Clark Capital MANAGEMENT GROUP

Portfolio Commentary

Navigator® All Cap Core U.S. Equity

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Navigate Your Future. Enjoy the Journey.

Stepping on the Gas Heading Downhill

I think it's pretty hard for anyone—English majors, equity portfolio managers, Federal Reserve board members, Siberian forest cats, etc.—to have vastly differing interpretations of the U.S. unemployment rate chart since the Great Recession. It goes virtually straight down, meaning better. On Friday, the September employment rate reached its lowest level since December 1969 at 3.5%.

While we can nitpick over the term "full employment", we now appear closer to the Fed's nebulous goal than ever before. So why now, with unemployed persons per job opening at a record low (0.8) is the U.S. Federal Reserve "stepping on the gas" and cutting the federal funds rate by 0.25% twice from 2.50% to 2.00%?

One justification for an "insurance cut" or two is that the unemployment rate is a coincident and not a leading economic indicator. As such, a potential shortcoming of policy is its dependence on historic employment data which ignores the anticipatory track record of the NM-Purchasing Managers Index, which has fallen below 50 for two consecutive months. With this said however, current Fed policy no longer appears to be guided by two simple objectives—full employment and contained inflation. We seem to be distracted, confused. Is the U.S./China trade war suppressing future growth?

Maybe we should try to *stimulate* inflation because all measures of it are not above our 2% goal? Should U.S. interest rates not be lower because we want to be tethered to Japanese and German demographic declines? Wait, what? Let's keep it simple. The U.S. economy is at or near full employment and inflation is contained. Mission accomplished. Do nothing until you see actual corroborated evidence of an economic decline or of inflation rising sharply above the 2% objective. Blindly following the unsuccessful monetary paths of two other developed economies will likely bring about unanticipated market excesses. How can near zero interest rates not?

When Will Value Matter?

Along with quality and business momentum, value serves as a critical component to our investment philosophy. With respect to the value factor, sound sleep requires us to hold a portfolio whose calculated value (albeit imperfect) exceeds market price. Otherwise, it would encourage restlessness. Of course, value, like beauty, often rests in the eye of the beholder and as such, we use multiple differing valuation approaches to assess a company's likely worth.

While the value factor has demonstrated long-term excess returns in security selection, it can experience long periods of underperformance relative to the growth style. By combining value with quality and business momentum, we attempt to provide more consistent excess returns. Recently, the Russell Large Cap Value Index has suffered a long period of underperformance (from August 2006 to September 2019),

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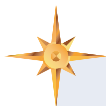

underperforming the Russell Large Cap Growth Index by 4.1%/year.

This combined with the underperformance of small and mid-cap companies since December 2017, has impacted our performance in the all-cap space as we have traditionally had a larger allocation to both value and small-mid cap companies than the benchmark. Although it is difficult to forecast when this long-standing trend will reverse, we are beginning to see extraordinary discrepancies between these two cohorts and of the valuation of stocks which act as bond surrogates – Utilities and REITs.

In September for instance, J.P. Morgan's Chief Equity Strategist wrote to clients that "value is trading at the biggest discount ever" highlighting that both the median forward price-to-earnings ratio and the median price-to-book ratio of the cheapest portion of the S&P 500 was trading at their lowest levels in 30 years relative to the broader index. By other measures, we see that the value contingent is trading more than 1 standard deviation cheap to growth compared to its historic average.

While we can't be sure of a forthcoming regime change, in the past when large-cap value got this cheap relative to growth, a sharp performance snap-back typically ensues. Additionally, the bond proxies, Utilities and REITs (as measured by their S&P 500 sub-indices), hit record highs in September. The Utilities Index hit a record high forward P/E multiple of 19.8, which is 3.4 points higher than one year ago. Interestingly, REITs have also benefitted from the decline in 10-year Treasury rates by earning a whopping 29.65% total return this year despite having the worst forecasted earnings growth rate for 2020. I wonder if late WeWork lease payments are included in those forecasts.

Less Excess Promotes a Gentle Landing

In our commentary nine months ago, we urged readers to "ignore the deafening noise" and today is no different. Slowing growth, trade wars, negative earnings growth, impeachment, negative interest rates, the list goes on. It's easy to be a pessimist. Despite all of the above however, U.S. equity markets remained firm through the first nine months of 2019 as both the Russell 3000 Broad Market Index and Russell 2000 Small Cap Index provided returns over 10%.

Like other commentators, I have my own opinion as to why this has been this case and much of it has to do with the lack of excess in the system. Credit markets have functioned well, and individual lending has been tempered since the days of No Income, No Job or Asset (NINJA) home loans. Of course, some excesses do exist, and we are concerned that the leveraged loan market has replaced the high yield market, that many BBB credits are on the precipice of becoming junk BB bonds, and that many REITs may be stuck with bad tenants just when their securities are priced at record low yields.

With this said however, the next 12 months of anticipated S&P 500 revenues and earnings are slowing and are moving up and out. 80% of the world's central bankers have adopted easing monetary policy and a few European countries, recognizing the impotency of driving interest rates more negative, have begun to adopt fiscal stimulus. Taken together, world economic growth will likely be stronger in 2020 and 2021 than in 2019 as some of these policies will counteract the overriding slowing effects of debt levels, demographics and deflation.

Value and Quality Characteristics Continue to Drive All Cap Strategy

For the third quarter of 2019, the Navigator® All Cap Core U.S. Equity strategy had a return of -0.01% (-0.75% net) versus a 1.16% gain in the Russell 3000 Index. Since inception, All Cap gained 7.97% gross (4.79% net) vs. 8.55% for the Russell 3000. Our positioning in Industrials and Energy helped relative performance while our positioning in Healthcare and Financials acted as a drag in the third quarter of 2019.

Portfolio holdings in SYNNEX and Lam Research helped relative performance while holdings in Alexion and Centene lagged. During the quarter, the strategy was overweight large-cap companies with market capitalizations above $15 billion. The value and quality characteristics of the All Cap strategy remain solid in comparison to the S&P 500 as it possesses a lower P/E of 16.1 vs. 18.9 and lower earnings variability combined with higher gross and net profit margins with similar business growth characteristics.

Ticker	Quarter Ending September 30, 2019	Average Weight (%)	Contribution to Return (%)
Top 5 Contributors			
SNX	SYNNEX Corporation	2.40	0.38
LRCX	Lam Research Corporation	1.72	0.36
NOC	Northrop Grumman Corporation	2.26	0.35
HFC	HollyFrontier Corporation	1.53	0.34
AAPL	Apple Inc.	2.20	0.28

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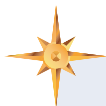

Ticker	Quarter Ending September 30, 2019	Average Weight (%)	Contribution to Return (%)
Top 5 Detractors			
ALXN	Alexion Pharmaceuticals, Inc.	1.70	-0.51
CNC	Centene Corporation	2.49	-0.48
SSNC	SS&C Technologies Holdings, Inc.	1.21	-0.45
CSCO	Cisco Systems, Inc.	2.14	-0.34
UNH	UnitedHealth Group Incorporated	2.88	-0.29

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.

The Russell 2000 Index measures the performance of the 2000 smallest U.S. companies based on total market capitalization in the Russell 3000, which represents approximately 11% of Russell 3000 total market capitalization.

The Russell 2500 Index measure the performance of the 2500 small and mid size U.S. companies based on total market capitalization in the Russell 3000.

The Russell 1000 Index measures the performance of the 1,000 largest U.S. companies based on total market capitalization, which represents 90% of the investable U.S. equity market.

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An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to weaken the obligor's capacity to meet its financial commitments on the obligation.

An obligation rated 'BB' is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions that could lead to the obligor's inadequate capacity to meet its financial commitments on the obligation.

The Russell Midcap Index measures the performance of the 800 U.S. companies that comprise the Russell 1000 Index and is a subset of the Russell 3000 Index.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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