

## The Turn

### *Todd Large Cap Intrinsic Value Review*

	4Q 2016	2 <sup>nd</sup> Half 2016	1 <sup>st</sup> Half 2016	As of 12/31/2016				
				YTD	3 Years*	5 Years*	7 Years*	10 Years*
LCIV(Gross)	10.2%	17.0%	-5.1%	11.0%	7.3%	13.0%	11.7%	6.8%
(Net)	10.0%	16.6%	-5.4%	10.3%	6.7%	12.3%	11.0%	6.1%
S&P 500	3.8%	7.8%	3.8%	12.0%	8.9%	14.7%	12.8%	7.0%
Russell 1000 Value	6.7%	10.4%	6.3%	17.3%	8.6%	14.8%	12.7%	5.7%

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

Our intrinsic value strategies lagged their benchmarks in the first half of 2016 to an extent we have not seen since the internet bubble distorted investment realities in the late 1990s. Following that bubble, when reality returned, our domestic strategy went on to outperform the S&P 500 for eight of the next nine years. The distortion in our current episode feels comparable and could be described as the yield bubble. During the first part of the year, domestic investors sought only dividends and international investors sought only extremely cheap stocks because of slower growth expectations and negative rates. By mid-year, both of these cycles were extremely stretched and we were looking for a turn in sentiment that would reward fundamental strategies like ours. Like a good horse race, after the turn you often see leaders change. We are pleased to report that the turn is here for US stocks, and we believe it is starting for International ones currently. It has dramatically helped our style and we think it should last for some time to come.

Since mid-year, our domestic LCIV and Opportunity strategies have outperformed, closing much of the gap with the S&P 500 and the Russell 1000 Value indexes. We did not get all of the performance back, but believe that as 2017 plays out we should see better returns. We believe the turn in performance illustrated above is likely to be durable, as investor confidence is rising while they sense better economic growth. This has allowed fundamentals to be part of their investment selection process again and is leading to our recent recovery.

Economic growth has undershot most estimates over the past few years due to:

- Consumers and corporations in the US paying off debt,
- The Chinese slowdown as they shift their economy to more consumption,
- The commodity bust,
- US regulations,
- European austerity, and;
- Negative interest rates worldwide.

These were some of those forces that tended to depress confidence and restrict growth, causing investors to turn their backs on value and fundamentally oriented stock pickers.

Recently, the mood has begun to change. Economic forecasts have firmed up and are rising as Chinese stimulus has prompted an economic recovery and the beginnings of reflation. Chinese

producer price inflation was significantly negative since 2012 while they pursued their economic shift to consumption. Recently, this turned positive. Why is this important? Deflation in China has been exported as low inflation (and a fear of deflation) worldwide. This is what prompted central banks to implement negative interest rates. Negative interest rates depressed confidence as investors assumed there was something dramatically wrong that Central Banks knew about, but were withholding. This was the major factor behind the sentiment driving the yield bubble. Central banks have begun to back away from negative rates, helping business confidence firm up. Other things that have helped the mood shift have been a resurgent US economy, the end of the US earnings recession, limited fallout from the Brexit and anticipation of more pro-growth policies in the US as the new administration pursues their agenda.

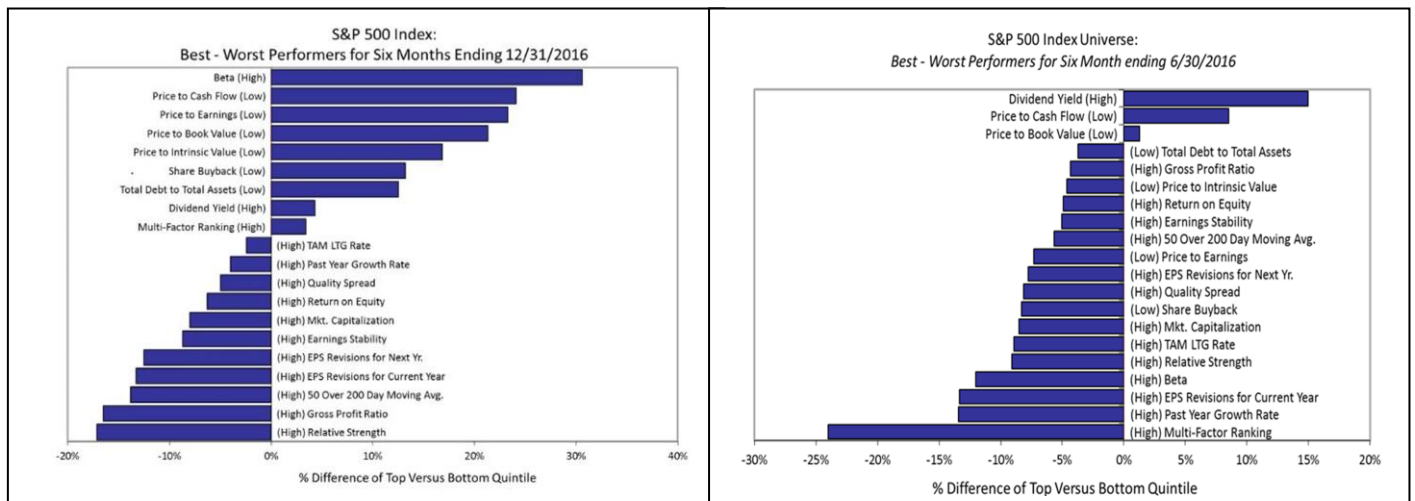
Interestingly, most of these forces were in play in the US market before the election, and fundamentals had already begun to matter again for investors. The election of Mr. Trump has led many investors to anticipate some significant near term tailwinds for the economy. We're not so sure it will be that simple. Many of his plans will require some time to implement, so items like tax reform, the repeal of the Affordable Care Act and other goals requiring laws to be written will probably take a year to implement. Some things he can pursue immediately include the elimination of regulations that were imposed by executive order, and beginning talks on trade matters. On balance, the recent acceleration of the US economy should last unless we get too much uncertainty from Washington. Unless President Trump pursues a trade war, or proposes tax reform that causes consumers to recoil from large expenditures (think elimination of mortgage tax deduction) then we think the expansion remains fairly robust. If President Trump can spur infrastructure spending and corporate investment, then the expansion could last a lot longer than most anticipate. We need some clarity on what to expect from DC for a clearer picture on the markets, and we think that is why the post-election market rally has paused since mid-December.

A coordinated global economic expansion is probably beginning. While the US is in a later stage of expansion, our base case is that the economy can avoid a recession for 2017 and 2018 and may see a capital spending cycle unfold. Europe has a slow recovery that is building, and an earnings recovery should be underway for developed markets as the headwinds posed by lower oil and commodity prices ease up. Japan has exited recession, and is pursuing many actions to spur growth. China is also pursuing pro-growth policies, which appear to be working. Latin America has seen better market action since the commodity bottom in February, but is still working through political turmoil. Economically, they seem to be putting a bottom in place.

Markets are acting as though economic growth is more likely to be a tailwind than headwind. Fundamentally oriented strategies have performed better in the U.S. since midyear 2016 because of this confidence. As confidence grows overseas, we are starting to see our fundamentally oriented strategies regain traction there as well.

Our customary charts that illustrate the factors being rewarded within the marketplace are presented below. The charts present the factors favored in the first half of 2016 compared with a comparable list for the second half. In the first half of 2016 (chart right below), fear of recession or another 2008 type event led the market to only reward tangible returns like yield. In

the second half of the year (chart left below), investors have started to diversify the factors they are rewarding. Our multi-factor model is regaining traction. This accounted for a dramatic improvement in our relative performance allowing the LCIV (gross) to outperform the S&P by over 9% and the Russell 1000 Value by over 6.5% in the second half. While growth expectations continue to rise, the recovery in our relative performance should continue as investors broaden the list of factors they reward.

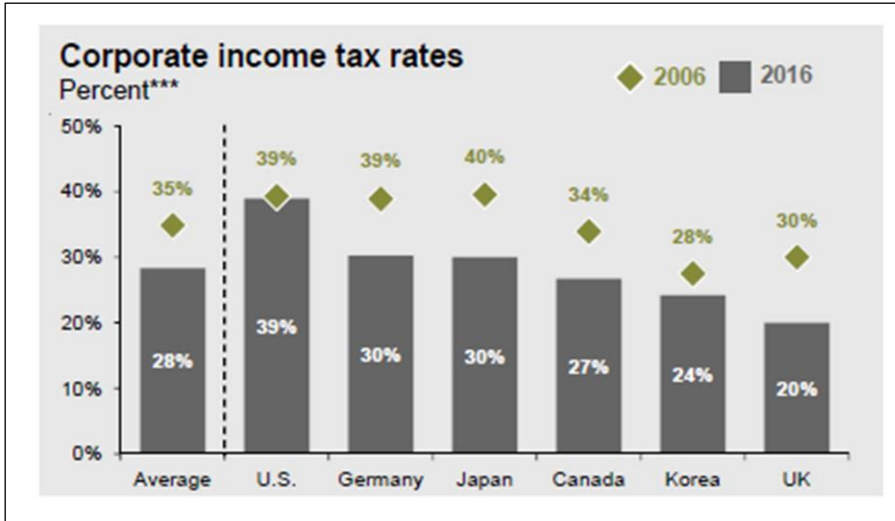


Source: Bloomberg, TAM estimates

**Other Interesting Charts We Saw This Quarter**



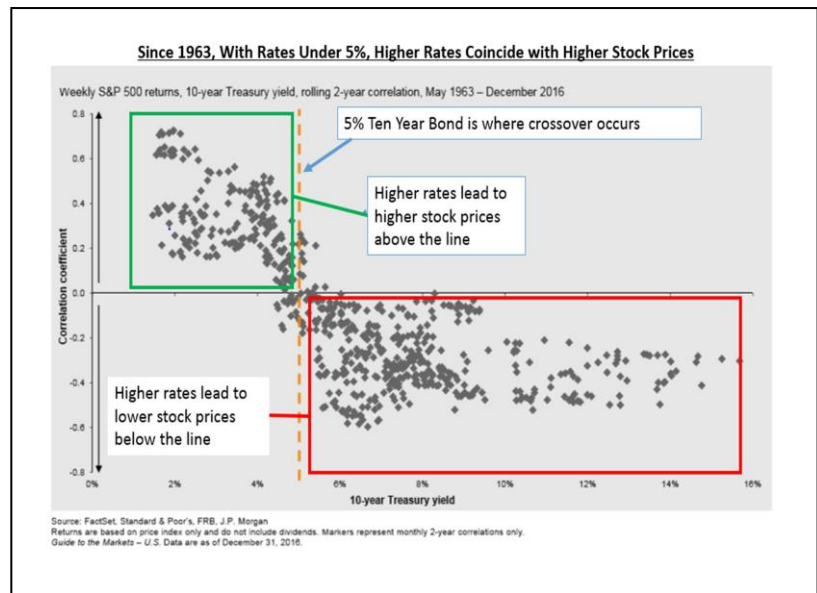
Chinese producer prices have a high correlation with GDP growth have been solidly negative since 2012. Weak commodity prices have been one source of this deflation, but the more important one was overcapacity. This contributed to lower worldwide inflation and interest rates. Recently, the Chinese PPI went positive. We think this signals that much excess capacity has been absorbed, and deflationary fears (along with negative interest rates) should dissipate over time. Chinese nominal growth is accelerating.



Source: JP Morgan

A quick scan of the chart to the left shows a comparison of corporate income tax rates for major economies between 2006 and 2016. Many of our trading partners have significantly lowered rates, putting the US at a comparative disadvantage. Expect the new administration to push for major tax reform.

Higher interest rates can co-exist with higher stock prices, as long as rates are below 5%, as seen in the chart to the right. Once rates surpass 5%, higher rates indicate inflation, and lead to lower stock prices.

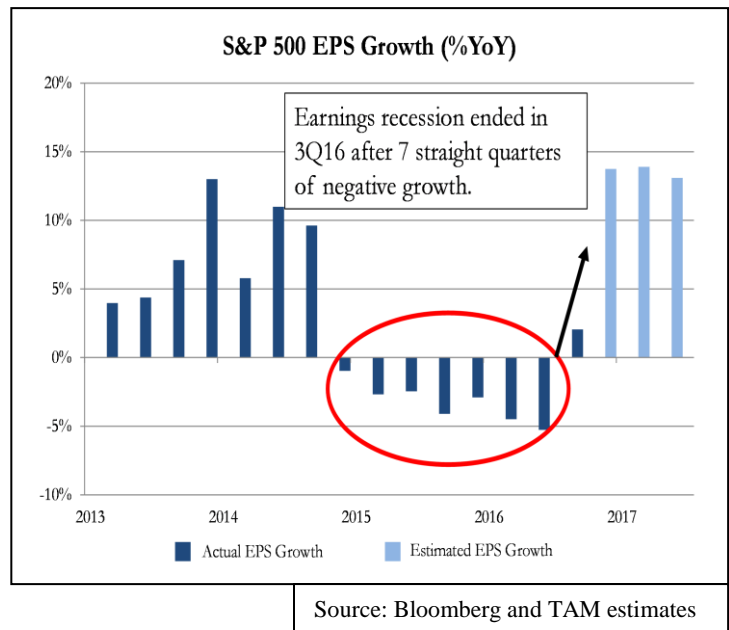


Source: JP Morgan



Post financial crisis, US economic growth has broken below its prior trend line. If reversion to the trend is as strong as we believe it is, then perhaps the efforts to restore US growth to a 3% or 4% rate would help close the gap over the next 10 years. Consumers and Corporations have reset their balance sheets which should allow for renewed growth.

The earnings recession, brought about by negative impacts of a stronger dollar and lower commodity prices, is over. This phenomenon coincided with a sideways moving market for much of 2015 and 2016. As this earnings recovery unfolds, investor confidence should rebound from previously depressed levels. We expect markets to remain generally firm with an upward bias for now.





*Other items you should be aware of:*

Bond rates are backing up. The US 10 year rate has risen to 2.4% from below 1.4% as confidence about the economy grows. Some fear of inflation may be present too.

Commodity Prices have firmed up and some indexes have gained 50% over the past year.

The Russell 2000 index of small stocks surged 20% between November 3 and December 8. Since 1990, when the small caps gain over 10% in two weeks (like this rally between 11/3/16 and 11/17/16), the S&P went on to post double digit gains over the following year in eight of ten instances.

Volatility (as measured by the VIX index) has dropped to low levels indicating a fair amount of complacency about the market outlook.

### **Performance Review**

The LCIV strategy increased +10.2% (gross) during the quarter, outperforming both the S&P 500 (+3.8%) and Russell 1000 Value (+6.7%). As confidence in the economic acceleration built, the low-volatility, high dividend yield trade continued to unwind in the 4<sup>th</sup> quarter. This expanded on the outperformance we saw last quarter and brought us within 1% of the S&P 500 for the full year, while we still lagged the Russell 1000 Value in 2016. For the full year, the LCIV increased +11.0% (gross), trailing the S&P 500 (+12.0%) and the Russell 1000 Value (+17.3%).

Stock selection drove performance during the quarter, particularly within the Financial, Technology and Industrial sectors. Factor analysis shows that valuation metrics and our Multi-factor Ranking helped to differentiate between winners and losers. Our underweight position in the higher yielding sectors (Consumer Staples, Utilities and Real Estate) also added to performance. We are overweight the Consumer Discretionary, Financials, Industrials and Technology sectors. We are underweight the Consumer Staples, Utilities, Energy, Health Care, Materials and Telecom sectors. We have been looking for opportunities to add to Energy and Materials as earnings continue to recover.

Our top five contributors to performance during the fourth quarter were Citizens Financial, Nvidia, Goldman Sachs, JPMorgan Chase and Lincoln National. Citizens Financial, along with most of the Financials, benefited from the dramatic rise in interest rates following the US election in early November. The US 10yr Treasury yield increased from 1.85% on 11/8 to a high of 2.60% in mid-December. Nvidia beat consensus estimates again as the company's Gaming and Datacenter segments posted record results in the most recent quarter. Goldman Sachs, JPMorgan and Lincoln National all benefited from the rise in interest rates, mentioned above. Separately, a shift in investor expectations about the regulatory and tax environment also gave many of these large Financials a lift after the election.



Our worst five detractors from performance during the fourth quarter were McKesson, Amgen, CVS Health, Cisco and Intel. McKesson posted disappointing results and guidance due to pricing pressures. Similarly, Amgen provided commentary around drug pricing pressures on their earnings call that weighed on shares. CVS Health lowered 2017 guidance on competition from Walgreens, who is expected to receive 40 million prescriptions migrating from smaller networks. Cisco surprisingly saw service provider orders decline in the quarter and was forced to cut forward guidance. Intel guidance also disappointed investors, citing a weak PC market and a slowdown in enterprise computing.

We are pleased with these results, as they indicate that the market is getting past the impact of the yield bubble. Active managers have suffered over the past several years as artificially low interest rates have kept bad players in the market from being penalized. Fundamental analysis is not rewarded when that occurs because there is always a monetary authority waiting to bail out an overleveraged badly performing company. Our sense is that the turn is in for markets. In other words, investors are anticipating stimulative fiscal actions, interest rates normalizing and a business cycle aimed towards growth. Fundamentals have begun to matter again, and should allow our style to extend the recent outperformance in both the Domestic and International markets.

With that said, there are several items coming up that could cause market disruptions. Elections are occurring worldwide and more populism could roil markets in Europe. Additionally, in the US, we need to see the blueprint for the first hundred days of the new administration to get a sense of what developments are likely. Currencies and rates are resetting as well, which could have unintended consequences for markets. Still, we believe the push towards more pro-growth policies should help our fundamentally based style to outperform in this environment.

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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Todd Asset Management LLC

01-20-2017  
S&P 500 – 2,269  
Russell 1000 Value – 1,107

***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 LARGE CAP INTRINSIC VALUE 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 tax-exempt fully discretionary intrinsic value accounts, invested primarily in large cap domestic equity securities with the objective to seek capital appreciation. This goal is pursued by investing in a diversified portfolio of equity securities that TAM believes are trading at a discount to their intrinsic value.

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 Large Cap Intrinsic Value Composite contains fully discretionary, tax-exempt accounts that use either the S&P 500 Index or Russell 1000 Value Index as the benchmark. Prior to April 1, 2010, this composite was known as the Relative Value Equity Composite; no changes in the strategy were made in conjunction with the name change. 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®). The Firm has been verified for the period January 1, 2008 through September 30, 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 Large Cap Intrinsic Value Composite for the period January 1, 2011 through September 30, 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](http://www.toddasset.com)

The performance information is presented on a trade date basis, both gross and net of management fees, net of transaction costs and includes the reinvestment of all income. Net of fee performance was calculated using the applicable annual management fee schedule of .60% applied monthly. Prior to September 2001, the management fee schedule applied to the composite was .50%. 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 index(es) 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.