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November 1, 2017

Centre Funds Insight – Winter 2017/18 Market Review & Outlook – U.S. Equities

As we reflect upon the equity market environment over the past one year, we recognize that this stock bull market that began in 2009 continues to exhibit some unusual and conflicting characteristics relative to prior market cycles. There are five key observations that we deem as potentially problematic in allowing the bull market to continue but are not widely reported or discussed, even amongst professional investors and will concentrate our comments on these below.

Firstly, we have now seen an extended period of monetary accommodation by the Federal Reserve that has allowed a valuation multiple expansion period (2014-2016) to continue as profits have recovered in 2017. Namely, business and stock market cycles typically witness a period of valuation multiple expansion when the Federal Reserve is reducing interest rates and earnings have yet to recover from a slowdown or recession as they did starting in late 2014, and then essentially pass the market driver baton off to earnings growth in an attempt to move the stock market higher. Normally, as profits recover, valuation multiples then contract or de-rate in anticipation of a less accommodative Federal Reserve and the increasing demand for higher risk premiums as the profits cycle matures. Although stock prices can be pushed up by higher earnings or a rising price/earnings multiple, they normally do not occur simultaneously. Over the past one year however, not only have we seen profits recover but valuation multiples have moved higher, best illustrated by the price/earnings ratio, moving from 21x to 23x for the average S&P 500 Index company¹. The key issue to examine, at least in terms of the expected growth rate in future profits, in our view is whether the rebound in the price of oil and other commodities, which contributed to the overall earnings declines during 2015 and 2016, is a simple normalization or if there is a genuine broad-based recovery that will persist and give credibility to the continued valuation multiple expansion. Stock prices are reflecting the latter with an implied growth rate of earnings of 12.5% in perpetuity for the equal weighted S&P 500². Such a figure is normally associated with a broadly depressed earnings environment when the economy and profits are at a recessionary trough; not in the eighth year of economic expansion from the 2009 recession.

Secondly, as active bottom-up fundamental analysts, we're pleased to see that equity, sector, and style dispersion remains at cycle highs benefitting active stock selection and favoring a pragmatic, bottom-up approach such as ours over thematic ones. Historically, the divide of growth versus value styles has been dependent on the relative performance at the sector level, namely technology and consumer growth stocks vis-à-vis financials and energy stocks in terms of price returns, respectively. Whilst the technology and consumer sectors tend to be more heterogeneous historically than financials and energy, we've seen that dispersion expand across all sectors, allowing for differentiation of winners and losers in an overall economic and market environment that remains sub-par and is preventing all boats from rising.

Thirdly, one concern that we witness is the increase in passive investing dominance and how high frequency trading ("HFT") may be creating an illusion of liquidity in equity markets, thus far untested in down markets. With this shift favoring passive investing comes an increasing volume of "uninformed" and "price-only informed" versus fundamentally informed investors³. This is especially relevant given the current market environment, which we view as materially extended from a valuation perspective. Specifically, in analyzing prior market liquidity conditions during significant corrections and crashes, such as 1987 or 1929, what we observed was that trading volume increased exponentially as prices fell due to one main reason:

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uninformed investors as well as price-only informed investors concluded that falling prices indicated a conviction by informed investors that something unknown but terrible must be happening so, as prices fell, it led them to sell reactively and prices to fall even further. In 1987 it was in the form of portfolio insurance programs, which only represented approximately 0.3% of equity investment funds that contributed to this accelerating liquidity in a down market and a similar story can be told about the 1929 crash, the only difference was that portfolio insurance hedging replaced stop-loss orders.

Over the past decade, there has been unprecedented growth in passive and systematic strategies, each of which in many cases rely on momentum and asset volatility to determine the level of risk taking (e.g., volatility targeting, risk parity, trend following, option replication hedging, etc.). An emerging market correction of even modest amounts could prompt these strategies to programmatically sell into weakness. Also, in exchange market making, there has been a shift from human market makers, who are slower and deliberate, to programmatic liquidity that is faster and relies on volatility-based value-at-risk models to quickly adjust the amount of risk taking. This trend strengthens momentum, in up and down markets, and reduces day-to-day volatility but increases the risk of major market disruptions such as the smaller ones we've witnessed already in May 2010, October 2014, August 2015, and January 2016. We fear that the next disruption will not bounce back as quickly now that the Federal Reserve seems to be moving away from its accommodative policies.

Fourthly, the prior vigilantism of the debt markets seems to have ceased to function due to unprecedented Central Bank activity and has impacted equity valuations as well. The best example being the fact that European High Yield Bond Indexes now have a lower yield than comparable maturity U.S. Treasury Bonds. Central Bank policies globally have distorted markets with many countries in Europe now having negative short-term interest rates, a phenomenon never seen in recorded history. Another indication of how potentially flawed the global markets have become is reflected in the way central banks across the world are now buying stocks; the Swiss National Bank and Bank of Japan most publicly. In addition, many risk models today are relying upon a correlation regime that is counting on bonds to offset equity risk given the trading relationships of the major asset classes over the past two decades. Prior to this current relationship and for most of this century, except during the Great Depression in the 1930's, stock and bond prices have moved together; again, unlike the inverse today and opposite of what's happening now. Thus, stocks and bonds did not provide a material offset to one another in the case of declining prices during most of the past century when excluding the current period. We expect at the turning point of monetary accommodation – which appears to have begun, this assumption of bonds being able to offset equity risk will most likely fail. Such failure would increase risk substantially for most balanced and multi-asset portfolios. In the next crisis therefore, bonds would likely not be able to offset equity losses (due to the current extraordinary low rates). Another risk miscalculation may be related to the use of volatility as the measure of portfolio risk. Currently, richly valued assets such as U.S. stocks have very low volatility, despite significant downside risk potential from a fundamental valuation perspective, and in our opinion nonsensically deemed lower risk by these models.

Lastly, we believe that the virtuous and essentially “cost-less” debt financed stock buybacks and government deficits over this current market cycle, that began in 2009, have sown the seeds of earnings manipulation and complacency, and, most importantly, witnessed the re-direction of cash flow usage away from productive assets. Furthermore, the evidence seems to support that corporations in the S&P 500 Index execute stock buybacks with an indifference to stock prices at best, or rather tied to price momentum at

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worst; evidenced by the fact that share repurchases virtually came to a halt broadly during the collapse in stock prices arising from the financial crisis in 2008 and 2009 as well as in the Energy and Materials sectors in 2015 and 2016.

Our quibble is not with companies who recognize that they must wisely contract and re-direct their cash flow usage of their business after, in hindsight, a too aggressive period of expansion. Our focus is that since 2014, aggregate stock buybacks for the S&P 500 have exceeded free cash flow with the shortfall, plus whatever growth capital expenditures were made, financed with new borrowings leaving the debt to asset ratio for the average S&P 500 company the highest in modern times. This seems to have been mainly an attempt to water down the impact of executive stock compensation plans and make per share metrics look better, rather than expand and create productive assets as well as research and development whose cash flow would service the debt in the future. Call us at Centre old fashioned, but we believe borrowings should be used to invest, not leverage buybacks. More to the point, it seems irreconcilable to us that the stock market should simultaneously have a current market cycle high implied long term growth rate, or value of future growth, when there is a unprecedented re-direction of cash flow usage away from productive assets that will support future growth.

Each of the concerns we raise above were partially or fully applicable for the past two years, yet the U.S. stock market has recorded significant advances, particularly since the 2016 Presidential election and despite no major legislative accomplishments or prospects for tangible tax reform or infrastructure spending that would alter the negative demographic impact to growth or alter the continuing productivity slide. In addition, the normal logic generally is that market corrections or bear markets are caused by the discounting of imminent recession, which in the post-war era has been triggered by monetary tightening by the Federal Reserve as a means to fight inflation in the latter part of the business cycle. In the absence of inflation it seems unlikely that the Fed will kill this current expansion and, as they say, economic expansions don't die of old age. All of this being said, to us the following are key risks to consider: a rise in U.S. interest rates ("pain" from debt burdens may be felt from much, much lower peak of rates) or a major debt event impacting all time low risk premiums (debt-ceiling crisis, default by major borrower); a political or accounting-driven event that triggers a re-pricing of risk akin to 2002 with Enron and WorldCom; or a stock market correction/crash that contributes to recession reversing "normal" order of events. It is the last of these risks that gives us the most concern as it's outside of the current orthodoxy of thinking and reflects the era of financialization of nearly every aspect of the U.S. economy. This is exacerbated by the fact that the excess of this cycle seems to be in stock buybacks that have no future utility whatsoever to contribute to economic growth or future debt service.

In light of these conditions, with risks creating what we deem to be a potentially dangerous backdrop for not only capital growth but capital preservation, we continue to emphasize a barbell of secular growth stocks with contrarian, opportunistic cyclical growth companies. In addition, we continue to employ tail-hedges on the Fund's underlying stock portfolio with deep out of the money protective put options as well as deep out of the money single stock covered call selling. So, despite our bottom-up optimism for the companies owned currently by the Fund, we remain less enthusiastic about the prospects for capital gains in U.S. stocks as a whole than we have been in the past. Also, with capital protection from traditional diversification ebbing, we believe that our pragmatic large capitalization valuation sensitive growth and concentrated, high-conviction approach to stock selection, with a cognizance of risk management that

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includes tactically implementing capital protective investments, seems positioned to perform well relative to less risk aware strategies.

James A. Abate, MBA, CFA, CPA

Fund Manager – Centre American Select Equity Fund
Managing Director & Chief Investment Officer
Centre Asset Management, LLC



James A. Abate, MBA, CPA, CFA, is the Chief Investment Officer of Centre Asset Management, LLC, and the portfolio manager of the firm's American Select Equity Strategy. He also serves as the firm's Managing Director and as the President and Trustee of the Centre Funds. Prior to founding Centre Asset Management, LLC, Mr. Abate was U.S. Investment Director, North America, for GAM. Prior to GAM, Mr. Abate served as Managing Director & Fund Manager/Head of U.S. Active Equity at Credit Suisse Asset Management responsible for its U.S. Select Equity Strategy and stable of Global Sector Funds. While at GAM and Credit Suisse, Mr. Abate achieved Standard & Poor's Funds Research AAA rating, has received numerous "Category King" mentions in The Wall Street Journal, as well as multiyear Investment Week award nominations. Prior to transitioning to asset management, he was a Manager in Price Waterhouse's Valuation/Corporate Finance Group and served as a commissioned officer in the U.S. Army and Reserves, achieving the rank of Captain. Mr. Abate holds a B.S. in accounting from Fairleigh Dickinson University and an MBA in finance from St. John's University, and formerly was a Visiting Professor in the graduate program at the Zicklin School of Business, Baruch College. Mr. Abate is a contributing author to several John Wiley published books: Applied Equity Valuation, Focus on Value, Short Selling and The Theory and Practice of Investment Management; his article writings have appeared in The Journal of Portfolio Management, Investment Week, FT Investment Adviser, The Wall Street Journal, Mergers & Acquisitions and other various publications; and other writings — with Professor J. Grant, Ph.D. — on EVA, or economic value added approach to security analysis have been adopted by the CFA Institute candidate study programs. Mr. Abate is a former member of the editorial advisory board of The Journal of Portfolio Management.

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About The Fund

The Fund is a U.S. large capitalization valuation sensitive growth stock fund that seeks long-term growth of capital and is focused on risk adjusted returns through active and pragmatic management; the Fund may complement its equity securities with hedges and other capital preservation strategies when deemed appropriate. The Fund is intended to be a risk managed core growth fund.

The process used by Centre Asset Management, LLC (“Centre” or “we” or the “Adviser”) to manage the Fund focuses on each individual portfolio company's growth outlook and capacity to create shareholder value by utilizing our bottom-up fundamental stock selection process. We utilize a disciplined, Economic Value Added (EVA) framework to select investments. The framework focuses on the fundamentals of wealth creation or wealth destruction similar to the way a traditional, long-term focused corporate financier looking at all aspects of the business would assess a company's value. In the shorter-term, markets may often undervalue or overvalue a company's ability to create or destroy wealth. The framework seeks to identify and capture these investment opportunities. The approach is designed to capture excess returns when a business is creating shareholder wealth and the market price of the stock converges toward our target price. Centre not only analyzes earnings but also strives to understand and link the capital allocation decisions being made today by each portfolio company and how they will lead to future earnings growth. In other words, we expect the companies in which the Fund invests in for they themselves to invest in productive assets of the business, organically and through opportunistic purchases which, in turn, should provide the foundation for future revenue and profits growth that should create shareholder value. Alternatively, if companies cannot invest in productive assets due to a cyclical downturn or existing excess capacity, we expect these companies to “wisely contract” through the restructuring of their assets and other resources to regain their footing for future shareholder value creation. The key is that we look at the company drivers that create true shareholder wealth: capital spending or alternative capital allocations such as acquisitions, stock buybacks, or dividends; company specific risk levels of a business to determine appropriate hurdle rates; and whether the company is generating operating returns on its underlying assets vis-à-vis the cost of capital. Wealth creation from growth or from wise-contraction – that’s how we believe companies create shareholder value.

To meet its objective as a risk managed growth fund, the Fund may complement its equity securities with hedges and other capital preservation strategies when deemed tactically appropriate. Specifically, and in accordance with the Fund’s investment policies, the Adviser may tactically employ hedges and other capital preservation strategies on up to 100 percent of the value of the Fund’s underlying securities positions when the Adviser’s assessment of market valuation indicates forward returns for the stock market, as a whole, are low relative to downside risk and the cost to upside potential from portfolio preservation tools is deemed reasonable in order to respond to adverse market, economic, political or other conditions. The Adviser may also tactically employ hedges to reduce volatility. For example, through the tactical use of put options, the Fund may allow for enhanced performance and more limited risk. Index put options are designed to hedge the Fund from significant market declines that may occur over short periods of time. The value of an index put option generally increases as the underlying securities in the Fund decrease in price and decreases as those securities increase in price. The Adviser may also seek to enhance returns by writing (selling) out of the money call options tailored with exercise prices generally above the current market prices of stocks held in the Fund. As the seller of the call option, the Fund receives cash (the premium) from the purchaser. The

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Adviser varies its hedging strategy and defensive positions across changing market cycles but has generally employed such strategies within the Fund since late 2014.

Definitions and References

1. Price/Earnings ratio is the ratio for valuing a company that measures its current share price relative to its per-share earnings. The price/earnings ratio is also sometimes known as the price multiple or earnings multiple.
2. S&P 500 is an index of 500 stocks seen as a leading indicator of U.S. equities and a reflection of the performance of the large cap universe, made up of companies selected by economists.
3. High frequency trading (HFT) is a program trading platform that uses powerful computers to transact a large number of orders at very fast speeds. It uses complex algorithms to analyze multiple markets and execute orders based on market conditions.
4. Economic Value Added (EVA) is an estimate of a firm's economic profit - the value created in excess of the required return of the company's investors (shareholders and debt holders). Quite simply, EVA is the profit earned by the firm less the cost of financing the firm's capital. The idea is that value is created when the return on the firm's economic capital employed is greater than the cost of that capital. EVA® is a registered service mark of EVA Dimensions LLC.
5. A hurdle rate is the minimum rate of return on a project or investment required by a manager or investor. The hurdle rate denotes appropriate compensation for the level of risk present; riskier projects generally have higher hurdle rates than those that are deemed to be less risky.
6. A covered call is an options strategy whereby an investor holds a long position in an asset and writes (sells) call options on that same asset in an attempt to generate increased income from the asset. This is often employed when an investor has a short-term neutral view on the asset and for this reason holds the asset long and simultaneously has a short position via the option to generate income from the option premium. A covered call is also known as a "buy-write".
7. ¹ Source: Centre Asset Management, as of September 30, 2017.
8. ² Source: Centre Asset Management, as of September 30, 2017.
9. ³ See Market Liquidity, Hedging, and Crashes, The American Economic Review, Vol. 80, No. 5, Gerard Genotte; Hayne Leyland.

Disclosures

Investors should consider the investment objectives, risks, charges and expenses of the Funds carefully before investing.

To obtain a prospectus containing this and other information, please call 1-855-298 4236 or download the file from www.centrefunds.com. Read the prospectus carefully before you invest.

There is no assurance that this investment philosophy will consistently lead to successful investing. An Investment in the Funds involves risk, including loss of principal. The Fund is subject to risks including undervalued securities risk, portfolio turnover risk (which may result in tax consequences), and political/economic risk. Funds focusing on a single sector may experience greater price volatility.

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Diversification does not eliminate the risk of experiencing investment losses.

The statements and opinions expressed are those of James A. Abate as of the date of this report. All information is historical and not indicative of future results and subject to change. Reader should not assume that an investment in the securities mentioned was or would be profitable in the future. This information is not a recommendation to buy or sell. Past performance does not guarantee future results.

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The content of this document is part of the Centre Funds annual report covering the twelve-month period ending September 30, 2017.

Top 10 Holdings – As of 9/30/2017

Alphabet, Inc. 6.2%
Apple, Inc. 6.1%
Microsoft Corp. 5.1%
Facebook, Inc. 5.1%
NVIDIA Corp. 4.1%
UnitedHealth Group, Inc. 3.7%
Amazon.com, Inc. 3.2%
Adobe Systems, Inc. 3.2%
Johnson & Johnson 3.0%
Exxon Mobil Corp. 2.7%

For current fund holdings, visit <http://www.centrefunds.com/holdings.php?cusip=261782106>.

DRX000758 Exp. 11/16/2019

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