The Dragon Fund Analyst Team
FIN 341/Prof. Daniel Dorn

DREXEL UNIVERSITY
LeBow
College of Business
Department of Finance

Drexel University
The Dragon Fund

Quarterly update
March 31, 2015

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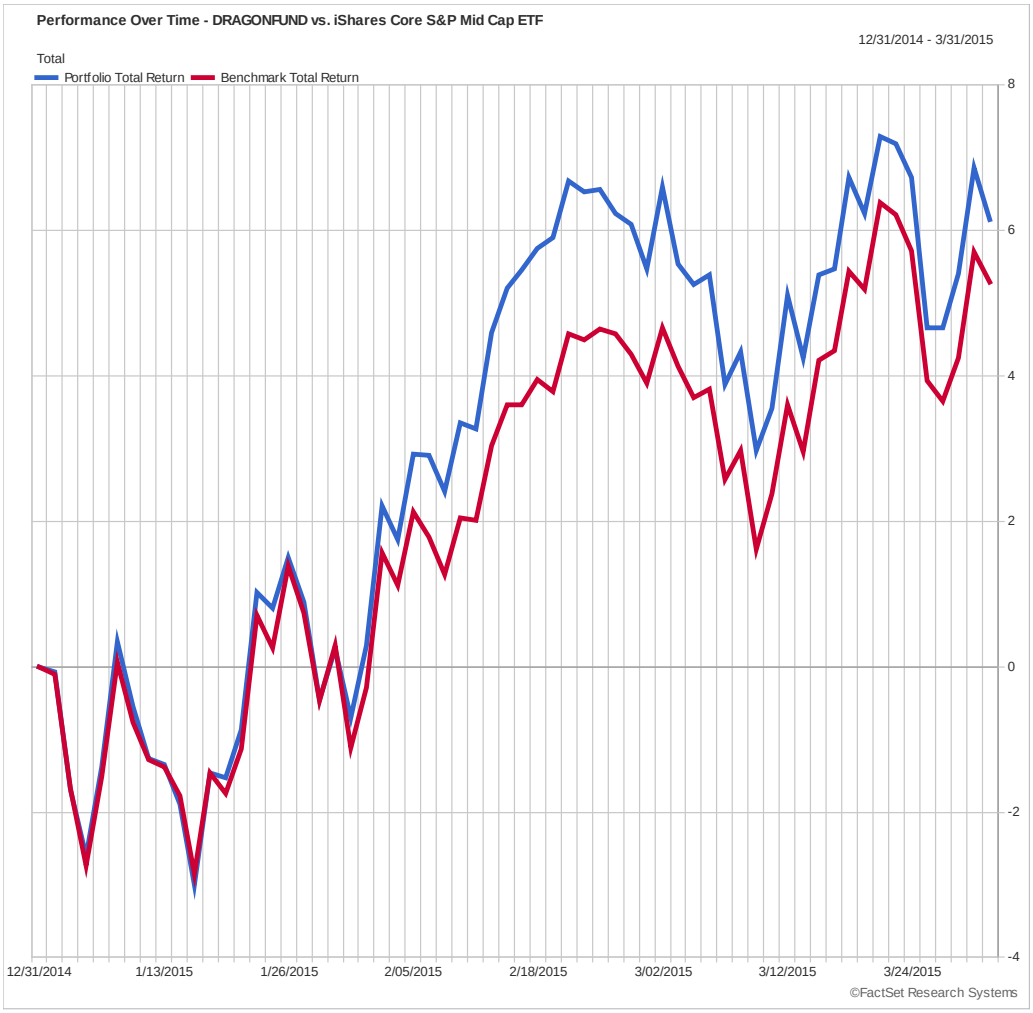
How did the fund perform?

During the first quarter of 2015 the Dragon Fund gained 6.1% thus outperforming the S&P 400, the Dragon Fund's benchmark, which returned 5.3%. In a reversal of 2014, small and mid-cap stocks outpaced large-cap stocks; the S&P 500 only advanced 1% during the first quarter. This performance differential was partly due to the strength of the U.S. dollar weighing more on the earnings of large-cap multi-nationals than on those of mid- and small-caps, which tend to have a more domestic focus.



Source: Dragon Fund model portfolio, ishares S&P 400 ETF
Note that model portfolio performance can slightly deviate from actual account performance since the model is only updated quarterly.

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Which sectors and stocks contributed to performance?

Since the Dragon Fund weights were closely aligned with the benchmark weights, most of the deviation from the benchmark was due to stock selection effects.

Stock selection in Industrials delivered the largest performance boost during the first quarter; Dragon Fund industrials stocks yielded 11.4%, outpacing their industrials peers in the S&P 400 by more than 5%. Trinity Industries (TRN), a 2014 Q4 addition to the fund, gained 27% as it reported solid fourth quarter earnings and won a partial victory as a defendant in a guardrail lawsuit. Within the Consumer Discretionary sector, the Dragon Fund's auto parts holdings Lear (LEA, a 2014 Q4 addition) and Borg Warner (BWA) performed particularly well, as did discount retailer Dollar Tree (DLTR). The organic food manufacturer White Wave (WWAV, also a 2014 Q4 pick) stood out with a 27% return in the Consumer Staples sector during the first quarter. Within healthcare, M&A activity continued at a frenzied pace. The Dragon Fund benefitted from this through the acquisition of NPSP, its biotech holding, by Shire Pharmaceuticals in February, yielding a 28% return for the quarter.

Which sectors and stocks detracted from performance?

Century Aluminum (CENX), a Dragon Fund holding in the Materials sector (a 2014 Q4 addition) lost more than 40% during the quarter, accounting for a 0.5% overall performance drag. The company has bet heavily on being able to expand production to serve higher anticipated demand for aluminum products in the future. This bet did not pay off during the first quarter, as unexpected soft demand added to existing supply glut woes. This prompted both Bank of America/Merrill Lynch and Morgan Stanley to downgrade the stock, which plummeted 25% during just two trading sessions. During the quarter, CENX management doubled its share repurchase program to $130 million, suggesting that management is confident in its strategy which will be closely reviewed by the Dragon Fund materials analysts during the upcoming quarter.

Performance attribution: January 2015 – March 2015

DF 2015 Q1	Dragon Fund		ishares S&P400		Performance effects [%]			
Sector	Weight	Return	Weight	Return	Allocation	Selection	Interaction	Total
Cash	1%	0.0%	0%	0.0%	-0.05	--	--	-0.05
Consumer Discretionary	15%	6.7%	14%	4.3%	-0.01	0.34	0.01	0.35
Consumer Staples	3%	17.2%	3%	6.7%	-0.01	0.35	-0.08	0.26
Energy	4%	1.2%	4%	0.8%	-0.03	0.02	-0.00	-0.01
Financials	23%	5.6%	23%	5.1%	0.01	0.12	-0.03	0.10
Health Care	10%	13.1%	10%	13.4%	0.04	0.02	-0.02	0.05
Industrials	16%	11.4%	15%	6.1%	0.01	0.77	0.04	0.83
Information Technology	18%	5.9%	18%	6.5%	-0.01	-0.09	-0.02	-0.12
Materials	7%	-9.1%	7%	2.2%	0.04	-0.85	0.14	-0.67
Utilities	4%	-5.5%	5%	-5.1%	0.13	-0.03	0.00	0.10
Total		6.15%		5.30%	0.13	0.66	0.06	0.85

Source: Dragon Fund model portfolio, ishares S&P 400 ETF holdings

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Market review and outlook

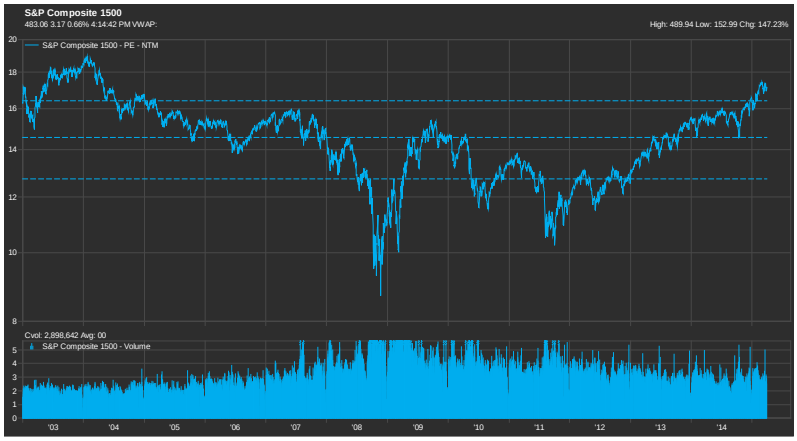
Last quarter, we noted signs for solid economic growth, but expressed concerns about stock market valuations given flat to slightly declining long-term earnings growth expectations.

The U.S. economy indeed performed well with GDP growing at a seasonally adjusted annualized rate of 2.2% during the fourth quarter, especially when viewed in a global context. Together with accommodating monetary policy moves abroad, particularly in Europe, this provided the backdrop for a strengthening dollar which has weighed on earnings of U.S. stocks with substantial foreign exposure. The aggregate U.S. stock market still managed to eke out a 1%+ gain for the first quarter, but much of the positive sentiment appeared to be coming from investors betting on the Fed postponing rate hikes, as opposed to a fundamentally improved economic outlook.

Relative to last quarter's outlook, economic indicators provide mixed signals and thus a less optimistic reading this time around.

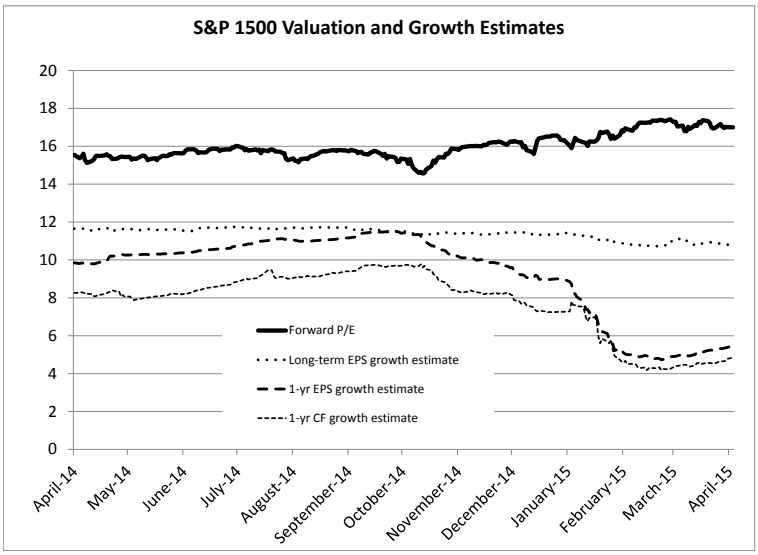
On the demand side, consumer sentiment indices are climbing towards their pre-2008 crisis levels, but retail sales declined and disappointed every month during the first quarter. Non-farm payrolls expanded at a solid pace of 250k+ per month during the first quarter, but wage growth was modest.

On the supply side, the ISM index – which hovered in the upper 50s during the fall of 2014 – has been in the low 50s during 2015 Q1, indicating a slowing expansion which was disappointing relative to consensus forecasts provided by FactSet. Durable goods orders contracted during the first quarter, and housing starts disappointed in March.



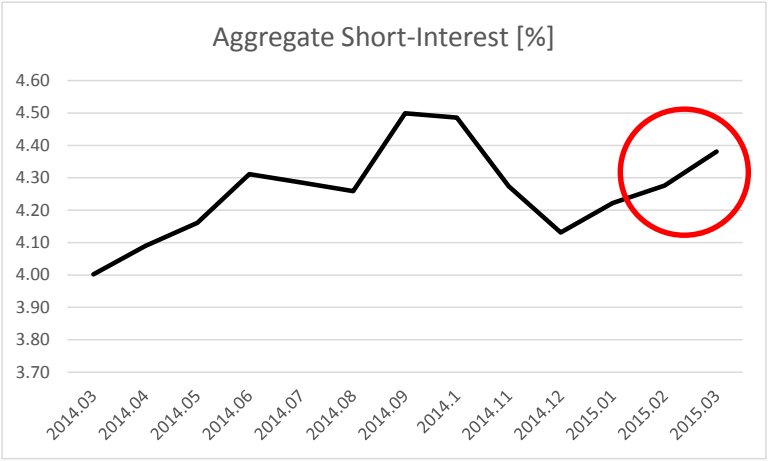
Source: One-year forward FactSet consensus estimates for S&P 1500

Valuation-wise, the picture has also worsened during the first quarter. Aggregate one-year forward price to earnings multiples have risen to 10-year highs (see the long-term chart above) without accompanying upward revisions in either short-term or long-term earnings growth (see the shorter-term chart below). In fact, earnings expectations revisions for the upcoming months have been substantially negative, owing to the strong dollar coupled with weak demand growth overseas.



Source: FactSet consensus estimates for S&P 1500

As part of our macro research, we also track other, less conventional valuation indicators. One example is aggregate short interest. In a recent working paper, Rapach et al (2015, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2474930) suggest that investors' tendency to short stocks, in aggregate, can help predict future stock returns.



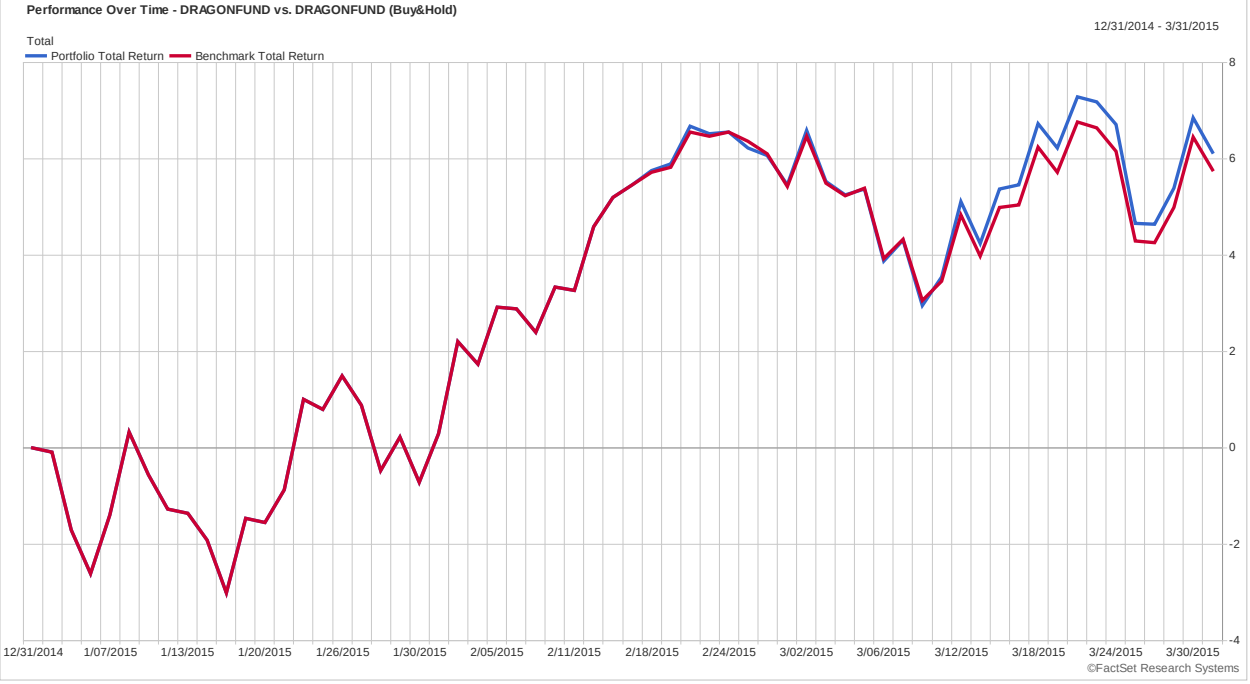
Source: NYSE/NASDAQ/AMEX short interest, Dragon Fund estimates

The equally-weighted average short interest across stocks (excluding the smallest stock quintile) has increased throughout the first quarter, suggesting greater skepticism among potentially informed traders.

Overall, thus, we expect a challenging quarter for the stock market and see no room for a substantial upside. Such upside is a function of robust fundamentals and an orderly transition to a higher interest rate regime.

Impact of 2015 Q1 trades

The graph below shows the impact of the Dragon Fund's 2015 Q1 rebalancing which took place on February 10. The rebalancing contributed about 20 basis points towards the fund's outperformance during the first quarter.



Source: Dragon Fund model portfolio, December 2014 Dragon Fund buy-and-hold benchmark

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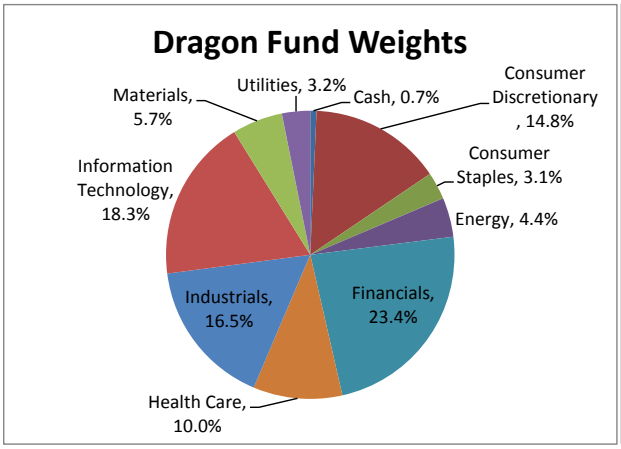
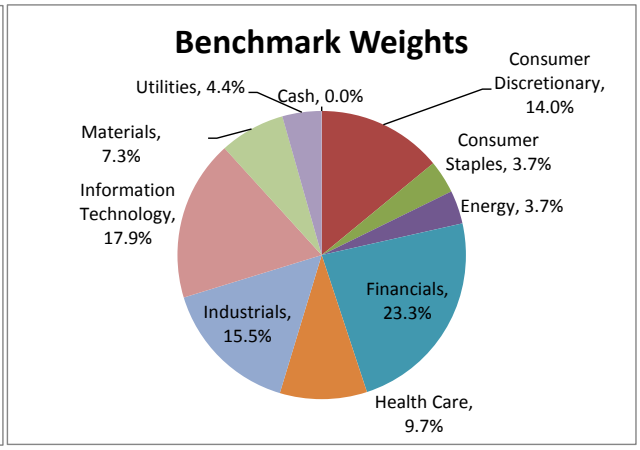
Current holdings profile

Sector allocation as of March 31, 2015





Source: Dragon Fund model portfolio in FactSet, ishares S&P 400 ETF holdings

Top ten holdings as of March 31, 2015

Ticker	Name	Weight [%]
AOS	A. O. Smith Corporation	3.0
HF	HFF, Inc. Class A	3.0
BX	Blackstone Group L.P.	3.0
DLTR	Dollar Tree, Inc.	2.9
SWKS	Skyworks Solutions, Inc.	2.7
JAH	Jarden Corporation	2.6
SNA	Snap-on Incorporated	2.3
SBNY	Signature Bank	2.3
OHI	Omega Healthcare Investors, Inc.	2.2
MYL	Mylan N.V.	2.2
Total		**26.3**

Source: Dragon Fund model portfolio in FactSet

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Top and bottom 5 contributors, 2015 Q1

Ticker	High/Low - Port. Contribution To Return	Average Weight	Total Return	Contribution To Return
	Total	**100.00**	**6.38**	**6.38**
	5 Highest	**11.98**	**26.22**	**2.97**
SWKS	Skyworks Solutions, Inc.	2.55	35.39	0.79
NPSP	NPS Pharmaceuticals, Inc.	1.48	28.29	0.73
BX	Blackstone Group L.P.	3.07	17.43	0.51
AOS	A. O. Smith Corporation	3.03	16.76	0.48
MAN	ManpowerGroup Inc.	1.85	26.38	0.46
	5 Lowest	**6.29**	**-18.16**	**-1.34**
CENX	Century Aluminum Company	1.00	-43.44	-0.51
LRCX	Lam Research Corporation	1.00	-14.06	-0.30
OUTR	Outerwall Inc.	1.74	-11.69	-0.26
PAY	VeriFone Systems, Inc.	1.68	-6.21	-0.14
NFG	National Fuel Gas Company	0.87	-6.66	-0.13

Source: Dragon Fund model portfolio in FactSet

Valuation characteristics of Dragon Fund holdings as of March 31, 2015

Characteristics (medians)	Dragon Fund	S&P 400
Market Capitalization	6,730	3,930
# of Securities	58	404
Dividend Yield	1.1	1.2
P/E using FY1 Est	17.7	19.0
Price/Cash Flow	12.3	13.1
Price/Book	3.4	2.7
Price/Sales	2.1	1.9
Est 3-5 Yr EPS Growth	11.6	10.5
ROA	7.8	5.3
ROE	15.5	10.9
Operating Margin	14.8	12.7
Net Margin	9.3	7.6
LT Debt/Capital [%]	32.7	34.2

Source: Dragon Fund model portfolio in FactSet, ishares S&P 400 ETF holdings.
NB: The Dragon Fund statistics exclude ETFs, which accounted for ~4% of the portfolio

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Dragon Fund analyst team and contact information, Spring quarter 2014/15

Please feel free to contact us regarding more in-depth research reports, recruiting information, or other inquiries about the Dragon Fund.

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