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SBH NEWSLETTER

Thoughts on the Current Environment

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Quite a war has been waged for the hearts and minds—and wallets—of investors over the last few years, and it has intensified over the last 12 months. The war is being fought by the advocates of passive, or index-based, investing and those supporting active management. This debate,which has its modern-day roots in academic work going back to the 60's,has taken on new vigor as recent experience has shown that a majority of active managers have not kept pace in recent years with the passive indices they use as benchmarks. If active managers do not keep pace, so goes the argument, and if their fees are higher than the cost of an index fund, why should investors overpay to get less? On the basis of that simple statement, it seems a compelling argument. A Vanguard index fund has become the largest mutual fund in the U.S., supplanting a PIMCO bond fund which was actively managed by fixed income superstar Bill Gross. Interestingly, Gross' fund took its place from an equity fund that was led by another active management superstar (Peter Lynch of the Magellan Fund). Could it be that the age of indexing is indeed upon us?

"Ability is nothing without opportunity."

Attributed to Napoleon

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For those of us who toil in the vineyards of investing, there is a strong sense of déjà vu. Indexing has all the earmarks of a fad. Like many fads that periodically course through Wall Street, the current enthusiasm for indexing is somewhat situational, the product of a set of economic forces that will change in due course. Indexing is a style of investing that will go in and out of favor, just like growth and value. Indexing supporters, however, will argue the underlying factors are immutable and there is no reason to think otherwise. This is an old game, which has played out on countless occasions in the past. The "game" involves the embrace of an investment idea which is then carried to an extreme conclusion. Invariably, that which seems most obvious is often most likely to be wrong.

Examples abound. In the early 1970's, the U.S. economy had been growing steadily since the end of World War II. A minor recession had occurred in 1970, but it ended quickly. The stock market, too, had moved steadily higher since the mid-50's. Confidence in stocks had increased, and speculation on new technologies – fueled by the success of winners like Polaroid, Xerox, and IBM – was growing. Within that setting, a collective mind-set developed (what we called a "thought-virus" in a recent edition of the Quarterly Review) that a certain set of high quality stocks were impervious to market risk. Their balance sheets were pristine, and their management skilled and experienced in their industries. Their earnings advances were so predictable that they could be extended into the future on the line of a ruler. They were, in short, bullet-proof. No valuation was too high for these "Nifty Fifty" companies, as they came to be called. If you paid too high a valuation, that would self-correct in time as the earnings grew. They became known as "one-decision" stocks. All you had to do was decide when to buy and sit back.

In short order, economic realities set in. The U.S. economy slowed under the pressures of accelerating inflation and ever-higher interest rates, and the stock market finally entered a bear market.The Nifty Fifty were the hardest hit, falling by 70%-80% by the time the bottom was reached in 1976. (This presented a great opportunity for the true growth stock survivors in that group, but that's another story.)

The same story, only with a different cast and a slightly different script (but the same ending), played out again in the late 1970's, with energy stocks in the lead role and in the late 1990's, featuring technology and internet stocks. Who could forget the bravura performance of Tech stock advocates telling all and sundry how Microsoft, Cisco, et al. were "must-own"/ "must-have(s)"/buys at any price and why internet stocks ought to be valued on the basis of "clicks per eyeball". The most recent revival of this morality play was in2007, starring the housing market. After all, didn't home prices go up each and every year?

We are of the opinion we are watching the familiarly story play out yet again in the current marketplace. This time, the spotlight is focused not on any one sector of the market, but rather on an ancillary part of the market, the Index Fund. First introduced in the 70's, index funds – supported by a wealth of academic research – have garnered considerable attention and more than considerable asset inflows in the last several years. Rather than trying to "beat the market", the "prudent" step is now thought to be striving to match the index at the lowest cost. Whether valid or not, the concept has gained a lot of adherents in the last few years. Even Warren Buffett wrote in his 2013 Chairman's letter that he would counsel his children to use Index funds if he were not available to invest for them. Quite a striking acknowledgment from one of the best investors of the modern era!

All of these fads in style have had certain common characteristics. First, there was some underlying fundamental economic dynamic that was driving the sector in vogue and producing very strong profit gains. This trend was not a fly-by-night affair. It had developed over time and was thought to be durable over the long run. The leading companies in the sector had become market darlings. The popular press would pick up the theme and write commentary about how good a set of investments they had been and why this would continue indefinitely. Not to be fully involved with the market darlings in a portfolio was a sign of a money manager out of touch. The heralded Warren Buffett was thought to be impossibly old (in 1999!) and losing his touch because he would not succumb to the internet craze. He was too old to "get with the program". And since no one wants to be left out of a group, everyone felt compelled to participate. The notion would thus become self-reinforcing. This process would go on until the fact that the Emperor was wearing no clothes became painfully obvious. Should one's memory need refreshing, recall the day – in September, 2008 that has come to symbolize the end of the last boom – when Lehman Brothers went bankrupt.

We postulate that the market's rise since March, 2009 has been more the product of the times than of a fundamentally-driven rise. Since hitting bottom, the markets have been driven by the actions of the global Central Banks. Ben Bernanke, prior Chair of the Federal Reserve, had said that increasing asset values was a key transmission element of their massive Quantitative Easing programs.

The table below shows how effective they have been at this effort:

QE RETURN TABLE				
Periods	**Beginning Date**	**End Date**	**Point Change**	**Gross Return**
QE 1	11/25/2008	3/16/2009	-97.92	-11.50%
QE 1 Expanded	3/17/2009	3/30/2010	419.38	55.63%
QE 2	8/27/2010	6/28/2011	249.45	23.82%
Operation Twist	8/26/2011	4/3/2012	254.11	21.92%
No Twist End Date	6/6/2012	8/16/2012	130.01	10.11%
QE 3 Hinted	8/17/2012	11/28/2012	-5.58	-0.39%
QE 3 Implemented	11/29/2012	4/30/2013	187.64	13.31%
Taper Tantrum	5/1/2013	9/16/2013	100.03	6.26%
Tantrum Off	9/17/2013	12/16/2013	88/94	5.24%
Tapering QE 3	12/17/2013	10/27/2014	175.09	9.80%

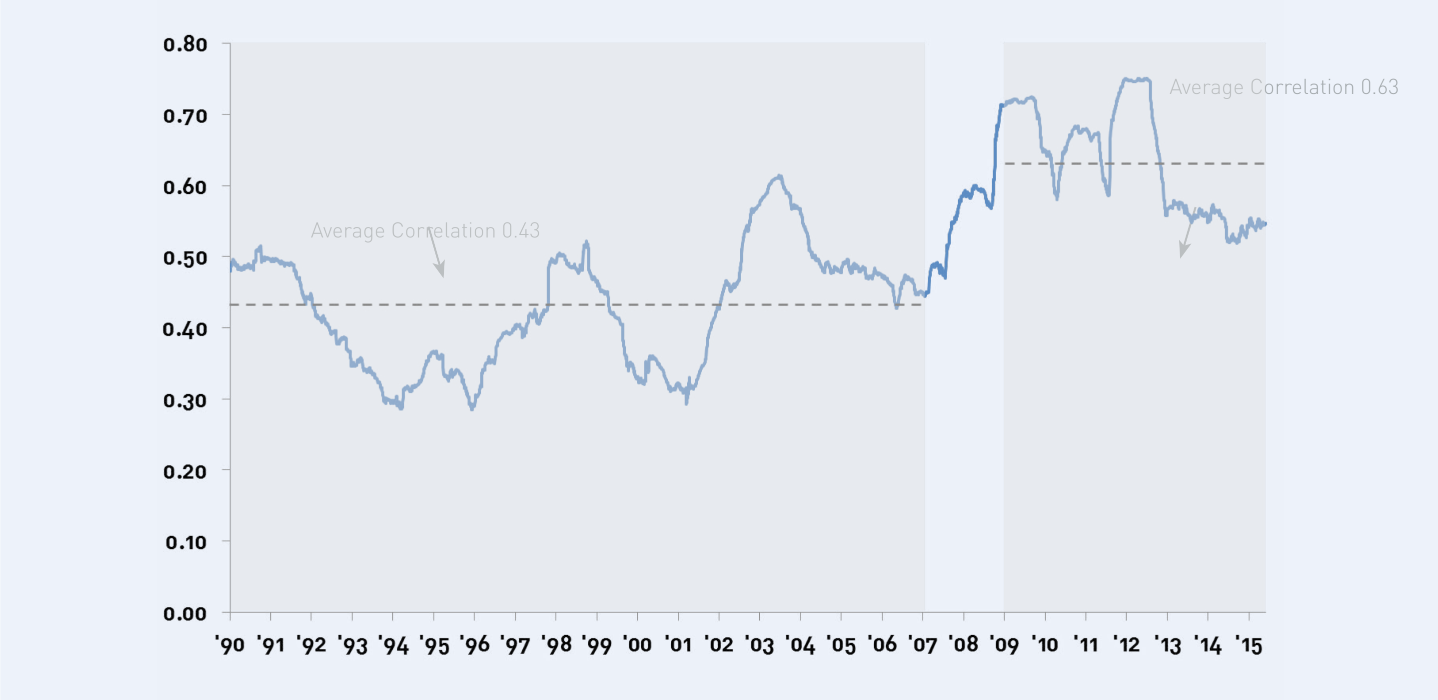
Source: Bianco Research

NON QE RETURN TABLE				
Periods	**Beginning Date**	**End Date**	**Point Change**	**Gross Return**
No QE 1	3/31/2010	8/6/2010	-126.05	10.74%
No QE 2	6/29/2011	8/25/2011	-137.40	-10.60%
Twist End Date Suggested	4/4/2012	6/5/2012	-127.88	-9.05%
QE 3 Hinted	10/28/2014	5/6/2015	112.57	5.74%

Source: Bianco Research

Associated with this one-way movement in stock prices has been a marked increase in the correlation of stocks, not just to the broad market index, but to each other, as shown below.

S&P 500 ROLLING 250-DAY CORRELATIONS



Source: Strategas Research Partners

In a world in which stock prices are moving in one direction and in which all stocks are behaving more as one than as a disparate group, it is no wonder that indexing has done well. As in prior examples, there is a tendency for managers to be human, and follow the hottest trends in the industry, and to engage in "closet-indexing" more than they would care to acknowledge. We have long thought that managers in general focus too much on the index as they select their investments and structure their portfolios. Ironically, producing index-like (or worse) returns at active management fees only goes to prove the point of the passive advocates. As a means to combat this trend, an emphasis on more concentrated strategies has emerged to create more, not less, separation from the index. Do these trends serve as an indication that the game is fundamentally changed, or are they simply just this particular market environment's set of questions and challenges? Is Quantitative Easing a program that can last indefinitely? We will be glad to offer our opinion on the last question. (A hint: It is a one-word answer that has two letters, the first of which is N.) If it doesn't last indefinitely,is there any reason to think stocks won't begin to behave in a more autonomous fashion? If dispersion increases, won't those managers who can add value (via fundamental research?) be able to bring that skill to bear for clients again? (Reflect on the quote from Napoleon at the beginning of the Review.) We have issues with the notion of passive investing, as you can tell. We do because we are active managers and believe that it is possible to add incremental value (either by reducing risks for a given return or by generating additional return for a given level of risk) through our efforts. As our Compliance Group would nod approvingly as I write, we could not guarantee that outcome nor can we predict that we will continue to do it in the future. We can observe, however, that we have done so in the past, but we are equally obliged to point out that past experience is no guarantee of future results.

(The preceding paragraph comes to you through the courtesy of the Compliance Department of Segall Bryant & Hamill, LLC, a Department dedicated to upholding all the professional standards the S.E.C. and the I.C.A.A. have established for investment advisors... The author wishes to express his appreciation to that group for keeping his essays on the right side of the line over the years.)

Russell Investments. (The stocks in an Index don't pick themselves.) This quest for the Holy Grail is a never-ending one, and fads (which is what "the answer" usually prove to have been) come and go. The reality is that the only true solution to investment success lies in a strategy called exercising good judgment, which is, regrettably, a technique requiring a resource always in short supply.

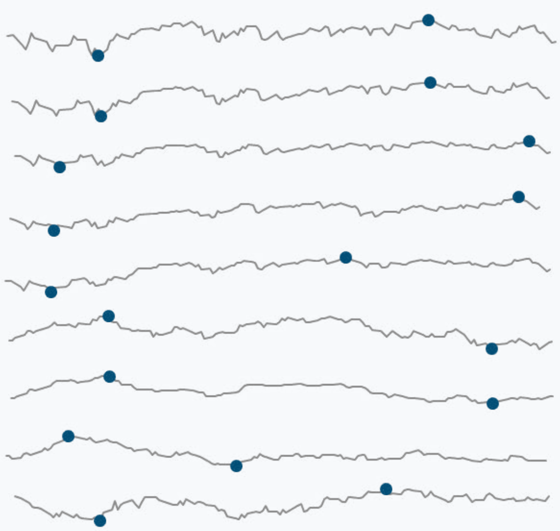
Is there a way to identify such managers? One recent paper[1], drawn from work done at Notre Dame and Rutgers Business schools, suggests two attributes of managers who do outperform. The first is that these managers have high

Active Shares. Active Share is a term which measures the degree to which a portfolio differs from the holdings of the benchmark. The higher the Active Share, the less a portfolio will perform like the Index. The second attribute of such managers is low turnover of their holdings. They are not actively buying and selling what they own. Intuitively, this makes a lot of sense. Trading is an expensive proposition and high turnover can eat into incremental returns. Moreover, the kind of long-term insights that lead to superior returns can take a while to come to fruition and gain the appreciation of other investors.

Whether the findings in the paper referenced above hold up under the scrutiny of peer review is not crucial to the debate over indexing. Investing in common stocks is an exercise in choosing among the opportunities presented by over 6,500 discrete companies whose common stocks trade on U.S. markets. They operate in a vast array of businesses with almost an infinite range of management skill sets and opportunities. Clearly, there will be winners and losers. Index investing implies you are better off owning a small portion of all of them, both the good and the bad. We patently reject this notion. To identify a portfolio of stocks that will produce acceptable returns with a prudent degree of risk is a significant challenge. We remain steadfast that it is possible. No one said it would be easy; nothing that requires skill ever is. Investors are always looking for a way to deal with that problem and, every now and then, it will appear as though "the answer" is at hand. Currently,"the answer" is indexing, which means abdicating the responsibility for security selection to the investment committees at Standard & Poor's or at Russell Investments. (The stocks in an Index don't pick themselves.) This quest for the Holy Grail is a never-ending one, and fads (which is what "the answer" usually prove to have been) come and go. The reality is that the only true solution to investment success lies in a strategy called exercising good judgment, which is, regrettably, a technique requiring a resource always in short supply.

MARKET BAROMETERS
AS OF JUNE 30, 2015

	Dec 31, 2014	1Q15 / 2Q15	Jun 30, 2015	Low	High
Dow Jones Industrial Index	17,823.07		17,619.51	17,164.95	18,312.39
S&P 500 Index	2,039.00		2,054.40	1,973.50	2,120.40
Russell 3000 Stock Index	1,224.11		1,236.12	1,184.61	1,273.39
Russell 2000 Stock Index	1,204.70		1,253.95	1,154.71	1,295.80
Russell Midcap Index	747.89		775.08	722.16	803.63
Barclays Cap Aggregate Index	1,906.01		1,904.05	1,892.08	1,946.50
Barclays Cap Muni Bond Index	1,100.36		1,101.62	1,095.48	1,120.12
Gold (Price/Oz) London AM Fix	$1,199.25		$1,175.00	$1,149.00	$1,298.00
Goldman Commodity Index	3,232.80		3,226.12	2,878.39	3,335.08



Source: Bloomberg

[1] Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently. Martijn Cremers (Univ. of Notre Dame) and Ankur Pareek (Rutgers Bus. School), Draft of September, 2014.

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