Convergence Investment Partners

Convergence Long/Short Strategies
Q4-2016 Review and Commentary

Q4-2016

> ***"If what we think we know is actually wrong, then the opposite must be right."***
>
> *- George Costanza*

Status quo gets a surprise!

The year of 2016 has closed its chapter in history and will go down as a year full of upheavals, surprises, and inflection points. From a market perspective, many predictions and expectations by the "professional thinkers" proved to be completely wrong or opposite the expected result. Just take a look at the various news articles in the days and weeks leading up to Brexit and the U.S. elections for a sample of professional predictions hugely missing their mark. The surprises and inflections from this past year have ushered in an environment of increased stock dispersions of returns, which in turn has benefited astute and shrewd investors to source alpha opportunities.

— ***"Greater dispersions can lead to greater opportunities"*** —

A transformation of what the equity market is rewarding and penalizing has already begun to be realized. For years, investors have been bidding up large stocks that were perceived to be safe or defensive, as well as anything with a high dividend. This environment has been labeled by some as "secular stagnation" as the fear and pain of the global financial crisis brought about a period of more regulation, less capital expenditures, and an attitude of seeking safety and income in all forms. That mindset has been rapidly evolving not only here in the U.S., but also globally as populations have been rallying and voting to overturn the "status quo". These activities are transforming the market environment. Recently, within the equity markets, smaller companies, cyclical businesses, and undervalued earnings have all been rewarded. In sum, the market is grappling with how to price in an atmosphere that could be more "business friendly" and a new administration that is heavily tilted towards cabinet members with business backgrounds.

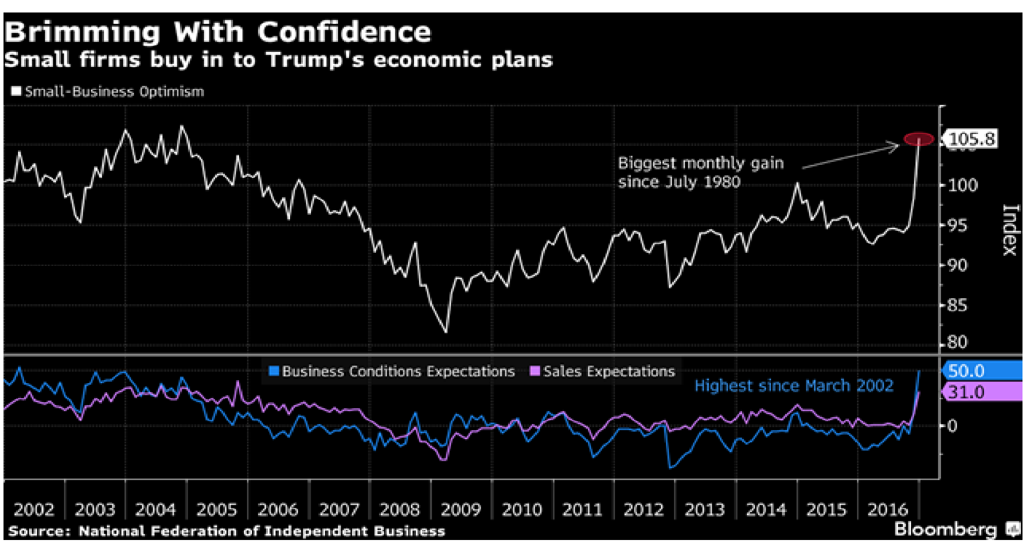
Our friends at ConvergEx summarized the changed regime with the following. ***"The bottom line here is that the current investment environment for US stocks is exactly the opposite of the last decade. President-Elect Trump's plans all point to higher earnings power than before. Yes, onshoring jobs may crimp profit margins, but lower taxes and reduced regulatory costs will make up the difference (or more). And after 3 years of stagnant earnings growth, the hope for better EPS growth in 2018-2020 is enough to hold the market's attention."***

Unleash the Animal Spirits!

The anticipated tax and regulation cuts, combined with higher fiscal spending incentives from the new administration, have produced some changes in consumer and investor attitudes. Evidence of a change in mindset is found most prominently within measures of both consumer and business confidence over the past couple of months. The recently reported spike in the Conference Board's Consumer Confidence Index moved to its highest level in 15 years!

Source: Bloomberg

The unleashing of the animal spirits has also been pronounced among small businesses. These small companies make up a huge part of the U.S. economy and are vital to future growth prospects. Since the recent election, these same businesses have significantly ratcheted up their business conditions and sales expectations. Such a dramatic change in these expectations among business owners has the ability to affect many areas of the economy including hiring, buying, building, investment, etc. Again, these changes in attitudes will produce differentiations and dispersions among companies for active managers to measure and position accordingly within portfolio holdings. The following Bloomberg chart highlights the surge in business confidence from the National Federation of Independent Business survey.



Source: Bloomberg

Obviously, the key to having this optimism meaningfully impact the economy is the support and compromise that goes into the current proposals. Separately, the historically favorable interest rate environment and the speed and magnitude of forthcoming rate increases will help to embolden disparities in stock price behavior. In the end, the two most important inputs for equity markets are earnings and interest rates. Simply stated, if earnings growth and the expectation for economic growth improves faster than a gradual rise in interest rates, stocks will go up. However, unlike the past several years, this will not be a one size fits all "beta trade". Rather, a byproduct of this new regime could lead to greater differentiation between stock winners and losers. As the folks at Nomura recently pointed out, rising interest rate environments are often favorable to active managers as good (bad) business fundamentals tend to get rewarded (penalized) in a purer fashion without the "backstop" of a central bank.

The Convergence Perspective

We at Convergence are thrilled by the positive returns and the results of our strategies through the end of 2016. Very few teams go undefeated, and trees do not grow straight to the sky; but a sound strategy wins a great many games, and most trees grow in the same direction. Our fundamentally focused methodology has been tested in recent years; however, a strategy that is built on sound economic logic has the opportunity to stand the test of time. As the year 2016 drew to a close, there was a renewed focus by investors to evaluate and differentiate the underlying fundamentals of the companies in which they invest. As our long term investors are aware, our methodology is founded on a strong process of measuring and ranking companies based on economic and fundamental variables that are relevant to U.S. companies within each industry group.

For the past several years, the outlook for stocks has been heavily dependent on the expectations for monetary policy. Now with the prospect for tax changes, fiscal growth policies, and a reduced regulatory environment, individual stock fundamentals will matter more. As we say in most of our quarterly write ups: **Stay Fundamental!**

As the investment landscape evolves and is impacted by economic and worldwide events, we believe the "beta" type bets that have been successful in recent past will fall short going forward. As the Federal Reserve reduces accommodation, the political status quo is challenged, and as the once omnipresent "lower forever" interest rate trend reverses course, shrewd and discerning investors will likely bid up the prices of fundamentally sound U.S. companies. Moreover, these same participants will likely shun the high flying "hope" stocks and punish mismanagement. Over the coming years, Convergence will carefully and meticulously monitor the abundance of U.S. equities and seek to reward our investors by not only investing in companies with positive and improving fundamentals, but also by shorting names with weak or declining businesses. At Convergence we play with our entire hand of cards and seek to generate alpha on both the long and short side of our best ideas.

Overview of performance

Our Convergence Long/Short portfolios had an amazing finish to 2016. Equity indexes rallied into the close of the year as investors heavily valued fundamentals. Fundamentally strong companies were handsomely pushed up in price while risky companies with spendthrift management were left in the dust.

Aided by the aforementioned strong finish, equity markets delivered some solid returns for 2016. Small Caps, represented by the Russell 2000 Index, nearly doubled the returns of larger cap indexes (S&P 500, Russell 3000). It is also interesting to note that, not only did a huge portion of these returns occur in the second half of 2016, but also that the third and fourth quarters were very similar in terms of their return percentages. These occurrences were extremely apparent in the small cap space.

Index	2016	H1	H2	Q1	Q2	Q3	Q4
S&P 500 Index	11.95%	3.84%	7.82%	1.35%	2.46%	3.85%	3.82%
Russell 3000 Index	12.72%	3.62%	8.78%	0.96%	2.63%	4.40%	4.20%
Russell 2000 Index	21.28%	2.21%	18.66%	-1.53%	3.79%	9.05%	8.82%

Source: Bloomberrg Finance L.P.

Although the Index returns of the last 2 quarters were quite similar (given our fondness for factor analysis) they looked quite different and exciting to us at Convergence. This is made quite obvious by simply looking at the returns of our strategies and knowing that we seek to benefit from fundamentally superior companies outperforming their inferior peers. Specifically, the Q3 & Q4 returns of our strategies were not as similar as those of their benchmarks. Our Strategies had much stronger Q4 returns when compared to Q3.

Strategy	2016	H1	H2	Q1	Q2	Q3	Q4
Core Plus	12.80%	-2.90%	16.10%	0.10%	-3.00%	5.70%	9.90%
Market Neutral	5.80%	-3.60%	9.80%	0.60%	-4.20%	1.50%	8.20%
Small Cap	19.20%	-0.10%	19.40%	1.80%	-1.90%	6.30%	12.30%

*Returns presented net of fees

A large part of the outstanding Q4 performance can be explained by robust factor efficacy. However, before we dig in to factor performance, let's briefly review the overall results of each strategy and the returns of each respective long and short component of the portfolios.

Our long/short portfolios delivered some strong returns in 2016 (all presented net of fees). Our Large Cap Core Plus Strategy returned 12.8% for the year and our Market Neutral Strategy delivered an impressive 5.8% return. Our highest returning strategy in 2016 was our Small Cap Strategy, up 19.2% for the year. The bulk of these returns came in the second half of 2016, primarily in the fourth quarter. During the last three months of the year, all of our strategies realized robust long/short spreads (the return differential between our long and short positions.) We were quite pleased to note that in the fourth quarter we realized a positive contribution in all three long/short strategies, from both the long AND the short sides of the portfolio. The long positions in both the Core Plus and Market Neutral Strategies nearly doubled the return of the "market" (S&P 500 or Russell 3000) in the quarter, and the short portfolios of each delivered near zero returns. These "beats" worked together to generate around 800 basis points of spread return, and to contribute significantly to strategy performance. The long names in our Small Cap Strategy kept pace with the +8.9% Russell 2000 index, while the strategy's short names delivered about half the index return, which is good for short returns. This generated approximately 420 basis points of positive spread, and allowed the strategy to outperform its benchmark in the fourth quarter.

Strategy	Q4-2016 Spread (Long-Short)
Core Plus	7.60%
Market Neutral	8.50%
Small Cap	4.20%

What Factors Worked?

For the year, our best performing factors were Valuation, Low Risk and Leverage. In looking at how these factors performed, the "two halves" of 2016 become very apparent. Over the entire year, lower risk companies outperformed their higher risk counterparts and allowed our RiskOff composite to deliver a positive spread of over 10%. This spread was generated as ~5% in the first half and ~5% in the second half. Interestingly, when we dissect the returns of Leverage (RiskON) and Valuation, we see that these strong spread returns, 8.3% and 14.7% respectively, really materialized in the latter half of 2016. As small businesses' attitudes, consumer confidence, and animal spirits swelled, investors flocked to cheaper firms with the expectation that higher levels of leverage would allow them to capitalize on the potentially, soon-to-be-improved environment for U.S. businesses. Another factor where we saw a tremendous turnaround was Capital Discipline. Capital Discipline is a factor that buys prudent spending and share buybacks and sells swollen budgets (R&D, Capex) and slashed dividends. In the first half of 2016, companies that were destroying shareholder value and spending wildly, outperformed their counterparts by nearly 5%. This reversed in the second half of the year when investors (in our opinion) came to their senses. Our Capital Discipline factor had a 5.9% positive spread in the second half of 2016 and ended 2016 with a 1.3% positive spread. As we back away from individual factor spread returns and start to "see the forest from the trees," a clear pattern is emerging. Investors are beginning to look harder at individual company fundamentals. Our factors, which encapsulate thematic investor preferences (value, earnings, growth, etc.,) are starting to generate returns commensurate with their long run averages. We believe that as the Federal Reserve and monetary policy continue to fade away, the importance of individual company fundamentals will again take the driver seat in terms of selecting winners and losers for publicly traded companies.

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 our evidence supports aggregating 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:

Category	Factor	LONG Market Neutral	LONG Core Plus	LONG Small Cap	MARKET Russell 3000	SHORT Market Neutral	SHORT Core Plus	SHORT Small Cap
Value	Price to Free Cash Flow (P/FCF)	10.1	10.9	9.1	21.4	-18.7	-16.3	-9.8
Value	Price to Earnings (P/E)	16.6	17	19.5	26.7	157.4	-213.3	-69.2
Profitability	Net Income Improvement	16.51%	14.07%	19.37%	1.41%	-7.71%	-9.22%	-10.50%
Profitability	Net Income/Total Assets	5.34%	5.83%	4.36%	5.84%	0.05%	-1.82%	-3.11%
Capital Discipline	Change in Shares Outstanding	-2.3	-2.3	-0.6	1.2	22.7	22.8	18.7
Capital Discipline	Multi Year Dividend Growth	108.1	145	53.1	96.6	39	32.6	18
Accelerating Sales	3 Month Improvement of TTM Sales Growth (bps)	37	28	69	10	-1541	61	-53
Accelerating Sales	6 month Improvement of TTM sales growth (bps)	-3.13%	-0.44%	-4.90%	-0.09%	-79.15%	-137.62%	-110.17%
Quality	Return on Equity (ROE)	19.32%	38.17%	11.79%	13.77%	-0.58%	-392.39%	-10.92%
Quality	Return on Assets (ROA)	5.35%	5.82%	4.76%	5.75%	-0.18%	-1.76%	-3.04%
Earnings Momentum	Standardized Unexpected Earnings	2.73	2.23	3.13	1.82	0.6	0.77	0.8
Earnings Momentum	Implied future EPS growth (2yr vs. 1yr)	12.84%	12.78%	11.59%	10.38%	6.32%	5.20%	4.96%
Historical Growth	Consecutive Earnings Growth	1.2	1.3	1.8	0.7	0	-0.4	0
Historical Growth	TTM Change in Earnings	0.78	0.73	0.93	0.13	-0.55	-0.4	-0.6

As of 21/31/2016; Source: Wilshire Analytics & Convergence Investment Partners. TTM = trailing twelve months. bps = basis points

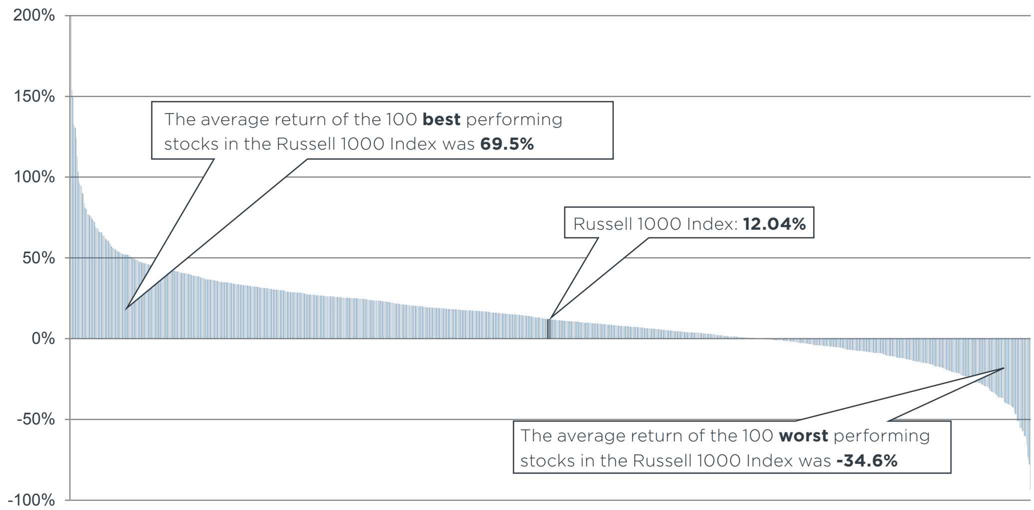
As the table above demonstrates, the Convergence fundamental stock picking methodology leads us toward holdings in the long portfolios with strong cash flow, earnings, profits and other desirable financial characteristics. In addition, these favorable portfolio statistics are achieved without overpaying in terms of valuation as shown in the price to earnings (P/E) 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. Separately, the Convergence process identifies companies with weak or declining fundamentals demonstrated in the statistics above, and our research, as well as long term results, has shown this to be effective in sourcing additional alpha opportunities.

Concluding Thoughts

We believe the investing world is in the midst of a significant shift. We at Convergence are very excited about this new regime, as we believe it will significantly aid our ability to deliver strong results for our clients. Sometimes investors have trouble overcoming the mindset that the events of the recent past are likely to continue in the future. This is known as recency bias. Over the past 5+ years the main driver/influence on stock prices has been monetary policy. The investment environment has begun to transform as the narrative for the market has changed from what has been the norm for many years. The huge shift is: Monetary » Fiscal. New policies in taxes, regulations, incentives, costs, and interest rates will have an impact on U.S. company financial statements. These changes will undoubtedly have varying effects on company fundamentals, which in turn will have varied impact on stock prices in every industry group. This massive shift has had and will continue to have a profound impact on stock prices, most significantly intra stock return dispersion. This increased dispersion will allow managers that shrewdly select companies for investing and present a challenging environment for "beta" investors.

It is also important to note that increased dispersion of stock prices typically enhances the benefits of utilizing a short component within a portfolio. We often refer to the ability to short as playing a game of cards with your "entire hand". We foresee that this new environment will increase the power of the "shorting" part of our hand. In this past year we saw large dispersions within the Russell 1000 Index, where the top 100 performing stocks in the index averaged 70% while the worst 100 names fell 35% on average (Wilshire Associates, 1/1/16 - 12/31/16). This presents a great opportunity for us as a manager to capture those opportunities on both sides of the equation. With the aforementioned changes, uncertainties, and a "new sheriff in town," it is conceivable that investors will witness higher level of dispersions, much like we have witnessed in past decades. In such environments, it's wise to be invested in a strategy that is built to harvest those opportunities.

2016 Stock Performance of Russell 1000 Index Constituents



Source: Wilshire Associates, trailing twelve months ended 12/31/16

Disclosures

Past performance is no guarantee of future results.

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.**