



Centre Funds

Centre Funds Insight – Spring/Summer 2016 Market Review & Outlook - American Equities

The U.S. stock market has struggled to record any meaningful advance since the end of 2014, a point in time when we alerted our investors that we thought it prudent to adopt a much more cautious approach. Given that valuation is the most critical element of successful investment, we see markets struggling to meaningfully move higher for the foreseeable future unfortunately as valuation multiples have actually expanded over the past year, from levels that we viewed at peak already, despite deterioration in fundamental measures and growth outlooks for most companies in our investable universe. Furthermore, the sharp drawdowns seen in August 2015 and January 2016 as well as the increase in volatility will likely be present until the business cycle goes into a recession and there is enough corporate restructuring globally that eliminates much of the excess capacity built up across many areas of the economy. Currently, this is happening but at a pace that has not yet brought overall supply into balance with reduced corporate and consumer demand across most industries. *As it stands now, we see a fundamental backdrop whereby the economy continues to operate at a very low growth level, almost stall-type speed, vulnerable to any type of demand shock and at risk of lurching into outright contraction.* Without a significant increase in productivity and efficiency or a change in fiscal policies conducive and contributing to better sales growth, incremental improvement in profit margins, and increased asset efficiency, *the only driver to enable the stock market to move higher is continued reliance upon valuation multiples re-rating even higher on further accommodative monetary policies or a significant increase in risk appetite by investors, neither of which we see occurring at this time.* Given this, the Fund currently continues to concentrate the number of positions in the Fund in an attempt to maximize individual stock rather than market risk and use derivative instruments intended to hedge the risks of existing equity positions, namely put options on the S&P 500 Index as a potential hedge against its underlying stock holdings in the event of a material correction.

To appreciate our outlook on the economy and market trends, we think it's important to understand where we've come from. The recession in 2008-9 was concentrated mainly in the financial and real estate sectors after a period of excessive and imprudent credit expansion. Its impact clearly had broader implications but, nevertheless, it was concentrated in the housing market and banking industry. In early 2009 we began to witness a broad based restructuring of assets and excess capacity by U.S. companies across nearly all sectors and industries at a pace and efficacy that we had never seen before in our careers. Despite the significant risk aversion of many if not most investors at that time, we embraced a bullish outlook for stock markets starting in early 2009 as we felt that most investors were underestimating the impact from the efforts by most U.S. companies in terms of a favorable turn in profit margins and asset efficiency resulting in a general improvement in returns on invested capital. In other words, one could be bullish on stocks mainly due to the significant increase in corporate profits starting in 2009 and lasting through 2012 from cost-cutting and asset restructurings despite the fact that overall economic growth, as well as sales growth for the average company in the S&P 500 Index, was well below the levels seen in other post-recession economic recoveries.

As we moved into 2013, we saw what we call a "baton-transfer" of positive stock return drivers. Specifically, we believed that the inability of the economy to accelerate further and the diminishing efficacy of restructuring efforts would lower, but not alter the positive incremental profit picture and returns on capital for most companies. However, as investors further distanced themselves from the carnage of markets in 2008 and the fact that monetary policy remained highly accommodative, we felt that the second stage, or positive re-rating period (whereby valuation multiples would increase providing stock markets with positive tailwinds). Near the end of 2014, we reminded investors that *Wall Street has always extrapolated earnings growth and the re-rating phase of stock market cycles indefinitely into the future without taking into account the effects of the normal economic and business cycles.* This was the same in 2000 and 2007.



Centre Funds

We began 2015 as well enter 2016 in the same manner and, more importantly, we've seen further deterioration in overall company fundamentals with what we see as an increasing reliance upon monetary policy accommodation to "bail-out" stock markets after greater than ten percent drawdowns. Furthermore, despite a deterioration in the industrial segment of the economy that's now starting to pollute the consumer and services sectors, the pace of restructuring and cost cutting witnessed during the sharp economic contraction in 2008-9 is not evident today as companies seem satisfied to maintain a status quo-type approach as no one wants to lose market share in the event the economies accelerate somehow but, at the same time, a very low level of confidence by company managements that the economy will do so. It's that cautiousness in capital spending and long term value-enhancing investment that is resulting in a tepid economic backdrop and reduced business and consumer confidence, translating into a circular trap of low growth, deteriorating asset efficiency, and a decline in profit margins leaving the stock market highly vulnerable to a re-set in valuation due to lowering growth outlooks. We'd almost prefer a demand shock that leads to a one to two quarter sharp economic and stock price contraction to the ongoing sideways path that we seem to be experiencing. In other words, we'd prefer an outright recession and re-rating of equities back to intrinsic values over a drawn out "lost decade" that we fear is an increasing possibility.

The key practical themes we gleaned from our aggregation of bottom-up company research are: **1) profit margin deterioration combined with flat/declining sales growth could lead to earnings deterioration which, in turn, could lead to valuation multiples declining; 2) it's too early to buy "recovery" stocks – deep cyclicals - and traditional value, e.g., simple low price to earnings strategy¹**, likely underperforms until the economic cycle troughs and we're frankly unsure when that is; and 3) with bond yields so low and other asset classes disappointing, **we continue to emphasize a "new Nifty-Fifty"² group of companies in the Fund** and, because of that, diversification is good but over-diversification is bad, leading us to concentrate the Fund in our best ideas and own a number of stocks at the lower end of our normal range for the Fund. As always with our process, we expect all companies in the Fund to make value-added reinvestments back into the business or wisely contract in an effort to improve efficiency, maintain positive sales growth, and achieve incremental improvements in profit margins and returns on capital.

In terms of company profit margins, the decline since 2014 is a glaring indicator that **recession probability is very high. Historically, the average lead time between the peak in profit margins and the onset of recession has been eight quarters. This would imply that the economy could enter recession in the second half of 2016.** Margins historically peak ahead of recession and, indeed, there has not been one business cycle in the post- WWII era in which this has not been the case except for 1985, when the margin decline was concentrated in the Energy sector. Profit margins peaked during the third quarter of 2014, and have been steadily declining since. Normally, margins compress because of cost pressures, such as higher worker pay and raw material price increases. In turn, inflation pressures ignite the Federal Reserve to begin raising interest rates in an effort to slow down demand based on credit. That's less of the case today as it's been more about decreasing sales but the impact to the bottom line has been the same as certain measures of inflation have picked up. With regard to recently falling oil prices and the analog to 1985, margin erosion that has occurred since 2014 has been much more widely distributed across industrial sectors than it was in 1985, meaning the chance of at least some economic slowdown is likely strong. Furthermore, we have yet to see the lower fuel costs translate into increased consumer demand. In sum, the incremental deceleration in profit margins in the face of a slow sales outlook will likely be a significant constraint on equity prices,

¹ 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.

² The 50 or so stocks that were most favored by institutional investors in the late 1960s and early 1970s. Companies in this group were usually characterized by consistent earnings growth and high P/E ratios.



Centre Funds

all else being equal, as profits have tended to drive the most important economic variables, capital spending and employment in particular. It may also likely have negative implications for corporate activity given the decrease in sources of cash flows, especially as mergers & acquisitions, stock buybacks and dividends, all of which are now at record highs but are likely to decelerate if such trend continues.

When it comes to the suitability of purchasing most recovery-type or the stocks of industrial companies at this point in the business and stock market cycle, we'd make several observations as to why it's premature generally. Although the U.S. economy is in better shape relative to the rest of the world, it doesn't have enough strength to fend off weakening fundamentals elsewhere, particularly in the emerging markets and the related currency impact of a strong U.S. dollar on exports. It's important to recognize that what we're experiencing is not just a run-of-the-mill economic slowdown in emerging markets, but the reversal of a decade plus long cycle in which capital has flowed into emerging markets year after year while debt grew. At the same time, the developed economies in the U.S., Europe, and Japan in particular, are now experiencing the advent of a long-term secular growth deceleration resulting from ageing populations and lower aggregate demand. Looking at the global economy as a whole, the biggest source of profit growth in recent years was the net investment in emerging market export capacity. With capacity now at significant excess relative to demand, whether for steel or electronic components for example, the net investment is slowing with most of the emerging markets going into a recession akin to a secular adjustment. The tumult in emerging markets and the commodities sectors creates further hits to a U.S. economy that is already growing sluggishly. As deflation takes down asset prices, profits, and economic growth, it's difficult to see the turn in growth and profitability for most U.S. based but globally exposed cyclical and industrial businesses.

The background noted above likely leading to the misfortune and lack of opportunities in the stocks of most cyclical and industrial businesses has (and will continue), however, led to a flight to quality for many blue-chip stocks. In all likelihood as a result, we foresee an extended period like 1971-72, when investors paid extraordinarily high prices for a select group of growth stocks that came to be known as the Nifty Fifty; companies like McDonald's, Coca-Cola, Johnson & Johnson, PepsiCo, and General Electric. ***The "New Nifty Fifty" of today includes many of those original names, along with some new giants that were nonexistent or tiny in 1972, such as Amazon, Apple, Microsoft and Nike.*** The problem back then was that the basic idea behind a Nifty Fifty stock would be the same. Namely, that many investors regarded them as "one-decision" stocks, the kind you buy and hold forever, and the kind that deserve a high premium in their prices because their long-term earnings growth prospects appear unmatched by most other companies and investment choices. Our belief today is that the New Nifty-Fifty must be dynamic, and we currently believe that even the slightest deterioration in a company's fundamental performance, lack of incremental profit margins or deterioration in the level of returns on capital, should result in the company being eliminated from the Fund's portfolio.

The market's trend over the last year or so has strongly suggested that a select group of blue-chip stocks is, indeed, emerging as an alternative to low and sometimes negative real interest rates earned on bonds and other investments. In addition, it's important to remember what has happened in the past. Namely, some investors became willing to pay an ever higher price for these blue-chip stocks relative to their underlying earnings, leading to one of the oldest questions in investing, "how high is too high?" In our view, it simply depends on the company and our ability to manage the Fund with alertness to selling a stock if we see fundamentals deteriorate even in the slightest. That said, in an environment where sales growth and margin improvement is becoming an ever scarce attribute, many of these stocks in the New Nifty-Fifty could get more expensive with their stocks' prices relative to their earnings going much higher because of rising expectations that corporate earnings growth overall is going to slow markedly in coming years. Of course,



Centre Funds

knowing when to sell is perhaps the most critical issue but also it's important to ignore the natural human tendency to want to take profits in stocks that have had enormous run-ups, a stock like Amazon being an example, the risk being that you sell prematurely. Lastly, the demise of the 1970's Nifty-Fifty was a material change in inflation which negatively impacted their valuation, much less of a concern to us today.

While 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 and we see aggregate fundamental operating trends decelerating. ***With a stall-speed economic backdrop, we believe a small crisis can morph easily into a global problem and the U.S. entering a recession sometime this year or next.*** With the pricing of risk & expectations for future growth as high as they are, it's tough to see market appreciation driven by a further re-rating of valuation multiples. Large-capitalization Consumer Staples, Technology, Health Care, and Consumer Discretionary companies remain our main areas of emphasis; the best of which we refer to as a New Nifty-Fifty given their higher degree of idiosyncratic or company specific risk and still under-appreciated valuations in a relative context. Aside from the continuation of a circular trap of low growth, deteriorating asset efficiency, and a decline in profit margins leaving the stock market highly vulnerable to a correction, we remain highly concerned that we lurch from an unexciting economic recovery straight into the next economic downturn with real interest rates already negative and debt levels high across corporations and the governmental level leading to deflation/recession regardless of the actions taken by the Federal Reserve. As we progress further into 2016, despite our bottom-up optimism for the companies owned currently by the Fund, we are less enthusiastic about the prospects for capital gains in U.S. stocks as a whole. With capital protection from traditional diversification ebbing, we believe that our large capitalization valuation sensitive growth approach to stock selection, with a cognizance of risk management that includes tactically implementing capital protective investments, seems positioned to perform well relative to less risk aware strategies.

James A. Abate, MBA, CFA, CPA

Fund Manager – Centre American Select Equity Fund

Managing Director & Chief Investment Officer

Centre Asset Management, LLC

**Disclosures**

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

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Centre Funds

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Top 10 Holdings – As of 3/31/2016 (subject to change)

Apple 5.4%
Microsoft 4.7%
Amazon 4.5%
Johnson & Johnson 3.5%
PepsiCo 2.8%
Facebook 2.8%
S&P 500 Index Put Options 2.7%
Lowe's 2.7%
Home Depot 2.5%
General Mills 2.4%

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