Droms Strauss Wealth Management Communiqué

May 2017

In our last Communiqué, we discussed the ongoing debate about passive versus active equity investment and our "core/noncore" approach of using passive (index) equity funds in the large and mid-cap U.S. equity categories and actively managed equity funds in the U.S. small cap and other less efficient market sectors. In this issue, we would like to expand our discussion of the active/passive debate to the fixed income sector and explain our logic behind using all actively managed funds for our bond investments. We also briefly revisit our discussion of the Brown Small Company Institutional Fund that we highlighted in our last Communiqué.

Active Management for Bond Funds

Pimco, one of the largest and most successful bond fund managers in the U.S., published a white paper last month entitled "Bonds are Different: Active versus Passive Management in 12 Points." This paper encapsulates much of the research on the value of active bond management that goes back literally decades. In fact, the seminal research paper on investment performance attribution, which is one of the most widely cited papers in the entire academic finance literature, noted the value of active bond management over 30 years ago in a 1985 article in the Financial Analysts Journal that was re-published in the 60th anniversary issue of the Journal in 2005. In that article, Brinson, Hood and Beebower observed that of those widely diversified pension funds that outperformed their custom benchmarks, the outperformance was most often attributed to superior performance of active bond management rather than active equity management. This original research is one of the reasons that we have consistently invested in active bond funds since our founding in 1995.

We will not review all 12 points of the Pimco paper but it is worth pointing out some of the highlights. Their first point is the bottom line for our investment approach: their data shows that "unlike their stock counterparts, active bond mutual funds and exchange-traded funds (ETFs) have largely outperformed their passive peers after fees." Within the three largest categories of fixed income funds (intermediate term, high yield, and short term), which are the three categories in which we mainly invest, Pimco points out that over the past five years, between 60% and 84% of active mutual funds and ETFs outperformed their passive peers. Another important point made by Pimco is that bond fund managers should be evaluated over a long (time) horizon. They ask the question: "How long would it take for the hypothetical active manager to beat the index with a 90% probability? The answer, it turns out, is 7 years….Over 1 year, this hypothetical manager would have a 69% probability of outperforming and over 3 years, the probability would rise to 80%." We'll buy that without reading the full mathematical proof just because it also makes a lot of sense. We have never selected bond funds (or any other funds) based on short-term performance.

So how about the proof in the pudding of our actively managed bond funds? We own three investment grade U.S. bond funds in virtually all of our portfolios above $200,000. For tax-sheltered accounts, we own three taxable bond funds: Loomis Sayles Investment Grade Institutional Bond Fund (LSIIX), TCW Total Return Institutional Bond Fund (TGLMX) and Blackrock Low Duration Institutional Bond Fund (BFMSX). In taxable accounts, we own three tax-exempt funds: Vanguard Intermediate Term Tax Exempt Admiral Shares Fund (VWIUX), Vanguard Limited Term Tax Exempt Fund (VMLTX) and Wells Fargo Short-Term Muni Institutional Fund (WSBIX). For accounts under $200,000, we own Pimco Income Fund (PONDX). Looking at these funds' returns over the five years ended 4/30/17, we see that these seven funds rank at the following percentiles for performance within category: LSIIX – 17th, TGLMX – 4th, BFMSX – 20th, VWIUX – 23rd, VMLTX – 21st, WSBIX – 24th, and PONDX – 2nd. And, of course, all of these funds outperformed their passive benchmarks. Not a single fund outside of the top quartile of performance for the past 5 years puts us squarely in the "active management pays off for bond funds" camp.

In the international space, for the five years ended 4/30/17, Pimco Foreign Bond Institutional (dollar hedged) (PFORX) ranks at the 2nd percentile, Templeton Global Bond (TGBAX) ranks at the 13th percentile, and TCW Emerging Markets Income (TGEIX) ranks at the 20th percentile. On the high yield side, Blackrock High Yield Bond Institutional (BHYIX) ranks at the 10th percentile, and Franklin High Yield Tax-Free Income (FHYVX) pops up as an outlier and the only fund in which we invest with performance outside of the top quartile for the last five years. Currently at the 79th percentile within category, Franklin's return is lower than peer high yield funds for two reasons. First, on average, Franklin holds higher quality bonds than peer high-yield funds and higher quality begets lower yields. According to Morningstar, 58% of Franklin's portfolio is invested in bonds rated "A" or better, which is approximately double that of peer funds. Secondly, the merger of the Franklin Double Tax-Free Income Fund into FHYVX one year ago increased FHYVX's percentage investment in Puerto Rico bonds from 3.0% to 3.8% and this has been a drag on performance. Longer term, FHYVX 10-year performance ranks at the 17th percentile within category. Also, in spite of the low within category ranking, the last 5 years have delivered positive performance above that of the fund's passive benchmark: 4.45% per year compared to 3.39% for the Barclays Municipal Bond Total Return Index. We expect the experienced team at FHYVX to right the ship at this $7.4 billion, Morningstar 4-star rated fund going forward.

Brown Capital Small Company Institutional (BCSSX)

Thinking about active management on the bond side brought us back to thinking about active management on the equity side and our policy of using active equity funds in less efficient market sectors, such as small cap stocks. Since singing the praises of BCSSX last issue, we had an opportunity to meet with one of the portfolio managers and other representatives of Brown at the Morningstar Investment Conference held the last week of April in Chicago. We already had a high degree of confidence in Brown from evaluating "external" information that we highlighted last issue: the BCSSX management team was selected as the Morningstar domestic manager of the year in 2015, and BCSSX is rated a 5-star fund (raised from 4 stars on our last report) with an Analyst Rating of Gold by

Morningstar. An update of their performance record in the small cap growth category through 5/25/17 shows that BCSSX performance ranks at the 7th, 1st, 1st, 1st and 2nd percentiles for the past 1-, 3-, 5-, 10-, and 15-year holding periods, respectively. Having the opportunity to meet face-to-face with one of the Brown managers strongly reinforced our already high opinion of their work. They have what we try to find in successful equity managers; a thorough, disciplined and repeatable investment process, a high degree of conviction in their selections, a relatively small number of individual holdings (approximately 40 at present) and low turnover (about 15% to 20% per year). We expect to continue as Brown shareholders for many years to come.

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

Contact Us

William G. Droms, CFA	bill@droms-strauss.com
Steven N. Strauss, CPA/PFS	steve@droms-strauss.com
Anthony Z. Gennaoui, CFP®	anthony@droms-strauss.com
Robert J. Hines, CFP®	bob@droms-strauss.com
Michael S. Murphy	mike@droms-strauss.com
Rachel Strauss Rosen	rachel@droms-strauss.com
Gregory (Joe) Goltermann, CPA, CFP®	joe@droms-strauss.com