

Market Commentary

The fourth quarter of 2023 began with yields continuing their uptrend which started back in May (this is why the first word of our third quarter commentary was 'pain'). The rate rise continued through the month of October, before the market pivoted hard and began a furious two-month rally into year-end. Duration went from being enemy to friend, and no maturity was long enough. Equities and credit all participated in the move, to modestly varying degrees. Inflation began to exhibit signs of containment and progress towards the eventual goal. Markets front-ran the Fed for the umpteenth time, but this time Chairman Powell and the Fed did not push back against the pivot narrative, which turbocharged the rally even further. Whether the last mile of inflation progress is quick or challenging will be a driver of 2024 performance.

10yr UST rates started the quarter at 4.57%, reached an intra-quarter high of 4.99% on October 19th, before declining steadily to 3.88% by year-end. While some economic indicators began to slow, GDP clocked in at a torrid 4.9%, fueled by continued strength in consumer spending. Labor markets remained tight on the surface but began to show cracks underneath. Declining temporary labor, slower quits, fewer job openings, and moderating hourly earnings all suggest the labor market is cooling, which is key to taming the services component of inflation. The Fed left rates unchanged at both meetings, deviating from the skip/raise pattern of the previous few meetings.

Markets are now pricing in six cuts in 2024, while the FOMC dot plots only indicate three. This is a very different phenomenon than the last several quarters, where the market wanted cuts and the Fed was still indicating hikes. Whether the first cut comes in March, May or June will impact the front end of the yield curve, although it shouldn't create massive volatility in the intermediate and longer portions of the yield curve. We still believe the Fed will wait too long to start to cut, in essence overtightening, because they are more comfortable with the tools for stimulating the economy out of a recession than they are with fighting inflation that becomes entrenched. The long end of the yield curve may have other drivers of volatility including increasing issuance, rising fiscal deficits, and continued debates on the appropriate amount of term premium. The market is now pricing in a goldilocks-type soft landing; while this is possible, it has not been the norm historically. We believe the landing may be bumpier than expectations, but not necessarily deep enough or long enough to cause massive blowouts in spreads or a crash lower in rates.

As yields were climbing earlier in the year, we continued to position the portfolio by reducing lower credit quality issuers that we believe are less recession resilient and adding longer-duration high quality bonds such as investment grade bonds. We found all-in yields on these high-quality bonds to be compelling, and wanted to ensure firstly that our borrowers will undoubtedly be able to pay us all interest and principal due throughout a recession. Adding these longer maturity bonds had the effect of increasing the duration of the portfolio, as we believed that intermediate and longer-term interest rates would peak and start to decline. We spent much of 2023 being premature on the duration component, and it was gratifying for this drag to flip hard and become a strong contributor to performance. As we had been asserting, the irony was not lost on us that the highest quality bonds were on sale just as they should be most attractive. In our view, the all-in yields and low dollar prices were very enticing, and actuarially driven investors would be locking in these rates in droves. Once rates stabilized, we believed there would be a feeding frenzy for intermediate and longer-term high-quality bonds, especially since there had been a lack of corporate bond new issue supply on the long end. This is exactly what happened in November and December. Once investors gained confidence that the top in yields was in the rearview mirror, the floodgates of cash began to enter bond markets. The rotation came from other risk assets, other countries' bond markets, and out of zero and short duration money market funds, all chasing longer duration assets. As of quarter-end, BBB-rated investment grade bonds yielded 5.28%, BB rated bonds yielded 6.41%, and investment grade municipal bonds yielded 3.22% (approximately 5.44% on a federal income tax adjusted basis). Even if credit spreads widen into a recession, the risk-free component will likely go lower from here, pushing potential total returns above 10% over the next 6-12 months.

In Q4 2023, the Fund generated returns of +6.13% (DEBIX) and +6.03% (DEBTX). On the following page is a table of returns for the Fund, various relevant indices, and the Morningstar Nontraditional Bond category. Performance in the quarter was strong relative to our positioning on credit and rates. The Fund outperformed less rate-sensitive or shorter-duration indices and underperformed longer duration and riskier or more credit-intensive indices. In December, the fund reached its 10-year anniversary, and the performance of the fund since inception stands very tall relative to peers. We believe our performance is a testament to our ability to overcome the vagaries of the rates markets and the occasional idiosyncratic hiccups by stringing together significantly more idiosyncratic winners than losers over time. We feel this is well evidenced in our 10-year performance, which ranks in the ninth percentile of the Morningstar Nontraditional Bond Fund category, and our 10-year upside/downside capture ratio of 91%/55% as of 12/31/23.

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Portfolio Management

Peter Higgins

Head of Fixed Income & Sr. Portfolio Manager



Peter Higgins has over 25 years of experience in fixed income investing, most notably as Partner and Lead Portfolio Manager at both Ares Management and BlueBay Asset Management. Previously, Peter specialized in global leveraged finance at investment banks such as Deutsche Bank AG, Goldman Sachs & Co. and Credit Suisse in both London, England, and New York City. Peter earned a bachelor's degree in Economics-Political Science from Columbia University.

Jeffrey Rosenkranz

Portfolio Manager



Jeffrey Rosenkranz has 25 years of experience investing in the credit markets, with an emphasis in high yield, distressed debt, and special situations and has worked at firms including Cedar Ridge Partners, LLC, Durham Asset Management, Cooperstown Capital Management and Ernst & Young LLP. He holds an MBA from the Stern School of Business at New York University and a B.A. from Duke University. He is also a Certified Public Accountant.

William Mock

Portfolio Manager



William Mock has 25 years of experience as a trader and portfolio manager of fixed income and derivatives portfolios, working at Citibank, Societe Generale, and TKI Capital prior to joining Shelton Capital in 2010. He is also lead portfolio manager of Shelton Capital's other municipal and government bond mutual funds. William holds a B.S. in Electrical Engineering from Kansas State University and an MBA from University of Chicago Booth School of Business.

Chris Walsh

Portfolio Analyst



Chris Walsh has over nine years of experience analyzing credit and equity markets. He has been with Shelton Capital since November 2016. Chris earned a B.A. in Economics, Villanova University.

4Q 2023 Shelton Capital Management: Fixed Income Commentary

| | 4Q23 | YTD | 1YR | 3YR | 5YR | 10YR |
|--|-------|--------|--------|--------|-------|-------|
| Shelton Tactical Credit Fund (DEBIX) | 6.13% | 5.70% | 5.70% | 1.63% | 2.90% | 3.43% |
| Bloomberg U.S. Aggregate Bond Index | 6.82% | 5.53% | 5.53% | -3.31% | 1.10% | 1.81% |
| Bloomberg U.S. Investment Grade Corporate Bond Index | 8.50% | 8.52% | 8.52% | -3.29% | 2.63% | 2.95% |
| Bloomberg U.S. High Yield Corporate Bond Index | 7.16% | 13.45% | 13.45% | 1.98% | 5.37% | 4.59% |
| Bloomberg U.S. Investment Grade Municipal Bond Index | 7.89% | 6.40% | 6.40% | -0.40% | 2.25% | 3.03% |
| Bloomberg U.S. High Yield Municipal Bond Index | 9.21% | 9.21% | 9.21% | 0.75% | 3.49% | 5.00% |
| Morningstar Nontraditional Bond Fund Category | 4.09% | 6.81% | 6.81% | 0.51% | 2.28% | 1.84% |

Performance figures represent past performance and are not a guarantee of future results. The investment return and the principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost; current performance may be lower or higher than the performance data quoted. For more current month-end Fund performance information, please call our office at (800) 955-9988.

Shelton Capital Management has contractually agreed to reimburse expenses incurred by the Fund to the extent that total annual fund operating expenses (excluding acquired fund fees and expenses, certain compliance costs, interest and broker expenses relating to investment strategies, taxes, and extraordinary expenses such as litigation or merger and reorganization expenses, for example) exceed 0.98% and 1.23% until May 1, 2024.

Fund Expenses - DEBIX (gross): 1.86% | DEBIX (net): 0.99%
DEBIX (gross): 2.11% | DEBIX (net): 1.24%

Portfolio weightings were higher in corporate bonds and lower in municipal bonds. We also did not have any credit short positions in acknowledgement of the significantly higher cost of carry and the need to carry positions longer given expectations for the delayed onset of a recession.

Corporate bond long positions were a strong contributor to performance overall, as the dramatic interest rate move and resulting price appreciation added to the coupon income. Favorable credit selection did allow us to avoid any major downside surprises. For a change, higher-quality rate-sensitive bonds outperformed lower-rated credits, mainly because they tend to be longer duration and more rate-sensitive. Notably, nearly every single corporate bond position had a positive total return and a positive contribution to performance. We continued to strike a good balance between prudent credit selection in single B credits we believe are underappreciated by the market and rating agencies, while avoiding weaker single Bs and CCCs which could be severely punished in a downturn.

The borrowers in our portfolio reported solid Q3 earnings generally across the board, reinforcing our decision to upgrade the quality of the portfolio in the face of cost pressures and an economic slowdown. We enjoyed some single-name outperformance where better than expected earnings were applauded, credit improvement was recognized by the markets and rating agencies, or corporate transactions were announced. We expect this dispersion, where strong performance is rewarded, and poor performance is penalized, will accelerate going forward, especially into the pending earnings season where companies may provide FY '24 guidance. Issuers that materially miss earnings, call off corporate transactions, or otherwise disappoint their investors will be severely punished. This kind of market is highly conducive to our strategy, when markets are generally rangebound or sideways and individual credit selection is rewarded or punished.

Municipal bonds detracted from performance as a legacy position was written down, which offset positive performance from the performing long-duration municipal bonds. Our decision to substantially reduce municipal exposure was prudent, as the asset class modestly underperformed corporate and taxable fixed income.

The top 5 contributors and detractors for the quarter are listed below:

Top 5 Contributors

The Kraft Heinz Company
AerCap Holdings NV
Iron Mountain Inc.
Sirius XM Holdings Inc.
Sun Communities Inc.

Top 5 Detractors

California Pollution Control Authority
US Treasury Bond 3.875% /5/15/43
Pfizer Inc.
WorldPlay Inc.
Brookfield Finance Inc.

Corporate Commentary

High yield corporate bonds began the quarter struggling, then flipped around hard and joined the rally into year end. The more rate-sensitive portion of the market, BBs and Bs, outperformed CCCs. We believe the massive outperformance of CCC-rated credits throughout much of 2023, which correlated highly with equity markets, is unlikely to persist, and when the payback comes it could be harsh. Spliced by rating bucket, BBs returned +7.36%, Bs +7.01% and CCCs +6.91% during the quarter. Investment grade bonds followed a similar pattern, but at a higher level as the longer duration and interest rate sensitivity was a tailwind, finishing at +8.50%. BBBs outperformed AAs and As given the additional spread, while AAAs conquered all cohorts, given they are most rate sensitive. BBBs returned +8.78% versus single-As +8.21%, AAs +8.29% and AAAs +9.76%. Investment grade funds had an overall quarterly outflow of -\$17.3 billion, while high yield saw an inflow of +\$9.2 billion. Investment grade new issuance was slightly ahead of this quarter last year, with supply totaling \$228 billion, topping \$213 billion in Q4 2022. High Yield issuance was \$42 billion in Q4 versus \$16 billion in Q4 2022 and a massive \$81 billion in Q4 2021. The \$196 billion of high yield new issue supply for 2023 is a 69% increase from the \$116 billion issued last year, with September 2023 being the busiest month of issuance since January 2022. Of the \$196 billion issued, about 64% was for refinancing or repayment of debt, a trend we expect to continue.

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Corporate Commentary (continued)

In tandem with this healthy refinancing, the balance sheets of HY issuers appear to be in good shape on the aggregate. The level of leverage ticked down from 3.99x to 3.96x and is still well-below where it was pre-pandemic and the long-term average of 4.32x, while interest coverage metrics sit near all-time highs at 5.03x. Additionally, there has been a healthy cohort of issuers moving up to investment grade, keeping a limit on total HY supply and thus providing a minor technical tailwind. Loan supply has also been limited, with the market contracting this year after years of rapid expansion.

The default rate increased slightly from 2.8% to 3.0%, and remains very low by historical standards, for now. Spreads tightened -69bp in the quarter to +334, which still feels low for a pre-recessionary period and is even tight compared to non-recessionary averages, but the elevated all-in yields are a powerful draw for investors. How much pain will continue into 2024 as the Fed is hiking in the face of markets? Dislocations may prove attractive entry points at all-in yields close to double digits.

We plan to continue to search for names that have been neglected or miscategorized by the market, and as always apply a contrarian mindset in trading. With rates having risen quite a bit since their issuance, many higher quality (generally longer duration) names are trading at steep dollar price discounts to par. We like the safety here with the added optionality to the upside if there is some sort of event leading to a takeout at par.

Dealers had been net-short for much of 2022, but this flipped around to a net long position, which has been rangebound throughout 2023. By the end of December dealers had been lifted out of some of their inventory during the November/December rally and had \$2.86 billion of exposure as compared to \$3.9 billion at the end of Q3. How quickly and aggressively they choose to replenish some of this inventory will have an impact on trading levels in 2024. We have fully taken advantage of our tactical mandate and agility to trade around these bouts of volatility and enhance returns. We will continue to stay disciplined and opportunistic, identifying compelling opportunities in complex, out-of-favor, misunderstood credits, many of which are going through secular or regulatory changes or have cycles that are not aligned with the traditional economic cycle.

Municipal Commentary

Municipal markets joined the US Treasury market, with the selloff that began in May finally reversing course and rallying for the final two months of the quarter with investment grade (7.89%) and high yield (9.21%) tax-exempt bonds both beating the US Treasury (5.66%) returns. The Treasury curve shifted lower across the curve as the market began to assume the FOMC would pivot to an easing cycle in the 1st quarter of 2024. The table below shows the change in AAA municipal yields in basis points across the curve during the quarter.

| Maturity | October | November | December | Full Quarter |
|----------|---------|----------|----------|--------------|
| 2 Years | 10 | -91 | -34 | -115 |
| 5 Years | 16 | -95 | -39 | -117 |
| 10 Years | 20 | -97 | -41 | -117 |
| 30 Years | 23 | -88 | -37 | -102 |

From a relative value perspective, tax-exempt bonds continue to be historically rich relative to Treasuries. AAA Muni/Treasury ratios ended the quarter substantially lower than where they began, falling from 72% to 59% in 2 years, 73% to 58% in 5 years, 75% to 58% in 10 years, and 94% to 84% in 30 years. The rich ratios were supported by the highest nominal rates for municipal bonds in over a decade, and negative net supply that was expected to evaporate in the Fall months but carried forward as the increased new issue supply fell short of expectations. Municipal Fund flows were negative for the year, with total outflows of \$16.1 billion, consisting of \$28.5 billion of outflows from open-end funds and \$12.4 billion of inflows to ETFs. New issue supply is generally expected to increase this year, which should put upward pressure on the AAA/US Treasury ratios, though this could be offset by fund flows should they turn positive.

We anticipate the tax-exempt bond market to remain relatively rich on a ratio basis and continue to take direction from US Treasury markets. There is potential volatility over the coming months as the market has priced in an earlier start and more aggressive easing cycle than the Federal Reserve's own projections. Though appearing increasingly likely, it remains to be seen if the Federal Reserve can navigate a 'soft landing' for the economy while bringing inflation back to the 2% target rate. Should the economy slow substantially, the historical credit quality of municipal bonds relative to corporates should gain attention as a safe place for fixed income investors, which would further support demand.

Outlook

The Atlanta Fed GDPNow Forecast for Q4 sits at 2.21%, which would mark a sharp deceleration from the too-hot Q3 figure of +4.9%. We expect GDP to continue to decelerate in 2024, hindered by the continued lagged impact of higher rates, withering contribution from fiscal stimulus, and rising consumer debt balances. The key question is whether this will be a few quarters of below trend but still slightly positive growth, a technical recession with a few quarters of very shallow declines, or a harder landing with a deeper or longer recession. Whether rate cuts begin in March, May or June may gyrate the bond market within a relatively narrow range, and we plan to continue to be tactical and trade around these ranges and mini bouts of volatility to enhance returns. The philosophical debates around term premium required to hold longer dated bonds and the real-world impact of rising supply of treasury bond issuance will determine the shape of the yield curve and performance for intermediate and longer dated fixed income. Of course, microeconomic fundamentals and corporate earnings will be the key to changes in credit spreads, but supply and demand technicals will also factor into corporate bond performance as well. We believe that real interest rates are unnecessarily high and will come down as the economy slows, offsetting concerns about a rising supply of treasuries. Furthermore, since we do not expect corporate earnings to reach estimates amidst a slowing economy, equities seem vulnerable and the appeal of bonds as a safer fixed income return should counterbalance the mania for term premium.

We know that Fed policy operates with a lag, and because such a small percentage of mortgages, auto loans, and corporate borrowings have re-set at higher rates, the lags this time around might be even longer. The rapid dis-inversion of the longer end of the curve earlier in 2023 is an important transmission signal of acceptance and capitulation, which should help move the lags along. The housing market slowdown should finally begin to roll through the data in coming months, which should push inflation readings lower. Because the Fed is more comfortable running the playbook of re-stimulating an economy out of a recession rather than trying to re-conquer entrenched inflation, we fully expect them to try and keep financial conditions tight for longer, and over-correct in the process.

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Outlook (continued)

The nearly 26 million people holding public student loan debt had required payments suspended for more than three years, and the vast majority of this group made no voluntary payments during that time. The extra disposable income has given a meaningful inflationary impulse the last three years, and the estimated \$200-\$300 average monthly payment that kicked-in during the quarter is best thought of as a tax increase that will slow aggregate spending. Consumers have been the engine behind economic growth, but now they are dipping into their savings, as evidenced by the personal savings rate falling below pre-pandemic levels to 4.1%.

Much progress has been made on supply chains and bottlenecks, morphing from the challenge of too little inventory over to a surplus of inventory or supply in certain circumstances. Plummeting freight rates and other concurrent indicators of shipping demand indicate at least a pullback from exuberant strength if not a more pronounced slowing of the economy. We are keeping an eye on the lower water levels in the Panama Canal and the Houthi attacks in the Red Sea for a possible uptick of inflation caused by shipping delays and rising freight costs, but don't expect them to be material. Recent corporate commentary continues to signal the onset of economic slowing. Consumers who faced unprecedented increases in food, energy and broader goods and services subsidized those expenditures with stimulus, savings from not consuming services during the pandemic, and wage growth from the exceptional strength of the labor market. The housing market has started to roll-over, as home prices peaked last July and have declined steadily since mortgage rates exceeded 8%. How long and deep this impending recession might be is the next key question. If it turns out to be more severe, equities and lower-quality fixed income have more downside. However, in the case of fixed income, given where all-in yields are now, we believe they are adequately compensating investors for additional spread widening all the way down to the single-B rating tier. Below single-B you better get your credit analysis and downside protection correct, as the lack of trading liquidity in that tier severely punishes mistakes.

Third quarter earnings season was a mixed bag overall, and delineated companies who have pricing power or moats around their businesses versus those whose products or services are discretionary to the point of unnecessary in a slowing economy, or at least not worth paying up for. The result was a wide range of gross margin performances. Over the coming months we look for economic data to build a trend of slowing economic activity and lower inflation readings, but it won't be a straight line. Oil prices declined during the quarter as recessionary demand concerns offset Saudi Arabia and Russia's continued coordination to withhold supply and keep the market tight. Whether or not services prices and the labor markets follow is the key. While job openings have started to decline, measures of labor force participation and the number of people seeking jobs remain muted. In a highly favorable development, labor productivity has been rising, which allows labor unit costs to remain under control despite an overall tight labor market. While conventional wisdom believes the Fed needs to push the unemployment rate close to 4.5% to achieve its objectives, with continued increases in productivity, perhaps that isn't the case. This would allow the Fed to be more aggressive on rate cuts, which we believe could be a catalyst for a further rate rally. However, if the Fed believes they need to keep interest rates higher for longer, more damage will be inflicted on corporate earnings. Estimates would be revised lower and create bouts of volatility as corporate fundamentals deteriorate, and cause credit spreads to widen.

We believe the sweet spots for future total returns are BBB, BB, and certain single-B corporate bonds we believe are stronger and more resilient than the market. CCC's are now screening a bit cheap on a relative value basis, but we will await further broader spread widening before tactically being selective down the credit spectrum. Mathematically, even if spreads widen a few hundred basis points further, BBs at yields of 6.41% would still produce acceptable returns over the next 6 – 12 months. If rates go lower and/or the recession proves to be milder, then total returns could easily eclipse 10% over that period. In this scenario, we would make the tactical adjustment to add more credit risk to the portfolio. There are valid reasons to believe spread widening might stop short of previous recessions, as the index has a higher quality composition (more BBs, fewer CCCs), beginning all-in yields are higher than the onset of a typical recession, and the average dollar price of bonds is much lower and much closer to recovery rates. However, if spreads were to blow out to levels above +800 basis points that are often reached in severe recessions, total returns would likely be flat or even negative. Navigating these bouts of volatility by adjusting credit quality overall and selecting the right individual securities will be the keys to success, and we are confident in our ability to thrive in such an environment.

As always, we will be cognizant of valuations, while continuing to seek value and compelling risk/reward investments across fixed income products with a focus on the corporate and municipal bond markets.

IMPORTANT INFORMATION

Investors should consider a fund's investment objectives, risks, charges and expenses carefully before investing. The prospectus contains this and other information about a fund. To obtain a prospectus, visit www.sheltoncap.com or call (800) 955-9988. A prospectus should be read carefully before investing.

Credit-related instruments typically decrease in value when interest rates increase. Concentration in a small number of issuers increases the risk that one issuer could have a large adverse impact on the Fund's return. Borrowing and frequent trading could increase the Fund's operating expenses. High-yield bonds involve greater risk of default, and may be more volatile and less liquid, than investment grade securities. Subordinated and unsecured loans may be disproportionately affected by default and downgrade. Foreign investments may be adversely affected by currency fluctuations, lower liquidity, tax regulation, and political instability. Derivatives can be highly illiquid and difficult to unwind. The Fund's short positions may equal up to 100% of the Fund's net asset value. Short sales theoretically involve unlimited loss potential since the market price of securities sold short may continuously increase. The Bloomberg Barclay U.S. Aggregate Bond Index is an unmanaged index of the U.S. dollar-denominated investment grade fixed-rate taxable bond market. It includes government, corporate, mortgage-backed, and asset-backed debt securities with a maturity of at least 1 year. It is not possible to directly invest in an index. Effective May 15, 2023, David Falk is no longer a portfolio manager of the Fund.

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