Blue Current

BLUE CURRENT GLOBAL DIVIDEND



# 2017 – Q1 Quarterly Letter

Blue Current SMA Strategy

March 31, 2017

Dear Investors:

The Blue Current Global Dividend Strategy returned +6.4% (net) during the first quarter of 2017, improving the trailing one-year performance to +12.4% (net). We remind investors that our strategy is not managed to any specific equity index, but instead we focus on identifying companies that will pay a stable and increasing dividend and generate an attractive total return for our investors. For comparison, the MSCI World High Dividend Yield Index returned +5.9% and the MSCI World Index returned +6.4% during the quarter. For the trailing one-year period, the MSCI World High Dividend Yield Index returned +11.5% and the MSCI World Index returned +14.8%.

**INTERNATIONAL TAILWINDS**

The first quarter was a classic risk rally, in that markets with high risk premiums delivered high performance - emerging markets led, followed by international developed, followed by the U.S. Only the anemic performance of U.S. small caps (+2% during the quarter) contradicted the trend, but investors were rewarded in 2016. Although our strategy does not invest in emerging markets because of inconsistent dividend policies and sub-optimal shareholder governance, we were fortunate to benefit from improved performance across developed markets. The appetite for risk was supported by improving fundamentals. Increasing earnings growth, attractive relative and absolute valuations, and strengthening macroeconomic releases across Europe all underpinned the strong move, and they are likely to prove sustainable over the next several months. The conclusion of key elections, including the French presidency, should also benefit the investment environment in 2017.

The good news is that the first round of the French election is now in the rear-view, reducing a degree of uncertainty that has blanketed the European market in recent weeks. The leading two candidates, Marine LePen and Emmanuel Macron, overcame a deep field of candidates, including Jean-Luc Mélenchon, an extreme candidate whose popularity, spurred by recent terrorist activity, soared in recent weeks. LePen and Macron will now face off during France's second-round election on May 7 to decide the next French president. If the polling data is to be believed, Macron is forecast to win the second round, adding additional stability to the eurozone, following successful Dutch elections earlier in the year. Prior to his presidential run, the 39-year-old candidate was relatively obscure in French politics, serving briefly under Hollande, and although Macron leans left on most issues he has vowed to reform French labor laws in favor of businesses. If elected, Macron is likely to have a challenge ahead in forming a government, due to the lack of support from France's primary parties. New policy initiatives could be slow in the making, but importantly, the conclusion eliminates one of the largest risk overhangs in the region. We would not be surprised to see continued investor flows into the region – note roughly $120 billion left European equities last year.

In our previous letter we made the case that the US dollar was likely to buck the consensus view of continued strength in 2017 and, contrary to opinion, weaken in the early months of 2017. Our view was predicated on improving economic and earnings trends across the eurozone, and a U.S. Federal Reserve that would prove more dovish than expected. This has largely materialized through the early months of the year, and the British pound, Swiss franc, and euro all are stronger four months into the year. This has been an additional tailwind for our portfolio companies domiciled outside the U.S. As a reminder, we estimate that the strong dollar subtracted roughly 3% last year from our portfolio, and we could expect those losses to be recouped in 2017.

## BLUE CURRENT PHILOSOPHY AND OBJECTIVES

The Blue Current investment team utilizes its expertise in growing cash flow to invest in what we believe is a niche universe of high-quality, dividend-paying companies with sustainable business models and dividend policies. The primary objectives are to pay a stable and increasing dividend each quarter and to deliver attractive, long-term capital appreciation to investors.

The portfolio is concentrated and invests in 25 to 50 companies across developed markets that meet our stringent quality requirements. We focus on companies that we believe have a strong history of rewarding shareholders and have the financial ability to continue to increase the dividend over time. We also focus on the future earnings potential of each company and strive to purchase those businesses when they are trading at a discount to their true value.

## PORTFOLIO COMMENTARY

The portfolio exhibited good breadth during the first quarter, with a number of regions and sectors contributing to returns. Unilever was our top contributor, returning +22% during the quarter. In a risk-on environment, it is unusual for a consumer staples stock to lead our portfolio, however, Unilever benefitted from a failed acquisition discussion with Kraft Heinz that ultimately led to management refocusing on its competitive position (and share price). To our liking the company announced a 12% increase in the dividend and a $5bn share buyback. After participating in the earnings calls of various European consumer brands, it is clear that the approach by Kraft Heinz is having ripple effects across the industry. If Unilever can nearly succumb to a takeover by an American brand, Nestlé and Danone are equally (probably more) at risk, and both have announced new initiatives in recent weeks to acquiesce to shareholders, sending stocks higher. The proposed acquisition of Unilever was a tailwind to our portfolio, but Q1 results (announced on April 20) also proved the value of the Unilever brand, with sales up nearly 3% organically, an acceleration from recent trends. Unilever is one of the few consumer facing product producers that have proven resilient in the face of global retail price deflation, and as an example, the company was able to raise prices 3% on a consolidated basis in the first quarter (this follows a 2.8% increase in prices in 2016). Few companies have been as successful as Unilever in maintaining pricing power in the current environment.

Another consumer behemoth, France-based LVMH, returned +16% during the quarter and posted one of its strongest quarters of growth in recent years, with Q1 revenue increasing 13% year-over-year. The company represents a rare collection of the highest quality consumer brands ranging from champagne (Dom Pérignon) to watches (TAG Heuer) to fashion (Christian Dior), all methodically assembled under the guidance of Bernard Arnault during his tenure as CEO. At the time of this writing, LVMH announced a further consolidation of the LVMH brands by acquiring its remaining interest in Christian Dior. LVMH also has a long history of increasing its dividend, generating a 9% annual increase for the prior five years and a 13% growth rate over the trailing 12 months. Despite the growth, the dividend remains well covered. LVMH's operating cash flow has increased by more than 50% since 2011, to over €6.3bn last year, providing ample coverage for the company's €1.8bn annual dividend payment.

Lastly, Stanley Black & Decker, returned +16% during the quarter, and it represents one of our favorite consumer companies in the portfolio and a top 10 holding for several years. The Stanley management

team has been busy in recent quarters solidifying its tools and storage business, acquiring Craftsman Tools, and the tools business of Newell Brands. Including the acquisitions, Stanley now manufacturers 30% of all hand tools sold in the United States. The company is a perennial dividend grower, with a five-year dividend growth rate near 7%. We believe the stock has additional upside, stemming from synergies related to recent mergers and a housing market that remains exceptionally strong.

Exiting the quarter, our non-U.S. exposure represented approximately 47% of the consolidated portfolio, an increase from approximately 40% one year ago. The increase has been driven by an increasingly attractive opportunity set abroad, specifically in continental Europe, where the valuation gap versus comparable U.S. companies was widening. Late last year, we initiated positions in Sanofi (France), Swiss Re (Switzerland), and Bayer (Germany), all at less than 12x earnings with attractive dividend yields and growth prospects. In our upcoming second-quarter shareholder letter, we will share details of a new European position that we are currently building, further increasing our non-U.S. exposure closer to 50% of the portfolio.

Transitioning back to the U.S., we initiated a new position in Nordstrom during the quarter, taking a counter-consensus view of brick-and-mortar retail. Across the consumer discretionary sector, there is no more beleaguered sector than traditional retail, spurred by investor and media belief that the physical shopping experience is dead. We love it when investors paint a sector with such a broad brush that all business models - regardless of market positioning, product strength, and balance sheet - are lumped together. It provides us with the opportunity to sift through the carnage and identify gems that represent mis-priced businesses, but more importantly, dividend yields that are above average and well supported even in a difficult environment. We believe Nordstrom fits that description. Unlike most big-box, anchor retailers that each operate thousands of stores, Nordstrom oversees approximately 120 full-price store locations, the majority of which (approximately two-thirds) we estimate are located in premium, tier 1 mall locations. The consolidated store footprint does not insulate Nordstrom from competitive or pricing pressure, but Nordstrom does benefit from its off-price brand, Nordstrom Rack, which operates 226 smaller -footprint (high sales per square foot) outlets across major metropolitan areas. Off-price is perhaps the only segment of retail that is currently expanding square footage, and while full-price brick-and-mortar businesses are valued between 5 and 6x EBITDA, off-price businesses are valued closer to 10x EBITDA. Off-price represented approximately 30% of Nordstrom revenue in 2016, up from 25% only a few years earlier. Nordstrom has also invested heavily in e-commerce, which now represents nearly 22% of revenue and is the fastest growing distribution channel for the company. Using three valuation methodologies, including valuing the off-price business separately, we believe Nordstrom can be conservatively valued at $60 per share, representing almost 50% upside from our initial purchase.

As many of our investors understand, our strategy emphasizes dividend growth, and we would be remiss if we did not share some of the recent dividend growth announcements:

- Valero: 17%
- Unilever: 12%
- Cisco Systems: 12%
- Intercontinental Hotels: 11%
- Enbridge: 10%
- Bayer: 8%
- Royal Bank of Canada: 5%
- Allianz: 5%

## INVESTMENT OUTLOOK

The investing landscape is as supportive of a global, high quality, dividend growth strategy as we have experienced in several years. The valuation discrepancy across the United Kingdom and the eurozone has persisted for several years without notable investor exploitation; however, recent events in the U.S. and positive economic and political momentum abroad, have resulted in a notable arbitrage for investors. The simplest explanation is a U.S. industrial business trading at a 30% premium compared with a European industrial business. The combination of improving top-line growth in Europe and higher multiples within the U.S. is reducing the valuation discrepancy at this moment. Adding to the momentum, the U.S. dollar remains largely contained, providing a currency uplift from our non-U.S. positions, a phenomenon that we do not expect will be a tailwind for the full year. Looking ahead, if consensus is to be believed we expect high single-digit earnings and dividend growth for the portfolio, and we will remain well balanced across industries and regions to provide the best risk-adjusted return possible for our investors.

Our portfolio statistics are as follows:

| | |
|---|---|
| Gross Dividend Yield: | 3.2% |
| 2017 Price/Earnings: | 15.1x |
| 2017 Expected Earnings Growth: | 9% |
| International Exposure: | 47% |
| AAAA/AAA Exposure:* | 62% |

For more information on our strategy, please visit www.bluecurrentportfolios.com.

*Defined as a percentage of the portfolio invested in companies with 10+ years of dividend growth.

Sincerely,

**Henry "Harry" M. T. Jones**
Co-Portfolio Manager
Blue Current Global Dividend

**Dennis Sabo, CFA**
Co-Portfolio Manager
Blue Current Global Dividend

| EQUITY PERFORMANCE | | |
|---|---|---|
| | Blue Current Equity Composite (net of 1% manager fee) | MSCI World High Dividend Yield Index (no transaction costs or fees) |
| 2009 | 15.0 | 32.9 |
| 2010 | 12.7 | 6.3 |
| 2011 | 8.6 | 3.9 |
| 2012 | 11.4 | 12.2 |
| 2013 | 28.9 | 21.9 |
| 2014 | 3.4 | 2.5 |
| 2015 | -2.0 | -3.2 |
| 2016 | 9.0 | 9.3 |
| 2017-YTD | 6.4 | 5.9 |
| **CAGR (since inception)** | **11.0** | **10.6** |
| **CAGR (trailing 5 years)** | **9.2** | **8.4** |
| **CAGR (trailing 7 years)** | **10.0** | **8.2** |

Source: Blue Current Investment Management. 2016 performance has not yet been verified by our independent verification service provider, Ashland Partners & Company. See GIPS® disclosure at the end of this report.

**BLUE CURRENT INVESTMENT MANAGEMENT**

EQUITY ONLY COMPOSITE

Annual Disclosure Presentation

**1/1/2009 to 12/31/2015**

| Year | Blue Current Gross Return | Blue Current Net Return | MSCI World High Div Yield Net Index Return | MSCI World Net Index Return | Blue Current Standard Deviation | MSCI World High Div Yield Net Standard Deviation | MSCI World Index Net Standard Deviation | Internal Dispersion | Number of Portfolios | End of Period Assets | End of Period Firm Assets |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 2009 | 16.11% | 14.97% | 32.48% | 29.99% | NA 2 | 24.23% | 21.70% | NA 1 | < 6 | $1,565,376 | $10,970,324 |
| 2010 | 13.85% | 12.71% | 6.29% | 11.76% | NA 2 | 25.89% | 24.05% | NA 1 | < 6 | $2,363,654 | $32,789,983 |
| 2011 | 9.67% | 8.58% | 3.89% | -5.54% | 14.98% | 21.81% | 20.44% | NA 1 | < 6 | $19,499,442 | $77,655,266 |
| 2012 | 12.50% | 11.40% | 12.24% | 15.83% | 12.58% | 15.33% | 16.98% | 0.49% | 16 | $30,917,548 | $190,942,763 |
| 2013 | 30.14% | 28.88% | 21.91% | 26.68% | 10.53% | 11.88% | 13.73% | 0.29% | 46 | $71,025,142 | $267,812,275 |
| 2014 | 4.40% | 3.35% | 2.48% | 4.94% | 8.84% | 10.44% | 10.37% | 0.31% | 57 | $115,318,155 | $337,317,537 |
| 2015 | -1.04% | -2.03% | -3.20% | -0.87% | 10.37% | 11.16% | 10.80% | 0.64% | 58 | $122,654,070 | $325,139,286 |

N.A.1 - Information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year.
N.A.2 - The three-year annualized standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period. The three-year annualized standard deviation is not presented for periods with less than 36 months of data.

***Blue Current Global Dividend Composite*** includes all fully discretionary, fee-paying accounts under management following a common investment objective, including those accounts no longer with the firm. The composite invests primarily in domestic or international securities the portfolio manager feels have the potential to deliver outperformance

due to a combination of price appreciation and current income in the form of a dividend. The composite will typically invest in securities with a current dividend yield in excess of the broad equity markets with a history of consistently increasing the dividend rate and with what we believe to be strong fundamentals at an attractive price (i.e. low use of leverage, operating margins in excess of 5%, free positive cash flow yield, a price-to-earnings ratio at or below the market average, and earnings growth). The Global Dividend Equity Composite was created on January 1, 2009. The annual composite dispersion presented is an asset-weighted standard deviation calculated for the accounts in the composite the entire year.

The U.S. dollar is the currency used to express performance. Returns are presented gross and net of management fees and include the reinvestment of all income. Net of fee performance was calculated using the highest allowable annual management fee of 1% applied monthly. The annual composite dispersion presented is an asset-weighted standard deviation calculated for the accounts in the composite the entire year. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Past performance is not indicative of future results.

The investment management fee schedule for the composite is 1% on the first $5 million, 0.7% on the next $5 million, 0.65% on the next $10 million, 0.55% on the next $30 million, 0.45% on the next $50 million, 0.40% on the next $150 million, and 0.20% on any amount above $250 million. Actual investment advisory fees incurred by clients may vary.

*The benchmark MSCI World Index includes 1,611 stocks located across 24 developed countries and captures approximately 84% of the free float-adjusted market capitalization in each country.* MSCI uses the maximum withholding tax rate applicable to institutional investors in calculating MSCI net dividends.

The MSCI World High Dividend Yield Index is based on the MSCI World Index, its parent index, and includes large and mid-cap stocks across 23 developed market countries. The index is designed to reflect the performance of equities in the parent index (excluding REITs) with higher dividend income and quality characteristics than average and dividend yields that are both sustainable and persistent. The index also applies quality screens and reviews 12-month past performance to omit stocks with potentially deteriorating fundamentals that could force them to cut or reduce dividends. MSCI uses the maximum withholding tax rate applicable to institutional investors in calculating MSCI net dividends.

Blue Current claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Blue Current has been independently verified for the periods January 2009 to June 2015 by Ashland Partners & Company. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Blue Current Global Dividend composite has been examined for the periods January 2009 to June 2015 by Ashland Partners & Company. The verification and performance examination reports are available upon request. Note: Blue Current firm AUM has been amended.

Blue Current Investments is a subsidiary of Edge Advisors, LLC ("Edge"). Edge is an independent registered investment adviser based in Atlanta, Georgia. Blue Current manages separate account strategies with defined investment objectives. Edge's total firm assets of approximately $2.7B (as of July 31, 2015) include the assets managed by the Blue Current division of Edge ($295.98M) as well as those managed by Edge but not by the Blue Current division. All employees who work within the Blue Current division of Edge may also manage assets for Edge outside of the Blue Current division. The firm's list of composite descriptions is available upon request.

Withholding taxes may vary according to the investor's domicile. Composite returns are gross of withholding tax and represent investors domiciled primarily in the United States. The MSCI Indices incorporate withholding tax rates applicable to GHI country holding companies.

**Disclosure and Risk Summary**

The opinions expressed herein are those of Edge Advisors, LLC, and the report is not meant as legal, tax, or financial advice. You should consult your own professional advisors as to the legal, tax, financial, or other matters relevant to the suitability of investing. The external data presented in this report have been obtained from independent sources (as noted) and are believed to be accurate, but no independent verification has been made and accuracy is not guaranteed. The information contained in this report is not intended to address the needs of any particular investor.

The information contained in this document does not constitute an offer to sell any securities nor a solicitation to purchase any securities. Index returns reflect the reinvestment of dividends.

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