ALTMAN
INVESTMENT MANAGEMENT

EQUITY STRATEGY FOCUS

JANUARY, 2016

IN FOCUS:

We've prepared this update in an effort to provide our clients with a macro overview of our current investment program, as well as offer a timely discussion on specific market sectors/industries and the implications relative to portfolio strategies:

- *Credit Markets*
- *Energy*

We hope that this will help you better understand our investment strategy. For further information and discussion, please don't hesitate to give us a call.

The Equity Backdrop

- Increased financial market volatility at the start of 2016 and somewhat tighter financial conditions spurred fears of an impending U.S. recession. We see minimal odds of contraction at this time.
- Notable risks to the near-term outlook include slow factory activity, weak demand from abroad, excess inventory accumulation, and widening credit spreads.
- But those are offset by robust services activity, improving housing and jobs markets, and healthy consumer spending growth.

On the top of our list of concerns for 2016 has been the potential for market valuations. Our preferred metric has been the median Price-Earnings (P/E) ratio for the S&P 500 Index which is slightly above the median band historically, especially if we exclude the technology bubble of 2000. There are of course two options to correct a relatively high P/E premium. Valuations could contract via lower prices, or the market could grow itself out of its current valuation predicament. However, it is worth noting that at 16.1x the S&P 500 forward P/E is above its average 14.6x but not excessive. We expect earnings to grow more than consensus expectations for forward P/E to return to its long-term norm without additional price declines. Keep in mind that the forward P/E is being held down by estimates of a sharp rebound in earnings versus 2015 reported record.

According to Bloomberg, the S&P 500 operating earnings are for $120 per share in fiscal 2016, which represents a 15.2% increase from fiscal 2015. We predict that those estimates could be vulnerable as we run into stronger comparisons in Q2. For these estimates to improve materially, the economy needs narrowing credit spreads, better economic data, and firmer commodity prices all pointing to macro conditions that are favorable for an earnings rebound.

Operating margins at near high levels, resulting in a higher dependency on accelerating earnings coming from sales growth, are also dependant upon economic growth. The recent GDP report for Q4 at 0.7% did little to support the consensus forecasted optimism. The macro backdrop remains mixed with a light January jobs report providing the Federal Reserve some room to postpone a second rate hike and extend the accommodative policy.

We believe that current investor fears are not emanating from a contraction in the U.S. economy but rather from the contagion of China, commodities, and the global financial instability. We focused our attention in this commentary on the three lead indicators, Energy stocks, Financial stocks and incumbent credit spreads. Recent evidence shows that Energy stocks have coincided more with the recent stock market bottoms than with correlations with crude oil prices. Furthermore, we can see the contagion with the coincident movement recently in the Financial sector that has also fallen to its lowest level relative to the S&P 500 since October 2012.

Certainly financial weakness reflects both a flattened yield curve and the potential excessive loan exposure to the energy-related industries. Since credit spreads have widened to a new cyclical high, we anticipate that any decline in spreads would validate that contagion fears have abated.

Keep in mind that weak markets not associated with recessions tend to be much shorter and less brutal on average, declining less than 25% and lasting on average 150 days. A broader gage of the stock market shows that the Dow Jones 65 stock average peaked at the end of 2014 and declined 17% over 270 market days. This compares to the MSCI All Country World Index which fell 19% over 200 market days. We could certainly build a case that the bear market is largely over.

IN BRIEF: A Look at the U.S. Economy

Following the Federal Reserve's decision to raise the Fed Funds Rate on December 17th, risk assets remained volatile as U.S. equities, junk bonds and commodities prices experienced the worst January in recent years. The decline was not as much from a 25 basis point rise in rates that caused the dislocation but rather the inference of the possibility of 4 more rate hikes in 2016 and 2017 that has spooked the market. We believe that unless the Fed anticipates a huge inflationary problem on the horizon, it is hard to understand why the US economy really needs eight more rate hikes.

Although recent job growth slowed in January as the labor market tightened, the year over year change remained at 2.5%. We believe the financial conditions and slower job creation should delay further Fed rate hikes until after the March meeting.

Low energy prices are not expected to have as significant an impact on the economy as did residential mortgages. In the Great Recession, the most imposing factor weighing on the economy was the inflating real estate market that lacked sufficient boundaries and ultimately failed to protect bank loan books. Since that time, banking loan books have been shored up and balance sheets restored. Residential mortgages grew as large as 6.5% of GDP before collapsing, as compared to energy which now stands at 0.4% of GDP. Therefore we would expect that in the unlikely event that the U.S. enters into a recession the impact would be relatively mild.

CLOSE-UP: Equity Investment Overview

Benchmark Performance Highlights

EXHIBIT I

S&P 500 Index – 2015 Performance

	Sector Wgt. As % of S&P as of 12/31/2015	4th QTR Total Return	4th QTR Sector Contribution of S&P 500	YTD Total Return	YTD Sector Contribution of S&P 500
		7.03		1.4	
Consumer Discretionary	12.9	5.8	0.8	10.3	1.2
Consumer Staples	10.1	7.6	0.8	5.5	0.7
Energy	6.5	0.2	0.1	-21.2	-1.7
Financials	16.5	6.0	1.0	-1.4	-0.3
Health Care	15.2	9.2	1.3	6.7	0.9
Industrials	10.1	8.0	0.8	-2.9	-0.2
Information Technology	20.7	9.1	1.8	5.7	1.1
Materials	2.8	9.8	0.3	-8.7	-0.3
Telecommunication Services	2.4	7.6	0.2	3.4	0.1
Utilities	3.0	1.1	0.0	-4.8	-0.2

Source: Bloomberg

S&P 500 Index – Sector Performance Summary

- The S&P 500 ended 2015 posting a return of 1.36%, thanks to strong Q4 results when all but 2 market sectors (energy and utilities) posted returns in the mid to high single digits.
- Large Cap Growth Stocks were the top performing style for the second consecutive year as investors sought after earning growth in a declining earnings environment. Value styles across all market caps lagged the market for the year.
- Although leading, even large cap growth stocks were sluggish with returns only in the low single digits. Small cap growth and mid-cap growth had returns of 1.47% and .75% respectively. All other style benchmarks posted negative returns for the year.
- It was a mixed year in sector performance with neither cyclical nor defensive sectors taking a definitive lead. Consumer Discretionary was able to achieve low double digit returns, followed by Healthcare, Information Technology and Consumer Staples in the mid-single digits.
- The best performing industries during the year were Consumer Services, Software and Services, Consumer Durables & Apparel, Food Beverage & Tobacco, and Retailing. Each of these industries falls within either the Information Technology or Consumer Discretionary Sectors.

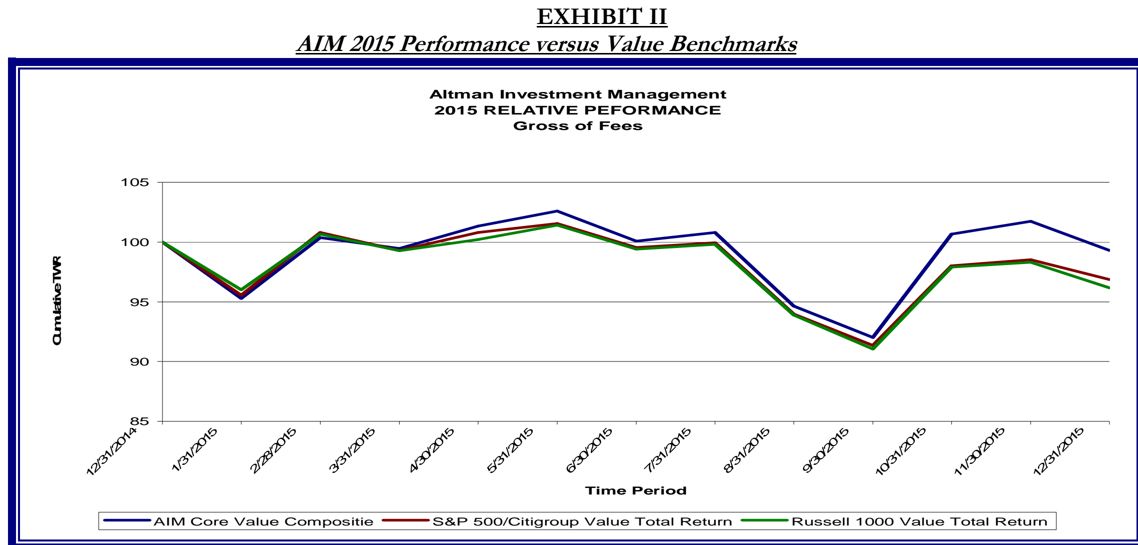
A Value Perspective

Throughout 2015, the value indexes were overweight the Energy sector and underweight the Technology (software and services) and Consumer Discretionary (Retailing) sectors, resulting in their underperformance against the S&P 500 by over 400 basis points. During times like this past year when spreads widened so considerably between value and growth investment styles, it makes sense to compare our composite against the value benchmarks as well as the broader large cap markets.

The AIM Composite is Outperforming its Value Benchmarks

EXHIBIT II

AIM 2015 Performance versus Value Benchmarks



Source: Bloomberg and Altman Research

- In a year marked by tumbling oil prices, a slowdown in China and deteriorating earnings, only 3 asset classes outperformed the S&P 500. These classes were the Dollar, up 9.37%, NASDAQ (an index heavily weighted towards growth) up 5.73% and EAFE (developed markets in Europe, Australia and the Far East) up 5.33%. All other asset classes posted flat to negative returns for the year.

AIM's Attribution Highlights

EXHIBIT III
AIM Composite - 2015 Performance

	Sector Wgt. as % of Portfolio as of 12/31/2015	Relative Wgt. versus S&P 500 Index	4th QTR Total Return of AIM Composite	4th QTR Total Attribution of AIM Composite	2015 Total Return of AIM Composite	2015 Total Attribution of AIM Composite
AIM Composite			7.9	0.9	-0.5	-1.8
Consumer Discretionary	9.4	-27%	7.3	0.2	1.5	-0.9
Consumer Staples	11.0	9%	2.4	-0.6	16.3	0.5
Energy	8.2	26%	-2.6	-0.4	-28.9	-1.6
Financials	19.3	17%	7.8	0.3	-0.1	0.1
Health Care	16.1	6%	10.2	0.2	3.1	-0.5
Industrials	9.1	-9%	11.6	0.3	7.7	0.9
Information Technology	18.2	-12%	13.1	0.6	0.1	-1.3
Materials	2.6	-6%	37.8	0.6	-4.7	0.1
Telecommunication Services	2.2	-9%	7.2	0.0	8.4	0.1
Utilities	2.1	-30%	-5.4	-0.1	-7.0	0.0

Source: Bloomberg and Altman Research

AIM Composite Attribution Analysis

- The AIM composite outperformed the overall market in Q4 by 90bps. Stock selection was the primary influence on outperformance, due to positions held in DuPont, Applied Materials, Microsoft, Cardinal Health, Ace Ltd., and Northrop Grumman. Each of these stocks was up double digits in Q4 as compared to the overall market return of 7%.
- Strong Q4 performance in our AIM Core Value Composite helped close the gap in relative returns versus the S&P 500 benchmark for the year. In 2015 our composite lagged this index by -180 basis points.

Equity Strategy

During the past year of weak to negative earnings growth, investors pursued growth stocks, and thus assumed higher risk. Earnings overall declined -4% in Q3 with gains in only 4 out of 10 market sectors. As one would expect, Healthcare, Consumer Discretionary, and Information Technology posted relatively strong results for the year. As the outlook for corporate profit growth improves, we expect to see a shift in investor preference from growth towards value stocks. In Q4, Energy and Materials continue to weigh on earnings growth. With more than 80% of the S&P 500 having reported, earnings growth is 1.7% ex energy, versus -4.2% including all sectors.

Large Cap Growth stocks led the market in 2015 followed by Small and Mid-Cap Growth. Looking ahead as the market enters a period of moderately rising interest rates, the environment favors large cap, high quality, dividend growth, and developed market stocks. Large Cap Value stocks have not led the market in several quarters. This phenomenon is best exemplified by measuring assets in U.S. Exchange Traded Funds (ETFs) that stand at $2.123 trillion up 8% over the prior year. This follows an 18% y/y gain in ETF assets in 2014. Growth rates of ETF assets have been consistently more than double that of mutual funds over the last decade, suggesting that investors are becoming more reliant upon market efficiencies in order to track the market. These passive strategies, while effective at moving in and out of markets rapidly, don't benefit from an investment process that focuses on owning undervalued companies that can substantially enhance longer term portfolio performance results.

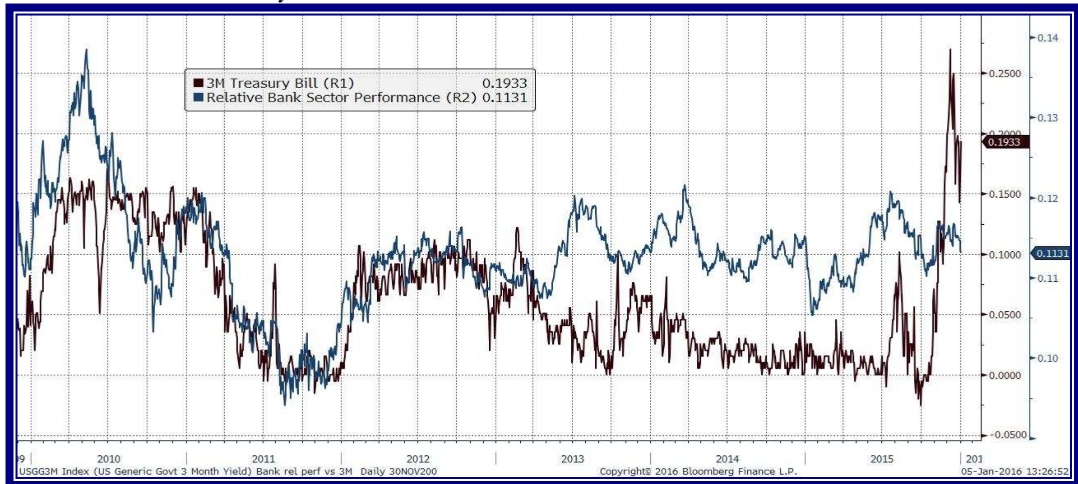
In Q1 2016, we hedged our Financial sector exposure, while still maintaining a relative overweight. Several factors have led us to believe that while banks remain long term beneficiaries of rising interest rates, the cycle has been somewhat pushed back leading us to rebalance the banking sector in favor of stocks with more favorable valuations and stronger balance sheets. This has had the effect of reducing interest rate sensitivity within the sector.

The expectation of the Fed raising rates towards the end of the 4th quarter in conjunction with accommodative Central Banking policy has strengthened the U.S. dollar. The strength of the U.S. dollar has been cited by many companies over the past year as weighing on earnings. In addition, yields on the short end of the treasury curve have been rising at a faster pace than the longer end, flattening the curve and squeezing net interest margins. Finally, regulatory action is also working against bank stock prices. Regulators are prohibiting many banks from buying back stock or raising dividends until stress tests reveal more favorable results. Now that consensus on the timing of Fed rate hikes is closer to 1-2 times during 2016, down from the initial 3-4 time, we have pushed back the recovery in the banking sector to some degree.

Financial stocks potential for dividend growth and lending activity tends to pick up in rising rate and rising dollar environments.

EXHIBIT IV

Treasury Yield versus Financial Sector Performance



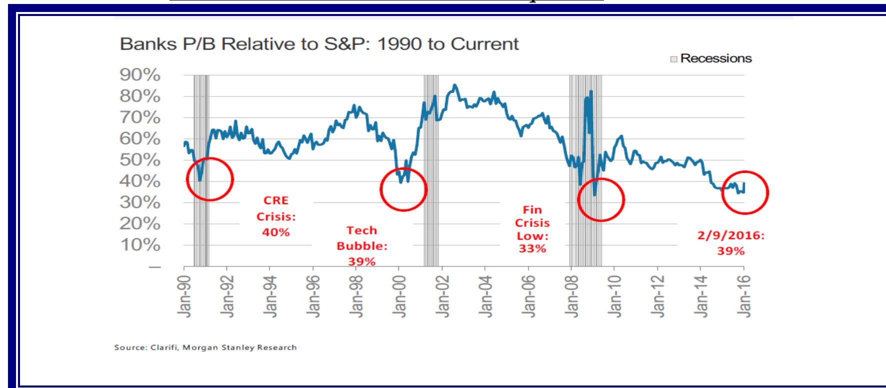
Source: Bloomberg and Altman Research

Bank stocks are trading at 40% of market multiples in comparison to prior cycle lows. We believe that value investors with long term perspectives will step up to the plate once there is evidence of Fed accommodation and the price of oil stabilizes. The chart below illustrates the relative outperformance of financial stocks against the 3 month Treasury bill rate. Based on free cash flow yield the banks trade at the cheapest ratio to the market at an average of 24% of their market capitalization or twice the rate experienced in the early 90s.

P/B levels are near recession levels, but the outlook for bank stocks has mostly upside for patient investors.

EXHIBIT V

Banks Price to Book - Historic Perspective



Source: Bloomberg and Altman Research

Although our time frame has been pushed out a bit, we continue to anticipate strong relative performance from the Financial sector, given not only the aftermath of restructuring and deleveraging, but also as we approach a slow and steady rising interest rate cycle.

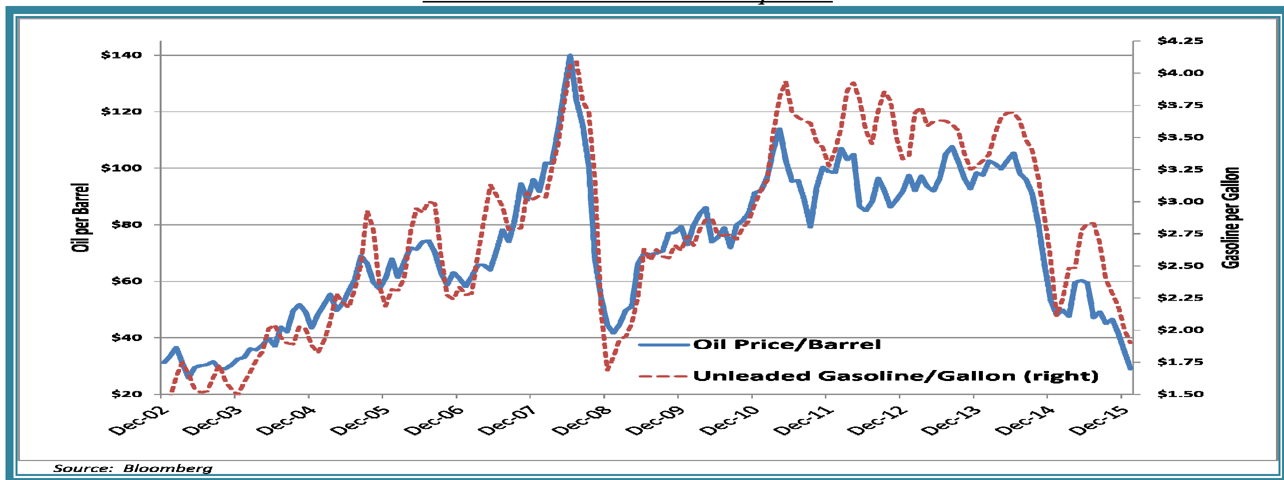
In addition, we brought our Energy sector weighting back up to an overweight in the portfolio. After the commodity (WTI) declined 37% during 2015, oil prices fell another 12% in January in part due to escalating tensions within the Middle East, global inventory builds, and waning Chinese demand. The most recent volatility is a result of escalating Saudi/Iranian tension. On one hand, prices could fall not only as sanctions against Iranian supply are lifted, but as the two countries may decide to increase oil production in attempts to gain market share. On the other hand, oil prices typically rise with escalating geopolitical pressures within the Middle East. But currently, the premium that is normally associated with rising tensions is being muted by oversupply. Although we expect volatility in oil prices to continue in the short term, we believe the fundamentals supporting demand growth are in place.

While we maintain our opinion that oil will ultimately rise above the $40 level, the time frame appears to have been pushed back as well and is weighing heavily on our more levered names. Rather than hold steady, we have increased our overweight position within Energy. However we have limited our direct exposure to the commodity and instead shifted allocations to companies with broader product scope and geographic diversification. In doing so, should oil drop into the mid to low $20's before returning to normalized levels, we'd expect the portfolio to perform better with names that can better withstand the downturn in prices levels.

The Impact of Deflation on the Energy and Financial Stocks

EXHIBIT VI

Oil and Gas Prices- Historic Perspective



Source: Bloomberg and Altman Research

Oil prices began eroding in the summer of 2014, along with what in retrospect was a record speculative long position in crude oil futures. Our positon at that time was that the decline was a net benefit for the U.S. economy - a big importer of oil. We noted that this drop in oil prices would be particularly beneficial for the consumer, who was hindered by lethargic income growth. Until mid-last year this benefit appeared to be a net positive for the stock market and helped keep the Fed policy accommodative. However, this decline materialized in what has been termed a "tipping point," where good deflation materialized into bad deflation.

To determine the "tipping point' one must examine the companies that produce the goods in question and determine when their balance sheets are compromised. At that point, the yield on their debt begins to rise and liquidity can dry up. Clearly this started to weaken commodity companies in 2014, but even the yield for investment grade corporate bonds started to rise in January 2015. That, in itself, was a real problem for commodity companies and showed up in the liquidity data. It is worth noting that while the banks are still extending consumer loans, they have tightened their standards. Although this credit contraction is nowhere near the magnitude experienced in the last three recessions, it is still a potential headwind to monitor.

For the stock market itself, the weakness in energy and commodity stocks was bullish for consumer stocks, so deflation had losers but still mainly winners. It is at the point when bad loans begin to hit the Financials that deflation becomes a real problem. Financial stocks' relative strength peaked in mid-2013, and went mainly sidewise until the summer of 2015.

Our conclusion is that an inordinate amount of capital is tied up in Financial stocks. This leads us to conclude that if Energy is a problem for Financials and the stock market, a bottom in Energy stocks would be a good sign. Energy stocks now appear to be substantially underweighted relative to the broad indices from a historic perspective. The recent decline along with other sentiment measures show Energy "oversold," Although we have concluded that this group is near the low, there is likely to be a period of adjustment before the group resumes normalized valuations.

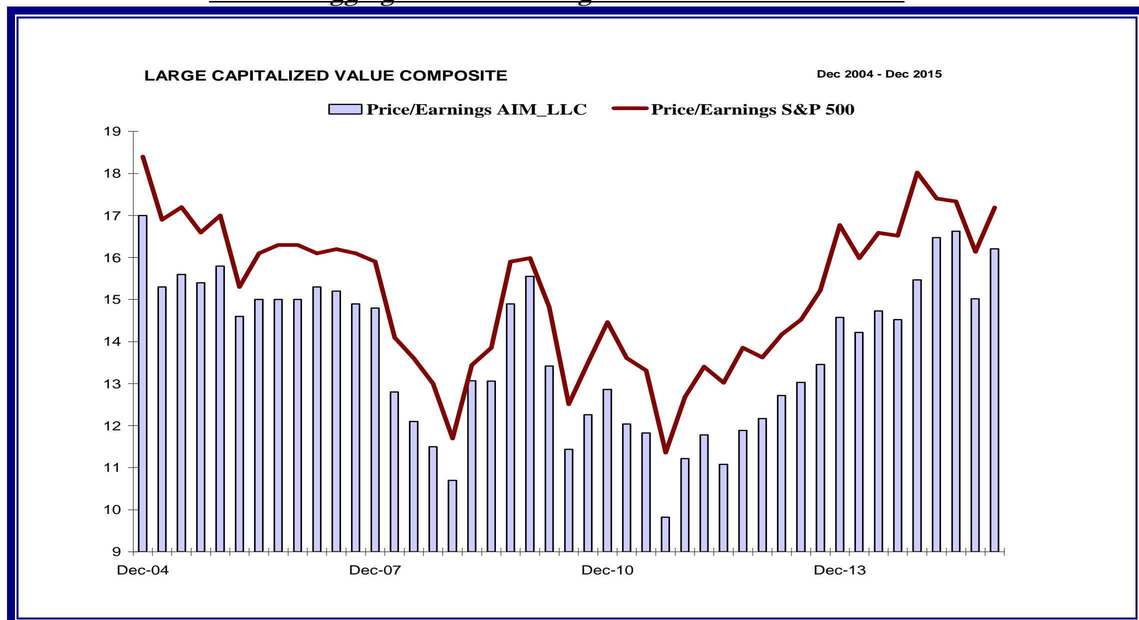
EXHIBIT VII

Valuation Metrics on a Sector Level

	SPX	Energy	Materials	Industrials	Con Desc	Staples	Healthcare	Fincl	Tech	Telecom	Utilities
# holdings	500	40	27	66	86	38	56	86	69	5	29
Beta	1.00	1.26	1.11	1.08	0.97	0.64	0.93	1.02	1.14	0.71	0.37
P/B	2.79	1.51	3.25	3.68	4.97	4.56	3.91	1.37	4.26	2.71	1.64
TTM P/E	18.15	17.92	16.70	16.27	21.62	20.43	21.76	14.59	18.90	13.63	15.86
P/E cur	17.19	19.44	16.70	16.31	20.32	20.76	17.23	14.66	17.08	12.66	15.97
P/E FY1	15.84	21.45	15.28	15.42	17.68	19.40	15.94	13.44	15.29	12.12	15.42
P/S TTM	1.79	1.17	1.40	1.53	1.53	1.29	1.86	2.21	3.39	1.37	1.59
Div yield	2.19%	3.79%	2.38%	2.32%	1.53%	2.70%	1.66%	2.12%	1.59%	5.17%	3.91%
P/CF	10.59	7.48	9.26	11.04	12.75	15.48	16.69	7.18	12.82	5.43	6.21

EXHIBIT VIII

Portfolio Aggregate Price Earnings Ratio versus The S&P 500



Source: Factset, Bloomberg and Altman Research

IN SUMMARY:

During the past year we have seen a growing disparity between the cheapest stocks and the most expensive stocks in the market. Our research shows that the spread between the growth and value sectors of the markets are more than three standard deviations above their five year average. The dilemma for most investment professionals is that these distorted valuations can be negative for stocks overall, or a signal to orient portfolios into value stocks and sectors that have underperformed recently. Narrowness in the leadership could also be a pre-condition of a negative indicator for the market direction, unless the breadth broadens out to include other sectors of the market on rebounds.

On closer examination of the traditional value areas like Utilities, Energy, Financials and Materials, these prominent sectors are still viewed to be in an unfavorable macro environment. Oil stocks may stay lower for longer and the recent flattening of the yield curve will have a negative impact on bank profits. Despite the observation that historically lower beta or value stocks generally hold up well during corrections, in this particular case a cautious stance is still warranted. We are encouraged to emphasize our hybrid approach focusing attention on new investment positions in growth companies at reasonable prices, the universe of companies that are cheap on a free cash flow basis.

The opinions expressed in this commentary are those of Altman Investment Management, LLC as of the date appearing on this material only and are subject to change. The material is based upon information we consider reliable but we do not represent that it is accurate or complete and should be relied upon as such. This material does not take into account the particular investment objectives, financial situation or needs of the individual client and should not be viewed as an endorsement of any particular investment. Certain investments give rise to substantial risk and are not suitable for all investors.