



COMMENTARY – 1ST QUARTER 2016

Global developed equity markets were in slightly negative territory for the first quarter of 2016, with the MSCI World Index down -0.19%. In a volatile quarter, when market averages dipped almost 10% at one point, we were pleased that the portfolio achieved admirable results. Foreign exchange gains boosted the returns, with most developed world currencies except the British Pound, appreciating against the U.S. dollar.

Market volatility created buying opportunities, and several sales were executed, with Guangdong Investment Ltd. and Rexam PLC reaching our valuation limits, the latter of which was due to a takeover by Ball Corporation.

PERFORMANCE ANALYSIS

Outperformance against the benchmark may be attributed to positive performance in a majority of sectors, led by information technology, utilities, telecom and energy. Healthcare and financials were the main detractors. On an individual stock basis, contribution to performance was widespread. Wesco International Inc., rebounded on the back of better than consensus earnings and the proposed acquisition of Atlanta Electrical Distributors. Another industrial holding, elevator/escalator manufacturer Kone Oyj, generated impressive sales in a rebounding Chinese housing market. Frontier Communications Corp. and Verizon Communications both had double-digit gains, following the completion of a deal whereby Frontier bought Verizon's wireline assets in Texas, Florida and California. Children's clothing manufacturer Carter's Inc. noted good quarterly results with swelling revenues driven by e-commerce. The company announced encouraging 2016 guidance, increased their dividend by 50% and committed to further share buybacks.

Marathon Petroleum Corp. was a significant detractor to performance, as the company lowered the 2016 distribution expectations of its master limited partnership (MPLX) and cut capital expenditures as commodity prices declined. The company is expected to provide further financial support to MPLX by injecting its inland marine business in exchange for units, along with a potential private placement of up to \$1 billion. Allergan PLC and Teva Pharmaceutical Industries Ltd. were down, as the companies signaled a delay in Teva's \$40.5 billion acquisition of Allergan's Actavis generics unit. The majority of U.S. banks were in negative territory due to a prevailing low interest rate environment.

Information technology companies, Wincor Nixdorf AG and Infosys Ltd both had double-digit gains for the quarter. Wincor Nixdorf was up, as its slated acquirer U.S.-based Diebold, Inc. received 68.9% of Wincor Nixdorf shares for purposes of satisfying the minimum tender condition. Infosys, the Indian outsourced technology consultant, rallied after raising 2016 revenue forecasts to 9%. Semiconductor equipment manufacturer Brooks Automation, Inc. was sold in favor of two new companies with more attractive fundamentals, Web.com Group Inc. and Avnet, Inc. Web.com is a domain registration/web hosting service geared to small businesses, with a loyal subscription base. With the recent acquisition of Yodle, Web.com is positioned to not only host and design websites, but also to participate in digital marketing. Avnet is an electronics distributor, with a global footprint and customers across the value chain. Avnet consistently delivers over various business cycles, generates significant free cash flow and operates efficiently.

The Frontier-Verizon wireline acquisition boosted stock prices of both companies, and each provider referenced other promising developments, which resulted in double-digit gains. Frontier delivered the 12th consecutive quarter (ending December 31, 2015) of broadband momentum by adding 28,500 broadband connections. The company subsequently launched “Frontier Vantage”, a new suite of higher value-add products including multichannel TV packages, faster broadband and phone service. Verizon reported a solid fourth quarter of 2015, as the company regained momentum in wireless subscribers, while reducing customer attrition. German telecom Freenet AG reduced sector results, as the company’s acquisition of a 23.8% stake in Swiss telecom, Sunrise, was a departure from the previously-stated focus on the German market.

Contributors in the consumer discretionary sector included International Game Technology PLC (IGT) and Regal Entertainment Group. IGT’s Italy-based Lottomatica subsidiary is leading a consortium bid on an Italian lottery concession, after which a joint venture will be arranged. The announcement came just ahead of IGT’s positive fourth quarter earnings report. Regal reported a record 2015 across most financial metrics, partially due to a strong fourth quarter of blockbuster film releases, investment in premium amenities and consistent focus on operational execution. The company also got a tangential boost from the AMC-Carmike Cinemas acquisition. A consolidating market is positive for the movie theater industry and opens up the possibility of a similar merger & acquisition (M&A) transaction for Regal. British homebuilders, Barratt Developments, Bellway Plc and Taylor Wimpey, hampered sector performance, as most were weaker on profit taking. In London, transaction volumes and prices were declining in wealthier locales, where homebuilders had minor exposure.

Utility company, NextEra, delivered strong annual results, with earnings up 8% for the 2015 year. Their Florida Power & Light unit and renewable energy portfolio, Energy Resources, had healthy growth. ALLETE, Inc. also reported strong 2015 earnings and announced another dividend increase; impressively, the company has paid dividends since 1948.

Australian energy company, WorleyParsons, rose more than 20% as the company announced overhead reduction programs that will deliver \$300 million annual savings over the next 18 months. The company also plans to strengthen its balance sheet through lower capital expenditures, tighter cost controls and asset disposal. Thai Oil benefitted from higher gross refining margins as lower energy prices spurred higher consumption.

Last quarter we reported that U.S. banks had benefitted from the prospect of rising interest rates after the Federal Reserve decision to nudge the federal funds rate up. However, in the subsequent two meetings the Fed decided to leave rates unchanged at between 0.25% and 0.50%. This quarter, U.S. banks were impacted by the revised outlook, as higher interest rates can boost banks’ net interest margins and income. British multinational banking and financial services company Standard Chartered was under pressure due to emerging market and commodity exposure. The company’s new CEO embarked on an aggressive capital and cost savings plan to position the bank through these challenging conditions.

Among other financial holdings, Russia’s Sberbank had a strong quarter as net interest margins continued to recover due to lower funding costs, coupled with a peak in loan loss provisions. The expectation is that 2016 will likely be better for the bank allowing for dividend growth. Norwegian savings bank Sparebank 1 SR recovered on better commodity prices, as the majority of their customer base has exposure to the energy sector.

In the past two years, our valuation screens have identified several value opportunities in financials and information technology sectors. Much of our bottom-up research has revolved around these sectors, and we have sought entry points when companies reached value pricing levels. For example, U.S. banking institution J.P. Morgan shares lost approximately 20% of their value from the end of December

2015 to mid-February 2016; we took this precipitous drop as a purchase opening. The stock rebounded more than 10% by quarter end. Shares of asset management companies often trade down in market turmoil; we bought Franklin Resources when it was out of favor, suffering from outflows and foreign earnings kept abroad due to U.S. tax rules. We also invested in Siam Commercial Bank, one of the largest banks in Thailand.

The Valeant Pharmaceuticals debacle has cast a shadow on the entire big pharma industry, as concerns surge about drug access and costs. This has impeded shares of Allergan and Teva, although fundamentals of both companies remain healthy. Teva is still intending to acquire Allergan's generic division on a postponed timeline, due to the U.S. Federal Trade Commission's lengthy review. Novartis was down more than 10%, on news of its cancer drug Gleevec going off-patent in July 2016. The lost revenue streams were supposed to be replaced by heart failure drug Entresto, but the drug has yet to gain wide-scale adoption. Additionally, Novartis' Alcon division underperformed for the past year.

INVESTMENT ENVIRONMENT AND STRATEGY

We capitalized on market volatility, purchasing companies at attractive valuations. Many of the newly-added companies had been on our research screens for some time, backed by carefully crafted fundamental analysis. These "richly valued" stocks came off prior highs allowing opportunity for entry. Portfolio turnover is likely to increase in the coming months, as we intend to capitalize on ongoing market turmoil. We believe volatility will persist, as even modestly-growing economies might still experience some downside risks. Developed countries with substantial financial leverage and the majority of emerging markets are likely to be susceptible.

Other economies, namely the U.S., will continue to see slow progress as lower oil prices contribute to healthier consumer pocketbooks. Discussions with a number of our portfolio companies proved fruitful, as they identified three consumer spending patterns including: 1) spending on automobiles, home purchases and some discretionary goods; 2) investing more for both short- and long-term retirement goals; and 3) saving money via bank deposits/accounts, thereby repairing personal balance sheets. All of these initiatives bode well for a moderate but longer and more sustained economic recovery. We expect that many of the European countries will follow the lead of the U.S., within a two- to three-year time lag. We will keep these themes in mind as we manage the global portfolio with a goal toward continued long-term outperformance.

We appreciate your comments and feedback.

Regards,

Polaris Capital Management, LLC