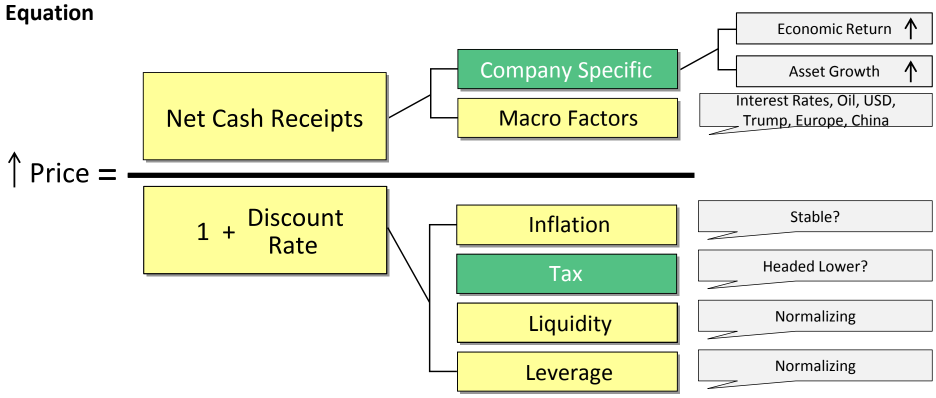
*"In the short run, the market is a voting machine.
In the long run, it's a weighing machine."*
- Benjamin Graham

Quarter Review

Global markets continued to make progress in the first quarter. The MSCI World Index (net) increased 6.38% and the Russell 1000 Index returned 6.03%. After last quarter's sizzling rally, U.S. small stocks lagged large stocks. The Russell 2000 and Russell 2500 Indexes increased 2.47% and 3.76% respectively. Company-specific growth in cash flow generally exceeded expectations.

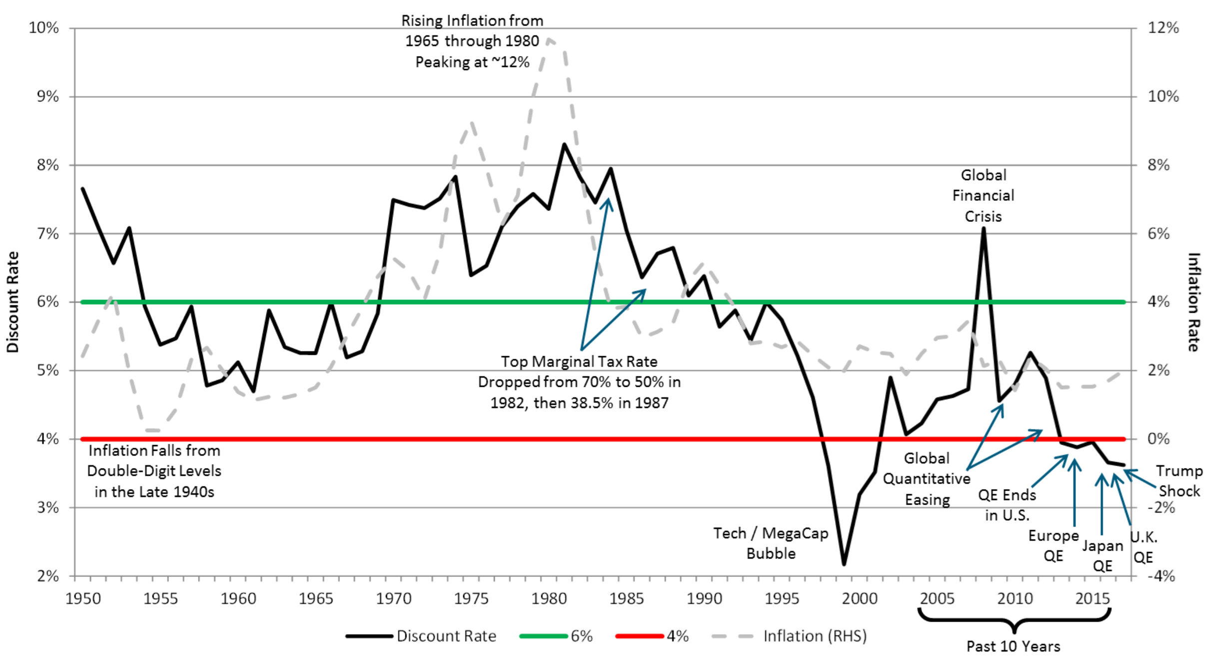
Figure 1: Pricing Equation



Source: IronBridge Capital Management, L.P.

The discount rate remains at historically low levels and should continue to support elevated equity values as long as liquidity remains accommodative and credit risk remains stable.

Figure 2: Discount Rate



Source: Credit Suisse HOLT ValueSearch and IronBridge (Data Date: March 31, 2017)

We see signs we are back on track in regard to the transition from excessive to neutral global liquidity. For example, the U.S. Federal Reserve (Fed) is raising short-term rates and is discussing reducing its balance sheet. The European Central Bank (ECB) is expected to wind down quantitative easing (QE) later this year. The free ride from eight years of declining rates may be coming to an end as it is clear that central banks are moving toward rate normalization, but there is nothing to indicate they plan to move toward restrictive liquidity conditions any time soon. Markets should be able to handle rising rates as long as the numerator (GDP/Corporate Profitability) continues to demonstrate growth. Growth appears to be accelerating.

Figure 3: Analysts Expect Earnings to Report Largest Quarterly Gains Since 2011

Source: FactSet, IronBridge Capital Management, L.P.

According to the World Bank and the International Monetary Fund, global gross domestic product expectations range from 2.7% to 3.4% for the year. Corporate profits are expected to grow around 10%.

Further, as central banks stop the flow of excessive liquidity applied over the last eight years, the numerator is beginning to take over as the main driver of market prices. However, within the market, macro factor volatility remains elevated. Uncertainty over President Trump's ambitious plans has investors reacting to his daily tweets, each new appointment, regulatory repeals, and new proposals. As highlighted in our last letter, new rules can change entire groups of winners and losers in the competition for capital—drug companies, coal companies, steel companies, highly-taxed companies, highly-regulated companies, dollar-sensitive companies, and interest-rate sensitive companies. Trump anxiety will likely continue to drive volatility among companies sensitive to macroeconomic factors, which has the potential to create risks, noise, and opportunity.

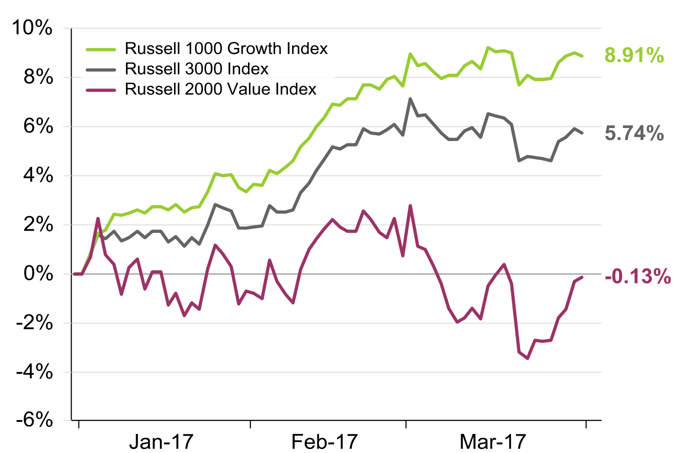
Risks, Noise, Opportunity

Risks: In last quarter's letter, we noted the near-term risk that "If Trump's agenda takes longer than anticipated, or gets significantly watered down, or Washington remains gridlocked, equity values are vulnerable." Then quality would outperform higher risk names and large cap growth and defensive staples would likely outperform small cap value.

While equity values have generally held up pretty well, Trump's failure to make progress on healthcare reform drove weakness among many "Trump Bump" beneficiaries as well as increased risks to Tax Reform. As expected under delays to the Trump agenda, large cap growth has significantly outperformed small cap value.

Whether this is a temporary setback for "Trump Bump" beneficiaries or the beginning of a full reversal will likely depend on the President's ability to unify a fractured Congress.

Figure 4: Large Cap Growth Outperformed Small Cap Value by 9% YTD



Source: FactSet, IronBridge Capital Management, L.P.

Market risks are not confined to U.S. political turmoil. Europe is facing several elections likely to impact expectations regarding the sustainability of the European Union. China shows signs of potential credit and currency stress. With discount rate levels historically low in both the equity and credit markets, investors do not have much room for error. While we do not see any immediate clear and present danger, it is the risks one does not see that can creep up and catch investors unaware and why we believe owning a portfolio of high-quality names is always a good idea.

Noise: The macro uncertainty that accompanies this Presidency has increased the volume of noise on a daily basis. One of the most important analytical skills we continually hone is the ability to separate news from noise. Analysts who are able to develop this skill, better yet, anticipate noise-related events, are in a position to exploit mispriced company-specific risk when it appears in the market. Mispriced company-specific opportunities arise when markets overreact to short-term “noise,” providing attractive buying/selling opportunities for those that can distinguish the difference. Expectations move stocks in the short term, while economic reality determines value over the longer term. What makes the task so challenging in today’s environment is the exponential proliferation of “information” via the internet, most of which is noise.

Trump’s strong remarks about drug prices wipe 3% off a biotech exchange-traded fund (ETF) in a matter of minutes. A report alleging fraud can wipe 30% off the value of a company in less than a day. We source our information from the annual 10-K and quarterly reports, and, where necessary, we seek answers directly from company management. Our approach is increasingly rare. Today, robots respond to noise, news, and rumors via the purchase and sale of various factor-based ETFs, which drive sector correlations up. While this can present short-term challenges to diversified stock pickers, in the longer term, we believe this environment is creating even greater opportunities.

Opportunity: As passive strategies such as smart beta and ETFs continue to gain market share, we find they are forced to act in ways that undermine price discovery and the whole notion of efficient markets. For example, a preferred stock manager shared a story of how he is able to sell preferred stocks with negative yield to call characteristics to a preferred stock ETF. In other words, this manager is able to sell a security guaranteed to provide a negative rate of return to its investors. When I asked if he was always able to do this, he laughed and explained that ETFs are the best thing that happened for him. If he has a preferred stock that is overvalued, he sells it to a preferred stock ETF. If he wants to buy one cheaply, he looks at the daily flows to the ETF, and if there is a big outflow that day, he buys what he wants since they have to sell to meet the redemption.

<u>ETFs are making markets less efficient in the shorter term as they must accommodate liquidity flows without regard to the security’s price</u>.

While inefficiencies for equities may not be as obvious as for the preferred markets, we believe they exist. For example, during our conversations with the management of Leggett & Platt (LEG), they shared their belief that the stock price of the company was being influenced by the inflows and outflows of several dividend ETFs. We confirmed their suspicion and estimate that 14% of the market capitalization is owned by ETFs. We also confirmed that the price behavior of these ETFs tends to be inversely correlated with interest rates. As such, there is an opportunity to exploit mechanistic ETF selling triggered by a sharp rise in interest rates if one is prepared in advance, as was the case on March 10th when we bought LEG at a discounted entry point.

As passive strategies (arbitrarily defined indices) continue to gain market share there is no doubt, the idiosyncratic mispricing opportunities are growing. Short term, it is very difficult to predict how the combinations of increasing noise and rapidly changing liquidity will play through the passive complex and impact stock prices. But long term, there is still reason to believe the market will reflect true economic value creation.

Our goal over the long term is to outperform the market. We seek to do this by identifying distinct patterns of value creation, supported by the best allocators of capital that make the world a better place through innovation and/or productivity. Then, we buy and hold these companies for as long as possible while they offer attractive upside potential compared to downside risk. A portfolio that diversifies most factor risk should allow company-specific economic value creation to drive long-term excess return. This proven disciplined approach has worked historically in the long term. We understand that the outcome of our process leads to a higher quality bias, which has been out of favor for several years. As we assess the current liquidity and credit cycle, as well as the increased risks, noise, and opportunity, we are confident that the environment is shaping up well for our high-quality approach to investing.

Outlook

In our last quarterly letter, we said "this year's outlook is more of a decision tree analysis where we simply have to monitor and adapt as the future plays out." The milestones we are monitoring for our most bullish thesis require swift implementation of tax and regulatory reform. Quite honestly, President Trump is not off to a great start in terms of working with either Republicans or Democrats in Congress and failed on his biggest regulatory reform target – Healthcare.

However, he is swiftly making good on several other regulatory reforms via executive orders. There are literally too many to address in this outlook, but big regulatory relief is in store for financials, energy, industrials, and biotech industries. Within Congress, Ohio Senator Rob Portman has introduced the Regulatory Accountability Act aimed to curtail the power of unelected government. Progress on non-healthcare regulatory reform is supportive of the bullish thesis for equities.

Next up will be tax reform, which we view as critical to support our bullish thesis on the economy and equities. If tax reform succeeds, we think equity markets will be off to the races, interest rates could rise, and stocks could significantly outperform bonds. If tax reform fails, then we believe companies may have a difficult time meeting current expectations, stocks could give back post-election gains, and bonds could rally. The Trump bump could easily shift to Trump dump and maybe even a Fed pump.

As outlined in the body of this letter, there are risks. Real risk as the Trump presidency embarks on an ambitious agenda and international risks as the rest of Europe decides to stay together or continue to fracture. Then there are perceived risks manufactured by the media that get amplified through factor chasing ETFs and smart beta investors, which may provide opportunities for active managers to exploit.

IronBridge's quality bias is intended to help limit exposure of investor gains accumulated over the past eight-year bull market to downside risk because real value creation is more permanent than temporary cyclical factor risk. IronBridge's dual diversification portfolio construction across sectors and life cycles is meant to minimize macro shocks and work for investors over the long term. We would have preferred more value added over the short and medium term as quality could be misinterpreted as a lagging "factor." To put this uniquely rare decade into perspective, after reviewing 40 years of historical returns on a quarterly basis, the Wilshire 5000 Index was down 30% of the time. From the start of 2000 through the first quarter of 2009 markets were down 43%. Since the initiation of global QE, the market has been down only 13% of the time on a quarterly basis. As a result, the relative performance statistics for quality portfolios with strong downside capture ratios have lagged more aggressive portfolios tilted to favor upside capture at the expense of downside capture/protection. We suspect, over the next decade, quality will begin to work its magic again as rate normalization results in more normal markets, especially given where credit spreads are and the current level of the discount rate—both near historical lows.