Fort Washington Investment Advisors, Inc.

Focused Equity Quarterly Commentary

4Q16

Philosophy

The Focused Equity team believes that paying as little as possible for future value creation for businesses that generate or are capable of generating excess returns on capital and have higher barriers to entry will generate competitive investment returns.

Process

The Focused Equity strategy utilizes a four step process which narrows the potential universe of 4,600 companies to 10-20 new opportunities. The process is centered on linking valuation with competitive business strategy. Valuation is categorized into three layers of value. Ideal investment candidates have no future value creation implied in the current stock price, earn above their cost of capital and have higher barriers to entry.

The portfolio generally has 25-40 securities and maintains a flexible cash policy to remain liquid during times when the market is expensive and investment opportunities are limited. Generally, the Focused Equity strategy holds 10% or less in cash. The top 10 holdings typically represent 35% or more.

Investment Professionals

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Performance and Quarterly Market Recap

U.S. equity indices continued to move higher in the 4th quarter of 2016 as the Russell 3000 Index increased 4.95% to another record high. While many feared a stock market correction, investors cheered President-elect Donald Trump's pro-growth agenda. This also led to rising interest rates as inflationary expectations increased. As a result, Financial stocks led the market higher, rising more than 20% during the quarter. Infrastructure-based sectors like Industrials, Energy, and Materials also outperformed the broader index. Health Care, Real Estate, and Consumer Staples declined in value during the quarter while Utilities and Information Technology also underperformed. The Focused Equity strategy outperformed the Russell 3000 Index during the quarter.

Factors Contributing to Performance

Within the Focused Equity strategy, sectors that outperformed its respective peers included Consumer Staples, Health Care, Information Technology, Energy, Materials, Financials, and Telecommunication Services. Sectors that lagged its respective peers included Industrials, Real Estate, and Consumer Discretionary. Stock selection accounted for the majority of the outperformance. Cash holdings detracted from performance given the positive move in the market while sector allocation had a positive impact driven by zero weight in Utilities along with an overweight in Industrials.

Stocks adding the most to performance were a leading provider of capital market services that has advantaged access to customers, a leading investment management and services company, and a leading North American distributor of food and related products that benefits from economies of scale. Stocks detracting the most from performance were an online e-commerce company that has a high level of customer captivity, a diversified provider of health care products that benefits from economies of scale, and a leader in retail real estate ownership, management and development.

During the quarter we reduced the overweight in Industrials and Information Technology, and increased the weighting of Real Estate. The weight in Financials increased nearly 200 basis points due primarily to price appreciation. Cash holdings at the end of the quarter stood at 4.0%, largely unchanged from the third quarter. One new position was added during the quarter while two positions were eliminated. Each change was made in order to improve the overall risk/reward of the portfolio.

As the fourth quarter of 2016 came to a close, the strategy had an overweight in the Industrials and Health Care sectors and an underweight in the Materials and Consumer Discretionary sectors. The weights of the Consumer Staples, Information Technology, Energy, Financials, Real Estate, and Telecommunication Services sectors were generally equal to the index. No positions were held in Utilities at the end of the quarter.

From a market cap perspective, the strategy maintained a zero weight in smaller cap stocks (companies with a market cap below $2 billion). The index weight for this segment is 5.1%. The strategy remained underweight in mid-cap businesses which now comprise 12.5% of assets, compared to an index weight of 15.2%. Lastly, the strategy continues to maintain an overweight in larger cap businesses (companies with a market cap above $10 billion). The weight in that segment is currently 83.4% which is higher than the index weight of 79.7%. This allocation decision had a moderately negative impact to performance during the quarter.

Investments made in international companies which comprised 5.1% of assets, underperformed the benchmark while domestic holdings outperformed.

Portfolio Outlook and Positioning

Instead of making largely fruitless attempts to divine where the market will end 2017 we thought we would make some comments regarding the political situation and the potential impacts on the markets over time. These are preliminary thoughts subject to change over the coming months as we learn more regarding President-elect Trump's policies.

The consensus view was that a Clinton victory would be better for the equity market than a Trump win and many strategists were saying the U.S. equity market would decline between 5 to 10% if Trump was elected. So far this view has been wrong as the equity market has shifted its view from low growth to pro-growth and reflation. Specifically, pro-cyclical sectors have outperformed defensives.

Trump's lack of government experience makes his elected presidency truly unique, he is arguably the first President with no experience in government, which makes it difficult to figure out his true intentions as he likely does not have well-developed views on public policy issues. As a result, it is important to distinguish

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between market expectations regarding Trump's policies and what will ultimately occur. Currently, markets are confident that many of his initiatives will prevail. However, there will inevitably be roadblocks for many policy areas, and there is ample room for disappointment on several fronts. There is typically a honeymoon period of 100 days or so for a new President to unveil the legislative agenda for the first term. Incoming Presidents typically rush to get as much legislation passed in this period as they can, knowing that chances for compromise become smaller with the passage of time. That said, we think it is going to be difficult for the market to have it all – more spending, lower tax rates, higher interest rates, less government regulation, less imports – and we would expect further volatility as the next administration further develops and outlines its policy objectives.

Tax reform at the individual and corporate levels, reduced government regulation, higher infrastructure spending, repeal of the Affordable Care Act and increased military spending are a few of Trump's key items that will impact corporate America. Notably, Trump does not seek changes in entitlement programs; if so, outsized budget deficits could lead to higher government bond yields. More controversial is Trump's stance on trade. It is hard to tell whether it is a negotiating tactic to obtain better trade deals, or whether he would increase tariffs and quotas on certain countries that would invite retaliation. Through the Trade Act of 1974, trade policy is an area where the President can act unilaterally in many regards. For example, the President has authority to: (1) impose tariffs of up to 15% on countries that are deemed to engage in "unfair practices," and (2) take retaliatory action against "discriminatory" trade practices. One of the first indications of his trade intentions will be proposals Trump puts forth for renegotiating NAFTA and whether he asks the Treasury to declare China to be a currency manipulator. In our view, these proposals will serve as litmus tests on how far he is prepared to go on trade issues and whether he would risk a possible trade war. Policymakers that believe the answer is in adopting protectionist policies are naïve. The trade issue is important as Trump's anti-globalization views could hurt U.S. equities, especially when considering almost half of S&P 500 sales are generated abroad.

Trump's stance raises two issues: (1) Will the Republican leadership in Congress acquiesce and scrap plans for entitlement reform? (2) If so, how much will the federal budget deficit expand? While Trump has proposed to cut back spending on other programs by 1% over the next ten years, most budget experts believe it would not be sufficient to prevent a major increase in U.S. budget deficits for the foreseeable future. Investors, therefore, need to weigh the prospects for reviving U.S. economic growth versus the specter of outsized budget deficits in the next four years. During the Reagan era, the outcome was favorable for financial markets, mainly because the Federal Reserve succeeded in lowering inflation and inflation expectations; consequently, bond yields fell in nominal terms (due to lower inflation). The outcome is likely to be different this time because interest rates are near record lows and the Fed is poised to raise them. Therefore, we would expect government bond yields to rise if budget deficits were to increase materially. Also, Reagan had a different starting point as corporate margins were low and equities had not materially appreciated between 1965 and 1981. The impact on the stock market will depend on whether faster revenue growth associated with stimulus will offset the impact of higher interest rates.

More U.S.-oriented companies (banks, retail, transportation, etc.) stand to benefit from a reduced corporate tax rate. Our view is the corporate tax rate will not be reduced to 15% as Trump has proposed. A 25% tax rate seems more reasonable (and what the market has priced in at this point in our view), as it is a globally competitive tax rate and budget constraints do exist, which is a concern for House Republicans. The significant impact of potentially lower corporate tax rates has been predominately seen in small-caps, where effective tax rates are higher versus mid-caps and large-caps, as the recent small-cap outperformance seems to be somewhat indiscriminate with similar performance across the top and bottom of the quality spectrum. Defense, steel, and drug industries stand to benefit while companies exposed to trade with Mexico and China (for example Mexican beer imports represent around 10% of the U.S. beer market and U.S. electronics companies sell a considerable amount of products in China) are unlikely to emerge unscathed (for example the impact on the U.S. labor force). Technology stocks could benefit from Trump's pro-growth policies and a repatriation tax holiday, but could be hurt by protectionist policies against China. With infrastructure-related companies, even if an infrastructure spending bill is enacted fairly quickly, it would take a while to see the benefits due to a lack of "shovel-ready" projects. Trump's plans to roll back environmental regulations and his goal to promote more fossil fuel extraction is a positive for oil & gas companies, coal miners, and utilities versus Clinton's intention to put an end to an era of hydrocarbons. Finally, pharmaceutical and biotechnology companies, which comprise a majority of the healthcare sector, should benefit more than utilization plays such as hospitals, as drug makers will likely face fewer threats to pricing power.

As highlighted above, there are many moving parts at this point. Our strategy is focused on continuing our process of buying higher quality businesses with a large margin of safety and higher barriers to entry. In our view, there are opportunities in pharma (with a focus on drugs that meet a high medical need) and high-quality compounders to name a couple. On the other hand, defense, highly cyclical industrial and basic material companies, and most small-caps do not offer us the opportunity to buy with a large margin of safety at this juncture. In other words, many companies that are levered to a Trump administration are not attractively priced. Looking at our portfolio, however, we do have exposure to many companies which are on the positive side of the Trump ledger and, in our view, should benefit whether his policies are fully enacted or not.

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