ValueInvestor INSIGHT
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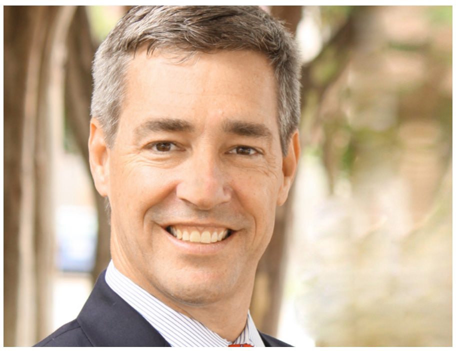
The Leading Authority on Value Investing

Nuts and Bolts

Small-cap investors typically spend much of their time following dynamic, even exciting, businesses. For Queens Road Funds' Steve Scruggs, not so much.

INVESTOR INSIGHT



Steve Scruggs
Queens Road Funds

Investment Focus: Seeks companies that are "boring and underfollowed" or whose shares are beaten down due to a "hiccup rather than fundamental problem."

Were he in elementary school and asked to report on his summer, Steve Scruggs would likely discuss his latest project to make a knife from scratch. "I'm at the pool, but Steve is in his backyard using a old grill as a forge to anneal the steel for his knife," says Bragg Financial colleague Benton Bragg. "That helps explain why he's a good investor."

Scruggs' nuts-and-bolts curiosity has translated well to money management. The Queens Road Small Cap Value Fund he has run since inception in 2002 has earned a net annualized 9.3%, vs. 8.1% for the Russell 2000 Value Index. Today he's finding value in such areas as banking, insurance, railroad equipment, energy services and touchscreen technology.

Inside this Issue

FEATURES

INVESTMENT HIGHLIGHTS

Other companies in this issue:
Barrick Gold, Chart Industries, Darling, Exxon Mobil, Frank's, Goldcorp, Graham, L.B. Foster, Newmont Mining, Orbital ATK, Sanderson Farms, Seacor

Investor Insight: Steve Scruggs

Queens Road Funds' Steven Scruggs explains how he distinguishes between more-attractive and less-attractive cyclical industries, the potentially positive impacts he sees from the U.S. elections, why he's fine with selling too early, and why he sees unrecognized upside in Greenbrier, Synaptics, Hilltop Holdings, UGI Corp. and Horace Mann Educators.

Can you generalize about the types of small-cap companies that typically attract your investment attention?

Steve Scruggs: I'd say the first type of situation that attracts our attention would be the really boring company that is underfollowed and therefore not too expensive. It should also have a strong balance sheet, dependable management and a business model that generates a lot of free cash flow and produces long-term economic profits, meaning returns on invested capital exceed the cost of capital.

As an example of that currently in the portfolio, I challenge you to find a more boring company than Horace Mann Educators [HMN]. It's an insurance company, with a pretty even spilt between property/casualty and life/annuity business lines, that sells only to the niche market of K-12 educators. Its products are targeted and well accepted by that market, and sold by a captive sales force made up of many former teachers. It's very well managed, still has a small penetration of an addressable market of maybe six million people, and has grown tangible book value over a long period of time at an average of 10-11% per year.

When we find a company like that at a good time, it can generate very attractive returns. I would say generally that now is not the best time for these types of ideas, as companies with the good business models and managements are looking pretty pricey.

The second type of situation, which we're finding more available today, is the company with a firm-specific problem or, more likely, that is beaten down by an industry-wide risk or cycle. The stock-price performance tells you something is going on, and our job is to properly assess whether this is a temporary hiccup to which the market has overreacted or a more fundamental problem.

That leads us often to out-of-cycle industries, but we favor those we believe are somewhat more predictable. We've had success in the past with Smithfield Foods in the pork business, for instance. The business is very cyclical, but fairly reliably the company wasn't as cheap as it looked when things were great and wasn't as expensive as it looked when things were bad. We developed a great deal of confidence in management to run the company over the full cycle with a long-term view, which meant they'd be out buying herds when others were in trouble, and they'd be cutting back when everyone else had the pedal to the metal. That actually dampened the volatility of their specific business and ended up creating a lot of shareholder value over time. [*Note:* In what was then the largest acquisition of a U.S. company by a Chinese one, Smithfield in September 2013 was bought for $4.7 billion by Shuanghui International Holdings Ltd.]

ON CYCLES:

We're often drawn to out-of-cycle industries, but favor those we believe are somewhat more predictable.

Another example that we own is Darling Ingredients [DAR], which recycles waste from slaughterhouses and restaurants into a wide range of ingredients and specialty products. (Another exciting business!) It goes through cycles and the last three years have been a bit rough, but it's out there expanding its plants and making strategic acquisitions to position it for success in the long term. That depresses near-term earnings and the market is punishing them for that, but that's exactly what we want management to do.

You've mentioned in the past digging in when a company announces a financial restatement or legal issue that hurts the stock. Have things like that been a source of potential ideas?

SS: Yes. I would say the analysis is a bit more problematic in these cases because we have to make a unique judgment on whether the issue is inadvertent and immaterial or whether it signals a deeper problem with management or the ongoing operation.

We took a small position in May in L.B. Foster [FSTR], an industrial company that makes products for the rail, construction and pipeline industries. In addition to cyclical problems, the company had a significant ongoing dispute over warranty claims with a major client, Union Pacific Railroad, culminating in a lawsuit filed in January of last year. Our view was that Foster had adequately reserved for the ultimate exposure and could get past it without fundamental damage being done. While that part of the thesis hasn't changed, we were unpleasantly surprised by the company's announcement not long ago that it was writing down a significant portion of the assets of an oil-and-gas tubing company it acquired last year. If that wasn't bad enough, we really disliked that management didn't seem to own up to the mistake. We've already reduced our position in the stock, which is unusual for us over such a short time period.

How did you respond in August when aerospace and defense supplier Orbital ATK [OA], which you own, announced a significant accounting error tied to a legacy contract and the shares promptly fell 20%?

SS: We stood pat with the position we had. The adjustment had to do with an ATK ammo contract that turned out to be much less profitable than expected. Was the original accounting aggressive? Probably, but we're comfortable that it's not a sign of something worse to come. A lot of that has to do with our having been involved with the company for some time and having confidence in management. That had an impact on how we responded to this, say, versus how we responded to L.B. Foster, where we haven't developed the same confidence.

Once an idea is identified as having potential, where does your research focus?

SS: Much of this probably isn't that different from what you typically hear, but we usually start with an assessment of the balance sheet. We want to see serviceable levels of debt, which takes into consideration the absolute debt level, the repayment terms, and the volatility of the overall business. We own utilities that have a great deal of debt, for example, but in many cases the standard deviation of their operating margins or the fluctuation in their revenue or revenue growth is close to zero, so they can service a great deal more debt. Also very important to us is that there's enough operating cash flow to fund growth without having to tap the capital markets.

We care a lot about management, primarily their proven ability to lay out a strategy and execute to it. A lot of that comes just from looking at what they've done in the past as reflected in the financials. That takes me back to a company like Horace Mann. There is no catalyst, no angle, no theme. It's a well-managed company in a boring sector of the market that creates a lot of value. That's more than good enough for us.

The third key area of research focus is the industry environment. We want companies that are competing in industries that are generally growing and that allow the participants to earn reasonable returns on their investment capital. This is primarily designed to help us avoid value traps, which we've fallen into generally when we haven't paid close enough attention to this particular step. This to me is more important than ever. Many of the things that appear cheap, when you look deeper, absolutely deserve to be.

One lesson we've learned is to watch out for false positives. Years ago we bought Radio Shack, which was in the middle of reinventing itself to focus on driving traffic by being an independent retailer of smartphones and other consumer electronics. It had a strong balance sheet, lots of cash and new management with an exemplary track record. We bought in as everything appeared to start moving in the right direction, but what we learned was that the success we attributed to the new strategy turned out to be almost entirely due to a government program at the time that gave people who didn't have digital TVs a certificate for a free digital converter. We expected that to have a positive impact on Radio Shack's traffic and profits, but we didn't know that would be the sole reason the new strategy appeared to be working. Seeing that more clearly would have saved us quite a bit of money.

ON AVOIDING ENERGY:

It's harder to find, especially in small caps, companies that add real value above and beyond the commodity price.

You mentioned earlier favoring businesses whose cycles were somewhat more predictable. Where does energy fall on that spectrum for you?

SS: We've spent a great deal of time looking at the energy sector and are generally going to be underweight in it because we find the cycle much less predictable. Another issue is how dominant the commodity price is to the investment outcome. While it's better to be a more capable operator, there isn't as much incremental value added from one player to another in the extraction process. With something like Sanderson Farms [SAFM], a poultry processor we've successfully owned off and on over time, its efficiency in raising, deboning, delivering and marketing chicken adds real value above and beyond just what the price of the underlying commodity is. In energy it's harder to do that, especially in the small-cap area.

That doesn't mean we don't keep looking in energy, especially when share prices there are as beat up as they have been lately. Companies like Frank's International [FI], which does offshore piping, tubing and cementing, or Atwood Oceanics [ATW], a small driller, are potentially interesting. Frank's, for instance, has some value-added expertise in horizontal drilling, but it's just not going to make money unless the number of wells going in the ground goes up from oil prices being at a higher level than they are today. We're willing to wait, not trying to time the bottom. In general, we'll be late to buy, early to sell.

The exposure today we do have to energy is in the industrials we own that have businesses tied to oil and gas, but are diversified in other areas that are doing well and making money. Graham Corp. [GHM] would be a good example. It sells industrial equipment, with roughly a third of the business related to refining and other energy infrastructure. The company is diversified enough that when energy is out of favor it's still going to be profitable, but its return on invested capital is running about 5-6%, which is nothing to scream about and quite a bit lower than its long-term average. But when energy recovers, it will be really profitable. And we're getting all of that at a valuation we think is very attractive.

How generally do you arrive at what you think something is worth?

SS: We're primarily using discounted-free-cash-flow models, where a key input is always using what we consider a normalized operating margin over a full market cycle. It won't be the most recent 12 months or a projected number for next year. We'll judge what's happening today that is different from the past, good or bad, and set a normalized margin that we think provides a better measure of the true economic earnings power of the company. In 2009 we would have adjusted the operating margins upward because in our estimation they were abnormally low. Today we're often adjusting them down a bit, because they seem abnormally high.

The discount rates we use depend on the riskiness of the business. The balance sheet obviously plays into that, but we also look closely at the standard deviation of the operating margin. Greenbrier [GBX], which we'll discuss later, is in the cyclical railcar business, so we'll discount its cash flows at a higher rate, say, than we would something like Owens & Minor [OMI], which is in the healthcare distribution business and whose operating margin barely ever moves.

Because there's uncertainty with our model inputs and because we're making projections, we tend to think in terms of defining a range of intrinsic values that we believe are reasonable. To buy, we want to have confidence we can earn 8-14% annually on an individual investment, depending on the risk. If we can't find ideas that meet that criteria, we'll let cash build.

Where is your cash today?

SS: At the moment we're just under 25% cash, which is around where we've been for a few years and is purely a function of our bottom-up process. We had about the same amount of cash as we have today in 2008, which we started putting to work and were fully invested by February of 2009. If you asked me in early 2009 what I thought the stock market was going to do in the near term, it would not have been positive. But sticking to the discipline, looking three to five years out at companies we knew and thought we understood, it was clear it was a buying opportunity we should take advantage of. We're doing the same thing now, just the other side of the coin.

You typically hold 50-60 positions at a time, with none more than 3% or so of the portfolio. What's your rationale for that?

SS: I know this is a generic answer, but we think 50-60 positions gives us all the benefits of diversification and still allows for each holding to be a meaningful portion of the portfolio. We are strongly focused on downside protection, most of which comes from disciplined security selection, but portfolio management plays a role as well. That's why we keep position sizes at 3-3.5% – we don't want too much exposure to individual investments.

We're in the camp that our ideal holding period is forever, but volatility provides opportunity to buy or sell and impacts our portfolio turnover. From 2010 to 2015 our annual turnover was in the single digits, because volatility wasn't providing us with opportunities. It picked up last year and in the first quarter of this year, so our turnover has been running a bit higher, in the 25% range this year.

Describe how you're assessing the freight-railcar cycle and its impact on Greenbrier?

SS: Long-term demand for new freight cars in North America is about 50,000 per year. Demand in the last couple of years has been higher than that, at 70,000 to 80,000, but we expect that to revert over

INVESTMENT SNAPSHOT

Greenbrier
(NYSE: GBX)

Business: Designs, manufactures, sells, leases and services railroad freight-car equipment in North America and Europe; also manufactures ocean-going marine barges.

Share Information (@11/29/16):

Price	**37.65**
52-Week Range	19.89 – 38.75
Dividend Yield	2.2%
Market Cap	$1.07 billion

Financials (TTM):

Revenue	$2.68 billion
Operating Profit Margin	14.7%
Net Profit Margin	6.8%

Valuation Metrics
(@11/29/16):

	GBX	S&P 500
P/E (TTM)	6.6	24.3
Forward P/E (Est.)	20.1	18.4

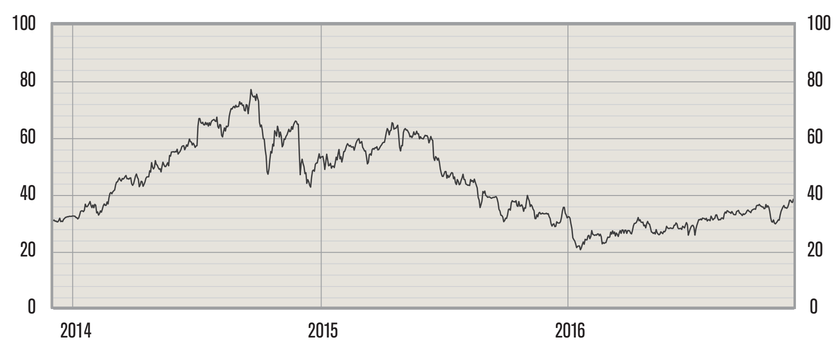
Largest Institutional Owners
(@9/30/16):

Company	% Owned
Vanguard Group	16.3%
BlackRock	9.7%
Dimensional Fund Adv	6.8%
RBC Global	4.7%
Merrill Lynch	3.8%

Short Interest (as of 11/15/16):

Shares Short/Float	30.4%

GBX PRICE HISTORY



THE BOTTOM LINE

While demand for the company's tanker railcars is impacted by cyclical energy prices, it should benefit in a more consistent way from new regulations requiring the upgrade of such cars, says Steve Scruggs. Assuming 3% annual revenue growth, some margin contraction and a 12% discount rate, he estimates the shares' fair value today at $48.

Sources: Company reports, other publicly available information

time to the longer-term average. Greenbrier, however, mostly focuses on tankers and covered hoppers used for carrying oil and ethanol, segments we expect to be more stable over the next five years than the industry in general. New safety regulations require existing tankers to be retrofitted with stronger outer shells and more relief-valve equipment, for example. That's work the company does, and it also benefits generally from the replacement cycle accelerating due to tougher regulation.

Are you counting on higher energy prices as a tailwind?

SS: A key impact of energy prices is how it affects the competitive dynamic between rail and trucking. Higher oil prices make rail more efficient relative to trucking, and vice versa. Higher prices also result in larger shipping volumes out of the U.S. West and Midwest on tankers, which would have a positive impact on tanker demand. While we do expect somewhat of a tailwind from higher oil prices, that's not as important in our view as the required upgrading and replacement of freight cars due to new regulations. That should happen regardless of the level of oil prices.

Hasn't the company been making some inroads internationally?

SS: Greenbrier did recently sign a deal with Saudi Arabia's railway company to provide 1,200 tank cars. They also in October entered into a joint-venture agreement with Germany's Astra Rail to create a Europe-based freight-railcar manufacturing, engineering and repair business. So while the international business is still a relatively small percentage of the total, we expect its expansion to be an increasingly positive contributor going forward.

How cheap do you consider Greenbrier shares at today's $37.65?

SS: While the shares have come off their lows, the market has not been kind to the stock over the past two years. Falling oil prices took a toll, as have increasing concerns that railcar demand was peaking. In our DCF model we assume 3% annual revenue growth, some margin contraction and a 12% discount rate because it's a more cyclical industry. With what we think are conservative assumptions, we arrive at a fair-value estimate today of $48 per share, which means we could pay that price today and still expect to earn a 12% annual return on the investment. Obviously if the discount to fair value closes, the return will be even better.

In assessing the downside, we like that the current $3.2 billion backlog is above historical levels and provides some comfort on visibility. The company has also done a good job of making its manufacturing more flexible, resulting in higher variable costs that adjust when and if demand slows.

Synaptics [SYNA] is in a much sexier business – touchscreen technology – than most companies you've spoken about so far. What's happening to it that has made the shares interesting to you?

SS: The company makes biometric sensors and the chips that help control touchscreens. Every iPhone 6 has a Synaptics

INVESTMENT SNAPSHOT

Synaptics
(Nasdaq: SYNA)

Business: Leading developer of biometric sensors and touchscreen controllers used in a variety of personal computers, smartphones and other consumer-electronics products.

Share Information (@11/29/16):

Price	**53.17**
52-Week Range	47.09 – 90.91
Dividend Yield	0.0%
Market Cap	$1.86 billion

Financials (TTM):

Revenue	$1.58 billion
Operating Profit Margin	3.9%
Net Profit Margin	3.3%

Valuation Metrics
(@11/29/16):

	SYNA	S&P 500
P/E (TTM)	37.9	24.3
Forward P/E (Est.)	10.6	18.4

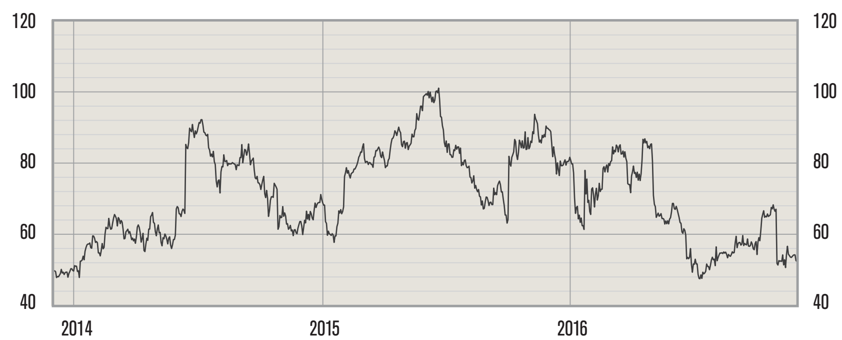
Largest Institutional Owners
(@9/30/16):

Company	% Owned
Vanguard Group	10.5%
Columbia Mgmt	9.5%
BlackRock	8.6%
AQR Capital	3.7%
State Street	3.7%

Short Interest (as of 11/15/16):

Shares Short/Float	12.7%

SYNA PRICE HISTORY



THE BOTTOM LINE

The market's fears about increased price competition are overdone, says Steve Scruggs, who believes the company's leading technology will allow it to continue to take profitable advantage of an expanding addressable market. Assuming 10% top-line growth and a return to historical margins, his DCF model pegs intrinsic share value in the high-60s.

Sources: Company reports, other publicly available information

display driver, for example, and its touchscreen technology is found in a number of other smartphones, mobile devices and, increasingly, in new applications like those in automobiles.

Historically Synaptics has been in mostly high-end products, but as it has expanded its product reach there is concern about competition across the board starting to erode margins, which have been weaker in recent quarters than in the past. That's had a significant impact on the share price, which as late as April was above $85 and is now around $53.

We generally believe the company's technology is best-of-breed and that its ability to innovate and to acquire new technology should allow it to continue to earn high returns on invested capital. Their latest designs, for example, place touch controllers and display drivers on the same chip, which allows for thinner and brighter screens that use less energy. It's also encouraging that the overall addressable market continues to expand. We're increasingly likely to see fingerprint sensors not just on your phone, but on your car, your laptop, on the machines that print your plane tickets at the airport and elsewhere.

The company talks a lot about its "China strategy." How key is that to its future?

SS: They're making inroads in China and last month announced a large deal to have their technology built into the new mid-range phone of Huawei, the largest Chinese smartphone maker and third-largest in the world. This broader effort is something we'll keep our eye on. This is not their intention, but if being big in China requires competing on price with commodity products, we think that would be a strategic mistake.

What upside do you see in the shares from today's price?

SS: We believe that the company's technology advantage in expanding addressable markets can allow it to grow its top line at 10% per year, and get its operating margins back to the 10-12% range earned historically. Using those key assumptions and a 10% discount rate, our fair value estimate comes out today in the upper-$60s. We think we are being conservative on the revenue-growth side, but decided that was prudent to reflect the potential of increased industry competition.

From biometric sensors to banking, describe your investment case for Texas-based Hilltop Holdings [HTH].

SS: We first got involved with Hilltop in late 2008 after Gerald J. Ford took over the company when it essentially had $600 million in cash, no debt and a tiny insurance subsidiary of little consequence. Ford had very successfully bought up busted savings and loans in the early 1990s, eventually creating Golden State Bancorp, which he sold to Citigroup in 2002 for $5.8 billion.

Today Hilltop is a financial-services holding company consisting of PlainsCapital Bank, the sixth-largest bank in Texas, a national mortgage provider called PrimeLending, and a full-service brokerage firm called HilltopSecurities. Total assets are nearly $12.5 billion, and the com-

INVESTMENT SNAPSHOT

Hilltop Holdings
(NYSE: HTH)

Business: Controlled by financier Gerald J. Ford, Texas-based financial-services holding company using its PlainsCapital Bank as an organic and inorganic growth platform.

Share Information (@11/29/16):

Price	**27.80**
52-Week Range	14.28 – 28.37
Dividend Yield	0.9%
Market Cap	$2.78 billion

Financials (TTM):

Revenue	$1.61 billion
Net Profit Margin	8.2%
Return on Assets	1.1%

Valuation Metrics
(@11/29/16):

	HTH	S&P 500
P/E (TTM)	20.9	24.3
Forward P/E (Est.)	15.5	18.4

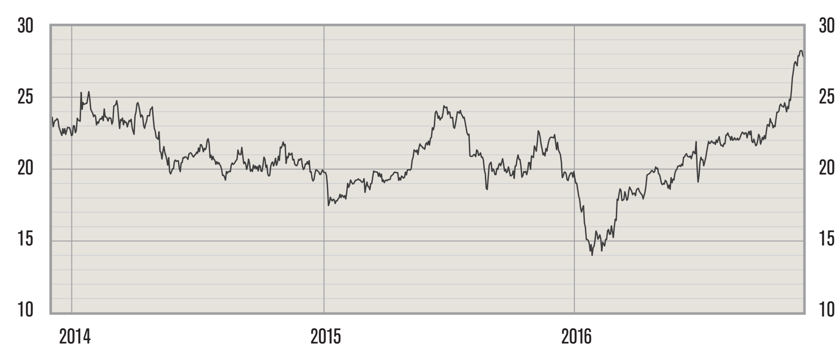
Largest Institutional Owners
(@9/30/16):

Company	% Owned
Vanguard Group	5.6%
Dimensional Fund Adv	5.4%
BlackRock	4.0%
Wellington Mgmt	4.0%
Fidelity Mgmt & Research	2.8%

Short Interest (as of 11/15/16):

Shares Short/Float	2.3%

HTH PRICE HISTORY



THE BOTTOM LINE

Company Chairman Gerald J. Ford has a long, successful history in building financial firms through acquisition, and Steve Scruggs believes he's in the early stages of writing another such success with Hilltop. Assuming 8% annual top-line growth, some operating leverage and a 10% discount rate, he estimates the stock's fair value at about $35.

Sources: Company reports, other publicly available information

pany has $500 million in excess capital to invest in further acquisitions.

Are they dealmakers more than operators?

SS: We believe they're both. On the banking side their underwriting discipline kept their exposure in Houston and to the oil and gas industry in general to a manageable level, and their overall loan-quality metrics and capitalization ratios are above average. On the mortgage side, the business has been doing quite well as housing markets have improved, but they run things so that they can adjust their expense structure down fairly quickly when and if demand falls off. Their primary focus is on loans to buyers rather than those to refinance, and the purchase market tends to hold up better as rates rise.

Up 45% year-to-date, how attractive do you consider the shares at today's $27.80?

SS: At 1.5 times book value, the shares do trade at a bit of a premium to many peers, which we believe is justified by both the growth profile and management quality, and the fact that the broker/dealer business deserves a higher valuation.

The stock currently trades at 15.4x our $1.80 EPS estimate for next year. Modeling 8% annual revenue growth, some expansion of operating margins due to increased operating efficiencies and lower integration costs, and discounting back at 10%, we arrive at a fair value today of about $35. We still consider that quite attractive even after the increase this year.

Given the vibrancy and size of the Texas market, Hilltop would make a good acquisition target itself, say, for a big regional bank looking to expand its geographic footprint. The history of management would certainly indicate that they would, depending on price, be a buyer or a seller.

Back to the more mundane side of things, describe your interest in Pennsylvania-based UGI Corp. [UGI].

SS: The company through its role as general partner and 26%-owner of AmeriGas is the largest liquid-propane provider in the U.S. It also operates an energy-midstream business in the U.S., natural-gas and electric utilities in Pennsylvania, and sells liquefied petroleum gases in certain markets in Europe.

Breaking down the business somewhat, AmeriGas is the most efficient and profitable seller of liquid propane in the U.S. market, where it benefits from its scale in what is still a fragmented, mom-and-pop type of business. The value-add is in the delivery system and we like that the company takes no commodity risk, passing on increases and decreases to the end consumer. We see slow and steady growth in the demand for propane driven by transportation-industry demand and propane's price competitiveness against electricity and natural gas for residential and commercial end users.

The energy-midstream business continues to grow, with two attractive prospects on the horizon. One is the 35-mile Sunbury pipeline, which will transport low-cost Marcellus-region natural gas to a large gas-power plant currently under construction in Pennsylvania. UGI is also a partner in the consortium building the 120-mile PennEast Pipeline, which again

INVESTMENT SNAPSHOT

UGI Corp.
(NYSE: UGI)

Business: Operates natural-gas and electric utilities in Pennsylvania and also distributes, markets, stores and transports a variety of energy products throughout the U.S.

Share Information (@11/29/16):

Price	**46.34**
52-Week Range	31.51 – 48.13
Dividend Yield	2.1%
Market Cap	$8.02 billion

Financials (TTM):

Revenue	$5.69 billion
Operating Profit Margin	18.1%
Net Profit Margin	6.4%

Valuation Metrics
(@11/29/16):

	UGI	S&P 500
P/E (TTM)	22.3	24.3
Forward P/E (Est.)	19.3	18.4

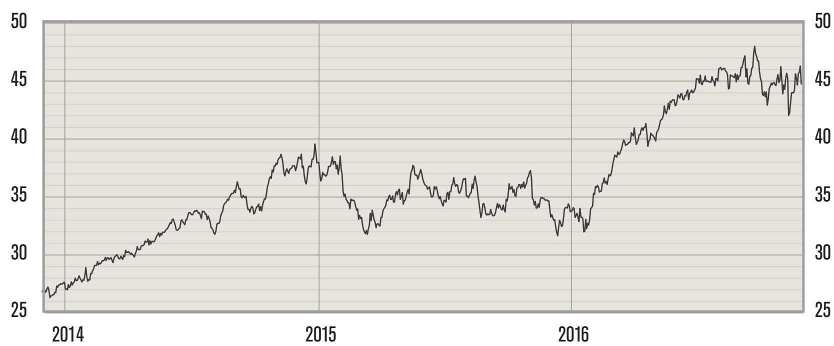
Largest Institutional Owners
(@9/30/16):

Company	% Owned
Vanguard Group	10.2%
Wellington Mgmt	9.3%
BlackRock	6.8%
State Street	5.2%
First Eagle Inv Mgmt	4.0%

Short Interest (as of 11/15/16):

Shares Short/Float	1.4%

UGI PRICE HISTORY



THE BOTTOM LINE

The company's regulated-utility and unregulated energy-related businesses provide it with what Steve Scruggs considers an attractive combination of growth prospects and stability. Assuming 6% annual growth, stable operating margins and an 8% discount rate, his DCF model yields a current fair-value estimate for the stock of $51 per share.

Sources: Company reports, other publicly available information

will transport Marcellus gas, this time to a major pipeline interconnection near Pennington, New Jersey.

The regulated-utility business accounts for over 25% of the company's net income and continues to perform quite well, with strong management and a favorable regulatory environment. This isn't the most interesting part of the company, but we think it should continue to generate good, sustainable returns that can help fund new initiatives in other areas.

UGI shares are also up significantly, 37%, this year. Why are you still positive on the stock at today's price of $46.35?

SS: The stock isn't dirt cheap, but assuming 6% annual growth, margins going forward that are consistent with what they have been, and an 8% discount rate, we estimate fair value today at $51 and growing. That's still interesting to us, given the high level of visibility and positive future outlook.

You described earlier your basic thesis for "boring" Horace Mann Educators, which rests largely on it continuing to create value going forward as it has in the past. What could disrupt that?

SS: The insurance business is obviously very competitive, but we're confident that Horace Mann's distribution model is differentiated and provides an ongoing advantage. The company knows its end market extremely well and tailors its products and its communication in a way that is difficult for larger competitors like Voya or Progressive to replicate. Its sales force is made up of many former teachers, who understand the mindset, risk tolerance, wants and needs of the target market better than anyone else could. That shows up in above-average customer renewal rates and strong metrics around cross selling of investment-oriented and insurance-oriented products.

The addressable market not growing would be a problem, but that's not the case here. The number of teachers grows every year and Horace Mann has plenty of room to increase its market share. It now has around 360,000 account holders, which is out of some six million individuals in the K-12 education market in the U.S. There is still a long runway for growth.

I guess the quality of management could always deteriorate, but there's no reason to believe that's at all a risk. They have a long record of being conservative underwriters who are also conservative when reserving for losses. Expense ratios are below average on both the property/casualty and annuity sides of the business. They've grown book value at 10%-plus a year – the business model works, and we just don't see that changing.

Is this something you'll do a DCF model on to judge if the current $40 share price is attractive?

SS: What we do is look at tangible net book value, how fast it has grown and what could change for the better or worse in the future. We think book value can still grow at a rate of a bit above 10% a year. Since the shares trade slightly above book, we expect to earn about 10% per year owning the stock from today's price.

INVESTMENT SNAPSHOT

Horace Mann Educators
(NYSE: HMN)

Business: Underwrites and markets property/casualty, annuity and life insurance products sold primarily to teachers serving more than 4,100 school districts in the U.S.

Share Information (@11/29/16):

Price	**40.20**
52-Week Range	27.15 – 40.50
Dividend Yield	2.6%
Market Cap	$1.62 billion

Financials (TTM):

Revenue	$1.12 billion
Operating Profit Margin	11.6%
Net Profit Margin	7.6%

Valuation Metrics
(@11/29/16):

	HMN	S&P 500
P/E (TTM)	19.7	24.3
Forward P/E (Est.)	17.8	18.4

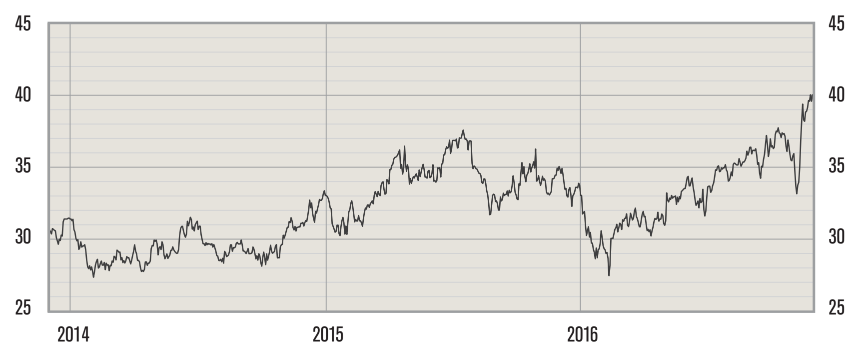
Largest Institutional Owners
(@9/30/16):

Company	% Owned
BlackRock	9.7%
Dimensional Fund Adv	8.7%
Vanguard Group	8.3%
Silvercrest Asset Mgmt	7.6%
Hotchkis & Wiley	6.6%

Short Interest (as of 11/15/16):

Shares Short/Float	1.5%

HMN PRICE HISTORY



THE BOTTOM LINE

The company's distribution model in selling insurance-based products through a captive sales force to teachers provides it with an ongoing competitive advantage in a still highly fragmented market, says Steve Scruggs. He considers its historical 10%-plus annual growth in book value a reasonable expectation for returns in holding the stock as well.

Sources: Company reports, other publicly available information

You mentioned being late to buy, early to sell. Doesn't it annoy you to be chronically early to sell?

SS: We accept the fact that we're going to buy too late and not try to find the bottom, and that we're going to sell too early and not try to find the top. With selling, I'll give you a classic example. We started buying Chart Industries [GTLS], which is in liquefied-natural-gas infrastructure, for all the right reasons in 2009 after its stock had fallen sharply – strong balance sheet, well managed, leadership positions in its markets, great valuation based on normalized earnings power. Then the LNG market started taking off, Chart became a story stock, and we sold out in summer 2012 at around $63 per share, roughly triple where we bought.

By the fall of 2013 the shares were above $120 and we felt silly. But then LNG wasn't the great story any more and the stock started trading on fundamentals again and fell off a cliff. Early this year it fell below $15. [*Note*: Chart shares currently trade at around $35.] This is not to say we're always ultimately proven right when we sell – some just keep right on going – but we're happy to play the game we know and not try to play one we don't.

We saw you recently reduced your stake in Sanderson Farms. Why?

SS: This is kind of a unique situation. Despite the glut in grain crops and weak prices for pork and beef, we'd been surprised that Sanderson's chicken pricing had held up so well. Over 35% of its chicken is sold under contracts pegged to what's called the Georgia Dock index, which usually tracks grain prices and other protein prices, but more recently had stayed higher. Then information started coming out, seemingly with good basis, that the index may have been influenced by some producers who were trying to keep it artificially elevated. Hearing that, we began to sell. First, there's potential litigation exposure if the claims turn out to be true. Second, if contract prices get adjusted down to better reflect the market, that would likely have a negative effect on Sanderson's performance.

Any thoughts on the aftermath of the U.S. presidential election?

SS: There are two things we think may be significant from an investment perspective. One would be if tax policy changes, particularly around reducing the corporate tax rate. Most of the companies we own are very profitable and pay a lot of taxes, so lower tax rates would certainly change the economics of those companies for the better.

Second, we expect there to be some rollback in the regulatory burden that has been placed on companies since the financial crisis. We regularly hear from management on earnings calls how new regulations are hindering growth, so on a case-by-case basis lightening that load could have real positive impact. Coal would be one example. Reversing some of the regulations that have hampered that business would not only benefit coal producers, but also railroads, barge companies and other firms that benefit from increased coal production, like a Greenbrier, or an L.B. Foster.

I don't mean this as a political comment and that I'm against any specific regulation. I do think it's possible that given where the economy was that maybe we tried to do too much at once on the regulatory front, and backing off that somewhat might be healthy for the economy.

With cash as a dead weight on your portfolio in a rising market, have you been tempted to refine how you do things in a way that would get you more invested?

SS: Yes. I do believe in general that we could probably take a bit more risk in the portfolio. But what keeps me from doing that to any real degree is that we just can't get past that the current period with 0% interest rates is anomalous. Should I take more risk in a period where you're almost lured into it unwittingly? It's something we think about a lot, but as of now we're confident that the answer is no. VII

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