CAPITAL MARKETS QUARTERLY

1st Quarter 2015

HIGHLAND'S ACTIVE EDGE

INTRODUCTION

Highland strives to be the best every single day. We look to maximize every opportunity and gain any edge possible. We have this drive and determination because our clients deserve the very best. This quarter's letter explains one of the ways we gain that edge.

There are a few things that are certain: death, taxes, and the debate over active vs. passive. It seems the argument picks up steam at the same time every year, usually around the time of the release of the S&P SPIVA Scorecard. This scorecard is released twice a year and compares how active managers compare versus their respective passive index. In 2014, active management took another hefty blow as fewer than 20% of active equity managers outperformed their respective benchmarks. Using the past 15 years as a guide, it would appear that active management doesn't pay since only 40% of active managers on average outperformed their benchmark. After many years of participating in this argument, Highland is conceding victory to the pro-passive crowd. We agree that the average active manager struggles to outperform.

This now raises an important question? Is Highland suddenly abandoning active management and implementing passive investment strategies? The answer is emphatically **NO**. This seems to contradict our early concession, but we will argue that the two are not mutually exclusive. You see, it is entirely plausible to believe that the average active manager struggles to outperform yet still employ active management as a value additive practice. Our friends at Capital Group made an analogy that we believe illustrates the point perfectly. They stated that the average person cannot dunk a basketball. Knowing this fact doesn't necessarily mean that dunking a basketball is impossible. In fact, the NBA is full of many that have no problem at all achieving this feat.

What NBA General Managers ("GM") have been extremely successful at doing is employing a process that allows them to select players that have no problem succeeding at the very highest level of their profession. While dunking a basketball isn't the focus of the process, the players selected in the NBA have all of the characteristics that allow them to consistently achieve this feat. Much like NBA GMs, we believe that by studying active managers over very long periods of time, we have developed a sound process to find managers that can outperform passive indices over the long-term. We call this the Highland Active Edge.

CHARACTERISTICS OF SUPERIOR ACTIVE MANAGERS

Highland has spent a great deal of time and energy studying active managers, and we believe we have a sound process for identifying superior active managers. We believe it all boils down to four Ps, with the first three Ps ultimately generating the fourth P.

OUR SERVICES

1. DEVELOPMENT OF INVESTMENT POLICY, OBJECTIVES AND GUIDELINES
2. ASSET ALLOCATION STUDIES
3. INVESTMENT MANAGER SEARCH
4. DEVELOPMENT OF INVESTMENT MANAGER PERFORMANCE STANDARDS/GUIDELINES
5. GENERAL CONSULTING SERVICES
6. PERFORMANCE MEASUREMENT & MONITORING
7. ASSIST IN FUND DIVERSIFICATION
8. RESEARCH
9. COMMUNICATIONS WITH MANAGERS
10. MANAGEMENT SUPPORT

INVESTING FOR THE TOTAL CLIENT

- *Investment services*
- *Reporting services*
- *General support*

We believe that the People, Philosophy, and Process ultimately drive Performance.

Through many years of studying active managers, we believe there are certain characteristics that superior managers share. These characteristics are:

- Low Fees
- Alignment of Interests with Investors
- Long Tenure
- Understandable Philosophy/Process
- Open Communication
- Consistency

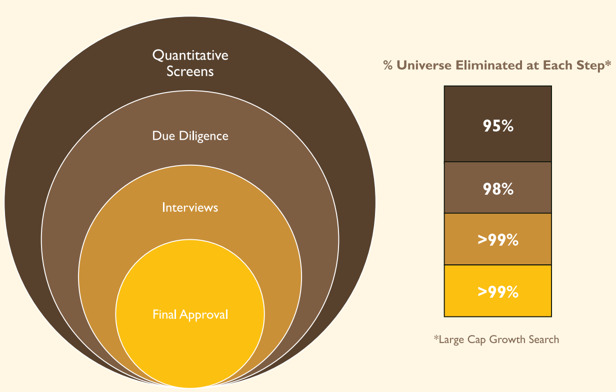
HIGHLAND'S PROCESS

Identifying the attractive qualities of managers is a labor intensive process. Most advisors take the approach of following a large number of the managers in a universe. Highland's philosophy is counter to this, and we are convinced that our clients are better served by us knowing a select group of managers in each universe extremely well. This allows us to build a partnership with managers to truly understand what is driving returns. This means we need to quickly filter the universe, so we can spend the appropriate amount of time with managers that will ultimately matter for us and our clients.

Our manager search process is a multi-step process that allows us to quickly narrow down the universe of available managers and focus our attention on those that have the highest probability of achieving above benchmark returns. Much like the NBA GM, we focus our attention on those that give us the best chance of success. **Figure 1** shows the steps to our process and the percentage of managers that are eliminated with each step.

FIGURE 1

HIGHLAND'S EVALUATION PROCESS: WHERE SHOULD YOU FOCUS RESEARCH?



As you can see, we use quantitative screens to weed out the vast majority of the universe. These screens, while extensive, are highly automated and take very little of the total search time. We spend far more time and effort narrowing down the remaining 5% of the universe to three to five managers approved for use in portfolios. This process often takes three months (sometimes much longer) and includes:

- Detailed Due Diligence Questionnaires
- Initial Strategy Calls
- Introduction to Highland's Investment Committee
- Initial Manager Scorecard
- Follow-Up Meeting with Highland's Investment Committee
- On-Site Visits
- Final Approval by Highland's Investment Committee

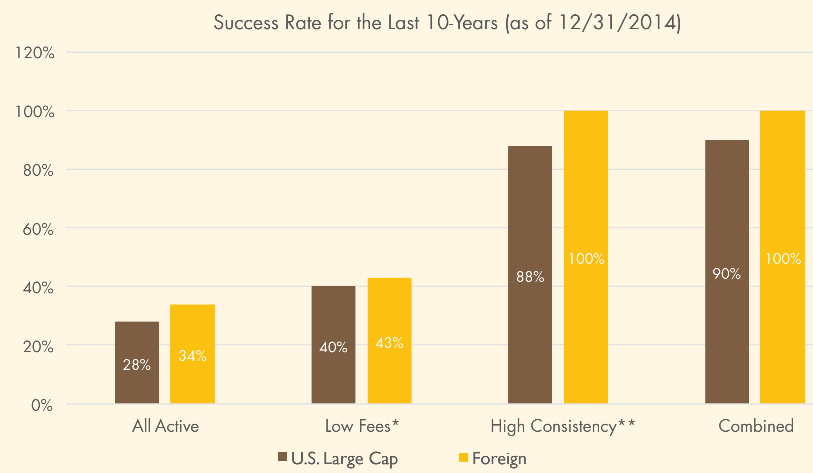
DOES HIGHLAND'S PROCESS PRODUCE RESULTS?

At Highland, we foster an environment of intellectual curiosity that pushes each one of our investment professionals and challenges the status quo. Because of this, we try to continually refine our process. This means we are in a constant state of review to understand what works and what we can do to improve. In this process, we search for proof statements for our process. In this case, we went back and examined managers which passed two of our simple screens (our actual screens contain numerous variables) in the first step of our process. The variables were low fees and high information ratios (i.e. risk-adjusted outperformance). We then ran these returns on the available universes on December 31, 2004. We took the lowest quartile of fees and the highest quartile of information ratio and analyzed the next ten years of returns. The results are in **Figure 2.** The results are stunning. This simple screen shows that we can sufficiently narrow down the universe and put our clients in a position to pick superior managers. It should also be noted that these screens are a very small portion of our process. We actually spend a great deal of time improving the success ratio by further examining the potential managers, which allows us to focus on the ones we believe will give our clients the best chance of success over the long term.

CAN GOOD MANAGERS UNDERPERFORM?

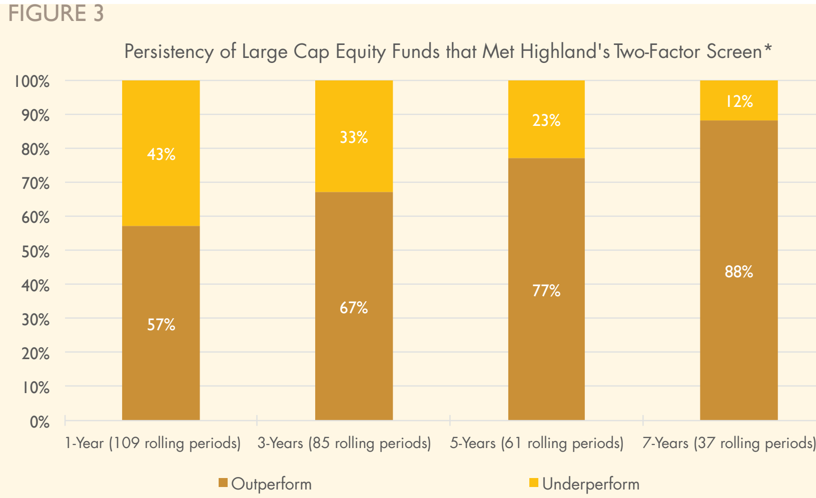
At Highland, we believe in several investment tenets to guide our investment philosophy and ultimately determine success. One of these tenets is the concept of a proper time horizon. We believe that investors should measure success over the appropriate time horizon. Investors that don't take into consideration proper

FIGURE 2



time horizon can make mistakes. The success rate in **Figure 2** is over a ten year time horizon. Even though 90% of domestic managers outperformed, 80% of these successful managers were in the bottom half of their peer group during at least one twelve-month period. Extending to a three year time horizon doesn't prove much better, as the domestic managers only outperformed 67% of the rolling three periods (i.e. underperformed one-third of the time). If an investor were judging managers over these short time frames, it would be difficult for a manager to maintain employment in your portfolio. **Figure 3** shows how extending the time horizon increases the probability of an investor experiencing outperformance. Highland firmly believes that superior managers will add value to a portfolio. Furthermore, investing is a probability based exercise, meaning we can make all the right calls and still have underperformance. Utilizing longer time horizons to judge investment performance is how we combat emotional corrosion, which is illustrated in **Figure 3**. The longer the time horizon, the better we are able to judge success.

FIGURE 3



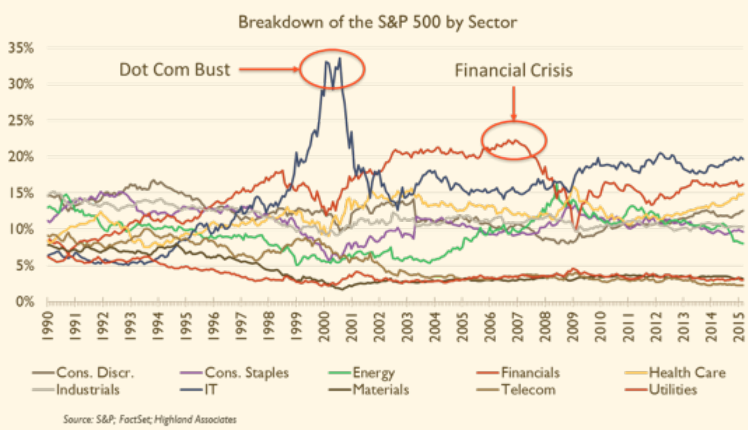
ISNT INDEXING EASIER, SAFER, AND CHEAPER?

Many of the proponents of passive indexing strategies will argue that indexing is a safer and cheaper choice. They would argue that investors would be better served utilizing their time in search of better returning investments (i.e. private investments). While the process we have at Highland is extensive and labor intensive, we are confident that it is well worth the time. Easier very rarely translates to better.

What about safer? It seems that indexing would be a safer choice. After all, picking an underperforming manager can have a large impact on a portfolio. On the surface, this point seems to makes sense. Investors should just accept "market" returns and risk below market returns. This argument has a couple of flaws. First, we all assume that indices are a true indicator of the stock market. While popular, this is not necessarily true. Stock market indices are nothing more than a proxy for an investment style. For example, the S&P 500 Index is one of the most recognized indices in the world, but what is it a proxy for exactly? It is an index of the 500 largest stocks in the U.S. weighted by market capitalization. To calculate market capitalization, we multiply the number of shares outstanding by the current market price. This seems reasonable doesn't it? It does if price and number of shares are important factors for you. When you focus on these two factors, the ultimate drivers of performance will be price movement and the changing level of shares. This means that the best performing stocks combined with the highest share count will dominate the index. We classify the S&P 500 Index as a momentum based strategy.

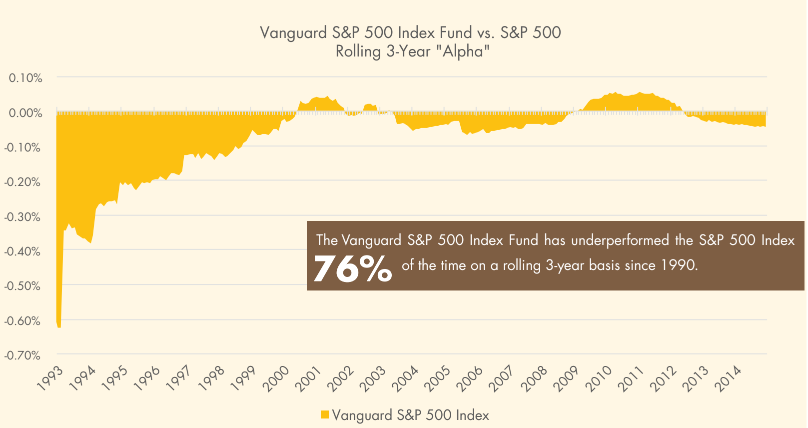
While the S&P 500 is widely used, the momentum nature used in its construction actually makes this type of strategy less safe than others. Think about the weighting of the index again. By weighting the best performing stocks as the highest weights, the index is actually amplifying the risk in the portfolio. This is because the weight of a stock/sector is the highest at the peak. This is the point in time in which most investors would want the lowest weight. Conversely, the weighting would be the lowest at the trough when it is most beneficial to be the highest weight. **Figure 4** illustrates the historical sector weights of the S&P 500 Index. This graph shows that a passive investor would have concentrated their allocation in the Technology sector at the moment the Dot Com bust occurred. As with the Dot Com bust, Financials were the largest weight in the index just before the financial crisis. More recently, an investor's allocation to Energy would have reached its highest point prior to last year's oil price collapse. These are only three examples of the poor risk management properties of the index.

FIGURE 4



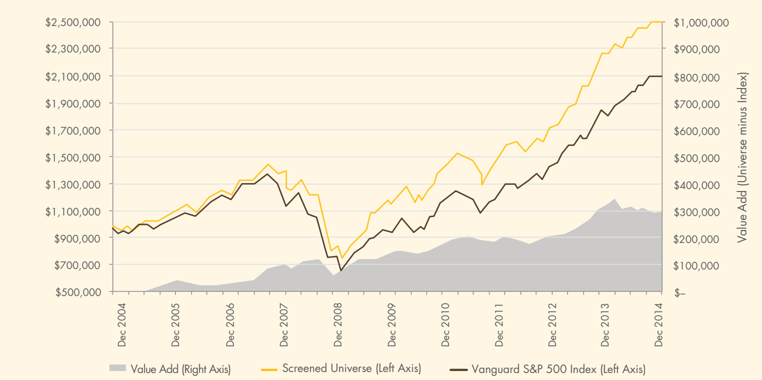
Another counter point to the index being safer is that investors receive index returns. This is simply not the case. Investors actually realize below market returns as management fees (while low) and transaction costs become a drag on performance. Another point that index investors must understand is that exchange-traded funds (ETF) and mutual funds are also susceptible to cash flows, which can generate significant tracking error (variation from the actual benchmark). **Figure 5** shows how these two points can be significant for investors. This chart looks at the Vanguard S&P 500 Index Fund versus the S&P 500 Index on a rolling three-year basis since 1990. The Index Fund underperformed the S&P 500 over 76% of the rolling three-year periods. Since investing is a probability-based exercise, we don't believe that accepting below benchmark returns is a safe proposition.

FIGURE 5



While it may not be the safest choice, isn't indexing the cheap There is no denying that on a management fee basis, indexing is much cheaper than active management. Management fees are not the only costs. Investors must weigh the opportunity costs of indexing. Active managers are often judged on performance net of fees and expenses. How do index funds look on the same basis? We took Highland's naïve universe used earlier and examined how a $1 million investment (invested on an equal weighted basis) with these managers would have performed versus the Vanguard S&P 500 Index Fund. The results are pretty stark (see **Figure 6**). The screened universe returned 9.1% per year versus 7.7% per year for the Index Fund, which translates into approximately $306 thousand in additional value (more than 30% of the original investment). This represents a significant opportunity cost to investing in an index fund.

FIGURE 6



CONCLUSION

While it is true that the average active manager struggles to outperform their passive benchmark, it doesn't necessarily mean that active management should be abandoned. Just as NBA General Managers haven't thrown in the towel because the average person can't dunk a basketball. We believe that our extensive experience in studying active managers has allowed our firm to identify certain qualities that ultimately lead to consistent outperformance. Most of these characteristics are qualitative; therefore, one is better served concentrating their efforts on a small number of managers. Although our process contains many steps, we utilized the first step to illustrate how it puts our firm in position to add value.

We also examined some of the arguments for why indexing is viewed as a better choice. While it is often easier, it doesn't translate to better. Indexing isn't necessarily safer either. It allocates capital based on recent performance, putting investors in a position to experience large drawdowns. Indexing also consistently gives its participants below market returns, which is not safer by any stretch of the imagination. Although the management fees are lower than active management, when examining the net of fees performance, the cost of indexing can be very high. Just as the NBA GM is drafting players to compete for championships, we select managers for our clients' portfolios to win. That means settling for average just won't cut it.

About HIGHLAND ASSOCIATES

Highland Associates, Inc. is an independent institutional investment advisor headquartered in Birmingham, Alabama. Highland Associates was founded in 1987 with the mission of providing objectives-based portfolio solutions for the total client. Its national client base consists of foundations and endowments, defined benefit plans, defined contribution plans and non-profit health care organizations. Highland remains solely independent and is 100% employee owned. As of March 31, 2015 it serves as investment consultant on $20.4 billion in assets. Please visit our website at www.highlandassoc.com to learn more about our firm.

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