Droms Strauss Wealth Management Communiqué

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If you have followed the financial press over the last year or two, you probably have noticed the continuing trend among individual investors of transitioning investment funds from actively managed to passively managed (index) funds. A recent article in the Wall Street Journal noted that over $300 billion moved from active to passive funds during the last year and that the Vanguard Group, the grandfather of mutual fund indexers, has now surpassed $4 Trillion in assets under management.

Passive management generally refers to the use of "index" funds, which simply are mutual funds or exchange traded funds (ETFs) constructed to track the performance of some stock index. Active management generally refers to a portfolio management strategy where the manager makes specific investments with the goal of outperforming an investment benchmark index in an attempt to produce above-average returns on a risk-adjusted basis.

Even the Vanguard Group, universally acknowledged as the pioneer of indexed mutual funds, offers some actively managed funds, most notably the Windsor and Windsor II Funds which manage just over $65 Billion between them. All told, industry estimates are that, counting both stock and bond funds, Vanguard has about $1 Trillion in actively managed funds under their roof. And a recent article profiling Jack Bogle, the force behind the first Vanguard index fund in the early 1970's, reports that Mr. Bogle has close to 25% of his personal investments in the actively managed Windsor II Fund.

Why this seemingly schizophrenic approach to investment management? Actually, a mixture of active and passive funds makes eminent sense and, in fact, is how we have approached investment management at Droms Strauss for the last two decades. Our approach is grounded on the theoretical bedrock of efficient market theory. Mindful of one of our favorite Yogi Berra admonitions - - in theory, there's no difference between theory and practice, but in practice, there is - - we have followed a blend of theory and practice in our approach to investment management.

This active versus passive management issue really is a never ending debate that most likely never will be settled definitively. However, it is possible for active and passive approaches to logically co-exist in the context of what might be called "investment management in a nearly efficient market." Market efficiency essentially states that stocks in aggregate are priced efficiently such that their market prices fairly reflect the "intrinsic value" of the stock. If stock prices were perfectly efficient, there would be no sense in doing any kind of analysis to try to outperform the efficient market. This has been a hotly debated point in finance for nearly 50 years now and Warren Buffet, for one, has been famously quoted as saying that telling investors that markets are efficient is akin to telling bridge players that it doesn't do any good to look at the cards.

Active managers attempt to exploit market inefficiencies by purchasing securities that are undervalued or by selling securities that the manager believes are overvalued. Active managers use a variety of factors and strategies to construct a portfolio, including quantitative measures such as P/E ratios, attempting to anticipate long-term macroeconomic trends and/or purchasing stocks of companies that are temporarily out-of-favor or selling at a discount to the company's intrinsic value.

A "core/non-core" compromise

There is a deep well of academic studies to support the position that the market for large cap U.S. stocks is highly efficient, even if not perfectly efficient. However this market is close enough to efficiency that for most investors, the best returns will come from investing solely in index funds in the large cap sector. In implementing asset allocation guidelines for the accounts that we manage, we have settled on two types of index funds to meet our large cap U.S. allocation: a traditional or "cap" weighted S&P 500 Index and a fundamental index fund that weights its allocation to large cap stocks based on "fundamental" factors (e.g., earnings and dividends) rather than strictly market capitalization.

As one moves out of the large cap space into midcaps (generally $2 to $12 billion average market cap) and small caps (generally less than $2 billion average market cap), markets become less efficient and the probability of outperforming an index fund with actively managed funds increases. This is a market segment where a "core/noncore" approach makes sense to index the core of mid and small cap investments invest the rest in actively managed funds. In our asset allocation guidelines, we generally own one index fund and two active funds in these market sectors.

In the less efficient international equity market sector, we generally employ actively managed funds as we do in the "alternative investments" sphere (which would include funds that invest in assets such as real estate investment trusts and infrastructure). Thus, overall, our selection of fund investments may run from 100% in index funds in the large cap U.S. market sector down to 0% index funds in the international and alternatives investment sectors. This core/noncore approach takes advantage of market efficiency in the market segments that are most efficient and takes advantage of active management in the segments that are less efficient. The active/passive debate will no doubt continue in the future, but the core/noncore compromise is a reasonable way to take advantage of the best features of each argument.

<u>Brown Capital Small Company Institutional</u>

One good illustration of the benefits of active investing can be seen in our investment in the Brown Capital Small Company Institutional Fund. The Brown management team was selected as the Morningstar domestic manager of the year by Morningstar for 2015. Brown Capital is highly rated on both Morningstar performance dimensions: it is a 4-star fund with an Analyst Rating of Gold. Brown is in the Morningstar small cap growth category where its in-category performance (as of 2/27/17) ranks at the 46tt, 11th, 2nd, 1st and 15th percentiles for the past 1-, 3-, 5-, 10-, and 15-year holding periods, respectively. Brown Capital is a good illustration of the virtues of investing in a small company fund before its asset base gets too large. As strong performance attracts more investment dollars, small cap funds in particular become concerned that a much larger and less nimble asset base will cause performance to deteriorate as the fund becomes less able to find enough attractive small cap investments when they have to deploy a swelling asset base. Therefore, small cap funds often close to new investors as their success attracts "too much" money to continue their investment strategy. And this is the case with Brown: the fund has been closed to new investors since October 2013. Fortunately, since we have been investing in the Brown Capital Small Company fund since 2009, we are not "new investors" and are able to continue to buy shares for our client accounts.

Brown Capital also is a good illustration of the reason that we are slow to sell a fund in which we have confidence when it occasionally hits a rough patch in performance. For the trailing twelve months (TTM), Brown has slid to the 46th performance percentile; still above the median but well below its TTM standing at the 4th percentile at the end of 2016. Based on our experience, we know that all actively managed funds occasionally hit a period when performance lags, and Brown is no exception to this rule. Looking at Brown's long-term record and its strong recovery from performance downturns in 2010 and 2014, we do not feel that any alarm is warranted based on these most recent results.

A Note on Past Performance: It always bears repeating that past performance does not predict future results. The performance numbers presented above represent past performance and do not guarantee future results. Furthermore, the performance reported does not reflect the actual returns of the funds owned by any particular individual over the time period the funds were owned because individual results are affected by the timing of buys and sells for each individual account and that account may or may not have held any particular fund for the time period for which performance of the fund is reported. The fund data simply report the results at the fund level for the time period specified and not the results of any particular fund owner.

Thanks for sharing

We would like to thank our clients and friends that have shared our Communique' with their friends and family members and ask those of you that haven't to think about forwarding the Communique' to your friends, family or a business colleague you think could benefit from working with us.

We would welcome the opportunity to discuss the services we offer and our investment philosophy with others as we continue to grow our business.

Sincerely,

Droms Strauss Wealth Management

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