Navigator® Global Opportunity

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Third Quarter — Portfolio Commentary

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John serves as a Portfolio Manager on the Navigator Global Opportunity management team, focusing on trend and risk analysis and is a member of the Clark Capital Investment Committee. John has over 20 years of experience in the investment advisory business. Prior to joining Clark Capital in 2011, John spent 15 years at Wachovia Securities and its predecessor firm Wheat First Butcher Singer, where he spent his last two years managing the Absolute Return ETF portfolio. John holds a degree in Economics from Millersville University and pursued graduate studies in economics at Lehigh University, with an emphasis in Econometrics. He is a Certified Financial Planner (CFP®) licensee and a Chartered Financial Consultant (ChFC) with the American College. He is also an Affiliate of the Market Technicians Association, a professional organization of market analysts, and is currently studying for Level III of the Chartered Market Technician's examination.

THINNING THE THUNDERING BULL HERD

"Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."
John Maynard Keynes

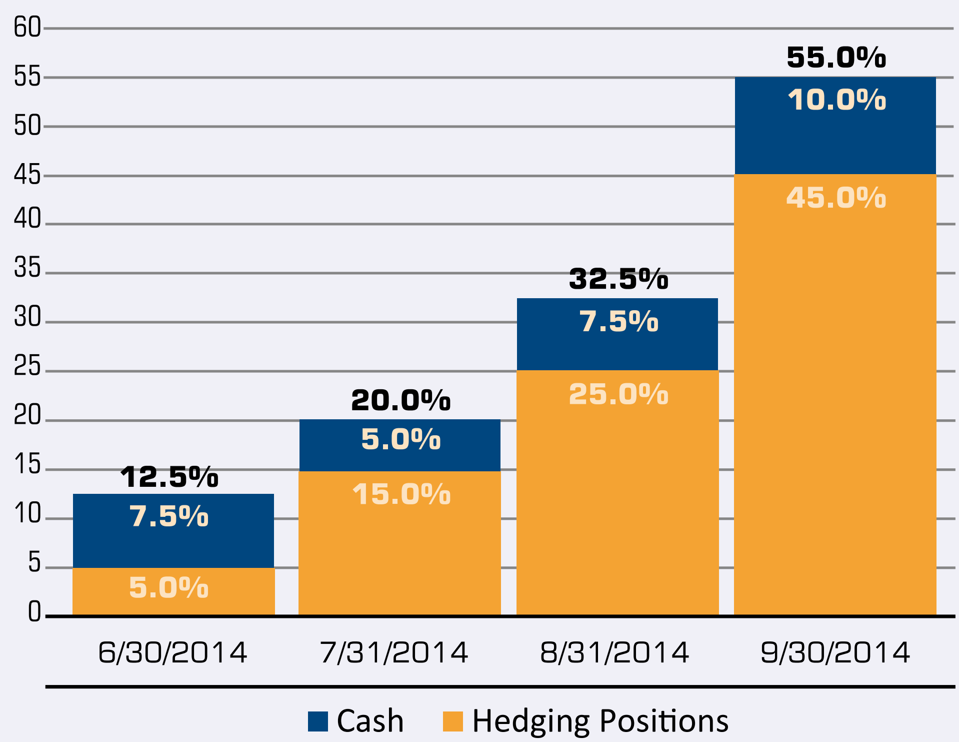
Executive Summary

- Lack of market volatility and normal corrective activity have created a legion of "weak hand" investors.
- Market risk factors have been building over the past quarter.
- A larger correction (that is, greater than 5%) would be healthy for the markets.

After major corrections or bear cycles, many reflect woefully on how so many market participants didn't see the "obvious" risks to the trend. How could so many fail to see the warning signs? And of course afterwards, there is always the parade of money managers who show up on the financial news programs, telling us how they saw the bear coming, and protected themselves beforehand.

There are strong "herding instincts" not only in individual investors, but also within the institutional money management commu-

Defensive Positions (Last Four Months)



Past performance is not indicative of future results.

This is not a recommendation to buy or sell a particular security. Please see attached disclosures.

Source: Reuters

nity. No one wishes to appear "out of step"; no one wishes to lose face. This is a very powerful social force embedded in our collective psyche — **and not one of us is immune to it.** Why? Current evidence from neuroscience suggests our brains are hard-wired to avoid social pain. Going "against the herd" (such as a contrarian investment strategy) generates brain activity in the same area of the brain that is activated by real physical pain.[1] James Montier, an analyst who specializes in behavioral finance, suggests that investing in contrarian strategies is "really like having your arm broken on a regular basis."[2]

Recently on CNBC we saw a manifestation of "herd behavior" when commentators were ridiculing the "death cross" in the Russell 2000 small cap index. The "death cross" is simply a sell signal when the 50-day moving average crosses below the 200-day moving average — this occurred on September 19th. The point of the matter is that commentators spent more time laughing at the signal than explaining that it is a sign of short-term trend risk vis-a-vie the longer-term trend. (Also not mentioned, the signal usually is more significant when the 200-day moving average is moving down along with the 50-day moving average.) In the eight trading days following this signal, the Russell 2000 lost 6% — everyone stopped laughing. These behaviors are signs of investor overconfidence.

Another sign is the massive inflow of funds that have recently poured into passive S&P 500 index funds. Why seek active risk management when the market continues to go up? This in turn creates a crowd of "weak hand" investors. This condition is quite evident in the quick reversals in short-term sentiment we've seen lately from investors. This bull cycle has gone on for five years, with no meaningful corrections in over two years (i.e., greater than 10% draw downs). See the accompanying S&P 500 Draw Down chart. We've seen short-term sentiment flash from bullish to bearish in 1.5% market down swings. This lack of price volatility has made the herd sensitive to even small down turns.

All of the above are sentiment markers demonstrating a large crowd of market participants are not investing in long term economic prospects but on the supposition that stocks will continue to go up. Why? Well… because the Fed wants them to. This mindset doesn't show strong hands. The herd can use some thinning.

Below we can summarize the market risk factors which have been accumulating over this past quarter:

- Reduced future liquidity. The Federal Reserve has been slowing their bond buying program, also known as tapering, with an end to all buying in mid-October 2014.
- Negative seasonality. The markets were entering a very negative seasonal period.
- Market volatility has been gradually trading upward from historically low levels.
- Severe negative internal divergences have been building as the market indices continue to advance: e.g., number of advancing vs. declining issues, number of issues trading at new highs, as well as the performance divergence between domestic small caps versus large caps.
- Sentiment. In addition the to above discussion, investor surveys[3] have been showing an extraordinary low level of bears (under 15%). Remember, there's no better stock buyer than a panicked short.

How have we been adjusting to the above? The answer lies on the first page under the "Defensive Positions" summary by month. As one can see over the last three months, we have slowly become incrementally more defensive and by the end of the third quarter decidedly bearish for the short-term.

We are looking for the character of the market to change after this correction. As mentioned repeatedly in past commentaries, we have characterized this trend over the last two years as a "blow-off" trend, which could break down without a prior multi-week distribution. This means a quick price break down — where "weak hand" investors fearfully sell to protect their profits. Remember their conviction level with respect to fundamentals is low.

Once there is doubt regarding the existence of the "Fed put," we believe a more historically normal trading environment may ensue; where volatility is not as suppressed. From a sentiment standpoint, the bear/bull ecosystem would be rebalanced. In our opinion, this is a market environment more suited to the strategy and process of the Global Opportunity portfolio. In addition to relative strength, trend analysis is also an important factor in the portfolio's management process. Although the overlay of this trend analysis reduces performance when the corrections are very shallow and short in time (such as in 2013), it is critically important in protecting the portfolio from larger magnitude drawdowns which may lie in our future.

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1. Eisenberger, N.I. and Lieberman, M.D. (2004) Why rejection hurts: a common neural alarm system for physical and social pain, Trends in Cognitive Sciences, 8(7), 294-300.
2. Montier, James, Behavioral Investing: A practitioner's guide to applying behavioral finance, Wiley (2007)
3. American Association of Individual Investors (AAII)

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 NASDAQ Index is a market-weighted index of all common stocks listed on the NASDAQ exchange.

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 World Index is a freefloat-adjusted market capitalization index that is designed to measure global developed market equity performance.

The MSCI World Index ex. U.S. is a freefloat-adjusted market capitalization index that is designed to measure global developed market equity performance excluding the U.S.

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

The MSCI All Country Europe is a freefloat-adjusted market capitalization index that is designed to measure the performance of European equity markets.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

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

Barclays U.S. Government/Credit Bond Index measures the performance of U.S. dollar denominated U.S. Treasuries and 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 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.

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.

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