

Thornburg Investment Management, Inc.
U.S. Equity Strategy
Third Quarter 2015

If there were a theme that seems to have been driving—or rather, dragging— equity markets lately, it’s concern over slowing global growth. In the United States, we are now six years into an economic recovery, but some market participants seem to believe growth of about 2.5% per year may be about all we can expect here. Overseas, concerns over the slowdown in China are dominating financial headlines and driving sentiment. It has not been an easy quarter for global equity markets, which suffered their worst three months since the depths of the eurozone crisis in 2011, with an estimated \$11 trillion wiped off the value of shares worldwide.¹

Against this uncertain backdrop, it was a tough quarter for U.S. equity markets too, with the S&P 500 Index having declined 6.44%, erasing all its gains for the year. Likewise, the Thornburg U.S. Equity Strategy declined 7.56% (net of fees) trailing the index for the quarter. For the year to date, however, the U.S. Equity Strategy has done what we hope and work hard for it to do—protect investor capital during down markets—with a decline of 1.74% (net of fees) versus the S&P 500’s decline of 5.29%. So while it has been a difficult quarter, we remain focused on downside protection in shaky markets.

Our Flexible Mandate Lets Us Look Different from the Index

From a sector and capitalization perspective, a few points: your portfolio operates under a flexible investment mandate and has from the beginning. We’re not limited to the large-cap stocks such as those that dominate the S&P 500 Index. We can invest wherever we see value, in big companies and in small. Lately, we have found a number of small- and mid-cap stocks trading at big discounts to our calculation of intrinsic value. Over the long run, we believe the prices of these securities in the market will more closely reflect our views of these businesses, but our overall market cap exposure served as a drag on performance in the third quarter. With our small-cap exposure at roughly 12% of the portfolio and mid-caps at roughly 24%, we have greater exposure to this part of the market than our index (the S&P 500 Index has essentially no small-cap exposure and only about 8.5% in mid-caps). Small-caps dramatically underperformed large-caps during the quarter (the small-cap Russell 2000 Index’s decline of 11.9% was almost twice as much as the S&P 500’s 6.44% drop), and this was felt in the Strategy.

A Neutral View of U.S. Fundamentals

We should emphasize here that our view of U.S. economic fundamentals is pretty neutral. When we survey the landscape of economic indicators, we see an economy on reasonably stable footing. Do we worry more today about recession in the United States? Perhaps. But the crosswinds that have buffeted markets over the past few months may be just that— crosswinds—driven by fleeting factors.

¹ Nick Fletcher, “11 Trillion Wiped Off Global Markets in Worst Quarter Since 2011,” The Guardian, September 30, 2015.

We've said before in this space that we believe a rising-interest-rate environment will be more constructive for active managers. The third quarter, with weak global market performance and falling interest rates, was a tough environment. This showed in the leading and lagging sector performers in the S&P 500. The consumer staples and utilities sectors led the way, while the energy and materials sectors were the worst performing. The sorts of stocks we like, especially in the leading sectors, were relative underperformers. As we've seen before, periods of economic uncertainty have helped propel flows into what are viewed as the safest equity investments—what we call “expensive defensives.”

Health Care Catches a Cold

Health care was also very difficult during the quarter. This is somewhat surprising as the health care sector often acts defensively in tough economic environments. This is a presidential election cycle; candidates are starting to float specific policy proposals for public scrutiny. And it was the prospect of prescription drug pricing reform that, late in the quarter, sent the health care sector into a tailspin. On September 21, Democratic presidential frontrunner Hillary Clinton responded to a story in the New York Times on inflated drug pricing via Twitter, saying “Price gouging like this in the specialty drug market is outrageous. Tomorrow I'll lay out a plan to take it on.”

Indeed, she did. Mrs. Clinton was referring to a story in the New York Times on a 62-year-old drug called Daraprim, which was acquired in August by a pharmaceutical company. This company had raised the price for one tablet from \$13.50 to \$750.00, sparking a storm of protest. As the Times notes, there is growing concern about mammoth price increases on drugs that have been on the market for some time—some of them generic—that have been relied upon by doctors and patients for years.

The Affordable Care Act (ACA), it can be argued, solved several problems in the health care system, most notably reducing the portion of the U.S. population that is uninsured. But drug pricing was not among the problems solved. Even with a Democratic president, a Democratic house, and a filibuster-proof 60 votes in the Senate (before Senator Kennedy's passing), drug pricing was left unaddressed by the ACA. So when a major presidential contender with a history of advocacy in the field proposed a plan to bring those costs under control, investors in the health care sector listened—and stocks of many of those companies sank. The selloff was quite dramatic. Health care accounted for a large portion of the S&P 500's decline for the quarter.

Our role as active managers is to evaluate the long-term fundamentals of individual companies, and in recent quarters, we have found compelling values in health care. Since we've seen more value there, our exposure in the sector has been heavier than that of the market, and health care detracted more from the strategy's returns than it did from the index. But again, our job as individual stock pickers is to try to uncover value at what may be tumultuous times in certain areas of the markets, when those areas are out of favor. We believe the recent action in the space is disjointed from the fundamentals, which have not changed so far.

Active Management Lets Us Choose Where a Passive Investment Can't

With sentiment in a given sector in a shambles and likely to stay that way, fundamentals may not matter much over the near term. But over the long term they will, and that points to why truly skilled active managers, who don't have to hold every company in the index, can outperform over time. We can search the wreckage for opportunities that may pay off 12 months down the road, and if you're an index investor, you have no choice but to buy the entire wreckage.

While recent crosswinds have shown that we won't outperform every quarter or every year, these corrections provide ample opportunity for us to do what we set out to do when the strategy was launched in 1995: to buy promising companies at a discount to their intrinsic values.

Contributors to performance² (Representative Account)			Detractors from performance² (Representative Account)		
Name	Contrib %	Avg Wgt %	Name	Contrib %	Avg Wgt %
Activision Blizzard Inc.	0.56	2.50	Dynegy Inc.	-0.58	1.67
Google	0.41	3.38	Weatherford Intl.	-0.56	1.66
Amazon	0.23	1.76	Horsehead Holding Corp	-0.45	0.62
CDW Corp	0.17	0.99	Phibro Animal Health Corp	-0.43	2.30
Essent Group	0.10	0.72	Whole Foods	-0.43	1.45

Top Contributors to Performance

- Activision Blizzard Inc. - Activision is well positioned to benefit as the installed base of next generation video game consoles grows. Activision has a strong pipeline of high-quality video game content hitting the market over the coming years.
- Google - Soon to be called Alphabet, Google reported strong results during the quarter. The company's Youtube video service reported accelerating view time in the U.S., which should drive strong advertising revenue growth in the future.
- Amazon - Amazon continued its strong recent execution during the third quarter, reporting quarterly results that were better on the top and bottom line than consensus expectations. Retail in the U.S. and internationally were both strong for Amazon, as was their Amazon Web Services (AWS) business. A growing base of shoppers in the U.S. and abroad seem to be going to amazon.com first for their online shopping needs.
- CDW Corp - CDW reported strong second quarter 2015 results and a recent acquisition should improve future profitability.

² Past performance does not guarantee future results. To obtain the calculation methodology and a list showing the contribution of each holding in the representative account to the overall account's performance during the reporting period, please email a request to mcg@thornburg.com. The holdings identified do not represent all of the securities purchased, sold or recommended for advisory clients.

- Essent Group – The stock of Essent Group has advanced as the company continues to perform well in a growing private mortgage insurance market.

Top Detractors from Performance

- Dynegy Inc - Despite several positive fundamental developments in the quarter, Dynegy has sold off with the rest of the Independent Power Producers (IPPs), primarily due to investor risk aversion during the quarter.
- Weatherford Intl - Weatherford was weak during the quarter on declining oil prices and a failed attempt at a capital raise.
- Horsehead Holding Corp. - Continued struggles at the company's new Mooresboro facility has hurt confidence on the earnings trajectory of the business.
- Phibro Animal Health Corp - Phibro Animal Health traded lower with the overall health care sector even though drug price regulatory concerns should in no way impact animal health companies. The stock has appreciated a lot since purchase, though remains below our price target.
- Whole Foods (WFM) - Industry woes have been hurting Whole Foods. Increased pricing competition from other grocers has caused WFM to have to sharpen their price points. At the same time, WFM has had some very public mishaps (namely, the improper weighing of deli items in NYC). Lastly, investors are worried that the new store format, 365, is a sign that the more expensive store is running out of room to grow.

Thank you for investing in the Thornburg U.S. Equity Strategy.

Performance data for the US Equity Strategy is from the US Equity Composite, inception date of November 1, 1995. Performance is based on a one-portfolio composite for the period November 1, 1995, to April 30, 1999. From May 1, 1999 to the present, the composite represents all accounts under management in fee based equity separate accounts. Returns are calculated using a time-weighted and asset-weighted calculation including reinvestment of dividends and income. Returns are annualized for periods greater than one year. Individual account performance will vary. The performance data quoted represents past performance; it does not guarantee future results. Net of fee returns are net of transaction costs and investment advisory fees. For periods prior to 2011, net returns for some accounts in the composite also reflect the deduction of administrative expenses. Thornburg Investment Management Inc.'s fee schedule is detailed in Part 2A of its ADV brochure. Gross of fee returns are net of transaction costs. Performance results of the firm's clients will be reduced by the firm's management fees. For example, an account with a compounded annual total return of 10% would have increased by 159% over ten years. Assuming an annual management fee of .75%, this increase would be 142%.

As of 9/30/2015	1 Yr	3 Yr	5 Yr	10 Yr	Inception 11/1/1995
US Equity Composite (Gross)	3.18%	16.13%	11.47%	6.97%	11.13%
US Equity Composite (Net)	2.75%	15.62%	11.01%	6.54%	10.47%
S&P 500 Index	-0.61%	12.40%	13.34%	6.80%	8.19%

The views expressed by the portfolio managers reflect their professional opinions and should not be considered buy or sell recommendations. These views are subject to change and are not intended to predict or guarantee the future performance of any individual security or the markets generally, nor are they intended to predict the future performance of any Thornburg Investment Management Inc., account, strategy or fund.

Portfolio holdings and characteristics shown herein are from a representative account managed within the investment composite. The representative account was selected based on account characteristics that Thornburg feels accurately represent the investment strategy as a whole. Holdings may change daily and may vary among accounts, which may contribute to different investment results.

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The information provided in this report should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed may not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings.

It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.

The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index including approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

The S&P 500 Index is an unmanaged broad measure of the U.S. stock market.

Portfolio construction will have significant differences from that of a benchmark index in terms of security holdings, industry weightings, asset allocations and number of positions held, all of which may contribute to performance, characteristics and volatility differences. Investors may not make direct investments into any index.