



FOURTH QUARTER 2016



Gary Lenhoff, CFA
Chief Investment Officer-
Fundamental Equities



Benjamin Kim, CFA, CPA
Portfolio Manager

Investment Results

Americans awoke the morning of November 9th, 2016 having elected Donald Trump as 45th President of the United States. This unexpected outcome set off a series of market responses around the world that led generally to higher asset prices, higher interest rates, and broadly higher expectations for future economic growth. The Russell 2000 Index gained 8.8% in the fourth quarter of 2016 on the heels of a torrid 13.5% advance over the 33 trading days between Election Day and year end. For the full year the index advanced an impressive 21.3%. The broader large company S&P 500 Index closed the quarter 3.8% higher, and gained 12% for the full year. Most major U.S. equity indices are now trading at or very near all-time record levels. Globally, Brazil's Bovespa index vaulted 61% higher, reversing a five-year period in which it had lost almost 70% in value (both in U.S. dollar terms.) Laggards included Italy, Spain and the U.K. (down 12%, 6% and 5%, respectively) as EU financial concerns resurfaced and Brexit fears lingered. China was down slightly, while Japan and Germany each gained about 1%. Emerging equity markets rebounded, gaining about 9% led by Latin America's 30% advance.

Crude oil closed the quarter 7% higher at about \$53/barrel, representing a 6+% gain for the year. Metals including palladium, copper, and silver closed the year 15-20% higher, while gold gained 8% despite falling 13% in the Q4. The U.S. dollar reversed course in Q4 (again, much of it post-election), climbing 7% which allowed it to post a 3% gain for the full year. The Euro lost 4% of its value in 2016 after declining 6% in the fourth quarter.

Perhaps most importantly, the yield on the 10-year Treasury note rose 88 basis points in Q4 to finish the year at 2.48%, its highest level in over two years and double the post-Brexit low of 1.27% just six months earlier. In a well telegraphed move, the Federal Reserve raised the Federal Funds rate by 25 basis points, and signaled the potential for multiple rate hikes in 2017.

It was another tumultuous year. Investors were forced to process startling results in both the U.K. (Brexit) and the U.S. inside a five-month timeframe. Our Small Cap model portfolio appreciated 9.7% in the fourth quarter, besting the index by 90 basis points. For the full year the portfolio closed 26% higher, ahead of the index by 470 basis points. More detailed information related to those factors helping and hurting our quarterly and full-year results follows.

Fourth Quarter Attribution

Solid results across the portfolio helped fuel the quarter's performance. Investments in the Consumer Discretionary, Health Care and Materials sectors were particularly good, while our Technology holdings were the only meaningful detractor from results.

- Within the Consumer space our substantial overweight position (19% versus an index weighting of 13%) coupled with solid stock selection yielded 188 basis points of positive relative return. One holding leapt 43% as investors expect a more lenient regulatory environment under President Trump. Another security gained 39% after agreeing to be acquired. The only substantial loser in the quarter was a company which is again struggling with the impact of a strong U.S. Dollar on its international business segment. While organic growth in Europe and Asia has been challenging, improvements in South America are encouraging and we remain confident in this company's ability to generate substantial returns to patient investors.
- In the Health Care arena our lack of exposure to Biotechnology and small cap pharmaceutical companies paid dividends. These two sectors were off 10-11% in the quarter, driving the entire sector's loss of more than 6%. We remain substantially underweight in the sector, having about 6% of assets invested compared to a 13% weighting for the index.
- One holding almost doubled from its low base in the quarter after reaching an agreement with its lenders, which includes the possible sale or restructuring of the company. Another security also

benefited from better global pricing.

- Our Financials holdings returned more than 21% in the quarter, edging out the sector's 20% total return. However, our underweight position (18% vs. 23%) prevented any gains in relative value returns. Nine of the ten companies we own enjoyed at least 15% appreciation in their shares during the quarter.
- Our lack of exposure to the exploration and production industry led us to dramatically underperform in the Energy sector where our holdings gained only 5% compared to the index's 20%+ jump in the sector. Higher energy prices and expectations of more pro-drilling government policies under a Trump administration led the sector higher.
- Technology was mixed in Q4. Good performance from three companies was offset by weakness in three other firms.
- Lastly, our 7% average cash holdings in the quarter cost us 105 basis points of relative performance. It is not unusual in such a volatile quarter to see cash levels increase as we trim or sell shares that are approaching fair value. At year end, our cash position was 6% and, while it is a bit harder to find great businesses at attractive valuations today than it has been in the past, we expect to be fully-invested during 2017.

Full Year 2016 Attribution

The portfolio gained 26% in value for the year, comfortably beating the Russell 2000 return of 21.3%. We believe 2016 demonstrated the value of our active approach to investing in undervalued businesses. Our outperformance was the result of (1) a substantial overweight position in companies in the Consumer Discretionary and Industrial sectors that dramatically outperformed their peers; and (2) a substantial underweight position in the Healthcare sector, in which our two holdings dramatically outperformed the sector. We did not make a "top-down, macro" call that led us to invest in these parts of the U.S. economy. Instead, our "bottom-up" analytical process, beginning with our screens, identified specific companies that investors were mispricing based on their perception of the risks involved. Our careful analysis led us to a different conclusion than the market, and our portfolio management process put us in the right position to benefit from this analysis. These three sectors added more than 1200 basis points of positive relative performance. More specifically:

- In the Consumer Discretionary sector we held 16 securities, 15 of which appreciated in value during the year. Our weighting of 22% far exceeded the index weighting of 14%, and we were rewarded with aggregate performance of +40.7%, 2700 basis points better than the sector return of 13.7%. Four companies were acquired and all gained 35%-60% during the year. Two companies fared better than their peers in a tough retail environment. Three other stocks were all up more than 20%, and our only poor performer lost 10%.
- Our Industrial sector weighting of 22% also greatly exceeded the index weighting of 14%. You may recall that this overweight position hurt our results in 2015. Many of the same stocks drove our outperformance in 2016. Our aggregate sector return of 39% was more than 900 basis points better than the index sector return. Seven of our 18 holdings gained 23% or more and only one stock declined in value.
- We have been consistently underweight small cap health care stocks for the last six years, and 2016 was no different. Biotechnology and small cap pharmaceuticals (many of which look like biotech) comprise one-half of the sector's 14% weighting in the Russell 2000 Index. We typically cannot find attractive investment opportunities in these industries because many tend to have negative or no earnings, and, as such, cannot gain comfort that they will meet our cash flow and balance sheet criteria. Not surprisingly, our sector weighting of 6.5% is about one-half that of the index. Again, this is a result of our "bottom-up" screening and analytical approach, and should not be considered a mandate.
- The biotech and pharma segments of the small cap market were each down 20% in 2016 after enjoying prolonged periods of outperformance. This drove the entire Healthcare sector down almost 8% for the year. Our two holdings gained 12% in aggregate, more than 2000 basis points better than the sector.

Among the detractors from results:

- Our Technology holdings gained almost 17% in aggregate but underperformed. In addition to one security, our investment theses in two other securities proved incorrect, and as a result we exited the positions earlier in the year. Those two positions cost us roughly 145 basis points of relative performance.
- One stock did underperform for the year, which resulted in flat results for our Materials sector holdings for the year. This compares poorly to the sector's sizzling 48% return and cost the portfolio about 170 basis points of relative performance.
- Our investment in another security declined by almost 14% during the year, mostly in the aftermath of Brexit. Nonetheless, the Real Estate sector, which is comprised almost exclusively of REITs, gained 23% during 2016, and led us to underperform on a relative basis by about 100 bps.
- Our Financials holdings gained 26% in the year but we still underperformed as the sector had a torrid 32% gain. Small cap financial institutions catapulted up post-election, gaining more than 25% since November 8th, which drove full year results. Two holdings were eliminated; one company failed to execute, and the other fell victim to the Department of Labor's new Fiduciary Rule (which may now be placed on hold by the Trump Administration.) We eliminated both from the portfolio during the year, but these positions cost us about 120 basis points in aggregate.
- Lastly, as was true in Q4, our average cash position during the year ran higher than is typical, and cost us about 266 basis points.

Outlook

Investors are beginning to view a Trump Presidency as a potential game changer. U.S. equity markets finished 2016 strong, interest rates rose across the yield curve, and commodity prices generally rose into the final days of the year. In mid-December we commented on market conditions, and much of what we wrote still applies. We wrote:

Investors have poured into U.S. equities in the last five weeks, believing that a Trump Administration will be unabashedly positive for the U.S. economy and U.S. companies. Several reasons supporting this belief are frequently cited:

- *Trump is likely to support increased government spending programs (such as an infrastructure program) in an effort to jumpstart economic growth.*
- *U.S. tax policies are likely to be modified. Frequently cited changes include reductions in both individual and corporate tax rates, amnesty for multinational companies allowing repatriation of billions of dollars of foreign profits, and allowing more generous tax deductibility of capital investments.*
- *Deregulation, especially in areas such as environmental law, energy production and banking and finance could also be a factor.*

The rapid response by investors to these possibilities has been somewhat remarkable. We are mildly concerned that several potential negative factors have been largely ignored. First, increased government spending in tandem with lower tax rates is likely to result in upward pressure on materials and wages, and hence inflation. This additional spending is also likely to require an increase in government borrowing, potentially at a higher rate of interest. Indeed, the ten-year Treasury yield has increased by 65 basis points since Election Day, and now stands at about 2.50%.

Second, President-Elect Trump has been quite vocal about U.S. trade policy and how disadvantageous it is to U.S. workers and consumers. Many multinational companies could suffer to the extent that trade agreements are renegotiated or tariffs on imports are introduced. We estimate that the constituents of the S&P 500 derive about one-half of their revenue outside the U.S., which could be at some risk if trade barriers grow. Indeed, one reason smaller company stocks may be outperforming is that they derive a much larger percentage of their revenue—perhaps as

much as 80%--from within the U.S.

As we mentioned in our Election Day note, we are avoiding “short-termism” and instead will evaluate the longer-term impact of these and other potential changes on financial markets. Our investment approach is decidedly “bottom-up”, focusing on each potential investment’s fundamental condition.

We did allow, however, that we felt compelled to make one change to our analytical process at the time, which we went on to elaborate:

However, we have made one tangible change to our forecasting methodology that is worth highlighting.

As you know, we build our own Fundamental Equity models to forecast earnings and free cash flow generation for many potential investments, including all companies included in our small cap and large cap value portfolios. We now believe it is more likely than not that a new Trump Administration will succeed in reducing the U.S. corporate tax rate, currently set at 35%. There are several competing proposals being discussed, ranging from a reduction to 15% (Trump campaign) to the low 20’s (supposedly “revenue neutral”) or perhaps 25%. After careful consideration and much discussion among the Fundamental Equity team, we are now assuming in our “high-end” forecast, to which we typically assign a 20% probability of occurrence, that the corporate tax rate will be reduced to 20%. In our “base case” forecast, typically assigned a 40% probability, our tax rate assumption is now 25%. We have not made any change to the tax assumption in our “low-end” cases, which typically also carry a 40% probability of occurrence.

The impact of this change varies across our holdings as a variety of other factors affect a company’s “effective” tax rate. The impact has been to increase the value of the stocks we own by as much as 10% in some cases, and 6-8% on average. Of course, we may simply be playing “catch-up” as markets have already moved by this much and more.

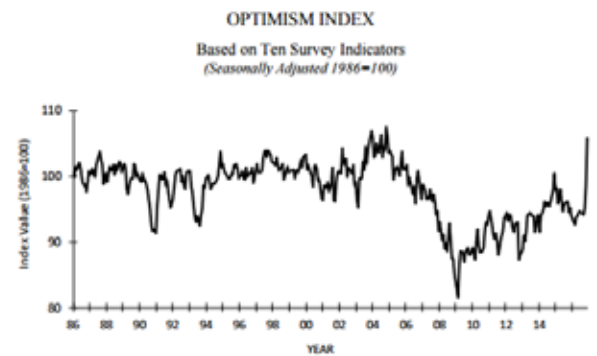
We continue to evaluate this and other potential policy changes to determine how they may affect U.S. equity values. In the meantime, the U.S. economy continues to drive global economic growth. Job creation continues apace and inflation appears to be in check. On January 6 the Bureau of Labor Statistics reported that average hourly earnings rose by 2.9% in December, another positive data point as we strive to return to 3%+ wage growth we enjoyed prior to the 2008-2009 recession.



OVERVIEW - SMALL BUSINESS OPTIMISM

Another positive sign emerged on January 10, when the National Federation of Independent Businesses (NFIB) released the results of its December Small Business Economic Trends survey. In it NFIB stated “The December Survey confirmed the euphoria observed in the post-election survey...if this optimism continues, it will translate into spending plans ...and ultimately into reports of actual hiring, inventory spending and capital outlays.” The report, one of the strongest we have seen in its existence, also noted that job creation plans reached a nine-year high level. Creating well-paying jobs and boosting wage growth above the elusive 3% threshold was a central tenet of President-elect Trump’s campaign, and through all of the rhetoric (of which there is certainly no shortage) we suspect that yardstick will be among the most important by which his Presidency shall be measured.

As we wrote last month, it stands to reason that we may experience periods of above-average short term volatility as the new Administration’s plans unfold. In any event, 2017 promises to be another exciting year for equity investors around the globe. We continue to turn over every rock in search of good value, and are confident our active approach to investing will continue to produce satisfying results over the longer term.



Source: NFIB Small Business Economic Trends, Dec 2016.

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