Convergence
Investment Partners

Convergence Long/Short Strategies - Q1-2016 Review and Commentary

It's all about the Fundamentals

Q1-2016

> *The market does not run on chance or luck.*
> *Like the battlefield, it runs on probabilities and odds.*
>
> *-David Dreman*

To everything turn, turn, turn

That opening line to the 1965 folk rock hit song by the Byrds seems appropriate in describing the two back-to-back sharp corrections followed by sharp market recoveries in the past 6 months. An inflection is underway as improving U.S. economic conditions are being weighed versus the Federal Reserve's desire to balance global risk, improving domestic employment, and inflation pricing trends. Historically, in times of shifting market perceptions, we have observed that market volatility/dispersions tend to increase. This tension between U.S. economic fundamentals and the timing of any tightening by the Central Bank, has resulted in the whipsaw activity of the markets and an increase of stock dispersions. To paraphrase from our opening song title, it has been a "time to weep (correction), a time to laugh (rally)."

S&P 500 price action has been an environment of Turn, Turn, Turn…

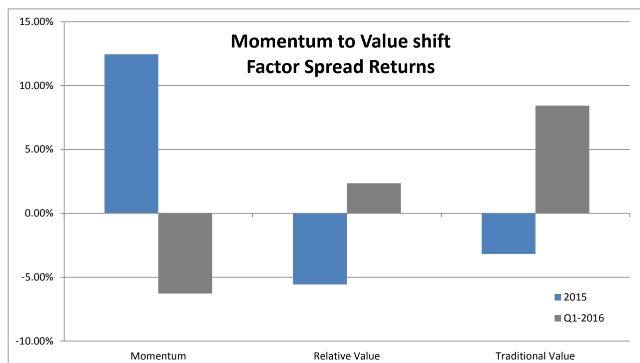
Source: Bloomberg Finance L.P.

Overview of performance

After the dust settled from the January sell off, the markets were almost unchanged in the first quarter. We are pleased to report that all of the Convergence Long/Short strategies ended the quarter with positive returns. Large caps, represented by the Russell 3000 Index, were down 10% near mid-quarter but rallied

back and ended the quarter in positive territory, 0.96%. The large cap Core Plus Strategy ended the quarter up 14 basis points, within 1% of its Russell 3000 benchmark (net of fees). The historically more volatile small caps did not disappoint; the Russell 2000 was down over 15% in early February but finished the quarter down less than 2%. Our Small Cap Core Plus Strategy continued its strong performance and ended the quarter up 1.82%, beating its benchmark by over 300 bps (net of fees). After a strong January, where the Convergence Market Neutral Strategy delivered a positive return as the market sold off, the strategy essentially marked time during February and March. The Convergence Market Neutral Strategy ended Q1-2016 with a 0.63% return (net of fees).

From a factor performance perspective, the first quarter marked an encouraging shift and a bit of backtracking. First, the encouraging shift was the backing off of the momentum trade that had been in place for most of 2015. This price momentum trade was replaced by a healthy focus on valuation. This "Momentum -> Value" shift can be clearly observed in the chart below. The chart compares the factor spread returns of a momentum, relative value, and traditional value from a long/short spread perspective for 2015 against the first quarter of 2016. The backtracking that we noted was due to heightened dovish sentiment within the global central banks, most notably the US Federal Reserve and Janet Yellen.



Source: Convergence Investment Partners
*(Factor spread defined as returns of top quintile minus bottom quintile of stocks from the top 1500 largest stocks of the Russell 3000 within each category)

In this quarter's commentary, we want to discuss a few market occurrences that we believe have had notable influence on our success. First, we want to share events that we consider favorable tailwinds. We will talk about factor/return dispersion, the sum is greater than the parts of factor investing, and earnings season. Secondly, we will discuss periods that cause us stress. Short squeezes and exogenous forces will be the main topics here. Finally, we will close out with a case study on the dynamic and noteworthy software group and some factor commentary.

Where did the returns come from?

The bulk of our returns came from our long short spread, or the extension piece, across all portfolios in Q1, much like in 2015. The larger cap long portfolios slightly trailed the large cap benchmarks in first quarter. Separately, the small cap strategy long holdings generated positive results for the quarter, unlike the negative return of the Russell 2000 Index.

In January, our long portfolios trailed the broader market, but our short portfolios contained holdings that really fell apart (good for short holdings). In all three strategies, our short holdings produced returns that were nearly **twice** as bad as their benchmarks.

A short squeeze on low quality/risky companies took hold in February while the indexes "marked time." All of our long portfolios outperformed their bogeys by a small margin. In February our short portfolios

generated positive returns (not good for short portfolios). We believe that the dovish chatter from the "Fairy Godmother" of the stock market (Janet Yellen) caused an undesirable short squeeze across a number of our short holdings. This is discussed in detail later under "What we don't".

The quarter ended with some very strong March returns. These returns were beta fueled and more "unfundamental" in nature. Our Market Neutral and Core Plus long portfolios essentially matched performance in this up-move, while our small cap names added to the outperformance. Given the lower quality of this "risk-on" rally, our shorts detracted from performance in all portfolios in March.

Now we would like to provide our investors and clients with a "look under the hood" of our investment process to provide insight regarding various market events and the impact to our fundamental investment process.

What we love

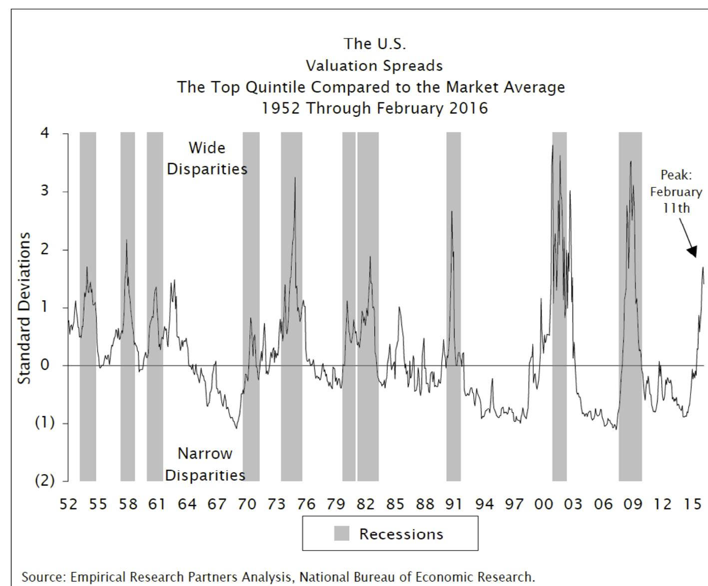
Dispersion (factor and return)

At Convergence, we work to identify the characteristics of stocks that we believe will outperform in subsequent periods. If all stocks have identical characteristics, it becomes difficult to distinguish the relative attractiveness of one stock from another. Conversely, if all stocks vary significantly, on a wide array of characteristics, then we believe we would be very capable of identifying attractive opportunities.

A simple example: If companies managed by younger CEO's tend to outperform those run by octogenarians, then an industry group where all CEO's are 46 does not lend itself to this factor or characteristic.

A real portfolio example: Valuation dispersion is when the spread between high and low price to earnings stocks has contracted from both the top and the bottom. Causes of low valuation dispersion: (1) a re-rating of cheaper, lower quality and less profitable stocks, and (2) a de-rating of more expensive, higher quality and more profitable stocks.

The chart below (from our friends at Empirical Research) shows the spread between the top 10% of pE names and the market average PE. Given the heightened level of these spreads, we as fundamental managers, are finding what we believe to be great opportunities for investing and are looking forward to the mean reversion.



The Reese's Peanut Butter Cup effect

Chocolate is good. Peanut butter is good. When you put the two together, we're not sure how it happens, but it is better than good (some of you might be having a flashback to an overplayed 1980's commercial for that delicious peanut butter cup…yes, it's available on YouTube). We call this the Reese's Peanut Butter Cup effect. Please just bear with us if you don't like the delicious cups.

This "anomaly" is frequently found in the world of factor investing. This effect occurs when combining two or more factors generates a return that is greater than any single factor, which may seem counterintuitive to those who are steeped in mean-variance and efficient frontier analysis.

As an example, let's take a look at some factors within our Capital Discipline Short composite.

At Convergence, as part of our process, we have a rolling schedule where we review a specific factor composite and its factor inputs to monitor efficacy. During a recent review of our Capital Discipline Short composite we observed a very succinct example of the "Peanut Butter Cup effect."

Our Capital Discipline composite ranks companies on how they re-deploy capital to shareholders and the business; specifically this composite considers dividends, share repurchases, capital expenditures, and research and development. We have three factors within our short composite: capex to depreciation, capex to sales, and share buybacks. Admittedly, we are fast-forwarding over a significant amount of analysis that we do here at Convergence, but we are trying to succinctly make a point. If we look at the returns of each of these factors and then compare them to the aggregate, we see a significant "Peanut Butter Cup effect." The table below shows the average annual return of each individual factor, the aggregate of the three (CD Short) and a "market" proxy (the top half of the Russell 3000, equally weighted to eliminate any capitalization bias). The point here is that the interaction effect (covariance matrix and aggregate stock ranking) typically has a significant impact on returns due to the ranking of stocks from those combined attributes. Unlike with mean-variance, where your returns are bound and enhancements are realized through correlations and lower volatility, factor combinations can have a profound impact on performance. We are always thrilled to find when 1+1=3!

Capital Discipline Short: Individual Factors, Composite and equally weighted index.
(Remember: with Shorts lower returns are better)

	Rebuys	Capex/Sales	Capex/Depr	CD Short	Russell 1500
Average Annual Return	6.51%	8.45%	5.93%	3.98%	10.06%

Returns from May 1997 – Dec 2014, Bottom Decile, Sector Neutral
Source: Convergence Investment Partners

The above table clearly displays that the combination of rebuys, capex/sales and capex/depr identifies companies with combined characteristics that can generate returns which are less positive than any single factor alone. Therefore, we believe the interaction effect or the creation of factor composites is essential in our systematic fundamental process.

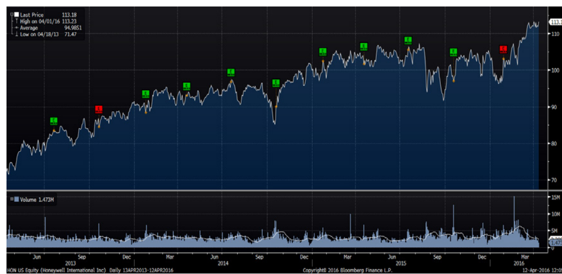
Earning's season

We love earnings season here at Convergence Investment Partners. Since the inception of our firm, we have found that over time companies with strong fundamentals tend to outperform and those with poor fundamentals flounder or go out of business. We have found that earnings season is the time where "the rubber meets the road." It is when estimates, forecasts, and predictions have opportunity to turn into

hard facts. Companies that have quietly been improving their balance sheets and profit margins are able to post their strong numbers and move up in price. Conversely, companies that are playing games with their financials or eroding shareholder value are forced to compliantly and publically disclose their dismal financials. And, ideally, those of us who have been skeptical of such firms are rewarded as the company slides in worth.

Another way to think of this is that we don't like "Business Channel" stocks. These are fun to talk about companies that receive an outsized amount of media attention and tend to trade on stories, rumors and speculation more than on their underlying fundamentals. A few examples in our opinion are Twitter, Shake Shack, and GoPro.

Honeywell, a "boring" company
Has chugged along on strong earnings



Source: Bloomberg Finance L.P.

Twitter, a "Business Channel" stock
Notable down moves when earnings have been released

Source: Bloomberg Finance L.P.

Many people have different seasons that they call their favorite time of the year. For some it is the holiday cheer that goes along with the winter season. For others it may be a season like spring due to the new growth and colors. For us at Convergence, as fundamental stock-pickers, earnings season is "the most wonderful time of the year" as companies are required to give an account for their business.

What we don't

Short squeeze

At Convergence, we dislike short squeezes. This is another example of when a company trades on something other than its underlying fundamentals. According to Wikipedia:

> *"A short squeeze is a rapid increase in the price of a stock that occurs when there is a lack of supply and an excess of demand for the stock. Short squeezes result when short sellers cover their positions on a stock. This can occur if the price has risen to a point where short sellers must make margin calls, or more loosely if short sellers simply decide to cut their losses and get out. Since covering their positions involves buying shares, the short squeeze causes an ever further rise in the stock's price, which in turn may trigger additional margin calls and short covering."*

Short squeezes can also come in the flavor of an overall "risk burst" in the market as risky/low quality stocks are rapidly bid up due to some exogenous event and short term positioning within the market. By definition, low quality companies with poor fundamentals that have a short term surge from short covering, will likely see a reversal at some point as these types of companies face reality.

We believe that some companies were displaying this characteristic during the latter half of Q1-2016. For example, FireEye, a software company that makes malware and provides network threat prevention services, moved up over 56% the four weeks after the market bottomed in early February (02/08/16). This is a company that, in the 13 quarters for which they have reported earnings, has never been profitable with current operating margins less than -20%. Regardless of a company's growth prospects, there is very little

news to support a 50+% price appreciation in less than 4 weeks.

Another example is Platform Specialty Products, a specialty chemicals company in the materials group. Over the same period, this stock was up over 40%. This is a company whose leverage ratio has doubled over the past year, and has remained unprofitable for the last 5 quarters. Again, it is difficult to justify a 40-50% four week move in a single stock without “earth shattering” news.

Exogenous Forces

It is most likely becoming obvious that we at Convergence prefer the stock market to be driven by the underlying fundamentals of the individuals stocks that make up the market as opposed to external influences (or exogenous factors). When markets are significantly influenced by large, unexpected and “unfundamental” factors, our stock ranking methodology and most other fundamental investors will be caught off guard. Luckily, historical evidence shows that these periods of exogenous influence have been short lived. As we highlighted in our opening quote from David Dreman, over the long run the market “weighs” fundamentals like a scale and rewards (penalizes) those fundamentals over time.

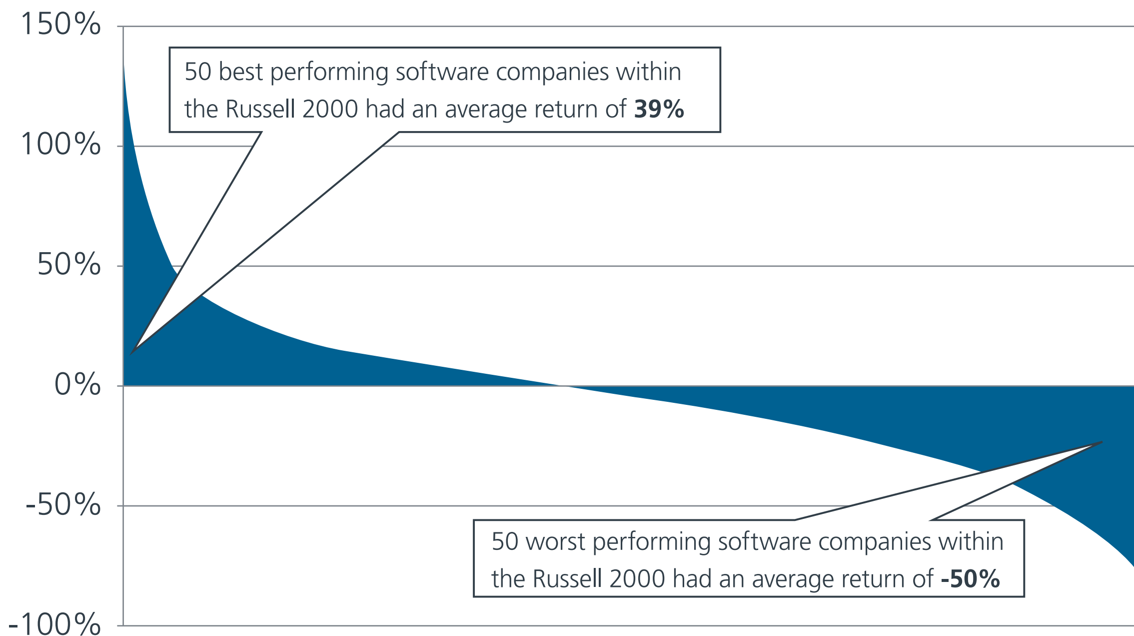
The unprecedented Federal Reserve influence, which it seems is trying to unwind, has been in place for nearly 3 years. During this period of extreme central bank manipulation, excesses and adverse consequences were created within the equity market. Through their influence, the Federal Reserve “enabled” struggling companies to avoid bankruptcy. For example, companies with high debt levels who, if rates were to rise, would have struggled to make debt payments were pardoned each time the fed “kicked the can.” These low quality companies would spike up in price, which counters the empirical evidence that fundamentally weak companies underperform.

The positive side to this is twofold. First, these exogenous periods end and tend to be short lived. And second, as the Federal Reserve continues to back away, the market will likely continue to distinguish high risk/high debt companies or the so-called “zombie” companies from good-quality companies.

Small Cap Case Study: Software & Services

Similar to last quarter, we would like to finish this quarter’s commentary with a case study of a topical industry group within our small cap universe. For this study we thought it might be interesting to take a deeper dive into the exciting Software & Services group. We will look at what drove our stock selection over the past year within this eclectic and highly idiosyncratic group filled with opportunities. Within Software, our stock selection methodology was very effective in the past 12 months in terms of both our long stock ranking as well as our short stock ranking. Let’s review a few key reasons we believe led to that success for that success and then detail the results.

Trailing 12 Month Software & Service constituent returns of Russell 2000 Index



Source: Wilshire Associates

Software companies tend to exhibit a high level of return dispersion (see above chart). There were 201 names in the Russell 2000 Index that represented this group over the past year. The top quintile (top 50) names in this group had an average return over the past year of 39 percent while the bottom quintile of performers had an average return of minus 50 percent! This diverse set of returns is actually somewhat normal for an industry group like software. These are companies with diverse business plans that transform daily life or crash and burn. Such a pattern of returns can produce a bumper crop of opportunities for an active manager, particularly a manager that has the ability to exploit not only the successful companies with a competitive advantage and attractive fundamentals, but also leverage the short-side for companies that are failing.

In the past twelve months, our dynamic approach found that outperforming Software companies had the following characteristics: reasonable valuation, low volatility, and significant sales, cash and earnings. Historically, we have found that the Software group has significant "fundamental dispersion." Such groups often provide greater alpha potential as the large fundamental gap between successful and unsuccessful businesses provides clear signals to identify which stocks will out/underperform in subsequent periods.

When examining our shorts, our process found that poor balance sheet quality, high volatility, high variability of earnings, and expensive companies were prescriptions for successful shorting.

Software	Long	Short
Looking for…	Low Risk Large Economic Size Traditional Valuation Low Earning Risk	High Accruals High Risk High Earnings Risk Overvalued

As demonstrated by the results within this group, our fundamental tilts within our long and short stock selection was very effective. In our Small Cap Strategy the Software longs returned a positive 5.8% versus the

† The returns in this paragraph were sourced from Wilshire Stock based attribution. They reflect the twelve months ended 03/31/2016 and are gross of fees. Past performance does not guarantee future results. Holdings are subject to change without notice.

industry group average -3.1%, while the short holdings fell -13% (also a good thing). Our ability to short in this eclectic group provided a distinct advantage to the Convergence Small Cap Strategy in in the past 12 months.†

Stick to fundamentals

Historically, in times of shifting market perceptions, we have observed that market volatility/dispersions tend to increase, which leads to opportunities for fundamental stock picking as the market rewards and penalizes company fundamentals accordingly. Given these observations, we believe a prudently constructed long (short) portfolio focused on fundamentally superior (inferior) firms will handsomely reward investors over the long term.

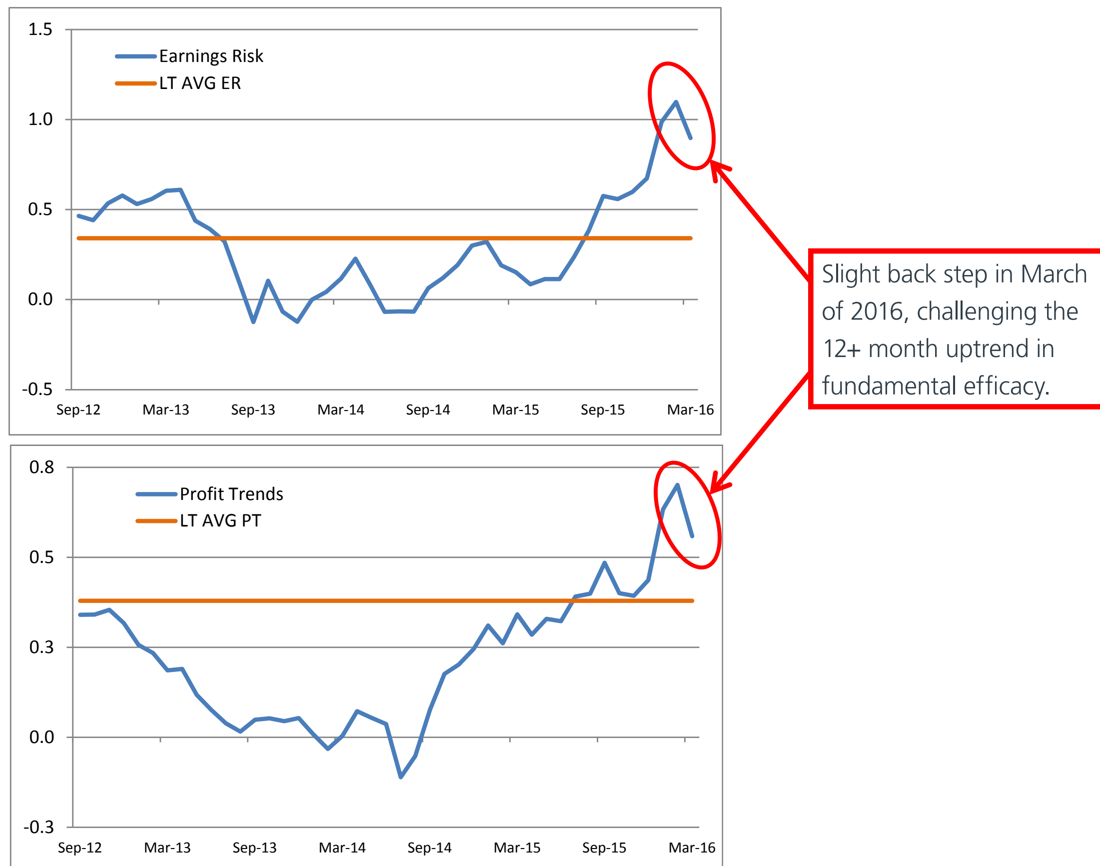
Factor commentary:

When comparing the spread returns of 2015 against those on Q1-2016 we see the following…

Improving	Unchanged	Breaking down
1. Traditional Value 2. "RiskON" 3. Relative Value 4. Risk 5. Accruals 6. Size	7. Price Reversal 8. Earnings Risk 9. Historical Growth	10. Price Momentum 11. Earnings Momentum 12. Accerating Growth 13. Capital Discipline 14. Expected Growth 15. Profit Trends

When we compare against their long run averages:

It seems most factors in late Q1 took a back step versus the longer term trend of an improvement in fundamental performance. As we know, trees don't grow straight up. We expect this hiccup to pass and for there to be a return to the longer term trend of fundamental performance that our research and empirical evidence supports.



Disclosures

Past performance is no guarantee of future results.

This communication is limited to the dissemination of general information pertaining to Convergence Investment Partners, LLC's (Convergence) services and general economic market conditions. The information contained herein is not intended to be personal legal or investment advice or a solicitation to buy or sell any security or engage in a particular investment strategy. There is no guarantee that the views and opinions expressed in this letter will come to pass. The views expressed are for informational purposes only and do not take into account any individual personal, financial, or tax considerations. There is not guarantee that any claims made will come to pass. The opinions and forecasts herein are based on information and sources of information deemed to be reliable, but Convergence Investment Partners does not warrant the accuracy of the information that this opinion and forecast is based upon. Opinions expressed are subject to change without notice.

Strategy returns are presented net of fees. Net of fee performance returns are presented after actual standard management fees, actual performance-based management fees and all trading expenses. No other fees are deducted aside from trading and management fees for the calculation of net of fee performance.

Convergence Investment Partners is an investment adviser registered with the Securities and Exchange Commission and is a majority owned subsidiary of Montage Investments, LLC ("Montage"). Montage is a wholly owned subsidiary of Mariner Holdings, LLC. Registration of an investment adviser does not imply any level of skill or training. The information contained herein is not intended to be personal legal or investment advice or a solicitation to buy or sell any security or engage in a particular investment strategy. The views expressed herein are for informational purposes only. There is no guarantee that the views and opinions expressed in this letter will come to pass. Investors should note that income from such securities may fluctuate and that each security's price or value may rise or fall. For additional information about Convergence please refer to the Investment Adviser Public Disclosure website at www.adviserinfo.sec.gov.

Alpha is a measure of performance on a risk-adjusted basis. It is a gauge of excess returns of a fund relative to the return of a benchmark index.

Beta is a measure of a fund's sensitivity to market movements. A portfolio with a beta greater than 1 is more volatile than the market, and a portfolio with a beta less than 1 is less volatile than the market.

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

Basis points (BPS) refer to a common unit of measure for percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% (0.0001), and is used to denote the percentage change in a financial instrument.

No graph, chart, or formula should in and of itself be used to determine which securities to buy or sell. The Russell 3000 Index and the Russell 2000 Index are measures of the performance of the largest 3000 and 2000 US companies respectively. They are constructed to provide a comprehensive, unbiased, and stable barometer of the broad market and it is reconstituted annually to ensure new and growing equities are reflected. Comparison to these benchmarks are for illustrative purposes only and the volatility of the benchmark may be materially different from the volatility of the strategies due to varying degrees of diversification and/or other factors. Index performance returns do not reflect any management fees, transaction costs, or expenses. Indices are unmanaged. You cannot invest directly in an index.