

Asset Allocation and Risk Assessment Report

PLEASE READ ALL DISCLOSURES AT THE END OF THIS REPORT

This report was produced by the *Rules Based Investing*® team at Empirical Asset Management (EAM) on 1/20/2020 at the request of Financial Advisor (FA) of the FA Team at FA Investment company.

The analysis compares the asset allocation as well as several other risks of client's portfolio to a model portfolio. The model portfolio allocation was chosen by FA manually or through the use of an EAM Risk Tolerance Questionnaire.

Modern portfolio theory holds that there is a tradeoff for investing in assets – you get paid to assume risk. Taking risk is a necessity but understanding all of the risks you are taking and controlling them if you can and where you can is critical for long-term success in an investment portfolio. While others focus on return, EAM focuses on risk, it is more predictable and more controllable than return.

The most important principle for all investors is to have a plan and process for investing in any environment and to guard against all risks regardless of how improbable or unfathomable they may be. This requires having a strategic process not a tactical one. Within a strategic framework one of the most important things you can do for your portfolio is to remove emotional decision making. *Rules Based Investing*® is just that, “Using Proven Sets of Rules to Build and Protect Wealth.” *Rules Based Investing*® squarely focuses on risks and risk control not on chasing hot managers or products in an attempt to obtain better returns.

This report focuses on areas where the current allocation leaves risks unattended. Chart #1 displays the current asset allocation for the portfolio that was provided including asset category weightings and also displays the asset category adjustments necessary to get in sync with the model portfolio asset allocation. Chart #2 includes suggestions on adjustments to the holdings necessary to gain a more precise match to the chosen allocation and to control other risks better. Chart #3 offers a comparison check list of risks that are attended to by all three of the portfolios; the original portfolio, the suggested changes portfolio and the turnkey EAM Asset Allocation portfolio.

The EAM Asset Allocation Moderate portfolios is an alternative to the original portfolio and the suggested adjusted portfolio. It provides a turnkey alternative with precision allocation to the chosen risk tolerance while also covering many/most of the other risks outside of asset allocation.

A more detailed description of all risks assessed can be found at the end of this report.

There are several limitations to this kind of assessment so please read all disclosures carefully.

Chart #1

		Current Weight	Current Value	Target Weight	Target Value	Adjust Weight	Adjust Value
Asset Class	Market Segment						
Equity	Large Cap Growth	10.94%	889,152	10.00%	812,646	-0.94%	-76,507
Equity	Large Cap Value	14.03%	1,139,886	12.50%	1,015,807	-1.53%	-124,078
Equity	Mid Cap	12.28%	997,974	11.50%	934,543	-0.78%	-63,431
Equity	Small Cap	7.88%	640,642	7.50%	609,484	-0.38%	-31,158
Equity	Int'l Developed	14.95%	1,214,711	14.50%	1,178,336	-0.45%	-36,375
Equity	Int'l Emerging	4.72%	383,375	5.50%	446,955	0.78%	63,580
Fixed Income	Treasuries & Corporates	13.95%	1,133,621	14.50%	1,178,336	0.55%	44,715
Fixed Income	High Yield	0.61%	49,236	0.50%	40,632	-0.11%	-8,604
Fixed Income	International	4.68%	379,989	4.50%	365,691	-0.18%	-14,299
Fixed Income	TIPS	1.98%	161,226	2.00%	162,529	0.02%	1,303
Cash	Cash	2.05%	166,924	2.00%	162,529	-0.05%	-4,394
Alternatives	REITs	2.31%	187,810	2.50%	203,161	0.19%	15,352
Alternatives	Commodities	3.90%	317,167	4.50%	365,691	0.60%	48,524
Alternatives	Hedge Funds	5.72%	464,744	8.00%	650,117	2.28%	185,373
Total		100.00%	8,126,458	100.00%	8,126,458	0.00%	0

Chart #2

		Current Weight	Current Value	Target Weight	Target Value	Adjust Weight	Adjust Value
Symbol	Market Segment						
SPX	Large Cap Growth	10.94%	889,152	10.00%	812,646	-0.94%	-76,507
DEF	Large Cap Value	14.03%	1,139,886	12.50%	1,015,807	-1.53%	-124,078
GHI	Mid Cap	12.28%	997,974	11.50%	934,543	-0.78%	-63,431
JKL	Small Cap	7.88%	640,642	7.50%	609,484	-0.38%	-31,158
MNO	Int'l Developed	14.95%	1,214,711	14.50%	1,178,336	-0.45%	-36,375
PQR	Int'l Emerging	4.72%	383,375	5.50%	446,955	0.78%	63,580
STU	Treasuries & Corporates	13.95%	1,133,621	14.50%	1,178,336	0.55%	44,715
VWX	High Yield	0.61%	49,236	0.50%	40,632	-0.11%	-8,604
YZ1	International	4.68%	379,989	4.50%	365,691	-0.18%	-14,299
234	TIPS	1.98%	161,226	2.00%	162,529	0.02%	1,303
567	Cash	2.05%	166,924	2.00%	162,529	-0.05%	-4,394
890	REITs	2.31%	187,810	2.50%	203,161	0.19%	15,352
EAM	Commodities	3.90%	317,167	4.50%	365,691	0.60%	48,524
RBI	Hedge Funds	5.72%	464,744	8.00%	650,117	2.28%	185,373
Total		100.00%	8,126,458	100.00%	8,126,458	0.00%	0

Chart #3

	<u>Original</u>	<u>Adjusted</u>	<u>EAM AA Moderate</u>
Emotion	✗	✗	✓
Currency	✗	✓	✓
Asset Allocation	✗	✓	✓
Converging Correlations	✗	✓	✓
Systematic	✓	✓	✓
Unsystematic	✗	✗	✗
Sequence	✗	✗	✗
Accumulation Period	✗	✗	✗
Serial Correlation	✗	✓	✓
Fat Left Tail distribution	✗	✓	✓
Hot/Star manager	✗	✗	✓
Rising rates	✗	✗	✓
Falling rates	✓	✓	✓
Factor selection and factor timing	✗	✗	✓
Volatility	✓	✓	✓
Taxation	✗	✗	✓
Sector	✓	✓	✓
Liquidity	✗	✓	✓
Reinvestment	✗	✓	✓
Inflation	✓	✓	✓
Foreign country	✗	✗	✗

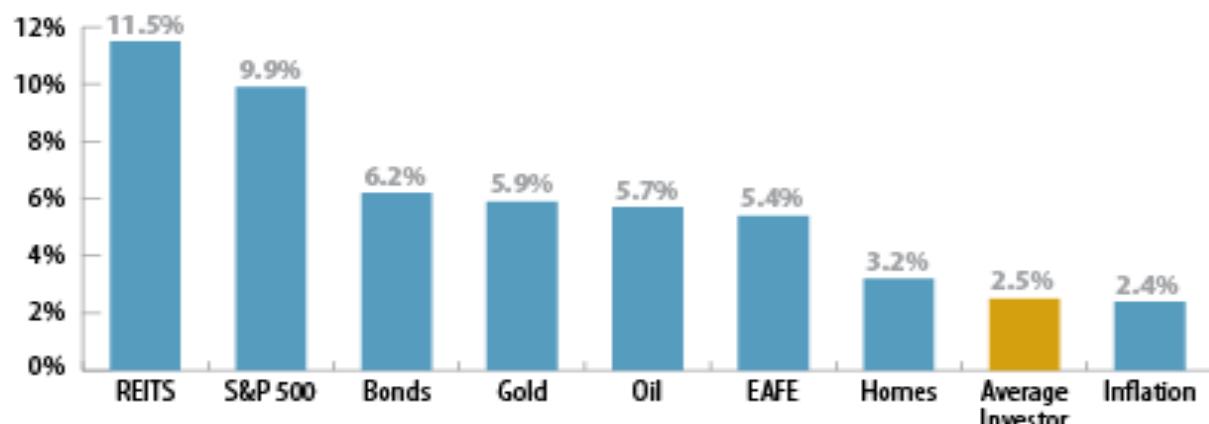
Political/Government	✗	✗	✗
Concentrated stock	✗	✓	✓
Transparency	✗	✗	✓
Expense ratio	✗	✓	✓
Growth	✓	✓	✓

Assessed Risks

Emotion

The most destructive force to successful investing is emotion, specifically fear and greed. This Dalbar chart explains that concept clearly. The average investor return does not come close to any of the asset class returns because investors disrupt their portfolios too frequently, often based on emotional decisions. A disciplined Rules Based investment process can help reduce or eliminate emotion from the investment process.

20-Year Annualized Returns by Asset Class (1995–2014)



Sources: Dalbar, Inc. Indexes include: REITS: NAREIT Equity REIT Index; EAFE: MSCI EAFE; Oil: WTI Index; Bonds: Barclays Capital U.S. Aggregate Index; Homes: median sale price of existing single-family homes; Gold: USD/troy oz.; Inflation: CPI. Average asset allocation investor return is based on a Dalbar Inc. analysis, which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior.

Currency

Many investors are unaware of the currency risk they are taking in their international investments. This example helps explain that risk. How a currency does can have a meaningful effect on your overall international investment performance.

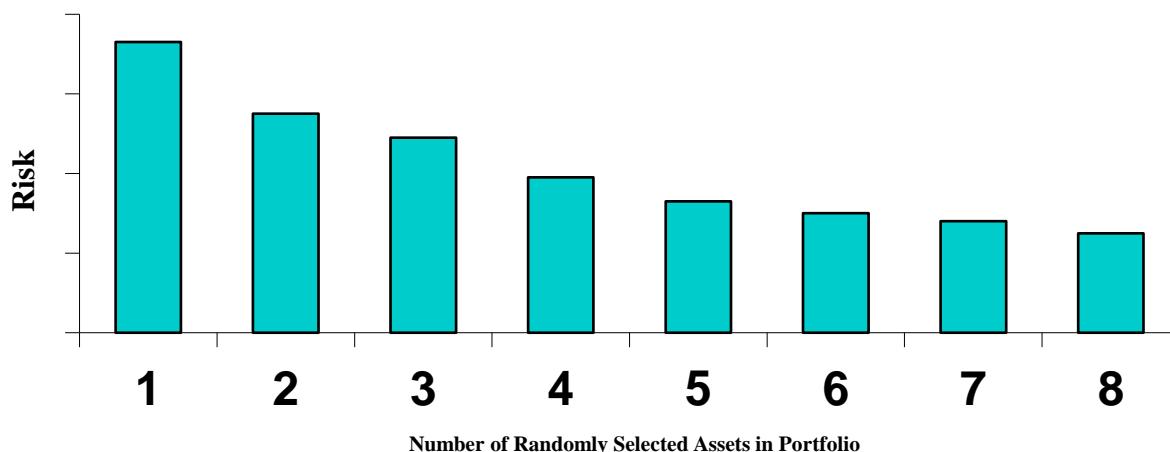
International returns are comprised of two components, local market return and currency return.

In this example we assume a 10% International market return but with two different currency returns resulting in two very different net results:

1. A 10% local market gain with a 5% currency **gain** = **+15% gain**
2. A 10% local market gain with a 5% currency **loss** = **+5% gain**

Asset Allocation

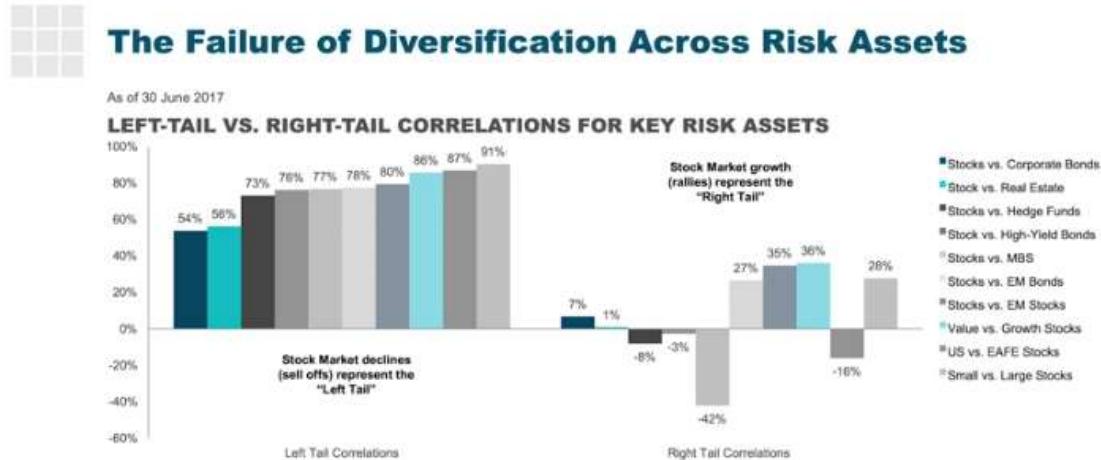
It is commonly known that adding asset categories to a portfolio reduces risk. Each asset category has positive returns long-term but acts differently in the short-term. Holding one or only a few asset categories can lead to higher volatility and emotional difficulty sticking with a portfolio when the performance is poor. Increasing the number of asset classes helps to diversify and lower portfolio risk. In this Ibbotson Associates chart eight portfolios are created, with each successive one including an additional asset class.



Converging Correlations

Correlations of risk assets are quite different in each of the tails of the investment bell curve as is evidenced in this T. Rowe Price graph. Risk asset's correlations typically converge in the left

tail (large loss periods). Most asset allocation modeling is incorrectly done using average correlations when what should be used is left tail correlations.



The table above illustrates that correlations (the degree to which two securities move in relation to each other) between different asset classes have tended to increase in down stock markets (sell offs) and decrease in rising stock markets (rallies). The Table reminds investors that what looks like a diversified portfolio during market rallies (right tail) may be much less diversified than generally thought during broad stock markets sell off (left tail). Past performance cannot guarantee future results.

All investments are subject to market risk, including the possible loss of principal. Again, all charts and tables are shown for illustrative purposes only.

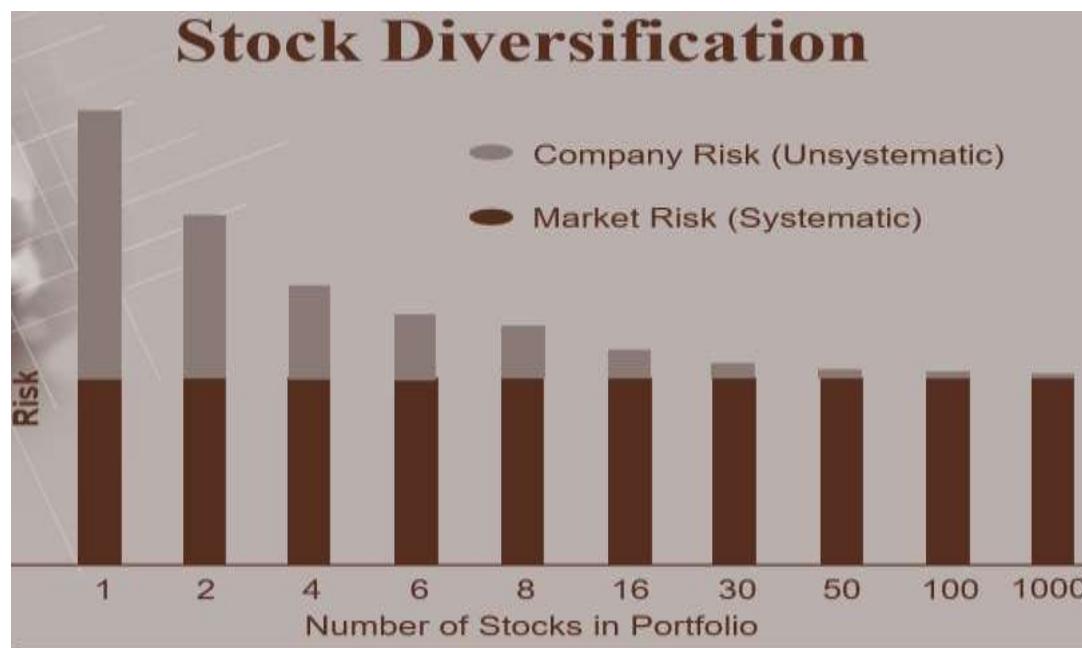
EM is emerging market. Monthly data with start dates based on availability. Please refer to page 27 for data sources and start dates.

Left-tail and right-tail correlations are at the 1st and 99th percentiles but were adjusted by the data-augmentation methodology.

Analysis by Sébastien Page, CFA, head of Global Multi-Asset at T. Rowe Price, Baltimore and Robert A. Panarelli, CFA, a portfolio manager and a quantitative analyst in the Multi-Asset Division at T. Rowe Price, Baltimore.

Systematic and Unsystematic

There are two categories of stock risk, systematic (market) risk and unsystematic (individual company) risk. Adding more stocks to a portfolio can reduce unsystematic risk. However, systematic risk can only be eliminated by selling stocks and going to cash which can be a dangerous tactical decision for long-term investors.



Sequence

This example by Dana Anspach from February 08, 2019 aptly explains sequence risk.

Sequence risk, or sequence of returns risk, analyzes the order in which your investment returns occur. It affects you when you are periodically adding or withdrawing money from your investments. In retirement, it can mean that you earn a much lower internal rate of return than what you expected. The best way to understand sequence risk is with an example.

Accumulation: No Additions, No Sequence of Returns Risk

Suppose you invested \$100,000 in 1996 in the S&P 500 Index. These are the index returns:

- 1996: 23.10%
- 1997: 33.40%
- 1998: 28.60%
- 1999: 21.0%
- 2000: -9.10%
- 2001: -11.90%
- 2002: -22.10%
- 2003: 28.70%
- 2004: 10.90%
- 2005: 4.90%

Your \$100,000 grew to \$238,673. Not bad. Your \$100,000 earned just over a 9% annualized rate of return.

If Returns Occur in the Opposite Order

Now if those returns played out in the opposite order, you still would have ended up with the same amount of money: \$238,673.

- 1996: 4.90%
- 1997: 10.90%
- 1998: 28.70%
- 1999: -22.1%
- 2000: -11.90%
- 2001: -9.10%
- 2002: 21.0%
- 2003: 28.60%
- 2004: 33.4%
- 2005: 23.10%

The order in which the returns occur has no effect on your outcome if you aren't either investing regularly (buying investments) or withdrawing regularly (selling investments).

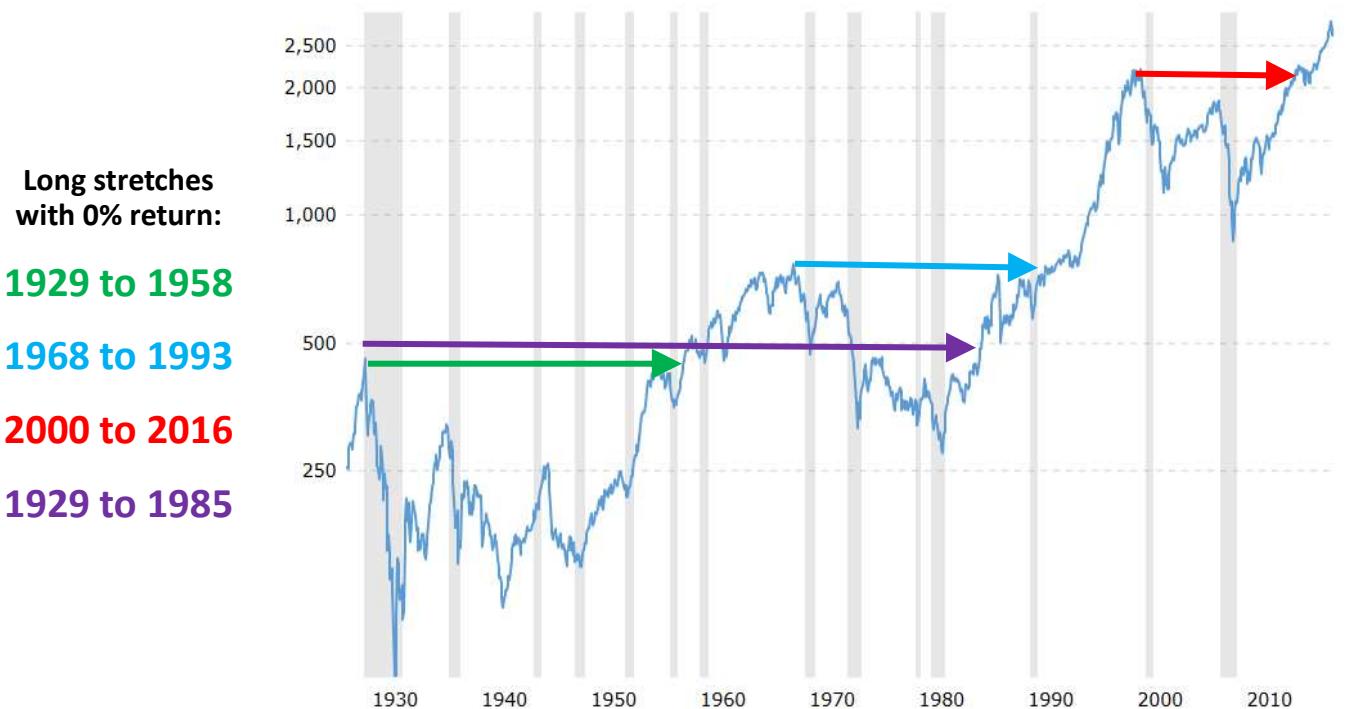
Once you start withdrawing income, you're affected by the change in the sequence in which the returns occurred. Now at the end of the 10 years, you have received \$60,000 of income and have \$125,691 left. Add the two together and you get \$185,691. This equates to about a 7.80% rate of return. Not bad, but not as good as the \$222,548 you would have received if the returns had happened the other way around.

During your retirement years, if a high proportion of negative returns occur in the beginning years of your retirement, it will have a lasting negative effect and reduce the amount of income you can withdraw over your lifetime. This is called the sequence of returns risk.

When you're retired, you need to sell investments periodically to support your cash flow needs. If the negative returns occur first, you end up selling some holdings, and so you reduce the shares you own that are available to participate in the later-occurring positive returns.

Accumulation Period

A typical investor has a period of accumulating wealth which lasts about 40 years on average, something we will define as an Accumulation Period. The investment conditions during various Accumulation Periods can differ drastically as is evident in the macrotrends.com chart of the S&P 500 on a log scale and inflation adjusted seen below.



Serial Correlation

Serial Correlation: A critical pillar of many traditional asset allocation frameworks (i.e. frameworks built on a premise of “normality”), is the assumption that asset returns from period to period are independent and identically distributed. However, if one month’s return is ‘influenced’ by the previous month’s return, then there may be a need to account for this effect in future asset projections. Typically, traditional asset allocation frameworks do not allow for serial correlation, but five of the seven asset classes we’ve looked at display some degree of serial correlation. Serial correlation, if not adjusted for in the underlying data, masks true asset class volatility and biases risk estimates downwards, leading to underestimation of overall portfolio risk.

Fat Left Tail distribution

“Fat” Left Tails (Negative Skewness and Leptokurtosis): Another form of non-normality relates to observing negative returns in greater magnitude and with a higher probability than implied by the normal distribution. This phenomenon is commonly referred to as “fat” left tails.

Emotion accounts for the fatter Left Tails in investment return bell curves. Tail events are very rare in a normal curve, but investment market bell curves are in fact “fatter” or have more frequent large losses than most people realize.

Normal Distribution

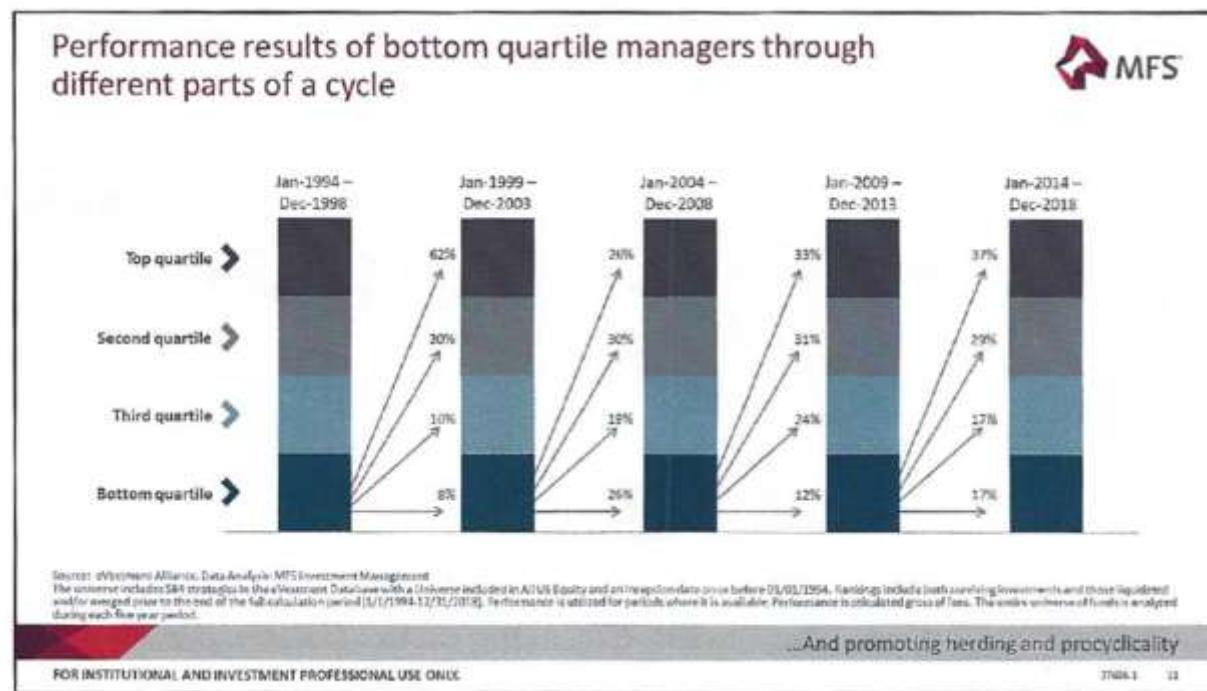
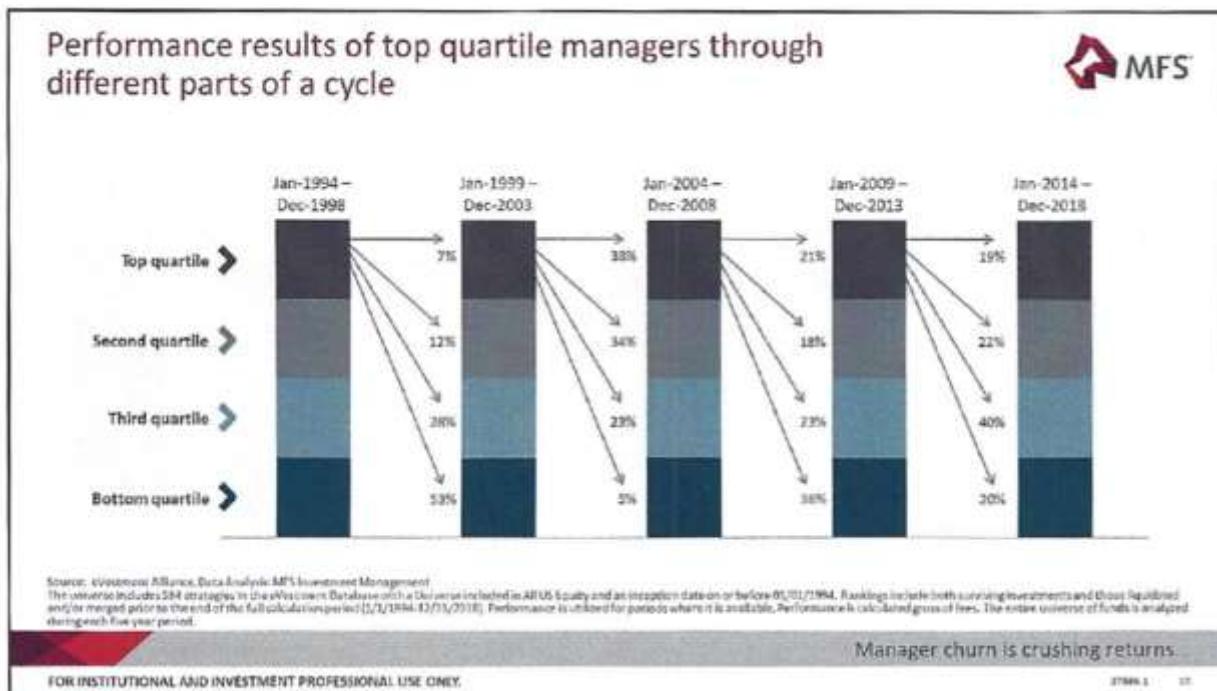
“Fat Left Tail” Distribution of investment bell curve

- Latin American debt crisis in the early 1980s
 - Stock market crash of 1987
 - U.S. Savings & Loan crisis in 1989–1991
 - Western European exchange rate mechanism crisis in 1992
 - East Asian financial crisis of 1997
 - Russian default crisis and the LTCM Hedge Fund crisis in 1998
 - Bursting of U.S. Technology bubble in 2000–2001
 -
- 1973, 1974, 1987, 2000-2002, 2008-2009,...

Higher Probability of Big Losses

Hot/Star manager

Chasing short-term performance (3-5 years) and hot managers is a mistake as is explained by the following two charts.



Rising rates and Falling rates

Rising rates typically have a negative effect on stock returns while also having a similar effect on bond returns. Rising rates are typically associated with inflation, a loss in confidence for a government to repay their debts, or both. Falling rates on the other hand can be a sign of deflation and a weakened or weakening economy and will lower the yield on bonds and other fixed income instruments making it more difficult to achieve investment goals. This often forces investors into more risky instruments like stocks in an attempt to compensate for the lower return in fixed income.

Factor selection and Factor timing

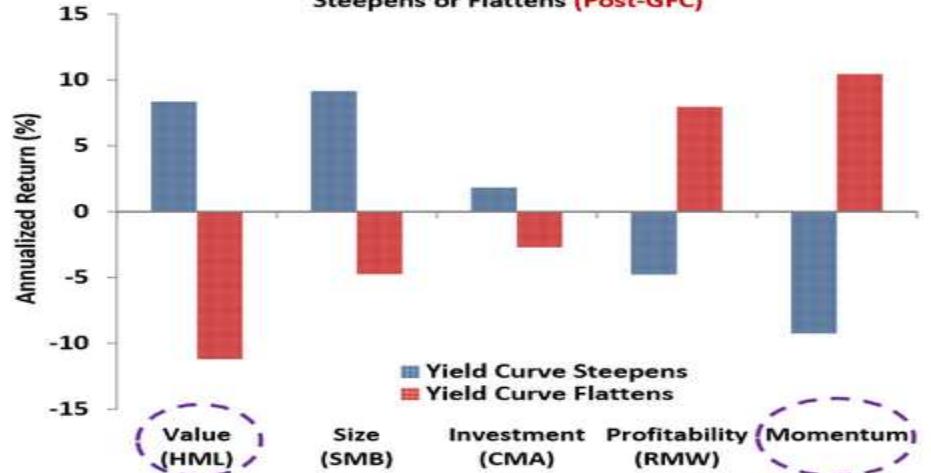
Factor investing has become very popular on Wall Street especially with advent of the ETF, and further, Smart Beta ETFs. The problem with factor investing is the same as with asset allocation. Knowing the proper amount of each factor to employ at all times. They all have good years and they all have bad years with little to no consistency over time for what will be in favor and for how long. The evil.com chart below shows that each factor spends time both at top of the chart and at the bottom of the chart.



Activity in the markets can affect different factors in different and sometimes opposite ways as is evidenced by the chart below of changes in the Yield Curve.

Fig. 3: Direction of the Yield Curve Has Had Large Impact on Factor Performance

Performance of Fama-French Factors When Yield Curve Steepens or Flattens (Post-GFC)



Note: Shows annualized average monthly returns of the five Fama-French factors (value, size, investment, profitability, and one-year price momentum) during months of yield curve steepening or flattening by more than 5bp. The slope of the yield curve is measured by the spread between 10-year and 2-year Treasury yields. Period is July 2009 through May 2019 (post GFC).

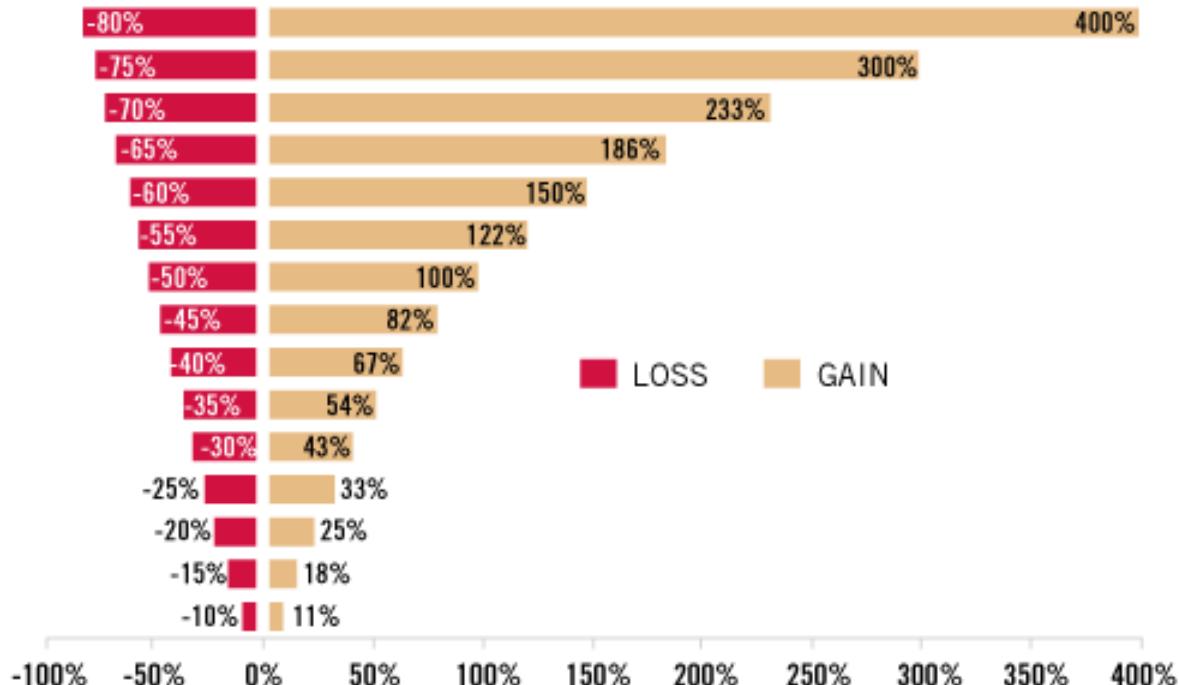
Source: Kenneth R. French Data Library, Bloomberg, Instinet analysis

Volatility

The ability to live through downturns in the market and with investment returns is critical for long-term success. The following example of two investment portfolios with similar results is informative when you realize that the greater volatility of Portfolio A would make it much harder for an investor to live with than Portfolio B.

	Portfolio A	Portfolio B
Year 1	+ 80%	+ 5%
Year 2	- 40%	+ 5%
	\$108,000	\$110,250

Downside volatility is extremely destructive as is evidenced by this chart which explains that for percent of downturn it requires an ever greater positive return to get back to breakeven.



Taxation

Investment vehicles and investment processes that throw off tax consequences, especially short-term consequences, dramatically increase the likelihood of holding an investment longer than desired and potentially suffering a negative effect by doing so. Additionally, when the vehicles and process is not tax conscious it eats into the net returns achieved. ETFs are fairly tax efficient with most imbedding no gains and throwing off little to no tax events annually. Mutual Funds on the other hand imbed gains and as a buyer of a mutual fund you inherit cost basis which can be significantly detrimental to net returns.

Sector

Knowing which sectors to tilt toward is an almost impossible task. The chart below shows a heat map of performance for the various sectors in the S&P 500 and how consistently inconsistent the order of performance is each year. Diversification into all sectors is preferable to eliminate sector related risk.

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
INFT 47.2%	ENRS 31.5%	ENRS 31.4%	TELS 36.8%	ENRS 34.4%	CONS 15.4%	INFT 61.7%	COND 27.7%	UTL 15.9%	FINL 28.8%	COND 43.1%	UTL 29.0%
MATH 36.2%	UTL 24.2%	UTL 16.8%	ENRS 24.2%	MATH 22.5%	HLTH 22.8%	MATH 40.3%	INDU 26.7%	CONS 14.0%	COND 23.3%	HLTH 41.5%	HLTH 25.3%
COND 37.4%	TELS 19.9%	FINL 6.5%	UTL 21.0%	UTL 19.4%	UTL 29.0%	COND 49.3%	MATH 22.2%	HLTH 12.2%	TELS 18.2%	INDU 40.7%	INFT 29.1%
INDU 32.2%	INDU 18.0%	HLTH 6.5%	FINL 19.2%	INFT 16.7%	TELS 30.5%	S&P 26.5%	ENRS 26.5%	TELS 6.3%	HLTH 17.9%	FINL 35.6%	CONS 16.0%
FINL 31.0%	COND 13.2%	S&P 4.9%	CONS 19.5%	CONS 14.2%	COND 33.5%	INDU 20.9%	TELS 19.0%	COND 5.1%	S&P 16.0%	S&P 32.4%	FINL 15.2%
S&P 28.7%	MATH 13.2%	MATH 4.2%	MATH 16.6%	INDU 12.0%	ENRS 34.9%	HLTH 19.7%	S&P 15.1%	ENRS 4.7%	INDU 15.4%	INFT 28.4%	S&P 13.7%
UTL 26.2%	TELS 10.9%	CONS 3.6%	S&P 15.8%	TELS 11.9%	S&P 37.0%	FINL 17.2%	CONS 14.1%	INFT 2.4%	MATH 15.0%	CONS 26.1%	INDU 9.8%
ENRS 25.6%	S&P 10.9%	INDU 2.3%	CONS 14.4%	HLTH 7.2%	INDU 39.9%	CONS 14.9%	FINL 12.5%	S&P 2.1%	INFT 14.8%	MATH 23.5%	COND 9.7%
HLTH 15.1%	CONS 8.2%	INFT 1.6%	INDU 13.3%	S&P 5.5%	INFT 43.1%	ENRS 13.8%	INFT 10.2%	INDU -0.6%	CONS 10.8%	ENRS 25.1%	MATH 8.3%
CONS 11.6%	INFT 2.0%	TELS 5.8%	INFT 6.4%	COND 13.2%	MATH 48.7%	UTL 11.9%	UTL -5.5%	MATH 6.8%	ENRS 4.5%	UTL 13.2%	TELS 3.0%
TELS 7.1%	HLTH 1.7%	COND 6.4%	HLTH 7.5%	FINL -18.6%	FINL 55.3%	TELS 8.0%	HLTH 2.9%	FINL -17.1%	UTL -1.7%	TELS 11.5%	ENRS 7.8%

Abbr.	Sector Index	Annual	Best	Worst
COND	S&P 500 Consumer Discretionary Index	11.56%	43.1%	-33.5%
CONS	S&P 500 Consumer Staples Index	10.58%	26.1%	-15.4%
ENRS	S&P 500 Energy Index	12.45%	34.4%	-34.9%
FINL	S&P 500 Financials Index	3.27%	35.6%	-53.3%
HLTH	S&P 500 Health Care Index	10.22%	41.5%	-22.8%
INDU	S&P 500 Industrials Index	10.48%	40.7%	-39.8%
INFT	S&P 500 Information Technology Index	11.09%	91.7%	-43.1%
MATH	S&P 500 Materials Index	10.36%	48.6%	-45.7%
TELS	S&P 500 Telecommunication Services Index	7.61%	36.8%	-30.5%
UTL	S&P 500 Utilities Index	12.16%	29.0%	-29.0%
S&P	S&P 500 Index	9.55%	32.4%	-37.0%

Past performance does not guarantee future returns. The historical performance is meant to show changes in market trends across the different S&P 500 sectors over the past twelve years. Returns represent total annual returns (reinvestment of all distributions) and does not include fees and expenses. The investments you choose should reflect your financial goals and risk tolerance. For assistance, talk to a financial professional. All data are as of 12/31/14.

Source: Novel Investor

Liquidity

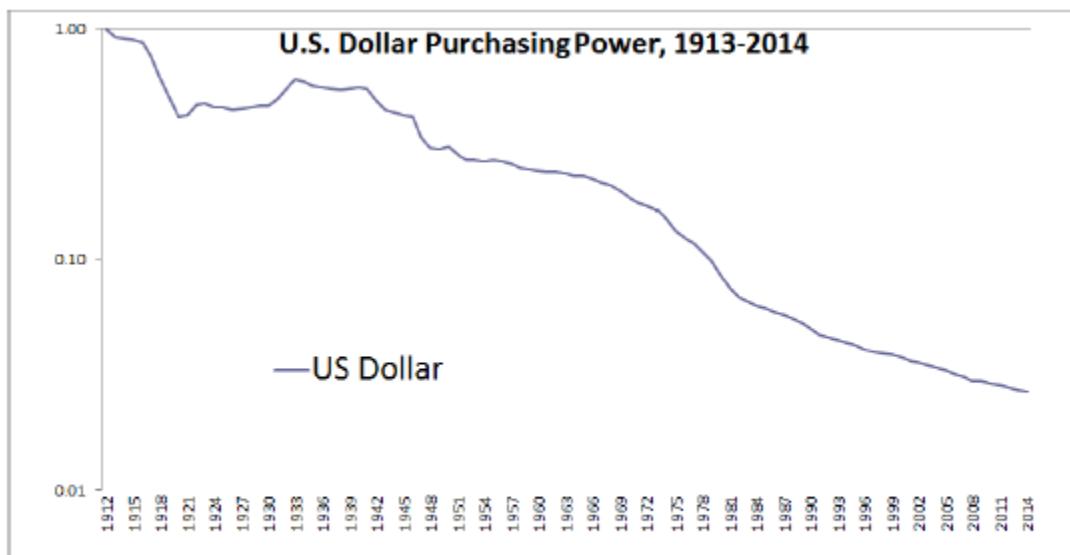
Each product (ETF) has its own liquidity (ability to turn into cash in short order) and each security underlying those ETFs has its own liquidity. Both must be considered when structuring a portfolio. Low liquidity of either can subject a portfolio to undo risk both in trying to transact and also to a potential lower pricing in the market because of the lower liquidity.

Reinvestment

If an asset class, a company or a product is not viable, reliance on any of those can cause unnecessary risk both in modelling and in the market pricing of the product.

Inflation

This is a chart of the purchasing power of the dollar over the past 100 years. It has declined by 94%. \$1.00 in 1913 is only worth about three cents in current dollars due to the effects of inflation which have averaged about 3.2% per year.



Source: Global Financial Data, Shiller

Concentrated stock

Many investors have concentrated positions in equities of companies that they have worked for. Idiosyncratic risk is the risk of that particular company. Diversifying would reduce the company specific risk but taxation, transaction and the emotional impact of reducing the position have to be addressed in doing so.

Foreign country and Political/Government

The idiosyncratic risk in this case is the risk of investment in securities in a particular country. The political structure, government form, accounting rules and business environment are just some of the issues that can be unique to a foreign investment. Diversifying by country would reduce this risk.

Transparency

Investment vehicles that lack full transparency make modelling for asset allocation or other risks very difficult and unreliable. Individual securities are the easiest to assess followed by ETFs which, in most cases, provide daily transparency of holdings. Mutual funds on the

other hand only need to report holdings quarterly making them more difficult to model with and Hedge Funds and Private Equity funds are even less transparent.

Expense Ratio

With trading costs dropping toward zero, transaction costs in most cases for ETFs are negligible to nonexistent. Internal expenses of products become even more important to assess. Individual securities have no internal expenses, ETFs typically have relatively low internal expenses and mutual funds typically have much higher internal expenses as they include things such as marketing costs in their expense ledger passed through to investors.

Growth

There is a risk of being too conservative and not having an allocation to enough risk assets that can grow in a portfolio.

Disclosure Statement

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