Bernzott Capital Advisors

July 18, 2014

Mean reversion and the herd

Mean reversion is a powerful concept and one that is difficult to grasp for most investors. As professional stock pickers, we believe markets are efficient over time and company fundamentals matter. However, we acknowledge that in the short run irrational behavior can drive stock prices to extremes in either direction. While we will not opine on the merits of behavioral finance, we do believe that investor sentiment (herd behavior) creates opportunities for investment managers like ourselves. The Bernzott U.S. Small Cap Value's year-to-date performance serves as a good case study in this regard.

Our strong second quarter (and July month-to-date) results were a sharp contrast to the spectacular underperformance from the first quarter. There is no doubt that our underperformance in the first quarter raised eyebrows. We lagged by over 5%. However, we have been managing money successfully for nearly 20 years and have experienced underperformance of such magnitude in the past and on multiple occasions. As we noted in our Q1 update letter, when the 'Herd' favors companies in the areas of the market we do not own, we will surely underperform. Without understanding how we pick stocks and construct portfolios, it might be easy to conclude that we lost our way overnight. This could not be further from the truth.

As Warren Buffet stated in his 1990 Chairman's Letter for Berkshire Hathaway;

> "The most common cause of low prices is pessimism - sometimes pervasive, sometimes specific to a company or industry. We *want* to do business in such an environment, not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer. None of this means, however, that a business or stock is an intelligent purchase simply because it is unpopular; a contrarian approach is just as foolish as a follow-the-crowd strategy. What's required is thinking rather than polling."

Simply because our stocks have become cheaper does not mean we immediately add to our existing positions. Instead, we spend time evaluating the investment thesis for each and every name in the portfolio. We do this at least quarterly and often more frequently as information becomes available. As estimated fair values for our holdings are updated, our investment committee determines a course of action: hold, add, trim, or sell. Our investment objective is to buy high quality companies at price that offers a significant margin of safety and sell them when they reach our estimated fair value. Over the years, this disciplined, risk-managed approach has generated excess performance for our clients. As herd mentality vacillates with the day to day gyrations of Mr. Market, we see no reason to alter our time-tested approach.

Second quarter review

The U.S. Small Cap Value composite's return for the second quarter was +4.70% (net) compared +2.38% for the Russell 2000 Value and +4.20% for the Russell 2500 Value. The majority of outperformance versus the Russell 2000 Value during the period was driven primarily by strength in IT (+170 bps), Industrials (+100 bps), Materials (+80 bps) and Consumer Discretionary (+60 bps) offset by our underweighting in Financials (-60 bps) and Utilities (-60 bps). Year-to-date, the strategy's net return is +1.36% versus the Russell 2000 Value at +4.20% and the Russell 2500 Value at +7.87%.

Small Cap Equity Composite Performance (06/30/14)

	QTD	YTD	1YR	3YRS	5YRS	7YRS	10YRS	Inception*
Bernzott Small Cap Value Equity (Gross)	4.9%	1.7%	22.0%	16.5%	19.2%	7.7%	9.9%	14.9%
Bernzott Small Cap Value Equity (Net)	4.7%	1.4%	21.2%	15.7%	18.4%	6.9%	9.1%	14.0%
Russell 2000 Value	2.4%	4.2%	22.5%	14.7%	19.9%	5.5%	8.2%	11.3%
Russell 2500 Value	4.2%	7.9%	24.9%	16.0%	21.6%	6.7%	9.4%	12.3%

We should comment on the recent dislocation in performance between the Russell 2000 Value and Russell 2500 Value. Certainly sector weightings deviate, but only at the margin, and historically these two benchmarks have tracked each other quite closely. However, we can see that investors in recent quarters have had a preference for larger capitalization companies in the small cap space. When comparing individual sector performance of the two benchmarks, in every instance, Russell 2500 Value sectors outperform their smaller cap brethren by a wide margin, quarter-to-date and year-to-date (see table below). As a result, the Russell 2500 Value index has been difficult to beat so far in 2014.

	Q2 Sector Weighting		Q2 Performance		YTD Performance	
Sector	R2000V	R2500V	R2000V	R2500V	R2000V	R2500V
Consumer Discretionary	10.1%	10.6%	3.2%	4.4%	2.4%	5.7%
Consumer Staples	2.5%	1.8%	-0.2%	6.4%	2.1%	6.1%
Energy	7.8%	7.8%	7.5%	11.0%	13.9%	19.6%
Financial	40.0%	37.7%	1.5%	2.7%	3.3%	6.8%
Healthcare	4.7%	5.0%	3.7%	5.9%	5.7%	8.3%
Industrials	13.3%	13.3%	1.1%	2.7%	0.9%	3.2%
Information Technology	10.2%	9.2%	0.8%	2.0%	2.4%	7.0%
Materials	4.5%	5.7%	-0.9%	2.4%	0.3%	3.9%
Telecomm	0.5%	0.9%	-1.4%	4.7%	0.7%	16.8%
Utilities	6.4%	8.0%	9.0%	9.6%	14.9%	17.4%

*Index information gathered from Russell Investments.

During the quarter, the IPO surge continued with 83 offerings, the most since the peak of the dot-com bubble in early 2000. We also continued to see low quality, speculative companies outperform with certain sector ETFs delivering momentum driven and therefore unsustainable performance. An example is the biotech industry (the SPDR S&P Biotech ETF +18.9%). In addition, interest rate sensitive sectors like REITs and Utilities have outperformed given investor's desire for yield. We feel these sectors are particularly vulnerable to an increase in interest rates. Lastly, energy has done very well this year. While we have one holding in the energy sector, Dresser-Rand (DRC), we do not aggressively invest in companies that are significantly exposed to commodity price movements (i.e. the price of oil). In the case of DRC, 50% of the its revenue and 67% of its profits are derived from its stable after-market parts and service business.

While equity markets experienced broad gains, individual company stories within the Bernzott portfolio were catalysts to our outperformance. As we have noted in the past, merger & acquisition and activist investor activity can unlock significant value for our names. We saw this in Q2 as MICROS, International Game Technology and Clean Harbors all benefited from these activities. MCRS spiked on news that Oracle would be acquiring the company, while IGT rallied on news the company had put itself up for sale. CLH stock rose sharply after a 'friendly' activist, Relational Investors, announced it has taken a significant ownership stake in the company. We only had five names contribute negatively to performance with SP Plus the outlier. SP missed EPS estimates and guided lower due in large part to inclement weather. Investors punished the stock over the quarter sending SP Plus down over 18%. We took advantage of price weakness and added to our position.

We established no new positions in Q2. Along with our additional buy of SP Plus, we added to five other names: International Game Technology (IGT), Hill-Rom (HRC), Landauer (LDR), PetSmart (PETM), and Verint Systems (VRNT). We exited one position that reached fair value: Energizer (ENR). And we trimmed four positions as prices escalated: Broadridge (BR), Compass Minerals (CMP), Outerwall (OUTR) and Teleflex (TFX).