RGA INVESTMENT ADVISORS, LLC

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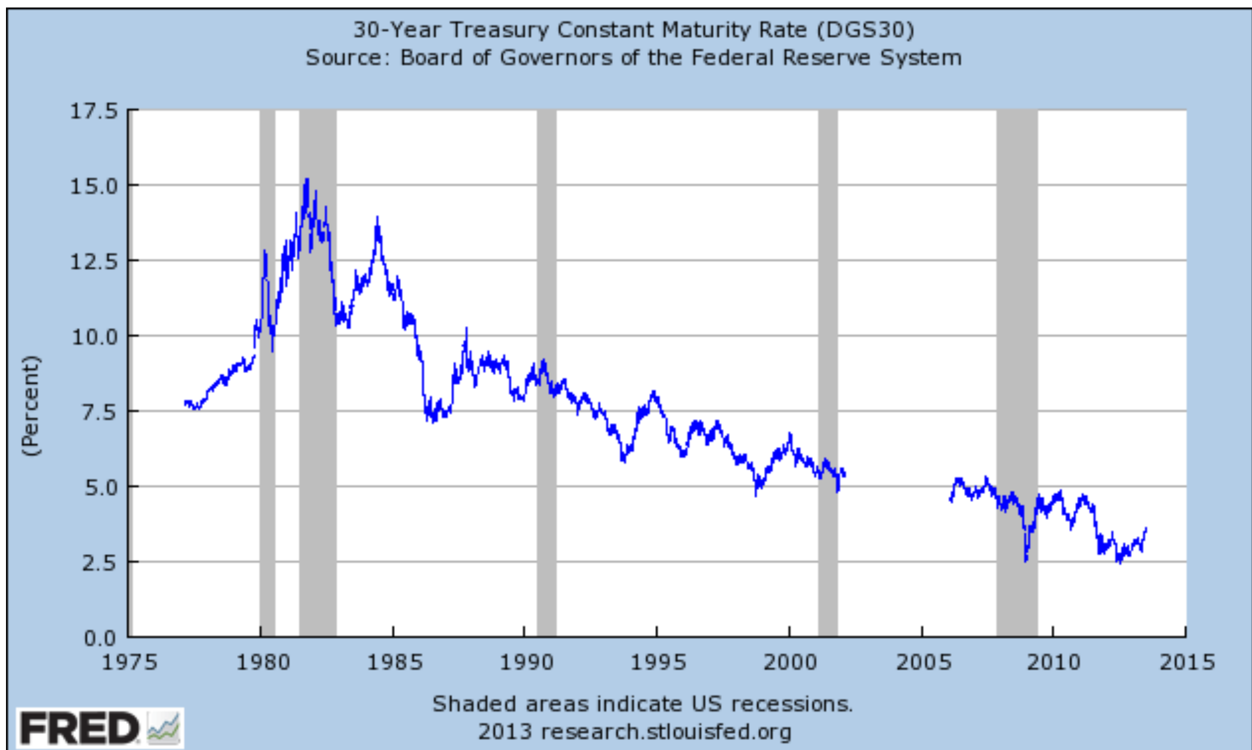
Revisiting our 2013 Outlook

The positive momentum for the stock market carried through from the first quarter to the second. The S&P 500 led the way with a 4.3% gain on the quarter, the Dow Jones Industrial Average added 4.0%, and the Russell 2000 tacked on 3.6%. As we discussed in our May commentary (http://www.rgaia.com/uploads/files/May_2013_Investment_Commentary.pdf), the most notable move during the quarter was in the bond markets, with rates rising rather quickly. While this move is substantial compared to where rates have been, some historical context is necessary—in the grand scheme of things, this rise in interest rates is fairly small. This chart clearly shows just how small:



Despite the bigger picture context, the move was large enough in scale to seriously disrupt certain classes of our capital markets. Over the past few years of zero interest rate policy (ZIRP) and quantitative easing (QE), investors sought relative yields in areas not traditionally associated with income. Dividend yielding stocks are one area where this phenomenon was particularly stark, and during the second quarter, higher yielding stocks lagged the indices by a wide margin.

Moreover, investors chased yield with increasing leverage in order to earn returns previously associated with a "normal" environment. A recent favorite has been the "Risk Parity" strategy, which levers each asset class in order to obtain an investor's targeted return in each respective market. For example, an investor who targets equity like returns (let's say 7% annualized) in a

Risk Parity fund would lever up the 1.81% yields on the 10 year Treasury at the start of this quarter in order to capture the 7% target. With rates so low, leverage in these strategies increased apace. When the pendulum flipped from falling to rising rates, this leverage compounded the losses experienced in bonds. As a result, this category of funds was amongst the hardest hit, though it should be noted that not all Risk Parity funds are created equal, and some are in far better position to weather the storm than others (for those in the know, the "pun" on weather was indeed intended).

Meanwhile, the Municipal Bond ("muni") market was one segment of the yield universe that experienced the worst pain. This was largely due to structural reasons, as the muni space has longer durations (in other words, there are greater price sensitivities to changes in interest rates), and less liquidity. The lesser liquidity is due to the Federal tax-free status of these bonds and its correspondingly limited pool of potential investors. We used this mini-panic as an opportunity to buy a closed-end fund of municipal bonds at a 10% discount to its net asset value (NAV), locking in a 6.1% cash yield, or a 9.4% tax-equivalent yield. As bonds within this fund pay coupons and/or mature, the fund will reinvest incoming cash flows at higher yields moving forward. This should inevitably lead to even better yields in the coming months. While there is room for rates to rise further (and principal values to fall), we think the disconnect in municipal bonds went far beyond the rate of change in the underlying fundamentals, creating an opportunity for a more favorable yield investment in what remains today's ZIRP environment.

Since we are at the mid-point of this year, this is a great opportunity to briefly revisit our outlook for 2013[1]. There is one glaring weakness in our outlook: the technology sector remains sluggish year-to-date compared to the broader market, despite our belief that its performance would catch up. Yet, this weakness has become increasingly illusory as Apple, the largest component of the sector remains in the doldrums. The majority of the sector's companies are performing at least in line with the broader indices. Beyond technology, our outlook is playing out within our expectations, including the healing of Europe's financial markets, improving household balance sheets, resurgence in real estate, and the move towards energy independence.

What do we own:

Now we'll turn to our second edition of *What do we own: the Leaders and the Laggards*. Last quarter we were fortunate enough to have only one laggard down more than 1%. While we were not as lucky this time around, the strength in our leaders was particularly noteworthy, as two stocks returned more than 50% for our portfolios in the quarter.

The Leaders:

iRobot Corp (NASDAQ: IRBT) +54.99%

[1] http://www.rgaia.com/uploads/files/December_2012_Commentary.pdf

This is iRobot's second consecutive appearance in *The Leaders* section. While we attributed the first quarter's strength largely to "regression to the mean following a challenging 2012," this quarter, the company actually showed very real signs of strength. iRobot's rally gained steam in April when the company beat its already raised earnings guidance, while further increasing its full year earnings outlook[2]. Further, the company's development of a telepresence robot for healthcare applications continued to move forward, and towards the tail end of the quarter, iRobot announced a partnership with Cisco to use a similar technological platform for a telepresence robot in office buildings[3].

Power-One Inc. (NASDAQ: PWER) +52.66%

Last quarter, Power-One appeared in *The Laggards* section so we were especially pleased to see the it rise to the leaderboard this time. The stock surged 56% when ABB announced it will buy the company for $6.35 per share[4]. While this deal certainly helped boost the company's share price, we believe it still deeply undervalues the company's true fundamental worth. At the take-over price, 37% of Power-One's market cap is cash on the balance sheet, and the solar sector appears to be emerging from a severe trough. During the solar sector's woes, Power-One was the only solar-related business that did not report substantial losses, while steadily earning positive free cash flow throughout. The sale to ABB was most likely driven by Silver Lake's (a private equity company that owned a significant portion of Power-One and held 2 board seats) desire for liquidity on its investment, as much as it was an effort to reverse a sinking stock price. Our best hope for a fairer price at this point is the prospect of another strategic buyer swooping in to offer a higher price.

Fiat SpA (OTC: FIATY) + 32.77%

Fiat is a name many global car aficionados know well. The historic Italian automaker builds cars under various brand names, including Fiat, Alfa-Romeo and Maserati, and owns substantial stakes in Ferrari and Chrysler. Fiat rose on the back of continued strength in Chrysler (of which it owns 58.5%) and the US auto market, and on a more secure outlook for the company's financing of its acquisition for the 41.5% of Chrysler it does not already own. In our outlook for 2013, we talked about the prospects for an improving auto market in the U.S., and this is certainly playing out as hoped. We think Fiat will continue to benefit from this trend, but also, we think once the overhang of the if/when/how of completing the combination with Chrysler is lifted, there is substantially more upside ahead for this position. While it's unclear exactly when Fiat will resolve its dispute with VEBA over what price to pay for the remainder of Chrysler, we think it is an inevitability which likely could happen by the end of calendar 2013.

The Laggards:

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[2] http://finance.yahoo.com/news/irobot-reports-first-quarter-financial-200100319.html

[3] http://finance.yahoo.com/news/irobot-launches-ava-500-video-120000228.html

[4] http://www.reuters.com/article/2013/04/22/us-abb-power-one-idUSBRE93L04U20130422

Starwood Property Trust (NASDAQ: STWD) -9.11%

Starwood is a commercial real estate (CRE) REIT, which both invests in and originates CRE loans. The management team is led by Barry Sternlicht, the founder of Starwood Hotels (hence the common name), and an immensely capable real estate investment team. Starwood's portfolio of loans is full of premium, high quality properties and the company continues to evolve, as evidenced by the recent acquisition of LNR Property[5], a special servicing business from Vornado. Starwood's stock turned lower as interest rates started rising. This is due to real estate's sensitivity to the level of interest rates. We think the magnitude of the selloff was unfairly large, and that the recent disruption in markets actually increased the pool of potential investments for Starwood more than it hurt the existing portfolio.

Devon Energy Corp (NYSE: DVN) -7.69%

Devon Energy has been a dog throughout the year. The company engages in oil and natural gas production in North America and has been hurt by the challenging price environment for natural gas in particular. During the quarter Devon released what we perceive to be some good news in announcing its intent to form a midstream master-limited partnership[6], though the market greeted the announcement with a snooze. Further, the company will repatriate $2 billion in overseas cash in order to use this idled capital strategically to invest in increasing production and/or to repurchase its cheap stock[7]. We see the newsflow over the past quarter as largely constructive, and expect a turnaround of the recent woes during the second half of 2013.

IMAX Corp (NYSE: IMAX) -7.00%

It's surprising to see IMAX on this list considering so many of our small cap companies fared rather well during the quarter. IMAX suffered a series of negative days after a perceived competitor in RealD announced its own large screen theaters[8]. Investors would be mistake to take this as a real threat to IMAX, for RealD's theaters are purely about size, not size, quality and immersion, and RealD's large screens do not offer the integrated approach that IMAX has built with the studios and theater companies alike. Early in the quarter, we published our detailed investment thesis on IMAX and we would urge all with an interest in this particular holding to read it for more depth on the company[9]. Right now we are in a seasonally strong period for IMAX's box office take, which just so happens to correspond with the stock's seasonally weak

[5] http://www.bloomberg.com/news/2013-01-24/sternlicht-s-starwood-firms-said-to-buy-lnr-for-1-05-billion.html

[6] http://www.bloomberg.com/news/2013-06-06/devon-plans-to-form-master-limited-partnership-for-midstream-1-.html

[7] http://www.bloomberg.com/news/2013-05-01/devon-energy-plans-to-return-2-billion-of-overseas-cash-to-u-s-.html

[8] http://www.latimes.com/entertainment/envelope/cotown/la-fi-ct-big-screen-theaters-20130604,0,4555123.story

[9] http://www.rgaia.com/uploads/files/IMAX_Research_Report.pdf

period. We expect these near-term fears to subside, and for the company to continue the growth of its theater network into the indefinite future.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail. You can reach Jason or Elliot directly at 516-665-7800.

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