Portfolio Commentary

Navigator® MultiStrategy

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Exaggerated Emotions: Investing in a Late Market Cycle

Reading or watching the media in constant conflict regarding both the markets and politics must have an effect on a person's mood, and on the broader public's psychology. Whether it's good or bad, the news may have you convinced that the situation is extreme, demanding a strong reaction and immediate action.

Market uncertainty has risen, and public psychology is more volatile, making it a tough environment to invest in and more specifically, to hold on to your current asset allocations in. Our analysis of the economy and markets agrees that the situation is potentially more volatile. We are so late in the economic cycle that a negative outcome like a bear market, modest recession, and major market losses is more possible, but a closer look at the data does not confirm this scenario.

While the range of outcomes is wide, right now the data is mixed. We believe that the best course of action is to wait for a clearer course and trend to develop, which is what many of our tactical models are pointing towards. If one factor will determine the market's direction, it will likely be the U.S./China trade war. If we see even a modest resolution or pause in tensions, a strong market rally is likely. Conversely, a further breakdown in talks could push the U.S. and global economy into negative growth.

Third quarter market activity was driven by the bond market, and particularly by U.S. Treasuries. A more dovish turn by the European Central Bank, along with many other global central banks, boosted foreign demand for U.S. Treasuries. Combined with softening U.S. economic data, the effect on Treasuries was profound.

By mid-August, Treasury yields fell to levels only seen in 2016 in the aftermath of Brexit. Stocks underwent a modest 5-6% correction and have been moving within that range ever since. Our tactical fixed income models favored Treasuries during July and August but as September began, markets underwent dramatic internal changes while the overall price index hardly moved.

For much of 2019, and for almost all of the last few years, the market rewarded growth stocks and interest rate sensitive stocks such as large-cap growth, Technology, Utilities, Consumer Staples, and high-quality balance sheets. The consistent underperformers have been value stocks, small-caps, Financials, and Energy. However, the fear in the bond market reached a peak by late August, and it turned out that all of the bad economic news was priced into bonds.

Bond yields surged, and interest rate sensitive stocks and growth stocks were slammed in early September. There was considerable damage done to these names, but the market indexes were flat because the prior losers showed huge gains.

Small-caps, Financials and value stocks were winners across the globe. The gap between value and growth/momentum stocks experienced a 4-5 standard deviation movement within a week. Our U.S. equity style and factor models have shifted

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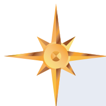

slightly towards more risk-on value and small-cap stocks, but more than anything, these models signal that a neutral position is merited here. The long-awaited shift towards value stocks and away from growth is simply not established enough to make a large portfolio bet on it.

U.S. Equity—Cracks in Growth and Momentum

The U.S. equity portion of the Multi-Strategy 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 broad-based portfolio that attempts to outperform the Russell 3000.

The portfolio focused on growth stocks and minimum volatility stocks through most of the quarter, but our position favoring large-cap growth in particular began to fade even before September's momentum crash. Technology and particularly internet stocks have lost their leadership, and growth stocks have failed to make new relative highs.

After the crack in growth and momentum, we sold our positions in large-cap growth (SPYG) and momentum (MTUM) and replaced them with large-cap value (SPYV) and small-cap value (IJS). However, we also added to our core neutral position in the S&P 500 itself; our benchmark ranks very high in our ETF rankings, and that is an indication of a trendless, often defensive market.

While we hope that value stocks will soon have their day, we are unwilling to allocate them en masse until we see a more well-established trend in their favor. In particular, we are looking for a series of higher lows in their relative strength.

The following were other developments in the portfolio during the quarter:

- For the quarter, large-cap value (SPYV) gained 2.8%, while large-cap growth (SPYG) rose by 0.8%. small-cap value (IJS) was up 1.5%, while small-cap growth (IJT) declined 2.0%. Momentum (MTUM) was a laggard and gained only 0.9%, while minimum volatility (USMV) was the clear winner with a 4.3% gain. High beta (SPHB) declined 2.0% and the S&P 500 (IVV) was up 1.7%.
- Among all of the stock selection strategies highlighted by Ned Davis Research, the most effective in the third quarter was short-term mean reversion, but it was closely followed by long-term relative strength. Thus, prior long-term winners were served well, but amidst a volatile, news-driven environment. One major change was that long-term EPS growth and sales growth were not rewarded and underperformed; the relative weakness in internet stocks is reflective of that change.
- Currently, our models favor value modestly over growth, and large-caps over small. The S&P 500 itself continues to rank very highly, and thus it gets a large allocation until a major trend takes hold. The shift towards value stocks was in and of itself bullish, as market breadth has improved, and gains are not as concentrated in the mega-cap growth names.
- The top contributors to the portfolio during the quarter were the iShares S&P 500 ETF (IVV) and the SPDR S&P 500 Growth ETF (SPYG). The top detractors were the iShares Edge MSCI USA Momentum ETF (MTUM) and the SPDR S&P 500 Value ETF (SPYV).

Fixed Income—High Yield Bonds See Renewed Price Strength

The fixed income portion of the Multi-Strategy portfolios engages in segment rotation within fixed income, owning high yield bonds, Treasuries, or cash, whichever our model determines has recent relative trends in its favor.

The fixed income slice of Multi-Strategy owned U.S Treasuries during July and August, which performed well, as fears of a global economic slowdown and never-ending trade war turned the tone of markets defensive. As September began, interest rates spiked and optimism returned to equities, and in particular, small-cap and value stocks enjoyed strong gains. High yield bonds saw renewed price strength, and spreads quickly came in near recent lows.

As a result, we purchased back into high yield bonds on September 13th and we held them until the end of the quarter. The move was precipitated more by U.S. Treasury relative weakness and what appeared to be an explosive blow-off in Treasury yields than any surge in high yield bonds.

While we owned Treasuries during July and August, they again served as a defensive anchor for the portfolio during market uncertainty. They produced solid gains through the end of August before losing some ground in September. We are always mindful that providing a smoother, risk-adjusted ride through the credit markets is the portfolio's primary mission, and we will not hesitate to turn towards Treasuries and risk-off again if credit market confidence and economic data show a trend of weaker confidence.

- The portfolio maintained a duration of over 7 years while in Treasuries, a number that is a bit larger than during past defensive stances. The larger duration was helpful during August as investors surged

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in Treasuries after seeing disappointing economic data. When re-entering high yield bonds, we established slightly larger positions in two High Yield ETFs, Bloomberg Barclays Short-Term High Yield Bond SPDR (SJNK) and X-Trackers US Corporate High Yield Bond (HYLB). Both offer attractive expense ratio and liquidity profiles.

- Over 50% of the U.S. Investment Grade corporate market is now rated BBB, with the next downgrade moving them into the High Yield category. With low interest rates, this is not an immediate cause for concern. However, the next time that we see a recession or major credit downgrade cycle, the price pressure on lower quality investment grade and high yield credit could be huge and provide opportunities to play defense and become a tactical buyer as sentiment turns.
- On the quarter, the top performing holdings were the Navigator Tactical Fixed Income Fund (NTBIX) and the SPDR Long-Term Treasury ETF (SPTL). Detractors included the PIMCO 0-5 Year High Yield Bond ETF (HYS) and the Blackrock High Yield Bond Fund (BRHYX).

Outlook

Looking forward, the range of potential market outcomes over the next 6 to 24 months looks to be at its widest since this bull cycle began in 2009. It's worthwhile going through a long list of negative and positive market indicators.

Some negative data and/or concerns include:

- Uncertainty surrounding the U.S./China trade war
- Washington drama and impeachment talk
- The shape of the yield curve
- Strong U.S. dollar and defensive equity leadership
- Slowing global manufacturing
- The sudden market momentum crash in early September
- Consumer confidence falling off in the future

It's important to note that there are just as many if not more indicators that are bullish than bearish. Reasons to remain bullish include:

- Improved market breadth and an uptick in value stocks
- The advance/decline line making new highs
- Jobless claims remaining low and under control
- Leading Economic Indicators that continue to rise
- A strong U.S. consumer and services economy
- Massive central bank easing on a global level
- A strong U.S. housing market
- Compelling relative value for stocks (the S&P 500 dividend yield is well above the 10 year U.S. Treasury yield)
- Generally high levels of investor fear than investor optimism (which is contrarian and bullish)

We certainly are confronted today with an environment that is noisy, volatile, and muddled. However, it is important to keep in mind that the reason investing over the long-term succeeds owes to being compensated for being willing to ride out uncertainty and for taking on that risk.

Today we see many bullish indications regarding the economy, market breadth, credit markets, and relative valuations. Stock valuations are not in bubble territory, but investor fears and the public's concern regarding the economy are elevated, which contrarily is a positive sign because fear is often a temporary emotion that fades away.

So, despite growing headline concerns and some weak economic data, particularly in international markets, our reading of the evidence is that a bullish resolution to the current market stress is just as likely. However, we'd like to reassure investors that ever since the yield curve inverted earlier this year, we began to watch other recession and bear market indicators especially closely.

Among the more important ones are the unemployment rate, Initial Jobless Claims, the Leading Economic Indicators, and the strength of the U.S. consumer and U.S. services sector. So far, these indicators have held up well, but we continue to monitor them closely.

If major economic indicators take a turn for the worse, we will quickly move to take on a more defensive stance towards risk. Such are the perils, but also the opportunities, of investing very late in the economic cycle.

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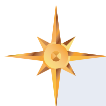

Ticker	Quarter Ending September 30, 2019	Average Weight (%)	Contribution to Return (%)
Top Contributors MultiStrategy 25-75			
NTBIX	Navigator Tactical Fixed Income Fund Class I	72.46	0.52
USMV	iShares Edge MSCI Min Vol USA ETF	5.61	0.23
SPYG	SPDR Portfolio S&P 500 Growth ETF	7.15	0.11

Ticker	Quarter Ending September 30, 2019	Average Weight (%)	Contribution to Return (%)
Top Detractors MultiStrategy 25-75			
SPYV	SPDR Portfolio S&P 500 Value ETF	0.81	-0.05
MTUM	iShares Edge MSCI USA Momentum Factor ETF	4.73	0.02
IJS	iShares S&P Small-Cap 600 Value ETF	0.18	-0.00

Ticker	Quarter Ending September 30, 2019	Average Weight (%)	Contribution to Return (%)
Top Contributors MultiStrategy 50-50			
USMV	iShares Edge MSCI Min Vol USA ETF	10.67	0.44
NTBIX	Navigator Tactical Fixed Income Fund Class I	47.25	0.35
SPYG	SPDR Portfolio S&P 500 Growth ETF	15.15	0.25

Ticker	Quarter Ending September 30, 2019	Average Weight (%)	Contribution to Return (%)
Top Detractors MultiStrategy 50-50			
SPYV	SPDR Portfolio S&P 500 Value ETF	1.76	-0.10
MTUM	iShares Edge MSCI USA Momentum Factor ETF	9.90	0.04
IJS	iShares S&P Small-Cap 600 Value ETF	0.42	0.00

Ticker	Quarter Ending September 30, 2019	Average Weight (%)	Contribution to Return (%)
Top Contributors MultiStrategy 75-25			
USMV	iShares Edge MSCI Min Vol USA ETF	16.15	0.68
SPYG	SPDR Portfolio S&P 500 Growth ETF	23.13	0.38
IVV	iShares Core S&P 500 ETF	13.90	0.31

Ticker	Quarter Ending September 30, 2019	Average Weight (%)	Contribution to Return (%)
Top Detractors MultiStrategy 75-25			
SPYV	SPDR Portfolio S&P 500 Value ETF	2.72	-0.15
MTUM	iShares Edge MSCI USA Momentum Factor ETF	15.02	0.07
IJS	iShares S&P Small-Cap 600 Value ETF	0.60	0.00

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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