GOTHAM FUNDS

LONG/SHORT VALUE INVESTING

September 1, 2015

Current Market Volatility: A Return to an Appreciation for Risk

After roughly tripling over the last 6 years and with no substantial corrections over the last 4, most market indexes fell approximately 6% in August. However, the more important development for most market participants may end up being the return to an appreciation for risk. After such a long bull run, at the end of July we wrote the following in our Second Quarter letter to investors:

"Though our portfolios are a mix of companies that are usually categorized by Russell and Morningstar as a "blend" between value and growth (as our stocks are not generally low price/book, low price/sales or low quality companies), our long selections are generally out of favor companies with low near term expectations built into their prices. The market this year has put a premium on growth, momentum, companies losing money, passive investing (where money continues to pile into whatever indexes have done well) and money losing IPOs. In short, the current environment is antithetical to our fundamental approach and not an environment in which we would expect our long/short spreads to outperform.

We believe, however, that the long term will be kind to our strategy. We typically favor companies with high cash flows relative to price that generate high returns on capital and generally short the opposite, companies generating little or negative cash flows that produce much lower or negative returns on their capital investments on average. If we continue to do a good job of analyzing and valuing companies, we believe our effort will be rewarded—even if it takes some time. In the short term, though, we are seeing extreme conditions.

This is the first time since the late 1990s that over 80% of IPOs are losing money. Buying the top momentum stocks and shorting the bottom momentum stocks (from the Morgan Stanley momentum index) would have achieved positive 18% returns so far this year whereas buying the top value stocks and shorting the bottom value stocks (from the Morgan Stanley value index) would have lost 13%.(1)

Money flows into passive investments vs. active investments are running at levels of 8 to 1 or more. Buying only those companies that lose money has earned investors anywhere from 20% to 50% over the last twelve months(2)*. Whether you equally weight, market cap weight, use medians or averages, returns of that magnitude represented a significant multiple to market benchmark results.*

In short, we do not believe current conditions are sustainable. Though we do not know when these conditions will change, our research shows that when the turn comes it is often quick and substantial. As always, we plan to continue with our disciplined process of valuing businesses and managing our long/short portfolio risks. If our strategy worked every day, or month or year and in every market environment, everyone would follow it. Suffice it to say, it doesn't and we believe they won't (precisely because of periods just like this one)."

Though we had modestly positive long/short spreads in our funds during the month of August, during big market drops correlations between securities generally move toward 1. In essence, when investors start to panic they throw everything out without much discernment. Given our research into prior market periods, it is our expectation that this discernment should start to play out over the next 6 to 12 months as an appreciation for risk returns.

In other words, we would expect that there will be a renewed appreciation for the companies in our long book which produce high cash flows relative to price and also generate attractive returns on capital in their business. In contrast, we would expect that those companies we are short (that generate much lower or negative cash flows relative to price and lower or negative returns on capital) to struggle relative to the market and particularly relative to our much more reasonably priced long book. Over the last several years, these “hope” stocks have been priced with little concern for the risks to those high expectations.

As we often say, stocks are not pieces of paper that bounce around that we put Sharpe or Sortino ratios on. Stocks are ownership shares of businesses that we value and then either buy at an attractive discount to that value or sell short when they are expensive relative to value. This process often takes time to work, but this is the only way we know how to invest. As opposed to the extreme market conditions that we wrote about in our second quarter letter at the end of July, we are optimistic that recent market activity will help produce a particularly rewarding environment for our strategy over the coming year.

Current Valuation Levels

Currently, the Russell 1000 is in the 38th percentile toward expensive and the Russell 2000 is in the 13th percentile towards expensive, meaning the indexes have been cheaper 62% and 87% of the time, respectively, over our 25 year research history. Based on these levels in the past, the year forward return of the Russell 1000 index has been approximately 6-11% and the year forward return of the Russell 2000 Index has been approximately 1-2%.

Of course, we don’t buy or sell market indexes. However, due to the valuation disparities between large caps and small cap stocks, our longs are currently skewed toward the cheapest stocks among the larger caps and our shorts are skewed toward the most expensive smaller cap stocks within an already very expensive small cap universe. Based on current valuations and our portfolio positioning, we believe this valuation disparity between large and small caps should also help contribute to attractive long/short spreads in the coming year.

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) Source: Bloomberg; MSZZMOMO Index (Morgan Stanley US Momentum Custom Index representing an equal notional pair trade of going long the US Momentum Long and Short the US Momentum Short Index) and MSZZVAL Index (Morgan Stanley US Value Custom Index representing an equal notional pair trade of going long the US Value Long and Short the US Value Short). Performance of each of the indices reflects each side being rebalanced back to equal notional at the close of each trading day.

(2) 20% and 50% is based on the median and average return respectively of an equally weighted portfolio. Companies in this calculation lost money based on Gotham's proprietary metrics and were selected from the investable universe of certain of Gotham's mutual funds.

Important Information

This document may contain 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.

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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