EQUITY STRATEGY REVIEW

JANUARY 2020

- The last decade brought some of the highest equity returns in history, with 2019 being one of the best years on record.
- While some believe performance was driven by a re-rating of the market, research shows that the market's strong run was primarily driven by earnings growth.
- The composition of earnings growth has evolved, now more driven by margin expansion than top-line growth as economic growth has slowed and companies have learned to do more with less.
- Given the dynamics of the past decade and the current low interest, low inflation environment, we feel there is still room for equities to run.
- From baby boomers to climate change, we expect a variety of economic, social, and political trends will present the markets with new challenges and opportunities as we move into a new decade.

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MARKET OBSERVATIONS

Lode Devlaminck, Managing Director, Equities

By now, you have probably received several market commentaries describing what an exceptional year 2019 was. While certainly true, we find it more meaningful to look at things from a longer-term perspective as opposed to drawing conclusions from what is a relatively short time period and trying to extrapolate what it means for the year ahead. As we enter a new decade, we prefer to briefly review the last decade, and think about the challenges and opportunities that lie ahead in the next decade.

Exhibit 1 shows that the 2010's delivered some of the highest annualized returns in history with 2019 being one of the best years on record. As we were still coming out of the Great Financial Crisis at the start of the decade, both earnings and valuations were at relatively low levels. It is also worth noting that annualized equity returns were very low or even negative during the prior decade (2000's). So while the 2000's was the decade of fixed income and emerging markets, the 2010's was the decade of the U.S., growth over value, the tech sector, and greater corporate efficiency.

While most equity asset classes generated positive returns over the last decade, we saw wide divergences between them. U.S. equities were the stand-out performer, helped by compositional differences (higher tech component in the index) and structural advantages (more pro-active fiscal and monetary policies), while Emerging and International markets were inhibited by the strength of the U.S. Dollar. Meanwhile, the low growth nature of the recovery coupled with lower rates and the adoption of new technologies gave growth an advantage over value.

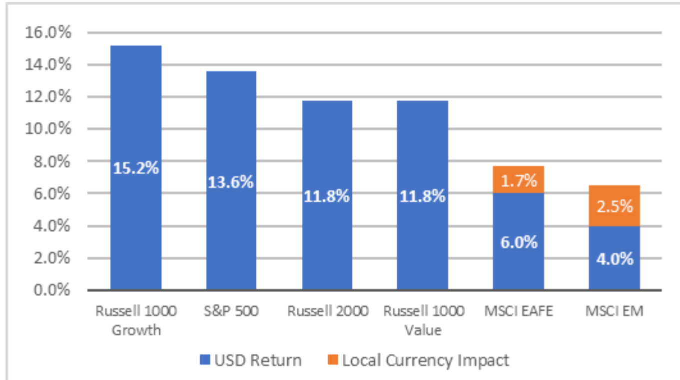
Interestingly, while we saw some re-rating of the markets, most of the return for the last ten years was attributable to the highest annualized earnings growth on record (Exhibit 2). The composition of the earnings growth, however, has evolved.

Despite the longest economic recovery on record, U.S. GDP growth has been low at an annualized rate of roughly 1.8%. In comparison, GDP growth averaged 3.5% in the post-war period. Slower economic growth has translated into a below average top line growth for S&P 500 companies of 3.9%. However, the lower trend growth was more than compensated by margin improvement (Exhibit 3), and further enhanced by capital returns (buybacks and dividends). While the margin improvement of the index was helped, in part, by the higher weight of technology companies, it has largely been driven by traditional companies doing more with less (automation, outsourcing, decreases in capital intensity). Lower taxes and interest charges provided an additional boost.

DRIVERS OF THE RE-RATING

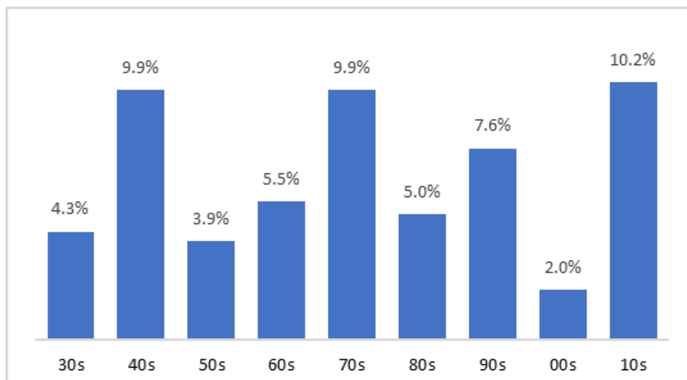
Despite quantitative evidence to the contrary, there is a broad

EXHIBIT 1: 2010-2019 ANNUALIZED EQUITY RETURNS



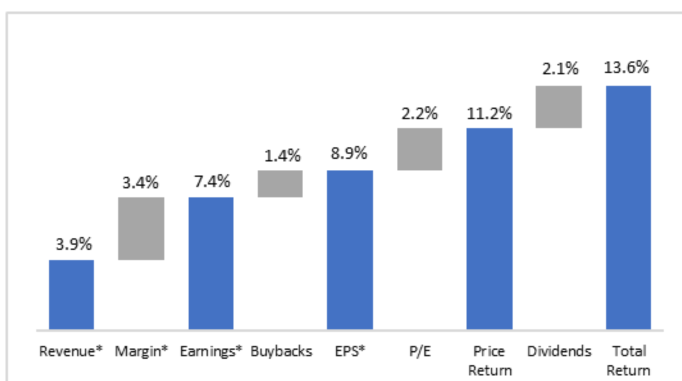
Source: Standard & Poor's, Russell, MSCI, FactSet, Credit Suisse

EXHIBIT 2: S&P 500 ANNUALIZED EARNINGS GROWTH



Reported EPS prior to 1988, operating EPS thereafter. Current consensus EPS estimate used for 2019.
Source: Standard & Poor's, Thomson Financial, FactSet, Haver Analytics®, Credit Suisse

EXHIBIT 3: 2010-2019 RETURN DECOMPOSITION



*Change in forward estimates
Source: Standard and Poor's, FactSet, Thomson Financial, Credit Suisse

misconception that performance has primarily been driven by a valuation re-rating, so therefore, the market is deemed expensive. We believe differently. Even ignoring record earnings growth, earnings and cash flows only represent half of the valuation equation. Discount rates and risk determine the other half.

Exhibit 4 shows Credit Suisse Strategist Jonathan Golub's estimates of the implied valuation level of the S&P 500 given different 10-year yields and credit spreads. The chart shows that compared to 10 and 20 years ago, the market is not necessarily expensive given the current rate and risk environment. Leaving aside cyclical variations, we are solidly in the lower for longer camp when it comes to rates and inflation (due to the impact of demographics, technology, and a large base effect). As such, we do not feel the markets are overvalued.

The Short Term Outlook

Phase One of the U.S.-China trade deal offers the prospect of rising business confidence, with increasing PMIs and greater confidence in earnings forecasts. This improved economic confidence is already evident in a steeper yield curve and should allow the performance trends we saw in late 2019 to persist into early 2020.

While the short-term cyclical environment looks encouraging, we do see several major economic, social, and political trends that could have a significant impact on the medium to long term investment landscape (representing both risks and opportunities). Our list is certainly not exhaustive. Here, we briefly elaborate on the ones we personally find the most important or interesting.

Central Banks backed into a corner?

While easy and unconventional monetary policy avoided a melt-down of the financial system, it also failed to genuinely accelerate economic growth because of low capital investment, declining money velocity, already high absolute debt levels, and demographics. While the steady and sustained decline in "the natural rate of interest" makes it possible to shoulder more debt, it also limits the ability of central banks to maneuver around the next genuine recession.

The Forgotten Americans

The long-term increase in income and wealth inequality has become a powerful political catalyst globally. The free market philosophy is being challenged partly because the longest economic recovery on record left behind significant segments of the population. While President Trump called them the "Forgotten Americans," this is not a phenomena isolated to the U.S. Large groups of people in many countries have experienced a similar fate. Increasing inequality is a negative for the economy as it reduces opportunity, mobility, and growth and leads to a more bifurcated society. This hollowing out of the middle class creates both opportunities and threats to certain industries.

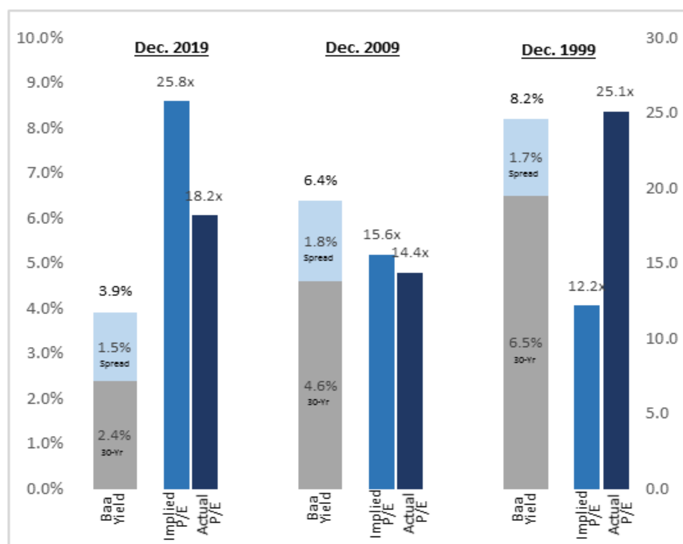
The Retiring Baby Boomers

Labor force participation rates now stand at 63% versus 65% at the start of 2010. This reduction in the productive capacity of the economy is partly driven by baby boomers reaching full social security retirement age. We also see significantly lower labor force participation by teens and young adults during the academic years (down 10.2% from 2000 to 2018). While an aging population presents specific investment opportunities, it could also be contributing to the lower dynamism of the overall U.S. economy.

The rise of Asia and Africa

According to United Nations estimates, the world population will reach roughly 8.5 billion by 2030 (Exhibit 5), 1 billion or 13.7% more than in 2017. This rise will be accompanied by growing

Exhibit 4



Source: Redburn (as of 10/5/19)

Exhibit 5: World Population Growth (In Millions)

Region	2017	2030	% Change
Africa	1,256	1,704	+35.7%
Asia	4,504	4,947	+9.8%
Europe	742	739	-0.4%
Latam	646	718	+11.1%
N. America	361	395	+9.4%
Oceania	41	48	+17.1%
World	7,550	8,551	+13.3%

Source: Financieel Economische Tijd, UN

urbanization and migration. It is estimated that by the end of the decade, 2/3 of the global population will live in urban centers, including 45 mega cities (defined as > 10 million people). A growing and migrating population will require access to jobs, food, water, energy, and infrastructure, not all of which are equally distributed.

The U.S. versus China

Can China continue to increase its economic, political, and military power? If so, how will the U.S. and other leading countries react? The current trade war might just be a prelude to a more tenuous and volatile geo-political environment.

Winner takes most

It is hard to imagine what could slow the pace of technological progress, or, more importantly, the deployment of these technologies on the factory floor. 5G networks, robotics, and increasingly sophisticated AI algorithms are bound to reduce production, service, and supply chain inefficiencies.

The potential benefits of ever-increasing efficiency (through margins, sales, or cash conversion) are not without costs or risk. Next to the increased risk of cyber-attacks, companies will need to remain at the forefront of sector specific technologies. As has occurred within the technology sector itself, there is a distinct possibility that other sectors evolve into a "winner takes most" industry structure. From a societal perspective, there is the risk that technology driven efficiencies further widen the inequality gap, adding to political volatility.

Climate change

Whether there is global agreement on limiting carbon emissions or not, climate change (global warming, bio-diversity crisis), will ultimately impact the investment landscape. Of growing concern to businesses is the increased volatility of weather. Industries like agriculture, aviation, and insurance are likely to face greater volatility and more frequent disruptions (impacts will likely be felt in specific regions), while other sectors like product testing, water treatment, and alternative energy providers see their addressable market expand. Regulations in regions or states like Europe and California will shape companies' product offerings, while a small minority of countries could potentially benefit from a warming climate (e.g. shipping routes open up for Russia).

Performance (gross/net) as of December 31, 2019 (Preliminary)

U.S. Equity	% QTD	% YTD	% 1yr	% 3yr	% 5yr	% 10yr	% 15yr	Inception
DCM U.S. Large Cap - Value Creators* *(inception date – 01/01/2017)*	9.97	39.97	39.97	19.70	-----	-----	-----	19.70
Net of Fees	9.83	39.30	39.30	19.11	-----	-----	-----	19.11
S&P 500 Index	9.07	31.49	31.49	15.27	-----	-----	-----	15.27
DCM U.S. Mid Cap - Value Creators* *(inception date – 01/01/2017)*	5.70	35.00	35.00	15.39	-----	-----	-----	15.39
Net of Fees	5.56	34.28	34.28	14.77	-----	-----	-----	14.77
S&P 400 Index	7.06	26.20	26.20	9.26	-----	-----	-----	9.26
DCM Small Cap Equity* *(inception date – 04/01/1999)*	8.28	21.51	21.51	7.68	8.79	12.42	8.47	10.62
Net of Fees	8.05	20.50	20.50	6.77	7.88	11.47	7.56	9.69
Russell 2000 Index	9.94	25.52	25.52	8.59	8.22	11.82	7.92	8.59
DCM Merger Arbitrage* *(inception date – 06/01/2015)*	1.20	4.77	4.77	4.07				4.11
Net of Fees	1.07	4.25	4.25	3.55				3.60
3 Month T-Bill	0.46	2.22	2.22	1.62				1.12

Non-U.S. Equity	% QTD	% YTD	% 1yr	% 3yr	% 5yr	% 10yr	% 15yr	Inception
DCM Emerging Markets Equity* *(inception date –10/01/1999)*	13.90	17.51	17.51	11.96	6.38	3.48	8.71	9.54
Net of Fees	13.57	16.12	16.12	10.64	5.12	2.27	7.50	8.29
MSCI EM Index	11.84	18.44	18.44	11.57	5.61	3.68	7.48	7.80
DCM EAFE Equity High Conviction* *(inception date – 01/01/2017)*	9.04	24.90	24.90	10.60				10.60
Net of Fees	8.88	24.16	24.16	9.94				9.94
MSCI EAFE Index	8.17	22.01	22.01	9.56				9.56
DCM Global ex-US Small Cap Structured* *(inception date –01/01/2015)*	12.16	26.68	26.68	12.67	8.47			8.47
Net of Fees	11.93	25.63	25.63	11.73	7.56			7.56
MSCI AC World ex USA Small Cap Index	11.01	22.42	22.42	9.65	7.04			7.04

* Gross of Fees
Net returns are calculated using highest fee on ADV. Returns greater than one year are annualized. Please see the last page for important performance disclosures.

U.S. Large and Mid Cap - Value Creators

Kevin Fogarty, CFA, Portfolio Manager and Senior Equity Analyst

During the quarter, equity markets were again impacted by the tariff war between China and the U.S. However, unlike during the third quarter, the fourth quarter saw a Phase One agreement between the two countries, helping to calm fears over the prospect of a more pronounced global slowdown. The U.S. equity markets responded with positive performance during the fourth quarter, capping a record year for equities with the S&P 500 generating a total return of 31.49% for the whole of 2019.

However, despite this positive backdrop, some sectors came under pressure during the quarter. The U.S. health care sector was whipsawed by commentary made by prospective U.S. presidential candidates, particularly the managed care insurers. Democratic candidates have introduced their views on universal health care and Medicare for all program concepts, which if enacted, would negatively impact key health insurance companies. Valuations came under significant pressure in shares of Anthem and UnitedHealth Care. During the quarter, valuations reached the very attractive level of 10.4 and 13.3x, respectively, a compelling risk-reward. Both companies, in our opinion, manage their businesses in a balanced fashion by reducing overall health care delivery costs, improving patient health outcomes, and providing fair returns to shareholders. We added to both positions during the quarter, believing the share prices reflected a more positive risk reward over the long-term.

The value creators portfolios use a bottom-up stock selection process and focus on specific industries and companies with solid franchises, superior cash flow generation through cycles, and management teams with an emphasis on the longer-term. When companies with these characteristics experience short-term underperformance, we look to add to positions to take advantage of better valuations.

As shown below, the portfolios have a higher return on equity and growth rate vs. the benchmark, but are valued similarly based on the fiscal year 2 price-to-earnings multiple. We believe these quality factors, and resulting expected cash flows, will be key drivers of the portfolio over the long-term.

Exhibit 6: Value Creators Portfolio Characteristics (Preliminary as of 12/31/19)

	U.S. Mid Cap - Value Creators	S&P 400	U.S. Large Cap - Value Creators	S&P 500
Debt Level				
Debt/Capital	73.0	40.6	50.3	47.9
Debt/Equity	94.2	48.8	60.7	40.7
Debt/EBITDA	2.3	2.6	1.8	2.2
Growth				
Dividend Growth 5 year	17.4	10.8	18.3	13.0
EPS Growth 3 year	15.0	14.9	17.4	16.9
EPS Growth 5 year	15.2	11.8	13.2	10.8
EPS Est Growth 3-5 Year	9.7	12.3	11.7	10.5
Dividend Payout Ratio	22.5	68.4	26.2	48.7
Profitability				
Return on Equity	26.0	13.9	27.6	21.8
Return on Assets	13.6	7.8	11.5	8.8
Valuation				
Price/Earnings using FY2 Est (ex Negatives)	22.7	32.5	24.5	22.9
Price/Cash Flow	16.7	10.4	18.6	13.5
Price/Book	5.5	2.3	5.8	3.4
Price/Sales	4.7	4.1	5.6	4.8
Dividend Yield	0.9	1.7	1.1	1.9

As of December 31, 2019 (Preliminary)
Source: DuPont Capital, Barra

HIGH CONVICTION EAFE

Andrew Smith, CFA, Associate Portfolio Manager and Senior Equity Analyst

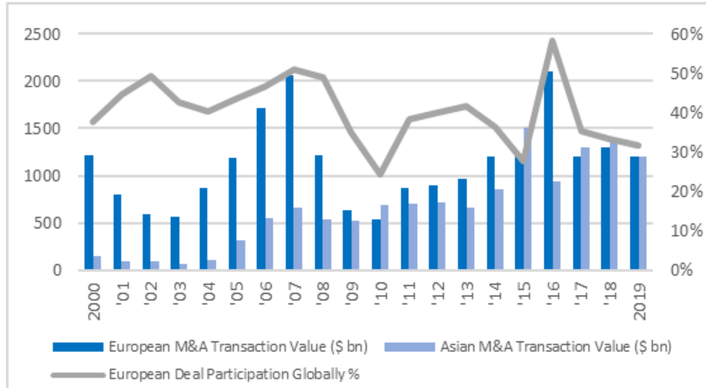
Last summer we ruminated on the potentially fertile conditions for increased share buybacks among Japanese firms. The increased propensity to repurchase shares being exhibited by a number of historically hidebound and high-profile corporations continues to bode well for shareholders longer-term. Nevertheless, it is worth reiterating that, particularly for the caliber of companies we invest in, the more strategically significant aspects of balance sheet management are M&A. However, both academic research and market experience show that surprisingly few management teams are consistently able to exercise financial discipline and demonstrate success in operational integration. There is no universal recipe for success, and companies that exhibit both skill-sets are a relatively scarce and valuably-compounding commodity.

European M&A as a percentage of global deal-value participation has been relatively muted in recent years. A hard-nosed EU Commissioner for Competition, German economic softness, and Brexit uncertainty have all played a part. It is noteworthy that in dollar terms, annualized activity levels in Asia have been on par with Europe since 2017, just north of $1 trillion in aggregate.

However, there is reason to believe that European deal activity may pick up, and two recent transactions illustrate the different types of deals that exist. First, the plan to combine auto manufacturers Peugeot and Fiat-Chrysler, quick on the heels of the failed Renault/Italian group merger, acknowledges an urgent need within the industry to address costs and build platform scale in the face of daunting transformational investments. The challenges of this merger are complex enough for us to maintain a watching brief, but the risks are likely to prove less severe than those of defying necessary industry consolidation. Second, and more relevant to our portfolio, is French luxury goods conglomerates LVMH's bid to acquire iconic jeweler Tiffany. Despite the sumptuous business category and price tag of $16.9bn (17x trailing EBITDA), this is far from being a "trophy asset" deal. Rather, it bears the hallmarks of LVMH's fundamental strengths as a well-managed group with ample scope to diversify its world-leading portfolio of brands and augment an existing roster of growth generators via earnings accretive deals.

M&A expertise, an elusive mix of financial and operational prowess in timing and integrating deals, is often a feature of our individual company investment theses. The specific cadence and significance of strategic deal-making is determined by industry dynamics and concentration levels. Chemical distribution specialist Brenntag is an example of a frequent, but piecemeal, consolidator of a globally fragmented industry where secular and digital trends should reward economies of scale. Conversely,

EXHIBIT 7: GLOBAL M&A ACTIVITY



Source: Bloomberg

freight forwarder DSV has accrued considerable investor goodwill over the years for its unblemished track record of acquiring more sizable but underperforming competitors and over-delivering in terms of the scale and timing of operational synergies.

To underscore the fact that buying rather than building cross-border growth can be fraught with risks, we should humbly acknowledge where M&A has not lived up to our expectations. There is little doubt that one German chemical company is experiencing "Bayer's remorse" in the wake of its big-ticket acquisition of Monsanto. However, we believe that the company's market cap destruction due to glyphosate litigation risks likely exceeds the ultimate financial impact, and we remain holders.

Finally, it is worth considering cases where targeted acquisitions were successfully rebuffed. Pharmaceutical company Astrazeneca spurned U.S. rival Pfizer in 2014, and has since successfully navigated a "patent cliff" of expiring blockbuster drugs and reinvigorated the pipeline of next generation therapeutics. We bought the company in 2Q of 2018, and it remains a key holding having gained a further 30% in 2019. On the other hand, Unilever was able to escape the combined clutches of Kraft Heinz, 3G, and Warren Buffett in 2017. However, this required management to undertake some of the activist, cost-eliminating practices of its predators, including zero-based budgeting techniques and more frugal marketing spend within SG&A. The resultant margin uplift helped to buoy shares but the ongoing de-emphasis in brand investment ultimately led to slower revenue growth. In anticipation of these sales headwinds persisting, we sold our Unilever position in 1Q of last year. The shares subsequently endured a steady de-rating in the second half of 2019, culminating in a downgrade to financial guidance in December.

Emerging Markets Equity

Erik Zipf, CFA, Head of Emerging Markets Equity

With Phase One of the U.S.-China trade deal complete and relaxed monetary policy across most of the globe, optimism for emerging market equities is picking up. That increase in optimism is reflected in the asset class's 18% gain last year, driven by strong returns during the fourth quarter. However, emerging market equities are only back to where they started two years ago. Valuation levels do not appear stretched and earnings may receive a boost from a rebound in global trade.

The U.S-China dispute has had a negative impact on global trade and thus the growth of emerging economies. Global supply chains have been disrupted and inventories have been reduced as a result of trade uncertainty. While the recent Phase One deal between U.S. and China is just a start of a more comprehensive deal, it reduces uncertainty for businesses and investors. This is a positive development that should not be overlooked. Chinese economic activity is beginning to show signs of improvement and business sentiment is picking up. Given the low level of business inventories, an improved outlook could cause a traditional inventory restocking and a tailwind for economic growth in the coming year.

Despite the improved near-term outlook for emerging economies and the recent strong performance of emerging market equities, the valuation gap between the most expensive and the least expensive stocks remains very wide by historical standards. We expect this gap to narrow in the coming year driven by a pick up in global trade and improvement in economic activity. Our portfolio is positioned to benefit from a narrowing of this valuation gap.

Among our more recent purchases that illustrate this valuation dynamic are a steel company in China and a beverage company in Chile. Before our purchase, the Chinese steel company dropped nearly 30% during 2019 due to the trade war and fears regarding steel prices. While legitimate concerns, the very depressed valuation suggested investors expected a significantly worse outcome than what we deemed to be a worst-case scenario. The market value of the company was less than the cash on its balance sheet at one point during the year. The very depressed valuation, strong financial position of the company, and its low-cost operations made the shares a very attractive investment for the portfolio.

Political turmoil in Chile brought us an investment opportunity in one of the largest Coca Cola bottlers in Latin America. The shares dropped more than 25% in U.S. Dollar terms after Chilean political leaders were caught off-guard by wide spread protests demanding action on growing income inequality. We felt investors over-reacted to these developments. Importantly, the company only generates a third of its sales in Chile, has a strong financial position, good levels of profitability, and the consumption of soft drinks tends to be very stable over time. We were able to add this high-quality company to the portfolio at a discounted valuation relative to similar companies due to these near-term uncertainties.

Overall, we continue to focus our research and portfolio construction efforts on finding companies with characteristics (financial strength, profitability, debt levels, etc.) that are similar to or better than the overall market at lower valuations. Company valuations are often depressed due to temporary issues, which we believe enables us to add them to the portfolio at a discounted valuation and outperform as that valuation discount closes over time.

Exhibit 8: Summary of Portfolio Characteristics

	DuPont Capital Emerging Markets	MSCI Emerging Markets Index
# of Securities	78	1,404
Active Share	71.0	--
Price/Earnings	10.8	14.1
P/E using FY1 Est	11.1	14.2
P/E using FY2 Est	10.1	12.8
Price to Cash Flow	8.1	8.9
Dividend Yield	3.4	2.6
Est 3 Yr EPS Growth	28.7	28.9
Est 5 Yr EPS Growth	13.5	17.2
Price/Book	1.3	1.7
ROE	12.2	11.5
ROA	8.4	8.4
LT Debt to Capital	21.6	23.2
Market Capitalization	74,029	68,097

As of December 31, 2019
Source: DuPont Capital

U.S. Small Cap, Structured Equities

Caleb Piper, CFA, Portfolio Manager and Senior Investment Analyst

Value as an investment framework had a pretty rough go of it in the last decade, but we think today's setup is noteworthy on several fronts.

Exhibit 9 shows the performance of the Russell 2000 Value index ("Value") relative to the Russell 2000 Growth index ("Growth") starting in 2010. When the line is declining, Value is underperforming Growth. Clearly, last decade was not kind, with Value underperforming Growth to the tune of 30%. Surprisingly, Value's underperformance has been a persistent yearly phenomenon. The almost lone exception was 2016, where Value outperformed by 17% (2012 was marginally positive at +2%).

Interestingly, today's setup looks eerily similar to 2016 in the following ways, which could have positive ramifications for value in 2020:

- Going into 2016, Value underperformed Growth by 23% from 2010 to 2015. Since 2017, Value has underperformed by 22%.
- Value bottomed in August of 2015 and somewhat rallied into the end of the year. In 2019, Value bottomed in September and somewhat rallied into the end of the year.

What makes things more interesting are valuations. Last summer we wrote about how cheap the forward earnings-to-price value factor had become. To gauge cheapness, we observed the difference between the 97th percentile and the 3rd percentile of the Russell 2000 forward IBES earnings to price ratio. Our conclusion was that while value looked cheap, we weren't ready to jump in just yet. Exhibit 10 shows an expanded list of factor valuation spreads, giving a broader picture of what we might typically expect comprises value.

Broadly speaking, with roughly 4 of the 5 valuation spreads currently 2+ standard deviations above the mean, value is undeniably cheap. In fact, it's the cheapest its been since 2009 and compares similarly to the 2000 Dot com bubble based upon our data. Most certainly, 2020 sets up cheaper than 2016.

Compounding the return similarities and better valuations versus 2016, the future economic picture is looking similar as well. The Conference Board U.S. Leading Index, typically referred to as the LEI, is a gauge of ten items the Board deems indicative of the future direction of economic growth. Declines in the index foreshadow slower economic growth and vice versa. At the beginning of 2016, the index had been declining for the 17 months prior and bottomed in June 2016. Today, the LEI has been falling for the last 15 months, and we similarly expect it to bottom in the first half of 2020.

Exhibit 9: Value Relative to Growth

Represents the Russell 2000 Value Index relative to the Russell 2000 Growth Index
Source: Bloomberg, Russell

Exhibit 10: Factor Valuation Spreads

	Beginning of 2016	End of 2019
Forward P/E	2.3	2.5
Trailing P/E	1.7	2.5
Book/Price	0.7	1.9
Cashflow/Price	0.4	2.0
Dividend/Price	1.4	0.7

Represents the number of standard deviations from the historical 110 year mean spread.
Source: DuPont Capital

Despite these parallels, there are some dissimilarities that must be factored into the equation. First, the Russell 2000 index sold off 10% in 2H15 while rising 6% in 2H19. Second, economic activity was much weaker in 2015 with 4Q15 GDP growing only 0.1% versus 2.1% in 3Q19 (in real terms). Third, the Fed was much more accommodative in 2016. The Fed funds rate averaged around 40 bps during 2016 while today the rate stands at 155 bps with the futures market forecasting one cut over the next year.

All told, value as a style typically works when valuations are inexpensive, and the market is recovering from a period of economic worry. We believe we may be entering an environment similar to 2016 that was conducive to better returns from value. Value's underperformance and historically low valuations set up well, but we temper our excitement given the macro and economic backdrop doesn't seem to have as much "fuel" as in 2016. From a positioning standpoint, our small cap quantitative process currently is overweight value relative to our long-term factor allocation model we recently employed.

MERGER ARBITRAGE

Harris Arch, CFA, Portfolio Manager and Senior Equity Analyst
Dan Moore, CFA Portfolio Manager, Merger Arbitrage

In the most recent quarter, M&A activity continued to slow due to numerous factors including weakening macroeconomic indicators, political uncertainty, and trade tensions. Corporate managements remained cautious of engaging in major deals due to substantial uncertainty across the regulatory landscape. M&A is still an option, as most corporate balance sheets are in decent health and the private equity sector has significant uncommitted capital, but the focus is on smaller, bolt-on deals and capturing cost synergies.

During the quarter, the trade hostility between the U.S. and China drifted between optimism and outright despair. From a merger arbitrage perspective, many pending deals that need Chinese regulatory approval have often traded at a wide spread, particularly in sensitive industries such as technology. The opaque and difficult process of obtaining approval in China remains a key impediment for many management teams that consider large M&A. While some market pundits point to the Phase One trade deal agreement as a positive step toward a more normalized approval landscape, we remain cautious and look for more concrete signs.

Political risk has emerged as a heightened risk in merger arb analysis. For example, the Sprint/T-Mobile merger has been approved at the federal level but is still being challenged by several states. Past merger challenges have not generally followed this path. Historically, State level approvals have been more benign than the Federal process. We await greater clarity on whether enough concessions can ameliorate competition concerns at the State level and push this merger to completion. Another point of concern in the political arena involves the upcoming U.S. presidential election. It is unknown who the Democratic candidate for president will be and there appears to be a large variation in the policy positions of potential candidates regarding M&A. For example, Elizabeth Warren has recommended revisiting past mergers and possibly unwinding them, an unprecedented step. One can easily see how this might put a damper on the M&A market. In our view, there seems to be a window in the near term where mergers with a shorter completion time frame can be completed, whereas deals with a longer time to close in multiple jurisdictions will most likely be shelved until the political environment is more certain.

Government bond yields were relatively steady throughout the quarter. In general, this has led to low volatility in arb spreads for rate of return type deals. Credit markets remain very accommodative for issuance with volume strong throughout the quarter. Both investment grade and high yield spreads have continued their march tighter for much of the quarter with CCC debt joining in later in the quarter. Market expectations are for a robust debt issuance environment in 1Q 2020, which should accommodate the issuance needs for M&A announcements. One area of concern often flagged is the larger representation of BBB debt in the investment grade market. This concentration has moved steadily higher for over a decade as corporate leverage has risen.

Merger arb continues to demonstrate its low correlation to both equity and fixed income benchmarks. Deal flow continues to be dominated by strategic mergers, with a greater emphasis on stock consideration as equity multiples have expanded during the ten-year long bull market. The ultimate success of a merger arb strategy is whether the portfolio deals will close, rather than such quantitative investment factors as style or leverage. This uncorrelated attribute is a useful diversifier in an overall investment portfolio.

GLOBAL SMALL CAP (EX. U.S.), STRUCTURED EQUITIES

Juncai Yang, CFA, Portfolio Manager and Senior Investment Analyst

For the last quarter of 2019, the strategy added another 110 bps of outperformance, bringing the YTD alpha to 4.23%. In the factor space, beta was the best performer, which contributed 99 bps, earning yield added 31 bps. No other factors made any material impacts. The outperformance of high beta and earning yield matched our predictions in our third quarter comments where we said investors may take a risk-on approach to bet on cheap and high beta stocks. In the industry space, industrial outperformed, but IT, utilities and health care lagged. Outside factor and industry impacts, as well as other factors such as stock selection, added 32 bps.

During the fourth quarter, a U.S.-China Phase One trade agreement was reached. In addition, major global central banks and governments continued to implement various accommodative policies, all above factors led investors to dial down expectations of potential global recession risk, despite some economic data showed deterioration, a broad global market rally sustained till year end due to abundant liquidity in the financial system.

We made no significant changes in the positioning of the portfolio. Relative to the benchmark, the strategy has positive exposure to earning yield, beta, size, liquidity, growth, momentum and dividend yield, while relatively neutral on book to price, leverage and residual risk.

EQUITY STRATEGY REVIEW
JANUARY 2020

ABOUT OUR FIRM:

DuPont Capital Management is an SEC registered investment advisor based in Wilmington, Delaware. Since the firm's establishment in 1993, we've had a long history of developing global investment opportunities in both traditional and alternative strategies across equity, fixed income and alternative investments. Our investment team structure gives us the ability to be flexible and adapt to changing market conditions. DuPont Capital's focus is delivering consistent investment management results for our clients. Our history of institutional asset management is rooted back to 1942 when our former parent company, DuPont, established a pension plan for its employees. Corteva Inc. succeeded DuPont as sponsor of the DuPont Pension Plan in 2019. DuPont Capital is a wholly owned subsidiary of Corteva and continues to manage the legacy DuPont Pension Plan.

DuPont Capital's President and CEO, Valerie Sill believes in education and diversity of experience as represented in our investment teams which are comprised of PhDs, engineers, medical doctors, and scientists. We believe their global expertise creates a portfolio implementation edge that benefits our clients.

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IMPORTANT DISCLOSURES:

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Composite Performance - Disclosures

September 30, 2019:

1. DCM is an investment adviser registered under the Investment Advisers Act of 1940. DCM is a wholly owned subsidiary of Corteva, Inc. 2. Performance results reflect the reinvestment of dividends, income and other earnings 3. Gross-of-Fees returns are presented before management and custodial fees but after all trading expenses. Net-of-Fees returns are calculated by deducting the highest applicable fee rate in effect for the respective time period from the gross return. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolios size. DCM's fees are available upon request and also may be found in Part II of our Form ADV. 4. Securities and other instruments in which the composite invests may be denominated or quoted in currencies other than the U.S. dollar (Base Currency). Changes in foreign currency exchange rates can affect the value of an investor's account. This risk, generally known as "currency risk," means that a strong U.S. dollar (Base Currency) will reduce returns for investors while a weak U.S. dollar (Base Currency) will increase those returns. 5. Past performance is not indicative of future performance. It should not be assumed that results in the future will be profitable or equal to past performance. These performance disclosures apply to all of the DCM investment performance data presented herein.

Composite Descriptions:

DCM Small Cap Equity (inception date – 04/01/1999) includes all accounts that are primarily invested in U.S. small cap equity securities utilizing a value-based strategy. This strategy, which is industry neutral, utilizes a multi-factor model that includes proprietary estimates of normalized earnings, normalized cash flow, sustainable growth, and quality. The composite benchmark is the Russell 2000® Index.

DCM U.S. Mid Cap - Value Creators (inception date – 01/01/2017) includes all accounts that are primarily invested in U.S. mid cap equity securities utilizing a value-based strategy. Investments are focused in companies having a favorable competitive environment, excellent management teams, superior fundamental outlooks, and return incentives well-aligned with shareholders. Through in-depth fundamental research supplemented by quantitative screening, the portfolio targets investments possessing these characteristics which we believe have the greatest potential to generate superior per share value creation throughout economic cycles. The composite benchmark is the S&P 400 Index.

DCM U.S. Large Cap - Value Creators (inception date – 01/01/2017) includes all accounts that are primarily invested in U.S. Large cap equity securities utilizing a value-based strategy. Investments are focused in companies having a favorable competitive environment, excellent management teams, superior fundamental outlooks, and return incentives well-aligned with shareholders. Through in-depth fundamental research supplemented by quantitative screening, the portfolio targets investments possessing these characteristics which we believe have the greatest potential to generate superior per share value creation throughout economic cycles. The composite benchmark is the S&P 500 Index.

Composite Descriptions (continued):

DCM Merger Arbitrage (inception date – 06/01/2015) includes all accounts that invests in pending merger and acquisition deals, seeking to capture the spread between the target's current price and the deal price upon close. The strategy invests in both cash and stock deals. In cash deals, the strategy is long the target's equity security. In stock deals, the strategy is long the target's equity and short the acquirer's equity, according to the deal terms. Portfolio weightings are dependent on the risk and return characteristics of the pending deal. The strategy makes use of leverage (by borrowing securities for shorting). The composite benchmark is the 3 Month T-Bill.

DCM Global Ex -US Small Cap Structured Equity Composite (Inception Date – 01/01/2015) includes all accounts invested in global small cap (Ex-US) securities that utilize a quantitative value-based strategy that ranks stocks based on several measures of value, sentiment and improving risk. Portfolio optimization influences stock weighting. This strategy is industry and country neutral. The composite benchmark is the MSCI ACWI Ex-US Small Cap Index.

DCM EAFE High Conviction (inception date –01/01/2017) includes all accounts that are primarily invested in non-US equity securities. Portfolio holdings include equity securities from developed and on occasion emerging markets. This strategy uses a bottom up fundamental approach investing in stocks that trade at a discount to their intrinsic value, supplemented by measures of business quality and improving fundamentals. The composite benchmark is the MSCI EAFE Index.

DCM Emerging Markets Equity (inception date –10/01/1999) includes all separately managed and sub-advised accounts that are primarily invested in equity securities incorporated in emerging market countries. The strategy invests primarily in ordinary shares; however, it can also invest in American Depository Receipts (ADR), Global Depository Receipts (GDR) and US dollar-denominated equity securities. This is a value-based strategy which seeks to broadly diversify holdings across emerging market countries, striving to overweight companies that are attractively priced (low price-to- earnings, price to book and/or price to cash flow ratios) relative to other companies in the index. The composite benchmark is the MSCI Emerging Markets Index

Benchmark Descriptions:

The Russell 2000® Index is based on 2,000 small-cap companies in the Russell 3000® Index. The index returns are calculated on a total return basis with dividends reinvested. The returns for this index do not include any transaction costs, management fees or other costs.

The S&P 400 Index is based on mid-capitalization of 400 companies of the U.S. stock market. It is a capitalization-weighted index calculated on a total return basis with dividends reinvested. The returns for this index do not include any transaction costs, management fees or other costs.

The S&P 500 Index is based on the market capitalizations of 500 large companies of the U.S. stock markets. It is a capitalization-weighted index calculated on a total return basis with dividends reinvested. The returns for this index do not include any transaction costs, management fees or other costs.

3-Month T-bills are issued by the U.S. Government and mature every three months.

MSCI ACWI (All Country World Index) Ex-US Small Cap Index, which captures small cap representation across 22 of 23 developed markets countries (excluding the US) and 24 emerging markets countries. With 4,355 constituents, the index covers approximately 14% of the global equity opportunity set outside the US. This index is net total return which reinvests dividends after the deduction of withholding taxes. The returns for this index do not include any transaction costs, management fees or other costs.

The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. This index is net total return which reinvests dividends after the deduction of withholding taxes. The returns for this index do not include any transaction costs, management fees or other costs.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. This index is net total return which reinvests dividends after the deduction of withholding taxes. MSCI uses the maximum withholding tax rate applicable to institutional investors. The returns for this index do not include any transaction costs, management fees or other costs.