VOLUME 30 ◆ NUMBER 9

SEPTEMBER 2019

Sound Mind Investing®

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Mastering the Market Cycle

An old proverb claims, "What the wise man does in the beginning, the fool does in the end." According to Howard Marks, co-chairman of global investment firm Oaktree Capital Management, that saying summarizes much of what investors need to know about market cycles and their impact. In this excerpt from his recent book *Mastering the Market Cycle*, Marks explains that while market cycles may not repeat precisely, they have recurring and recognizable characteristics.

by Howard Marks

Our job as investors is simple: to deal with the prices of assets, assessing where they stand today and making judgments regarding how they will change in the future. Prices are affected primarily by developments in two areas: fundamentals and psychology.

- Fundamentals can largely be reduced to earnings, cash flow, and the outlook for the two. They are affected by many things, including trends in the economy, profitability and the availability of capital.
- And psychology—how investors feel about fundamentals and value them—is likewise affected by many things, particularly investors' level of optimism and attitude toward risk.

There are cycles in the elements mentioned above, and several aspects to each cycle. The themes behind the cycles' behavior—and the ways in which they interact and combine—have a repeating, understandable pattern. They all come together—and they combine with random influences—to cause the behavior of the securities market.

It's my goal to give you a feel for the cyclical ups and downs of the market. Not for the fact that it rises and falls, or how it has done so in the past, or what these movements were in reaction to. But rather the forces—and specifically the non-fundamental, non-economic forces—that cause it to go up and down, often in manic fashion.

If the market were a disciplined calculator of value based exclusively on company fundamentals, the price of a security wouldn't fluctuate much more than the issuer's current earnings and the outlook for earnings in the future. In fact, the price generally should fluctuate less than earnings, since quarter-to-quarter changes in earnings often even out in the long run and, besides, don't necessarily reflect actual changes in the company's long-term potential.

And yet security prices generally fluctuate much more than earnings. The reasons, of course, are largely psychological, emotional and non-fundamental. Thus, price changes exaggerate and overstate fundamental changes. Here's the shorthand version as to why:

- Events in the economy and in corporate profits turn increasingly positive.
- Positive events feed investor psychology. Emotion and investors' tolerance for risk rise with those positive events (or sometimes despite negative ones).

(continued on page 131)

IN THIS ISSUE

"FOR GOD HAS NOT GIVEN US THE SPIRIT OF FEAR BUT OF POWER, AND OF LOVE, AND OF A SOUND MIND."

EDITORIAL

Wait for It!

We live in a hurry-up, get-it-done-yesterday world. We eat instant oatmeal for breakfast, drop our clothes at the one-hour dry cleaner, travel to and from work in the express lane, pace in front of the microwave as we wait for dinner, and then check our Instagram feed before going to bed.

There are drive-thru lanes for restaurants, pharmacies, and banks. Several funeral homes have even experimented with drive-thru viewings for people who don't have time to park and come inside to pay their respects.

Patience, it seems, is out of fashion. And that's too bad, because there's much to be said for it.

You may have heard about the so-called "marshmallow experiment" conducted at Stanford University in the 1960s. One at a time, hundreds of four-year-olds were brought into a room where they were given their choice of treats, including marshmallows. They were told that they could have one treat right away. Or, if they could wait some unspecified amount of time while the researcher stepped away and then returned, they could have two.

Some of the children couldn't wait at all. Before the researcher was out of the room, they had eaten the treat. Most held out for an average of three minutes. But, to get the better reward, about 30%of the kids found a way to wait for what turned out to be 15 minutes.

A dozen years later, when these same kids were in high school, lead researcher Walter Mischel tracked them down. He asked their parents, teachers, and academic advisors how well these students were thinking ahead, coping with problems, and getting along with peers. He also requested their SAT scores.

What he found was amazing. The kids who could wait had fewer behavioral problems, handled stressful situations more successfully, were better able to pay attention, and found it easier to maintain friendships. As for their SAT scores, the patient ones scored an average 210 points higher than the others.

Clearly, good things really do come to those who wait.

More recently, a study of 80,000 adults in 76 countries identified patience as a key determinant of a country's prosperity. The study found that "patient individuals are more likely to save and have higher educational attainment." Armin Falk, a professor of economics at the University of Bonn and lead author of the study, said, "The more patient people are and the more they save, the more they can invest in equipment and education—and they become that much more productive and rich."

There are many financial benefits to patience. Those who save for what they want instead of impatiently buying today on credit save thousands of dollars in interest. Those who patiently invest over long periods of time stand the best chance of having enough money for their retirement.

Researchers involved in the marshmallow experiment noted that the kids who could wait used various coping strategies, such as trying not to look at the treat in front of them. Understanding that a greater reward awaited them provided motivation to be patient.

The Apostle Paul said something similar about heaven—that everyone who has placed their faith in Christ has "the firstfruits of the Spirit," meaning that the Holy Spirit enables us to glimpse our *ultimate* greater reward. And he said this taste of heaven naturally results in a patient waiting (Romans 8:22-25).

At first glance, patience may seem like a character trait that you're either born with or not. But patience is a skill that can be nurtured. As investors, some helpful steps include:

- Gaining some knowledge of stock market history. As this month's cover article describes, the market moves through cycles. Bear markets follow bull markets as surely as night follows day. Therefore, we can expect the investing journey to be marked by gains and losses, all the while remembering that bull markets tend to last longer and add more value than bear markets take away.
- Choosing a strategy you understand and that is appropriate for your time frame and risk tolerance.
- Developing a written investment plan that includes a statement of what you will do—and *not* do—at times of market stress.
- Taking a lesson from the marshmallow experiment kids by choosing not to look at your portfolio so often.
- Reflecting on God's patience through verses such as 2 Peter 3:9, Romans 15:5, and 1 Timothy 1:16. Memorizing these verses will write them on your heart, becoming guiding influences in your life.

There's certainly a lot to *know* about investing, but how we go about it is just as important, and the most profitable path is marked by patience.

Matt

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MANAGING EDITOR

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POSTMASTER
Sound Mind Investing is published monthly by Sound Mind Investing, 9700 Park Plaza Ave Ste 202, Louisville, KY 40241-2287. Periodicals postage paid at Louisville, Kentucky USPS (006344). POSTMASTER: Address changes to: SMI, 9700 Park Plaza Ave, Unit 202, Louisville, KY 40241-2287. This is Issue 351 • Volume 30 Number 9. Mailing date: 9/05/2019.

Mastering the Market Cycle

(continued from front page)

- Rising psychology causes investors to be less demanding in terms of risk protection and prospective return.
- The combination of positive events, strengthening psychology and the lowering of investors' return requirements causes asset prices to rise.
- Eventually, however, the process goes into reverse. Events fail to live up to expectations, perhaps because the environment that produces them becomes less hospitable, or perhaps because expectations were unrealistically high.
- Investors eventually prove that psychology can't remain positive forever. Cooler heads conclude that prices have reached levels that are unjustified, or psychology may soften for any of a million possible reasons (or for no apparent reason).
- Prices fall when events are less positive or come to be viewed less positively. Sometimes it happens simply because prices have reached levels that are unsustainable, or because of negative developments in the environment.
- Having turned downward, asset prices continue to decline until they fall so low that the stage is set for their recovery.

It's important to understand the way fundamentals and psychology interact, as described above. But it's essential that I repeat something about this process: while the description above is of one that is orderly and sequential, the process is nowhere as neat as this description may make it seem. The sequence in which these things occur is subject to change.

Sometimes events cause psychology to strengthen, and sometimes improving psychology has a positive impact on events (e.g., bolstering the economy and corporate profits).

And while it's obvious that improved investor psychology makes asset prices rise, it's just as obvious that rising prices make investors feel wealthier, smarter and more optimistic.

The speed at which things play out is highly variable from cycle to cycle and over the course of a given cycle. And lastly, cycles don't necessarily progress smoothly; rather, they can be marked by dips, recoveries and feints along the way.

It's for reasons like these that investing can't be described as scientific, and can't be depended on to work the same every time. The reasons and results are never the same as in the past, but they're usually reminiscent of developments we've seen before. Regardless of the imprecision of the process, it's clear that past events and expected future events combine with psychology to determine stock prices. Events and psychology also influence the availability of credit, and the availability of credit greatly affects stock prices, just as it feeds back to influence events and psychology.

In sum, these things all come together to create the market cycle. We hear about it every day, most prominently in connection with the ups and downs of the stock market, but also with regard to markets for things like bonds, gold and currencies.

The myth of the rational investor

Financial theory portrays investors as "economic men" (i.e., objective, rational optimizers). Thus it suggests that the market they collectively form is what author and investor (and Warren Buffett's teacher) Ben Graham called a "weighing machine": a disciplined assessor of the value of assets.

In stark contrast, however, the truth is that financial facts and figures are only a starting point for market behavior; investor rationality is the exception, not the rule; and the market spends little of its time calmly weighing financial data and setting prices free of emotionality.

Investment fundamentals are rather straightforward. Past events have already taken place and been recorded, and many people have the quantitative skills required to analyze them. Current performance is captured in financial statements, which sometimes present an accurate picture and sometimes require skillful adjustment. And future events are unknown to everyone. Fundamentals aren't the most variable part of investing or the part that intrigues me most. And anyway, I can't write a book telling you how to know more than others about future events.

The part of investing that fascinates me regards the ways in which investors deviate from the assumption of rationality, and the contribution of those ways to the oscillation of cycles.

A large number of elements play parts in this aspect of investment decision making, interfering with the process of arriving at purely economic decisions. They may come under the headings of human nature, psychology or emotion—the distinction isn't straightforward or important for our purposes here—and they absolutely are capable of dominating investor behavior and thus markets. Some but not all vary cyclically, and they all can affect or exacerbate cycles. Here are the most important influences:

- the way investors fluctuate rather than hold firmly to rational thinking and the resulting rational decisions;
- the tendency of investors to hold distorted views of what's going on, engaging in selective perception and skewed interpretation;
- quirks like confirmation bias, which makes people accept evidence that confirms their thesis and reject that which doesn't, and the tendency of most people to value a dollar *lost* more highly than a dollar *made* (or a dollar of potential profit forgone);
- the gullibility that makes investors swallow tall tales of profit potential in good times, and the excessive skepticism that makes them reject all possibility of gains in bad times;
- the fluctuating nature of investors' risk tolerance and risk aversion, and thus of their demands for higher expected returns;
- the herd behavior that results from pressure to fall into line with what others are doing, and as a result the difficulty of holding non-conformist positions;
- the extreme discomfort that comes from watching others make money doing something you've rejected;
- thus the tendency of investors who have resisted an asset bubble to ultimately succumb to the pressure, throw in the towel and buy (even though—no, *because*—the asset that is the subject of the bubble has appreciated substantially);
- the corresponding tendency to give up on investments that are unpopular and unsuccessful, no matter how intellectually sound, and
- finally, the fact that investing is all about money, which

introduces powerful elements such as greed for more, envy of the money others are making, and fear of loss.

The three stages of a bull market

Investors have been characterized for at least a hundred years as either "bulls" (optimists who think stocks will rise and behave aggressively as a result) or "bears" (pessimists who think they'll fall and who thus behave defensively). Consequently, people apply the label of "bull market" to a market that has risen, is rising or will rise (it's quite imprecise) and "bear market" to the opposite.

About 45 years ago—in the early 1970s—I received one of the greatest gifts I was ever given, when an older and wiser investor introduced me to "the three stages of a bull market":

• the first stage, when only a few unusually perceptive people believe things will get better,

• the second stage, when most investors realize that improvement is actually taking place, and

• the third stage, when everyone concludes things will get better forever.

The arrival of this simple truth opened my eyes to the notion of investors' psychological extremes and the impact of those extremes on market cycles. Like many of the great quotations and adages, it captures disproportionate wisdom in a few simple words. It's all about the changeability of attitudes, the pattern they follow over the course of a cycle, and how they contribute to error.

In the first stage, because the possibility of improvement is invisible to most investors and thus unappreciated, security prices incorporate little or no optimism. Often the first stage occurs after prices have been pounded in a crash, and the same downtrend that decimated prices also has wiped out psychology, turning the members of the crowd against the market and causing them to swear off investing forever.

In the last stage, on the other hand, events have gone well for so long—and have been reflected so powerfully in asset prices, further lifting the mood of the market—that investors extrapolate improvement to infinity and bid up prices to reflect their optimism. Trees generally don't grow to the sky, but in this stage investors act as if they will...and pay up for the limitless potential they perceive. Few things are as costly as paying for potential that turns out to have been overrated.

It follows from the above that someone who invests in the first stage—when almost no one can see a reason for optimism—buys assets at bargain prices from which substantial appreciation is possible. But someone who buys in the third stage invariably pays a high price for the market's excessive enthusiasm and loses money as a result.

The description of the three stages of the bull market offers a lot of wisdom with great economy. But not long after learning about the three stages, I came across something even better and briefer—essentially the same message in just 14 words: "What the wise man does in the beginning, the fool does in the end."[1]

I consider this the number-one piece of investment wisdom and an incredible distillation of the import of cycles. Again, the early discoverer—who by definition has to be that rare person who sees the future better than others and has the inner strength to buy without validation from the crowd—garners undiscovered potential at a bargain price. But every investment trend eventually is overdone and bid up too far, so that the buyer in the end pays up for potential that is overrated. He ends up with capital punishment, not capital appreciation. "What the wise man does in the beginning, the fool does in the end" tells you 80% of what you have to know about market cycles and their impact.

The three stages of a bear market

Of course, cycles work in both directions, and the depths of the Global Financial Crisis gave me an opportunity to invert the old saying and describe the three stages of a bear market in my market memo "The Tide Goes Out" (March 2008):[2]

• the first stage, when just a few thoughtful investors recognize that, despite the prevailing bullishness, things won't always be rosy,

• the second stage, when most investors recognize that things are deteriorating, and

• the third stage, when everyone's convinced things can only get worse.

"Capitulation" is a fascinating phenomenon, and there's a dependable cycle to it, too. In the first stage of either a bull or bear market, most investors refrain from joining in on the thing that only a tiny minority does. This may be because they lack the special insight that underlies that action; the ability to act before the case has been proved, and others have flocked to it (after which it's no longer unappreciated and un-reflected in market prices); or the spine needed to take a different path than the herd and behave as a non-conforming contrarian.

Having missed the opportunity to be early, bold and right, investors may continue to resist as the movement takes hold and gathers steam. Once the fad has resulted in market movement, they still may not join in. With steely discipline, they refuse to buy into the market, asset class or industry group that has been lifted by bullish buyers, or to sell once selling by others has caused prices to fall below intrinsic value. It's not for them to join the trend late.

But most investors do capitulate eventually. Once the asset has doubled or tripled in price on the way up—or halved on the way down—many people feel so stupid and wrong, and are so envious of those who've profited from the fad or sidestepped the decline, that they lose the will to resist further. My favorite quote on this subject is from Charles Kindleberger: "There is nothing as disturbing to one's well-being and judgment as to see a friend get rich."[3]

Market participants are pained by the money that others have made and they've missed out on, and they're afraid the trend (and the pain) will continue further. They conclude that joining the herd will stop the pain, so they surrender. Eventually they buy the asset well into its rise or sell after it has fallen a great deal. In other words, after failing to do the right thing in stage one, they compound the error by taking that action in stage three, when it has become the wrong thing to do. That's capitulation. It's a highly destructive aspect of investor behavior during cycles, and a great example of psychology-induced error at its worst.

[1]A proverb of Spanish (or perhaps German) origin. [2]bit.ly/Marks-Tide (PDF)
[3]From *Manias, Panics, and Crashes: A History of Financial Crises* (Basic Books, 1989).

TABLE A: UPSWING
• The economy is growing; economic reports are positive.
• Corporate earnings are rising and beating expectations.
• The media carry only good news.
• Securities markets strengthen.
• Investors grow increasingly confident and optimistic.
• Risk is perceived as being scarce and benign.
• Investors think of risk-bearing as a sure route to profit.
• Greed motivates behavior.
• Demand for investment opportunities exceeds supply.
• Asset prices rise beyond intrinsic value.
• Capital markets are wide open, making it easy to raise money or roll over debt.
• Defaults are few.
• Skepticism is low and faith is high, meaning risky deals can be done.
• No one imagines things going wrong. No favorable development seems improbable.
• Everyone assumes things will get better forever.
• Investors ignore the possibility of loss and worry only about missing opportunities.
• No one can think of a reason to sell, and no one is forced to sell.
• Buyers outnumber sellers.
• Investors would be happy to buy if the market dips.
• Prices reach new highs.
• The media celebrate this exciting event.
• Investors become euphoric and carefree.
• Security holders marvel at their own intelligence; perhaps they buy more.
• Those who've remained on the sidelines feel remorse; thus they capitulate and buy.
• Prospective returns are low (or negative).
• Risk is high.
• Investors should forget about missing opportunity and worry only about losing money.
• This is the time for caution!

Of course, when the last resister has given up and bought well into the rise—or sold well into the decline—there's no one left to fall in line. No more buyers means the end of the bull market, and vice versa. The last capitulator makes the top or bottom and sets the scene for a cyclical swing in the opposite direction. The following account from history shows that even the most brilliant among us can fall prey to capitulation:

> Sir Isaac Newton, who was the Master of the Mint at the time of the "South Sea Bubble," joined many other wealthy Englishmen in investing in the stock [of the South Sea Company]. It rose from £128 in January of 1720 to £1,050 in June. Early in this rise, Newton realized the speculative nature of the boom and sold his £7,000 worth of stock. When asked about the direction of the market, he is reported to have replied "I can calculate the motions of the heavenly bodies, but not the madness of the people."
>
> By September 1720, the bubble was punctured and the stock price fell below £200, off 80% from its high three months earlier. It turned out, however, that despite having seen through the bubble earlier, Sir Isaac, like so many investors over the years, couldn't stand the pressure of seeing those around him make vast profits. He bought back the stock at its high and ended up losing £20,000. Not even one of the world's smartest men was immune to this tangible lesson in gravity![1]

The market cycle progression

The progression shown in Table A at left serves to sum up the upswing of the market cycle. The most important thing to note is that maximum psychology, maximum availability of credit, maximum price, minimum potential return and maximum risk all are reached at the same time, and usually these extremes coincide with the last paroxysm of buying.

Likewise, the progression shown in Table B outlines what happens in a downswing. In the reverse of the "top" that results from the upswing of the market cycle, now we see that the nadir of psychology, a total inability to access credit, minimum price, maximum potential return and minimum risk all coincide at the bottom, when the last optimist throws in the towel.

The progressions outlined here are simplistic, but they are not imaginary. It is absolutely logical that each event will bring on the next one in both directions... until an illogical extreme is reached and the house of cards collapses. The events don't always occur in the same order, and not all are present in every market cycle. But these behaviors are real, and they certainly are elements that "rhyme" in the markets from decade to decade.

The first time an inexperienced investor lives through an upward market cycle, the beginnings of the progression may seem logical, as the positives compound in a bull market or bubble. The fact that so much good news and good feeling can end in losses can come as a surprise. It is inescapable that it will seem so to the uninitiated, of course, because if the progressions weren't permitted to go on to extremes on the basis of errors in judgment, markets wouldn't reach bull market tops to collapse from (or bear market bottoms to recover from). ◆

Excerpted from chapter 12 of *Mastering the Market Cycle* by Howard Marks.

TABLE B: DOWNSWING
• The economy is slowing; reports are negative.
• Corporate earnings are flat or declining, and falling short of projections.
• Media report only bad news.
• Securities markets weaken.
• Investors become worried and depressed.
• Risk is seen as being everywhere.
• Investors see risk-bearing as nothing but a way to lose money.
• Fear dominates investor psychology.
• Demand for securities falls short of supply.
• Asset prices fall below intrinsic value.
• Capital markets slam shut, making it hard to issue securities or refinance debt.
• Defaults soar.
• Skepticism is high, faith is low, meaning only safe deals can be done, or maybe none at all.
• No one considers improvement possible. No outcome seems too negative to happen.
• Everyone assumes things will get worse forever.
• Investors ignore the possibility of missing opportunity and worry only about losing money.
• No one can think of a reason to buy.
• Sellers outnumber buyers.
• "Don't try to catch a falling knife" takes the place of "buy the dips."
• Prices reach new lows.
• The media fixate on this depressing trend.
• Investors become depressed and panicked.
• Security holders feel dumb. They realize they didn't understand the investments they made.
• Those who held give up and sell at depressed prices, adding further to thedownward spiral.
• Implied prospective returns are sky-high.
• Risk is low.
• Investors should forget about the risk of losing money and worry only about missing opportunity.
• This is the time to be aggressive!

[1]From "Bubble.com" (a January 2000 memo to Oaktree Capital clients), bit.ly/Marks-Bubble (PDF).

Strengthening Your Foundation

Wise money management begins with a strong financial foundation. In this column, we cover topics such as how to manage cash flow, apply strategies for getting debt-free, make wise purchasing decisions, build savings, choose appropriate insurance protection, navigate marital financial issues, and many more.

"By wisdom a house is built, and through understanding it is established." Proverbs 24:3

DO YOU KNOW WHAT'S IN YOUR CREDIT REPORTS?

A data thief who recently targeted credit-card issuer Capital One gained access to an estimated 80,000 bank account numbers and 140,000 Social Security numbers. Although the alleged hacker was captured and Capital One insisted that it is "unlikely that the information was used for fraud or disseminated," the theft—like the massive 2017 data breach at credit-reporting agency Equifax—underscored the importance of finding out what's showing up in your credit reports. Any person who gains access to your personal information could steal your identity and run up charges—or open new credit accounts in your name.

Even if credit fraud weren't a concern, checking your reports at least once a year is wise. A Federal Trade Commission study (in 2012) discovered that about one credit report out of every four contained errors.

The particulars in your credit files can affect everything from your employability to your insurability, so inaccurate information—something as simple as a mistyped number or a missing paid-in-full notation—could spell trouble. Credit-report data also serve as the basis for your credit "score," a metric of creditworthiness that affects your access to credit and the interest rates you'll pay.

Free once a year

By law, you're entitled to a credit report annually, at no cost, from each of the three major credit reporting bureaus: Experian, TransUnion, and Equifax. You can request your reports and download them via annualcreditreport.com.[1] (Although other websites offer free credit reports, the reports typically are from just a single bureau. Such sites also attempt to "upsell" users into paying for additional services such as credit scores, credit monitoring, and ID-theft protection.)

Annualcreditreport.com offers the option of requesting a single report (i.e., from just one bureau), two reports, or all three. If you want to monitor your credit activity on an ongoing basis, you may wish to stagger your requests, asking for one report every four months. That's a good "maintenance" approach for those who already have cleaned up their credit files and aren't planning to apply for a mortgage or other loan in the near future.

However, if you are planning a purchase that will involve a loan, it's probably better to request all three reports at once. That way you can scan each report for errors and ask for any needed corrections before applying for the loan. (Keep in mind that each bureau works independently, so just because you don't see any issues in one report doesn't mean issues aren't lurking in the others.)

Unfortunately, getting your free reports online doesn't always work. Before allowing access to a report, the annualcreditreport.com website poses a series of multiple-choice security questions related to accounts you have (or may have once had) or about the names and locations of relatives. If you get an answer wrong, you won't be offered a second chance. Instead, you'll be instructed to request your report by regular mail, and you'll have to supply documentation via mail (such as a recent W-2 form and a copy of your driver's license) that verifies your identity. As if that's not inconvenient enough, receiving a report by mail typically takes several weeks.

Reading your report

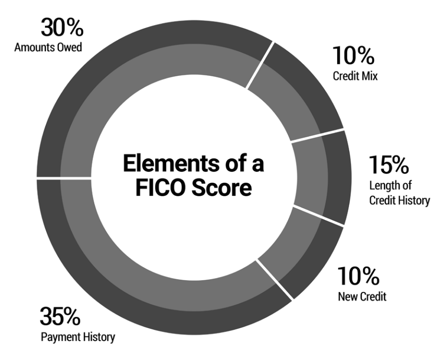
When you get a credit report, look it over to make sure your personal information is accurate and that you recognize all the credit accounts listed. If you see any you don't recognize, that may be a sign of identity theft.

As noted earlier, credit *scores*, although different from *reports*, are derived from credit-report data. The two most widely used scores, each based on its own scoring model, are the FICO[2] score and VantageScore. The FICO score is the one used by most lenders, so we'll focus on that one.[3]

FICO's primary scoring model takes five factors into account:

1. Payment History. This is the most important factor and accounts for 35% of your score. Each bureau, by the way, reports payment history differently.

- With Equifax, the ideal is for the "Status" of each account to be listed as "Pays as Agreed" and for "Date of first Delinquency" to be blank.
- With Experian, you want the "Status" of open accounts to read "Current" and closed accounts to read "Paid."
- With TransUnion, you want the "Pay Status" to read "Paid or Paying as Agreed," the "Past Due" section to read "0," and "Rating" to read "OK."



If you see an error on your credit report, such as a timely payment shown as having been paid late, contact the specific creditor, plead your case (it'll help to have proof!), and ask the creditor to contact the credit bureau(s) to request a change to your file.

2. Amounts Owed. This relates to how much of your available credit you are using (i.e., "credit utilization"), and it determines 30% of your score. Once a month, the bureaus check to see how much you owe each creditor and compare that amount *(continued on page 140)*

[1]Credit information is tied to one's Social Security number, so there is no such thing as a joint credit report. If you're married, both of you should request reports. [2]From Fair, Isaac and Co. [3]Several large credit-card companies now offer free FICO-score access to their customers. Also see discover.com/free-credit-score.

LEVEL 2 TWO

Developing Your Investing Plan

Investing decisions are best made as part of a comprehensive personalized plan. In this column, we focus on topics that will help you implement an investment strategy that takes into account your personal goals, attitude toward risk-taking, and current season of life. We explain investing essentials, discuss SMI's core investing strategies, and help you decide which strategy is best for your situation.

"The plans of the diligent lead to profit as surely as haste leads to poverty." Proverbs 21:5

FED BEGINS NEW RATE-CUTTING CYCLE

Interest rates are a key ingredient in investing returns, affecting bond returns directly and the returns of most other asset classes indirectly. Investors pay close attention to changes in rates, especially those that potentially signal a new interest-rate cycle. Let's take a closer look at interest rates generally and unpack what the Federal Reserve's July 31 rate cut means to investors in the context of a new rate-cut cycle.

Interest rate basics

Investors often are confused by the fact that while the Federal Reserve plays a key role in determining interest rates, it doesn't control *all* interest rates. The Fed, the central bank here in the United States,[1] sets the baseline short-term rate that most other U.S. interest rates are based upon. This "Federal Funds Rate" is essentially the shortest-term (and lowest-risk) rate, so it makes sense that as longer-term or higher default-risk bonds are evaluated, they are assessed higher rates to compensate investors for those higher risks.

We're glossing over the mechanics of how the Federal Reserve's Open Market Committee establishes the Federal Funds Rate, but the important thing to understand is that the Fed *controls only this baseline rate*. All other, longer-term interest rates are set by the bond market, which is collectively made up of all bond investors. This means longer-term interest rates can, and do, move up and down somewhat independently of what the Fed is doing.

We've seen a clear example of this in 2019: Longer-term interest rates have been falling all year, yet the Fed just made its first rate cut on July 31. The market (i.e., bond investors) had been viewing economic conditions with an increasingly skeptical eye for many months and *anticipated* the Fed cutting the Federal Funds Rate well before it did so.

Why the July 31 rate cut was important

The end-of-July rate cut is having direct impacts on savers and borrowers. This 0.25% reduction is translating into banks paying slightly less interest to savers while charging somewhat lower rates on mortgages and other loans.

But arguably more important than these direct impacts is the *message* sent by this rate cut. The July rate reduction was the first time the Fed has lowered interest rates in more than 10 years, since the depths of the Global Financial Crisis in 2008. The primary significance of this cut is the *implicit acknowledgment by the Fed that economic conditions have shifted*. This rate reduction was a signal to the financial markets that the Fed's primary focus at this point is holding the next recession off as long as possible.

This is an important change. The Fed had cut rates to near zero in late 2008, then left them there for years. Over the past few years, the Fed had attempted to "normalize" rates through nine quarter-point rate hikes. After the stock market revolted with a steep correction last December, the Fed relented and stopped that rate-*hiking* cycle. The July rate cut signifies the beginning of a new rate-*cutting* cycle, with the market clearly expecting more cuts as soon as September.

How interest rates impact the economy

The Fed's interest-rate policy can be thought of as the "accelerator" and "brake pedal" on the broader economy. When the Fed grows concerned about the economy slowing down too much, it cuts rates. This promotes more borrowing, increases the money supply, and effectively pushes the economic accelerator. When the Fed thinks the economy is running a little hot and is at risk of higher inflation, it raises rates, effectively reversing these processes and tapping the economic brakes.

That's how it *normally* works. However, the Fed's rate-hiking cycle over the past few years (2015-2018) wasn't a typical response to a belief that economic activity was running hot. Rather, it was an effort to "normalize" interest rates after a long period of unusually low rates. Think of it this way: the economic patient got so sick during the global financial crisis a decade ago that the world's central banks threw everything they had at it. As the global economy slowly recovered, they were reluctant to raise interest rates. Only in the past few years has the U.S. Fed finally been willing to slowly let interest rates creep higher again. These hikes arguably were more about creating future rate-cut ammunition to deal with the next recession than they were a response to the strength of the economy.

Given that context, what should we make of the recent Fed rate cut, along with the fact that the financial markets expect this to be the beginning of a new rate cut *cycle*, and the message the bond market has been sending all year through dramatically declining longer-term interest rates? It is simply this: The threat of an economic recession has increased substantially.

Inverted yield curve

One might think that if the Fed normally cuts rates because the risk of recession is rising, investors would view rate cuts as a bad thing. But that's generally not the case. The stock market almost always cheers lower rates—at least initially. Over the past decade, the Fed has been extremely responsive to declines in the financial markets, and we've seen the stock market rally repeatedly following central bank rate cuts. So we can't discount the possibility that a new series of rate cuts might spur the financial markets higher this time too.

However, it's worth noting that the Fed *always* cuts interest rates as bear markets unfold. So at some point, the initial adrenaline rush of new rate cuts gives way to the so- *(continued on page 141)*

[1] Other countries also have central banks. The actions of the other major central banks—particularly those of the European Union, Japan, and China—combine with the Fed to have a significant impact on global interest rates and economic activity.

Broadening Your Portfolio

This column goes beyond the investing essentials taught in Level 2, introducing you to a wider range of investment securities and markets. By further diversifying your holdings, you can create a more efficient, less volatile portfolio. We also comment quarterly on the performance of the various markets, and on how SMI's fund recommendations and strategies have fared.

"Divide your portion to seven, or even to eight, for you do not know what misfortune may occur on the earth." Ecclesiastes 11:2

DON'T BE SURPRISED IF TARGET-DATE FUNDS MISS THE MARK

As a general rule, an investment portfolio should be weighted toward the stock side when an investor is young, then move toward bonds as the years go by. An investor is thereby positioned for asset growth in their younger years (with ample time to recover from market losses), but then dials back on risk and preserves gains as retirement age nears.[1]

Trying to follow that guideline, however, raises questions: When should you start cutting back on stock-based investments? What kind of bonds should you buy? How much "de-risking" is too much? How little is too little?

In the early 1990s, mutual-fund companies rolled out an investment option aimed at freeing investors from having to wrestle with such questions: the target-date fund (TDF).[2] Such funds got a big boost in 2006 when Congress passed legislation that encouraged employers to auto-enroll workers in company retirement plans, while also allowing the employers to set a target-date fund as the default investment option.

Employees, rather than being faced with a dizzying array of options as before, were presented the alternative of a simple, all-in-one solution—one that would automate the "downsize-stocks-bump-up-bonds" process on a predetermined schedule. The employee had only to pick a target date—typically a year close to planned retirement. For example, a worker intending to retire in 2034 could simply pick a "2035 Fund"—whether offered by Vanguard, Fidelity, T. Rowe Price, BlackRock, or any of the three dozen other companies offering 2035 funds.

The 2006 legislation turbo-charged target-date products. TDF mutual-fund assets have risen from about $110 billion in 2006 to more than $1 trillion at the start of 2019. An additional $677 billion is now invested in target-date "collective investment trusts," a lower-cost alternative to mutual funds available via many qualified retirement plans.[3]

Vanguard, by far the largest TDF provider, reports that 77% of participants in Vanguard-managed retirement plans are now using target-date investments, up from only 18% in 2007.

What's under the hood?

The holdings in a target-date fund typically are a collection of underlying funds from the same fund company offering the TDF. Because each company has its own perspective regarding what constitutes an appropriate asset allocation, even for investors of the same age, TDFs focused on the same retirement date can vary widely in their portfolio mix. Taking the 2035 universe as an example, the Fidelity Freedom 2035 fund has 86% in stocks, roughly 11% in bonds, and 3% in a commodity fund. Meanwhile, the Vanguard Target Retirement 2035 fund (note the identical target date) has 76% of its assets in stocks, with the rest in bonds and cash.

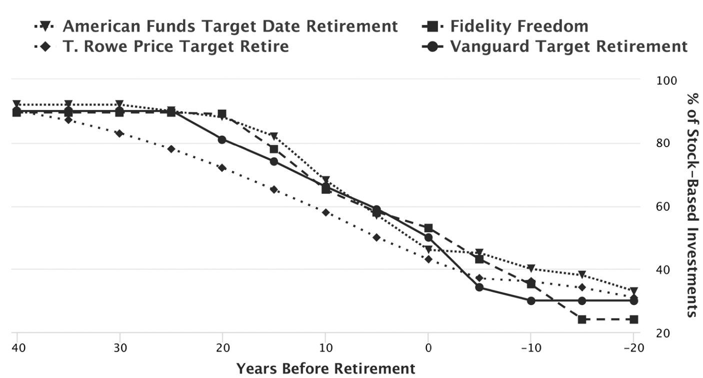
Which is better? That's difficult for even the experts to say, much less the ordinary investor looking for simplicity.

The asset-allocation disparity among funds with identical target dates came into the spotlight following the 2008 financial crisis. As it turned out, some funds with a 2010 target date had about 20% of their holdings in stocks, while others had more than 50% in stocks. Not surprisingly, performance differences were significant, ranging from modest losses of -3.5% to massive losses of -41.3%. (Remember, these were funds labeled as being appropriate for those planning to retire in 2010, just two years later.)

Another key difference in approach among similar-sounding funds comes down to the difference between the words *to* and *through*. Some funds use a "glide path"—i.e., how the mix of stocks and bonds changes as the target date approaches—designed to take the investor "to" retirement, meaning the fund will adopt its most conservative allocation by the time it reaches the target date. (In some cases, the target fund is then merged into a fund focused on generating regular income.) Other TDFs use a "through retirement" model that doesn't reach its most conservative allocation by the target date. Instead, the fund continues to reduce stock-based holdings for several years thereafter (see graph).

It is worth noting that some investment researchers have suggested that target-date glide-paths should *reverse* after retirement, once again becoming more growth-focused. This approach, they argue, would help ensure that investors who live for two or three decades after retirement don't run out of money. Thus far, *(continued on page 142)*

"GLIDE PATHS" USED BY THE TOP 4 PROVIDERS OF TARGET-DATE PRODUCTS*



*All four companies employ a "through" approach that continues to adjust allocations even after reaching the target date.

[1]SMI's Dynamic Asset Allocation strategy (available to premium-level members) takes a different approach to balancing growth and safety. See Sep2014:p136. [2]Target-date funds sometimes are referred to as "life-cycle" funds. [3]The asset figures reflect both strong inflows and asset growth.

LEVEL 4 FOUR

Looking Toward Retirement

As you move through your 50s, 60s, and beyond, you face a new set of financial decisions related to reducing your investment risk and generating income from your portfolio. In this column, we address such topics, as well as those pertaining to Social Security, long-term health care, advanced giving strategies, estate planning, and other matters of importance to those nearing and in retirement.

"There is precious treasure and oil in the dwelling of the wise." Proverbs 21:20a

A CLOSER LOOK AT THE "DIVIDENDS ONLY" RETIREMENT-INCOME STRATEGY

Let's compare two retired investors: Dividend Dan and Total Returns Tom. Dan's portfolio consists mostly of dividend-paying stocks. To highlight the wisdom of his approach, Dan points to 2008, when his 5,000 shares of AT&T generated $8,000 of dividend income. It didn't faze him that AT&T's share price fell 31.4% that year because it didn't decrease his income. In fact, the $8,000 he received was more than the $7,100 he received in 2007—a remarkable increase of 12.7%. Like other so-called "dividend aristocrats," AT&T has a long history of annually increasing its dividend payout, come what may in the markets.

On the other hand, the mutual fund-based portfolio of Total Returns Tom is built around an assumption that total returns (which includes the reinvestment of most capital gains, interest, and dividends generated by his holdings) will be sufficient to allow him to periodically sell shares while still growing his portfolio. Selling during the downturn of 2008, however, meant locking in significant losses.

With an example like that, it's easy to understand the appeal of dividend investing. However, as with so many things, there's more to it than meets the eye.

Dividend investing 101

Profitable companies have several choices when it comes to their excess cash. Young and/or fast-growing companies often plow the money back into their businesses to fuel expansion or greater efficiency. Established companies with stable earnings and strong margins, but with less need for capital to reinvest in the company or few opportunities for growth, often distribute some of the money to shareholders in the form of dividends. Investors can have dividends automatically reinvested to purchase more shares or take the money as income.

Company dividends are issued as a dollar amount per share, not a percentage of the share price. That's why Dividend Dan did so well in 2008. While his net worth took a hit because the value of his holdings fell, AT&T, flush with cash, significantly increased its dividend.

The unique math of dividend investing

Dividend investing is especially popular with a segment of retirees—those adamant about taking only income from their portfolios, never principal. Many such investors think dividend income fits that definition. After all, they don't have to sell shares to receive income.

This is what Samuel Hartzmark, associate professor of finance at the University of Chicago, calls the "free dividend fallacy"—the belief that dividends are independent from the price of the stock that issued the dividend. He says investors "wrongly view dividends as additional income, rather than a shift of money from the stock price to the dividend."[1]

The fact is that when a dividend is issued, the stock's price declines by the same amount. It's where the term "ex-dividend date" comes from. That's the date, announced in the same news release that tells investors how much the next dividend will be, when a dividend-paying stock will begin trading at a price that is reduced by the amount of dividend.

Some investors believe dividends are as reliable as the interest paid by bonds, but they aren't. A bond is sold with a promise to repay the full amount at maturity, with interest payments made along the way that do not reduce the value of the bond. As long as the issuer doesn't go bankrupt, that's what will happen. With a dividend-paying stock, there are no guarantees that its price will ever recover to where it was before the dividend was paid, or that the dividend will continue.

The pros and cons of dividend investing

As with most strategies, dividend investing has both benefits and drawbacks.

• **Simplicity.** With dividend investing, you don't have to decide what to sell or when. The income just flows, usually quarterly. In retirement, when there are no more regular paychecks, having a source of consistent portfolio income can do wonders for a person's peace of mind. While it's true that dividends are not guaranteed, there are many companies with long histories of not only paying dividends, but increasing them.

• **Taxes.** If you take dividends as income and they are deemed to be "qualified," the tax rate can be far lower than ordinary income-tax rates. In 2019, for example, a married couple with household income between $78,751 and $488,850 would pay just 15% on qualified dividend income vs. 22-35% for ordinary income. (A couple with income of $250,000 or more may be subject to an additional 3.8% "net investment income tax" on their dividend income.) To receive this favorable tax treatment, the stock needs to have been held for 60 days within a 121-day window that begins 60 days before the stock's next ex-dividend date.

While many investors see the regular flow of dividend income as a benefit, others prefer more control over when they receive income. They have dividends automatically reinvested and then sell shares on a schedule of their choosing. (Either way, dividends are taxable in the year they are received.)

• **Risk.** When a dividend-paying stock sports an especially attractive yield, that may be because the company is in distress. Remember, a dividend is set as a dollar amount per share, not a percentage of the share price. A stock that sells for $20 today and that pays a quarterly dividend of $0.15 works out to a yield of 3%. A year from now, if the stock has fallen to $12, its yield will rise to 5%, assuming the *(continued on page 142)*

[1]cnb.cx/2zgf0Sh

Basic Strategies

The fund recommendations shown for Upgrading account holders are based primarily on “momentum” scores calculated just before this issue was published (not the earlier end-of-month scores shown on this page). Consistency of performance is also considered, along with the portfolio manager’s philosophy and number of years at the helm. Three recommendations are made in each risk category. Select the one(s) most in accord with your preferences and broker availability.

“Plans fail for lack of counsel, but with many advisers they succeed.” Proverbs 15:22

RECOMMENDED FUNDS FOR SMI’S JUST-THE-BASICS STRATEGY

Data through 7/31/2019	Portfolio Invested in	MOM	Performance YTD	1Mo	3Mo	6Mo	12Mo	3Yr Avg	Rel Risk	Expense Ratio	Stock/Bond Mix 100/0	80/20	60/40	40/60	Ticker Symbol
Total International Stock	Foreign stocks	-2.5	11.1%	-1.9%	-1.9%	3.2%	-3.8%	6.7%	0.94	0.11%/0.09%	20%	16%	12%	8%	VTIAX/VXUS
Extended Market Index	Small company stocks	11.9	21.5%	1.6%	1.0%	8.8%	2.1%	11.8%	1.24	0.07%/0.07%	40%	32%	24%	16%	VEXAX/VXF
S&P 500 Index	Large company stocks	20.9	20.2%	1.4%	1.7%	11.3%	8.0%	13.3%	1.00	0.04%/0.03%	40%	32%	24%	16%	VFIAX/VOO
Total Bond Market Index	Medium-term bonds	16.6	6.4%	0.2%	3.3%	5.3%	8.1%	2.1%	1.00	0.05%/0.035%	None	20%	40%	60%	VBTLX/BND

JUST-THE-BASICS FOOTNOTES: Just-the-Basics is an *indexing* strategy that requires just minutes a year to assure your returns are in line with those of the overall market. You won’t “beat the market,” but neither will you fall badly behind. Depending on your particular stock and bond mix, your JtB portfolio should be allocated among either three or four traditional mutual funds/ETFs (see ticker symbols in rightmost column). For more on JtB, see Jan2019:p7-8.

RECOMMENDED FUNDS FOR SMI’S FUND UPGRADING STRATEGY

Risk	Data through 7/31/2019[1]	Date Added	E-Trade Avail[2]	Fidelity Avail[2]	Schwab Avail[2]	MOM[3]	Performance YTD	1Mo	3Mo	6Mo	12Mo	3Yr Avg	Rel Risk[4]	Exp Ratio	Number Holdings	Redemp Fee?[5]	Ticker Symbol
Category 5 Foreign	1. ☎ Fidelity Intl Capital Apprec	09/19	Yes	NTF	Yes	23.2	22.7%	-0.3%	2.9%	13.6%	6.7%	10.3%	1.02	1.06	108	None	FIVFX
	2. Lazard Global Infrastructure	11/18	NTF	NTF	NTF	18.6	15.0%	0.6%	2.4%	8.7%	7.6%	10.9%	0.77	1.21	33	None	GLFOX
	3. Sextant International	06/19	NTF	NTF	NTF	29.0	21.5%	0.3%	3.4%	13.6%	12.1%	13.1%	0.86	1.05	32	None	SSIFX
Category 4 Small/Growth	1. Value Line Mid Cap Focused	12/18	NTF	NTF	NTF	47.5	29.0%	1.0%	5.8%	19.9%	21.8%	18.1%	0.97	1.18	45	None	VLIFX
	2. ☎ DF Dent Midcap Grwth Inv	09/19	NTF	Yes	NTF	44.2	32.6%	0.9%	4.9%	21.0%	18.2%	19.5%	1.13	0.98	35	2%60days	DFDMX
	3. Baron Opportunity	03/18	NTF	NTF	NTF	26.2	30.2%	1.1%	3.6%	17.7%	4.9%	23.4%	1.38	1.37	72	None	BIOPX
Category 3 Small/Value	1. Invesco S&P MidCap Low Vol	12/18	ETF	ETF	ETF	22.0	17.8%	1.1%	1.8%	9.8%	10.4%	11.3%	0.83	0.25	82	None	XMLV
	2. Touchstone Mid Cap Z	05/19	NTF	NTF	NTF	32.3	25.7%	3.0%	3.5%	17.0%	11.8%	14.5%	1.04	1.21	31	None	TMCTX
	3. Weitz Hickory	06/19	NTF	NTF	NTF	21.2	25.7%	0.1%	1.0%	13.4%	6.9%	6.0%	1.12	1.27	38	None	WEHIX
Category 2 Large/Growth	1. Akre Focus Retail	05/19	NTF	NTF	NTF	47.0	29.5%	2.5%	4.0%	20.8%	22.2%	21.2%	0.89	1.32	23	1%30days	AKREX
	2. Polen Growth Investor	10/18	NTF	NTF	NTF	35.1	24.9%	1.3%	1.9%	16.3%	16.9%	18.6%	1.02	1.25	23	2%60days	POLRX
	3. MS Insight Fund – LW[10]	05/18	NTF	NTF	NTF	60.4	39.6%	2.2%	8.0%	23.4%	29.0%	30.2%	1.41	1.15	48	None	CPOAX
Category 1 Large/Value	1. SPDR Large Cap Low Vol	07/19	ETF	ETF	ETF	40.7	24.0%	1.6%	5.4%	16.6%	18.7%	13.6%	0.82	0.12	128	None	LGLV
	2. Invesco S&P 500 Low Vol	12/18	ETF	ETF	ETF	32.8	20.6%	1.1%	3.9%	13.1%	15.9%	11.4%	0.76	0.25	102	None	SPLV
	3. Vanguard Div Appreciation	07/19	ETF	ETF	ETF	30.8	21.3%	2.2%	4.0%	14.1%	12.8%	13.7%	0.96	0.06	186	None	VIG
Bond Categories	Vanguard I-T Bond[6]	2/19	ETF	ETF	ETF	19.9	7.8%	0.1%	3.8%	6.1%	10.1%	2.2%	1.21	0.07	6.1[7]	None	BIV[8]
	Permanent: Vanguard I-T Bond	Perm	ETF	ETF	ETF	19.9	7.8%	0.1%	3.8%	6.1%	10.1%	2.2%	1.21	0.07	6.1[7]	None	BIV[8]
	Permanent: Vanguard S-T Bond	Perm	ETF	ETF	ETF	9.8	3.5%	0.0%	1.7%	2.9%	5.2%	1.6%	0.46	0.07	2.6[7]	None	BSV[9]

Upgrading Footnotes: [1] The funds in each risk category have been selected and ranked (1 through 3) based primarily on their momentum scores in late August, rather than on the end-of-July data shown above. The fund ranked third is the one that currently appears most likely to be replaced next. If there is a telephone symbol (☎) next to a fund’s name, that fund is a new recommendation. **[2]** Fund Availability: NTF means the fund can be bought and sold free of transaction fees as long as you stay within the trading limitations imposed by E-Trade (800-387-2331), Fidelity (800-343-3548), and Schwab (800-435-4000). Policies change frequently, so be sure to verify their accuracy. ETFs trade like stocks and are typically available at all brokers for a modest commission. **[3]** Momentum is a measure of a fund’s performance over the past year and is our primary performance evaluation tool. For more, see Jan2019:Cover. **[4]** A 1.0 relative risk score indicates the fund has had the same volatility as the market in general over the past three years. For example, a fund with a score of 1.4 would mean the fund was 1.4 times (40%) more volatile than the market. See June2015:p88. **[5]** Depending on how long you hold this fund, a redemption fee may be applicable when selling (for example, a fee of 1% if you sell within 60 days of purchase). Fees change often and vary from broker to broker, so be sure to check with your broker for the most current information. **[6] Rotating Fund:** This bond recommendation changes periodically based on SMI’s Upgrading methodology. The Short-Term and Intermediate-Term Index recommendations shown below that fund are fixed and don’t change from month to month. See January2015:p7 for more information. **[7] Duration:** For bond funds, this column shows the average duration of the bonds in the portfolio in years. Typically, the longer the duration, the greater the risk/reward. To learn more, see Nov2018:p167. **[8]** Those preferring a traditional mutual-fund option can buy VIBLX. **[9]** Those preferring a traditional mutual-fund option can buy VBIRX. **[10]** Normally is a load fund but is available load-waived (LW) through some brokers. Purchase only if available to you at your broker without paying a load. See original fund write-up for details.

☎ Changes in our fund recommendations are explained in the MoneyTalk column.

Upgrading: Easy as 1-2-3

Fund Upgrading has long been SMI's most popular Basic Strategy. Whether used in isolation or in combination with SMI's Premium Strategies, Upgrading forms a solid foundation for an investing plan. Upgrading has proven itself over time with market-beating returns over the long haul, and it is easy to implement. This page explains exactly how to set up your own Upgrading portfolio.

"The plans of the diligent lead to profit as surely as haste leads to poverty." Proverbs 21:5

WHY UPGRADE?

SMI offers two primary investing strategies for "basic" members. They are different in philosophy, the amount of attention they require, and the rate of return expected from each. Our preferred investing strategy is called Fund Upgrading, and is based on the idea that if you are willing to regularly monitor your mutual-fund holdings and replace laggards periodically, you can improve your returns. While Upgrading is relatively low-maintenance, it does require you to check your fund holdings each month and replace funds occasionally. If you don't wish to do this yourself, a professionally-managed version of Upgrading is available (visit bit.ly/smifx).

SMI also offers an investing strategy based on index funds called Just-the-Basics (JtB). JtB requires attention only once per year. The returns expected from JtB are lower over time than what we expect (and have received) from Upgrading. JtB makes the most sense for those in 401(k) plans that lack a sufficient number of quality fund options to make successful Upgrading within the plan possible. See the top section of the Basic Strategies page at left for the funds and percentage allocations we recommend for our Just-the-Basics indexing strategy.

WHERE TO OPEN YOUR ACCOUNT

Opening an account with a discount broker that offers a large selection of no-load funds greatly simplifies the Upgrading process. This allows you to quickly and easily buy/sell no-load mutual fund shares without having to open separate accounts at all the various fund organizations. There are several good brokerage choices available. We recommend reading our latest Broker Review (March 2018:Cover article, also available online at bit.ly/smibroker) for details regarding the pros and cons of each broker, as your specific investing needs will largely dictate which broker is best suited to your situation.

401(K) INVESTORS

For a detailed explanation of how to Upgrade within your 401(k) plan, see bit.ly/smi401ktracker. That article also contains ideas on Upgrading in any type of account where your available fund choices are limited.

HOW TO BEGIN STOCK UPGRADING

❶ First determine your stock/bond target allocation by working through the investment temperament quiz online in the "Start Here" section (see the link near the top of the home page on the main navigation bar). For example, Table 1 below provides guidelines for those with an "Explorer" temperament. For more on asset allocations, see Jan2018:p8.

❶ PICK YOUR ALLOCATION

Seasons of Life	Stocks	Bonds
15+ years until retirement	100%	0%
10-15 years until retirement	80%	20%
5-10 years until retirement	70%	30%
5 years or less until retirement	60%	40%
Early retirement years	50%	50%
Later retirement years	30%	70%

Note: These are SMI's recommendations for those with an "Explorer" temperament. See Step ❶ in the text for information on our investment temperament quiz. You may want to fine-tune the above percentages to suit your personal approach to risk-taking.

❷ Find the column that matches your stock/bond allocation in Table 2. (If your target falls between two listed columns, split the difference.) Multiply each percentage by the value of your total portfolio amount to calculate the dollar amount to invest in each risk category.

❸ Buying your funds is easy. Look at the recommended funds on the opposite page. In each category, start with the #1 listed recommendation. If it's available at your brokerage (indicated by Yes, NTF, or ETF), buy it. If it's not, continue down the list to the next available fund. Then contact your broker—online or via phone—to buy the fund you've picked.

Let's see how a new subscriber 12 years from retirement with $50,000 to invest and an account at Fidelity would proceed. First, the investor selects the stock/bond mix for his or her situation (let's assume 80/20). Then, from Table 2, finds the percentages for each risk category. Multiplying $50,000 by each percentage yields the dollar amount for each category as shown in Table 3.[1] Looking at the Fidelity column on the Basic Strategies page, the highest-ranked Cat. 5 fund is Fidelity Intl Cap Appreciation, the highest-ranked Cat. 4 fund is Value Line Mid Cap Focus, and so on. After making decisions for each category, the orders are placed and the stock portion of the Upgrading portfolio is complete!

From then on, it's just a matter of checking the Basic Strategies page each month. When an owned fund is *removed* from this page (not when it merely shifts out of the #1 ranking), you should immediately sell that fund and invest the proceeds in the highest-ranked position in the same risk category that is available at your broker.

❷ FIND YOUR PORTFOLIO MIX

Portion of Portfolio Allocated to Stocks:	100%	80%	60%	40%
Portion of Portfolio Allocated to Bonds:	**None**	**20%**	**40%**	**60%**
Stock Cat. 5: Foreign Stocks	20%	16%	12%	8%
Stock Cat. 4: Small Companies/Growth	20%	16%	12%	8%
Stock Cat. 3: Small Companies/Value Strategy	20%	16%	12%	8%
Stock Cat. 2: Large Companies/Growth	20%	16%	12%	8%
Stock Cat. 1: Large Companies/Value Strategy	20%	16%	12%	8%
Bond Cat. 3: "Rotating" Bond Fund	None	10%	20%	30%
Bond Cat. 2: Intermediate-Term Bond Fund	None	5%	10%	15%
Bond Cat. 1: Short-Term Bond Fund	None	5%	10%	15%

❸ BUY YOUR FUNDS

Example uses an 80/20 mix between stocks and bonds		Dollars	Invest in Funds
Stock Cat. 5: Foreign	16%	$8,000	Fidelity Intl Cap Appreciation
Stock Cat. 4: Small/Growth	16%	$8,000	Value Line Mid Cap Focus
Stock Cat. 3: Small/Value	16%	$8,000	Invesco S&P MidCap Low Vol
Stock Cat. 2: Large/Growth	16%	$8,000	Akre Focus Retail
Stock Cat. 1: Large/Value	16%	$8,000	SPDR Large Cap Low Vol
"Rotating" Bond Fund	10%	$5,000	Vanguard I.T. Bond Index
Intermediate-Term Bond Fund	5%	$2,500	Vanguard I.T. Bond Index
Short-Term Bond Fund	5%	$2,500	Vanguard S.T. Bond Index
Total	100%	$50,000	

BOND UPGRADING

Your bond allocation is divided among three funds as seen in Table 2. One-half of that is invested in the rotating Upgrading selection, which is reviewed monthly and changes from time to time. The other half is divided evenly between short-term and intermediate-term index bond funds, which are permanent holdings. For more on why SMI approaches bond investing in this way, see "Introducing an Upgrading Approach to Bond Investing that Outperforms the Bond Market" (bit.ly/smibondupgrading). ◆

[1] Rounding off to the nearest hundred is fine. As time goes by, your portfolio will gradually move away from these starting percentages as some funds perform better than others. This will be fixed once a year when you "rebalance" back to your desired portfolio mix (see Jan2018:p8).

MONEYTALK

STOCK UPGRADING — NEW FUND RECOMMENDATIONS

[When more than one fund in the same risk category is replaced, you should evaluate which of the newly recommended funds is the best fit for your portfolio. The simplest method for picking new funds is to refer to our 1-3 rankings on the "Basic Strategies" page and invest in the highest-ranked fund in each risk category that is available through your broker. • We choose our recommended funds with the hope they will be held for at least 12 months and therefore qualify for long-term capital gains tax treatment (applies to taxable accounts only). Nevertheless, we suggest a change when a fund's performance falls below the threshold of our mechanical guidelines. Our guidelines provide objective criteria for making the decision as to when to "upgrade" to a better-performing fund. When a fund no longer meets our performance guidelines, we suggest you sell it even if the 12-month holding period hasn't been met. However, a "$" symbol following the name of the fund being sold lets you know that we still think well of the fund and its management and you might elect to continue holding the fund for a month or two to achieve a tax benefit or to save on transaction or redemption fees. Be aware, however, that from 2006-2010, the average performance "cost" of retaining such funds was roughly 0.5% per month. For more details, see Oct2011:p153.]

◆ **In the Foreign group, Invesco International Dividend Achievers ETF (PID, 3/2019) is being replaced.** PID was a solid performer from March-June. But like most foreign funds, it struggled in July and August. Its loss of -4.1% in August (through 8/26) flipped our modest overall gain to a loss of -1.1% since the fund was recommended at the beginning of March. While most foreign funds have had similar struggles in recent months, this August performance pushed PID below the foreign-fund category quartile, necessitating a replacement.

• **Fidelity International Capital Appreciation (FIVFX) is being added.**[1] This fund uses a unique process that has delivered strong results since manager Sammy Simnegar took control in 2008. Over the past decade, the fund's annualized return of +9.48% is almost exactly double the +4.77% of its benchmark index (the MSCI ACWI ex-USA).

That's particularly interesting given Simnegar's approach. He regularly reviews each stock in the benchmark index, evaluating whether he likes each one. Those that pass this review are added to the portfolio and overweighted relative to the index allocation by a certain uniform amount. Those that *don't* pass muster aren't included in the portfolio at all—Simnegar doesn't believe in underweighting. The result is a portfolio that looks a lot like the benchmark index, but with significant twists. For example, using the fund's most recent public portfolio, the four heavyweights at the top of the index were also the four largest fund holdings, in the same order. But several of the next largest stocks in the index weren't in the portfolio at all. One other significant difference from the index: FIVFX normally has 15%-20% of its assets in U.S. stocks, while the index has none. These U.S. holdings "fill the gaps" left by foreign stocks that are in the index but aren't included in the portfolio, although Simnegar says he chooses U.S. firms that have no comparables in the foreign index.

◆ **In the Small/Growth group, Neuberger Berman Small Cap Growth A (NSNAX, 5/2019) is being replaced.** This Neuberger fund's gain of +2.5% from May-July solidly beat the +1.6% gain of the average fund tracked in Morningstar's small/growth category over that period. But NSNAX has lost more than most of its peers during August (-6.2% through 8/26), causing it to slide down the category rankings and fall below the category quartile, so we're moving on.

• **DF Dent Midcap Growth (DFDMX) is being added.**[1] DF Dent and Company has been around since 1976 and currently manages more than $6 billion in assets. But you're forgiven if, like us, you've never heard of them before, as their retail mutual funds are relatively new (much of their clientele is endowments, pensions, and corporations). This Midcap Growth fund launched in 2011, and while there's nothing obviously unique about the investment process, the four-person management team clearly has executed it well, delivering solid returns at all intervals throughout this bull market (specifically over the past 12 months, which is what SMI cares about, but also posting competitive 3-year and 5-year returns). The fund didn't exist during the last bear market so we can't evaluate that performance, but it's worth noting that DFDMX is being recommended now largely due to the strength it exhibited relative to the rest of the small/growth group during this year's big down months of May and August. While the S&P 500 index was losing -6.4% in May, DFDMX lost only -2.8%. And while the final numbers aren't in yet for August, the fund has climbed the momentum rankings. These results are due to the fund's below-average (for the small/growth group) relative-risk score of just 1.13. That means this fund has been roughly 13% more volatile than the S&P 500 index over the past three years, a marked step down in risk from the fund it replaces (NSNAX), which had a relative risk score of 1.37. ◆

LEVEL 1 / CONTINUED FROM PAGE 134

DO YOU KNOW WHAT'S IN YOUR CREDIT REPORTS?

to your credit limit (regardless of whether you pay your balance in full each month). For example, if you have a credit card with a $10,000 credit limit and you've made $1,500 worth of purchases, your utilization for that card is 15%.

Only the Equifax report shows the utilization information. You'll find it on the first page under "Credit Accounts" where your debt-to-credit ratio—for each type of account and in total—is listed. To avoid a negative impact on your credit score, it's wise to keep your use of "revolving" credit (such as credit cards) to less than 20% of available credit—not only for each card but overall.

3. Length of Credit History. This accounts for 15% of your score. If closing an old account shortens your recorded credit history, that could negatively affect your score.

Closing an account also will affect your credit utilization percentage. For example, as noted above, if you typically charge $1,500 of purchases per month and your credit limit across all cards is $10,000, you're utilizing 15% of your available credit. But if you close an account with a $5,000 limit and continue charging $1,500 each month, your utilization will suddenly become 30% ($1,500 divided by $5,000). To maintain a strong score, therefore, it's generally better to not close old accounts.

[1]For more on this fund, visit www.morningstar.com.

Of course, there is an important exception to this general rule. For some people, having access to too much credit is a difficult-to-resist temptation, and reducing the amount of credit available would lessen that temptation. If that is the case, we suggest closing more-recent accounts while keeping the card with the longest history open.

4. Types of Credit in Use. The FICO credit-scoring model looks positively at a "credit mix"—i.e., a combination of revolving credit (credit cards) and installment loans (auto loans, student loans). Your mix affects 10% of your score. Even so, don't take out an installment loan just to try to raise your score. Improving your credit score is a worthwhile goal, but it's not worth borrowing money unnecessarily to do so!

5. New Credit. This impacts 10% of your score. Opening several lines of credit over a short period will weigh negatively on your credit score, at least temporarily.

Other information

In addition to listing the types of data described above, your credit report will identify companies that have reviewed your credit file recently. Numerous recent inquiries by companies to which you have applied for credit—known as "hard pulls"—can lower your score. (If you don't recognize the organizations making such inquiries, that may be another indication of identity theft.)

Some types of inquiries won't affect your score (so-called "soft pulls"), such as when you request your credit report or when a prospective employer checks your report (which can be done only with your permission).

On your Equifax report, be sure to review these sections: "Accounts with negative information" (late payments), "Collections" (accounts turned over to a collection agency), and "Public Records" (bankruptcy, foreclosure). Any activity listed in these areas will definitely lower your score, so make sure there's nothing there that shouldn't be. By law, most negative marks on your credit report must be removed after seven years.

Stay away from companies that offer to fix errors or "repair" your credit for a fee. The Federal Trade Commission says such firms can't do anything that you can't do for yourself for free. Each credit report contains information about how to correct mistakes, along with details about what to do if you suspect identity theft.

Put a freeze on

If you're concerned about preventing identity theft and want to block anyone from opening a credit account in your name, you can "freeze" your credit reports at no cost. This prevents lenders from accessing your reports, effectively stopping any new accounts from being opened until you unfreeze your reports. You can freeze accounts by going to these specific web pages for each of the three major reporting bureaus: freeze.transunion.com, www.experian.com/freeze, and www.equifax.com/personal/credit-report-services. ◆

LEVEL 2 / CONTINUED FROM PAGE 135

FED BEGINS NEW RATE-CUTTING CYCLE

ber realization that rates are being cut only because economic growth is slowing. And if that slowdown gets severe enough, it has dire consequences for profits and stock prices, especially if those prices are starting at a high level, as they are today.

One marker along the way in the transition from rate-cuts-as-good-news to rate-cuts-as-bad-news is when the yield curve "inverts." As we discussed near the beginning of this article, short-term interest rates are normally lower than long-term interest rates because lending money for a longer period entails more risk, which is compensated by a higher interest rate. When longer-term interest rates drop *below* shorter-term interest rates, the yield curve is said to invert.

We wrote a separate primer on the yield curve inverting last month on the SMI website, which we recommend reading if you haven't already.[1] But the most important takeaway from that article is that the same type of yield-curve inversion that signaled approaching recessions in the past has recently taken place. This doesn't guarantee a future recession, but it does mean the probability of one likely has increased. However, even if this is true, the *timing* remains uncertain, as the stock market has often continued to rise for many months following past yield-curve inversions.

Conclusion

Putting all this together, historically when the Fed has started cutting interest rates in an effort to forestall a future recession, it normally has been good news for investors in the short term, but bad news in the longer term. The last time the Fed started a new rate-cutting cycle was September 2007. The stock market would peak exactly three weeks later, though it took the better part of a year for that bear market to kick into high gear. At other times, however, the market has rallied to new highs as long as *18-22 months later*. So it's impossible to generalize what we should expect this time.

SMI's perspective is that both the shift to a new rate-cutting cycle and the recent inversion of the yield curve are further signals that stock market risk, which was already high, has increased further. The pattern of each bull- and bear-market cycle over the past 25 years has been clear. First, the Fed lowers interest rates and keeps them low (too long), inflating stock prices. The Fed then eventually raises rates (too much), choking off growth and starting the economy on the path to recession, resulting in substantial losses for stock investors. While the timing of this remains uncertain, there's no reason to think this iteration of the cycle will end differently.

The good news for SMI investors is that if you're using a blend of SMI's strategies that's anything like the 50-40-10 blend we often discuss as a good starting point, you're already following a reasonably conservative plan.[2] As a result, most SMI investors likely don't need to take any specific action at this point, as these strategies will adapt to changing market circumstances and should provide a healthy buffer against future bear-market

[1] bit.ly/invertedcurve [2] Blending strategies adds complexity. Some members may prefer an automated approach. See bit.ly/SMIPrivateClient.

MONEYTALK

losses. That doesn't mean we won't lose any money, but rather that defensive measures are already in place. The recent performance of Dynamic Asset Allocation has been a good example of this, as two-thirds of its portfolio has been performing great at times when the stock market has taken big hits.

Ultimately, the best course is to follow your individual long-term plan and the SMI strategies as they're laid out. DAA and Upgrading 2.0 have been designed for periods such as this, when we don't want to rush prematurely to the exits late in bull market cycles, but we don't want to lose a lot of ground in an upcoming bear market either. Both strategies have done a good job of protecting capital in past bear markets and setting us up for the opportunities that always exist on the other side of those bear markets. There's every reason to believe they will continue to be effective, regardless of how this particular cycle unfolds. ◆

LEVEL 3 / CONTINUED FROM PAGE 136

DON'T BE SURPRISED IF TARGET-DATE FUNDS MISS THE MARK

however, no major company offering TDFs has adopted a reverse-glide-path model.

A more personalized approach

A target-date product is presented as a "one size fits all" investing approach based on a projected retirement date. Unfortunately, one size *doesn't* fit all.

Although a guideline based on age (or retirement date) is better than no guideline at all, an investor should, if possible, take other variables into account when choosing a portfolio mix. The best approach is to incorporate not only one's projected retirement date, but also risk tolerance, savings level, health, and so on. A target-date product can't do that. It is a blunt instrument. And, as noted, how that instrument is wielded can vary widely from one fund company to the next.

That's not to say there's no place for target-date products in the investing landscape. As a default option in a company retirement plan, a reasonable, low-cost TDF is likely an improvement over what the typical plan participant would otherwise choose.

But in our view, SMI members—who have access to our various strategies and the Personal Portfolio Tracker—are likely to be better off keeping as much control as possible in their own hands, rather than delegating asset-allocation and diversification decisions to a target-fund manager. Maintaining control will help ensure that you have a personalized plan that aligns your investment choices with your particular temperament and goals.[1]

Again, there is nothing wrong with investing in a target-date fund. If you have only a few investment choices in your 401(k) plan, a TDF may be the best option. But before you invest, research the details. Understand a specific fund's portfolio mix and its "glide path" for moving toward more fixed-income investments as retirement approaches. ◆

LEVEL 4 / CONTINUED FROM PAGE 137

A CLOSER LOOK AT THE "DIVIDENDS ONLY" RETIREMENT-INCOME STRATEGY

dividend amount stayed the same. But the higher yield (caused by the lower price) may not signal a more attractive stock.

The fact that many companies continue paying dividends through market declines may tempt some investors to pay too little attention to the share price, figuring the dividend income will continue no matter what. But it doesn't always work that way. Even some companies with long histories of paying dividends have reduced or eliminated them.

Take GM, for example. After decades of issuing dividend distributions, the automaker ran into trouble in the lead-up to the financial crisis. Its stock price fell from over $60 in early 2003 to under $20 three years later. For a while, the company maintained its dividend, which made its yield look especially appealing. However, the company cut its dividend in half in 2006, eliminated it all together in 2008, and went bankrupt in 2009. There are plenty of other cautionary tales out there as well, such as Enron and GE.

By the time your dividend income from a particular stock is reduced or eliminated, the value of your investment likely will have declined to the point that you could not sell that stock and buy another that would replace your former income.

• **Conservatism.** Taking a dividends-only approach to retirement income means counting on dividend increases that will outpace inflation. AT&T's double-digit dividend increase in 2008 was unusual. Since then, it has continued to increase its dividend, but in a much more moderate 2%-2.5% range. That may be fine today, but what if inflation rises?

Especially during a bull market, a dividends-only approach may leave an investor living on an unnecessarily low income while their portfolio grows substantially. If leaving a large inheritance or bequest is a goal of yours, there's certainly nothing wrong with that. Just make sure you understand the trade-off you're making.

The bottom line

Given some of the advantages of dividend income described earlier, it would be understandable if an SMI member wanted to diversify retirement income streams by holding a portion of his or her portfolio in dividend-paying stocks. However, we believe most SMI retirees would be better off taking a "total returns" approach with most or all of their portfolio, periodically selling shares to generate needed income.

A blended portfolio[2] that uses Dynamic Asset Allocation and Fund Upgrading, with perhaps a small allocation to Sector Rotation, would give you objective buying and selling guidance and should prove better able to outpace inflation while providing healthy measures of downside protection. Pairing that approach with "the bucket strategy," where two-to-three years' worth of living expenses are kept liquid, would provide further protections, helping prevent you from having to sell shares in a falling market.[3] ◆

[1]SMI's risk tolerance quiz and allocation calculators can help. See soundmindinvesting.com/resources.
[2]Blending strategies adds complexity. Some members may prefer an automated approach. See bit.ly/SMIPrivateClient. [3]bit.ly/bucket-strategy

PREMIUM STRATEGIES

The strategies described below are available to those with an SMI Premium web membership. These strategies can be used in combination with—or in place of—our Just-the Basics and Upgrading portfolios. They have special characteristics that could make them desirable depending upon your individual goals, risk tolerance, and tax bracket. You can learn more about each strategy in the Premium section of the SMI website.

DYNAMIC ASSET ALLOCATION

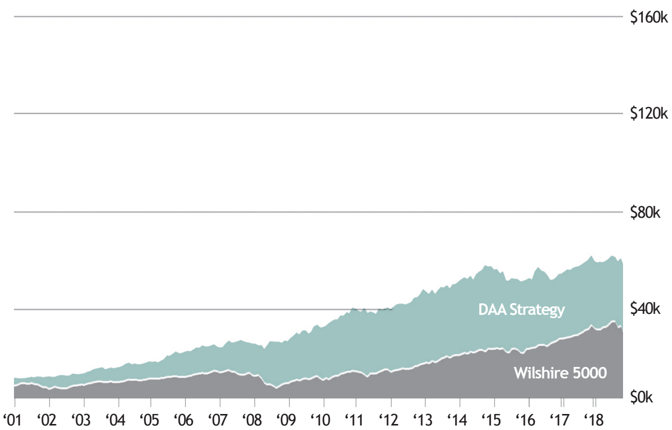
Overview

This is a stand-alone strategy that can be used in combination with (or in place of) SMI's basic strategies. DAA is designed to help you share in some of a bull market's gains, while minimizing or even preventing losses during bear markets. It's a low-volatility strategy that nonetheless has generated impressive back-tested results over the long term. DAA involves rotating among six assets classes—U.S. stocks, foreign stocks, gold, real estate, bonds, and cash. Only three are held at any one time.

Who Should Consider This Strategy

Anyone, but especially investors who are more concerned with avoiding major losses during bear markets than they are with capital growth during bull markets. **Pros:** Excellent downside protection during bear markets, reflected in a very low worst-case result and relative-risk score. Great long-term track record. **Cons:** Subject to short-term whipsaws. Lags the market in up years. Making trades promptly and concentrating entire portfolio in only three asset classes can be emotionally challenging.

Dynamic Asset Allocation vs Wilshire 5000
Growth of $10,000 January 2001-December 2018



Strategy	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Avg[1]	Worst12[1]	Rel Risk[1]
DAA	4.0%	10.4%	22.4%	19.3%	8.6%	25.7%	10.1%	1.3%	17.6%	20.3%	1.4%	13.9%	16.2%	13.0%	-6.8%	-0.5%	16.0%	-4.5%	9.9%	-13.7%	0.62
Wilshire 5000	-11.0%	-20.9%	31.6%	12.5%	6.4%	15.8%	5.6%	-37.2%	28.3%	17.2%	1.0%	16.1%	33.1%	12.7%	0.7%	13.4%	21.0%	-5.3%	5.2%	-43.3%	1.00

SECTOR ROTATION

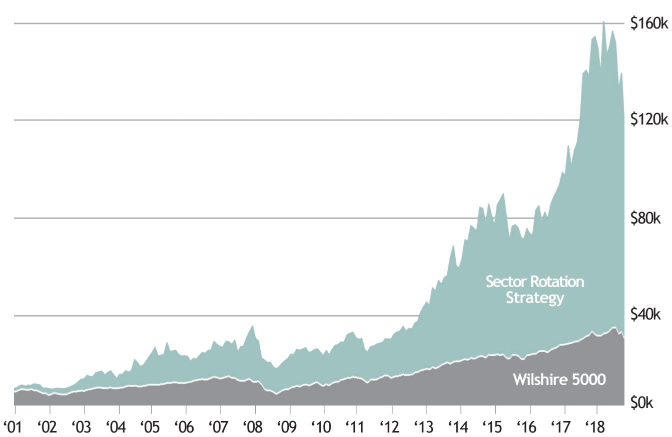
Overview

This high-risk strategy involves investing in a single special-purpose fund that focuses on a specific sector (such as biotech, energy, or financial services). Because these stock funds invest in a narrow slice of the economy, they carry a higher degree of risk. Only one fund, selected based on having superior momentum relative to other sector options, is held at a time. The sector-fund recommendations in this strategy are designed to be used in combination with Just-the-Basics, Fund Upgrading, or DAA (or a combination of these) up to a maximum of 20% of the stock allocation. While the performance peaks and valleys of Sector Rotation have been higher and lower than all other SMI strategies, it's a strategy that has generated especially impressive long-term returns.

Who Should Consider This Strategy

Experienced investors willing to concentrate an investment in a single sector of the economy. **Pros:** Very attractive long-term returns. **Cons:** Much greater month-to-month volatility and relative risk with dramatic short-term loss potential.

Sector Rotation vs Wilshire 5000
Growth of $10,000 January 2001-December 2018



Strategy	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Avg[1]	Worst12[1]	Rel Risk[1]
Sector Rotation	3.7%	-13.1%	54.4%	12.6%	46.1%	-1.9%	28.1%	-31.5%	30.5%	9.1%	-3.2%	23.3%	65.7%	49.9%	-9.7%	16.8%	56.7%	-15.8%	15.7%	-38.6%	1.85
Wilshire 5000	-11.0%	-20.9%	31.6%	12.5%	6.4%	15.8%	5.6%	-37.2%	28.3%	17.2%	1.0%	16.1%	33.1%	12.7%	0.7%	13.4%	21.0%	-5.3%	5.2%	-43.3%	1.00

[1]The three data points on the far right in each of the two tables are for the Jan2001-Dec2018 period. "Avg" represents the average annualized return from 2001-2018. "Worst12" represents the worst investor experience over 181 rolling 12-month periods from 2001-2018.

PERIODICALS POSTAGE
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Dated Investment Material
Please Do Not Delay!

PERFORMANCE DATA

SOUND MIND INVESTING MODEL PORTFOLIOS • DATA THROUGH JULY 31, 2019

BASIC STRATEGIES

	Year to Date	1 Month	3 Months	12 Months	3 Yrs Annual	5 Yrs Annual	10 Yrs Annual	15 Yrs Annual
U.S. Stock Market[1]	20.4%	1.5%	1.5%	7.0%	13.1%	11.1%	14.0%	9.3%
Just-the-Basics[2]	18.8%	0.9%	0.7%	3.2%	11.4%	8.7%	12.4%	8.9%
Stock Upgrading[3]	15.9%	1.2%	2.3%	0.6%	9.9%	7.5%	11.1%	9.0%
U.S. Bond Market[4]	6.3%	0.2%	3.2%	8.0%	2.0%	2.9%	3.6%	4.1%
Bond Upgrading[5]	6.2%	0.1%	3.3%	7.0%	2.0%	2.9%	5.6%	5.9%

PREMIUM STRATEGIES

	Year to Date	1 Month	3 Months	12 Months	3 Yrs Annual	5 Yrs Annual	10 Yrs Annual	15 Yrs Annual
DAA[6]	9.2%	0.7%	4.0%	3.4%	3.2%	3.8%	8.6%	10.1%
Sector Rotation	-2.0%	3.8%	-7.0%	-24.3%	10.4%	10.3%	17.3%	14.7%
50-40-10 Blend[7]	10.7%	1.2%	2.2%	-0.7%	6.8%	6.2%	10.7%	10.6%

Notes: Transaction costs and redemption fees—which vary by broker and fund—are not included. • [1] Based on the float-adjusted Wilshire 5000 Total Return index, the broadest measure of the U.S. stock market. • [2] Calculated assuming account rebalancing at the beginning of each year with 40% of the stock allocation invested in the Vanguard S&P 500 (VOO), 40% in Extended Market (VXF), and 20% in Total International Stock (VXUS). • [3] For a 100% stock portfolio, assuming the portfolio allocation for each risk category was divided evenly among all recommended funds. • [4] Based on Bloomberg Barclay's U.S. Aggregate Bond Index, the broadest measure of the U.S. bond market. • [5] For a 100% bond portfolio, assuming 25% of the portfolio was invested in Vanguard I-T Bond Index (BIV), 25% in Vanguard S-T Bond Index (BSV), and 50% in the rotating recommended bond fund. The results prior to January 2015 are hypothetical, calculated from backtesting the strategy following a mechanical rules-based system. • [6] The results prior to January 2013 are hypothetical, calculated from backtesting the strategy following a mechanical rules-based system. • [7] For a portfolio allocated 50% to DAA, 40% to Stock Upgrading, and 10% to Sector Rotation. See the April 2018 cover article for details. Results prior to January 2013 are hypothetical, calculated from backtesting the strategy following a mechanical rules-based system.

THE SOUND MIND INVESTING MUTUAL FUND (SMIFX)

Current Returns as of 7/31/2019	Year to Date	1 Month	3 Months	12 Months	3 Year Annual	5 Year Annual	10 Year Annual
SMIFX	14.57%	1.58%	1.47%	-3.21%	8.38%	5.78%	9.64%
Wilshire 5000	20.42%	1.49%	1.47%	7.01%	13.14%	11.07%	13.98%
S&P 500	20.24%	1.44%	1.69%	7.99%	13.36%	11.34%	14.03%

Quarterly Returns as of 6/30/2019	Year to Date	1 Month	3 Months	12 Months	3 Year Annual	5 Year Annual	10 Year Annual
SMIFX	12.80%	5.19%	2.81%	-4.25%	8.97%	4.84%	10.39%
Wilshire 5000	18.66%	6.96%	3.99%	9.09%	14.03%	10.33%	14.66%
S&P 500	18.54%	7.05%	4.30%	10.42%	14.19%	10.71%	14.70%

Total/Gross expense ratio: 2.04% as of 2/28/19 (includes expenses of underlying funds)
Adjusted expense ratio: 1.16% as of 2/28/19 (excludes expenses of underlying funds)

Notes: The performance data quoted represent past performance, and past performance is not a guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance information quoted. • ***You should carefully consider the investment objectives, risks, fees, charges and expenses of the Funds before investing. The prospectus contains this and other information about the Funds. To obtain a prospectus or performance information current to the nearest month end, call 1-877-764-3863 or visit www.smifund.com. Read the prospectus carefully before investing.*** • Because the SMI Funds invest in other mutual funds, they will bear their share of the fees and expenses of the underlying funds in addition to the fees and expenses payable directly to the SMI Funds. As a result, you'll pay higher total expenses than you would investing in the underlying funds directly. • Returns shown include reinvestment of dividends and capital gains. The Wilshire 5000 index represents the broadest index for the U.S. equity market. The S&P 500 Index is an unmanaged index commonly used to measure the performance of U.S. stocks. You cannot invest directly in an index. • The Sound Mind Investing Funds are distributed by Unified Financial Securities (member FINRA).

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