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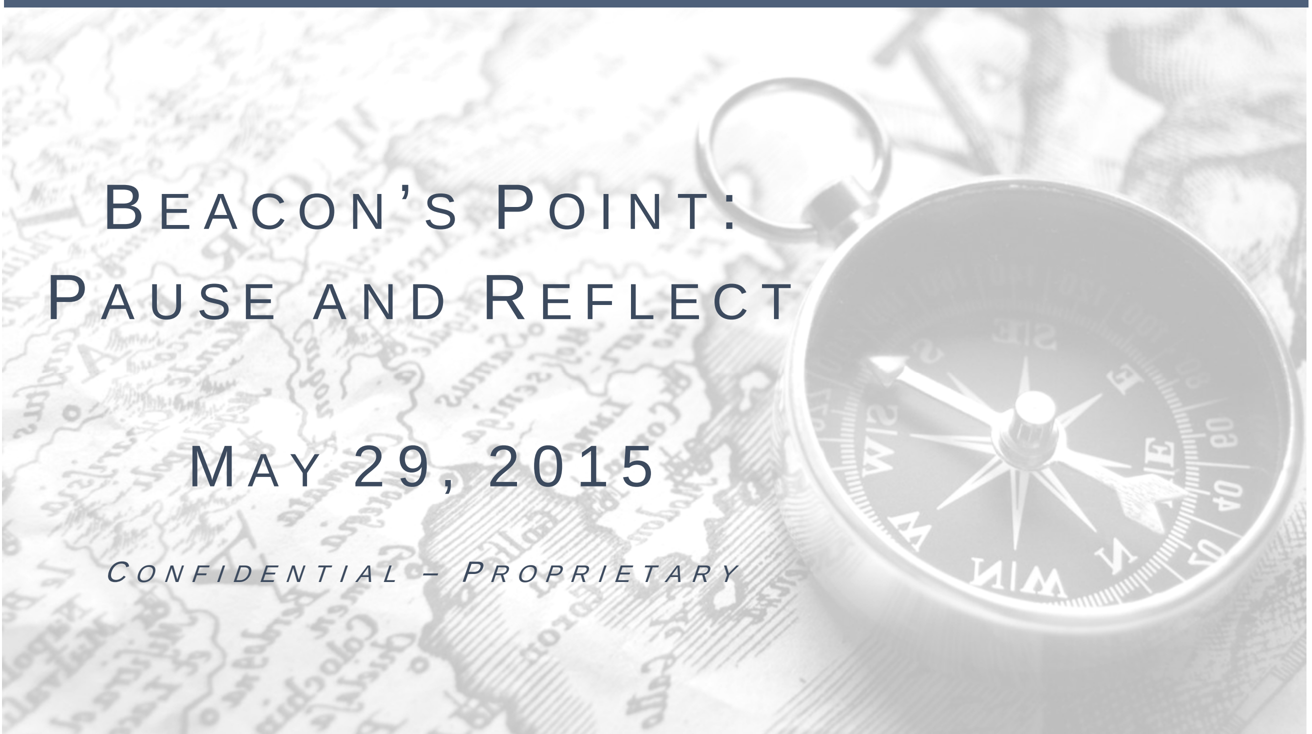

BEACON'S POINT: PAUSE AND REFLECT

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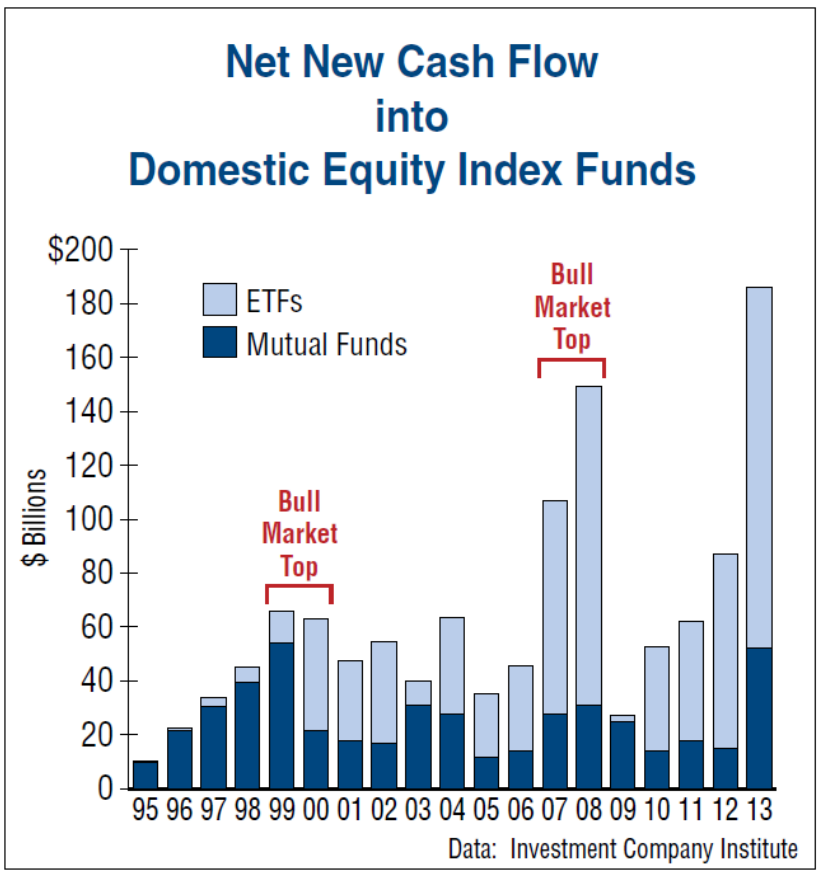
CONFIDENTIAL – PROPRIETARY

24 Corporate Plaza Drive, Suite 150, Newport Beach, CA 92660
TEL 949.718.1600 FAX 949.718.0601 www.bpadvisors.com

Pause and Reflect

At the end of 2014 (and 38 years after the launch of the first index fund by Vanguard), institutional investors had $2.5 trillion allocated to passive U.S. equity vehicles, according to data from eVestment Alliance. This data point has many proclaiming victory for passive products and forecasting the end of active strategies. Mark Twain's advice – "Whenever you find yourself on the side of the majority, it is time to pause and reflect" – is a timely reminder to think critically and serves as the impetus for the following review of active and passive strategies over time. Beacon Pointe strongly believes that neither investment approach works <u>all</u> the time, that there is a natural and repeatable cycle that favors one over the other in certain market environments, and that active investment strategies continue to play a very important role in portfolio construction for prudent long-term investors.

The popularity of passive equity products generally peaks around major stock market tops, as indicated by the data from InvesTech Research in the chart below. That was the case in the last two cycles – combined net flows into ETFs and index funds reached new highs in 1999 and then again in 2008. Inevitably, ETF and index fund flows slowed down each time the stock market entered bear territory. It is not surprising, according to InvesTech Research, to see investors flocking into ETFs and index funds six years after the last bottom: "Longer bull markets erase the painful lessons and memories of the previous bear market. Investors start to think of the previous bear market as an 'aberration' – an anomaly caused by an extraneous event that won't be repeated any time soon."



Source: InvesTech Research

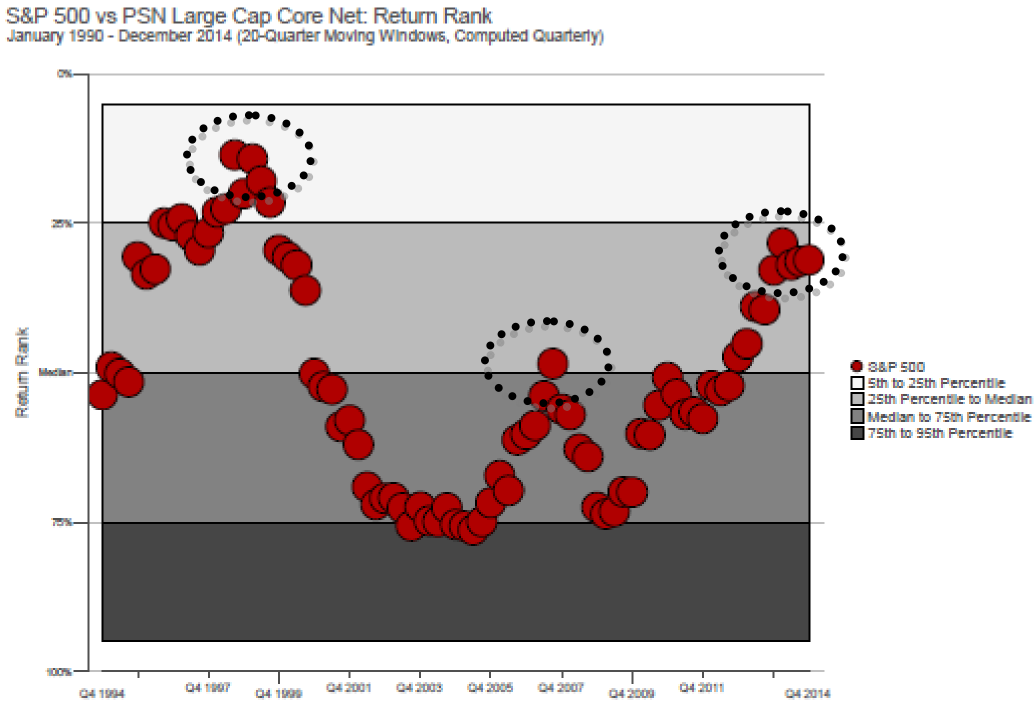
Why are passive vehicles so appealing at this point in the cycle? In addition to their cost advantage, they give investors a sense of comfort, remove the burden and responsibility of decision-making, save time and effort on the research front, and assure them of capturing gains that they believe are likely to continue. As stock prices march on, many investors start to believe that ETFs and index funds are safer than actively managed portfolios. However, these same investors are likely to capture 100% of the market's downside. In the early 2000s, that meant a 49% drawdown, and in 2008-2009, an even more painful 55% loss. Simply put, index funds and ETFs lose their "safe" luster in bear markets.

In an aging bull market, risk management – whether it is in the form of a valuation discipline, keeping some cash as "dry powder", or avoiding market segments that show signs of mania – works against active managers. Leadership becomes quite narrow. For instance, in 2014, the S&P 500 Index advanced 13.7%. Over half of the return was accounted for by just 25 companies (or 5% of the index constituents), while 23% of the companies in the S&P actually lost ground during the year. The largest companies by market cap trounced their smaller cap counterparts and U.S. equities vastly outperformed international and emerging market equities in 2014. Asset class diversification and portfolio risk controls typically lower volatility and improve return potential, but ironically did the exact opposite last year. We view this as a short-term phenomenon.

A discussion of passive and active management should include the following considerations:

- Passive vehicles are not free of cost – investors cannot simply earn the return of an index, but must, instead, invest in a fund that tracks the index. This fund is likely to charge an expense ratio of 10-40 basis points (or even more, depending on the asset class.) In addition, trading costs related to tracking changes in the underlying index are often overlooked by investors.
- ETFs and index funds, by definition, are backward-looking and have a built-in momentum bias. They are typically market cap weighted and, as a result, the stocks and industries that perform well become an ever larger portion of the index and the funds tracking it. (For an example of this, think back to the "dotcom" bubble in the 1990s, at the end of which technology accounted for over 55% of the Russell 1000 Growth Index). As a result, passive products tend to do best in momentum-driven markets, but lose ground in valuation-driven markets.

Our research shows that active strategies tend to consistently add value in down or range-bound markets. In the graph on the following page, we show the return ranks of the S&P 500 index within a universe of Large Cap Core Equity managers (as reported by the PSN database) over each rolling 5-year period since the 1990s. A red dot (representing the rank of the S&P 500) in the upper half of the graph indicates periods when the index was more competitive against the universe of actively managed strategies (whose returns are shown net of fees.) For example, a 25th percentile rank of the index versus the category means that 75% of Large Cap Core Equity managers trailed the S&P 500 over a specific 5-year period. Clearly, the peaks in index return ranks occur towards the end of cycles – the late 1990s, 2007, and potentially the most recent period. History shows that active investment managers stage a comeback and outperform the index during bear markets and in more normal market environments. It is impossible to predict the timing of the next tipping point, but we believe it is not a question of "if", but rather "when".



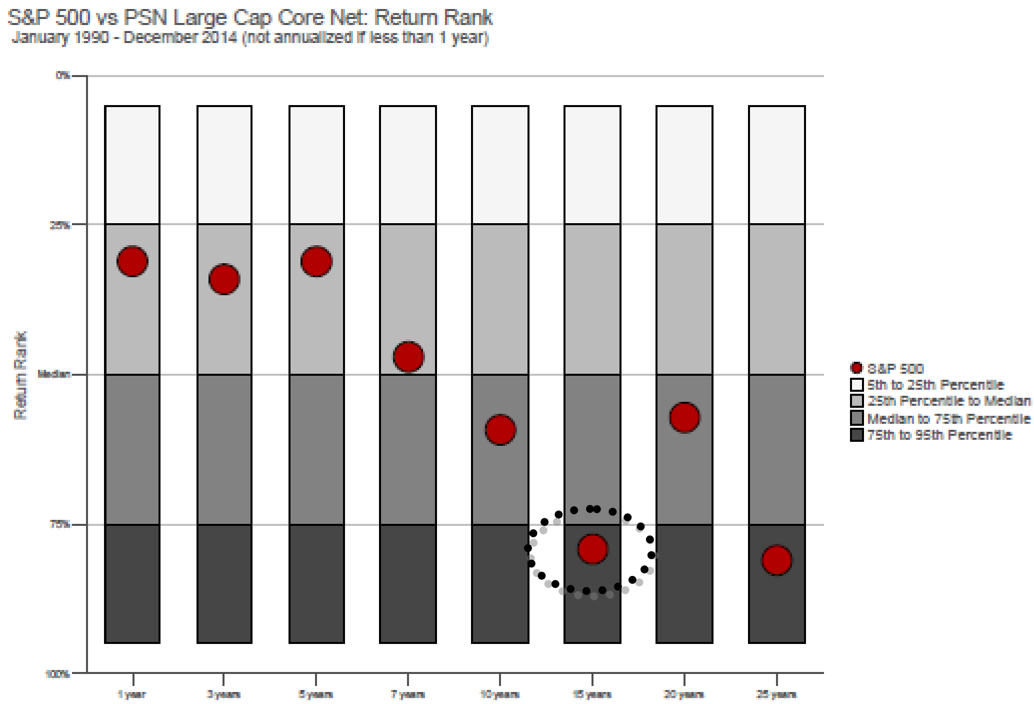
Source: Zephyr Style Advisor, PSN Database

(Additional research from Voya Investment Management on the performance of active investment managers in down, trading range, and up markets is provided in the addendum on page 5.)

It is that outperformance in down markets that gives active investment strategies the <u>long-term edge</u>. As we have discussed many times in the past, downside protection is the key to wealth accumulation because of the punishing math of capital destruction:

- If you lose 10%, you need to gain 11% to get back to even;
- If you lose 25%, you need to gain 33% to get back to even;
- If you lose 33%, you need to gain 50% to get back to even; and
- If you lose 50%, you need to gain 100% to get back to even.

Although equity markets spend more time going up than they do retreating, it is almost always the performance during difficult markets that determines an investor's financial – as well as emotional – health. Taking the long-term view on the S&P 500 Index's performance relative to the same Large Cap Core Equity manager universe (shown on page 4) reinforces the case for investing in active strategies. Over the past 15 years (a period roughly equal to two full market cycles), the S&P 500 ranked in the bottom quartile of the universe – in other words, over three-quarters of the actively-managed strategies in the Large Cap Core Equity universe beat the benchmark <u>after fees</u>**.**



Source: Zephyr Style Advisor, PSN Database

Risk should always be considered alongside return, in good times and in bad. However, investors are more likely to focus on risk **relative** to a specific benchmark – typically measured by "tracking error" – when stocks are making new highs and the race to keep up sends caution to the wind. This favors passive products and drives the growth in index fund and ETF assets. On the other hand, in down markets, the only risk that an investor cares about is **absolute** – his or her goal is to limit losses as much as possible and protect the portfolio's ability to compound capital over the long term. We think the best time to focus on absolute risk is now, before the cycle turns. Current valuation levels limit the pool of investment opportunities and certain areas of the market (such as biotechnology) have started to look like potential bubbles. While index funds and ETFs expose investors fully to risks in the market, skilled active managers are able to handle these challenges and potentially benefit from them.

Please feel free to call Beacon Pointe at 949-718-1600 should you need additional information or have any questions.

ADDENDUM

Excerpt from Voya Investment Management "Revisiting the Active-Passive Decision" (March 2013)

Does Risk Management Matter?

Some market conditions favor active management, while others do not. Active managers have distinct investment processes and philosophies, each of which may or may not behave in ways suggested by observations that only distinguish between broad market tendencies. Nevertheless, we can see in the illustrations below that, across four equity asset classes, active managers (with the median institutional manager as a proxy) have tended to outperform in both down markets and trading-range markets, which collectively account for two-thirds of the observations over the last 20 years.

Figure 15. Active Management Tends to Outperform in Both Down and Trading-Range Markets

Returns are illustrated for the 50th percentile manager versus relevant indexes in the U.S. large-cap, mid-cap, small-cap and international equities universes. "Down Markets" are defined as months in which the market loses 3% or more. "Up Markets" are months in which the market gains 3% or more. "Trading-Range Markets" are months in which the market return is between 3% and -3%. Returns are average returns for the period October 1992 through September 2012 before deduction of expenses.

Source: eVestment Alliance, MSCI, Russell Investments, Voya Investment Management