SFM's Risk Management Strategy:

USING INVERSE INDEX FUNDS

The foundation of our investment philosophy is risk management – the idea that there is a time to allocate more assets to the stock market, and a time to reduce portfolio exposure when equity market risk is high. As such, the primary method of controlling risk in SFM portfolios comes from reducing allocation to the equity market and increasing our defensive cash reserve. Beyond asset allocation, sector and industry weighting adds another layer to managing risk and investing strategically as leadership changes throughout a full market cycle. We also mitigate risk through fundamental stock selection, as high-quality companies with strong management teams tend to outperform during an economic downturn. When bear market warning flags become more definitive, adding an Inverse Index Fund can further reduce exposure to downside market movements and lower portfolio volatility.

What is an Inverse Index Fund?

An Inverse Index Fund is an exchange-traded fund (ETF) designed to increase in value as its associated index drops. Conversely, the fund will lose value when the index rises. At SFM, the primary reason for using an Inverse Fund is to hedge a portion of existing portfolio holdings and serve as effective, low-cost portfolio insurance to offset equity exposure during periods of high risk.

Why use an Inverse Index Fund instead of selling positions and raising cash?

Increasing cash in the portfolio is an important part of our investment strategy, but there are several reasons for maintaining select long positions and partially offsetting them with an inverse fund.

- **Diversification:** Inverse funds allow us to maintain more stocks in the portfolio which increases overall diversification while providing a counteracting position during market volatility.
- **Dividends:** Holdings in the portfolio will continue to provide dividend income which increases total return over time.
- **Reduce capital gains:** In taxable accounts, selling stocks can create sizable realized gains especially at the tail end of a very long bull market cycle. Reducing these sales can lessen the tax effect.
- **Prepare for the next bull market:** When risks begin to dissipate and we look to increase equity allocation, exposure can be quickly adjusted upward by removing the inverse fund.

When and how would SFM allocate a portion of my portfolio to an Inverse Index Fund?

Inverse funds are used to neutralize portfolio risk, not as a tool for speculation or short-term trading. Using our weight of the evidence approach, this strategy can act as an insurance policy to offset a portion of the portfolio. Furthermore, the position can be incrementally implemented as market risk increases and a bear market becomes more likely.

Why don't you use a leveraged inverse fund?

A leveraged inverse fund is designed to go up two or three times as much as its benchmark goes down on a daily basis. While more might sound better, trying to time bear markets or corrections rarely works, and one can easily get hurt with leveraged funds if the market moves in a different direction than anticipated. With this in mind, we will not use a leveraged inverse fund in SFM portfolios.

Summary

Our safety-first investment strategy manages risk in a number of different ways throughout a full market cycle. As described in the following disclosure from our ADV Part 2A Brochure, SFM may decide to allocate a portion of your portfolio(s) to inverse market strategies to hedge existing portfolio holdings. This additional layer of risk management can help our clients preserve capital and achieve their long-term financial goals.

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IMPORTANT DISCLOSURE INFORMATION

Stack Financial Management, Inc. ("SFM") may utilize long and short mutual funds and/or exchange-traded funds that are designed to perform in an inverse relationship to certain market indexes (at a rate of 1 time the inverse [opposite] result of the corresponding index) as an investment strategy and/or for the purpose of hedging against downside market risk. There can be **no assurance** that such strategy will prove profitable or successful. In light of this risk/reward, **a client may direct SFM, in writing, not to employ such strategy for his/her/its accounts.**

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