ClarkCapital
MANAGEMENT GROUP

# Navigator® Global Opportunity

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Fourth 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.

## HOLD ON, PASSIVE INDEX INVESTORS.
## THE RIDE COULD GET A LITTLE BUMPY.

The difference between active equity management and passive equity investing can be described in two words: risk management. Active managers, such as the managers of the Global Opportunity portfolio, have a process to evaluate and control risk at the position level and/or at the portfolio level. Conversely, passive index investors simply place assets into an unmanaged equity index investment instrument and let it ride. However, given the building of macro risks in today's markets, that ride could get a little bumpy in the near future.


### Executive Summary

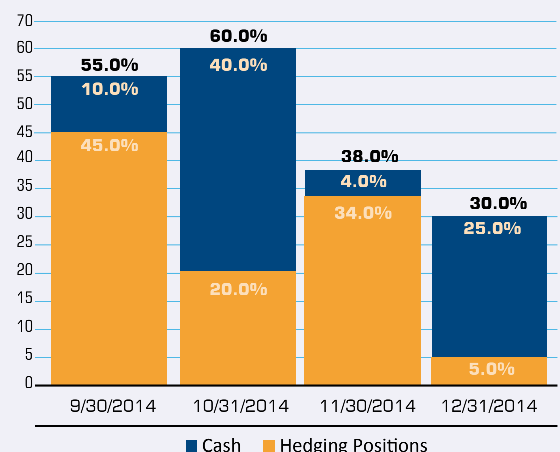
- Active risk management may become important again as market volatility rears its head. This would diminish the luster of the passive index investing strategy.
- Currency turmoil remains a major source of macro risk in global markets today.
- The Global Opportunity investment process complements Clark Capital's other Navigator portfolios.


Over the last two years, there have been large inflows into these equity index instruments; and the strategy has paid great returns with little in the way of drawdowns. Drawdowns are the percentage drop in price from the earlier previous highs within the trend. In 2013, the return of the S&P 500 was 29.60% (price only.) During that year, there were only seven drawdowns greater than -1.5% and only one greater than -5%. The "buy the dip" behavior was well rewarded, with the Fed managing their risk in the background.

Traditionally, the Federal Reserve has been mandated by Congress to pursue the following monetary policy objectives: maximum employment, stable prices, and moderate long-term interest rates. However, there appears to be another mandate in operation at the Fed now. Commenting on a speech made on December 1st by New York Fed President Bill Dudley, Jim Grant in Grant's Interest Rate Observer noted, the Fed had taken on a new mandate, "the administration of American equity prices" (also known as the "Fed put").

Passive equity index investors have been the beneficiaries of this new implicit mandate. But we believe the effectiveness of this so called "Fed put" has diminished and equity markets may experience more volatility going

Defensive Positions (Last Four Months)

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forward. Why? As we have mentioned repeatedly in our commentaries over the last two years, the likely source of future market turmoil will originate from a currency crisis. Something the Fed will not be able to control. In our March 31, 2014 commentary we wrote:

*Why are these currency issues important to us when we continue to enjoy an extremely market-friendly Federal Reserve? Succinctly stated, the Federal Reserve primarily serves U.S. interests; while the other central banks serve their own respective parochial interests. Although there are coordinated central bank actions, they are the exception rather than the rule. Currencies are the equilibrating mechanisms between economies and they are not easily controlled, at least not unilaterally. In addition, currency trading is typically highly leveraged, with leverage sometimes reaching 100:1. When money stock, currency flows and arbitrage relationships are disrupted this leverage creates high volatility effects in other financial markets.*

In our June 30, 2013 commentary, we reviewed the history of some past crises where currency disequilibrium was the spark that lit the fire. The Federal Reserve "put" won't immunize us from these risks, and we refuse to become complacent because of it.

We believe the market risks, due to currency issues, are now increasing. Additionally, market disequilibrium stemming from fast movements in highly leveraged commodity instruments could also play into wider financial market instability. For example, as this commentary is being written, the Swiss National Bank (SNB) has decided to remove the Swiss franc from the euro peg, causing volatile dislocations due to the unwinding of large short positions, especially in Swiss franc/U.S. dollar and Swiss/euro currency pairs. This may have a decidedly strong negative impact on equity markets depending on the damage done through the fast unwind of leveraged currency positions and their associated carry trades.

Could this be a so-called "Black Swan" event that causes a jolt in markets? The SNB decision came despite repeated prior assurances in recent months from Thomas Jordan, head of the SNB, that the central bank was committed to defending its euro peg. Therefore, this came as a complete surprise to the currency markets and has begun a massive unwinding of leveraged currency positions. It is too early to state how significant this will be but a similar incident began the unwinding of the Bretton Woods currency system back in 1971. In May of 1971, the West German government abandoned the U.S. dollar peg and quit the Bretton Woods system. This began an exit of other countries from Bretton Woods and a rush to the Federal Reserve gold exchange window by Switzerland and France. On August 15, 1971, three months after the Germans broke the U.S. dollar peg, President Nixon was forced to stop the convertibility of the U.S. dollar into gold and effectively end the Bretton Woods system. At the time, the West German government decision to decouple from the dollar was contrary to the wishes of the Bundesbank (the West German Central Bank) and done as a result of conservative political pressure. Likewise, the Swiss decoupling from the euro was influenced by conservative political pressure. Remember the Swiss Gold referendum on November 30, 2014? The referendum was in fact a drive by Swiss conservatives to reign in monetary policy. So this is not without precedent. In 1971, it resulted in a 16% correction in the Dow Jones Industrial Average lasting almost seven months, a time when there was limited globalization of the financial system (unlike today).

However, in order for us to act on macro risks such as the above, the risks must first manifest themselves in the form of technical evidence. At this point, it would be helpful to describe how this works within the context of our portfolio management process. So let's back up and describe what we've seen from a technical perspective (market supply/demand forces) going step by step through our process.

**Step 1: Evaluate and establish the level of macro risk in the broad market and set the portfolio's overall allocation to risk based and defensive positions accordingly. This is accomplished by evaluating the following factors (listed in the order of importance):**

- Market internal readings and pattern of trend of the broad market indices
- Patterns of trend of key sector constituents within the broad market indices
- Momentum and volatility
- Cycle analysis and intermarket price analysis
- Sentiment measures and volume

On the front page of each Global Opportunity portfolio commentary, there is histogram of the end-of-month Defensive Positions over the prior four months. These Defensive Positions are comprised of Cash and/or Hedging Positions, where the latter have an inverse negative correlation to a market/sector index. The amounts allocated into these "Defensive Positions" are the result of the Step 1 process. Although we've reduced somewhat our end of month Defensive Positions during the quarter, as of this writing in mid-January, we have increased them to 60% (Cash: 15%, Hedging: 45%) to address the evolving deterioration in market internals, key stocks, as well as the growing volatility. Admittedly, this is an unusually high level of defensiveness but our technical risk profile of the broad market warrants it. Almost all of the factors in Step 1 above are flashing warning signs and we must act accordingly.

**Step 2: Select risk based assets based upon relative strength analysis, comparing all investable ETFs against one another. In order to keep the number of portfolio positions from exceed-**

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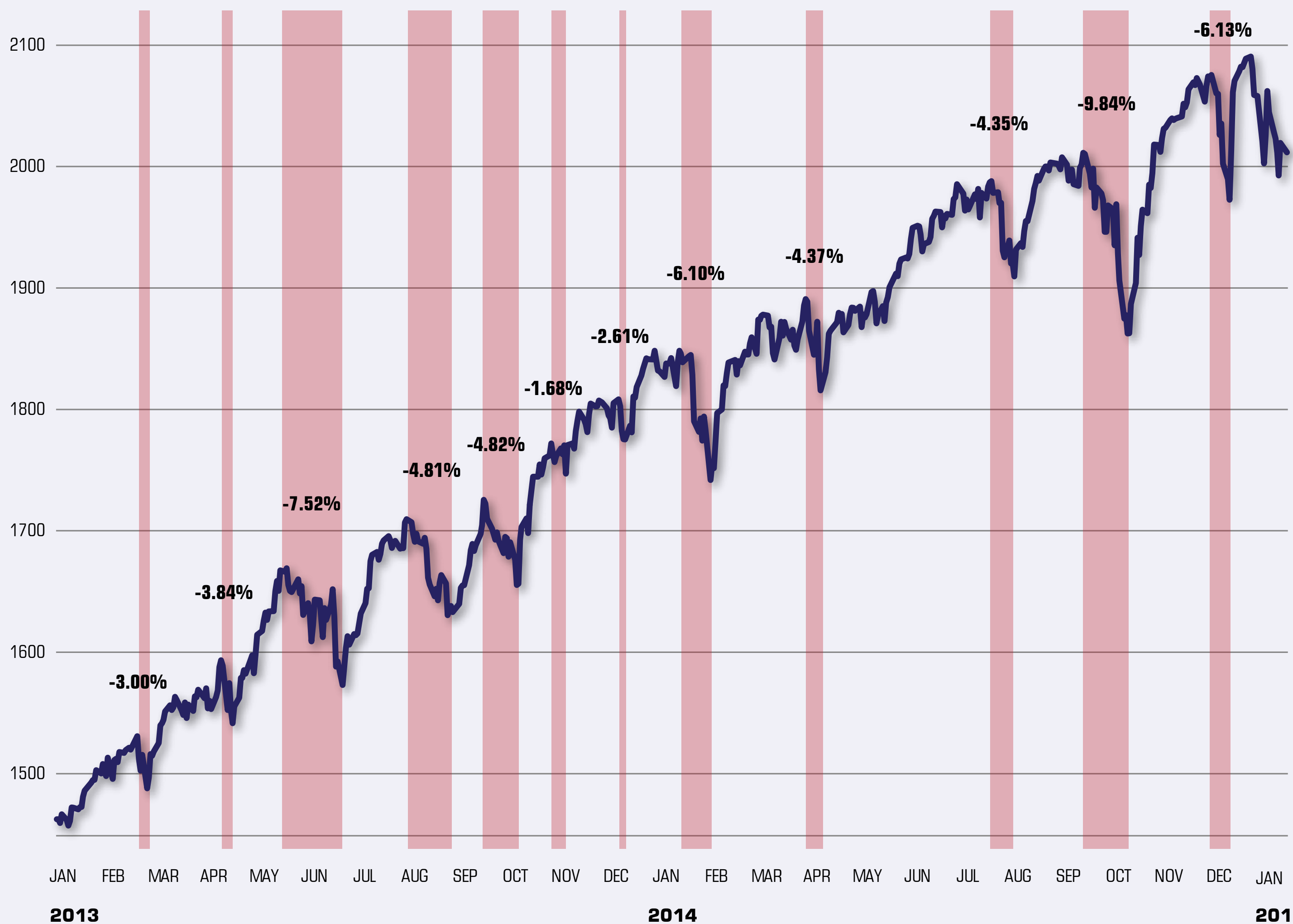
**ing our position maximum, we will narrow our selection of ETFs with similar relative strength profiles, using a pattern of trend analysis and cycle analysis. If we determine that there is no definitive relative strength advantage for taking on sector, international, or alternative asset class risk, then we will opt for exposure to a broader market ETF instead. In periods of higher macro risk, we often find this lack of relative strength advantage frequently occurs between the broad market indices and the narrower sectors (and alternative asset classes). As a result, we will severely limit our number of positions to four to six, primarily to the broad index ETFs. Conversely, in periods of low macro risk, we typically find more distinguishable and durable relative strength between asset classes and will expand our portfolio to up to 12 positions in order to maximize our opportunities for return.**

In view of this, we have narrowed our risk based assets to five positions, where half the portfolio is allocated to the broad S&P 500 index ETFs. The S&P 500 has exhibited extraordinary long term relative strength, especially over the last year. As a side note, in the portfolio, we have two S&P 500 ETFs (SPY and IVV) for the purpose of preserving long term capital gains. We have maintained our long term capital gains in the SPY ETF, and used the IVV as a short term vehicle to expand or reduce market exposure as needed.

Finally, we would like to discuss how the Global Opportunity portfolio complements Clark Capital's other Navigator portfolios. All

S&P 500 Drawdowns 2013-2014




Source: Bloomberg

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other Navigator portfolios are constructed using relative strength as the backbone of their ETF selection process (Step 2 only). We believe there is a strong and time tested advantage in using relative strength only for position selection. It aims to not pull you out of positions early and will keep you in a trend until it signals you to pull out of risk based positions in favor of defensive ETFs (such as treasuries, cash and other defensive sectors).

The Global Opportunity process begins to adjust defensively to early warning signs (Step 1), while a relative strength only process (Step 2) will give you defensive signals but generally later in the drawdown. This is good and bad depending on the nature of the trend. In a strong uptrend, possessing shallow drawdowns and quick reversals, the relative strength only process can outperform the Global Opportunity process. As described in the second paragraph, the S&P 500 in 2013 was a classic case in point; each market weakening was met by a QE inspired snapback rally. So each time the market began to roll over AND we got the confirming negative signals as described in Step 1, the quick reversal left the Global Opportunity portfolio underperforming versus the S&P 500. Shown on the previous page is a two year chart of the S&P 500, where up to the fourth quarter of this year, every drawdown was a fast "bump down, reverse and run up" movement. The effect of this is evident if one compares the other Navigator portfolio returns in 2013 versus Global Opportunity's lackluster 2013 performance.

However, as volatility returns to markets, along with deeper drawdowns, Global Opportunity's extra level of risk management at the macro level (Step 1) can add meaningful value, complementing Clark Capital's other actively risk managed portfolios. We believe volatility in 2015 will at least highlight the importance of risk management and teach passive equity index investors there is more to investing than buying the dips.

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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 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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