Portfolio Commentary

Navigator® SMID Cap Core U.S. Equity

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The News Diet

With everything going on in today's world, the 24-hour news cycle can feel relentless and overwhelming—especially as we move closer to the upcoming election. I recently watched the Netflix documentary "The Social Dilemma," which highlights a lot of these same feelings.

After talking about this with my partner Maira Thompson, we agreed that maybe taking a break from the noise wouldn't be such a bad idea. For this quarter's commentary, I am doubling down on my efforts to focus exclusively on the data, and not the noise.

Fortunately, our investment approach, which is a disciplined application of a quantitative investment process, helps keep our focus on the proper investing criteria and not get distracted by the noise. Right on cue, the U.S. Economy has followed the same V-shaped recovery as the stock market – just two months behind. The stock market began its advance during the extraordinary two-month lockdown recession from March to April, which saw payrolls decline by 22 million and the unemployment rate soar from 3.5% to 15.1%.

Through September, nearly half of jobs lost have been recovered and the unemployment rate has fallen to 7.8%. Clearly, the economy is not yet back to pre-pandemic levels and human and economic hardship, especially among the most vulnerable, is high. The economy's improvement in backward looking data like the Atlanta Fed's GDPNow tracking model shows Q3 real GDP up over 30%. More anticipatory or coincident data like mobility, airlines miles traveled, OpenTable reservations and the ISM Non-Manufacturing Index (NMI), which rose in September to 57.8, shows expansion for the fourth month in a row. All of these statistics corroborate the V-shape advance.

The Path Forward

As noted above, near-term earnings and economic growth for many parts of the economy appear on firm footing. S&P 500 Q3 earnings exceeded estimates at a record pace and service industries in which workers can stay-at-home or manufacturers who can undertake health protocol adjustments are doing quite well. Conversely, air travel, hotels, restaurants, in-person education and socially dense leisure and entertainment activities continue to suffer as the persistence of the 7-day average of new COVID cases and the lack of a COVID vaccine limits re-opening.

Some portion of the improvement in economic activity can be attributed to the CARES Act's federal stimulus payments, expanded unemployment benefits and the Fed's use of emergency lending tools to support credit markets. In lieu of a generally available vaccine, we believe that a continued successful path forward will require additional government support as the expiration of PPP loans may push temporary layoffs to permanent ones and cause consumer demand to sputter as supplemental unemployment insurance benefits expire. Unfortunately, political wrangling has delayed the passing of an COVID support package.

To Lend, but Not Spend

The biggest recent cheerleader for additional fiscal stimulus has been Fed Chairman Jerome Powell. Committed to using his emergency lending powers to support credit markets until maximum employment is reestablished, it appears as though monetary policy will remain accommodative, keeping short-term interest rates near zero till 2023. Powell has repeatedly emphasized that the Fed has the limited power to lend, but not the power to spend. This authority to spend rests with Congress. Essentially, the Fed is eager to buy (lend) what the Treasury sells (to fund government stimulus), but it cannot make direct expenditures.

Prior to the pandemic, the Fed followed its dual mandate of full employment and target inflation of 2% by providing an upward bound. Breaking the upper bound was introduced by prior Fed Chair Janet Yellen, as she discussed the concept of hysteresis or letting the economy "run hot". Last month, Chairman Powell added flexibility to this objective by "seeking to achieve inflation that averages 2% over time, and therefore judges that, following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time." Taken in sum, clear Fed guidance, depressed inventories, low long-term interest rates, strong ISM Export Activity and residential housing construction on the verge of exploding, should keep a fragile, bifurcated economy moving higher into Q4 and the beginning of 2021.

SMID Remains Steady in Third Quarter

Navigator® SMID Cap is positioned approximately 63.3% in small-cap stocks with the balance in mid-cap stocks and cash. Industrials are now the largest sector weight in the portfolio as economic conditions continue to improve. Consumer Discretionary, Technology, Healthcare, and Financials represent our next largest sector weights, each greater than 13%.

Our Technology position increased during the month with the addition of analytics company Verint. We removed Holly Corp as carbon-based energy conditions continue to deteriorate. We replaced our more defensive Healthcare holdings Encompass and United Therapeutics with HMS Holdings to upgrade relative out-year earnings growth prospects. The portfolio's quality characteristics, as measured by earnings variability and gross and net margins, have now tilted towards a barbell of what we believe are high quality, high margin and high yielding companies. We believe that the strong antifragility characteristics score of its holdings will help keep portfolio volatility low.

For the five years ending September 2020, the Navigator® SMID Cap Core U.S. Equity strategy delivered annualized gains of 4.49% gross (1.41% net) vs. 8.97% annualized gains for the Russell 2500 Index. In the third quarter of 2020, the Navigator® SMID strategy had a gain of 5.52% gross (4.74% net) vs. a 5.88% gain in the Russell 2500 Index.

Positioning in Financials and Real Estate helped relative performance while positioning in Consumer Discretionary and Consumer Staples hurt performance. Our holdings in PennyMac Financial and Ensign Group helped performance during the quarter while positions in Sprouts Farmers Market and Atkore International hurt performance. The value characteristics of the SMID Cap strategy remain compelling. Its current P/E of 16.6 is less than that of the S&P Mid Cap (25.5) or S&P Small Cap (35.5) indices with similar quality and business growth characteristics.

Ticker	Quarter Ending September 30, 2020	Average Weight (%)	Contribution to Return (%)
Top 5 Contributors			
CRL	Charles River Laboratories International, Inc.	2.79	0.72
PFSI	PennyMac Financial Services, Inc.	2.11	0.71
EBS	Emergent BioSolutions Inc.	2.36	0.71
ENSG	Ensign Group, Inc.	2.32	0.68
TMHC	Taylor Morrison Home Corporation	2.46	0.64
Top 5 Detractors			
SFM	Sprouts Farmers Markets, Inc.	2.17	-0.42
HFC	HollyFrontier Corporation	1.07	-0.33
POR	Portland General Electric Company	1.47	-0.33
ATKR	Atkore International Group Inc.	1.93	-0.33
HRC	Hill-Rom Holdings, Inc.	1.06	-0.31

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: Portfolio-Analytics@ccmg.com.

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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.

The Russell 2500 Index measures the performance of the small to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. The Russell 2500 is a subset of the Russell 3000® Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership.

The ISM Non-Manufacturing Index (NMI) is an economic index based on surveys of more than 400 non-manufacturing (or services) firms' purchasing and supply executives, within 60 sectors across the nation, by the Institute of Supply Management (ISM).

The S&P 500 is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States.

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