Clark Capital MANAGEMENT GROUP

Navigator®
Fixed Income Total Return

K. Sean Clark, CFA, Chief Investment Officer

Second Quarter — Portfolio Commentary

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Chief Investment Officer

As Clark Capital's Chief Investment Officer, Sean oversees all of the Firm's investment activities and heads the Firm's portfolio team. Sean joined the Firm in 1993 and is responsible for asset allocation and investment selection for Navigator Investment Solutions as well as directing ongoing market research and contributing to the development of proprietary products. Sean is a member of the Clark Capital Board of Directors, the Investment Committee and the Management Committee. He graduated from the University of Delaware, earning a B.S. and an M.A. in Economics. Sean is a Chartered Financial Analyst and a member of the CFA Institute (formerly AIMR) and the Financial Analysts of Philadelphia, Inc. Sean is considered an industry expert and is often asked to appear on CNBC and Bloomberg television to share his views on the market. In addition, Sean has been featured in a number of articles in nationally distributed business journals and newspapers.

AGAINST ALL ODDS

Coming into the year almost everyone believed interest rates would rise from an already very low rate environment. However, contrary to consensus expectations, bonds have been one of the best asset classes to be invested in so far this year. For the quarter and year-to-date periods, bonds performed well with both treasuries and high yield bonds posting gains. For the quarter, the Barclays Aggregate Bond index gained 2.04%, Barclays 7-10 Year Treasury index was up 2.49%, and the Barclays High Yield index posted a 2.41% gain. Year-to-date the Barclays Aggregate Bond index is up 3.93%, Barclays 7-10 Year Treasury index is up 5.20%, and the Barclays High Yield index has gained 5.46%. The market was positioned for rising rates, but the 10-year Treasury rate has actually fallen from 3.03% at the beginning of the year to 2.52% at the of June.

Executive Summary

A Good Quarter for Fixed Income: Fixed income benefitted as equities stalled, and credit conditions have remained firm in the face of continued tapering and talks of interest rate hikes.

The Changing of the Guard: New Fed Chair Janet Yellen has the monumental task of reigning in quantitative easing without jeopardizing the markets and economic expansion.

Long Term Outlook: A slow and gradual shift will take place toward inflation as the fight against deflation comes to an end.

Yields have fallen against expectations. There are several reasons why we believe rates have come in: international influences, less debt outstanding, and renewed flows into bond funds. Much of the reason for yields coming down in the U.S. is globally driven. The deflationary risks in Europe and the move by the ECB to stimulate a stagnating economy pushed European yields lower, dragging other markets including benchmark U.S. rates. Major European yields collapsed during the quarter. In Germany, Spain, and Italy 10-year yields closed the quarter at 1.25%, 2.66%, and 2.85% respectively. In addition, the 10-year rate in France and Spain hit record lows during the quarter. With periphery European rates so low, U.S. yields had no choice but to be dragged along for the ride lower.

The market is still awash in liquidity fueled by the Federal Reserve (Fed). During the quarter the Fed did taper their bond buying program at each of their FOMC meetings and are now buying $35 billion of bonds a month, down from a peak of $85 billion at the end of last year. Even so, the Fed is still purchasing a larger share of treasuries today than at any other time during Quantitative Easing (QE). The reason for this is that the government is issuing debt at a slower pace than the Fed is tapering QE. Over the last two months the amount of outstanding Treasuries has been reduced by about $100 billion while the Fed was in the market buying $58 billion. The government was reducing debt at the same time the Fed was buying Treasuries from the shrinking supply. On a six-month rolling basis the Fed has purchased 73% of new Treasury issuance. That leaves very little for normal investors to buy and we believe provides another good reason that yields fell during the quarter. The benchmark 10-year Treasury fell from 2.72% to as low as 2.44%, before settling at 2.52% to end the quarter.

Q2 Portfolio Analysis & Performance

Top Contributor

- BlackRock High Yield Bond

Top Detractor

- Eaton Vance Income Fund of Boston

The credit markets have given investors a clear signal as to what to think about the report of first quarter GDP falling 2.9%: don't worry about it! One would think that such a negative report would perhaps foreshadow recession and cause investors to flee risky assets, but that has not been the case in stocks or in fixed income. High yield bonds continue to perform very well, and in our view their rock-solid price action shows that investors as a group are simply not very concerned about the global economy for the near term. Spikes of violence in Iraq and Syria and higher oil prices have not been a deterrent so far, either. It is amazing what can happen when central banks around the globe coordinate to keep interest rates and volatility low. The Fixed Income Total Return (FITR) portfolio moved to a 100% fully invested position in High Yield Bonds nearly a year ago on July 18, 2013. The portfolio's primary evaluation regarding which asset class to own involves comparing the relative strength of High Yield Bonds versus Treasuries. By that measure, high yield bonds remain very strong. From July 18, 2013 until June 30th of this year, High Yield Bonds as measured by the Barclays High Yield Bond SPDR (JNK) gained 8.13% while the iShares 7-10 Year U.S. Treasury ETF (IEF) gained 3.20%. The FITR model remains very close to new all-time highs. Our best forecast for the markets' path this year predicts a more volatile and turbulent third and early fourth quarter 10-year yields but nothing close to a full blown bear market. As much as we believe in that forecast, the Fixed Income Total Return portfolio is not influenced by any forecast. It is only influenced by its model, which has been undeterred and very bullish. While we are always watchful for deterioration in credit conditions that might force us to become defensive, we see no evidence of any need to become cautious at this time.

Outlook

The credit markets remain very stable with 10-year rates stuck in a range between 2.40% and 2.80%. This range will eventually be broken, and as we said in our outlook for the year, we believe that yields will traverse higher before year-end. Investors have overlooked a disastrous report on first quarter economic growth that had many calling an end to the five-year economic expansion. The economy contracted at a 2.9% annual pace in the first quarter as consumption plummeted. The combined GDP growth for the last four quarters fell from 2.6% to only 1.5% 10 year yields — lower than the trend of 2.0% for the last five years. That report was not even enough to push yields to new lows and in fact signs that the economy is improving has led to a breakout higher in two-year Treasury yields. We find further confirmation that the economy is strengthening in the firming labor market. The economy has added an average of 231,000 jobs per month over the first six months of 2014 compared to an average of 185,000 jobs over the last six months of 2013.

At the current low levels of yields the market may not be pricing in the full extent of rate hikes that we believe are coming our way. Recent Fed member comments suggest that the long-term average overnight rate is 4.0% and they expect full employment and their 2.0% inflation target to be hit by the end of 2016. If that is the case, going from effectively 0% to closer to their long-term average would mean that investors are underestimating both the timing and path of interest rates. Historically the Fed has waited about a year from its last easing to its first tightening. If the Fed keeps on its tapering path, it will be finished buying securities come November. That makes June or September of 2015 the most likely time to raise rates.

In the Fixed Income Total Return portfolio we continue to favor credit over duration risk as the strengthening economy offers support to lower quality fixed income. Credit spreads are historically tight. At the end of June the Barclays High Yield index traded at a 231 bp spread over the 10-year Treasury, and given continued economic growth spreads could stay low for an extended period as they did in the mid 90s.

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The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities.

The Dow Jones Industrial Average is a stock market index that shows how 30 large publicly owned companies based in the U.S. have traded during a standard trading session in the stock market.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performers of developed markets outside the U.S. and Canada.

The MSCI Emerging Markets Index is a free float adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

The CBOE Volatility Index (VIX) is a forward looking index of market risk which shows expectation of volatility over the coming 30 days.

The volatility (beta) of a client's portfolio may be greater or less than its respective benchmark. It is not possible to invest in these indices.

Barclays U.S. Government/Credit Bond Index measures the performance of U.S. dollar denominated U.S. Treasuries, government-related & investment grade U.S. corporate securities that have a remaining maturity of greater than one year.

The Barclays U.S. Aggregate Bond Index covers the U.S. investment-grade fixed-rate bond market, including government and credit securities, agency mortgage pass-through securities, asset-backed securities and commercial mortgage-based securities. To qualify for inclusion, a bond or security must have at least one year to final maturity and be rated investment grade Baa3 or better, dollar denominated, non-convertible, fixed rate and publicly issued.

The B of A Merrill Lynch U.S. High Yield Index tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

The Barclays 7-10 Year Treasury Index tracks the investment results of an index comprised of the U.S. Treasury bonds with remaining maturities between seven and ten years.

The Barclays 20+ Year Treasury Index tracks the investment results of an index comprised of the U.S. Treasury bonds with remaining maturities greater than twenty years.

The Barclays Long-Term Year Treasury Index tracks the performance of the long-term U.S. government bond market.

The Barclays U.S. Corporate High-Yield Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

The Barclays U.S. Treasury Bond Index is an issuances-weighted index measuring the performance of the U.S. Treasury bond market, one of the largest and most liquid government bond markets in the world.

Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

Returns are presented gross of investment advisory fees and include the reinvestment of all income.

Gross returns will be reduced by investment advisory fees and other expenses that may be incurred in the management of the account. For example, a 0.50% annual fee deducted quarterly (.125%) from an account with a ten year annualized growth rate of 5% will produce a net result of 4.4%. Actual performance results will vary from this example. The Firm's policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

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