quality noun

1 a : peculiar and essential character

2 a : degree of excellence

Source: Merriam Webster

The primary form of communications for the Equity Opportunity Group is via email. Throughout the week (and weekend) we share research, company filings, and news as it pertains to the portfolios. Friday at lunch is when we meet to have a more formal discussion surrounding new ideas, current stocks in the portfolio, and what stocks should be considered for sale. Because members of the investment team have their savings invested in the strategies, these discussions can become heated because everyone has a passion for the same goal, generating above average returns with below average risk.

What makes our process different, if you speak to members of the investment team who have worked at other shops, is that at most firms investment ideas are discussed among two people, the portfolio manager and the analyst. Two sets of eyes. Over time, the analyst learns to recommend only stocks that "fit" the portfolio manager's world view. From a behavioral finance perspective, this dynamic can engender "confirmation bias" where smart people will dig up information that can support their preconceived notion on a stock. By having generalists with different perspectives but aligned goals, we seek to stamp out confirmation bias that is a systematic error in inductive reasoning and decision making.

The most recent heated exchange happened last month over a position in the portfolio and whether the security was a "quality" investment. What is quality? How is it defined?

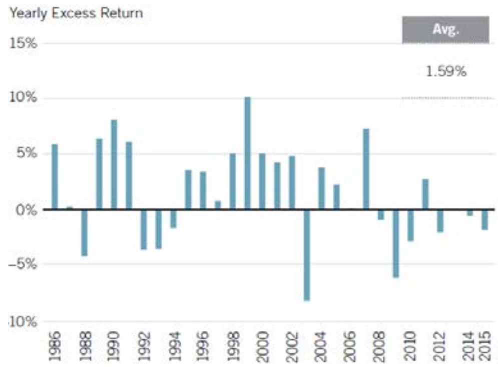
Typically, quality is defined by a company's return on invested capital, low leverage, and earnings stability. A 2016 study by Fidelity, with a chart shared on the second page, found that from 1985 to 2015, the quality factor outperformed the S&P 500 by 1.58% per year. These are components to our process' investment pillars and provide a backdrop where we begin to roll up our sleeves and work on new ideas. Quantitative screens can also be used by ETF's to create a basket of stocks that may meet a qualitative interpretation of quality and "set it and forget it."

The shortcomings of merely screening on vague metrics and "setting and forgetting" are that these screens are based on what's happened in the past. As Amazon CEO Jeff Bezos said, "Your margin is my opportunity." Companies with strong returns are the targets of upstarts looking to attack those competitive advantages such as brands, leading market positions, and resources. The price for owning "the last winners" can be felt in performance as Credit Suisse's Michael Mauboussin's research has shown that "the market rewards improvement and punishes decline in economic returns." This is where the "rubber hits the road" in our investment discussions as we want quality companies that not only have dominant and protected advantages to defend their business, but also competitive strengths to win more business and press their competitive advantages to our benefit and that of our clients.

Perhaps the best example is a former Equity Opportunity Group holding, General Electric. GE was a former member of the now defunct Deutsche Bank Equity Quality Factor Index that stopped trading last year. GE is still an "A" rated company by S&P and at the time of our

Exhibit 5 Excess Returns of Quality Portfolios

High-quality stocks with strong profitability tend to exhibit long-term outperformance



Return on equity: a measure of profitability that calculates how many dollars of profit a company generates with each dollar of shareholders' equity. Quality returns shown are yearly returns of the equal-weighted top quintile (as measured by return on equity) of the Russell 1000 Index. Past performance is no guarantee of future results. Source: FactSet, as of Mar. 31, 2016.

Source: Fidelity

sale in 2015 we noted, "the picture is rarely black and white and we have tried to balance the risks versus the rewards. At this point, in our opinion, the divergence in valuations versus peers and the darkening near/intermediate business trends outweigh GE's longer term attributes." Through passionate debates we assessed the difficult to quantify "darkening trends" for GE.

In our Quintiles process, where we force rank stocks on a 1 (best) to 5 (worst) in the portfolio, GE's ranking had declined from above average to below average. Fortunately, our sale occurred before the credit rating agencies began downgrading GE's credit rating a year later. We believe active debate and management where goals are aligned can produce profitable outcomes for clients in dynamic markets. Although our portfolios tend to have lower than average turnover, there is no "set it and forget it."

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

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