BEYOND BETTER DAYS FOR ACTIVE MANAGEMENT

"How Active Strategies Can Potentially Deliver Over a Full Market Cycle"

Have your clients asked the big question yet: **Is this the active management renaissance we've been waiting for?**

With the major market averages breaking their nine-quarter winning streak ending the first quarter 2018, it's renewed an old debate. This update will help you prepare for that coming conversation.

Much has been made about the death of active strategies. The reality is: active investing has evolved. Beating or timing the market was always a race to the bottom. Today's financial advisors are using active to add incremental return while historically reducing downside risk.

However, many advisors don't have a sell discipline in place to protect against market drawdowns – after a decade of record market growth, why would they. For investors and advisors who only recently began investing in the past 10 years, they have never experienced a major market correction resulting in a bear market. These necessary but unpleasant conversations have largely been swept under the rug.

HOW WE ARRIVED HERE

The stock market has steadily marched higher in a virtual straight line from the lows in March 2009. We seemingly touched new highs every day in a fixed path to ever-increasing peaks, resulting in a decade where investors had good reason to question holding anything but simple indexes, such as the S&P 500. On the way up, the tech rally made even the most passive investors look like investing geniuses.

However, many investors and financial advisors have forgotten, or perhaps never experienced, what a full market cycle looks like.

Low-cost index-tracking funds weighted by market cap have benefited from a self-reinforcing pattern; as tech stocks outperformed, they became a larger portion of the total fund, further making large indexes look great. That same dynamic can make the downsides more severe, however.

This should come as no surprise. Large concentrations in certain sectors have pushed bull markets along before, only to result in an even steeper crash.

Lengthy bull markets are prone to over-concentration in glam sectors. There were the Nifty Fifty stocks in the 1960s, oils in 1981, tech stocks in 1999, and banks in 2005.

HERD BEHAVIOR

Here we are again, at the end of April 2018, technology stocks accounted for more than 25% of the S&P 500, with five stocks making up 14.4%. That's more than some entire sectors, like industrials.

Increasingly, investors are worried this most recent rally has the makings of another "melt-up" – a sudden, market pop driven by a stampede of investors who've previously missed out on gains.

In response, market strategists report the market's herd behavior is driven by strong fundamentals. Yes, but just as any other melt-up, there's always a good story. Maybe this is a "this time is different" moment. But markets have been here before – these things don't unwind smoothly.

Perhaps many investors can't deal with the idea that there's a bull market somewhere, and they're not fully benefiting.

HISTORY DOES NOT REPEAT ITSELF, BUT IT OFTEN RHYMES

If history is a guide, stocks will remain volatile this year. According to DataTrek Research, the S&P 500 moved more than 1% in either direction on 23 days in the first quarter 2018; that's nearly triple the number of such days for all of 2017.

In the 9 other years since 1958 in which the 1st quarter notched 20 to 25 days of a 1% move, the remaining 3 quarters all had an above-average number of such days. There was a mean total of 86 1%-days annually, with the most volatile months historically coming in April, June, August, and October.

The Upshot: Average price performance during those nine years was 6.1% for the year, and the average total return, 9.6%. There's good reason to believe this rally still has legs, but it's shaping up to be temperamental.

23 DAYS

Number of days the S&P 500 moved more than 1% in either direction during **1Q2018**, according to DataTrek Research.

9 YEARS

# of years since 1958 where the 1st quarter notched 20-25 days of a 1% move, and the remaining 3 quarters all had an above-average # of turbulent days.

3 TIMES

That's nearly triple the number of such days for **all of 2017**.

THE CASE FOR ACTIVE MANAGEMENT

After years of gains in stocks and bonds, 2018's shaky 1st quarter is reminding investment professionals the business cycle, like the market cycle, isn't dead. With markets forecasted to remain bumpy, it's going to get harder to deliver steady returns with pure momentum-focused asset allocations.

As the rally in stocks grows longer, it gets ever harder for investors to step away from the low-cost, passive oriented strategies that have pushed equities to market highs. But with greater levels of volatility expected ahead – higher dispersion of returns and lower correlations – we believe markets look to favor adding active strategies.

Passive strategies, while favored of late, haven't always outperformed. Before the most recent rally, buoyed by unprecedented levels of government monetary and fiscal accommodations, active strategies outperformed passive in 9 out of 10 years during the 2000-2009 period. The reality is: investment strategies, whether passive or active, come and go out of style because they are cyclical.

The two clearest reasons for adding the potential benefits of active management are starting to come into focus: active strategies attempt to proactively manage risk, and trending markets create inefficiencies.

Coupled with the cyclical nature of economic cycles, these factors are creating opportunities for active managers to deliver excess returns while potentially limiting downside capture – essential elements to superior risk-adjusted performance.

10 RECESSIONS

Of the last 13 Fed tightening cycles since 1950, 10 have ended in recession. The Fed is again raising rates. Invariably, they tighten until something breaks, leaving financial professionals to pick up the pieces.

DESPITE HIGHS, INVESTORS WANT HELP

Despite a record bull run, according to Gallup surveys, a majority of Americans have consistently sought financial advice. This against the market touching regular new highs. Imagine the demand for financial planning when things are not so rosy.

No doubt, cutting costs is easier than finding alpha. Unfortunately, investors overwhelming confuse low-cost strategies with greater value.

Evidence suggests some investors may not fully understand the key differences between active and passive investment strategies. A survey by the Natixis Center for Investor Insight points out only 58% of investors surveyed thought index funds were cheaper than active strategies.

Even more worrisome: nearly 6 in 10 investors (62%) believe index funds to be less risky than actively managed strategies and believe that index funds help to minimize portfolio losses (63%).

Of all the ways an investment professional can add value, perhaps behavioral coaching – or more generally, relationship management – is the most rewarding for advisors and their clients.

This boils down to having a distinct ability to help clients understand what strategies they own and why they own them. For over a decade, a trending market has made this challenging element relatively easy.

This won't come so naturally if bumpier markets are on the horizon. Undoubtedly, the next deep correction will test even the best investor's mettle. The S&P 500 lost nearly 57% in the 2007-09 bear market. Indexed strategies didn't intervene to lessen the decline – they were never designed to.

REFRAMING THE "ACTIVE" VALUE PROPOSITION

No strategy is truly "passive" anymore – allocating to indexes will always require a discretionary decision on some level.

This responsibility has been passed to financial advisors. When markets shift, advisors are expected to execute allocation and exposure changes to keep client portfolios in line with numerous financial goals and distinct risk tolerances.

Through tactical adjustments, not market timing, active wealth managers can rapidly adjust an investment strategy for changing market conditions – freeing advisors to focus on high-value relationship management services.

By streamlining certain aspects of their planning process, advisors can redefine their value propositions away from time-consuming portfolio management activities.

As more investors come to remember the devastating impacts of a full market cycle, advisors are reframing the active vs. passive debate from "Are better days ahead for active management?" to "There are better ways to actively manage."

5 POTENTIAL ADVANTAGES OF ACTIVE MANAGEMENT

- ✓ Downside risk management
- ✓ Flexibility in asset allocation
- ✓ Take advantage of market inefficiencies
- ✓ Potential for above-market returns
- ✓ Service in all markets

"What happens when the markets turn down? If investing in passive index funds, you can't call up a portfolio manager and ask what their strategies are to attempt to limit their downside exposure or potentialy take advantage of the volatility. That's one of the unsung virtues of active management."

INTERESTED IN MORE INFORMATION?

For questions or to speak with a relationship manager about adding any of the 10 Buffalo Funds to your portfolio, contact:

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ABOUT THE BUFFALO FUNDS

The Buffalo Funds are a family of 10 actively-managed mutual funds offering a variety of domestic equity, international equity, and income-generating investment strategies. Located in Mission, Kansas (a suburb of Kansas City), employee-owned Kornitzer Capital Management, Inc. (KCM) has been the exclusive investment advisor to the Funds since inception in 1994.

At KCM, we believe that patient investing backed by solid, intelligent research is the best way to achieve potential long-term financial rewards. Disciplined investment decisions are made using a distinct, time-tested investment approach guided by trend analysis, rigorous fundamental company research, and strict security valuation parameters.

Our fund family is characterized by a long-term growth investment strategy and a team-based, idea-sharing management style. "Trends and Patience" is our mantra, and our great strength.