Comparison of Features and Benefits of

Active and Passive Investment Management

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A Dalbar Report

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DOES PASSIVE PERFORMANCE OVERCOME ACTIVE BENEFITS?

A growing volume of data has been accumulated that shows Investment Returns of index funds ("Passive Investments") exceed those of managed funds ("Active Investments"). This is to be expected since the cost of active management reduces Investment Returns.

If Investment Returns were the only criteria, there would be little argument to ever use an Active Investment. In fact over the last fifteen years there has been a major shift away from Active Investments into Passive Investments. This shift to Passive investing raises the question of how well investors are being served by these investments.

To date, there has been no meaningful measure of whether this shift has been beneficial to Investors. In fact, the basic advantages and disadvantages have been generally misunderstood and the effects ignored. For example, advocates of Passive investing tirelessly point out that returns are higher and expenses are lower. Lost in that noise, is the fact that Passive investments are also more heavily invested in stocks and offer few of the features available from Active investments.

This report summarizes the differences between Active and Passive investments from the Investor perspective. By offering explanations for the differences, the report will assist in making prudent choices between Active and Passive investments.

Investor Returns

This section compares the effects of Active and Passive investing on investor returns.

Investor behavior, reflected in decisions of when and how much to invest or how much to withdraw from investments, has a material long term effect on the returns that investors actually earn ("Investor Returns"). The Investor Returns differ greatly from the published statistics of historical performance, with Investor Returns being significantly lower.

While historical performance statistics of Active investments are generally lower than Passive counterparts, the Passive investments are more vulnerable to behavioral influences that are costly to Investor Returns.

The question addressed by this study is the extent to which the historical performance advantage of Passive investments is eroded by the behavioral influences.

Period Ending 12/31/2016	Annualized Investor Returns		Active Advantage
	Actively Managed	Passive Funds	
15 Year	4.04%	2.85%	1.19
10 Year	4.37%	4.37%	0.0
5 Year	8.51%	8.12%	0.39
3 Year	3.66%	5.40%	(1.74)
1 Year	6.73%	9.38%	(2.65)

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ACTIVE AND PASSIVE INVESTMENT MANAGEMENT

The annual S&P return for the 15 year period was 4.98% while inflation rate was 1.58%.

This study uses data from the Investment Company Institute (ICI), Standard & Poor's and proprietary sources to compare mutual fund investor returns of Active and Passive Investments. Covering the period from January 1, 2002 to December 31, 2016, the study utilizes mutual fund flows as the measure of investor behavior. These behaviors reflect the "average investor." Based on this behavior, the analysis calculates the "average investor return" for various periods.

Analysis

As is consistent with historical data, Investor Returns for both Active and Passive Investments are substantially lower than the Investment statistics. It should be noted that both Active and Passive Investments include both equity and fixed income funds.

Actives Are Long Term Winners

The Investor Returns for five years and longer favor Active Investments. This time frame is sufficient to include market cycles of both boom and bust.

The shorter time frames (one and three years) reflect the unexpected post-election boom that disproportionally benefited Passive Investments.

Passives Ahead in Rising Markets, Actives When Markets Decline

For the ten months when Passives had the greatest advantage over Actives, returns were positive in eight of the months.

When Actives had the greatest advantage, all ten months had negative returns.

The evidence shows that Passive Investments provide greater capital appreciation while Active Investments offer greater capital preservation.

No Clear Preference

The closeness of the results indicate the choice of Active or Passive Investment should not be based purely on investment characteristics but must always include situational factors applicable to each investor.

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HOW DO FEATURES COMPARE?

The features in this section should be considered in light of an investor's needs, preferences, skills and the specific situation. Each situation may place a different level of importance on factors.

	Active	Passive
Design Objective	Serve one or more investor goals (retirement, income, growth, etc.)	Track one market sector (S&P, Wilshire, Emerging Markets, etc.)
Role of Investment Manager	Make investment decisions consistent with investor goals	No investment decisions, mimics activity of the index
Investment Selection	Performed by investment manager	Performed by creator of the index that is tracked
Investment Return Objective	Consistent with investor goal	Match selected index
Changes to Fund Portfolio Composition	Frequent: As needed to achieve investor goal	Rare: When index creator makes changes
Diversification	At discretion of investment manager	Limited to index content
Asset Allocation	Available	Not available
Other Capital Preservation	Available	Not available
Regulation of Investment Decisions	Securities and Exchange Commission (Federal Government)	None
Performance Measurement	Independent benchmark	Comparison to itself
Vulnerability to Imprudent Action	Low: Requires proactive inquiry or driven by quarterly statement	High: Driven by publicity of index that emphasizes bad news
Down Market Retention	High	Low
Costs	High: Fund Management and Services cost	Low: Fraction of Active Investment cost

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Advantages/Disadvantages of Active Investments

Advantages

- Capital preservation tactics are available
- Strategies can be adapted to align with various investor needs
- Temporary market changes are less visible

Disadvantages

- Costs are higher
- Investment Returns are lower
- Negative flows further depress Investment Returns

Advantages/Disadvantages of Passive Investments

Advantages

- Costs are lower
- Rarely exposed to sub-par performance
- Positive inflows boost heavily used indices

Disadvantages

- Unable to limit losses
- No meaningful evaluation/regulation of index decisions
- Cannot be adapted to investor's needs
- Excessive exposure to temporary market changes

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Active and Passive Investment Management

Effect of Expenses

It has been pointed out that the cost of Active Investments are significantly higher than Passive Investments but the question remains, "When are the costs justified?" The answer obviously depends on the value that these costs represent to the particular investor. Since the value differs from one investor to another, this section outlines six factors that are valuable to a large proportion of the investing public.

- Allocate assets to various investment classes
- Research and select investments
- Monitor portfolio and make changes as needed
- Manage to an objective that matches personal goals
- Outperform an applicable index
- Preserve capital to the extent possible

Cost Factor and Intent	Estimated Probability of Success	Value to Investor
Asset Allocation Find appropriate balance to achieve financial goal with minimum risk.	65%	**Capture some upside potential while limiting loss in relation to overall market losses.**
Investment Selection Select investments that achieve or exceed expectations.	50%	**Obtain higher appreciation and/or dividends than an alternative.**
Portfolio Monitoring Identify and replace investments before they have a negative effect on portfolio.	30%	**Prevent investments that become questionable from causing a loss of return.**
Manage to Personal Goal Specify the personal goal that is intended and meet expectations.	50%	**Ease of selecting the investment that is most consistent with personal goals.**
Outperform Index Produce results for a specified period that are at least as high as a selected index.	40%	**Demonstrate that choice of investment was prudent.**
Capital Preservation Consistently limit losses to levels that are less than the selected index.	60%	**Alleviate concerns over deterioration of portfolio value.**

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Methodology

Investor Return is designed to show the overall effect on the investor's wallet that includes:

- Capital gains (losses) and distributions.
- Delayed decisions to invest.
- Withdrawals at market lows.
- Market timing attempts
- Fees, expenses and other costs.
- The effect of compounding.

Investor Return

Definition

Investor return is the change in assets, after excluding the effects of sales, redemptions, and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses and any other costs. After calculating investor returns in dollar terms two percentages are calculated:

- Total investor return rate for the period
- Annualized investor return rate

Total return rate is determined by computing the percentage of the investor return dollars to the net assets, sales, redemptions and exchanges for the period.

Annualized return rate is calculated as the uniform rate that can be compounded annually for the period under consideration to produce the investor return dollars.

Note: This is the same method used for the Quantitative Analysis of Investor Behavior ("QAIB").

This study was conducted by an independent third party, DALBAR, Inc. A research firm specializing in financial services, DALBAR is not associated with Fusion Capital Management. The information herein is believed to be reliable, but accuracy and completeness cannot be guaranteed. It is for informational purposes only and is not a solicitation to buy or sell securities.

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