ClarkCapital MANAGEMENT GROUP

Navigator®
Global Equity ETF Hedged
K. Sean Clark, CFA, Chief Investment Officer

Second Quarter — Portfolio Commentary

K. Sean Clark, CFA
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.

A PINCH OF GREECE AND A DASH OF CHINA = VOLATILITY

The U.S. and global stock and bond markets faced several obstacles in the first half of the year. We entered the year with the U.S. market overvalued and earnings expectations a bit aggressive. The plunge in oil prices and its impact on capital expenditures and oil company earnings sent earnings expectations plunging throughout the first six months as analysts were forced to look reality in the face given a 60% drop in oil prices, a 12-year high in the U.S. Dollar Index, and a 0.2% contraction in U.S. real GDP. The flow of negative news came on top of the uncertainty over if and when the Federal Reserve would raise short-term interest rates for the first time since 2006, over whether or not Greece would default, and over gyrations in Chinese equities and policy responses.

The global markets turned volatile in the second quarter as the Greek crisis hit another boiling point and the bubble that was Chinese stock prices got deflated. Up until now we have seen volatility in commodities, currencies, and fixed income. The next logical spot for volatility to land was in equities, and it began to be a factor just as the quarter was closing and most of Wall Street was hoping for a relaxing vacation. The relaxing vacation was not to be as global markets became uneasy at the prospect of Greece defaulting and leaving the euro and Chinese investors seeking the exit door at the same time.

Executive Summary

An Aging Bull Carries On: U.S. stocks have been in a bull market for 6.3 years, compared to the average bull market since 1932, which lasted 3.8 years. The index has gone 914 days without a 10% correction, its third-longest run on record.

Foreign Markets Leading: Even though volatility in international markets really picked up in the second quarter, given fears of a Greek exit from the Eurozone, foreign markets have been the clear leaders so far this year.

A Volatile June for Bonds: Bonds with any duration risk got hit hard in mid-June while credit exposure, in particular lower credit quality bonds, held up quite well.

Against this backdrop, the S&P 500 Index posted its worst start to a pre-election year since 1941. For the first six months it gained 1.23% and for the second quarter it eked out a small 0.28% gain. One of our concerns coming into the year was the age of this bull market. U.S. stocks have been in a bull market for 6.3 years, compared to the average bull market since 1932 which lasted 3.8 years. This bull is long in the tooth. Even with the headwinds mentioned above, the largest correction so far this year in the S&P 500 was only 4.7% in mid-January. The S&P 500 has now gone 914 days without a 10% correction, its third-longest run on record. In addition, on April 23rd the NASDAQ Composite finally eclipsed its old high set in 2000. It took only 15 years!

Even though volatility in international markets really picked up in the second quarter given fears of a Greek exit from the eurozone, foreign markets have been the clear leaders so far this year. The MSCI EAFE index gained 0.80% for the quarter and 5.94% year to date and the MSCI Emerging Market Index gained 0.82% for the quarter and 3.06% year to date.

Past performance is not indicative of future results.

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Bond investors didn't fare so well. The Federal Reserve has signaled a desire to hike rates in the second half of the year and an improving economic landscape in the U.S. evidently supports the view that rates are set to rise. Yields have risen as it became apparent that the Federal Reserve will lift interest rates this year for the first time since 2006. The 10-year Treasury yield bottomed in early February at 1.67% and rose to a high of 2.48% in mid-June, before settling at 2.34% on June 30th. Bonds with any duration risk got hit hard while credit exposure, in particular lower credit quality bonds, held up quite well. The Barclays Capital Long-Term Treasury Index plunged 8.30% for the quarter and lost 4.67% for the first six months, its worst pre-election year start since 1999. The Barclays Aggregate Bond Index fell 1.68% during the quarter and is down 0.10% through the first six months. Meanwhile, lower quality debt, with its higher yield and economic sensitivity has performed well. The Barclays High Yield Index was unchanged for the quarter and is up 2.53% year to date.

Q2 Portfolio Analysis & Performance

U.S. Style Opportunity

Top Contributor

- iShares Russell 2000 Growth ETF
- iShares Russell Microcap ETF

Top Detractors

- iShares Russell Midcap Growth ETF
- iShares S&P 500 Growth ETF

During the second quarter, the U.S. Style Opportunity portfolio followed its relative strength-based ranking system and maintained a constant emphasis on small cap and growth stocks. The portfolio had 58% devoted to the small cap stocks, with the largest single position being the iShares Russell 2000 Growth (IWO). The trend favoring small cap growth has been intact for all of 2015 and has provided considerable magnitude. Through June 30th, Small Cap Growth stocks are up over 8% (net) on the year[1], while the S&P 500 has risen by just over 1%. Small cap technology and biotechnology firms in particular have been soaring, while their valuations are rich by any measure, so far we do not see a slowing in their relative strength. Our relative strength-based approach has led the Style Opportunity portfolio to own a fast growing but expensive area of the market. The portfolio's long-term growth rate is 15.7% versus 11.3% for the Russell 3000, and its forward P/E is 27.0 versus 16.4 for the Russell 3000[2]. From a sector perspective, the portfolio overweights the Consumer Discretionary, Health Care, and Technology sectors, while underweighting Consumer Staples, Energy, and Financials. The portfolio's style tilt towards small cap and growth stocks drove performance during the quarter. The iShares Russell 2000 Growth ETF (IWO) and the iShares Russell Micro Cap (IWC) were both top contributors. In fact, while these two ETFs were positive on the quarter, most of the other holdings declined. The iShares Russell Midcap Growth (IWP) and the iShares S&P 500 Growth (IVW) were the top detractors.

U.S. Sector Opportunity

Top Contributors

- iShares U.S. Health Care Providers ETF
- iShares NASDAQ Biotechnology ETF

Top Detractors

- iShares PHLX Semiconductor ETF
- iShares S&P No. American Networking ETF

During the second quarter the Sector Opportunity portfolio continued to focus on cyclically sensitive sectors, including Consumer Discretionary, Technology, and Health Care. Late in the quarter, our relative strength models indicated a weakening in Technology, and we have notably reduced our position in the sector since May. For many months our models have sent the same signals: to favor Consumer Discretionary and Health Care and avoid Energy, Consumer Staples, Utilities, and Industrials. Those messages continue to hold, but finally a new and important sector has begun to rise: Financials. The first half of the year has been dominated by a strange mix of weak economic news but rising interest rates, as projected Fed action during the third and fourth quarters inches closer and closer. The rising rates and steepening yield curve present an ideal environment for banks and insurance companies to grow earnings, and their stocks finally began to move after lagging for well over a year. Thus, during June we added a number of financial ETFs to the portfolio, including Banks (KBE), Regional Banks (KRE), Broker Dealers (IAI), and Insurance (KIE). Health Care ETFs provided the lion's share of positive performance on the quarter, particularly Biotechnology (IBB) and Health Care Providers (IHF). In accordance with its weakening in our rankings, Technology ETFs, particularly Semiconductors (SOXX) and Networking (IGN) were the top detractors. In pursuing our relative strength rankings-based strategy, the Sector Opportunity portfolio in aggregate favors faster growing stocks (15.5% vs. 11.3% for the S&P 500) that are priced at a modest premium above the market (a forward P/E of 18.5 vs. 16.4 for the S&P 500). The market remains growth-starved. Top-line sales growth is anemic at best, and companies that can still provide real earnings growth have been big winners. The portfolio's current sector weightings are as follows: Financials 27.5%, Health Care 27.5%, Consumer Discretionary 22.5%, Technology 19.5%, and Cash 3.0%.

1. iShares Russell 2000 Growth ETF.
2. Bloomberg estimated composite annual growth rate over 3 to 5 years.

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International Opportunity *(Developed, Emerging & Frontier)*

Top Contributors
- iShares MSCI EAFE Small-Cap ETF
- S&P China SPDR

Top Detractors
- iShares Asia ex Japan ETF
- iShares All Country Currency Hedged Eurozone ETF

The International Opportunity portfolio's stated mission is to allocate tactically between international country and region ETFs that are displaying significant relative strength. In 2015, the portfolio's relative strength rankings have been drawn to currency-hedged European equities and Japanese and Chinese equities. For the most part, these rankings did not change during the quarter. Japan continues to display steady and persistent relative strength. China skyrocketed up into May, and now its market is undergoing a sharp and painful correction. Currency hedged ETFs did lose steam in the second quarter as the decline in the euro stalled. As the third quarter opens, we are finding growing relative strength in Europe. We have recently added positions in Ireland (EIRL), the Netherlands (EWN), and Italy (EWI). France and broader Europe are candidates for addition in the coming weeks as well. Turbulence surrounding the Greek/euro currency crisis and the popping of an equity bubble in China has made international equities a treacherous place to be lately, and as a result, we again added U.S. small cap stocks (IWM) to the portfolio. We may increase our U.S. position in the coming weeks, and the portfolio can allocate up to 25% of its exposure to domestic equities. The China (GXC) and EAFE Small Cap (SCZ) ETFs were the portfolio's top contributors during the quarter, while Asia ex Japan (AAXJ) and Hedged Europe (HEZU) were the top detractors. In contrast with our U.S. based relative strength-based rankings, the International Opportunity portfolio seems quite attractively valued in our view, with a long-term growth rate equivalent to its benchmark, but with a P/E of 12.5 vs. 14.1 for the MSCI World ex-U.S. Surprisingly, the most attractive valuations can be seen particularly in large cap Chinese companies, despite the talk of the stock market bubble there. The portfolio currently allocates 56% to the Asia-Pacific region, with particular emphasis on Japan (34%) and China (21%); the remainder of the portfolio is underweighted in Europe (28%) and allocated to the U.S. (12%). Latin America, the Middle East, and Africa receive no significant weight.

Sentry Strategy *(Hedge/Volatility)*

Hedging one's equity exposure during a strong market for equities is an exercise in patience and requires understanding the proper role of a hedge in a broader portfolio. When our assessment of the markets are broadly bullish – as they remain today and for most of 2015 – the Navigator Sentry Managed Volatility Fund attempts to manage the cost of hedging while maintaining a minimal hedge required to safeguard client assets. Under these circumstances, the Navigator Sentry Managed Volatility fund is a net loser in client portfolios, waiting for its day when protection will shine.

Put spreads on the S&P 500 that manage the cost of the hedge combined with call spreads on volatility (VXX) are at the core of the portfolio's hedging philosophy. The core of the protection strategy continues to be using these S&P 500 put spreads, usually putting on spread trades that are 2% and 7% or 3% and 8% below the S&P 500's price level at the time of execution. By both owning puts and then writing puts at a lower level, we are able to greatly reduce the cost of equity portfolio protection. During the quarter, we moved in and out of these put spread trades, attempting to cash in on what are most often fleeting gains in volatility. Of course, maintaining a constant protective position has a cost, and much of the portfolio's other activity is devoted to minimizing the cost of hedging. To do that, the portfolio has placed call spread trades on the iPath S&P 500 VIX Short-Term ETN (VXX), looking to slowly and gradually earn profits taking advantage of the huge cost of owning volatility when markets are up or even flat (which we estimate is over 70% of the time). We should note that the put spread and call spread strategies that we are using can and will be adjusted if our market outlook becomes a more defensive one. At that time, we will increase the portfolio's downside protection within the spreads, or take the spreads off entirely and simply own puts and go long volatility. Finally, when volatility has spiked and we sense that extreme optimism or pessimism and thus froth or panic have taken over the markets, the portfolio will attempt to monetize the portfolio's cash and tactically go long or short volatility. We did not take on any of these trades during the second quarter.

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Outlook

Despite all the recent noise surrounding Greece and China and the looming Fed rate hikes, the market had held up a lot better than the intra-day volatility would suggest. Overall we see evidence of a bullish trend for stocks with global liquidity still driving risk assets higher. U.S. stocks have traded flat for most of the year. In fact, this year marks the first in the S&P 500's history when the index was never up or down more than 3.5% on a closing basis during the first half. It was a very uneventful six months for the market. Analyzing the ten years in which the S&P 500 was closest to unchanged during the first half of the year shows that the second half of the year tended to be stronger than average. In those years, the S&P 500 traded higher for an average gain of 6.01% during the second half of the year.

In addition to historical precedent, we perceive several encouraging signs under the surface that suggest the market continues to work higher, albeit at a slow pace. Market leadership has been very resilient with small caps, technology, healthcare, and consumer discretionary leading all year. In addition, banks and financials have begun outperforming, with banks benefiting from the steepening yield curve. These are favorable signs for stocks and suggest investors are positioning for continued economic improvement. That is a sign of a healthy advance with investors embracing risk.

The U.S. economy is set to accelerate from the first quarter slowdown in which it declined at a 0.2% annual rate. Employment growth has been solid with the economy adding jobs for 57 consecutive months.[3] Over the past year and a half, the economy has created an average of 242,000 jobs per month. In addition, leading indicators of the economy continue to advance, with the Conference Board's Index of Leading Indicators soaring to new highs. That suggests continued economic growth with no recession on the horizon. Of course, we need to be vigilant in watching for signs of weakness. The Federal Reserve will likely begin hiking interest rates this fall. When the Fed does finally hike rates it will have been the most telegraphed move in Federal Reserve history. The mantra out of the Fed had been "lower for longer," but that seems to have changed to "slower but sooner." Fed Chair Yellen recently told the House Financial Services Committee that "If we waited longer, it certainly could mean we have to do [hikes] more rapidly." She also said, "An advantage of moving earlier may be that we can have a more gradual path of rate increases." And that moving slowly after nearly seven years of near-zero rates "strikes me as a prudent approach to take."[4]

3. U.S. Bureau of Labor Statistics
4. Mullaney, Tim. "Yellen Defends 'Soon and Slow' Approach to Rate Hikes in Congress." July 15, 2015. The Street. (Retrieved from http://www.thestreet.com/story/13219615/1/yellen-defends-soon-and-slow-approach-to-rate-hikes-to-congress.html.)

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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 Russell 2000 Index measures the performance of the 2000 smallest U.S. companies based on total market capitalization in the Russell 3000, which represents approximately 11% of Russell 3000 total market capitalization.

The S&P MidCap 400 provides investors with a benchmark for mid-sized companies. The index covers over 7% of the U.S. equity market, and seeks to remain an accurate measure of mid-sized companies, reflecting the risk and return characteristics of the broader mid-cap universe on an on-going basis.

The MSCI ACWI stands for All Country World Index. A market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International, and is comprised of stocks from both developed and emerging markets.

The MSCI All Country World ex USA Total Return (MSCI ACWI), market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International, and is comprised of stocks from both developed and emerging markets.

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 Barclays U.S. Government and Credit Bond Index measures the performance of U.S. dollar denominated U.S. Treasuries, government-related, and investment grade U.S. corporate securities that have a remaining maturity of greater than 1 year. In addition, the securities have $250 million or more of outstanding face value, and must be fixed rate and non-convertible.

The Barclays U.S. Corporate High-Yield Index covers the U.S. dollar 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 30-Year U.S. Treasury Bellwethers Index is a universe of Treasury bonds, and used as a benchmark against the market for long-term maturity fixed-income securities. The index assumes reinvestment of all distributions and interest payments.

The Barclays 10-Year U.S. Treasury Bellwethers Index is a universe of Treasury bonds, and used as a benchmark against the market for long-term maturity fixed-income securities. The index assumes reinvestment of all distributions and interest payments.

The Barclays 5-Year Municipal Bond Index is the 5 Year (4-6) component of the Municipal Bond index. It is a rules-based, market-value-weighted index engineered for the tax-exempt bond market. The index tracks general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds rated Baa3/BBB- or higher by at least two of the ratings agencies.

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.

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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The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices and which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking and is calculated from both calls and puts. The VIX is a widely used measure of market risk. 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 Barclays U.S. Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most U.S. traded investment grade bonds are represented. Municipal bonds, and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The index includes Treasury securities, Government agency bonds, Mortgage-backed bonds, Corporate bonds, and a small amount of foreign bonds traded in U.S. The Barclays Capital Aggregate Bond Index is an intermediate term index.

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.

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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