INVESTMENT APPROACHES

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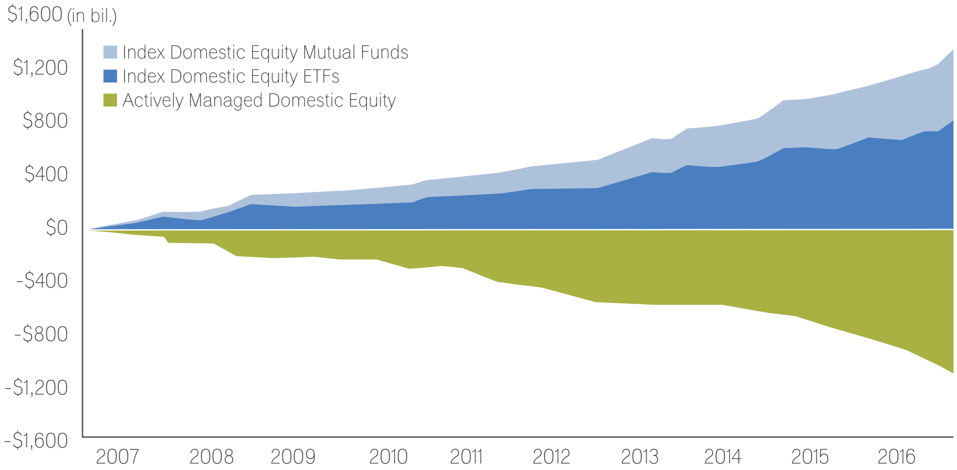
Active Versus Passive Management

What's the difference between active and passive investing? Why do we prefer active? We often hear these questions when discussing our investment managers and strategies with clients — and understandably so. As active managers have underperformed over the past decade, we've seen explosive growth in passive exchange-traded funds (ETFs) and a dramatic shift of assets into index-matching instruments (see Exhibit 1, next page).

EXHIBIT 1. CUMULATIVE NET FLOWS INTO U.S. EQUITY FUNDS



Source: Investment Company Institute, Southeastern Asset Management, Inc.

CURRENT CHALLENGES FOR PASSIVE INVESTING

The active vs. passive debate is not new. As seen in Exhibit 2, the two strategies move in cycles, with one typically outperforming the other at any given time since 1970. We believe the current period of passive dominance has been mainly due to nine years of dovish monetary policy, which has helped extend the bull market beyond normal valuation metrics (see Exhibit 3). Federal Reserve intervention has also contributed to low interest rates, low volatility, and narrow disparity between winners and losers.

The concern is that passive strategies are highly sensitive to changes in central bank policies. When the current cycle comes to an end and rising interest rates are coupled with quantitative tightening, capital flows could rapidly exit passive instruments, causing significant losses for investors.

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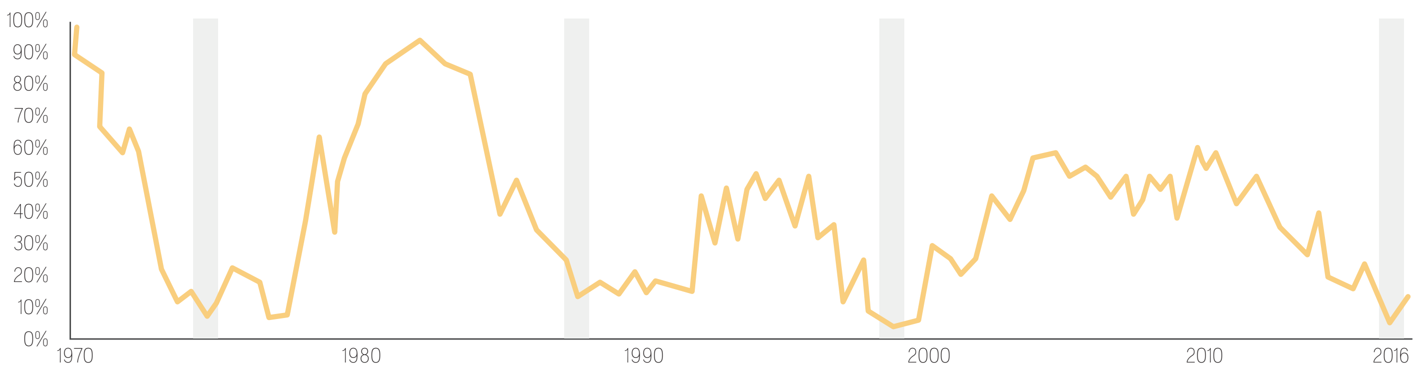
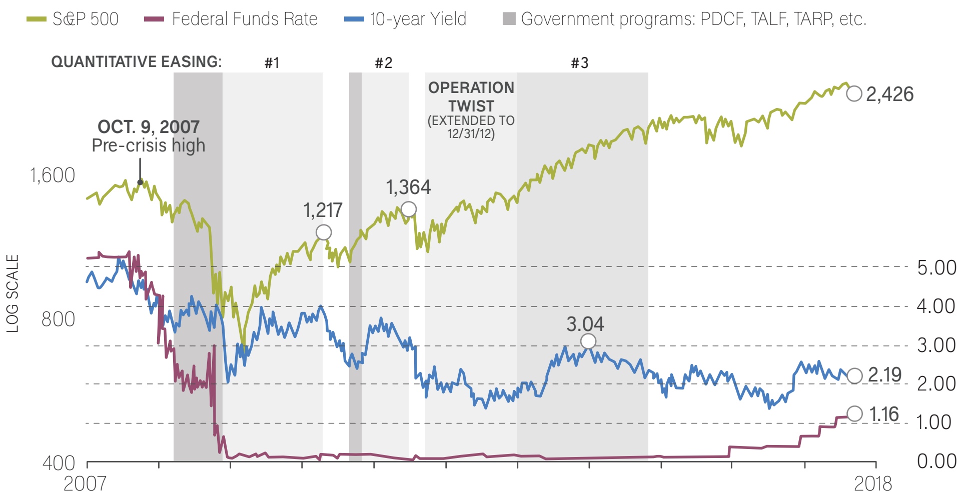
EXHIBIT 2. PERCENT OF ACTIVE FUNDS OUTPERFORMING S&P 500 OVER ROLLING 5-YEAR PERIODS



Source: CRSP, Bloomberg, Robert Shiller data, Instinet Research.

EXHIBIT 3. **THE S&P 500 AND FEDERAL RESERVE INTERVENTION**



Source: dshort.com. Data through August 18, 2017.

By design, ETFs carry almost no cash reserves. If we experience another severe market correction that dries up liquidity, ETF holders may be unable to exit their positions and could be forced to accept significant losses.

ETFs can also be structured to track the performance of specific indices and sectors, such as the S&P 500 and Russell 1000. These indices are market cap weighted, meaning large-cap or overpriced stocks tend to be disproportionately represented. This issue is magnified by the tremendous inflows of cash to ETFs, which, in turn, pour that money back into already-overrepresented stocks. For investors, this means that a major market correction may put overwhelming downside pressure on large-cap stock prices, as they make up such a big percentage of the assets in ETFs.[1]

ETFs that attempt to track the performance of fixed income assets face unique issues of their own. For example, being unable to perfectly replicate benchmark holdings can cause fixed income ETFs to experience frequent performance lags.

The rise of ETFs not only impacts market liquidity and performance, but corporate governance as well.[2] Academic studies found that ETFs' indiscriminate stock buying has caused some executives to be less driven to achieve shareholder return. After all, the effect of their decisions on a firm's stock price can be greatly overshadowed by a massive ETF's single bulk transaction.

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IF WE EXPERIENCE ANOTHER SEVERE MARKET CORRECTION THAT DRIES UP LIQUIDITY, ETF HOLDERS MAY BE UNABLE TO EXIT THEIR POSITIONS AND COULD BE FORCED TO ACCEPT SIGNIFICANT LOSSES.

[1] The largest 10 stocks in the S&P 500 Index (a mere 2% of the index) make up almost 25% of the index's total market value.

[2] www.fa-mag.com/news/the-worst-case-scenario-for-passive-investing-part-ii-34461.html?print

Lastly, the initial public offering (IPO) markets have also been affected by the rise of passive investing. As ETFs buy as many IPO shares as allowed, they make it extremely difficult for investment bankers to determine the true market demand and price of their offerings.

OUR APPROACH TO INVESTING

In contrast to passive investing and ETFs, active managers make specific investments aimed at achieving specific goals, such as outperforming a benchmark, preserving capital, or managing risk.

Our approach is to find and choose active managers in each asset class who can execute specific investment strategies. To select managers who meet our criteria, we've dedicated ourselves to conducting due diligence, monitoring and vetting managers, and performing scenario analysis.

The managers we have chosen are not "closet indexers" who claim to be active but whose portfolios are very similar to their benchmarks. Our active managers have demonstrated a disciplined process for selecting only securities that meet stringent criteria, such as a strong competitive position, growing intrinsic value, experienced management partners, and free cash flow. In addition, our managers may maintain cash reserves, meaning they can act as liquidity providers in the event of a market correction.

We find **Active Share** to be a useful tool for identifying true active managers. **Active Share** is a measurement showing how significantly a manager's portfolio differs from its respective benchmark. For example, if a portfolio's allocation perfectly matches its benchmark, that manager's active share would be 0%. A portfolio with no benchmark overlap would have 100% active share.

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CONCLUSION

Investment managers may exercise various degrees of active or passive investing. At Schultz Financial Group Inc., we recommend active managers who select companies with strong competitive positions, growing intrinsic values, experienced management partners, and discounted security prices. Then, we build your portfolio with these managers, based on your goals and objectives. Finally, we continue to identify, monitor, and evaluate managers according to our investment philosophy.

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