ClarkCapital MANAGEMENT GROUP

Portfolio Commentary

Navigator® Small Cap Core U.S. Equity

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Navigate Your Future. Enjoy the Journey.

A Faster Gondola

Approximately every four years, I risk life and limb and agree to go skiing for our family vacation. Let's just say, I am not a good skier. While most would agree that I have reasonable athletic skills in some areas, anything more challenging than "BLUE GROOMED" is petrifying. But my wife likes it and my boys act like two puppies playing up and down the hill, running, jumping and nipping. The biggest noticeable change since my last experience, which left me beautifully bruised from hip to knee for three weeks, was a faster gondola.

Rising from the base of Mt. Warner, the floor-to-ceiling heated glass cube gently lifts eight passengers mid-mountain in just six minutes, or 50% faster than its predecessor. Apart from Thursday's record 17,000 skier day, the gondola line was a non-event, whisking passengers through the RFID readers and up the mountain. For those who ski frequently, or maybe for recent Disney visitors, the incorporation of RFID technology to track human access and location may not be a surprise, but for me I found it transformational.

Taken together, a faster gondola and RFID technology alters the skiing experience: it's safer – the mountain knows where each of its skiers are; it's more efficient – faster transportation means more ski runs/day; it's interactive – there's an app that gives you hosts of mountain data and can track your runs, calorie count etc.; and it's more inclusive – allowing skiers of more ability levels to warmly travel to differing parts of the mountain. Although I used to poo-poo inflation measures which adjusted for changes in technology – i.e. the new 20-megapixel camera if priced the same as the old 10-megapixel camera is deflationary, I must argue that today's skiing experience is truly "more for the money."

It's Called Technology, Bro

Much of the experience upgrade is rooted in technological improvements or the progression of the "internet of things." As you would guess, many technology companies are integrated together to change how skiing is enjoyed. For example, NXP Semiconductors (NXPI) provides solutions ranging from high power radio frequency integrated circuits for smart cards while Broadcom (AVGO) manufactures semiconductors for NFC enabled devices like our phones. Microsoft (MSFT), in turn, provides Cloud Services for all the data and Apple (AAPL) iPhones hosts the app.

Of course, these improvements have not gone unnoticed by the equity markets. Not only are Apple and Microsoft the world's largest companies by capitalization, but their outsized performance gains have driven broad market, large-cap growth and technology index returns and valuations. Since 2016, the S&P 600 Small Cap's 26.5% return has been dwarfed by the Russell 3000's 49.7% gain, the Russell 1000 Growth's 73.7% advance and the S&P 500 Informational Technology surge of 106%.

Although earnings gains among these indices have been strong, stock performance has significantly altered the relative valuations. The P/E ratio for the Russell 3000

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has adjusted up from 22.1 to 23.0, the Russell 1000 Growth has grown from 22.1 to 29.0, the S&P 500 Info Tech has advanced from 20.7 to 26.7 – all while the S&P 600 Small Cap index P/E ratio has DECLINED from 28.2 to 25.8. Additionally, the changing weight of the Technology sector within indices is now beginning to have a significant impact on risk management and diversification. Now up from 16.1% in 2016 to a 22.4% weight now, Technology's dominance in the Russell 3000 tests our desire to limit overall portfolio risk versus tracking error.

Shred the Gnar

Despite the difficult political terrain of impeachment and trade wars clouding the economic environment, many global equity prices "shred the gnar", navigating to new highs with exceptional speed. Full employment, low inflation, accommodative central banks, anticipated strong economic and earnings growth and a year-end reconciliation of trade with China, Canada and Mexico have all conspired to lift investor confidence, CEO optimism and consumer sentiment. While most of our valuation metrics are at high levels – but not at "obscene levels" – and credit conditions remain accommodating, I am not highly concerned about an immediately forthcoming recession or bear market. However, this does not feel like the early innings of an investing cycle.

Late inning metrics such as the overall level of Non-financial Corporation Debt levels relative to GDP, overall high nominal valuation levels and the length of this economic recovery, gives me respectful skepticism about returns over the next 10 years. With a starting Russell 3000 Forward P/E ratio of 21, I believe long-term returns to more closely mimic typical cycle returns and thus should be significantly less than the Russell 1000 Growth's 3-year returns noted above.

Additionally, I would not be surprised to see a greater frequency of 10%, 15%, and 20% downdrafts versus the relative stability over the past 10 years. With 10-year U.S. Treasuries yields at just 1.92% or approximately equal to the dividend yields offered by U.S. and international stocks, I think stocks should remain an important part of investor long term portfolio – albeit with a lower expected return than that recently experienced.

Small Cap Rallies with Russell 2000

For the 12 months ending December 31, 2019, the Navigator® Small Cap Core U.S. Equity strategy delivered gains of 26.51% gross (22.84% net) versus 25.52% gains for the Russell 2000. For the fourth quarter of 2019, the strategy had a gain of 9.26% gross (8.47% net) vs a 9.94% gain for the Russell 2000 Index. Positioning in real estate and financials helped relative performance while positioning in Healthcare and Industrials sectors acted as a drag.

Our higher quality holdings such as Newmark Group Inc. and RH helped performance in the quarter as positions in Taylor Morrison Home Corporation and Herman Miller, Inc. hurt performance. The value characteristics of the strategy remain compelling. Its current P/E of 16.1 is far less than that of the S&P Small Cap (23.6) and Russell 2000 with favorable quality characteristics.

Ticker	Quarter Ending December 31, 2019	Average Weight (%)	Contribution to Return (%)
Top 5 Contributors			
NMRK	Newmark Group, Inc. Class A	2.46	1.04
RH	RH	3.11	0.78
ATKR	Atkore International Group Inc.	2.17	0.68
AEL	American Equity Investment Life Holding Company	2.17	0.51
CRMT	America's Car-Mart, Inc.	2.57	0.46
Top 5 Detractors			
TMHC	Taylor Morrison Home Corporation	2.63	-0.43
MLHR	Herman Miller, Inc.	2.91	-0.22
EVR	Evercore Inc Class A	0.63	-0.17
CVI	CVR Energy, Inc.	0.36	-0.12
CPK	Chesapeake Utilities Corporation	0.64	-0.12

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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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.

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 S&P SmallCap 600 seeks to measure the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable.

Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

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..

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