SHELTON CAPITAL MANAGEMENT

Fixed Income

Quarterly Commentary
As of September 30, 2021

Market Commentary

The great Covid reopening was fun while it lasted, and our positioning to take advantage of these reopening trades allowed us to ride the wave. However, as we became more concerned about stretched valuations and the emerging threat of the delta variant, we positioned the fund more defensively by reducing overall exposure and paring back cruise lines, airlines, and certain other thematic trades. People's behavior became more careful, and economic data began to soften in August.As markets dusted-off their calculus textbooks to remember how to identify the second derivative of the curves of Covid cases, hospitalizations and deaths, we were methodically deploying a little of our cash to take advantage of the weakness.

We have consistently held the view since late last year that inflation would be coming, and it has now become the market's obsession. While the Fed and many economists and strategists labeled it "transitory," our view from the real world was that wage pressures were accelerating and supply chain issues were only just beginning, and thus that "persistent" would be a better descriptor. The Fed has finally started to acknowledge this in their latest forecast update. The increase in their forecast for 2022 to 2.3% is now the highest next-year inflation projection since 2007. Coming out of the September Fed meeting, the long-awaited and well-telegraphed move to begin tapering will begin in November, barring any major surprises. What seems to have caught market participants by surprise is the speed at which the taper should be completed – mid 2022. Although widely expected, markets nonetheless reacted to the announcement, with 10yr US Treasury yields rising 17bps from just before the meeting through the end of the month. Here, our hedges have served us well in protecting the portfolio. This rise in rates will likely trigger outflows, particularly in municipal bonds. We have our shopping list ready and are excited to deploy our ample dry powder into market weakness and at higher yields.

As a reminder, the DEBIX portfolio is constructed in a way to be relatively agnostic to changes in rates or the slope of the yield curve. We do our fundamental research and due diligence on companies and municipal issuers and generate our returns from credit rather than duration or moves in rates. We would rather invest in our experience in identifying undervalued, mispriced, complex, out-of-favor and otherwise underpriced securities. The fund is hedged against rising interest rates using low-cost out of the money options, which minimizes drag but maximizes protection. This strategy is repeatable, and we believe should generate attractive risk-adjusted returns throughout the economic cycle.

In Q3 the Fund generated solid absolute and very strong relative returns of +0.63% (DEBIX) and +0.49% (DEBTX), bringing year-to-date returns to +7.88% and +7.61% respectively.

Description	Returns 3Q2021	YTD
Shelton Tactical Credit Fund (DEBIX)	+0.63%	+7.88%
Bloomberg Barclays U.S. Aggregate Bond Index	+0.05%	-1.55%
Bloomberg Barclays U.S. Investment Grade Corporate Bond Index	+0.00%	-1.27%
Bloomberg Barclays U.S. High Yield Corporate Bond Index	+0.89%	+4.53%
Bloomberg Barclays U.S. Investment Grade Municipal Bond Index	-0.27%	+0.79%
Bloomberg Barclays U.S. High Yield Municipal Bond Index	+0.38%	+6.53%
Morningstar Nontraditional Bond Fund Category	-0.06%	+1.75

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.

Portfolio Management

Jeffrey Rosenkranz
Portfolio Manager

Jeffrey Rosenkranz has over 23 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.

David Falk
Portfolio Manager

David Falk has over 30 years of broad-based fixed income experience as a trader, research analyst and investment banker for firms including Cedar Ridge Partners, LLC, Bear, Stearns & Co. Inc. and Lazard Freres with a focus on the municipal securities market. He is also a Portfolio Manager for the Green California Tax-Free Income Fund and fixed income managed accounts. He holds a Master of Regional Planning from the University of North Carolina at Chapel Hill and a B.A. from Northwestern University.

William Mock
Portfolio Manager

William Mock has over 20 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 six 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.

Kyle Johnson
Fund Analyst

Kyle has been with Shelton Capital Management since July 2019. He has nine years of industry experience and previously worked with OppenheimerFunds, ALPS, and an independent RIA. He has a B.S. in Finance with a certificate in Entrepreneurship from Florida State University and is also a CFA® charterholder.

These returns were driven by prescient tactical adjustments during the quarter and effective security selection. Portfolio weightings were higher in high yield corporate bonds, and lower in municipal bonds and short positions. Almost all positions generated positive returns during the quarter, with notable contributions from credit-intensive idiosyncratic positions, higher-quality IG upgrade candidates and certain longer-duration municipal bonds. Also notable was that our corporate short positions were positive contributors overall, and the Wynn Las Vegas bonds were a top 5 contributor as the market started to come around to our view that US/China tensions would manifest themselves in the upcoming re-licensing process. The few detractors were modest losses in reopening trades and a few special situations which retraced modestly after strong performance earlier in the year. The top 5 contributors and detractors for the quarter are listed below:

Top 5 Contributors	Top 5 Detractors
CBL & Associates Properties	Pyxus International
Ferroglobe plc	Transocean Ltd.
Wynn Las Vegas LLC (short)	Carnival Corporation
Cuyahoga Cty Hospital - MetroHealth System	NY State Transportation - Delta LaGuardia
Iron Mountain Incorporated	Hawaiian Holdings, Inc.

Corporate Commentary

Fund flows and coupon reinvestment continued to provide a very supportive foundation for strong new issuance. Flows into investment grade were $39 billion, while high yield posted modest inflows of $1.9 billion. This has allowed companies to refinance higher coupon debt with lower interest rates and extended maturities. Investment Grade issuance totaled $321 billion and High Yield issuance totaled $108 billion. As a result, corporate creditworthiness is very healthy. Leverage is back to pre-Covid levels, interest coverage is at multi year lows, and overall levels of debt as a percentage of equity market values are at ALL TIME LOWS. Certainly, this is attributable to the long bull market in equities, but these credit statistics are real, and they are spectacular. However, since the new-issue market has been wide open for a while now, and most solid companies have already taken advantage of the refinancing benefits, what's leftover is gradual additional refinancing as bonds become callable, and issuance in support of dividends, acquisitions, and LBOs. The recent Medline Industries deal is a perfect example of a high-quality issuer where all the pricing was squeezed-out of the deal and post-deal trading performance was lackluster. Therefore, recently we have found more compelling opportunities in the secondary market versus new issuance. During the quarter, HY spreads widened 9bps, yet still sit towards the low end of historical ranges, leaving little room for additional spread tightening. Even after adjusting for mix and quality, overall valuations are uninspiring. Importantly, given that BBs now represent a larger component of the HY market, the duration of the HY asset class is longer and therefore more rate sensitive. If rates keep grinding higher, the resultant weak performance may surprise people.

Bed Bath & Beyond's earnings miss was the canary in the upcoming earnings season coal mine. Supply chain and labor issues are getting worse and are about to collide with the holiday season demand surge. There will be plenty of retailers who have inadequate inventory to meet the robust demand that is expected. Those who do manage to navigate logistical challenges will do so with the added cost of additional labor, premium freight etc. The silver lining for these businesses should be less aggressive mark-downs and better margins on merchandise. There will be winners and losers, and losers will be punished harshly. We are being cautious and not placing outsized wagers on any individual company where the holiday season is make-or-break. 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 bond yields moved 4, 13 and 16bps higher over the third quarter in the 5-, 10- and 30-year maturities, respectively, as measured by the Bloomberg "AAA" scale. Tax-exempt yields were lower in July, retraced that move to unchanged on the quarter through August and then moved more firmly to higher yields in September as municipal rates followed the Treasury market's reaction to the beginning of Fed tapering in November. Technical factors remained supportive overall but softened a bit as the quarter progressed. New long-term issuance over 2021Q3 totaled $116.1 billion bringing year-to-date issuance through September 30th to $334.967 billion --- approximately equaling issuance for the same period in 2020. Taxable municipal bond issuance year-to-date totals $76.8 billion representing 23% of total issuance, down from 30% for same period in 2020. Lipper reported tax-exempt mutual fund flows for 2021Q3 totaled $29 billion bringing the year-to-date total to $88.5 billion. Flows were solid through much of the summer but began to weaken toward quarter end. Total flows for the last week of September totaled only $408 million compared to the year-to-date average weekly inflow of $1.5 billion. Redemptions and maturities of bonds along with coupon payments provided a good source of reinvestment capital over most of the summer and solid support for the new issue market. However, as we moved into September, a continuing new issue calendar of $10 billion per week was a bit more challenged by a combination of factors: (i) the moderation in reinvestment flows, (ii) move to higher yields, (iii) increased secondary market selling and (iv) continued uncertainty around fiscal policy. We think the adjustment to higher absolute yields in the municipal market is constructive overall and provides opportunity as we move into 2021Q4. Increased trading activity is welcome after municipals have been somewhat rangebound over much of the quarter. Longer dated municipal bonds are also more attractive on a relative basis to Treasuries. For example, the Bloomberg Municipal AAA/Treasury ratio moved from 68.5% to 74.5% in 10 years and from 75.5% to 82.9% in 30 years during the quarter.

Despite a full court press the last week of September, neither the $1.2 trillion bipartisan infrastructure ("BIF") bill nor the $3.5 trillion reconciliation bill ("Reconciliation Bill") moved forward. Progressive Democrats in the House will not approve the BIF until the Reconciliation Bill is passed by the Senate. And moderate Democrats cannot get comfortable with either the size or many of the proposed new social programs contemplated in the Reconciliation Bill. Knowing that the reconciliation process will not allow for debate, Conservative Democratic senators have reasonably requested a Congressional Budget Office scoring of the Reconciliation Bill to understand the cost and anticipated revenue sources before voting. Unfortunately, this legislation may follow Speaker Pelosi's "We have to pass it to find out what is in it" playbook. Fortunately, Congress was at least able to pass a continuing resolution for government funding through December 3rd. Also, still unresolved is the need to raise the federal debt ceiling which analysts project will be reached around October 18th.

Given the uncertainty about where the final size and cost of these legislative pieces will end up makes it difficult to determine exactly how the municipal market will be affected. Will direct subsidies for taxable municipal bonds be included? Will tax-exempt advance refunding ability be restored? Where will individual and corporate tax rates end up? What about deductions for state and local taxes? Answers to these questions and others will ultimately inform us as to how municipal market demand and supply will be affected going forward. At this writing it looks like October 31st is the new target for completion of the BIF and Reconciliation Bills, so please stay tuned for more developments.

Municipal Commentary (continued)

With respect to municipal credit, we offer a few observations. First, the combination of federal funding together with the impact of economic reopening has fueled state tax revenues beyond forecasted levels. Data compiled by the Tax Policy Center at the Urban Institute through June 2021, the last month of the fiscal year for most states, indicates that overall state taxes were 26.5% higher for fiscal year 2021 than in 2020. With respect to a few of our specific focus sectors, we note that toll roads have prudently managed administration, operation, and maintenance expenses during the pandemic. While the switch of many to working from home has had a negative impact on commuter traffic, we note that commercial vehicle traffic resulting from increased consumer spending has had a strong positive impact and overall traffic levels for some systems are moving closer to pre-pandemic levels. Finally, for the not-for-profit acute care hospital sector, federal funding has been critical through the pandemic. The ability to devote resources to higher margin procedures and to continue managing costs efficiently will remain critical. One thing we are monitoring closely is the significant increases in staffing costs and staffing shortages --- especially in nursing. Systems that have borrowed to increase beds must have staff to use those beds and realize revenues. Hourly wages for "traveling nurses" have more than doubled from pre-pandemic levels and the implementation of vaccine mandates is causing additional shortages in some places as well.

Outlook

We are encouraged by the apparent cresting of Covid cases and deaths in the United States. However, as the weather turns colder in the northern part of the country, we would expect another wave over the coming weeks, which should be manageable given vaccination patterns, but could have a bit of a dampening effect on certain sectors. More importantly, Covid-related shutdowns and supply chain issues in goods-producing countries around the world show few signs of abating, and this will continue to pressure both the availability and cost of intermediate and finished goods. Upward pressure on costs, wages, and energy will continue to push rates higher, triggering weakness in generic fixed income and outflows. We stand ready with dry powder and our shopping list to take advantage of this weakness. Additionally, rising US/China tensions, extreme energy pricing, and the continuing polarization in Washington also have our attention as we surveil for risk. As always, we will be cognizant of valuations, while continuing to seek value and compelling risk/reward investments in 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.

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