Special Situations

Portfolio Update: Second Quarter 2019

The Special Situations strategy (the "Portfolio") increased +5.98% gross of fees (+5.69% net of fees) during the second quarter of 2019, outperforming both the +2.10% total return of the Russell 2000 Index and +4.30% total return of the S&P 500 Index.

	3 Months	YTD	1 Year	3 Years	5 Years	Since Inception (Annualized)
Special Situations Strategy	+5.69%	+29.89%	+1.52%	+10.06%	+5.63%	+11.93%
Russell 2000 Index	+2.10%	+16.98%	-3.31%	+12.30%	+7.06%	+11.66%
S&P 500 Index	+4.30%	+18.54%	+10.42%	+14.19%	+10.71%	+13.08%

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.

We were pleased that the Portfolio's strong first quarter for absolute and relative outperformance continued in the second quarter. Unlike the first quarter that benefited from thematic items, such as some of the worst performers in the fourth quarter bouncing back strongly and success with deploying cash into "January effect" tactical trades, the second quarter had no overriding theme to the outperformance, and it was largely due to company-specific factors. We will discuss individual contributors and detractors in a few moments.

Our cash weighting exiting the first quarter ballooned to approximately 20% as many of our holdings had appreciated to levels we believed no longer offered favorable risk/reward profiles, and in our last letter, we expressed a desire to pare down our cash levels over the ensuing months. Indeed, we purchased seven securities that, on net, brought our cash position down to approximately 10%. We feel the Portfolio is appropriately balanced across various market and economic factors, which we believe will allow it to hold up better than it did in the fourth quarter of 2018 in the event of a significant market pullback.

The second-quarter market environment was a continuation of the rebound from the late 2018 selloff with most major indexes approaching or exceeding new all-time highs. Keeping with last year's storyline, domestic headlines continued to be dominated by the trade war between the U.S. and China, with the pendulum swinging between optimism and pessimism around the likelihood of an eventual deal. This overhang comes at a time that economic data continues to show more signs of slowing global growth. The U.S. has remained one of the strongest and most resilient economies in the world over the past couple of years, although recent domestic data points are pointing to some deceleration post a very strong 2018. This slowdown has been reflected in the bond market with the 10-year Treasury yield falling 40 basis points from 2.41% to 2.01% in the quarter and down from 3.06% just three quarters ago. A flattish yield curve is telling us that the bond market is pricing in an increased probability of an economic recession over the next one to two years. The Fed has also taken a dramatic change in its tone with the market expectation for two to three 25-basis point *cuts* in 2019. Remember it was only a year ago when consensus for the Fed policy direction was multiple *hikes* going forward. It's quite remarkable how quickly we've gone from a hawkish to dovish environment, and we'll get another update on Fed policy on the last day of July. Thus far, the stock market has applauded lower rates, outweighing slowing economic data and the higher recession risk implied by the bond market.

First-quarter earnings reports released in the second quarter saw revenues and earnings continue to surprise positively vs. low expectations, although year-over-year earnings growth for the market as a whole was actually negative. While there continues to be concerns under the surface about the sustainability of revenue growth and historically high profit margins, the market has largely shrugged this off thus far. With second-quarter earnings about to be reported as we write this letter, we harbor some concerns about the forward outlook for the second half of 2019 and 2020. Current consensus is for about 4% growth in operating earnings for the S&P 500 in the second half of 2019 (bringing the full year to only +3%), with 12% growth in 2020. These estimates have been slowly revised lower over the past few months, and we wouldn't be surprised to see them notched lower again after the current round of reporting. Estimates for 2020 particularly look overly optimistic at this point. Given high levels of uncertainty around global growth, we would expect management teams to remain on the conservative side when setting forward expectations and will watch closely for any change in management's tone toward demand for their products and services.

Our message about overall equity valuations is consistent with how we felt at the end of last quarter. While not overly expensive, especially given an even lower interest-rate backdrop, we are not finding bargains to be abundant by any means. Equities have significantly rebounded from the big fourth-quarter selloff without any upward revisions in earnings estimates. Said another way, the market return this year has come entirely from multiple expansion. From a longer-term perspective, we also must be cognizant of the fact that we are, more likely than not, in the late innings of a historically long positive economic cycle. While we do not necessarily see a recession as imminent, the probability continues to grow, and the bond market is sending a strong signal. As we have penned recently, the concept of "peak earnings" has remained a debate these days that, even if the U.S. does not 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 with any hopes of being consistently accurate. We remain focused on bottom-up stock selection within a concentrated, yet diversified, portfolio of companies with asymmetric risk/reward profiles.

Contributors and Detractors

We were pleased that the largest contributors dwarfed the largest detractors during the quarter. Our largest contributor was Skyline Champion Corp. (SKY), a company we have held since January 2018 when Skyline and Champion announced they would combine to form the second-largest manufactured home company in the U.S. Skyline reported bullish fourth-quarter results in May. Besides handily beatings consensus earnings-per-share (EPS) expectations, the company bullishly commented about underlying consumer demand for manufactured homes, outlined favorable regulatory and government financing developments, and introduced an attractive long-term margin target. Our second-largest contributor was Marvell Technology Group Ltd. (MRVL), a networking and storage company. Sentiment around the stock is improving as its transformation into a network infrastructure company is coinciding with the dawning of the multi-year 5G buildout across U.S. carriers. The transition from 4G to 5G quadruples the content opportunity for Marvel's products. Our third-largest contributor was Kornit Digital Ltd. (KRNT), a digital textiles printer. The company is launching several innovative products this year that will allow it to print on dark polyester, have odorless ink, and work with large e-commerce customers who possess higher throughput needs. There is much optimism that Kornit will announce their first branded customer within the next six months, such as Nike or Adidas.

Conversely, our biggest contractor was Plantronics Inc. (PLT), a communications hardware company largely for enterprise markets. Alongside its first-quarter earnings report in May, the company offered fiscal 2020 guidance moderately short of consensus revenue and adjusted EBITDA[1] estimates. The

Special Situations
SECOND QUARTER 2019 CONTRIBUTION REPORT
Ranked by Basis Point Contribution

	Basis Point Contribution	Return
Top Contributors		
Skyline Champion Corp. (SKY)	+225	+43.77%
Marvell Technology Group Ltd. (MRVL)	+134	+20.15%
Kornit Digital Ltd. (KRNT)	+94	+32.28%
PayPal Holdings Inc. (PYPL)	+62	+10.23%
Fidelity National Financial Inc. (FNF)	+45	+11.12%
Bottom Detractors		
Plantronics Inc. (PLT)	-54	-19.10%
Cision Ltd. (CISN)	-44	-14.85%
DuPont de Nemours Inc. (DD)	-39	-9.75%
Signature Bank (SBNY)	-27	-5.22%
Viper Energy Partners LP (VNOM)	-21	-5.95%

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.

[1] Earnings before interest, taxes, depreciation, and amortization

disappointing guidance was amplified by its heavily levered balance sheet, though proceeds from a likely sale of its consumer business is expected to bring its net debt leverage ratio to in line with its 3.0x target within a year. Our second-largest detractor was Cision Ltd. (CISN), a provider of software and services that enable organizations to distribute, target, and track press releases. Management encountered setbacks in integrating sales forces from their Falcon and TrendKite acquisitions, which contributed to below-consensus second-quarter revenue guidance. However, organic revenue growth, the key metric we have been watching, is slowly accelerating and is tracking in-line with our original thesis. Our third-largest detractor was DuPont de Nemours Inc. (DD), which was spun out from DowDuPont (DWDP) in early June. DowDuPont came under some pressure in May largely due to concerns around its exposure to cyclical end markets and its outsized presence in international markets, which have shown signs of economic weakening.

Portfolio Activity

The second quarter was another active one, though not quite to the same degree as the first quarter, which featured the close out of the “January effect” trades. As mentioned earlier, we reduced our cash position to approximately 10% from 20% and did so via seven new purchases, partly offset by five sell-offs.

The seven new purchases were Argo Group International Holdings Ltd. (ARGO), Bausch Health Companies Inc. (BHC), Gardner Denver Holdings Inc. (GDI), iRobot Corp. (IRBT), KAR Auction Services Inc. (KAR), Masco Corp. (MAS), and Verra Mobility Corp. (VRRM) We purchased Argo because we are optimistic that an activist campaign will create value in what is already a high-quality specialty property & casualty insurer. There is a chance the company gets acquired, which would be a continuation of a trend seen across its peer group. Even if the company isn’t purchased, we are confident the stock has limited downside risk given its cheaper valuation relative to close peer W.R. Berkley Corp. (WRB). Meanwhile, Bausch Health fits into the classic turnaround bucket. Formerly known as Valeant, the company has made significant progress in strengthening the balance sheet through asset sales and refinancing. It has also returned to organic growth because of the Bausch & Lomb and Salix franchises, together approximately three quarters of revenue. If EBITDA can grow on plan with its three-year targets of 5–8% annually, then significant value should accrue to shareholders. Gardner Denver is a transformative acquisition story as this industrial and energy pumps and fluids provider combines with Ingersoll Rand’s industrial businesses in a merger of equals. There exists substantial opportunity to improve Ingersoll Rand’s below-potential margin profile, generate revenue and cost synergies given the overlapping and complementary product portfolio, and diversify away from less-attractive upstream energy and European markets. This could be a multi-year holding for us as synergies are captured and the combined company works to earn higher valuation multiples commensurate with its improved margin profile, reduced cyclicality, and less-levered balance sheet.

TOP FIVE HOLDINGS AS OF 6/30/19

Company	% of Assets
PayPal Holdings Inc. (PYPL)	6.28%
Royal Caribbean Cruises Ltd. (RCL)	4.87%
Skyline Champion Corp. (SKY)	4.48%
Prestige Consumer Healthcare Inc. (PBH)	4.38%
Fidelity National Financial Inc. (FNF)	4.15%

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.

We repurchased iRobot in May after it sold off significantly following its disappointing first-quarter earnings report in April. Recall we had purchased shares in late January following the company’s introduction of its third major product category—robotic lawnmowers—and sold out of our position in early March when shares quickly rallied to our desired sell price. First-quarter results were negatively impacted by tariff-related demand pull-forward into fourth-quarter 2018 and lost sales momentum ahead of expected third-quarter product launches of its latest and greatest Roombas (robotic vacuum cleaners). However, we remain comfortable with the core business and are excited by the full lawnmower launch (named Terra) in the U.S. next year, so we were pleased with the opportunity to buy back shares at a slightly higher price than what we paid in January. Additionally, we purchased KAR Auction Services during “when-issued” trading, ahead of the company’s spin off of their salvaged car auction business IAA Inc. The leftover whole-car auction businesses is not as sexy as IAA because of its lower long-term growth prospects and lack of a highly valued public peer—CoPart, Inc. (CPRT). However, we felt that KAR was being overlooked and sufficiently cheap to warrant purchase, especially considering it possesses sound quality characteristics and operates within a duopolistic market structure. Our Masco buy reflects the valuation re-rating opportunity we see from the expected sale of its lower margin and more cyclical cabinets and windows businesses. Once they are sold over the next six months or so, what will remain are relatively high-quality, high-margin plumbing and paint businesses. As likely sale dates approach, investors are increasingly likely to compare Masco to best-in-class peers such as Sherwin Williams, which carries significantly higher valuation multiples. The last new buy was Verra Mobility, which is an underfollowed niche business early in the discovery process by investors. The toll road transponder and speed/red light camera operator recently came public via a special-purpose acquisition company (SPAC) structure, which generates a lot less attention than a traditional IPO. In meeting with the management team, we were attracted to the mid-single-digit growth and high recurring revenue profile, and we believe the stock offers an attractive risk/reward profile.

The five sales were Corteva Inc. (CTVA), Dow Inc. (DOW), Gibraltar Industries, Inc. (ROCK), Kornit Ltd. (KRNT), and Versum Materials, Inc. (VSM). Dow and Corteva were spun out from DowDuPoint (DWDP) in June and April, respectively, and we sold out of both shortly after their respective spins. We felt the third piece of the pre-spin business—DuPont (DD)—was the highest quality and most attractive, and we have retained our position there. With Dow, we were fortunate that the shares rallied in the first two weeks post-spin, and we sold near the highs before the stock began to sell off.

We moved on from Gibraltar not too long after we learned that the CEO at the time, Frank Heard, was going to retire. A big part of our thesis on the company was that it would use its strong balance sheet to make a transformative acquisition, onto which it would employ its 80/20 toolkit to extract shareholder value. Frank's departure significantly reduces the probability of such a transaction, so we sold our position. Although we continue to like the fundamental prospects for Kornit, our original oversold thesis fully played out and shares had more than doubled from our initial purchase in August 2017. We would welcome a temporary company setback that would afford us an opportunity to buy back shares at lower levels. The final sale to note was Versum, which resulted from the February announcement that the firm would be acquired by Germany's Merck KGaA for $53 per share in cash. We were confident that Versum would not receive a superior offer—and has not yet as of this writing.

Outlook

From when we last wrote you three months ago, market conditions have remained about the same with the addition of further declines in long-term interest rates and an increasingly accommodative Fed. Market volatility has dampened somewhat, although picked up late in the quarter heading into earnings season. 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 generally 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 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, consistent with the tone that we got last quarter. Near-term U.S. economic data points have generally been decent, although they have decelerated from first-quarter levels. Employment in the U.S. remains quite 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 and consumer confidence should continue to be positive for consumer spending. Consumers in the lower half of income levels should be healthier than they have been in recent years given rising wages and very low unemployment. Rising wages do present a challenge for corporate margins, which have been at or near peak levels. Business confidence remains at high levels, although well off peak, and we have seen some signs that capital investment is no longer accelerating. Much of this near-term slowdown and uncertainty could be attributable to the trade war with China, thus some type of resolution could improve the near-to-intermediate U.S. economic outlook. We can't ignore that 2020 is a presidential election year and any type of stimulus to help the economy, including a trade deal, can have an impact on the election.

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 knew that 2019 earnings growth would slow dramatically as the lower corporate tax rate hit its first-year anniversary, but, as mentioned earlier, there are other sources of risks to revenue growth and margins. Over the past three quarters, market earnings estimates for 2019 have fallen from 10% growth to about 3% growth currently. The cycle of Wall Street earnings estimates being too optimistic and having to be ratcheted back is a recurring pattern that the market typically sees through, but this is still a major reduction in growth expectations. With the overall market multiple having re-inflated from 2018 year-end levels, it now sits a bit under 18x 2019 and 16x 2020. The long-term average for the market is around 16x, but given we may be nearing peak earnings, there might not be a whole lot of value implied in current market expectations. As always, while we may opine on our view of the overall market, we do not pretend to have any ability to predicting where the market is heading in the short or intermediate term. Market timing is a very difficult, if not impossible, task to add value with. We continue to focus the Portfolio's efforts on opportunistically owning companies with asymmetric risk/reward profiles. If we see there is a dearth of opportunities, we have the flexibility to hold some cash until we uncover them, as was the case in portions of the first and second quarters.

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
Portfolio Manager

James Krapfel
Portfolio Manager

Past performance is not indicative of future results, and there is a risk of loss of all or part of your investment. The opinions and analyses expressed in this letter are based on RMB Capital Management, LLC's ("RMB Capital") research and professional experience, and are expressed as of the date of our mailing of this letter. Certain information expressed represents an assessment at a specific point in time and is not intended to be a forecast or guarantee of future performance, nor is it intended to speak to any future time periods. RMB Capital makes no warranty or representation, express or implied, nor does RMB Capital accept any liability, with respect to the information and data set forth herein, and RMB Capital specifically disclaims any duty to update any of the information and data contained in this letter. The information and data in this letter does not constitute legal, tax, accounting, investment, or other professional advice. The information provided in this letter should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in the Portfolio at the time you receive this letter or that securities sold have not been repurchased. The securities discussed do not represent the entire Portfolio and in the aggregate may represent only a small percentage of their holdings. It should not be assumed that any securities transaction or holding discussed was or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein. A complete list of security recommendations made during the past 12 months is available upon request. An investment cannot be made directly in an index. The index data assumes reinvestment of all income and does not account for fees, taxes or transaction costs. The investment strategy and types of securities held by the comparison index may be substantially different from the investment strategy and types of securities held by your account. The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. It includes approximately 2000 of the smallest U.S. equity securities in the Russell 3000 Index, based on a combination of market capitalization and current index membership. The Russell 2000 Index represents approximately 10% of the total market capitalization of the Russell 3000 Index. The S&P 500 includes 500 leading companies in leading industries of the U.S. economy. The S&P 500 focuses on the large-cap segment of the market and covers approximately 75% of U.S. equities.