Convergence
Investment Partners

Convergence Long/Short Strategies
Q1-2017 Review and Commentary

Q1-2017

> ***"There are two ways to be fooled. One is to believe what isn't true; the other is to refuse to accept what is true."***
>
> *- Soren Kierkegaard*

The Convergence Perspective

The first quarter of 2017 was a strong quarter for equities in general. In terms of specific performance metrics within equities, it was a quarter of reversals, where previous winners became losers and vis versa. For example, this quarter saw companies with expensive valuations outperform inexpensive stocks on average. In addition, companies with high variability (higher risk) in cash flow, earnings, and sales, outperformed companies with stable/consistent cash flow, earnings, and sales. These type of performance characteristics can be referred to as "upside down fundamentals". Our research shows that although these periods do occur, they are considerably shorter in duration than positive fundamental periods. When markets go "upside down," we at Convergence often refer to the environment as "fundamentals on sale." Throughout history, we have witnessed that those with a disciplined investment process of investing in strong corporate fundamentals are rewarded for their persistence.

As we said in our year end 2016 commentary, "very few teams go undefeated and trees do not grow straight to the sky, but a sound strategy wins a great many games." We find it very hard to believe that the winners in Q1 will be the winners over the long haul. Unprofitable, Cash burning, and overvalued dreams are unlikely to remain the consistent best performers. In the end, it's not hope and expectations that drive stock price behavior over the long run. Rather, companies are rewarded and stock performance is differentiated by the underlying fundamental RESULTS that are produced.

Remember…. Stay Fundamental.

Overview of performance

After our strong finish to 2016, the Convergence Long/Short portfolios had a challenging start to 2017. The fundamentally strong rally that materialized after the presidential election seems to have morphed into a risk and beta fueled melt up. Most U.S. indexes ended the quarter higher with growth focused indexes trouncing their value biased counterparts. In the first quarter, a number of traditionally profitable factors were inverted, including absolute value, relative value, risk, profit margins, earnings risk, and accruals. This means that what we would expect to happen, good outperforming bad, was turned on its head… Superman lost to Lex Luthor. For example, high profit margin companies were outperformed by companies that have recently LOST money. We at Convergence never want to underperform, however, given the environment it is hard to imagine how our strategies could have kept pace in such an un-fundamental period.

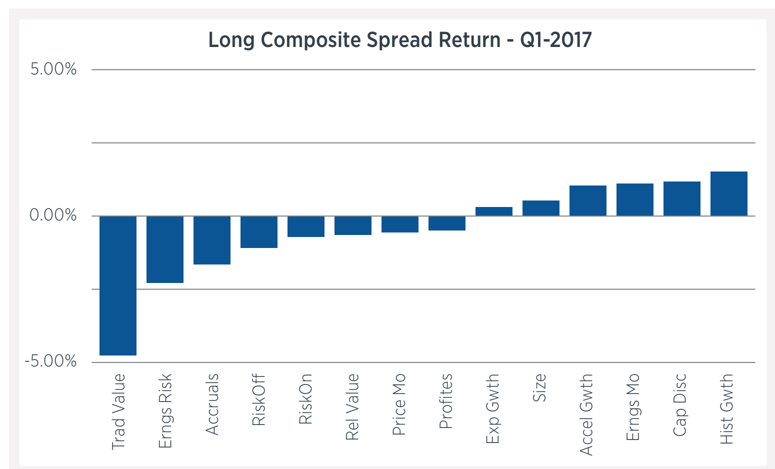
Our long-short extension "130/30" strategies both trailed their respective benchmarks by approximately 350 basis points in the quarter and our market neutral strategy was down 2.1% (performance is net of fees). A quarter like this tells us a few things. First, the fact that all strategies stumbled in similar fashion shows that we consistently apply our philosophy across all of our strategies. Secondly, it affirms our empirical research that although fundamentals win over the long-term they don't win all the time. Finally, if fundamentals do win over the long term, the forthcoming mean reversion will be an exciting time to hold fundamentally tuned portfolios.

To get a clearer picture of how our strategies performed in the quarter, let's take a quick look at our long-short spread. For the Large Cap Core Plus, we had negative spread in all three months, however, January was notably worse than February or March. It was a slightly better story for our small cap strategy: January had a small negative spread, February was the worst month and March actually had a very slight positive spread. Our Market Neutral strategy essentially mirrored our large cap core plus, all negative, with January being the worst. The silver lining to this paragraph is that the worst is behind us and the long short spread is improving. In March alone, within Market Neutral and Small Cap there was notable improvement in the last few days of March where 5 of the 8 last days had a positive spread.

Factor Discussion

For Q1-2017, our best performing factors were Price Reversal, Historical Growth and Capital Discipline. Price reversal is a technical factor that we use within our short process. It seeks to benefit from short term pullbacks in stocks that have rapidly appreciated relative to their peers. Our Historical Growth composite measures the growth rates of recently reported earnings; while our Capital Discipline composite quantifies how management is redeploying capital within the firm, in terms of Capex, buybacks or dividends. Conversely, our worst performing factors in the quarter were Traditional Value, Earnings Risk and Accruals. Traditional Value ranks companies from the most reasonably priced to the most overvalued in terms of earnings, cash flow and sales multiples and is historically one of the more powerful factors in terms of returns. Our Earnings Risk and Accruals factors differentiate companies in terms of variability of earnings and accounting obfuscation, respectively.

When we talk about factors performing "well," what we are looking at is the difference between the top and bottom 20% of stocks within the universe (top 1500 of the Russell 3000 Index) as ranked by the composite returns, equally weighted and sector neutral.



Digging a bit deeper into the returns of these factors shows that our best performers barely outpaced their ten year averages while the worst performing factor categories turned in returns firmly below their long term averages. Moreover, when looking at the direction and magnitude of our Q1 long composite returns, one quickly notices that although we had a comparable number of factors generating positive and negative spread, the MAGNITUDE of the negative returners outweighed the positives.

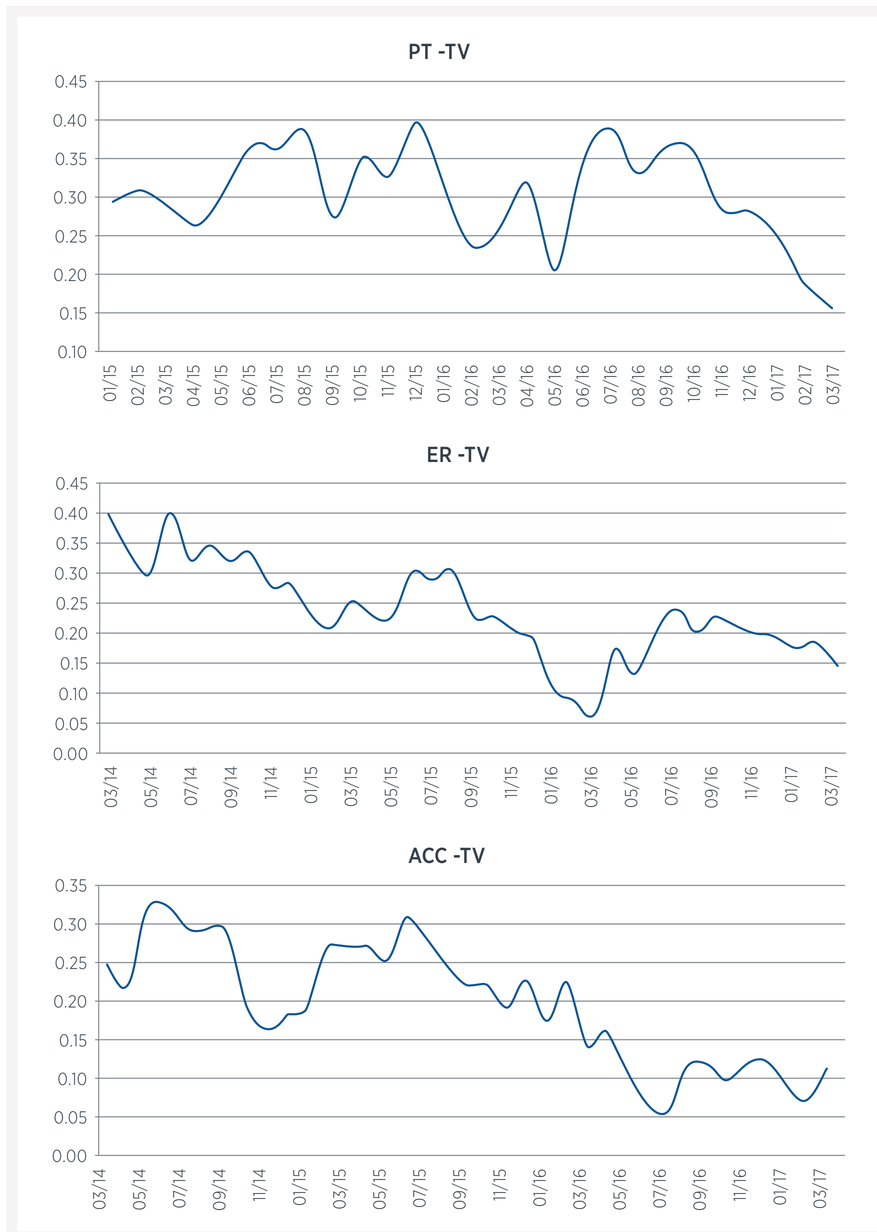
In our Q4-2016 commentary we stated that we saw a pattern emerging, that investors were beginning to look harder at individual company fundamentals. We also saw that our factors, which encapsulate thematic investor preferences were starting to generate returns commensurate with their long run averages. Although Q1 didn't jibe with our "pattern" we still believe this theory to be intact. We continue to believe that as the Federal Reserve and monetary policy fade away, individual company fundamentals will again be the key driver for identifying winners and losers.

Fundamentals on Sale

As we mentioned earlier, our perspective is that fundamentals are "on sale." Just like items at our favorite stores, occasionally factors can be purchased at reduced prices. Consider the following illustrative example. If an investor finds a stock attractive at $100 a share, it should be more attractive at $90 or less, ceteris paribus. Moreover, if that stock traded at a 20X earnings multiple and its earnings were expected to be $5 per share, then its price should be $100, or 20 X $5 = $100. Now if the earnings forecast has not changed, then the investor is buying those same forecasted earnings at an 18X multiple at the $90 stock price (or is paying only $18 for each $1 of forecasted earnings.) Now we will extend this same idea to factors.

Our historical analysis shows that sorting companies from most to least profitable generates a meaningful return. In fact, over the 20 years ended 12/31/2016, our Profitability composite has returned an 11% average per year spread return. This is the difference between the top and bottom quintile of stocks as ranked by Profitability. Preferably this positive spread return was earned consistently over the 20 year period, however, we all know this not to be the case. Moreover, we would like these returns to come from the factor itself and not valuation/multiple expansion or compression. In a valuation compression environment, highly ranked companies would see their valuations slip. This compression scenario is what we call… "fundamentals on sale." When this occurs, essentially one can buy the most attractive stocks for a discounted price. And looking forward, one should realize price appreciation from not only the factor but also from valuation. Our empirical evidence shows that in addition to factors generating positive returns, factor valuations oscillate around a mean valuation. And when the valuation "rubber band" stretches, it reverts back to its normal state.

Currently, our research shows that the "rubber band" has stretched fairly noticeably, thereby creating an attractive stock selection environment, within a number of our factor composites. Here at Convergence, we look at valuation it terms of our traditional value (TV) composite. TV is comprised of ratios like… Earnings/Price, Book Value/Price, Free Cash Flow/Price, Sales/Enterprise Value, etc. We compared the average TV score of the stocks that comprised the top/bottom deciles of each Factor Composite. Our analysis showed that, as of 03/31/2017, the valuation spread of our Profitability composite was more than 2.5 standard deviations below its 3 year average and more than 2 standard deviations below the long term (160 month) average valuation spread. We have also noticed similar valuation compression in our Accruals and Earnings Risk factor composites. The following charts show the factor valuation spread for these composites, charted over the most recent 3 years, ended 03/31/2017.



The above charts graphically present how the past three years have transpired to stack the deck in favor of fundamentally focused investors like Convergence Investment Partners. If one believes the Convergence investment philosophy: that strong fundamentals outperform poor fundamentals over the long term, than a multiple expansion tailwind within these fundamentals should prove irresistible. We are not necessarily looking for multiples to expand beyond their historical norms, we are simply looking for a return to normal. Therefore, we at Convergence are increasingly excited about the coming months and years as the recent past has added another opportunity to outperform.

For those of you that are interested in the minutia of what we look at when determining factor composite valuation spread, please see the appendix at the end of this report.

How is Convergence positioned?

In order to provide some more tangible evidence for how we invest at Convergence Investment Partners, the next table highlights several fundamental factors from each of our composites. Our composites are groups of such factors that are aggregated to best encapsulate the theme or gist of a specific investor preference. The values shown for each factor below represent the weighted average value of that specific factor for that particular portion of the portfolio (long or short) and the broader market overall (Russell 3000 Index). Therefore, this provides insight into understanding how the strategies are positioned relative to these major fundamental metrics.

As an example, take a look at the Return on Equity (ROE) of our long portfolios, the broader market (Russell 3000), and our short portfolios. ROE is found in the Quality category below. Most investors would prefer a HIGH return on equity, all else equal. Our long portfolios all have a higher ROE than the Russell 3000. Conversely, the names that we are short are not only returning less than the index, but they are actually DESTROYING VALUE. Generally such negative fundamental behavior is a great recipe for identifying attractive short holdings.

Average Fundamental statistics of Long & Short holdings for each Strategy:

		LONG			MARKET		SHORT		
Category	Factor	Market Neutral	Core Plus	Small Cap	Russell 3000	Russell 2000	Market Neutral	Core Plus	Small Cap
Value	Price to Free Cash Flow	11.1	11.6	9.1	21.9	29.5	-13.9	-21.8	-9.0
Value	Free Cash Flow to Enterprise Value	13.9	13.8	13.0	24.9	104.7	-41.3	-63.4	-15.1
Profitability	Net Income Improvement	17.4%	14.5%	25.8%	3.8%	7.3%	-0.8%	-3.6%	-7.0%
Profitability	Cash Flow to Sales	20.4%	22.5%	22.1%	-34.5%	-755.1%	-518.3%	-1016.5%	-1400.5%
Profitability	Internal Growth	14.0%	20.4%	11.4%	-1.5%	-137.4%	-0.9%	-3.5%	-13.3%
Capital Discipline	Change in Shares Outstanding	-0.4	-1.4	1.0	1.2	5.9	24.1	22.7	15.2
Capital Discipline	R&D to Sales	2.6%	3.6%	2.5%	59.3%	741.9%	585.4%	1151.0%	1295.3%
Quality	Return on Equity (ROE)	19.8%	28.0%	13.4%	5.2%	-134.2%	2.8%	0.8%	-11.1%
Quality	Return on Assets (ROA)	5.7%	6.1%	5.3%	6.3%	0.5%	-0.5%	-1.8%	-4.5%
Earnings Growth	Consecutive Qtrs Earnings Growth	1.5	1.3	1.7	0.9	1.0	-0.3	-0.3	-0.8
Earnings Growth	Slope of Earnings	0.71	0.41	0.65	0.01	0.30	-0.34	-0.42	-0.17
Cash Flow Growth	Consecutive Qtrs Cash Flow Growth	1.0	0.8	1.0	0.8	0.4	-0.1	-0.2	-0.6
Sales Growth	Change in Slope of Sales	1.33	1.71	0.75	-0.19	-0.41	-0.24	0.26	-3.58

As of 03/31/2017; Source: Wilshire Analytics & Convergence Investment Partners. TTM = trailing twelve months. bps = basis points. T3M – trailing 3 months.

As the table above demonstrates, the Convergence fundamental stock picking methodology leads us toward holdings in the long portfolios with strong cash flow, earnings, profits and other desirable financial characteristics. In addition, these favorable portfolio statistics are achieved without overpaying in terms of valuation as shown in the "Value" ratios. Over time, companies with strong fundamental traits trading at reasonable valuations have rewarded investors handsomely as these are signs of healthy and growing companies with competitively strong business models.

Appendix: Understanding the factor valuation spread charts

What we are really looking at in the factor valuation spread charts is the 3 year history of the valuation spread between our longs and shorts within each composite. What does this mean? And why do we do this? As our long term investors are aware, we score all stocks within the Russell 3000 relative to each other in terms of each factor composite. Our scores are z-scores, or the count of standard deviations from the mean. So, a Traditional Value score of 1.5 means that the stock scored is 1.5 standard deviations more UNDERvalued (or more attractive) than the entire Russell 3000. Now when determining the valuation of a composite, it is important to understand that 3 things can happen that would be positive:

1. The Longs can become cheaper relative to their history
2. The Shorts can become more expensive relative to their history
3. Both the longs and shorts can move away from their historical means

In our analysis, we simply looked at the spread between the long TV z-score and the short TV z-score. In order to remove capitalization skew we took the simple arithmetic average of the z-scores of the top/bottom quintile (20%) of stocks. For example, historically the longs in our profitability composite (PT) have averaged a TV z-score of 0.10, as of the end of Q1 that score was 0.11. This implies that our long names are reasonably valued relative to their long term (160 month) history. Conversely, the short names in our PT composite have averaged a -0.22 TV z-score and as of the end of Q1 these names had a score of -0.05. This shows that the most unprofitable names within the Russell 3000 are valued as AVERAGE within the index. Therefore, the short names within the composite present a more attractive opportunity in terms of valuation mean reversion.

In order to simplify this analysis, we calculated the difference between the long TV z-score and the short TV z-score to determine the extent of the valuation compression. Using the current valuation z-scores of our PT composite (below) gets us to the value of the last point in the above PT-TV chart.

0.11 – (-0.05) = 0.16

Compare this to the longer term averages (below):

0.10 – (-0.22) = 0.32

Although, this difference may seem small, it is important to consider the standard deviation of this spread, which has been, 0.08. Therefore, we can determine that the current valuation spread (0.16) is slightly more than 2 standard deviations below the long term average. For you statisticians, this type of move occurs approximate 2.3% of the time or 97.7% of the time that valuation spread is higher than it is right now…

…this looks like a massively stretched rubber band to us!

Disclosures

Past performance is no guarantee of future results.

Source of all factor data: Convergence Investment Partners.

No graph, chart, or formula should in and of itself be used to determine which securities to buy or sell.

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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. Returns include the reinvestment of income.

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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.

Return on Assets (ROA) s an indicator of how profitable a company is relative to its total assets, calculated by dividing a company's annual earnings by its total assets. Return on equity (ROE) is a measure of profitability that calculates how many dollars of profit a company generates with each dollar of shareholders' equity.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock.

Cash flow is the total amount of money being transferred into and out of a business, especially as affecting liquidity. Price to free cash flow (P/FCF) is an equity valuation metric used to compare a company's per share market price to its per share amount of free cash flow.

Shares outstanding are all the shares of a corporation or financial asset that have been authorized, issued and purchased by investors and are held by them.

The Russell 1000 Index, Russell 2000 Index and the Russell 3000 Index are measures of the performance of the largest 1000, 2000, and 3000 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. The S&P 500 Index is based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. Comparison to any index is 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.