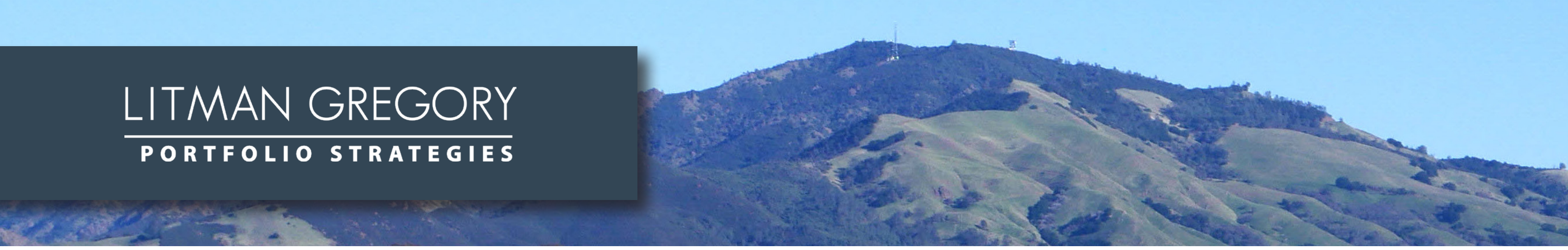


First Quarter 2018 Research Q&A

MAY 2018

Each quarter, we address questions from clients and advisors about our investment views, long-term strategy, and current positioning. Below, we discuss some of the key topics coming out of the first quarter: tariffs and trade wars, portfolio positioning, and the possible move away from passive equity investing.

TARIFF TALK AND TRADE WARS

Do you have current thoughts on the tariff talk and how a potential trade war might impact your view on international stocks?

There are many viewpoints on this topic out there. For what it's worth, our view is that the most likely scenario is one in which the United States and China negotiate and prevent an all-out trade war because it's not in either country's best interest. China, through its initial retaliation, has shown to Trump it can hurt his political base with its tariff measures. Meanwhile, China is in a relatively weak position in that it's managing a transition from an investment-led economy to one more consumer-driven, while making sure the imbalances from its previous credit binge do not derail its economy. So, it cannot afford a major slowdown in its economy. (The major slowdown due to the credit binge is still a risk scenario—it's a difficult task they have at hand.)

We assume both parties know this and will come to an agreement. It might mean China gives Trump a "win" so he can go back to his base and declare victory and feel good about the midterm elections. Whilst China will know that they can still largely adhere to their strategic vision of gaining a competitive advantage in key industries they have highlighted, perhaps if not by 2025 then a bit later—in the overall scheme of things even a decade does not matter much.

However, there is a risk that negotiations fail and we enter into a trade war. In that case, in the short term we'd expect all risk assets to suffer, including international. But looking out longer term, we'd venture to say it would be more of a negative for the United States because, in our view, its companies have benefited the most from globalization by expanding their complex network of global supply chains (this has contributed to the United States' relatively high profit margins) and will end up hurting more as they are forced to unwind it.

The underlying reality is that China is fast becoming a major competitor in some key industries, such as solar, and aims to become one in other high-tech industries. In his April 10 *Financial Times* op-ed, "US-China rivalry will shape the 21st century," Martin Wolf states that in 2017, China's GDP was 119%, measured in PPP terms, and their R&D spending as a percentage of GDP is similar to the United States (a gap of less than 1%). This alone suggests to us that China will continue to make progress on its "Made in China 2025" vision. The developed world will have to adjust to this reality, but also rightly sees this as a threat and wants to see greater trade interdependence from China. As Wolf points out, and we agree, trade tensions will be with us for a while. It's very likely in the long run to turn out fine, but it will be even more important for investors in this world to think globally rather than locally.

PORTFOLIO POSITIONING AND SCENARIO UPDATES

What is your case for a higher weighting to Europe, in particular, more than developed international in general?

Europe is about two-thirds of the developed international universe, so our tactical allocation to Europe gives us the majority of exposure to developed international markets. The other remaining country with a material weighting in a typical developed international index is Japan. Japan has gone through a long cycle of deflation since the early 1990s, and when we modeled it, we concluded the range of scenarios was so wide that we could not gain a high level of confidence overweighting it, whereas in Europe we could reach the level of confidence we needed to make a tactical investment. The case for overweighting Europe is their depressed earnings relative to their normalized level, which we don't think is reflected in valuations.

Does your optimistic scenario for U.S. stocks consider consistent above-trend earnings growth?

Yes, our optimistic scenario considers earnings can grow 20% above trend, or the normalized level. And recently, we added some benefit of corporate tax cuts and raised our optimistic earnings number. History has shown that earnings don't stay above trend for long and revert to their normalized level, mostly because margins ultimately revert due to competitive pressures and wage pressures (when economies come close to full employment). As such, over the long term, corporate profits grow in line with the nominal growth rate of the economy (around 6% in the case of the United States). In the past several decades, more of the share of economy-wide profits have gone to corporations than labor, elevating margins. But we are starting to see wage pressures come through and interest rates rise. Even the recent threat of protectionism, if it comes to fruition, will be a mean-reverting force for margins and therefore slow earnings growth. We don't know what earnings will do in the short term, but they could continue to grow above trend due to a number of factors, which we capture in our optimistic scenario.

Can the team provide the rationale behind your approximate 11% allocation to alternatives? Why not more?

As always, our allocation to alternatives or any actively managed investment is a function of (1) our manager due diligence—identifying managers that we have a high degree of confidence can achieve their alternative strategy risk and return objectives; and (2) the role of these strategies within our portfolios' overall risk/return objectives. Having identified alternative funds in which we do have conviction, it is then a portfolio construction and portfolio management process of weighing their expected returns, risks, and diversification/correlation characteristics in absolute terms and relative to the other available investment options and opportunities in our portfolios.

Our current 7% allocation to managed futures is meaningful, and we are not looking to increase that exposure. The 4% in arbitrage funds is a function of their more modest risk, return, and diversification profile. They are not exactly table-pounders in terms of expected returns, but we like what they bring to our balanced portfolios in terms of their diversification benefits, downside risk, and risk-adjusted return potential, particularly given our outlook for very low five-year expected returns for the stock market and high short-term downside equity risk. But there are also several other investments in our portfolio with somewhat similar risk, return, and diversification characteristics in which we have a lot of confidence, such as our absolute-return-oriented bond funds. So we believe our allocations to the lower-risk alternative strategies are appropriate as well.

Now, if expected stock market returns drop to the point where we want to further reduce our equity exposure, we might increase our tactical allocation to these lower-risk alternative strategies. We are also open to increasing our overall alternatives exposure if and when we find other compelling liquid alternative strategies that are run by managers in which we have confidence.

WILL THE PENDULUM SWING BACK TOWARD ACTIVE MANAGEMENT?

After trailing index strategies for the better part of a decade, some forecasters say active equity funds are poised for better returns (at least relative to the market indexes) due to certain macro trends. What is your current take on the possible move away from passive investment?

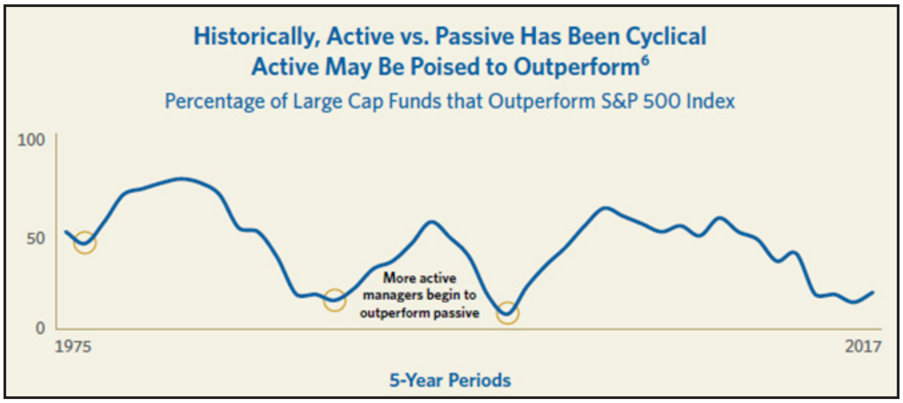
Our investment approach takes into account a range of potential macro scenarios, but we are not economic forecasters and our analysis is not based on predicting trends. We often utilize both active and index strategies in a portfolio, and we are not planning on changing this approach due to any shifts in the macro environment. However, we would agree that U.S. stock market returns are likely to be poor, at least looking out over our five-year investment time horizon. This could indeed surprise and disappoint many index investors who have become accustomed to double-digit annualized returns since the end of the financial crisis.

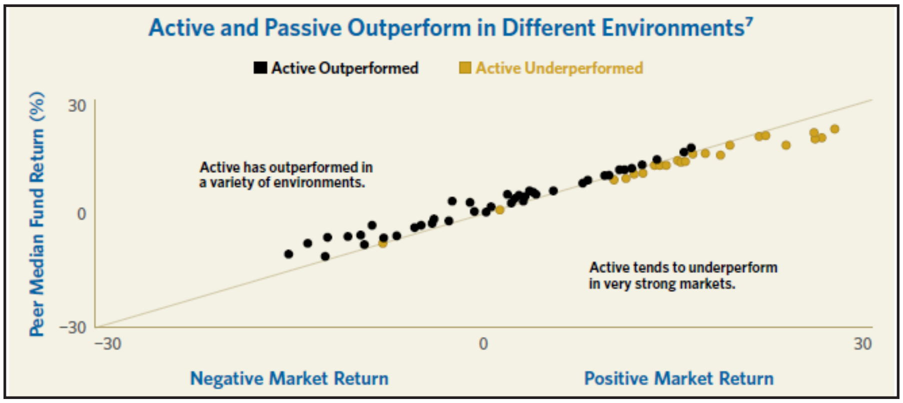
Specific to our performance expectations for active equity funds, we believe there are a number of *cyclical* factors that have been tailwinds to the S&P 500 Index outperformance relative to active equity management over the past 5–10 years, starting with the unprecedented central bank stimulus policies. And it's likely these factors will shift to tailwinds for *active* equity managers, or at least *skilled* active managers, in the years ahead.

We are believers in the cyclicality of most financial market phenomenon, whether we are talking about asset classes, investment styles, or investment strategies. No investment approach and no asset class "works" all the time.

On the cyclicality point, the first chart below from Davis Advisors shows the percentage of large-cap U.S. active managers in the Morningstar database that outperformed the S&P 500 over five-year rolling periods, going back to 1975. The gold circles represent inflection points where the number of active managers outperforming the market bottomed and began to increase. Outperformance of active funds was near an all-time low in 2017. The *timing* of inflection points is always uncertain, but the cycle may be turning in favor of active management. Most importantly, we don't believe this cyclical pattern of active vs. passive performance has been permanently revoked. It is *not* different this time around.

Another related point highlighted by Davis Advisors is that active managers have tended to perform relatively better vs. the S&P 500 when the absolute return of the index has been more modest or negative (something we haven't experienced for a while now). In the next chart, each dot above the line represents a period in which the average manager outperformed the index. As shown, the lower the market return, the more active managers outperform.





Source: Davis Advisors

Given our strong expectation that we are facing a period of subpar market index returns, this history would seem to bode well for active management in general.

We've also discussed the importance of stock return dispersion and correlation as factors that impact how attractive an environment is for skilled active stock pickers. These variables have recently been moving more in favor of active management. Specifically, higher cross-sectional dispersion of stock returns within a market is a tailwind to skilled active stock pickers. And higher volatility is also correlated with higher stock dispersion, so to the extent increased volatility is here to stay (at least for a while), that should provide a more fertile environment for active managers. Furthermore, there is evidence that the most "active" managers—those with high active share or the willingness to invest very differently from the market index portfolio—produce their strongest outperformance during periods of high dispersion in returns. All the active equity managers we invest with have this attribute. Volatility and dispersion also typically increase during bear markets, which is consistent with the chart above on active manager outperformance during periods of sub-par market returns.

We've also commented on the multiyear run of sharp outperformance for growth and momentum stocks versus value stocks. This has been a tailwind for the S&P 500 and a headwind for many of our managers who have a strong valuation bias in their investment approach. The significant outperformance of the S&P 500 versus foreign stocks and versus smaller-cap stocks has also contributed to the favorable environment for the index versus active fund managers. These are all cycles that will turn the other way—and in some cases already are.

So, we do think there are several plausible arguments or catalysts for a shift in the current cycle that will favor active management over indexing.

In this business, assets chase performance. Indexing has beaten active managers over the past several years and seen huge asset inflows. As those assets go into the stocks held in the indexes they provide a further price boost to those stocks and indexes in a self-fulfilling cycle. This feedback loop will likely operate in reverse to some extent over the down leg of the cycle—we saw that very dramatically when the tech growth stock bubble burst in 2000.

But beyond this cyclical aspect, there are undoubtedly longer-term secular or structural forces that *favor* indexing, with the focus on their extremely low fees being a key one. So, while we expect a change in the cyclical trend, we think it is likely to be in the context of a *secular* trend where indexing will continue to gain market share from active management.

But that's not directly relevant to what we do as analysts, investors, and portfolio managers. Our job is not to bet on asset flows or forecast market-share shifts or try to predict mega trends. For our actively managed portfolios, our focus, time, and energy is spent on identifying skilled managers with a sustainable investment edge that we believe will enable them to outperform their relevant investable market index over the longer term. We have always been of the view that you don't want to invest with the *average* active manager, whether or not active management in general is facing tailwinds or headwinds.

If you don't have a disciplined process for evaluating and selecting active managers—including not just the buy decision, but the ongoing monitoring and the sell decision—then you shouldn't do it at all. Just buy the index ETF, get your asset class exposure, and build your portfolio that way.

People will continue to chase shorter-term outperformance and flee shorter-term underperformance. And we believe skilled active management is set up for a period of relative outperformance again vs. indexing. But the long-term benefits of low fees and the inability of most active fund managers to earn their fees is the reality. It's always been the reality.

For clients with certain temperaments or preferences, investing in passive index funds to build a diversified portfolio is an intelligent and entirely appropriate long-term investment approach. We manage both index-oriented and active fund portfolios. When it comes to investing, one size does not fit all. There are many paths to achieving one's long-term financial objectives. But whatever your approach, the most critical point is that you need to stick with it through its inevitable performance cycles. Don't chase the herd.

—Litman Gregory Research Team (5/10/18)

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