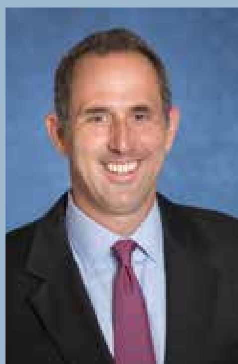
RIP OFF THE BAND-AID!



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Tony serves as a portfolio manager in the Premier Portfolios group and is a member of the Clark Capital Investment Committee. He has over 25 years of portfolio management experience utilizing both a quantitative and fundamental process. From 1997 to 2013 Tony was the President and Chief Investment Officer of Global Capital Management which he founded. He was cited as a Top Guns Manager in 2006 and 2007 and was named Manager of the Decade in 2011 by PSN. From 1986 through 1997, Tony was Director of Portfolio Management at RTE Asset Management where he was responsible for portfolio management across all asset classes. Tony is a graduate of the Wharton School of the University of Pennsylvania and holds the CFA designation.

Forecasting Fed activity is a national pastime only surpassed in popularity by Fantasy Football. Over the last 25 plus years, I have written many times about the Fed, their objectives, the factors which would likely influence their decisions and my forecast for their next move. Unfortunately, virtually none of this analysis has earned excess equity returns for my clients. It's almost pointless. Like economists, professional Fed watchers only deserve fame and fortune if they have a mechanism which can directly impact the wealth of investors. Since they don't, they shouldn't. Investment managers, conversely, can directly impact the wealth of their customers on a daily basis by selecting potentially superior assets or securities and that's where I spend the bulk of my energy. Fortunately that focus seems to have paid off for clients this year as our ability to pick stocks has dramatically helped more than our ability to articulate market color or prognosticate the next Fed hike.

With that said however…

I believe the Fed is behind the curve in its attempt to neutralize monetary policy. In July, my comments entitled "Traffic Lights and Stop Signs" summarized the last six years of QE, how it was successful up to that point and the rationale for moving to a new policy. Now "Monetary Neutralization" — which I advocate — should be clearly distinguished from "Monetary Tightening." Tightening is the act of raising short term interest rates to a level which discourages borrowing and investment. It's simple. If the borrowing rate exceeds your likely return on investment, you don't borrow. Neutralization, on the other hand, moves rates from their extraordinary low levels — negative real interest rates — to a level which is neither accommodative nor restrictive AND reduces the size of the Fed's bloated balance sheet. The most recent expansion of the Fed's balance sheet to $4.2 trillion represents an increase in both assets such as Treasuries and mortgage backed securities AND in liabilities like $2.6 trillion in excess reserves. In a positively sloping interest rate environment, the U.S. Treasury has been the fortunate beneficiary of the arbitrage of high interest earned which is greater than the +0.25% paid on reserves. If inflation moves up rapidly or U.S. credit deteriorates, the arbitrage could reverse. While I don't see rampant inflation in the near future, shouldn't the Fed safely scale back its liabilities? The unwinding of junk bonds earlier this year and its progression to high grades currently should serve as a warning that leveraged buyers do not always control their refinance options. Now's the time to "Rip Off the Band Aid!" — for risk management purposes, if for nothing else.

Just the Tail

Are we no longer the center of the economic universe? Post September's Fed meeting, it certainly doesn't feel that way. According to Janet Yellen, China's economic deceleration is so pronounced that Fed neutralization as described above has been put on hold. It is now unclear if our monetary policy has a broader objective than just U.S. full employment and contained inflation or if the Fed perceives the China slowdown as a source of not-yet-seen collateral damage to our economy. Honestly, the U.S. is becoming just the tail of the dog in the

1. Bureau of Labor Statistics.

Past performance is not indicative of future results.

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global economy. BCA Research reports* that Emerging Market (EM) plus China imports are, in fact, greater than the combined imports of U.S. plus Europe. While the U.S. may not fall into recession from the slowdown in EM/China imports — as it has little exposure to these areas — the Fed is beginning to recognize a decline in the dog's health and its material impact on global economic and earnings growth. Although U.S. and European consumption continues to support solid annual import growth, now between 4 to 5%, this is not enough to overcome EM/China weakness as U.S. export growth has declined 3.2% and global exports are on the verge of contracting year over year.

In Theory

Equity markets hit a sharp skid this quarter on the back of slowing EM/Chinese economies, devaluation of the yuan, declining U.S. earnings and revenues and flip-flopping Fed policy. Declines corresponded to historical measures of risk — S&P 500 declined about 6.5%, large cap international foreign stocks fell about 10% and broad international indices and the Russell 2000 both declined 12%. Chinese stocks fell about 22% on slower economic expectations and an abrupt 2% yuan devaluation by the People's Bank of China (PBOC) designed to aid their export driven economy. Despite strong GDP growth, overall U.S. sales and earnings both declined year over year in the second quarter. Recently, Goldman Sachs reduced its 2015 S&P 500 earnings per share estimate to $109 or down 3% from 2014. While the decline in energy prices has driven a substantial portion of the earnings shortfall, weak results and expectations have leaked over into the dollar-sensitive Materials and Industrial sectors as well. Old economic theory concluded that oil price declines helped U.S. economic growth, but in a now virtually energy import/export neutral economy, capital expenditure shortfalls may be overwhelming consumer gains. As Yogi Berra said, "In theory there is no difference between theory and practice. In practice there is."

Quality Exposure Helps All Cap

Despite the significant underperformance of Small and Mid Cap U.S. stocks during the quarter, Navigator All Cap declined just approximately 6.39% gross (net -7.06%) — in line with large cap and broad market measures. For the 10-year period ending June 30, Morningstar performance analytics ranks this strategy in the top 3% of similar equity strategies. The strong dollar and declining oil prices continued to have injurious effects on Industrials, Materials and Energy stocks in the portfolio as Atwood Oceanics, American Railcar and Eastman Chemical each fell more than 20% for the period. Conversely, low oil prices helped airlines (Allegiant Travel up 21%) and a still passive Fed aided dividend payers like Edison International (+13%) and Wisconsin Energy (+16%). In our view, the value and quality characteristics of the All Cap strategy remain superior to the S&P 500 as it possesses a lower P/E of 14.5 vs 16.7 with lower earnings variability and higher gross and net profit margins.

*Emerging Markets Strategy, BCA Research, September 30, 2015,
"How Important Is EM/China To Global Trade.

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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 S&P SmallCap 600 measures the small cap segment of the U.S. equity market. The index is designed to be an investable portfolio of companies that meet specific inclusion criteria to ensure that they are liquid and financially viable.

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 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.

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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 and 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 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 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.

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CCM-669