Convergence Long/Short Strategies

Q4-2020 Review and Commentary

> ***"some things are simply unknowable before they happen"***
> \- *John Maynard Keynes (principle of fundamental uncertainty)*

The year 2020 was a wild year that will not be soon forgotten. Pandemic, global lock downs, contentious elections, blistering bear market and rebound, eye-popping trading volume, monumental stimulus, IPOs, ZIRP, TINA and drama from index committees concerning their timing to add hyper-growth companies into their indexes.

Look up the word "unprecedented" in the dictionary, and one wonders if the folks at Webster will need to insert the year 2020 into its definition. As the IMF said, "the Great Lockdown: Worst Economic Downturn since the Great Depression. The magnitude and speed of collapse in activity that has followed is unlike anything experienced in our lifetimes." Just as unprecedented was the speed, coordination, and magnitude of both fiscal and monetary stimulus injected into the economy to help usher in a swift turnaround to many, but not all parts of the economy. The nomination for the favorite letter of the year must go to the letter "V" for its visual representation of the speed and intensity of both the decline and the recovery in many items relevant to investing including economic activity (GDP), housing activity, and yes, the overall stock market. Throwing this much fuel into the system has not been without consequences and is creating some interesting investment opportunities both in the long and the short side of the equation.

At this point during the pandemic, there have been 78 million cases which has translated into 1.7 million deaths. At the current moment, three unique and highly effective vaccines have been approved in record time. All of this occurred during a contentious presidential election. Even though it has been divisive, this country has seen other very volatile presidential election years.

Market Summary

In early 2020, The Russell 3000 Index plunged into a bear market in just one month (02/19/2020 to 03/23/2020) with a drop of -34.96%, one of the fastest drops in history. But then the country's economic institutions delivered a one-two punch with the combined right hook from the Federal Reserve's bond buying and massive rate cuts, along with the left jab of one the biggest fiscal stimulus packages of all time. The result was a rally in the Russell 3000 Index through the rest of the year, proceeding to jump 76.82% from the March 23rd low. That stimulus-induced rally played a part in supporting companies hurt by the pandemic, as hope for a rebound grew for industries most directly impacted. The so-called "animal spirits" have also been alive and well in the performance of companies with high future growth expectations and potentially higher risk.

In June 2020, Bank of America reported that the value of U.S. stocks/ETFs traded by retail investors grew 80% from the previous June. As of December 24th of last year, companies raised $167.2 billion through 454 public offerings compared with the previous full-year record from the 1999 dot-com boom of $107.9 billion, according to Dealogic. The pandemic turned the typical rhythm of the IPO market on its head, with $67.3 billion raised in the fourth quarter. That is roughly six times the total for the first three months of the year. Before mid-June, governments throughout the world had allocated $10 trillion for economic stimulus. When measured as a percentage of GDP, some countries' stimulus was ten times what it was in the financial crisis of 2008-09.

Our friends at Capital Economics in their 2021 forecast letter reminded us of a memorable statement from Keynes that seems rather perfect when reflecting on 2020.

> *"I'm willing to bet that this time last year nobody (including us) was forecasting that a pandemic would rip through the world in 2020, causing the biggest fall in global GDP since World War Two. What's more, I'm willing to bet that anybody that did forecast such an event, failed also to forecast that stock markets would end the year at a record high. As I've noted before, the pandemic is a useful reminder of Keynes' principle of fundamental uncertainty – some things are simply unknowable before they happen."*

Looking toward 2021, we anticipate a choppy start to the year, as vaccines roll out and society reopens. The second half of the year and the quarters beyond should prove quite beneficial for economic growth and thus stock investors. As we have mentioned, low interest rates for the foreseeable future allow investors to discount very distant cash flows and earnings. These low rates encourage borrowing and discourage saving. This is supportive of the TINA (there is no alternative) investing strategy where the only game in town is equities. We do remain cautious since there is almost unilateral agreement from market forecasters that the future is bright for growth and equites. For example, JPMorgan says, "The year ahead could deliver the strongest growth and the fewest geopolitical shocks in a decade, but still below average returns across many cyclical parts of fixed income, currencies and commodities. The issue is starting valuations…"

Aside from our concerns about the widespread optimism, we see an advantageous period for fundamentally focused investors to source opportunities found in favorably ranked long and short holdings.

One concept has been floating around at the Convergence investment team meetings. We call it "the barbell" because recently, two groups of stocks seem to have attractive characteristics while performing well. What is interesting is that these groups of stocks are quite different, and most would say they are at opposite ends of spectrum, thus the "barbell approach". One end of the barbell is comprised of growth stocks that are producing lots of free cash flow, many of them technology issues that are considered "disruptive" growth names. We caution about using the broad term "technology". Technology is now utilized extensively in most industries and therefore our utilization of the term expands well beyond the GICS Sector classification. What this group is doing is pushing the boundaries of convention or facilitating growth through technology and modernization. Conversely, the other side of the barbell is made up of deep value ideas drawn primarily from the financial, energy, travel-related, and commodities groups. Our friends at Empirical Research Partners have expressed and researched a very similar theme. They found that near the end of of the 4th quarter of 2020, U.S. value names were significantly undervalued relative to historic forward price-earnings ratios, free cash flow margin, and revenue growth. We believe a portfolio that includes both ends of this barbell is poised for success in 2021 and beyond.

The success of the disruptive growth group seems at odds with the traditional fundamental factor analysis that we do here at Convergence. However, given the ZIRP environment and how this has taken capital from fixed income (TINA, no duration risk) we are finding that immediate fundamentals are less of a concern. Factors built upon sales expectations, research and development spending, and cash balances are buoying these names to the top of our industry group rankings as opposed to valuation metrics or shorter-term historical growth analysis. As a result of our dynamic process, factors that are less common among industry group winners are systematically lowered in weight in the ranking process. We are finding exciting opportunities in genome sequencing, robotics, cloud computing, energy storage, autonomous vehicles, and fintech, which includes: payments, digital wallets, and streamlined payment processing.

The deep value side of the barbell is fueled by the resurgence of sectors and industry groups that were significantly punished during the pandemic sell-off and have yet to recover. These names show strong cash flow growth with robust sales growth prospects in a recovered economy. Stocks like these tend to surge when the disruptive growth names take a breath. The financial names in this group should move higher as a far distant rate hike inches closer. For the energy group, we expect they will benefit when global energy demand increases as we return to the skies for business and personal travel. Travel-related names will welcome the continued rollout of the global vaccine and normalcy returns.

The contemplation of these two sides of the barbell have fueled some exciting factor analysis at Convergence. We are constantly reviewing our existing factors and searching the landscape for new and exciting ideas. The firm has developed multiple new factors and a new composite that we are monitoring in our bullpen of ideas. It is import to constantly monitor and assess processes. As our own Kenneth Mayer recently heard on a podcast... "If you are married to your models, you can't date reality."

On the back of this barbell analysis, the Convergence Long/Short Equity Strategy finished the 4th quarter of 2020 up 4.29% and returned 7.62% in the second half of 2020. The Convergence process is designed to identify and purchase (go long) companies with strong and improving fundamentals, while simultaneously identifying and selling (going short) companies with weak and/or deteriorating fundamentals. Our strategies are based on corporate fundamentals and supported by compelling empirical results. Convergence applies this “strong over weak” approach within each industry group. Our firm’s name, Convergence, communicates our philosophy of a fundamental stock picking process that incorporates quantitative tools for data assimilation and speed delivered in a systematic process designed to maximize the repeatability of strong returns and reduced risk.

Overview of performance

Much like in the third quarter, markets rejoiced over the vaccine news and the “reopening” theme really picked up steam. The Convergence Long/Short Equity Strategy finished the 4th quarter of 2020 up 4.29%. Over the past two years the Convergence Long/Short Strategy has had a long allocation between 121% and 154%, while the shorts have ranged from 41% to 56%. The net exposure has ranged from 69% to 107%. The Convergence Long/Short Strategy ended 2020 with 153.8% long and 47.1% short. The Convergence Long/Short Strategy has averaged over 11.21% annually since the end of 2009, net of fees.

Our large cap Long/Short Equity Strategy has averaged 50.3% of its capital in short positions this year. Additionally, since its inception, the strategy has outperformed the Morningstar Long-Short Equity and the HFRX Equity Hedge peer groups by 742 and 974 basis points respectively on an average annual basis. All returns are stated net of fees and inclusive of reinvested dividends.

Beyond looking at the returns of the strategy in total, it is important to understand how the long and short sides of each portfolio performed. The spread between long and short holdings provides insight into how the market is rewarding and penalizing stocks based on fundamental rankings. Over the three months in the 4th quarter of 2020, our Long/Short Equity Strategy generated a negative spread between its longs and shorts. This negative long/short spread was driven entirely by our short holdings. Our long positions very nearly matched the Russell 3000 Index. Our short positions suffered as the holdings appreciated, even outperforming the index.

Factor Attribution

Our factor attribution is conducted relative to our selection universe, which is the top half of the Russell 3000 Index as ranked by market cap, and then equally weighted. For our long holdings, our Relative Value and Price Momentum factors contributed positively in the quarter. Relative Value had a positive return, but our relative overweight explains a large part of the positive contribution. Our Price Momentum contribution came from a balance of both an overweight and a nice factor return. Our largest detractors from the long side of the portfolio were Size and Profitability. Both factors, which we overweighted, had a very poor return for the quarter which, detracted from the performance. When looking at the short portfolio, our largest contributors were Expected Growth and Price Reversal. Expected Growth and Price Reversal both had very strong returns for the quarter which explains the strong contribution. The most significant short detractor was Profitability. Tied for a distant second place (a dubious honor) were Historical Growth, Earnings Risk and Accelerating Sales Growth. Profitability had both a very poor return and a notable underweight.

The table below shows the industry groups from which each strategy had the most/least absolute return contribution in the fourth quarter of 2020.

Strategy	Top Contributors to Performance	Top Detractors from Performance
Long/Short Equity (Long)	Software & Services Media & Entertainment Technology Hardware & Equipment	Retailing Household & Personal Products Telecommunications
Long/Short Equity (Short)	Food & Staples Telecommunications Commercial & Professional Services	Software & Services Pharmaceuticals, Biotechnology Media & Entertainment

Source: Convergence Investment Partners, Bloomberg Financial LP.

The table below shows the industry groups from which each strategy had the most/least absolute return contribution during all of 2020.

Strategy	Top Contributors to Performance	Top Detractors from Performance
Long/Short Equity (Long)	Software & Services Retailing Media & Entertainment	Energy Banks Food, Beverage & Tobacco
Long/Short Equity (Short)	Energy Banks Utilities	Software & Services Retail Health Care Equipment

Source: Convergence Investment Partners, Bloomberg Financial LP.

The previous tables show that there were some beta moves in the quarter and industry group moves in 2020. Software names all seem to have moved higher regardless of their underlying fundamentals. This can be observed as the Software industry group was a contributor (detractor) in the long (short) portfolios, respectively. The Energy group continues to move lower again, seemingly independent of individual company fundamentals.

The fundamental focus of the Convergence stock picking methodology helps us to identify long holdings with strong sales growth, cash flow, and earnings that trade at reasonable valuations. Over time, companies with these ingredients have tended to reward investors as these are signs of healthy and growing companies with competitively strong business models. Furthermore, the Convergence process also identifies companies with weak or declining fundamentals as demonstrated in the statistics. Our research has shown that shorting these types of firms is effective in sourcing alpha from this side of the trade.

There have always been periods throughout history where irrational investments seem to make sense at the time. However, we have seen that companies that are consistently profitable and manage their assets effectively are the ones that build wealth in the long run. Investors that can be disciplined through these environments are the ones that should ultimately be rewarded.

Let us know if you would like to discuss our portfolio exposures or any other aspect relative to recent portfolio results.

Thank you for your support!

Convergence Long/Short Equity Composite (as of 12/31/2020)

	Gross of Fees Return	Net of Fees Return	Benchmark Return (Russell 3000)	Composite Dispersion (Full Period)	Number of Separate Accounts (End of Period)	Total Composite Assets (End of Period)	Total Firm Assets (End of Period)	3 Year Annualized Standard Deviation (Composite)	3 Year Annualized Standard Deviation (Russell 3000 Index)
2010	24.58%	23.31%	16.93%	N/A*	1	$25,212,822	$93,181,292	N/A	N/A
2011	5.41%	4.32%	1.03%	N/A*	1	$57,971,568	$154,362,324	N/A	N/A
2012	22.62%	21.38%	16.42%	N/A*	1	$92,258,454	$217,790,421	17.35	15.95
2013	32.97%	31.65%	33.55%	N/A*	1	$299,305,670	$492,677,907	13.79	12.71
2014	12.16%	11.05%	12.56%	N/A*	1	$320,015,938	$553,692,556	10.32	9.42
2015	1.26%	0.23%	0.48%	N/A*	1	$213,526,814	$444,781,578	10.81	10.72
2016	13.88%	12.75%	12.74%	N/A*	1	$130,544,576	$398,488,819	11.70	11.04
2017	19.27%	18.09%	21.13%	N/A*	1	$125,380,012	$409,273,927	10.91	10.23
2018	-0.66%	-1.66%	-5.24%	N/A*	1	$97,192,833	$390,434,667	12.24	11.34
2019	15.93%	14.81%	31.02%	N/A*	1	$58,866,057	$343,819,819	11.12	12.38
2020	-5.44%	-6.42%	20.89%	N/A*	1	$18,800,895	$223,805,605	14.03	19.69

*N/A is shown because there were five or fewer portfolios in the composite for the full year.

Disclosures:

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Past performance is no guarantee of future results. Any investment contains risk including the risk of total loss. There is no guarantee that an investment or strategy will meet its investment objectives.

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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.

GIPS COMPLIANCE DISCLOSURES

Convergence Investment Partners claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Convergence Investment Partners has been independently verified for the periods 1/1/2011 to 6/30/2020. The verification report(s) is/are available upon request. Verification does not ensure the accuracy of any specific composite presentation. The firm maintains a complete list and description of composites, which is available upon request. Results are based on discretionary separate accounts under management, including those accounts no longer with the firm. The results portrayed relate only to the adviser's clients invested in the portfolio that meet the criteria for inclusion in composite performance. The U.S. Dollar is the currency used to express performance returns and assets. Performance results are presented both net and gross of management fees and include the reinvestment of income. From the inception of each composite until 01/01/11, Time Weighted Return was compounded on a monthly basis. Beginning 01/01/11 through present, Time Weighted Return was compounded on a daily basis.

Definition of the Firm

The firm is defined as Convergence Investment Partners, LLC ("Convergence Investment Partners"), a majority-owned subsidiary of Nile Capital Group, LLC effective October 1, 2018. Convergence Investment Partners was founded in November 2004. From December 2008 to September 2018, Convergence Investment Partners was a majority-owned subsidiary of Montage Investments, LLC. Convergence Investment Partners (CIP) is an investment adviser registered with the Securities and exchange Commission. Registration of an investment adviser does not imply any specific level of skill or knowledge. Convergence Investment Partners is an active equity manager dedicated to managing U.S equity strategies. Convergence uses its proprietary process to select and rank investments, construct portfolios, and help manage risk in each of its products. Convergence strategies are based on corporate fundamentals supported by compelling empirical research applied within each industry group. The name, Convergence, communicates the firm's philosophy of a fundamental stock picking process that incorporates the intersection of sound investment theory executed in a disciplined environment utilizing advanced technology. The total firm assets will be defined as all discretionary and non-discretionary assets under management within Convergence Investment Partners. This includes primary investment management accounts and sub-advisory investment management accounts, as well as both fee-paying and non-fee paying assets.

The Convergence Long/Short Equity Composite

As of April 1, 2019, the composite name was changed to Convergence Long/Short Equity. Prior to April 1, 2019, the composite was named Convergence Core Plus. The firm updated the composite name to better reflect the objective and management of the strategy. The creation date of the composite is December 31, 2009. The objective of Convergence Long/Short Equity is to achieve long-term capital growth. The strategy seeks to achieve its investment objective by establishing long and short positions in equity securities of domestic and foreign companies. The strategy focuses primarily on companies with medium and large market capitalizations, although the strategy may establish long and short positions in companies of any market capitalization. The strategy will hold long (purchase) securities that the Adviser believes will outperform the market and will sell short securities expected to underperform the market.

Additional Index Definitions

For comparison purposes, the Convergence Long/Short Equity Composite is measured against the Russell 3000® Index as a primary index. The Russell 3000 Index measures the performance of the largest 3000 U.S. companies. It is 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 a market-value weighted index provided by Standard & Poor's comprised of 500 stocks chosen for market size and industry group representation. 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. Unmanaged index returns assume reinvestment of any and all distributions and do not reflect fees, expenses or sales charges.

Fees and Related

The full fee schedule for all Convergence Investment Partners products is available upon request. It should be noted that the collection of fees produces a compounding effect on the total rate of return net of management fees. Convergence Investment Partners Convergence Long/Short Equity strategy charge 1.00% annually and is assessed .0833% on a monthly basis. Convergence Investment Partners reserves the right to modify fee structures on an account by account basis at its discretion. Gross of fee performance returns are presented before management fees but after all trading expenses. No other fees or expenses are deducted for gross of fee performance. Net of fee performance returns are presented after actual standard 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. Valuations are net of all applicable withholding taxes. Portfolios are valued in accordance with GIPS® Valuation Hierarchy Principles. More information regarding standard investment management fees is available upon request.