ClarkCapital MANAGEMENT GROUP

Navigator®
SMID Cap Core U.S. Equity
Tony Soslow, CFA®, Senior Portfolio Manager

Third Quarter 2016 — Portfolio Commentary

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Senior Portfolio Manager

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.

FIRE AND WATER

Foreign equities trailed U.S. equities this quarter and the underperformance was not just confined to the drama surrounding Samsung and Deutsche Bank. If you didn't giggle upon learning that Samsung's Galaxy Note 7s were catching fire, you had to smile when the U.S. Consumer Product Safety Commission warned that Samsung's top loading washing machines were exploding. Does unexpected water on the laundry room floor compensate for the unwelcome fire? On a more serious note, Deutsche Bank's potential inability to shore up their $1.8 trillion balance sheet has begun to shake up the credit markets. With just $60 billion in balance sheet equity to support $1.8 trillion in assets, the thought of the bank losing an additional $14 billion to a U.S. mortgage backed security fine from the Department of Justice has investors, German politicians and trading counterparties highly concerned about the bank's ability to withstand typical changes in asset volatility. Reminiscent of the Lehman disaster in 2008, supposedly 10 hedge funds cut their counterparty trading exposure to the bank.

Turkeys and Muppets

Speaking of Black Swans, you have to wonder if we as credit and equity investors are not just Turkeys, mindlessly trotting to the food trough after the farmer rings the bell, oblivious to the fact that tomorrow is Thanksgiving. Deutsche Bank's highly leveraged balance sheet scares me as much as the Bank of Japan's Governor Kuroda's comments that there is "No limit to monetary policy" – i.e. he can purchase Japanese Government Bonds in unlimited quantities. It's worth noting that the highly indebted/leveraged often pay their loans by taking on more debt until such point that they can't. Thus, it's all good...until it isn't. While, I do not know when either Deutsch Bank or Japan will stop being able to repay their loans, I do know that the initial signs of credit concerns have surfaced. This conflicts with Austrian Finance Minister Schelling's conclusion that the Deutsch Bank situation is not Europe's Lehman moment due to additional measures put into place by EU bank regulator's Basel lll to stabilize financial markets.

Don't Be So Negative

Negative rates and low growth are not only hurting Deutsche Bank, but other German financials as well – underscoring the weakness in the European banking model in which approximately one third of Italy's loans are in trouble. Commerzbank suspended their dividend and announced job cuts of 25% and Nord/LB is expected to report a loss due to heavy shipping loan exposure. Confronted with this loss and a Moody's downgrade, Nord/LB, in turn, abandoned plans to sell seven-year euro-denominated notes, citing "market conditions." While the European Central Bank's Draghi and the Bank of Japan's Kuroda defend their negative interest rate policy by claiming it rescued them from deflation, I believe these policies reinforce the pessimism based in the belief that current levels of high debt equate to low growth going forward. Instead of inspiring businesses to borrow, negative rates can harm lenders by narrowing net interest margins, while providing little help on improving balance sheet asset values deep in the economic recovery.

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SMID Misses High Beta Gains

Over the last three years, the Navigator SMID strategy delivered annualized gains of 10.45% gross (7.21% net) vs 7.77% annualized gains for the Russell 2500 Index. In the third quarter of 2016, Navigator SMID strategy gained 4.26% gross (3.49% net) vs 6.56% gain in the Russell 2500 Index. An underweight position in Utilities and Real Estate sectors helped the relative performance while Health Care and Energy sectors acted as a drag. Our holdings in Universal Insurance Holdings and Cooper Tire & Rubber helped performance in the quarter as positions in Atwood Oceanics Inc and AMN Healthcare Services Inc hurt. Since its inception, Morningstar performance analytics ranks this strategy in the top 2% in comparison to similar managers. While the value characteristics of the SMID Cap strategy remain compelling, its current P/E of 14.7 is less than that of the Russell 2500 Index (23.4), S&P Mid Cap (19.8) and S&P Small Cap (21.7), indices with similar quality and business growth characteristics.

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 Russell 2500 Index measures the performance of the small to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. The Russell 2500 is a subset of the Russell 3000® Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership.

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 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 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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