Convergence Investment Partners

Convergence Long/Short Strategies

Q3-2020 Review and Commentary

> ***"Most people get interested in stocks when everyone else is. The time to get interested is when no one else is. You can't buy what is popular and do well."***
>
> - *Warren Buffett*

As we reflect on the 3rd quarter and the year 2020 overall, the traditional investment measurements and analogies may not suffice in explaining the narrative of the recent results within equities. As in the famous opening line of the original Star Trek series, we have truly gone "to where no man has gone before." The irony is that even with all the unthinkable exogenous events impacting equities from pandemic fear, systematic closing of businesses, trillions of dollars of stimulus, Zero Interest Rate Policy (ZIRP), etc; a given company's value in the end still needs to reconcile over time to its tangible revenues, cash flows, earnings and the future growth or decline of those items.

Can you imagine walking into a conference room of investment professionals to pitch an investment strategy based on the following philosophy? Let's call this investment company "FakeCo" and here is the pitch:

> FakeCo's premier product is based on the premise that companies with certain characteristics outperform. FakeCo seeks high momentum companies across all industry groups, where the price has moved up most significantly in the past 12 months. Additionally, these companies are most desirable if they have extremely high valuations. FakeCo also tilts towards unprofitable companies or companies that have unstable earnings. Finally, FakeCo seeks after companies that manage their capital poorly, which may indicate obfuscation within their financials. FakeCo targets only the highs… high momentum, high accruals, high expenses, and of course high valuations! FakeCo always says… *how can you lose when you pay a high price?*

It seems that FakeCo executives would have a tough time finding willing investors. One might expect that most investors would not consider a manager whose philosophy is based on high valuations and unprofitable companies. However, over the past 6-months, a strategy based on FakeCo's philosophy would have had a stellar track record. The following table using the top 1500 members equally-weighted of the Russell 3000 Index illustrates this. Looking at the trailing 6-month performance of the bottom 20% equities by each factor (except Price Momentum, which is the top 20%) drives home the point that low-quality has been performing well.

Factor	6-Month
High Price Momentum	42.5%
High Accruals	43.2%
High Earnings Risk	45.1%
Low/No Profits	41.0%
High Valuation	47.7%
S&P 500 Index	31.3%
Russell 3000 Index	33.2%

Relative Returns vs S&P 500	
Factor	**6-Month**
High Price Momentum	11.2%
High Accruals	11.9%
High Earnings Risk	13.9%
Low/No Profits	9.7%
High Valuation	16.4%

The tables above show that high momentum stocks outperformed the S&P 500 Index by over 11%. The most astonishing relative outperformance, 16.4%, was from overvalued companies. The top 20% most overvalued companies, within each industry group returned nearly 48% in the past 6-months!

Last quarter we wrote a great deal about the irrational behavior moving stock prices. It seems this behavior went unchecked into the third quarter. We have always remained true to our investment philosophy that fundamentals matter over the long term, but the past few months have forced us to remember the famous and often re-phrased quotes from Keynes mentioned below.

> ***"There is nothing so disastrous as a rational investment policy in an irrational world."***
>
> - *John Maynard Keynes*

The past months and quarters have presented a challenging environment for any investment manager that intends to identify opportunities in the market based on tangible fundamentals. Today's historically low interest rates allow investors to barely discount cashflows that are decades away. These same low rates provide an unprecedented permanent back stop for overleveraged companies that borrow to amass huge customer lists with no concern for profitability. Also, the fiscal mentality of "whatever-it-takes" when providing stimulus, support, and relief distorts the concept of "creative destruction", by not allowing weaker businesses to fail or for investments to go bad. We feel like we are trying to identify great bowlers when the bumpers are up, do-overs are allowed, and the score keepers have huge erasers.

In the television series Star Trek, there are these amazing occurrences in space called wormholes. These wormholes allow one to shortcut travel through space covering billions of miles in just hours. In the real world, it appears the Federal Reserve has cut through investment space with its "ZIRP4EVER" approach: buy bonds to drive interest rates down, ignore price stability and, maintain near zero rates for the next several years. This "ZIRPY" attitude has had an obvious effect on the discount rate and its impact on stocks, including and especially the riskiest companies with challenged business models in many cases. That obviously has an impact on shorting companies with low or no cash flow, sales or earnings. We liken this to a rubber band, as it stretches potential energy increases. This energy can be released in a powerful snap as the rubber band (the company) delivers on real, tangible fundamentals, like cash flows and sales. Not all companies are able to experience this snap as they can fail due to capital constraints, competition, or lackluster customer sales. It is these low-quality companies with weak or declining fundamental metrics that make great short candidates. However, over short-term time periods, outside forces (such as the FED) can allow "junk" to shine. Artificially low levels of interest rates have temporarily impacted the properties of the equity market and created a wormhole of performance for many of these stocks to travel through.

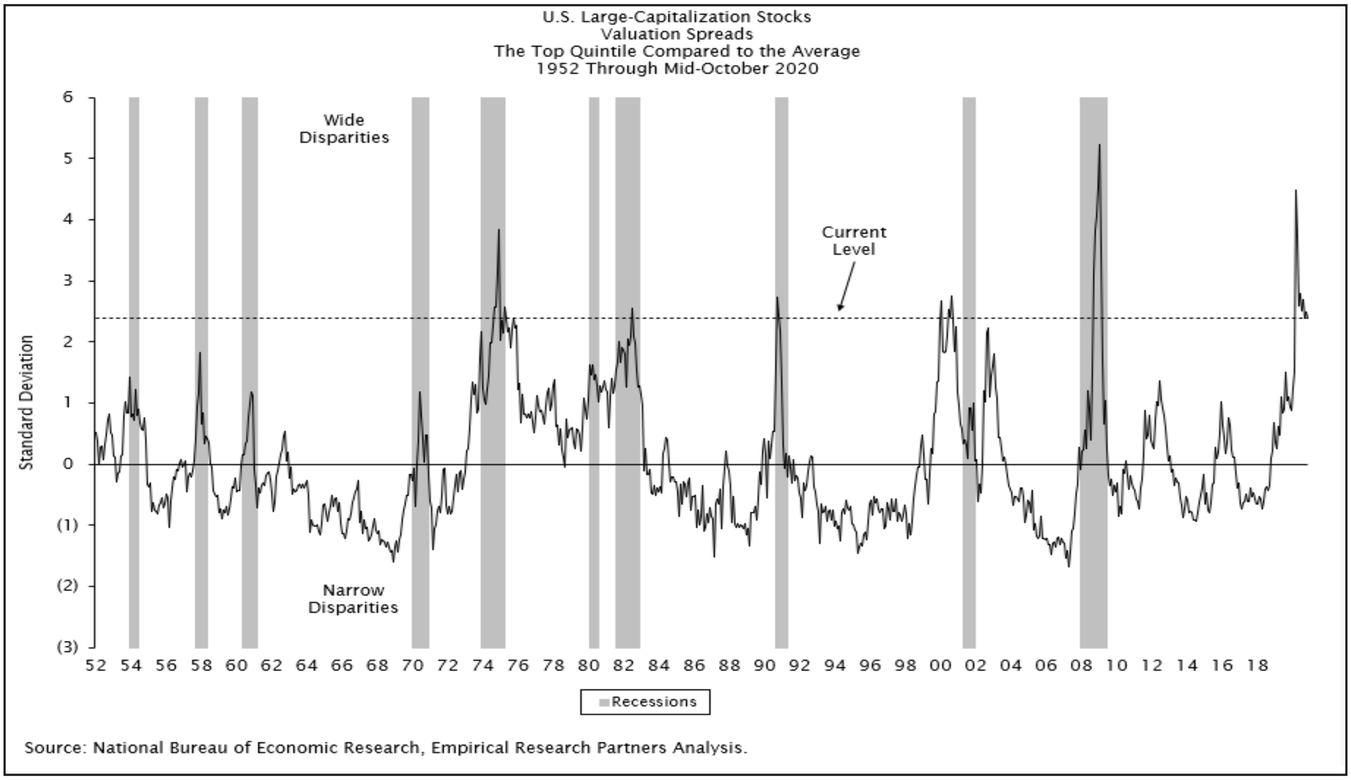
> ***You want to stabilize the wormhole; you don't want the wormhole to collapse. Keep the wormhole open: that requires something new called Negative Matter."***
>
> - *Dr Michio Kaku*

As the third quarter drew closer to the end, our research observed a few indications that the ridiculous behavior to start 2020 may be starting to abate. The meteoric rise of popular tickers seems to have peaked. Wingstop has cooled after a 235% spike from the March COVID low. Hertz settled into more typical bankruptcy performance. Its price oscillated around $1.25 and ended the quarter at $1.11. Nikola joined forces with General Motors (11% stake) and the critics had a ball with the "due diligence." Our favorite was from Bloomberg:

> Trevor Milton (founder) appointed his brother, Travis, as "Director of Hydrogen Production/Infrastructure" at the company. Hindenburg Research said Travis's "prior experience looks to have largely consisted of pouring concrete driveways and doing subcontractor work on home renovations in Hawaii."

Furthermore, in September, Milton abruptly resigned following the announcement that the SEC and DOJ are investigating him and Nikola on claims of securities fraud.

In terms of less anecdotal evidence, there were an increasing number of days where valuation factors delivered some strong returns and the high short interest index has returned to underperforming the broader market. For the quarter, the Citi High Short Interest Index underperformed the Russell 1000 Index by over 735 basis points. Also, we are encouraged by the extreme valuation spreads that our friends at Empirical Research are noting. Such extreme valuations spreads have historically led to periods of re-normalization. Those periods of renormalization have historically benefited investment strategies that differentiate stocks based on underlying fundamental measures. Their research shows we are about 2.5 standard deviations above the mean (going back to 1952), when observing the valuation dispersions among large capitalization stocks as shown below. Over the 60-year time period there were only five times when this level has been reached and typically these lofty levels are short lived.



This observation is interesting when coupled with what Candice Tse of Goldman Sachs recently wrote:

"We think there is still value in owning value stocks. But the macro environment suggests a high-quality growth tilt remains appropriate."

To us, this implies that an opportunity for value stocks may exist in the medium term and growth investors are rotating from rampant speculation to more "high-quality growth." Essentially, an environment favoring fundamentally sound companies is on the horizon and the warning bell is ringing for irrational exuberance.

Convergence Long/Short Equity strategy finished the third quarter of 2020 up 3.19%, net of fees. 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

The third quarter of 2020 was marked by COVID and the election. Americans returned to work and school in some states as the COVID-19 coronavirus pandemic simmered or surged in various parts of the country. Markets rejoiced as vaccine news steadily improved. Most reopenings seemed to go well and death rates have been trending lower. The Convergence Long/Short Equity strategy finished the third quarter of 2020 up 3.19%. Over the past two years the Convergence Long/Short Equity strategy has had long allocation between 121% and 141%, while the shorts have ranged from 45% to 56%. The net exposure has range from 69% to 96%. The Convergence Long/Short Equity strategy has averaged over 11.0% annually since the end of 2009, net of fees.

Our large cap Long/Short Equity strategy has maintained approximately 50% 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 789 and 1025 basis points respectively, average annual. 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/penalizing stocks based on fundamental rankings. Over the three months in Q3-2020, our Long/Short Equity strategy generated a negative spread between its longs and shorts. This negative Long/Short spread was driven by both our long and short holdings. Our long positions trailed the Russell 3000 Index, while our short positions outperformed the index (bad for shorts).

Factor Attribution

Now let's transition and talk about factor attribution for the third quarter. This 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. The equal weighting of the universe helps explain why our size factor was such a positive contributor to long portfolio performance last quarter. Large Cap stocks really shined in the quarter, which when paired with our overweight to the factor, was a nice tail wind for the strategy. For our long holdings, our Historical Growth and Price Momentum factors contributed positively in the quarter. This was primarily due to the strong returns of these factors with a slight allocation benefit coming from our weight to Historical Growth. Our largest detractors from the long book were Capital Discipline and Relative Value. These were both due to poor factor performance, not our allocation decisions. When looking at the short portfolio, our largest contributors were Price Momentum and Sales Growth. Price Momentum had a very strong return while Sales Growth was a good performer and had a beneficial allocation. The most significant short detractors were Accruals (quality of accounting) and Earnings Risk. Accruals suffered from a negative relative return while our large underweight was the main culprit for our Earnings Risk contribution. Given that Price Momentum was the primary driver of all stock returns for Q3, it is unsurprising that we had lower contribution from the other factors over the three months.

The table below shows the industry groups from which the Long/Short Equity strategy had the most/least absolute return contribution in the third quarter of 2020.

Strategy	Top Contributors to Performance	Top Detractors from Performance
Long/Short Equity (Long)	Retailing Capital Goods Software	Energy Telecommunications Banks
Long/Short Equity (Short)	Technology Hardware & Equipment Energy Household & Personal Products	Healthcare Equipment & Service Retailing Media & Entertainment

Source: Convergence Investment Partners, Bloomberg Financial LP.

Much like last quarter, the above table shows that there may have been some beta moves in the quarter at the industry group level. Retailing names all seem to have moved higher regardless of their underlying fundamentals. And the Energy industry group continues to move lower, again, seemingly independent of individual company fundamentals. This can be observed as the Retailing industry group was a contributor (detractor) in the long (short) portfolios, respectively.

The Convergence stock picking methodology is fundamentally focused and drives us to identify holdings for the long portfolios with strong cash flow, earnings, profits and other desirable financial characteristics, 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, the 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 will 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 6/30/2020)

	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 (as of 6/30/2020)	-12.59%	-13.04%	-3.48%	N/A*	1	$31,049,533	$248,403,477	13.63	17.69

*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.

This communication is limited to the dissemination of general information pertaining to Convergence Investment Partners, LLC's (Convergence) services and general economic market conditions. The information contained herein is not intended to be personal legal or investment advice or a solicitation to buy or sell any security or engage in a particular investment strategy. There is no guarantee that the views and opinions expressed in this letter will come to pass. The views expressed do not take into account any individual personal, financial, or tax considerations. The opinions and forecasts herein are based on information and sources of information deemed to be reliable, but Convergence Investment Partners does not warrant the accuracy of the information that this opinion and forecast is based upon. Opinions expressed are subject to change without notice.

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.