TODD
ASSET MANAGEMENT LLC

July 20, 2016
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Partner, Senior Portfolio Manager

# Brexit… A Turning Point?

*Todd Intrinsic Value Opportunity Review*

| | 2Q 2016 | YTD | 1 Year | 3 Year* | 5 Year* | 7 Year* | 10 Year* |
|---|---|---|---|---|---|---|---|
| Intrinsic Value Opportunity (Gross) | -6.3% | -5.9% | -13.0% | 5.9% | 9.2% | 14.6% | 7.2% |
| (Net) | -6.5% | -6.3% | -13.8% | 5.1% | 8.4% | 13.8% | 6.4% |
| S&P 500 | 2.5% | 3.8% | 4.0% | 11.7% | 12.1% | 14.9% | 7.4% |
| Russell 1000 Value | 4.6% | 6.3% | 2.9% | 9.9% | 11.4% | 14.5% | 6.1% |

** Annualized Total Returns. Please refer to the attached Performance Disclosure for further information.*

The Intrinsic Value Opportunity strategy underperformed the benchmark during the second quarter, returning -6.3% (Gross) compared to the S&P return of 2.5% and the Russell 1000 Value return of 4.6%. For the trailing one year period, the IVO lost -13.0% (Gross) compared with an index gain of 4.0% for the S&P 500 and 2.9% for the Russell 1000 Value index. The Opportunity Strategy has lagged fairly dramatically over the past year as the market has become more selective in its search for yield and yield supportive characteristics, while shunning names possessing characteristics that this strategy actively seeks (namely cheap stocks that are highly profitable and buying back shares). Over the past year, this has been cyclically out of favor, but we believe a recovery should be taking hold in the near future. We have seen the strategy underperform like this in 2007 and 2008 as investor's desire for intrinsic value was diminished during that episode. Following that episode, we went on to outperform the S&P 500 for five of the next seven years between 2009 and 2015. We believe this episode could play out similarly.

Without a doubt, one of the largest geopolitical surprises of the past decade was the British vote to exit the EU. In hindsight, we probably should not have been surprised as populist candidates have been surging in the polls in most election contests we have seen recently. Following the election, the "Leave" camp leaders found themselves in the quandary of a dog chasing a bus. Namely, what to do once they catch it? They seem to not have thought that far ahead, and a power vacuum emerged as PM Cameron resigned and a new leader needed to be selected. That situation appears to be sorting itself out, as a new PM has been elected, but there are still many elements of uncertainty to play out in this drama. We think this could be a turning point for governments worldwide as they realize that unhappy electorates want growth oriented policies.

There were other notable developments besides Brexit in the quarter, including:

- Most major central banks left policies unchanged. The US Federal Reserve has been tiptoeing towards another rate hike, but economic developments seem to keep them on hold. The Bank of Japan surprised most investors when they left policy unchanged in April. They are currently considering several policies that amount to "helicopter money", i.e. fiscal stimulus directly to consumers to bolster the economy. The European Central Bank left rates unchanged after aggressive moves in March to bolster their economy. The Peoples Bank of China left rates unchanged as well.
- Market rates for bonds have plummeted post Brexit. Many European and Japanese sovereigns moved deeper into negative rates, and the U.S. 10 year government bonds

briefly got to 1.35%, before recovering to the current rate of nearly 1.6%. Refinancing of mortgages has surged.

- Most governments are either stimulative or becoming that way. The U.S. has seen government spending go from a drag to a support for growth. China is pursuing more fiscal stimulus and just reported a modest upside surprise to GDP. Japan is on the path to becoming more stimulative. The British vote could push both the UK and Eurozone governments to adopt more growth oriented policies as their electorates are clearly unhappy with the low growth regimes they have been experiencing.
- Economic progress was uneven in the quarter. The IMF and World Bank lowered estimated 2016 growth. Other trends we have seen include:
    - Second quarter US GDP growth estimates firmed up to something at or above 2.5%.
    - Chinese GDP came in slightly ahead of estimates at 6.7% growth in Q2. The IMF actually raised their estimates of Chinese growth in the quarter.
    - Japanese growth estimates were cut by the government to 0.7% from 1.4% for the year ending April, 2017.
    - Estimates for British and EU growth are being re-evaluated by most investors, with an eye towards reducing them as a messy divorce gets underway.
- A poor May employment report for the U.S. concerned investors heading into the British vote, but a spectacular rebound in June employment led the US market to new highs.

Currencies generally behaved themselves during the quarter. Though many analysts are wondering why the Dollar has not strengthened more given the turmoil in Europe. The dollar and Euro remain in a trading range compared to each other. The yen has been very strong versus most other currencies, much to the dismay of their central bank. Our sense is the Dollar probably stays in the current range for the rest of the year. The Chinese currency has declined in value, but investors are not nearly as fearful of that as they were earlier this year.

While the Brexit vote will be what most investors remember about this quarter, we think in time it will be seen as a turning point for the EU. Since the financial crisis, European institutions have tended to take half measures when trying to improve economic activity. The ECB participated in the first round of extraordinary bank measures with the US and British central banks during the financial crisis. After this, they allowed their balance sheets to contract, draining stimulative policies from the market. While this was occurring, governments pursued austerity. Tighter monetary policies and austere government spending led Europe to weaker growth. The electorate in Britain has backed a populist movement to leave because of subpar growth and concerns about losing control of their borders. Other populist parties are rising in Europe. This may prompt those governments to pursue pro-growth policies like infrastructure spending and possibly employment, tax and entitlement reforms.

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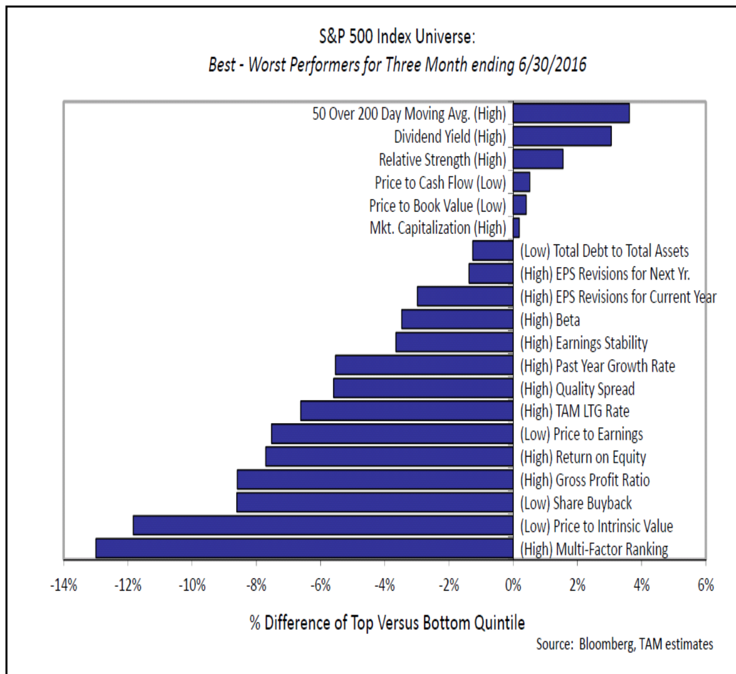
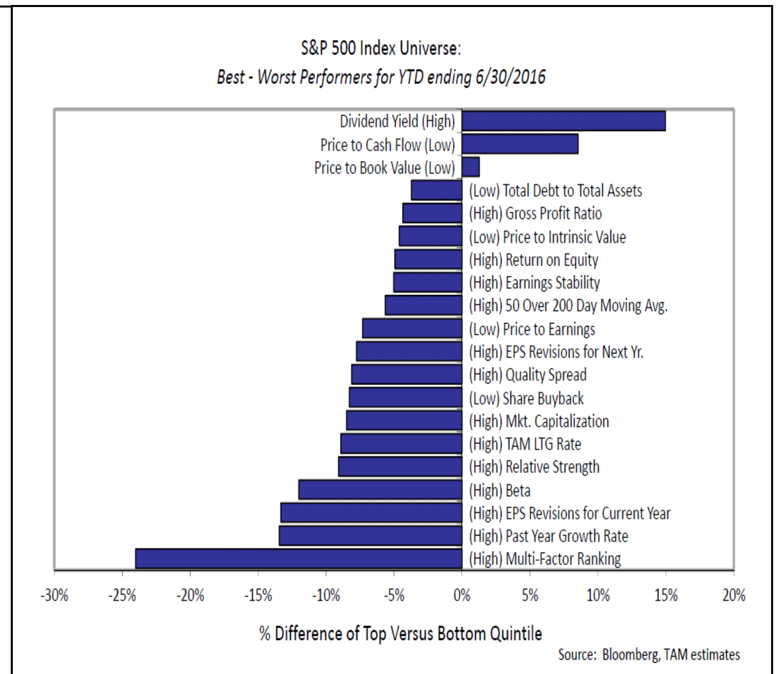
***<u>What Worked… And What Didn't</u>***



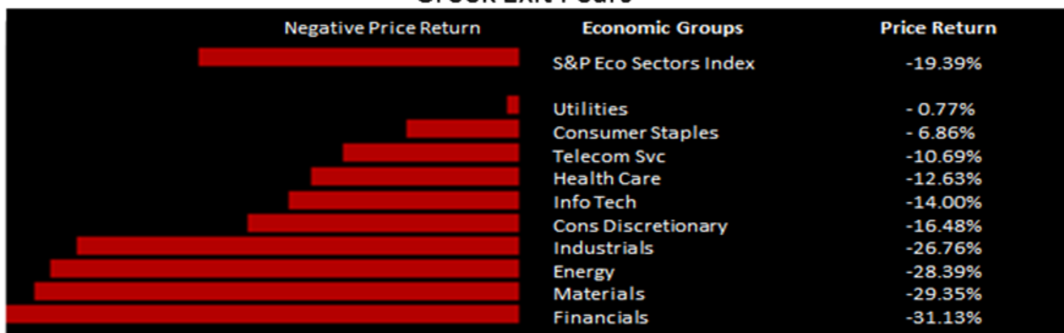

In the two charts above, we monitor how various attributes help or hurt market performance to see if the investors are seeking attractive value, earnings growth or something more concrete like dividends. The charts present this performance for the second quarter and year to date period. This chart measures how the best ranked 100 stocks on each measure compare with the lowest ranked 100 stocks within the S&P 500. The only factors that meaningfully worked thus far this year are High Dividend Yield and Low Price to Cash Flow (probably seen as a dividend support). ***For seventeen out of the total twenty factors we monitor, the best ranked names underperformed the worst ranked names!*** Historically reliable measures of attractive value, strong fundamentals or improving technical pictures did not work**.** Fear overrode reason, and the only factor the market rewarded was dividend yield. What was the worst performing factor? That was our proprietary multi-factor model that combines attractive valuation with improving fundamentals and attractive relative strength. ***In our opinion, this historically extreme reading is the primary reason for our underperformance this year and we believe it does not last much longer.***

Since July of 2015, the market's economic sectors have traded like they have in prior recession induced bear markets, pursuing a flight to safety. How do we know this? During the bear markets starting 2000, 2007 and the Greek exit (Grexit) scare of 2011, Consumer Staples, Telecoms and Utilities were consistent leaders (chart below). Generally, the best performing sectors outperformed the worst by 30-50% in the 2007 and 2011 safety trades. The performance advantage was even wider than that during the 2000 episode.

Where are we now? As you can see in the second chart, since July of 2015, Utilities, Telecom and Staples have been the sector leaders, and they have beaten the Energy and Financial sectors by over 30%. This is very similar to prior bear markets. The only difference between now and the prior episodes is that the S&P has not dramatically declined during this safety trade.

We believe as recession sentiment fades, our performance should recover. This episode seems to most closely resemble the 2011 Grexit worries. The current safety trade is already twice as long as that episode. As Brexit developments unfold and we get the uncertainty of U.S. elections out of the way, we believe fundamental measures will regain traction.

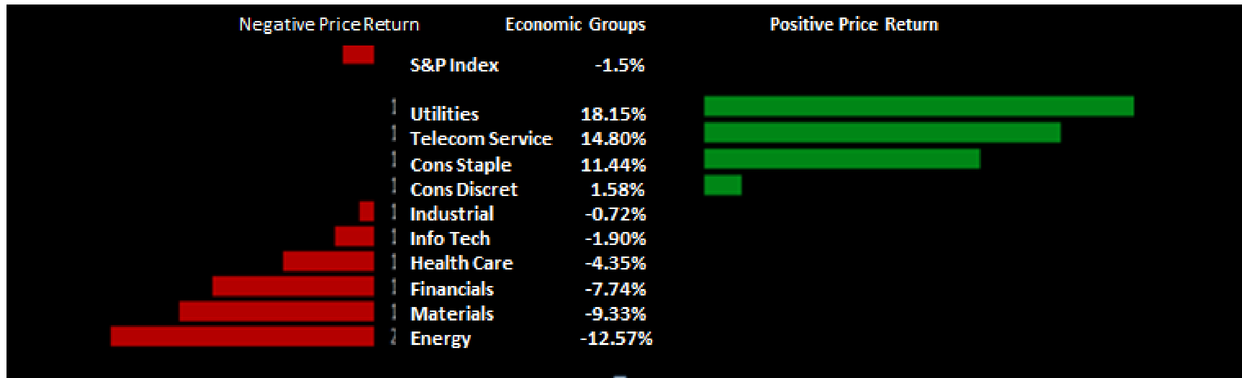
S&P Sector ranked returns 4/29/11 thru 10/03/11
Greek Exit Fears




Sector performance during the 2011 "Grexit" scare closely resembles current market action.

Source: Bloomberg

**S&P Sector Relative Performance 7/20/15 through 6/30/16**
**A Flight to Safety Like in Bear Markets**



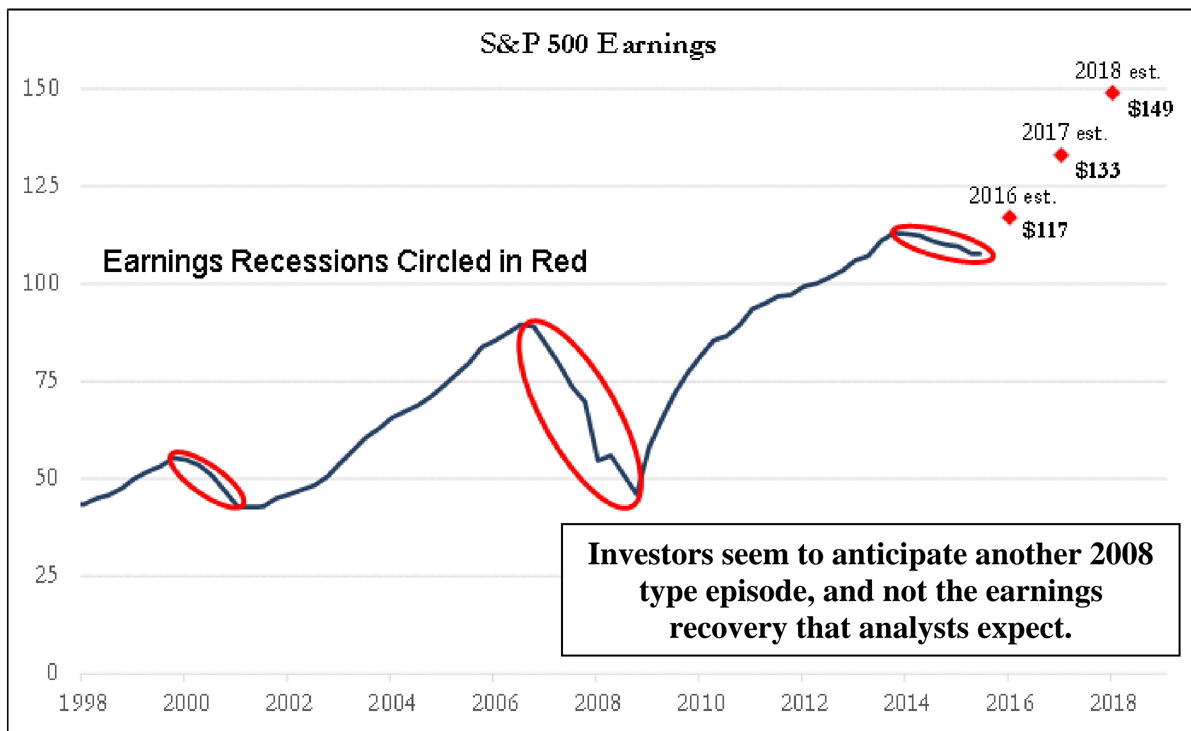

Source: Bloomberg

After the markets bottomed, the leading sectors usually lagged and the laggards became the leaders over the year following the market lows. If that holds true this time, we would expect Financial, Health Care and Technology stocks to outperform post recovery. They are the economic sectors that have suffered over the past year that our discipline has favored. Energy stocks have been laggards as well, but our discipline is not directing us to them yet.
We think the relative sector performance has already priced in a modest recession.

Can relationships get more stretched and see the "safe" sectors continue to outperform? Yes, if there is a recession. We do not think a U.S. recession is probable at this time.

We see several catalysts that could ease recession fears through the next couple of quarters, including:

- Energy prices have weakened since 2014, but are now stabilizing. The Dollar strengthened in 2014 and through early 2015, but has stabilized. Stability in those two key drivers of earnings should help guidance.
- The weaker Energy price and strong Dollar have prompted a U.S. earnings recession. We continue to expect a second half earnings recovery as those impacts lessen, illustrated in the chart below. Also, see our Chart of Interest titled, "It's the Earnings Stupid!" available on our website.
- Growth has been sluggish worldwide. Central bankers are telling Governments that growth oriented fiscal policies are needed. The Brexit vote could prompt government spending programs and perhaps some supply side solutions.




Source: Bloomberg

Any number of other developments could change this situation as well. The uncertainty from the U.S. and other key elections worldwide should be resolved before year-end, just as the earnings recession is ending. All of these developments could help sentiment.

**Performance Review**

The Intrinsic Value Opportunity strategy underperformed the benchmark during the second quarter, returning -6.3% (Gross) compared to the S&P return of 2.5% and the Russell 1000 Value return of 4.6%. For the trailing one year period, the IVO lost -13.0% (Gross) compared with an index gain of 4.0% for the S&P 500 and 2.9% for the Russell 1000 Value index. The Opportunity Strategy has lagged fairly dramatically over the past year as the market has become more selective in its search for yield and yield supportive characteristics, while shunning names possessing characteristics that this strategy actively seeks (namely cheap stocks that are highly profitable and buying back shares).

The investment discipline remains unchanged. The strategy has experienced these types of lags in performance before, both during the period it has been managed as well as during the test period prior to launching the product. Despite the recent weakness, our gross performance is competitive with the Russell 1000 Value and S&P 500 over longer time frames (7+ years). We view this period of underperformance as a good time to add to the strategy. The safety trade has created bubble-like distortions in the market and the factors that achieved the long term performance should come back into favor.

The Opportunity Strategy is an unconstrained discipline within the S&P 500 that invests in stocks possessing excellent value characteristics, and then pairing those with exceptional measures of profitability, balance sheet strength or market acceptance. We employ a stop loss methodology to limit risk from any one stock. During the quarter, we had a very heavy exposure to the Consumer Discretionary sector and more modest overweight positions in Technology and Materials. The rest of the sectors were underweighted, most dramatically in Health Care, Consumer Staples and Industrials. Our stock selection within Health Care helped performance, while our selection within Consumer Discretionary, Industrials and Energy were significant detractors.

Themes focused on during the second quarter included Luxury goods, Discount Retail, Home oriented companies, Network Security and Insurance.

The top five performers during the quarter were CR Bard, Michael Kors, Dollar General, F5 Networks and Corning. The turnaround story at CR Bard continues to unfold as increased R&D spend have boosted the company's pipeline and improved top and bottom line growth. Michael Kors was initiated in the middle of the quarter and benefitted as investor concerns around the brand were eased as mgmt. reduced wholesale shipments. Dollar General posted solid quarterly results in May with SSS growth despite the difficult retail environment. F5 Networks jumped in June on takeout rumors and Corning benefitted from an improved outlook within the LCD supply chain.

The five largest detractors from performance were Goodyear Tire, Seagate, American Airlines, Nordstrom and H&R Block. Goodyear Tire reported 1Q results that missed estimates and investors became increasingly worried that FY2016 guidance was unattainable given the recovery in commodity prices. Seagate sold off on concerns around the weak PC demand environment continuing after the company negatively preannounced F3Q results in April. American Airlines lowered profit guidance and shares sold off as investors became concerned of overcapacity and softening demand as recession risks rose. Nordstrom reported bad quarterly results as store traffic dramatically declined during the quarter. H&R Block also reported disappointing quarterly results as tax return statistics deteriorated.

**Review and Outlook**

We have not changed how we buy stocks. In 2016, the primary attributes investors have sought are Dividend Yield and Price to Cash Flow (a ratio seen as supportive of dividends). The Opportunity Discipline combines factors that do not consider yield or Cash Flow and has suffered in performance this quarter because of that. As investors get more comfortable with buying stocks, we believe they will return to favoring fundamental characteristics and our style should recover.

Investor concerns are being addressed one by one. The Brexit vote is out of the way. Several other European elections have been held, and most of the continent still seems to be committed

to the European Union. The Japanese elections are out of the way, and Prime Minister Abe's mandate for growth was renewed. U.S. elections are coming up, but we now know who the candidates are and will soon have a better understanding of how they will compete for the office. The Chinese stimulus program has been a question mark for some, but appears to be working. Commodity markets seem to have bottomed. Against all of this as a backdrop, the S&P 500 just broke out to a new high. It may be a scared market based on stock selection factors and sector winners, but we believe it will broaden out as the economic recovery in the US continues.

As always, we are here to assist you. If you need any additional information, please feel free to contact any of us.

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Jack White, CFA
Jack Holden, CFA
Shaun Siers, CFA

Todd Asset Management LLC

7-20-2016
S&P 500- 2,173
Russell 1000 Value – 1,041

***Refer to Performance Disclosure on the following page for more information on the performance numbers presented. These notes are an integral part of this letter and should not be reproduced or duplicated without these notes.***

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# TODD ASSET MANAGEMENT LLC
## INTRINSIC VALUE OPPORTUNITY COMPOSITE DISCLOSURE

**Past performance does not provide any guarantee of future performance, and one should not rely on the composite or any security's performance as an indication of future performance. Investment return and principal value of an investment will fluctuate so that the value of the account may be worth more or less than the original invested cost.**

**Specific stocks discussed in this presentation are included to help demonstrate the investment process or as a review of the Composite's quarterly results and are not and were not recommendations for purchase or sale by investors. All or some of the specific stocks mentioned may have been purchased or sold by accounts within the Composite during the period, or since the period, and may be purchased or sold in the future. A complete listing of the holdings as of the period end is available upon request.**

Todd Asset Management LLC ("TAM") is a registered investment adviser. The performance presented represents a composite of fully discretionary accounts invested in equity securities within the S&P 500 Index with the objective to seek capital appreciation. This goal is pursued by investing in a portfolio of securities that are in the least expensive third of the S&P 500 Index using a rules based process based on financial strength, profitability strength and market acceptance.

Todd Asset Management LLC, formerly Todd-Veredus Asset Management LLC began operations on June 1, 1998 as Veredus Asset Management LLC (VAM). Effective May 1, 2009, VAM combined with Todd Investment Advisors, Inc. (TIA). TIA (and its predecessors) was founded in 1967 by Bosworth M. Todd. Upon the combination of VAM and TIA in 2009, Veredus Asset Management LLC changed its name to Todd-Veredus Asset Management LLC (TVAM). On February 28, 2013, after a change in ownership involving some VAM unitholders, TVAM changed its name to Todd Asset Management LLC. The firm continues to offer the same strategies managed by individuals using the process founded under TIA.

The Intrinsic Value Opportunity Composite contains fully discretionary, taxable and tax-exempt accounts that use either the S&P 500 Index or the Russell 1000 Value Index as the benchmark. All fee-paying, fully discretionary portfolios under our management are included in a composite. Accounts are eligible for inclusion in the composite at the beginning of the first calendar quarter after the month of initial funding and upon being fully invested.

TAM claims compliance with the Global Investment Performance Standards (GIPS®). TAM's compliance with the GIPS® standards has been verified for the period January 1, 2008 through March 31, 2016 by Ashland Partners & Company LLP and for the period July 1, 1989 through December 31, 2007 by a previous verifier. TIA's compliance with the GIPS® standards has been verified for the period January 1, 1993 through April 30, 2009 by Ashland Partners & Company LLP. In addition, a performance examination was conducted on the Intrinsic Value Opportunity Composite for the period January 1, 2011 through March 31, 2016. To receive a complete list and description of TAM composites and/or a full disclosure presentation which complies with the GIPS® standards, please contact TAM at 1-888-544-8633, or write Todd Asset Management LLC, 101 South Fifth Street, Suite 3100, Louisville, Kentucky 40202, or contact us through our Web site at www.toddasset.com.com.

The performance information is presented on a trade date basis, both gross and net of management fees, net of transactions costs, and includes the reinvestment of all income. Net of fee performance was calculated using the applicable annual management fee schedule of .80% applied monthly. From October 2009 to March 2014 the management fee schedule applied to the composite was 0.70%. Prior to October 2009, the management fee schedule applied to the composite was .60%. Actual investment advisory fees incurred by clients may vary. The currency used to calculate and express performance is U.S. dollars. All cash reserves and equivalents have been included in the performance.

The composite performance has been compared to the following benchmarks. The indexes are unmanaged, and not available for direct investment; they include reinvestment of dividends; they do not reflect management fees or transaction costs:

**S&P 500 Index** is a widely recognized index of market activity based on the aggregate performance of a selected portfolio of publicly traded common stocks. The performance data was supplied by Standard & Poor's. It is included to indicate the effect of general market conditions.

**Russell 1000 Value Index** is a widely recognized index of market activity based on the aggregate performance of common stocks from the Russell 1000 Index, with lower price-to-book ratios and lower forecasted growth values. The performance data was supplied by Frank Russell Trust Company.