November 21, 2019

Centre Funds Insight – Winter 2019/20 Market Review & Outlook – U.S. Equities

As the year progresses into the fall and winter seasons, the Fund's portfolio manager sees the likelihood increasing that the current industrial slowdown metastasizes into a recession, albeit a shallower one than that experienced from the fallout of the financial and residential real estate crisis of 2008. Thus far, the protracted slump in the manufacturing sectors of the economy has been largely contained and not spilled over into the consumer segments of the economy nor have we seen the strong employment conditions deteriorate which, based on history, are usually evident only in hindsight and highly subject to later revisions. Again, we see the demarcation between manufacturing and services beginning to erode and raise our concern level. Where we have reduced our expectations is for a full recovery, whereby the recent slump somehow is reversed allowing the economy to exit its current recessionary window of vulnerability and witness a recovery in the downward trend of profit margins and asset efficiency now seen for the average company in the S&P 500 Index. We've lowered this expectation likelihood as we have become less constructive on a meaningful trade "truce" being reached outside of the agricultural areas, see almost zero probability of any fiscal stimulus being implemented in the period up until the 2020 presidential election, and see a low likelihood of a meaningful capital spending cycle being renewed.

Assuming that the economy as a whole is able to contain the slowdown to the industrial areas with little or no spillover effects to the consumer segments, stock market indexes are likely to continue the sideways time correction that has been in effect since what we view as the speculative bull market high of January 2018. Furthermore, sector and industry leadership should remain in place for Telecommunications, Utilities, and software related Technology stocks. If, on the other hand, we see the protracted manufacturing slump lead corporations to enact layoffs and rescind existing budgeted capital spending initiatives, leadership in the stock market is likely to become even more narrow and defensive with Staples, Health Care, and precious metals stocks (on the basis of more aggressive monetary policy emerging). Lastly, if global growth inflects higher and the U.S. exits its recessionary window of vulnerability, leadership will likely shift towards traditional early cycle areas such as Technology hardware, Financials, and Industrials. We believe the Fund is positioned to perform in-line with benchmarks in the contained slowdown scenario, be geared positively on a relative basis if a broader recession emerges, and be somewhat laggardly on a relative basis if global growth inflects substantially higher.

One of the key arguments put forth in support of continued economic and stock market optimism is that the manufacturing sector is only 11.6 percent of U.S. economic output, according to the Bureau of Economic Analysis, and employs only 8.5 percent of the workforce, according to the Bureau of Labor Statistics. Hence, the service and consumer segments far outweigh the importance of manufacturing and can more than offset any slump in the industrial industries. However, factors that significantly move the economy may have a far lesser impact on equity market profits as approximately 65% of S&P 500 Index companies' profits are derived from manufacturing and goods-producing industries despite the lower GDP (Gross Domestic Product) impact and number of Americans who are employed by manufacturing and goods-producing industries. To underscore the point, the correlation of manufacturing sector surveys to S&P 500 profits have a much greater impact than Service Sector inputs. Unfortunately, the ISM Manufacturing PMI in the U.S. dropped to 47.8 in September 2019 from 49.1 in the previous month, missing market expectations, and the latest reading pointed to the steepest contraction in the manufacturing sector since June 2009. More importantly, the trend in the PMI Index is moving downward, unlike the situation in 2009.

Based on historical data, it's both the level and trend of the PMI Index that have a coincident relationship to S&P 500 Index profits, margins, and stock prices and, currently, all are indicated to be lower.* Furthermore, even some degree of trade détente will not alleviate the downward trend in the business cycle and profit margins, with risk of recession and the end of the business cycle an increased probability. The importance of a now persistent trend in profit margin deceleration has historically led to a curtailment in capital spending, inventory investment, and then finally to corporations announcing layoffs. This is why the slowdown in manufacturing is likely to have such an outsized impact to the overall economy. The fact that profit margins are decelerating from abnormally high levels is an additional concern as the magnitude of drop to historical trends is quite material.

Stock buybacks have been cheered this stock market cycle almost universally because they lower the supply of shares and, by reducing the number of outstanding shares, buybacks inflate per-share earnings, even when underlying profits stay the same. Buybacks last year hit a record in the U.S., reaching $806.4 billion for the S&P 500, besting the previous high point of $589.1 billion in 2007, according to S&P Dow Jones Indices. Lower interest rates have been a big catalyst for buybacks for years and more than half of all buybacks are now funded by debt.** As we've articulated at length in the past, borrowing money to buy back shares at the end of an economic cycle, when share prices are near record highs, is especially unwise. Furthermore, the evidence supports the fact 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 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. With corporate debt now higher than its peak in late-2008, Dallas Fed President Robert Kaplan has warned, overly leveraged companies "could amplify the severity of a recession." Linking debt-financed stock buybacks to manufacturing sector surveys highlights a strong relationship of the trend in indicators to borrowing costs, most notably the spread of corporate BAA credit to 10-year Treasury bonds. Credit spreads have remained near all-time lows, approximately 2.3%, despite the fact that the ISM Manufacturing Index (PMI)'s recent decline and trend indicate, based on history, that they should be nearer to 3.6%, or more than 50% higher. Thus, if corporate credit rates move toward higher spreads making the current ultra-low borrowing costs more impactful, we would expect to see a shift and a sudden desire of companies to refrain from increasing their leverage to buy an asset that has no future utility to service existing debts, i.e., treasury stock. Further, we'd likely see an increase of cash cushions on balance sheets to protect existing credit ratings and meet existing obligations without disruption should a recession occur.

In sum, we envision a near to intermediate term environment that indicates 1) some degree of spillover from the current manufacturing slowdown to the services and consumer segments of the economy, possibly leading to a recession or, at best, a continued malaise in growth; 2) a deceleration in profit margins for the average S&P 500 Index company from all-time highs; and 3) a potential reversal in the appetite for stock buybacks as credit becomes more expensive and companies re-think their use of leverage. As an investor, it's critical to now reconcile our three broad-based expectations to what may be priced into markets or consensus in order to profit from the perceived arbitrage. Even if one has a super-bullish outlook for growth and profitability, there is no valuation upside if such attributes are already discounted. Today, however, we see the opposite. Namely, the Fund's portfolio manager sees a deteriorating fundamental backdrop married with an expectation or valuation level for the average company that we cannot reconcile. Over the past five years ended September 30, 2019, the total historical earnings per share (EPS) growth rate on an annualized basis for the S&P 500 Index on an equal weighted basis has been 10.7%. The contributions to this growth have been 3.2% from revenue growth; 6.4% from operating profit margin expansion; and 1.1% from stock buybacks or net share count reductions. Currently, IBES long term growth rate expectations are 10.1% and the bottom-up aggregate market implied future growth rate of EPS is 9.2%. In other words, consensus is that the next five years will replicate essentially the past five years despite the fact that the current economic expansion is the longest in U.S. history with clear signs of deterioration and recession vulnerability. In addition, a major concern of ours remains that, unlike the normal sequence of events of the stock market being a leading forecast indicator of the economy, the financialization 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; meaning a stock market sell-off due to any number of reasons while the economy is within a recessionary window of vulnerability, is then compounded by the reliance upon low financial market volatility, which then leads to a slowdown in corporate and consumer confidence. All of this then could potentially lead to slower economic growth becoming circular in impact to stock markets and the economy. In other words, a stock market correction catalyzes an economic slowdown into a recession, not a recession causing a correction as a forewarning. Despite the deteriorating fundamental backdrop and the elevated expectations associated with the average company in the S&P 500 Index, we believe that some stock level opportunities do exist. In the near term as more defensive, non-cyclical companies are expected to perform better, we see opportunity in the Health Care, Telecom, and Staples sectors as well as within the precious metals mining industry.

Despite several false starts thus far in 2019 where more-cyclical, particularly early cycle industries such as the banking, transportation, semiconductors and other industries that have attempted to assume stock market leadership only to pull back, our belief is that a rotation towards these areas will happen but not just yet. Using history as our guide has indicated that the relative performance penalty for being too early on cyclical stocks is pronounced and asymmetric as more economically sensitive stocks will suffer disproportionally from a decline in profits as well as a compounding of valuation de-rating. Absent absolute value opportunities, we remain patient in embracing the durability of such a shift to companies in early cycle industries.

Given the “aggregate” market concerns, the process used by Centre to manage the Fund stays disciplined and focused on each individual portfolio company's growth outlook and capacity to create shareholder value, utilizing our bottom-up fundamental stock selection process and consider valuation or the price one pays at purchase as the most critical element of successful investment. We remain much less enthusiastic about the prospects for capital gains in the broad U.S. stock indexes than we have been since this bull market began in early 2009. The Fund’s portfolio manager therefore has positioned the Fund with the fundamental foundation that: 1) the forward return from beta or benefit by simply being invested in the market will be much lower, or even negative, due to these headwinds; 2) the Fund will further focus its stock investments in those companies deemed to have a higher relative degree of company specific or idiosyncratic risk as well as a lower than average level of cyclicality; 3) we will remain disciplined and concentrate the portfolio in our best investments; and 4) we will continue to utilize hedges and other capital protective strategies (e.g., put options) when deemed appropriate. 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.

James A. Abate, MBA, CFA, CPA
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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 BS in accounting from Fairleigh Dickinson University and an MBA in finance from St. John's University, and is a visiting Adjunct Professor in the graduate and honors academic programs 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 Centre American Select Equity 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 to manage the Fund focuses on each individual portfolio company's growth outlook and capacity to create shareholder value, utilizing our bottom-up fundamental stock selection process. We utilize a disciplined, Economic Value Added 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 investor 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 may lead to future earnings growth. In other words, we expect that the companies in which the Fund invests will themselves 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 by Centre. While the use of hedging and certain investment techniques involve risk, 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 have 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. The ISM Manufacturing Index is a widely-watched indicator of recent U.S. economic activity. The index is often referred to as the Purchasing
2. Manager's Index (PMI).Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. Beta is used in the capital asset pricing model (CAPM), which calculates the expected return of an asset based on its beta and expected market returns.
3. A credit spread is the difference in yield between a U.S. Treasury bond and another debt security of the same maturity but different credit quality
4. A valuation multiple measures some aspect of a company's financial well-being, determined by dividing one metric by another metric.
5. Earnings per share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock.
6. The Institutional Brokers' Estimate System (IBES) is a database that gathers and compiles the different estimates made by stock analysts on the future earnings for the majority of U.S. publicly traded companies. After starting with annual earnings estimates and estimates of long-term growth, the database later was expanded to include quarterly earnings estimates.
7. The 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.
8. A risk premium is the return in excess of the risk-free rate of return an investment is expected to yield; an asset's risk premium is a form of compensation for investors who tolerate the extra risk, compared to that of a risk-free asset, in a given investment.
9. 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.
10. Out of the money (OTM) is a term used to describe a call option with a strike price that is higher than the market price of the underlying asset, or a put option with a strike price that is lower than the market price of the underlying asset.
11. 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.
12. 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.
13. 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".
14. * Source: Centre Asset Management, as of October 17, 2019.
15. ** Source: Fortune, August 20, 2019.

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 annual report covering the twelve-month period ending September 30, 2019.

Top 10 Holdings – As of 9/30/2019 (subject to change)

Microsoft Corp. 8.6%
Alphabet, Inc. 6.2%
Amazon.com, Inc. 6.0%
Johnson & Johnson 4.6%
Medtronic PLC 4.6%
Barrick Gold Corp. 4.5%
Abbott Laboratories 4.2%
Verizon Communications, Inc. 4.1%
Merck & Co., Inc. 3.9%
Facebook, Inc. 3.6%

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