GOTHAM FUNDS

LONG/SHORT VALUE INVESTING

September 13, 2018

Market Observations

1. U.S. Equity Markets Remain Very Expensive (based on our 28-year valuation history)

Valuations are high:

- The S&P 500 and the Russell 1000 are both in the 15th percentile towards expensive, meaning the indexes have been cheaper 85% of the time.
    - When markets have been at these levels in the past, one-year forward returns have averaged 2-4% and two-year forward returns have averaged 7-9%, which is well below normal returns historically.
- The Russell 2000 is in the 3rd percentile toward expensive, meaning the index has been cheaper 97% of the time over the last 28 years.
    - When the Russell 2000 has been this expensive in the past, one-year forward returns have averaged between -3 to -5%.

Markets are speculative:

- The S&P 500 has returned 9.9% for the year-to-date period through August 31st. Large cap stocks are on pace for an annualized return of 15% for the year, which is well above the normal returns for the 28 year history that we examine.
- Small cap returns have been even higher; the Russell 2000 returned over 14% for the year-to-date period through August 31st.
- The MSCI US Momentum Index has returned 15.5% for the year-to-date period through August 31st. This puts it on pace for an annualized return of over 24% for the year.

Fortunately, we believe the current environment has created a very strong opportunity set going forward. Based on our research, our **SPREADS**[1] typically perform best following periods of speculation and high valuations, as markets revert to more normal levels.

2. The Large Disparity Between Growth and Value has Continued

We are cash flow oriented value investors, not low price/book, low price/sales investors. Morningstar generally categorizes us as "blend." As such we would expect to perform better than traditional value investors during these periods. However, such large disparities between value and growth/momentum will be challenging for us.

Outperformance of growth and momentum-driven indexes over value has continued through the year-to-date period (as of August 31st):

- The Morgan Stanley Momentum Index has outperformed the Morgan Stanley Value Index by 31.8% (11.0% v. -20.8%).

[1] Spread is defined as how much our long portfolio outperformed our short portfolio adjusted for leverage (i.e. 100% exposure to the long portfolio, less 100% exposure to the short portfolio).

- The Russell 1000 Pure Growth Index has surpassed the Russell 1000 Pure Value Index by 25.7% (28.6% v. 2.9%). The "Pure" style indexes include only those stocks that are considered fully value or growth as defined by Russell.[2]
- The Russell 1000 Growth Index has outperformed the Russell 1000 Value Index by 12.7% (16.4% v. 3.7%).

Looking back historically, we are in an extraordinary period of significant divergence between growth and value:

- From 1980 to 2006, value outperformed growth by an average of 2% (as measured by the Russell 1000 Value versus Russell 1000 Growth Index) to 5% (as measured by the Russell 2000 Value versus Russell 2000 Growth Index) per year. Since the global financial crisis in 2007, value-oriented strategies have underperformed growth strategies by an average of 5% per year (as measured by the Russell 1000 Value versus Russell 1000 Growth Index). Over this period, the only year where value substantially outperformed growth was 2016.
- In the trailing 11-year period in which growth has beaten value in an unsurpassed manner, there have been only two calendar years with a greater disparity (between the Russell 1000 Growth and Russell 1000 Value indexes) than the 2018 year-to-date period where growth has beaten value by 12.7%: 2009 (disparity of 17.5%) and 2017 (disparity of 16.5%).

3. There Has Been Outperformance by Money Losers

Over the year-to-date period, money-losing names have outperformed the overall indexes. Stocks represent ownership shares in a business. **We do not believe this trend can persist and are confident that markets will revert back to reflect underlying company fundamentals.**

- Our recent analysis for the year-to-date period through August 31st showed:[3]
  - Average return of all companies with negative cash flow in the Russell 1000: 15.7%.
  - Average return of all companies with negative earnings yield in the Russell 1000: 31.5%.
  - Average return of all companies with negative cash flow in the Russell 2000: 18.4%.
  - Average return of all companies with negative earnings yield in the Russell 2000: 22.0%.
- Additionally, we continue to find the more expensive names, the companies we short, in the smaller cap universe, which has outperformed for the year-to-date period through August 31st.
  - The Russell 1000 was up 10.1% while the Russell 2000 was up 14.3%.

Based on history, this kind of environment is one where our style of value investing is not at its strongest. We are generally short "hope stocks," many of which burn cash and/or trade at 50 to 100 times free cash flow. When people are attracted to those kind of stocks, our shorts don't perform well.

[2] The Russell Pure Style Indexes provide concentrated exposure to stocks that exhibit strong growth or value signals. Building upon Russell's traditional, cap-weighted style methodology, the Pure Style methodology is style-weighted, and effectively narrows the universe delivering a more tailored, 'pure' exposure to only those stocks considered fully value or growth.

[3] Average returns of an equally weighted portfolio comprised of companies that lost money within the specified indexes based on Gotham's metrics.

4. The Opportunity Set is Significant

Expensive valuation levels and the disparity between stock returns and fundamentals both point to very attractive expected spreads for us going forward.

- Even though the market is expensive based on history, we do expect positive returns. Our long portfolios are much cheaper than the market, according to our research, and we therefore expect them to outperform meaningfully.
- Our shorts are very expensive, according to our research, and can produce significant returns when markets revert to more normal levels.
- Additionally, based on our research, predictive indicators of our strategy include:
    - Our spreads perform best following periods where markets are expensive.
    - Our spreads perform best following periods where the most expensive stocks beat the cheapest stocks (based on our metrics).

The valuation gap between value and growth has become very stretched. Although we can't predict exactly when, we believe it will inevitably snap back in a big way. In the meantine, we stick to our systematic valuation process. In the periods following 1999 and 2007, valuations normalized leading to long periods of significant outperformance for our investment style. We believe our opportunity set is significant and our long/short returns over the next few years will rhyme quite well with similar periods in the past.

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-CIOs

Important Information

This document contains forward-looking statements regarding future events, forecasts and expectations regarding equity markets and certain of Gotham's strategies. Forward-looking statements may be identified terminology such terms as "may," "expect," "will," "hope," "believe" and/or comparable terminology. No assurance, representation, or warranty is made that any of Gotham's expectations, views and/or objectives will be achieved and actual results may be significantly different than reflected herein.

Index, portfolio and stock valuations are based on Gotham's valuation methodology.

Broad-based securities indexes mentioned herein are unmanaged and are not subject to fees and expenses typically associated with investment funds. Investments cannot be made directly in an index. The performance and volatility of Gotham's strategies will be different than those of the indixes.

The S&P 500 Total Return Index and Russell 1000 Index are commonly followed equity indexes 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 markets. Returns for the indexes are calculated on a total return basis with dividends reinvested, unless otherwise noted.

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 by clicking here or by calling 877-974-6852. The prospectus should be read carefully before investing.

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