Convergence
Investment Partners

Convergence Long/Short Strategies
Q3-2017 Review and Commentary

Q3-2017

> ***"Luck is what happens when preparation meets opportunity."***
> *- Roman philosopher Seneca*

At Convergence, we have been successfully managing Long-Short equity products for over 12 years, and our firm's founders have been managing and refining our systematic investment process, rooted in fundamentals, for over two decades. Our core tenets of providing competitive, long-term returns, by ranking companies within each industry group by their relevant fundamental characteristics have remained steadfast. Since inception, each of Convergence's Long-Short strategies has outperformed its respective benchmarks and has generated a positive return spread of the long versus short holdings (net of fees). Those return spreads have also been accompanied by a negative correlation of the return spread versus the overall market return, thereby boosting the power of diversification in investor portfolios.

We are also excited to announce the launch of two new levered versions of our fundamental ranking process this past quarter. These strategies have approximately 350% total gross exposure with roughly a 50% net exposure. Utilizing our fundamental ranking methodology, we introduced a Large/Mid-capitalization Long-Short levered product, as well as a SMID cap Long-Short levered product. Both products are off to a strong start as we apply the same disciplined process that we have successfully employed in our other Long-Short equity structures.

Odds and Probabilities

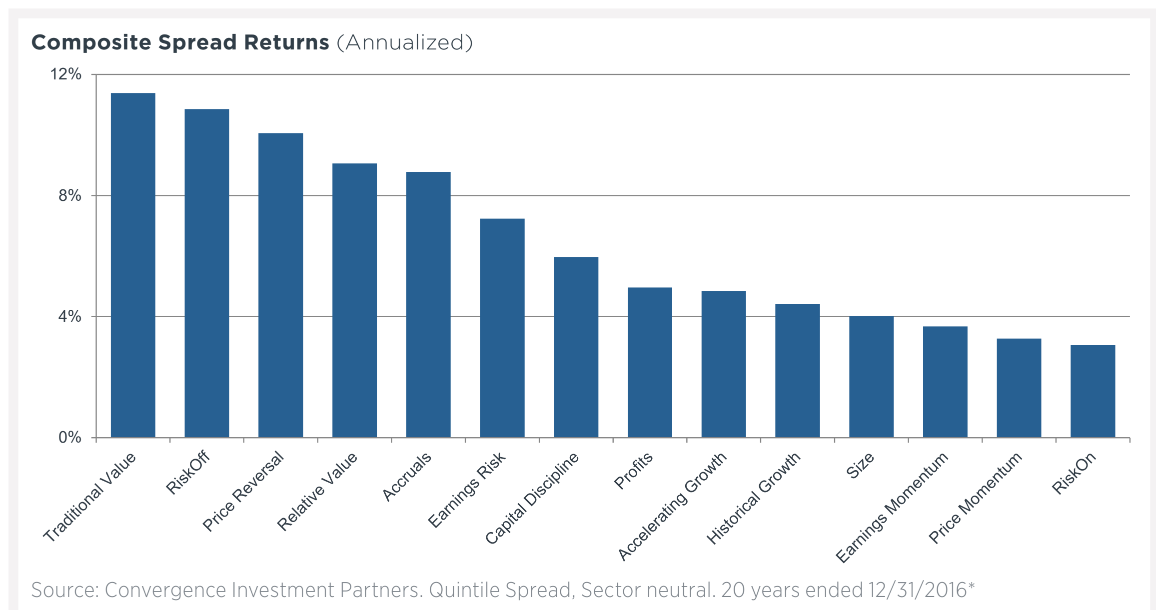
The phrase, "Nobody knows nuttin" is often used by our friends at Empirical Research as they describe macro-economic and exogenous forces that "professionals" try to predict, but are proven wrong the majority of the time. That phrase seems appropriate as we ponder the many predictions that are made about certain asset classes, expectations for various economic variables, or predictions of the performance of individual stock names.

As we reflect on the year that has transpired, we are reminded of the varied predictions by "experts." Opinions from a year ago ranged wildly, from an armageddon 50% drop in equities should one particular presidential candidate win, to others who were convinced that interest rates would skyrocket because the growth rate of the economy would be stupendous!

Fortunately, at Convergence we do not have to guess or speculate on bold predictions. Instead, we focus our efforts on probable outcomes based on the stock fundamentals emphasized within each industry group. We are like "fundamental farmers" who are

constantly "planting" our long and short positions into favorably ranked companies within each industry group. Over time, the market environment provides the conditions to generate a spread in long-short returns due to the underlying fundamental tilts of our long versus short portfolio holdings. It is that fundamental spread that we work to harvest within each strategy year after year.

As history has shown, there is indeed a meaningful amount of "fundamental spread" to take advantage of within the markets. The following chart measures the spread in returns between the top and bottom ranked stocks over the past 20 years from some of our major factor composite categories. As evidenced here, a strategy that is based on sound economic principles and positioned to tilt long versus short portfolios based on those principles can provide meaningful value over time.

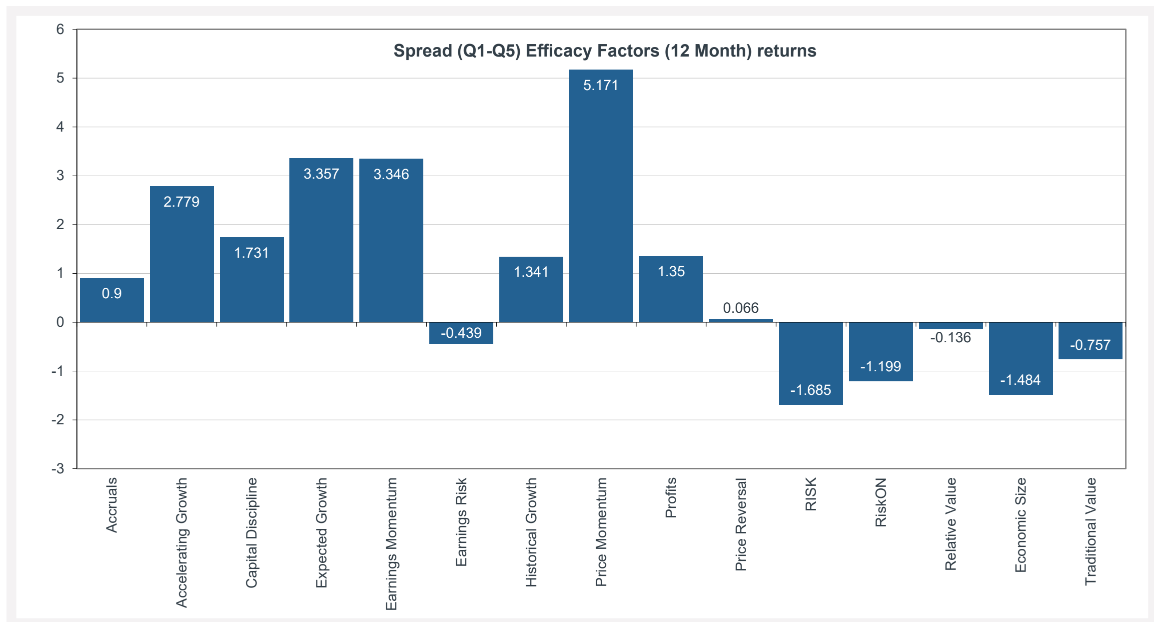


Composite Spread Returns (Annualized)

Source: Convergence Investment Partners. Quintile Spread, Sector neutral. 20 years ended 12/31/2016*

*The chart is presented for informational purposes and does not represent performance of any product or strategy, nor do returns take into account fees and expenses.

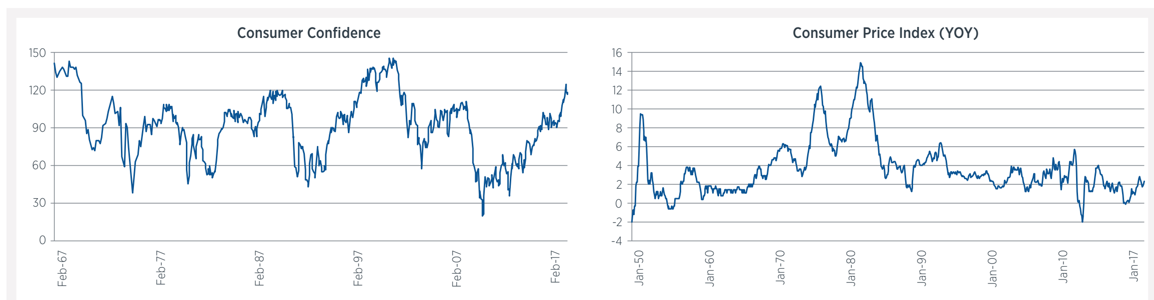
It should also be noted that utilizing a broad set of fundamental metrics is also central to the ability to harvest value over time. We incorporate a multitude of fundamental signals to determine the relative attractiveness of a given company within each industry group. This factor diversification is beneficial as the market tends to reward different fundamental metrics to a varying degree over smaller time frames.

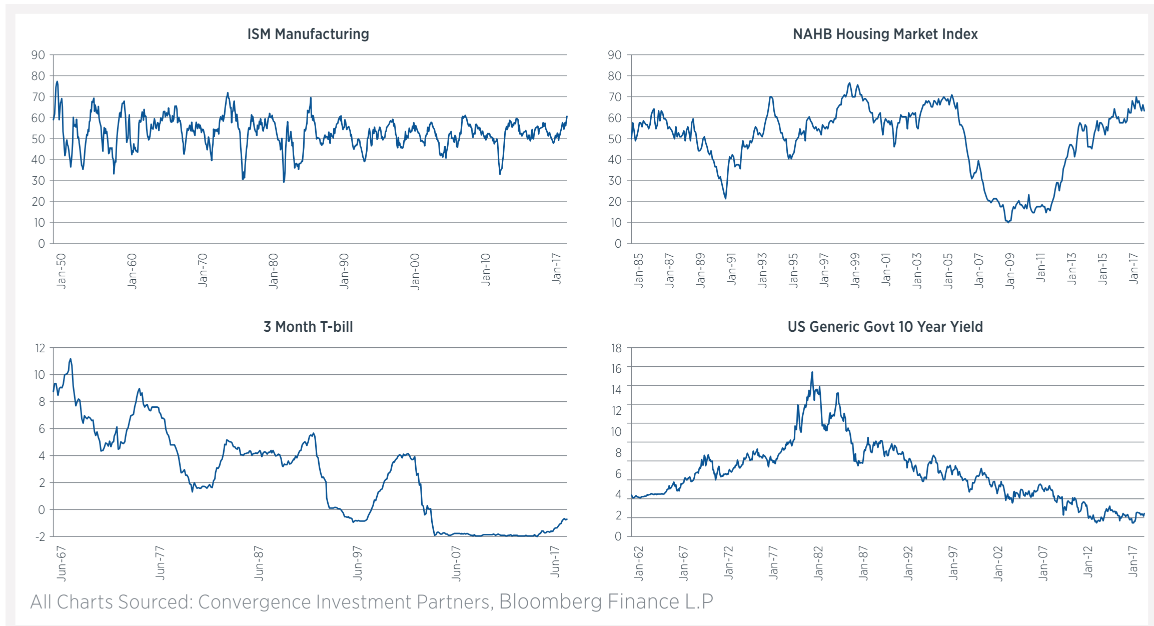


Looking at a shorter period of time such as the recent quarter, we see that much of the positive spread or differentiation in stocks has been a combination of quality, growth (both top and bottom line growth), price momentum and profitability. Separately, there has not been much production or benefit from fundamental tilts in valuation or risk measures in the recent period. This demonstrates the benefit of the fundamental factor diversification that we employ at Convergence. While it is unlikely for all fundamental tilts to generate a positive spread in short time periods, these fundamental spreads, based on sound economic principles, produce real wealth for investors over time (shown by our research) as they provide their complimentary attributes.

Economic backdrop

We continue to witness confidence from both consumers and businesses (particularly given where we were 9 years ago). Inflation has remained subdued as global competition and technology innovation have kept have kept a lid on wages and prices as Dr. Ed Yardeni of Yardeni Research points out. Recent economic growth has been robust, as measured by the ISM Manufacturing Index, with a 13 year high reading of 60.8. Housing continues to strengthen as borrower credit scores have recovered and interest rates have remained favorable. Finally, short term interest rates have begun to rise as the central banks are on a path of normalizing rates via rate hikes and balance sheet reduction.

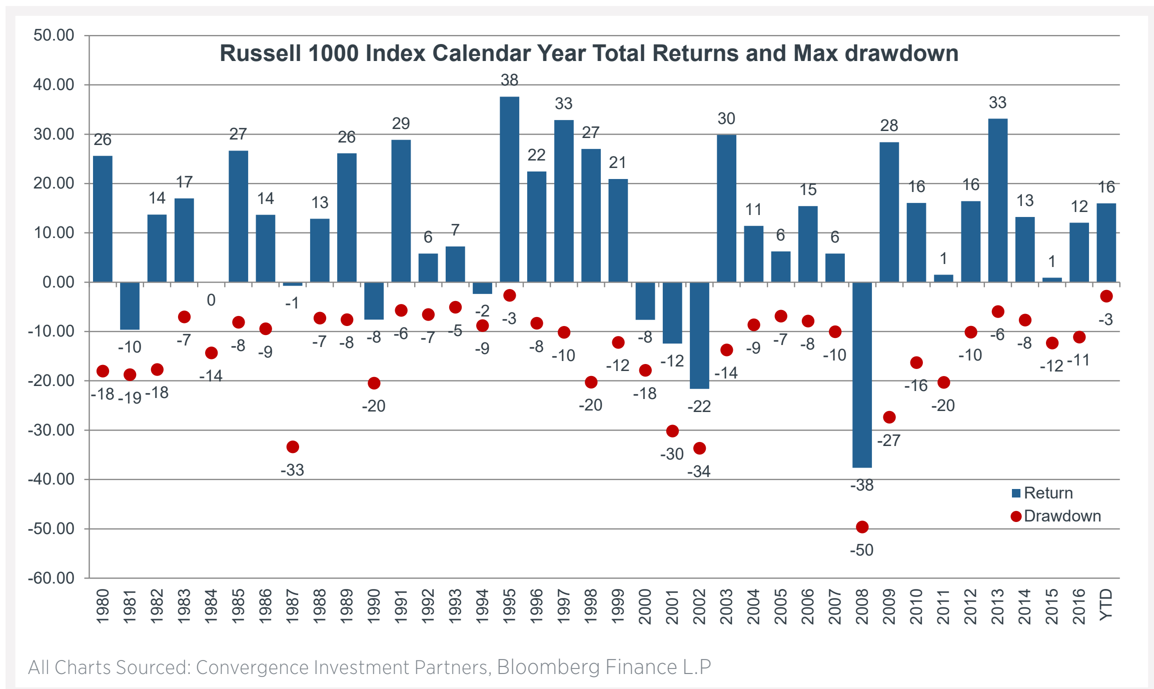




All Charts Sourced: Convergence Investment Partners, Bloomberg Finance L.P

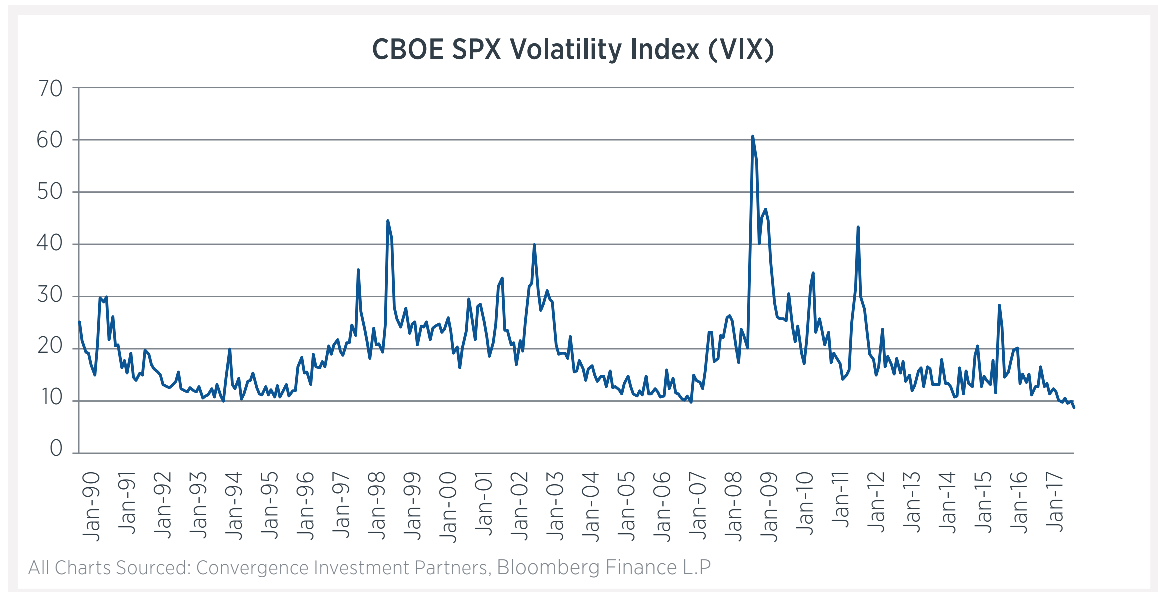
Where does this leave investors?

While the economic backdrop continues to look solid, there are some extremes that are beginning to seep into the equity market, which usually lead to opportunities in sourcing alpha-generating anomalies. As an example, we have seen the market chug higher like a freight train, without even a hint of a modest pullback throughout the first 3 quarters of this year. In fact, unless something shakes investor confidence in the remaining weeks of the year, the 2.8% pullback earlier this year will go into the record books as one of the lowest drawdowns in the past 40 years!



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

In addition, volatility, as measured by the CBOE Volatility Index (VIX), continues to smash historical records from the low levels of fear being priced into the markets. This record low estimate for future volatility (low investor fear) might also be interpreted as potential complacency building into the mindsets of investors.



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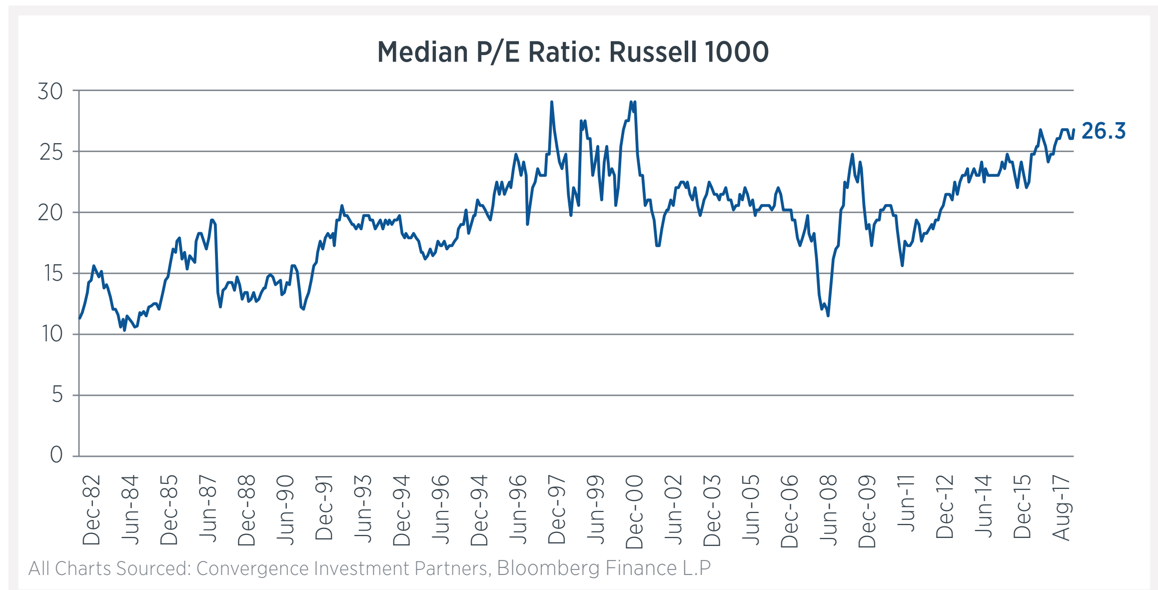
Furthermore, equity valuations based on nearly every metric or measurement choice are elevated both from an absolute and relative standpoint. With higher average valuations come increased opportunities for shorting attractively ranked candidates at higher prices (a.k.a. sell high, buy back low).



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Finally, what makes this environment enticing as a long-short manager is that the stronger economic conditions are forcing the hand of the Federal Reserve to begin to normalize its balance sheet (i.e. sell or let bonds roll off) as well as continue to raise interest rates modestly. As noted in our previous commentary, an environment of generally rising interest rates has benefits to investors who utilize shorts:

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.*

Therefore, we see a favorable period for fundamentally focused investors to source opportunities found within attractive long and short stock holdings.

Overview of performance

The equity markets have enjoyed strong gains since the crisis of 2009, and the more recent time periods are no exception as shown in the table below.

Index returns, ended 09/30/2017	Since 03/09/09	5 year	3 year	2 year	1 year
S&P 500 Index	19.08%	14.20%	10.80%	17.00%	18.66%
Russell 3000 Index	19.34%	14.21%	10.73%	16.81%	18.75%
Russell 2000 Index	20.34%	13.77%	12.16%	18.06%	20.78%

Annualized Total Return, including reinvested dividends, sourced from Bloomberg L.P.

We are excited to report that over the past year (09/30/2016 – 09/30/2017) our strategies have delivered outstanding returns. We are even more pleased that the markets have again shifted to a more fundamental focus in recent months. It's no surprise that this shift has benefited our results and leads us to believe that this trend will provide a tailwind as we close out 2017. As shown in the table below, our active extension strategies have handsomely outperformed their respective benchmarks, and our market neutral fund has delivered powerful returns for a strategy that targets a 0.0-0.2 beta given, its low net exposure.

Trailing 12 month performance, ended 09/30/2017				
Strategy	Benchmark	Strategy	Benchmark	Outperformance
Large Cap Core Plus	Russell 3000	21.31%	18.70%	2.61%
Small Cap	Russell 2000	22.17%	20.78%	1.39%
Market Neutral	Citi 90-day Bills	9.61%	0.64%	8.44%

**Net of fee strategy returns, dividends reinvested. Source: Convergence Investment Partners. Benchmark returns are total returns dividends reinvested. Source: Bloomberg L.P. & Zephyr

Our research shows that the favorable trends we witnessed at the end of Q2-2017 have persisted through the third quarter. See the following from our Q2 commentary:

> ***"...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."***

The following table shows the returns that our strategies delivered in the third quarter of 2017.

		Q3-2017 Return	
Strategy	Benchmark	Strategy	Benchmark
Large Cap Core Plus	Russell 3000	6.66%	4.57%
Small Cap	Russell 2000	7.90%	5.67%
Market Neutral	Citi 90-day Bills	2.84%	0.26%
Small Cap	-2.8%	-2.8%	-2.8%

*Net of fee strategy returns, dividends reinvested. Source: Convergence Investment Partners. Benchmark returns are total returns dividends reinvested. Source: Bloomberg L.P.

Beyond looking at the returns for each strategy in total as discussed above, the long-short spread is also extremely important to observe. This 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 produced a significant positive spread between the long and short holdings over the past 12 months. Moreover, the small-cap strategy also generated a notable positive spread between its long and short positions over the past 12 months.

Strategy	12-Month Spread (Long-Short)
Large Cap Core Plus	8.21%
Small Cap	5.39%
Market Neutral	8.43%

What Factors Worked?

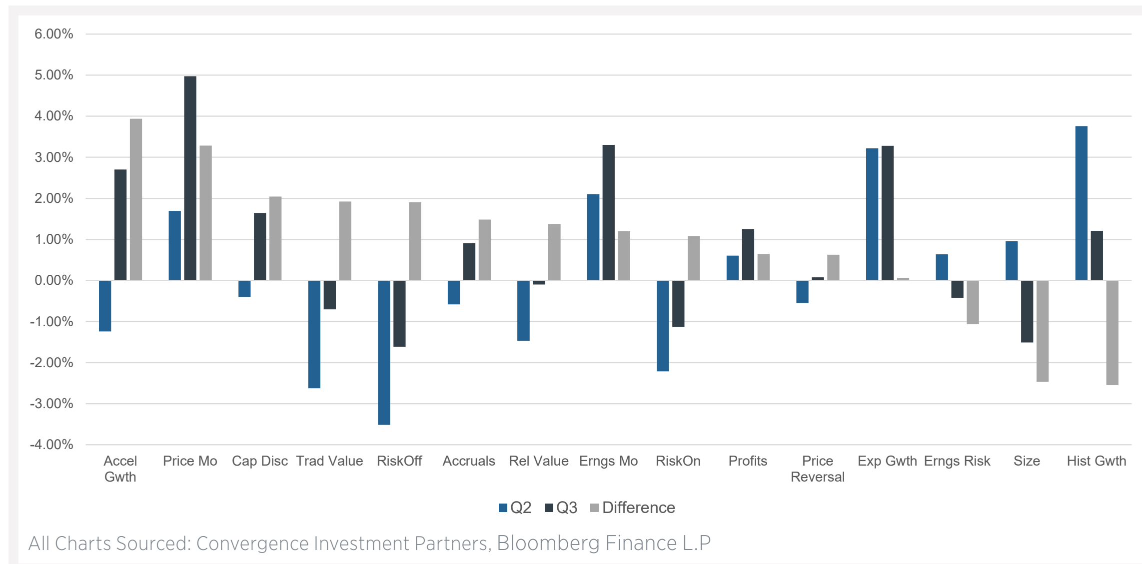
The following table shows the top and bottom three performing factors over different time periods. We ranked all 15 factor composites by spread return, in order to show that what works over the long term is not always true in the short term, as we summarized above.

	SHORT TERM			LONG TERM		
	3 months	6 months	12 months	5 years	10 years	20 years
Top 3	Price Momentum	Price Momentum	Earnings Momentum	Traditional Value	Traditional Value	Price Reversal
Top 3	Earnings Momentum	Expected Growth	Historical Growth	Capital Discipline	Price Reversal	Traditional Value
Top 3	Expected Growth	Earnings Momentum	Capital Discipline	Earnings Momentum	Earnings Risk	Low Risk
Bottom 3	RiskOn	Traditional Value	Relative Value	Accruals	Profits	Size
Bottom 3	Size	RiskOn	Accruals	Relative Value	Expected Growth	Price Momentum
Bottom 3	Low Risk	Low Risk	Low Risk	Expected Growth	Price Momentum	Expected Growth

The table above clearly shows a few important items:

- What works in the long term does not always match the short term (see arrows).
- Traditional Value (one of the best long term factors) is moving out of the "basement."
- Despite a strong pick up in fundamental factors in the past 3 months (12 of 15 factors improved) the leadership didn't change much.

Let's expand the last bullet point and compare the factor spread returns in Q2-2017 and Q3-2017. The following chart has a tremendous amount of information. The blue bars are the spread returns for each factor in Q2. Q3 returns are in black, and the difference of the two returns is shown in grey. 12 of our 15 factors improved their spread return from Q2 to Q3. Moreover, factors that showed marked improvement were some of our longer term "heavy hitters" (e.g. Traditional Value, Captial Discipline), while those that slipped (e.g. Size, Expected Growth) are typically some of our least impressive factors.



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

In summary, recent factor results seem to validate a move back to what one would expect given the long term averages. A continuation of this mean reversion would bode very well for Convergence investors.

How is Convergence positioned?

Finally, as in previous quarterly updates, we wanted to share with our investors a summary of the fundamental tilts found within each strategy. The following table illustrates a few of the many fundamental factors that we utilize to rank the relative attractiveness within our investment process. The values shown for each factor represent the weighted average value of that specific factor (long or short component of the portfolio) versus 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 **"Return on Assets."** This is a measurement of how much profit is generated from each dollar of assets and gives an idea as to how efficient management is at using its assets to generate earnings. This factor is found in the Quality category below. Most investors would prefer their managers to be more efficient with asset utilization, all else equal; therefore a higher Return on Assets (ROA) is generally preferred. Our long portfolios all have a higher ROA. The Russell 2000 Index actually averages a negative return on assets, indicating that on average, smaller companies are not generating a positive net income. Additionally, the names that we are short are, on average, failing to generate income. Generally, this is beneficial for identifying attractive short holdings.

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

Category	Factor	LONG			MARKET		SHORT		
		Market Neutral	Core Plus	Small Cap	Russell 3000	Russell 2000	Market Neutral	Core Plus	Small Cap
Value	Price to Earnings	15.5	15.8	23.0	25.1	68.3	129.5	279.2	-46.0
Value	Price to Free Cash Flow	10.5	11.4	10.0	23.5	36.7	-11.4	-19.1	-6.9
Value	Free Cash Flow to Enterprise Value	7.2%	7.2%	7.5%	4.0%	3.0%	-4.2%	-1.3%	-4.7%
Profitability	Net Income Improvement	30.4%	23.8%	28.9%	7.5%	7.7%	-10.3%	-9.1%	-11.6%
Profitability	Cash Flow to Sales	23.7%	22.1%	25.3%	-2.3%	-288.1%	-464.8%	-850.2%	-1048.3%
Profitability	Internal Growth	15.2%	7.0%	13.0%	-4.1%	-0.7%	-7.9%	-8.7%	-105.4%
Capital Discipline	Change in Shares Outstanding	0.3	-1.3	1.4	1.1	10.4	19.4	22.5	17.9
Capital Discipline	Dividend Growth	120%	143%	79%	112%	48%	41%	25%	9%
Quality	Return on Equity (ROE)	16.2%	2.5%	14.9%	0.1%	1.9%	-7.9%	-5.9%	-102.5%
Quality	Return on Assets (ROA)	7.6%	7.7%	6.6%	6.5%	-0.5%	-2.6%	-4.5%	-7.9%
Earnings Growth	Consecutive Qtrs Earnings Growth	2.3	1.9	2.1	1.4	1.1	-0.3	-0.5	-0.4
Earnings Growth	Slope of Earnings	0.48	0.36	0.54	0.05	0.12	-0.14	-0.08	-0.36
Sales Growth	Change in Slope of Sales	1.61	1.05	1.8	0.83	0.3	-0.4	-0.2	-0.8

As of 09/30/2017; 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 valuation ratios above. Over time, companies with these ingredients have 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 as demonstrated in the statistics, and our research has shown this to be effective in sourcing alpha from shorting.

In closing remember, “Always stick to fundamentals!” Thank you for your support.

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.

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.

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.