

## Brexit... A Turning Point?

### *Todd Large Cap Intrinsic Value Review*

	2Q 2016	YTD	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
Large Cap Intrinsic Value (Gross)	-2.4%	-5.1%	-9.3%	6.9%	8.7%	12.2%	6.3%
(Net)	-2.6%	-5.4%	-9.8%	6.3%	8.0%	11.6%	5.7%
S&P 500	2.5%	3.8%	4.0%	11.7%	12.1%	14.9%	7.4%
Russell 1000 Value	4.6%	6.3%	2.9%	9.9%	11.4%	14.5%	6.1%

\* Annualized Total Returns. Please refer to the attached Performance Disclosure for further information.

The LCIV discipline underperformed the benchmarks during the second quarter, declining -2.4% (gross) compared with the S&P index return of 2.5% and Russell 1000 Value index return of 4.6%. We continue to manage the strategy as we always have, blending attractive valuation with indications that earnings trends are solid and the market action is constructive for stocks. Over the past nine months, this has been cyclically out of favor, but we believe a recovery should be taking hold in the near future. We have seen the strategy underperform like this once before, during the internet bubble. Investor's desire for intrinsic value was diminished during that episode, and stock prices disconnected from fundamentals. That is what we are currently seeing as well. Following that episode, we went on to outperform the S&P 500 for eight of the next nine years between 2000 and 2008. We believe this episode could play out similarly.

Without a doubt, one of the largest geopolitical surprises of the past decade was the British vote to exit the EU. In hindsight, we probably should not have been surprised as populist candidates have been surging in the polls in most election contests we have seen recently. Following the election, the "Leave" camp leaders found themselves in the quandary of a dog chasing a bus. Namely, what to do once they catch it? They seem to not have thought that far ahead, and a power vacuum emerged as PM Cameron resigned and a new leader needed to be selected. That situation appears to be sorting itself out, as a new PM has been elected, but there are still many elements of uncertainty to play out in this drama. We think this could be a turning point for governments worldwide as they realize that unhappy electorates want growth oriented policies.

There were other notable developments besides Brexit in the quarter, including:

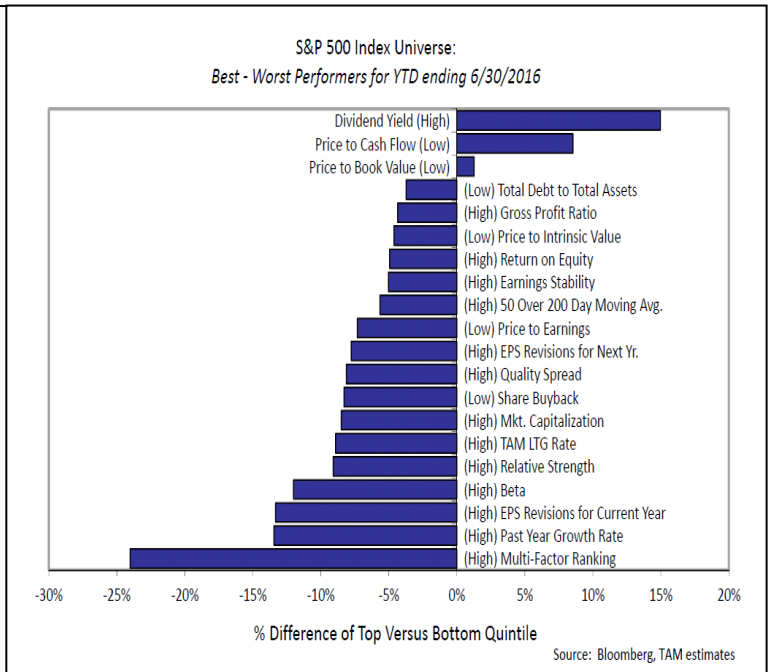
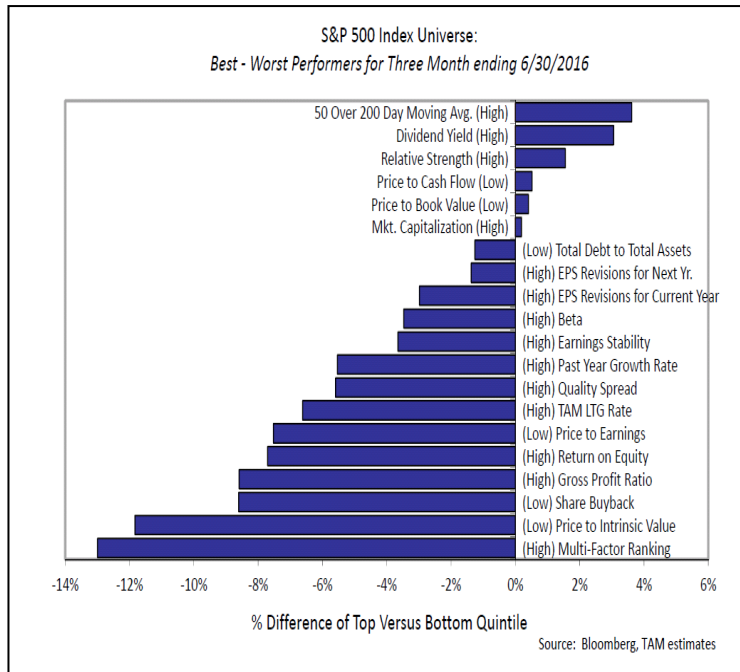
- Most major central banks left policies unchanged. The US Federal Reserve has been tiptoeing towards another rate hike, but economic developments seem to keep them on hold. The Bank of Japan surprised most investors when they left policy unchanged in April. They are currently considering several policies that amount to "helicopter money", i.e. fiscal stimulus directly to consumers to bolster the economy. The European Central Bank left rates unchanged after aggressive moves in March to bolster their economy. The Peoples Bank of China left rates unchanged as well.
- Market rates for bonds have plummeted post Brexit. Many European and Japanese sovereigns moved deeper into negative rates, and the U.S. 10 year government bonds briefly got to 1.35%, before recovering to the current rate of nearly 1.6%. Refinancing of mortgages has surged.

- Most governments are either stimulative or becoming that way. The U.S. has seen government spending go from a drag to a support for growth. China is pursuing more fiscal stimulus and just reported a modest upside surprise to GDP. Japan is on the path to becoming more stimulative. The British vote could push both the UK and Eurozone governments to adopt more growth oriented policies as their electorates are clearly unhappy with the low growth regimes they have been experiencing.
- Economic progress was uneven in the quarter. The IMF and World Bank lowered estimated 2016 growth. Other trends we have seen include:
  - Second quarter US GDP growth estimates firmed up to something at or above 2.5%.
  - Chinese GDP came in slightly ahead of estimates at 6.7% growth in Q2. The IMF actually raised their estimates of Chinese growth in the quarter.
  - Japanese growth estimates were cut by the government to 0.7% from 1.4% for the year ending April, 2017.
  - Estimates for British and EU growth are being re-evaluated by most investors, with an eye towards reducing them as a messy divorce gets underway.
- A poor May employment report for the U.S. concerned investors heading into the British vote, but a spectacular rebound in June employment led the US market to new highs.

Currencies generally behaved themselves during the quarter. Though many analysts are wondering why the Dollar has not strengthened more given the turmoil in Europe. The dollar and Euro remain in a trading range compared to each other. The yen has been very strong versus most other currencies, much to the dismay of their central bank. Our sense is the Dollar probably stays in the current range for the rest of the year. The Chinese currency has declined in value, but investors are not nearly as fearful of that as they were earlier this year.

While the Brexit vote will be what most investors remember about this quarter, we think in time it will be seen as a turning point for the EU. Since the financial crisis, European institutions have tended to take half measures when trying to improve economic activity. The ECB participated in the first round of extraordinary bank measures with the US and British central banks during the financial crisis. After this, they allowed their balance sheets to contract, draining stimulative policies from the market. While this was occurring, governments pursued austerity. Tighter monetary policies and austere government spending led Europe to weaker growth. The electorate in Britain has backed a populist movement to leave because of subpar growth and concerns about losing control of their borders. Other populist parties are rising in Europe. This may prompt those governments to pursue pro-growth policies like infrastructure spending and possibly employment, tax and entitlement reforms.

***What Worked... And What Didn't***



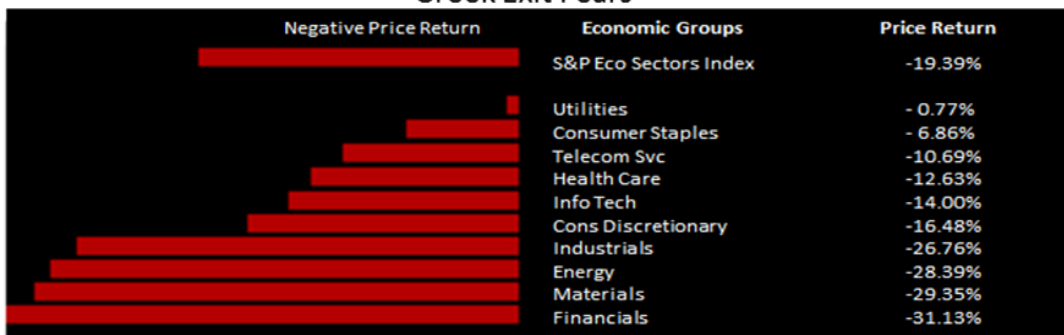
In the two charts above, we monitor how various attributes help or hurt market performance to see if the investors are seeking attractive value, earnings growth or something more concrete like dividends. The charts present this performance for the second quarter and year to date period. This chart measures how the best ranked 100 stocks on each measure compare with the lowest ranked 100 stocks within the S&P 500. The only factors that meaningfully worked thus far this year are High Dividend Yield and Low Price to Cash Flow (probably seen as a dividend support). ***For seventeen out of the total twenty factors we monitor, the best ranked names underperformed the worst ranked names!*** Historically reliable measures of attractive value, strong fundamentals or improving technical pictures did not work. Fear overrode reason, and the only factor the market rewarded was dividend yield. What was the worst performing factor? That was our proprietary multi-factor model that combines attractive valuation with improving fundamentals and attractive relative strength. ***In our opinion, this historically extreme reading is the primary reason for our underperformance this year and we believe it does not last much longer.***

Since July of 2015, the market's economic sectors have traded like they have in prior recession induced bear markets, pursuing a flight to safety. How do we know this? During the bear markets starting 2000, 2007 and the Greek exit (Grexit) scare of 2011, Consumer Staples, Telecoms and Utilities were consistent leaders (chart below). Generally, the best performing sectors outperformed the worst by 30-50% in the 2007 and 2011 safety trades. The performance advantage was even wider than that during the 2000 episode.

Where are we now? As you can see in the second chart, since July of 2015, Utilities, Telecom and Staples have been the sector leaders, and they have beaten the Energy and Financial sectors by over 30%. This is very similar to prior bear markets. The only difference between now and the prior episodes is that the S&P has not dramatically declined during this safety trade.

We believe as recession sentiment fades, our performance should recover. This episode seems to most closely resemble the 2011 Grexit worries. The current safety trade is already twice as long as that episode. As Brexit developments unfold and we get the uncertainty of U.S. elections out of the way, we believe fundamental measures will regain traction.

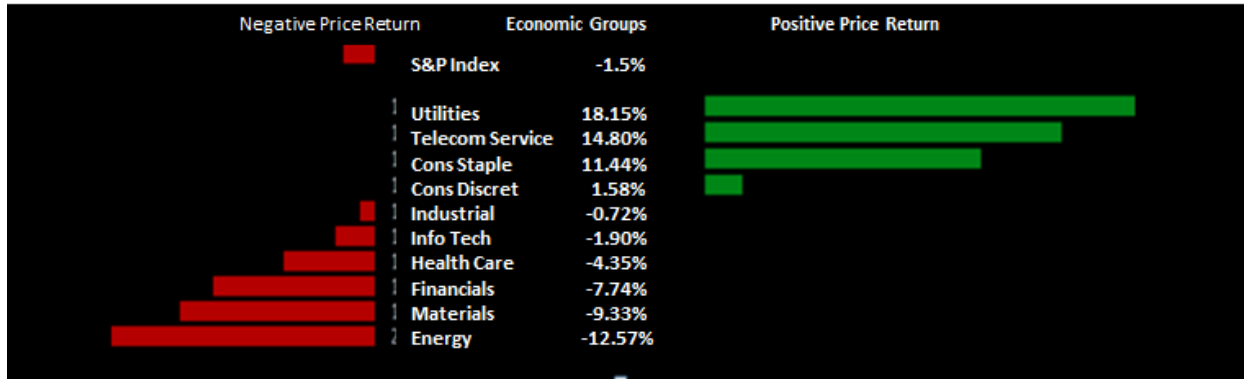
S&P Sector ranked returns 4/29/11 thru 10/03/11  
 Greek Exit Fears



Sector performance during the 2011 "Grexit" scare closely resembles current market action.

Source: Bloomberg

**S&P Sector Relative Performance 7/20/15 through 6/30/16**  
**A Flight to Safety Like in Bear Markets**



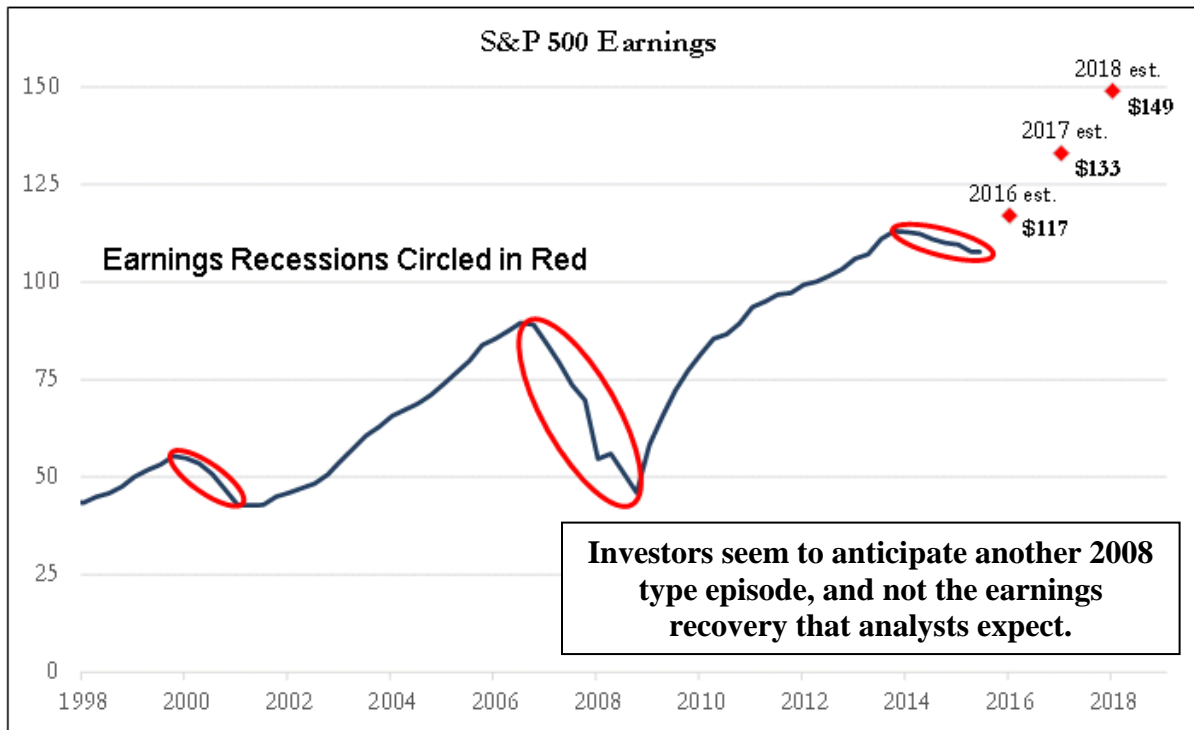
Source: Bloomberg

After the markets bottomed, the formerly leading sectors usually lagged and the laggards became the leaders over the year following the market lows. If that holds true this time, we would expect Financial, Health Care and Technology stocks to outperform post recovery. They are the economic sectors that have suffered over the past year that our discipline has favored. Energy stocks have been laggards as well, but our discipline is not directing us to them yet. We think the relative sector performance has already priced in a modest recession.

Can relationships get more stretched and see the “safe” sectors continue to outperform? Yes, if there is a recession. We do not think a U.S. recession is probable at this time.

We see several catalysts that could ease recession fears through the next couple of quarters, including:

- Energy prices have weakened since 2014, but are now stabilizing. The Dollar strengthened in 2014 and through early 2015, but has stabilized. Stability in those two key drivers of earnings should help guidance.
- The weaker Energy price and strong Dollar have prompted a U.S. earnings recession. We continue to expect a second half earnings recovery as those impacts lessen, illustrated in the chart below. Also, see our Chart of Interest titled, “It’s the Earnings Stupid!” available on our website.
- Growth has been sluggish worldwide. Central bankers are telling Governments that growth oriented fiscal policies are needed. The Brexit vote could prompt government spending programs and perhaps some supply side solutions.



Source: Bloomberg

Any number of other developments could change this situation as well. The uncertainty from the U.S. and other key elections worldwide should be resolved before year-end, just as the earnings recession is ending. All of these developments could help sentiment.

### **Performance Review**

The LCIV declined -2.4% (gross) in the quarter compared to an S&P return of +2.5%, and a return from the Russell 1000 Value of +4.6%. The last time we even approached lagging this much in one quarter was during 1999-2000 Internet bubble. Uncertainty related to the unexpected vote in Britain to exit the European Union compounded a negative bias investors have had to any stocks except those offering tangible dividends. We believe this safety trade is behind this underperformance and is extended. It appears that all market participants are searching for are dividends or dividend supportive characteristics. In our opinion, this suggests to us that the only buying that went on was driven by negative interest rates from Europe and Japan. If investors are being forced into stocks, they seem to be saying “give me some yield.” History shows these trends do not last forever, and we expect the market to broaden out in terms of the characteristics that are rewarded.

Markets know two sentiments, fear and greed. Fear has the upper hand currently despite the elevated level of the indexes. Our discipline is guiding us to sectors that have upside if we get better economic growth, and have done so for several years now. With the U.S. headwinds of a higher dollar and lower oil prices leveling out on a year over year basis, we think that the



earnings recession should be almost over which would prompt investors to pay attention to fundamentals.

Stock selection was the primary headwind for us in the quarter. Our analysis of the factors that helped performance versus the ones that did not pointed to only higher yield or attractive cash flow as adding value. Most other factors detracted. Sector weighting also cost us performance across most sectors.

We are overweight the Financials, Technology, Consumer Discretionary and Industrial sectors. At the end of the quarter, we were underweighted the Staples, Utilities, Telecommunications Service and Healthcare sectors. Most of the sectors we currently underweight versus the index are expensive and generally have slower earnings growth, which prevents us from paying up for them. An end to recessionary fears should also force some renewed focus on fundamentals.

Our top five contributors to return during the quarter were Nvidia, UnitedHealth Group, Altria, McKesson and F5 Networks. Nvidia has seen good acceptance of new products geared for autos and data centers, while their gaming graphics boards continue to dominate the market. UnitedHealth has decided to exit the public health exchange business in 2017, which prompted investors to buy the stock. Altria has benefitted from the demand for high dividend paying stocks. McKesson announced plans to joint venture their IT business into a new unit, and the market rewarded their stock. F5 Networks announced they were exploring finding suitors to acquire them.

Our worst five detractors from the portfolio were Delta Air Lines, Synaptics, Delphi, Carnival and Apple. Delta and the airlines have been pressured as investors fear high capacity additions, which could hurt future pricing. Synaptics has been penalized after guiding estimates lower on the competitive environment for their smartphone fingerprint scanning devices. Delphi Automotive suffered with the auto industry as investors fret about consumer finances and the potential for recession. Carnival also saw pressure for the same reason. Apple has declined as investors temper their expectations for the new iPhone 7 launches.

### **Review and Outlook**

We have not changed how we buy stocks. We look for stocks that are attractively valued, with positive earnings trends and constructive relative strength measures. In 2016, the primary attributes investors have sought are Dividend Yield and Price to Cash Flow (a ratio seen as supportive of dividends). Our average stock trades at less than 15 times earnings compared to the S&P's multiple of almost 20. Having attractive fundamental attributes has not helped performance yet this year. As investors get more comfortable with buying stocks, we believe they will return to favoring fundamental characteristics and our style should recover.

Investor concerns are being addressed one by one. The Brexit vote is out of the way. Several other European elections have been held, and most of the continent still seems to be committed to the European Union. The Japanese elections are out of the way, and Prime Minister Abe's



mandate for growth was renewed. U.S. elections are coming up, but we now know who the candidates are and will soon have a better understanding of how they will compete for the office. The Chinese stimulus program has been a question mark for some, but appears to be working. Commodity markets seem to have bottomed. Against all of this as a backdrop, the S&P 500 just broke out to a new high. It may be a scared market based on stock selection factors and sector winners, but we believe it will broaden out as the economic recovery in the US continues.

As always, we are here to assist you. If you need any additional information, please feel free to contact any of us.

Curt Scott, CFA  
Jack White, CFA  
Jack Holden, CFA  
Shaun Siers, CFA

Todd Asset Management LLC

7-20-2016  
S&P 500 – 2,173  
Russell 1000 Value – 1,041

***Refer to Performance Disclosure on the following page for more information on the performance numbers presented. These notes are an integral part of this letter and should not be reproduced or duplicated without these notes.***

This publication has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy, or investment product. Commentary may contain subjective judgements and assumptions subject to change without notice. There can be no assurance that developments will transpire as forecast. Information contained herein has been obtained from sources believed to be reliable but not guaranteed. No part of this publication may be reproduced in any form, or referred to in any other publication, without express written permission of Todd Asset Management LLC. © 2016.





## TODD ASSET MANAGEMENT LLC LARGE CAP INTRINSIC VALUE COMPOSITE DISCLOSURE

**Past performance does not provide any guarantee of future performance, and one should not rely on the composite or any security's performance as an indication of future performance. Investment return and principal value of an investment will fluctuate so that the value of the account may be worth more or less than the original invested cost.**

**Specific stocks discussed in this presentation are included to help demonstrate the investment process or as a review of the Composite's quarterly results and are not and were not recommendations for purchase or sale by investors. All or some of the specific stocks mentioned may have been purchased or sold by accounts within the Composite during the period, or since the period, and may be purchased or sold in the future. A complete listing of the holdings as of the period end is available upon request.**

Todd Asset Management LLC ("TAM") is a registered investment adviser. The performance presented represents a composite of tax-exempt fully discretionary intrinsic value accounts, invested primarily in large cap domestic equity securities with the objective to seek capital appreciation. This goal is pursued by investing in a diversified portfolio of equity securities that TAM believes are trading at a discount to their intrinsic value.

Todd Asset Management LLC, formerly Todd-Veredus Asset Management LLC began operations on June 1, 1998 as Veredus Asset Management LLC (VAM). Effective May 1, 2009, VAM combined with Todd Investment Advisors, Inc. (TIA). TIA (and its predecessors) was founded in 1967 by Bosworth M. Todd. Upon the combination of VAM and TIA in 2009, Veredus Asset Management LLC changed its name to Todd-Veredus Asset Management LLC (TVAM). On February 28, 2013, after a change in ownership involving some VAM unitholders, TVAM changed its name to Todd Asset Management LLC. The firm continues to offer the same strategies managed by individuals using the process founded under TIA.

The Large Cap Intrinsic Value Composite contains fully discretionary, tax-exempt accounts that use either the S&P 500 Index or Russell 1000 Value Index as the benchmark. Prior to April 1, 2010, this composite was known as the Relative Value Equity Composite; no changes in the strategy were made in conjunction with the name change. All fee-paying, fully discretionary portfolios under our management are included in a composite. Accounts are eligible for inclusion in the composite at the beginning of the first calendar quarter after the month of initial funding and upon being fully invested.

TAM claims compliance with the Global Investment Performance Standards (GIPS®). The Firm has been verified for the period January 1, 2008 through March 31, 2016 by Ashland Partners & Company LLP and for the period July 1, 1989 through December 31, 2007 by a previous verifier. TIA's compliance with the GIPS® standards has been verified for the period January 1, 1993 through April 30, 2009 by Ashland Partners & Company LLP. In addition, a performance examination was conducted on the Large Cap Intrinsic Value Composite for the period January 1, 2011 through March 31, 2016. To receive a complete list and description of TAM composites and/or a full disclosure presentation which complies with the GIPS® standards, please contact TAM at 1-888-544-8633, or write Todd Asset Management LLC, 101 South Fifth Street, Suite 3100, Louisville, Kentucky 40202, or contact us through our Web site at [www.toddasset.com](http://www.toddasset.com)

The performance information is presented on a trade date basis, both gross and net of management fees, net of transaction costs and includes the reinvestment of all income. Net of fee performance was calculated using the applicable annual management fee schedule of .60% applied monthly. Prior to September 2001, the management fee schedule applied to the composite was .50%. Actual investment advisory fees incurred by clients may vary. The currency used to calculate and express performance is U.S. dollars. All cash reserves and equivalents have been included in the performance.

The composite performance has been compared to the following benchmarks. The index(es) are unmanaged, and not available for direct investment; they include reinvestment of dividends; they do not reflect management fees or transaction costs.

**S&P 500 Index** is a widely recognized index of market activity based on the aggregate performance of a selected portfolio of publicly traded common stocks. The performance data was supplied by Standard & Poor's. It is included to indicate the effect of general market conditions.

**Russell 1000 Value Index** is a widely recognized index of market activity based on the aggregate performance of common stocks from the Russell 1000 Index, with lower price-to-book ratios and lower forecasted growth values. The performance data was supplied by Frank Russell Trust Company.