

Convergence Long/Short Strategies

Q3-2016 Review and Commentary

Q3-2016

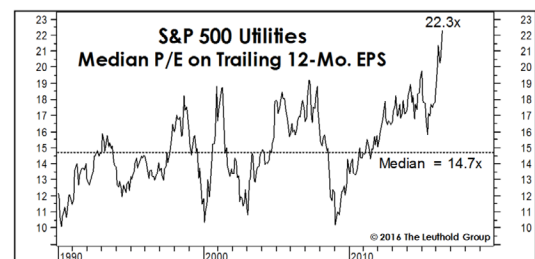
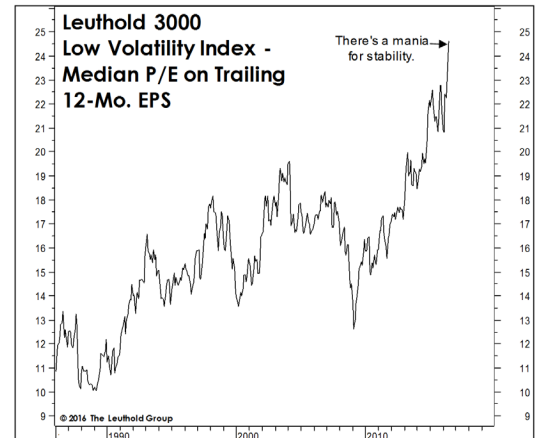
*Fireman: **How do you live with yourself?**
 George: **It's not easy.***

- Seinfeld quote

Party like its 1999!

Let's reimagine the equity market is a large block-party, and certain parts of the crowd are becoming obnoxious and "out of hand." At the same time, there are other partygoers who are behaving sensibly, but who are amused by the behavior of "that other crowd." In this case, the obnoxious crowd is the swelling mass of investors loading up on low volatility "low vol" stocks. And the "sensible" group is looking on and thinking this trade looks quite "long in the tooth" as stocks within the Utilities, Staples, and Real Estate categories are trading at dangerous levels.

Question: If historically defensive groups are trading at extremely high multiples without the support of future high growth, where will investors run for protection in a pullback or correction? Hint: One should run not to stocks that have elevated to excessive levels.



Source: The Leuthold Group

Another group at the equity block party is comprised of extremely risky companies: weak balance sheets, exceedingly high debt levels, and low levels of cash generation. This group of partygoers has also been stirring up trouble with excessive behavior that is atypical for this group of underachievers over the long run. We will speak to this in more detail later in a case study format.

A key driver behind these raucous themes is the intense focus on Central Banks and exogenous macro-economics instead of company fundamentals. In 2016, markets have been massively impacted by the intense focus on every signal, hint, or sneeze emanating from the central banks. Is the Fed tightening? Is it not? Hawk? Dove? In the end, a ¼% rate change is nearly meaningless. However, the market's attention to every gesture from central banks and the ultra-accommodative environment is starting to produce some interesting, anomalous behaviors in certain pockets of equity securities.

The problem is that the Federal Reserve has become the market's chatty neighbor, constantly stopping by for a cup of coffee and conversation.

- Yardeni Research

Wait, haven't we seen this party before?

For those of us experienced enough, this type of behavior reminds us of the late 1990's. The founders of Convergence remember it well. Investors were tempted to chase companies with no earnings, no cash flow, and even NO SALES. They just needed to make sure the company they were buying had a really cool name that ended in "dot com." We also recall that "the Greenspan Put" phrase was coined to explain the extremely accommodative monetary policies used to stave off the scary "Y2K." This mindset resulted in a feeding frenzy for IPO's, high risk assets, and companies without strong fundamental underpinnings. It was a period where "it's different this time" and "there is no alternative" were common utterances. The argument was that one had to be invested exclusively in new-economy internet companies, because all other companies which were part of the "old-economy" were irrelevant and should be ignored.

It is quite well known how this feeding frenzy ended. The markets dramatically punished overvalued, low quality companies with no financial foundation. For fundamental managers, the years following the frenzy were some of the most rewarding and justifying. As market participants were forced once again to select their investments based on sound logic and tangible fundamentals, those of us who did not buy into the dot com propaganda stood to benefit. This is why we get goosebumps of excitement when we see some of the extreme behavior today! For managers like Convergence, it is an incredible time to hold equity positions intended to exploit the building anomalies and market excesses. Importantly, our process is designed to take positions on both the long and short side of these extremes. We will demonstrate how we are positioned for the coming normalization later in this report.

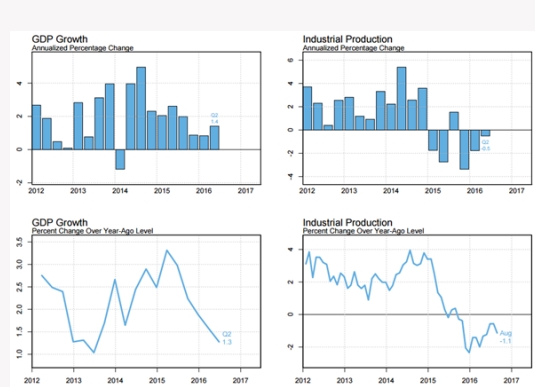


Once TINA arrives at the party, it's time to leave before things get rowdy

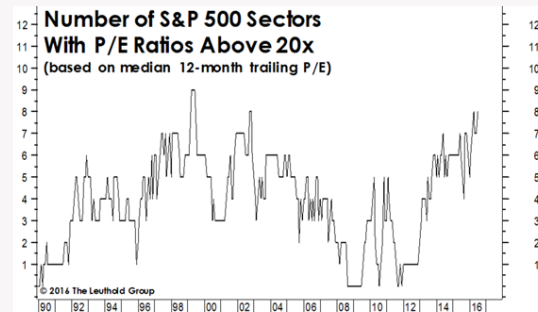
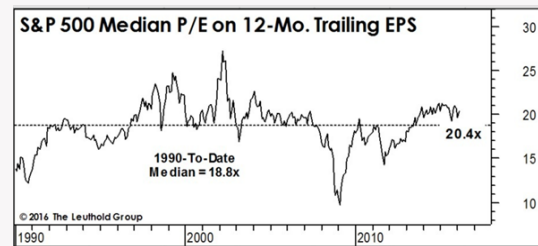
In the current environment, investors are facing a persistently disappointing macro environment given the sluggish economic growth (see NY Fed exhibits), with valuations in many segments of the market trading at or above long term historic levels (see Leuthold exhibits). Many investors over the past year have resorted to what is referred to as the “TINA investment” (There Is No Alternative). These investors are buying high-yield and low-volatility with the justification based on TINA. At Convergence, we would argue that the so-called TINA trade falls into the same category as, “Don’t worry, it’s different this time” or “fundamentals don’t matter anymore because the world has changed.”

As noted earlier, many of the so-called safety or defensive stocks are trading at elevated valuations. In addition, bonds no longer offer much cushion as global yields hover around zero. Investors will not be able to follow the standard “duck & hide” playbook by just parking assets in defensive/safe names.

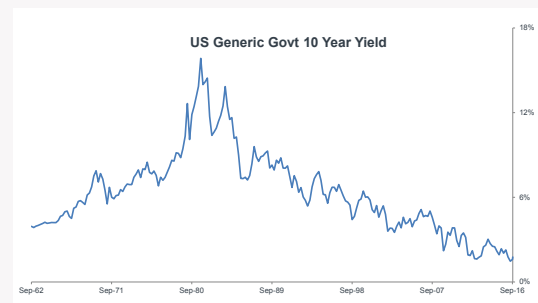
We believe investors should consider using strategies that employ an active short component as an alpha source. In terms of shorting, we are not talking about hedging (although that can have benefits at times). Rather, in times of anomalous behavior and “irrational exuberance,” there are potential benefits to incorporating short stock selections within an investment strategy. The reason is twofold. First, the market will tend to punish stocks with weak or declining fundamentals, as those companies are re-rated back to “normal” fundamental values relative to their peers. Second, short holdings from a typical short manager tend to have higher volatility as measured in a stock’s Beta, and therefore, can have a larger move downward in a market pullback. Either way, the benefit from shorting is realized as a potential added alpha source to the overall portfolio, versus just trying to win with long securities.



Source: New York Federal Reserve Bank



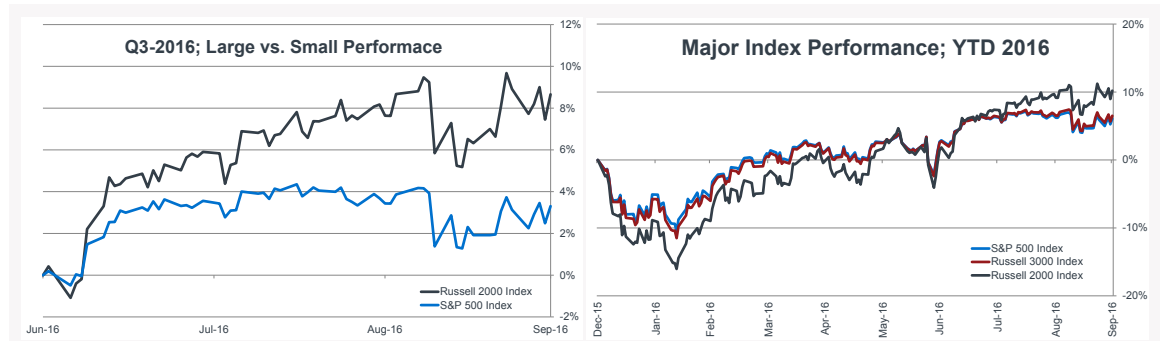
Source: Leuthold Group



Source: Bloomberg, Convergence Investment Partners

Overview of performance

The equity market delivered a solid return for the latest quarter as the S&P 500 Index generated a positive 3.85% return for the quarter. Even more notable was the significant outperformance of the small capitalization stocks represented by the Russell 2000 Index which was up 9.05% for the quarter, as the investors bid up the prices of riskier companies aggressively.



Source: Bloomberg Finance L.P.

Hope is not a very effective strategy

As the market climbed the wall of worry since the February 11 market bottom, we have found some notable cracks forming in the proverbial wall. The common characteristics of the companies that have led this market higher are not those that often correspond to normal economic principles. This market climb caused us to ask some questions:

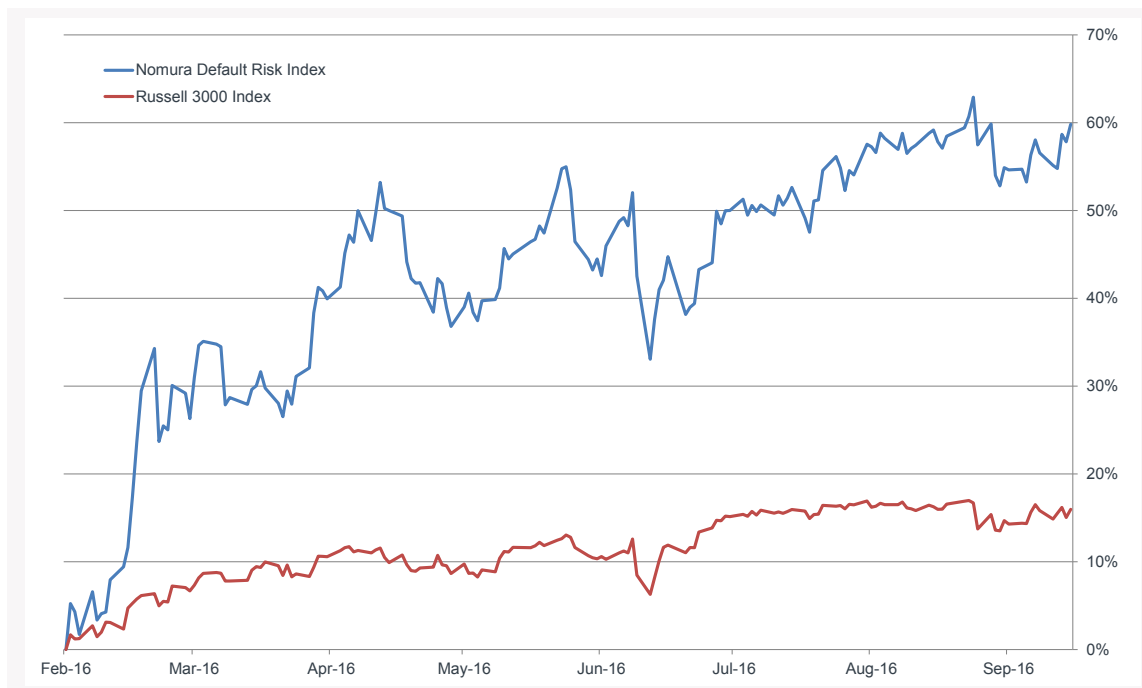
Are we in Wonderland?

How long can companies with poor corporate fundamentals lead the pack?

2016 has seen some nice returns from U.S. indexes... but what is driving these returns?

- Companies most likely to go bankrupt are leading the pack.
- The most profitable companies, with strong ROE's have badly trailed the overall market.
- Stocks with the highest growth in sales have been left in the dust (see our Q2 commentary for more on sales growers).
- Bad Jobs numbers... and the market goes UP!
- Factset is currently projecting third quarter profits for the S&P 500 to drop 2.1% YOY. This would make this quarter the sixth straight quarter of a profits correction.
- And GDP growth continues to be lackluster.

This is not sustainable; history has shown that these types' of environments do reverse meaningfully. Since mid-February, stocks "most likely to go bankrupt" have been on a tear! Nomura has created a Default Risk index that invests in the top 10% of Russell 1000 companies that are mostly likely to go bankrupt as ranked by Merton-type default probability. The following chart shows how this index has performed since 02/15/2016.



Source: Bloomberg Finance L.P., Nomura

History suggests that after periods of excessive outperformance of risky/low-quality factors, valuation and positive fundamental-type factors tend to greatly outperform as investors become more selective and resolve market dislocations. We believe, the current performance leaders will either fall down to join their high quality compatriots (good for shorts), or they will stagnate as companies with strong/tangible fundamentals deliver strong returns (good for fundamental investors). Both scenarios are optimal for Convergence.

So how did this “wonderland” environment impact the Convergence long/short portfolios? Not surprisingly, the short portfolios played a significant role in strategy performance.

Performance	Large Cap Core Plus	Small Cap	Market Neutral
Q3-2016	5.65%	6.29%	1.49%

*Performance presented net of fees

All three Convergence long/short strategies had a strong finish to the third quarter of 2016. The Convergence Large Cap Core Plus strategy and the Small Cap strategy ended the month of September ahead of their respective benchmarks, and our Market Neutral strategy posted a strong positive 1.5% return (net of fees). We were encouraged by the strong returns of July 2016 to start to Q3. Our two active extension strategies bested their benchmarks, and the Market Neutral posted an impressive 2.0% return (net of fees). In August, (when the market came off its fundamental rails) our Long/Short strategies trailed their respective benchmarks. However, strong relative performance resumed in September as our strategies benefited from the strong shift back to a focus on corporate fundamentals. See below for applicable index of each strategy.

Relative Performance (strategy - benchmark)	Large Cap Core Plus	Small Cap	Market Neutral
Benchmark	Russell 3000 Index	Russell 2000 Index	None (0.0%)
Jul-16	1.00%	0.60%	2.00%
Aug-16	-0.30%	-3.90%	-1.20%
Sep-16	0.60%	0.80%	0.70%

To gain a better understanding of what was driving 2016 performance, we will now look a bit deeper at the respective long and short components. In the third quarter, the short positions in all strategies detracted from performance. This was most notable in our Small Cap strategy, where the short positions were up over 10%, detracting just over 3% from performance. Our long portfolios in the large cap space (Core Plus and Market Neutral) delivered some impressive returns in the third quarter; both had returns more than 200 basis points, net of fees, above the Russell 3000 Index's 4.4% return. With the longs in our Core Plus being -130%, this had a very strong positive impact contributing over 8% to return (net of fees), again during a period where the market (Russell 3000 Index) was up 4.4%. Full for full year-to-date period, short holdings, on average, have detracted from overall results.

How is it that our short positions are outperforming most market benchmarks? If we are shorting the most "unfundamental" names, would it be reasonable to assume that we have experienced a temporary period where zombie companies have defied the laws of fundamentals? Here at Convergence, we know there can be relatively short aberrations to the rewards from positive fundamentals, but we always bet on the laws of fundamentals. Although the roulette wheel occasionally lands on green, the bulk of outcomes are black and red.

In order to support our view that fundamentals win over time, we provide the following case study on the robust, bankruptcy prediction model: The Ohlson O-score.

$$T = -1.32 - 0.407 \log(TA_t / GNP) + 6.03 \frac{TL_t}{TA_t} - 1.43 \frac{WC_t}{TA_t} + 0.0757 \frac{CL_t}{CA_t} - 1.72X - 2.37 \frac{NI_t}{TA_t} - 1.83 \frac{FFO_t}{TL_t} + 0.285Y - 0.521 \frac{NI_t - NI_{t-1}}{|NI_t| + |NI_{t-1}|}$$

Where:

TA = total assets	CA = current assets
GNP = Gross National Product price index level	X = 1 if TL > TA, 0 otherwise
TL = total liabilities	NI = net income
WC = working capital	FFO = funds from operations
CL = current liabilities	Y = 1 if a net loss for the last two years, 0 otherwise

Case Study on a Bankruptcy prediction model:

The Ohlson O-Score is a bankruptcy predictor equation (an expansion and modernization of the more commonplace Altman Z-Score). All companies are given a score based on financial statement inputs, and those with a scores greater that 0.5 are predicted to default within two years. We, at Convergence, have built a proprietary dynamic Ohlson bankruptcy scoring model. Over the long term (12/89-08/16), these high-risk companies have underperformed those with the best O-scores by nearly 15% per year. Since Feb 2016, this has INVERTED. See the table below:

	Long Term Annualized (12/89-08/16)	Long Term Cumulative (12/89-08/16)	Short Term (03/16-08/16)
Most likely to go bankrupt	-0.70%	-17.80%	36.20%
Least likely to go bankrupt	14.80%	3845.20%	14.10%
S&P 500 Index	9.30%	980.40%	13.60%

Source: Convergence Investment Partners

Takeaway: Over the long term, betting on companies likely to default is a losing strategy, but you would have looked rather smart (or lucky) in the past 6 months. It seems rationality might have been "out the window" for a while in 2016.

In addition to the O-Score, many of the major investment firms use ratios and equations to explain or quantify market themes. The following table highlights some of the best and worst themes YTD 2016 (through 08/31).

Best Performers YTD	Worst Performers YTD
<p>HIGH-RISK</p> <ul style="list-style-type: none"> • High default risk (Nomura) • Weak Balance Sheet Companies (Goldman) • HY Debt Sensitivity (Morgan Stanley) • High Probability of Default (Credit Suisse) <p>YIELD</p> <ul style="list-style-type: none"> • Dividend Yield (Nomura) • GS Dividend Growth (Goldman) • US Dividend Yield (Long) (Morgan Stanley) • HOLT Sustainable Dividends (Credit Suisse) 	<ul style="list-style-type: none"> • Strong ROE (Nomura) • Quality (S&P DJ) • Strong Balance sheet Companies (Goldman) • High Revenue Growth (Goldman) • MS Growth Basket (Morgan Stanley) • HOLT High Quality (Credit Suisse) • HOLT Best in Class (Credit Suisse)

Source: Bloomberg Finance L.P.

The table does not include securities held in client accounts, but represents market trends. The information is not intended to be a recommendation to buy or sell securities listed in the table.

The main takeaway here is that... the columns seem to be switched! How can high-quality, strong revenue growers UNDERPERFORM stocks with the highest probability of default.

At Convergence, we have witnessed two main forces moving the markets during several months of 2016... “yield reach” and “risk-on.” This observation is supported by the above table.

The fuel for the “yield reach” is a lack of options when looking for income or yield. Investors searching for yield are pushing the valuations of high dividend payers to excessive levels (think REITs and Utilities). It is important to note that a number of good quality companies have also been swept up in this fervor. If you are searching for yield, we believe you should focus on companies with sustainable and growing dividends.

The “risk-on” theme is spurred by “lower for longer,” and companies that are over levered (unsustainable debt levels) have been artificially propped up beyond normal economic principles.

It’s important to note that in the month of September this pattern began to reverse, which corresponds to the relative performance of each of our strategies that we spoke about earlier. In fact, the majority of our factor composites produced a positive spread between the best ranked stocks compared to the worst ranked stocks which is an indication of normal fundamental differentiation (a good thing).

How is Convergence positioned?

As mentioned earlier, as a manager who is true to fundamentals, we want to demonstrate how each of our strategies is positioned. Having an understanding of this will help show how an investor can potentially benefit by being invested in a strategy that is built to **capitalize on the market rewarding fundamentals over time**. The table below shows specific factors and the weighted average strategy long, short, and Russell Index values for each factor. As an example, the Convergence Market Neutral strategy has a portfolio average Price-to-free cash flow valuation of 10 which compares favorably to the market with 19.0 on the same valuation metric. In addition, the Market Neutral Short holdings have an average of -16.7 times price-to-free cash flow meaning that our average short holdings are burning through free cash flow.

As the table below 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.

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

Category	Factor	LONG			MARKET	SHORT		
		Market Neutral	Core Plus	Small Cap	Russell 3000	Market Neutral	Core Plus	Small Cap
Value	Price to Free Cash Flow (P/FCF)	10	9.9	9.5	19	-16.7	-20	-10.6
Value	Price to Earnings (P/E)	14.8	15.4	26.7	26.7	17,313.00	233.2	-19
Profitability	Net Income Improvement	15.60%	12.40%	20.80%	0.70%	-10.50%	-12.00%	-13.60%
Profitability	Net Income/Total Assets	5.70%	5.90%	4.00%	5.90%	-0.50%	-2.00%	-4.20%
Capital Discipline	Change in Shares Outstanding	-3	-3.2	-0.6	0.7	17	17.1	15.5
Capital Discipline	Multi Year Dividend Growth	142.9	171.9	66.7	105.2	31	28.8	10.3
Accelerating Sales	3 Month Improvement of TTM Sales Growth (bps)	79	47	42	10	-386	-161	-1,318
Accelerating Sales	6 month Improvement of TTM sales growth (bps)	14	1	29	-46	-1,212	-1,371	-3,628
Quality	Return on Equity (ROE)	20.90%	18.10%	21.20%	4.00%	2.20%	-6.60%	-0.10%
Quality	Return on Assets (ROA)	5.69%	5.95%	6.81%	5.74%	-0.81%	-2.13%	4.37%
Earnings Momentum	Standardized Unexpected Earnings	3.42	3.32	3.29	1.61	1.25	1.07	0.68
Earnings Momentum	Implied future EPS growth (2yr vs. 1yr)	13.80%	14.00%	12.10%	10.90%	7.50%	6.80%	3.80%
Historical Growth	Consecutive Earnings Growth	1.3	1.2	1.8	0.6	-0.6	-0.9	-0.5
Historical Growth	TTM Change in Earnings	4.3	3.6	4.4	0.4	-1.7	-0.5	-1

As of 09/30/2016; Source: Wilshire Analytics & Convergence Investment Partners. TTM = trailing twelve months. bps = basis points

Winning over the long haul

At Convergence, our strategies are built on the premise that over the long run, companies with strong and improving fundamentals tend to win, while companies with weak or declining fundamentals tend to lose. There are times when behaviors in the markets become temporarily unhinged from those financial tenants of investment philosophy, but we know that successful investing is based on consistently executing on a sound and validated process. We don't plan on investing in "unfundamental" names, and we are excited as we see the signs of the beginning stages of the market's "snap back" to fundamentals.

Again, as always, stay fundamental.

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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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) is 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.

GDP = gross domestic product.

YOY = year-over-year.

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.**