Quality Approach to a Slowing or Struggling Economy

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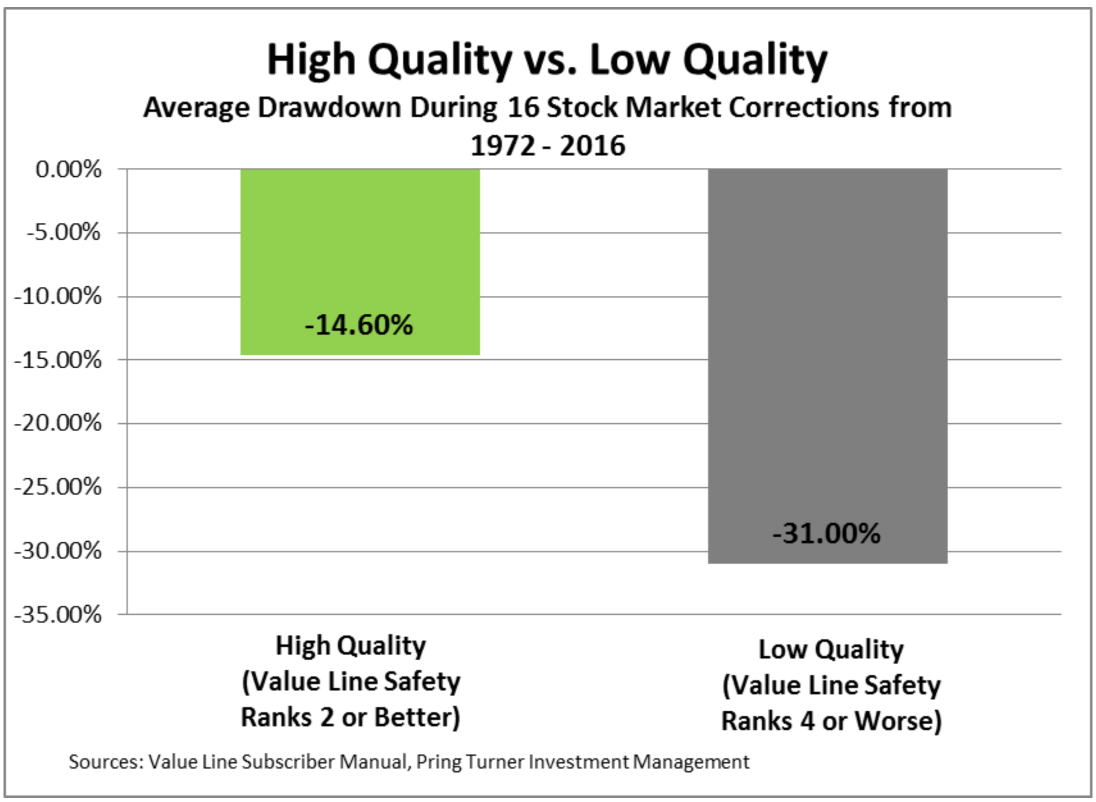
At SmartTrust®, we look to provide for diversified income and total return opportunities through innovative investment strategies. We use a bottoms-up approach to develop our Unit Investment Trust (UIT) product strategies, based in large part on the input received from the many advisors we are fortunate to work with across the country. In so doing, we look to only bring products to market when the strategy has value in the market and demand from the marketplace. The majority of SmartTrust® UITs offer diversified income opportunities, as well as the potential for total return, and have incorporated such underlying investment product types as individual taxable and tax-free bonds, individual stocks, preferred securities, business development companies (BDCs), closed-end funds (CEFs), real estate investment trusts (REITs), American depository receipts (ADRs), master limited partnerships (MLPs) and exchange-traded funds (ETFs).

This particular report will focus on a target asset allocation approach built to help provide total return potential with a focus on quality. The term quality means different things within different industries. Within the financial services industry, and more specifically with the investments community, quality often is associated with equity securities - or stocks as they are commonly known. Quality stocks are typically a part of value-based investing strategies. Benjamin Graham, referred to by many as the father of value investing, was known to classify stocks into two categories; 1) quality or 2) low quality. His studies found that the biggest risk of buying bargain stocks was settling for low quality companies that were unable to compete and that finding quality stocks was the key to successful value investing or investing in general for that matter.

Picture Source: *Times Higher Education*

Determining if a stock is associated with a company that is either quality or low quality is a time consuming process and often involves a review of its management team, balance sheet strength, valuation, and competitive positioning. Following this approach can help to identify well-run and financial stable companies that may also be attractively priced. These types of companies can be reasonably expected to weather economic downturns, including both slowdown and recessionary periods, better than companies that are not well-run, not financially stable and perhaps overpriced from a valuation standpoint. It may seem like common sense, but it is worth emphasizing that investors should try to avoid the stocks of less healthy companies that have a greater likelihood of bankruptcy during economically trying times.

Economic slowdowns, or recessionary periods, are often accompanied by market volatility. It is during periods of market volatility that quality has historically shined the greatest over low quality. Consider the following chart that shows the relative outperformance of high quality stocks vs. low quality stocks across sixteen different major stock market declines between 1972 and 2016. In this study performed by Pring Turner Investment Management, they applied Value Line Safety Ranks to make the distinction between high quality and low quality. Value Line compares and combines a company's balance sheet, financial strength and price stability to arrive at a final safety ranking. The stocks of those companies with a safety rank of 2 or better were determined to be high quality while those with a safety rank of 4 or worse were determined to be low quality.

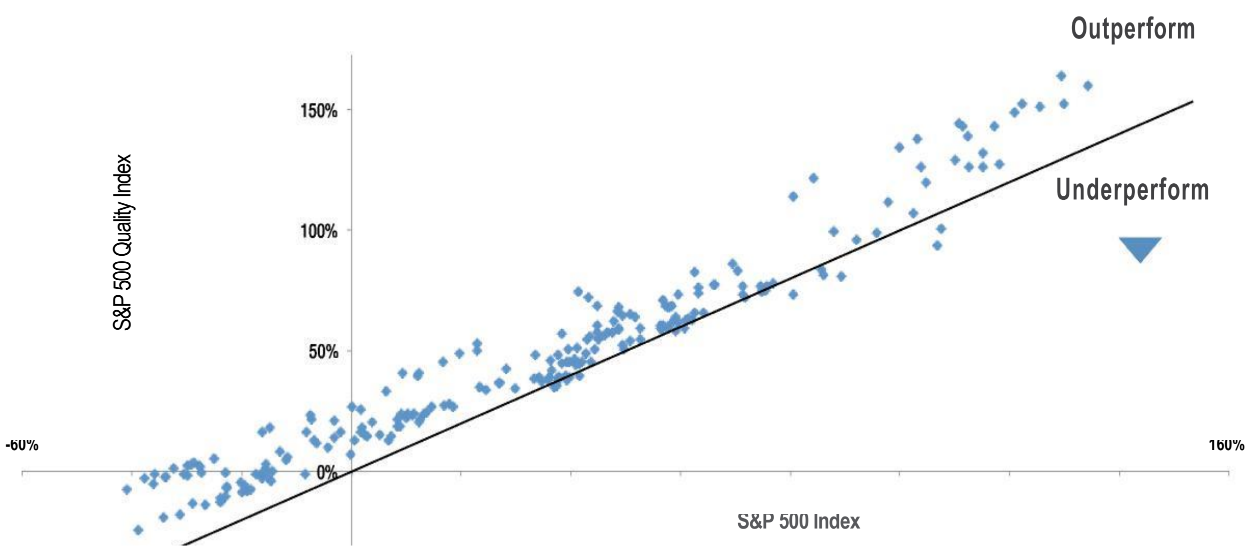


Source: *Pring Turner Investment Management, "They Holy Grail Investment Formula: Better Returns with Less Risk", May 23, 2018. Past performance is not an indication of future results.*

This relative outperformance is compelling considering that according to the same Print Turner research study, the worst market declines have historically occurred when the economy enters a recession and 3 out of every 4 bear markets for stocks, where a bear market is defined as a stock market loss of 20% or greater, have occurred during recessions.

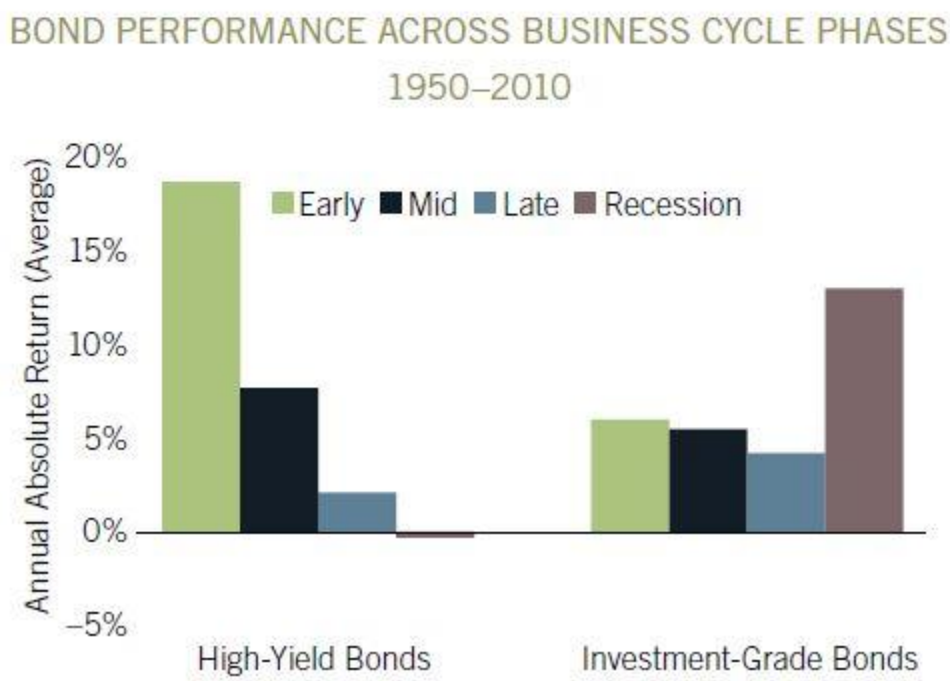
Not only can quality stocks outperform non-quality stocks during periods of heightened market volatility but they also have historically outperformed the market in general over the longer term. Consider the following chart which shows the relative outperformance of the S&P 500 Quality Index vs. the S&P 500 Index in 93% of the rolling three year time periods during the timeframe of December 1994 – September 2016. As a means of background, the S&P 500 Quality Index is designed to track high quality stocks in the S&P 500 Index using a quality score, which is calculated based on a blend of return on equity, financial leverage, and quality of earnings (accruals ratio). The S&P 500 Index on the other hand is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies and is widely regarded as being representative of the U.S. stock market in general.

S&P 500 Quality Index Returns Outperform the S&P 500 Index in 93% of 3-Year Rolling Periods
(12/94 – 9/16, measured monthy)



Source: *Barrow Street Advisors, "The Timely Case for Quality and Value Stocks", December 2016, based on data from Bloomberg as of 9/30/16. Market information shown (such as that of the S&P 500 Index and S&P 500 Quality Index) is inclusive of reinvestment of dividends and shows relative market performance for the periods indicated. Past performance is not an indication of future results. You cannot invest directly in an index.*

The application of quality screening criteria can also be expanded to fixed income from our perspective. As it relates to fixed income – or bonds as they are commonly known – credit ratings can be a major determinant of quality. For example, we would identify investment grade corporate bonds and U.S. Treasuries as quality. The issuers of such debt, from our standpoint, would be better able to withstand periods of economic slowdowns or contractions than issuers of below investment grade (i.e. "junk") corporate bonds or sovereign debt securities who may have a greater chance of potential default. While the chart below from Fidelity Investments only shows comparative performance through 2010, it does capture sixty years of different business cycle phases and does show that historically investment grade bonds have outperformed high yield bonds during both late cycle (i.e. slowdown) and recessionary periods.



Source: *Fidelity Investments. Past performance is not indicative of future results.*

As I write this whitepaper, many strategists are suggesting that we are nearing the end of the current period of economic expansion and likely heading into a slowdown, and perhaps even a recessionary period, over the next 2 years in the United States. To this end, according to a recent Reuters poll conducted in February 2019, economists believe that there is a 25% chance of a recession in the next 12 months and a 40% likelihood within the next two years. If this outlook proves true, having allocations to quality equities and quality fixed income securities may prove beneficial to an investment portfolio.

A SmartTrust® UIT Quality Strategy for a Slowing or Struggling Economy

At SmartTrust®, we approached the idea of building a portfolio ahead of a slowing or slow growth economy using a balanced, target asset allocation strategy blending both quality equities and quality fixed income securities. Our definition of quality in this context focuses more on financial health and credit ratings than on valuations (*ex. Price-to-Earnings ratios*) as is seen in many value-based investing styles. Our resulting **60/40 Quality Allocation Trust** is a 2 year unit investment trust that seeks total return potential through capital appreciation and dividend income.

This trust strategy seeks to invest approximately 60% of the portfolio in equity securities and 40% of the portfolio in ETFs as of the trust's inception. To help balance risk and provide total return opportunities, the trust seeks to invest in quality equity securities and quality ETFs that invest primarily in fixed income securities. We believe that such a 60%/40% allocation in quality securities will provide the potential for the trust to achieve its objective even where economic growth may be slowing or contracting over the life of the trust.

For the equities side of the portfolio, we define quality equities securities for these purposes as those associated with companies that it believes as of the time of selection:

- have strong and stable balance sheets
- have a history of earnings growth
- have relatively low volatility
- pay dividends

To help identify equity securities with the above characteristics, we consider securities for inclusion in the portfolio that actively trade on a U.S. exchange meeting some, but not necessarily all, of the following criteria at the time of selection:

• ***Altman Z-Score*** *above 3*
Altman's Z-Score is a formula published in 1968 by Edward I. Altman, who was, at the time, an Assistant Professor of Finance at New York University. The formula is designed to be used to predict the probability that a firm will go into bankruptcy within two years. The Altman Z-Score is a composite score based on five financial ratios that are found on a company's annual 10-K report. These ratios are used to evaluate a company's profitability, leverage, solvency and activity in an effort to predict whether a company has a high probability of being insolvent. The five ratios used are:

o working capital/total assets;

o retained earnings/total assets;

o earnings before interest and taxes ("EBIT")/total assets;

o market value of equity/total liabilities; and

o sales/total assets.

The higher the Z-Score, the lower the predicted probability of bankruptcy. A score < 1.8 indicates bankruptcy is predicted to be imminent. A score > 3 indicates bankruptcy is predicted to be unlikely.

• ***Healthy companies***
For these purposes, healthy companies are determined based on an analysis of the company's Standard & Poor's credit ratings combined with their Altman Z-scores

• *T**otal debt to total assets ratio*** below 40;

• ***Positive trailing twelve-month free cash flow*** *("FCF");*

• Companies that pay a ***dividend;***

• Positive ***five-year earnings per share ("EPS") growth****;*

• Companies with a ***Beta*** of 1.00 or less
Beta is a coefficient measuring the volatility of an individual security in comparison to the unsystematic risk of the entire market.

• Companies with a ***mean analyst consensus recommendation*** of Hold or better

• Companies with ***average daily trading volume*** of $500,000 or more

We implement the fixed income securities side of the portfolio using exchange-traded funds (ETFs). For these purposes, we define "quality" fixed income-oriented ETFs as those that at the time of selection:

- have strategies to invest primarily in investment-grade fixed income securities
- have relatively low expense ratios
- have relatively low volatility
- pay dividends

To help identify fixed income-oriented ETFs with the above characteristics, we consider securities for inclusion in the portfolio that meet some, but not necessarily all, of the following criteria at the time of selection:

• strategies to invest primarily in ***investment-grade corporate bonds*** and ***U.S. government securities***

• pay **dividends**

• have a low or even negative ***Beta***. Beta is a coefficient measuring the volatility of an individual security in comparison to the unsystematic risk of the entire market

• have an ***average trading volume*** of $500,000 or more

• have low ***expense ratios*** relative to their peer group

Risk Factors

It is important to remember that investors can lose money by investing in this trust. An investment in units of the trust should be made with an understanding of the risks related to the trust which can be found in the Prospectus.

While no screening criteria can guarantee a positive total return, we believe that the security selection approach employed at SmartTrust®, as described throughout this whitepaper, can be helpful in creating a portfolio strategy that seeks to provide total return potential during the life of the Trust by investing in a 60/40 allocation of quality equities and fixed income-oriented ETFs.

If you are interested in learning more about this particular Trust strategy, or any of our other innovative UIT portfolio strategies, please contact your Financial Advisor or visit www.smarttrustuit.com.
