Convergence Long/Short Strategies
Q4-2017 Review and Commentary

Q4-2017

As we close the book on 2017 and look forward to 2018, at Convergence we foresee the global expansion continuing, however, we anticipate a few cracks in the strong foundation that supported the recent low volatility and ever increasing asset prices. The countervailing forces of global central bank tightening and U.S. corporate tax relief will likely be notable contributors to the stress that may affect these cracks. Growth in major central bank balance sheets is set to drop by $1.4 trillion over the next 12 months as the Fed winds down its balance sheet and the European Central Bank (ECB) pares back on quantitative easing.* These uncertainties can create opportunities for shrewd and discerning market participants who invest in fundamentally sound companies with strong growth characteristics. Moreover, they can also create opportunities for investors who take positions against (short) companies that exhibit poor and/or deteriorating fundamentals. As always, our guiding mission will be to stay focused on long-term returns and to identify companies that present opportunities based on their underlying fundamentals. 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. We believe that successful investing is based on consistently executing on a sound and validated process.

Again, as always, stay fundamental.

Overview of performance

The equity markets continue to charge upward making this one of the longest bull markets in history. The uninterrupted push higher, exemplified by scant pull backs, slip-ups and scares is rather unusual when looking at market history, but then again the central bank accommodation and financial crisis were also unique occurrences. According to Piper Jaffray's Craig Johnson, one out of every four trading sessions in 2017 was an all-time new high.

The Convergence Long/Short strategies delivered some strong returns to close out 2017. On an absolute basis our longest running Core Plus strategy delivered 18.1% for 2017, and since inception, this strategy which maintains approximately 30-35% of capital in short positions, has delivered a 14.9% average annual return. Our next longest running strategy, the Small Cap Strategy, returned 11.2% in 2017. This small cap focused portfolio which has maintained a short position of 35-40% of invested capital, has delivered a 14.5% average annual return since its May 2012 inception. And finally, our 32 month old Market Neutral Strategy delivered a 3.94% return in 2017 and has returned 6.4% average annual since its May 2015 inception. This market neutral strategy is typically 100/80 in its long/short exposure, and seeks to maintain a forward looking beta of 0.0-0.2. All of the aforementioned returns are stated net of fees.

*Source: Fidelity Investments (AART) "2018 Outlook: Global Expansion to Continue, but Markets Likely More Volatile White Paper" G4 Central Banks: Federal Reserve (Fed), European Central Bank (ECB), Bank of Japan (BOJ), Bank of England (BOE). Fed to roll-off balance sheet assets by lesser of stated caps or total bonds maturing each month. ECB to begin tapering in January 2018 to EUR30B of monthly purchases for nine months. BOJ to purchase at annualized rate of JPY 60T going forward. BOE to keep balance sheet constant. Source: Federal Reserve, Bank of England, European Central Bank, EPFR, Haver Analytics, Fidelity Investments (AART), as of Sep. 30, 2017.

Long/Short Strategy Performance, ended 12/31/2017				
Strategy	**% Short** (of capital)	**Inception**	**2017**	**Since Inception Annualized**
Large Cap Core Plus	~30-35%	Dec 2009	18.09%	14.94%
Small Cap	~35-40%	May 2012	11.19%	14.49%
Market Neutral	~80%	May 2015	3.94%	6.38%

Annualized Total Return presented net of fees, including reinvested dividends

Our research shows that the favorable trends we saw materializing at the end of Q2-2017 persisted through year end. Beyond looking at the returns for each strategy in total, it is important to understand how the long and short sides of the portfolio performed. The spread between long and short holdings provides insight into how the market is rewarding/penalizing stocks based on fundamental rankings. In our Core Plus strategy the long positions trailed their benchmark in 2017 while the shorts contributed positively to performance. As the year progressed this improved, and in the fourth quarter both the long and short portfolios contributed to the outperformance of our large cap focused core plus strategy. Our small cap focused strategy faced a challenging short environment to start 2017. In 2017 the long positions kept pace with the Russell 2000 Index, however, the short positions outperformed the benchmark which contributes negatively to performance. Finally, our Market Neutral strategy which also invests in the large cap space, delivered its 2017 return primarily from its leverage ratio as the long and short positions of this portfolio nearly matched those of the broader market. We attribute this to low inter-stock dispersion, low volatility and a complacency driven beta move up for the markets. Thankfully for active managers, we have started to see a reversal of this trend as market dynamics and an aging of this bull market will provide more opportunities for active managers that utilize long and short positions.

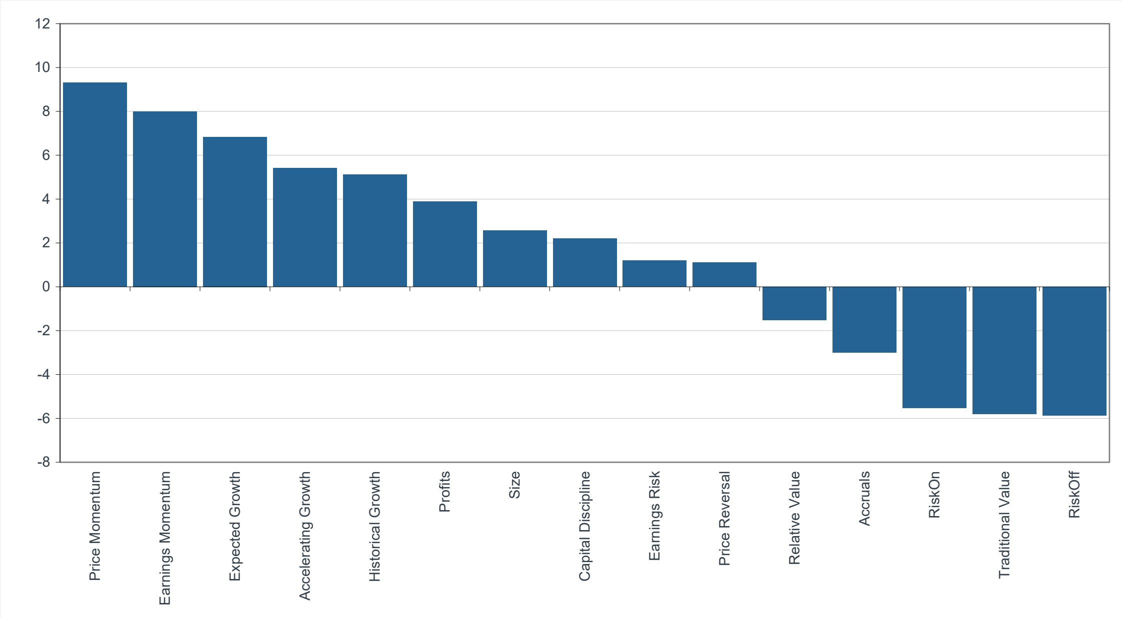
What Factors Worked?

The following table shows the top and bottom three performing factors over different time periods. We ranked all 15 factor composites by quintile spread return in order to show that what works over the long term is not always true in the short term (see disclosures for a definition of quintile spread return).

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

Source: Convergence Investment Partners, Wilshire Analytics.

The table below shows how the factors that we monitor and employ at Convergence Investment Partners performed in 2017 based on long-short quintile spread return.



As of 12/31/2017; Source: Wilshire Analytics & Convergence Investment Partners.

One of our best long term factors, Traditional Value, had a rough 2017. We found that **overvalued names outperformed undervalued names** by 5.81% in 2017. This doesn't make intuitive sense to us at Convergence and we (like Warren Buffet) will always play the long game and bet on less expensive stocks for our longs. Also, we found that lower risk companies trailed their higher risk counterparts by 5.84% in 2017... again, we believe the same principle applies.

How is Convergence positioned?

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 and the broader market overall.

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	17.0	17.7	20.6	25.8	72.6	92.1	568.1	-43.7
Value	Price to Free Cash Flow	11.9	13.3	12.3	23.1	42.0	-13.6	1306.1	-90.6
Value	Free Cash Flow to Enterprise Value	7.9%	7.5%	5.9%	3.9%	2.6%	-2.1%	-0.1%	-1.4%
Profitability	Net Income Improvement	26.3%	24.0%	31.8%	8.1%	6.1%	-9.0%	-15.4%	-12.6%
Profitability	Cash Flow to Sales	21.0%	20.5%	21.3%	2.2%	-233%	-394%	-423%	-1252%
Profitability	Internal Growth	12.6%	13.5%	10.8%	-15.4%	-344%	-520%	-583%	-1711%

Category	Factor	LONG Market Neutral	LONG Core Plus	LONG Small Cap	MARKET Russell 3000	MARKET Russell 2000	SHORT Market Neutral	SHORT Core Plus	SHORT Small Cap
Capital Discipline	Change in Shares Outstanding	0.1	-1.2	1.2	0.7	10.9	15.6	15.4	14.9
Capital Discipline	Dividend Growth	101%	139%	88%	100%	40%	39%	16%	23%
Quality	Return on Equity (ROE)	1.6%	2.1%	1.8%	3.1%	3.0%	10.4%	11.3%	8.0%
Quality	Return on Assets (ROA)	7.2%	7.8%	6.4%	6.7%	-0.7%	-1.1%	-2.8%	-6.6%
Earnings Growth	Consecutive Qtrs Earnings Growth	2.3	2.2	2.3	1.8	1.0	-0.4	-0.2	-0.2
Earnings Growth	Slope of Earnings	0.35	0.30	0.52	0.15	-0.12	-0.22	-0.26	-0.54
Sales Growth	Change in Slope of Sales	1.5	1.3	1.4	1.0	0.3	-0.4	-0.5	-0.9

As of 12/31/2017; 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, at reasonable valuations. Over time, companies with these ingredients have typically rewarded investors 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, and our research has shown this to be effective in sourcing alpha from shorting.

In closing, as we always say, “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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Quintile spread return: The return difference between the top 20% of stocks and the bottom 20% of stocks as ranked by a specific factor or statistic, such as Price-to-Earnings ratio or 5-year earnings growth rate.

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. 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.