STERLING CAPITAL MANAGEMENT, INC.
Registered Investment Advisor

2015 Year-End Commentary

"How poor are they that have not patience!"—Iago to Roderigo in Shakespeare's *Othello*

My recollection of the context of this quote is somewhat hazy, but it appears that Iago may have been making a case for value investing, which requires the ability to wait patiently for the market to re-price undervalued stocks. History has shown that this market strategy works, but the last few years have been rough ones for its practitioners, including Sterling Capital Management. 2015 was particularly trying. In fact, many value investors have been no doubt tempted to respond to Iago's exclamation by wailing: "Poorer still are we that *have* patience!"

Performance. On a total return basis, the S&P 500 gained about 1.4%, considerably exceeding the performance of Sterling Capital's equities, which were down on the year. But the S&P's slight gain masks the weakness in the overall market. Because the S&P is capitalization-weighted, the performance of a few large stocks can cause pronounced moves in the Index. This year, four large-capitalization stocks (Google, Facebook, Netflix, and Amazon) powered the market into positive territory. Without these stocks, the S&P would have lost around 3%.

Growth vs. Value. The fact that these four large-caps are also growth stocks (three of the four trade at *triple-digit* price-earnings ratios) is not a coincidence. As we discussed in our August client letter, the performance of the 2015 stock market was characterized by a sharp dichotomy between growth and value stocks. The performance of the S&P 1500 Pure Value Index vs. the performance of the S&P 1500 Pure Growth Index illustrates the point.

The Pure Value Index, comprising the 350 or so stocks with the lowest price-to-book, price-to-earnings, and price-to-sales ratios, lost 10.4% on a total return basis. Its Pure Growth counterpart, populated by high-priced momentum stocks, gained 2.1%. Such a disparity is certainly eye-catching, but even more surprising is that the worst-performing companies in the value universe were those with the highest earnings quality. According to Dartmouth Professor Ken French, among the 20% slice of all publicly traded companies with the lowest price-to-book ratios (the least expensive companies), the poorest performers by far were those with the highest net profit margins. These most reasonably priced, most efficiently run companies fell 50% in 2015. Another analyst summarized French's findings pithily: "Value Investing: The Pain Train Has Arrived and It Sucks."

Adding to the frustration of value investors was the poor performance of dividend-paying stocks. The highest-yielding 50 stocks in the S&P 500 at the beginning of 2015 fell 14.6%. Stocks in the S&P that paid no dividends rose an average of 3.9%.

This divergence in performance between growth and value stocks explains much of Sterling Capital's underperformance this year. But we certainly acknowledge that the earnings of some of our companies fell well below our expectations. We were among the universal consensus of analysts and investors who anticipated that the Saudis would adhere to their longstanding policy of adjusting production to maintain stable oil prices. Their decision to flood the world with oil, sending prices spiraling downward, caught us by surprise. As a result of this decision, earnings in the energy sector receded and our energy holdings took a beating. Another mistake was our conclusion that Wal-Mart's consistent earnings record, reasonable valuation, and respectable yield relative to the 10-year Treasury would provide support for the stock in the event of an earnings disappointment.

Despite the underperformance of our portfolios this year, we do not believe it is time to throw in the towel on value investing. Although value stocks have substantially outperformed their more expensive counterparts

over the long haul (at least since 1926), there have been a handful of periods, generally lasting from 1 to 3 years, in which growth has outperformed. Following each of these periods, value stocks have recovered and moved to new highs versus growth stocks. Value stocks' performance relative to that of growth stocks has been bumpy since 2007, and they have substantially underperformed growth stocks the last two years. History and common sense suggests they will recover, although picking a date for the resumption of value's outperformance cannot be done with confidence.

Because of the weakness in both the U. S. and overseas economies, corporate sales growth has stalled, heightening the allure of the small group of companies still generating strong revenues. Investors have piled into these stocks, driving the price-to-sales and price-to-earnings multiples to exorbitant, unsustainable levels. At some point, these excesses will correct, and more and more investors will return to reasonably priced companies. An improvement in global economic conditions would hasten the return of the outperformance of value stocks.

A Quick Look at a Few Stocks. Of course, we continue to evaluate the fundamentals of our companies. Just because a stock's price has fallen to low levels does not make it a value stock, and we will remove stocks from the portfolio if their prospects begin to dim. But we believe the stocks in your portfolio are currently undervalued. Here is a look at just a few. Perhaps these brief summaries will give you an idea of some of the attributes we seek in an investment candidate and why we are maintaining positions in stocks that underperformed last year.

Ceco Environmental Corporation (CECE)
CECE, which manufactures equipment for the power and petrochemical industries with a strong focus on air pollution control and other environmental protection systems, fell hard in 2015 despite substantially increasing cash earnings. The market punished the stock apparently because most of its growth came from acquisitions rather than from existing operations. Economic turbulence in China, where it has expanding operations, and fears that the weak oil market will erode the budgets of its industrial and energy customers were also likely factors.

We believe these concerns have been more than fully reflected in the stock price. Excluding the write-off of a portion of its goodwill from acquisitions, which does not affect cash earnings, CECE sells at a depressed p/e ratio of around 7X anticipated 2016 earnings, much cheaper than it has traded in the last three years. Its peers trade at multiples more than twice as high, which gives us confidence that CECE's multiple will expand. There is certainly a risk that issues in integrating recently acquired companies will pressure margins, but the company so far has done a solid job of improving efficiencies in its new businesses.

In our view, CECE is poised to deliver strong growth when the global economy improves. Its presence in China brings near-term risks but also presents the company with prospects for accelerating future growth, given the country's energy needs and pressing environmental concerns. The low P/E multiple and hefty 3.4% dividend should provide downside support while we wait for the world's economy to strengthen.

Landec Corporation (LNDC)
Another one of our holdings that retreated last year was Landec Corporation, which focuses on developing products that promote healthy living, an objective with growing public appeal. The company has failed to meet earnings expectations during the current fiscal year, largely because of the deferral of purchases by a large customer who experienced inventory issues and rainy weather that increased vegetable costs. But we believe the longer-term outlook is still very promising. Landec's primary business is packaging fresh vegetables for sale in grocery and club stores nationally. One of the early movers in self-contained fresh vegetable salads, Landec's proprietary packaging technology to preserve freshness has helped the company become one of the leaders in its category. Sweet Kale Salad is its top-selling product.

Landec also holds a 27% stake in Windset Farms, the largest hydroponic greenhouse grower of vegetables in North America. We have visited their state-of-the-art facilities in California twice and have come away impressed with the massive size of the complex as well as the technological leadership and attention to detail that have made Windset a global leader in the field. Greenhouses have a number of advantages over traditional farming, including energy efficiency, less use of water, and less reliance on weather conditions, all of which position the company for strong growth.

Another of Landec's profitable businesses is Lifecore, which supplies fermented hyaluronic acid for cataract surgery, orthopedics, drug delivery, and aesthetics. As baby boomers age, Lifecore's products should experience increasing demand. In our opinion, the Lifecore operations are not being fairly valued by the stock market, and we would not be surprised to see them spun off to shareholders, an event that could unlock the operations' unrealized value.

Landec's earnings in the next fiscal year are expected to grow sharply (consensus analyst estimate of $.87 per share) vs. their earnings of the current fiscal year, which ends this May (estimate of $.56 per share). Despite this projected earnings growth, the stock trades at 13X next year's estimate and less than 3X its tangible book value, which does not include the value of its patents. With a very manageable debt load (the company's debt-to-total capitalization equals just 17%), we believe the company will be able to withstand short-term setbacks and deliver healthy long-term growth.

National Oilwell Varco (NOV)
One of Sterling Capital's energy holdings, National Oilwell Varco, the world's leading manufacturer of oil drilling equipment, fell sharply in 2015 as oil producers reduced their capital equipment budgets in response to falling oil prices. As a result, the stock, now around $30 per share, yields a hefty 5%. The softness in NOV's markets may persist for another several months, but drilling equipment budgets will have to be increased eventually to replace deteriorating equipment. Rising oil prices, caused by the expected dip in production, could trigger sharp growth in NOV's revenues. Unlike many companies in the energy sector, NOV is not in financial distress and in fact has publicly announced its intention to pursue acquisition opportunities, which will likely be available at buyers' prices.

The decline in oil prices has persisted much longer than Sterling Capital anticipated, and hindsight certainly reveals that hanging on to NOV was a mistake. But in our opinion, selling now would compound the error. NOV has the balance sheet to capitalize on oil's collapse, and this leading company's competitive position should be even stronger in the future.

Par Technology (PAR)
Our experience with Par Technology has not been a particularly profitable one so far, but recent developments are encouraging. Last year, the company sold an unprofitable technology solution, enabling it to focus on its main business lines. The sale immediately enhanced the company's profit outlook and provided additional cash for core business needs.

PAR's main business is providing point-of-sale hardware and software systems to 50,000+ restaurants in more than 110 countries. The next time you go to a McDonald's, Taco Bell, Pizza Hut, Kentucky Fried Chicken, Subway, or Five Guys, check the name on the system used to take your order. There's a good chance it was made by PAR. A little more than a year ago, PAR purchased Brink Software, a provider of cloud-based point-of-sale software designed for smaller restaurant chains. PAR is now combining its own hardware with Brink's software into an integrated, state-of-the-art solution. The PAR-Brink merger recently won a major contract with Five Guys, one of the fastest-growing casual restaurants. We expect more wins in the future.

Another of PAR's key products is SureCheck, a computerized food safety solution that PAR sells to restaurants and supermarkets, including the grocery segment in Wal-Mart's 5,000 domestic stores. We expect demand to increase for SureCheck because of the recent food contamination problems at Chipotle and other restaurants.

PAR is extremely well-positioned to take advantage of the trend of increased dining out and the growing awareness of food safety issues. After struggling with profitability for a number of years, PAR has registered two consecutive profitable quarters and appears poised to produce even stronger results.

Quanta Services (PWR)
Longtime holding Quanta Services also failed to meet our expectations in 2015, largely because of delays in issuing project permits by regulated utilities and the cloud over the entire energy sector. PWR designs, installs, maintains, and upgrades infrastructure for the electric power, oil, and natural gas industries. As the largest and most profitable specialty contractor to companies in these industries, PWR's future remains bright despite this year's earnings setback.

Spending on the nation's electric grid infrastructure and natural gas pipeline network is likely to increase substantially in the coming years. Noting "ongoing permitting issues, weather events, and limited maintenance," the American Society of Civil Engineers recently gave the electric grid a grade of D+. Seventy percent of the grid's transmission lines and power transformers are over 25 years old, and blackouts in the U.S. have tripled since 1984, when the government began collecting data on electric grid power losses. As our country confronts this problem, Quanta is positioned to benefit greatly. The ongoing change from coal to natural gas and renewable energy sources, mandated by the EPA's recently released Clean Power Plan, should also boost PWR's revenues. The electricity from solar installations, wind farms, and unconventional gas wells must be transported to populated areas, usually miles away. New transmission lines will be required, with Quanta once again at the center of the solution.

America's oil and gas infrastructure was also targeted for expansion by the Clean Power Plan. Pipeline capacity constraints in the United States and Canada cause bottlenecks in the delivery of fossil fuels, leading to an increase in rail transportation of the fuels and a concomitant jump in serious rail accidents. As North America's largest pipeline construction company, Quanta will also benefit as shale gas and unconventional oil production from areas that have not been traditional fuel sources continue to play a major role in energy production. Infrastructure will be required to transport these energy sources across the continent and for export to other countries.

We do not believe that the turbulence in the oil and natural gas markets will have a substantial impact on Quanta's prospects. Most of Quanta's pipeline business is driven by long-term development of new energy sources, and short-term volatility will not likely play a major role in project planning. Even in an extremely tough environment, Quanta's backlog of business grew over the past year. And PWR has a balance sheet, unmatched in the industry, that will support its long-term growth strategies. After the politics of the presidential election have played out, leaders in both parties will begin to endorse the needed infrastructure spending in the electrical and domestic energy areas. Quanta will be ready to capitalize on the opportunity.

A Bumpy Ride. The 2016 stock market promises to be extremely volatile. Questions about stagnation in critical global economies, including China, persist, and uncertainty about the Fed's interest rate policy and its impact on U. S. growth have made investors extremely jittery early this year, contributing to waves of what appears to be indiscriminate selling of stocks with reasonable valuations. Investors are also reacting to feared ramifications of the oil price collapse, which extend far beyond the energy sector, as we discussed in last year's letter. In the long term, however, the market will recognize the value of solid companies. As a result, adhering to our value discipline is the most effective response to the market's turbulence. Market history and our own experience show this to be the case.

We certainly appreciate your trust and confidence during these tough times. I urge you to call if you have any questions about our approach or any matter regarding your portfolio.