



"Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down..."
-Warren Buffett's 2008 letter to shareholders

S&P 500 Return on Invested Capital Factor Strategy Performance

Last 33 year(s) Statistics							
Strategy	GPA (%)	Sharpe Ratio	Max Draw Down (%)	Downside Deviation (%)	Return During Bear Markets (%)	% Weekly Returns >0	Last Week Return (%)
Top Decile (---)	13.72	0.53	-55.61	13.22	-33.93	57.64	-1.06
Bottom Decile (.....)	6.21	0.12	-74.53	16.36	-45.92	52.82	0.34
Long Top Decile, Short Bottom Decile (---)	4.90	0.10	-65.96	10.66	18.05	53.22	-1.40

Source: Ned Davis Research

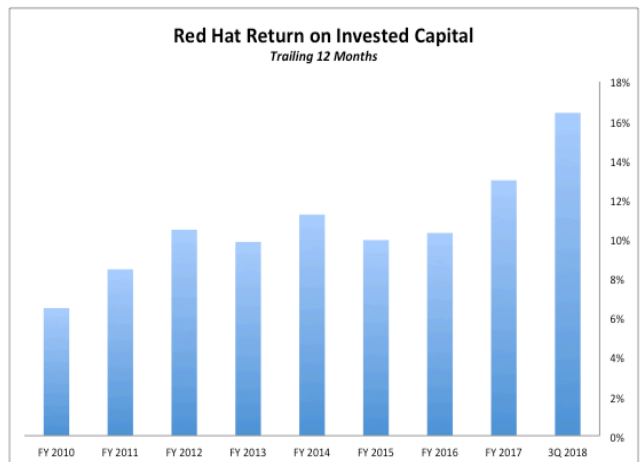
Is it Possible to Have Your Cake and Eat it Too?

One passion that many of the folks on the investment team have here is the love for baseball. The biggest news last month was Los Angeles Angels signing the Japanese superstar, Shohei Ohtani. What makes him so unique is that he not only plays offense (hitting over .300) but is a pitcher as well. Finding impact players who can contribute in terms of offense and defense is unique in competitive sport. Is it possible to sift through hundreds of stocks to find a few that can contribute both offense and defense?

One of the most common questions from our long term clients as we exited 2017 was that while the equity markets generated strong double digit returns for the year, how would we expect the portfolios to perform if the market became more challenging? Last year was a remarkable year as it was the first on record for both the S&P 500 and MSCI World to report positive returns for every single month of the year. With only a (3%) maximum decline during the year, it was difficult to get a gauge of how portfolios would perform in a down or choppy market.

While the head of our team, George Shipp, likes to say "we want both" in terms of value and growth characteristics of stocks in the portfolios, the same can be said for one of our investment pillars, searching for companies with strong returns on invested capital, a core principal for our strategies. While high returns on capital are an indication of a company's advantageous competitive position, in terms of seeking to generate competitive returns versus a benchmark, it can provide an edge in both up and down markets. In 2017, in a year where the S&P 500 was up 21.8%, Merrill Lynch notes that the top 10% of companies in the index in terms of return on invested capital were up 23.8%. Return on invested capital, in terms of a stock's characteristic, was an advantage in an impressive up market.

What may be as impressive is that having a portfolio populated with high return on invested capital stocks can be just as helpful in down markets as well. Note the performance difference in the fifth column in the table above provided by Ned Davis research. During the periods of bear markets as tracked by their firm, companies with the best returns on capital outperformed those in the bottom by over 18%.



Source: Bloomberg

While finding stocks that can play both offense and defense is great, what we really like to see in the stocks that we own are those where returns are increasing. Take for example software company, Red Hat, one of the better performers in the Special Opportunities portfolio last year. We have a preference for software companies like Red Hat that invest in the development of a product once and then can sell it many times. This "razor, razor blade" recurring business model enables the company to generate higher returns as its sells more and more product after the initial investment is made. As seen in the chart above, the steady stair step of higher returns can lead to a higher valuation being placed on the company's shares. Clients get the benefit of higher earnings and a higher valuation, a great combination.



By creating high conviction portfolios of roughly 30 stocks, we can create portfolios that are different from the index. By focusing on companies such as Red Hat in technology but also carefully selecting stocks in other sectors with high returns on capital, we can benefit from the unique characteristic of stocks with high return on capital – their propensity to work well in both up and down markets.

As always, we thank you for your interest and trust managing your investments.

Chip Wittmann, CFA®
Executive Director
(757) 417-4901
cwittmann@sterling-capital.com

*The **Chartered Financial Analyst® (CFA)** charter is a graduate-level investment credential awarded by CFA Institute — the largest global association of investment professionals. To earn the CFA charter, candidates must: 1) pass three sequential, six-hour examinations; 2) have at least four years of qualified professional investment experience; 3) join CFA Institute as members; and 4) commit to abide by, and annually reaffirm, their adherence to the CFA Institute Code of Ethics and Standards of Professional Conduct.*

The opinions contained in the preceding commentary reflect those of Sterling Capital Management LLC, and not those of BB&T Corporation or its executives. The stated opinions are for general information only and are not meant to be predictions or an offer of individual or personalized investment advice. They also are not intended as an offer or solicitation with respect to the purchase or sale of any security. This information and these opinions are subject to change without notice. Any type of investing involves risk and there are no guarantees. Sterling Capital Management LLC does not assume liability for any loss which may result from the reliance by any person upon any such information or opinions.

Investment advisory services are available through Sterling Capital Management LLC, a separate subsidiary of BB&T Corporation. Sterling Capital Management LLC manages customized investment portfolios, provides asset allocation analysis and offers other investment-related services to affluent individuals and businesses. Securities and other investments held in investment management or investment advisory accounts at Sterling Capital Management LLC are not deposits or other obligations of BB&T Corporation, Branch Banking and Trust Company or any affiliate, are not guaranteed by Branch Banking and Trust Company or any other bank, are not insured by the FDIC or any other government agency, and are subject to investment risk, including possible loss of principal invested.