STERLING CAPITAL

COMMENTARY
Enhanced Equity SMA | 4th Quarter 2019

Our Sterling Capital Enhanced Equity portfolio is designed as a product for investors who seek the long-term capital growth of equity markets and who are comfortable with the trade-offs inherent in selling call options against underlying common stock positions. To implement our strategy, we first carefully construct a diversified portfolio of perceived high-quality stocks that we believe will appreciate over time. Then, we give others the right to buy those same stocks from us (we sell a call option), at a pre-determined price (the strike) and at a pre-determined point in time (the expiration date). We forego upside in our stocks beyond the strike price, while the buyer of the call option gives us cash (the premium) for that right to participate in any share price appreciation beyond our chosen target. We write "out-of-the-money" options (meaning, the strike is above the stock's prevailing market price) that provide us both cash income up front (via the premium) and some defined appreciation potential to the strike price.

In essence, our call-writing strategy involves a calculated series of low-return but high-probability bets (a cash return up front is assured, while we "lose" versus a non-hedged portfolio only if our stocks advance beyond the strike price). The call buyer(s) on the other side of our transactions are making a series of low-probability, but potentially high-return, bets on each of our stocks. Over time, we believe the option premiums we are able to generate will "enhance" our underlying equity performance, while reducing overall volatility. We benchmark our portfolio against the CBOE BuyWrite Index, or "BXM." BXM tracks the performance of an unmanaged strategy based upon writing at-the-money, one-month calls against the S&P 500 index. We seek to add value with our stock selection disciplines, and via active tactical management of our options exposures.

Performance

The Sterling Enhanced Equity portfolio returned +7.1% (gross) and +6.6% (net) for the quarter versus the +4.3% gain for the CBOE BuyWrite (BXM) index and the S&P 500's (SPX) total return of +9.1%. For the full year, the strategy gained +28.1% (gross) and +26.2% (net) versus the BXM's +15.7% and SPX's +31.5%.

Winners & Losers

The portfolio featured eight double-digit percentage gainers and no double-digit losers during the fourth quarter of 2019. The largest three moves in both directions are presented below.

Managed Care provider **Centene** led the way, rising +45% during Q4. Heightened political concerns faded and valuation became depressed as the company delivered 38% earnings growth in the first nine months of the year. The company also got a boost from an appeal in North Carolina where it was awarded two additional Medicaid regions, a favorable ruling from the 5th Circuit Court in Texas related to ACA and approvals from 27 states for its pending acquisition of WellCare.

In October, **HCA** (+23%) posted a "bounce back" quarter according to Citi. In addition to managing costs, revenue reaccelerated to a solid 6.2% organic growth. Equivalent admissions grew 4.2%. NICU admits grew 9.6% while total joint surgeries rose 7%. Management proclaimed that the few markets that showed volume weakness in Q2 rebounded nicely in Q3. Management also spoke to early 2020 expectations with commentary suggesting 6-8% EBITDA growth. At sub 13x forward EPS, we still consider valuation attractive.

Morgan Stanley (+21%) benefited from fixed income trading growth and solid investment management revenues. Deal flow has slowed overseas, but remains robust domestically – where Morgan Stanley enjoys incumbency as an advisory juggernaut. CEO James Gorman's plan to shore up recurring revenues while controlling costs continues to yield results.

Occidental (-6%) led the quarter's losers as the company continues to work to restore investor confidence amid multiple challenges to its business. Though reported cash flow was disappointing in the most recent earnings results, the company is taking remedial action to shore up fixed charge coverage – for example, by winnowing 2020 capital expenditures to boost free cash flow. Meanwhile, the company is upgrading its board representation – recently adding former Schlumberger CEO Andrew Gould to its team.

Akamai (-5%) was the second worst performer. The stock underperformed on the quarter as management guided the fourth quarter of 2019 in-line with expectations. After a 50% rise from the beginning of the year through Q3, we are okay with a mild retrace. Per B. Riley, "While 4Q is typically the strongest quarter of the year driven by e-commerce and media, management was clear that is also the most unpredictable." It is possible that the guide could be conservative considering the momentum of Akamai's cybersecurity business and recent launches of major over-the-top (OTT) services: Apple TV+ and Disney+, which have the potential to drive considerable traffic over Akamai's content delivery network (CDN).

Sealed Air (-4%). Earlier this year, Sealed Air announced the acquisition of Automated Packaging Systems for $510 million in a dilutive transaction that adds leverage to Sealed Air's balance sheet. In June, the company terminated CFO Bill Stiehl "for cause … related to an internal review by the Audit Committee of the Board of Directors in connection with the previously disclosed investigation by the U.S. Securities & Exchange Commission." In November, SEE met expectations for Q3, but lowered its sales outlook for the remainder of the year. Yet, the company reaffirmed its earnings and free cash flow outlook as the CEO allayed fears of global demand headwinds by pointing to increased demand for innovative and sustainable solutions across fresh foods and protective packaging. It would be one thing if we just trusted management at their word, but the new CFO backed up said words with his personal wallet, buying nearly $200k in stock on the open market after earnings. Bank of America Securities then upgraded the stock in December, noting a depressed valuation along with an improving environment in global trade and a healthy U.S. economy.

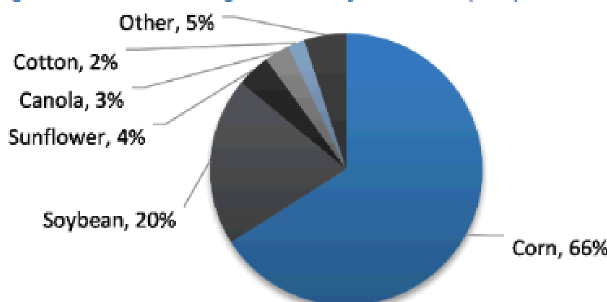
Purchases and Sales

We added three positions in the fourth quarter and sold one. The following four were called away: CVS, PSX, BMY and PINC.

We added shares of **Corteva (CTVA)** in December. Corteva may be an unfamiliar name, as it's the new moniker for the recently spun agricultural businesses of the former DowDuPont. Dow developed its first agricultural products in 1906, while Henry Wallace (who later became Vice President under Franklin Roosevelt) developed seeds such as Hi-Bred corn, which have been sold under the Pioneer brand since 1926. In 1926, the average U.S. corn yield was 25.7 bushels per acre, while in 2017 it stood at 176.6 bushels per acre, according to Pioneer.

Today, Corteva is a global leader in seed and crop protection, generating 52% of sales in North America, with the remainder split between Latin America (20%), EMEA (20%), and Asia (8%). Seeds represent 55% of sales, with corn by far the largest category. Crop protection, including herbicides, fungicides and insecticides, represents the remaining 45% of sales.

Figure: Corteva – Seed Segment Sales by End Market (2018)



Source: Company Reports

The company ranks #1 in the United States for corn, soy, alfalfa, sorghum and sunflower seeds. It also ranks #1 in Canada, EMEA, and Asia for corn.

We believe the company is well positioned, by virtue of its technological leadership. At first blush, that statement may stand out relative to an industry that could be perceived as staid. It may come as a surprise that Corteva spends more than 15% of sales on research and development. The company recently received its sixth Green Chemistry Award (more than the rest of the industry combined), bestowed for products with favorable environmental profiles. "Sustainability is a key focus for Corteva and we are innovating for it earlier in the product development process," EVP of Business Platforms Rajan Gajaria said at an investor conference in September 2019.

Corteva's spin from DowDuPont occurred this past summer, and the environment hasn't been conducive to robust results. Specifically, one of the wettest spring seasons in the last century, along with a trade war with China, and adverse foreign exchange rates, caused the company to post a couple of sloppy quarters in its debut as a standalone company. "Spring 2019 was one of the wettest seasons in over 100 years in the Midwest, impacting CTVA's EBITDA by $250M," according to Citi Research. "A higher than normal proportion of farmers opted to replant flooded fields, [and] loyal customers received highly discounted or even free seed deliveries," according to Merrill Lynch. That should set up easy/easier comparisons for 2020, or as Credit Suisse said, "Fewer re-plant acres (normalized) should materially boost 'mix' in '20." African swine fever also has been a headwind that should normalize in 2020.

Aside from normalization of weather, trade, and foreign exchange, Corteva also should benefit in 2020 and beyond from company-specific cost-saving programs that are already in-flight, with factory consolidation and brand rationalizations high on the agenda. As Bernstein Research opines, "Corteva has the right strategy, focusing on cost improvements (a $1.2B synergy program plus $500M of productivity enhancements) and product innovation. If they deliver, we believe this could deliver a 16% EPS CAGR over 5 years barring unforeseen headwinds."

Such results would be consistent with the company's articulated growth algorithm, which calls for 4-6% top line growth (above market), driven by new-product launches, with EBITDA and FCF margin expanding, driving 12-16% EBITDA growth.

2020 and Mid-Term[1] Financial Targets

2020

2020 Operating EBITDA Growth – Directional Guide*

($ in millions)	2020E
Cost Synergies	$200
Productivity Programs	$30
Normalized NA Market Conditions[2]	$250
New Product Growth	~$100
Headwinds (e.g., COGS impact, inflation)*	~($100)

*To be updated as harvest progresses

2020 Free Cash Flow Conversion*

- FCF[4] growing to >50% of Operating EBITDA driven by working capital improvement and disciplined capital investment

Mid-Term

Sales Expected to Exceed Market Growth

Corteva Total Revenue Growth[3]:	
Seed	3-5%
Crop Protection	5-7%
Total	4-6%
Market Growth[1]:	2-4%

Mid-Term Operating EBITDA Growth

Operating EBITDA Margin[5] Expansion:	100-200 bps
Corteva Operating EBITDA[5] Growth:	12-16%

1. Mid term reflects years beyond 2019
2. Assumes acres at the 2018 level
3. Revenue and operating EBITDA growth forecasts assume year over year currency impacts are flat.
4. FCF is defined as cash flow from operations less capital expenditures.
5. Pro Forma Operating EBITDA and operating margin are non-GAAP measures. See slide 3 for further discussion

Source: Corteva

Beyond the near-term opportunity for 2020 to snap back, Credit Suisse says that "there are numerous areas of [longer-term] upside optionality. The primary LT theme is CTVA's broader goal to cut net royalty payments in half. A few additional themes worth flagging are: 1. International growth across eastern Europe, Africa, and Asia, 2. Growth in gene editing (CTVA retains best-in-class access to tech), 3. Further use of precision ag/digital solutions, and 4. Potential to isolate pension liabilities via a debt swap."

At the time of our purchase, shares traded at less than 14x estimated 2020 earnings, a discount to the S&P 500, despite expectations for earnings to grow at a double-digit clip for the foreseeable future. While we await better results and a potentially improved valuation, Corteva supplies a 2%+ dividend yield, as well as an active stock buyback program. In June, the company authorized a $1B repurchase plan, which it expects to complete within three years, and against which it bought $25M in the most-recent quarter. Several insiders have purchased Corteva stock in recent months, including the CEO and CFO. "Four executives emerged to buy after the recently spun agricultural chemical maker's stock pulled back," InsiderScore said. "All four executives have a long history with CTVA's predecessor companies. CEO James Collins was only a seller during his tenure as a DuPont executive." Perhaps they see *green shoots* emerging, as we do.

We added shares of **Restaurant Brands (QSR)** in December. QSR is a self-described "leader in the quick service restaurant industry" with an attractive asset-light model, impressive cash flow generation, and a long runway for future development.

QSR consists of three restaurant brands. The largest of these is Tim Hortons, a coffee and donut shop started by former National Hockey League star, Tim Horton. With Tim Hortons, Burger King and Popeye's, the company has over 24,000 stores in 100 countries and 100% of the brands are franchised. Franchise fees range from 3% to 4.5% across the brands and real estate is owned by QSR.

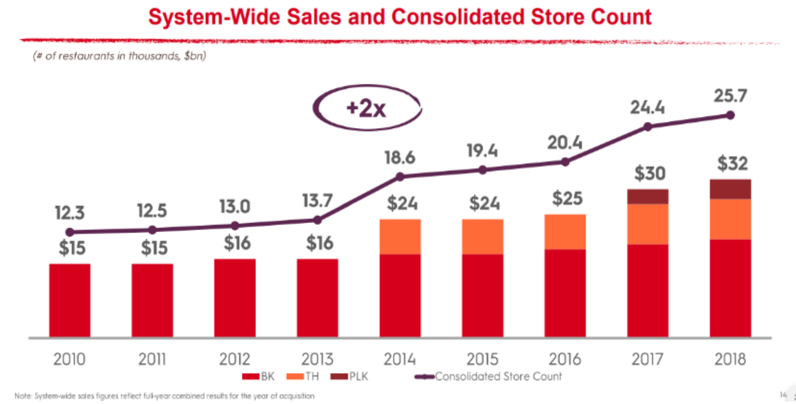
Company at a Glance

rbi restaurant brands international

	Burger King	Tim Hortons	Popeyes Louisiana Kitchen
Since	1954	1964	1972
Acquired	2010	2014	2017
Restaurants	>17,800	>4,800	>3,100

Source: Restaurant Brands

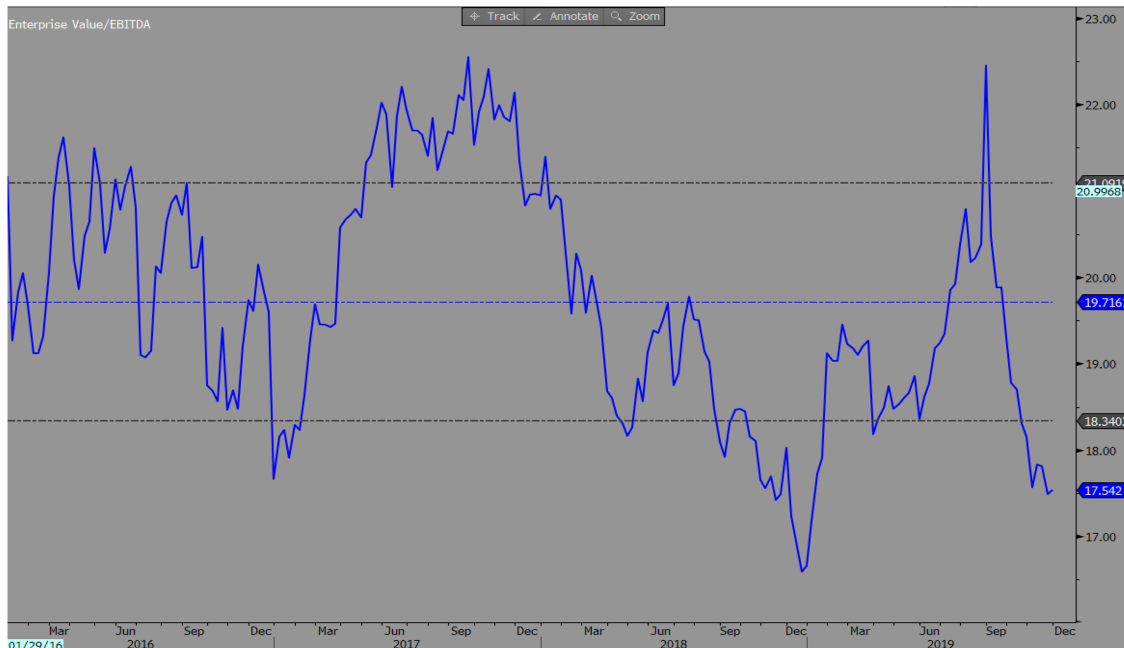
QSR serves up an appetizing plate of valuable franchises in various states of growth. Tim Hortons is an established brand in Canada that is growing in the U.S. In Canada, Hortons is dominant with 70% market share in drip coffee serving 5 million cups of coffee per day. In fact, 80% of Canadians visit the restaurant at least once a month. Burger King is an international franchise that has seen reinvigorated growth under QSR's direction and is now a leader in alternative protein offerings with the new "Impossible Burger." Popeye's is a smaller chain with significant growth opportunities in the U.S. and abroad.



Source: Restaurant Brands

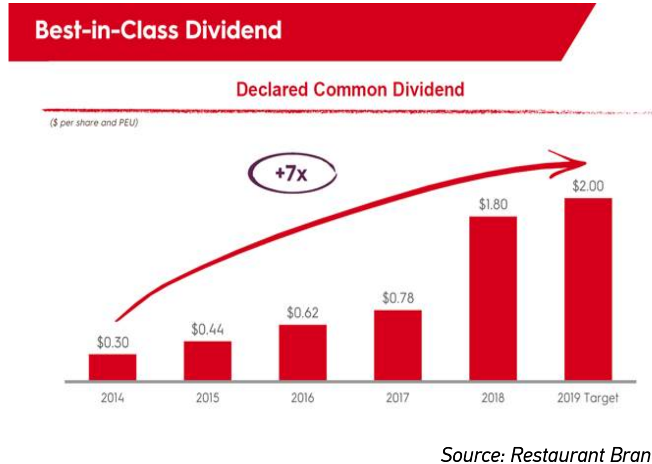
What is changing as we enter 2020 is that proven management from the Burger King brand is taking over the largest brand, Tim Hortons, and has the ability to accelerate growth. Tepid growth at Tim Hortons over the past 12 months has caused the stock to reach the low end of its historic valuation range. This Burger King team has proven adept at generating revenue growth. Burger King's growth and an acceleration in Tim Hortons has the potential to boost earnings and the stock's valuation. In 2020, management is expected to serve a double shot of expresso throughout the store base with a new coffee platform that will triple output while improving quality after 40 years without innovation.

QSR packs a "caffeinated" combination in terms of our investment pillars sporting a return on equity of 38%. Earnings growth has also been above the market with the potential for an acquisition to fuel additional earnings growth as the balance sheet has strengthened. Finally, the stock appears attractive on valuation when assessing cash flow. Perhaps the best way to look at the current valuation is Enterprise Value/EBITDA. As seen in the following chart, QSR shares appear compelling relative to recent history.



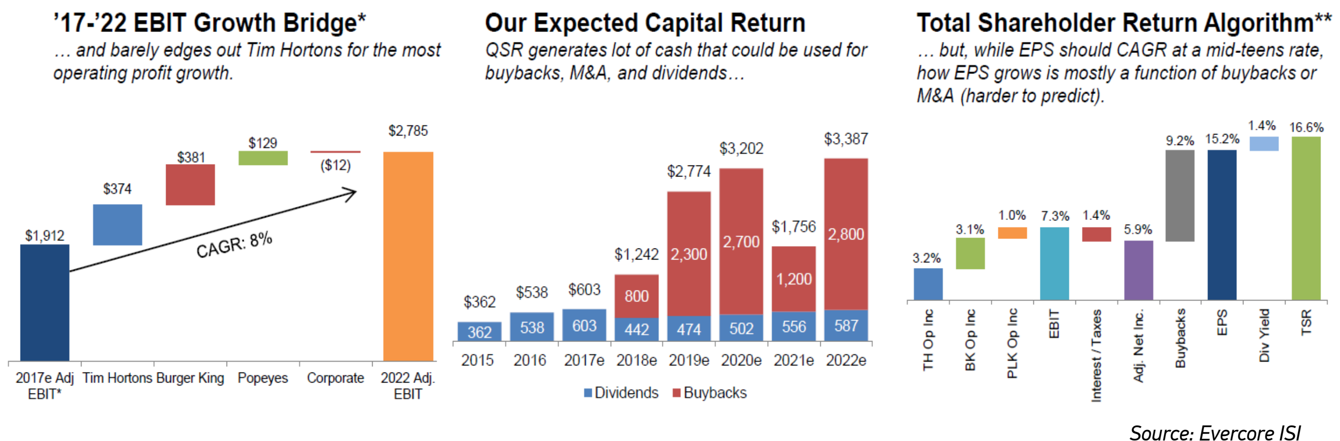
Source: Bloomberg

The cash flow QSR produces has been directed to the growing dividend generating a yield that is not only in excess of the market, but one that grew 25% last year. With de minimis capital requirements, QSR appears to have the capacity to grow its dividend in excess of the rate of the benchmark for the foreseeable future.



Source: Restaurant Brands

QSR provides a unique combination of a business model that produces meaningful growth in cash, requires minimal capital outlays, with a management team that's proven adept at acquiring new brands that are additive to the overall growth equation. We have noted QSR has been able to drive revenue growth, and when attractive acquisition platforms present themselves, QSR integrates assets well by reducing overhead and replicating its growth strategy through the acquired assets. Below, Evercore ISI lays out the opportunity for EBIT to grow 50% in five years.



Source: Evercore ISI

Just as customers can select from a variety of items on the menu at each one of QSR's brands, management appears to have multiple items on the menu to serve up and drive shareholder value into 2020 and beyond. Store owners are hungry to open new stores, from Indiana to India. Improvements north of the border at Tim Hortons could provide a boost to the valuation. The acquisition of an additional brand may fuel even faster earnings growth through QSR's proven integration recipe. With a valuation on the shares offering an attractive entry point, QSR shares appear to offer the potential for a satisfying return.

Making another return to the portfolio, we added shares of **Comcast (CMCSA)** in December. We would refer you to prior commentaries for the storied history, but Comcast is a dominant cable and broadband provider (Xfinity) with a diversified entertainment arm that operates the likes of NBCUniversal and recently acquired Sky, one of Europe's largest TV and broadband companies, with over 23 million customers in seven countries.

Comcast is a diversified conglomerate in which its financials could be characterized by steady growth, strong returns on equity, a well-managed balance sheet and a propensity to return capital to shareholders. Comcast also has notable growth catalysts to consider in Peacock, a direct to consumer offering, and Sky's Q technology. Peacock is planned as a differentiated over-the-top (OTT) service focused on ad-supported video on demand (AVOD) that will balance exclusive and non-exclusive content. Sky's Q is a modern TV platform, a satellite service connecting a TV dish with broadband while including an in home Wi-Fi mesh network to strengthen the signal throughout the home.

Our opportunity comes as concerns arise over cord cutting and potential disruption from 5G. On the former concern, we believe Comcast has a diversified strategy that addresses those that stick with the cable bundle and those that opt for direct to consumer content. On the latter, we think broadband over Wi-Fi will be hard to disrupt and the current value proposition to consumers and businesses is quite sticky.

Meanwhile, at purchase CMCSA looks attractive relative to EOG's pillars: 13x forward EPS, 17% ROE, 3x net debt/EBITDA, 1.9% dividend yield and an estimated long-term EPS growth rate of 11%, per Bloomberg.

We sold shares of **CBS** in December prior to the merger with Viacom. For lack of a better term, our sale could best be characterized by a fear of "uncertainty." The operational and strategic decisions at both companies and now combined entity and industry progressions brings about some major considerations, such as: the ouster of Les Moonves, embroiled battle between Shari Redstone and the boards of both CBS and Viacom, rise in content spending from competition, questions of the outcomes of cable bundles versus direct-to-consumer content offerings, Viacom turnaround momentum and growth outlook, monetization concerns comparing subscriptions to advertising, new pro forma balance sheet and capacity for capital returns to shareholders and management, and strategic changes coming from the combination of the two companies. Though the long-term strategic vision may have some merit, we did not feel comfortable enough to hang around in the near term to see how such material issues play out.

Conclusion

According to the CBOE Volatility Index (VIX), volatility has steadily risen since the end of 2017, perhaps as elections, trade wars, global macroeconomic slowdowns, geopolitical unrest and elevated military threats dominate news headlines; yet, volatility tends to highlight covered call strategies like Enhanced Equity. In one sense, the strategy can lower risk by writing out-of-the-money call options, collecting cash from the premium up front. In another, volatility may boost the price for the premiums we receive. Moreover, we participate in the upside of the stocks we buy and see evidence that stock picking adds value. As we consider our current and future investment prospects for the Enhanced Equity portfolio, we believe we can generate above-average value for our clients while managing inherent market and stock-specific risks.

As always we thank you for your trust and investment in us.

Sincerely,

Dan Morrall
Executive Director

Performance is preliminary and is annualized for periods longer than one year. Net of fees performance returns are presented net of the investment management fees and trading expenses. Gross of fees performance returns reflect the deduction of trading costs; a client's return will be reduced by the management fees and other expenses it may incur. Investment management fees are described in Sterling's Form ADV 2A. Performance reflects the reinvestment of interest income and dividends and realized capital gains. The performance presented represents past performance and is no guarantee of future results. Performance is compared to an index, however, the volatility of an index varies greatly and investments cannot be made directly in an index. Market conditions vary from year to year and can result in a decline in market value due to material market or economic conditions. The Performance is considered Supplemental Information to the Composite Disclosure Presentation which is attached.

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Sterling Capital Management – Enhanced Equity SMA Composite

December 31, 2003 – December 31, 2018

<u>Description:</u> *Consists of all discretionary separately managed wrap Enhanced Equity portfolios. Sterling's Enhanced Equity portfolios invest primarily in companies held in other Equity Opportunities Group portfolios where call options are written opportunistically to enhance the portfolio's cash flow.*

Year	Total Return "Pure" Gross of Fees	Total Return Net of Fees	No. of Portfolios	Composite Assets End of Period ($MM)	Percent of Firm Assets	Total Firm Assets ($MM)	Composite Dispersion (%)	BXM	Composite 3-yr St Dev (%)	Benchmark 3-yr St Dev (%)
2018	-9.23	-10.46	12	6	0.0	56,889	0.75	-4.77	9.96	7.38
2017	12.93	11.30	15	9	0.0	55,908	0.58	13.00	8.50	5.74
2016	13.20	11.17	13	9	0.0	51,603	0.50	7.07	8.79	6.59
2015	-1.90	-3.72	16	9	0.0	51,155	0.49	5.24	8.21	6.43
2014	9.39	7.27	19	11	0.0	47,540	0.30	5.64	8.23	5.90
2013	22.13	19.74	20	11	0.0	45,638	0.50	13.26	11.35	9.44
2012	10.49	8.26	23	10	0.2	4,422	0.69	5.20	13.68	11.60
2011	2.26	0.21	29	12	0.3	3,932	0.77	5.72	15.62	13.69
2010	12.42	10.23	31	15	0.4	3,548	0.60	5.86	20.29	17.22
2009	30.73	28.20	35	21	0.7	2,839	1.03	25.91	18.99	15.88
2008	-32.00	-33.44	48	21	1.1	1,907	1.84	-28.65	16.45	13.42
2007	11.71	9.30	44	22	1.1	2,059	0.75	6.59	6.98	4.69
2006	16.50	13.80	44	22	1.7	1,314	0.63	13.33	6.20	4.11
2005	9.96	7.54	34	14	1.5	904	0.45	4.25		
2004	13.91	11.30	18	7	1.3	522	0.00	8.30		
Annualized Since Inception	7.10	5.01						5.05		

Sterling Capital Management LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sterling Capital Management LLC has been independently verified for the periods 01/01/01 to 12/31/17. The verification report(s) is/are available upon request. 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. Verification does not ensure the accuracy of any specific composite presentation.

<u>*Notes:*</u>

1. Sterling Capital Management LLC (SCM) is a registered investment advisor with the SEC. Registration does not imply a certain level of skill or training. Sterling manages a variety of equity, fixed income and balanced assets. Prior to January 2001, Sterling was a wholly owned subsidiary of United Asset Management (UAM). In January 2001, Sterling Capital Management LLC purchased all the assets and business of Sterling Capital Management Company from UAM to become an employee owned firm. There were no changes in personnel. In April 2005, BB&T Corporation purchased a majority equity ownership stake in Sterling Capital Management LLC. There were no changes in personnel. In October 2010, the management group of Sterling Capital entered into an agreement with BB&T Corporation that reduced and restructured management's interest in Sterling Capital Management. Additionally, BB&T Asset Management merged into Sterling Capital Management. There were no material changes in personnel. In January 2013, CHOICE Asset Management firm merged into Sterling Capital Management. There were no changes in personnel. "Percent of Firm Assets" and "Total Firm Assets" prior to 2013 are for CHOICE Asset Management. In August 2015, 8 new employees joined Sterling Capital management via Stratton Management Company following the close of BB&T's purchase of Susquehanna Bancshares. There were no changes to personnel.
2. George F. Shipp, CFA, has managed the portfolio since inception. No alterations of composites, as presented herein, have occurred due to changes in personnel or other reasons at any time.
3. Inception date of composite: December 31, 2003. Creation date: December 31, 2003. The appropriate index is the <u>CBOE Buy/Write Index (ticker symbol BXM)</u> that is designed to show the performance of a basket of S&P 500 stocks with calls written monthly at the money. It represents the universe of stocks from which covered call managers typically select. Total return includes price appreciation/depreciation and income as a percent of the original investment. A complete list of all of SCM's composites and their descriptions is available upon request. Policies for valuing portfolios, calculating performance and preparing compliant presentations are available upon request.
4. Performance reflects reinvested interest income and dividends and realized and unrealized capital gains and losses. All portfolios are valued monthly as of calendar month-end and utilize trade-date and accrued income accounting. Valuations and performance are reported in US dollars. Portfolio returns are calculated monthly using the Modified Dietz method. Portfolios are revalued for cash flows greater than 10%. Composite returns are calculated by weighting the individual portfolio returns using beginning of period market value plus weighted cash flows. Periodic time weighted returns are geometrically linked. Returns are not calculated net of non-reclaimable withholding taxes due to immaterial dollar amounts.
5. "Pure" gross of fees returns do not reflect the deduction of any fees including trading costs. The net of fee return reflects the actual SMA fee of the individual account. The SMA fee includes all charges for trading costs, portfolio management, custody and other administrative fees. Sterling's actual management fees are 32 basis points annually.
6. The annual composite dispersion presented is measured by an asset-weighted standard deviation calculation method of all portfolios in the composite for the entire year. It is not meaningful when there are less than six portfolios in the composite for the entire year. The three year annualized standard deviation measures the variability of the composite and benchmark returns over the preceding 36 month period. It is not required to be presented for annual periods prior to 2011 or when a full three years of composite performance is not yet available.
7. The performance presented represents past performance and is no guarantee of future results. Stock market conditions vary from year to year and can result in a decline in market value due to material market or economic conditions.