THE VALUE OF ACTIVE INDEX MANAGEMENT

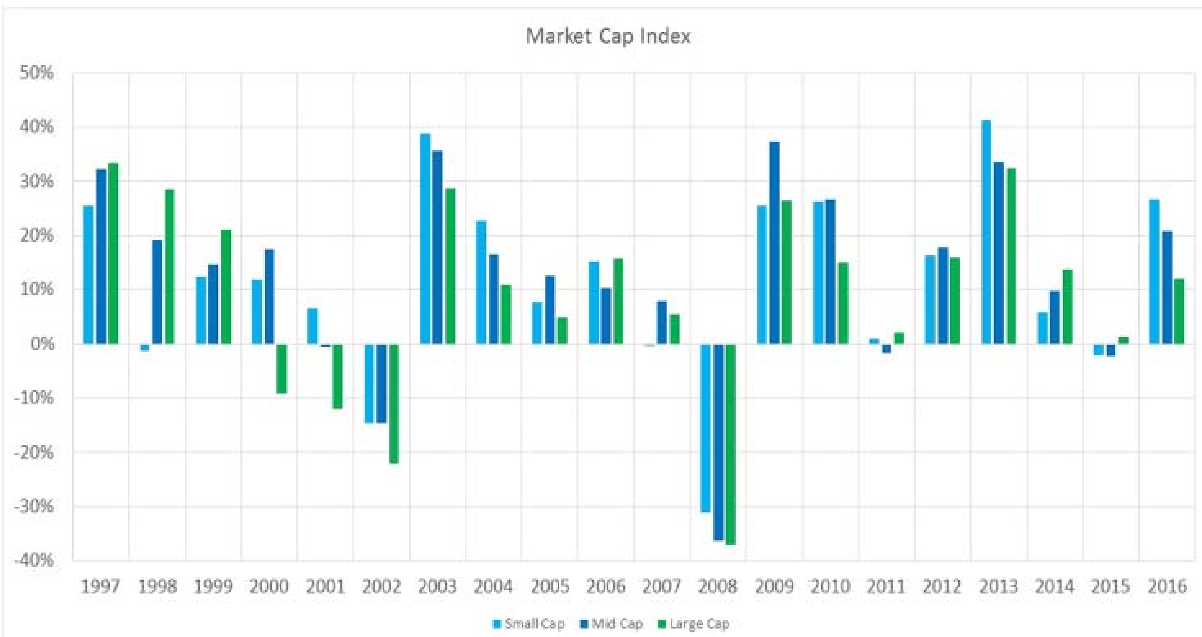
The theory of modern portfolio management leading to the emergence of the index fund as a mechanism to mimic the performance of a market index received little notice when the Vanguard Group launched its first passive fund based on the Standard and Poor's 500 index. This index was structured in 1957 and is widely regarded as the best single gauge of large-cap U.S. equities. The S&P 500 is weighted by the market capitalization of the stocks in the index so the largest companies have the biggest influence on returns.

According to Wikipedia, the first index fund called Qualidex that was based on the Dow Jones Industrial 30 stocks was launched in 1972. Ironically, the fund was acquired by Templeton Funds but the founder of the company, John Templeton, didn't believe in the index approach so the fund was liquidated! In 1974, John Bogle, a proponent of passive investing, founded the Vanguard Group that has since become one of the world's largest investment companies with more than $4 trillion under management. Mr. Bogle started the First Index Investment Trust in 1975 that was later named the Vanguard 500 Index Fund. At the time of the fund's launch, Edward Johnson, the founder of Fidelity Investments, was reported as saying he "couldn't believe that the great mass of investors are going to be satisfied with receiving just average returns."

Initially, investors were persuaded by the idea that investing in just the S&P 500 would provide a reasonable rate of return. As new indices proliferated such as the market capitalization and the style (growth vs. value) of the underlying stocks, investors were presented with the opportunity to invest in several funds. As institutional investors gravitated toward the index fund approach primarily due to a combination of low costs and low risk, mutual fund companies invented indices based on parameters other than market capitalization and style. Some other approaches included a fundamental-weighted index of the S&P 500 that is the selection and weighting based on company revenues and company earnings, for example. As these new funds experienced varying rates of return there was the expectation that fund companies would advertise the better performing ones. Investors would then be challenged to come up with a suitable mix of funds for their portfolios—somewhat like picking stocks. In such an environment as 2015-2016 where actively managed funds underperformed selected index funds, the flow of funds into passive funds skyrocketed.

In 1995, the founders of Victoria Capital Management, Inc. created actively managed portfolios of indexed funds that offered a range of risk and return variations to meet the needs of investors saving for retirement. In 2005, the firm created similar portfolios utilizing index exchange-traded funds. These portfolios are actively managed based on short-term performance and traditional economic and market analyses. The question might be asked: Does adding indices to a portfolio make a difference? While history tells us that there is reasonable similarity among the cumulative rates of return of traditional indices, there is a noticeable difference in the short-term returns of indices.

The following exhibit provides a comparison among three traditional market capitalization indices: Large-, mid- and small-cap. First, while index investments do not prevent a substantial short-term price decline as in 2002 and 2008, those losses were recovered in the following two years of the decline. Second, the difference in returns among these indices can be substantial sometimes by 10 percentage points or more. Such divergent returns present the opportunity for tactical managers to weight a portfolio to take advantage of these short-term events. In 2016, there was a 10-percentage point difference in returns between large-cap and mid-cap indices and a 20-percentage point return differential between large-cap and small-cap indices. Also, the exhibit demonstrates that there are no sustainable trends of better performance for one index over another.



Conclusions:

Using index funds as a method of inexpensive saving has led to a proliferation of these offerings and the need to pro-actively select a mix of funds that have an actual history of investment performance and low portfolio expense ratios.

Victoria Capital Management, Inc. has managed portfolios of indexed funds since 1995. Today, these actively managed portfolios contain exchange-traded funds and are structured to provide target rates of return that allow for the selection of investment options that could meet certain risk and reward parameters. By prioritizing the use of well-known, low-cost index funds investors can have increased confidence and knowledge of how their savings are being managed.