Aston Funds

Manager Perspectives: The Elephant is Still in the Room

March 2013

Views on the Market from Aston's Subadvisers

In the last couple of weeks we have met with most of our subadvisers and while there is no unanimity on the outlook or valuation, there is absolute agreement that the developed world economies are in a unique situation and one for which there is essentially no historical precedent. In the US, the Federal Reserve has instituted an unconventional monetary policy whose goal seems to be to raise long-term asset prices and maintain negative real short term interest rates. In Europe, the central bank's main goal has been to support the Euro currency bloc by providing unlimited support to peripheral countries that might otherwise be tempted to exit the Euro. In Japan, the central bank's new role appears to be to drive up inflation rates and depreciate the yen. Each of these actions complicates any attempt to determine fair value for securities and makes market levels particularly dependent on political decisions rather than business and economic fundamentals. What follows is a brief summary of our investment managers' perspectives on markets all recognizing that the major "known unknown", is what will central banks do next?

Stuart D. Bilton
Chairman and Chief Executive Officer
Aston Asset Management

Montag & Caldwell

According to Montag & Caldwell we have a modestly overvalued equity market with the average stock very fully priced, but a relatively undervalued market for large-cap growth stocks. The relative price to earnings premium of large-cap growth to the S&P 500 is usually around 25%, it is currently about 10%. The overall market could remain at current elevated levels for as long as the Fed continues its unconventional monetary policies and Congress does nothing about fiscal issues. Liquidity trumped fundamentals in 2012 and it could do so again in 2013, even in the face of weakened U.S. earnings growth. The Federal Reserve (Fed) has literally managed history by manipulating asset values, which in turn has overwhelmed fundamental analysis. The U.S. economy is currently operating at slightly above stall speed and the key to the market will be avoiding a recession when the Fed's Quantitative Easing finally ends. They believe the rotation to large-cap growth is just beginning because growth, yield and stable cash flows will be scarce as declining earnings expectations finally meet reduced liquidity.

Large Cap Growth
MCGFX / MCGIX

Mid Cap Growth
AMCMX

Balanced
MOBAX / MOBIX

Ronald E. Canakaris, CFA
Chairman and Chief Investment Officer

River Road Asset Management

The River Road small cap and dividend teams are increasingly concerned about valuations, with portfolio discount-to-value measures trading at historical highs. While valuations in all capitalizations are rich, valuations in the mid-cap range appear to be the least attractive. Additionally, earnings growth remains tepid and the economy faces a fiscal drag. While the Federal Reserve remains "all in," which continues to inflate asset values, the risks of unintended consequences from extraordinarily low interest rates are mounting. From a positive perspective, increased merger and acquisition activity, continued improvement in the housing market, and inflows from more expensive asset classes may provide additional near-term support for equities, especially dividend-paying stocks (which may provide an attractive alternative to the government and high yield bond asset classes). However, with valuations high and growth scarce, we believe the risk of a significant market correction is high.

Dividend All Cap Value
ARDEX / ARIDX

Dividend All Cap Value II
ADVTX / ADIVX

SMID Cap Value
ARSMX / ARIMX

Small Cap Value
ARSVX / ARSIX

Long-Short
ARLSX / ALSIX

R. Andrew Beck
President, CEO and Senior Portfolio Manager

Lee Munder Capital Group (LMCG)

LMCG does not make macro market forecasts, but is finding plenty of opportunities in the small cap growth sector of the market. It is true that price-earnings multiples for small cap growth stocks have generally risen from around 12 1/2 times in early 2012 to 16 1/2 to 17 times currently, but what this means is that extra diligence must be paid when evaluating small cap stocks. In addition, small cap growth stocks are the "Wild West" of investing, where the level of market inefficiency is massive. The team believes that if in your analysis you can eradicate the "noise," this should continue to be a very rewarding sector.

Small Cap Growth
ACWDX / ACWIX

Emerging Markets

Andrew Morey, CFA
Partner and Portfolio Manager

Fairpointe Capital

The Fairpointe team is positive on U.S. markets. Unemployment is improving, housing is on the upswing and capital spending is strong. Company balance sheets are in good shape, stock buy-backs are increasing and dividends are being raised. The team is also encouraged by recent merger activity in mid cap companies because it looks to be part of a renewed trend by larger European companies to look to the U.S. for growth and strategic acquisitions. In addition, manufacturing is moving back from Asia to both Mexico and the U.S. While mid-cap equity valuations appear rich, the Fairpointe portfolio is trading at a significant discount to the mid and large-cap benchmarks.

Mid Cap Core
CHTTX / ABMIX

Thyra E. Zerhusen
CEO, Chief Investment Officer and Lead Portfolio Manager

TAMRO Capital Partners

TAMRO is reasonably constructive on equity markets for the next 12 months. The Federal Reserve will continue to provide liquidity, which should help consumer sentiment and provide a backstop for retail sales. It will be a slow growth environment mainly because of fiscal issues and problems overseas. They believe that small cap companies should do well in this environment, particularly those with a domestic focus. Inevitably, given large amounts of cash on corporate balance sheets, small cap companies will become acquisition targets.

Large Cap Core
ATLVX / ATDEX

Small Cap Core
ATASX / ATSIX

Philip D. Tasho, CFA
CEO, Chief Investment Officer and Co-Founder

Lake Partners

Equity markets are likely to keep grinding slowly higher, according to Lake Partners, as the global economy and financial system continue to recover, but the trend will be punctuated by bouts of downside volatility induced by political and policy uncertainties. Central banks continue to support markets in the U.S., Europe and Japan with both conventional and unconventional monetary actions and their activities have certainly improved the global financial situation. However, Europe continues to struggle with its sovereign debt and austerity measures, the U.S. needs to address fiscal and deficit concerns, Japan faces long-term demographic challenges, and China must manage the transition of its economy while undergoing political change. While equity markets generally are at fair valuations, fixed income markets will face significant risks when central banks eventually unwind their support for asset prices.

Multi Strategy
ALSNX / ALSOX

Frederick C. Lake
Co-Chairman, Treasurer and Co-Founder

Ronald A. Lake
Co-Chairman, President and Co-Founder

River Road Asset Management

Based on fourth quarter commentaries from operating managements in public company reports, the independent value team at River Road believes that the economy was stagnant in the fourth quarter of 2012, despite the unprecedented support provided by the Federal Reserve. While the business climate continues to be challenging, margins and cash flows remain elevated; however, earnings for many businesses appear to have reached a plateau. It is difficult to see the profit cycle improving from where it is today given the already high level of operating margins. Equity prices remain high, making it difficult to allocate cash to small-cap investments that will adequately compensate for the risk assumed. The team also has concerns about the sustainability of government spending and how that might impact corporate cash flow. Their focus list is expensive based on normalized free cash flow assumptions and therefore, until valuations improve the portfolio will remain defensively positioned.

Small Cap Value
ARIVX / ARVIX

Eric Cinnamond, CFA
Vice President and Portfolio Manager

Cornerstone Investment Partners

Cornerstone notes that while there has been lots of volatility, the S&P 500 has basically been in a straight line upwards since the market lows of March 2009. They believe that the U.S. is the place to invest. Even though the rate of economic growth will continue to be slow, industrial production is picking up, manufacturing and housing are improving, the jobless rate is trending down, interest rates are at historical lows, consumer prices are falling, energy independence is on the horizon and we are seeing improved economic data from China and Japan. While there are negatives, employment is still well below its pre-financial crisis peak, taxes and regulations are increasing and the costs of Obamacare will soon become an issue, companies are lean and mean. Cornerstone's "fair value model" which gauges the attractiveness of the stock market suggests that U.S. stocks are highly attractive. Only at the bottom of the financial crisis, did the model suggest that stocks were materially more attractive than they are today. While short-term prognostications of the stock market are a fool's errand, Cornerstone remains positive toward the U.S. equity market for both the medium and long-term.

Large Cap Value
RVALX / AAVIX

Rick van Nostrand, CFA
Portfolio Manager

Herndon Capital Management

Markets were frantic in 2012; sound business fundamentals did not seem to matter as much as a "Chicken Little" approach as investors overreacted to the macro economic and political issues that dominated the headlines. This compressed valuations in some sectors while inflating them in others. Herndon believes that there will be opportunities in 2013, for those with the courage of their convictions. They will position the portfolio for continued growth in the U.S. and the Far East, as well as a resumption of growth in Europe. They are currently overweight energy, materials, technology, consumer staples and consumer discretionary. They are not making a market call, but rather making a valuation decision on the basis of how fundamentals should be appropriately priced. Fear could have kept them out of a fairly robust market in 2012; similarly, it will not keep them out of the market in 2013.

Large Cap Value
AALIX / AHRNX

Randell A. Cain, CFA
Principal and Portfolio Manager

DoubleLine Capital

Markets are only partly about value. Fundamental imbalances can persist and build for a long time before investors take notice. But when they do, the shift in market attitudes can come swiftly. In investing, timing has never been more critical. DoubleLine CEO Jeffrey Gundlach recently used the Chinese "Year of the Snake" as a metaphor for risks – mainly in the form of government policy - which are coiled like a snake and may strike in any direction at any time. The team believes that 2013 will be much more volatile than 2012 and more like 2011. Global uncertainty remains with no resolution in sight for the U.S. fiscal deficit and unfunded liabilities, uncertainty over the ultimate viability of the European Monetary Union, and recognition that Japan is running out of options to address its debt and demographic dilemmas. All of these developed markets have deferred the day of reckoning through circular financing schemes, including implicit currency debasement of the U.S. dollar, British pound and euro and explicit debasement of the yen. But at some point, a break will occur. Recognizing the cusp of that change, and whether it takes the form of default or inflation, will be critical. In the meantime, talk about a bond "bubble" is premature; with the 10-year bond at 2%, Treasuries are reasonably valued relative to corporate and emerging markets debt. The Federal Reserve has made it clear that the central bank will continue with its bond-buying program. This will mute fixed income volatility in 2013, recent handwringing by dissenters in the Federal Open Market Committee (FOMC) minutes notwithstanding. In fact, the 30- year Treasury may end the year at a lower yield than prevails currently. Three years from now, Treasury yields may be higher, perhaps by a large amount, but it is too early to put any precise timing on a bear market in bonds. The persistent low-rate environment, however, is pushing yield seekers to lever up credit portfolios, which could set the stage for a credit bubble.

Core Plus Fixed Income
ADBLX / ADLIX

Jeffrey E. Gundlach
Co-Founder, CEO and Principal

TCH

Real interest rates are at their lowest point in history, and while that may mean that rates will have to go up, the question is when and how. Factors weighing on the U.S. economy include poor labor market velocity and continued concerns over U.S. fiscal policy, while the unprecedented level and duration of an accommodative monetary policy has held interest rates low and compressed volatility. Interest rates within the euro zone have subsided to post crisis lows, although implied default probabilities indicate that risk remains elevated. The timing of interest rate cycles is very difficult, but most interest rate shocks have resulted in lower yields penalizing investors who have shortened their overall duration. Historical performance suggests that investors were paid for taking duration risk. Similarly, risk-based valuations suggest that U.S. investment grade credit is attractive over the intermediate to long-term perspective.

Fixed Income
CHTBX / CTBIX

Alan M. Habacht
Principal

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