Clark Capital MANAGEMENT GROUP

Navigator® Fixed Income

Jamie Mullen, Senior Portfolio Manager

First Quarter 2018 — Portfolio Commentary

Jamie Mullen
Senior Portfolio Manager

As a Senior Portfolio Manager, Jamie manages the Taxable and Tax Free Fixed Income Strategies. He is a member of the Clark Capital Investment Committee. Jamie has over 30 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, trust departments and money managers. He received his degree from St. Joseph's University. He joined Clark Capital in 2005.

LAWYERS, GUNS AND TARIFFS

Volatility has hit the fan

As 2018 began, higher volatility in the markets was a distant memory from before the 2008 financial crisis. Over the past decade, volatility became an asset class and the short volatility trade became profitable.

In January, stocks continued their optimistic march higher. The Fed was on autopilot to raise interest rates and bond yields increased at gradual pace. During this time, the increase in bond yields had no apparent effect on stock market valuations. But there were signs that something was about to change and that maybe outcomes could be unpredictable and volatile once again, and they came from an unlikely source, the National Football League.

As the sports world watched, everything seemed normal. The Philadelphia Eagles were the first number one seed in the history of the sport to be a home team underdog against any possible playoff opponent. Could it be any other way in Philly? Unpredictably, the Eagles walked into the Super Bowl. The Patriots were there as well. Anticipated was the timeworn script of a blowout win and a Brady comeback in the championship game. Then the predictable went awry. Brady had the greatest Super Bowl game of all time and had the ball with the chance to get the win. But Father Time said, "Not this time." No more magic. The Eagles won the Super Bowl and unpredictable was about to become the norm.

On February 5th, a day after the Super Bowl, NYSE volatility as represented by the VIX Index would rise over 200% and would take with it investors' money positioned to capitalize on the low market volatility. Suddenly — in a flash — volatility was back with a vengeance in most markets, and we would see it continue into the end of the first quarter.

Caught between a rock and a hard place

When stocks closed at an all-time high on January 26th, the 10-year Treasury closed at a yield of 2.66%. On February 5th, the day the VIX moved up over 200%, the 10 year traded at 2.70%. This is significant because it signaled a change in the marketplace. As volatility exploded and the S&P 500 dropped 114 points, bonds were no longer viewed as a safety asset. As stock volatility continued through February the 10-year bond yield peaked on February 21st at 2.95%.

With quantitative easing over and the Fed reducing its balance sheet, stocks may lose the Central Bank "put" protection. We are in the early innings of this Fed tightening or as they call it "normalization" of rates. Ultimately higher rates, higher cash flow, and reinvestment money is beneficial to savers and risk adverse investors. The concern for investors is as rates rise they could exude pressure on stock market valuations while bond prices continue to drop.

The Fed is on autopilot to raise rates an anticipated three times this year. After years of crisis management, Treasury bond yields out to three years are at levels not seen in the past nine years. As reported by Bloomberg, 2-year Treasury bond yields closed the quarter at 2.26%. This may not seem like much, but it is a welcome level to short-term riskless savers that were paid little to virtually no yield for years. Even Warren Buffet chimed in, stating he had purchased $100 billion in Treasuries because he was having a hard time finding value in stocks.

Past performance is not indicative of future results.

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Rising short term rates are beneficial for savers but have started to cause some stress in the short end of the yield curve. The London Interbank Offered Rate or LIBOR is used to set rates on short term loans and has been rising significantly since December 2017. Why is this a problem? Well, it also rose prior to the U.S. financial crisis in 2008 and the European debt crisis in 2010. With memories of these events not far behind in the rear view mirror, bond traders have begun to focus on this benchmark. The realization is that it doesn't take too much of a rise in LIBOR to cause some problems for borrowers when we factor in that trillions of dollars are priced according to this reference.

Get me out of this

There is no wonder volatility has returned to the market. Every time we pick up a newspaper there is a new headline — White House resignations, Mueller's investigation, Russian election hacks, Kim Jong-un and North Korea, Stormy Daniels, tweets, Facebook and privacy rights. The list just keeps going on and on. Next up are tariffs and a potential trade war with China.

Warren Zevon said it a little differently in his song, but it is becoming clearer that "The 'vol' has hit the fan."

Comments on Fixed Income Portfolios

Is the bond bull market over? This is the burning question. The answer is probably yes. The real question is what to do about it. The answer, in our opinion, is to be tactical within bond allocations and adjust accordingly. Would it make sense that if the Fed is going to actively manage interest rates, why wouldn't you actively manage your fixed income holdings?

Treasury bonds out to three years are trading at levels not seen since 2008. One of the most important properties of a bond is that it matures and investors receive par or their principal value back. If the Fed stays on course and continues to raise rates over the next year, bond prices can move lower but you can reinvest coupon payments at higher interest rates. As you move through time, the bond value can recover, eventually converging to par value at maturity. Therefore, building par value in a portfolio is of paramount importance. This is done through systematic exposures and thoughtful allocations to various fixed income sectors, issuer coupons, and bond durations and maturity structures. The goal is a more thoughtful and tactical approach to fixed income management through all the portfolios we manage.

Taxable Bond Portfolio

We believe pricing in BB credits are approaching peak valuations. We have recently seen some rotation out of the fixed income space, which in turn has generated attractive yields and created some buying opportunities across the entire asset class.

Our general portfolio strategy has been to increase the credit quality of the investment grade allocation, and we are also looking to shorten overall portfolio duration. The portfolio's high yield exposure is currently about 15% of the portfolio's allocation. Our high yield exposure has been the beneficiary of several credit upgrades in the portfolio. The high yield asset class has been relatively immune to market volatility especially when compared to the performance of other equity and fixed income asset classes. Investment grade credits have been a drag on first quarter 2018 portfolio performance as we have observed widening spreads to Treasuries throughout the quarter.

Drilling into the fixed income sectors, banks and finance offerings have dominated the landscape, causing their spreads to widen. Technology is an area where spreads remain steady but prices have dropped, primarily due to rising interest rates. We have been actively barbelling the portfolio by overweighting both short-term and intermediate-term positions. Roughly one third of the portfolio is positioned in short-term paper. We are currently observing yields around 250 bps out to 14 months and further out on the curve at the 15 to 24 month range, paper is yielding around 300 bps. We think both areas of the yield curve present compelling yields and offer relatively limited duration exposure.

Tax-Free Portfolio

Our general focus in the tax-exempt fixed income strategy has centered on maintaining income, decreasing duration, and reducing our overall dollar value exposure (i.e., selling $115 bonds and buying $110 bonds). Throughout the first quarter, the strategy has focused on selling higher priced bonds with longer call dates at 8 to 10 years and buying lower priced bonds with shorter call dates at 5 to 7 years.

We recently started to see the effects of the Fed rate hikes as munis began the month of March trading more in line with, in our view, traditional metrics. What this means for muni investors is that we are now purchasing lower dollar priced bonds that are less sensitive to principal amortization compared to higher priced premium bonds.

Municipalities across the country are all facing the same risks, such as insufficient pension funding ratios and changes in the advanced refunding. We note that municipal bond insurance, as we see it, has been priced cheaply, and we have been looking to add these policies to our holdings as an effective way to enhance asset protection and to lower credit risk. We have purchased insurance on several general obligation names held throughout the strategy that we believe will act as an additional measure to preserve portfolio principal value.

Source: Bloomberg, Ned Davis Research

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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 Bloomberg 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 Bloomberg 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 Bloomberg 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 Bloomberg 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 Bloomberg 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 Bloomberg 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 Bloomberg 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.

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