JANUARY 2018
BEACON'S POINT: THE YIN AND YANG OF INVESTING

In Chinese philosophy, yin and yang (陰陽 yīnyáng, literally "dark-bright" or "negative-positive") describe how seemingly opposite or contrary forces may actually be complementary, interconnected, and interdependent in the natural world, and how they may give rise to each other as they interrelate to one another (source: Wikipedia).

At Beacon Pointe, we contend that active and passive investing are the yin and yang of today's financial markets. Each has its potential benefits and shortcomings and one cannot exist without the other. Inevitably, market environments change, proving one investment approach more advantageous than the other. After a while, the pendulum swings back in favor of the previously disadvantaged. Over time, active and passive investing complement each other as both can add value to investor portfolios.

The current up cycle, which is approaching its ninth anniversary, has not been kind to active management. Some commentators have gone so far as to pronounce it doomed and predict its imminent demise. Short term performance trends have been extrapolated into perpetuity and dire conclusions have been hastily drawn. Many investors – individuals and institutions alike – were sufficiently convinced by the headlines or their own research to abandon active management as a strategy and transition some or all of their portfolios to passive investments. Trends in aggregate flows (out of active and into passive) indisputably show a major shift in investor preferences. However, is this shift permanent or temporary? Does active management still have a role to play in client portfolios? And what circumstances might serve as catalysts for change? We address these questions in the remainder of this paper.

First, we define active management and highlight its advantages and disadvantages:

Active Management Defined

Active management is an investment strategy where managers attempt to add value over the returns of an index by picking stocks based on models, insights, and analytical research. Unlike passive managers, active managers will not seek to match the risk and return profile of an index. They believe that markets are inefficient and therefore, stocks are often mispriced. Active managers will try to identify those stocks and exploit pricing inefficiencies to obtain excess return.

Advantages of Active Management

- Potential to beat the market – proponents of active management argue that pricing inefficiencies can be exploited by highly skilled managers. By taking active "bets" relative to the benchmark, or by assuming a different level of risk than the market, active managers have the potential to realize excess returns relative to the benchmark.
- Potential for protection in down markets – unlike indexed portfolios, which have no discretion to adjust cash reserves to serve as a cushion in declining markets or to selectively invest in higher-quality securities that are less volatile, an actively-managed strategy could hold more cash or reposition the portfolio into more defensive names to preserve capital in bear markets.

Disadvantages and Risks of Active Management

- Higher costs and fees – some of the cost differential is a result of the higher turnover rate associated with the maintenance of active portfolios. In addition, the average fee for active management is higher than that of the passive alternative in the asset class.
- Risk and unpredictability – active management requires that investors have complete confidence in their ability to hire the right manager who has the skill and ability to outperform the market consistently over time.

Source: Beacon Pointe and State Street Global Advisors

The existence of financial bubbles and busts suggests that market inefficiencies do exist. Active managers attempt to exploit those inefficiencies with the objective of beating a particular index on a risk-adjusted basis. To that end, they only invest in what they perceive to be the most attractive securities while avoiding or even shorting other securities they believe to be overvalued relative to their investment universe.

In contrast, the case for passive management is built on the theory of fully efficient markets. This presumed absence of market anomalies equates to a dearth of opportunities to outperform, thereby making lower-cost index-tracking strategies more appealing to investors. An overview of the definition, advantages and disadvantages of passive management is provided below:

Passive Management Defined

Also known as index investing, passive management is an investment strategy that attempts to replicate the returns of an index or benchmark by owning the same assets, in the same proportions, as the underlying index. Passive investing does not seek to capture any excess returns, but rather to match the performance of an index before fees. Mutual funds and exchange traded funds (ETFs) are common vehicles used for passive investing.

Advantages of Passive Management

- Diversified, risk-controlled exposure – passive portfolios are market-driven and not manager-driven. As such, they deliver broad, diversified exposure to the market and can effectively eliminate style drift or capitalization bets relative to an index.
- Lower expenses and improved tax efficiency – index portfolios are usually less expensive to maintain than active funds. Since passive portfolios do not require managers to dedicate resources on research or stock selection, passive management, in theory, should be less costly than active management. In addition, because of the generally low turnover, indexing is inherently tax-efficient.

Disadvantages and Risks of Passive Management

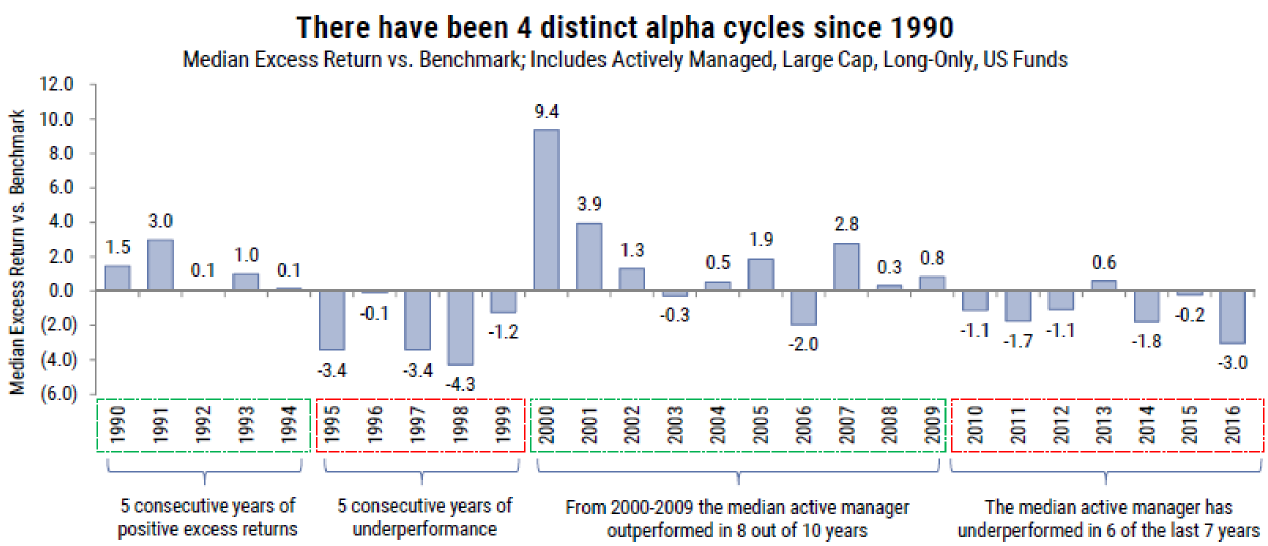
- Market returns at best – indexing is not about timing the market or hand-picking stocks. Rather, it seeks to generate market returns and does not seek to "beat" a benchmark. Investors in search of – and who believe they can achieve – returns that are better than the market will not realize excess returns by utilizing a passive investment approach.

- No ability to defend against down markets – a passive investment approach does not have the ability to provide defensive measures during market downturns. Indexing offers purity, and therefore, when markets are up, index trackers take full advantage of the benefits. However, when markets decline, index trackers have no reprieve from the fall.
- Largely untested in a liquidity-constrained market – the vast majority of passively managed funds and ETFs came into existence during the last few years which have been characterized by ample liquidity and low volatility. It is unclear how these vehicles will trade and perform in a more challenging liquidity environment.

Source: Beacon Pointe and State Street Global Advisors

Neither active nor passive management can exist without the other. As mentioned previously, active managers rely on market inefficiencies to add value; these inefficiencies are created by passive investors who make purchase and sale decisions based not on the specific fundamental characteristics of a security, but on its inclusion in, or exclusion from, a market benchmark. Such indiscriminate trading leads to market dislocations which in turn can be exploited as alpha generating opportunities by the discerning and disciplined active investor. In turn, passive investors need active managers for price discovery through the forces of supply and demand. Without this essential component, financial markets simply cannot function properly.

There exists a natural cycle whereby active and passive management take turns leading the way for several years. In general, steadily rising markets favor passive strategies while periods characterized by high volatility or negative market returns allow active strategies to outperform. For instance, in the large cap U.S. equity space, the period since 1990 can be broken down into four distinct stages:



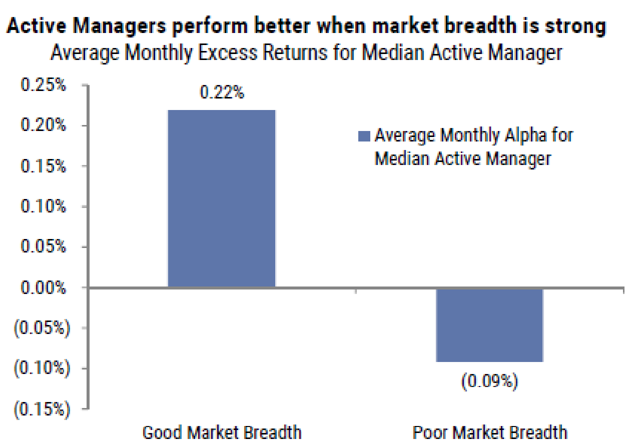
Source: Goldman Sachs

- Five consecutive years from 1990 to 1994 (which included the Savings and Loan Crisis and the 1990-1991 recession) during which the median large cap long-only fund outperformed its benchmark on a net-of-fee basis; followed by
- The period from 1995 to 1999, the height of the Dot Com Bubble, that saw the median manager underperform its benchmark for five consecutive years; followed by

- The eventful 2000-2009 decade during which the median manager generated alpha in eight of ten calendar years – this period encompassed two economic recessions, the 9/11 terrorist attacks, the 2003-2007 bull market, the housing market bubble and bust, the Great Financial Crisis, and two of the most severe bear markets in history; followed by
- The current period (2010 to present) – the median manager has struggled to keep up with its benchmark in six out of seven years, as shown in the excess return chart on the previous page [2017 data not available yet].

Why has the latest leg of this cycle been particularly challenging for active managers? Several powerful forces at work have combined into a seemingly relentless headwind for non-index investors over the past eight years. Quantitative easing – the set of tools used by Central Banks around the world to address the aftermath of the Great Financial Crisis – resulted in record low (and in some cases, negative) interest rates and persistent below-normal levels of volatility. In addition, technological innovation and the rise of social media and e-commerce have spurred enthusiasm for certain companies and industries that are being rewarded by outsized gains. This has led to increasingly narrow market leadership and significant outperformance of growth over value stocks and of large caps over small caps. Consider this:

- Market breadth, which measures the degree of participation by the underlying index constituents in an up or down market, has been steadily diminishing in recent years, thereby limiting the alpha generating opportunities for active managers. Unless a manager invests in the exact handful of stocks that account for most of the benchmark return in a narrow market, and does so at equal or greater weights than represented in the benchmark, it would face a great headwind in terms of relative performance during up markets.



Source: Goldman Sachs

In the late 1990s, a narrow market favored technology and media stocks; in the mid-2000s, financial and housing stocks led the pack; and today's market darlings are the likes of Amazon, Apple, Alphabet, PayPal, Netflix, and Facebook. These account for a big portion of the S&P's recent returns and any portfolio that did not own (enough of) them has been at a disadvantage.

- In addition, indexes are in most cases market-cap-weighted and therefore dominated by the largest companies. According to Invesco, this market-cap-weighting index methodology "*has a tendency to overweight overvalued stocks and underweight undervalued stocks, which can cause benchmark investors to buy high and sell low – the opposite of sound investment strategy. While* *proponents of benchmark indexing often say that these strategies remove the emotion from investing, that's not an accurate statement. To the contrary, these strategies don't offer investors any shelter from the collective emotions of market participants*." (Source: Why Invest in Average? Five Truths about Benchmark Investing", Invesco, November 2016)

In contrast to the market-cap weighted indexes, actively-managed portfolios often have meaningful exposure to smaller index constituents or companies that are not included in their respective benchmarks. This inherent smaller cap bias as well as any non-index investments (such as ADRs) have hurt active managers' relative returns during a period when U.S. mega cap names beat U.S. small caps and non-U.S. equities by a sizeable margin. Finally, while index portfolios are by default "fully invested", active portfolios always hold at least some cash. It can range from a frictional amount meant to meet redemptions to more significant allocations that are driven by the active manager's portfolio construction process and the relevant valuation and fundamental considerations. The following table summarizes these common portfolio biases:

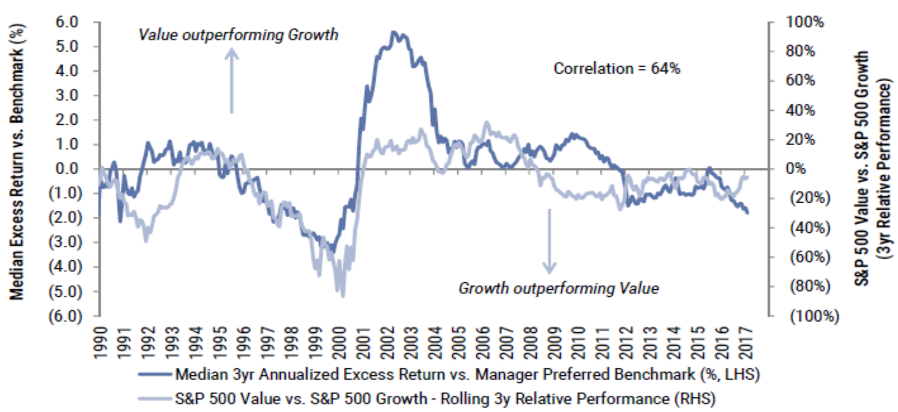
Common portfolio biases explain performance of active managers

Cash Drag T-bills vs. S&P 500	Fund managers hold some cash to meet redemptions. This can be a drag on performance during stronger than average up-markets.
Less Mega Cap Exposure Top 25 stocks vs. the rest	Managers' biggest active positions tend to be outside the largest names in the benchmark. Narrow markets can be a headwind.
Exposure to Small Caps Russell 2000 vs. S&P 500	Active managers often have some exposure to smaller cap stocks relative to the benchmark.
Exposure to Non-US Stocks MSCI EAFE vs. S&P 500	Active managers often have some non-benchmark exposure to international equities.

Source: Prudential Investments

- Finally, in terms of style regimes, active managers have historically generated higher alpha when value stocks outperform growth stocks, such as during the early 1990s and the 2000s. The current period of growth outperformance started after the market bottomed in 2009 and is now the longest in the last 40+ years. Once the pendulum swings back in favor of value, a new leg of the cycle – active manager outperformance – is likely to begin.

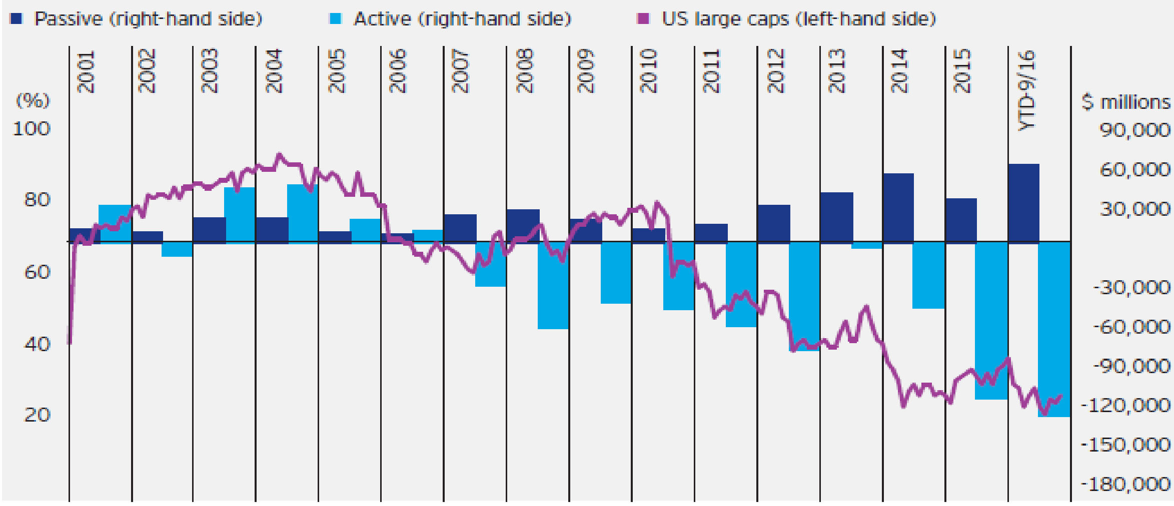
Active Managers have been more successful at beating their benchmarks when "Value" outperforms "Growth"
Median Manager Rolling 3-year Annualized Excess Return (LHS) vs. 3-year Relative Performance of S&P 500 Value to S&P 500 Growth (RHS)



Source: Goldman Sachs

Data on investor flows show a clear relationship between the recent relative performance challenges for active managers and the explosive growth in passively-managed assets over the last decade. This type of behavior is frequently observed in market cycle history – investors chase performance and sell the assets or styles that are underperforming in order to redeploy their capital into what is currently working.

Figure 2: Investor flows have followed performance
% of active funds that delivered excess return over their market-cap-weighted benchmarks, over five-year rolling periods, and flows into and out of active and passive strategies

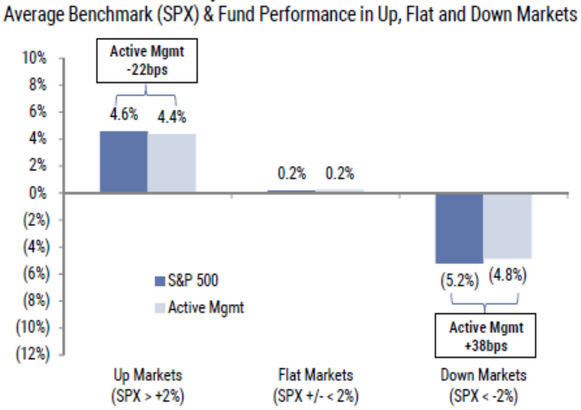


Source: Morningstar. Performance data as of Oct. 31, 2016. Flows data as of Sept. 30, 2016.

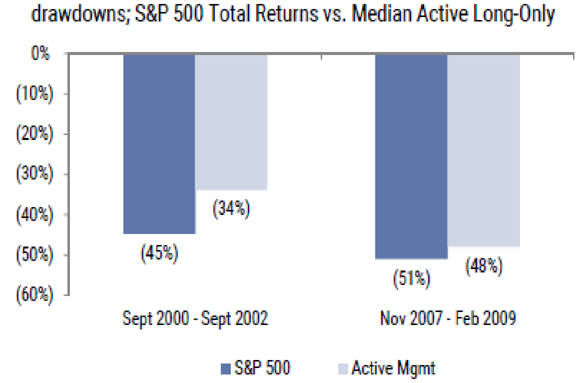
Source: Invesco

Faced with several years of active management underperformance, even some long-term conservatively-minded investors appear to have adopted the passive approach for at least a portion of their portfolios. We acknowledge the appeal of indexing, especially in a steadily rising market, but argue that actively-managed strategies still play a crucial role in terms of risk management, customizing a portfolio to the investor's specific goals, and protecting capital during the inevitable bumps in the road. Data from Goldman Sachs, shown below, provides support for the case of active management in market downturns.

Actively managed funds, on average, lag benchmarks in up markets and outperform in down markets
Average Benchmark (SPX) & Fund Performance in Up, Flat and Down Markets

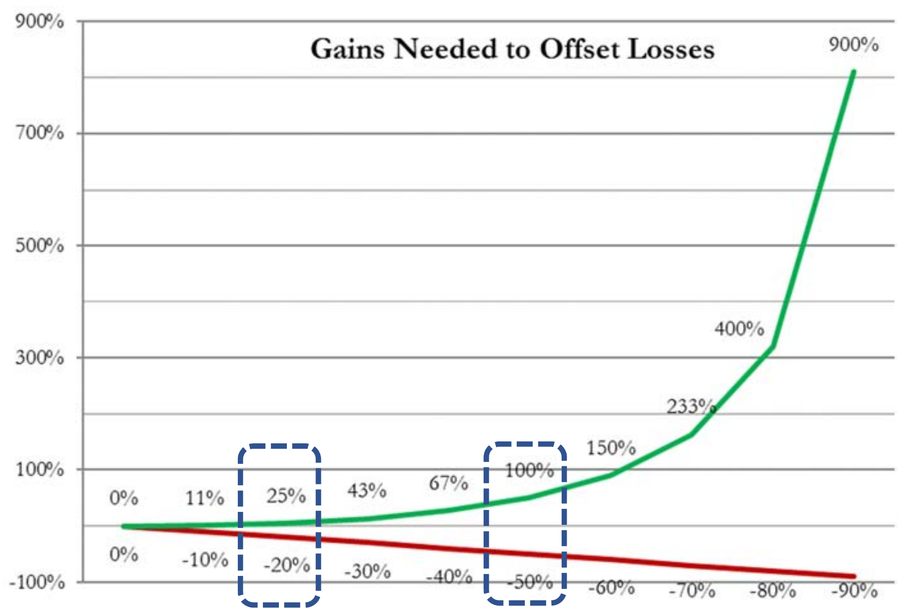


Active managers outperformed through the two largest market drawdowns
Cumulative performance during the 2000-2002 and 2007-2009 market drawdowns; S&P 500 Total Returns vs. Median Active Long-Only



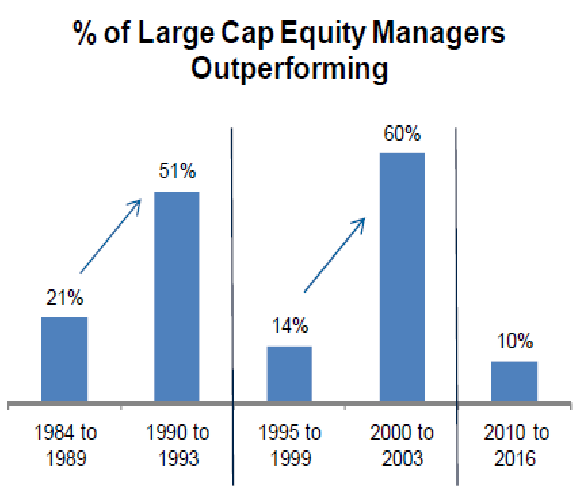
Source: Goldman Sachs

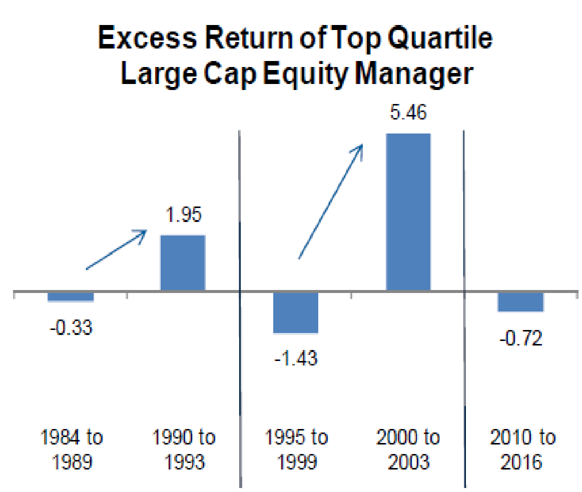
It has been nine long years since the last meaningful market downturn. For many investors, the 2008 bear market is all but a distant memory. However, with losses exceeding 50% in many asset classes and market indices, such severe bear markets have the potential to permanently destroy investor capital and prevent clients from achieving their long-term personal or institutional financial objectives. As noted in our prior commentaries, the impact of an investment loss can be punitive – a 25% gain is needed to erase a 20% loss but a 100% gain is needed to recoup a 50% loss. The graph below is a visual representation of how the math of negative (in red) and positive (in green) returns works:



Source: Beacon Pointe

Although inflection points in the market are impossible to time accurately, the recurrence of cycles is undeniable. Specific to the question of active and passive management, we note that every period of outperformance by one of these styles of investing is followed by a period of outperformance by the other, as the two Prudential Investments/Morningstar Direct charts below illustrate.





Source: Prudential Investments, Morningstar Direct (as of 6/30/16)

Prudential Investments points out that periods of difficulty for active management correspond to unusual market conditions. Specifically, during the late 1980s, a post-recession bull market quickly gained a lot of momentum and reached excessive valuations that ultimately led to the Black Monday crash of 1987; the Fed was forced to deal with inflation head on, the OPEC cartel collapse resulted in falling oil prices, and smaller market cap companies lagged the broad market. A decade later, during the Dot Com Bubble, technology stocks fueled one of the strongest bull markets in history, but also produced an environment defined by irrational valuations, extreme momentum, and low market breadth; value stocks and smaller cap companies trailed large cap growth names by a wide margin. Each of these periods of unusual market conditions was followed by normalization and renewed outperformance by active managers.

Will this pattern hold again? We believe it will. However, several conditions are required for normalization and a more constructive environment for active managers. To summarize:

- Fundamentals-driven markets – macro considerations, such as monetary policy, should recede in importance, giving way to company-specific fundamentals as the main driver of security price performance; with more rational linkages, active manager skill should be rewarded;
- Sensible valuations – over the past several years, broad-based multiple expansion has served as a powerful market tailwind; going forward the valuation of a security will likely follow earnings and the health of the underlying business more closely;
- Slowdown or reversal of momentum in the e-commerce/social media and other crowded trades – once value starts outperforming growth, active managers should see improved relative results;
- Higher or normal levels of volatility – it is more difficult for active managers to profit from stock specific insights when low volatility reflects a complacent market and when the traditional research tools used by bottom-up security analysts are rendered ineffective.

For investors to benefit from an eventual resurgence in active management, an additional requirement is the ability to find skilled managers with a competitive edge and to maintain their investment discipline despite the vicissitudes of market cycles. At Beacon Pointe, we believe that, on behalf of our institutional and private clients, we can identify best-in-class investment strategies that apply fundamental security research and bottom-up portfolio construction to generate attractive risk-adjusted returns. Our Investment Committee and research team are dedicated to a comprehensive on-going due diligence process that ensures our clients are only invested in our highest conviction manager selections.

Importantly, included in our research coverage are also passively-managed funds – just like with active strategies, it is important to follow a research process for passive vehicles and be selective and deliberate in the investment decisions. Successful passive investing often hinges on picking the right provider; analyzing tracking error and index replication methodologies; paying attention to fees and transaction costs; and being cognizant of liquidity, size, and volumes. Not all ETFs and index funds are created equal, as we will undoubtedly be reminded when this fairly new industry is tested by the next market drawdown.

Finally, Beacon Pointe has the experience and objectivity necessary to consistently steer our clients towards their financial goals and to keep them committed to a thoughtfully designed long-term investment strategy, regardless of which style of investing – the yin or the yang – rules the day.

Please feel free to call Beacon Pointe should you need additional information or have any questions.

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