Convergence Investment Partners

Convergence Quarterly Update

When Turmoil Benefits

Q3-2015

IN PARTNERSHIP WITH Montage Investments

The sharp reversal in the market's fortunes in the third quarter was only the most visible sign of change. After 6 years of unprecedented central bank accommodation, investor behavior had become distorted, almost schizophrenic. The mad rush to indexed based product became self-fulfilling, driving up correlations between stocks, compressing dispersion, and undermining traditional active management. At the same time, risk was without value in an environment of a central bank "put option." Companies without earnings, but trading on the eternal hope for the next big thing, roared to new heights. It all played out, until it didn't.

The Convergence Core Plus, Small Cap Core Plus, and the new Market Neutral Strategies recorded very strong results relative to both their respective benchmarks and their peers for the quarter just passed. As the market reminded investors of the notion of risk, our dynamic approach, coupled with our ability to short over-valued and over-hyped story stocks drove real value.

Convergence Strategy Composition Performance (net)

			Since Inception	
	Quarter	Year to Date	Compound Annual	Inception Date
Convergence Core Plus	-4.52%	-4.24%	14.13%	Dec. 29, 2009
Russell 3000	-7.25%	-5.45%	11.98%	
Convergence Small Cap Core Plus	-7.38%	-5.17%	14.24%	May 1, 2012
Russell 2000	-11.92%	-7.73%	10.63%	
Convergence Market Neutral	4.78%	N/A	6.43%	May 1, 2015

Market corrections serve to reestablish rational thought. It is the benefit that turmoil spawns.

The Current is Strong, The Surface Calm

The Russell 3000 Index lost 7.25% for the quarter, and stood 5.45% below its starting value for 2015. The Russell 2000 Small Cap Index lost a more meaningful 11.92% in the quarter, and rested just under 7¾% below where it closed on December 31, 2014. Disappointing, particularly in light of what we have become accustomed to in the post-financial crisis era; yet, hardly the magnitude to reignite lasting fear.

Below the surface, however, things are very different. Of the 1000 stocks in the Russell 1000, 262 lost more than 20% in 2015. Of the 2000 stocks in the Russell 2000, fifty percent, or 1000 lost more than 13.8% in the first nine months of 2015. More startling is the fact that 198 stocks or nearly 10% of the Russell 2000 Index lost over 50% this year. While the "averages" have only flirted with the official definition of a bear market, a large percentage of the underlying stocks are in an outright depression.

Dispersion, or the variance of stock price performance, is rising. This is good news for active managers as the wider the variance in performance between stocks, the greater the opportunity for managers to add value through active management. In fact, much of the interest in passive management is a direct result of dispersion being at or near historic lows ever since the Federal Reserve embarked on an unprecedented money printing operation. If the central banks ultimately make room for fundamental decision making in the stock market, dispersion will continue to rise and active management at least has an opportunity for revival.

Capturing the Opportunity

The opportunity presented itself, but few had the ability to capture it. According to JPMorgan just 35% of managers beat their benchmark on a year to date basis, and just 33% were able to add alpha in the volatile 3rd quarter.* In the large cap space only 21% were able to pull ahead year to date, and only 19% during the quarter.

There are some very important reasons for the lack luster performance. Starting toward the end of the first quarter, the market moved away from rewarding value and decisively toward growth. After nearly five years of outperformance by valuation, managers found their style tilt out of balance with a rapidly changing environment. Many active managers simply do not have the ability to respond to and implement such a change with the speed necessary. The Convergence approach is by design dynamic, and is a process specifically built to measure and actively respond to just such a change. Yet, while important, this did not account for the single largest reason managers were not able to exploit the pick-up in dispersion in our opinion.

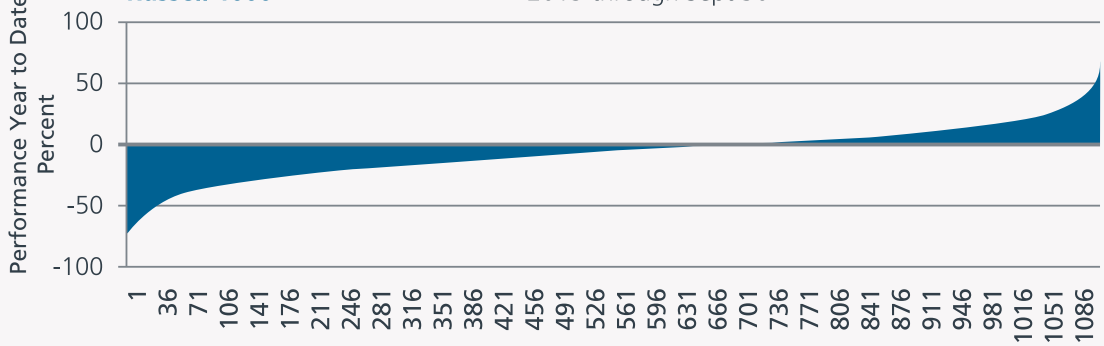
The largest contributor to the under–performance this year was a structural limitation most traditional managers have, the inability to short.

Dispersion to the Downside

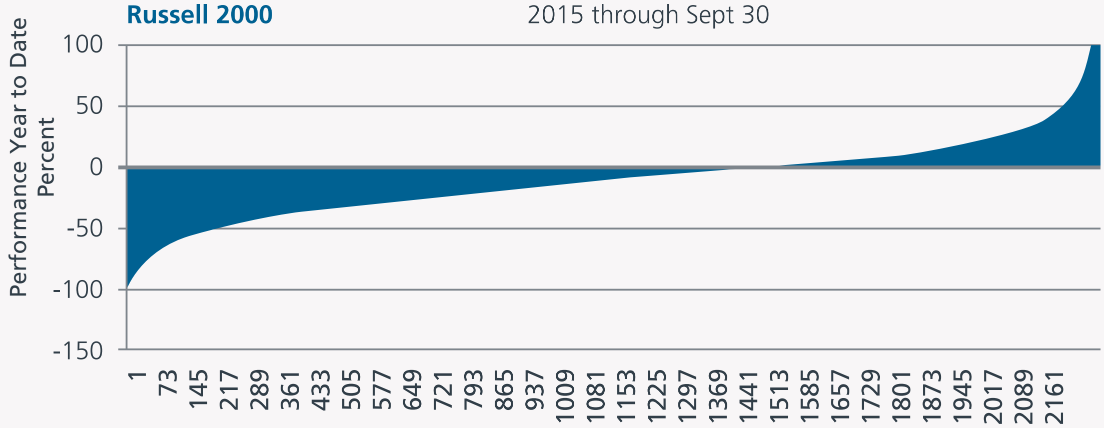
As noted earlier, a significant percentage of the individual stocks that make up both the Russell 1000 and the Russell 2000 declined by very significant percentages so far this year. For the traditional manager, the only decision that can be made regarding a stock expected to underperform is "not to own." For the index investor, there is no decision; you own them all.

*Source: JPMorgan US Equity Strategy Report

Individual Stock Performance
Russell 1000
2015 through Sept 30



Individual Stock Performance
Russell 2000
2015 through Sept 30



The decision “not to own” is a decision to implicitly short the stock in question, at least in comparison to the benchmark. For example, for a manager to decide not to own Apple is significant. In effect, that manager is placing a bet against Apple, and assuming Apple represents approximately 3% of the Russell 1000 it is an important one. But what if the stock in question is a very small percentage of the index? The decision not to own, even if the manager is convinced that the stock is grossly overvalued, is inconsequential if the stock were to represent 5/100 of 1 percent for example.

The breakdown in performance noted above makes this point. Of the 262 stocks that lost over 20% in the Russell 1000 so far this year, their average weight in the index was less than 6/100 of 1%. Of the 50% of the stocks in the Russell 2000 that lost over 13.8%, their average weight was 3.5/100 of 1%. The 198 stocks that lost over 50% in the Russell 2000 each represented 1.9/100 of 1% on average.

When dispersion is to the downside, the traditional approach is often ineffective. Further, historically corrections force a reevaluation of fundamentals, leading to broader dispersion of performance for underperforming companies. The significant opportunity lies in identifying these companies.

Shorting as an Alpha Source

The Core Plus Strategy out-performed the Russell 3000 Index by 274 basis points in the third quarter. The spread in performance between our long positions and our short positions during the quarter ballooned to 829 basis points. All of the positive performance variance came from our ability to short. Year to date, the Core Plus Strategy out-performed by 121 basis points, 60% of which was a direct result of our ability to short.

The Small Cap Core Plus Strategy out-performed by 454 basis points in the third quarter as the market was correcting. The performance spread between our long and short positions was 740 basis points and contributed 260 basis points to the overall performance of the Strategy.

The Convergence Market Neutral Strategy isolates the long/short strategy imbedded in the Core Plus and Small Cap Core Plus Strategies. During the quarter, the Market Neutral was up 4% while the market, as defined by the Russell 3000, declined 7.25%.

The Market May Be Up, or Perhaps Down, or …

We remain constructive longer term on the US economy, and the markets. Notwithstanding, a fair statement is that after nearly 6 years of a strong bull market, the easy money has been made. The Fed inspired "beta" trade is likely at an end. Volatility is likely to remain higher, the market less directional, and pricing more discriminatory. In such an environment, the ability to exploit widening dispersion, both to the upside and the downside will require a higher level of flexibility and agility in our opinion. Historically, the ability to short has represented 40% to 60% of our alpha production. The contribution may be higher in the future.

Disclosures