Centre Funds

December 1, 2016

Centre Funds Insight – Winter 2016/17 Market Review & Outlook - American Equities

Judging solely by the U.S. stock market's performance since the election, it sure seems that America is Great Again! With a potential positive inflection in economic growth and company earnings, the indexes seem set to reach new highs as we head into 2017. There's one really big problem though – the stock market as a whole is in our opinion overvalued by about 30% and, after having driven valuations to their current extremes on the basis of ultra-low interest rates, the script has been replaced and it's now higher gross domestic product (GDP) growth that will enable valuations to be extended further, despite higher interest rates. Our investment principles and discipline remain intact post-election. With a high conviction on innovation-focused companies, supplemented by cyclical names that still have operating room to run, as well as a further de-emphasis on stable growth companies, we continue to employ capital-protective hedges and anticipate the path forward to be anything but smooth for investors.

As we move past the U.S. presidential election and attempt to reconcile our company and industry bottom-up research with our top-down view of prospective policy changes in taxes, regulation, and trade, we observe the following:

Aggregate bottom-up observations:

- We see profit margins (net income and, more importantly, EBITDA) for the average non-financial S&P 500 Index company begin to reverse the downtrend in place since late 2014 and start to inflect higher during the most recent quarter (positive);
- Despite continuing poor sales growth, low capital investment trends combined with the inflection of profit margins driven by cost-cutting have allowed return on invested capital (ROIC) to also inflect higher in the most recent quarter (positive);
- Despite the low capital investment trends in pace over the past few years, average debt to asset and debt to EBITDA ratios are alarmingly high as companies gorged themselves on stock buybacks, rather than productive assets, during the growth slowdown (negative);
- Admittedly getting caught flat footed since the election with a long-standing near nil weight in the financial sector, we struggle to see the capital requirements for the largest banks becoming significantly more accommodating. We thus maintain our skepticism that a slightly better return on asset environment due to a steepening yield curve and improved credit conditions will transform into a "leveraged" mid-teens return on equity to justify multiples well in excess of book value for the major money center banks (neutral); and
- Valuation levels for the stock market as a whole remain at extreme levels whether looking at implied long term growth rates of earnings, cash flow, etc., or more traditional multiples based on sales or EBITDA (strongly negative).

Top-down observations:

- The risk of recession in the U.S. has eased but the two year downtrend in cyclical growth has not yet reversed materially – we still expect GDP trend line growth rate of near 2% until we see an upward shift in productivity from its current dismally low levels;
- We see a high likelihood of Congressional actions on lower corporate tax rates and repatriation of overseas capital on favorable terms in the very near term providing a boost in available cash flow. However, we remain unconvinced that cash flow usage will materially shift away from stock buybacks and towards capital investment and research and development (R&D) until an investment tax credit or other incentives, e.g., import value-added tax (VAT)-type tax, are put in place;
- We see delays in getting a national infrastructure program in place and expect an eventual shift from a "national infrastructure bank" legislation to a regional model buildup akin to the twelve Federal Reserve Districts with Army Corps of Engineers' influence to "work around" environmental roadblocks; and
- The next "shock" event to stock markets will derive from events outside the U.S., most likely in the European banking or insurance sector, due to the continuation of the strengthening dollar and interest rate/economic growth and political risk differentials. It's important to remember that nearly half of the revenues for S&P 500 Index companies are derived outside the U.S.; domestic GDP does not equal the S&P.

At its core, the election of Donald Trump as the next President of the United States was a middle class revolt against 1) unfair trade practices in place, mainly allowing China to become a member of the World Trade Organization (WTO) in December 2001 and maintaining an artificially low exchange rate with the dollar resulting in an unprecedented transfer of industrialization and intellectual property; 2) illegal immigration; 3) Wall Street- and Washington-connected big business interests; and 4) a foreign policy under both parties that left the U.S. military in a state of costly, perpetual war with little to show for it and recognize that there is not enough money to build bridges abroad and rebuild at home.

From an economic perspective, the election potentially represents a shift from a low growth, low interest rate environment to a higher nominal growth, higher interest rate one. A simple extrapolation of the winners and losers since the election could dictate that a portfolio exposed to economically sensitive, low multiple and domestically focused stocks should continue to outperform yield oriented stocks and stable growers with high valuation multiples. In other words, after a two year period of having the raison d'etre for owning stocks be low interest rates and no other asset class providing an attractive alternative, there's a supposed game changing in that one needs to own stocks for growth and potential inflation hedging. To us, the matter might even be simpler; Trump needs to end the trade deficits that have bled thousands of factories and millions of manufacturing jobs. If he fails here, those slim majorities in Michigan, Pennsylvania and Wisconsin may disappear. The bottom line remains that it's more about the economy and less about the stock market.

When asked to summarize the Fund's portfolio positioning since early 2015, we've expressed it as follows:

- With fewer companies within our large capitalization investable universe being able to deliver sales growth and continuous incremental improvements in profit margins and returns on capital, we've embraced a preference towards a "New Nifty-Fifty" of companies, focused on innovation and stable growth due to brand power or competitive positioning. We felt that, with bond yields reaching lows, valuation multiples could expand even further and to levels only seen during prior rushes to these types of companies, e.g., 1998 for consumer stocks. As the profits recession lingered into 2016, the number of Fund positions was consistently whittled down to reflect this funnel narrowing of companies that could genuinely create shareholder wealth, reaching its nadir with the Fund holding only 43 positions a month back (below the target range of 45-75 securities); and
- With valuation and complacency levels at historic highs combined with an erosion of underlying fundamentals, we have believed that markets were susceptible to shocks or "risk-off" events and mini-corrections. Thus, the Fund has tactically employed capital protection strategies, including protective put options, to significantly limit downside market capture.

As could be appreciated, the "Trump trade" has been the polar opposite of our posture and, frankly, what has worked very well for us since early 2015. Namely, the S&P 500's financials component is up 12.0% since the election, galvanized by the prospects of deregulation, and the industrials (7.0%) and energy (5.0%) sectors have followed suit, each banking on infrastructure projects and Trump's desire to make the United States even more energy-independent. The robustness of the stock market is made more notable against the backdrop of a spike in bond yields that has eclipsed the early days of the 2013 taper tantrum, and the rejuvenated optimism about the profit outlook under Trump seems to be supplanting the negative impact from rising rates. The most important questions to answer now are: 1) whether there is indeed a sea change in the economic growth backdrop away from disinflation and low growth to a broadening influence, and 2) can the stock market as a whole transition smoothly from having been driven by lower interest rates and a perceived lowering of risk aversion that led to valuation multiple expansion to one now driven by improved growth in earnings that offsets a higher cost of capital?

Despite our fondness for trying to draw historical analogies to understand the current set of circumstances, we've cautioned that today's set of conditions in terms of demography and central bank interventions render such analysis of lesser use. That said, the profits recovery that began in 2002 after a period of significant mal-investment strikes us as somewhat helpful. The bottom line, however, is that broad stock market valuations were 30% lower than they are today and, despite evidence during 2002 of economic and profit expansion, the major stock market indexes endured a significant increase in volatility and drawdown back then prior to finally bottoming in early 2003. In other words, an inflection of economic growth positively did not directly translate to a favorable stock market environment due to lingering valuation and debt excesses. Furthermore, if someone with perfect hindsight today was willing to embrace an overweight on commodity- and industrial-related companies back then and just prior to the biggest boom in emerging markets' infrastructure build-out, the valuation levels were vastly lower; e.g., Caterpillar traded in 2002 at an enterprise value/EBITDA multiple of ~11x; today it trades at over 16x.

So, given the above and our intermediate-term expectations, what changes have we made in the Fund's positioning and what changes do we anticipate making as the Trump "hope" becomes Trump "reality"?

1. We have since the summer and will continue to trim and eliminate stock positions within the "stable growth" area of the market, namely consumer staples and healthcare. To us, the past summer months represented the euphoric top in these types of stocks. Our portfolio sales of General Mills, Phillip Morris, Nike, and other similar companies on valuation concerns seem prescient in hindsight and are likely to continue – as with the original Nifty-Fifty, our New Nifty-Fifty loses its luster in an environment of rising interest rates;
2. Our significant exposure to "innovation," namely Alphabet, Facebook, Amazon, etc. will likely remain intact but has been and likely continue to be supplemented with more cyclical technology companies such as KLAC Tencor, Corning, etc., as growth will broaden out due to tax-driven and investment stimulus;
3. After getting caught flat footed on the financial sector, we can see in the most recent quarter fundamental improvement in the domestically focused regional banks as a steeper yield curve ameliorates net interest rate margins and some alleviation of regulatory burdens will accrue to them. We expect to add to individual names on price pullbacks given the parabolic moves upward since the election. However, we continue to see little attractiveness in the "too big to fail" money center banks as we do not see a repeal of Dodd-Frank or the Volcker Rule as a political priority of a Trump administration given its populist orientation. Furthermore, as noted, we see a very high potential for a crisis to emanate in the non-U.S. financials sector and a likely high impact to these institutions due to their interconnectedness from counterparty exposures;
4. A strong dollar will be a significant headwind to resource companies, including energy, along with production increases benefitting workers in these industries but not shareholders;
5. Within traditional cyclical areas of the market, our current preference is towards consumer rather than industrials companies despite the purported benefits from Trump's planned infrastructure spend. In other words, we prefer to be "long" on the quality of employment and wages derived from an improved capital investment and infrastructure spending environment. Also, we've witnessed many companies in the consumer cyclical sector undertake far reaching and efficacious restructurings of their operations during the growth slowdown over the past two years, examples being Coach and Urban Outfitters, with ample room for margins to expand further and attractive valuations relative to history and the market; and
6. From a tactical perspective, we still believe that low volatility makes capital protection implementation worthwhile in the event that the 30% or so valuation excess we see today across the stock market is remedied sharply rather than through a catchup in earnings. Furthermore, an analysis of history indicates that earnings-driven environments tend to produce much lower and more volatile returns when compared with periods when valuation multiple expansion was driving stock market performance. More importantly, earnings driven periods are much more volatile and tend to have a higher frequency of negative returns and specifically periods of significant pullback (10% loss or more). On the margin, we'll look to tail hedging (using deeper out-of-the-money put options) to be cost efficient and recognize that, while remaining highly susceptible to a correction

with a high expected drawdown being associated historically with extremely high valuation levels as where we are today; reduced risk of recession most likely eliminates a drawn out bear market but makes a fall in a violent, concentrated manner more likely.

We believe that our large capitalization valuation sensitive growth approach to stock selection, with a cognizance of risk management that includes tactically implementing capital protective investments, remains positioned to perform well relative to less risk-aware strategies. I want to thank my fellow shareholders for their continued support and confidence in the Centre Funds.

James A. Abate, MBA, CFA, CPA

Fund Manager – Centre American Select Equity Fund

Managing Director & Chief Investment Officer

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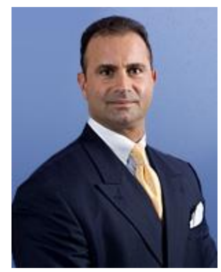

Definitions

1. EBITDA: Earnings before interest, taxes, depreciation and amortization. EBITDA is a profitability measure that removes the effects of financing and accounting decisions.
2. S&P 500 Index: Standard & Poor's composite index of 500 stocks, a widely recognized, unmanaged index of common stock prices.
3. ROIC: A financial ratio of after-tax net operating profit over invested capital.
4. Debt to EBITDA ratio: A ratio derived from dividing a company's debt by its EBITDA.
5. Yield curve: A curve on a graph in which the yield of fixed-interest securities is plotted against the length of time they have till maturity.
6. Return on equity: A financial ratio of net income over total equity.
7. Book value: The value of a security or asset as entered in a company's books.
8. Nifty Fifty: 50 popular large-cap stocks on the New York Stock Exchange in the 1960s and 1970s that were widely regarded as solid buy and hold growth stocks.
9. Dodd-Frank: A piece of financial reform legislation passed in 2010 that established new government agencies tasked with overseeing the financial and banking systems.
10. Volcker Rule: A federal regulation that prohibits banks from conducting certain investment activities with their own accounts, and limits their ownership of and relationship with hedge funds and private equity funds, also called covered funds.

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.

Diversification does not eliminate the risk of experiencing investment losses.

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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, 2016.

Top 10 Holdings – As of 9/30/2016 (subject to change)

Amazon 5.8%
Apple 5.3%
Microsoft 4.6%
Facebook 4.5%
General Electric 3.9%
Alphabet, Inc., Class A 3.6%
Alphabet, Inc., Class B 3.5%
PepsiCo 3.4%
NVIDIA 3.0%
S&P 500 Index Put Options 2.8%

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