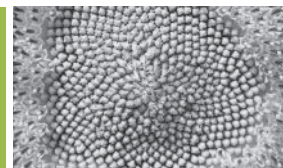


▶ ACTIVE MANAGEMENT

The Importance of Conviction

JUNE 2015

Active equity managers have struggled to beat benchmarks since the 2008/2009 financial crisis, causing investors to question whether active management is a dead end. We don't believe so. The trend results from what we believe are cyclical and transitory forces. Investors and managers should redouble their conviction: investors in the ability of skilled managers to produce superior long-term results and managers in the value of their discipline.



Catholic
Responsible
Investing



Active management is struggling. Few funds are beating benchmarks. An article in a prestigious financial journal begins, “Gifted, determined ambitious professionals have come into the investment business in such large numbers during the past 30 years it may no longer be feasible for any to profit from the errors of others sufficiently often and by sufficient magnitude to beat the market averages.”¹ It’s a clarion call for indexing and a pretty good summary of what seems to be the state of affairs in the investment business today. Here’s the twist: the quote is from July 1975. As the French proverb says, “Plus ça change, plus c’est la même chose” (The more things change, the more they remain the same). In the ensuing 40 years, several generations of successful active managers went on to produce enviable records and happy clients.

There’s no question that active management is on the ropes again. **2014 was active equity’s worst year in a quarter century; academic studies and other performance analyses cited in the financial media found that as many as 70% of large-cap managers underperformed benchmarks.** Pronouncements of futility and failure abound. The year was “biblically bad” for active management according to a *Financial Times* columnist², the Wall Street Journal called it “dismal”.³ Yet investors

Summary

- Active management has been thwarted since the 2008/2009 financial crisis by government interventions in markets, easy access to capital by weak and failing companies, and low dispersion of stock returns.
- Forty years of history shows that active management success is cyclical and episodic. Periods of poor performance, for individual managers and active management in general, are inevitable.
- Top-quartile managers produced attractive excess return for the ten-year period ending December 31, 2014, yet all ranked in the bottom half of peers at least one calendar year and about 80% ranked in the bottom quartile at least once.
- Investors willing to tolerate relative return volatility have more to gain than lose by redoubling conviction in the ability of well-chosen active managers to achieve superior long-term results.

who are old enough, or who have studied history, have seen this movie before, and not just in the 1970s but in the late 1990s too. In both eras, a string of rough years called into question the very premise and value of the stock picker's discipline.

A look at history shows that active management success is cyclical and episodic. While performance trends are impossible to predict in advance, CBIS does not believe active management is any more futile today than it was 40 years ago. A few broad themes frame our perspective.

I. THE DEATH OF ACTIVE MANAGEMENT?

*"The relative performance of institutional portfolio appears to be getting worse."
— Financial Analyst Journal Article*

GUESS THE YEAR!	S&P 500 AVERAGE	INSTITUTIONAL MEDIAN	SHORTFALL
Trailing 12.25 years	5.3%	4.1%	-0.8%
Trailing 8 years	2.2%	0.4%	-1.7%
Trailing 4.25 years	2.1%	-0.3%	-2.5%

Source: "The Loser's Game" by Charles D. Ellis, *The Financial Analysts Journal*, July/August 1975; data as of December 31, 1974

- ▶ **Market Trends** — The period following the 2008/2009 financial crisis has been especially challenging for managers committed to thoughtful fundamental analysis combined with a valuation discipline, and for reasons we believe will prove transitory;
- ▶ **Manager Success** — To gain superior long-term performance investors need to accept the reality of periods underperformance, while active managers need to adhere to their discipline during tough out-of-favor stretches; and
- ▶ **Manager Selection** — Investors don't invest in active management as a genre or in the "median" manager or in the "average" manager, they invest with specific managers. Based on CBIS' more than 30 years of experience selecting equity and bond managers — and we've had our share of mistakes and learning experiences — we believe certain identifiable characteristics maximize an investors' odds of

success. Moreover, we believe skilled managers can achieve attractive excess returns. We try to select managers who embody these characteristics and we give them the time and patience to perform.

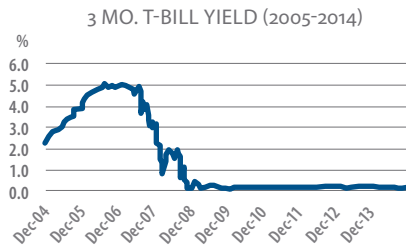
MARKET TRENDS: CONTENDING WITH A FLOOD OF LIQUIDITY

If you had told any central banker or investment manager circa 1975, 1985, 1995, or even 2005, that a time would come when Treasury Bill yields would have been zero for six straight years and the Fed's balance sheet would have reached \$4 trillion, that central banker would have thought you were crazy. But here we are. The past six years are so historically unprecedented in terms of conventional central banking theory as to defy analysis. In some respects, this has caused one of the period's headwinds for active managers. Historically low interest rates, wide open capital markets, investor's stretch for yield with confidence the Fed "has their back" in the form of additional interventions if markets falter, have created a difficult backdrop. Weak companies have been able to freely access capital to remain in business while speculative companies with deep losses and severely negative cash flow can raise abundant equity capital and soar in market value (the phrase "profitless prosperity" has been coined to describe this phenomenon).

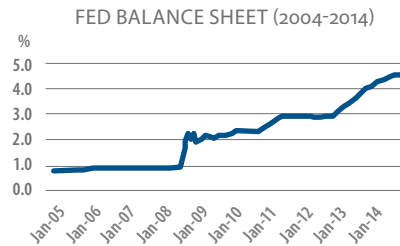
Such patterns have rendered financial analysis with a strong valuation discipline at times ineffective and even counterproductive. Financially fragile or highly speculative stocks aren't those that active managers typically seek out, yet with the support of six years of zero short-term yields and three rounds of quantitative easing (QE), these have periodically led surging markets since the financial crisis. There have been other distortions. Yield hungry investors have in recent years bid up prices of traditional defensive, dividend-paying companies to historically very high valuations, while active managers who stick to their discipline resist paying high prices. Benchmark comparisons suffer.

II. THE RISING TIDE OF LIQUIDITY: 2009 to present

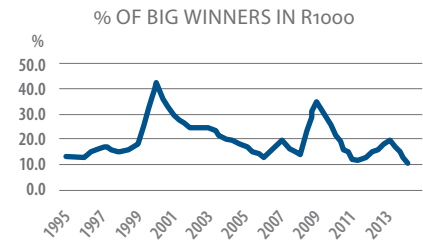
Post-crisis central bank liquidity has lifted weak and strong companies alike, eroding the benefit of insightfully fundamental analysis



Source: Federal Reserve Bank of St. Louis (FRED)



Source: Federal Reserve Bank of St. Louis (FRED)



Source: FactSet, CBIS

The suppression of return differences within the S&P 500 is another factor cited as a challenge to active management. Standard & Poor's reports that return dispersion — a measure of the variation of stock returns across the 500 index constituents — has been low since the financial crisis and hit a historic low in 2014.⁴ Low dispersion makes it harder for stock pickers to benefit from picking big winners and avoiding losers. Table II presents another view of dispersion, using an approach suggested by CBIS sub-adviser Wellington Management.⁵ The far right graph shows the percent of Russell 1000 Index companies in each calendar year from 1995 through 2014 that outperformed the broad index by 25 percentage points or more, indicating the size of the opportunity set of big winners available to stock pickers. The number has been low in the past few years and in 2014 the ratio was the lowest in the 20-year data set.

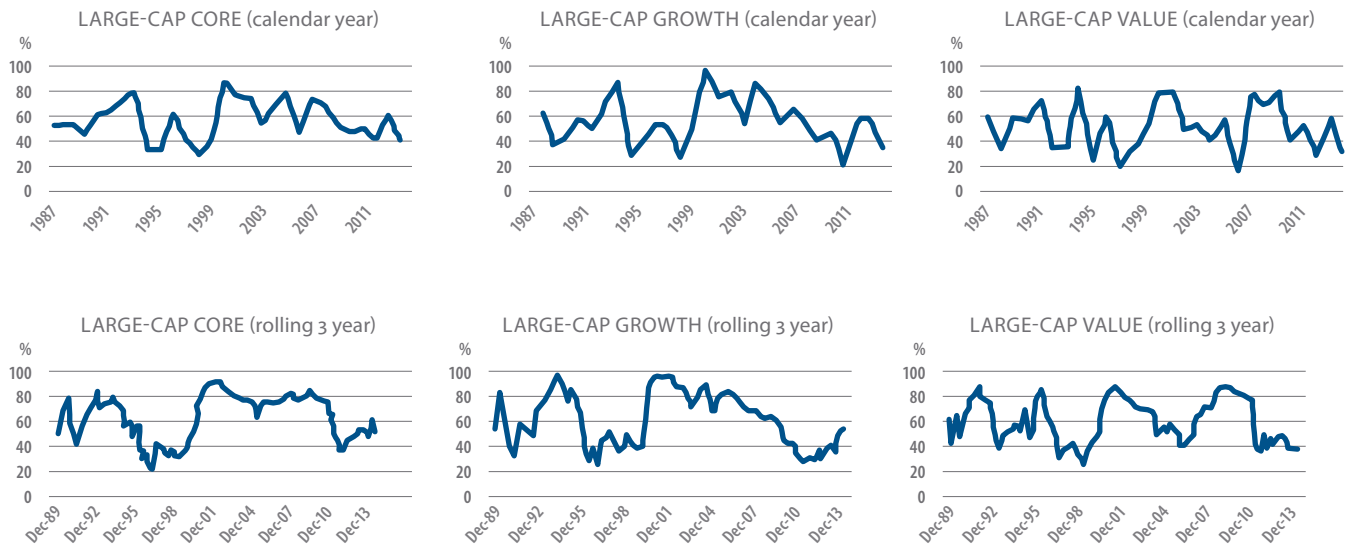
A flood of money into index funds as active managers struggle may also be a trend-reinforcing factor. According to a January 2015 Morningstar Direct asset flow analysis⁶, since January 2012 more than \$400 billion has poured into equity index funds, partly at the expense of active managers, who have seen outflows of more than \$200 billion. Index funds buy without regard to company valuation or the quality of company financial fundamentals; the only criteria is matching company weights in an index. Large-cap companies can occupy large

index weights while active managers tend to emphasize diversification and larger allocations to moderate cap sizes. Selling pressures as funds leave for index exposure and buying pressure from index funds may produce a self-reinforcing cycle. In 2014, large-cap stocks gained about 14% while small-caps (Russell 2000) returned only 5%, the largest performance gap since the late 1990s.

Recent active manager performance reflects the impact of all these forces. As shown in Table III, active managers in the large-cap space have generally struggled, with less than half beating their benchmarks over the past six years. The historical data also shows a general cyclical trend (albeit erratic across time and style). Active management saw broad success in the years following the bursting of the late 1990s tech bubble and struggled during the mid/late 1990s tech boom, when valuation paradigms were temporarily shattered and surging indices were hard to beat. (Less than 10% of large-cap managers beat the S&P 500 over the 1995-1999 period). And there was also a degree of broad success in the early 1990s. Data thins out in terms of the number of managers with return histories that go back beyond the early 1990s, but we think the trend shown by the limited data is worth presenting. What's clear is that active management has seen multi-year stretches of failure and success, with failure followed by recoveries and vice-versa.

III. ACTIVE MANAGEMENT TRENDS: CYCLICAL, EPISODIC AND UNPREDICATABLE

% institutional active funds ahead of their benchmarks during the January 1987 through December 2014 period



Source: eVestment and CBIS / Notes: gross-of-fee performance; benchmarks: Core (S&P 500); Growth (R1000 Growth); Value (R1000 Value)

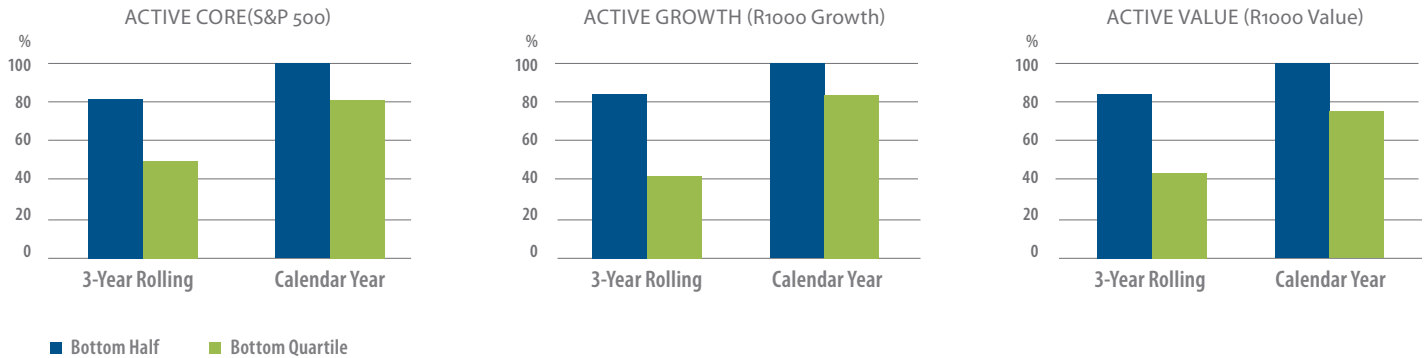
One of the paradoxes of indexed investing is that it requires the efforts of active managers in order to work at all. If everyone indexed, and there were no analysts who sought to determine stocks' fair values, trading would cease and markets would collapse. The price discovery created by active managers is essential for markets to function. But can that effort be rewarded? Looking forward, we think there are good reasons to believe active management in general can regain success.

The Federal Reserve seems determined to wean markets off the extraordinary measure put in place since 2009. The unemployment rate has declined from a recession high of 10% to under 6% in early 2015, and the economy is about to complete a sixth year of expansion from the early 2009 recession low. Three rounds of quantitative easing and six years of near-zero short-term yields are increasingly seen by Federal Reserve officials as policy measures that served their purpose and should now end in favor of policy normalization. Given the surging U.S. dollar (and its negative impact on U.S. exports

and overseas corporate earnings) along with inflation readings well below the Fed's 2% target rate, the Fed may not feel an immediate need to raise rates, yet it seems unlikely that the historically unprecedented monetary policy backdrop of the past six years will characterize the next ten. In a more normal environment, it seems reasonable to believe companies will survive or fail more on the merits of their business models and management skills than on their ability to tap unlimited low-cost capital. Stock market performance will likely be tied more to financial fundamentals and less to government interventions and momentum created by money flows. Stock selection that emphasizes skilled industry and company analysis, thoughtful financial statement analysis and earnings projections may again be rewarded, while momentum-driven index approaches that ignore fundamentals may falter. This is not a forecast, but it seems a plausible vision of the future. The ability to thoughtfully value stocks and assemble portfolios may again prove beneficial to patient investors.

IV. ACTIVE MANAGEMENT SUCCESS: NEARLY ALL TOP-RANKED MANAGERS UNDERPERFORM ON THE WAY TO THE TOP

% top-quartile institutional active funds for trailing 10-years at 12/31/14 who ranked in bottom half or quartile at least once during period



Source: eVestment Alliance and CBIS / Notes: gross-of-fee performance used to eliminate impact of fee customization on ranks; benchmarks in parentheses

MANAGER SUCCESS: LOSING ON THE WAY TO WINNING

Let’s say you could know future manager peer ranks with enough accuracy to select a manager guaranteed to rank in the top quartile of peers over the next ten years. If you had done this ten years ago, what follows is exactly what you would have experienced. Here are the compounded annual gross returns for the top 5% threshold of peers, the top quartile threshold and the benchmark’s return for the ten-year period (from December 31, 2004 through December 31, 2014):

Annualized Total Returns: 10-yr. period ending Dec. 31, 2014

	TOP 5%	TOP QUARTILE	BENCHMARK
Active Core (S&P 500)	10.90%	9.23%	7.67%
Active Growth (R1000G)	10.98%	9.45%	8.49%
Active Value (R1000V)	10.36%	9.08%	7.30%

Source: eVestment

Returns are presented gross of management fees. Returns seen by the investor would be reduced by the impact of fees. For example, if an annual management fee of .60% were deducted quarterly from your account, a ten-year annualized cumulative composite return of 10.00% would be reduced by .64% to 9.36%.

Despite the struggles of the past several years, which account for about half the 10-year period, top-quartile managers have in fact delivered performance over and above their benchmarks. Annualized excess return (shown below, gross of fees) was generally very attractive:

Annualized Excess Returns: 10-yr. period ending Dec. 31, 2014

	TOP 5%	TOP QUARTILE
Active Core (S&P 500)	3.23%	1.63%
Active Growth (R1000G)	2.49%	0.96%
Active Value (R1000V)	3.06%	1.78%

Source: eVestment

Returns are presented gross of management fees. Returns seen by the investor would be reduced by the impact of fees. For example, if an annual management fee of .60% were deducted quarterly from your account, a ten-year annualized cumulative composite return of 10.00% would be reduced by .64% to 9.36%.

But what would you have had to experience on your way to success? Table IV shows exactly what. Each graph shows data for managers who ranked in the top-quartile of peers for the December 31, 2004 through December 2014 ten-year period. In each case, we tracked peer ranks for i) each calendar year and ii) each rolling three-year period. The graphs show the percentage of top-quartile managers (for the full ten-year period) who ranked in the bottom half and bottom quartile of peers at least once during the ten years.

The results are illuminating. For each style, every single manager who ended up in the top quartile for the full ten-years ranked in the bottom half for at least one calendar year. Around 80% ranked in the bottom quartile at least once. Results for rolling three-year periods were similar, but not quite as stark. Roughly 80% of top-quartile managers ranked in the bottom half of peers over at least one rolling three-year period. Approximately 40% ranked in the bottom quartile at least once.

Winning long-term means losing from time to time on the way to victory. Yet when performance is evaluated quarter-to-quarter, a complete calendar year seems like a very long time and a three-year period feels like an eternity. Three years of underperformance is often enough to destroy a career. Yet to achieve long-term success, investors need to recognize that periods of poor performance, both for individual managers and active management as a whole, are inevitable. Managers succeed by structuring portfolios that differ from the benchmark; “active share” — which quantifies the cumulative weight differential between benchmark holdings and index names — is a widely used metric that measures the difference between portfolio and benchmark construction. It takes a reasonably high active share to outperform over the long term, but given the vagaries of market moves and the transitory forces that drive shorter-term trends, a long-term winning portfolio with moderate to high active share will unquestionably experience periods of underperformance.

An influential academic paper, “Conviction in Equity Investing”, published last year in *The Journal of Portfolio Management* makes the same case after reviewing decades of performance data, urging that investors embrace more concentrated portfolios in search of excess return, arguing that “high conviction strategies require a long-term focus and patience with short-term volatility” and that “investors who allocate to more volatile concentrated managers should choose to treat these public investments as if they were as illiquid as private investments and resist making portfolio changes mid-stream.”⁷

MANAGER SELECTION: AN EMPHASIS ON CONVICTION

CBIS also uses the word conviction to summarize what we believe it takes for both an investor and a manager to rank in the top quartile over a ten-year period. And candidly, that’s not enough; it takes a little luck too. But to maximize the odds of success, investors need to cultivate a conviction formed around the recognition that winning requires patience and periodic losing. Investment managers need conviction too. While they are full-time investment professionals, they are also human beings with human emotions. Even skilled managers will second-guess their market views, question the validity of assumptions that underlie their process, and make adjustments as necessary to reflect evolutions in markets and security structures. Yet they need to balance this with the conviction to adhere to a proven process when market trends temporarily go against them.

There’s a degree of irrelevance attendant to any study of aggregate manager returns, despite the lessons offered. This is because an investor doesn’t invest in active managers as a group, or in the median manager (unless by chance) or in the average manager. They invest in, at most, a few in any given style. How best to choose those few? Is there a way to maximize your chances of success?

CBIS believes investors have a good chance at earning above-benchmark returns over the long term with a thoughtful approach to manager selection. Our manager selection philosophy is formed around the following beliefs.

1. **Skill** — Skilled investment managers can generate superior long-term returns, although they will likely at some point underperform benchmarks over short-term periods when their particular style/investment themes are out of favor.
2. **Core Competency** — Successful investment managers possess a core competency (a unique approach to investing which may encompass elements of research and analysis, portfolio construction, stock selection, risk management and trading) which drives their investment decisions.

3. Conviction — Our investment managers must have the conviction to adhere to their process for successful alpha generation, even during periods of underperformance relative to style benchmarks. They recognize that enduring periods of performance volatility, while maintaining conviction in their portfolio themes and adhering to their proven investment process, is a key to achieving superior long-term performance.

4. Risk Management — An intelligent approach to risk management is crucial to achieving superior long-term returns. The diversification of core competencies, along with broad diversification of potential alpha sources, is a cornerstone of both CBIS' philosophy and fund construction.

We also look for well-defined organizational characteristics in managers we hire, including:

- i. Experienced investment teams who've worked together for years or decades;
- ii. Independent and employee-owned or managerially independent from corporate owners lack of significant staff turnover;
- iii. Evidence that financial incentives are properly aligned with those of investors like us;
- iv. Demonstrated ability to retain and incentivize key staff.

Conclusion

When the herd is moving in one direction it's very hard to go the other way. But that's often what it takes to succeed over the long term as an investor. Today's herd is running full speed into index funds while pronouncing active management a dead end. There are no guarantees in this business and CBIS does not presume to offer any. But we do believe that active management success is cyclical, that today's struggles will give way to success, and that investors who are willing to tolerate relative return volatility have more to gain than lose by redoubling conviction in the ability of well-chosen managers to achieve superior long-term results. However, indexing continues to be appropriate for investors unwilling to accept the periodic underperformance that comes with successful actively managed portfolios.

Notes:

1. "The Loser's Game", Charles D. Ellis; *The Financial Analysts Journal*, Vol. 41, No. 4, July/August 1975
2. "An active headache for fund managers", John Authers, *Financial Times*, December 3, 2014
3. "Stock Indexing Racks Up Another Triumphant Year", Jason Zweig, *The Wall Street Journal*, November 30, 2014
4. "Stock Markets: where have the good times gone?", John Authers, Michael Mackenzie and Laura Noonan, *Financial Times*, March 1, 2015.
5. "The Cyclical Nature and Changing Role of Active Management", Kent Stahl, CFA; Gregg Thomas, CFA; Tom Simon, CFA, FRM, Wellington Management, November 2012.
6. Morningstar DirectSM U.S. Asset Flow Update, Morningstar Manager Research, January 15, 2015.
7. Conviction in Equity Investing; Mike Sebastian and Sudhakar Attaluri; *The Journal of Portfolio Management*, Summer 2014

ACTIVE MANAGEMENT SUCCESS: LUCK OR SKILL?

There is a long running debate in academic finance as to whether it is possible to outperform a benchmark on a consistent basis. One point of view is that markets, particularly in liquid large-cap styles, are so competitive and so efficient that excess return over any series of time periods is simply a random outcome of portfolio selection — basically just luck. A simple thought experiment illustrates how this idea leads to an amusing and startling perspective. Suppose 1,000 managers seek to outperform a benchmark, each with a 50/50 chance of success. At the end of one year 500 have outperformed. At the end of two years, half of those, or 250, have outperformed for two years in a row. After three years half the 250, or 125, have outperformed three straight years. After four years the number is 62. After five it's 31. After six it's about 15. Outperforming for six straight years would probably qualify a manager as “skilled” in the eyes of most investors (particularly happy clients). That record would certainly be trumpeted by the firm’s marketing department. But it may only be the random outcome of 50/50 odds.

Separating luck from skill is no easy task. Academic studies scrutinize the adequacy of historical data; examine the impact of various forms of statistical bias (such as “survivor bias” when firms with poor performance close and disappear from historical records); they debate mathematical thresholds for statistical significance; and exhaustively explore other nuances of applied statistical methods. It is a debate best left to academics, who after 40

years of analysis still can't agree. But it's a debate whose basic ideas are worthy of close attention.

The other side of the argument centers on the notion that markets are hard, but not impossible, to outperform. Market prices are formed on the basis of information, which can be costly to procure, and analysis, which requires judgment and skill. Markets trend to irrational extremes and mean revert. Skilled investors can achieve an information or analytical advantage and encode this advantage into a rigorous, disciplined and repeatable process — a “core competency” that gives them an edge. They can take advantage of mistakes made by other investors, some systemic based on human emotion and herd following, some resulting from informational disadvantage or analytical error. Skilled managers can also capitalize on other market patterns that are perhaps less mistakes than outcomes of investors’ differing investment horizons and risk tolerances.

CBIS respects the first view. Markets are indeed very hard to beat and it is difficult to tell luck from skill. But we subscribe more to the latter view; this is what underlies our investment philosophy and selection of active managers within our funds.

We are happy to discuss our views here, debate the quantitative and qualitative considerations and expound on what we do and why.

Important Information

The CUIT Funds are exempt from registration with the Securities and Exchange Commission and therefore are exempt from regulatory requirements applicable to registered mutual funds. All performance (including that of the comparative indices) is reported net of any fees and expenses, but inclusive of dividends and interest. Past performance is not indicative of future performance. The return and principal value of the Fund(s) will fluctuate and, upon redemption, shares in the Fund(s) may be worth less than their original cost. Complete information regarding each of the Funds, including certain restrictions regarding redemptions, is contained in disclosure documents which can be obtained by calling 800-592-8890. Shares in the CUIT Funds are offered exclusively through CBIS Financial Services, Inc., a broker-dealer subsidiary of CBIS. This is for informational purposes only and does not constitute an offer to sell any investment. The Funds are not available for sale in all jurisdictions. Where available for sale, an offer will only be made through the prospectus for the Funds, and the Funds may only be sold in compliance with all applicable country and local laws and regulations.