Clark Capital Management Group

Fourth Quarter 2013

navigator® REPORT

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The Lost Decade Has Been Recovered!

It is hard to remember way back to January 2000 when the equity markets reached the highest level in history. Since then the U.S. equity market has been subjected to two generational bear markets: 2000 to 2002 and 2007 to 2009. While neither of those bear markets were worse than that of the 1930s, the last one, during the financial crisis, came very close. The time from 2000 to 2010 has been dubbed the "lost decade" and included such disastrous events as the September 11th terrorist attack, the Enron scandal, the housing bubble and the global financial crisis, just to mention a few. Both bear markets were terrifying to the average investor and have caused many to swear off stocks forever. **But hope and optimism have finally returned.** In late March 2013, the Dow Jones and the S&P 500 surpassed their prior peak levels in price and on December 20, 2013, both indexes finally recorded new highs adjusted for inflation (the consumer price index is used for the adjustment). The NASDAQ is still about 20% away from its all-time high price. **So, in a sense, the "lost decade" has been recovered.**

> "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."
> Sir John Templeton

The year 2013 began with a bang following a deal struck by our illustrious leaders in Washington on New Year's Day in order to avoid the dreaded "Fiscal Cliff." The S&P 500 gained 10.61% in the first quarter. The market experienced one of its rare pullbacks during May and June, amid mixed signals from the Federal Reserve, but still managed to gain 2.29%. In the third quarter, it gained 5.24% when the Federal Reserve admitted that the economy was too soft to permit any lessening of Quantitative

SUMMARY

Equity Market:

The Bull Run that began in 2009 is getting long in the tooth and most likely will end sometime this year. Over the past 82 years mid-term election years have been characterized by corrections averaging 21.7%. A decline of 20% or more would be classified as a cyclical bear market that would end the current bull market. However, corrections during this year have been followed by very explosive rallies beginning in the fourth quarter and averaging 48.5% into the following year and 60% into the election year.

We believe that we are in the early stages of a Secular Bull Market that, potentially, will last for several years. Long term secular movements or trends include shorter term movements. These shorter trends are called cyclical movements. A long term secular bull market will experience several shorter term cyclical bear markets.

Bonds:

We have entered a long term secular bear market in bonds. Bonds will continue to fall in price as yields rise. We expect the 10 year Treasury note to fluctuate in a range of 2.4% to 3.75% and to end the year with a yield of 3.50%.

The current yield is 3.03% up from the low yield of 1.43% in 2012. We favor credit risk over duration risk as credit spreads can stay low for extended periods supported by continued economic growth and low default rates.

Easing. With the Federal Reserve promising to keep interest rates very low during 2014, 15, and 16, the fourth quarter chalked up a gain of 10.50%. Did you notice the prevalence of the words Federal Reserve above? Yes, it has been a liquidity driven market based on the Federal Reserve pumping huge amounts of money into the economy. And, yes, the economy has been improving albeit at the slowest pace of any economic recovery of the past fifty years.

For the year, the S&P 500 gained an outstanding 32.36%. The year has been called the all-gain no-pain year with no corrections worse than 6%. Japan came in a close second by gaining 27.16% while MSCI Europe gained 25.23%. Emerging markets lagged badly due to weak currencies and rising interest rates and only gained 2.60% on the MSCI Emerging Markets Index.

Fixed income was another story with the Barclays Aggregate Bond Index losing 2.02%. **The largest loss for this bond index since 1994! Treasury Bonds did much worse than the Aggregate Index, losing 6.04% on the Barclays 7-10 Year Treasury Index and losing 13.88% on the Barclay 20+ Year Index.** As you may know, we have been saying that the bull market in bonds of the past 30+ years is over and that we believe it is likely we will have an extended period of weakness in bond prices going forward.

It is apparent that equities had the best return over the past year and portfolios that were diversified into other asset classes lagged badly. As mentioned above, markets were fueled by Fed driven liquidity and an improving economic landscape both in the U.S. and overseas. The year turned out better than even the most bullish analysts on Wall Street expected, including ourselves. Coming into 2013 the average year-end target for the S&P 500 predicted by the major Wall Street firms was 1531. The most bullish of the major Wall Street firms was Citigroup, which expected the S&P 500 to close 2013 at 1615. **To our credit, we were more bullish than most. Our forecast called for the S&P 500 to end 2013 at 1625, which would have been a 14% gain for the year.** That would have been double the historic average for the first year Presidential Cycle gain. As it turned out, even though we were one of the most bullish firms on the street, the gains still trumped our expectations. We have been fairly accurate in our forecasts since we started making annual predictions, and last year was our largest miss.

	Our Target	Finish	% Missed by
2013	1625	1848.36	13.7%
2012	1425	1426.19	Spot on
2011	1350	1257.60	6.8%
2010	1300	1257.94	3.2%
2009	1100	1115.10	1.5%

HOW DID WE DO?

We manage assets in several different portfolios or programs. Some portfolios are **concentrated** and made up entirely of common stocks, others are made up entirely of Exchange Traded Funds (ETFs), others invest only in tax free, taxable, or high yield bonds. These portfolios are called Separately Managed Accounts (SMA). We also combine these portfolios into several **diversified** portfolios that combine individual common stocks, ETFs, bonds, and alternative investment vehicles such as commodities or currencies. These are named Unified Managed Accounts (UMA). Balanced accounts would combine some equity or ETF portfolios with a bond portfolio. And we offer a **hedging strategy** in the attempt to avoid larger risks when present.

We offer such a broad range of programs; **concentrated, diversified and hedged** to allow clients, and their financial advisors, to tailor their investments to fit their personal needs and risk

tolerance. During 2013, concentrated equity portfolios performed much better than either diversified or hedged portfolios. In some years that has not been the case.

The results below are net of the highest fees that could be potentially charged including management, trading, custody and your financial advisors fee.

One of our **concentrated** individual common stock portfolios is the **Navigator All Cap Core Portfolio**. This portfolio consists of about forty common stocks which includes small-cap stocks, mid-cap stocks and large-cap stocks. The lead senior portfolio manager for this portfolio is Anthony Soslow. The result for 2013 was net 34.98%.

Mr. Soslow also manages a **concentrated** portfolio of international stocks in the form of ADRs (American Depository Receipts). The result for 2013 was net 17.05%.

Maira Thompson is lead senior portfolio manager on our **concentrated Navigator High Dividend Equity** Portfolio. This large-cap portfolio returned net 25.85%.

In the universe of ETFs we offer several **concentrated** portfolios, U.S. Sector, U.S. Style, and International. The Sector Portfolio returned net 25.94%. The Style Portfolio returned net 29.07%, and the International Portfolio returned net 10.27%.

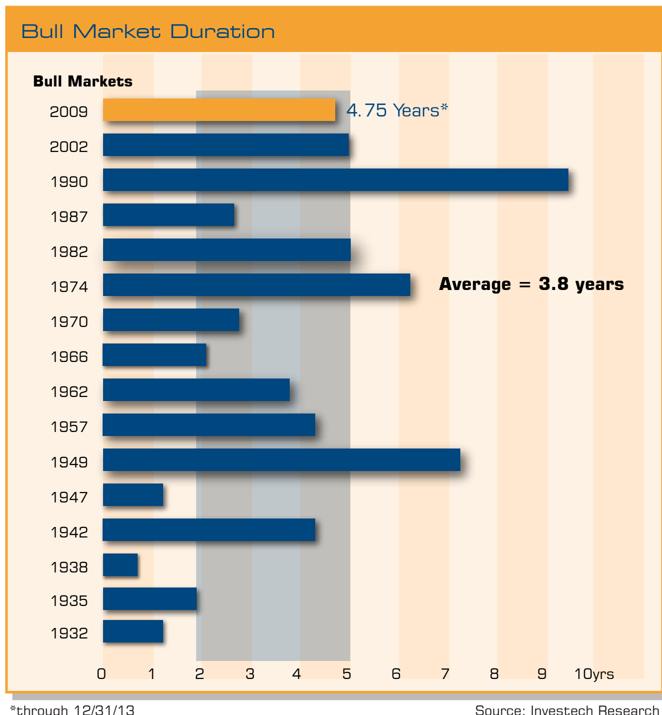
In the UMA selection we offer five levels of risk, one being the least aggressive and five being the most. These are **highly diversified portfolios** combining ETFs, individual common stocks, bonds (taxable or tax-free), high yield bonds and alternatives. Level I returned 7.80% unhedged and 5.79% hedged. Level II returned 13.65% unhedged and 10.21% hedged. Level III returned 15.30% unhedged and 11.53% hedged. Level IV returned 18.08% unhedged and 12.77% hedged. Level V returned 20.45% unhedged and 13.40% hedged. Notice that the higher level the portfolio the more expensive was the cost to hedge. This is because the higher level portfolios have a larger exposure to equities and take a larger hedge.

We also manage several types of bond portfolios, high quality taxable, tax free municipal, and high-yield lower quality. As mentioned above, it was a very tough year for bonds with losses in most categories except high-yield bonds. The taxable bond portfolio returned net 1.59%. The tax free municipal portfolio lost net 3.13%. The high yield portfolio (Total Return Fixed Income) returned net 3.08%. We favored credit risk over duration risk and therefore were able to negotiate the fixed income markets pretty well throughout the year.

WHERE DO WE GO FROM HERE?

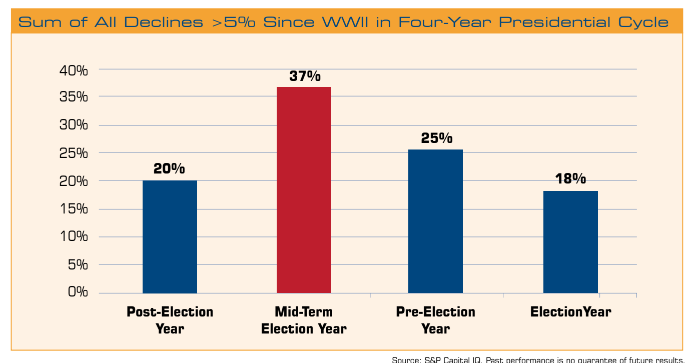
An old adage on Wall Street by Sir John Templeton says, **"Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."** Over the past year I believe that we have entered the optimism stage as the economy has seemed to strengthen and employment has been looking up. **The year's return was over twice that normally seen in the first year of an election year cycle so I believe that the market can also be categorized as being optimistic.** But I do not believe that we are in a state of euphoria just yet, especially among the general population of investors. Another Wall Street adage says that "the general public will not buy into a bull market until it is too expensive." It is a known fact that retail investors always seem to buy at or near a major market top only to sell when they can't stand the drama and sell out near the next bottom. Even though the current bull market is about to become the fourth longest since 1932, I just do not see either a state of euphoria or massive buying by the general public so we should have further to go for now.

Past performance is not indicative of future results. Returns are shown net of investment advisory fees and include the reinvestment of all income.

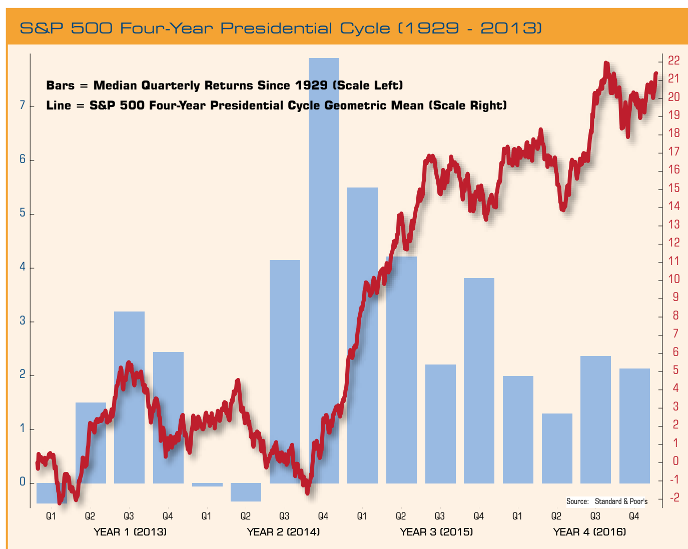


History suggests that good years tend to follow great years. **On average the S&P 500 rose 10.0% in the year following a 20% or greater advance** (versus an average gain of 8.7% for all years since 1945) and increased in price nearly 80% of the time versus the more normal 70%. So, this suggests that the strong momentum experienced in 2013 may carry over to 2014. In addition, the S&P 500 posted a 10.50% gain in the fourth quarter, one of its best fourth quarter performances of the past 85 years. **A big question many are asking as we enter 2014 is if the strong momentum will carry through to the New Year or if a first quarter pullback is in order.** History suggests that momentum should be respected. Following the top twenty fourth quarters since 1928 (return of 8% or greater), markets have rallied well in excess of the longer-term averages to start the New Year with median returns of 3.6% and 5.9% in January and the first quarter respectively. In more recent history we have seen year-end rallies continue well into the New Year. For example, in January 2013 we saw the largest market spike in years as a result of the fund flows and the QE program already in place. The S&P rallied 250 points in five months. In 2012, the S&P 500 rallied 225 points from December 20th through the end of March. In 2011, the rally started off on December 1st and lasted until mid-February for a gain of 160 points. **Simply using history and momentum as a guide suggests the markets will likely have additional upside early in 2014.**

This year, 2014, is a mid-term election year and those are usually wrought with uncertainty as investors speculate about how the balance of power may shift within both houses of Congress. As a result, according to S&P Capital IQ, it should come as no surprise that the greatest number of notable declines since 1945 were clustered in the mid-term election year. In particular, 20% of all declines of 5% or more concluded in the post-election year, 37% ended in the mid-term election year, 25% fell in the pre-election year, and, finally, only 18% occurred in the final year of the election cycle. **In addition, the second and third quarters have been especially challenging in mid-term years and are the only two quarters to average successive declines.** *Furthermore, the average correction in mid-term years dating back to 1934 has been 21.7%. So historical precedent suggests we should be especially wary of a correction beginning as the second quarter begins.*

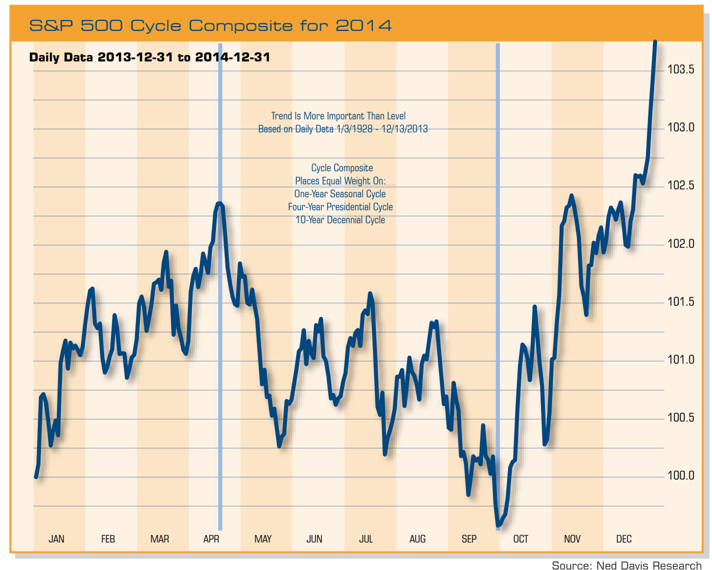


However, the rebound out of the mid-term correction, once a low is established, has been very powerful. The four best quarters of the presidential cycle immediately follow the two challenging ones, and gains from the mid-term into year-end have averaged 22.8%. **The gains are even more impressive when measured into highs during the next year and the Presidential Election year, averaging 48.5% and 60.0% respectively.** So, we would view the potential for a deep correction in 2014 as setting the stage, replanting the seeds of doubt from a sentiment perspective and relieving valuation concerns, for an explosive rally into 2016.



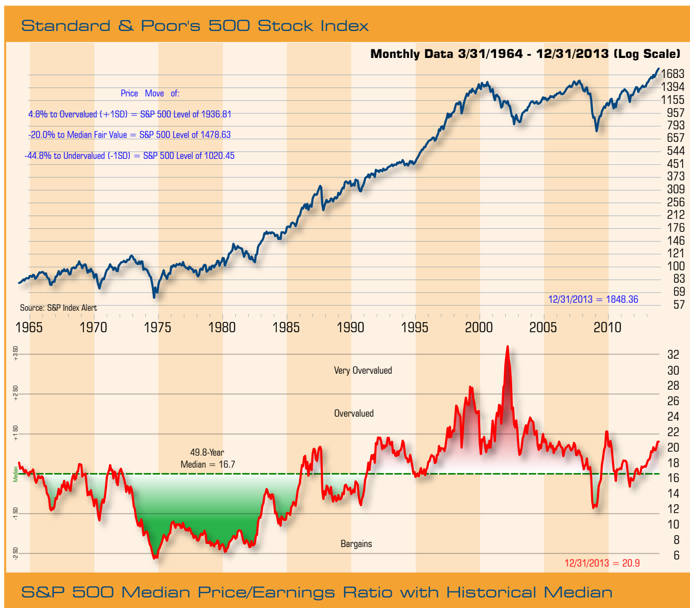
Source: Ned Davis Research

Our Chief Investment Officer, K. Sean Clark, CFA® uses many tools and methods of analysis when preparing our annual *Market Outlook* publication which this Report is based on, one of which is the Ned Davis Research (NDR) Cycle Composite. The Cycle Composite is a combination of the market's historical one-year, four-year, and ten-year cycles combined into a single composite and serves to provide a framework or possible roadmap of how the market may trade. The cycle composite for 2014 shows that we should expect strength early in the year and then possibly two quarters of general weakness before the market stages a dramatic recovery into year-end. The cycle composite confirms the general historical trends highlighted above during mid-term election years. We don't think that should go unrecognized and when multiple analyses provide confirming evidence, it usually suggests a higher probability of success.



Source: Ned Davis Research

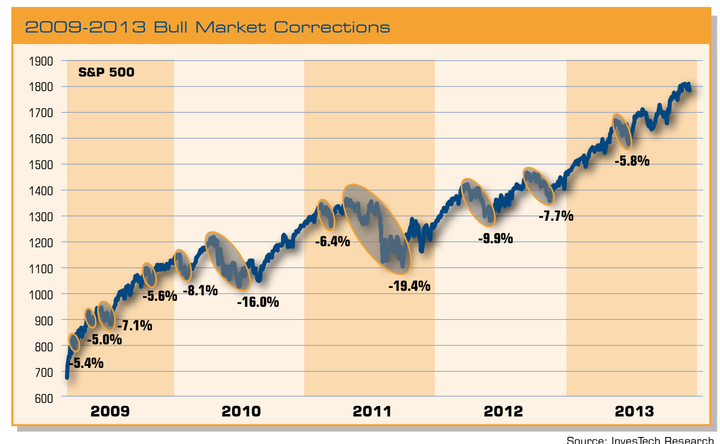
On a valuation basis the market is more than fairly valued. The price to earnings ratio (P/E) of the S&P 500, based on trailing earnings, is 17.50. A different measure of valuation from Ned David Research using the S&P 500 median P/E ratio shows the market to be overvalued with a P/E of 20.9. By this measure the market is currently approaching a valuation that is one standard deviation above fair value. The chart illustrates that this is a very rare occurrence. Cyclically the market is more overvalued than in any period other than 1999 to the early 2000s.



Our upside reward and downside risk range comes out of analyzing valuations, the cycle composite, and mid-term election year trends. **Our upside of 2000 on the S&P 500 would be a 12% gain from the December low.** That would stretch valuations beyond one standard deviation above fair value based on the median P/E ratio. We expect the upside for the market and the probable high for the year to be in the first quarter. Our downside risk area of 1575 on the S&P 500 is near the June 2013 lows and would also represent close to the average correction of 21.7% experienced during a mid-term year from the upside range.

Adding to the concerns about valuations is the quality of record earnings and the record high profit margins. Corporate America is flush with cash but, by and large, earnings growth has been driven more by cost cutting and productivity enhancements than by top line revenue growth. That could change if the economy surprises to the upside. But, according to Reuters, earnings warnings and guidance for the fourth quarter are running at the worst rate since they began tracking the data. Historically there are about 2.2 negative guidance events for every company with positive guidance. For the fourth quarter they are currently running more than 10 to 1 negative to positive guidance. At the same time profit margins are at record highs and we know that margins can't grow to the sky and are cyclical. We feel trends make it a tall order to expect much in the way of multiple expansion.

Adding to the concerns about valuations is that, by historical standards, the current bull market is no spring chicken (see chart on page 4). It began in March 2009, and at 4.75 years of age it is longer than the 3.8 year average bull market duration and the fourth longest of the past 80 years. Fortunately, bull markets do not die from old age and investors have profited by that during this run. However, the age of this bull does suggest that risks are rising and expecting it to last much longer without a cyclical downturn would be stretching historical probability. Another fact is that we have not had many deep corrections since the crisis lows in 2009. We have only had two corrections of more than 10% on the S&P 500 since the bear market lows and last year the largest correction was only 5.75% on the S&P 500. The historic average is a 10% or greater correction and three 5% or greater corrections every year in addition to at least one 20% correction every three years.



Source: InvesTech Research

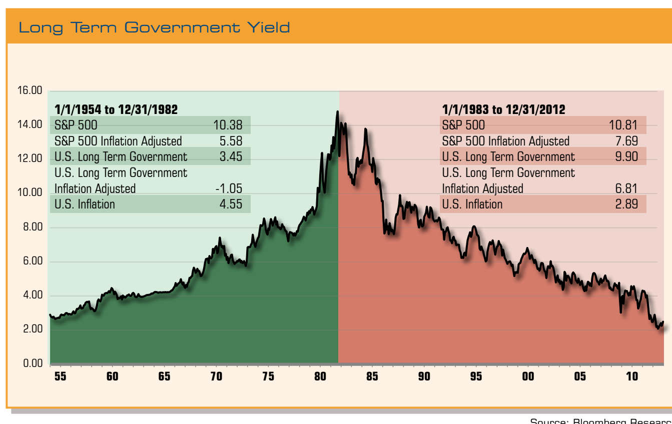
Adding to the likelihood of a mid-term election year correction is the fact that we now have a new Chairman of the Federal Reserve Board. Mrs. Yellon is the 14th Chair of the Fed since 1916. While there is great hope for a new Chairman the market always tests the mettle

of the new person by taking a nosedive in the first six months of the new term. **The average drawdown over the first six months has been 16.1% with no exceptions.** The largest drawdown was when Mr. Greenspan took office in 1987 and the market declined by 38.1%. If you would like to see the entire results of this situation please refer to the prior *Navigator Report* on our website, www.ccmg.com.

The market cycles, mid-term election year trends, longevity of the current bull and a new Fed Chairman make it likely that we will see a sizable correction this year.

BONDS

As you may know, we have been saying for the past year and a half that we believe the 30-plus year great bull market in bonds is over. The chart below shows the great bear market that existed from 1954 to 1981 and the great bull market that began in 1981 and ended in 2012. What usually follows an extended market of any type is an extended market in the other direction. Just as a secular bear market will follow a secular bull market, a secular bull will eventually follow a secular bear market.



Source: Bloomberg Research

In the case of the Bond markets we have already seen a substantial reversal in bond yield and hence bond prices. Using the 10-year Treasury Note as a proxy we see that the note reached the lowest point in yield (therefore the highest point in price) in May 2012 at 1.43%. At the end of 2013 the yield had increased by over 100% to 3.03%. That resulted in quite a substantial drop in price on this bond.

Source: Ned Davis Research

So far the household portion of assets allocated to bonds has declined from 23.5% to 19%, the lowest level since 2008. The postwar mean for this number is 13.7% so we have a way to go to get down to that level. During the last great bear market in bonds, prior to 1981, that number got as low as 8%. Foreign holding of bonds in the U.S. got as low as 22% during the sixties, peaked at 48.4% and are now down to a level 43.7%. This flight from bonds will be a catalyst for future gains in equities over the longer term. But just as stocks do not go up or down in a straight line neither do bond prices and yields. There will be times when yields decline, allowing bond prices to move higher. If we do have a substantial correction in the equity market this year, I expect bond prices to move higher as a "flight to quality" occurs.

Our expectations are for the 10-year note to end the year with a yield of 3.50% although we could see a level as low as 2.50% during a market correction.

LONGER-TERM PICTURE

We laid out our expectations for this year and shared, that while we think it will be a good year overall, there are a lot of risks and historic trends that suggest a meaningful cyclical decline in the middle of the year. However, looking out longer term, we are very positive on the markets and think we are in the early stages of a secular bull in stocks. An interesting comparison can be made of this bull market to other **new secular bull markets that began in 1921, 1942, and 1982.** The average annualized gain four years into those secular bull markets was 22%, 22%, and 24% respectively. Four years into the current bull run the market was up 22%, closely tracking those previous examples.

On a relative valuation basis, stocks are downright cheap compared to bonds. Comparing the relative valuation of stocks to bonds using the S&P 500 earnings yields and the 10-year Treasury yield, **stocks are just now coming off their most undervalued level relative to bonds since 1974**, and they have a long way to go before they are fairly valued, let alone overvalued. In addition, the depressed levels of consumer sentiment suggest we are early on in the trend of rising stocks as historically the long-term picture for stocks hasn't dimmed until consumer sentiment became too optimistic. Currently consumer sentiment is still at depressed levels. **In addition, the NDR Cycle Composite shows that any mid-year weakness could be followed by an explosive rally into 2016 and a continued rising trend into and through 2017.** Finally, the energy revolution in the U.S. is quickly turning the U.S. from a net importer to a net exporter of energy, and forecasts suggest we will be energy independent over the next decade. That has huge long-term economic, employment, and fiscal implications.

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