GOTHAM FUNDS

LONG/SHORT VALUE INVESTING

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2016 Outlook: Same Simple Secret to Long-Term Investment Success

After a disappointing year for any strategy, there are really only two main questions to ask:

1) Does the strategy still make sense?
2) Does the recent underperformance make sense?

The first question is straightforward. On a daily basis, we rank approximately the largest 2,000 stocks in the U.S. based on their discount to our assessment of value. We buy over 300 of the cheapest stocks and we short over 300 of the most expensive stocks in our investment universe (generally, the cheaper or more expensive a stock is, the larger weight it receives in the portfolio). Our long book consists on average of high cash flow generating firms (with current cash flow yields approximating 10% relative to price) with very high returns on tangible capital (averaging over 50% currently).[1] Our short book is the opposite, consisting of high priced companies with little or no cash flow and averaging minimal or negative returns on tangible capital (with cash flow yields near zero).

Some worry about a new paradigm where rapidly growing companies with huge future prospects, such as Amazon or Tesla, take over the world regardless of valuation and despite no or low current cash flows. In our mind, these companies are likely to be the exception, not the rule (new perceived paradigms have a way of reversing abruptly, with sharp reversals in 1999 and 2007). It is our belief that the basic economics of business ownership will not be repealed on average. We are confident that by owning over 300 stocks that produce huge cash flows relative to price and deploy capital well (avoiding value traps this way) and shorting 300 with limited or negative cash flows relative to price and much lower returns on capital, we are pursuing a winning long-term investment strategy. (We are also confident that doing the opposite, buying expensive companies that earn little money and achieve poor returns on capital is a bad idea--even though last year this would have been a better way to go!)

So, how do we explain recent underperformance? Last year our longs underperformed large cap weighted indexes and our long/short spreads were poor. Of course, every 3 or 4 years we would expect underperformance relative to major benchmarks. If our logical valuation approach worked every month or year, everyone would follow it and it would stop working. But besides this, what specifically contributed to last year's performance?

One contributor was the disparity between equally weighted indexes and market cap weighted indexes. The market cap weighted S&P 500 and Russell 1000 were up approximately 1% last year. As many of you know, a few large cap stocks drove these returns. The equally-weighted Russell 1000 actually fell approximately 4% and the equally weighted Russell 2000 fell approximately 10%. Since we choose from the largest 2000 stocks, we select our long portfolio from both of these indexes. Our long portfolio, adjusted for leverage, fell approximately 5.6%[2] for the year, in line with these indexes.

Our shorts, and therefore, our long/short spreads, were a different story and the other main contributor to poor performance. Our shorts, adjusted for leverage, were up approximately 1.7%[2] last year. Based on our assessment, the market favored more speculative, high priced momentum stocks, money losers, and companies priced on prospective growth and/or hope. Furthermore, large amounts of money flowed into index strategies that have already done well, accelerating this trend. While we are not typical value investors (our stocks are not low price/book, low price/sales, etc. and Morningstar and Russell usually categorize our style as "blend"), we still short many highly valued companies priced on hope or prospects rather than actual results. This is a good strategy on average but last year these types of stocks were in favor and our shorts outperformed our long holdings resulting in our negative spread. So these spreads plus relative underperformance of equally weighted indexes vs. large cap market weighted benchmarks tell the story.

More important, what now? When do we expect our logical long-term valuation strategy to start paying off again?

Our research looking at the last 25 years indicates that our valuation metrics tend to act like gravity. The diversified valuation weighted indexes that we have created and studied have reached their expected return levels 95% of the time within two years. In other words, we believe that in most cases, two years is a reasonable time to expect valuations and market prices to revert toward each other. If our strategy results follow our expectations, we would expect that results should improve in the near future.

Valuation levels should also help our returns. The Russell 1000, at this writing, sits in the 39th percentile toward expensive over the last 25 years (it has been cheaper 61% of time during that period and more expensive 39%). Year forward returns for that index have averaged approximately 7-12% in the past from these valuation levels. Our long book is skewed larger cap and we would expect that buying the cheapest stocks within this index should add nicely to the expected returns from the index looking forward. The small cap Russell 2000 is now in the 28th percentile towards expensive over our 25 year research period and this has indicated average returns between 2-6% in the year forward period. Many of our shorts are smaller cap, and we would expect being short the most expensive stocks in this already expensive index should add to returns nicely.

In summary, as we've said before but hope not to rely on very often: "Research into the characteristics of returns for top performing managers is compelling. Investors need to be patient to take advantage of higher long-term returns. Over a recent decade[3], looking at just the top quartile (best-performing 25 percent) of investment managers, almost all of these top-performing managers (96 percent) spent at least one three-year period during that decade in the bottom half of the performance rankings. Fully 79 percent of those who ended up with the best 10-year record spent at least three of those years in the bottom quartile of performance and a staggering 47 percent, about half, spent at least three of the ten years in the bottom decile of performance (it's unlikely that many of the original investors in this last group stuck around to achieve those great ten year returns!) Yet all of these managers ended up with top ranked 10 year performance. In other words, to beat the market, managers must do something different than the market. In the vast majority of cases, the returns for long-term top performing managers zig and zag quite differently from market benchmarks."

The message is clear. Invest in a strategy and a process that makes sense and stick with it. Unfortunately, for most investors, this is easier said than done. Yet, this is the simple secret to long-term investment success.

Please feel free to contact us at any time by phone (877-974-6852) or email (gothamfunds@gotham.com).

Sincerely,
Joel Greenblatt and Robert Goldstein
Managing Principals and Co-Chief Investment Officers

[1] The cash flow yield and return on tangible capital figures are representative of the Gotham Absolute Return Fund, Gotham Enhanced Fund and Gotham Neutral Fund. Figures are based on Gotham's assessment of value.
[2]The long portfolio and short portfolio results (scaled to 100%) are representative of the Gotham Absolute Return Fund.
[3]Source: Davis Advisors (1/1/00 – 12/31/09).

Important Information

This document contains certain information that constitutes "forward-looking statements," which can be identified by the use of forward-looking terminology such as "may," "expect," "will," "hope," "believe" and/or comparable terminology. Market and index valuations are based on Gotham's proprietary assessment of value. No assurance, representation, or warranty is made by any person that any of Gotham expectations, views and/or objectives will be achieved.

The Russell 1000 Index and the S&P 500 Index are commonly followed equity indices and are generally considered barometers of the U.S. equity market. The Russell 2000 Index is a commonly followed equity index and is generally considered a barometer of the U.S. small to mid-capitalization market. Returns for the indices include the reinvestment of income. It is not possible to invest in the indices. The performance and volatility of Gotham's strategies will be different than those of the indices.

The Russell 1000 Equally Weighted Index and the Russell 2000 Equally Weighted Index equal weight the companies in the Russell 1000 Index and Russell 2000 Index, respectively.

Mutual fund investing involves risks, including possible loss of principal. Short sales by a fund theoretically involve unlimited loss potential since the market price of securities sold short may continuously increase. It is anticipated the funds will frequently adjust the size of their long and short positions and thus may experience high portfolio turnover which tends to increase brokerage costs. The funds will use leverage to make additional investments which could result in greater losses than if the funds were not leveraged. The prospectus contains this and other information about the funds. A copy of the prospectus is available in PDF format on www.gothamfunds.com or by calling 877-974-6852. The prospectus should be read carefully before investing.

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