

PMV September 2017 Quarterly Review

The U.S. equity markets advanced for the eighth consecutive quarter during Q3 of 2017, an impressive feat even in the midst of a bull market. As measured by the broad Russell 3000 Index, equities have only declined once in the last 21 quarters. This bull market is now over 8½ years old and the second longest on record in U.S. history. As the saying goes, all good things must come to an end, and we would be remiss not to point out the heightened risk at this stage in the investment cycle.

During Q3 2017 Reinhart's Mid Cap Private Market Value ("PMV") strategy trailed the Russell Mid Cap Value Index, with two primary factors detracting from performance.

The first culprit was a poor start to the Q2 earnings season, as several of our portfolio holdings missed EPS expectations or guided down for Q3. The magnitude of these EPS misses was small, and none of the stocks declined by more than 15% on the news. The negative surprises came mostly within health care, consumer discretionary and business services. The PMV portfolio was able to offset some of these negative reports with positive EPS results and strong stock selection within real estate and industrials.

After reviewing our thesis for each holding that disappointed during the quarter, we decided to exit one position completely (Cardinal Health) due to fundamental concerns. However, we kept the remaining stocks, and in several cases added to the position to take advantage of attractive valuations. While it is important to analyze every short-term issue, we believe the PMV process helps us maintain a longer-term perspective to invest with conviction in quality companies, even when their stocks are out-of-favor.

The second cause of recent underperformance involves what we view to be an increasingly skewed market environment. The growth style is beating value significantly this year with price momentum strategies leading the charge. The table below highlights the magnitude of this phenomenon:

<u>Investing Style</u>	<u>Q3 Returns</u>	<u>YTD 9/30/17</u>
MSCI USA Momentum Index	+8.0%	+27.6%
Russell Mid Cap Growth Index	+5.3%	+17.3%
Russell Mid Cap Value Index	+2.1%	+7.4%

Investors appear to be chasing performance in 2017, causing the gap between expensive and cheap stocks to widen significantly. Reinhart's research suggests that the standard deviation of P/E multiples within the mid cap universe has widened by 14% since year-end. It is possible that increased equity flows into valuation-agnostic passive strategies may be exacerbating this effect. This valuation indifference seems to have contributed to a 'popularity contest' market, bidding-up stocks with positive headlines and acting as a headwind to the PMV philosophy. We do think this valuation divergence among individual securities has stretched too far, creating opportunities (although sometimes contrarian) that can be identified via the PMV discipline.

As Benjamin Graham (known as the father of value investing) said many decades ago - "In the short run the market is a voting machine, but in the long run it is a weighing machine." We agree, and believe the PMV portfolio is currently well positioned - owning undervalued, quality stocks that will grow cash flows over time - and ultimately tip the scales in our clients' favor.

MSCI USA Momentum Index: an unmanaged index that measures the performance of U.S. large and mid-capitalization stocks exhibiting relatively higher momentum characteristics. An investment cannot be made directly to an index.

Russell Midcap Growth Index: an unmanaged index that measures the performance of those Russell Midcap companies with higher price-to-book ratios and higher forecasted growth values. An investment cannot be made directly to an index.

Russell Midcap Value Index: an unmanaged index that measures the performance of those Russell Midcap companies with lower price-to-book ratios and lower forecasted growth values. An investment cannot be made directly to an index.