ALTMAN
INVESTMENT MANAGEMENT

EQUITY STRATEGY FOCUS

APRIL, 2016

IN FOCUS:

We have prepared this update in an effort to provide our clients with a macro overview of our current investment program. In addition, we have taken a closer look at specific market sectors/industries and the implications relative to our portfolio strategies. Our focus includes:

- Sector Winners and Losers
- Opportunities for Value Investors
- Earnings Expectations and Surprises

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

At the conclusion of the mid-March Open Market Committee meeting, Fed Chairwoman Yellen indicated that global economic and financial uncertainty pose risks to the U.S. economy and justify a slower pace of interest rate increases. Investor appetite for credit risk exploded during the quarter, pushing nearly every asset class in the fixed income markets skyward. The Fed's dovish response pointed to slowing growth in China, weak oil prices and accommodative global central bank policy. Market forecasters and the futures market are now suggesting that they need to push back their expectations for the Federal Funds Rate during 2016, with perhaps only one tightening move this year. Fed guidance continues to emphasize that future moves will be data-dependent with inflation and employment gains being key factors in their consideration.

Monetary policy alone lacks the ability to reach beyond avid investors or borrowers, therefore leaving out a potentially large portion of the economy in need of relief. In fact, U.S. fiscal policy has been a drag on GDP growth since the financial crisis. Similarly, state spending is at its lowest point as a % of GDP since the 1980s. Only recently have both Federal and State spending accelerated somewhat. While some strides have been made on both levels, we should not discount the impact strategic fiscal policy could have on the future of markets.

The counter to this argument, and rightfully so, lies the concern over increased fiscal policy and its impact on the level of U.S. national debt. After ballooning to 10% of GDP following the financial crisis, the Federal Deficit has been on a decline and currently rests below its historical level of approximately 3.5%. Indeed, this figure is double its level reached in 2000. But according to recent comments from the International Monetary Fund Monitor, "most of the debt accumulated since 2008 could be undone with one percentage point of additional real growth over the next decade." This statement underscores the need for strategic fiscal policy, i.e. targeting sectors in a way that supports growth and productivity overall. Targeted fiscal and monetary policies working in tandem have the potential to reinvigorate growth in an effective manner that provides support to financial markets

One of our main concerns has been the productivity of goods producing workers. We believe that one of the ways the government could help productivity would be to invest in infrastructure to improve efficiency in terms of the time to get to work and the time to move goods. Recent construction spending data released on Highways and Streets shows a 34% year over year increase and could be a big plus for the economy and improvement on productivity. This rebound could be related to the passage of the federal highway bill at the end of last year.

We have also been concerned that a very strong U.S. dollar has been a big weight on U.S. exports, and thus manufacturing construction, resulting in a continued drag on economic growth. The real trade weighted value of the U.S. dollar remains well above its average and trend levels of the last ten years. This suggests that the U.S. currency may still be fundamentally overvalued after its current slide this spring. Furthermore, the IMF recently forecasted that the U.S. current account deficit would be the equivalent of nearly 4% of GDP in five years' time exceeding the 3% threshold that the Peterson Institute for International Economics considers compatible with sustained external balance. Despite this apparent overvaluation we doubt there will be a significant change in the direction of the dollar given the likely contrast in the policies of the Fed and most other central banks. The recent decline has taken some pressure off the real economy and we would expect manufacturing production and exports orders to stabilize and show some improvement as we move into the second half of the year.

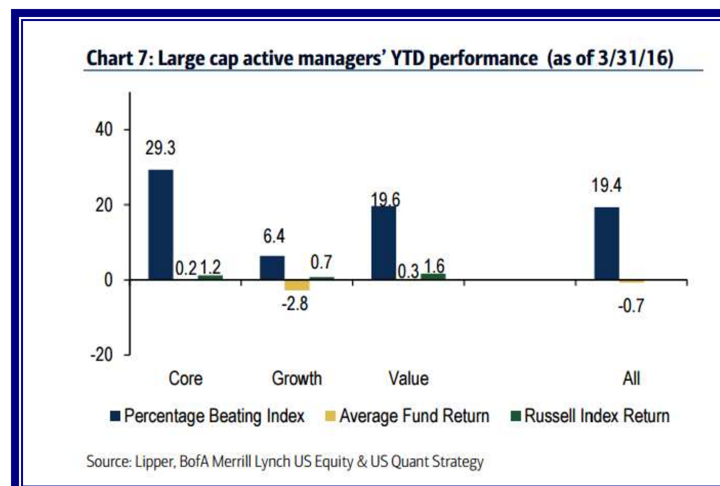
We expect GDP to begin recovering from the first quarter weakness with inflation still moderating. The low inflation figure reported reflects the rise in the U.S. dollar, and the deflationary pressure associated with dollar strength should begin to ease. Core inflation has actually been increasing throughout the OECD and encourages us to remain mildly bullish on U.S. economic growth.

The Equity Backdrop

- After rallying 13% off the bottom, U.S. stocks as measured by the S&P 500 outperformed small caps, non-U.S. Stocks and T-bills for Q1 2016. Gold and long term bonds outperformed in anticipation of rising inflation and a weaker USD.

- 2016 began on a challenging note for active managers as a whole, with only 19% of managers beating the Russell 1000 Index. Crowded trades (aka over-owned securities) were the most to blame as reversion to the mean took over and hindered the strongest stock performers in the recent past. Case in point, the 10 most crowded stocks underperformed the 10 least crowded stocks by nearly 7%.

EXHIBIT I
Large Cap Active Managers Snapshot



- The VIX (S&P 500 Volatility Index) climbed as high as 28 during Q1, and then settled back down in the low teens by quarter end. Value stocks tend to outperform during periods of heighted volatility. Value companies carry higher levels of cash on their books as compared to growth stocks which expand leverage in order to grow. We believe the market will continue to reward value companies amidst the current challenging credit cycle.

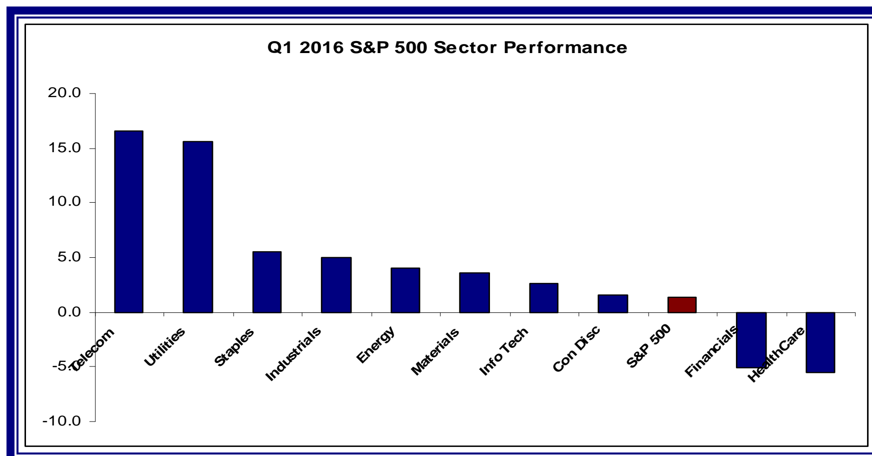
- Corporate earnings growth is expected to bottom during the first half and rebound in the second. Two prior drags on profit growth, low oil prices and a strong dollar, have since reversed course. In general, value stocks tend to pull ahead during periods of accelerating profits. Additionally, the two largest sectors in the Russell 1000 Value index are Financials and Energy. Energy has already rebounded sharply this year. However, the financial stock recovery has been less dramatic, as the Fed delays its interest rate increases awaiting improvement in the labor market and the tenuous state of the global rebound.

- The gap between reported earnings (GAAP) and adjusted (pro-forma) earnings continues to expand bringing into question the quality of earnings. To put this into perspective, FactSet estimates conclude that S&P 500 pro-forma earnings (based on figures that often exclude such items as restructuring charges, depreciation, and stock-based compensation) grew at a rate of 0.4% during 2015. But according to S&P Dow Jones Indices, S&P earnings on a GAAP basis actually fell by 12.7%, which is the steepest decline in earnings since the financial crisis. The gap is not only prevalent in the Energy sector given the dramatic drop in oil prices, but it is also evident amongst other sectors as well. Consequently, seeking earnings quality that incorporates reliable and relevant data continues to be a priority within our stock selection process.

CLOSE-UP: Equity Investment Overview

Benchmark Performance Highlights

EXHIBIT II
S&P 500 Index – Q1 2016 Sector Performance



Source: Bloomberg and Altman Research

- The S&P 500, our benchmark index, got off to a slow start finishing the first quarter up 1.35%. This follows strong Q4 performance when the market was up 7.03% - lifting the overall performance of the S&P 500 to end the year in positive territory.
- Earlier in Q1, it was defensive stocks that led the markets only to have the tide turn in favor of cyclicals after oil prices bottomed in February. Energy and Technology rallied in March, outperforming the benchmark by over 200 basis points. Material, Financial, and Industrial sectors also outperformed in March.
- Large cap active managers increased exposure to Consumer Discretionary, Industrial, Financial, and Consumer Staple sectors, while reducing exposure to Healthcare, Telecom and Utilities during Q1.
- Financials and Healthcare were the only two sectors underperforming the overall market during Q1. Big banks and pharmaceuticals/biotech companies were the largest contributors to their sector underperformance.

EXHIBIT III
AIM Composite – Q1 2016 Performance

	Sector Wgt. as % of Portfolio as of 3/31/2016	Relative Wgt. versus S&P 500 Index	1st QTR Total Return of AIM Composite	1st QTR Total Attribution of AIM Composite
AIM Composite			0.1	-1.2
Consumer Discretionary	9.7	-3.2	3.1	0.0
Consumer Staples	11.0	0.6	0.8	-0.5
Energy	10.5	3.7	0.2	-0.4
Financials	15.3	-0.3	-11.3	-1.0
Health Care	15.3	1.0	-4.8	0.0
Industrials	9.9	-0.2	8.8	0.5
Information Technology	19.2	-1.6	5.7	0.6
Materials	2.5	-0.3	-3.8	-0.2
Telecommunication Services	2.5	-0.3	15.5	-0.1
Utilities	2.5	-1.0	22.2	0.0

Source: Bloomberg and Altman Research

- Off the February 11th market bottom, the AIM composite out-paced the benchmark index by 55 bps helping to narrow the gap in performance against our benchmark index during the quarter. The AIM composite finished the first quarter up 0.13% versus the S&P 500 up 1.35%.
- Outperformance during the second half of Q1 was not surprising, due to our overweight in the Energy sector and stock selection within the Technology sector.
- Our top 5 attribution contributors during the quarter were Applied Materials, Accenture, Chubb, Baxter, and Oracle.
- Our bottom 5 attribution contributors were Mondelez, Express Scripts, Regions Financial, Bank of America, and Conoco Phillips.
- Year to date through April 20th, our AIM composite is leading the index by 177 bps.

EXHIBIT IV
Valuation Metrics on a Sector Level (as of 3/31/2016)

	Energy	Materials	Industrials	Con Desc	Staples	Healthcare	Fincl	Tech	Telecom	Utilities
# holdings	38	27	65	88	37	58	86	68	5	29
Beta	1.26	1.04	1.05	1.00	0.65	0.86	1.00	1.18	0.70	0.41
P/B	1.66	3.44	3.89	4.94	4.85	3.68	1.28	4.42	2.98	1.94
TTM P/E	19.94	17.40	17.09	21.20	22.17	20.21	13.92	19.03	15.40	18.39
P/E cur	30.50	17.75	16.52	18.61	21.50	15.38	13.64	17.05	13.92	17.88
P/E FY1	21.36	15.18	15.12	16.48	19.53	13.81	12.17	15.29	13.45	17.24
P/S TTM	1.37	1.50	1.59	1.52	1.36	1.66	2.08	3.33	1.56	1.92
Div yield	3.12%	2.30%	2.31%	1.58%	2.62%	1.75%	2.30%	1.60%	4.50%	3.47%
P/CF	8.78	10.00	11.43	12.52	15.82	14.79	7.53	12.83	5.84	7.03

Source: Bloomberg and Altman Research

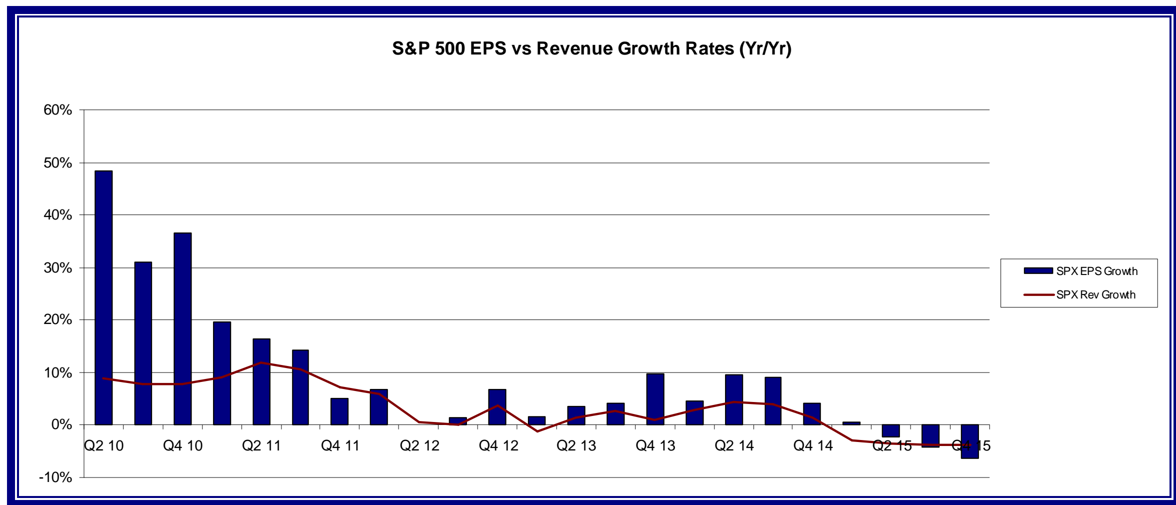
Equity Strategy

After Q4 earnings, the profits recession is continuing throughout the Q1 reporting season, but is expected to improve in the back half of 2016. The guidance ratio (above versus below consensus estimates), however, is in line with seasonal levels and has improved over last year. More specifically the guidance ratio is highest amongst multinational corporations over pure domestic plays.

EXHIBIT V

Earnings Expected to Reverse Quarterly Negative Earnings Growth

Data as of Q4 2015

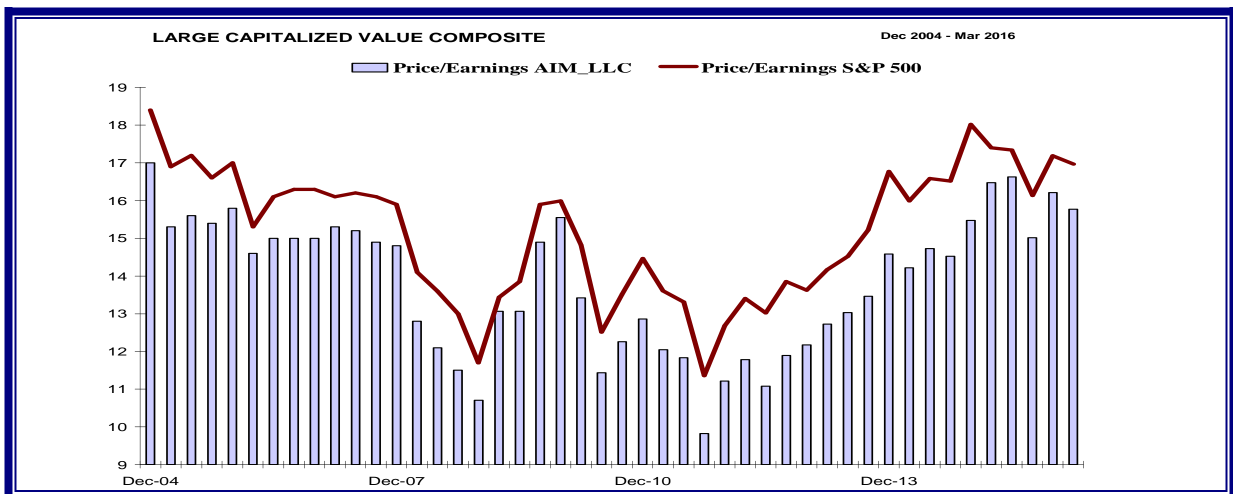


Source: Bloomberg and Altman Research

Now in the tail end of the Q1 2016 reporting season, nearly 88% of the S&P 500 has reported. Consensus estimates expect earnings growth of -7% y/y (-2% ex energy) and sales growth of -1%. Ex energy, sales are expected to come in +3% - a big improvement over the 1% and 2% ex energy sales growth reported over the past two quarters. All sectors, except Energy, Financials and Utilities, are seeing earnings surprises on the upside. As expected, high quality and multinational companies have received a larger share of beats on both earnings per share and sales.

EXHIBIT VI

Price/Earnings Comparison



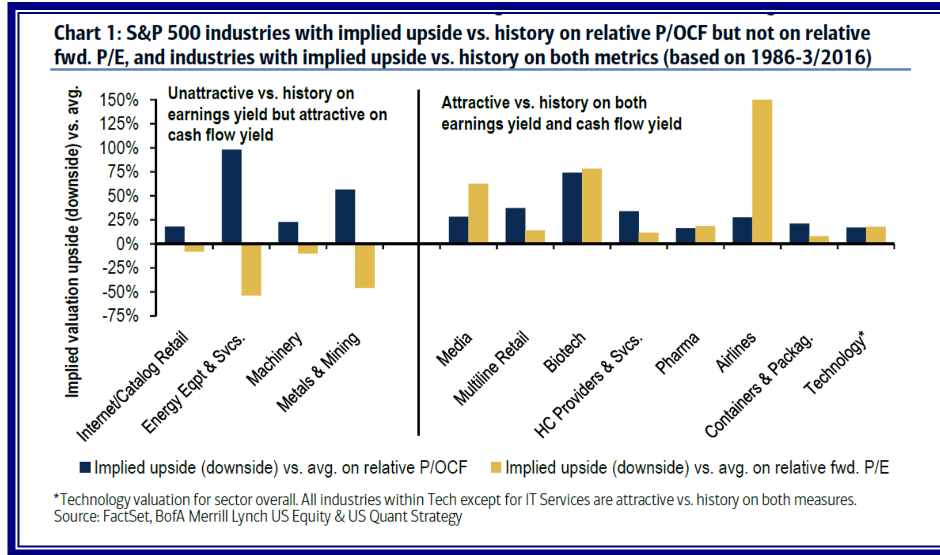
Source: Bloomberg, FactSet and Altman Research

The Market may be overvalued, but opportunities remain for Value investors. It is evident on many metrics (i.e. trailing and forward price to earnings, price to book, enterprise value to sales, price to earnings/growth rate, etc.) that the market as a whole has become expensive and is trading above its long term average multiples. After a closer look, we find that there are industries within the marketplace that still offer value across several metrics. Since there is always controversy surrounding earnings quality, it is important to consider metrics on a cash flow basis as well as earnings. Healthcare, Telecom and Information Technology sectors offer the most implied upside when measuring price to operating cash flow and price to earnings.

On an industry level, energy equipment, machinery and metals look cheap on a cash flow basis but not on earnings. Although we must point out that forward multiples within energy may be overstated given the current state of earnings. Technology, airlines, containers/packaging, media and multiple industries within healthcare look attractive on both metrics. Financial stocks, particularly banks, consumer finance and insurance, look cheap on both price to book and price to earnings. The takeaway here is that while investors must be cognizant of current market valuations, there are opportunities for Value investors who will benefit as metrics revert towards their mean historical averages.

EXHIBIT VII

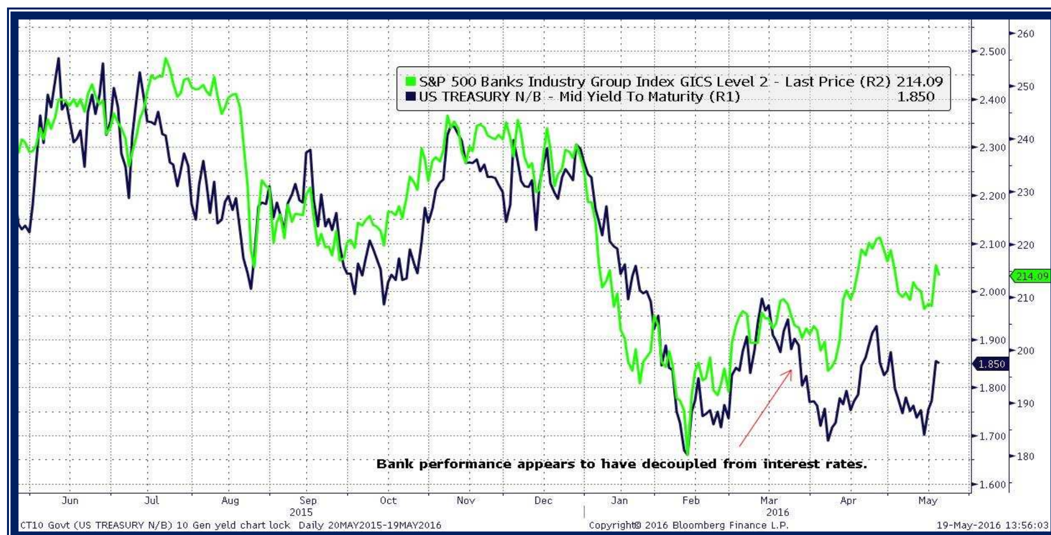
Cash Flow May Tell a Different Story than EPS



Energy-related loan defaults in the U.S. so far have remained in line with our expectation and largely contained within the high yield sector avoiding further hemorrhages into the general economy. Although spreads have widened for some investment grade bonds, we believe the energy and credit markets will prove manageable. Our analysis of the banking industry, also an overweight position in our portfolios, shows that most of the large banks have adequately provided reserves for marginal energy and commodity-related loans made during the period of higher energy prices. In general, the banks have demonstrated greater discipline in this cycle exceeding capital ratios and improving asset quality.

EXHIBIT VIII

Bank and Interest Rate Correlation



Source: Bloomberg and Altman Research

During this earnings season, the major banks reported earnings that were essentially in line with expectations. Announcements of both buy backs and the willingness to raise dividend payouts bolster our confidence in maintaining our expectation of improving profitability. We continue to believe that interest rates remain the primary driver of the financial stocks in the months ahead and will drive valuations higher (see Exhibit VIII). However, we have concluded that the trajectory of rate hikes in the U.S. is less certain following the recent FOMC comments, and have therefore moderately paired back our exposure to the credit markets in the shorter term. We are operating under the assumption that the markets are now pricing in one rate hike this year (at most two), and that U.S. banks could still outperform in this environment as long as net interest margins don't deteriorate from current levels.

EXHIBIT IX
AIM vs. Benchmark Characteristics

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AIM PORTFOLIO CHARACTERISTICS
As of March 31, 2016

	Value Equity	S&P 500
# of Holdings	38 stocks	500 stocks
Portfolio Beta	1.03	1.00
Wtd. Avg. Price to Book	2.05x	2.83x
Wtd. Avg. Price-Earnings (Current)	15.77x	16.97x
Wtd. Avg. Price-Earnings (FY1)	14.51x	15.22 x
Wtd. Avg. Price/Sales Latest 4 Qtrs	1.36x	1.80x
Wtd. Avg. Dividend Yield	2.54%	2.18%
Price to Cash Flow	10.52x	10.83x
Market Cap.	$100.0 Billion	$137.6 Billion
Ten Largest Holdings (% total)	34%	17%
Approx. Portfolio Turnover	30%-40% per annum	–
Maximum Cash Position	10%	–

Sources: AIM, LLC and S&P 500 characteristics are utilizing a Bloomberg as of March 31, 2016 for weighted average book value, price/earnings, price/cash flow, and price/sales figures.

Source: Bloomberg, and Altman Research

IN SUMMARY:

Our view has not changed over the past quarter. We continue to expect moderate U.S. economic growth, with real GDP advancing at an annual rate of 2.0-2.5% accompanied by additional employment gains and inflation trending slightly higher but remaining moderate. One Fed move this year, perhaps two rate hikes may still be an optimistic expectation for the year.

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