ClarkCapital MANAGEMENT GROUP

# Navigator®
# MultiStrategy Update

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First Quarter 2018 — Portfolio Commentary

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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.

## SINGLE DIGIT RETURNS, DOUBLE DIGIT VOLATILITY

The first quarter of 2018 finally delivered a long-awaited correction in equities. As usual, the trigger was unanticipated. To our eyes, a combination of overvaluation in Technology and momentum stocks along with the rise of protectionist talk — the timing of which was closely correlated to the market's short-term top — were the triggers of the correction. The S&P 500 declined by over 11% on an intraday basis between the January 26th high and February 9th. Among international markets, emerging markets outperformed developed markets. Bonds were down across the board, as the Fed continued its slow hiking of interest rates. High yield bonds outperformed on a relative basis.

For the quarter, the NASDAQ was up 2.3% while the S&P 500 declined 0.8%. Growth stocks outperformed value stocks, though growth's edge was narrowed considerably during and after the correction. Technology (up 3.2%) and Consumer Discretionary (up 2.8%) were the leading S&P 500 sectors, while Consumer Staples (down 7.8%) and Telecommunications (down 8.7%) lagged. Given just a small loss in the S&P 500, one can argue that stocks hardly underwent a correction at all. Valuations, however, became much more attractive during the quarter, partially as a result of the market decline and partially as a result of very strong earnings. The S&P 500 began the year with a forward P/E of 19.9, but by the end of March, it had fallen to 16.9, a 15% decline. Small caps (as represented by the S&P Small Cap 600 Index) began the year with a forward P/E of 25.0 but that declined to 19.1, a 23% decline. Valuations bolster the bullish intermediate to long-term case for stocks. The S&P 500 earnings yield has now returned to the level seen at the end of 2014. Moreover, there are few signs of a recession — in fact, a strong corporate earnings environment combined with solid global economic growth and a strong U.S. labor market portends well for the broader economy and markets.

### 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. Those ETFs with higher rankings, are assembled into a broad-based portfolio that attempts to outperform the S&P 500. Those with lower rankings are avoided. The portfolio continued on its longer-term path during the quarter, as it favored momentum and growth stocks. Performance trends were so persistent that our ranks remained entirely unchanged during the heart of the February correction. The correction has gradually moved trends in its aftermath, as slowly defensive factors are moving higher in the ranks as are small caps. Perhaps the rise of small caps is due to potential protectionism, which small caps with their domestic-oriented focus are by their very makeup less vulnerable to.

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- For the quarter, among small caps, growth was up 2.3% while value declined 2.6%. Momentum stocks were up 2.8%, while minimum volatility declined 1.1%. Though these differences were significant, they were even more dramatic in late January at the market's peak.
- Value stocks continued to lag behind the market and were particularly hurt because they are sensitive to rising interest rates. Among traditional value-oriented sectors, only Financials are showing relative strength. Only in the last week of the quarter did the defensive-oriented Staples and Utilities begin to outperform, and that was as interest rates began to move down.
- In aggregate, the Style Opportunity portfolio is overweight in the Technology and Consumer Discretionary sectors and underweight in Consumer Staples and Energy.
- 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 iShares S&P 500 Growth ETF (IVW) and the iShares Russell 2000 Growth ETF (IWO)..

## 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 has favored high yield bonds since the end of February 2016, a period of over two years. Since the February 29, 2016 buy of high yield, the Bloomberg Barclays High Yield Index is up 26.2%, while the Bloomberg Barclays U.S. Treasury Index is down 0.9%. In the first quarter, equity markets saw their first real correction since early 2016, which was incidentally the last time the Multi-Strategy portfolio turned defensive with regards to credit. During this correction, however, our credit model declined but remained fairly firm. We believe that the difference in our model's positions over the last two corrections comes down to what area of the markets were under stress. In 2016 the stress was in Energy and Materials, two debt-heavy sectors in which high yield bond recovery values came under fire. In 2018, the correction hit Technology stocks and their valuations, most of which do not issue any high yield bonds. As a result, though our model has weakened, it remains positive on high yield but only modestly so. Still, a relatively small breakdown in credit markets could move the portfolio towards a cautionary stance. A new and important development will be the portfolio's defensive vehicle, which will now be cash and/or money market equivalent vehicles, as cash now outpaces U.S. Treasuries in our models. If we truly are entering a bond bear market where interest rates are often rising, cash could often be the vehicle of choice. Here are some additional developments during the quarter:

- While high yield bonds experienced modest losses in February and March, the longer-term picture remains bright. In January the OAS (option adjusted spread) for high yield reached its lowest point since 2007. The correction in February and March did not even drive the OAS above its highs of November 2017.
- While the high yield OAS reaching eleven-year lows in January is an indication of rich valuations in the high yield sphere, history tells us that spreads stayed at these low levels for over two years between late 2004 and 2007. Thus, while valuations point towards potential downside risk in high yield bonds, the low spreads do not indicate any imminent risk. Economic and credit conditions remain strong as well. As always, our model is watchful and ready to act upon a meaningful breakdown in the space.
- Returns were muted and modestly negative for the quarter. High yield bonds modestly outperformed Treasuries. The Bloomberg Barclays High Yield Corporate Bond Index declined 0.9%, while the Bloomberg Barclays U.S. Treasury Index declined 1.2%.

## Outlook

Now that markets have seen a correction, the first since early 2016, investors are asking if that means the future is free and clear. We certainly cannot say that, as midterm election years often undergo corrections, and after all, the S&P 500 never got below its 200-day moving average in the first quarter. Nevertheless, the first quarter took much of the froth out of markets and sentiment reached short-term extremes not seen through all of 2017. Still, valuations in the U.S. remain elevated compared to the rest of the world, and returns on equities are likely to be single digits with double digit volatility. A further turn down in U.S. equities would not be surprising to us, as serious corrections often happen in midterm years. Even if the correction deepens though, we would view that as a buying opportunity, and ask investors to keep in mind that our intermediate to long-term view remains bullish. Often during midterm election years

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the markets will sell off on the political uncertainty around the elections, but after the elections markets have tended to rally.

The possibility of a genuine bear market accompanied by recession remains quite low in our mind. Economic data continues to be strong, with both the U.S. and most international economies growing at faster rates than most of 2017. Credit conditions also point towards healthy corporate balance sheets. While many fear inflation rising and threatening markets, we have not seen any evidence of a sustained trend. Within the fixed income sphere, high yield bonds continue to offer a higher yield, but at the same time at their high valuations historically, investors are not being compensated for the level of risk. Nevertheless, we do not take valuations alone as an indication to sell out of the asset class. Rather, we will invest in the asset class until its relative performance falters and our model indicates an exit.

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The MultiStrategy benchmark consists of an allocation to the Russell 3000 and an allocation to the BBgBarc US Corporate High Yield. The Russell 3000 Index measures the performance of the 3000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. The BBgBarc 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 benchmark for this composite is based upon the approximate allocation of equities and fixed income in the MultiStrategy composite. The Russell 3000 is generally representative of broad based equities. The BBgBarc US Corporate High Yield is generally representative of broad based U.S. fixed income.

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