Convergence
Investment Partners

Convergence Long/Short Strategies
Q2-2017 Review and Commentary

Q2-2017

> ***"The young man knows the rules, but the old man knows the exceptions."***
> *- Oliver Wendell Holmes, Sr.*

Absentminded Investing

The market dynamics that have ensued thus far in 2017 remind us of the game show, *"Are You Smarter Than a 5th Grader?"* The equity market is enjoying its 9th straight year of positive returns and the first 6 months of 2017 are no different. However, a disproportionate amount of the YTD move can be attributed to "popular" and pricey names with extremely high expectations for future growth. Remember that *expectation* is a concept that is based on predictions that may or may not come to pass. In this quarterly review we will discuss not only portfolio and factor performance but also how investing in the aforementioned "popular" stocks is generally not a good long-term investment philosophy. We believe investing in such fad stocks is risky, as the market tends to "mean-revert" just when something becomes popular. So the question is: Are these popular stock investors smart enough to "call the top" or will they buy the (insert your favorite 5th grade fad here)[1] just before it becomes uncool?

While the overall Russell 1000 Index is up 9.27%, popular stock names have garnered much of the gains. The trifecta of high expectations, high popularity, and high ownership has produced the rocket fuel to inflame growth expectations and allow the market to soar higher. However, as disciplined investors know, once the excitement of a stock fades, expectations must convert into tangible results, i.e. the basic ingredients to company valuation (sales/cash flow/earnings). As we have said many times, these three horseman (sales/cash flow/earnings) are what ultimately determine the long-run performance of a stock. Even *armchair quarterbacks* know the names and excitement behind many of these popular stocks. Such as, Facebook (FB) up 31.2%, Apple (AAPL) up 25.4%, Amazon (AMZN) up 29.1%, Netflix (NFLX) up 20.7%, Alphabet (GOOGL), (GOOG), up 17.3%, and Tesla (TSLA) up 69.2%, in just the first 6 months of 2017. These are a few examples of stocks that have garnered attention due to their future growth potential. This attention and price appreciation causes a virtuous cycle whereby names receiving higher weighting in the various cap weighted indexes (whose weights are dependent on price movement only) and with the commensurate investor capital that passively tracks those indexes. The attention to some of these so-called popular stocks may have less to do with efficient allocation of capital to strong business fundamentals, but rather it has been a theme of chasing "growth at ANY price."

[1] Some fad ideas: Dot Com Stocks, Garbage Pail Kids, Tulip bulbs, Beanie babies, Hyper color shirts, Pet Rocks, Puka Shells.

A Culture of Fitting In

As humans, we love to be loved, and with that comes a desire to feel like we fit in (think of the premise behind Facebook for evidence on that.) The challenge as an investor is to build a disciplined investment strategy anchored to sound investment and economic principles that will lead to long term expansion of wealth, not short-term feel-good results. In the late '90s we witnessed a lot of "feel-good investing." To the extent one stuck to sound investment principles to select securities, an investor would actually be ridiculed, questioned, and experience the peer pressure of being "un-liked."

> ***"Instantiate – To provide an instance of or concrete evidence in support of (a theory, concept, claim, or the like)."***

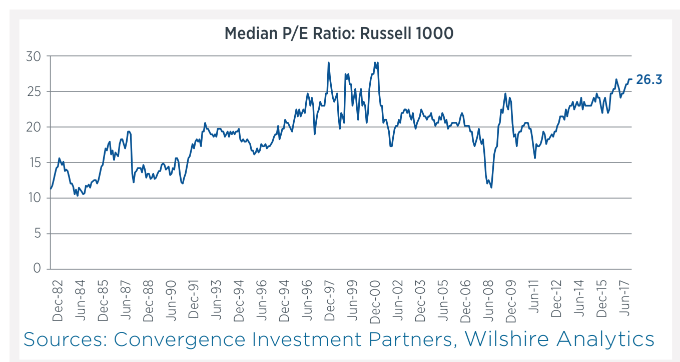
The problem with investing with so-called "popular stocks" is that once a stock or group of stocks becomes popular, the money flows have already flooded into such securities which means the incremental fund flows to further drive up the price of a stock, becomes more sparse… there might not be a greater fool. In a recent report, Credit Suisse noted the following, *"We see signs of crowding in FAANG (sell-side net buys have stalled at post Tech bubble highs; GOOGL, FB, and AMZN have also been heavily over weighted by large cap growth funds). Additionally, the performance of FAANG stocks relative to the broader market has moved inversely with interest rate direction since 2003 (implying that a move higher in interest rates in 2H17 could be a challenge for the group from a trading/sector rotation perspective)."*

In addition, BofA Merrill Lynch makes this observation, *"Avoid crowded stocks – especially right now: Over the short-term (3 months), our work suggests that positioning matters more than fundamentals: buying stocks which are the most underweight by large cap active managers has led to stronger three-month returns than investing in Low P/E stocks or stocks with favorable growth or ROE."*

At Convergence, experience has shown us that environments of excess are followed by periods of significant reversion as mismatched fundamentals are realigned. The intuitive logic for such realignment is that very few things earn outsized returns for a long-sustained period of time without absolute barriers to entry or an impossible to replicate technology. Therefore, over time, outsized returns are diminished or reversed as competition and different alternatives get their turn on the "rotating ferris wheel" of life.

> ***- With extreme excesses comes great opportunities***

One of the most common excess/reversion examples is valuation. Currently, the overall equity market has been treading water at its current above average valuation. To remove the biases of capitalization and the impact that varying sizes of companies have on averages, Convergence also monitors the median valuation levels of stocks.



Sources: Convergence Investment Partners, Wilshire Analytics

Looking at the median numbers on a historical perspective, we observe that currently the average stock is trading on the upper end of where stock valuations have been trading in the past 35+ years.

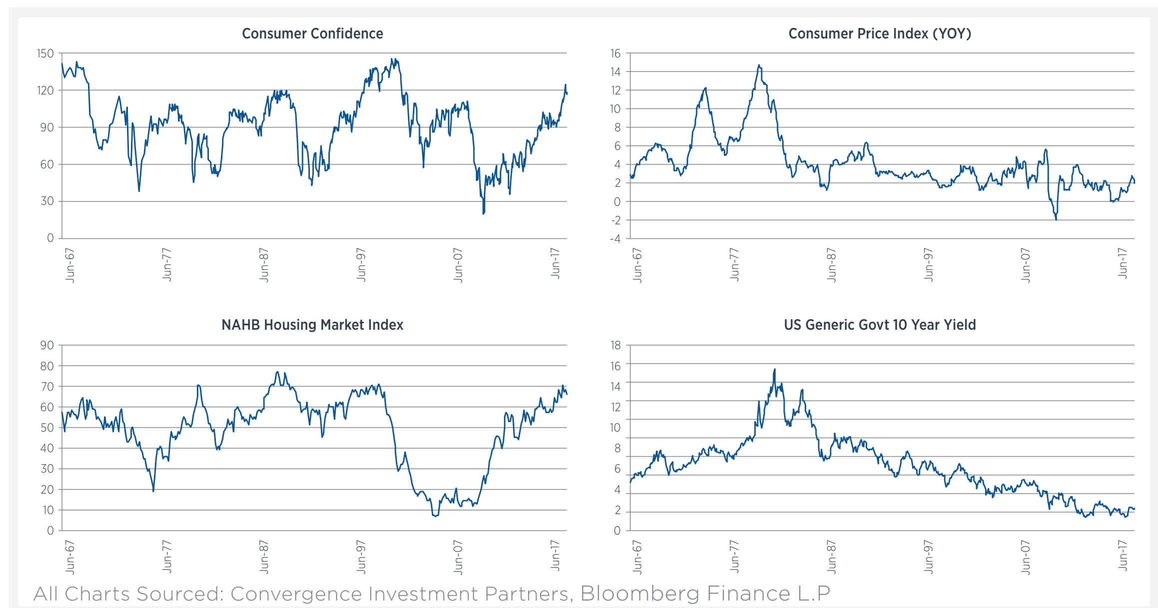
The Leuthold Group recently made the following observation, *"When examining median trailing P/E ratios by market cap decile, we find that all but the top decile of the Leuthold 3000 universe currently trades above 20x."*

Valuations alone do not determine market direction. In fact, if earnings continue to rise (the "E" of the P/E ratio) higher levels of valuation can persist for years. However, when the overall median averages are inflated, the environment signals a plethora of opportunities for managers, like Convergence, that utilize shorting as a component of the overall investment strategy. Finding stocks with extended valuations/high prices combined with weak and declining business fundamentals packs a powerful punch for shorts.

Economic backdrop

The economic activity behind market action can be summarized in the following highlights:

We have been in an environment where businesses and consumers are relatively confident (particularly given where we have come from over the past 9 years). Inflation remains contained, as global competition and technology innovation have kept prices under control. Overall economic growth continues to be relatively subdued both in terms of GDP and productivity measures. Housing has continued to improve as borrower credit scores have recovered while interest rates have remained favorable. Finally, interest rates remain low from a historical perspective; however, the short end of the interest rate curve has begun to rise as the central banks are now on a path of normalizing rates via interest rate hikes and balance sheet reduction.



All Charts Sourced: Convergence Investment Partners, Bloomberg Finance L.P

Where does this leave investors?

We are optimistic given the aforementioned observations regarding the equity market and overall economic conditions. On the horizon, we see a favorable period for fundamentally focused investors to exploit opportunities found within attractive long and short stock holdings.

As noted, equity valuations are elevated both from an absolute and relative basis. With higher average valuations come increased opportunities for shorting attractively ranked candidates at higher prices (a.k.a. sell high, buy back low). In addition, with a backdrop of generally rising interest rates, two distinct benefits are ascribed to investors who short:

1. **Lower costs;** *short rebates are linked to interest rates, i.e. higher interest rates » higher rebates.*
2. **Higher minimum standard, the training wheels are coming off;** *higher rates, means higher interest expense. Low/no earning companies have an increased likelihood of default. Also, a higher and "normalized" discount rate means that the differentiation on capital allocation goes up as it becomes more difficult for companies with weak balance sheets and unsustainable business models to endure versus companies with stronger business fundamentals.*

Overview of performance

As previously mentioned, the equity markets have enjoyed strong gains in the first 6 months of 2017. This has been evident in each of the major market indexes. Year-to-date, the large-cap indexes have nearly doubled the returns of small-cap indexes. This should be unsurprising, given our previous observations about popular and large companies with high expectations. Nevertheless, over the past 12 months, the broad representation of the small cap companies is still ahead of the large capitalization-skewed indexes by several hundred basis points.

Index	12 Month	Q1	Q2	2017 YTD
S&P 500 Index	17.89%	6.07%	3.09%	9.34%
Russell 3000 Index	18.50%	5.74%	3.02%	8.93%
Russell 2000 Index	24.57%	2.46%	2.46%	4.98%

Source: Bloomberg Finance L.P.

While our long short strategies have trailed the broader market averages year-to-date, we are pleased with our returns over the most recent 12 months. We are also encouraged by the market dynamics that we witnessed in June of 2017. As shown below, the Convergence Core Plus strategy and the Convergence Market Neutral strategy have produced competitive absolute and relative returns due to overall favorable trends in our fundamental rankings over the past 12 months. Separately, the Convergence Small Cap Strategy has generated robust returns on an absolute basis, but has trailed the high-octane Russell 2000 during the environment of rewarding high risk/high expectations stocks. Recently, we have witnessed favorable trends which show that the equity market has begun to move from an environment of growth at ANY price to growth at a REASONABLE price. This obviously has positive implications for disciplined investors who favor stocks with strong fundamental characteristics trading at reasonable valuation levels.

Strategy	12 Month	Q1	Q2	2017 YTD
Core Plus	20.17%	2.07%	1.42%	3.51%
Market Neutral	8.16%	-2.09%	0.62%	-1.49%
Small Cap	20.34%	-1.05%	1.89%	0.82%

*Net of fee strategy returns, Dividends Reinvested. Source: Convergence Investment Partners

Beyond looking at the returns for each strategy in total, it is instructive to analyze the spread of returns by comparing the long holdings versus the short holdings (efficacy). The spread provides insight into how the market is rewarding/penalizing stocks based on fundamental

rankings. As shown below, the large-cap and market neutral strategies, which source candidates from the large and mid-sized companies produced a positive spread between the long and short holdings over the past 12 months. Conversely, the small-cap active extension strategy generated a negative spread between long and short holdings as the headwind from the outperformance of high risk companies over the recent time period made it challenging for shorting within that segment.

Strategy	12-Month Spread (Long-Short)
Core Plus	3.5%
Market Neutral	6.6%
Small Cap	-2.8%

What Factors Worked?

The following table shows the top and bottom three performing factors over a few different time periods. We ranked all 15 factor composites by spread return in order to show that what tends to work over the long term is not always true in the short term.

	SHORT TERM			LONG TERM		
	3 months	6 months	12 months	5 years	10 years	20 years
Top 3	Hist Gwth	Hist Gwth	Price Reversal	Trad Value	Trad Value	Price Reversal
	Exp Gwth	Exp Gwth	Cap Disc	Size	Price Reversal	Trad Value
	Erngs Mo	Erngs Mo	RiskOn	Erngs Risk	Erngs Risk	Low Risk
Bottom 3	Leverage	Leverage	Profits	Price Mo	Profits	Size
	Trad Value	Low Risk	Price Mo	Accruals	Exp Gwth	Price Mo
	Low Risk	Trad Value	Erngs Risk	Exp Gwth	Price Mo	Exp Gwth

The table above clearly shows that valuation, although historically very important, has not been on investors' minds in 2017 (the blue arrow.) Moreover, forecasted growth expectations have moved from one of the least effective factors to among the best in 2017 (the red arrow.) This shows that our numbers validate the theme of chasing "growth at ANY price."

How is Convergence positioned?

As we have done in previous quarterly updates, we wanted to share with our investors a summary of the fundamental tilts found within each strategy. As before, the following table highlights several fundamental factor examples that we utilize to rank the relative attractiveness within our investment process. The values shown for each factor below represent the weighted average value of that specific factor (long or short component of the portfolio) and the broader market overall. Our goal is to provide insight into how the strategies are positioned relative to major fundamental metrics.

As an example, take a look at **"Cash Flow to Sales."** This is a measurement of how much cash is generated from each dollar of sales. This factor is found in the Profitability category below. Most investors would prefer a HIGH level of cash flow generation, all else equal. Our long portfolios all

have a higher and positive cash flow to sales ratio. Both the Russell 3000 & 2000 Indexes have negative cash flow to sales ratios, indicating that on average, companies are not generating cash flow. Additionally on average, the names that we are short are also failing to generate cash. Generally, this is beneficial 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 Earnings	13.3	14.4	17.3	24.9	61.4	79.1	102.5	-68.2
Value	Price to Free Cash Flow	11.8	11.8	9.6	22.0	32.1	-12.1	-15.0	-5.7
Value	Free Cash Flow to Enterprise Value	9.6%	9.5%	10.3%	4.1%	3.2%	-2.6%	-2.2%	-7.1%
Profitability	Net Income Improvement	23.3%	21.4%	32.5%	6.8%	8.5%	-4.7%	-6.8%	-5.8%
Profitability	Cash Flow to Sales	21.0%	21.4%	22.1%	-15.2%	-470.0%	-520.4%	-875.8%	-3221.8%
Profitability	Internal Growth	23.0%	31.7%	12.1%	20.8%	-18.3%	-1.5%	-8.3%	-20.3%
Capital Discipline	Change in Shares Outstanding	-35.5%	-114.6%	202.5%	125.4%	861.8%	1620.9%	2028.2%	1256.4%
Capital Discipline	Dividend Growth	115%	127%	95%	90%	45%	26%	30%	13%
Quality	Return on Equity (ROE)	34.1%	56.8%	13.9%	31.6%	-15.7%	-0.1%	-10.1%	-18.7%
Quality	Return on Assets (ROA)	7.5%	8.0%	6.5%	6.4%	-0.1%	-0.9%	-2.8%	-6.2%
Earnings Growth	Consecutive Qtrs Earnings Growth	2.0	2.0	2.2	1.4	1.0	-0.7	-0.5	-0.1
Earnings Growth	Slope of Earnings	0.8	0.6	0.5	0.3	0.1	-0.5	-0.4	-0.2
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 06/30/2017; Source: Wilshire Analytics & Convergence Investment Partners.

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 these ingredients have typically rewarded investors handsomely as these are signs of healthy and growing companies with competitively strong business models. Separately, the Convergence process also identifies companies with weak or declining fundamentals demonstrated in the statistics above, and our research has shown this to be effective in sourcing alpha from shorting.

Concluding Thoughts

We have come to the conclusion that the environment for investing in long/short strategies is as positive as it has been in decades. We drew this conclusion after contemplating the mosaic of recent economic data, current market positioning/pricing and our exhaustive research. The combination of above-average valuation levels, low and increasing interest rates, and "crowd following" investing has created an atmosphere that we are finding increasingly promising. For a disciplined manager, with a process based on sound economic principles of ranking securities, the current and coming environment will be impactful as intra-stock return dispersion is likely to reward both on the long and short holdings. In such environments, it's wise to be invested in a strategy that has the objective of harvesting these opportunities! As we like to say, "Stay Fundamental!"

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.