ClarkCapital MANAGEMENT GROUP

Navigator®
Fixed Income Total Return
K. Sean Clark, CFA, Chief Investment Officer

Third Quarter 2015 — 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.

FED PASSES ON RATE HIKE AND VOLATILITY ARISES

The third quarter was a volatile quarter for equity and credit markets alike. The global equity markets suffered a long-awaited correction and that was accompanied by lower quality credit suffering its largest drawdown since the U.S. debt downgrade in 2011. The Barclays High Yield Index fell 6.3% from its high on May 29th through the end of the quarter. As high yield debt has come under pressure, credit spreads (yield on high yield bonds – 10-year Treasury yield) have widened out to 598 basis points at quarter end, their highest level in three years. For the quarter, the Barclays High Yield Index declined 4.86% while the Barclays Aggregate Bond Index rose 1.23%. It was a quarter in which the risk-off trade was prevalent. However, the normal risk-off benefactors, including Treasury bonds, advanced but not as aggressively, given their low yields and concerns about the Federal Reserve and looming rate hikes.

Most investors expected the Federal Reserve to finally pull the trigger and hike rates in September. However, the Fed decided to punt again and left the overnight bank lending rate unchanged. We are of the opinion it would be better to rip the Band Aid off and hike rates. The Fed has kept rates artificially low for too long and that has forced investors to assume more risk to gain yield, and it has distorted asset valuation. A problem now is not if or when the Fed will raise rates, it is the paralyzing discussion about when they will eventually raise rates.

It's one thing to acknowledge that rates are likely to stay low because we are in a deflationary world, but it is another thing altogether to leave rates zero bound. Lower or near zero rates and QE were necessary at the beginning of the Great Recession, but the Fed has now created an environment where the market needs low rates like a junkie needs his next fix. A legitimate fear is that the longer the Fed postpones normalization, the more difficult the return to normal markets is going to be. The Fed needs to rip the Band Aid off sooner rather than later.

Third Quarter Attribution

Early in 2015, on January 12th, the Fixed Income Total Return portfolio allocated 100% to high yield bonds. Our models remained positive towards high yield bonds through the second quarter, but as the third quarter progressed, the weakness that was isolated in the high yield energy sector spread into the broader high yield market. As a result, our models turned and the portfolio became 100% defensive on July 28th. The portfolio sold its high yield bond positions entirely, and now owns intermediate-term U.S. Treasuries. The move turned out to be timely, as the portfolio was completely defensively invested during the market turmoil in August. While the S&P 500 endured a 12% decline over four days in August, the portfolio produced slight gains in its defensive Treasury position. High yield bond spreads continue to widen as September comes to a close. We see no particular end to the fear that has gripped credit markets since May. Here are some additional developments in the portfolio during the quarter:

- The portfolio currently owns two U.S. Government ETFs, the iShares 3-7 Year Treasury

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ETF (IEI) and the iShares 7-10 Year Treasury ETF (IEF). The resulting duration of the portfolio is just over six.

- Leading into September's Fed announcement (in which they kept rates unchanged), our models nearly produced a neutral signal that would have allocated a third of the portfolio to each of high yield bonds, Treasuries, and cash. The Fed's announcement led to a stock market and high yield bond selloff, and our models have returned to their maximum defensive position.
- Many of the smaller explorers and producers in the high yield energy space face bank refinancing issues in the fourth quarter. Defaults are considered likely, particularly for smaller players. We believe that may lead to an extreme in fear and sentiment and could create a tradeable bottom.

Outlook

Credit spreads have widened to their highest level in three years and, in our opinion, have set the stage for a potentially nice entry point back into high yield. That hasn't happened yet, but it could as we move further into the fourth quarter. The yield on the Barclays High Yield Index ended the third quarter at 8.04%. Yields on below investment grade corporate debt are attractive on both an absolute basis and relative to other fixed income sectors. Meanwhile, the 10-year Treasury yield hovers near its recent lows at 2.06%, as Treasuries have benefitted from a risk-off environment and the Fed's delay in hiking rates. If there is any stabilization in the energy market, it should lead to better performance in credit given the yield advantage of high yield debt, the resiliency of the U.S. economy, and the fact that we are now entering into a seasonally strong period for risk assets.

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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 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 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 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.

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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