Clark Capital MANAGEMENT GROUP

Navigator® Fixed Income

Jamie Mullen, Senior Portfolio Manager

Fourth Quarter 2016 — Portfolio Commentary

Jamie Mullen
Senior Portfolio Manager

As Senior Portfolio Manager, Jamie developed and manages the Navigator Global Opportunity portfolio and manages the Premier Fixed Income Strategies. In addition, Jamie manages covered call options deployed on individual stocks and exchange traded funds in the Premier Portfolio Group and implements collar strategies on individual blocks of stocks. He is a member of the Clark Capital Investment Committee. Jamie has over 25 years of experience with fixed income securities. He began in municipal credit research and worked in public finance before moving to a position in trading where his experience included trading municipal bonds and employing fixed income futures and futures options. He has extensive experience in dealing with mutual funds, and trust departments and money managers. He received his degree from St. Joseph's University.

TEARS OF A FED

As Smokey Robinson might have sung:

If there's a smile on my face, it's only there trying to fool the public. But when it comes down to raising rates now, honey, that's quite a different subject.*

2017 should have a smoother start than 2016. 2016 started with the S&P falling nearly 8%. U.S. small and mid-cap stocks followed the S&P 500 lower. China's equity market slid into bear market territory. Oil prices collapsed, bottoming at $26 in February. High yield bonds began to free fall as the oil price drop exacted its vengeance on overleveraged commodity companies.

Global growth and the U.S. economic expansion came into question. Volatility was high and then the oil market bottomed in March. High yield bonds started to rally and the return to risk assets was on...until mid-year when the market became focused on Brexit. Finally after the Brexit and another brief sell-off, the markets focused on the upcoming U.S. elections.

The U.S. election shocked the pundits. Bonds traded in a wide range election night and traded lower the next day. To close the year, the Fed hiked rates 1/4 pt at the December meeting. Projections from Fed members were for three increases in 2017.

The U.S. Election

Now if I appear to be carefree, its only to camouflage my sadness.

In the spirit of Populist movements, Facebook, Instagram and Twitter, we may have just witnessed the polls and polling numbers as the new horse and buggy. An antiquated system being phased out by technology. We live in a reactionary world, and now opinions change with a Tweet. Instant gratification is demanded but, over the long term, that is not how the financial system works. The Fed always has been there for the protection of the banks. The idea is if the banking system is sound, the economy will flourish, providing for the masses.

To shield my pride I try to cover this hurt with a show of gladness.

The President-elect has been a huge critic of the Fed and their policies of low interest rates. The Fed has guided us back from the abyss since the Financial Crisis. Albeit with a zero interest rate policy (ZIRP) that has been followed by Central Banks around the world. In my opinion, The President-elect would like a less intrusive Fed in the financial system. But how will this work with the near celebrity status of the Fed Chairs? Doesn't every little baby economist want to be the next Fed Chairman to save the world? I

Past performance is not indicative of future results.

This is not a recommendation to buy or sell a particular security. Please see attached disclosures.

would think there is a lot of hand wringing going on behind the Fed's closed doors as we enter 2017.

> ***But don't let my show convince you that I've been happy since you decided to go.***

The election was a titanic shift in so many ways but there are still huge issues surrounding the size of U.S. debt. The argument here has been that debt is deflationary. We believe the new regime in all probability will expand a national debt that is at or near 20 trillion dollars.

Trumps plan for fiscal expansion is based on:

- Corporate and individual tax reform
- A more lenient regulatory environment
- An infrastructure spending program
- The repeal or reform of the Affordable Care Act (ACA)

Starting at a debt base of 20 trillion dollars the stakes are enormous. Since the election, rates on the 10-year Treasury have risen from 2.29 to a year end close of 2.46. A mere 17 basis points, but it feels like more than that. The rush to equities has been swift and relentless. But without one policy enacted, the cost of government borrowing has gone up. We believe the Fed will monitor all this and err on the cautious side, trying to stay news-relevant amid all the equity exuberance.

> ***Well, there're some sad things known to man but not too much sadder than the Tears of a Fed.***

Bonds, Facebook and the Millennial Question

As the New Year turns to 2017, if you have read my previous missives, you know we have been in the lower for longer camp on interest rates. As active managers, we need to adjust to fiscal and monetary changes that will affect how we invest fixed income portfolios. After observing this election fought on Facebook, Instagram and Twitter, I was looking for a macro idea to capture the public's reaction to the end of the Great Bond Bull market that began in 1981.

I came across some YouTube videos of Simon Sinek[1], author of the book *Start With Why*, speaking about the process of millennials entering the workforce. Facebook, Instagram and Twitter provide an immediate voice for people to be heard. And along with that, instant gratification in the form of "Likes." But the approval syndrome is addicting and intoxicating. Simon points out that Millennials grew up in this instant gratification world, so as they enter the workforce they become disenchanted when they don't reach the Summit, not quite realizing the path to climb the mountain and to reach the apex involves time.

Bonds became the "Dislike" overnight after the November election. Since the great bond bull market began, bonds provided the instant gratification. Taking a step back for a minute, buying a bond is buying a cash flow device. That's all it is. The duration of the portfolio is the climb. The duration is where the cash flow is. The cash flow leads you to your summit and for most of us that is retirement.

With no fiscal policy yet in place, the U.S. dollar has surged, which could affect companies' earnings. The bond bull market had 30 plus years duration. Any stumble in policy enactment, trade wars, etc. could help bonds a bit in the New Year. The world of bonds probably changed on election night 2016. A disciplined, prudent evaluation of all your investment allocations is always advised. Going from "Like" to "Dislike" is for opinions on the internet, not for longer term investors looking to reach their summit.

Other Comments on Fixed Income

The taxable portfolios pulled back in price a bit after the election. The cash flow should get re-invested at higher rates, providing a buffer over time as we build par value. The corporate market saw plenty of liquidity and what I would observe as normal price action through the end of the year.

The municipal bond market really became unglued after the election. When the "Dislike" button was hit, mutual funds came under selling pressure. The muni market has historically struggled with the unknown — lower personal tax rates making taxable bonds more attractive, a more aggressive Fed if inflation kicks up, talk of an Infrastructure Bank, etc. — so many unknowns. There are so many individual names and cusip structures in munis that the spreads can widen out rapidly. Tax swapping of munis with losses also exacerbated some of the selling.

Generally, the December-January period is favorable for munis. We saw munis rally into the year end after hitting a low in November. The late December rally kept the seasonality trades in place but they started at wider spreads leading to a down quarter.

Perhaps the next quarter we will be talking about Ch-ch-ch-Changes, á la David Bowie. 2017 could be a year where volatility and active management present opportunity in the fixed income environment.

[1]Simon Sinek on Millennials in the Workplace https://www.youtube.com/watch?v=hER0Qp6QJNU

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 freefloat-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 S&P 500 Index measures the performance of 500 large companies in leading industries of the U.S. economy, capturing 80% of U.S. equities.

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 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 Capital 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.

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.

Morningstar is the largest independent research organization serving more than 5.2 million individual investors, 210,000 Financial Advisors, and 1,700 institutional clients around the world.

For each separate account with at least a three-year history, Morningstar calculates a Morningstar Rating™ based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a separate account's monthly performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of separate accounts in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. The Overall Morningstar Rating for a separate account is derived from a weighted average of the performance figures associated with its three-, five- and ten-year Morningstar Rating metrics.

CCM-655