MD SASS

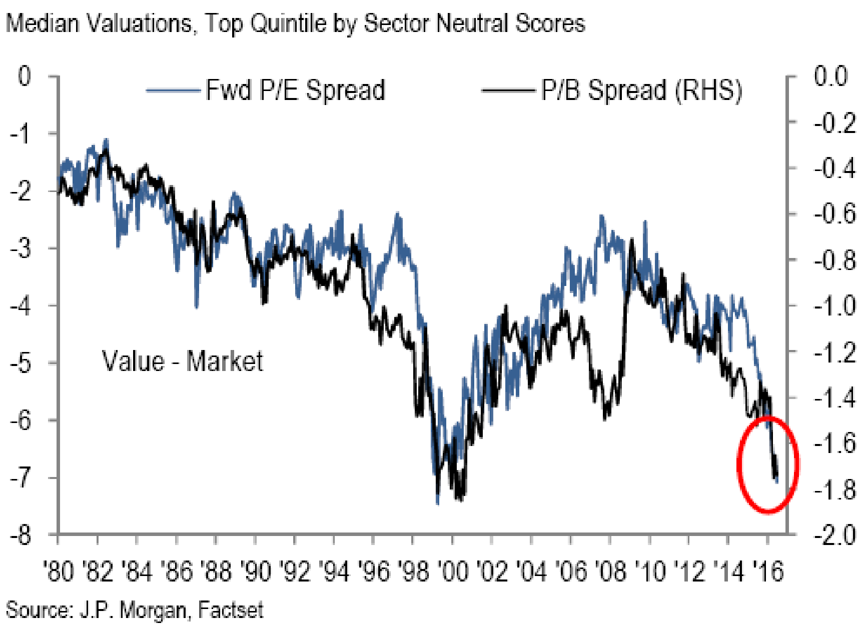
July, 2016

MID-YEAR 2016 OUTLOOK

VALUE IS BEING OVERLOOKED IN THE QUEST FOR YIELD

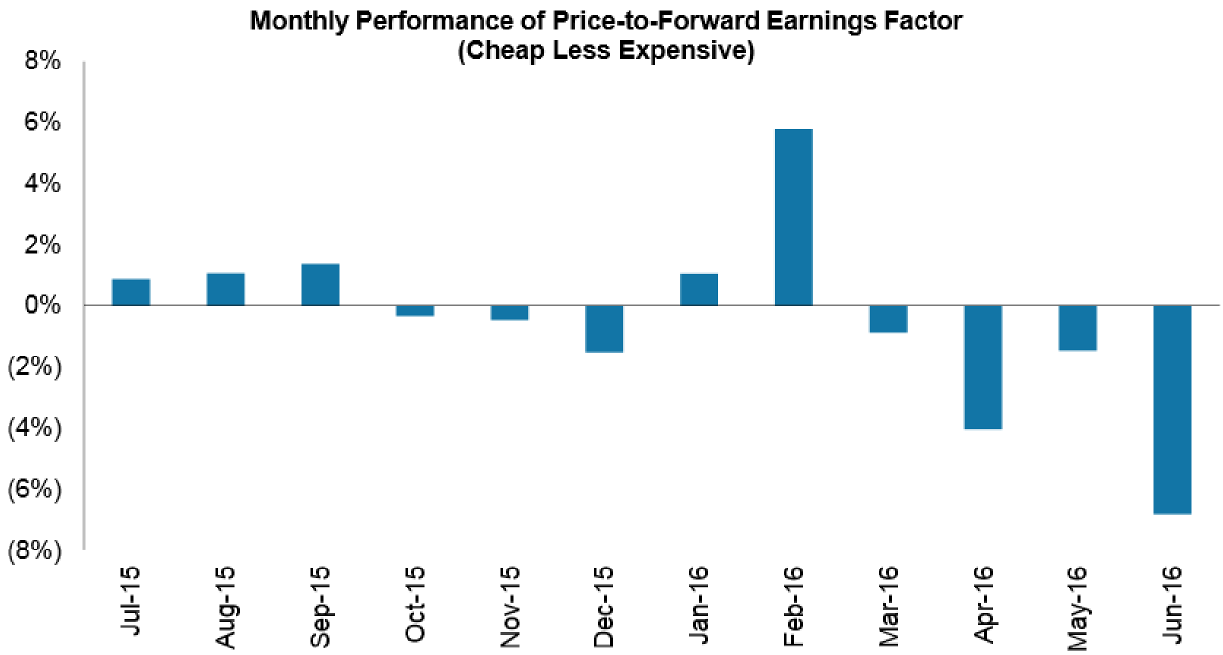
Valuation is largely being ignored and value stocks have underperformed, while defensive and high yielding stocks have been bid up sharply during this period of record low government bond yields and macro concerns (slowing global growth, Brexit vote, U.S. presidential election, etc.). This bifurcation has resulted in major dislocations of price from value, which parallels another period, in 1999, when value stocks were extraordinarily cheap relative to the overall market following dramatic underperformance for value stocks. Overvalued technology, media and telecom ("TMT") stocks soared in 1999 pushing the S&P 500 index to an unrealistically high 30 times earnings while valuations of low P/E value stocks went ignored. As shown below, both the Price/Earnings ratio Spread and Price/Book Spread vs. the Market are back today to their very depressed levels last reached in 1999.

Value vs. Market: Cheapest Since TMT Bubble in 1999



Meaningful underperformance by value managers in 1999 was followed by a sharp rebound as value stocks far outperformed the S&P 500 index during the ensuing three year market correction from 2000 through 2002. Thus, just at the time when investors were giving up on value stocks in late 1999, undervalued stocks turned around sharply and value investors made money while the technology, media and telecom bubble burst and the inflated S&P 500 index declined significantly.

The current relentless search for yield and safety has caused U.S. equity markets to again become dislocated. We believe there are now excessive and unsustainable valuations for perceived safe haven low volatility stocks with high dividends, while low multiple stocks have been ignored. Many value stocks are now priced for a recessionary environment, whereas we believe the U.S. economy remains in a sustainable expansion. The neglect of value stocks generally is illustrated below by the steep underperformance of value stocks with the lowest forward P/E ratios during 7 out of the last 9 months:



Source: ClariFI, Morgan Stanley Research

Large performance differentials amongst equity market sectors have caused unusually wide spreads between the most undervalued and the most expensive stocks. We believe underperforming healthcare and financials with low multiples have become extremely undervalued, while defensive income oriented telecoms and utilities appear to be most expensive based on fundamentals. Consumer staples have recession-resistant characteristics similar to healthcare but consumer staples trade at much higher valuations than healthcare (the latter are unduly depressed because of excess concerns about political rhetoric regarding drug pricing in our view). It is understandable that financials have been pressured due to the negative impact on the sector from sharply declining bond yields. However, with their large discounts from tangible book value, low P/E multiples and high yields, several quality financials appear attractive to us. When rate hike expectations increase, financials should rally strongly at the expense of defensive utilities.

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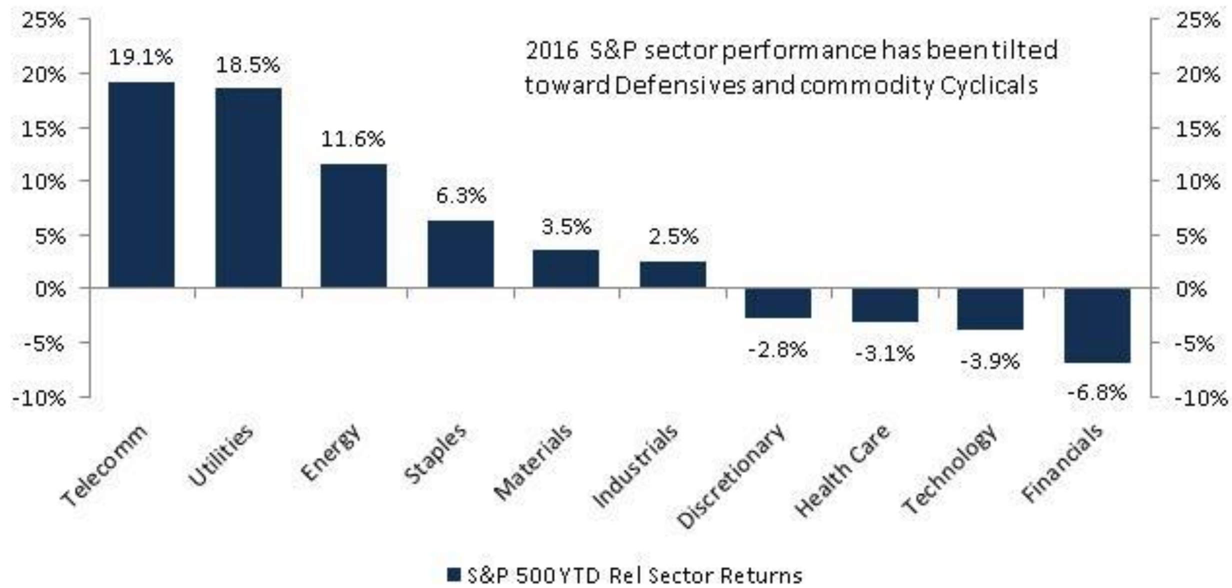

Source: Evercore ISI

Value stocks are the likely beneficiaries of the next market sector rotation, especially those in the consumer discretionary, health care and financial sectors, which have declined so far this year. Our contrarian orientation finds value stocks most compelling, given that they are so out of favor due to the lack of investor focus on valuation. Investors have been bidding up stock prices of dividend paying, safe haven assets at higher and higher prices with little, if any, regard to valuation. Utilities and telecom stocks are up 19.1% and 18.5% YTD largely due to their above-average dividend yields of 3.3% and 4.2%, respectively, according to Factset. Utilities trade at roughly 21 times their last 12 months earnings vs. the S&P 500's P/E of 18 times, according to Factset.

Investors' thirst for safety and yield in low volatility defensive stocks during this ultra-low yield environment is comprehensible, but soaring prices have brought many safe haven stocks to worrisome levels that present asymmetric and negative tail risk. The risk will become apparent when there is a meaningful sector rotation into value and out of safe havens. We believe a major sector rotation is likely to occur at any time and likely will come when one or more of the following occurs: 1) expectations are reignited for future interest rate increases, 2) U.S. economic growth accelerates, and/or 3) investors become more aware of extreme dislocations of price from value. A large risk for many high yielding stocks with high dividend payout ratios is potential dividend cuts when their businesses slow.

Regardless of the economic environment, history shows that value stocks tend to strongly outperform after they become very cheap and out-of-favor relative to other sectors. When the eventual mean-reverting tendency of valuation extremes materializes, we are confident that value stocks will again outperform.

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Unprecedented!

An unprecedented combination of…

- slow global growth,
- declining demand for credit on the part of the most credit worthy borrowers,
- massive government monetary stimulus implemented by central banks lowering short term interest rates and forcing down longer term interest rates through quantitative easing (the purchase of large amounts of outstanding debt issues by central banks)

…has created historically low interest rates, both in the U.S. and most developed countries. Those interest rates are summarized below

6/30/2016	1Y	2Y	5Y	10Y	30Y
U.S.	0.44%	0.58%	1.00%	1.47%	2.29%
Japan	**-0.33%**	**-0.30%**	**-0.31%**	**-0.22%**	0.13%
Germany	**-0.64%**	**-0.66%**	**-0.57%**	**-0.13%**	0.38%
France	**-0.55%**	**-0.55%**	**-0.36%**	0.18%	0.91%
U.K.	0.14%	0.09%	0.35%	0.86%	1.69%
Switzerland	**-1.15%**	**-1.19%**	**-1.05%**	**-0.61%**	**-0.11%**
Netherlands	**-0.61%**	**-0.60%**	-0.42%	0.08%	0.51%
Spain	**-0.19%**	**-0.14%**	0.26%	1.21%	2.28%
Italy	**-0.21%**	**-0.11%**	0.29%	1.26%	2.27%
Portugal	0.12%	0.56%	1.80%	2.99%	3.90%
Greece	--	7.21%	--	8.18%	--

Source: Bloomberg/MD Sass

(It is noteworthy that U.S. interest rates are higher than the others in Japan and Western Europe, despite the widely recognized superior economic recovery of the U.S. since the 2008 credit crisis that would generally lead to lower perceived credit risk and therefore lower interest rates.)

The goal of these extreme monetary measures has been to stimulate borrowing, capital investment and consumer spending and thereby stimulate economic growth and job growth to mitigate the impact of the global financial crisis that began in 2008 and ended in 2009 in the U.S. but continues to burden most other economies with below average recoveries since then. These low interest rates, particularly in Western Europe and Japan, relative to those in the U.S. have caused capital to flow into U.S. bonds as investors seek both the presumed safety of Treasuries combined with their higher yields. This in turn has strengthened the dollar relative to most foreign currencies. While a strong currency is most often favorable for the country that possesses it, in the current period it is also having a perverse effect. The strong dollar has lowered the cost of imported commodities and foreign manufactured products, which

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is good for consumers, but it has also made U.S. goods more expensive in the world markets and lowered the demand for them. This ultimately will have a negative impact on domestic job creation, capital investment and may create deflationary pressures. The U.S. trade deficit for June rose substantially as exports were negatively impacted and imports grew even though the cost of imported oil remained low. Concerns about the negative consequences of the dollar strength caused the U.S. Fed to pause raising interest rates after the initial hike. The unknown consequences of the British vote to exit the European Union have further strengthened the dollar and raised additional concerns about European economic growth and added reasons to reconsider domestic interest rate increases.

$ per FX	1/1/2016	6/30/2016
EURO	1.0858	1.1067
Pound	1.4736	1.3311
YEN	0.0083	0.0097
Australian $	0.7287	0.7450
Canadian $	0.7226	0.7738

Source: Bloomberg/MD Sass

This further strength of the dollar and concerns about the consequences of the "Brexit" is likely to keep U.S. interest rates low for an extended period of time.

Low interest rates are generally good for consumers and business; however the benefits are not evenly spread throughout the complex domestic and global economy. Several important constituents are in fact being severely damaged by the continuing low level of interest rate and they are briefly discussed below:

Banks:

A major component of bank earnings is derived from their net interest margin (NIM) and volume of loans. NIM is the difference between their borrowing costs and lending rates. Dodd Frank in the U.S. and Basel III in Europe have constrained bank credit to the most credit worthy borrowers. Many of them have strong balance sheets and excess cash. They can also issue long term bonds at historically low interest rates. Borrowing by these major credit-worthy corporations is therefore low. NIM is also low because quantitative easing (QE) has forced down longer term interest rates and central bank monetary policy has reduced short term interest rates that most bank loans are pegged to, to very low levels. This has made NIM very low and is suppressing bank earnings. This is particularly felt in European and British banks that have not yet undergone the major recapitalizations of U.S. banks and which stocks are very depressed by low loan volumes, low NIM and now increased credit concerns due to Brexit, thereby making it even more difficult and expensive to recapitalize now.

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Insurance Companies:

Insurance companies earn premiums to insure risks and depend on earning money on these premiums between the time they receive them and the time they pay out claims (float). Their combined ratio (CR) is the difference between premiums collected plus investment earnings compared to claims paid. Many insurance models, based on past interest rate levels, underwrote life insurance, casualty insurance and annuity policies that including the costs of operating the businesses broke even or lost money but due to high expected investment income on the float, were profitable. The current low level of interest rates adversely impacts the earnings on this float. New policies incorporate more modest interest rate assumptions but previously issued polices for many insurance companies are likely to create losses. To offset this, they are pressured to allocate more of their portfolio to less liquid and/or more volatile assets and thereby take more risk.

Pension Funds:

Pension funds are similar, in a financial modeling sense, to annuities. A corporation or municipal government contributes money to a pension fund to pay pensions to currently retired past employees and to build up a fund including an assumed return (actuarial assume rate or AR) on the fund's investments that will be sufficient to pay future benefits. In many cases the AR is in the 7% to 8% range. Over the long run the even minor shortfalls between the AR and the actual earnings can case major shortfalls in their funding ratio or the ability to pay future benefit. The current low level of interest rates makes it virtually impossible to have a traditionally balanced portfolio between stock bonds and cash plus some alternative investments that can earn the AR over a long term. Locking in long term bonds at 3% or less means that the other investments have to earn far higher returns for the overall portfolio to earn the projected AR. To mitigate this, they can make greater contributions that cost taxpayers more in the case of municipal plans and shareholders more in the case of corporate and multi-employer plans. Like insurance companies, pension plans can also seek to earn higher returns by allocating more of their portfolios to less liquid and/or more volatile investments.

Retirees:

The same factors impacting insurance companies and pension funds are putting stress on retirees' ability to either retire or spend the money that they anticipated they will need in retirement. For many, this means spending less with negative implications for the economy as the baby boom generation retires.

Because of the factors cited above, central bank policies to reduce interest rates are meant to be a short term approach to stimulate consumer demand and capital investment. Despite historically low interest rates for more than 20 years, Japan's economy has been stagnant. Simulative monetary policy has not worked over the long run in Japan and there is no reason to believe that it will work in the U.S. and Europe over the long term. The U.S., and to a greater extent Europe, face a conundrum. Raising interest rates now could stall their recoveries and raise their currencies at a time when they aspire to have a

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lower currency to spur exports and create domestic demand and jobs. Keeping interest rates low will eventually damage major economic constituents, such as those discussed above, and encourage investors to take greater risk to attempt to earn higher but necessary returns. It is uncertain how this will play out over the coming months or next few years, but it is unlikely to last beyond that without major financial consequences for pension funds and municipal governments.

What to do in the interim?

Cash pays almost nothing and longer term bonds pay way too little to earn the required returns while at the same time they are exposed to major price declines when and as interest rate rise, even modestly. Short duration U.S. Government Agency Mortgage Backed Securities currently have yields in line with 5-10 year Treasuries but we believe with less risk of price declines when interest rates rise. While not ideal, we believe this is the best place to store stable capital while earning a comparable yield. Neglected undervalued quality stocks and select income generating alternative investments also appear attractive in diversified portfolios. We are always pleased to discuss these in more detail with our clients.

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