November 12, 2018

Centre Funds Insight – Winter 2018/19 Market Review & Outlook – U.S. Equities

As we progress through the final quarter of 2018 and enter 2019, the bull market that began in March 2009, now one of the longest stretches in history, faces significant hurdles to continue its streak of gains. The economic expansion, efficiency gains and drop in input costs (such as raw materials like steel, etc.) due to globalization, low interest rates, dramatic rise in corporate debt, and financial engineering tools that have been the fuel of the stock market advance seem to be exhausting themselves or reversing course with adverse consequence. We therefore have 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; 3) remain disciplined and concentrate the portfolio in our best investments and, thus, stay at the lower end of the range (45-65) of the number of typical security positions; and 4) continue to utilize hedges and other capital protective strategies (*e.g.*, put options) when deemed appropriate.

There are a few points with regard to the economy that we would like to address which are unconventional in viewpoint and that may have a potentially significant and broad-based impact. The current business cycle started in mid-2009 and the expansion has now continued for over nine years without a relapse into recession. Part of the uniqueness of this cycle has been that the recovery remained at "training-wheels speed" as compared to prior cycles due to the apprehension of corporations to expand or make significant capital expenditures or new hires, both leading to gains coming from efficiency improvements on existing resources rather than top-line sales growth. Also, the economy experienced what was the closest-ever, non-recession slowdown experienced over our career during 2015 and 2016 as commodity prices collapsed, leading to a significant pullback in the one area of the economy where a significant level of capital investment was previously occurring. It was only due to continued accommodative monetary policies that suppressed interest rates and debt burdens that allowed the consumer component of the economy to offset the losses in the capital goods sectors, preventing a formal recession. With a second wind coming from very stimulative tax cuts, dramatic reductions in new regulations, and a recovery in commodity prices, the current environment after the Presidential election is witnessing both the consumer and the capital goods sectors being robust. We are not economists per se but have always prided ourselves on being able to create a "mosaic" from all the bottom-up information we gather on the companies we analyze. Along those lines, it was reported that former Federal Reserve Chairman, Alan Greenspan, when in office would regularly monitor the activities and stock price of Parker Hannifin (PH) as a leading economic indicator. Parker Hannifin Corporation was founded in 1918 and is headquartered in Cleveland, Ohio and manufactures fluid power systems, electromechanical controls, and related components – items that are exposed to many segments of the economic supply chain. Recently, the Chief Operating Officer of PH, Lee Banks, concurred with our assessment of the U.S. economy gleaned from other companies and stated that "this is the best global economy I've seen in my career." Mr. Banks also noted that supply chains are stretched and that the company is seeing this, along with other factors, cause inflation in the supply chain. Mr. Banks, matter-of-factly, stated that this gets passed through to the customer. This anecdote further reiterates our "mosaic" of coincident economic indicators and thesis that the market's earnings risk for the next couple of quarters is very low; that a pro-cyclical bias is warranted; that profit margins may be susceptible to compression for many companies due to end-market customer pushback on inflation in input costs; that the Federal Reserve ("the Fed") may become much more aggressive than the market expects; and that the principal risk to the stock market is not from a near-term recession but from an increase in the cost of capital and a de-rating of valuation multiples.

We believe that the widespread commentary by many market pundits that tariffs are bad for the U.S. economy defies any historical perspective and facts. The reality is that higher U.S. economic growth, since its founding in the late 18th century, has coincided with periods when import tariffs were in place and at their highest levels; protectionism was America's de facto policy from the passage of the original Tariff Act of 1816 until World War II. The argument of protective tariffs favoring local industry versus progressives favoring consumers and farmers has been with us in earnest since then, and disagreement over tariffs was a major contributing factor to the Civil War. It has only been the last twenty-plus years where there has been a uniform economic paradigm of neo-liberalism across the developed democratic world that free trade has become the new orthodoxy, especially in the U.S. The problem is that this paradigm has occurred alongside an intense mercantilism (export at all costs) in most Asian countries, most notably China. So, now after almost two decades of unprecedented trade imbalances and a rise in China's industrialization, mainly at the expense of the U.S., are we seeing a resurgence against the neo-liberal paradigm and progressivism. 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 World Trade Organization ("WTO") when it would have been less disruptive. The issue for investors now will be the realization that the U.S. economy may lose its link to the stock market; the S&P 500 Index tending to be almost a "global" benchmark due to overseas assets and revenues of its component companies. Namely, the economy may continue to grow as the U.S. brings its supply chain back home but the stock market could falter as the issue for corporations 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 an increase in risk, geopolitically as well as at the corporate level, negatively impacting valuation multiples such as price to earnings or price to sales ratios. The best example of how the great unwind from outsourcing to China can be seen in its potential impact to large multi-national companies is with the once iconic industrial giant General Electric (GE). Not widely reported alongside its recent leadership ills and poor acquisition timing is the fact that GE since 1991 has moved a substantial number of its employees, Research and Development ("R&D") centers, laboratories, and manufacturing bases to China from the U.S. In fact, GE has for the past decades trained Chinese executives at its former Connecticut headquarters for the company's leadership program reminding one of Karl Marx's famous saying that "the last capitalist that we hang shall be the one who sold us the rope". Now, GE finds itself not only competing with Chinese companies across nearly all its businesses that were somehow privy to its "shared joint venture intellectual property technology" but also scrambling to re-start its domestic manufacturing footprint and supply chains to ensure future adequacy of its products. Even the partial reversal of the cumulative $13 trillion in trade deficits, 60,000 factories lost, and over 3 million manufacturing jobs lost to China and other mercantile economies over the past two decades at the expense of the U.S.* will be highly disruptive to global transnational companies and, from a global risk perspective, we expect China to retaliate with its strongest weapon, devaluation of its currency as growth in China takes a tremendous hit and the economy there goes into potential recession in 2019. Without some arresting development of the recent embrace of tariffs by the U.S., either legally within the WTO framework or resurgence of Congressional pressures against the President, the divergence between the U.S. and rest of world economies may become more pronounced with negative ramifications to stock markets globally. We believe that the beneficial factors from globalization to multi-national companies and consumers experienced over the past two decades are not only impossible to repeat but are reversing.

Admittedly as an equity analyst, our confidence is the lowest in forecasting the direction of interest rates, one of the other main drivers of the cost of capital and stock market returns. On one hand, we are in the camp that, in the shorter term, interest rates will continue to move higher and at a speed that can be highly disruptive to leveraged or highly indebted concerns, particularly as the real component of interest rates have been moving higher. Federal Reserve officials have publicly stated that they remain convinced that continuing to gradually increase interest rates is the best formula to preserve a steady economy and prevent it from sparking higher inflation but also are somewhat cognizant that every Fed rate hiking cycle since the 1950s has ended in either a stock market crash or a recession. The Fed today seems motivated by actual economic numbers that allow them to pursue the imperative of continuing to normalize rates and have some “ammunition” on hand for the next inevitable recession. With the economic backdrop remaining healthy, and history as a guide, we expect the Fed to continue raising the Federal Funds Target Rate until something “breaks” in financial markets, an example being a mini-crisis in the debt and/or equity markets that somehow pollutes confidence and economic activity. Furthermore, while rate hikes may kill the party, it is not evident that rate cuts, when they happen, will quickly revive it.

Today is analogous to the environment that existed up to the year 2000 when cheap, abundant capital was the lifeblood of the dot-com mania and ended when the Fed turned off the spigots. In 2000, conditions were very similar in that the U.S. economy was incredibly strong throughout most of the year, investors were concerned that rates would still have to move meaningfully higher, the labor market was at 25-year highs in terms of employment, and oil prices moved higher. It was only in hindsight when the last Fed rate hike would occur did everyone see how quickly the economy turned down and aggregate S&P 500 Index earnings expectations for 2001, which had been at 12%, evaporated. In fact, only time allows us to appreciate that the surprising cut in U.S. interest rates in January 2001, followed by several others, was accompanied by double-digit declines in the S&P 500 Index in 2001 and 2002 debunking the “don’t fight the Fed” call by some analysts. More impactful now is the fact that demographic decline is the single most important economic phenomenon affecting interest rates long term, and which is deflationary as working age populations in most advanced economies are set to decline by 30% by the middle of the century. Nearly all Western economies, including the U.S., have reached the point where productivity must compensate for the decline in their working age populations. Otherwise, Greece, Puerto Rico, Italy, etc. and elsewhere where demographic declines are most pronounced are just the start of ongoing rolling crises as sovereign debt levels to Gross Domestic Product (“GDP”) are already in uncharted high levels and vulnerable to serious consequences, just lacking a catalyst. How stock markets discount a near-term cyclical uptick in inflation and rise in real interest rates then followed by a longer-term realization of disinflation and unparalleled uncertainty over real interest rates will, at a minimum, raise risk premiums and the cost of capital, depressing valuation multiples and, hence, negatively impact stock market returns all else being equal.

The most prominent mention in the epitaph we expect to be written on the gravestone of the current bull market (when it is over) will be regarding stock buybacks and, specifically, what were companies and their Boards thinking when they essentially leveraged themselves to buy back stock hand over fist and acquire an “asset” with no utility to service the debts taken on to do so. Our quibble has not been 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 reading in modern times. Despite the spin of being shareholder friendly, 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 return monies to shareholders via a dividend or alternatively, 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 finance leveraged buybacks, and we have witnessed an unprecedented re-direction of cash flow usage away from productive assets that should be used to support future growth or, if no investment projects were deemed worthwhile, been paid out more appropriately as a dividend or for debt reduction. 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 another icon of American business, Sears, declaring bankruptcy just recently and watching its stock price go to zero, we need to point out that Sears Holdings spent $5.8 billion buying back its shares from 2005 to 2010, draining the company of resources. The stock buybacks were done at an average price of $103.70 and at prices as high as $170 per share. Dell Computer was the only company we recall being vilified by the financial press following the dot-com crash when, despite spending over $10.5 billion to repurchase shares up through 2002, Dell's total shares outstanding actually increased by a fraction and only received about $1.5 billion in cash from issuing that stock to employees via options exercises and through an employee stock purchase plan with that value created by its business redistributed from shareholders to employees. Only the bear market in Dell’s stock price made shareholders and the financial press take notice. We couldn’t agree more with Warren Buffett’s advice from his 1999 Annual Report that "there is only one combination of facts that makes it advisable for a company to repurchase its shares: first, the company has available funds -- cash plus sensible borrowing capacity -- beyond the near-term needs of the business and, second, finds its stock selling in the market below its intrinsic value, conservatively calculated." The problem is that Dell was somewhat unique twenty years ago. Unfortunately, the near entirety of the S&P 500 Index of companies is using this playbook now and, due to the unparalleled use of debt to finance stock buybacks this cycle, the sensitivity of higher interest rates is especially acute.

In sum, we have a U.S. stock market trading at valuation multiples that we believe are potentially up to forty percent above intrinsic value, with the contributing factors that led to valuation multiples expanding - suppressed low interest rates and risk premiums, tariff-free implications on profit margins, low interest costs and debt burdens, and ample supply of debt capital usage dedicated to stock buybacks with complicit company Boards - that compounded the valuation re-rating with profit margins well in excess of historical averages now reversing. 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 remains rather unorthodox. What we mean is 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 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 a slowdown in corporate and consumer confidence. All this then leads to slower economic growth and becoming circular in impact to stock markets. In other words, a stock market correction causes a recession, not a recession causing a correction as a forewarning.

Considering 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 put options on the S&P 500 Index. So, despite our bottom-up optimism for the companies owned currently by the Fund, 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. Also, with capital protection from traditional diversification ebbing as the correlation relationship between stock and bond prices enjoyed over the past two decades reverts to its longer term pattern, 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.

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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 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. 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.
2. A valuation multiple measures some aspect of a company's financial well-being, determined by dividing one metric by another metric.
3. Price to earnings (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings.
4. Price to sales ratio is a valuation ratio that compares a company's stock price to its revenues.
5. 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.
6. 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.
7. 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.
8. A barbell strategy in reference to a stock portfolio consists of half the portfolio anchored in defensive, low-beta sectors or assets, and the other half in aggressive, high-beta sectors or assets.
9. A stock is secular when the associated company earnings remain constant regardless of other trends occurring within the market.
10. Tail hedges are one way to potentially limit losses in adverse markets. They may better enable investors to stick with their positions through bad times and thus be long-term.
11. Out of the money (OTM) is 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.
12. 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.
13. 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.
14. 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".

15. * Source: September 25, 2018 speech before the United Nations General Assembly by President Trump.

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, 2018.

Top 10 Holdings – As of 9/30/2018 (subject to change)
Apple, Inc. 7.7%
Microsoft Corp. 6.8%
Amazon.com, Inc. 6.3%
Alphabet, Inc. 5.6%
Facebook, Inc. 3.0%
NRG Energy, Inc. 2.4%
ConocoPhillips 2.3%
CF Industries Holdings, Inc. 2.2%
Mosaic Co. 2.1%
Regeneron Pharmaceuticals, Inc. 2.1%

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