"I saw the angel in the marble and carved until I set him free."

-Michelangelo

Source: Quotesgram

One purpose of this piece is for our current and potential partners to understand our investment philosophy and why we are passionate about active management. What unites the team together and when we decide what investments to make, why are those decisions made?

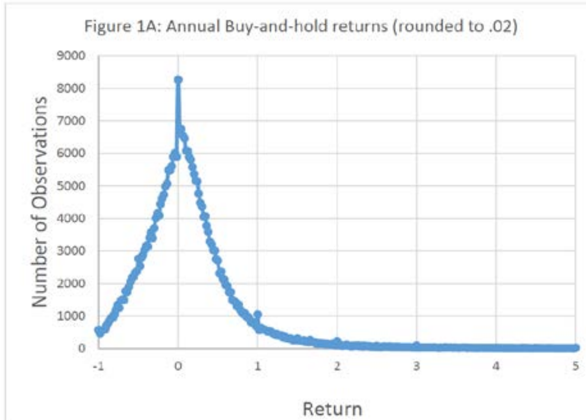
Michelangelo's David statue stands in Florence, Italy. His contemporary at the time said, "no other artwork is equal to it in any respect, with such proportion, beauty, and excellence did Michelangelo finish it." From an abandoned huge slab of marble from the Carrara quarries in Tuscany Italy, the 26 year old sculptor was given two years to complete it. When asked how he was successful creating the masterpiece the quote is: "It is easy, you just chip away at the stone that doesn't look like David." That quote and the one above have both been handed down through time, and we'd like to use the image of the creative process to how we select stock investments.

We see the passive index as the unhewn slab of marble, and we chip away and eliminate portions in our quest to create a masterpiece. This week Sterling equity research teams came together to discuss their best ideas. The time was productive because from the start of the event, expensive stocks with questionable accounting and no competitive advantage were never considered for discussion. While we all use math as a part of our work, it is in the qualitative discussions where the angel is hewn. A look at select strategies can highlight the qualities the team asks themselves when scrutinizing new investment ideas.

In our Smidcap strategy, Portfolio Manager Josh Haggerty eliminates from consideration companies that cannot earn a profit. It would seem common sense that owning companies that can cover their expenses would outperform the benchmark over time, and they do according to Ned Davis research, but roughly one-third of the companies in the smidcap benchmark don't generate a profit. Why own an index where a third of the companies are unprofitable? We choose not to, and use the hammer and chisel to eliminate these in client portfolios. Likewise, common sense would suggest that owning stocks where management teams are aligned with shareholders would make sense. Nowhere is this more evident than when an executive puts his or her money where their mouth is, using their own money to buy stock in the company. The Insight strategy owns stocks where insider buying has been exhibited and as one would expect, companies with recent insider buying have a history of outperforming "the market." With the Insight strategy, we eliminate stocks where management is not aligned with shareholders.

Why own companies that are losing market share and are making buggy whips in the automotive era? In Global Leaders, we own companies that are leaders in their industry and are taking share from weaker competitors to become more dominant and profitable in their market. Here we seek to chip away at the market share losers in the index and own the winners in the marketplace.

Monthly Returns All Common Stocks 1926-2016



Source: Do Stocks Outperform Treasury Bills?" Hendrick Bessembinder November 2017, Center for Research in Securities Prices (CRSP)

Within the Equity Income strategy, stocks in the benchmark that have cut or eliminated their dividend, can't afford to pay a dividend, or cannot generate sufficient profits to increase their dividend are chipped away and not considered. Again, common sense and data from Ned Davis research indicate that stocks with a history of raising dividends also have a history of outperforming "the market." As seen in the chart above, a masterpiece can be created by owning the select stocks that generate outsized returns, whereas the majority of stocks through history generate moderate or negative returns.

While certain passive investments can weight certain types of characteristics to improve the quality of the marble, we believe "freeing the angel" requires not only using quantitative tools found in our investment pillars, but also the qualitative refining process of a team approach where critical thinking is performed to understand a company's profitability, alignment of management, ability to pay a growing dividend and whether the company is winning market share. The number of companies that possess these desired qualities are limited in an index of hundreds (or thousands) of stocks, but the team has been chipping away in search of these "angels" since its founding in 2000.

As always thank you for your interest and trust managing your investments.

Chip Wittmann, CFA®
Executive Director
(757) 417-4901
cwittmann@sterling-capital.com

*The **Chartered Financial Analyst® (CFA)** charter is a graduate-level investment credential awarded by CFA Institute — the largest global association of investment professionals. To earn the CFA charter, candidates must: 1) pass three sequential, six-hour examinations; 2) have at least four years of qualified professional investment experience; 3) join CFA Institute as members; and 4) commit to abide by, and annually reaffirm, their adherence to the CFA Institute Code of Ethics and Standards of Professional Conduct.*