Portfolio Commentary

Navigator® Small Cap Core U.S. Equity

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Navigate Your Future. Enjoy the Journey.

Weecovery

Like many of us, quarantine, social distancing and a lack of TV sports programming have adjusted my daily pre-bedtime tv hour to Netflix. After finishing Tiger King, we moved on to the Scottish romance—Outlander. If you are unfamiliar, think of a mix of the Hallmark Channel and Game of Thrones set primarily in Scotland in the mid-1700s. Now finishing the 3rd and final season, the depth of my Scottish vocabulary is now rivaling my Yiddish. Applying this new language set to the ongoing economic recovery, one which is demonstrating fits and starts paralleling the stalls and re-openings of COVID-19 harmed hotspots, I think it is appropriate to classify the small economic rebound as a W shaped "Weecovery."

As foreshadowed last quarter, quick and forceful countercyclical fiscal ($2.3T Cares Act) and monetary measures (13 new Special Purchase Vehicles and a $2T expansion in the Fed's balance sheet) have lifted equity prices and reversed some of the recessionary effects of the COVID-19 shutdown. In response, there was a sharp decline in the unemployment rate from 14.7% in April to 11.1% in June and Purchasing Manager Indices jumped to over 50%. With the anticipation of further economic gains to come, broad stock indices recorded large gains between 16-24% during the quarter. While all indices gained during the quarter, large-cap growth indices again outperformed, further stretching their spread to large-cap value and small-caps since December of 2016. From January 1, 2017 to July 8th 2020, the Russell Large Cap Growth Index has doubled while Large Value and Small Caps have each gained just 10%.

Two or 2000?

Persistent nominal and relative gains in large-cap growth stocks vis-a-vis all other stocks noted above has complicated stock selection and risk management. As the advance stretches over 3.5 years, extreme valuations of large-cap growth stocks have spilled into both index valuation and concentration. Since growth stocks have a larger portion of their cash flows further in the future than cyclical or value stocks, their higher bond duration benefits from both low and falling interest rates. Together with intrinsically high free cash flow margins, big grower trailing P/Es have been bid-up to 110 and forward P/Es to 71. The relative trailing big grower P/E of 110 is a record 4.5 times greater than the market (excluding periods of negative earnings). Additionally, the relative free cash flow yield at -3.25% is also higher than the prior peaks in growth outperformance seen during the tech-led Go-Go run of the 1960s, the Nifty-Fifty of the 1970s or of the New Economy of the late 1990s. Concentration in the five "near-monopolies", Microsoft, Apple, Amazon, Google and Facebook, are now over 18% of the market's total capitalization. As of the beginning of the third quarter, the two largest companies, Microsoft and Apple, had a combined 10% weight that became larger than the total weight of the Russell 2000 within the Russell 3000 index. From a risk management/volatility perspective, it is now becoming more difficult to mathematically justify increasing the portfolio weight of just two companies versus a diversified bucket of 2000 companies.

Past performance is not indicative of future results.
This is not a recommendation to buy or sell a particular security. Please see attached disclosures.

Vaccine!

In early July, U.S. COVID-19 infections accelerated from the springtime curve, flattening to surpass three million total cases. As the shape of the new infection rate curve first accelerated, then flattened and then accelerated again, a corresponding outperformance in growth vs. value occurred. An accelerating infections curve or second wave limits business and school openings, helping the non-cyclical, or growth, cohort, while prospects of a slowing new infection rate or vaccine progress has helped cyclical, or value, stocks. Growth is also the relative beneficiary of political wrangling over a near term fiscal stimulus package to bridge the cliff of the July-ending unemployment insurance surplus.

Can Value catch a break or are social distancing, work-from-home, online learning, low interest rates, recession and low tax rates permanent? In each of our equity strategies we have attempted to have a balance of companies which a) are currently benefitting from the stay-at-home environment and b) have the balance sheets and business models to survive the current recession and thrive in the recovery.

Technology is a large sector holding in each of our strategies overall, but is often smaller than its respective weight in many of our benchmarks. Thus far over 100 biotech and pharmaceutical companies are working diligently to find a vaccine for COVID-19. Unfortunately, scientific testing and regulations take time, so a safe cure is not on the immediate horizon. While we always prefer our value and quality bias to pay immediate relative performance dividends, I believe it would be irresponsible and risky to bet against scientific progress by transitioning our entire portfolios to an undiversified portfolio of high momentum technology stocks.

Small Cap Rallies with Value and Quality

For the past five years ending June 2020, the Navigator® Small Cap Core U.S. Equity strategy delivered annualized gains of 2.16% gross (-0.86% net) vs. 4.29% gains for the Russell 2000. For the second quarter of 2020, the strategy had a gain of 21.63% gross (20.77% net) vs. a 25.42% gain for the Russell 2000 Index. Positioning in Financials and Consumer Discretionary helped the relative performance while positioning in Healthcare and Industrials sectors acted as a drag. Our higher quality holdings such as PennyMac Financial Services and Williams-Sonoma helped performance in the quarter as positions in Walker & Dunlop and AMN Healthcare Services hurt performance. The value characteristics of the strategy remain compelling. Its current P/E of 15.7 is far less than that of the S&P Small Cap(34.4) and Russell 2000 with favorable quality characteristics.

Ticker	Quarter Ending June 30, 2020	Average Weight (%)	Contribution to Return (%)
Top 5 Contributors			
PFSI	PennyMac Financial Services, Inc.	2.88	1.96
WSM	Williams-Sonoma, Inc.	2.52	1.80
LCII	LCI Industries	2.33	1.36
TMHC	Taylor Morrison Home Corporation	2.08	1.25
SNX	SYNNEX Corporation	2.21	1.22
Top 5 Detractors			
WD	Walker & Dunlop, Inc.	0.07	-0.76
AMN	AMN Healthcare Services, Inc.	1.79	-0.70
CASH	Meta Financial Group, Inc.	0.59	-0.57
SSB	South State Corporation	1.27	-0.35
JCOM	J2 Global, Inc.	1.82	-0.34

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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Returns are presented gross and net of investment advisory fees and include the reinvestment of all income.

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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 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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