MANAGING CLIENT EXPECTATIONS IN VOLATILE MARKETS

by Isaac Braley, President & Co-Portfolio Manager, BTS Asset Management, Inc.

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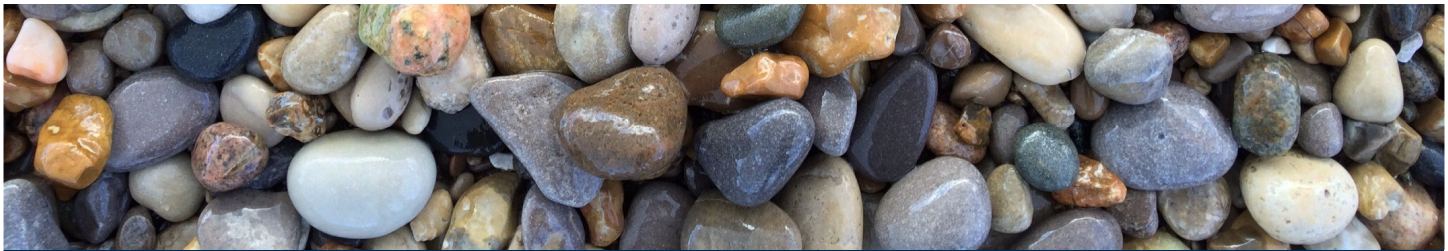

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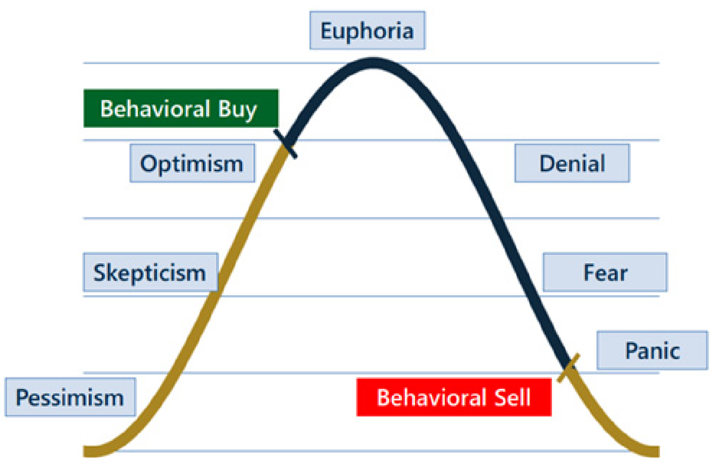
Whereas a near-absence of market volatility characterized last year, we are now back to more normal conditions. Twice already this year fear has spiked and then subsided — but at a much higher baseline than in 2017.

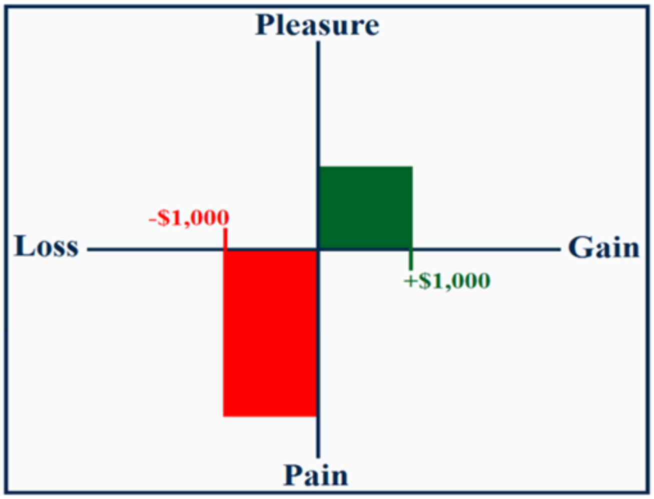
That means advisors are more likely to get calls from clients who are concerned and want to step to the sidelines — an action more likely than not to do investors long-term harm. Even if an investor is lucky enough to correctly time an exit, there's the reentrance to consider. Many investors exited in 2008 or 2009 and proceed to sit out five or more years of the current bull market's advances. Advisors can add value by helping investors avoid the undesirable "cycle of market emotions" (Figure 1).

Figure 1—The Cycle of Market Emotions



By seeking to manage client expectations, advisors can help investors chart a wise course based on investors' specific time horizons, risk tolerances and goals. One of the most obvious and important expectations to manage is investors' focus on short-term performance. Because investors "feel" losses more acutely than they "feel" gains — as demonstrated clearly by behavioral finance studies (see Figure 2) — they are especially likely to take actions against their long-term interests when their portfolio value dips. Advisors provide economic value to investors by helping them overcome such temptations.

Figure 2—Losses Are Twice as Painful as Gains are Pleasurable



Source: Amos Tversky & Daniel Kahneman. "The Framing of Decisions and the Psychology of Choice"

Probably the most important way to address "short-termism" is to remind investors regularly about longer-term historical performance — likely pointing out past examples of coming through volatile periods to reap rewards of larger gains over longer periods of time.

Sometimes it's helpful to go beyond historical performance and address the nature of risk itself — and the strategies in place to deal with it. Following are three points we at BTS consider fundamental to our philosophy on risk and the investment approach we implement to manage risk.

Each of these ideas may be helpful to advisors seeking to manage client expectations and stay in the market while managing risk appropriately.

1. "Volatility" is different from "risk" according to clients' real-life perspectives.

A recent *Wall Street Journal* article by James Mackintosh, titled "*The Real Risk Is Believing That Volatility Is Risk*" (April 30, 2018) gets at the heart of what really matters to investors—and their portfolios. Mackintosh writes:

> "Volatility matters a lot if you have a short-term investing horizon, because it is a proxy for how much money you might make or lose over a short period. If you can lose a lot because volatility is high, it is quite reasonable to demand a lower price as compensation . . . . But if you have a long-term horizon, volatility is an opportunity."
>
> "When the word 'risk' is used investors should question what it means, because one person's risk is another's opportunity. Consider the risk categories into which financial advisers attempt to lump assets. A high-risk portfolio has more equities and fewer bonds, while a very-low-risk portfolio might be mainly cash and Treasuries. Used like this, risk amounts to little more than volatility, as history shows."

In these paragraphs, Mackintosh separates the idea of volatility from risk. From a client perspective, "volatility" is essentially a neutral concept. It might be good or it might be bad, depending on time horizon. Or, it might be good or it might be bad depending on the *direction*. Most investors don't mind volatility to the upside; it's just the downside they're concerned with. That's one reason why we find risk statistics that focus on the Downside variance, such as Downside Deviation and the Sortino Ratio — more practically useful to more investors than risk statistics that focus on both upside and downside variance, such as Standard Deviation and the Sharpe Ratio.

By helping investors understand volatility itself as neither friend nor foe but rather just the context in which decisions must be made, advisors can help remove some of the temptation to flee the market out of concern about volatility.

Risk, on the other hand, is *not* a neutral concept from the perspective of most investors. *Risk* means, essentially, the chance they will not meet their goals — or, worse, that that their capital will be lost. *Risk* in this "real-life" sense is fundamentally different from volatility. Risk needs careful, constant attention.

And clients need reassurance about the portfolio-management philosophy mechanisms in place that are designed to help protect against loss of capital. In our case, that philosophy focuses on capital preservation first and foremost — even when it means a willingness to forgo some potential gains — and the mechanisms in place include stop-losses.

2. The proportion of bonds in a portfolio should increase as an investor advances toward retirement.

Comments from the Chairman's letter earlier this year speaks to this second key point. As Vilis Pasts explained, the philosophy of BTS was formed based on observations of periods of intense volatility in the 1970s and 80s. He wrote:

> "For me, the key lesson from 1973-74 was that tactical flexibility and attention to risk management are essential, especially for people with lower risk tolerances and/or a shorter time to retirement.
>
> "Then we had the bull market that began in 1982, quickly convincing people that stocks would advance every year. People were of course startled by the crash in October 1987. But even then, many investors were quick to shake off the downturn — and perhaps rightly so, if they had some gains behind them and decades more time to invest before needing use of their capital for retirement or other purposes.
>
> "By the 2000s, people were more on their own — pension funds to support retirement were largely a thing of the past. And many investors — older baby boomers, in particular — no longer had the luxury of time. In general, they were overweight in stocks going into the 2007-09 bear market. Because of their age, they had to take losses and exited the stock market, never to return. This was rational, as they did not have decades to invest and regain their wealth.
>
> "But how much better for these investors if they had learned the lessons of past crashes (including 1929, from which it took till the 1950s to get back to par) and apply risk-conscious approaches to ensure they didn't take a hit beyond their capacity to absorb — and therefore face no choice but to keep working into retirement years."

Advisors can provide economic value to clients by keeping them aware of their time horizons and making decisions accordingly. History has made it clear that staying too heavy in stocks too close to a need for capital puts too much at risk — up to and including the wipeout of most or all an investors' investable capital at precisely the worst-possible time.

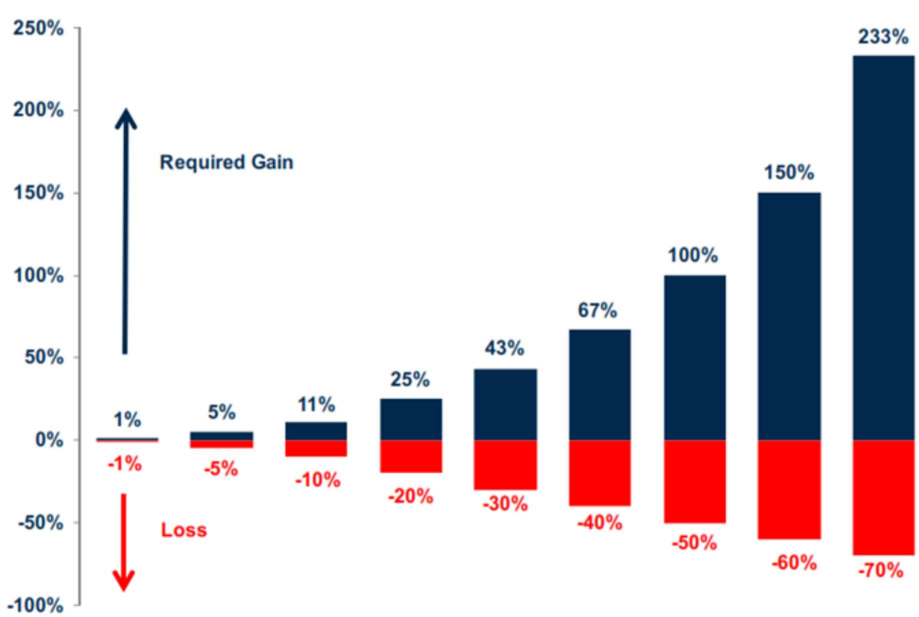
That's why bonds, with their greater stability (assuming no spike in defaults), have a clear place in aging investors' portfolios. Advisors can help clients manage their expectations in volatile times by pointing to the bond allocation and saying something to the effect of "this is why we have this allocation in place."

That said, bonds can be risky, too — not just from defaults but in the context of rising interest rates. We believe many investors don't yet have an adequate understanding of the risk they may be taking in their bond portfolios without realizing it . . . which brings us to our last key point.

3. At least a portion of the bond portfolio should be invested in a truly tactical approach that can shift entirely to a defensive cash position.

In our view, a strategy must have the option of stepping to the sidelines if preservation of capital is a primary goal. And for us, preservation of capital has always been our paramount focus. For investors with shorter time horizons — again, such as retirees or those nearing retirement — there simply may not be time to make up severe losses. Consider, too, that a 20% loss on a portfolio then requires a 25% gain to get back to even (see Figure 3).

Figure 3—Preservation of Capital is Key: Required Gain to Make Up a Loss



For Illustrative Purposes Only.

At BTS, our tactical approach includes the potential to go to Cash as a defensive posture when fixed income, in aggregate, is unattractive. More often, the low correlation between high yield bonds and government bonds means we seek to be invested in one or the other (High Yield in "risk on" environments; treasuries in "risk off" environments).

But sometimes — such as during certain periods of rising rates — all fixed-income securities may be negatively affected. At those times, or at times of severe market uncertainty, we believe the option to go to Cash is essential.

Conclusion

Volatility can be painful — but it also brings opportunity. The need is to have measures in place to seek to preserve capital regardless of what may come. Advisors can add value by helping clients eliminate negative behavioral tendencies that work against long-term success. They can add value by ensuring an appropriate allocation to bonds, particularly as investors advance toward retirement. And, in our view, they can add value by ensuring that at least a portion of the portfolio's bond assets are invested in a way that enables playing defense when necessary.

Fund Performance as of 6/30/18

Average Annualized Total Returns	YTD[2]	1 Year	3 Years	5 Years	10 Years	Since Inception 1/1/00
Class A[1] (NAV)	-3.73%	-4.08%	3.12%	2.39%	7.51%	8.43%
Class A (max. 5% load)	-8.51%	-8.85%	1.37%	1.33%	6.96%	8.13%
Class C	-4.10%	-4.82%	2.34%	1.63%	N/A	1.58%
Class I (Inception 5/28/15)	-3.62%	-3.80%	3.40%	N/A	N/A	2.79%
Class R (Inception 5/5/15)	-3.86%	-4.32%	2.88%	N/A	N/A	2.28%
BBgBarc Agg Bond Index	-1.62%	-0.40%	1.72%	2.27%	3.72%	4.88%
Nontraditional Bond	-0.38%	1.06%	2.05%	1.75%	2.48%	3.22%
S&P 500 BBgBarc Agg 50-50	0.51%	6.82%	6.83%	7.82%	7.31%	5.55%

The performance data quoted here represents past performance. Current performance may be lower or higher than the performance data quoted above. Investment return and principal value will fluctuate, so that shares, when redeemed, may be worth more or less than their original cost. Past performance is no guarantee of future results. A Fund's performance, especially for very short periods of time, should not be the sole factor in making your investment decisions. For performance information current to the most recent month-end, please call toll-free 1-877-287-9820.

Total Expense Ratios: Class A: 1.80%; Class C: 2.55%; Class I: 1.55%; Class R: 2.05%

[1]The BTS Tactical Fixed Income Fund does not have performance as a mutual fund prior to May 31, 2013. Performance prior to May 31, 2013 shown above is for the Fund's predecessor limited liability company (BTS Tactical Fixed Income Fund LLC, formerly known as BTS Asset Allocation/High Yield Fund LLC). The prior performance is net of management fees and other expenses. The predecessor limited liability company had been managed in the same style and by the same portfolio manager since the predecessor limited liability company's inception on January 1, 2000. The Fund's investment goals, policies, guidelines and restrictions are, in all material respects, equivalent to the predecessor limited liability company's investment goals, policies, guidelines and restrictions. The following information shows the predecessor limited liability company's annual returns and long-term performance reflecting the actual fees and expenses that were charged when the Fund was a limited liability company. From its inception on January 1, 2000 through the date of the prospectus, the predecessor limited liability company was not subject to certain investment restrictions, diversification requirements and other restrictions of the 1940 Act, which if they had been applicable, might have adversely affected its performance. In addition, the predecessor limited liability company was not subject to sales loads that would have adversely affected performance. The predecessor limited liability company's past performance is not necessarily an indication of how the BTS Tactical Fixed Income Fund will perform in the future.

[2]Performance for periods less than one year are not annualized.

There is no assurance that the Fund will achieve its investment objective.

Investors cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

Nontraditional Bond category contains funds that pursue strategies divergent in one or more ways from conventional practice in the broader bond-fund universe. Many funds in this group describe themselves as "absolute return" portfolios, which seek to avoid losses and produce returns uncorrelated with the overall bond market; they employ a variety of methods to achieve those aims. Another large subset are self-described "unconstrained" portfolios that have more flexibility to invest tactically across a wide swath of individual sectors, including high-yield and foreign debt, and typically with very large allocations. Funds in the latter group typically have broad freedom to manage interest-rate sensitivity, but attempt to tactically manage those exposures in order to minimize volatility. The category is also home to a subset of portfolios that attempt to minimize volatility by maintaining short or ultra-short duration portfolios, but explicitly court significant credit and foreign bond market risk in order to generate high returns. Funds within this category often will use credit default swaps and other fixed income derivatives to a significant level within their portfolios.

S&P 500 includes 500 leading companies in leading industries of the U.S. economy and is a proxy for the total stock market. BBgBarc Agg Bond Index refers to the Bloomberg Barclays Aggregate Bond Index, which is comprised of government securities, mortgage-backed securities, asset-backed securities and corporate securities with maturities of one year or more to simulate the universe of bonds in the market. S&P 500 BBgBarc Agg 50-50 is a blended benchmark made up of 50% S&P 500 TR and 50% Bloomberg Barclays Aggregate Bond Index and uses indexes to represent a stock/bond allocation that a conservative or moderate investor might have.

Mutual funds involve risk, including possible loss of principal.

The use of Credit Default Swaps involves investment techniques and risks different from those associated with ordinary portfolio security transactions, such as potentially heightened counterparty, concentration and exposure risks. There is a risk that issuers and counterparties will not make payments on securities and other investments held by the Fund, resulting in losses to the Fund. The Fund may invest in derivatives. Even a small investment in options may give rise to leverage risk, and can have a significant impact on the Fund's performance. Derivatives are subject to credit risk and liquidity risk. The values of foreign investments may be affected by changes in exchange control regulations, application of foreign tax laws changes in governmental administration or economic or monetary policy or changed circumstances in dealings between nations. In addition to the risks generally associated with investing in securities of foreign companies, countries with emerging markets also may have relatively unstable governments, social and legal systems that do not protect shareholders, economies based on only a few industries, and securities markets that trade a small number of issues. The Fund invests in fixed income securities, derivatives on fixed income securities or Underlying Funds that invest in fixed income securities.

The value of the Fund will fluctuate with changes in interest rates. Defaults by fixed income issuers in which the Fund invests could also harm performance. Lower-quality bonds known as "high yield" or "junk" bonds, present greater risk than bonds of higher quality, including an increased risk of default. An economic downturn or period of rising interest rates could adversely affect the market for these bonds and reduce the Fund's ability to sell its bonds. The lack of a liquid market for these bonds could decrease the Fund's share price. The use of leverage by the Fund or an Underlying Fund will indirectly cause the Fund to incur additional expenses and magnify the Fund's gains or losses. The Fund may engage in short selling activities which are significantly different from the investment activities commonly associated with conservative fixed income funds. Underlying Funds are subject to investment advisory and other expenses, which will be indirectly paid by the Fund. As a result, your cost of investing in the Fund will be higher than the cost of investing directly in the Underlying Funds.

Investors should carefully consider the investment objectives. risks, charges, and expenses of the BTS Tactical Fixed Income Fund. This and other information about the Fund is contained in the prospectus and should be read carefully before investing. The prospectus can be obtained on our web site, www.btsfunds.com, by calling toll free 1-877-287-9820 (1-877-BTS-9820), or by calling your financial representative. The BTS Tactical Fixed Income Fund is distributed by Northern Lights Distributors, LLC, Member FINRA/SIPC. BTS Asset Management, Inc. is not affiliated with Northern Lights Distributors, LLC.

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