Navigator®
MultiStrategy Update

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Fourth Quarter 2018 — Portfolio Commentary

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# PLAYING DEFENSE

Investors and asset managers alike are happy to turn the page from 2018 to 2019. Last year was a tough year for the markets. While 2018 started strong on the heels of tax legislation, it then faded as trade tensions, rising interest rates, peak earning growth, and geopolitical concerns at home and abroad weighed heavily on the global markets. In hindsight, it looks like 2018 turned out to be a year of consolidating the strong gains achieved since the Presidential Election in 2016.

Our expectations coming in to 2018 called for an uptick in volatility and the return of normal market corrections. We have certainly seen both of these expectations realized with risk assets suffering through several declines and the S&P 500 suffering two 10% corrections.

In review, the second half of 2018 was lower for all risk-on asset classes from U.S. equity to foreign equity, high yield debt, and commodities. Risk-off asset classes ended the year higher with Treasuries and investment grade debt benefitting from a flight to safety and municipal bonds ending with the highest returns.

## U.S. Equity — A Regime Shift in U.S. Stocks

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 seeks to outperform the Russell 3000.

Times of transition and regime changes in market leadership are some of the most difficult phases for investors to manage, and the fourth quarter represented a major regime shift to defensive U.S. stocks. Though we had seen growth stocks' momentum slowing as the quarter began, the portfolio was still aggressively positioned in Small Cap Growth and momentum stocks as the quarter began.

Quickly, Small Cap Growth fell out of favor and the portfolio's focus shifted towards large caps and defensive, lower beta names (USMV and HDV). Large Cap Growth (SPYG) also eventually fell out favor in the portfolio, as its longer-term market leadership faded in November.

Once our relative strength models signaled caution in U.S. equities and credit in November, we became even more defensive, and increased our position in cash up to 15%. As the decline steepened and the oversold conditions became the most extreme in over two years, we put that cash back to work on December 21st. As it turned out, the markets went even lower until a Christmas Eve bottom, from which markets have since found footing and rallied. The following were other developments in the portfolio during the quarter:

- For the quarter, Large Cap Value (SPYV) declined 11.98%, Large Cap Growth (SPYG) declined 14.63%. Small Cap Value (IJS) trailed all styles with a 20.60% decline, while Small Cap Growth fell (IJT) by 19.77%. Momentum stocks (MTUM) declined 15.44%, while Minimum Volatility (USMV) declined 7.56%. The S&P 500 (SPY) fell by 13.52%.
- Defensive, lower-beta ETFs dominated the portfolio in the fourth quarter, as they were the only theme within our model rankings that beat the S&P 500 itself. As the decline deepened and became more extreme, we did not want the portfolio to be 100% allocated defensively near a major bottom. As a result, we added a large position in the S&P 500 Index itself (IVV), which was near the top of our rankings.
- In aggregate, the portfolio is overweight the Utilities, Consumer Staples, and Energy sectors, and underweight Technology, Consumer Discretionary, and Communications Services. The portfolio avoids mid-cap and small cap stocks, as their relative strength trends remain weak. However, we do recognize that they could present a nice opportunity if markets and the U.S. economy display improved confidence as 2019 develops.
- The top contributors to the equity portfolio during the quarter were the iShares Edge USA Minimum Volatility ETF (USMV) and the iShares Core High Dividend ETF (HDV). The top detractors were the iShares Russell 2000 Growth ETF (IWO) and the SPDR S&P 500 Growth ETF (SPYG).

## Fixed Income — A Defensive End to the Year

During the period, fixed income markets came under some selling pressure as risk assets in general weakened. While high yield bonds had previously held up well compared to U.S. Treasuries and investment grade corporate debt, the weakness spread to high yield debt as tariff concerns and commodity market weakness impacted the asset class.

As a result, in mid-November, the fixed income portion of the strategy's allocation model shifted from favoring high yield bonds to cash equivalents, ending the year in a defensive position. The change in the portfolio's allocation marked the end of 32 consecutive months allocated to high yield bonds. In the previous quarter's commentary, we said that "the alpha of the strategy is driven by the disciplined and quantitative top down relative strength research process that determines the strategy's sector exposure within fixed income."

Since the strategy's allocation to high yield debt in February 2016 through the mid-November allocation change, high yield bonds significantly outperformed other fixed income sectors. Over that period, the Bloomberg Barclays Corporate High Yield Index gained 27.15%, the Bloomberg Barclays Aggregate Bond Index advanced only 2.07%, and the Bloomberg Barclays US Treasury 7-10 Year Index lost 3.35%.

## Outlook

We enter 2019 in the midst of a correction with a ton of uncertainty hanging over the markets. While there are risks that the markets and economy face, we believe there is no immediate risk of a recession in the U.S. economy. A lot of the same headwinds that pushed against the market in the second half of 2018 will continue to be concerns in 2019 such as slowing earnings growth, Brexit and the Italian budget standoff with the European Union, the China trade war, the growing budget deficit here in the U.S., and the risk of a Fed policy mistake. However, we feel confident that the U.S. economy will continue growing, although at a slower pace, and expect a 2.3% GDP growth rate in 2019.

In a year that saw a wide variety of asset classes decline in value, credit markets were no exception. For high yield, 2018 goes down as the fifth worst year on record. Since the data begins in 1987, this is only the fourth year where total return has been negative for both investment grade and high yield bonds. The only other years were 1994 (when the Fed surprised the markets and aggressively hiked rates), 2008 (the global credit crisis), and 2015 (when commodity weakness drove asset prices lower).

With the major central banks data-dependent, we anticipate another volatile year for credit, which we believe requires an active approach to managing fixed income. The current correction should be viewed within the context of continued economic expansion and once the correction runs its course, the secular tailwinds for the market should kick in and a new cyclical bull market will begin.

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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.

The volatility (beta) of an account may be more or less than its benchmark. It is not possible to invest directly in an index.

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