STERLING CAPITAL
MANAGEMENT, INC.
Registered Investment Advisor

Wait till the sun shines, Nellie
When the clouds go drifting by
We will be happy, Nellie
Don't you cry

2016 Year-End Commentary:

Singing a Happier Song

As each year draws to a close, traders on the floor of the New York Stock Exchange gather to salute the U.S. economy and stock market by singing "Wait Till the Sun Shines, Nellie." It is a forward-looking anthem, but one whose tone in any given year is shaped by the market's performance over the trailing twelve months. As we expected, this year's rendition was decidedly ebullient, a tribute to the resilience of the 2016 stock market, which sailed through nasty headwinds and finished the year with solid gains. The total return for the S&P 500 was nearly 12%, a substantial improvement over last year's 1% increase.

2016 was an even bigger year for Cubs, Trumps, and Brexiteers. Perhaps their successes made you smile . . . or frown. Maybe they did a little of both. 2016 was also a very good year for our clients' stock portfolios, which outperformed the S&P. And that should make us all sing a happy song.

Looking back. The stock market felt the headwinds' sting during the First Quarter as uncertainty over the Fed's interest rate policy, concern over equity sell-offs in China, and questions about the Bank of Japan's negative interest rate policy pushed the S&P 500 Index into negative territory. But the Index quickly recovered and worked higher throughout the year, surging after the election. It was delayed only temporarily by Brexit, terrorist attacks, and a raucous, gloves-off presidential campaign.

The outperformance of the Sterling Capital stock portfolio was largely attributable to value stocks' return to favor. As we noted in our last letter, stocks trading at lower multiples of asset value and cash flow have outperformed their higher-multiple counterparts over longer time periods. During the last few years, however, higher- multiple stocks produced superior returns as investors paid a premium for companies able to generate revenue growth in the tepid U.S. economy.

In fact, since the depths of the credit crisis in late 2008 through the last day of 2015, growth stocks out-performed value stocks in five of the seven one-year periods, according to data provided by FTSE Russell. The average yearly out-performance by growth stocks over this seven-year timeframe was a whopping 4% per year. It has been a rough environment for value investors.

12300 Old Tesson Road • Suite 100C / Saint Louis, MO 63128-2245 / 314.843.9999
www.scmstl.com

But 2016 may have signaled the end of this mini-era of growth-stock dominance. According to the FTSE Russell index of the 3000 largest publicly traded U.S. companies, value stocks gained 18% last year, dwarfing growth stocks' 7% total return.

We've got updates. Of course, company-specific factors also helped determine the performance of your stocks. You may remember that we briefly profiled five of our holdings in last year's letter as examples of stocks that had underperformed despite presenting what we believed to be compelling value. We have updated the reports below. As you can see, four of the five stocks did well in 2016. Entering 2017, we continue to hold these five positions in most client portfolios.

Landec Corporation (LNDC). After an extremely rough 2015 attributable to weather-related issues that depressed revenues in its fresh vegetable packaging business, LNDC had a respectable 2016, gaining nearly 17% and outpacing the S&P 500. Better, more normal weather was certainly a factor, but the transition from commodity-type products to higher margin items also helped earnings. In addition, Landec's Lifecore subsidiary, which develops hyaluronic acid for various healthcare applications, once again grew at a rapid clip as the high-margin fermentation business continued to expand. Brightening prospects, Lifecore has now become a fully integrated contract development and manufacturing operation. Although LNDC's investment in the industry-leading hydroponic greenhouse business, Windset Farms, did not produce significant returns last year because of regulatory delays, new greenhouses should come online this year, allowing Windset Farms to expand its product offerings.

Quanta Services (PWR). Citing likely spending increases over the next few years on the nation's electric grid infrastructure and gas pipelines, we remained upbeat on PWR in our letter summarizing 2015, a year that saw utility permitting delays and fears that energy companies would slash capital budgets push down the stock's price. PWR rewarded our optimism, soaring 72% during 2016. The Company is still extremely well-positioned to benefit from the much-needed infrastructure spending that was promised by both candidates during the presidential campaign. Of course, we will monitor the new President's infrastructure proposal very closely for its specific near-term impact on Quanta, and we remain bullish on the stock over the longer term.

Par Technology (PAR). Ugh. PAR was the only one of our five stocks we profiled last year to lose value in 2016. Internal control issues, which led to the canning of the company's CFO, were the main culprit and torpedoed a productive year for PAR's point-of-sale software systems and SureCheck, its industry-leading computerized food safety solution. For the year, PAR dropped 17%.

We confess that the Company has tested our patience, but we remain confident in our assessment that its untapped potential will soon be realized. Earlier this month, as required by federal regulations, Sterling Capital Management filed with the SEC that our clients and employees now own 5.7% of PAR's outstanding stock. (Yes, we feel your pain.) Supporting our bullishness was a recent presentation of PAR as a top pick at a conference of value investors. As of January 20, the stock was up 7% in the new year.

CECO Environmental Corporation (CECE). CECE, which manufactures pollution control and other environmental protection systems, was one of our most disappointing stocks in 2015 despite substantially increasing cash earnings. Noting its depressed price-earnings multiple (7X) compared to those of its peer companies and its attractive 3.4% dividend yield, we expressed cautious optimism a year ago that the stock's value would soon be recognized by the market. In 2016, management continued to execute, and the stock responded, powering ahead 85% (including the dividend).

Although the stock no longer trades at last year's steep discount to our estimate of fair value, it is still substantially cheaper than its peers on a cash flow basis. Uncertainty over the impact of the new administration's apparent plans to relax environmental regulations are a negative for the stock, but the Company's expanding margins are a positive, and an uptick in Chinese orders, which have been sluggish for several quarters, would likely provide additional upside. In short, this stock is approaching fair value, but it's not there yet.

National Oilwell Varco (NOV). The world's leading manufacturer of oil drilling equipment, NOV had a rough 2015 as declining oil prices caused oil exploration companies to slash capital equipment budgets. In our note in last year's letter, we expressed optimism that these budgets would rebound in the near future as oil prices stabilized. Oil prices have firmed, but orders for the NOV's offshore equipment product line, its largest, remain depressed, capping gains in the stock. For 2016, the stock improved 12%, but it is still far from its 2014 highs.

We believe 2016 saw the trough in the Company's cash flow and that meaningful improvements are likely in 2017 and 2018, driven by increased sales of onshore equipment. We are also encouraged by the Company's low debt levels, its ability to make small, strategic acquisitions, and its continued focus on strengthening its technological advantage over its competitors. The stock has been kicked to the curb by most analysts, which suggests that additional downside is limited.

A note on interest rates. As you know, Sterling Capital has been leery of extending maturities in our clients' fixed income portfolios during the current depressed-yield environment. At such low yields, even a small pop in interest rates will significantly erode the principal of longer-duration bonds, and our position has been that the incremental yield attainable by extending maturities does not justify taking this substantial risk. Ignoring our concern, however, interest rates continued to decline, making longer-duration bonds good investments since the initiation of our cautious stance.

Things abruptly changed, however, in 2016: yields on the 10-year Treasury note, which sat at a record low of 1.37% in July, rose to 2.60% in December. This yield spike pummeled bond prices, dropping recently issued 10-year notes over 10%.

The rise in interest rates was triggered by expectations of an uptick in inflation, a strengthening economy and, perhaps most important, increased borrowing to finance the deficit spending on the new President's agenda. Many analysts assert that these forces will continue to push interest rates higher throughout 2017, but others, citing long-term structural factors such as productivity enhancements, demographics, and the dampening effect of excessive debt on economic activity, argue that the likelihood of additional interest rate increases is low.

We believe that the upward move in interest rates is a positive development for the economy and the stock market, but we have not meaningfully extended the durations of our clients' fixed income holdings. After all, despite the sharp reversal in rates, the 10-year yield ended 2016 barely higher than it began the year. We are, of course, closely monitoring economic data as well as interest rates themselves as we evaluate the risk in extending the maturities of clients' bond holdings. As a general rule, additional rate increases will make accepting this risk more likely.

Thoughts about the 2017 stock market. We are cautiously optimistic on the equity market in 2017. A correction, or at least a pause, following the post-election Trump bump would certainly not be a surprise. After that, much will depend upon the extent to which the new President's tax-cutting, infrastructure spending, and regulation–reducing proposals are implemented. The market likes what it has heard about these ideas, but details have been sketchy. We are also cognizant that corporate profits had already begun to increase last year after a substantial decline during 2015. Data suggests that S&P operating earnings bottomed in 1Q2016, improved steadily throughout the year, and are projected to be up 5% year over year in 1Q2017. So Trump or no Trump, the profit outlook for the next twelve months has brightened.

As usual, there are plenty of risks. Trump's we-can-get-it-done attitude may re-awaken the "animal spirits" of companies and investors, but his unpredictable, free-wheeling leadership style certainly increases the possibility of market surprises and heightened market volatility. We also expect the market to express its displeasure if the new administration seeks to implement restrictive trade measures, particularly those affecting commerce with China. Trump aside, the Fed could raise rates too aggressively, threatening the economy's nascent recovery. And the dollar, which has shown impressive strength versus most of the world's major currencies, could rise to levels that crimp the profits of large U.S. multi-national companies and perhaps de-stabilize other economies, including China's.

Wrapping it up. As the economy strengthens, we believe investors will continue to focus on companies selling at depressed multiples rather than chasing the expensive stocks with above-average growth prospects that are popular in a sluggish economy. Even if this assessment is incorrect, the reasonable prices of the companies in your portfolio should afford substantial downside protection, even amidst heightened volatility, while we wait for the market to recognize their value.

The new year is shaping up as one that presents both significant opportunities and above-average risk. We believe our value-oriented philosophy is well-suited for this environment, and we will continue to adhere to it.

As always, we greatly appreciate your trust and confidence. Please do not hesitate to give us a call if you have any questions.