WHY INTERNATIONAL? – PART II

MARCH 31, 2017

DEAR FELLOW PARTNERS & FRIENDS,

It has been several months since the surprising US Presidential election and a few months since the new administration has taken office. The initial stages of the administration's first-term have been met with a historic stock market rally. The move up has been led by the banking sector, which as of this writing is in the midst of a relief rally, but in general, has included companies from almost every sector of the economy. The Centerstone Funds have participated in the rally, but rather modestly. As we often point out, our Funds are atypically-oriented, with a view towards long-term results. The businesses we own tend to be cash generative enterprises with solid balance sheets with proven management teams that (we hope) will continue to act in shareholders' best interests. We consider ourselves investors, not speculators, and view this market environment to be quite speculative in nature.

Whether issues such as interest rates, infrastructure spending, regulations or taxes, speculation has more to do with the appreciation of the popular indices than any fundamental change in the companies themselves. For instance, one can construct a bullish case for Goldman Sachs in a future headed towards banking deregulation, but Emerson Electric[1], a core holding in the Centerstone Investors Fund (CENTX), will not sell more garbage disposals regardless of what happens during this rally. While it may be hard to resist jumping in, we have found that over time it is better to check one's emotions at the door. We do this by focusing on long-term results and by tuning out the noise.

As previously written, we are still generally cautious despite the potentially improving backdrop for business conditions in the US. We still find that US equity valuations leave little room for error while the long-run prospects for most developed economies may, for a while, be constrained by demographic trends. That said, we are getting more excited about the valuations outside the US. Indeed, non-US stocks have begun to progress from appearing relatively cheap to absolutely cheap, as we further examine on the following page. We know from experience that cheap can get cheaper, but there seems to finally be a potential valuation safe harbor from US equity risk, for the first time in quite a while.

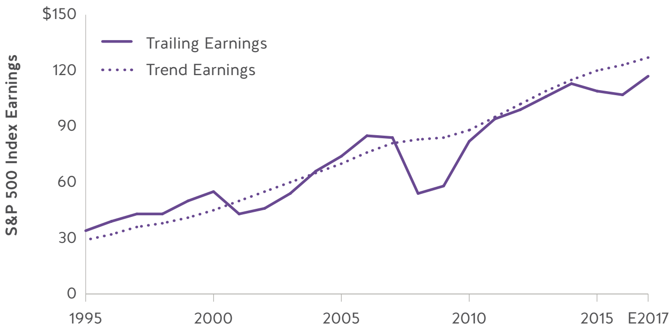
In our recent communication titled *Why International?*, we pointed to various measures which indicate to us that the long period of US stock outperformance may be in the latter stages of its life. In particular, US stocks have outperformed their non-US counterparts for the better part of eight years, accompanied by a historic rally in the US dollar over that time span. We pointed out very simply that "trees don't grow to the sky" and at times it has been worthwhile to move away from the crowd. In this case, we suggest that investors begin to consider shifting more of their exposure to overseas markets and to gain more exposure to foreign currencies as well. Indeed, this reflects the positioning of the Centerstone Investors Fund (CENTX), which places a much greater emphasis on non-US equities than the average fund in its Morningstar World Allocation category, 40% versus 27%[2], as of December 31, 2016.

Divergent Paths Among US and Non-US Companies Post Great Recession

One of the more impressive things to observe over time, cycle after cycle, is the long-run resilience of Corporate America. In what feels like just yesterday, businesses were mired in the Great Recession, in the midst of a historic decline in earnings. In fact, led lower by a range of industries, most infamously the banking sector, the S&P 500 index's earnings declined nearly 40%[3] during the Great Recession. In sharp contrast, present day earnings have surpassed the 2007 peak and again converged on the long-run trend line, as illustrated on the following page. Many will point to the boost from the major fiscal and monetary stimulus which undoubtedly acted as an accelerant to the recovery. However, businesses had plenty of headwinds to contend with as well — increasing regulations, a shrinking labor pool, weak productivity growth, higher taxes and lack of domestic capital investment opportunities, among other challenges. With the benefit of hindsight, it seems clear to us that businesses have recovered despite all of the meddling by the authorities.

1 Emerson Electric: 1.19% position in the Centerstone Investors Fund as of December 31, 2016.
2 Source: Morningstar
3 Source: Bloomberg
Portfolio holdings are subject to change and should not be considered investment advice.

S&P 500 INDEX TRAILING EARNINGS VS TREND EARNINGS

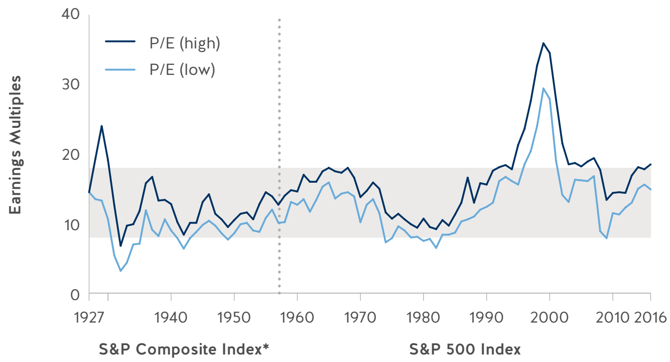


Source: Centerstone Analysis

Trailing Earnings: Trailing twelve months

Trend Earnings: Earnings at their long-term growth rate

S&P 500 PRICE TO EARNINGS (AT HIGH AND LOW PRICES FOR THE YEARS 1927–2016)



Source: Bloomberg, Shiller Data, Centerstone Analysis

In general, the market has done an efficient job of discounting this resilience. It is well-known that the current US bull market now counts as among the longest and most rewarding in the country's history. From a measurement standpoint, it helped that the bull market began with historically low valuations — on trend earnings, the S&P 500 index bottomed at 8x. (Recall, the resilience of Corporate America was seriously doubted by many investors at the time.) In addition to beginning with highly favorable valuations, the bull market's returns since the bottom are also flattered by historically high valuations currently. The market has gone from one extreme to another, since 2009, as shown in the graph above. Also apparent in the graph is that valuations can remain elevated for a time but that sustained advances from current valuations in the past have been during two distinct stock market bubbles (the late 1920s and late 1990s).

In summarizing the US, earnings have mostly fully recovered and stock multiples have reverted from historically low to historically high levels. The result is that the S&P 500 index has returned 17% annualized since the market bottom eight years ago. Keep in mind, if the past is any guide, to expect a lot more from this stock market is to expect another potential bubble.

On the Flip Side

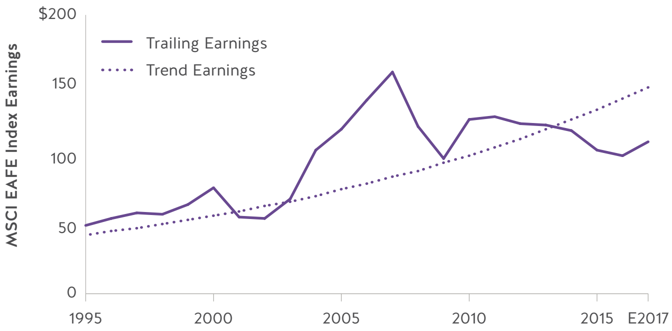
The contrast with developed markets outside the US could not be starker, even as many of the fiscal and monetary responses to the financial crisis were more aggressive than that of the US. For instance, the Japanese central bank is now an active stock market participant and owns over $140 billion of the nation's ETFs per the Bank of Japan. Both it and the European Central Bank are active direct buyers of corporate bonds. The Chinese response itself would require its own discussion but suffice it to say that there has been no lack of monetary and fiscal response from the rest of the world.

However, the impact of all this stimulus on the private sector outside the US has left a lot to be desired. After all, although the authorities responded in a similar fashion worldwide, the US is somewhat unique in having recovered all of its latent profitability. As shown on the following page, the MSCI EAFE index earnings peaked in 2007, declining 40% until finally stabilizing last year, still 25% below the trend line. In the meantime, it should be no wonder with those prospects that non-US stocks would lag during the past several years. While the S&P 500 index returned 17% annualized since the market bottom of 2009, the MSCI EAFE index has returned barely 10% annualized.

* The S&P 500 index, formerly called the Composite Index (and later Standard & Poor's Composite Index), had been launched on a small scale in 1923. It began tracking 90 stocks in 1926 and expanded to 500 in 1957.

The S&P 500 index is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the US economy and is not available for purchase. Although the S&P 500 index focuses on the large-cap segment of the market, with approximately 80% coverage of US equities, it is also considered a proxy for the total market.

MSCI EAFE INDEX TRAILING EARNINGS VS TREND EARNINGS

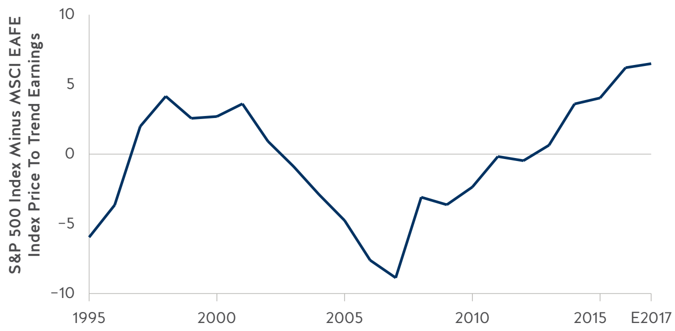


Source: Centerstone Analysis

Trailing Earnings: Trailing twelve months

Trend Earnings: Earnings at their long-term growth rate

PRICE TO TREND EARNINGS DIFFERENCE OF S&P 500 INDEX VS MSCI EAFE INDEX



Source: Centerstone Analysis

Naturally, since the recent past looks comparatively poor for non-US stocks, we believe investors have potentially mispriced those stocks. In particular, even though foreign stocks have been on a pause for the past few years, our analysis suggests the earnings power of those businesses and consequently their intrinsic values[4] have continued to potentially increase. Therefore, due to the trailing performance gap between US and non-US stocks, we believe there is a large and widening valuation gap that has emerged in the past year or so. Specifically, when comparing the S&P 500 index and the MSCI EAFE index to their respective normalized earnings[5], the S&P 500 index now trades at a historic premium to its counterpart, as shown above.

A natural question given the divergent earnings paths is why things may change. We would argue that conditions have already markedly improved in many developed markets but that the media obsession with European politics, most of which is noise, has distracted investors from that ground-level fundamental improvement.

For instance, while it is true that US earnings are forecasted to continue improving, it is the same case with non-US companies. The major and very important difference is that the S&P 500 index's potential improvement in earnings comes after its earnings already doubled from the lows of 2008, while the MSCI EAFE index's earnings have only begun to improve from the lows of 2008.

We see this in many of our companies as well. On average, the earnings of the companies in the Centerstone International Fund (CINTX) are still about 15% below their peaks. Unlike many stocks in the US, the prices of our typical non-US stocks remain well below peak. This combination of low-valuation and latent earnings power potentially provides some insulation from an otherwise fully valued US stock market.

As we noted in the first installment of *Why International?*, performance cycles shift over time to favor US versus non-US equities and vice versa. In addition, one of the influences is the trend in foreign currencies relative to the US dollar, with the current run in the US dollar becoming rather extended in our opinion. In this installment we have attempted to provide a fundamental overlay that suggests, from our point of view, that there is in reality quite the contrary to what we hear in the press, less risk and higher potential in foreign stocks. We understand that it may feel uncomfortable investing overseas given all the negative headlines but sometimes, when investing, discomfort is a positive signal.

4 Intrinsic value refers to the price a knowledgeable investor would pay in cash to control an asset.

5 Normalized earnings are adjusted to remove the effects of seasonality, revenue and expenses that are unusual or one-time influences.

The MSCI EAFE index is a free float-adjusted market capitalization index that is designed to measure the market performance of developed markets, excluding the US & Canada. The index is not available for direct investment and provides total returns in US dollars with net dividends reinvested.

Investors are not able to invest directly in the indices referenced in these illustrations and unmanaged index returns do not reflect any fees, expenses or sales charges. The referenced indices are shown for illustrative purposes only and are not meant to represent the Centerstone Funds. Past performance is not indicative of future results.

The Centerstone Investors Fund (CENTX) has a bias towards non-US stocks as our fundamental research has driven us there. The index-level analysis that we presented confirms for us that indeed there may be more long-term potential in foreign markets. In fact, our typical non-US portfolio holding's earnings are 15% below peak and well below normalized earnings power as well. The Centerstone International Fund's (CINTX) Price to Earnings (P/E)[6] ratio (based on normalized earnings) is roughly 15.5x. This is a premium to the MSCI EAFE index ratio, noted above, and is explained by the relatively higher quality of the Centerstone International Fund's (CINTX) holdings. Our lack of financials exposure explains what we view as the quality difference. For example, the Centerstone International Fund's (CINTX) weighted average Return on Assets[7] and Return on Equity[8] of 5% and 12% compares against the MSCI EAFE index's 1% and 8%, respectively.[9]

Our research suggests that non-US stocks and currencies are attractively priced and consequently the long-run potential for our Funds appears positive. However, regardless of the case we have made for international investing we are mindful of the many apparent risks in the world outside our borders and most importantly, we always appreciate that "anything can, and will, happen." As a result, we continue to favor businesses that have strong balance sheets, business model durability and management teams with a good track record of capital allocation.

Thank you for your continued support and interest in Centerstone.

Sincerely,

Abhay Deshpande, CFA
CHIEF INVESTMENT OFFICER

6 Price to Earnings is the ratio for valuing a company that measures its current share price relative to its per-share earnings. It is calculated by dividing market value per share by earnings per share.

7 Return on Assets is an indicator of how profitable a company is relative to its total assets.

8 Return on Equity is the amount of net income returned as a percentage of shareholders equity.

9 Source: Centerstone Analysis and Bloomberg data.

The Centerstone Funds are new and have a limited history of operation. An investment in the Funds entails risk including possible loss of principal. There can be no assurance that the Funds will achieve their investment objective. In addition, the Advisor is newly formed and has not previously managed a mutual fund.

Domestic economic growth and market conditions, interest rate levels, and political events are among the factors affecting the securities markets in which the Funds invest. Value investing involves buying stocks that are out of favor and/or undervalued in comparison to their peers or their prospects for growth. There is a risk that issuers and counterparties will not make payments on securities and other investments held by the Funds, resulting in losses to the Funds.

Our value strategy may not meet its investment objective and you could lose money by investing in the Centerstone Funds. Value investing involves the risk that such securities may not reach their expected market value, causing the Funds to underperform other equity funds that use different investing styles.

Large-Cap Company Risk is the risk that established companies may be unable to respond quickly to new competitive challenges such as changes in consumer tastes or innovative smaller competitors. Investments in lesser-known, small and medium capitalization companies may be more vulnerable than larger, more established organizations.

In general, a rise in interest rates causes a decline in the value of fixed income securities owned by the Funds. The Funds may invest, directly or indirectly, in "junk bonds." Such securities are speculative investments that carry greater risks than higher quality debt securities.

Investments in foreign securities could subject the Funds to greater risks including, currency fluctuation, economic conditions, and different governmental and accounting standards. Foreign common stocks and currency strategies will subject the Funds to currency trading risks that include market risk, credit risk and country risk. The Funds use of derivative instruments involves risks different from, or possibly greater than, the risks associated with investing directly in securities and other traditional investments. There can be no assurance that the Fund's hedging strategy will reduce risk or that hedging transactions will be either available or cost effective.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Centerstone Funds. This and other important information about the Funds are contained in the prospectus, which can be obtained by calling 877.314.9006. The prospectus should be read carefully before investing. The Centerstone Funds are distributed by Northern Lights Distributors, LLC, Member FINRA/SIPC. Centerstone Investors, LLC is not affiliated with Northern Lights Distributors, LLC.