SHELTON CAPITAL MANAGEMENT

Shelton Emerging Markets Fund

QUARTERLY
Commentary
As of March 31, 2023

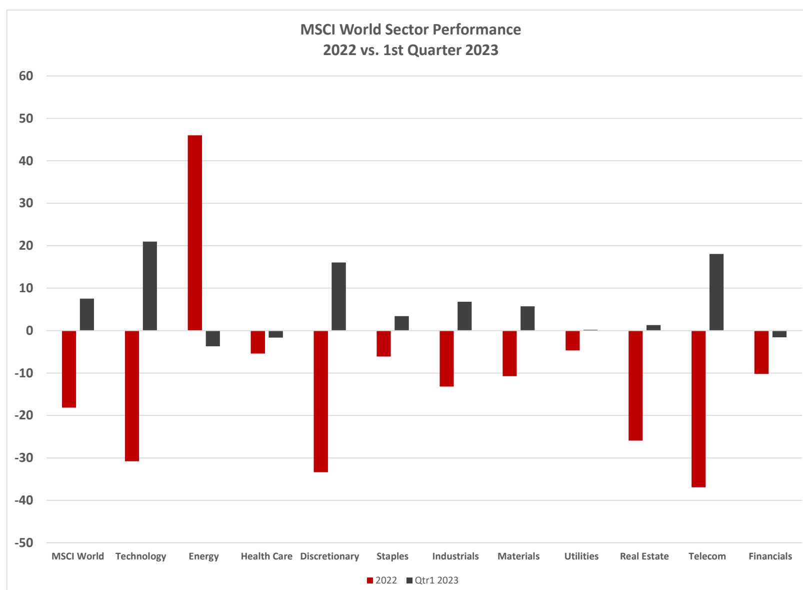
Market Commentary

First Quarter Review

The first ten weeks of 2023 reflected an adage about financial markets. "The only endearing truth is reversal to the mean."

After a year where many equity markets were down close to 20% and rates rose at an unprecedented pace, once inflation and interest rates began rolling over in the fall of 2022, some relief should have been expected. So far in 2023, global equity markets, as measured by the MSCI World Index, rose 7.7%. Emerging markets followed a bit behind, rising 3.9%. Internally as well, sector performance for the first quarter of 2023 was nearly a mirror image of sector performance in 2022.

In 2022, energy was the only sector to post positive returns, rising nearly 50% behind the commodity triggered by the Russia-Ukraine war. On the other hand, technology, consumer durables and utilities were the weakest sectors in 2022, each falling more than 30%. Once the market was confident that the end of rate hikes was on the horizon, this action reversed. In 2023, energy has been one of only three sectors to exhibit negative returns, while tech, durables and utilities were the three sectors to exhibit double-digit positive returns.



Sources: MSCI, Bloomberg

Growth and value styles exhibited a similar pattern. In 2022, the MSCI World Value Index outperformed the MSCI World Growth Index by 22.7%. So far in 2023, growth beat value by 14.2%.

Activity like this might provide an 'all clear' signal to investors after a year like 2022. That is, until the middle of March, when another investing axiom came to bear: you can't have a recovery without banks.

Silicon Valley Bank

The reversal might have been even stronger if it was not for the run on Silicon Valley Bank (along with a few other small technology focused banks) in mid-March. There is not much to say here that has not been elaborately described elsewhere, except about how the banking crisis demonstrated where risk is centered worldwide.

Currently the US represents 66% of the global equity market by market capitalization. Despite our status as economic leader, the US is not immune to financial and economic risk, and when such risks arise, the effects are wide ranging, even across national borders. When small and mid cap banks fell in price in the US, European banks fell as well.

A different story came from emerging markets. The emerging market universe consists of more than 20 countries, and you must add together the biggest four before you get to the same concentration as the US in developed markets.[1] Thanks to this diversification, emerging market banks and equity markets were relatively unaffected by the crisis. From the day the news about Silicon Valley Bank broke to the end of the quarter, developed world financial stocks fell 6.2%, while emerging market financials fell by 1.2%.

[1]Not to mention that these four countries combined would add up to less than 10% of the whole global equity market.

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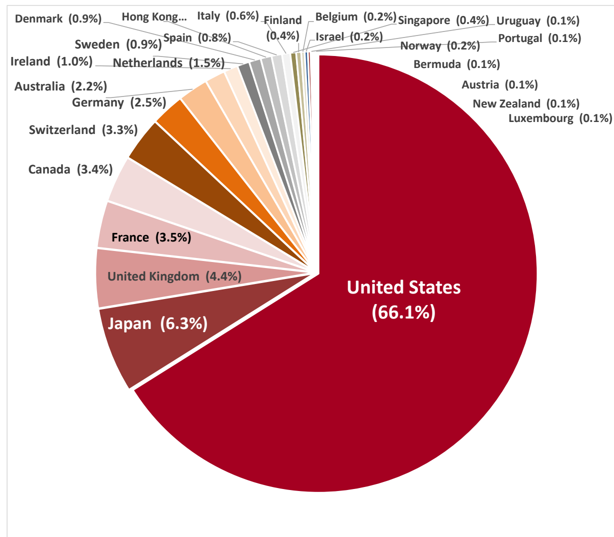
Portfolio Managers

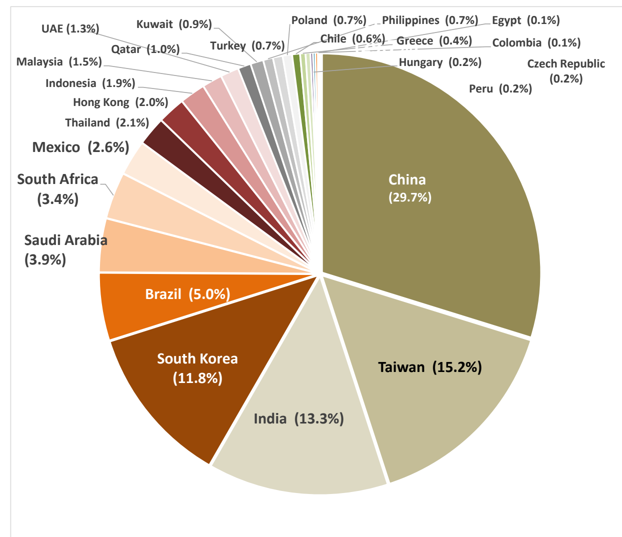
Derek Izuel, CFA

Derek Izuel, CFA is Chief Investment Officer and a Portfolio Manager of the International Strategies. He has over 24 years of portfolio management experience at Invesco, HighMark Capital and Vitruvian Capital. Derek earned his MBA from the Ross School of Business at the University of Michigan and a B.S. in Computer Science from the University of California at Berkley.

Justin Sheetz, CFA

Justin Sheetz, CFA is a Portfolio Manager of the International Strategies. His experience includes 12 years as an Investment Strategist at Blackrock/BGI's Scientific Active Equity Group, 3 years as VP and Equity Analyst at HighMark Capital and 3 years as partner at Vitruvian Capital.

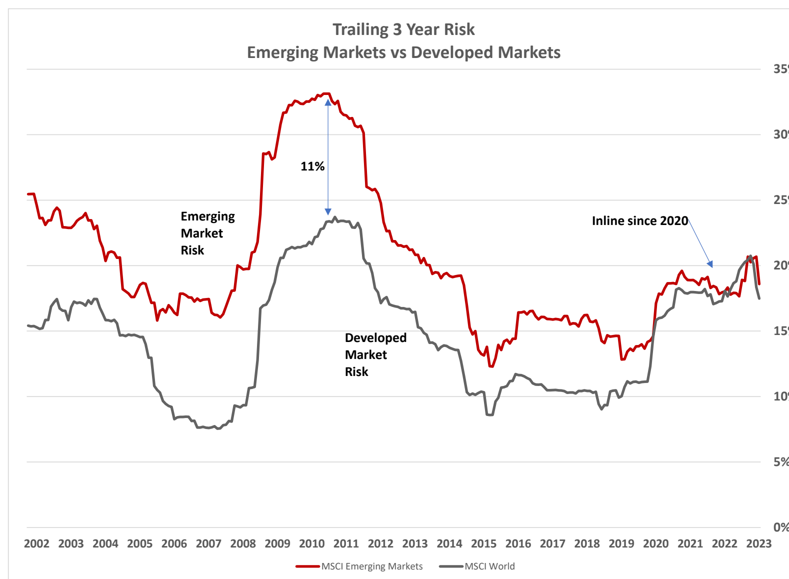




Sources: MSCI, Bloomberg

It points to a new story about emerging markets: they are less risky than ever before. The concentration risk of such a large US weight in developed markets is equivalent to all the political, economic, currency and developmental risks that emerging markets are famous for.

And the data supports it. Below shows the trailing 3-year volatility of the emerging and developed markets. While emerging market risk has been 5-10% higher than developed markets historically, emerging market risk has been in line with developed since the pandemic, and at times has been a bit lower.



Sources: MSCI, Bloomberg

The Dollar

The interest rate environment continues to favor dollar weakness. While the Federal Reserve has been accused of being behind the curve, relative to Europe and the UK they have been ahead. The US inflation cycle started earlier, triggered a central bank reaction quicker, and began to recede sooner. Net result is that while the Fed is only talking 25bp rate hikes at best, the UK just downshifted from 50bp to 25bp, but Europe continues to hike 50bp at a time.

The chart below reflects these trends. These are economist forecast of the central bank overnight rates for five of the main trading partners for the US who also have liquid, flexible foreign exchange markets[2]. Observing the slope of these lines, economists forecast the Fed Funds rate (and the equivalent rate for their neighbor to the north) to fall faster than similar rates in Europe, Australia, and the UK. As these rates become more attractive to investors, more funds will flow to these markets from the US, propping up their currencies versus the dollar.

[2]Japan certainly qualifies under these criteria, but their rate activity has a different dynamic. The Bank of Japan manages long rates to control their yield curve. They have struggled to do in the last 6 months, further contributing to the strength of the Yen.

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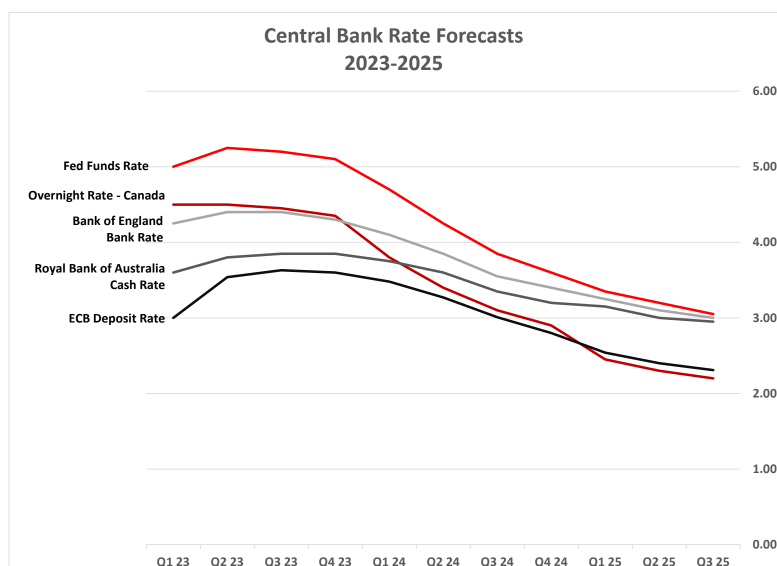

Source: Bloomberg

The dollar's weakness is a key catalyst for improving performance for international and especially emerging markets going forward. During the last extended period of dollar weakness, from 2003 to 2008, emerging market equities outperformed the US by 25%, nearly 5% per year. Given the relative strength of the US market over the past 10 years, and the resultant spread in valuation levels, they are certainly positioned to do so again.

Emerging Markets

The Shelton Capital Emerging Market Fund returned 9.90% in the first quarter, outperforming the MSCI Emerging Markets Index return of 3.96% by 5.94%.

Most geographic and sector allocations were small determinants to portfolio performance. Our overweights to Mexico and Indonesia were helpful, while underweights in China and Taiwan were slight detractors. Overweights in growth areas such as technology and health care helped the fund, while our underweights in financials (as mentioned, relatively unfazed by events in developed world banking) and utilities detracted.

Most performance was, by design, derived from the individual positions in the portfolio. Our biggest contributors:

Yadea Group (1585 HK), a Chinese manufacturer of scooters and bikes, rose 55% in the quarter on greater than expected revenue, attained without sacrificing margins. The company eyes expansion outside of mainland China to further their growth.

Dentium (145720 KS) had a 2nd straight strong quarter. The Korean supplier of dental implants and tools continues to improve margins, setting themselves up for strong profit growth once revenues improve. Re-opening in China put a damper on their recovery - high number of covid cases lowers dental visit volume - but the market sees through to the growth potential, and the stock returned 39.7% for the quarter.

Accton Technology (2345 TT) was another strong performer. Lesser known than the myriad of semiconductor manufacturers in Taiwan, Accton produces a wide range of networking products. The stock rose 23.5% as expectations for earnings growth steadily grew.

The quarter was not without weakness in some issues. Haier Smart Home (6690 HK) fell off after a strong start and lost -7.1%. The large appliance manufacturer maintains solid growth and margins, but saw expectations decline in the face of weakness in the property sector. Other Chinese names were also weak including Shenzen International (152 HK) and Kuaishou Technologies (1024 HK).

IMPORTANT INFORMATION

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The MSCI Emerging Markets Index captures large and mid cap representation across 26 Emerging Markets (EM) countries (Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates). With 1,403 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

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