Catalyst Funds
Intelligent Alternatives

# DYNAMIC EQUITY EXPOSURE

## Adapting To Changing Market Environments

### KEY TAKEAWAYS

- Last July, we warned investors that the FAANG stocks could be hit significantly harder than average in the event of market turmoil given their allocations to passive strategies. This materialized between June and December.
- Despite some market turmoil in 2018, fund assets in passive strategies increased from 46.15% to 48.15%, further growing the potential passive investing bubble.
- Historically, investing in unconstrained, high-active share funds has resulted in outperformance relative to benchmarks in a variety of different market environments.

**We believe that 4Q 2018 provided insight as to what might happen to investors exposed to a potential passive investing bubble in the event of more prolonged market turmoil. The S&P 500 TR Index declined by -13.52%, while the FAANG stocks dropped by an average of -23.41%. In fact, some of the top contributing stocks as of June 30th ended the year as some of the bottom contributing stocks.**

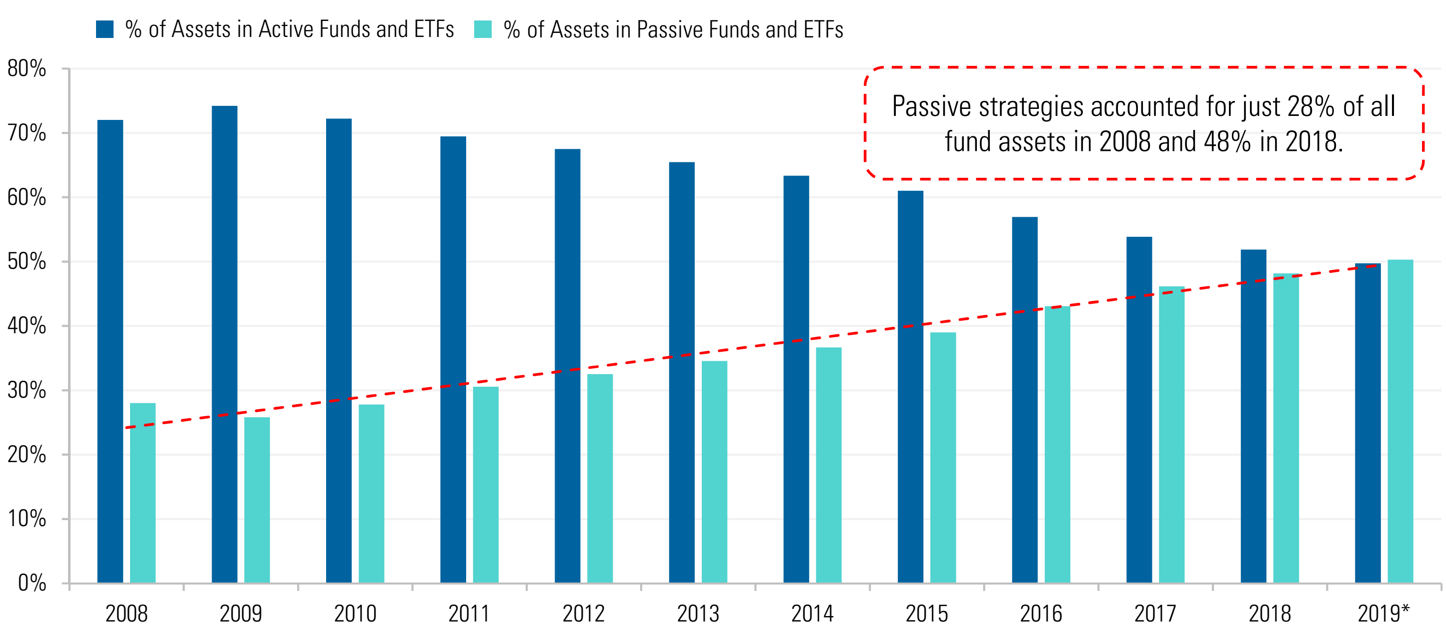
In our July 2018 piece, "The Passive Investing Bubble," we provided evidence to suggest the potential formation of a passive investing bubble. The thesis was as investments into capitalization-weighted indexes increase, the largest stocks that performed the best tended to get a disproportionately large allocation, creating a self-reinforcing cycle of these stocks performing well. In the event of market turmoil, investors with heavy exposure to certain stocks may experience significant losses. We cautioned that investors should be concerned about exposure to FAANG stocks given their allocations in passive strategies and their potential downside risk.

In the face of market volatility, it is important to be dynamic and adaptable to ever-changing market conditions. Being constrained to certain sectors and Morningstar categories limits the opportunity for outperformance. We believe that the recent return of market volatility leaves a lot of space for active managers to add value, particularly if market conditions deteriorate and assets flee passive strategies.

**Over the past decade, assets have shifted from active to passive funds, with 2019 expected to be the tipping point where most assets are in passive strategies.**

**A Potential Passive Investing Bubble: Percentage of Assets in Active and Passive Funds**

Chart represents the percentage of assets in active and passive mutual funds and ETFs since 2008. 2018 percentage is as of 11/30/2018. Source: Morningstar Inc. *2019 projections are based on annual average growth rate from 2008 to 2018.

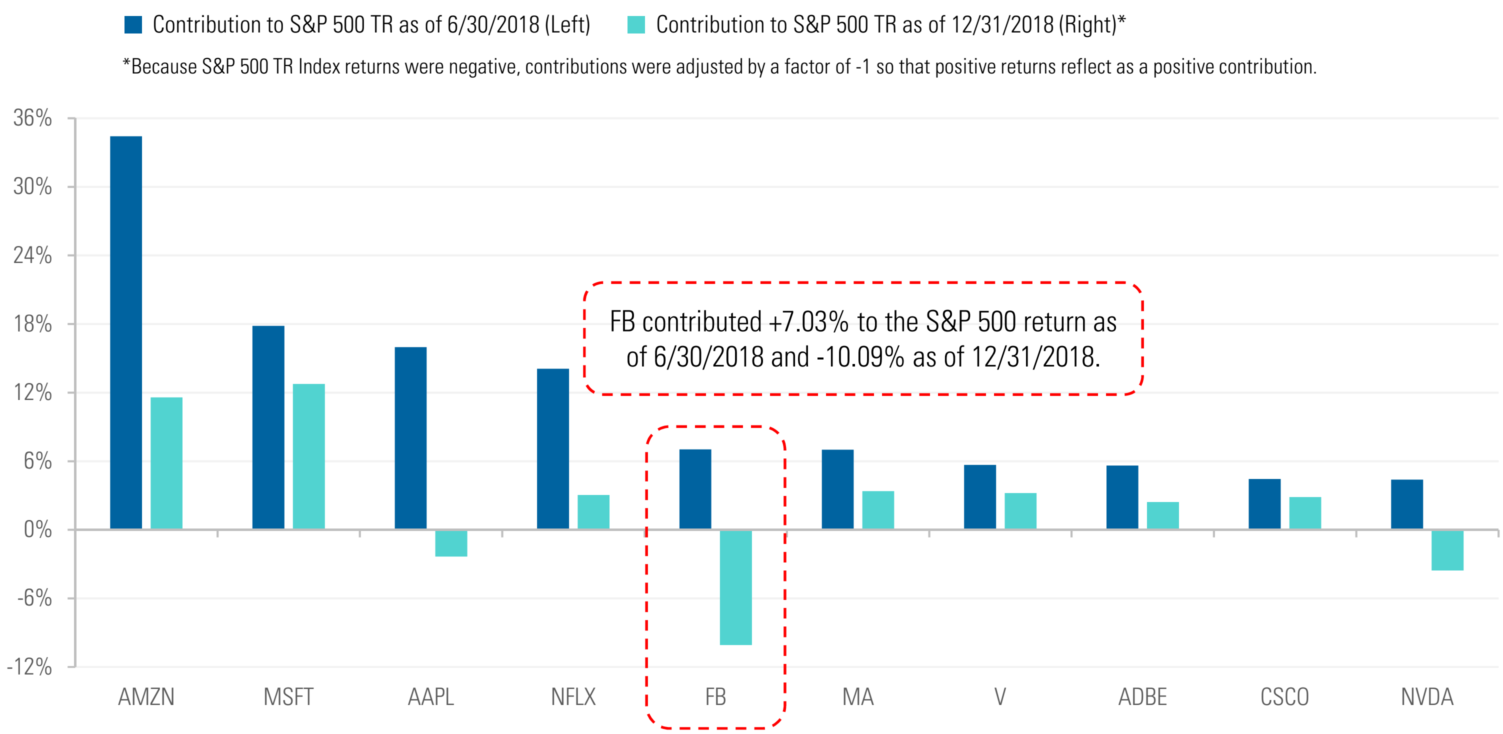


# The Case for a Dynamic Equity Strategy

As market volatility returned, 2018 highlighted the potential benefit to investors of holding a dynamic equity strategy, one that is not constrained to index exposure or to a certain style box. As of 6/30/2018, 10 stocks were contributing 116% to the S&P 500 TR Index return, while the remaining S&P 500 stocks were contributing -16%. By 12/31/2018, the top 10 contributing stocks accounted for just 53% of the S&P 500 TR Index return. When looking at the top 10 contributing stocks as of 6/30/2018, the average return declined from +30.85% during the first half of the year to -13.86% during the second half of the year. When looking at categories, small growth was the top performing category as of 7/31/2018 with a +12% return; that dropped to the third best performing category at the end of the year with a -6% return.

### 2H 2018 Market Turmoil Disrupts June 30th Top 10 Stocks by Contribution to S&P 500 TR Index Returns

YTD S&P 500 TR Index contributions as of 6/30/2018 and 12/31/2018 for Amazon Inc. (AMZN), Microsoft Corp. (MSFT), Apple Inc. (AAPL), Netflix Inc. (NFLX), Facebook Inc. (FB), MasterCard Inc. (MA), Visa Inc. (V), Adobe Systems Inc. (ADBE), Cisco Systems Inc. (CSCO), and NVIDIA Corp. (NVDA). Data Source: Bloomberg LP.




### Only Two of the Top 10 Contributing Stocks as of 6/30/2018 Posted Positive Returns in 2H 2018

Data Source: Bloomberg LP

| Ticker | 1H Return (12/31/17-6/30/18) | 2H Return (6/30/18-12/31/18) | 2018 Return |
|---|---|---|---|
| AMZN | 45.35% | -11.64% | 28.43% |
| MSFT | 16.31% | 3.86% | 20.80% |
| AAPL | 10.25% | -14.19% | -5.39% |
| NFLX | 103.91% | -31.62% | 39.44% |
| FB | 10.12% | -32.54% | -25.71% |
| MA | 30.23% | -3.77% | 25.32% |
| V | 16.55% | -0.06% | 16.48% |
| ADBE | 39.13% | -7.21% | 29.10% |
| CSCO | 14.09% | 2.17% | 16.57% |
| NVDA | 22.58% | -43.56% | -30.82% |
| Average | 30.85% | -13.86% | 11.42% |

**Past performance is no guarantee of future results.** The referenced indices and categories are shown for general market comparisons and are not meant to represent any fund. Investors cannot directly invest in an index; unmanaged index returns do not reflect any fees, expenses or sales charges.

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## The Potential Risks of Being Constrained to Categories: Morningstar Category Callan Chart Since 2000

Based on monthly return data from 2000 to December 2018 for Morningstar categories and S&P 500 TR Index. Analysis Source: Zephyr StyleADVISOR. Data Source: Morningstar Inc.

Large Value | Large Blend | Large Growth | Mid Value | Mid Blend | Mid Growth | Small Value | Small Blend | Small Growth | S&P 500 TR Index

| 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|
| SV 19% | SV 15% | SV -11% | SG 45% | SV 21% | MG 10% | LV 18% | MG 15% | SV -32% |
| MV 18% | SB 7% | MV -15% | SB 43% | SB 19% | MB 9% | SV 16% | LG 13% | SB -37% |
| SB 10% | MV 6% | MB -17% | SV 42% | MV 18% | MV 9% | MV 16% | SG 7% | MV -37% |
| LV 8% | MB -4% | SB -18% | MB 36% | MB 16% | SB 7% | S&P 16% | LB 6% | S&P -37% |
| MB 6% | LV -5% | LV -19% | MG 36% | MG 13% | LG 7% | SB 15% | S&P 5% | LV -37% |
| SG -4% | SG -10% | S&P -22% | MV 34% | LV 13% | SV 7% | LB 14% | MB 4% | LB -38% |
| MG -6% | S&P -12% | LB -22% | S&P 29% | SG 12% | SG 6% | MB 14% | LV 1% | MB -40% |
| LB -7% | LB -14% | MG -27% | LG 28% | S&P 11% | LB 6% | SG 11% | MV 1% | LG -41% |
| S&P -9% | MG -21% | LG -28% | LV 28% | LB 10% | LV 6% | MG 9% | SB -1% | SG -42% |
| LG -13% | LG -22% | SG -28% | LB 27% | LG 8% | S&P 5% | LG 7% | SV -6% | MG -44% |

As of 7/31/2018, SG was #1 for 2018 at +12%.

| 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|---|
| MG 39% | SG 27% | S&P 2% | MV 16% | SG 41% | S&P 14% | LG 4% | SV 26% | LG 28% | LG -2% |
| MB 37% | SV 26% | LV -1% | SV 16% | SB 38% | LB 11% | S&P 1% | SB 21% | MG 25% | S&P -4% |
| LG 35% | SB 26% | LB -1% | S&P 16% | SV 36% | LV 10% | MG -1% | MV 18% | S&P 22% | SG -6% |
| SG 35% | MG 25% | LG -3% | MB 16% | MV 35% | LG 10% | LB -1% | LV 15% | SG 22% | LB -6% |
| MV 34% | MB 23% | SG -4% | SB 15% | MG 35% | MV 9% | SG -3% | MB 14% | LB 20% | MG -7% |
| SB 32% | MV 22% | MV -4% | LG 15% | MB 34% | MB 8% | LV -4% | S&P 12% | LV 16% | LV -9% |
| SV 30% | LG 15% | MB -4% | LB 15% | LG 34% | MG 7% | MB -5% | SG 11% | MB 16% | MB -11% |
| LB 28% | S&P 15% | MG -4% | LV 15% | S&P 32% | SB 4% | MV -5% | LB 10% | MV 14% | SB -13% |
| S&P 26% | LB 14% | SB -4% | MG 14% | LB 31% | SV 3% | SB -5% | MG 6% | SB 12% | MV -13% |
| LV 24% | LV 14% | SV -4% | SG 13% | LV 31% | SG 3% | SV -7% | LG 3% | SV 9% | SV -15% |

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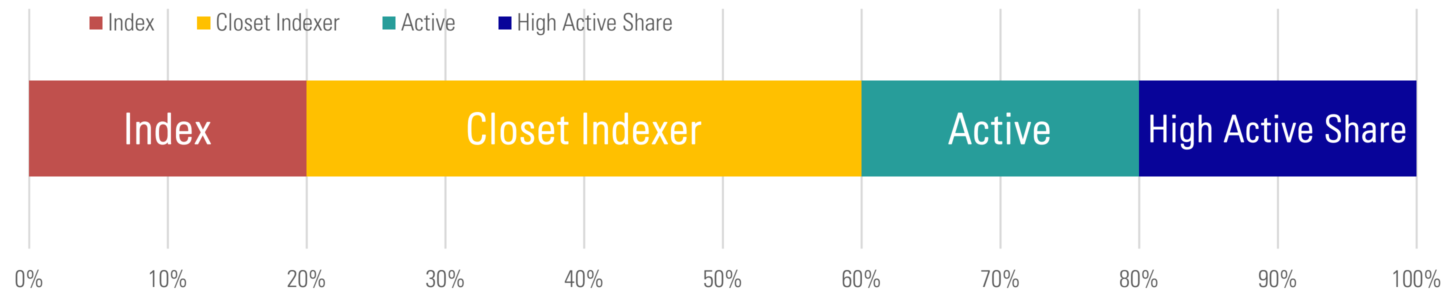
# Understanding Active Share

Active share measures the percentage of a portfolio's holdings that differ from its benchmark. A low active share is inherently problematic because it leaves a fund with limited potential to outperform its benchmark (i.e., a fund cannot outperform its benchmark if it looks like the benchmark). Investors should examine their active share exposure to ensure they are not paying active management fees for a strategy that simply shadows its benchmark, a practice known as closet indexing. An increasing percentage of mutual fund assets are in strategies with low active share, may be problematic because it potentially leads to underperformance.

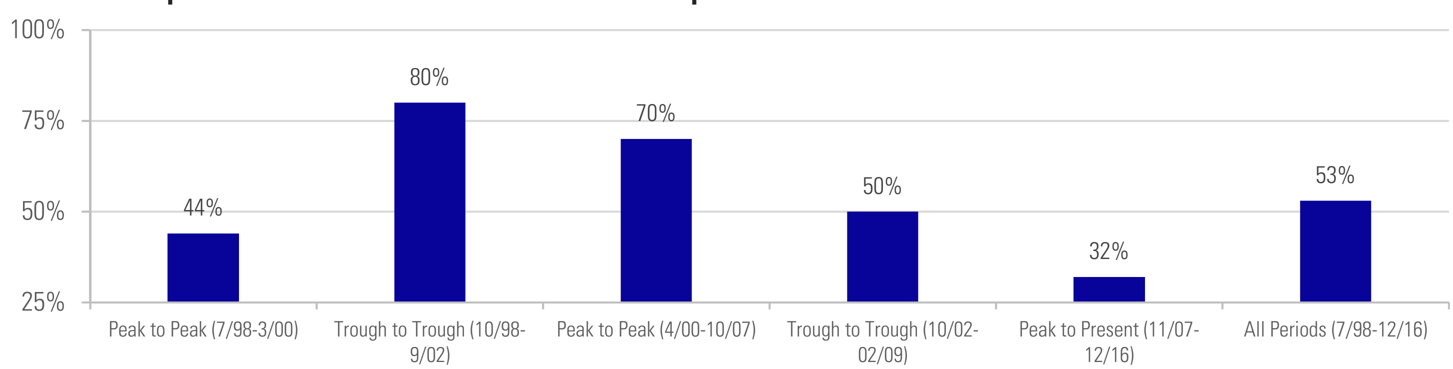
### The Active Share Spectrum

Spectrum breakdown of the four different categories of Active Share. "Index" funds represent an active share below 20%, "Closet Indexer" funds represent an active share between 20%-60%, "Active" funds represent an active share from 60% to 80% and "High Active Share" funds represent an active share above 80%.

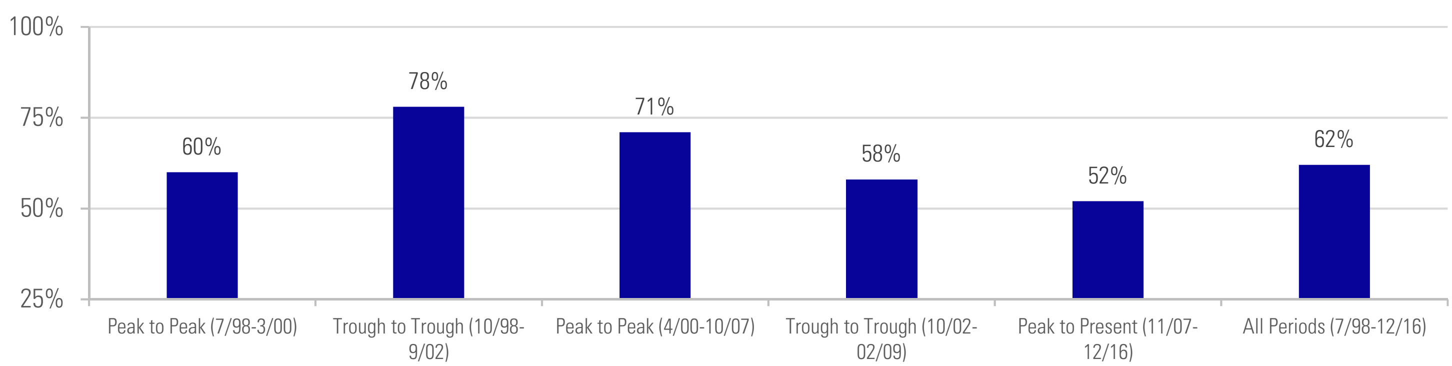



**Active share funds have a history of benchmark outperformance and less drawdown capture in a variety of different market cycles.**

### Active Share Outperformance: % of Active Share Funds That Outperformed Their Benchmarks




### Less Drawdown Capture: % of Active Share Funds That Captured Less Downside Than Their Benchmarks




Source: Wendler, Gary & Jonathan Peckham. "Think Active Can't Outperform? Think again." Invesco White Paper Series on the Active/Passive Debate, March 2017. Charts represent equal-weighted analysis of active share funds (defined as 60% or higher active share).

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## GLOSSARY OF TERMS

**Closet Indexers:** Low active share and a low tracking error.

**Drawdown:** A measure of the peak to valley loss of an investment for a stated time period. An investment does not recover from a drawdown until it surpasses the previous peak.

**MSCI ACWI Index:** A broad global equity index that represents large and mid-cap equity performance across 23 developed and 24 emerging markets. Index covers approximately 85% of the free float-adjusted market capitalization in each country.

**MSCI World Index:** A broad global equity index that represents large and mid-cap equity performance across 23 developed markets countries. Index covers approximately 85% of the free float-adjusted market capitalization in each country.

**Russell 1000 TR Index:** A market capitalization-weighted index of approximately 1000 of the largest companies in the U.S. equity market.

**Russell 2000 TR Index:** A market capitalization-weighted index of approximately 2000 small-cap companies in the Russell 3000 Index.

**Russell 3000 TR Index:** A market capitalization-weighted index of the 3000 largest U.S.-traded stocks which represents about 98% of the U.S. equity market.

**S&P 500 Index:** A market capitalization-weighted index that is used to represent the U.S. large-cap stock market. The Price Index does not include the impact of reinvested dividends. The Total Return (TR) Index reflects the effects of dividend reinvestment. Total Return Index data is not available prior to 1988. Any analysis period beginning prior to 1988 uses the Price Index.



## ABOUT CATALYST FUNDS

Catalyst Funds is an experienced alternative manager. Since our founding in 2006, we have understood that the market did not need another traditional family of mutual funds. We strive to provide innovative strategies to support financial advisors and their clients in meeting the challenges of an ever-changing global market environment.

Catalyst offers a broad range of distinctive, “intelligent alternative” funds. Our specialized strategies seek to address the needs of investors, including generating alpha, reducing volatility, limiting tail risk, mitigating interest rate risk and generating income. We strive to be “ahead of the curve” in exploiting emerging areas of opportunity to assist our clients in achieving their long-term investment goals.

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