Clark Capital MANAGEMENT GROUP

Navigator® Multi-Strategy Update

Mason Wev, CFA®, CMT®, Portfolio Manager

Fourth Quarter 2017 — Portfolio Commentary

Mason Wev, CFA®, CMT®
Portfolio Manager

Mason joined Clark Capital Management Group, Inc. in 2005 as a Portfolio Manager. He is a member of the Clark Capital Investment Committee, contributing to asset allocation policy and security selection. Mason has more than a decade of experience in the investment industry. He is responsible for quantitative investment analysis, security selection, and communicating the firm's investment policy to wealth advisors and consultants. He participates in the research and product development efforts of the Portfolio Team. A graduate of Dickinson College, Mason earned an M.B.A. in International Management from the Garvin School of Management at Thunderbird (the American Graduate School of International Management) and holds the CMT and CFA designations.

THE RIDE WAS SMOOTH AND UP

The year 2017 was very profitable for both U.S. stock markets and the U.S. high yield bond markets. The ride was smooth and exclusively up, as evidenced by the fact that the S&P 500 did not generate even a 3% correction. Bearish claims of doom have proven to be wrong over the last few years, and we would say that they forgot to ask: what can go right? A lot has gone right over the last five years, as we now have a synchronized global earnings recovery, stimulative tax cuts in the U.S., earnings growth fueled by low interest rates, and a global technology-driven stock boom that is now expanding into Industrials and Materials. How long can this continue without inflation? We would guess longer than most think. The global economy has three major deflationary forces that should keep prices and inflation under control: technology-driven efficiencies, globalization of labor, and aging demographics.

The fourth quarter of 2017 was largely a continuation of past trends. Technology led the way higher in the U.S. The NASDAQ was up 6.6% for the quarter and 29.6% for the year; the S&P 500 was up 6.6% for the quarter and 21.8% for the year. Fixed income markets were quite muted on the quarter, as high yield bonds gained 0.5%, while U.S. Treasury bonds were flat. Of greater importance was the continuing slow shrinkage in corporate bond spreads, which indicates broad investor confidence in the global economy and easy financing conditions. Beneath the surface, we did see potential new market leadership move forward. Financials, Industrials, and perhaps even Energy have displayed positive relative strength, and they all have longer runways than Technology, which is still very strong, but its trend is quite stretched. Our major concern regarding U.S. equities is not as much their trend as it is relative opportunity and valuation. The MSCI EAFE has a forward P/E of 16.1, and emerging markets is at 14.2. By comparison, the S&P 500 is at 20.0, and U.S. small caps are at 25.1. Substantially higher U.S. valuations mean that U.S. stocks could be leaders on the downside during the next correction. However, there are no signs of weakness on the horizon, and while we are well overdue for weakness that might resolve extreme bullish sentiment, we do not see evidence of forces that would break the longer-term bullish trend.

U.S. Equity — Style Rotation

The U.S. equity portion of the Multi-Strategy portfolios ranks a number of U.S. equity styles and factors using Clark Capital's relative strength based ranking methodology, and then purchases those ETFs with higher rankings (and avoids those with lower rankings), assembling them into a broad-based portfolio that attempts to outperform the Russell 3000. The portfolio shifted away from a pure growth emphasis to start the quarter moving toward a more balanced mix. The most notable addition was the S&P 500 High Beta ETF (SPHB), a portfolio that is over 40% financials and also includes overweights to Industrials and Materials. Financials have been staging a slow but steady relative strength rally over recent quarters. The flattening yield curve represents headwinds for earnings, but that is offset by what many measures show are the strongest credit conditions in years. While Financials, Consumer Discretionary — and later in the quarter Energy and Materials — have displayed newer relative strength trends, Technology continues to roll on. We are watching the sector closely as its relative strength may be flattening, but the longer-term trend is still holding. We are likelier to pare back than add to Technology, but we are reluctant to reduce until it displays a clearer breakdown. Large caps rank ahead of small caps in our ranks and with growth ahead of value, but that gap has been narrowing. High dividend equity and minimum volatility are at the bottom of our ranks and are least favored.

- Momentum (MTUM) gained 8.1% and the PowerShares S&P 500 High Beta (SPHB) gained 8.2%. Both were leading performers in our style box and factor matrix during the quarter. Small Cap Value (IWN) and Micro Cap (IWC) were up 1.3%% and 1.8% respectively and were the weakest ETFs in our universe.
- In aggregate, the portfolio is overweight the Technology, Financials, and Industrials sectors and underweight Consumer Staples, Health Care, and Energy.
- 2017 was dominated by growth stocks as large cap growth gained 31.9%, trouncing large cap value's 13.8% gain. Small cap growth and mid-cap growth each beat their value counterparts by over 10%. For that trend to reverse we need to see Financials and Energy assume market leadership. So far in 2018, their trends are modestly positive.
- The top contributors to the portfolio during the quarter were the iShares Edge MSCI USA Momentum Factor ETF (MTUM) and the PowerShares S&P 500 High Beta ETF (SPHB). The top detractors were the SPDR S&P 500 ETF (SPY) and the iShares Russell 2000 ETF (IWN).

Fixed Income — High Yield Bonds Were Favored for All of 2017

The fixed income portion of the Multi-Strategy portfolios engages in asset class rotation within fixed income, owning high yield bonds, Treasuries, or cash, whichever our model determines has recent trends in its favor. The strategy is effected via the Navigator Tactical Fixed Income Fund (NTBIX). The portfolio has owned high yield bonds since the end of February 2016, a period of nearly two years. It has been a great run for the high yield space, but with spreads already tight, clipping coupons is a best case scenario. The risks of a substantial drawdown in high yield always loom, and we do not know what event will fracture the credit market's confidence. We are poised to pull in the reins if we see market confidence trail off. However, confidence remains strong and historical evidence shows that spreads can remain very tight for a period of years before they reverse. The Federal Reserve increased rates once in December, and markets were unaffected. Two to three more rate hikes are anticipated next year. Confidence in the economy remains high, as indicated by the Barclays Corporate High Yield Option-Adjusted Spread, which continues to decline. As always, the Fixed Income Total Return model remains watchful for signs of weakness. We see none as of now. Here are some additional developments during the quarter:

- Within the high yield space, Utilities and oil and gas were the strongest sectors in the fourth quarter, while Telecommunications and Health Care trailed. For all of 2017, Utilities and Health Care were the top performers, while Telecommunications and Consumer Staples were the worst. We are watching the poor performance by Telecommunications closely, as it is the largest sector in the high yield market, and any troubles will quickly manifest themselves in high yield performance.
- While high yield bond issuance has declined over the past few years, that does not mean that overall corporate leverage has not increased. Instead, the lending has been in the leveraged loan area; 2017 has seen the highest leveraged loan issuance since 2011. In addition, many providers of leveraged loans (often large private equity firms) have been willing to provide covenant-lite or even covenant-free loans (thus the borrower can become even more leveraged without the lender's permission). We view these developments as just another reminder of the importance of managing the risk of this asset class. When the next major earnings or economic downturn does come our way, the high yield and leveraged loan spaces will see substantial losses as they have in the past, and we will rely on our model to guide us regarding the larger economically based trends.
- As of December 31st, the resulting option-adjusted duration of the FITR portfolio is 3.6. Average maturity is 6.8 years, and average credit quality is B+.
- The portfolio's Fixed Income exposure is effected via the Navigator Tactical Fixed Income Fund (NTBIX). The fund maintained exposure to High Yield throughout the quarter, and the performance stayed in line with the Barclays High Yield Index.

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Outlook

Looking forward into 2018, we remain bullish over the intermediate to long-term. We expect volatility to return to normal as the year develops. That would mean a few corrections of the 3% to 5% variety and perhaps a larger 7% to 15% correction. What could cause a correction remains a mystery. Potential trigger events include: earnings failing to meet lofty expectations, inflationary economic data that could force the Fed to be more restrictive, volatility surrounding the midterm elections, and a slowdown in China. We believe an earnings-driven disappointment is the most likely trigger, given that S&P 500 expected earnings growth is at its highest since 2013. It is important to emphasize that while we believe volatility will return to normal, we do not expect the longer-term bullish trend to be vulnerable. A number of winds at the market's back are supporting the trend, including a globally synchronized economic recovery, strong credit conditions, the stimulative effect of tax cuts, strong labor markets, and rising wages. We would expect that as the year develops the equity portion of our portfolios will continue to favor factors such as momentum and possibly even value stocks, which traditionally need stronger economic growth to excel. Strong credit conditions and very favorable readings towards high yield bonds in our models indicate that we will favor high yield bonds over U.S. Treasuries for the foreseeable future.