Special Situations

Portfolio Update: First Quarter 2019

The Special Situations strategy (the "Portfolio") increased +23.13% gross of fees (+22.81% net of fees) during the first quarter of 2019, outperforming both the +14.58% total return of the Russell 2000 Index and +13.65% total return of the S&P 500 Index. It felt good to get 2019 off to a strong start after last year's disappointing results. The Portfolio benefited from some of our worst performers in the fourth quarter bouncing back strongly, our decision to deploy available cash into "January effect" tactical trades, and successful individual stock purchases made during the quarter. We will discuss individual contributors and detractors in a moment.

	3 Months	YTD	1 Year	3 Years	5 Years	Since Inception (Annualized)
Special Situations Strategy	+22.81%	+22.81%	-4.37%	+8.51%	+4.82%	+11.60%
Russell 2000 Index	+14.58%	+14.58%	+2.05%	+12.92%	+7.05%	+11.74%
S&P 500 Index	+13.65%	+13.65%	+9.50%	+13.51%	+10.91%	+12.94%

Inception date: January 1, 2010. Performance is presented net of RMB Asset Management's maximum management fee and transaction costs. Performance is not net of RMB's Wealth Management advisory fee (if applicable). Please see important disclosures at the end of this document. Past performance is not indicative of future results, and there is a risk of loss of all or part of your investment.

Many of our holdings appreciated quickly to levels we believe no longer offer favorable risk/reward profiles, so we've trimmed or sold out of a number of positions, resulting in an atypical cash weighting of approximately 23%. We are constantly evaluating opportunities to redeploy cash and hope to bring cash back down to more normalized levels within the next couple of months. A byproduct of our sales is that the Portfolio is less comprised of cyclical and highly indebted companies, which along with the higher current cash levels, should allow it to hold up relatively well in the event of a market pullback.

The first-quarter market environment was a drastic reversal from what we experienced in the fourth quarter as the market rebounded dramatically. Continuing the storyline from the second half of 2018, domestic headlines were dominated by the trade war between the U.S. and China, with optimism around the likelihood of an eventual deal growing significantly. This increased probability of an agreement between the world's two largest economies comes at a time that economic data has shown more signs of slowing global growth. While the U.S. remains one of the strongest and most resilient economies in the world, there have also been recent domestic data points showing the U.S. is starting to slow from a very strong 2018. This slowing growth is reflected in interest rates that continued to fall, with the 10-year Treasury yield falling from 2.69% to 2.41% in the quarter and down from 3.05% two quarters ago. For a brief period in late March, the yield curve became inverted with the 2-year yield greater than the 10-year. This flat-to-inverted curve implies that the bond market views the probability of an economic recession over the next one to two years as being fairly high. A change in Fed policy has been impactful in the decline in rates as well. The Fed has done a complete reversal in its messaging to the markets over the past six months from three 25-basis-point rate hikes in 2019 to an increased likelihood of actual rate *cuts*. This comes at a time where near-term U.S. economic indicators have clearly slowed in the past few months but still remain quite strong by historical standards. Post quarter-end, the March jobs report released in early April remained healthy, helping allay near-term fears that growth was slowing more significantly. The dichotomy between the direction of the stock market and bond market on the future of the economy is remarkable.

Fourth-quarter earnings reports released in the first quarter remained relatively strong overall and helped revert the negative sentiment that had overtaken the market during the fourth quarter, particularly in December. Revenues and earnings continued to surprise positively, although there are concerns under the surface about the sustainability of revenue growth as well as profit margins, which are at or near historical peak levels. We believe first-quarter earnings, which are about to be reported as we write this letter, could be somewhat of a wakeup call as year-over-year revenue and earnings growth has decelerated dramatically, even when adjusting for end of the benefit lower corporate tax rates on earnings growth. Current consensus is for only 4% growth in operating earnings for the S&P 500 in calendar 2019. Given high levels of uncertainty around global growth, we'd expect management teams to remain on the conservative side when setting forward expectations, and we will watch closely for any change in management's tone toward demand for their products and services.

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Our message about overall equity valuations is much less constructive than we were just three months ago after the quick snapback in the market. While not overly expensive, especially given the lower interest rate backdrop, we are not finding bargains to be abundant by any means. From a bottom-up, individual company perspective, the Portfolio has more reward-to-risk ratios under one than it has greater than one. This is much different from where we stood at the end of December, which reflects the significant rebound in valuations in just one quarter. In fact, all of the market return in the first quarter came from multiple expansion, not increases in earnings estimates. When talking about market valuations, we also have to be cognizant of the fact that we are more likely than not in the late innings (if not extra innings) of a long positive economic cycle. While we don't necessarily see a recession as imminent, the probability has certainly grown. As we've discussed recently, the concept of "peak earnings" remains a debate these days that even if the U.S. doesn't roll into a meaningful economic recession, we could be close to the peak in corporate profitability given outside pressures on margins (particularly wage inflation) and weakening economies outside the U.S. As always, macro market predictions are very difficult to make, and we remain focused on opportunistic, bottom-up stock selection and less on the macro backdrop, looking for strong dislocations in individual stock prices that create distinct investment opportunities for the Portfolio.

Contributors and Detractors

Given the strong first quarter, contributors were numerous and sizeable, and there were no detractors of size during the quarter. Our largest contributor was Kinder Morgan Inc. (KMI), an owner operator of pipelines and energy storage assets. The stock reacted positively post its fourth-quarter earnings report and dividend increase, as well as being a modest beneficiary of increasing commodity prices. Versum Materials Inc. (VSM), a manufacturer of chemicals and industrial gases for the semiconductor industry, was the second-largest contributor. We purchased the stock in late January upon the announced merger of equals with peer Entegris Inc. (ENTG). We had prior knowledge of Versum and viewed the strategic and financial merits of the transaction favorably as well as the strong track record of integrating deals by Entegris' management team (who will lead the combined company) and seemingly little regulatory approval risk to the transaction. About a month after our purchase, Versum received a competing all-cash offer from Germany's Merck. We significantly cut our weighting in Versum after Merck's offer because Versum by then was trading above their offer price, it appeared Versum's board was going to stick with Entegris' offer, and Versum's stock price had approached our bull-case scenario.

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FIRST QUARTER 2019 CONTRIBUTION REPORT
Ranked by Basis Point Contribution

	Basis Point Contribution	Return
Top Contributors		
Kinder Morgan Inc. (KMI)	+186	+31.54%
Versum Materials Inc. (VSM)	+164	+37.49%
Skyline Champion Corp. (SKY)	+162	+29.34%
iRobot Corp. (IRBT)	+150	+42.34%
Signature Bank (SBNY)	+136	+25.12%
Bottom Detractors		
Ameris Bancorp (ABCB)	-23	-9.01%
Prestige Consumer Healthcare Inc. (PBH)	-20	-3.14%
Western Digital Corp. (WDC)	+2	+1.76%
L Brands Inc. (LB)	+5	+1.85%
DowDuPont Inc. (DWDP)	+5	+0.37%

Past performance is not indicative of future results, and there is a risk of loss of all or part of your investment. The above does not represent all holdings in the Portfolio. Holdings listed might not have been held for the full period. To obtain a copy of RMB's calculation methodology and a list of all holdings with contribution analysis, please contact your service team. The data provided is supplemental. Please see important disclosures at the end of this document.

Another name we quickly profited from was iRobot (IRBT). We purchased the robotic vacuum cleaner company in late January at $89 immediately after the company introduced its long-awaited robotic lawnmower. Although the global commercial launch will proceed slowly, we believe this third product category (in addition to the Roomba vacuum cleaner and Braava floor mopper) has the opportunity to eventually grow to a Roomba-sized opportunity. Growing excitement around the mower (named Terra) in addition to strong fourth-quarter results reported in February, caused the stock to rip. We began selling after the results at $116 and sold off the remainder of our position at $129 in early March as shares reached levels we thought offered limited further upside.

Conversely, our biggest contractor was Ameris Bancorp (ABCB), which we swapped into from First Foundation Inc. (FFWM) in late January because we felt Ameris was the higher-quality franchise with a better risk/reward profile that was set to benefit from industry consolidation activity in its Atlanta market. Ameris fell 10% from our buy point to quarter-end, as regional banks came under pressure following the decline in Treasury yields and a flattening (and inverting) yield curve. Prestige Consumer Healthcare Inc., an owner of branded consumer health products sold over the counter, was the second-largest detractor. The stock was under modest pressure after weaker fiscal third-quarter earnings. We continue to view the stock as undervalued and own it as an average-sized position.

Portfolio Activity

It was an especially active first quarter. As mentioned in last quarter's letter, we placed "January effect" tactical trades in late December and closed them out in the latter part of January. Our thesis that the worst performers of 2018 would outperform the market in the beginning of 2019 because of an abatement of pronounced tax-loss harvesting in late 2018 played out exceptionally well. Our equally weighted basket of 13 companies at ~1% position sizes each was up an average of +20.8% since our December 27 buy date and +18.6% since the start of the year, compared to +6.4% and +5.6% for the S&P 500 over the same time periods. The small-cap Russell 2000 was up +10.8% and +9.3%, respectively. As a side note, the January effect trades should be viewed as a one-off opportunity that is unlikely to be repeated in future periods. We viewed the setup going into 2019 as unusually attractive, and we would not expect this year's phenomena to necessarily occur or be as pronounced in most years. Although Special Situations buys stocks for fundamental reasons the vast majority of the time, it also has the flexibility in its mandate to pursue shorter-term trading opportunities such as this.

TOP FIVE HOLDINGS AS OF 3/31/19

Company	% of Assets
Kinder Morgan Inc. (KMI)	6.23%
PayPal Holdings Inc. (PYPL)	6.07%
Skyline Champion Corp. (SKY)	5.68%
Marvell Technology Group Ltd. (MRVL)	5.62%
Signature Bank (SBNY)	4.95%

Holdings are subject to change. Portfolio characteristics are intended to provide a general view of the entire portfolio, or Index, at a certain point in time. Characteristics are calculated using information obtained from various data sources. Past performance is not indicative of future results, and there is a risk of loss of all or part of your investment. The data provided is supplemental. Please see disclosures at the end of this document.

Besides the aforementioned purchases of Versum, iRobot, and Ameris Bancorp, we also established positions in L Brands Inc. (LB), Six Flags Entertainment Corp. (SIX), and Plantronics Inc. (PLT) during the first quarter. We view L Brands as a reasonably priced call option on a possible move to separate the thriving Bath & Body Works from the mightily struggling Victoria's Secret. An activist campaign increases the likelihood that investors benefit from attractive sum-of-the-parts valuation. Six Flags was purchased on a thesis that weakness at its international parks, specifically later-than-expected opening dates for its Chinese parks, was fully priced into the shares. We view the business as being fairly resilient and believe shares are well-supported by its 6.6% dividend yield. Finally, Plantronics was purchased as a transformative acquisition play following its $2 billion acquisition of Polycom, with our belief that shares were overly punished by a range of transitory factors prior to our purchase. We also think there are enhanced share price inefficiencies because only two sell-side analysts follow the company.

Other than the previously mentioned First Foundation and January effect sales, we sold out of Delphi Technologies PLC (DLPH), Allergan PLC (AGN), Beacon Roofing Supply Inc. (BECN), Universal Electronics Inc. (UEIC), and GTT Communications Inc. (GTT). We exited Delphi after a bounce in January given our concerns around the auto cycle and the company's mismanagement since its late 2017 spin. We sold Allergan after losing confidence in the strength of its Botox business, product pipeline, and diminishing prospects that the company would be broken up to realize shareholder value. Beacon was sold after it became increasingly clear industry roofing sales would be weaker for longer than previously anticipated, making it more challenging for the company to reduce their high levels of debt following their early 2018 Allied acquisition. We closed our Universal Electronic position near quarter-end after the shares significantly bounced as the company could face stumbling blocks in moving all its Chinese manufacturing capacity out of the country to avoid tariffs. GTT was sold after fourth-quarter results, which delivered strong synergies from its transformative Interoute acquisition but also disappointing organic revenue growth that will make important debt deleveraging more challenging.

Outlook

From when we last wrote you just three months ago, market conditions have spun a complete 180 degrees. We've gone from hyper volatility with high levels of fear to one of lower volatility and renewed optimism. The reversal of the Fed's messaging of future interest rate hikes to one where they may actually cut rates at some point in the next several quarters is a massive change. The upcoming corporate earnings report season that is about to kick off will once again refocus the market back on individual company fundamentals, which we think are decent for U.S. companies, but we have some areas of concern. Inflationary pressures from a tighter labor market, overseas demand levels, and the shorter-term impact from tariffs and rising energy prices will be areas of focus. Given a fair amount of macro uncertainty, we think management teams will continue to have an extra level of conservatism embedded in their 2019 guidance. Near-term U.S. economic data points have stayed reasonably positive although have decelerated from fourth-quarter levels. U.S. employment remains healthy with improving labor participation rates (however, with unemployment so low, increasing scarcity for skilled labor in various industries is a real problem as many job openings are going unfilled). Real wage growth should be positive for consumer spending, although winter weather, delayed tax refunds, and the government shutdown could have skewed short-term spending patterns. Consumers in the lower half of income levels should be healthier than they have been in recent years given rising wages and lower unemployment. These rising wages do present a challenge for corporate margins, which are already operating at peak levels. Business and consumer confidence remain at high levels, and we've seen capital investment increasing after several years of stagnant spending. If the trade war with China comes to some type of resolution, which has become current consensus thinking, the near-to-intermediate U.S. economic outlook may end up being better than what the bond market seems to be implying.

Overall, we have some reservations about the momentum in U.S. corporate earnings growth, which is the biggest long-term driver of stock prices. We all know 2019 earnings growth slows dramatically as the lower corporate tax rate anniversaries, but as mentioned earlier, there are other sources of risk to revenue growth and margins. Over the past two quarters, market earnings estimates for 2019 have fallen from 10% growth to around 8% to about 4% currently. The cycle of Wall Street earnings estimates being too optimistic and having to be ratcheted back is a recurring pattern the market typically sees through, but this is still a major reduction in growth expectations. With the overall market multiple reflating significantly after contracting in the fourth quarter, it now sits slightly under 17x, almost two points higher from a quarter ago. The long-term average for the market is around 16x, but given we could be nearing peak earnings, there may not be a whole lot of value implied in current market expectations. As always, we don't pretend to have any ability to predict where the market is heading in the short or intermediate term. Even with a generally favorable macro backdrop, we spend most of our time looking for highly opportunistic individual opportunities. A more volatile market can produce more of these on both the buy and sell side of the equation, thus the recent increase in overall volatility could improve opportunities for the Portfolio this year. Our strategy has several types of special situations that it gravitates toward, and it remains a good environment to look at corporate spin-offs and transformative mergers, which have remained abundant. We expect more of these to develop this year. Wall Street research breadth continues to shrink, helping create more opportunities in underfollowed securities; however, there have been fewer deep value and corporate restructuring opportunities as of late. As always, we will stick to a disciplined investment process and look for individual securities in many areas of the market that we feel are temporarily mispriced, offering us good risk-reward opportunities.

Thank you for the continued trust you place in us to manage your assets. If you have any questions, please do not hesitate to contact us.

Sincerely,

Todd Griesbach

Todd Griesbach
Portfolio Manager