May 14, 2018

Centre Funds Insight – Spring/Summer 2018 Market Review & Outlook – U.S. Equities

As investors move forward further into 2018, it is becoming clearer that the low volatility, highly optimistic tone that embodied U.S. stocks in 2017 has been disturbed and, in advance of such increased volatility and potential downside risks, we have positioned the portfolio accordingly. The most frequent argument we hear championed for a continuation of the positive momentum in the stock market is that revenue and profit growth for the vast majority of companies in the S&P 500 Index, as well as in aggregate, are expected to be the strongest since the economic recovery began in 2010. Unfortunately, in our view, economic and profit growth, whilst being the single biggest factor influencing stock prices over the long-term, have little to no correlation in the short and even intermediate term, as stock prices will be much more highly influenced by changes in interest rates and investors' re-pricing of risk. In other words, while understanding both secular and, even more importantly, cyclical trends as growth oriented investors, we believe that valuation is the single most critical element of successful investing year over year and over a three to five year "normal" investment cycle. The key is to find great companies when they present themselves as great stock investments. Unfortunately, the number of companies meeting both criteria to us is small and shrinking now.

The term "paradigm shift" is technically a valid way to describe material change but it has been so overused in the business world as to lose its efficacy in calling attention to matters. Regardless, we're at a loss for a substitute, with the change in course by the Federal Reserve to begin the process of normalizing short term interest rates and start reducing its vast holdings of Treasury Bonds and other assets while, simultaneously, the supply of new Treasury issuance explodes due to increasing budget deficits, bringing about the first challenge to the environment of ultra-accommodative monetary policy, liquidity, and suppressed low cost of capital that's been in place since 2009. While we do not expect interest rates to rise dramatically, especially on longer maturities, the rise in short term rates plus the prospect of additional increases in the Target Federal Funds Rate[1] in 2018 and 2019 will negatively impact stock valuations as the "risk-free" Treasury rate is the foundation of asset pricing for all levels of risk assets. Historically, rising interest rates are the kryptonite to long-dated, richly valued assets, namely stocks. One way to roughly estimate the impact that ultra-accommodative monetary policy and, in particular suppressed interest rates, have had is to isolate analysis to the Utilities Sector. The purpose of doing this is that it nearly eliminates the argumentative contrast that U.S. companies are more efficient, innovative and profitable now as demonstrated by secularly rising Returns on Assets (ROA) and Returns on Equity (ROE) for the S&P 500 Index in aggregate. Most utilities within the Sector, while admittedly better run than in the past, are regulated and subject to legislative caps on their ROE's as well as being capital intensive. Proving this point is the fact that, over the past twenty-five years, there has not been any material fundamental improvement in ROE's or ROA's for the Utilities Sector on an equal weighted basis, unlike the case for nearly all other Sectors of the S&P 500 Index. This being said, valuation multiples[2] that we emphasize for the Utilities Sector show the group being valued forty percent higher than its long term average, with all of the re-rating occurring since 2010. Applying this insight across the

[1] The federal funds rate is the rate at which depository institutions (banks) lend reserve balances to other banks on an overnight basis. Reserves are excess balances held at the Federal Reserve to maintain reserve requirements.

[2] Valuation multiples is a valuation theory based on the idea that similar assets sell at similar prices. This assumes that a ratio comparing value to some firm-specific variable (operating margins, cash flow, etc.) is the same across similar firms.

board means that stocks are up to forty percent overvalued simply from the suppressed level of interest rates in place since then but which are now seemingly moving higher and, perhaps, while not dramatically, will be significant amounts proportionally from the near zero levels enjoyed since 2010.

There have also been changes in stock-bond yield correlations, which have been largely positive since the late 1990's, increased significantly following the global financial crisis of 2008-2009, and have remained at a high level until very recently. This positive correlation is consistent with other episodes where there was an increase in uncertainty about the outlook for economic growth, such as the 1930s Depression. The recent period of positive stock-bond yield correlation has been in place for the past twenty years or so but, it's important to remember that this is abnormal and changes in U.S. monetary policy have historically driven correlations lower. Why the recent change in correlations from positive to negative is so critical now is that the traditional stock-bond mix of a balanced portfolio held assets that provided diversified returns with one directionally gaining and offsetting the loss on the other side and vice-versa. For the first time in many investment professionals' careers, the environment looks to be "back to the future" with potentially no place to hide other than cash amongst traditional asset classes (which has been largely abandoned in asset allocation due to the low level of short term interest rates), raising the value of hedges. The trading disruption from so-called "risk-parity" funds, which are nothing but an updated version of what used to be called tactical asset allocation funds, can be more dramatic now in an environment of increasing volatility and false sense of liquidity given the new phenomenon of smart-beta indexing, high frequency trading, artificial intelligence, and other so-called improvements to financial markets away from human fact based decision making and interaction and floor exchange based trading.

Looking at things optimistically, it is plausible to temper the negative impact from rising interest rates (from essentially zero) given the tremendous growth in earnings that began in 2017 which is expected to continue in 2018 and 2019. Aggregate S&P 500 Bottom Up ($/share) earnings estimates for calendar years 2019 and 2018 are expected to be $173.93 and $157.96, respectively, up from $132.00 in 2017 and $118.10 in 2016. This represents sequential growth rates of ten percent, twenty percent, and twelve percent, respectively[3], and highlights a definite change in the "secular stagnation" environment of 2014-2016. It is this rather positive outlook which underlies our belief that a long, drawn out bear market in anticipation of a recession remains a very low probability despite this economic recovery being one of the longest on record. Furthermore, many of the late cycle excesses in terms of over-aggressive asset growth – new plant and equipment, inventories, etc., are not evident now.

With rising interest rates in the minus column and increasing profits on the plus side, what tips our view to negative in this paradigm shift? In one word, it's risk. The mathematics in any valuation model, from basic to complex, captures a foundation risk-free interest rate, some measure of earnings or cash flow, a growth rate associated with such earnings or cash flow, plus a risk premium to represent compensation for risk, measured relative to the risk-free rate. Based upon our analysis, the equity risk premium has been extraordinarily low since the end of 2014 (and continued to fall), which explains why stocks rose in price in 2015 and 2016 despite the stagnation in aggregate S&P 500 ($/share) earnings and relative stability in interest rates. The compression of risk premiums has not been isolated to stocks but, in fact, has been more profoundly evident in bonds as overly cheap credit is best illustrated by the fact that European High Yield Bond Indexes, i.e., "junk bonds" [4], have a lower yield than comparable maturity U.S. Treasury Bonds. The most significant driver of this has been not only ultra-accommodative policies and liquidity

[3] Source: Thomson Reuters I/B/E/S

[4] A junk bond refers to high-yield or noninvestment-grade bonds. Junk bonds are fixed-income instruments that carry a credit rating of BB or lower by Standard & Poor's, or Ba or below by Moody's Investors Service. Junk bonds are so called because of their higher default risk in relation to investment-grade bonds.

supplied from the U.S. Federal Reserve but their counter-parts in the Eurozone, Japan, and China. From our proprietary analytical work, it is important to point out that risk premiums being low (as they are today) in themselves are not problematic as long as they are directionally trending even lower. Historically, market corrections occur when risk premium are low but the trend has turned to rising, recent example being years 2000 and 2008.

With the U.S. scaling back its monetary stimulus, the Eurozone under increasing pressure to not expand or extend its Quantitative Easing (QE) program, Japan's multi-pronged efforts to weaken the yen largely played out, and China's credit bubble reaching untenable levels, we see the suppression of risk premiums having run its course negatively impacting the valuation of all risky assets and, in particular, long duration assets most sensitive to changes in the required rate of return such as U.S. stocks. Aside from central bank policies, risk needs to be examined comprehensively and fundamentally, not just expressed in terms of stock market movements. Negatively, outside of the banking industry, the U.S. has not experienced a deleveraging since 2009 but has actually increased its risk from leverage, the difference being that it is now in the corporate and government sectors rather than the household sector. Furthermore, while it's been a positive that the use of such increased leverage in the corporate sector has not led to excessive industrial capacity and inventories, such debt financed cash sources have been used primarily in aggregate for stock buybacks. Thus, corporations have increased their risk from more leverage to purchase an asset that has no future utility in terms of generating revenue or cash flow to service such debt. From this perspective, risk has likely increased negatively impacting valuation multiples.

Consistent with his America First campaign pledges, President Trump has begun the process of trying to institute remedies that would offset the mercantilist export advantages and attacks on America's intellectual property that China has enjoyed since joining the World Trade Organization ("WTO") in 2001. The early stages of this relationship, cheap and plentiful consumer goods for U.S. consumers and the potential for democratic, pro-Western liberal reforms in China, was viewed as more than offsetting the costs of de-industrialization of America and potential loss of long-term competitive advantage. Furthermore, the "offshoring" [5] of America's prior inventory and excess capacity cycles to China diminished the traditional recession risks from excess capacity, which is why the recession in 2009 was largely a Wall Street phenomenon rather than a Main Street one.

Now after almost two decades of unprecedented trade imbalances and a rise in China's industrialization on a scale last seen by America in the mid- and late 19th century followed shortly thereafter by Bismarck's Germany (both at the expense of the United Kingdom), the age old argument of protective tariffs favoring local industry versus a progressive posture favoring consumers is front and center in American politics at a temperature level likely last seen during the turn of the 20th Century when Theodore Roosevelt was President. It's unimportant in terms of personal views on which side is right (our personal view is that despite China being a natural ally and partner of the U.S. for many reasons, this fight should have happened more than a dozen years ago within the mechanisms of the WTO but America still holds the one asset that no one else can match, access to the largest and richest consumption market in the World), the issue for corporations and stocks is that the net impact from this enormous change in politics and Sino-American trade relations will be a negative hit to profits margins (due to higher input and labor costs) and, within our paradigm shift proposal, an increase in risk, geopolitically as well as at the corporate level, negatively impacting valuation multiples.

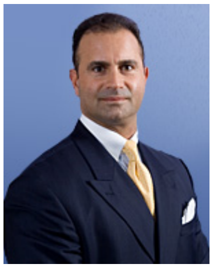
[5] Offshoring is the relocation of a business process from one country to another—typically an operational process, such as manufacturing, or supporting processes, such as accounting.

Although somewhat extraneous to the points raised above, the parabolic rise (and fall in 2018 thus far) in bitcoin and other crypto-currencies is somewhat useful in that it highlights how sudden a change in risk appetites can have on the price of a "so-called" asset. Having served as a fund manager of U.S. equity and technology-focused sector funds and navigated the rise in technology-related stocks in 1999 and their subsequent collapse in early 2000 ahead of the corrections in broader stock market indexes back then, it is tough not to similarly view the recent collapse of these crypto-currencies as the canary in the coal mine for other risky assets; crypto-currencies simply represent the most extreme point on the risk tolerance scale like dot-com stocks did back then.

In sum, we have a U.S. stock market trading at valuation multiples that are potentially up to forty percent above intrinsic value with the contributing factors that led to the re-rating higher, suppressed low interest rates and risk premiums, now reversing. On the other hand, profits are rising and certain Sectors, namely Energy, are displaying the best earnings growth in some time and, having underwent a severe rationalization due to the commodity price collapse in 2015-2016, is doing so more efficiently than in the past. We remain consistent in our belief that a bear market due to an oncoming recession is a low probability but an increase in sudden and sharp drawdowns, i.e., crashes, are more probable and likely to occur. Our biggest concern is rather unorthodox. What we mean is that unlike the normal sequence of events of the stock market being a leading forecast of the economy, the financialization[6] of the economy, best evidenced by the wholesale embracement of stock buybacks as the main usage of cash flows may lead to a reverse in sequence, whereby a stock market sell-off due to any number of reasons, is then compounded by the reliance upon low financial market volatility, which then leads to slowdown in corporate and consumer confidence that leads to slower economic growth, and becoming circular in impact to stock markets.

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

[6] Financialization refers to the increase in size and importance of a country's financial sector relative to its overall economy. Financialization has occurred as countries have shifted away from industrial capitalism. This impacts both the macroeconomy and the microeconomy by changing how financial markets are structured and operated and by influencing corporate behavior and economic policy.



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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.

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 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. 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.
2. 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.
3. 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.
4. 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.
5. 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".
6. Quantitative easing is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply.
7. A put option is an option contract giving the owner the right, but not the obligation, to sell a specified amount of an underlying security at a specified price within a specified time.

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.

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 semi-annual report covering the six-month period ending March 31, 2018.

Top 10 Holdings – As of 3/31/2018 (subject to change)
Apple, Inc. 6.2%
Microsoft Corp. 5.9%
Alphabet, Inc. 5.2%
Amazon.com, Inc. 4.9%
Facebook, Inc. 3.2%
UnitedHealth Group, Inc. 2.8%
NVIDIA Corp. 2.3%
ConocoPhillips 2.2%
Freeport-McMoRan, Inc. 2.2%
Western Digital Corp. 2.2%

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