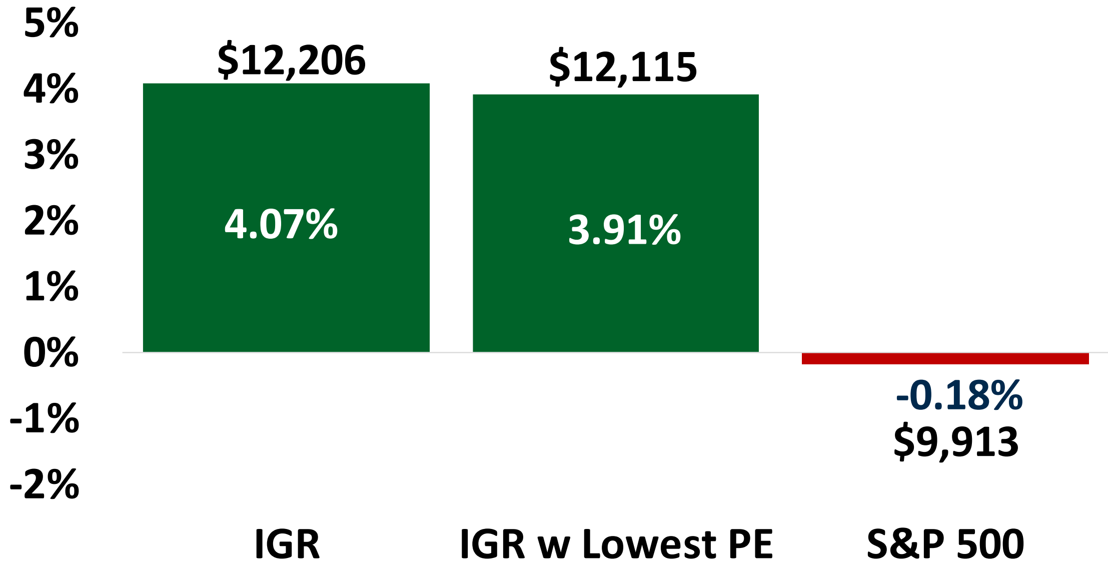
Data Source: Morningstar and Bloomberg (monthly returns)

In a recession that is highlighted by lofty valuations such as the Dot Com Recession, Fortress Equities outperform the period and those with the lowest Price-to-Earnings ratios outperform by a substantial margin because those companies have the strongest ability to grow internally with the most value in the market.

PAST OR HYPOTHETICAL PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS.

GREAT RECESSION PERIOD

Hypothetical Growth of $10,000 Over Five Years (Annualized Returns)
Starting one year prior to recession (12/01/2006 - 11/30/2011)



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Index	Sharpe Ratio
IGR	**0.28**
IGR with Lowest PE	**0.27**
S&P 500	**0.09**

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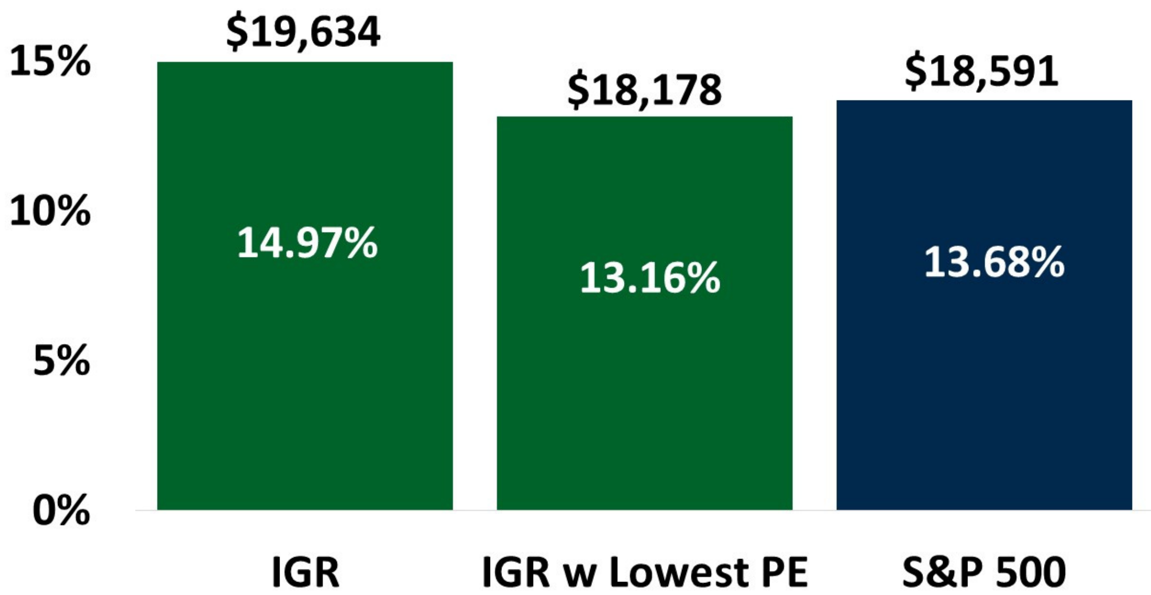
Data Source: Morningstar and Bloomberg (monthly returns)

In a traditional recession, such as the Great Recession in 2008, we would expect Fortress Equities to hold up well going into the recession and lead out of the recession due to their value propositions against other stocks. Over the period above, companies with high IGRs did exactly that and outperformed the S&P 500.

COVID-19 RECESSION PERIOD

Hypothetical Growth of $10,000 Over Four and Three Quarters Years (Annualized Returns)
Starting one year prior to recession (03/01/2019 -12/31/2023)



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Index	Sharpe Ratio
IGR	**0.72**
IGR with Lowest PE	**0.58**
S&P 500	**0.74**

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Data Source: Morningstar and Bloomberg (monthly returns)

In a shock event, such as a pandemic, we would expect Fortress Equities to hold up well in the crisis but depending on monetary conditions and the specifics of the crisis, they may or may not experience outperformance coming out of the contraction. We see this above as companies with strong IGRs basically matched the S&P 500 during the period. Growth-centric companies outperformed Fortress Equities coming out of the recession due to low costs of borrowing and the necessity of technology in the work from home culture, keeping market returns competitive.

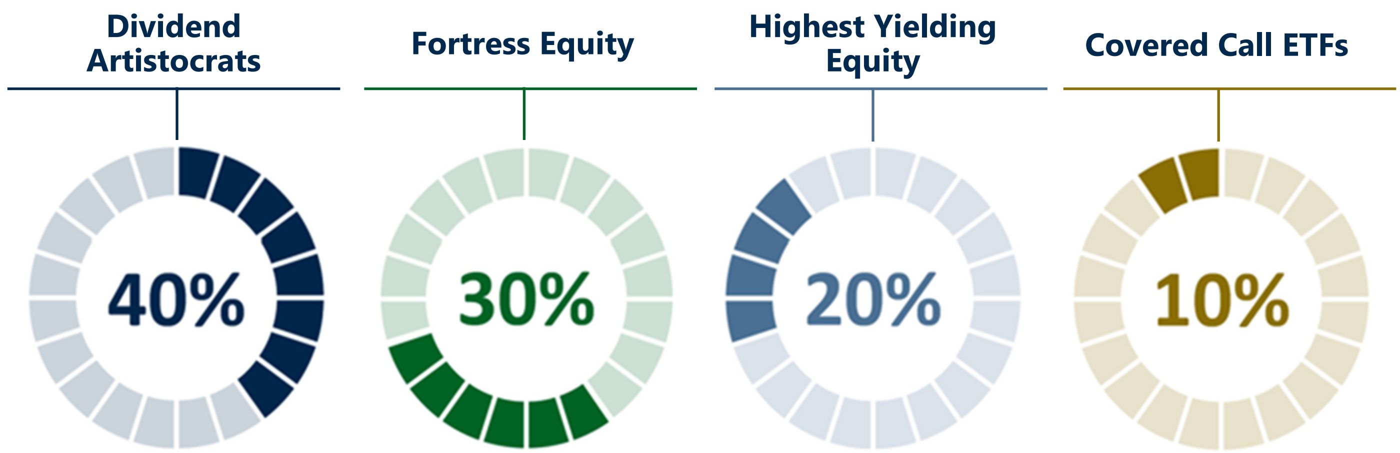
Key Takeaways

Whatever the next recession has in store for the equity markets, companies with strong Internal Growth Rates offer a value proposition in the equity markets and these securities should hold up better in severe downturns than securities without the ability to reward shareholders from internal growth. Highly leveraged companies with large amounts of debt are susceptible to economic downturns, whereas companies with strong Internal Growth Rates may be less affected by monetary conditions and have stronger balance sheets.

Combining Internal Growth Rate with other ratios, such as Price to Earnings Ratio, also shows efficacy to outperform in different types of markets. If a more traditional recession is expected, diversifying into Fortress Equities should be considered in a portfolio because they have shown a potential to outperform the market substantially.

A More Sophisticated Solution

BTS took the concept of the Fortress Equity and amplified it by adding more ratios to the analysis to further vet companies, while optimizing for less risk across the 11 GICS Sectors and comparing selections to how much they are outperforming historical trends in their respective sectors to make over and under weight decisions. In the Enhanced Equity Income Strategy, Fortress Equity consists of 30% of the Strategy.



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Past or hypothetical performance is no guarantee of future results.

Definitions

Annualized Return is the equivalent needed to obtain the same total return over the period.

Internal Growth Rate (IGR) is the highest level achievable for a business without obtaining outside financing, and a firm's maximum internal growth rate is the level of business operations that can continue to fund and grow the company.

Price To Earnings (P/E) Ratio is the ratio for valuing a company that measures its current share price relative to its earnings per share (EPS).

Internal Growth Rate w Lowest PE is the average rank of the highest IGR and the lowest PricetoEarnings data available on1 2/31 of each year. The top quartile of the average rank was used for the selections each year.

Sharpe Ratio measures risk-adjusted return, highlighting the average return earned in excess of the risk-free rate per unit of total risk. The US Treasury T-Bill Auction Average 3 Month is used as a proxy for the risk-free rate of return.

Market Capitalization refers to the total dollar market value of a company's outstanding shares of stock.

S&P 500 is an index that includes 500 leading companies in leading industries of the U.S. economy and is a proxy for the total stock market. This is the primary index used for comparison to the portfolio as we believe this portfolio should be used in the equity portion of a client's account.

S&P 1500 is an index of US stocks made by Standard & Poor's. It includes all stocks in the S&P 500, S&P 400, and S&P 600. This index covers approximately 90% of the market capitalization of U.S stocks.

The Global Industry Classification Standard (GICS) is an industry taxonomy developed in 1999 by MSCI and Standard & Poor's (S&P) for use by the global financial community. The GICS structure consists of 11 sectors, 25 industry groups, 74 industries and 163 sub-industries into which S&P has categorized all major public companies.

Dividend Aristocrats is a BTS strategy that breaks the S&P1500 into its 11 GICS Sectors and then filters all securities that have 10-15 years of increasing dividends, based on which sector it is in. These securities are then run through a proprietary securities selection algorithm that is rule-based in nature and does not change. The top security is then compared against similar historical Dividend Aristocrats in its sector and a historical outperformance is calculated. The top sector is overweighted, and the bottom 2 sectors are eliminated.

Equity Fortress is a BTS strategy that breaks the S&P1500 into its 11 GICS Sectors and then filters the top 5-10 securities in each sector based on a proprietary Equity Fortress Model that considers how well the security can finance internal revenue and asset growth without taking on excess debt. These securities are then run through a proprietary securities selection algorithm that is rule-based in nature and does not change. The top security is then compared against similar historical Equity Fortress securities in its sector and a historical outperformance is calculated. The top sector is overweighted, and the bottom 2 sectors are eliminated.

Highest Yielding Equity is a BTS strategy that breaks the S&P1500 into its 11 GICS Sectors and then filters the top 5-10 securities in each sector based on highest dividend yield. These securities are then run through a proprietary securities selection algorithm that is rule-based in nature and does not change. The top security is then compared against similar historical DOG securities in its sector and a historical outperformance is calculated. The top sector is overweighted, and the bottom 2 sectors are eliminated.

Covered Call refers to a financial transactional in which the investor selling call options owns an equivalent amount of the underlying security. To execute this, an investor who holds a long position in an asset then writes (sells) call options on the same asset to generate an income stream. The investor's long position in the asset is the cover because it means the seller can deliver the shares if the buyer of the call option chooses to exercise.

All returns are calculated using data from Morningstar Direct and Bloomberg starting on 1/1/2000.

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