GRYPHON
ADVISORS

The Reversion Process

So shall the last be first, and the first last.
– Matthew 20:16

At Gryphon, we do not believe that markets for financial securities are perfectly efficient; in fact, they are frequently mispriced, often diverging from our determination of fair value.

In the investment literature, some commonly cited reasons for the mispricings are a lack of information available to all market participants, encumbrances to frictionless trading such as the cost of shorting, and non-neutral regulatory structures that favor bullish investing. In light of these enumerated discrepancies, at Gryphon we ask ourselves if is it possible to profitably exploit these inefficiencies in a sustainable and risk-conscious manner. The answer we arrive at is that at a firm such as ours, it is impossible to pervasively and profitably exploit the aforementioned inefficiencies on a net of fee basis because the gains are simply too small relative to the transaction costs. Fortunately, there is one source of consistent and consistently exploitable mispricing available to us; human nature.

Human nature compels most investors to favor securities that have just risen in price while selling securities that have recently fallen in price because it feels better to own an investment that just increased in value relative to owning an asset that just lost value. This misguided but emotionally satisfying strategy perpetuates until the appreciating security has risen so much in price that there is very little potential for future appreciation while the depreciating security has discounted all but the most apocalyptic of outcomes. The cycle then reverses and, over time, this rise above and then fall below fair value appears in financial

1578 Sherman Avenue Evanston, Illinois 60201 Telephone: 847.424.0465 Facsimile: 847.424.0542

CONFIDENTIAL

returns data as "regression\progression to the mean". The price of a security orbits around the price at which the prospective rate of return provides adequate compensation for risks undertaken. In this perpetual rotation, the securities that were previously first, because they had the best recent rate of return, now become last because they will have the worst future rate of return. Likewise, those that were last will become first.

In this perpetual rotation, the securities that were previously first, because they had the best recent rate of return, now become last because they will have the worst future rate of return.

Not surprisingly, profiting from the proven process of mean reversion occurs consistently only over longer time frames. If it were possible to make a "quick buck" exploiting mean reversion, all investors would take up the strategy and thereby crowd out any potential for excess returns. Even for investors who accurately assess the opportunity for mean reversion, it will usually take a few years, and sometimes close to ten, for the investment thesis to play itself out.

This most recent quarter, the first of 2016, provided a microcosm of the reversion process. Between the end of December and February 11th, major equity asset classes across the world fell by 8% to 11% while the long-term US treasury bond ETF rose by 10%. Then, from that day in February until the end of first quarter, those same equity asset classes were up between 9% to 17% while the bond ETF had a negative return. Similarly, the spot price of oil fell to $26 per barrel in mid-February, and then subsequently rose by nearly 45%. So shall the last be first, and the first last…which brings us to the crux of our letter.

Since the nadir of the financial crisis, US large cap stocks have generated returns of over 11.5% annualized while emerging market equities have been down by over 4% annualized. In terms of the broad equity asset classes, the US was first and the developing markets were last. So what is Gryphon doing? You guessed it; we are selling US large cap, and when we buy back into risk assets, the first securities we arelikely to purchase will be emerging equities.

You guessed it; we are selling US large cap, and when we buy back into risk assets, the first securities we are likely to purchase will be emerging equities.

Anyone who has read the Wall Street Journal or turned on CNBC knows that there are many reasons to be bearish about emerging market stocks. The accumulation of debt by the private sector in emerging markets is cresting. Meanwhile, the drop in commodity prices is prompting companies in the resource sector to slash capital expenditure budgets, a phenomenon that is particularly destructive to a number of large, commodity-producing emerging countries like Venezuela and Nigeria. The slowdown in Chinese growth is a recurring story in the financial news, and the supposed luminaries of Brazil's leading socialist party are near impeachment and arrest. Meaningful growth slowdowns, if not outright recessions, are rolling across the developing economies.

The United States, meanwhile, seems to have more positive conditions in which to grow. It is experiencing one of the longest economic expansions in its history, it is politically stable, having had two-term Presidents for almost all of the past forty years and the wife of a former President likely to be elected in the Fall, and these are coupled with the strongest legal system and armed forces on the planet. Despite the strong dollar and nominally higher interest rates, the United States is unlikely to enter recession in 2016.

To the "CNBC" investor, favoring emerging market equities over US equities at this time must seem imprudent; but remember that little quote from the Gospels! Recall that since January of 1999, emerging market equities have had forty-nine declines of 10% or more and sixteen declines of more than 20%. The return over the next twelve months following a ten percent decline averaged +17.5%, and it averaged +25.5% in the year after a twenty percent decline. Compounded annually over the subsequent five years, emerging market equities rose 12% after declines of ten percent and increased 14% after declines of twenty percent. The regression phenomenon is quite robust, spanning geographies and time frames far beyond recent emerging market equity returns. From 1926 to 2015, US large cap stocks have had one-hundred fifty-two declines of more than 10% and thirty-nine declines of more than 20%, and over the succeeding five year periods, annualized compounded returns were +10% and +9.5%, higher in both cases than the return for the entire sample period.

As of this writing, developing market equities including China are trading at a historically depressed price-to-earnings (P/E) ratio of about 12 and a similarly cheap price-to-book ratio below 1.5. A number of valuation measures for the MSCI Emerging Markets index, such as price-to-book, price-tocash-flow and price-to-earnings, are trading at about 75% of these measures on the MSCI World index, due in part

1578 Sherman Avenue Evanston, Illinois 60201 Telephone: 847.424.0465 Facsimile: 847.424.0542

CONFIDENTIAL

to emerging markets' greater-than-average exposure to beaten down sectors such as energy, materials and banks. Meanwhile, the ratio of the emerging markets' Shiller cyclically-adjusted P/E ratio (CAPE) to the United States' CAPE ratio is at about 0.4; in the cheapest quintile of data since 1990, meaningfully below the long-term average of 0.8, and close to the December 1998 low of 0.3. Chinese Hshares are trading at a CAPE of 6.4 and a price-to-book of 0.9, while the more inclusive MSCI China index is trading at a CAPE of 9.5. The H-shares and MSCI China equity risk premiums are about 15% and 10%, respectively, versus their historical median of 5%.

With all that said, we believe that structural impediments and the major misallocation of capital have led emerging market equities into a secular bear market. Therefore, despite historically cheap prices, we are waiting to increase our exposure to this asset class.

Some parts of the emerging market equity space, such as Brazil, financials, energy and consumer discretionary firms, have already reached these low levels, but many components of the asset class have yet to reach generational lows. Credit market spreads in the emerging markets, especially in Asia, have not yet blown out to levels realized in past crises. We believe that the final "bloodletting" in the emerging markets will be the liquidation of credit bonds, with enormous stress placed on emerging market bank balance sheets. The onset of this credit contraction will precipitate the final downturn in emerging market equities and lay the foundation for a new era of wellallocated credit growth, corporate restructuring and structural reform.

Meanwhile, we now observe signs of the topping of the cyclical bull market in US equites. The market has experienced multiple declines of more than 10% since its high in mid-2015. On the whole, between the equity market's peak on July 20th and its trough on February 11th, the S&P 500 declined by 13% while the average moderately-allocated fund fell by more than 11%. The blood-brother of stocks, high yield bonds, also traded down, beginning to fall in the summer and bottoming in February. A number of the investment industry's most astute value-driven asset allocators have accumulated cash weightings of more than 10% in their portfolios. While equity valuations in the United States are still below the excessive levels realized during the tech bubble, these measures have continued to expand above their long-term averages. Adjusted for inflation, earnings per share on the S&P 500 are about two standard deviations above their long-term trend.

When we recently sold US equites and increased the cash in our portfolios, we exploited the optionality value of cash, giving us the opportunity to buy emerging market equities at a price that presages historically outsized returns. We are selling what is first and will be buying what is last because soshall the last be first, and the first last. ❧

1578 Sherman Avenue Evanston, Illinois 60201 Telephone: 847.424.0465 Facsimile: 847.424.0542

CONFIDENTIAL