

# A POTENTIAL PASSIVE INVESTING BUBBLE

## High Active Share Investing

### KEY TAKEAWAYS

- Billions of dollars are flowing into passive funds and out of actively managed funds.
- 10 stocks are contributing 116% to the S&P 500 TR Index return while the remaining are contributing -16%, as of 6/30/2018.
- History may not repeat, but it rhymes. Investors should be concerned about exposure to FAANG stocks.
- Historically, investing in high-conviction, high-active share funds has resulted in decreased portfolio volatility and outperformance relative to benchmarks.

Billionaire investor Carl Icahn recently called passive investing a potential bubble that **“[may] implode and could lead to a crisis bigger than 2009.”** Icahn explained that investors are making a mistake using the market as a casino, with too much money flowing into index funds and investors not knowing what they own.

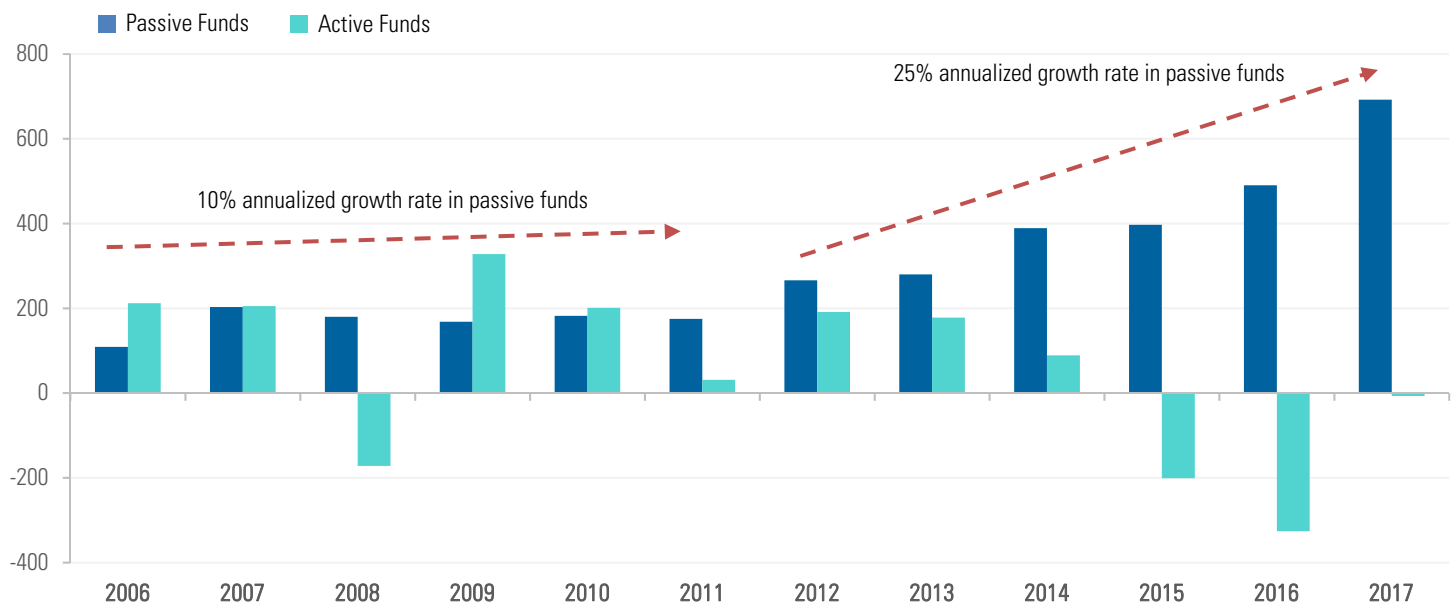
### So how did we get into a potential passive investing bubble?

With interest rates held exceptionally low for a prolonged period, artificially expensive bonds made stocks appear relatively inexpensive. Additionally, the race to the bottom for fund fees caused some investors to overlook net return potential for the lowest fees. These circumstances resulted in massive inflows into equities as an asset class via passive index funds, with the rising tide lifting all stocks and passive investing becoming a self-reinforcing cycle. In the event of market turmoil, investors with heavy exposure to certain stocks may experience significant losses. We believe that investors should consider moving into actively managed funds in an attempt to mitigate the potential burst of what may be the passive investing bubble.

Flows into passive funds have grown by 25% annualized since 2011, culminating in \$692 billion flowing into passive funds in 2017.

### The Creation of a Potential Passive Bubble: U.S. Fund Flows (\$ Billions) into Active and Passive Funds Since 2006

Source: Morningstar Direct. Inflows based on flow of U.S. money into passive and active funds between 2006 and 2017.



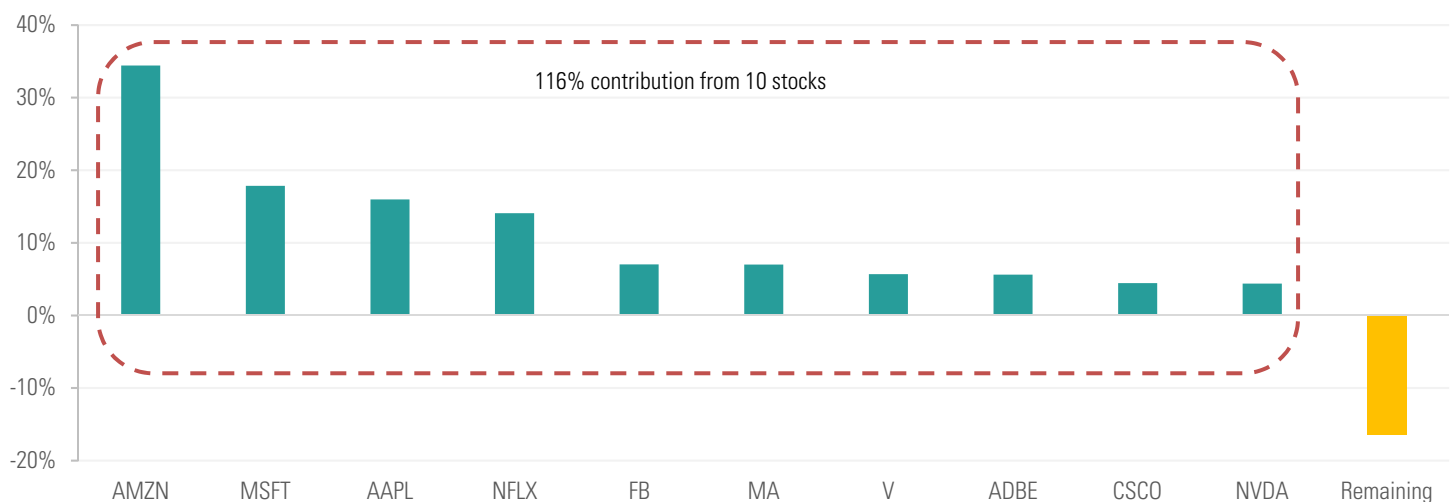
## 10 STOCKS ARE CONTRIBUTING 116% TO THE S&P 500 TR INDEX YTD RETURN WHILE THE REMAINING S&P 500 INDEX STOCKS ARE CONTRIBUTING -16%, AS OF 6/30/2018<sup>1</sup>.

This type of behavior is common in a capitalization-weighted index. A capitalization-weighted index is a type of market index with individual components that are weighted according to their total market capitalization. The larger components carry higher percentage weightings, while the smaller components in the index have lower weights. When significant funds flow into passive strategies, the largest stocks that have performed the best tend to get most of the allocation, creating a self-reinforcing cycle of these stocks performing well. This goes against traditional convention of buying low and selling high. Additionally, it sets these stocks up for significant risk in the event that investors offload their passive exposure suddenly.

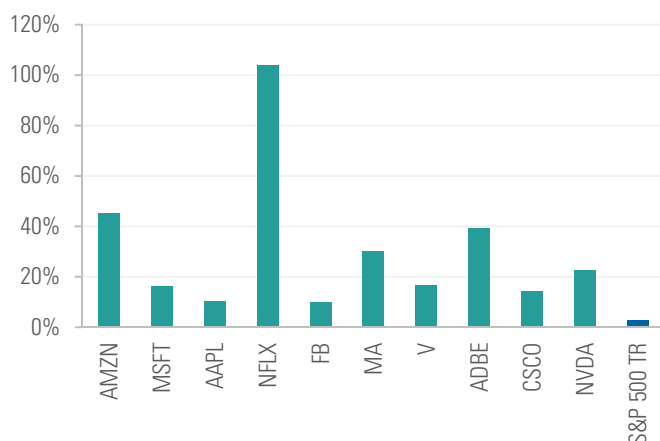
**Investors purchasing passive, capitalization-weighted index strategies now are at risk of buying into a crowded trade with already overbought shares at all-time highs.**

### Top 10 Stocks by Contribution to S&P 500 TR Index YTD Returns

YTD S&P 500 TR Index contributions as of 6/30/2018 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).

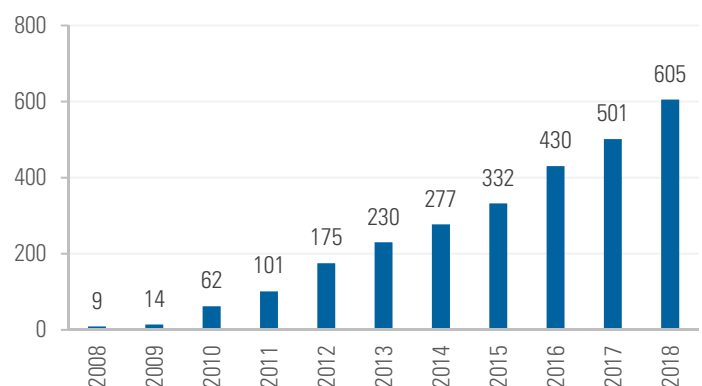


### YTD Returns of Top 10 Contributing Stocks



### A Crowded Trade: ETF Ownership of FAANG Stocks

Number of ETFs that own a FAANG stock (Facebook, Amazon, Apple, Netflix and Google) as a top 15 holding since 2008. Source: ETFDB data.

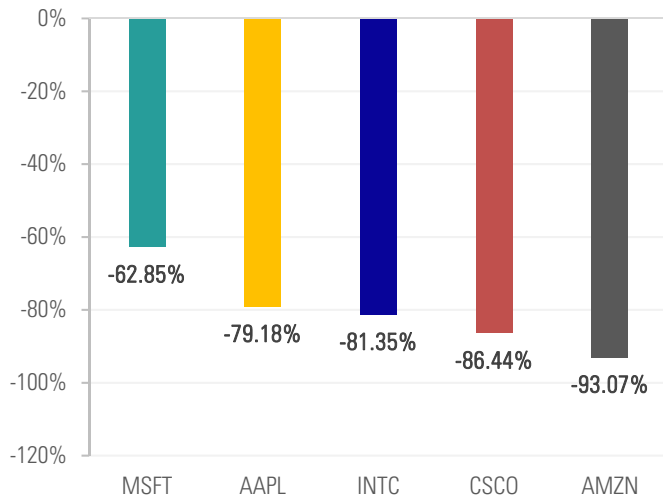


**Past performance is no guarantee of future results.** The referenced index and stocks are shown for general market comparisons and are not meant to represent any fund. Investors cannot directly invest in an index; unmanaged index returns do not reflect any fees, expenses or sales charges. <sup>1</sup>Data Source: Bloomberg LP.

History may not repeat, but it rhymes. As the potentially most crowded trade in history, FAANG-like stocks could be most at risk during the next period of turmoil.

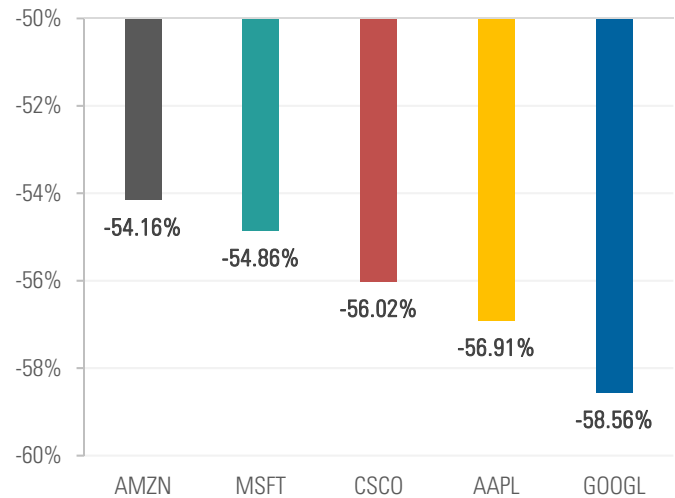
### Drawdowns During Dot-Com Bubble Crash

Worst drawdowns based on monthly return data from 1999 to 2003.



### Drawdowns During 2008 Financial Crisis

Worst drawdowns based on monthly return data from 2007 to 2009.



## The Case for High-Conviction, Concentrated Portfolios

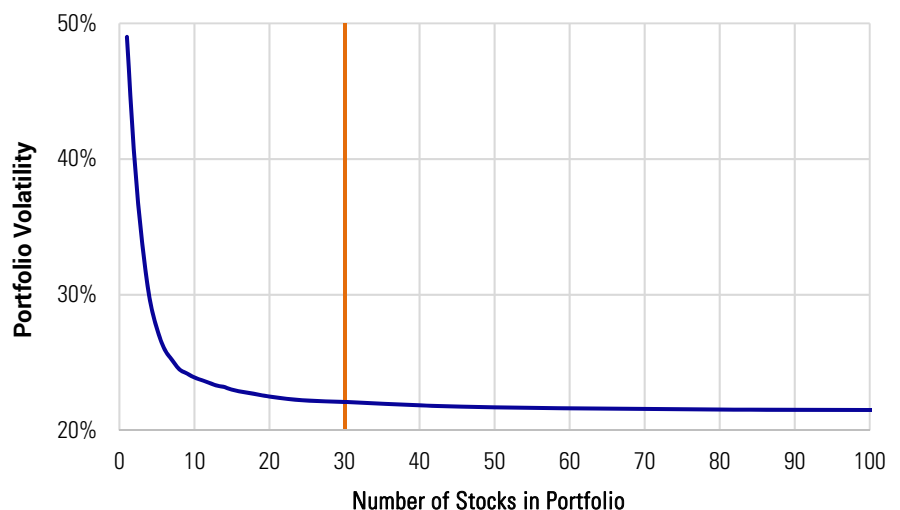
**“Wide diversification is only required when investors do not understand what they are doing.”**  
 - Warren Buffet

### Key Takeaways

- Academic research concluded that diversification benefits diminished after 30 stocks
- High-conviction (more concentrated) mutual funds have historically outperformed lower-conviction mutual funds
- Of all assets in U.S. stock funds, only about 10% are in funds that actively manage at least 90% of their assets<sup>2</sup>

### Diversification Benefits Diminished after 30 Stocks in a Portfolio

% of portfolio volatility relative to the number of stocks in a portfolio. Source: DeMarzo, Peter, and Jarrad Harford. "Chapter 12 Systematic Risk and the Equity Risk Premium."



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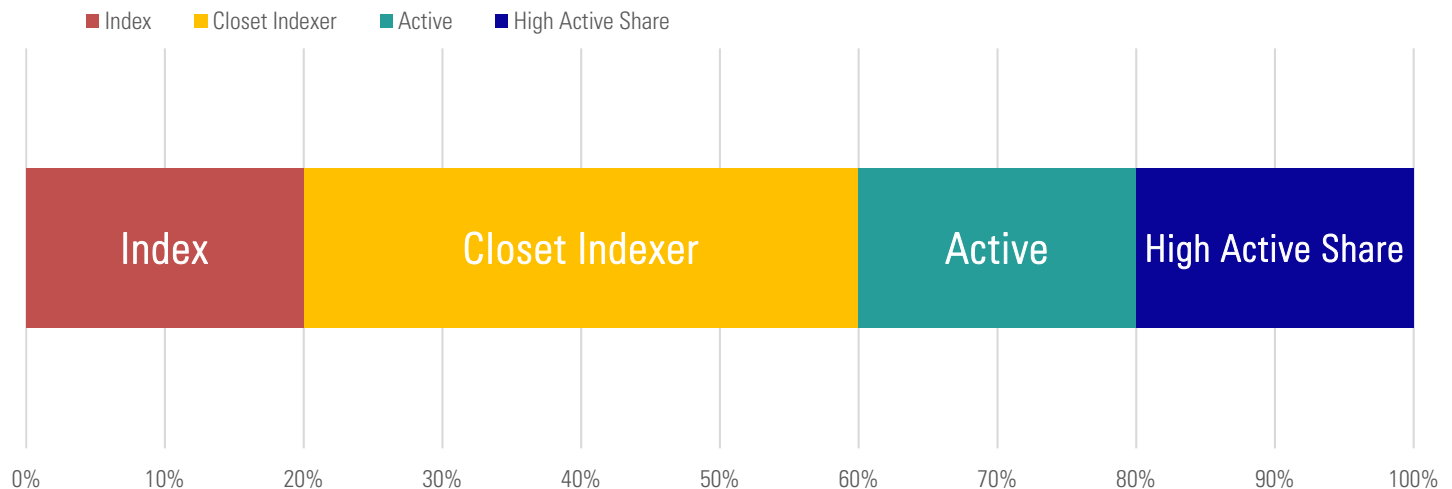
<sup>2</sup>Data Source: Cremers, Martijn. "Active Share and the Three Pillars of Active Management." Financial Analysts Journal, Forthcoming, December 2016.

# 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\*. An increasing percentage of mutual fund assets are in strategies with low active share; this 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%.



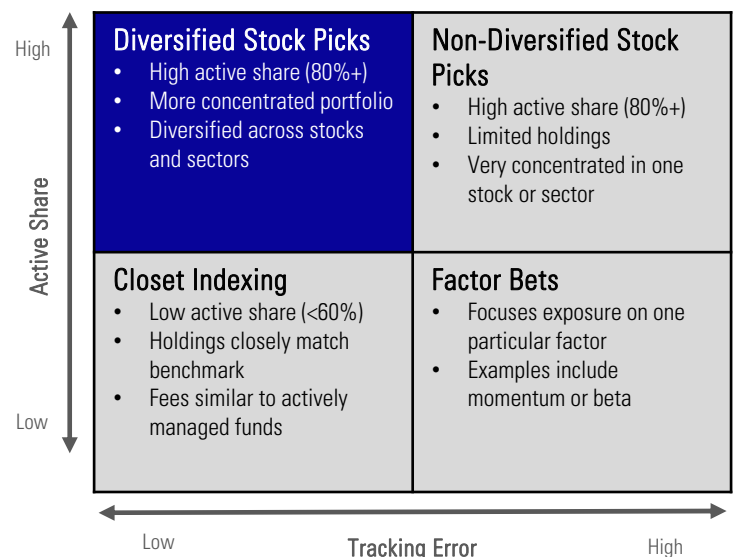
“Active managers are not all equal: They differ in how active they are and what type of active management they practice. These distinctions allow us to distinguish different types of active managers, which turns out to matter a great deal for investment performance”

-Antti Petajisto, Ph.D.

Professor of Finance, NYU Stern School of Business

## Active Share vs Tracking Error

Comparing Diversified/Non-Diversified Stock Pickers, Closet Indexing & Factor Bets

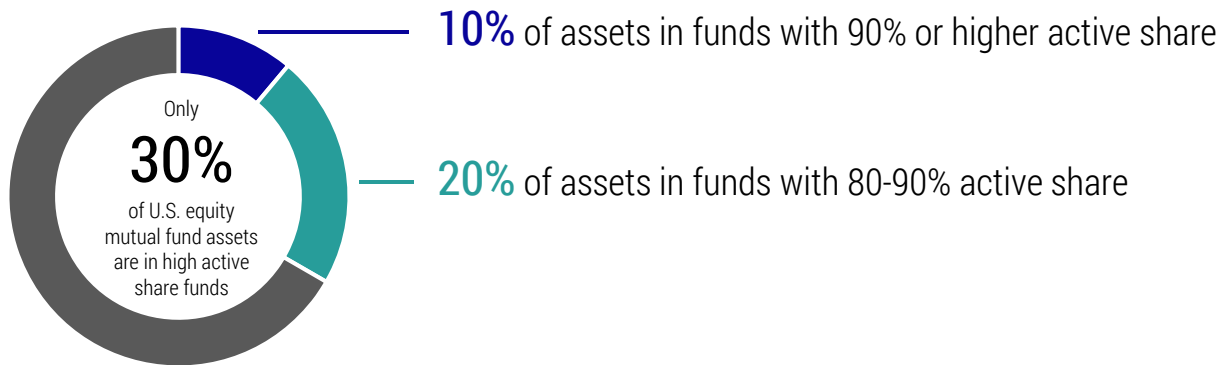


\*Having a high active share does not mean that a fund will outperform its benchmark.

According to academic research, a trend in U.S. equity mutual funds has been a decline in assets in actively managed funds. As of 2015, only 30% of assets were in high active share strategies (80% or higher), significantly lower than +50% in the 1980's.

### Most Assets in U.S. Equity Mutual Funds Are Not Actively Managed

Data Source: Cremers, Martijn. "Active Share and the Three Pillars of Active Management." *Financial Analysts Journal*, Forthcoming, December 2016.



Data is unavailable after 2015 and market conditions may have changed the allocations displayed above.

## GLOSSARY OF TERMS

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

**Concentrated:** High active share and a high 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.

**Factor Bets:** Low active share and a high tracking error.

**S&P 500 Index:** A market capitalization-weighted index that is used to represent the U.S. large-cap stock market. The **Total Return (TR)** Index reflects the effects of dividend reinvestment.

## 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.

## IMPORTANT RISK DISCLOSURES

As with any investment strategy, there is no guarantee that an asset class will continue to perform similarly in the future. Investment markets are unpredictable and there will be certain market conditions where a strategy will not meet its investment objective and will lose money. Returns will vary and you could lose money.

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