Clark Capital MANAGEMENT GROUP

Navigator®
Fixed Income Total Return

K. Sean Clark, CFA, Chief Investment Officer

Fourth 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.

FINALLY, NOW WHAT?

The Fed finally pulled the trigger and hiked interest rates in December. The Fed waited all year and finally boxed themselves into a corner that they couldn't get out of without pulling the trigger. As you know, we are of the opinion it would have been better to rip the Band-Aid off and hike rates much earlier in the year, and we think the Fed missed a perfect opportunity to begin normalizing rates sooner. In our opinion, the Fed kept rates artificially low for too long and that has forced investors to assume more risk to gain yield, and it has also distorted asset valuations. Now that the Fed has finally begun hiking rates, we expect it to be a slow rate-hike cycle, which should allow asset prices to move higher now that the news is out.

The global equity markets generally performed poorly in 2015, and one would think that with poor performance in stocks bonds would fare well. However, given the low interest-rate environment, risks of rate hikes, and the energy decline's influence on credit, fixed income didn't provide much of a safe haven. High yield spreads have risen to 674 bps and currently stand at about the 75th percentile for all periods but are not dramatically higher than their long-term average. A huge amount of the backup in credit spreads was driven by specific sectors such as commodities, paper, steel, chemicals, and railroads. However, most consumer sectors, financials, technology, and media are all trading at quite normal levels that reflect the overall health of the consumer and the domestic economy. In the fourth quarter, the Barclays High Yield Index declined 2.06% and the Barclays Aggregate Bond Index lost 0.57%. For the year, the Barclays Aggregate Bond Index gained just 0.55%, and the High Yield Index declined by 4.47%. Most of the decline in high yield was concentrated in the worst credit ratings. For example, BB credit was down only 1.0%, B -4.72%, CC -12.11% and CCC and below was down 56.15%. Meanwhile, according to Moody's and Barclays Research, default rates have risen to 3.0% on a trailing 12-month basis. We find that to be still very low given the stress in the energy sector and the fact that defaults bottomed at 1.1% in 2007 and peaked at 14.7% in 2008.

Fourth Quarter Attribution

As equity markets began to top and the energy sector showed the results of duress, the Fixed Income Total Return portfolio became 100% defensive on July 28th. The move turned out to be timely, as the portfolio was 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. As the fourth quarter began, high yield bonds found a bottom and staged a solid rally. The magnitude of the rally led us to move 100% into high yield on October 21st. The rally continued for a few weeks until early November, but the energy and materials sectors then took another turn for the worse. The weakness spread into the health care and utilities sectors as well. High yield bonds quickly began to take on water through November, and our model shifted away from favoring high yield. On December 8th, we sold two-thirds of our high yield position, and quickly thereafter, on December 9th, sold the remainder, moving the portfolio into 100% U.S. Treasuries, where it remains today. The portfolio saw losses of roughly 3 to 4% while in high yield. Although the portfolio's purchase of high yield bonds quickly reversed on us, the portfolio remains most committed to the defense of client assets and avoiding major losses while managing volatility in the fixed income markets. Here are some additional developments from the portfolio during the quarter:

- The portfolio currently owns four U.S. Treasury ETFs, the Barclays Intermediate Term Treasury SPDR (ITE), iShares 3-7 Year Treasury Bond ETF (IEI), the iShares 7-10 Year Treasury Bond ETF (IEF), and the Barclays Long Term Treasury SPDR (TLO). All of these ETFs are extremely liquid and have very low expense ratios.The resulting duration of the portfolio is 5.9, with a current yield of 1.99%. The portfolio's average maturity is 7.3 years.
- Option-adjusted spreads for the high yield energy sector continued to widen in December, and it appears to us only a change in underlying energy fundamentals will turn sentiment around.
- While the portfolio was invested in high yield, the two top contributors were Lord Abbett High Yield (LAHYX) and AB High Income Advisor (AGDYX), while the top detractors were the large high yield ETFs, the iShares iBoxx $ High Yield Corporate Bond (HYG) and the Barclays High Yield Bond SPDR (JNK).

Outlook

We reiterate our view that spreads can resist higher rates, as they did in the last three hiking cycles. In our view, to the extent rising rates are a response to stronger growth, risk appetite should remain firm and thus drive spreads tighter. At the same time, we expect the normalization of policy rates to be gradual. In addition, current spread levels are much wider relative to the last three hiking cycles, and the 8.74% yield on the Barclays High Yield Index leaves plenty of room to absorb the pressure from rising rates on total returns.

We think the combination of continued economic growth, moderate inflation and gradual monetary policy normalization in the U.S. remains supportive for credit. This leaves us with a constructive outlook for high yield, but cognizant of the fact that the recovery in risk appetite will likely be highly dependent on what happens in commodity sectors. There are risks that need to be monitored closely, such as a spillover effect from stress in commodity related sectors to other sectors and a lack of access to issue new debt by lower credit issuers. At this point, we think these risks are minimal but they bear watching for signs of potential deterioration.

Using historical precedent presents an interesting picture about how high yield debt has performed following a down year. Since 1987 the BofA Merrill Lynch US High Yield Master II Index has suffered only five years of negative returns. Following down years for high yield, the asset class has seen a major bounce back in the following year with positive returns every time, with an average gain of 30% in those bounce back years. On top of that, the four best years for high yield since 1987 all followed down years. We don't expect to see the same kind of gains this time around for high yield, but historical precedent is a factor favoring high yield in 2016.

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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.

Clark Capital Management Group, Inc. is an investment adviser registered with the U.S. Securities and Exchange Commission. Registration does not imply a certain level of skill or training. More information about Clark Capital's advisory services and fees can be found in its Form ADV which is available upon request.

The relative strength measure is based on historical information and should not be considered a guaranteed prediction of market activity. It is one of many indicators that may be used to analyze market data for investing purposes. The relative strength measure has certain limitations such as the calculation results being impacted by an extreme change in a security price. Clark Capital Management Group, Inc. reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs. It should not be assumed that any of the securities transactions, holdings or sectors discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.

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