

## QUARTERLY MARKETS REVIEW

The S&P 500 Index posted its ninth consecutive quarterly gain (albeit modest), reporting a total return of 0.95% in the first quarter of 2015. Despite finishing the quarter nearly flat, U.S. equity prices were quite volatile as investors shifted their focus from one economic report or news event to the next. Equities vacillated between caution and optimism on mixed data from around the world. The European Central Bank belied Europe's persistent economic troubles by announcing a larger-than-expected bond-buying program, while China reported its slowest economic growth rate in 24 years (still a 7.4% expansion) and began its own form of quantitative easing to encourage spending and lending. Meanwhile, oil prices continued to decline, which pleased consumers but soured energy-related companies. The U.S. economy showed further signs of improvement as unemployment declined and GDP grew. Nonetheless, the Federal Reserve appeared patient, and the timing of the seemingly inevitable yet elusive interest rate hike remained uncertain at the end of the quarter.

While the U.S. equity market ended the quarter only slightly higher than it began, some segments of the market performed better than others. The trend from the fourth quarter of 2014 continued, as performance was inversely related to size, reflecting investors' comfort with taking on additional risk. Among the U.S. Russell equity indices, small cap companies performed the best, followed by mid caps, while large caps trailed for the quarter. With regard to style, so-called "growth" companies meaningfully outperformed their value counterparts within each market cap segment. By sector, nearly 12 percentage points separated the leader from the laggard. Performance ranged from the Health Care sector's total return of 6.47% in the S&P 500 Index to -5.17% for the Utilities sector.

Meanwhile, most major developed equity markets outside the U.S. outpaced the S&P 500 Index, many of them rallying on the launch of the European Central Bank's major economic stimulus efforts in March as well as signs of economic improvement. The MSCI EAFE Index (net) reported a first quarter total return of 4.88% in U.S. dollars. Performance was even better in local currency terms due to the strong U.S. dollar, with MSCI EAFE (net) posting a gain of 10.85% for the quarter. Among the MSCI developed country indices, both Denmark and Japan posted double-digit advances, reporting U.S. dollar returns of 15.82% and 10.21%, respectively. The worst-performing developed

market in the quarter was resource-dependent Canada, with a total return of -6.04% in U.S. dollar terms. Only four other developed markets—Singapore, New Zealand, the U.K. and Spain—posted U.S. dollar losses. However, in local currency terms, all developed markets reported gains in the quarter.

The emerging markets also advanced in U.S. dollar terms in the first quarter, though to a lesser extent than the developed markets. The MSCI EM Index (net) reported a 2.24% total return in U.S. dollars, while the gain was 4.90% in local currencies due to the dollar's strength. Dispersion among the MSCI emerging markets was vast, ranging from a total U.S. dollar return of 18.61% for Russia to -29.34% for Greece.

This past quarter witnessed a sharp increase in the value of the U.S. dollar relative to most major foreign currencies, as the Wall Street Journal Dollar Index, which compares the greenback against a basket of 16 foreign currencies, gained 5.9% for the quarter (after a 12.0% rally in 2014). The lone exception was the Swiss franc, which de-pegged from the euro and rose sharply initially, though it finished the quarter very near where it began relative to the U.S. dollar.

In the fixed income markets, U.S. government bonds posted their fifth consecutive quarterly gain, the longest winning streak since the bursting of the dotcom bubble in 2001. Despite the impending hike in U.S. interest rates, investors bid up U.S. Treasury prices on continued dovish comments from the Federal Reserve as well as less-than-attractive investment alternatives around the globe. As of March 31, 2015, the 10-year Treasury yield was 1.930%, down from 2.173% at the start of the quarter. As low as that sounds, it compares quite favorably to the 0.183% yield on the German 10-year government bond and the 0.397% yield on the similar-maturity Japanese government bond.

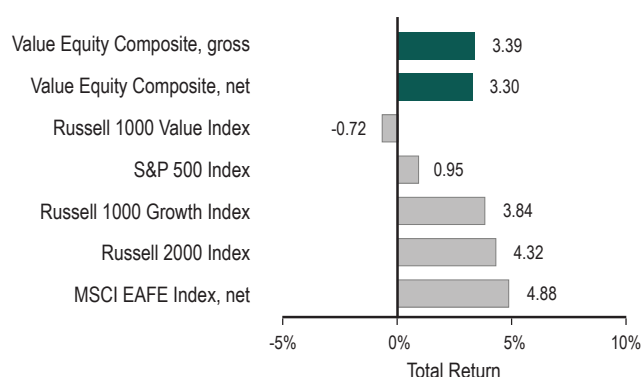
With respect to commodity prices, oil's decline slowed from its breakneck pace in late 2014, as U.S. crude oil prices slid 10.6% in the quarter, on top of the roughly 50% decline in 2014.

## PERFORMANCE AND ATTRIBUTION SUMMARY

For the first quarter of 2015, performance of Aristotle Capital's Value Equity portfolio was strong on both an

## Equity Performance Scorecard

First Quarter 2015



Sources: Advent; Russell Investments; Standard & Poor's; MSCI

Past performance is not indicative of future results. Returns are presented gross and net of investment advisory fees and include the reinvestment of all income. Aristotle Composite returns are preliminary pending final account reconciliation. Please refer to disclosures at the end of this document.

absolute and a relative basis. The **Value Equity Composite** posted a total return of 3.39% gross of fees (3.30% net of fees), meaningfully outperforming both the Russell 1000 Value Index and the broad S&P 500 Index, which reported total returns of -0.72% and 0.95%, respectively. For the year ended March 31, 2015, the Composite gained 10.77% gross of fees (10.38% net of fees), outpacing the 9.33% increase in the Russell 1000 Value Index but trailing the 12.73% rise in the S&P 500 Index. Longer-term performance was favorable, with the Value Equity Composite gaining 17.67% gross of fees (17.23% net of fees) for the three years ended March 31, 2015, ahead of both the Russell 1000 Value Index, 16.44%, and the S&P 500 Index, 16.11%.

Given our bottom-up, fundamentally focused security selection process, any value added relative to the Russell 1000 Value Index is typically generated by stock selection rather than sector allocation, and the first quarter of 2015 was no exception. (Sector allocation for the Value Equity portfolio is merely a by-product of individual stock selection decisions.) Security selection added value in most of the ten sectors, while in the aggregate, sector allocation detracted from relative performance for the quarter. The top five contributors to relative return were in five different sectors. As the graph on the next page shows, the investment team added at least 45 basis points to relative return in half the sectors. A few sectors were neutral, while the only sector to subtract value was Utilities.

Relative to the Russell 1000 Value Index, security selection added the most value in the Information Technology, Consumer Staples, Energy and Materials sectors; however, the portfolio's significant overweight in the quarter's worst-performing sector, Information Technology, partially offset

favorable stock selection in that sector. Meanwhile, stock selection in the Utilities sector detracted from performance relative to the Russell 1000 Value Index. The portfolio's moderate underweight in Health Care, the quarter's top performer, also hindered relative return, although the negative impact was completely offset by favorable stock selection in the sector.

**For the quarter, injection drug and infusion technology provider Hospira was the portfolio's top contributor to relative return.** After being a top contributor the prior quarter, shares of Hospira, Inc. appreciated more than 40% during the first quarter on the news that the company would be acquired by global biopharmaceutical giant Pfizer Inc. for \$90 per share in cash, representing a 39% premium from the prior day's closing price. From Pfizer's perspective, the acquisition expands distribution of Hospira's products outside the U.S., combines Pfizer's branded sterile injectables with Hospira's generic sterile injectables, and consolidates redundant biosimilar programs.

**After a minor pullback on profit-taking in the fourth quarter of 2014, aggregates and construction materials producer Martin Marietta rebounded in the first quarter to become a top contributor.** Martin Marietta Materials, Inc.'s solid execution continued, and shares advanced on better-than-expected earnings and establishment of a new share repurchase program that could reduce share count by 30% over the next three years. Volumes grew and Martin Marietta was able to continue to raise prices on strengthened demand. As mentioned in previous quarterly commentaries, Martin Marietta's integration of its acquisition of Texas Industries is ahead of schedule, and management reported that cost synergies will likely come in 40% better than originally anticipated. Given its ability to raise prices consistently in a poor construction market, we see the potential for Martin Marietta to further enhance its profitability and cash flow generation as infrastructure spending normalizes and utilization improves in the coming years.

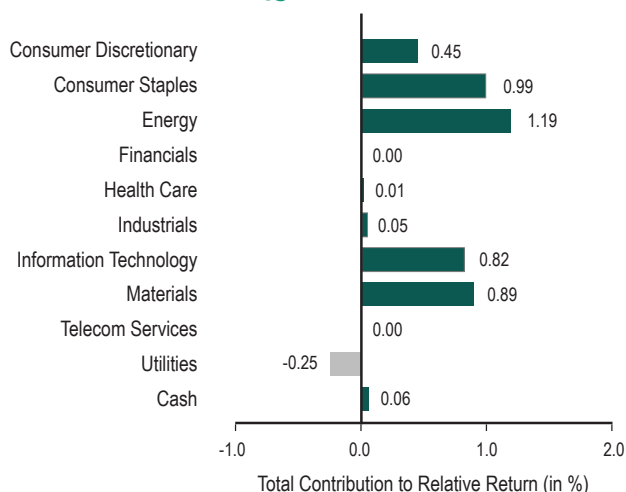
**In addition to the top contributor, the Health Care sector also housed the quarter's largest detractor, pharmaceutical company AbbVie.** Shares of AbbVie Inc. declined during the quarter due in large part to arbitrage pressure upon management's announcement of its intent to purchase biopharmaceutical producer Pharmacyclics, Inc. for \$21 billion (a bit pricey for some investors' tastes). Expected to close in mid-2015, this acquisition yields several potential catalysts for AbbVie, including: immediate commercial, clinical and regulatory capabilities and presence in hematology/oncology; blood cancer drug Imbruvica, a potential blockbuster therapy; and available synergies with other product lines. We also anticipate approvals for new indications (in addition to rheumatoid arthritis and Crohn's disease) for HUMIRA as well as new drug approvals to

treat a wide range of other diseases to serve as catalysts for AbbVie within our three- to five-year investment horizon.

*A recent addition to the portfolio, diversified energy holding company National Fuel Gas was a primary detractor from relative return.* We added National Fuel Gas Company (NFG), headquartered in upstate New York between Lakes Erie and Ontario, to Value Equity client portfolios during the quarter because we believe there is significant upside within our three- to five-year investment horizon. (Our detailed investment rationale appears in the following Recent Trades section.) However, the fact that we often invest in companies (like NFG) that are misunderstood or may have multi-year catalysts available to them means that, at times, we are “early” in making our investments. In its fiscal first quarter 2015 earnings report, management reported that low commodity prices negatively impacted production and that weakness in its E&P businesses in California as well as the Marcellus shale in the Appalachian Basin may continue over the short term. Weakness in the Utilities and Energy sectors is precisely what afforded us this investment opportunity at what we view to be an attractive valuation. While NFG pulled back during the quarter, our long-term thesis outlined below remains intact.

### Total Contribution to Relative Return by Sector versus Russell 1000 Value Index

First Quarter 2015



Source: FactSet

Past performance is not indicative of future results. Attribution results are based on sector returns, which are gross of investment advisory fees and include the reinvestment of all income. Please refer to disclosures at the end of this document.

## RECENT TRADES

During the first quarter, we sold two holdings and made two new investments in Value Equity client portfolios. We sold General Mills, Inc. as some of the catalysts we had

initially identified for the global consumer foods company have either been realized or are being re-examined. A main catalyst we had identified at the time of our initial investment was for the company to recapture market share in yogurt, as upstart Chobani had become the main player in the newer Greek category. Since our initial investment in 2012, General Mills has been able to regain market share in yogurt. However, another catalyst, the expected increased consumption of cereal in the U.S. as baby boomers age, is not playing out as we anticipated; we need to further analyze the U.S. decline in cereal consumption. Also, while small relative to the size of the company, its recent \$820 million acquisition of organic food producer Annie’s, Inc. makes the company further dependent on U.S. packaged foods. If we did not own General Mills today, we would do more research to better understand it. Therefore, we opted to divest the position and continue to study the company.

Our objective of identifying and investing in what we perceive to be high-quality businesses trading at discounts to intrinsic value often coincides with the goals of strategic or financial buyers, meaning that our holdings occasionally become acquisition targets. For example, during the quarter Pfizer offered to buy Value Equity holding Hospira for approximately \$16 billion, representing a nearly 40% premium to the previous day’s closing price and in excess of our intrinsic value target for the stock. Not wishing to take on the risk that the deal would be postponed or not go through (however unlikely those scenarios may be), we took advantage of the rapid price appreciation and sold Hospira in client portfolios to redeploy the proceeds in an investment that we believe has greater upside potential.

With the proceeds from these two sales, we initiated positions in diversified energy firm **National Fuel Gas Company** and global health care firm **Novartis AG**. To illustrate our disciplined investment process, we outline these latest investments here.

### National Fuel Gas

Incorporated in 1902, Natural Fuel Gas Company (NFG) is one of the oldest natural gas utilities in the United States. In fact, the company was one of the pioneers in utilizing depleted underground gas fields as storage reservoirs. Its roots as a utility laid the foundation for what we believe has become a conservative, well-run, integrated energy company. We began studying the company in earnest about three years ago, as our holding of Questar Corporation at the time piqued our interest in NFG due to the two companies’ similar business mixes.

In our view, NFG is a good company in an average/poor business (utility, pipeline/oil and gas). We believe

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the company is overlooked and misunderstood given both its history as a utility and its unique integrated structure. Its rapidly growing upstream business Seneca Resources (exploration and production), which comprises approximately half the value of the company today, is focused on natural gas development in one of the lowest-cost basins in North America, the Marcellus shale. Its NFG Midstream and Supply business has historically provided growth and predictability, represents approximately one-third of the value of the firm and is focused on gathering natural gas in the Marcellus, delivering it to the pipeline division that then transports the gas out of the oversupplied basins and into premium pricing markets. Finally, NFG Distribution, its gas utility business in and around Buffalo, provides stability and cash flow and represents about 15% of the company's value.

As described below, National Fuel Gas satisfies all three criteria requisite for inclusion in Aristotle Capital Value Equity client portfolios.

### *Quality Business*

Even though we are a value manager, our process neither begins nor ends with valuation. Rather, we begin by identifying businesses of high or improving quality. NFG exhibits several characteristics that we believe to signify high quality. This is rare among utilities, which are typically highly regulated businesses that earn regulated returns and generally have limited ability to add value beyond what is expected by investors. Among the high-quality characteristics we believe National Fuel Gas possesses are:

- Experienced and shareholder-friendly management team with a strong execution track record, including 112 years of consecutive dividend payments and 44 consecutive years of dividend increases;
- Free cash flow generation sufficient to fund its operations, modestly grow its dividend and keep its share count virtually flat;
- Low finding and development costs;
- Owned acreage in the Marcellus and Utica shale formations of Western New York and Pennsylvania provides value driver and diversification benefit from a “pure” utility; and
- Competitive advantage provided by its pipeline and natural gas storage business due to the current shortage of infrastructure to move gas eastward to where it is sorely needed (such as in Boston).

### *Attractive Valuation*

Once the necessary, though not sufficient, criterion of quality is met, we analyze the company's valuation. Low natural gas prices and recent high capital expenditures on midstream (pipeline, storage and gathering) projects have temporarily depressed NFG's valuation. In our opinion, a

“sum of the parts” analysis reveals that National Fuel Gas is meaningfully undervalued at its current stock price.

### *Catalysts*

We believe optimal investments are often found in companies continually striving to become better. We refer to these company-specific drivers—which we must identify *before* the market sees them to capture potential hidden value—as catalysts. Among the catalysts we have identified for NFG, which we expect to cause its stock price to appreciate toward our value target within our three- to five-year investment horizon, are:

- **Enhanced profitability** as finding and development costs continue to decline;
- **Natural gas switching** in its distribution territories;
- **Continued development of the Marcellus shale**, as the company is in the initial development stage with greater than a 20-year drilling inventory on acreage unencumbered by royalties (owns the mineral rights and has no lease expirations);
- **Continued steady, predictable growth in earnings and cash flows** due to pipeline and gathering (midstream) systems investments in a rapidly expanding region that is short on infrastructure; and
- **Realization of the value of its California assets.**

### *Novartis*

We have followed Novartis AG, a leading integrated pharmaceutical company, for years and have invested in the company in other investment strategies. Founded in 1895 and headquartered in Basel, Switzerland, Novartis operates in five business segments: branded pharmaceuticals, eye care products (Alcon), generic pharmaceuticals (Sandoz), vaccines (which is being divested) and diagnostics, and over-the-counter (OTC) consumer health products (which has recently become a joint venture with GlaxoSmithKline).

Novartis meets all three of our investment criteria, as outlined here.

### *Quality Business*

Novartis exhibits several characteristics that we deem to signify high quality, including:

- Relatively new CEO Joseph Jimenez and new CFO Harry Kirsch appear more focused on realizing shareholder value than their predecessors;
- Robust pharmaceutical pipeline with an abundance of late-stage products, including LCZ696 for chronic heart failure; and
- Free cash flow of \$13 billion annually (representing approximately 5% of market cap) used to fund drug



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development and further acquisitions of companies and/or products as well as dividend increases (current yield just under 3%).

### *Attractive Valuation*

In our opinion, over the past year, Novartis management has done a good job of “cleaning up” the business, shedding lower-margin businesses and focusing on more profitable ones. However, we do not believe the share price accurately reflects the “new and improved” Novartis structure, nor does it fully reflect the sum of all of its parts, such as the company’s stake in Roche and its robust pipeline. Thus, we were pleased to have the opportunity to add Novartis to Value Equity client portfolios in the first quarter at a meaningful discount to our assessment of fair value.

### *Catalysts*

We have identified several catalysts for Novartis, including:

- **Margin improvement from its announced portfolio transformation**, which includes the divestitures of vaccines and animal health in addition to the creation of a joint venture with GlaxoSmithKline for the OTC business;
- **Realization of value of its 6.4% equity ownership in Roche**, which in our opinion represents an underappreciated asset;
- **Eye care market share gains by Alcon** due to recent acquisition of one of its most formidable competitors, Allergan;
- **Sandoz’s market share gains in biosimilars** for drugs coming off patent, including a biosimilar version of Neupogen, which reduces the risk of infection during chemotherapy;
- **Approval of LCZ696** heart failure medicine in both the U.S. and Europe; and
- **Additional cost savings** to be realized from the company’s procurement and manufacturing rationalization plans.

This information is for illustrative purposes only and is not a recommendation to buy or sell a particular security. There is no guarantee that the securities discussed will prove to be profitable. Please refer to disclosures at the end of this document.

## OUTLOOK

The U.S. economy is *normalizing* and appears to us to be entering a transition phase, the first one in more than five years. Most global economies have yet to enter this transition. This *transition* we refer to could be one from “defense” to “offense.” That is, from an environment in which all external factors were supportive of keeping the economy from entering recession (even though we have not been in one since 2009) to one of a cyclical normalization of such factors. Some of the shifts could include:

- Low and/or declining interest rates may turn into (modestly) rising rates.
- Very tight bank lending standards may give way to more “realistic” loan practices (particularly as they pertain to residential mortgages).
- Significant cash accumulation by corporations may now turn into the need for greater capital expenditures to meet the growing demand for products and services.
- Weak labor markets with benign labor costs could quickly turn into a tight labor market, leading to escalating labor costs.
- Abundant office, factory, retail and commercial building space may turn into a supply-constrained environment, resulting in higher occupancy costs and reduced flexibility of work spaces.

While we cannot yet be specific, history suggests that transitions such as these are unlikely to be without bumps or unintended consequences. As always, we will be mindful of, and diligent in, evaluating these factors in our analyses of businesses while continuing to adhere to our bottom-up, fundamentally focused research process.

## Aristotle Value Equity Composite Performance

Year	Value Equity Composite (Gross)	Value Equity Composite (Net)	Russell 1000 Value Index	S&P 500 Index
2015*	3.39%	3.30%	-0.72%	0.95%
2014	11.63%	11.26%	13.45%	13.69%
2013	30.82%	30.41%	32.53%	32.39%
2012	22.11%	21.49%	17.51%	16.00%
2011	-3.21%	-3.61%	0.39%	2.11%
11/1/10-12/31/10	5.30%	5.21%	7.32%	6.70%
SUPPLEMENTAL PERFORMANCE				
1/1/10-10/31/10	13.22%	12.97%	7.63%	7.84%
2009	32.49%	32.14%	19.69%	26.46%
2008	-36.35%	-36.53%	-36.85%	-37.00%
2007	10.97%	10.67%	-0.17%	5.49%
2006	22.26%	21.93%	22.25%	15.79%
2005	12.07%	11.77%	7.05%	4.91%
2004	30.12%	29.77%	16.49%	10.88%
2003	35.05%	34.68%	30.03%	28.68%
2002	-19.30%	-19.52%	-15.52%	-22.10%
2001	-11.94%	-12.18%	-5.59%	-11.89%

*\*Year to date through March 31, 2015. Composite returns are preliminary pending final account reconciliation.*

*The Aristotle Value Equity strategy has an inception date of November 1, 2010; however, the strategy initially began at Mr. Gleicher's predecessor firm in October 1997. A supplemental performance track record from January 1, 2001 through October 31, 2010 is provided above. The returns are based on two separate accounts and performance results are based on custodian data. During this time Mr. Gleicher had primary responsibility for managing the two accounts. Mr. Gleicher began managing one account in November 2000 and the other December 2000. Past performance is not indicative of future results. Returns presented are gross and net of investment advisory fees and include the reinvestment of all income. Please refer to disclosure at the end of this document.*

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Returns are presented gross and net of investment advisory fees and include the reinvestment of all income. Gross returns will be reduced by fees and other expenses that may be incurred in the management of the account. The Russell 1000 Value<sup>®</sup> Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values. The S&P 500<sup>®</sup> Index is the Standard & Poor's Composite Index of 500 stocks and is a widely recognized, unmanaged index of common stock prices. These indices have been selected as the benchmarks and are used for comparison purposes only. The Russell 1000<sup>®</sup> Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 2000<sup>®</sup> Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000<sup>®</sup> Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada. The MSCI EAFE Index consists of the following 21 developed market countries: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. The volatility (beta) of the Composite may be greater or less than its respective benchmarks. It is not possible to invest directly in these indices.

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