Portfolio Commentary

Navigator® SMID Cap Core U.S. Equity

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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

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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 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.

SMID Steady as Russell 2500 Gallops Ahead

Since inception, the Navigator® SMID Cap Core U.S. Equity strategy delivered annualized gains of 11.50% gross (8.23% net) vs. 10.42% annualized gains for the Russell 2500 Index. In the second quarter of 2019, Navigator SMID strategy had a gain of 1.87% gross (1.11% net) vs. a 2.96% gain in the Russell 2500 Index.

Since inception through March 2019, Morningstar performance analytics ranks this strategy in the top 21% in comparison to similar managers in the U.S. Small Blend category. Positioning in industrials and healthcare helped the relative performance while positioning in consumer discretionary and financials hurt performance.

Our holdings in EMCOR Group and Herman Miller helped performance in the quarter as positions in G-III Apparel Group and Foot Locker hurt performance. The value characteristics of the SMID Cap strategy remain compelling. Its current P/E of 15.1 is less than that of the S&P Mid Cap (18.9) or S&P Small Cap (21.1) indices with similar quality and business growth characteristics.

Ticker	Quarter Ending June 30, 2019	Average Weight (%)	Contribution to Return (%)
Top 5 Contributors			
EME	EMCOR Group, Inc.	3.37	0.62
MLHR	Herman Miller, Inc.	2.44	0.61
EEFT	Euronet Worldwide, Inc.	2.74	0.45
WSM	Williams-Sonoma, Inc.	2.36	0.44
CW	Curtiss-Wright Corporation	2.25	0.40

Ticker	Quarter Ending June 30, 2019	Average Weight (%)	Contribution to Return (%)
Top 5 Detractors			
GIII	G-III Apparel Group, Ltd.	2.38	-0.97
FL	Foot Locker, Inc.	1.93	-0.89
KFY	Korn Ferry	2.40	-0.27
SSNC	SS&C Technologies Holdings, Inc.	2.70	-0.27
JLL	Jones Lang LaSalle Incorporated	2.29	-0.24

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 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 ISM Manufacturing Index is 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 Russell 2500 Index is a broad index, featuring 2,500 stocks that cover the small- and mid-cap market capitalizations. The Russell 2500 is a market cap-weighted index that includes the smallest 2,500 companies covered in the Russell 3000 universe of United States-based listed equities

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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