Convergence Investment Partners

Convergence Long/Short Strategies - December 2015 Review and Commentary

Convergence Shines as Investors Refocus on Fundamentals

Q4-2015

IN PARTNERSHIP WITH Montage

In the short run, the market is a voting machine,
but in the long run, it is a weighing machine.
-Benjamin Graham

Big Changes at a Time of Little Change

The market was little changed for the calendar year, with the Russell 3000 Index up less than one half of one percent. But as any bogie golfer will tell you, the score on the card rarely describes the game just played. The market underwent a series of major changes, each important in its own right.

- Return of Volatility
- Renewed Fundamental Focus
- Shift from Value to Growth

As we will discuss, these changes worked to the benefit of the Convergence Long/Short Strategies in 2015. Also, given the extreme nature of the Energy sector, we thought it timely to undergo a "case study" to see how our process navigated 2015.

Convergence Strategy Composite Performance (net)

Strategy	2nd half 2015 Outperformance to respective Index	Index
Convergence Core Plus	1.4%	Russell 3000
Convergence Small Cap Core Plus	4.2%	Russell 2000
Convergence Market Neutral	7.0%	Russell 3000

Volatility

The most obvious change was the return of volatility. In the last few months of 2015, the DJIA experienced multiple days of 500+ point moves. This increase in volatility should have been expected. After 6 years of repeated Central Bank "QE's," market participants had become complacent, comfortable in the notion that the Central Bank Complex would always stand ready to establish a floor. In the third quarter, it appeared that the Central Bank "put option" could no longer be relied upon. Volatility spiked.

Chicago Board Options Exchange SPX Volatility Index, 2015. Source: Bloomberg

Dow Jones Industrial Average, 2015. Source: Bloomberg

The increase in volatility aided the Convergence Long/Short Strategies in the second half of the year. With the ability to short in our Large Cap Core Plus, Small Cap Core Plus, and Market Neutral Strategies, we were in a position to take advantage. For 2015, in the Large Cap Core Plus Strategy the long/short extension produced a positive spread of 503 basis points, and contributed 125 basis points to strategy performance. For the Small Cap Strategy, the long/short extension produced a positive spread of 610 basis points, and contributed 399 basis points to strategy performance. And for our newly introduced Market Neutral, the first 8 months of its existence produced a net return of 7.2% at a time that the Russell 3000 was down -1.8%.

Strategy	Spread between longs and shorts	Contribution from extension (L/S) piece
Large Cap Core Plus Strategy	5.03%	1.25%
Small Cap Strategy	6.10%	3.99%

The Return of Rational Thought

The increase in volatility was accompanied by a profound change in investor behavior. With the Federal Reserve taking a step back from their frequent market intervention, investors were forced to evaluate stocks based on their underlying fundamentals. Since Janet Yellen was appointed Fed Chair in December of 2013, investors were frequently captivated by high expectation "story" stocks. The Fed's intervention encouraged risk taking behavior. Cocktail party favorites, particularly in the social media and biotech groups, performed reminiscent of the 90's internet craze and just like the dotcom party ended, so too it ended in mid-summer for these inflated, high expectation stocks.

As our long term investors are aware, the Convergence investment approach is grounded in fundamentals and systematically applied. We evaluate over 200 metrics on over 3000 stocks on a daily basis. We group these metrics into 14 composites as we have found that these 14 composites explain a large percentage of stock price movement.

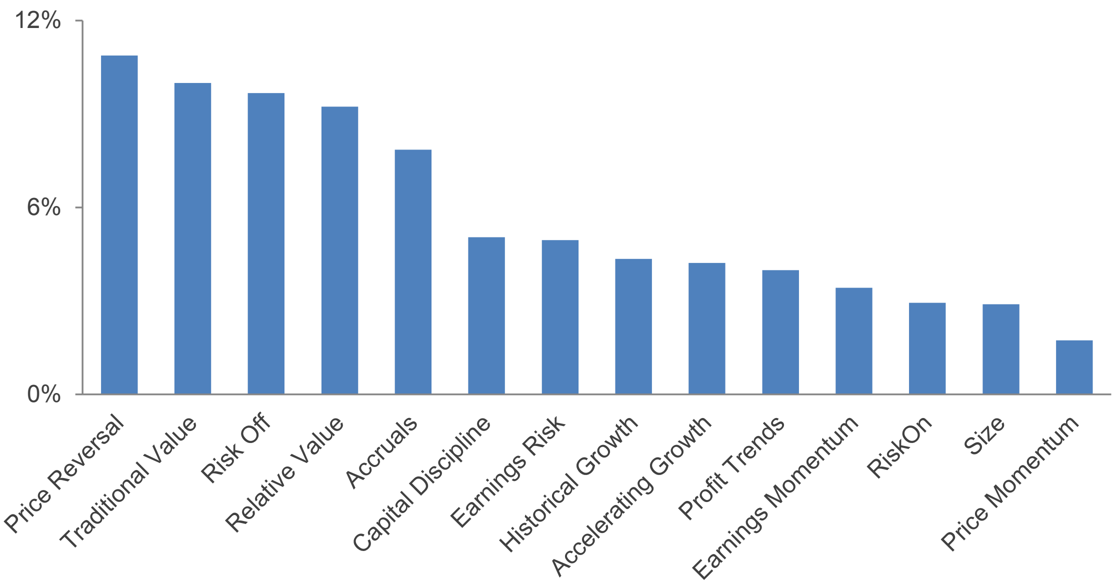
By examining the individual performance of each of these composites, we believe we can paint a clearer picture of what was moving stocks over a particular period. Each of these composites is, in effect, a long/short portfolio and can be benchmarked to zero. The table below compares the two halves of 2015 and allows us to determine if a strategy based on a certain composite generated positive returns. For example, in the first column, we are examining earnings risk. These returns are the difference (spread) between a basket of stocks with low earnings risk (long) and one with high earnings risk (short). All things equal, you would expect the market to reward companies that can reliably produce earnings and avoid surprises. Not so in the first half of the year. Companies with low earnings risk underperformed companies with high risk by 6%. Conversely, in the second half of the year, companies with low earnings risk significantly outperformed their high risk counterparts by nearly 12%. In 2015, a similar "return to fundamentals" shift can be observed in most of our composites.

Factor Composite Spread Returns, 1st Half of 2015 vs. 2nd Half of 2015

(for a chart of all fourteen factor composites please see Appendix 1) Source: Convergence investment Partners. These are factor spread returns for a long/short portfolio sorted by the factor (i.e. profitability). Compare these returns to 0.0% as these are designed to be market neutral portfolios, 100% long and 100% short.

The above chart shows five of our factor composites over relatively short periods of time. When this period is expanded to 20 years, our research shows that 14 of our composites have generated a positive spread. This is shown in the chart below in annualized returns. Over this 20 year time period, the monthly average of factor composites generating a "positive spread," is 60%. A positive spread indicates that a market neutral (0% net exposure) strategy based on that factor composite would have generated positive returns. In the first half of 2015, the monthly average was only 46%, showing that fundamentals were clearly out of favor. This average jumped to 70% in the second half of 2015, further supporting our "Return of Rational Thought" observation.

Composite Spread Returns (Annualized)



Source: Convergence Investment Partners. Quintile Spread, Sector neutral. 12/31/96-12/31/15.

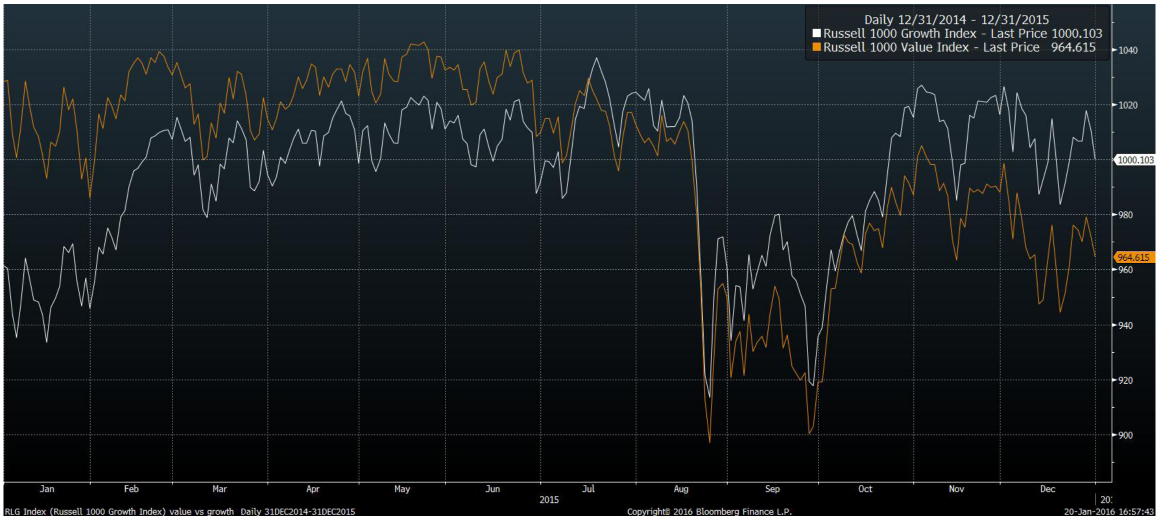
We quoted Benjamin Graham at the beginning of this piece. The quote is particularly relevant as he is stressing that over the long haul a successful stock picking strategy emphasizes fundamentals, and that short term hype cannot prevail. We believe that the market is entering a long phase driven by fundamentals. The behavior seen in the second half of 2015 is what is common over long periods of time.

This return to rational thought was the foundation for our success in 2015. Since June 30, 2015 the Core Plus strategy beat the Russell 3000 by 1.4%, and the Small Cap Strategy beat the Russell 2000 by 4.2%. The Market Neutral, our youngest and lowest beta strategy, was up 5.5% in the final 6 months of the year. We were especially pleased that Market Neutral was up 2.4% in the months of August and September which is in sharp contrast to the broader market (Russell 3000), which came under heavy selling pressure and plunged -8.4%.

Where Do You Go When There is no Value in Value

The increase in volatility and the dramatic shift to fundamentals were by themselves profound in their impact on the markets in 2015. On top of that, however, was a major shift away from valuation in favor of growth. As we began 2015, valuation disparities were compressed, undifferentiated from their peers. This was the result of 5+ years of strong value performance. As a result, valuation and risk-seeking factors performed poorly throughout most of the year. Essentially, cheap stocks proved they were not cheap enough. Instead, the market favored dependable and consistent growth measures such as earnings momentum, accelerating growth, and rising profitability.

Russell 1000 Growth vs. Russell 1000 Value. Source: Bloomberg



The Convergence dynamic approach is designed with this type of market shift in mind. While value managers road the tide of the last 5 years, the shift toward growth left them unable to respond. On balance, across the 24 industry groups, we witnessed a shift toward sales momentum, earnings momentum, and profitability. Armed with our dynamic approach, our stock selection migrated from value to growth over 2015 and allowed us to outshine a rigid value-only manager.

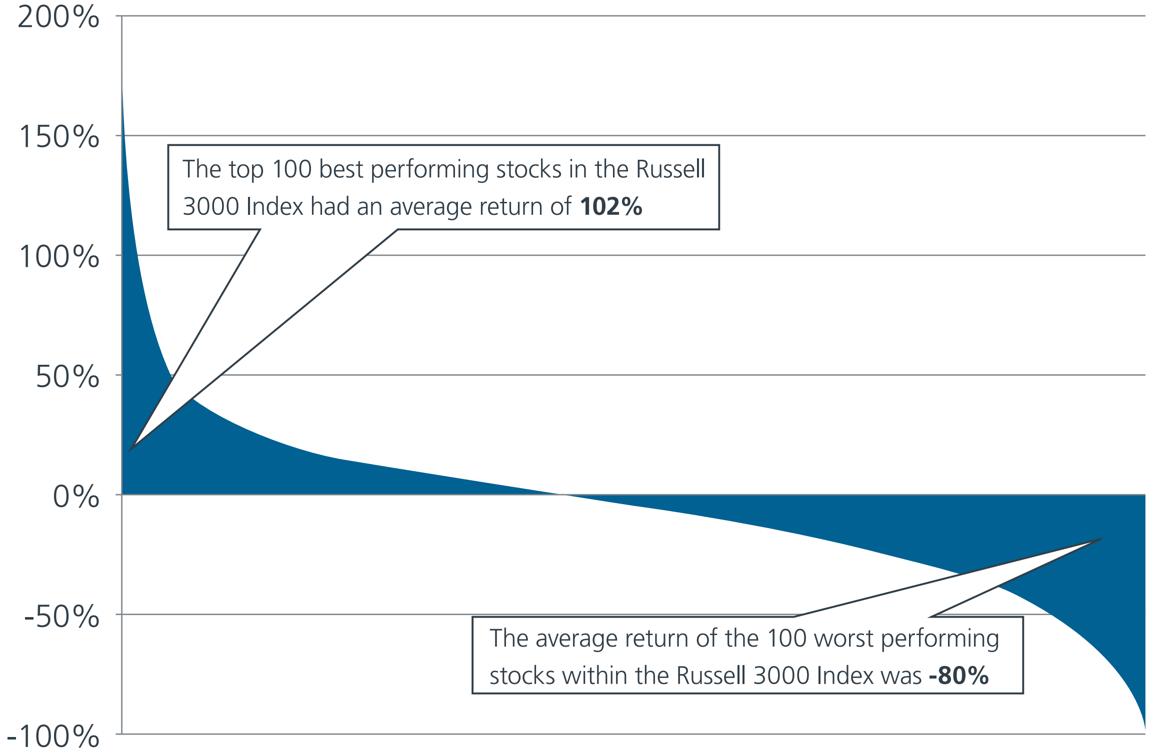
Encore Presentation: When Turmoil Benefits

In our third quarter commentary we showed that having the ability to short significantly expands the opportunity set for picking winners. And that this is enhanced in a period of heighted dispersion. Given the dramatic change in volatility in 2015, we believe it is worth reviewing a portion of that commentary.

While market returns were nearly flat in 2015… (from Q3-2015 commentary)

> *…a significant percentage of the individual stocks that make up both the Russell 1000 and the Russell 2000 declined by very significant percentages.*
>
> *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.*
>
> *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, the decision 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 3000, it is an important bet. 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 is a tiny fraction of the index.*
>
> *The breakdown in performance noted above makes this point. Of the 305 stocks that lost over 50% in the Russell 3000 in 2015, 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, as it was in 2015, the traditional long-only 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.*

2015 Stock Performance of Russell 3000 Index Constituents. Source: Wilshire Associates

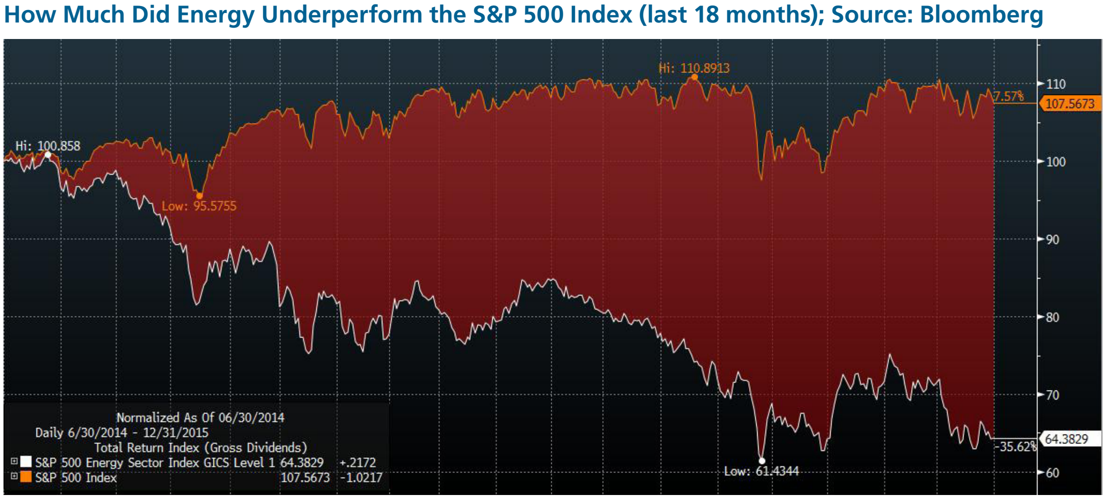


As we end 2015, volatility is on the rise, and wider dispersion in individual stock performance is becoming the norm. The broader mandate afforded the Convergence Long/Short Strategies gives us the opportunity to identify and exploit these trends to the potential benefit of the portfolio.

Case Study: Energy

To finish this quarter's commentary, we thought it might be interesting to take an individual industry group, a very topical one at that, and look at how the Convergence Investment Process evaluated the group and invested in the group in 2015. Within Energy, we feel that our stock selection methodology was very effective in 2015. Let's review a few key reasons for that success and then detail the results.

How Much Did Energy Underperform the S&P 500 Index (last 18 months); Source: Bloomberg



The Energy group was obviously under significant pressure in 2015 (see above chart). As the macro environment changed, the market sought to separate the good from the bad as oil plunged. The aforementioned 2015 shift to "growth" did not occur in the Energy sector. Conversely, our research indicated that Value was very much in favor during 2015. Our investment methodology examines each industry group, 24 in total, on an individual basis. In the case of energy, the macro environment was so hostile that the typical method of separating the wheat from the chaff was left in ruins. In 2015, our dynamic approach found that outperforming companies had the following characteristics: reasonable valuation, prudent capital spending, strong relative profit trends, and significant sales, cash and earnings. This four composite focus is relatively narrow. Normally we find efficacy in 8 to 10 of our individual stock composites, or "drivers" within each industry group.

When examining our shorts, our process found that weak and declining earnings, poor capital discipline, decelerating profitability, and negative price momentum were prescriptions for success.

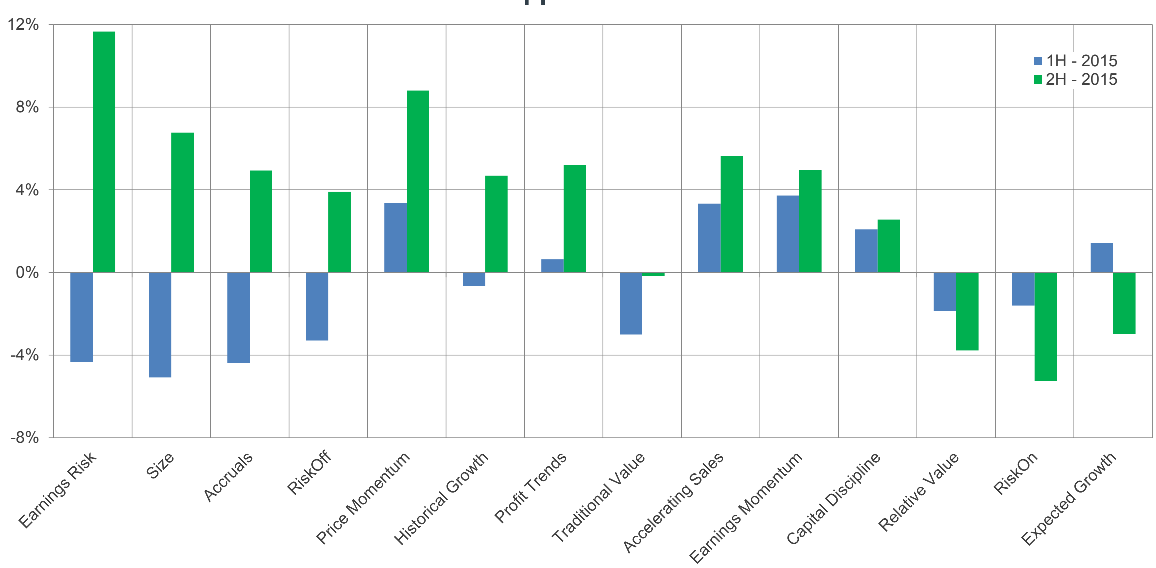
Energy	Long	Short
Looking for...	Traditional Valuation Capital Discipline Profit Trends Economic Size	Earnings Growth (poor) Capital Discipline (poor) Profit Trends (group laggards) Price Momentum (weak)

As our results show, the narrow focus of our long weights and our short model were very effective. In Core Plus our long portfolio within Energy returned 3.7% versus the average for the group at -23.2%. The shorts fell -36.8% (a good thing). In our Small Cap Strategy the Energy longs returned -5.8% versus the average for the group at -39.0%; and the short fell -43.3% (also a good thing). The ability to short in this troubled group contributed positively in both the Core Plus and Small Cap Strategy in 2015.†

Dawn of a New World

2015 was a transition year in our opinion. As noted, the shifts in the market were profound. We believe that the shifts experienced last year will be with us for some time. We believe these changes are healthy for the market longer term. For the Convergence Long/short Strategies, we believe that it sets a rich and potentially rewarding environment.

Appendix A:



† The returns in this paragraph were sourced from Wilshire stock based attribution.

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In addition to the aforementioned characteristics, there are numerous other alpha sources including, but not limited to, our ability to take short positions, our short extension structure, our autonomous short model, and factor tilts.

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.

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Past performance is no guarantee of future results.

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