Clark Capital Management Group

Portfolio Commentary

Navigator® All Cap Core U.S. Equity

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Navigate Your Future. Enjoy the Journey.

Avalon

If you're from Philadelphia and the surrounding areas, you know that a popular weekend getaway is going to the beach, or as the locals say, "going down the shore." There are many nearby shore points to choose from, but one of the top picks for local beach destinations is Avalon, NJ. It's a picturesque beach scene where the weather is perfect, and the is ocean refreshing. You can bike, go for a walk, or simply relax. It's a special place where you can leave your unlocked bike in town only to find it untouched two hours later. With coffee or cocktail in hand, a day in Avalon is like a day in paradise.

Stores are full, restaurants have wait lists, and home prices continue to creep persistently higher. The China-U.S. trade war, protests in Hong Kong, and slowing or negative 2019 earnings growth have had little to no visual impact on Avalon.

Ten Years and Counting

Of course, part of the Avalon story is routed in the length of the current U.S. economic expansion. According to the National Bureau of Economic Analysis, the current expansion began in June of 2009. Turning 10 years old this month, it is now the longest on record and still plugging away. While this expansion has out persisted all the previous in terms of time, its growth rate has been sub-par.

Industrial production, for example, is up only 25.8% since June 2009 vs. the average increase during the previous 11 post-WWII expansions of 32.4%. Although less robust than most, the "low volatility, slower for longer" nature of the expansion has guided the unemployment rate down to 3.7% in June (near May's 50 year low), lifted year-over-year average hourly earnings gains to 3.1% and expanded the gap between job openings and job seekers to record levels. In April, for instance, the number of job openings exceeded the number of unemployed Americans by over 1.60 million or the largest on record. While June's labor report showed a small retreat in the unemployment rate from the record 3.6 to 3.7%, payroll growth rebounded to 2018's robust levels as new workers entered the labor force.

Does Slower Anticipated Growth Justify Fuller Employment?

Current labor market tightness doesn't necessarily tell the evolving story of the economy as many important indicators are pointing to slower economic and earnings growth in 2019. The ISM Non-Manufacturing Index, the ISM Services Index and the growth in the Leading Economic Indicators Index all point to a slowdown from the first quarter's GDP of +3.1%. The ISM Non-Manufacturing Index (NMI) fell 1.8 points in June to 55.1, its lowest level since July 2017, as services activity grew at a slower pace.

The ISM Manufacturing Index slipped 0.4 points in June, down in four of the past five months, to 51.7, its lowest level since October 2016 and global manufacturing measured by Purchasing Manager Indices in China, the Eurozone and Japan have either

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entered contraction territory or are in a downward trajectory. All of the above corroborates the pessimistic message of both the decline in the 6-month growth of Leading Economic Indicators to just above zero and the negative yield spread between 3-month U.S. T-Bills and 10-year U.S. Treasuries.

The question for both Fed Governors and investors is: *does slower anticipated U.S. economic growth (with little evidence of credit stress) justify lowering interest rates to potentially exacerbate labor tightness and debt levels?*

Value Will Matter Again

Large-cap growth stocks continued to dominate value and small-cap stocks in the 2019 performance charts. Based on quintiles, the highest expected earning growth stocks outperformed the lowest earning (22.6% vs. 11.0%), large-cap stocks outperformed small-cap stocks (19.2% vs. 12.60%) and companies with attractive value characteristics like price-to-sales ratios underperformed the most expensive stocks (10.5% vs. 20.4%). Investors' obsession with growth companies and those with strong free cash flow margins has persisted for so long and to such an extent that J.P. Morgan's Chief U.S. Equity Strategist noted that "value is currently trading at the biggest discount ever."

Our research supports these claims when we view the historical price-to-earnings and price-to-book spreads of growth to value stocks. As value stocks have grown increasingly more attractive on a relative basis, they have now entered such an extreme relative valuation in which, historically, performance has "mean-reverted" and future value stock performance has excelled.

Although we are attracted to the business momentum characteristics of many of the large-cap growth cohort, we are concerned that the group is beginning to exhibit the characteristics of late-cycle momentum stocks as heavy ETF dollar flows begin to crowd into these names just at the time when their relative free cash flow yields (high prices) are at their lowest ever.

Value and Quality Characteristics Remain Solid in All Cap

Per our notes above on the extreme and persistent outperformance of large-cap and growth stocks at the detriment of small-cap and value stocks, we believe that our All Cap Core U.S. Equity investment process will produce solid risk-adjusted returns over the long-term.

Staying true to our investment process, growth's outperformance signals us to gravitate to the more attractive value components of the market. As such, long-standing style performance trends and the strategy's constraints on portfolio weights among the various market capitalizations (no more than 2/3 large-cap and no less than 1/3 mid and small-cap), have resulted in relative underperformance on a gross and net basis.

To this end, the All Cap Core U.S. Equity strategy holds a 9.7% weight in the five biggest members of the Russell 3000 Index (Microsoft, Apple, Amazon, Google and Facebook) compared to the 12.3% that is represented in the benchmark. Additionally, our 2/3 maximum weight constraint in large-cap stocks is less than the 80% represented within the benchmark, thus hampering our ability to outperform during a large-cap growth run-up.

For the second quarter of 2019, the Navigator® All Cap Core U.S. Equity strategy had a return of -0.73% (-1.47% net) vs. a 4.10% gain in the Russell 3000 Index. For the five years ending June 2019, the strategy gained 6.86% gross (3.71% net) vs. 10.19% for the Russell 3000.

Our positioning in industrials helped relative performance while our positioning in consumer discretionary and information technology acted as a drag in the second quarter of 2019. Portfolio holdings in Northrop Grumman and Facebook helped relative performance while holdings in G-III Apparel Group and PVH lagged.

During the quarter, the strategy held mostly large-cap stocks (63.1%) compared to mid and small-cap holdings (33.1%). The value and quality characteristics of the All Cap portfolio remain solid in comparison to the S&P 500 as it possesses a lower P/E of 15.7 vs. 18.7 and lower earnings variability combined with higher gross and net profit margins with similar business growth characteristics.

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Ticker	Quarter Ending June 30, 2019	Average Weight (%)	Contribution to Return (%)
Top 5 Contributors			
NOC	Northrop Grumman Corporation	2.13	20.37
FB	Facebook, Inc. Class A	2.81	15.78
MSFT	Microsoft Corporation	2.01	14.00
PGR	Progressive Corporation	2.45	11.03
WTFC	Wintrust Financial Corporation	1.64	9.02
Top 5 Detractors			
GIII	G-III Apparel Group, Ltd.	2.18	-0.88
PVH	PVH Corp.	1.78	-0.81
FL	Foot Locker, Inc.	1.68	-0.72
SWKS	Skyworks Solutions, Inc.	0.95	-0.32
KFY	Korn Ferry	2.44	-0.26

Source: Factset. For illustrative purposes only. Past performance does not guarantee future results. The holdings identified do not represent all of the securities purchased, sold or recommended for advisory clients. In the chart above, "weight" is the average percentage weight of the holding during the period, and "contribution" is the contribution to overall performance during the period. To obtain the calculation methodology and a list showing every holding's contribution to the overall composite during the period, contact: PortfolioAnalytics@ccmg.com.

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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 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.

ISM Manufacturing Index - A widely-watched indicator of recent U.S. economic activity. The index is often referred to as the Purchasing Manager's Index (PMI). Based on a survey of purchasing managers at more than 300 manufacturing firms by the Institute for Supply Management (ISM), the index monitors changes in production levels from month to month. The index is the core of the ISM Manufacturing Report.

The ISM Non-Manufacturing Index is an index based on surveys of more than 400 non-manufacturing firms' purchasing and supply executives, within 60 sectors across the nation, by the Institute of Supply Management (ISM). The ISM Non-Manufacturing Index tracks economic data, like the ISM Non-Manufacturing Business Activity Index. A composite diffusion index is created based on the data from these surveys, that monitors economic conditions of the nation.

The Composite Index of Leading Indicators, otherwise known as the Leading Economic Index (LEI), is an index published monthly by The Conference Board. It is used to predict the direction of global economic movements in future months. The index is composed of 10 economic components whose changes tend to precede changes in the overall economy. The Conference Board is an independent research association that provides its member organizations with economic and financial information.

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.

Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

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