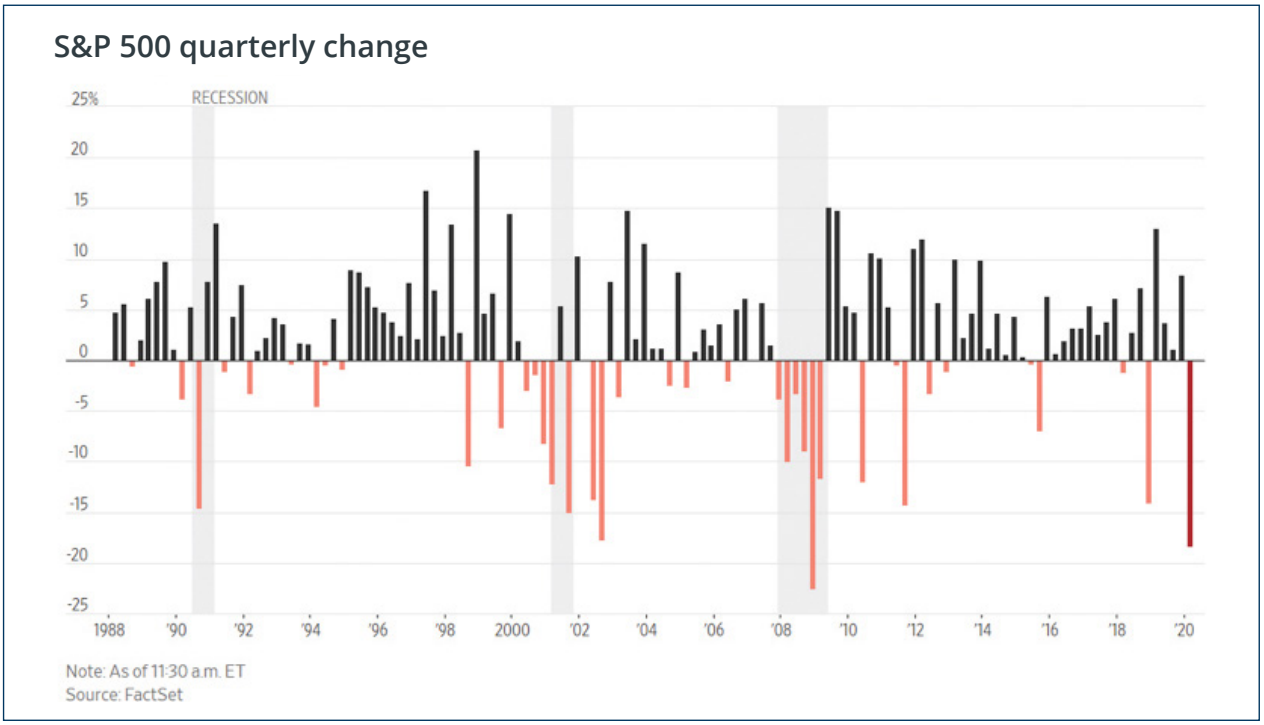
RISK MATTERS. DEFENSE MATTERS. DISCIPLINE MATTERS.

It wasn't what anyone expected or predicted at the start of 2020: One of the worst quarterly returns for the S&P 500 in over three decades (see chart below) and the worst first quarter for the Dow since 1987.

At the start of this new decade, the U.S. and China were making progress on trade talks. Global central banks were poised to keep rates low. But, like a black swan against the midnight sky, no one saw this coming: A global health crisis with massive economic implications and sharp market reactions in every asset class exacerbated by a massive price war over crude oil, between Saudi Arabia and Russia.



By the end of the first quarter of 2020, the broad U.S. stock market lost 20%, after sinking more than 30% by the third week in March, and small cap stocks were down much more.

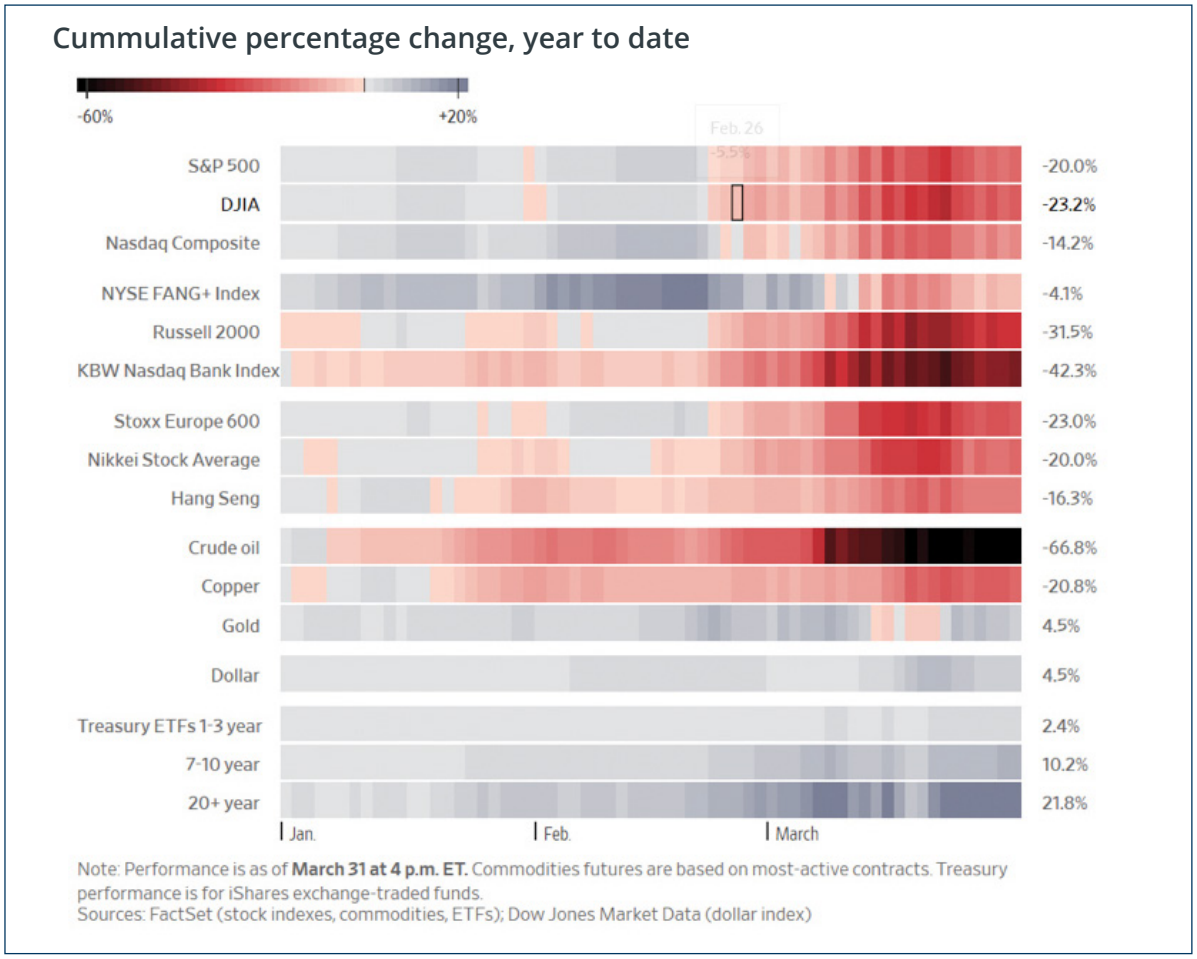
Fleeing for safety, investors piled into U.S. Treasury bonds, pushing prices up and yields down: The 10-year Treasury Note yield fell to 0.54% before recovering to 0.70% at the end of March. The historic lows are epic: the last record low was 1.34%.

The longest U.S. bull market on record fell firmly into bear market territory and did so with passion and a high level of fear about the future. With total clarity, we at Sierra Mutuail Funds recognize that it is futile to make predictions about any markets with any semblance of accuracy. In the toughest of times, that futility is magnified. What began as an unknown virus in a big city in China quickly evolved into a global pandemic. The human and economic tolls are still unknown. Markets were, and remain at writing, at the mercy of news on the virus.

However, hope is not a strategy and neither is panic. These mammoth disruptions presented a set of circumstances where our rules-based disciplines were able to navigate us through the volatility.

RISK MATTERS: AN EXAMINATION OF Q1 2020.

To say markets can be treacherous is an understatement. The selling became indiscriminate during March as investors scrambled to dump assets from stocks to commodities to emerging markets debt in frantic fear of a massive global economic downturn.



- Institutional investors questioned every bond market, essentially crippling liquidity before the Federal Reserve Bank ("the Fed") stepped in to address the deterioration, curbing the worst fears.
    - The Fed became a "buyer of last resort" establishing emergency intervention facilities to provide flow of credit to businesses, consumers, employees and municipalities.
    - The Fed also removed its cap on purchasing Treasuries, essentially buying as much as needed to keep the markets flowing. This includes buying TIPs, an inflation strip of bonds, at a higher level than ever before.
- Trading stops, designed to stabilize jittery stock markets, were hit 4 times in March.
- The S&P 500 pivoted from the longest bull market on record to firmly in bear market territory, destroying over one-third of that market's value in 22 trading days, before clawing back some of the losses by the end of the quarter.
- Restaurants, stores, businesses, beaches and parks were shuttered across the country.
- U.S. small stocks, as measured by the Russell 2000, were pummeled down as much as 40% before closing the books at a 30% decline for the first quarter.
- The Nikkei, representing the Japanese stock market, clocked its worst quarter since the 2008 recession.
- The stocks of emerging markets countries crumpled 30-40% over worries about how countries from India to Chile to Poland would manage through the health crisis.
- Bonds of emerging markets countries reflected much higher risk of default and lost at least 20% of their values and more.
- Fear of cratering demand coupled with a Middle East price war sent oil prices plunging to an 18-year low. As an example, WTI crude oil fell 75%, from over $60 a barrel at the start of 2020 to under $15 a barrel recently.
- In a panicky rush for safety, investors snapped up U.S. Treasury bonds. The longer the maturity, the greater the price gains and 20+ year Treasury bonds soared up 20% on the quarter. Even 7-10 year paper jumped up 10%.

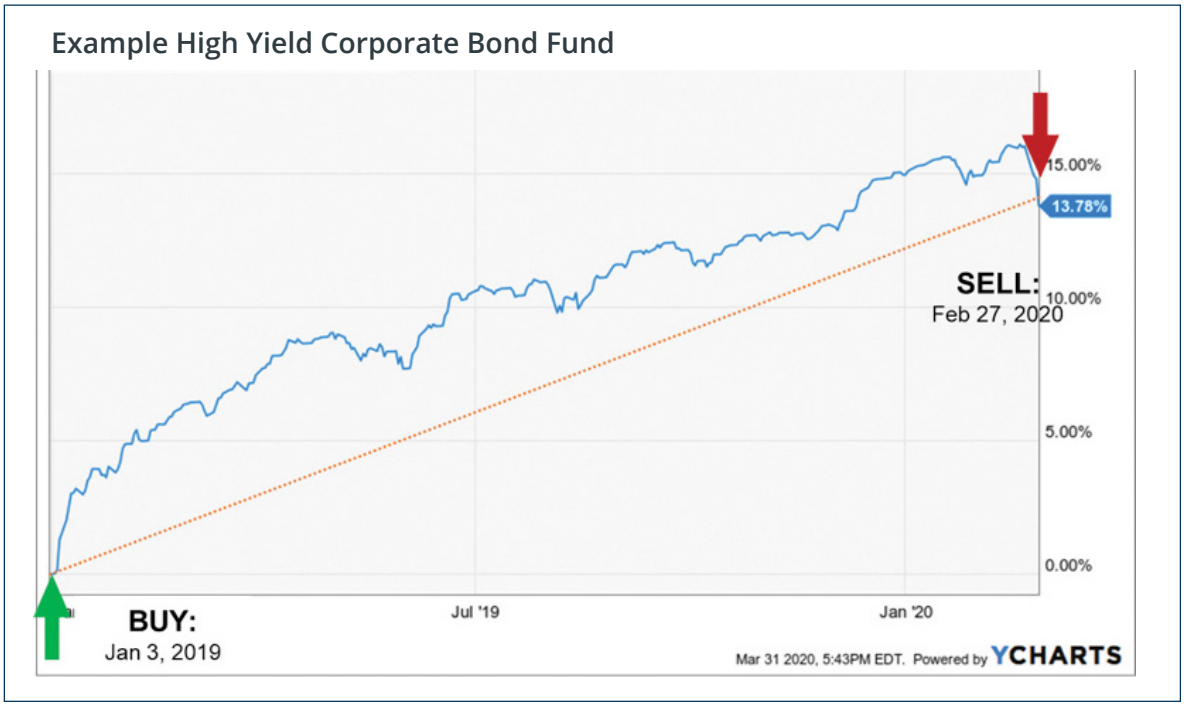
- Putting some numbers on the yields, the 10 -year Treasury fell from 1.92% to a record low 0.54%, before recovering to close the quarter at 0.70%. The historic lows are epic: the last record was 1.34%.
- Collapsing rates and a very flat yield curve hammered bank stocks, which make money on the difference in rates that they can lend to borrowers (such as home buyers) and to savers (such as savings accounts). Bank stocks reflected the dismal environment plunging 40% on the quarter.
- High yield corporate bond spreads blew out to a peak of +1087, nearly +700 bps wider than they had been at the end of February. Widely watched high yield corporate bond ETFs and actively managed mutual funds dropped as much as 20% from peak to trough during the quarter.
- Not even the boring municipal bond market was spared. Investment grade municipal bond funds declined around 10% and more, while high yield municipal bond funds dropped 16% and more before clawing back ground for the quarter.
- The VIX (S&P 500 Volatility Index) rocketed to levels not seen since at least the start of the millennium, peaking over 80 and closing the quarter over 50. These levels are far above average levels of around 15 and indicate massive fear in the markets (see chart below).
- Gold, also often viewed as a place to hide, picked up over 4% on the quarter rising to about $1580/ounce.
- Congress and the Trump administration approved a $2 trillion economic stabilization package, unprecedented in its sheer scope and size, to respond to the pandemic. The package includes direct payments, jobless benefits, a bailout fund for business and money for state governments.

DEFENSE MATTERS: IMPLEMENTING A DEFENSIVE STRATEGY.

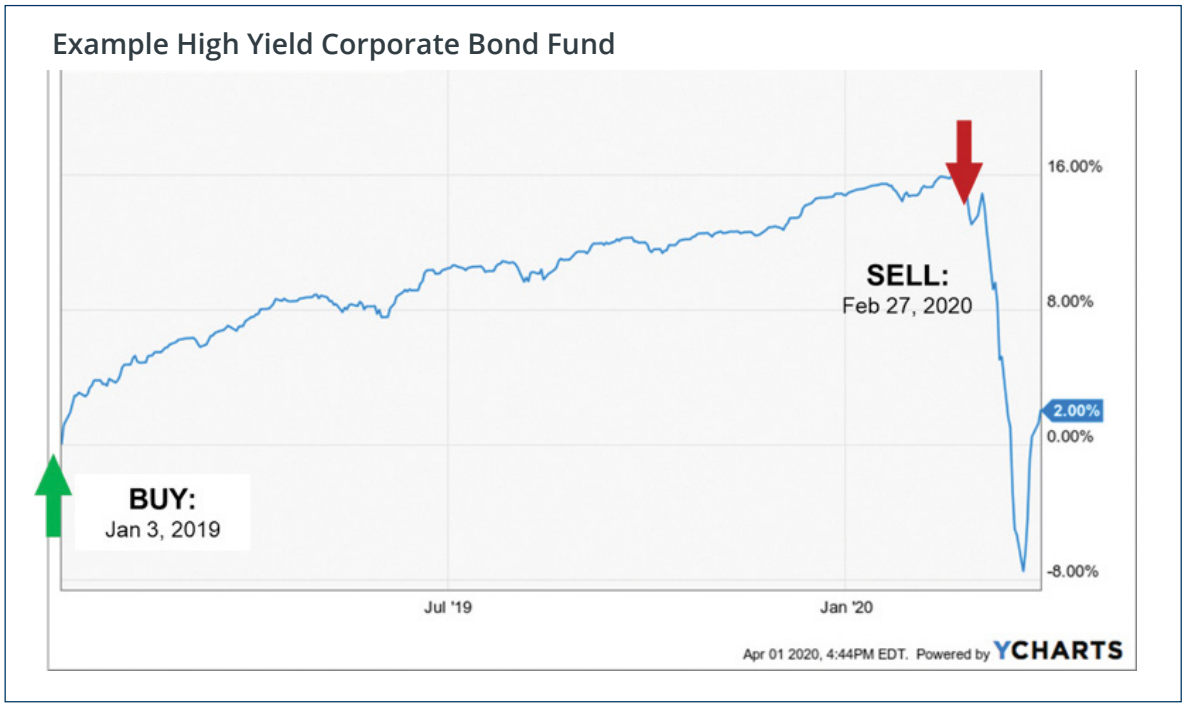
It can be gratifying to play offense in the investment markets, at least while the sun is shining. But defense is a critical element of a good strategy also – no one wants to take a "round trip" when the cycle changes.

The next two charts demonstrate the benefit of a disciplined participation in one investment holding as it played out from buy to sell.

The first chart (below) illustrates an investment purchased in the high yield corporate bond asset class. A Buy signal, as defined by Sierra Mutual Fund's long-proven rules in place at guided us to purchase on January 3, 2019, as indicated by the green arrow. Although this fund, like any investment, did not take a straight path, the trend to the upside lasted until mid-February 2020. The fund then turned down and continued falling until it reached a Sell signal (again as defined by Sierra Mutual Fund's rules-based trailing stop discipline). The sale occurred on February 27, 2020, closing out a +13.8% gain.



The next chart shows the same fund through the end of the first quarter. After the Sell signal, this fund went into a nose-dive of over 18%, erasing and all the gains of the prior 14 months. We loathe "round trips", and we expect that you and your clients do also.



Risk matters and investment defense matters. Understanding risk and applying that knowledge to investment strategies in the form of disciplined buy and sell rules can limit drawdowns and may result in holding on to gains.

As testing for the COVID-19 virus ramps up in the United States, reported cases will presumably grow too. Is there an end in sight? While this disease wreaks damage on people and their health, the response to contain it also brings very real economic consequences. Mandatory business closures have resulted in a standstill in spending and then massive layoffs. The longer the shutdown lasts, the deeper the impact on people, business, jobs and spending and possibly the slower the recovery too. Nobody really knows when life in the U.S. will begin to move back towards any semblance of normal. Will it be late April? May? Later?

DISCIPLINE MATTERS: MEETING EXPECTATIONS.

The far-reaching market action during first quarter of 2020 underscores how much a rules-based defensive discipline matters. By the end of February all common stock fund holdings and nearly all high yield corporate bond fund holdings were sold. The risk reduction progressed at a speedy clip in early March as Sell signals occurred across any remaining high yield corporate bond funds, all preferred stock funds, all emerging markets debt funds and all municipal bond funds. Some of the proceeds from these sales were invested in intermediate and long-term Treasury bond funds and back into recovered municipal bond funds. The rest is held in cash (money market funds).

Even the normally sleepy municipal bond asset class saw a lot of action during the month of March. At the height of the market fear, investors questioned the liquidity of the municipal bond asset class, resulting in a decline that triggered sell signals for all holdings. However, the muni market settled down enough to give a few new Buy signals in March.

Market turmoil can strain the advisor/client relationship. Have a process and understand that RISK MATTERS, DEFENSE MATTERS, and DISCIPLINE MATTERS.

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Definitions:

The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 9.9 trillion indexed or benchmarked to the index, with indexed assets comprising approximately USD 3.4 trillion of this total. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

The Dow Jones Industrial Average is the best-known U.S. index of stocks. A price-weighted average of 30 actively traded blue-chip stocks, primarily industrials including stocks that trade on the New York Stock Exchange. The Dow, as it is called, is a barometer of how shares of the largest US companies are performing. There are hundreds of investment indexes around the world for stocks, bonds, currencies, and commodities.

The NASDAQ Composite Index includes all domestic and international based common type stocks listed on The NASDAQ Stock Market. The NASDAQ Composite Index is a broad based Index.

The NYSE FANG+ is an index that provides exposure to a select group of highly-traded growth stocks of next generation technology and tech-enabled companies.

The Russell 2000 index is an index measuring the performance approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

The KBW Bank Index is designed to track the performance of the leading banks and thrifts that are publicly-traded in the U.S. The Index includes 24 banking stocks representing the large U.S. national money centers, regional banks and thrift institutions.

The STOXX Europe 600 Index is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 17 countries of the European region: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

The Nikkei Stock Average, the Nikkei 225 is used around the globe as the premier index of Japanese stocks. More than 60 years have passed since the commencement of its calculation, which represents the history of Japanese economy after the World War II. Because of the prominent nature of the index, many financial products linked to the Nikkei 225 have been created are traded worldwide while the index has been sufficiently used as the indicator of the movement of Japanese stock markets. The Nikkei 225 is a price-weighted equity index, which consists of 225 stocks in the 1st section of the Tokyo Stock Exchange.

The Hang Seng Index ("HSI") is one of the earliest stock market indexes in Hong Kong. Publicly launched on 24 November 1969, the HSI has become the most widely quoted indicator of the performance of the Hong Kong stock market.

The 1-3 Year Treasury Bond ETF seeks to track the investment results of an index composed of U.S. Treasury bonds with remaining maturities between one and three years.

The 7-10 Year Treasury Bond ETF seeks to track the investment results of an index composed of U.S. Treasury bonds with remaining maturities between seven and ten years.

The 20+ Year Treasury Bond ETF seeks to track the investment results of an index composed of U.S. Treasury bonds with remaining maturities greater than twenty years.

The VIX Index is a calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market, derived from real-time, mid-quote prices of S&P 500® Index call and put options. On a global basis, it is one of the most recognized measures of volatility – widely reported by financial media and closely followed by a variety of market participants as a daily market indicator.