Quarterly Investment Perspective

Bridging the Active-Passive Divide

Rebecca Patterson
Chief Investment Officer

Executive Summary

- **Recent years have seen a significant shift of capital toward passive investment strategies**
- **We believe portfolios can benefit from active and passive investing**
- **Taking advantage of both strategies requires dynamic asset allocation — knowing when and how to combine the two in the context of other critical portfolio decisions**
- **Looking at the coming year, we expect actively managed portfolios to benefit from lower market correlations and greater dispersion between securities, while passive strategies could prove useful to quickly shift allocations if macroeconomic fundamentals suddenly change**
- **Overall, we enter the second quarter neutral equities and tilted meaningfully to the U.S., with fixed income and credit holdings biased toward gradually rising U.S. interest rates**

How do you build the perfect portfolio? The answer is different for every investor. What kind of return is sought? How much risk is tolerable to achieve that return? How much liquidity is needed? What is the investment time horizon? What are the tax circumstances?

Indeed, even for one individual investor, the answer to that perfect-portfolio question will vary over time — as the economic and financial-market landscape changes, as the investor's personal situation changes, and as investment strategies and tools evolve.

At Bessemer, we constantly question and review how we construct portfolios, always with a mandate to participate meaningfully in rising markets and protect our clients' irreplaceable capital when times get tough.

In this edition of our *Quarterly Investment Perspective*, we explore one of the most frequently discussed aspects of portfolio construction today: active versus passive investing. We do not see active-passive as an all-or-nothing choice, but rather points along an investment continuum. Portfolios can benefit from both, albeit in different ways and at different times. We also put the active-passive debate in context — it is just one of many decisions investors should consider as they construct portfolios, and one of many more aspects of a sound wealth management plan.

As we look ahead toward the latter stages of the U.S. expansion, we expect active management to increasingly outperform truly passive strategies. More broadly, we remain constructive toward equities, although valuations, the implications of a tighter labor market, and policy uncertainty will likely limit gains.

Passive Aggressive

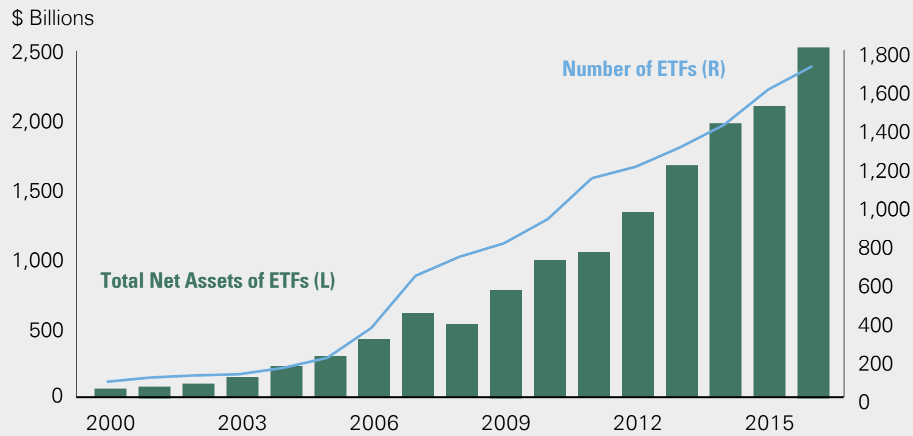
Recent years have seen capital aggressively leave actively managed investments for passive ones. Investors embracing passive strategies, usually in the form of index-tracking mutual funds or exchange-traded funds (ETFs[1]), strive to get the benchmark return of the underlying security or index, often with relatively low fees. (An ETF is an investment vehicle that can be bought and sold throughout the day and trades on a stock exchange.) Meanwhile, active strategies often have a higher fee; in return, investors expect performance surpassing that of underlying benchmarks through security selection and position sizing, among other factors.

[1] We broadly define ETFs as exchange-traded products that include ETFs, ETNs, and other similar investment products.

Every investment strategy has pros and cons, including passive.

Exhibit 1: Growth of the U.S. ETF Industry

Key Takeaway: The number of ETFs and corresponding assets under management has risen dramatically in recent years.



As of December 31, 2016.

Source: Bloomberg, Investment Company Institute

Globally, the ETF industry has grown from roughly $100 billion in the mid-1990s to approximately $2.9 trillion today, with around 2,000 different strategies on the market. The U.S. accounts for the largest share of the ETF market (Exhibit 1). Equities have experienced some of the fastest rates of growth, particularly in the U.S., where the share of U.S. equity assets held in ETFs and passive index funds rose from 17% in 2005 to 38% by the third quarter of 2016.[2]

Why such a sea change? We see three main reasons for the migration to passive:

- **Transparency.** At least with simple ETFs and indexed mutual funds, investors know exactly what they are getting, such as the S&P 500 or large-cap global bank stocks.
- **Cost.** Some ETFs charge lower fees, especially U.S. large-cap equities (Exhibit 2).
- **Performance.** Over the last several years, many actively managed equity mutual funds have not beaten their benchmarks. Passive investing — at least over the same time period and in this asset class — has generally provided better returns, especially net of fees.

All of this is true, but additional points are worth exploring. We believe that every investment strategy has pros and cons, including passive. Successful portfolio construction requires looking at both.

[2] Goldman Sachs Global Investment Research.

Take cost. While a couple of large-cap U.S. equity ETFs indeed have rock-bottom fees, the average ETF has an expense ratio of 0.44%,[3] with many costing substantially more (Exhibit 2).

In addition to cost differences, investors need to be aware of methodology and counterparty risk. Many ETFs may appear alike at first glance; an investor may be tempted to just pick the cheapest of the lot. However, in our view, ETFs require as much due diligence as actively managed funds. We prefer well-established counterparties (the firms issuing and managing the ETF) with strong operational capabilities and balance sheets. We also make sure we understand how the ETF trades and what underlying securities it holds.

ETF liquidity is another critical consideration: the further one strays from mainstream asset classes and the largest providers (such as BlackRock, Vanguard, and State Street), the less liquid the ETF tends to be. There are many small providers and niche ETF products, with new launches — and closures — quite common. Just last year, 128 ETFs closed.[4]

Even with mainstream asset classes and large providers, recent years have shown that ETF liquidity cannot be taken for granted. On August 24, 2015, the U.S. stock market experienced a "flash crash," with the Dow Jones Industrial Average (DJIA) dropping 1,100 points in the first five minutes of trading. During the sell-off, many ETFs fell in price much more than the underlying stocks on which they were based. Even the very liquid iShares Core S&P 500 ETF was down 26% at one point, roughly 20% below its fair value. Delayed openings of stocks, lack of transparency, and widening bid-ask spreads led to trading curbs and halts that ultimately (and fortunately only temporarily) disconnected some ETFs from a rational price. Eventually ETFs and underlying stock prices converged, but that was of little consolation to panicked investors who cashed out that morning. It also raised doubts as to how ETFs might perform in the next crisis, especially if it is longer lasting and/or deeper.

In our view, ETFs require as much due diligence as actively managed funds.

Exhibit 2: ETF Comparison

	Large Capitalization U.S. Equity	Small Capitalization Non-U.S. Equity
Total ETFs	130	13
Different Issuers	39	7
ETFs Using Leverage	22	0
Fee Range	3 to 125 bps	16 to 80 bps
AUM Range	\$1.2M to \$233.5B	\$1.4M to \$6.8B

As of March 22, 2017.

Source: FactSet

[3] The 44bps is a simple average; according to Morningstar, the asset-weighted expense ratio across all ETFs was 0.23% in 2016.

[4] According to ETF.com.

Over the last 20 years, a Bessemer portfolio with 70% equity risk and 30% bond risk has captured 80% of the S&P 500's return while limiting losses to 50% of the market's downside during bear markets.

Active and Passive: Happy Together

Bessemer's history is rooted in active investing for a good reason — over the long term, it has worked for our clients. Over the last 20 years, a Bessemer portfolio with 70% equity risk and 30% bond risk (what we refer to as "Balanced Growth") has captured 80% of the S&P 500's return while limiting losses to 50% of the market's downside during bear markets (Exhibit 3). Portfolio managers and their teams have been able to successfully participate and protect — in part through selecting specific securities and sizing them within respective strategies rather than owning everything regardless of valuations or underlying fundamentals. The Small & Mid Cap Core equity mandate, for example, has returned 15% per year on average (gross of fees) since its October 2008 inception versus its respective index, which returned 12.24%. Put another way, $1 million invested actively in this mandate at inception would have earned about $600,000 more than the same amount invested in a combination of ETFs designed to track the index.

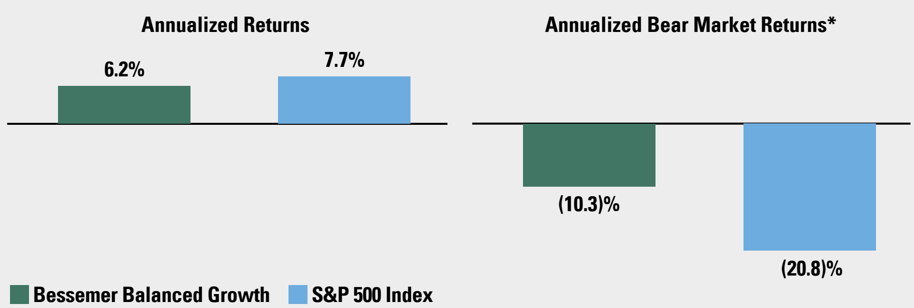
That said, we are always researching new investment vehicles and approaches, including passive investments, such as ETFs. We see room for both to add value in portfolios, albeit in different ways and, in some cases, at different moments of the economic cycle.

As we look at the world today and in the years ahead, we see reasons why actively managed investments should benefit relative to their passive peers. First, and most importantly, the U.S. expansion is maturing. Labor markets are tightening;

Exhibit 3: Performance of Balanced Growth 70/30 Portfolio

Key Takeaway: Over the last 20 years, a Bessemer portfolio with 70% equity risk and 30% bond risk has captured 80% of the S&P 500's return while limiting losses to 50% of the market's downside during bear markets.

20 Years Ended December 31, 2016



Past performance is no guarantee of future results.

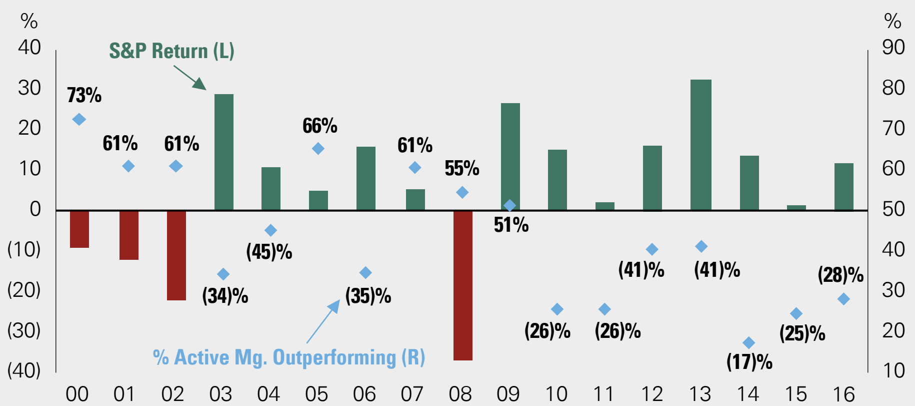
The Bessemer Balanced Growth 70/30 Portfolio (excluding Hedge Funds and Private Assets) represents a model portfolio comprised of Large Cap Core, Large Cap Strategies, Small & Mid Cap, Fixed Income, and Strategic Opportunities. Investments cannot be made directly in this model portfolio, and portfolio components and relative weightings vary over time. Please see the end of this publication for a complete description of Bessemer's Balanced Growth model portfolio. "70/30" represents the Stock/Bond profile, or intended risk profile, of the portfolio's neutral allocation.

* Bear Markets are defined as the years in which the S&P 500 Index returns were negative. For the time period shown, those years were 2000, 2001, 2002, and 2008.

Source: Standard & Poor's

Exhibit 4: Annual S&P 500 Performance versus % of Active Managers Outperforming

Key Takeaway: In the last four calendar years where the S&P 500 lost value, more than 62% of active managers performed better, many materially.



As of December 31, 2016.

Source: Strategas Research Partners

As this expansion ends and a recession ensues, we believe active management will continue to perform well.

greater competition for workers means firms need to offer higher wages. Rising wages and home prices, along with more stable commodity prices, are pushing up inflation. The backdrop leaves the Federal Reserve more comfortable tightening monetary policy, which drains liquidity from the financial system and provides a measure of support for market volatility. Indeed, in March, the Federal Reserve not only raised interest rates 25 basis points but also suggested an additional 125 basis points of tightening before the end of 2018.

On a separate but related note, shifting government policy is creating more dispersion within equity sectors and even companies. According to a recent survey of institutional investors conducted by Natixis Global Asset Management, 73% of respondents stated that the current market environment is likely to be favorable for active managers. Consistent with this, 55% of active managers outperformed their benchmarks in the fourth quarter of 2016 — results which were well above their respective 10-year averages, though this is clearly too short a period to draw any substantive conclusions.

Eventually, as this expansion ends and a recession ensues, we believe active management will continue to perform well. Basic ETFs and index-tracking vehicles will follow a rising market higher. Into and during a recession, however, they will also follow it down, tick for tick. In contrast, active managers can tactically increase allocations to cash and more defensive securities in such environments. It is no surprise to us that, over time, active managers have most consistently outperformed their benchmarks (and, by association, passive investments) during meaningful equity-market sell-offs (Exhibit 4). Looking at the last four calendar years where the S&P 500 saw losses, passive investments following this U.S. index would have lost an average 20% per year. More than 62% of active U.S. large-cap equity managers performed better, many materially.

Regardless of the state of the economic cycle, we typically include some ETF strategies, generally for one of three purposes.

First, we use ETFs to complement bottom-up security selection in an effort to achieve specific sector and/or regional weightings.

Second, if a portfolio-management team sells a security and does not want increased cash to drag down returns in a rising market, ETFs can be easily employed to get market exposure while waiting for a new, attractive investment to be identified.

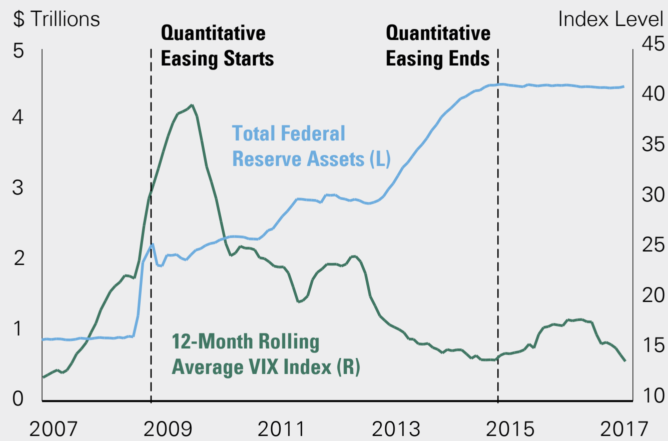
Third, ETFs work well when tactical portfolio shifts need to be made very quickly — such as positioning portfolios for a specific event, like the recent U.S. presidential election. Researching and selecting specific securities to adjust to a new macro paradigm could risk a portfolio missing an opportunity.

Our preference, therefore, is to use passive vehicles actively. Although this sounds like an oxymoron, our belief is that by actively managing our asset class and regional, country, and sector weights with help at times from passive vehicles like ETFs, we can generate better risk-adjusted returns as compared to simply buying and holding pure passive strategies.

When might we lean more passive and in what assets? Looking ahead, we would expect Bessemer portfolios to increase passive equity exposure near the trough of the next recession. Of course, we know timing a market bottom is like throwing a dart and hitting the bullseye. That said, we believe we can enhance performance by averaging into more passive exposure and tilting via both passive and active strategies toward more cyclically sensitive parts of the investment spectrum (value-style and small- and mid-cap equities, for instance) as a recession matures and policymakers respond meaningfully. Those early months of an economic recovery, at least historically, have shown high correlations between securities,

Exhibit 5: Federal Reserve Balance Sheet versus VIX Volatility Index

Key Takeaway: As the Fed has expanded its balance sheet and provided ample liquidity to financial markets, market volatility has dwindled, benefitting passive strategies.



As of February 28, 2017.

12-month rolling average for the VIX is based on monthly data.

Source: Bloomberg, Federal Reserve

even across different countries, helped by central banks lowering interest rates and adding to market liquidity. This "risk on" environment, where all securities are benefitting from a similar set of macroeconomic drivers, has tended to support passive strategies (Exhibit 5).

An Actively Managed Passive World

Active managers today and going forward have to be more attuned to trends in the passive space. Rapid, forceful capital flows into and then out of ETF areas can impact individual security valuations (both for the better and worse), moving them away from longer-term investment theses. Last year alone, seven out of the 10 most actively traded securities in the U.S. were ETFs (according to data from Credit Suisse); only three were individual stocks (Exhibit 6). Companies like Intel, Johnson & Johnson, and IBM are each held in more than 200 different ETFs today.

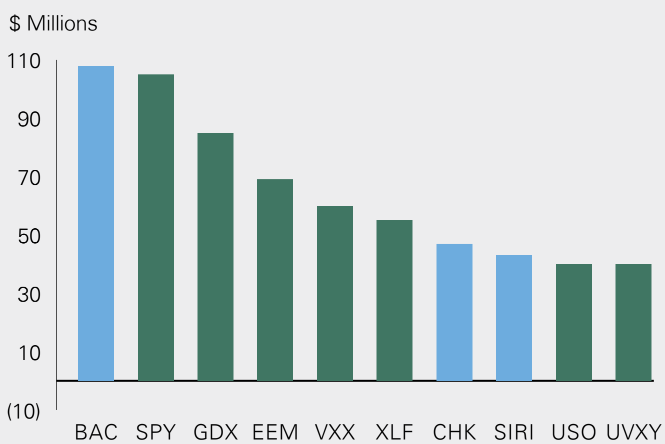
An active investor needs to appreciate these passive flows and positions and how they might impact the short-term performance of a security, ideally to benefit from it. If passive investors, for instance, have fled a corner of the investment universe (say, growth stocks), an active investor who has already done due diligence on a specific growth stock may be able to get an even better price for those shares due to short-term fund flows.

Bessemer's Quantitative Strategy team is exploring passive from another perspective as well.[5] Can we create ETF-like vehicles that provide clients with a better risk-adjusted return profile?

One such strategy tilts in the direction of specific factors (for example, inexpensive companies or steady dividend payers) that could improve risk-adjusted returns as compared to a standard index (or index-tracking ETF).

Exhibit 6: Most Actively Traded Securities in 2016, by Average Daily Volume

Key Takeaway: Among the most actively traded securities in 2016, only three were individual stocks; the remainder were ETFs.



Ticker symbols are as follows: BAC – Bank of America Corp; SPY – SPDR S&P 500 EFT Trust; GDX – Market Vectors Gold Miners ETF; EEM – iShares MSCI Emerging Markets Index ETF; VXX – iPath S&P 500 VIX Short-Term Futures ETN; XLF – Financial Select Sector SPDR ETF; CHK – Chesapeake Energy Corp.; SIRI – Sirius XM Holdings Inc.; USO – United States Oil; UVXY – ProShares Ultra VIX Short-Term Futures.

Source: Credit Suisse Trading Strategy

Another strategy being explored centers on after-tax returns. Specifically, can an investor achieve market returns while simultaneously maximizing tax losses (to harvest and use against gains recognized over the same time period)?

These approaches blur the lines between active and passive investing, but we believe they could be useful tools in managing client portfolios.

Multidimensional Investing

Active-passive decisions are important but only one component of successful asset allocation. A prominent research study on this topic found that "allocation policy explains nearly 90 percent of the monthly or quarterly return variability over time."[6] Indeed, investors must make a number of choices beyond active-passive when building an optimal portfolio, including:

- **Liquid or illiquid.** Many of our clients have a percentage of their wealth tied up in illiquid businesses or holdings and want a complementary, liquid financial portfolio. Conversely, other clients (often with longer investment horizons) are happy to hold a sizable portion of their wealth in illiquid assets, such as private equity or real assets. On a passive-active continuum, private equity managers are as active as managers can be, considering their ability to take control of companies and make strategic and operational decisions accordingly. Strong manager selection in these areas and a systematic investment approach can lead to attractive excess returns versus what public markets can provide.

  According to a recent McKinsey report, private equity returns have outperformed the public market index by at least 300 basis points over the long term. At Bessemer, we've been investing in private equity on behalf of our clients for 30 years. Manager selection has helped us build a successful long-term track record, with outperformance well in excess of that cited by McKinsey.[7]

5 "OutDex to Outperform an Index: Incorporating the Best of Active and Passive Investment Strategies." *The Journal of Index Investing*, Fall 2015 (10/8/2015).
6 Vardharaj, R. and F. J. Fabozzi. "Sector, Style, Region: Explaining Stock Allocation Performance." *Financial Analysts Journal*, Vol. 63, No. 3 (2007), pp. 59-70.
7 McKinsey & Company; Private equity: Changing perceptions and new realities; April 2014. Return data reflect funds raised from 1995-2010.

Investing is a multidimensional process with room for thoughtful use of active *and* passive, in conjunction with other strategies and considerations that are all necessary for successful wealth management.

- **Defensive or growth oriented.** While everyone loves to maximize return and minimize risk, each client has a unique goal along this spectrum. In some cases, it depends mainly on spending needs. In other cases, it comes down to "peace of mind"; how much risk can someone tolerate and still sleep well at night when markets are volatile.

Even if a portfolio is entirely made of passive vehicles (ETFs and/or index funds), there are still many unanswered questions — first and foremost, developing the right asset allocation, now and in the future. Even the growing "robo-advisors" (online investment providers) appreciate the need for asset allocation to ensure that passive strategies provide attractive longer-term returns. Asset allocation questions we address include the following:

- What is the right mix between U.S. and other countries' assets?
- How much in cyclical (growth-sensitive) assets?
- Where are we in the economic cycle?
- When is the next recession likely to emerge and why?
- Within equities, allocate more to small-, mid-, or large-cap companies?
- Are there equity sectors to avoid or emphasize?
- What influence could currency markets have on overall returns?
- How should the portfolio position for interest-rate trends?
- What are the main risks to guard against?

Bessemer's Investment Department is reevaluating our answers to these and other questions constantly. No matter where a client falls on the spectrum of active-passive investing, our work is to ensure that each client's assets are thoughtfully and actively allocated.

An Essential Part of a Holistic Wealth Management Plan

We see an optimal portfolio as an essential component of a holistic wealth management plan. As important as the active-passive debate might be, we don't think investors should overlook "planning alpha." Helping to reduce a family's estate tax bill, or optimizing a giving strategy to meet a family's philanthropic goals and reduce its income tax burden is every bit as important as figuring out the right blend of active and passive management, liquid and illiquid holdings, or overall portfolio risk. Our bottom line: A war between passive and active makes for good headlines but is the wrong discussion. At Bessemer, we believe investing is a multidimensional process with room for thoughtful use of active *and* passive, in conjunction with other strategies and considerations that are all necessary for successful wealth management.

A Peek into Q2 and a Final Word on Q1

With all those questions above, which are we focused on as we head into the second quarter? Three stand out.

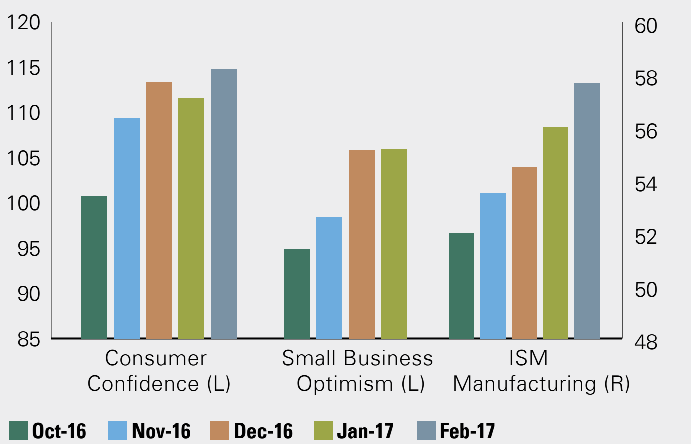
First, will upbeat sentiment data in the U.S. be followed by improving "real" economic data (Exhibit 7)? Usually, sentiment trends lead actual economic activity. If companies or consumers feel better, for instance, they are more likely to hire or spend. As we head into the second quarter, actual economic data have been decent but not improving as quickly as sentiment would suggest. In our view, equities would be somewhat more vulnerable if the confidence-data gap persists. With our portfolios currently neutral equities versus strategic benchmarks and including some defensive components, we feel comfortable about positioning if such a disappointment emerges, although that is not our base case. We note here that perceptions around U.S. fiscal-policy developments could substantially impact these sentiment trends, at least over short periods of time. In particular, we expect equities to continue moving alongside progress (or lack thereof) on tax reform and other growth-stimulating legislation.

Our second question would likely focus on Europe: specifically, who will win the French presidential election on May 7? Heading into April, independent centrist Emmanuel Macron and Front National's Marine Le Pen were the leading candidates, with Macron expected by opinion polls to prevail in the second-round May vote. Bessemer portfolios have been underweight

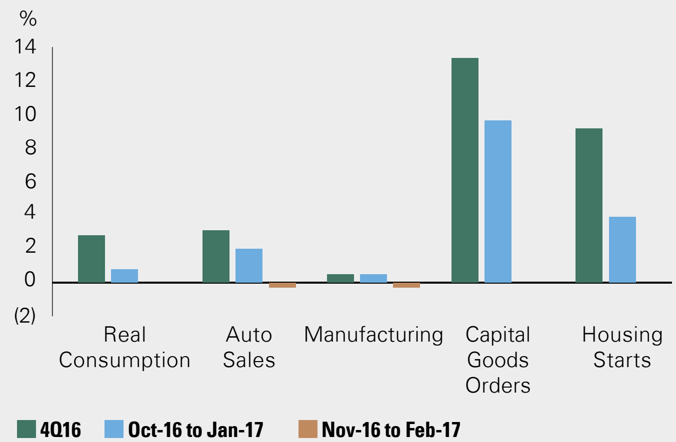
Exhibit 7: U.S. Sentiment Data versus Actual Economic Activity

Key Takeaway: Sentiment data point to an acceleration in economic prospects, but real economic data remain more mixed.

Survey Data Point to an Acceleration in Economic Prospects…



While Real Data Remain More Mixed



As of January 31, 2017, except auto sales, consumer confidence and ISM, which are as of February 28, 2017. Righthand chart reflects annualized figures.

Source: Bloomberg, Conference Board, Institute for Supply Management, National Federation of Independent Business, U.S. Bureau of Economic Analysis, U.S. Census Bureau, Ward's Automotive Group

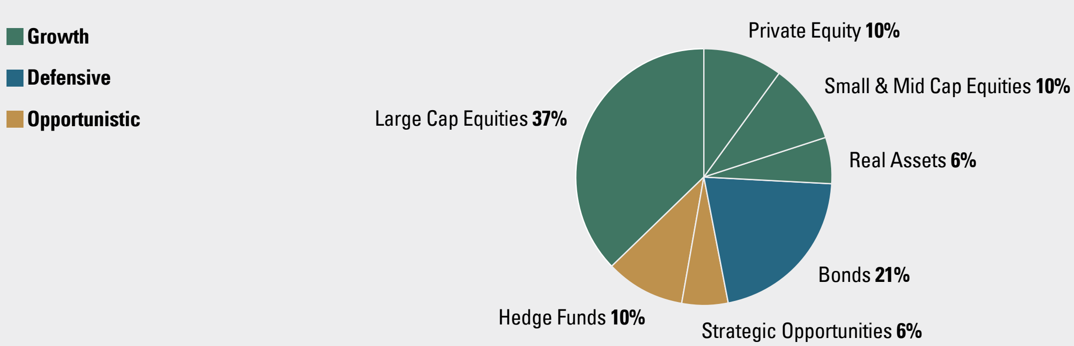
European equities and the euro for some time, mainly due to the negative shock that could follow a Le Pen win (she has campaigned on leaving not only the European Union but also the euro currency bloc). This is a low-probability event, but one that could have a very large impact. If the coming quarter brings a benign election outcome (Macron win), we would certainly consider adding more European exposure, since regional equity valuations are lower than those of their U.S. peers; the central bank is still easing policy; and economic growth, albeit sluggish, has positive momentum.

A third and related key question we're asking into the second quarter centers around the Fed. If U.S. data improve and European politics remain relatively smooth, we would expect the Fed to raise rates again as early as this coming quarter, likely by another 25 basis points. But how hawkish will the Fed be? The answer will help color performance of U.S. bonds, the dollar, various equity sectors, and emerging markets (the latter sensitive to the dollar and U.S. yields). Our base case is that the dollar will likely gain further this year and that yields will gradually rise (see *The Dollar Under President Trump*). But all three questions here will shape the conviction around these views and how we fine-tune asset allocations.

As for the first quarter that is just ending, a 70/30 "Balanced Growth" portfolio gained 4.6% on a preliminary basis, 30 basis points behind the benchmark. A modest decline in U.S. yields and the dollar hurt relative performance (the latter given an overweight position to U.S. equities and the currency), as did managed-volatility equity mandates (which often modestly trail equity benchmarks but with significantly lower volatility to help portfolios more smoothly navigate choppier markets). Meanwhile, portfolios were helped by strong security selection in large-cap emerging market and global growth equity mandates as well as internally managed small- and mid-cap and global large-cap mandates. To note, as of April, our small/mid-cap internal mandate will be made more broadly available for clients as a separately managed account.

With special thanks to Pat Boyle, senior investment strategist and managing director, for his contributions.

Bessemer's Positioning (70/30 Risk Profile with Alternatives)



Positioning as of April 3, 2017. This model displays Bessemer's Balanced Growth with Hedge Funds and Private Assets target portfolio allocation guidelines. Each client situation is unique and may be subject to special circumstances, including but not limited to greater or less risk tolerance, classes, and concentrations of assets not managed by Bessemer, and investment limitations imposed under applicable governing documents and other limitations that may require adjustments to the suggested allocations. Model asset allocation guidelines may be adjusted from time to time on the basis of the foregoing or other factors. Alternative investments, including Bessemer private equity, real assets, and hedge funds of funds, are not suitable for all clients and are available only to qualified investors.

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(March 21, 2017)

The Dollar Under President Trump — A Closer Look
(March 2017)

Dow Surpasses 20,000 — Investment Insights
(January 2017)

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The Sun Also Rises — Quarterly Investment Perspective
(First Quarter 2017, Video Available)

2016 Elections: First Thoughts — Investment Insights
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About Bessemer Trust

Privately owned and independent, Bessemer Trust is a multifamily office that has served individuals and families of substantial wealth for more than 100 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.

The **Bessemer Balanced Growth 70/30 Portfolio (ex Hedge Funds)** represents a model portfolio comprised of Large Cap Core, Large Cap Strategies, Small & Mid Cap, Fixed Income, and Strategic Opportunities. Investments cannot be made directly in this model portfolio. Portfolio components and relative weightings vary over time. Returns for the Large Cap Strategies, Strategic Opportunities, and Small & Mid Cap mandates are after all fees and expenses. Returns for Bessemer's Large Cap Core and Fixed Income Common Trust Funds are shown before fees and expenses. The results also include the reinvestment of all dividends and capital gains.

Prior to November 2011, Large Cap Core was named U.S. Large Cap and Large Cap Strategies was named Non-U.S. Large Cap; these portfolios operated under a different investment strategy and capitalization range, and performance is shown before fees and expenses. Small & Mid Cap returns began April 5, 2005. Strategic Opportunities returns began November 28, 2007. Prior to January 1, 2014, the Strategic Opportunities portfolio was named the Global Opportunities portfolio. The Bessemer Balanced Growth (ex Hedge Funds) included the performance of the Real Return portfolio, after fees and expenses, from April 28, 2005, through the liquidation date of March 17, 2015.

Effective July 1, 2014, the Dow Jones-UBS Commodity Index was rebranded as the Bloomberg Commodity Index.

The **Bessemer Balanced Growth 70/30 Portfolio** (ex Hedge Funds) included the performance of the Real Return portfolio, after fees and expenses, through the liquidation date of March 17, 2015.

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