FormulaFolios

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Models

FormulaFolio Investments is a Registered Investment Advisor that offers a distinct approach compared to traditional asset management. FormulaFolios uses emotion-free, statistically significant quantitative algorithms to aid in the investment decision making process. Unlike many quantitative investment firms, however, FormulaFolios focuses on longer-term market trends and lower turnover rather than using a high-frequency trading approach. With the ever-changing investment landscape, it is more important than ever to prepare for and adapt to new economic regimes. This is why FormulaFolios focuses time and talents on developing smarter investment formulas. By removing investing prejudices with an algorithmic based approach, FormulaFolios believes investors can increase the statistical probability of successful investment outcomes over time.

The following contains a description of each individual model utilized by FormulaFolios:

Tactical Growth

Tactical Growth focuses on five broad asset classes – US stocks, international stocks, REITs, gold, and bonds. The overall goal of the Tactical Growth model is to accentuate the asset classes showing the greatest potential for return with minimal risk, while maintaining a diversified asset allocation. To pass the initial screening process, an asset class must clearly be in an uptrend. This is measured by using various price momentum indicators over short, intermediate, and long-term time periods. Asset classes that pass the positive momentum screen are then ranked based on relative strength. This ranking process includes a proprietary smoothing filter that assists in the reduction of turnover and potential false signals when markets are volatile. The highest-ranking asset classes are allocated to the portfolio while the lowest ranking asset classes are left out (even if all asset classes are showing positive momentum). At times, few or none of the asset classes will meet the screen process. The maximum weighting for any individual asset class is 33.33%, so when this happens the model may invest heavily in short-term treasury bonds until more asset classes become favorable for investing.

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FormulaFolios US Equity

FormulaFolios US Equity is an individual stock model focusing on the US stock market. This model is designed to select up to 50 stocks from the Russell 3000 Index, which encompasses approximately 98% of all US incorporated equity securities. Under normal market conditions, the model will typically hold 80% of its assets in individual US equities while maintaining the flexibility to invest in small, mid, and large-cap companies. While FormulaFolios US Equity typically favors value stocks over growth stocks, it does maintain the potential to shift between growth and value depending on market conditions and where we are in the market cycle. The model may, from time to time, take temporary defensive positions in attempt to respond to adverse market, economic, political, or other conditions. During such periods 100% of the model's assets may be invested in cash or cash equivalents, protecting the portfolio from severe market risk and ultimately protecting investors' assets.

Smart Passive Growth

Smart Passive Growth is a mostly passive investment model with the ability to hedge itself during periods of perceived economic stress. Every month the model analyzes a macroeconomic screen to determine the strength of the equity markets. This screen is composed of numerous technical, economic, sentiment, and market breadth indicators. When a majority of the indicators are bullish, Smart Passive Growth utilizes a highly diverse mix of growth-oriented ETFs with a slight tilt towards small and mid-cap equities to achieve benchmark-like returns. As long as the screen remains bullish the strategy will remain passively invested, rebalancing toward the original target weights only when necessary. However, when all of the indicators turn bearish at the same time, the model will sell 50% of the growth-oriented ETFs and purchase intermediate-term treasury ETFs. This gives the model the ability to shift to a balanced 50% growth 50% fixed income strategy in order to hedge against downside risk when markets appear unfavorable. By combining numerous market indicators into a single screen, the model has the ability to react to major market movements while avoiding the numerous "false positive" signals experienced when using a single stand-alone indicator. This helps reduce overall portfolio turnover, resulting in greater tax efficiency and a more passive portfolio.

Flexible Growth

Flexible Growth is composed of two individual sub-strategy components, each making up a 50% allocation to the overall model. The first component is exclusively macroeconomic and utilizes broad US equity and treasury bond asset classes. When the economy appears healthy, this component of the model will invest in a diversified mix of US stock ETFs to take advantage of potential expansion. However, if the economy appears weak, this component will shift to a mix of US Treasury ETFs to help hedge against downside stock market risk. This part of the model typically changes infrequently because the economy tends to run in multi-year cycles, often resulting in holding periods of multiple years. Component two focuses on the individual sectors of the S&P 500 Index. This component measures the sectors based on price and volume patterns, as well as valuations and volatility. Sectors with lower volatility, stronger price trends, and cheaper relative valuations receive a higher ranking; the sector with the most desirable overall ranking is selected for the portfolio. If none of the sectors display a suitable risk-adjusted return, this component will invest in a short-term Treasury ETF until market conditions become more favorable for taking risk. By combining these two sub-strategies, the overall model achieves a unique diversification benefit within itself as each component can hedge the other during various time periods. The end result is a model that stays fully invested at all times with the flexibility to adjust to prevailing economic and market conditions.

Total Return Growth Lite

Total Return Growth Lite utilizes long and inverse US equity index funds in an attempt to take advantage of major trends during both bull and bear market conditions. To determine the direction of broad US equity markets, the model measures a combination of various technical indicators and inflection points. When markets are displaying bullish characteristics Total Return Growth Lite will invest in double leveraged equity index funds (i.e. funds that experience approximately two-times the positive and negative returns of a benchmark). This gives the model the ability to experience larger gains when equity markets are in a strong upward trend. When markets are displaying bearish characteristics Total Return Growth Lite will invest in inverse equity index funds (i.e. short the market), providing the potential to achieve gains when markets fall. The model can also shift to cash if there is no clear bull or bear trend. By utilizing both long and short equity index funds, the end result is a model that has the ability to produce non-market correlated returns, as well as the potential to produce positive returns regardless if US equity markets are rising or falling.

Sector Rotation

Sector Rotation identifies trends in the individual sectors of the S&P 500 Index, in attempt to accentuate the sectors showing the strongest potential for intermediate-term gains. The model uses a screen and rank process when analyzing appropriate investments. To pass the initial screening process, a sector must clearly be in an uptrend. This is measured by using various price momentum indicators over short, intermediate, and long-term time periods. Sectors that pass the positive momentum screen are then ranked based on various blends of technical momentum indicators, volatility gauges, and valuation multiples. The model also evaluates the strength of the S&P 500 as a whole. If the S&P 500 appears healthy, the ranking system will typically favor sectors that are more aggressive and cyclical in nature. However, if the S&P 500 appears weak, the ranking system will likely favor sectors that are more defensive in nature. The highest-four-ranking sectors are allocated to the model in an equal weight while the lowest ranked sectors are left out. At times, fewer than four sectors will meet the screen process. The maximum weighting for any individual holding is 25%, so when this happens the model may shift partially or completely to cash-like securities until more sectors pass the screen. Overall, the goal of the Sector Rotation model is to achieve strong equity-like returns during bull markets while maintaining a strong discipline for downside risk management in bear markets.

Tactical Income

Tactical Income focuses on five broad fixed-income asset classes - intermediate treasury bonds, total US bonds, high-yield corporate bonds, corporate investment-grade bonds, and international government bonds. The overall goal of the Tactical Income model is to accentuate the asset classes showing the greatest potential for return with minimal risk, while maintaining a diversified asset allocation. To pass the initial screening process, an asset class must clearly be in an uptrend. This is measured by using various price momentum indicators over short, intermediate, and long-term time periods. Asset classes that pass the positive momentum screen are then ranked based on relative strength. This ranking process includes a proprietary smoothing filter that assists in the reduction of turnover and potential false signals when markets are volatile. The highest-ranking asset classes are allocated to the portfolio while the lowest ranking asset classes are left out (even if all asset classes are showing positive momentum). The weighting for any individual asset class depends on the prevailing market conditions, with a maximum weight of 56.67% for high-yield US bonds and US treasuries and a maximum weight of 21.67% for US aggregate bond, corporate investment-grade US bonds, and international government bonds. At times, few or none of the asset classes will meet the screen process. When this happens, the model may move a portion of assets to short-term treasury bonds or more cash-like securities to protect investors' assets until more asset classes become favorable for investing.

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Smart Passive Income

Smart Passive Income is a mostly passive investment model with the ability to hedge itself during periods of perceived stress in fixed-income markets. Every month the model analyzes a macroeconomic screen to determine the strength of broad bond markets. When a majority of the indicators are bullish, Smart Passive Income utilizes a highly diverse mix of income-oriented ETFs, ranging from aggregate US bonds, corporate investment-grade bonds, treasury bonds, and international bonds. As long as the screen remains bullish the strategy will remain passively invested, rebalancing toward the original target weights only when necessary. However, when all of the indicators turn bearish at the same time, the model will sell 50% of the normal fixed-income ETFs and purchase short-term treasury ETFs. This gives the model the ability to shift to an even more conservative fixed income strategy in order to hedge against downside risk when bond markets appear unfavorable.

Flexible Income

Flexible Income is composed of two individual sub-strategy components, each making up a 50% allocation to the overall model. The first component identifies price trends in various bond asset classes, including corporate high-yield bonds, municipal bonds, corporate investment-grade bonds, US Treasuries, and floating rate bonds of any maturity and duration. Corporate high-yield bonds are analyzed first. If corporate high-yield bonds are experiencing positive momentum, the model will allocate 50% of its assets into this category. However, if corporate high-yield bonds are experiencing negative momentum, the model will analyze the remaining bond asset classes and allocate 50% of its assets to the highest-ranked asset class based on positive price momentum. Component two analyzes credit spreads and interest rates for the individual bond asset classes mentioned above. If corporate high-yield bond spreads and interest rates appear favorable (tighter credit spreads and steady interest rates), the model will allocate 50% of its assets into this category. However, if corporate high-yield bond spreads and interest rates appear unfavorable, the model will analyze the remaining bond asset classes' interest rate levels and trends, allocating 50% of its assets to the asset class with the most favorable interest rate patterns (generally identified as steady or falling rates). By combining these two sub-strategies, the overall model achieves a unique diversification benefit within itself as each component can hedge the other during various time periods. The end result is a model that stays fully invested at all times with the flexibility to adjust to prevailing economic and market conditions.

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Redwood Managed Volatility

Redwood Managed Volatility is a high-yield corporate bond strategy that seeks a combination of total return and prudent management of portfolio downside volatility and downside loss. To pursue its investment objective the model uses a trend-following strategy that seeks to identify the critical turning points in the markets for high yield bonds. This is done by utilizing a quantitative strategy takes into account macro market data and other market-based inputs and metrics to seek to identify market trends, including technical analysis. When markets are trending upwards the model will seek to invest in high-yield bond securities in attempt to take advantage of the positive trend. However, if markets are trending downwards the model can shift to short-term fixed income or cash-like securities to limit downside volatility and losses.

Redwood Managed Municipal Income

Redwood Manage Municipal Income is a high-yield municipal bond strategy that seeks to generate tax-efficient income while focusing on managing downside risk. To pursue its investment objective the model uses a quantitative and tactical approach to measure high-yield municipal bond market trends. When markets are trending upwards the model will seek to invest in high-yield municipal bond securities in attempt to take advantage of the positive trend. However, if markets are trending downwards the model can shift to short-term fixed income or cash-like securities to limit downside volatility and losses.

BCA Managed Income

BCA Managed Income is a tactically managed bond model with a focus on high-yield corporate bonds, though it can at times include other bond asset classes. The goal of BCA is to achieve a strong total return while keeping risk low, with preservation of principal as an important factor. When BCA's technical indicators determine an upward trend in high-yield bond prices is established, the model allocates capital into the market. Similarly, when BCA's indicators show the upward trend is deteriorating, the model becomes more defensive by shifting capital toward cash-like securities.

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Benchmarks

Because each individual model utilized by FormulaFolios has its own unique algorithm and investment strategy, FormulaFolios uses a specific benchmark for each individual model. This provides a more accurate representation as to how each model is performing relative to its design.

The following contains a description of each individual benchmark:

Barclay Global Macro Index

Global Macro managers carry long and short positions in any of the world's major capital or derivative markets. These positions reflect their views on overall market direction as influenced by major economic trends and/or events. The portfolios of these funds can include stocks, bonds, currencies, and commodities in the form of cash or derivatives instruments. Most funds invest globally in both developed and emerging markets. The Barclay Global Macro Index is used as a benchmark for Tactical Growth because Tactical Growth takes a macro approach at investing in various asset classes.

Russell 3000 Index

The Russell 3000 is a market capitalization weighted equity Index maintained by FTSE Russell and seeks to act as a benchmark for the entire US stock market. This Index measures the performance of the 3,000 largest publicly traded US stocks. Stocks within the Russell 3000 Index are reconstituted once a year, at which time the underlying companies are re-ranked based on their market capitalizations for that year. The Russell 3000 Index is used as a benchmark for FormulaFolios US Equity because the model seeks to select a diversified blend of stocks with desirable risk and return characteristics from the entire US stock market in order to achieve long term capital appreciation.

Dow Jones Aggressive Portfolio Index

The Dow Jones Aggressive Portfolio Index acts as a broadly diversified buy-and-hold benchmark. This index aims to achieve 100% of the risk of an all-stock Index based on the trailing 36-month semi-variance. The all-stock portfolio includes a blend of US and non-US stocks, with varying market capitalizations. Though this index does not include a specific carve-out for real estate, it does act as a strong proxy for a diversified growth portfolio and is used as a benchmark for the Smart Passive Growth model.

Barclay Equity Long/Short Index

This directional strategy Index involves equity-oriented investing on both the long and short sides of the market. The objective is not to be market neutral. Managers have the ability to shift from value to growth, from small to medium to large capitalization stocks, and from a net long position to a net short position. Managers may use futures and options to hedge. The focus may be regional or sector specific. The Barclay Equity Long/Short Index is used as a benchmark for Total Return Growth Lite and Flexible Growth because Total Return Growth Lite can shift between long and short positions and Flexible Growth can shift between various US equity sectors and capitalizations.

S&P 500 Index

The S&P 500 Index is a market capitalization weighted equity Index and seeks to act as a benchmark for large-cap US stocks. This Index measures the performance of 500 large publicly traded US stocks. Stocks within the S&P 500 Index are reconstituted on an as-needed basis. The S&P 500 Index is used as a benchmark for Sector Rotation because the model seeks to accentuate the most favorable sectors within the S&P 500.

Bloomberg Barclays Aggregate Bond Index

The Bloomberg Barclays Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The Index includes Treasuries, government-related and corporate securities, mortgage-backed securities, asset-backed securities, and commercial mortgage-backed securities; it represents the performance of the total US investment-grade bond market. This Index is used as a benchmark for Tactical Income and Smart Passive Income. Though the Index does not reflect the active nature of Tactical Income, and Tactical Income includes asset classes such as high yield bonds and non-US bonds which are not included in the benchmark, the overall goal of Tactical Income is to achieve stable long-term returns with minimal risk similar to the Index. Smart Passive Income largely utilizes the asset classes within the Index, though the weights differ slightly.

Morningstar Nontraditional Bond

The 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 of funds 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. This index is used as a benchmark for Redwood Managed Volatility, BCA Managed Income, and Flexible Income due to the unique nature of their investment management philosophies.

Morningstar High-Yield Municipal

The High-Yield Municipal category contains funds that typically invest a substantial portion of assets in high-income municipal securities that are not rated or that are rated at the level of or below BBB (considered high-yield within the municipal-bond industry) by a major ratings agency such as Standard & Poor’s or Moody’s. This index is used as a benchmark for Redwood Managed Municipal Income as the model primarily utilizes high-yield municipal bonds to generate long-term returns.