

Active or Passive? Yes, Please.

At RiverFront we seek to “filter” news through a fundamental lens and identify where markets have overreacted, or where the news has changed the game for a given market or investment. While the nuts and bolts of this kind of work do not garner the same level of excitement as the latest headline, it is the bedrock of our selection process. Stock selection can *passively* follow an index or *actively* deviate from it in an effort to generate higher returns and/or seek to reduce risk. While we believe asset allocation must be active, we employ both active and passive stock selection in our portfolios. (See Nov 2, 2015 Weekly View, “By Definition, Asset Allocation is Active” for more information.)

COMMON WAYS TO THINK ABOUT STOCK SELECTION: THREE APPROACHES

1. **Passive:** Buy all the stocks in an index where the weights are based on market capitalization.
2. **Smart Beta:** A systematic or rules-based way to deviate from traditional passive indexes using other factors to determine the weighting of individual stocks. Value and growth are factors that have been around for years. Recently, factors such as earnings, dividends and volatility have been used to build indexes. These indexes will tend to have biases which will often determine an index’s investment behavior – for example, low volatility ETFs will tend to lean heavily on defensive sectors.
3. **Active Management:** Smart beta and active management are similar in that both are driven by the belief that opportunities exist for investors to outperform a passive index through diligent portfolio construction. Active management approaches typically involve several of the following elements:
 - a. Subjective assessments of information that are not purely “by the numbers”;
 - b. Combining multiple signals / inputs into a unified strategy; and,
 - c. A robust risk management process to limit portfolio biases.

FACTORS USED IN RIVERFRONT’S EQUITY SELECTION

RiverFront’s equity selection process is rooted in a culture of diligent research. Whether we begin from the top down or the bottom up, our equity selection process begins by understanding broad investment themes. Our goal in our research is to identify, where possible, themes that can be applied to a set of stocks to differentiate winners from losers. Where we have rich history and reliable data, we have found some simple combinations of financial information that tend to differentiate winners from losers, in our view. While the specifics of our models are proprietary, our research identifies four broad themes that can be applied slightly differently in different segments of the equity market:

1. **Quality** – Quality measures focus on a company’s ability to generate profits sustainably. Whereas value and sentiment variables (described below) use market pricing as a key input, quality variables are defined by financial statements and focus on the ability of a company to



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generate persistent cash-flows over time. By looking at both growth patterns and quality patterns in financial statements, we are able to differentiate firms that are better positioned for future growth and analyze the associated excess stock returns. Cash flow/ earnings ratios, returns on equity, EBIT/assets, and profit-adjusted-for-accounting-accruals are all examples of quality measures used in our work.

- 2. Valuation** – There are numerous definitions of value, all of which attempt to capture when a company is cheap relative to a measure of earnings or profit at a given point in time. Valuation is a hybrid between a quality and sentiment variable in that it attempts to measure how the market “feels” about an accounting unit. For example, investing in stocks with a low price-to-earnings ratio implicitly means finding companies that have earnings, but for whatever reason, investors have soured on and are unwilling to pay a high price at the moment. The implicit assumption of value investing is that either the earnings (or whatever measure of profit is used) will improve, or investors’ view of future earnings will improve. This is why news matters to a value investor, and why they will pay more for current earnings, expecting better growth in the future. Price-to-earnings ratios, price-to-cash flow ratios, and price-to-book ratios are all examples of valuation ratios used in our research.
- 3. Technical** – Sentiment and momentum-based measures attempt to tease out what the market is telling you about a stock, and they tend to use pricing and volume data or analyst opinions as primary ingredients. There are two broad types of indicators in this family. Momentum indicators are based on the idea that there is natural herding in markets, and that this herding behavior creates a natural momentum in stocks. Analyst revision ratios and relative price momentum are examples of momentum measures. Sentiment measures attempt to tease out when markets have overreacted to recent information. RiverFront’s relative strength index (RSI) is a great example of a sentiment indicator.
- 4. Risk** – A recurring theme in our research is the sheer unpredictability implicit in the market. Any historical work that we have done has consistently reinforced to us the importance of measuring and managing unintended biases that might arise in pursuing combinations of strategies listed above.

COMBINING ALL THREE APPROACHES

RiverFront is an active manager, both in asset allocation (the big themes of our portfolio) and security selection (the actual securities we buy to fill the portfolio). That said, when putting a portfolio together, we actually apply all three approaches at different times. We believe that successful portfolio management involves blending the three approaches into a unified framework.

- 1. Passive Approach** – There are times when our macro research might lead us to a particular asset class where we see an opportunity, but we do not seek to choose between companies. MLPs are a good example of where we purchased a passive index to implement a view on a sector.
- 2. Smart Beta or Thematic Approach** – A lot of our research into equity markets involves finding themes that can be brought together into a portfolio. One of the great things about a smart beta indexes is that, even if they are concentrated in one theme and have biases, they still spread risks out across a number of individual companies. We can therefore combine a basket of these together to get a desirable mix of themes with an acceptable amount of risks/biases.
- 3. Active Management** – Active management is pervasive in our portfolios. At the asset allocation level, we often differ meaningfully from passive benchmarks due to both opportunity and risk. At the selection level, we control the magnitude of any deviation from a passive benchmark, but we seek to add value through our selection process.

Important Disclosure Information

Past results are no guarantee of future results and no representation is made that a client will or is likely to achieve positive returns, avoid losses, or experience returns similar to those shown or experienced in the past.

It is not possible to invest directly in an index.

Dividends are not guaranteed and are subject to change or elimination.

RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation.

Master limited partnerships (MLP) investing includes risks such as equity- and commodity-like volatility. Also, distribution payouts sometimes include the return of principal and, in these instances, references to these payouts as "dividends" or "yields" may be inaccurate and may overstate the profitability/success of the MLP. Additionally, there are potentially complex and adverse tax consequences associated with investing in MLPs. This is largely dependent on how the MLPs are structured and the vehicle used to invest in the MLPs. It is strongly recommended that an investor consider and understand these characteristics of MLPs and consult with a financial and tax professional prior to investment.

Diversification does not ensure a profit or protect against a loss.

International (more detailed)

Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.

Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.

Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.

Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Actively managed funds are subject to management risk. In managing a fund's investment portfolio, the sub-advisor will apply investment techniques and risk analysis that may not have the desired result.

ETFs are subject to substantially the same risks as those associated with the direct ownership of the underlying securities owned by the ETF. Additionally, the value of the investment will fluctuate in response to the performance of the underlying index or securities. ETFs typically charge and/or incur fees in addition to those fees charged by RiverFront. Therefore, investments in ETFs will result in the layering of expenses.

RiverFront uses earnings consistency and balance sheet strength to define quality.

The RSI compares the magnitude of recent gains to recent losses in an attempt to determine overbought and oversold conditions of an asset.

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Investments in international and emerging markets securities and American Depository Receipts (ADRs) are subject to certain inherent risks including difficulty predicting international trade patterns, currency fluctuations and the possibility of imposition of exchange controls, foreign taxes and regulations, lack of uniform accounting, and the potential for illiquid markets and political or economic instability. These risks are more pronounced in emerging market countries.

Riverfront regularly holds exchange traded funds (ETFs) in their portfolios. ETFs are subject to the same risks as their underlying securities, trade on an exchange throughout the day and redemptions may be limited and, if purchased outside of Riverfront’s fee-based advisory portfolios, brokerage commissions are charged on each trade.

Further, ETFs have their own operating expenses, which are reflected in the market value and net asset value of the ETF shares and therefore indirectly borne by ETF shareholders and Riverfront Portfolio accounts. Thus, because Portfolio accounts invest in ETFs those accounts bear two layers of fees, the advisory fee charged by Riverfront and the management fee and other operating expenses paid by the ETFs.

Investors should consider the investment objectives, risks, charges and expenses of the fund carefully before investing. This and other information about the fund can be found in the prospectus or summary prospectus. A prospectus or summary prospectus may be obtained from your financial advisor and should be read carefully before investing.