



Centre Funds

Centre Funds Insight – Fall/Winter 2015 Market Review & Outlook - American Equities

During this past one year period, the key barometer of the U.S. stock market as a whole was little changed as the S&P 500 Index¹ delivered a total return of -0.6%. During the period, the stock market experienced two correction episodes – in October 2014 and, most recently, a sharp drawdown during August 2015. In essence, we've seen an increase in stock market volatility without a commensurate increase in return, consistent with historical late cycle episodes and, to us, justifying a keen focus on downside risk management.

As the U.S. stock market moves further along into one of the longest bull markets in history, our concern over its vulnerability to further correction is now at very high levels. In particular, having experienced several complete market cycles and witnessing the anecdotal warning signs, we think it useful to identify several points that are being talked about as reasons for why the current bull market will continue and add our somewhat contrarian take on each observation. We continue to believe that we're in uncharted territory given the unprecedented intervention of Central Banks which have provided ultra-accommodative monetary policy for so long. Some commonly held beliefs, and our reasons for believing that some may prove at least partially wrong, are:

- Stock markets have, on average, gone up another 33% when prior interest rate hike cycles have started, so the Federal Reserve hiking rates is a good signal for future stock returns. Our refute is that, in the past, the Federal Reserve hiked rates early in economic and profit expansions, not when the economy's trajectory was indicating slowdown/contraction so such logic is faulty;
- The economy is accelerating and finally ready to reach "escape velocity". From our aggregation of bottom-up company research, we feel that the economic and profits cycle is actually decelerating, not accelerating and is best evidenced by the ISM Manufacturing Index² and S&P 500 Index of companies cash flow operating margins contracting;
- A recession, typically associated with bear markets, has never happened when the yield curve was positive like it is now. We refute this by simply pointing to Japan, which has seen numerous recessions although its yield curve has not inverted since 1991 due to distortive short-term interest rate policy in that country. In other words, during times of suppressed low short term interest rates, the historical predictive power of the yield curve seems to fall apart for developed economies;
- Stock prices are inexpensive given the fact that the S&P 500's current price to earnings (P/E) ratio³ is below the long-term 25 year average. We believe this valuation metric gives a false sense of value. Valuation multiples based on sales, not earnings, rival the peak in early 2000 and are consistent with what we consider warning-flashing "normalized P/E" indicators. Furthermore, elevated valuation multiples are vulnerable to de-rate lower with a drop in operating margins, deceleration in sales growth, and reduced share repurchases; and
- Stock buybacks, also referred to as share repurchases, should support further earnings per share (EPS)⁴ gains and equity prices. History indicates that buybacks are linked to share prices. Ironically, most companies seem to buy high and don't buy at all when their stock prices are low so history indicates that we should expect a slowdown in stock buybacks if share prices fall.

¹ An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

² The ISM Manufacturing Index is an index based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

³ The price-to-earnings ratio or P/E ratio is a ratio for valuing a company that measures its current share price relative to its per-share earnings.

⁴ The portion of a company's profit allocated to each outstanding share of common stock. Earnings per share serves as an indicator of a company's profitability.



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Away from monetary policy and on a positive note, the normal “CEO Hubris”⁵ seen at this advanced stage of the business cycle, namely high capital spending, aggressive hiring, and inventory growth, is not widespread. Most company use of cash flows directed towards growth has not been focused on organic capital expenditures but rather on mergers and acquisitions, which while at record high levels, have occurred with an emphasis on scale and cost-cutting. This may allow the U.S. to escape a normal five to seven year business cycle as experienced since the 1950’s with a continued mediocre, muddling low volatility economy as long as interest rates remain at historically low levels. Also, the usual disturbance (i.e., demand shock) to the economy – a sharp rise in interest rates leading to recession – is not evident as real interest rates are and will likely remain negative despite the Federal Reserve’s articulated plan to raise rates gradually later in 2015 or early 2016. So, unfortunately, we see the U.S. economy lurching into recession or, at best, continuing to muddle through at well below expected growth rates and going from crisis to crisis unless genuine structural reforms are put in place and, with the current state of political inaction and lack of creative America-first visions, we see little cause for optimism. Importantly and given the unusual current set of circumstances, we constantly remind ourselves that the economic, demographic, monetary, and fiscal situations in the U.S. and other developed countries today are unlike any circumstances endured in the past and can lead to shocks and instability much more quickly as a result of the still high level of leverage and dependence upon ultra-low interest rates in the financial system. Also, despite falling unemployment, the collapse in real wages and productivity we’re undergoing has been associated typically with pre-WWI recessions and not experienced first-hand by any current portfolio manager practitioner.

Bullishly, we believe it’s a long term losing bet to go against the flexibility and speed of best-in-class American companies to restructure responsively to slowdowns and crises. On the other hand, net profit margins for industrial companies are now 1.5 standard deviations⁶ from normal, the highest ever, meaning companies are over-earning at an unprecedented rate and margins historically have reverted to the mean more consistently than other indicators. Second, gross and EBITDA⁷ margins are decelerating in aggregate for the average company in the S&P 500 Index while net profit margins are plateauing, which may be a sign of financial engineering, e.g., stock buybacks, as well as the strong influence from low borrowing costs. Unlike in 2000, stock prices are not inflated relative to earnings; rather, earnings are inflated, masking the expensiveness of stocks from a rudimentary P/E ratio basis. Overall, within the industrial sectors, wealth creation from expanding companies is becoming harder to find and the Fund has a very high level of wise-contractors or companies restructuring for this stage of the business cycle. We continue to believe in a “New Nifty-Fifty”⁸ of companies that can generate and maintain profits acceleration and we attempt to invest the Fund’s assets in such companies, maintaining cognizance of our valuation sensitivity. Lastly and for financial companies, increased capital requirements and regulation are hampering their ability to leverage improving returns on assets (ROA’s)⁹ into similarly improving and pre-2008 levels of Returns on Equity (ROE)¹⁰. In sum, the stocks of banks, brokers and the financial sector in general hold little appreciation potential from here and will trade near book value¹¹ for the foreseeable future as ROE’s equal the costs of equity for most firms.

⁵ Hubris is a characteristic of excessive confidence or arrogance, which leads a person to believe that he or she may do no wrong.

⁶ A measure of the dispersion of a set of data from its mean. The more spread apart the data, the higher the deviation. Standard deviation is calculated as the square root of variance.

⁷ EBITDA is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

⁸ The 50 stocks that were most favored by institutional investors in the 1960s and 1970s. Companies in this group were usually characterized by consistent earnings growth and high P/E ratios.

⁹ An indicator of how profitable a company is relative to its total assets. ROA gives an idea as to how efficient management is at using its assets to generate earnings.

¹⁰ The amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation’s profitability by revealing how much profit a company generates with the money shareholders have invested.

¹¹ The net asset value of a company, calculated by total assets minus intangible assets (patents, goodwill) and liabilities.



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In summing up our observations from our bottom-up research and reconciling it to the overall economic environment, we believe that:

- The economic impact to the U.S. from overseas weakness, as well as the pullback in energy and other commodity-driven capital spending, is just now being felt in Industrials, Materials and other cyclical sectors; escape velocity for the economy in 2015 is like waiting for Godot; this cycle has already peaked and appears headed toward slowdown;
- We do not believe that the recent corrective phase in stock prices is complete but do not subscribe to a long, drawn out bear market given the excessive capital positions of the banking sector;
- We will likely continue to tactically hedge beta¹² using out-of-the-money puts in the Fund until risk/reward profile for the stock market as a whole becomes more favorable, in a manner that is consistent with the Fund's investment strategies and policies;
- We recognize that the "there is no alternative" (TINA) to stocks argument is powerful given low fixed income yields, commodity collapse, and unattractiveness of other asset classes but to accept risk in stocks because of this is valid only if one believes that stocks cannot experience negative returns;
- We therefore expect continuation of narrowing leadership, sectors, stocks, etc. and further emergence of new Nifty-Fifty group of favored companies; and
- We assume the return from "beta" will be much lower looking ahead due to structural headwinds, increased political/conflict risk, and the fact that investor sentiment and valuations are at historic highs. Therefore, we will continue to use hedges and other capital protective strategies (put options) when deemed appropriate. Secondly, while diversification is good, over-diversification is bad. Thus, if the return benefit from systematic risk is lower going forward, we aim to drive performance through active, concentrated stock selection and understand external influences on sector/stock returns as well as intra-industry price return correlations.

Since adopting a much more cautious posture in September 2014, we continue to see a much less friendly systemic backdrop for equities as a whole. Our focus remains on stock selection rather than sector/industry themes to achieve performance as no single area of the stock market seems uniformly inexpensive with operating trends improving. With such a backdrop and the likelihood that the U.S. lurches into a further economic slowdown or recession, we believe a small crisis can morph easily into a global problem (Thailand 1997, sub-prime lending sector 2008, etc.). With the pricing of risk low and expectations for future growth still elevated, it's tough to see market appreciation driven by further profit growth or a re-rating (multiple expansion). Large-capitalization less-cyclical sectors such as Health Care, Staples, and Consumer Discretionary companies remain our main areas of emphasis given their higher degree of idiosyncratic or company specific risk. Our biggest concern is that we could lurch from an unexciting economic recovery straight into the next economic downturn with real interest rates already negative and debt levels high leading to deflation/recession and the Federal Reserve apparently unable to provide further stimulus with interest rates already at historic lows. We do, however, feel that a violent change in sentiment within an environment of stability and complacency and low volatility could compress valuation multiples akin to sharp corrections seen in 1929 or 1987. As we progress further into 2015 and 2016, despite our bottom-up optimism for the companies owned in the Fund, we are less enthusiastic about the prospects for further sizable gains in U.S. stocks as a whole relative to what we believe remains a very bullish consensus. With capital protection from traditional diversification ebbing combined with low volatility, this makes option costs reasonable, especially given our expectation of a sharp "valuation re-set" or correction rather than a long drawn out bear market. We believe that our pragmatic large capitalization valuation sensitive

¹² Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.



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growth 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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**Disclosures**

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

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