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Active and Passing Investing

There are two primary approaches to investing:

**ACTIVE INVESTMENT**
Professional money managers actively manage a portfolio of investments to achieve a pre-designated absolute return target or generate a return in excess of a designated benchmark or index.

**PASSIVE (OR INDEX) INVESTMENT**
Portfolios are created to mirror the characteristics of and thus generate the returns of an underlying index either by owning all of the securities in the index or a subset (sample) of the underlying securities.
Index and Indexing

- A market index is a well defined "basket" of Stocks, Bonds or Commodities considered to represent a particular market or sector.

- The composition of the “basket” is determined by institutions such as S&P, Dow Jones, Barclays, Russell, MSCI, etc., and are periodically updated to meet the index mandate.

- For example, Alcoa and Hewlett Packard were removed from the Dow Jones Index and Nike and Visa were added in September 2013.*

**Indexing is the process of investing in a manner so as to achieve the returns of a desired Index. This is also referred to as passive investing.**

* Source: S&P Dow Jones Indices LLC
Common Types of Indexes

Stock (Equity)

- S&P 500 Index
- Dow Jones Industrial Average

Bond (Fixed Income)

- Barclays Capital U.S. Aggregate Bond Index
- Barclays Municipal Bond Index
Index Strategies

• Index investors use a “buy and hold” strategy to build their portfolios because it takes emotion out of the process and creates discipline.

• Occasionally, the portfolio may be rebalanced so that successful investments do not become too heavily weighted in the portfolio.
Generally, it is **not considered a passive or index strategy** if investors do any of the following:

- Actively trade individual securities
- Actively trade index products
- Time the market by switching between cash and/or other investments
Types of Investments

**Mutual funds**
- Typically available for many indices or actively managed strategies
- An investor might want to purchase
- Mutual funds trade daily at the close of business and typically settle the following day

**Exchange traded funds (ETFs)**
- Typically managed as passive strategies
- Have a unique structure that often further reduces the tax burden associated with interest, dividends and capital gains on investors
- Taxes can reduce the return available to taxable investors, creating an additional hurdle for active managers in generating excess returns
- ETFs trade intra-day and settle, like a stock, three days later

**Individually-managed portfolios** of securities are available to investors who prefer to own stocks, bonds or other assets directly or who have a special need.
Benefits of Passive Investing

**Passive investment strategies**

- Typically provide a **substantial cost advantage** over active investment strategies
  - *Compared to active management fees and transaction costs that create a higher hurdle for managers to overcome (in their effort to outperform the designated benchmark)*

- Passive investment strategies are often more **tax efficient** than active strategies as a result of their low turnover

- Passive strategies are relatively **easy to understand and manage** and are not dependent on a star investment manager or research team to execute

*FINANCIALLY PUZZLED? ASK BSAS*
Benefits of Passive Investing

Selecting an active manager who can outperform a designated benchmark after management fees, expenses and taxes is challenging. It’s important to note that performance can vary greatly between the best and worst managers in any given asset class – even within “efficient” asset classes such as large cap domestic equity:

<table>
<thead>
<tr>
<th>Trailing</th>
<th>1 Year</th>
<th>3 Years</th>
<th>5 Years</th>
<th>10 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>5th percentile</td>
<td>28.2</td>
<td>16.2</td>
<td>23.5</td>
<td>9.1</td>
</tr>
<tr>
<td>1st quartile</td>
<td>23.9</td>
<td>14.6</td>
<td>20.9</td>
<td>7.7</td>
</tr>
<tr>
<td>Median</td>
<td>22.0</td>
<td>13.3</td>
<td>19.6</td>
<td>6.9</td>
</tr>
<tr>
<td>3rd quartile</td>
<td>20.2</td>
<td>11.9</td>
<td>18.4</td>
<td>6.2</td>
</tr>
<tr>
<td>95th percentile</td>
<td>16.2</td>
<td>9.7</td>
<td>16.6</td>
<td>4.9</td>
</tr>
</tbody>
</table>

*Source: Performance is for large cap mutual funds through March 31, 2014. Performance greater than one year is annualized.*
US Large Cap Equity through March 31, 2014

<table>
<thead>
<tr>
<th></th>
<th>1 Year</th>
<th>2 Years</th>
<th>3 Years</th>
<th>4 Years</th>
<th>5 Years</th>
<th>7 Years</th>
<th>10 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500 Index</td>
<td>21.9</td>
<td>(54)</td>
<td>17.8</td>
<td>(35)</td>
<td>14.7</td>
<td>(24)</td>
<td>14.9</td>
</tr>
<tr>
<td>9th Percentile</td>
<td>28.2</td>
<td>20.4</td>
<td>16.2</td>
<td>16.4</td>
<td>23.5</td>
<td>8.9</td>
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<td>15.0</td>
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<td>4.8</td>
<td>6.2</td>
</tr>
<tr>
<td>95th Percentile</td>
<td>16.2</td>
<td>12.5</td>
<td>9.7</td>
<td>10.6</td>
<td>16.6</td>
<td>2.8</td>
<td>4.9</td>
</tr>
<tr>
<td>Population</td>
<td>2,138</td>
<td>1,976</td>
<td>1,872</td>
<td>1,761</td>
<td>1,669</td>
<td>1,457</td>
<td>1,145</td>
</tr>
</tbody>
</table>

Source: Investment Metrics

Notice that the S&P 500 Index (the + in each box) is in the top half of managers for all periods except one year and is 35th percentile after 10 years.
Benefits of Active Investing

Active managers often seek to **generate a return in excess of the index** and – depending on their investment approach – may incur lower risk in doing so (whereas passive or indexed investing strives to replicate the returns of a designated index).

Active managers may **avoid less attractive, slow growing companies** and provide greater exposure to companies with superior valuations or growth potential. Passive investing is “valuation agnostic” – the index buys the security regardless of valuation.

Depending on underlying index and its construction, passive investment can have unintended consequences including **concentration in economic sectors** or industries (e.g., NASDAQ Index is heavily weighted to Apple Inc. and technology stocks).
Benefits of Active Investing Cont.

- Some asset classes or market segments better lend themselves to active or passive investment
  - Active managers often have an edge in less efficient markets, such as smaller or international company stock investing.

- Active management may also provide a greater degree of flexibility to accommodate or complement existing investments.
  - For example, active strategies can be appropriate for taxable portfolios where there are low cost basis holdings that need to be managed. The manager can customize the strategy to meet the client’s needs.
Benefits of Diversification

Definition:
Spreading your investments across different asset classes (i.e., stocks, bonds, cash)

Why Diversify?
It lowers the severity of up/down movements in your portfolio (also known as volatility)
## Benefits of Diversification

<table>
<thead>
<tr>
<th>Historical Risk/Return (1926 – 2013)</th>
<th>20% Stocks / 80% Bonds</th>
<th>50% Stocks / 50% Bonds</th>
<th>80% Stocks / 20% Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Annual Return</td>
<td>6.7%</td>
<td>8.3%</td>
<td>9.6%</td>
</tr>
<tr>
<td>Best year</td>
<td>29.8% (1982)</td>
<td>32.3% (1933)</td>
<td>45.4% (1933)</td>
</tr>
<tr>
<td>Worst year</td>
<td>-10.1% (1931)</td>
<td>-22.5% (1931)</td>
<td>-34.9% (1931)</td>
</tr>
<tr>
<td>Years with a loss</td>
<td>12 of 88</td>
<td>17 of 88</td>
<td>23 of 88</td>
</tr>
</tbody>
</table>

Source: The Vanguard Group, Inc.
Note from Vanguard Regarding Data:

When determining which index to use and for what period, we selected the index that we deemed to be a fair representation of the characteristics of the referenced market, given the information currently available. For U.S. stock market returns, we use the Standard & Poor's 90 from 1926 through March 3, 1957, the Standard & Poor's 500 Index from March 4, 1957 through 1974, the Wilshire 5000 Index from 1975 through April 22, 2005, the MSCI US Broad Market Index from April 23, 2005 through June 2, 2013, and the CRSP US Total Market Index thereafter.

For U.S. bond market returns, we use the Standard & Poor's High Grade Corporate Index from 1926 through 1968, the Citigroup High Grade Index from 1969 through 1972, the Lehman Brothers U.S. Long Credit AA Index from 1973 through 1975, the Barclays U.S. Aggregate Bond Index from 1976 through 2009, and the Spliced Barclays U.S. Aggregate Float Adjusted Bond Index thereafter.

For U.S. short-term reserve returns, we used the Ibbotson 1-Month Treasury Bill Index from 1926 through 1977 and the Citigroup 3-Month Treasury Bill Index thereafter.
Types of Account

Pre-Tax
• A non-taxable or deferred tax account will have more flexibility in handling gain/loss

Taxable
• A taxable account might be better allocated to buy and hold strategy to avoid taxes

Risk Ability vs Tolerance

• Ability to take risk depends on age/income and other factors

• Willingness to take risk does not always match the ability; ability should always be considered
Making the Choice

Your Age/Financial Knowledge/Financial Health/Liquidity Needs

<table>
<thead>
<tr>
<th>Life phase</th>
<th>Ability to self manage</th>
<th>Ability to decide</th>
<th>For Education, Home Purchase or Retirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Age</td>
<td>Financial Knowledge</td>
<td>Financial Health Center</td>
<td>Liquidity Needs</td>
</tr>
</tbody>
</table>

Your decision on whether to use index or active strategies will depend upon your individual situation and resources.
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