THE ACTIVE INVESTOR'S FIELD GUIDE

VIRTUS INVESTMENT PARTNERS

THE PRO-ACTIVE INVESTOR

Pro-active investing never goes out of style. Recent financial innovations have created both a wealth of opportunity and an avalanche of complexity for investors. It has never been easier—or more overwhelming—to take investment risk. With complexity comes the need for simplification. How do investors cut through the noise and take control of their portfolios? This guide offers perspective on the so-called active and passive investing debate, with an eye toward prioritizing diversification, risk management, and investor behavior.

1 THERE IS NO SUCH THING AS "PASSIVE" INVESTING.

All investment decisions are "active," even choosing an index fund. The cornerstone decisions for any investor are picking the risks you want and avoiding those you don't—regardless of their wrappers. "Active" and "passive" are not asset classes or styles of investing.

2 DISTINGUISH "WHAT AM I BUYING?" FROM "WHAT AM I PAYING?"

We typically insist on paying the lower fee between two identical products. But in investment selection, our top priority is setting expectations for how an investment complements an overall portfolio. Unfortunately, some investors believe that indexing is "less risky." That's wrong and suggests that knowing what you own is easier said than done.

3 PLAN, DON'T PREDICT.

Many investors lack a well-considered financial plan. Instead, they try to predict and beat the market, which has little to do with real world objectives. Investors need clarity—not certainty—through a framework that maximizes the chances of meeting life's goals. This means prioritizing risk management over return chasing.

4 BEHAVIOR DRIVES BETTER OUTCOMES.

Avoiding bad decisions at the wrong times has paramount importance in achieving good long-term investment outcomes. The problem isn't that we're "irrational," but that we're *human*. Those who take psychology as seriously as finance are more likely to reach their goals.

WHEN THE BENCHMARK IS THE RISK

Pro-active investors deliberately choose the market risks they want in order to meet defined portfolio objectives. And, they seek to sidestep those they don't.

A fundamental mistake some investors make is to believe that buying "the benchmark" through an index fund is a way to take less risk. That mistake can be aggravated during prolonged bull markets. The perceived "simplicity" of an index fund in no way mitigates the risk of its underlying holdings. In fact, history has shown time and again that the benchmark itself can be the risk.

Three reasons the benchmark can be the risk

1

HIGH VALUATIONS

An index can hold overvalued securities.

2

WEAK FUNDAMENTALS

An index can own unattractive securities.

3

CONCENTRATED BETS

An index can take big bets on narrow market segments.

History gives us plenty of cautionary tales

LARGE-CAP STOCKS

A subset of sectors can dominate an index. In the late 1990s, for example, the S&P 500® was heavily tilted toward extremely expensive technology stocks.

SMALL-CAP STOCKS

Some small-cap indexes, such as the Russell 2000®, have substantial exposure to companies with no earnings.

GLOBAL STOCKS

Major international indexes, such as the MSCI EAFE®, can fail to discriminate between higher- and lower-quality companies.

GOVERNMENT BONDS

In recent years, the interest rate risk of certain government issues has risen sharply.

REAL ESTATE SECURITIES

"Diversified" exposure to the real estate sector has, at times, been one large concentrated bet on highly correlated securities.

CREATING DISTINCTION IN PRO-ACTIVE MANAGEMENT

The active fund management business has changed dramatically in recent years. With product proliferation in passive index and ETF offerings, the bar has been raised for those wanting to earn the attention of financial professionals and investors. Even so, the reasons for hiring investment experts have never changed. Going back decades, managers have always had to create distinction. There are three metrics for doing so:

1 HIGHER

Description:

An active manager can offer the **potential to deliver returns in excess of a benchmark.** There is, of course, never a guarantee that will happen in either the long or short run. But, we want to hire experts who have a fighting chance of doing so.

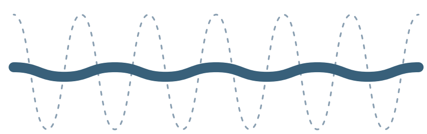
Metric:

ACTIVE SHARE

A measure of how distinct a fund's portfolio is from its benchmark.

How it works: Based on a simple calculation, the closer the figure is to 1.0, the less in common a fund has with its benchmark. Funds with concentrated portfolios will likely have a higher active share. The chance of becoming a "me too" product shrinks as concentration increases. A high active share does not guarantee outperformance.

2 SMOOTHER



Description:

One of the most important elements of successful investing is **staying put during volatile markets.** All else equal, managers who can provide a smoother ride offer investors a "behavioral hedge"—a means of avoiding short-term, emotional trading.

Metric:

MAXIMUM DRAWDOWN

A measure of the biggest peak-to-trough losses in a fund's performance history.

How it works: While "volatility" is often used to gauge a fund's stability, that statistic's usage is often abstract. As volatility is very much an emotional experience, max drawdown can help set expectations for the question of "How bad can it get?"

3 DIFFERENT

Description:

The crux of building a truly diversified portfolio is the ability to assemble **pieces that don't move in lock-step with each other.** Finding strategies that "zig" while others "zag" can be a key to investment success.

Metric:

CORRELATION

A measure of how much a fund's returns match other funds' returns.

How it works: This is a commonly available statistic in the investment world. The closer to 1.0, the higher the correlation and the less useful to a portfolio.

THREE PILLARS OF PRO-ACTIVE INVESTING

1

DIVERSIFICATION

Predicting top performers with consistency is impossible. Thus, even though diversification does not ensure a profit or protect from losses, it remains the cornerstone principle behind any sound portfolio. Exposure to diverse market risks is a must. We need to spread our bets because the future is unknowable.

2

RISK MANAGEMENT

Protecting against losses should be a primary concern for investors. That means asking hard questions about whether an investment's potential returns are justified by its anticipated risks. It also means that not reaching our personal financial goals is a more important risk than beating an arbitrary benchmark.

3

BEHAVIOR

Ultimately, our long-term investment results are driven by the good and bad decisions we make—not by picking the right stock, bond, or fund. Because humans are hardwired with many emotional and cognitive biases, we sometimes make regrettable choices. A focus on calm, patient decision making in the context of a well-designed financial plan may keep investors in good stead over the long haul.

✓ **Be pro-active to help drive better outcomes. To find out more, visit virtus.com or call 800-243-4361.**

The **S&P 500® Index** is a free-float market-capitalization weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **Russell 2000® Index** is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The **MSCI EAFE® Index (net)** is a free-float-adjusted market-capitalization weighted index that measures developed foreign market equity performance, excluding the U.S. and Canada. The index is calculated on a total return basis with net dividends reinvested. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

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