Jamie A. Upson
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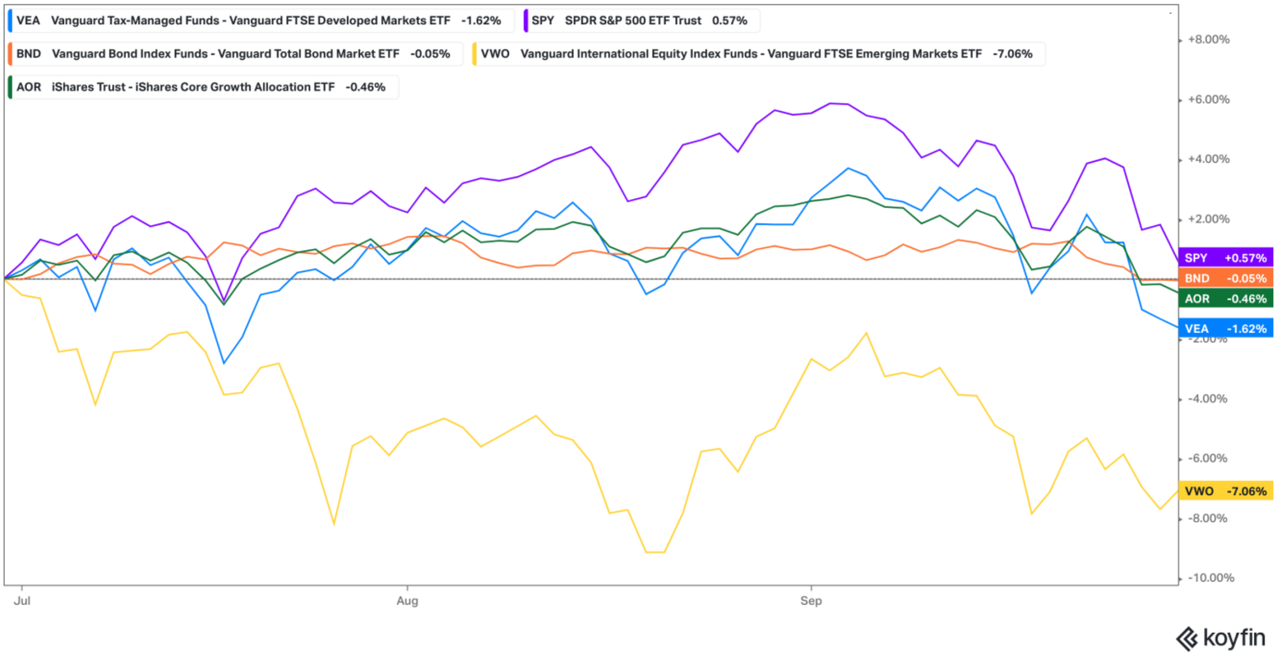
3rd Quarter 2021



The chart above shows last quarter's performance for five products. The first four, VEA, SPY, BND and VWO, represent four major asset categories and AOR represents a moderate-risk diversified portfolio. This chart provides a visual aid to help identify how major markets and a diversified portfolio performed last quarter.

The five products reported above include:

- **VEA, FTSE Developed Markets Vanguard:** This product represents the developed international equity/stock market.
- **SPY, S&P 500 SPDR:** This product represents the U.S. equity/stock market.
- **BND, Total Bond Market ETF Vanguard:** This product represents the U.S. bond market.
- **VWO, Emerging Markets ETF MCSI Vanguard:** This product represents the emerging equity/stock market.
- **AOR, Growth Allocation Ishares Core ETF:** This product represents a moderate-risk diversified portfolio. This product does not necessarily match how your diversified portfolio is allocated. You can find your allocation on the following report titled *Client Position Summary by Account*, top left, under *Asset Allocation*.

This quarter SPY was the only product that produced a positive return (0.57%). The other four products lost value. The worst performer was VWO (-7.06), which tracks emerging markets, and has roughly 30% exposure to China.

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This marks the 6th consecutive quarter that SPY has posted positive performance. I would love to see SPY continue to build upon its success, but I've been doing this long enough to know that all good things come to an end at some point. The ultimate question is *when*. To help answer this question, **one** of the areas that we turn to for help is *investor sentiment*. Investor sentiment represents how investors feel about the market. The general premise for how professional money managers use investor sentiment is to stay in harmony with investors until they reach extreme levels, at which time you should take a contrarian view. Let's look at an example to see how it works in real life.

Example 1. Meet Bob. About 5-years ago Bob did some research and decided to invest some money into Apple stock. The stock performed very well after his first 2-years of ownership, so Bob decided it was time to invest more into Apple. He decided to use his quarterly bonuses to buy more shares. This decision continued to work out well for him as the stock price continued to move higher. At this point Bob was feeling really good about his stock picking abilities and Apple's prospects going forward and he wanted to find another way he could buy even more stock. He soon learned that he could add margin to his account that would allow him to borrow money from the custodian that he could use to buy more stock, and that is exactly what he did.

Bob liked the stock when he originally bought it. He loved it when he started investing his bonuses into it. When he simply had to have more exposure to the stock despite 8% margin interest charges, he entered the euphoric state.

Historically it makes sense to invest along with the herd until we see extreme levels (capitulation on the downside or euphoria on the upside). When we hit extreme levels (like when Bob uses margin to buy more stock) it usually makes sense to take a contrarian view on the market. Below are the performance results (S&P500 index) of one of the investor sentiment indicators that we use in our risk model to track what Bob and his friends are doing. This particular indicator focuses on shorter-term trends in investor sentiment.

S&P 500 Index Performance Full History: 1994-12-30 to 2021-10-01		
NDR Daily Sentiment Composite is	% Gain/ Annum	% of Time
Above 62.5	-7.18	28.85
41.5 - 62.5	8.98	44.50
Below 41.5	28.71	26.65
Buy/Hold = 8.77% Gain/Annum		

Ned Davis Research report: Davis265

When the composite score is below 41.5 it means that there is enough pessimism in the market, and those investors who are nervous and want out of the market have probably already done so. We like to say at these levels, "sentiment is so bad, that it's good". Since 1995 when the score is below 41.5 the

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S&P500 has produced a gain of 28.71% (per annum). On the other extreme, when the composite score is above 62.5 it means that investors feel good about the market and have likely already invested any available cash they have access to (think of Bob), resulting in an overvalued market. Said another way, "sentiment is so good, that it's bad". Since 1995 when the score is above 62.5 the S&P500 has produced a loss of 7.18% (per annum). This indicator helps us quantify Warren Buffet's famous line, "be greedy when others are fearful and be fearful when others are greedy".

At the end of September this indicator's score was around 22, clearly in the pessimistic zone. This means over the short term the market is likely oversold and could easily experience a short-term rally. Please note, this is just 1 of 49 indicators that we watch. **When looking at all 49 indicators combined, the weight of the evidence is telling us to continue taking normal risks.**

Looking Forward

There are always things to worry about that could derail the market's upward trajectory. Here are my top five (in no particular order):

- Elevated inflation levels lasting longer than expected
- China and the possibility of contagion
- Federal Reserve tightening too much, too soon
- Congress's handing of the infrastructure bill, the debt ceiling and likely higher taxes ahead
- Earnings and valuations of US stocks

Most of these issues will likely just be noise, but they can spoil investor sentiment and markets over the longer-term, and for that reason they bear watching.

Hedging Protocol (Risk Management Tool)

Our hedging protocol looks at 49 different indicators that have been selected based on their historical track record at identifying market risk (*past performance is not indicative of future results*). 34 of these indicators come from Ned Davis Research (NDR), an independent research group, and the remaining 15 were chosen by Stonehearth's Investment Committee to complement NDR's indicators. Together they provide us the ability to observe risk as it unfolds to help us determine if trades are needed to manage risk within your diversified portfolio.

Our risk indicators remained relatively stable throughout the quarter and still support taking risk. Here are our current stock/equity exposures for each risk profile as of quarters end:

- Conservative: Beginning of quarter = 32.0%, and remains at 32.0% by end of quarter (benchmark = 30%)
- Moderate: Beginning of quarter = 63.5%, and remains at 63.5% by end of quarter (benchmark = 60%)
- Aggressive: Beginning of quarter = 90.5%, and remains at 90.5% by end of quarter (benchmark = 85%)

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We continue to monitor each of the indicators for guidance on how much risk we should be taking within each risk profile. We will be sure to let you know if/when we make changes to our hedged exposure, but for the time being, we are happy with how we have your portfolio positioned.

This quarter we did swap some of our bond exposure from corporate bonds to municipal bonds. Interest earned in taxable accounts that hold municipal bonds are exempt from Federal taxes. There seems to be broad agreement that the wealthy should pay for most of the infrastructure bill if/when passed. Therefore, we expect to see growing interest in municipal bonds by wealthy families as they search for ways to reduce their taxes.

Please join us for CIO's Corner: Quarterly Update Webinar with Chief Investment Officer, Chris Gauthier, CFA

- October 29th starting at 12:00 EST
- **Register Now**