January 2017 – Volume 7, Issue 1

Dear Mr. (Incoming) President…

… As we begin the year two thousand seventeen you will soon be taking the oath as the leader of the free world. While our firm, Aristotle Capital, is making great strides within our industry, you are likely not to know of us. Even though one of our Portfolio Managers grew up next to "Trump Village" in Brooklyn, you are likely not to know of us. Even though many of this PM's childhood friends lived in the Beach Haven apartments – that which your father, Fred C. Trump, bought, then later sold, you are likely not to know of us. Even though several of the Principals of our firm are native New Yorkers, you are likely not to know of us. Even though the Aristotle group of affiliated companies recently rolled out Aristotle Atlantic Partners, headquartered in New York City, you are likely not to know of us. We never had, nor are we likely ever to have, any business or personal dealings, so you are likely not to know of us. Yet we respectfully ask you to consider a few business/investment-related topics we deem worthy of such consideration by your (incoming) administration.

In this issue ...

ARISTOTLE
CAPITAL MANAGEMENT

➢ With the caveat that **all** businesses, regardless of size, should be treated fairly, we found some of the presidential campaigning all too often focused on "big business." This was despite the fact that 83% of U.S. employment (as measured by nonfarm payrolls) is in other than the 500 largest public companies. Will you ensure that neither "big" nor "small" business is either "ad-" or "disad-" vantaged versus others?

➢ "Government" is often spoken of as one amorphous entity. Please remember, Mr. President-elect, that two-thirds of total government employees are at the state and local levels. Many laws, law enforcement, business policies and regulations are determined locally. State and local budgets, too, are determined by local policymakers. Many such budgets (and credit ratings) are being hobbled by underfunded pension plans. There is a line between national initiatives and federalism. Where does one draw that line?

➢ Similar to the above question regarding Federalism versus Centralism, how does your incoming administration view "globalism?" We note that while income inequality has increased ***within*** most countries around the world over the years, such inequality has decreased using the ***world*** as the metric. That is, it appears as though, as you may have pointed out, developed economies, including the U.S., have sacrificed some of their potential for the benefit of those at lower living standard levels. Are there net benefits from such sacrifice? Shall this trade-off be viewed only from a country-centric perspective or from a global one? Might there be a "happy medium" or should it be every country for itself? Are symbiotic relationships with our fellow countries an attainable goal?

➢ According to the World Bank, the U.S. ranks very high in "ease of doing business." But the same studies put us lower in "ease of *starting* a business." Why is this and is there anything that can be implemented on the federal level to encourage small businesses to get going?

➢ Please do not misinterpret our messages or believe that viewpoints are implied where questions are being asked. For example, we do not wish to imply that "big" is "bad." Almost all large enterprises in the U.S. began as much smaller ones. Becoming large and successful did not, in the vast majority of cases, change the nature or complexion of the companies. Indeed, some tasks can ***only***, in our view, be performed by larger businesses capable of navigating vast complexity. How many companies can build the Space Shuttle, or passenger jets, or engines for such, or dams on our flowing rivers, or pipelines across mountains and under lakes? In some cases, competition may be highly non productive. How many companies should provide electricity or manage our grid, collect trash in our neighborhoods or make fire engines?

➢ The subject of "Entitlements" always gets some good air time during political campaigns and this past season was no exception. But perhaps, with all the discussions about federal expenditures on Social Security, health care, etc., still short shrift was made of this topic relative to its importance. Even with a faster growing economy (concomitant with increased tax receipts), entitlement spending is expected to soon dwarf that of **all** other federal expenditures. Add to this the also-growing payments for interest on the national debt, and a focus (budget wise) on just about anything else may be only marginally impactful, at best. Many choices are available today to optimally deal with budget issues and the nation's deficits, but over the coming years available options could be diminished as we eventually near a "crisis" period.

➢ While we are on the topic of "hot button" campaign issues … Please consider that a healthy banking system is the "grease that lubricates" our economic engine. By now we know the many, many interconnected reasons that contributed to last decade's financial crisis. We also know, from our own and global experience, that an economy cannot thrive without available credit. Of course we also know that "too much" credit or "bad" motivations are not healthy for the long run. How may we achieve balance on this topic?

➢ We shall not ask you much about your immigration policies because, like many issues you face, it is complicated and, in this case, quite sensitive. We do, however, request you consider the following fact. The U.S., like much of the rest of the world, has a declining birth rate. Left purely to our own devices, our population growth is trending toward zero. Net immigration has raised this growth rate to about 0.8%. Are these 2.1 million new persons each year productive and net beneficial to society? How may we protect this great society, yet remain a "*country of immigrants*" as we have always been?

➢ As for interest rates, and policies you may implement, we ask you to consider the following statement we took from a recent edition of *The Bank Credit Analyst*. "*Although global yields may have bottomed from a secular perspective, the upturn will be gradual in the years ahead. A post-Debt Supercycle environment implies that private sector credit growth will remain subdued… A more powerful bear trend in bonds awaits the more significant upturn in inflation that likely will follow the next economic downturn*." While we do not necessarily subscribe to this theory, the notion of "debt supercycles" followed by rising inflation is an important long-term trend that must be carefully monitored.

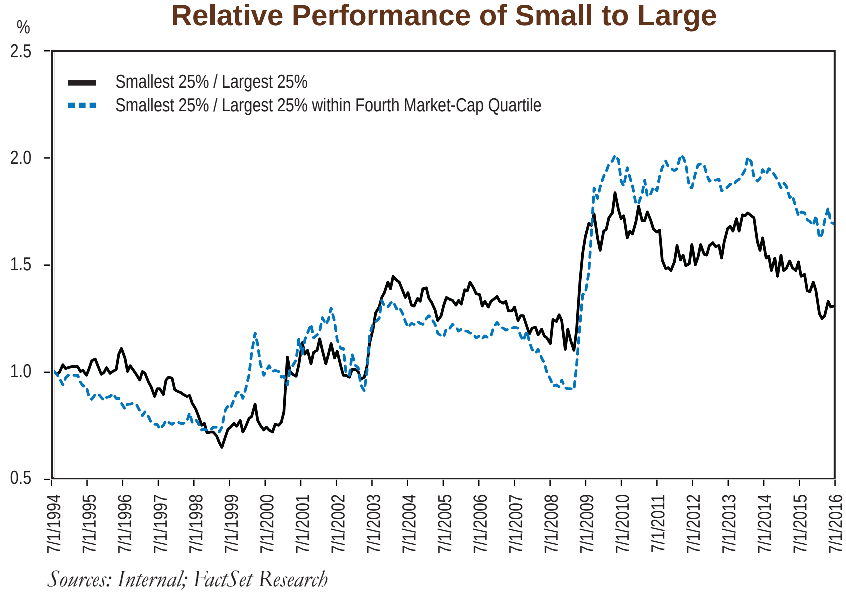
➢ The philosopher Aristotle, for whom our company takes its name, had been known to say that "*Invention is borne of necessity!*" So, please Mr. (Incoming) President, don't try to solve all of our problems. Perhaps clear the way so that society, acting through individuals, can solve its own issues in the order of individual preference.

➢ Finally, Mr. (Incoming) President, we agree with your desire to implement what you believe you were elected to do. But please consider the <u>long-term</u> good of your legislation. Remember, the policies of the Volcker/Reagan years are **still** being felt with disinflationary forces prevalent not only in reality, but in business and investment **psyche**. The results of your presidency, be it four or eight years, may not be felt (or even known) for perhaps long after you leave the Oval Office.

"Small" May Be Beautiful

One of the themes of the points we have asked Mr. (Incoming) President to ponder is exemplified by the following graph.

Relative Performance of Small to Large



Sources: Internal; FactSet Research

This graph depicts the relative performance (cumulative total return) ***within*** the Russell 3000 Index. The Index is comprised of 3,000 stocks deemed to represent the vast majority of U.S. public companies. All business sectors are represented. The data presented here reflect the time-period 1994 through 2016. This period encompasses several market/business/economic cycles of varying lengths and intensities. It includes the tech "boom" then "bust" of the late 1990s through early 2000s; it includes the financial "crisis" of 2007 – 2009, its predecessor period and aftermath; it includes oil prices up to $100 per barrel and as low as $25. It also includes three two-term presidential administrations. Summarily, we believe that the time-period used is representative of the past and, perhaps, indicative of the future.

The solid black line depicts the entire index comparing the smallest 25% of its constituents with the largest 25%. That is, a rising line indicates that the stock prices of the 750 smallest companies are outperforming their 750 largest peers. A falling line indicates that larger stocks are outperforming smaller ones. Note that over this 22-year period, the stocks of smaller companies have outperformed the larger ones – not all the time, but cumulatively. Furthermore – and as a confirmation of the results – each of the quartiles of the Russell 3000 exhibits a similar pattern. For example, the blue-dashed line in the graph represents only the smallest 750 companies in the Index. The dashed line compares the smallest quarter of *these* (188 companies) versus the largest 188 of these. The pattern is very similar to the overall index. Each sub-group shows a similar pattern as well. The "theme" presented here is that "small" may be beautiful.

There are many reasons why small company stocks tend to outperform larger ones over time. One is simply that the business profits, as a group, grow faster. Smaller businesses tend to be more focused, more nimble and often capable of out-innovating their larger (and sometimes complacent) peers. They also may have greater opportunities to gain market share coming from lower starting points. But in recent editions of *The Essence* we pointed out that larger companies were gaining an advantage of late in being able to better navigate endless and costly new regulatory requirements. Some of our topics for our (incoming) president to consider have addressed this issue.

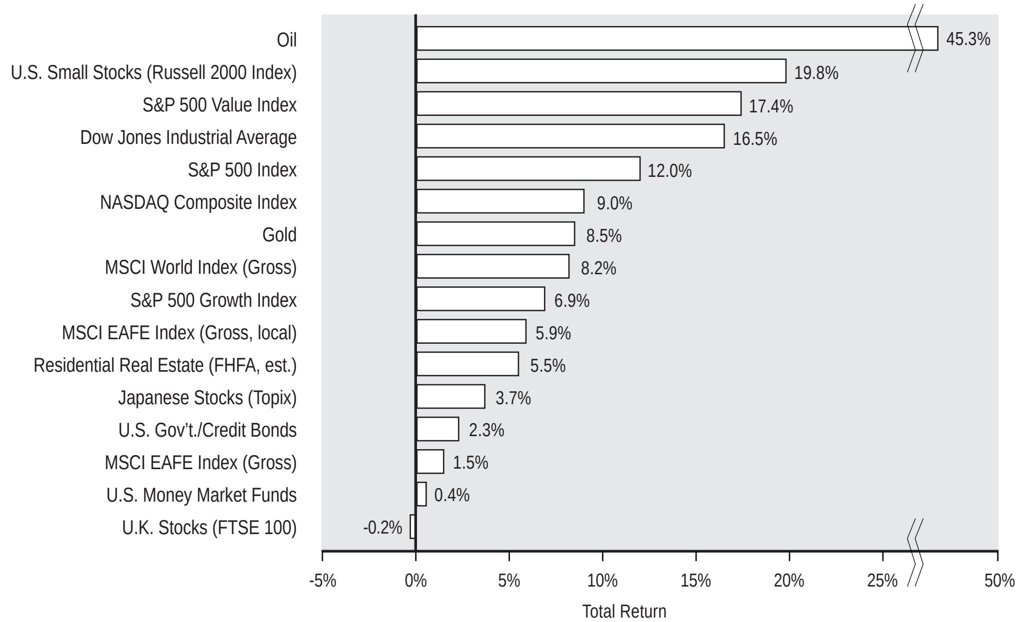
We, at Aristotle Capital, will not invest in a business only because of its size. We do recognize, though, that "small" may be beautiful if properly managed. We also are aware that almost all of today's "large" companies were, at a point in their histories, "small." We remain focused on identifying unique companies of any size; the smaller ones of today that can become tomorrow's leaders could hold the greatest opportunity for their businesses, and for us as investors.

EQUITIES STRATEGY

With our usual caveat that an individual year is not a particular focus of ours, in 2016 most global markets responded to the U.S. election with higher equity prices, higher bond yields and a stronger dollar. The "thinking" – as if markets are "living beings!" – is that the (incoming) Trump administration will move forward on growth-oriented structural reforms including corporate tax cuts and more effective regulation of finance, trade, labor and the environment.

The reality is that growth in business investment the world over has been slowing for several years, even though cash flows remain strong. Will business investment increase in response to these upcoming policy changes? We shall see.

2016 Asset Performance



Total return in U.S. dollars unless otherwise noted

Sources: Bloomberg; Various

Global equity performance was skewed last year by the volatility of the U.S. dollar. Relative to most currencies, the dollar strengthened. The euro, for instance, declined by ~3% while the British pound lost more than 16% (after the country, as one of its earliest members, voted to exit the European Union). Thus, while international stocks as a whole (as measured by the MSCI EAFE Index) rose +5.9% in local currencies, when converted to dollars, the gain was a muted +1.5%.

U.S. smaller companies outperformed their larger brethren (consistent with longer-term trends as described earlier), while "value"-oriented indices outperformed "growth" (and the market, overall) for only the second time since the financial crisis.

U.S. bond yields rose (prices fell), for the year, as the Federal Reserve Board (Fed) signaled, then executed, a short-term rate hike. Including interest income, however, fixed income total returns were mostly positive. Treasuries were nearly flat, while corporate bond total returns were up ~5%.

Residential real estate prices rose about 5.5% for the fourth consecutive year. Some markets (including the San Francisco Bay Area, Phoenix and parts of Florida) saw housing shortages drive prices up further. Other markets (particularly energy related, such as Houston) experienced slight corrections. Even with rising mortgage loan rates, we continue to believe that U.S. housing may continue its ascent at least until housing starts recover back closer to its "normal" level of 1.5 million annually – currently about 300,000 shy of that level.

Most energy and commodity prices recovered from their sharp drops of 2015. Oil (down -35% in the prior year) rose +45.3% while gold (down -8.9% in 2015), with some volatility, recouped +8.5%. Oil's rebound towards the end of the year was furthered by OPEC's agreement to reduce output. We shall see.

As related to our "advice to ponder" for our (incoming) president, we would like to raise the issue of Passive vs. Active investment management. While somewhat self-serving to Aristotle's business of active investing, we find the growth of "passive" troubling. We see it as a somewhat "defeatist" approach of "*if you can't beat them, join them.*" That is, if investors cannot identify clear long-term "winners" from "losers" consistently over time, then don't even try. Unfortunately, this allows for larger companies to gain in market strength at the expense of smaller ones. ETFs and other passive strategies allow for the concentration of investing in fewer and fewer companies (most indices are market capitalization weighted), thus lowering their cost of capital relative to their smaller peers. It may give larger companies an unfair and, perhaps, unwarranted advantage. It is, we believe, a self-fulfilling prophecy … until it isn't! We may have more to say on this topic in future editions of *The Essence*.

INVESTMENT ACTIVITY

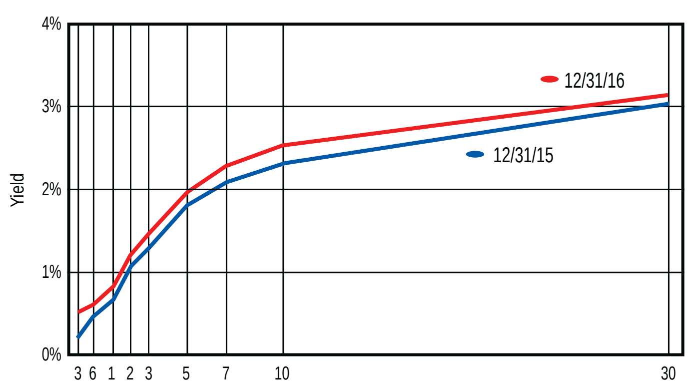
We would now like to highlight a recent addition to Aristotle Capital equity portfolios:

Coca-Cola Company (KO). QUALITY: Coca-Cola is one of the oldest, most predictable, best-known brands of any type the world over. Moreover, while given only marginal credit, the company has made significant strides at diversifying away from its flagship carbonated soft drink (CSD) products. While CSDs are highly cash generative, Coke's "still" beverages (including bottled water) are likely to continue to increase their share of the global beverage industry for the foreseeable future. VALUATION: Not, in our estimation, reflective of the transition the company is making to an "asset-light" strategy. We estimate an intrinsic value of $56/share reflecting nearly $3.00 in normalized earning power. This is versus $2.00 in earnings per share expected in both 2016 and 2017. CATALYSTS: Numerous, including: Refranchising of its global bottling operations (resulting in a less asset-intensive business), continued success at gaining market share in still (and also sparkling) beverages, cost initiatives resulting in higher margins and higher (even from a high base) returns on capital employed, "volume to value" strategy resulting in higher profitability per case, plus some "wild cards" such as the dramatic steps to improve profitability by global Coca-Cola bottlers, exemplified by those in Japan (where dozens of bottlers have consolidated over the years down to what soon will be <u>one</u>).

FIXED INCOME STRATEGY

As shown in the following graph, the U.S. Treasury yield curve shifted upwards by about 15 basis points (0.15%) on average from the end of 2015 to the end of 2016. This is about the same upward movement as occurred in the prior year. Most major international bond markets corrected, too, with even Japanese 10-year government bond yields now in positive territory. Many emerging market government debt markets had yields increase even more significantly, with several now having long-term government bond yields above 5.0%.

U.S. Treasury Yield Curve
12/31/15 versus 12/31/16



Source: Bloomberg

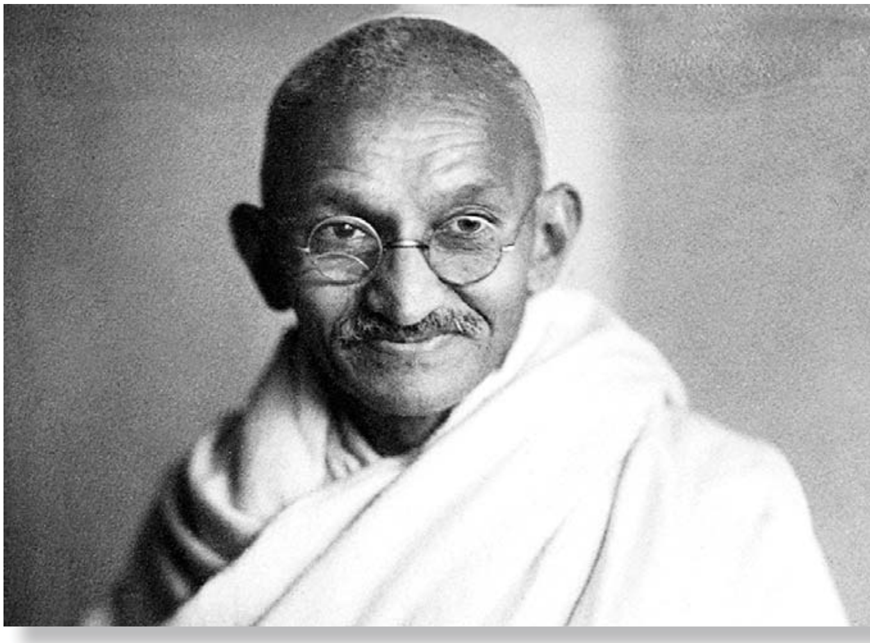
As yields normalize throughout the world over the coming years, we may see interest rates rise coincident with improvements in global GDP and (expected slight) upticks in inflation. Should this occur, total returns for high-quality (including government and government-backed) bonds may remain low. As we see the risk/reward balance for investment-grade fixed income as skewed somewhat negatively, we will remain cautious in our approach. Thus the fixed income portion of Aristotle Capital portfolios will remain prudently short- to intermediate-term and of high quality. [Opportunities for higher returns in lower-grade fixed income instruments may be better; we will leave those prospects for our sister company, Aristotle Credit Partners].

CONCLUSION

Dear Mr. (Incoming) President: In conclusion, while you may not know of Aristotle (yet), we ask that, in your governing process, you always consider what makes our country unique. Yes, we have natural resources. Yes, we have an industrious culture. Yes, as a society we embrace inclusion. What has helped make us stand apart for **centuries**, however, is our founding principle of "checks and balances." We have written about this in prior editions of *The Essence* (and its predecessor publications). While typically associated with three branches of government with the Executive, Judicial and Legislative each acting as a "check and balance" on the others, we find that, in addition, no one part of our society keeps a "hold" on the others indefinitely. There are always cycles (some longer, while others fleeting), but be it governmental power, the power of labor, the rights of the individual or of business, we have kept in check the power of one group over another. Be it the young or the elderly, the strong or the frail, the big and tall or small in stature, the native born or the naturalized, we have balanced the rights for all. Be it the "rich," "poor" or most of us in between, we (at least strive to) equalize the equation of opportunity.

We know that our thoughts to you are simplistic, devoid of the detailed intricacies that accompany each policy decision you will make. Yet, we sincerely ask that you consider, for your upcoming presidency, and beyond, that no one may be permanently disadvantaged versus others.

Campaign rhetoric being what it is, the winner and his opponents frequently alluded to the recent election as being "historic" in our lifetimes. We shall see.



Reporter: "What do you think of Western civilization?"
Mahatma Gandhi: "I think it would be a good idea."

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