Clark Capital MANAGEMENT GROUP

Navigator® MultiStrategy Update

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Third 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.

STOCKS LEAD GAINS, HIGH YIELD BONDS REMAIN STRONG

The third quarter was positive for U.S. equity investors, as a surging U.S. economy and labor market, in which consumer confidence hit an 18-year high, helped the S&P 500 enjoy a stable and steady uptrend, making new all-time highs near 2930 in September. The Federal Reserve (the Fed) increased rates for the third time this year, with an expected fourth increase coming in December. The Bloomberg Barclays U.S. Treasury Index finished down 1.6% for the 12 months ending September 30 and is only up 0.64% over a three-year period.

Stocks have been the leader in producing gains, though ten-year Treasury yields over 3.0% may begin to make bonds attractive competition. One of the most encouraging statistics is that equity valuations have come down as the year has progressed. The S&P 500's median P/E ratio hit 27 on January 31st but has now fallen to 24 despite substantial equity market gains. This leads us to believe that real profit and revenue gains have been seen, and no doubt aided, by January's corporate tax cut.

While much of 2018 has been filled with talk of tariffs and concerns, the picture began to clear by the end of the quarter. An updated version of NAFTA was signed, putting an end to the loudest of tariff concerns. The China tariffs are a different story, however. China's average tariffs per the WTO are 9.8%, and its trade dispute looks to be a higher stakes game that won't end soon. The China trade dispute along with the strength of the U.S. dollar is a source of stress on emerging markets, and we believe is one of the biggest risk factors that markets face.

U.S. Equity — Large Caps on the Rise

The U.S. equity portion of the MultiStrategy 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 portfolio that attempts to outperform the Russell 3000.

As the quarter developed, we continued to own large cap growth (SPYG) and momentum (MTUM) stocks, but the rest of our portfolio is slowly becoming more defensive in alignment with our rankings. The S&P 500 has risen into the top half of our rankings, as few ETFs are able to beat it. The pace of growth stocks' outperformance vs. value has slowed, though growth still made new relative highs in early September. The following were other developments in the portfolio during the quarter:

- Large cap value (SPYV) increased 5.8%, while large cap growth (SPYG) rose 9.2%. Small cap value (IWN) trailed all styles with a 1.67% gain, while small cap growth rose by 5.6%. Momentum stocks gained 8.7%, while minimum volatility increased by 7.8%. The S&P 500 was up 7.7%.
- Small caps enjoyed a strong second quarter and outperformed for much of the third quarter. However, that trend appears to have ended, perhaps due to higher interest rates beginning to have a bite, as small caps disproportionally rely on banks to fund their growth and operations. With small caps showing relative weakness, we see high dividend (HDV) and high quality (QUAL) ETFs rising in our ranking matrix. These ETFs could become buys as October develops.
- The top contributors to the portfolio during the quarter were the SPDR S&P 500 Growth ETF (SPYG) and iShares Russell 2000 Growth ETF (IWO). The top detractors were the iShares Edge MSCI USA Momentum Factor ETF (MTUM) and the iShares Core S&P 500 ETF (IVV).

Fixed Income — High Yield Bonds Enjoy Their Strongest Quarter

The fixed income portion of the MultiStrategy portfolios engages in sector rotation within fixed income, owning High Yield, U.S. Treasuries, or cash equivalents, depending on which sector our model determines has recent relative trends in its favor.

The fixed income portion of MultiStrategy has owned High Yield since the end of February 2016, now a period of over two and a half years. Since our 2016 buy of High Yield, the Bloomberg Barclays High Yield Index is up 30.5%, while the Bloomberg Barclays U.S. Treasury Index is down 1.4%. During the third quarter, the Bloomberg Barclays High Yield Bond Index pulled in a 2.4% gain, while the US Treasury Index declined 0.6%.

High Yield enjoyed its strongest quarter of 2018, as economic and corporate earnings news helped move spreads near their lowest level since 2008. For most of 2018, the portfolio's preferred defensive vehicle has been cash 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:

- Health Care and Telecomm were the best performing high yield sectors both during the quarter and year-to-date (YTD). All High Yield sectors were also up during the quarter and are up YTD.
- We have noticed that issuance in the High Yield space has fallen as companies have instead preferred to finance via bank loans. This has provided an important bullish reduction in supply to the High Yield markets. However, another consequence of the rise of bank loans is less issuance among weaker CCC High Yield credits. The number of lower-grade CCC bonds in the High Yield Index has fallen 26% in the past two years. Despite the past few years of the High Yield rally, the underlying High Yield Index now actually contains less risky credits.
- In broader corporate America, companies are adding leverage to fund growth and buybacks, which may lead to a higher supply in the High Yield markets. Amazingly, 49% of the U.S. Investment Grade corporates are now BBB, with the next downgrade moving them into the High Yield category.

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Outlook

As we look to 2019, our outlook remains bullish. Most market observers have long voiced worries that this economic expansion was or soon will be the longest on record. However, it's important to remember that it is also the slowest expansion ever, averaging only 2.3% GDP per annum.

With such a slow rate of expansion, it makes sense that it will take even longer than usual to have the economy's growth become unsustainable. How long, then, can the economy continue its solid growth? Ned Davis Research notes that the Fed's balance sheet normalization is still ongoing and will likely be reached in 2021.

Therefore, we believe a few more years of a stable underlying economy could be more likely than many think.

Within equities, we are continually watching for a shift away from Technology, Consumer Discretionary, and growth stocks towards Financials and value stocks. Beyond a normal correction, we have not seen that ship turn. We will continue to monitor style and factor trends and use our relative strength models as a guide.

High Yield credit remains quite strong and continues to hold its own during this period of rising rates. We remain watchful for risks, and our tactical approach allows us to adapt if a defensive market takes hold.