Model Capital
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Tactical Strategies – U.S.

1H-2014 Performance

Consistent Risk-On Not Influenced by Geopolitics

July 11, 2014
As of June 30, 2014

Roman Chuyan, CFA

- **As our model dictated, all of our tactical strategies were consistently in risk-on position throughout 1H-2014, and were not whipsawed by market volatility.**
- **The Complete Market and 2xStocks-Bonds strategies delivered above-10% YTD returns, outperforming their benchmarks by over 3.4%. The Stocks-Bonds strategy returned 6.3% YTD.**

Real-Time Performance[1]

For periods ending June 30, 2014, net of fees.

	Benchmark ->			Benchmark ->	
	60/40	Stocks-Bonds	Complete Market	S&P 500 (SPY)	2x Stocks-Bonds
3m Return	4.2%	4.5%	4.5%	5.2%	8.5%
YTD Return	6.6%	6.3%	10.1%	7.0%	10.3%
12m Return	18.1%	21.8%	22.1%	24.4%	38.2%
Since Inception Jan-2013	16.2%	23.7%	25.0%	26.0%	43.2%

Simulated Back-Tested Metrics[2]

	60/40	Stocks-Bonds	Complete Market	S&P 500 (SPY)	2x Stocks-Bonds
5 YEARS					
Return (annualized)	**14.6%**	**22.6%**	**24.7%**	**18.7%**	**39.7%**
Standard Deviation	8.7%	10.5%	11.4%	13.4%	18.3%
Max. Drawdown	-35.2%	-12.4%	-12.7%	-50.8%	-23.6%
10 YEARS					
Return (annualized)	**7.2%**	**15.6%**	**17.1%**	**7.7%**	**25.4%**
Standard Deviation	10.2%	10.6%	11.7%	14.7%	19.1%
Max. Drawdown	-35.2%	-16.5%	-18.2%	-50.8%	-31.6%
Relative Return		8.3%	9.8%		18.2%
Relative Risk (std. dev.)		0.5%	1.5%		8.9%
Tracking Error (monthly)		2.5%	2.7%		4.2%
Information Ratio		**0.97**	**1.06**		**1.26**
Sharpe Ratio (vs. Libor)	0.51	1.26	1.28	0.38	1.22
Sortino Ratio (vs. Libor)	0.72	2.44	2.52	0.53	2.34

Returns for periods longer than 1y are annualized. Standard deviations are monthly, annualized.

Investment Advisory services are provided by Model Capital Management LLC.

[1] Model real-time returns from inception on Jan 1, 2013, net of trading expenses and of MCM's management fee of 0.50%. Past performance is not a guarantee of future returns. MCM claims compliance with the Global Investment Performance Standards (GIPS®). See Appendix 1 for GIPS®-compliant performance presentation. See other important disclosures at the end of this document, or at modelcapitalmgmt.com/portfolio-disclosures.

[2] Simulated back-tested risk and return metrics are presented for all periods prior to January 1, 2013.

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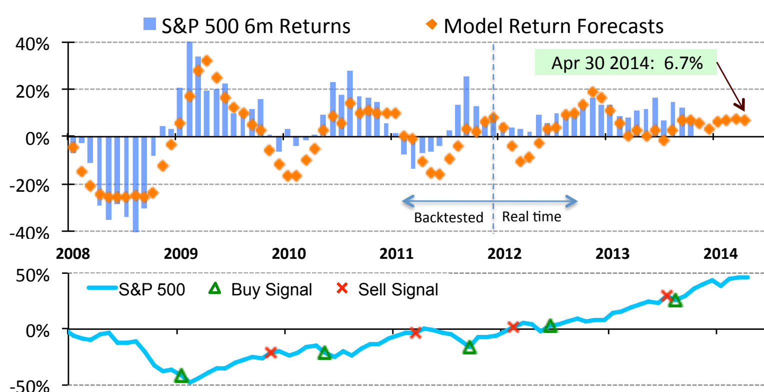
The first half of 2014 was characterized by a **conflict between strong fundamentals and perceived risks**. Many observers were puzzled by the equity market's continued strength, and predicted negative outcomes this year. Based on concerns about the new Chair Janet Yellen ending the Fed's bond-buying stimulus, equities experienced a sharp sell-off in January. The S&P 500 index dropped by as much as -5.7% (see chart on page 3), and some managers were lured into positioning for continued downside – and were whipsawed by the market that rebounded in just in seven trading sessions.

Concerns about the conflict between Ukraine and Russia dominated headlines in March and April. Citing geopolitical risk and debt problems in China, many investment managers reduced risk significantly, according to the BofA Merrill Lynch Fund Manager Survey[1]. Managers raised cash levels to 5% in May (the highest since June 2012), and reduced their risk-taking. Such a significant reduction in portfolio risk based on geopolitics – and despite improving fundamentals – set the stage for further gains in equities. When sentiment rebounded, the pool of un-used risk budget flowed back into equities.



At Model Capital, we believe that fundamentals drive markets. Our statistical forecasting PAR Model™ determines 6-month return forecasts for equities based on a wide range of Economic, Valuation, and Market factors. The fundamental economic data that our model has determined to be important for equities have been strong this year.

The strong housing market, improving consumer confidence and spending, and improving bank lending all contributed to strong 6m return forecasts by the PAR Model™. The forecasts generally stayed in a 6%-8% range; accordingly, we **kept all our tactical strategies in risk-on stance**. Geopolitical concerns "nudged" the market temporarily off course again in April (see chart below). On Apr 15, our model's equity return forecast rose to 7.8%. The discrepancy between the strong forecast and the negative sentiment was so large that we titled that month's Tactical Strategies report *Great Set-Up for Buying U.S. Equities*.

With such negative investor sentiment in the face of strong fundamentals, it was not all that surprising to see a stronger rally beginning in May. The S&P 500 broke above the psychologically-important 1900 level and finished June at 1960, for a 7% YTD return.

Our moderate-risk **Stocks-Bonds** strategy returned 6.3% YTD, 0.3% below its 60/40 benchmark. The **Complete Market** strategy (our largest in terms of assets) benefitted from its Growth exposure early in the year, and our rebalancing from Growth into Value in mid-March based on our model's forecasts helped us achieve a 10.1% return in this portfolio. Positioning our growth **2xStocks-Bonds** strategy for the upside based on the PAR Model's™ return forecasts (that turned out to be quite accurate) helped us achieve 10.3% YTD return in this portfolio.

[1] http://newsroom.bankofamerica.com/press-releases/economic-and-industry-outlooks/bofa-merrill-lynch-fund-manager-survey-finds-investo-1

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SPDR S&P 500 ETF (SPY) 6m Performance

SPY Price
SMA 50
EMA 100

Note: moving averages are provided for illustration only
We do not use or recommend technical indicators as a guide of any kind

Sources: Ycharts, Model Capital Management

What's ahead for the rest of 2014? After strong performance in May-June, the S&P 500 peaked at 1985 on Jul 3. The 2000 level seems to be within reach, but may take some time for the market to claim. Many observers are (once again) calling for a correction. At Model Capital, we make investment decisions strictly based on near-term asset class return forecasts by our PAR Model™, which is driven by fundamental data. The latest return forecast is still above-average, while indicates a more gradual rise in equities.

Tactical Portfolios

Research has shown that about 90% of return and risk for a typical balanced portfolio comes from **asset allocation**. Therefore, active investment managers can maximize their chances of delivering above-index performance by focusing on tactical asset allocation management, rather than on the remaining 10%.

At Model Capital, we construct tactical ETF-based portfolios based on our systematic modeling and forecasting approach. The strategies allocate to the best near-term return-risk opportunities in major asset classes. The stocks-vs.-bonds allocation decision is made based on our PAR Model™, which forecasts equity index returns using fundamental factors. We commonly allocate 100% to either stocks or bonds. If an allocation is recommended to bonds, allocation to a specific bond ETF is based on the term-risk and credit-risk premium in various bond markets.

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Three U.S. tactical strategies are presented here: Stocks-Bonds, Complete Market, and 2xStocks-Bonds. The **Stocks-Bonds** strategy allocates 100% of the portfolio to equities (the S&P 500, potentially with moderate Value/Growth biases), or to fixed income. The **Complete Market** strategy further allocates to the best return-risk opportunities in equity style (value/growth) and size (large/mid/small-cap), and other segments of public markets where opportunities exist. No leverage is used in these two strategies. When our model indicates weakness in equities, we allocate to fixed income index(es): short-term, long-term Treasuries, long-term corporates, or floating-rate loans, depending on their risk-return trade-off. We don't short-sell equities or use inverse ETFs. When the PAR Model's™ equity return forecast is especially attractive, the **2xStocks-Bonds** strategy utilizes 2x levered exposure to the S&P 500.

	Stocks-Bonds	Complete Market	2x Stocks-Bonds
Risk Profile	Balanced	Balanced	Growth
Benchmark	60% S&P 500 40% corp. bonds	60% S&P 500 40% corp. bonds	S&P 500
Equity Min/ Max/ Avg	0%/ 100%/ 59%	0%/ 100%/ 59%	0%/ 200%/ 104%
Inception	1/1/13	1/1/13	1/1/13

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APPENDIX 1

January 1, 2014 through June 30, 2014

Composite	Composite Gross Return (%)	Composite Net Return (%)	Benchmark Return (%)	Composite 3yr St. Dev. (%)	Benchmark 3yr St. Dev. (%)	Number of Portfolios	Internal Dispersion (%)	Composite Assets ($ M)	Firm Assets ($ M)
Stocks-Bonds	6.53%	6.26%	6.62%	N/A	N/A	<6	N/A	7.2	27.5
Complete Marke	10.38%	10.10%	6.62%	N/A	N/A	<6	N/A	10.8	27.5
2xStocks-Bonds	10.63%	10.34%	6.95%	N/A	N/A	<6	N/A	3.3	27.5

Model Capital Management LLC ("MCM") claims compliance with the Global Investment Performance Standards (GIPS®), and has prepared and presented this report in compliance with the GIPS® standards. MCM's performance has been independently verified to comply with GIPS® standards for the periods January 1, 2014 to May 31, 2014. The verification report is available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

Notes:

1. Model Capital Management LLC is an independent Boston based investment advisor that is focused exclusively on tactical management.

2. The Stocks-Bonds, Complete Market, and 2xStocks-Bonds composites include all accounts managed to respective MCM's strategies on a unified managed account (UMA) platform. Each UMA platform is considered as one portfolio for GIPS purposes, with a number of individual accounts in each UMA platform. All accounts allocated to a strategy from the beginning to the end of a month are included in the composite for that month. Monthly composite returns represent total returns. Geometric linking of monthly returns is used to calculate longer-term returns.

3. (a) The **Stocks-Bonds** Composite's goal is added performance above a buy-and-hold 60/40 benchmark, while reducing downside risk. The strategy allocates to the broad large-cap U.S. equity market (the S&P 500) and to its style components (Value/Growth), and/or to U.S. fixed income markets (short-term, long-term Treasuries, corporate bonds, TIPS). The risk allocation between equities and fixed-income markets is based on the PAR model's 6-month return forecast for equity index. The benchmark for the composite is 60% SPDR S&P 500 ETF (SPY) and 40% iShares Investment Grade Corporate Bond Index ETF (LQD), rebalanced monthly.

(b) The **Complete Market** Composite's goal is added performance above a buy-and-hold 60/40 benchmark, while reducing downside risk. The strategy allocates to the size- and style components of the U.S. equity market (Large/Mid/Small-Caps, Value/Growth), and/or to various U.S. income markets (short-term, long-term Treasuries, corporate bonds, senior loans, TIPS, MBS). The risk allocation between equities and fixed-income markets is based on the PAR model's 6-month return forecast for equity index. The benchmark for the composite is 60% SPDR S&P 500 ETF (SPY) and 40% iShares Investment Grade Corporate Bond Index ETF (LQD), rebalanced monthly.

(c) The **2xStocks-Bonds** Composite's goal is added performance above the S&P 500 benchmark, while reducing downside risk. The strategy allocates to the broad large-cap U.S. equity market (the S&P 500) and/or to U.S. income markets (short-term, long-term Treasuries, corporate bonds, TIPS, MBS). The risk allocation between equities and fixed-income markets is based on the PAR model's 6-month return forecast for equity index. When the model's forecast is especially strong, up to 200% exposure (2x leverage) to the S&P 500 can be utilized. The benchmark for the composite is SPDR S&P 500 ETF (SPY).

4. Gross-of-fees returns are presented before management fees but after all trading expenses. Net-of-fees returns are calculated by deducting the highest MCM's annual management fee of 0.50% from gross composite returns. Fees are deducted quarterly. The typical fee schedule is:

On AUM <$50 million: 0.50%

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On AUM between $50m and $100m:	0.45%
On AUM over $100m:	0.40%

5. Internal dispersion is calculated using the equal-weighted standard deviation of monthly net returns of those portfolios that were included in the composite for the entire year. The internal dispersion is not presented as the composite does not have an entire year of returns.

6. The three-year annualized standard deviation measures the variability of the composite and the benchmark returns over the preceding three-year period. The standard deviation is not presented as the composite does not have 3 years of returns.

7. Valuations are computed and performance is presented in US Dollars. A composite descriptions and policies for valuing portfolios, calculating performance and preparing compliant presentations are available upon request.

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