RIVERVIEW QUARTERLY INSIGHTS

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The last couple years have not been kind to "active" investment managers, those fund managers and investment advisors who try to either pick stocks or follow a "style" (like growth or value) in an effort to outperform the market. As it becomes clear that investors are paying high fees and not seeing a corresponding benefit, they are running from active managers and into "passive" investments (typically low-cost mutual funds or exchange-traded funds that track a market index like the S&P 500).

CONSIDER JUST FOUR ARTICLES FROM THE PAST YEAR OR SO:

- Financial Times, September 11, 2016: Passive investments in mutual funds now account for a third of all U.S. mutual fund investments, up from a quarter three years ago, while investments in active mutual funds have declined steadily since 2013.

- Wall Street Journal, January 26, 2017: Harvard University's endowment plans to outsource the management of most of its assets, and lay off half of its investment staff, after its actively managed portfolio (which focused on private equity investments and hedge funds) underperformed "a portfolio passively invested 60% in a U.S. stock index and 40% in a bond index" over the past five years.

- Wall Street Journal, February 11-12, 2017: Indexing pioneer Vanguard Group reached $4 trillion in assets. This move is "largely the result of a push to embrace funds that mimic broad indexes for a fraction of the cost of traditional actively managed mutual funds."

- The Economist, June 24, 2017: Noting that the "big investment shift of recent years is from active to passive," the author observes that just 22.4% of active funds that were in the top quartile of performance from 2007 through 2012 were able to remain in that quartile from 2012 through 2017. This is less than chance would even suggest. This is unsurprising, since the "iron law of costs" will cause more expensive active funds to underperform. Further, with thousands of funds poring over the same data, it is incredibly hard for one to produce consistently superior results.

In other words, active managers are underperforming passive, low cost funds, and the market is recognizing that by pouring money into them.

But what does passive investing mean, anyway? Look closer at the most popular single index, the S&P 500. Even though it may be the most significant benchmark for passive investors, which would seem to make it as objective as they come, it has a committee behind it that decides how the index is organized and which sectors are given weight (and which are even considered sectors at all). A Wall Street Journal article from May 20, 2017, noted that the committee in the 1990's was late to give technology its own sector, causing investors to miss some of the late '90s growth in that area, but fully implemented the sector in time to catch the drop in its value.

In fact, the entire concept of "passive" investing in large cap domestic stocks by using index investing seems less sure-footed the closer you look at it. Other indexes, like the Russell 1000, 2000 and 3000, also are set by committee. Further, the S&P assigns "weighting" of stocks in its index (that is, the proportion that a particular stock in the index bears to the whole) by market capitalization. This means that the biggest companies have an oversized impact on the movement of the index (in other words, Apple isn't simply 1/500th of the entire index; its rise and fall in price moves the price of the index more than any other single stock, at least for now).

All of these factors notwithstanding, the S&P 500 is still the most reliable broad index for the average large-cap domestic stock investor. And even though there is some subjective decision-making involved in choosing the 500 stocks, the overall approach is based on objective information.

Going outside the United States to invest in international stocks is even more challenging for passive investors. Perhaps the largest source of international indexes is MSCI, a research firm that was formerly a subsidiary of Morgan Stanley. It has several important indexes: EAFE (Europe, Australasia and Far East), All-World and Emerging Market, among others. Each MSCI index selects stocks that are quickly traded, have high liquidity and active investor participation, and are without owner restrictions. Each index tries to measure its underlying equity market as accurately and efficiently as possible. MSCI tries, in other words, to include as many stocks as needed to represent the equity market, without adding so many that it makes it difficult for ETFs and mutual funds to mimic them.

MSCI is a force to be reckoned with; according to its own website:

- $11 trillion U.S. dollars are invested in funds tied to one of its indexes;
- Over 950 ETFs are based on MSCI indexes, more than any other provider; and
- 94% of pension fund managers use MSCI indexes.

Clearly, MSCI is a market leader in passive investing.

But even MSCI isn't a perfect reflection of the markets it seeks to emulate. According to an article in the June 24th issue of The Economist, MSCI decided only four

days earlier to add Chinese stocks into its Emerging Markets and All World indexes. Even though China accounts for 15% of global GDP, is the second largest economy in the world and has the second biggest stock market, the biggest creator of global index benchmarks didn't include any stocks of mainland China in those benchmarks. And MSCI will only tiptoe into those stocks: Chinese stocks initially will make up only .73% of the Emerging Markets index.

This is not to say that MSCI was wrong not to include Chinese stocks earlier. It was a contentious decision, given how tightly China manages its markets (for instance, foreign investors can only "buy shares through a few quota-controlled channels"). And MSCI already included stocks listed in Hong Kong. Rather, the point is that a passive, index investing approach based on the MSCI Emerging Markets index would have largely excluded direct investment in the world's second largest economy.

Since indexes are less objective than they seem, is there a better way to approach equity investing? One approach that has gained in popularity is the so-called "smart beta" approach. Although there is no clear definition, Morningstar defines "smart beta" as index-based strategies that seek to increase returns by deviating from a strictly market capitalization-weighted index approach in a rules-based and transparent manner. Put another way, smart beta funds generally look for evidence of persistent outperformance (or anomalies) that can be executed in a low-cost manner.

The problem with smart beta investing is that it has become so broad a concept as to be meaningless. In fact, a recent study looked at 447 anomalies that have been used by various smart beta funds, and found that 80% of them could not withstand rigorous analysis. Most of these anomalies were either "demonstrably silly" or a "highly correlated version of the same idea," according to a May 12, 2017 article in the Wall Street Journal.
This does not mean that the data underlying some anomalies is all wrong. Certain anomalies (also known as "factors") have stood the test of time, showing persistent results beyond just the period for which it was tested (reducing the likelihood of apparent results being the product of simple data mining). These factors, first identified by Nobel Prize-winning economist Eugene Fama and Professor Kenneth French, include the following (for stocks):

- Value stocks (those that have lower prices relative to the market as a whole) tend to outperform growth stocks;
- Small cap stocks tend to outperform large cap stocks; and
- More profitable companies outperform less profitable ones.

There are a variety of lower cost funds that can exploit these differences.

Note, however, that these are very long-term trends only. For example, growth stocks have outperformed value stocks for most of the last ten years. This is why it doesn't make sense (based on the evidence) to only be a "value" investor, because long dry spells can lead to long-term underperformance.

So the question of active versus passive in equity investing is misleading. The approach that investors should follow is identifying the lowest cost fund that exploits those factors proven to give superior performance over time, and the greatest degree of diversification.

SPOTLIGHT ON PLANNING

PROTECTING YOURSELF FROM IDENTITY THEFT AND FRAUD: SIMPLE STEPS

In the last two months, Equifax (one of the three main credit reporting agencies), Yahoo and the Securities and Exchange Commission all made disturbing announcements regarding data breaches. It seems every day some new data breach or fraudulent scheme takes place. Technology and e-commerce are evolving faster than our security measures, requiring ever increasing diligence and monitoring on the part of the individual. Fortunately, although technology and criminals are advancing quickly, with fraud hitting record highs in 2016, we are also adapting, catching and reporting these attacks faster.

HERE ARE A NUMBER OF STEPS YOU CAN TAKE TO REDUCE YOUR RISK AND PROTECT YOUR INFORMATION:

1. Guard Your SSN – Never give your social security number to someone who calls, texts, or emails. Don't carry your social security card, or even the number, in your purse, wallet, car, or bag. Keep that information stored securely at home.

2. Secure or Shred Personal Information – Store personal paperwork in a secure location at home, especially if you have service providers in your home when you are away. Shred ALL mail with personal information, including your name and address information on junk mail and magazines.

3. Strong Passwords and Two-Factor Authentication – Use strong passwords and change them regularly. A strong password should be at least 12 characters, using a combination of numbers, symbols, and upper and lower case letters. It should not be a word, or combination of words found in the dictionary and shouldn't be obvious (like 'mom123'). Stay away from personal information like names, birthdays, address numbers, etc. Use different passwords for each financial institution, and as an added measure, enable two-factor authentication for your online accounts whenever available. Two-factor authentication involves a unique code or password sent to a separate device to independently authenticate you each time you log in, or only when you log in from a new device. Contact your financial institutions and other online service providers to ask whether this is offered and how to enable it.

4. Set Up Alerts – Many financial institutions and companies (such as Amazon) are now offering alerts for a variety of online activities, like a change to your account information, password updates, and transactions above a dollar amount or made over the phone. Take advantage of as many of these alerts as possible to quickly identify suspicious activity.

5. Monitor Your Accounts – Review your bank accounts, credit cards, and lines of credit regularly, and promptly report any suspicious activity. There's been a recent rise in fraudulent activity on home equity lines of credit, so be sure you are monitoring those balances as well. Don't ignore it just because you aren't using it. Additionally, if you use mobile banking or budgeting apps, you may be able to monitor activity on a daily or weekly basis.

6. Review Your Credit Report – You are entitled to a free copy of your credit report from each credit agency once every 12 months, which you can request at annualcreditreport.com or by calling 1-877-322-8228. Review your report for any new accounts, inquiries, or suspicious activity.

7. File Your Taxes Early – With your social security number and limited personal information, fraudsters may attempt to apply for a tax refund in your name. Filing your tax return early helps reduce this risk. If you know your information has been compromised, you may wish to file an Identify Theft Affidavit (form 14039) with the IRS. Filing this affidavit marks your account for possible questionable activity. You can also request a unique PIN to use to identify yourself when filing your tax return.

Finally, if you believe your information is compromised, you should immediately take the following steps:

- Contact the organizations where your accounts have been compromised.
- File a report with the Federal Trade Commission at ftc.gov.
- File a police report and obtain a copy for your records.
- Place an **Initial Fraud Alert** on your credit records by contacting any ONE of the three credit agencies (Equifax, Experian or TransUnion). They will then notify the other two agencies.
- Visit Identitytheft.gov for a checklist of additional steps needed based on the type of information exposed.
- Plan to renew your Initial Fraud Alert after 90-days, and consider whether an **Extended Fraud Alert** or a **Credit Freeze** (discussed below) is appropriate.

The **Initial Fraud Alert** is the simplest alert, with the shortest duration (90-days), and is placed by contacting only ONE of the three agencies. This alert places a message on your report that your information has been compromised and provides your correct contact information. Businesses accessing your credit report will receive this information and should verify your identity before opening an account or extending credit. This alert stays on your report for 90 days, and is renewable. The Initial Fraud Alert is the easiest alert to place, but requires ongoing renewal and does not guarantee that new credit or accounts will not be opened in your name.

Identity theft victims are entitled to an **Extended Fraud Alert**, which places a 7-year alert on your credit report warning of potential fraud and requires additional steps to verify your identity. You will need to first file an Identity Theft Report with the FTC, and then submit a request for an Extended Fraud Alert to ONE of the three credit agencies. They should then notify the other two, but be sure to confirm this with them. As an added benefit, you are entitled to additional free credit reports with this alert, and are removed from prescreened marketing and credit offers for five years. Again, like the initial fraud alert, the extended alert does not stop all access to your report.

A **Credit Freeze**, on the other hand, does stop all access to your credit report until you lift or remove it. You request a credit freeze by individually contacting EACH of the three credit agencies. You will be provided a PIN when the freeze is placed. To temporarily lift or remove the freeze, you must contact each agency and provide this PIN as well as additional identifying information. This lifting or removal process can take a few weeks. While the credit freeze

provides the highest level of security over your report, because of the effort and time required to lift or remove it, it is appropriate only if you will not need to access your credit report in the near future (such as to finance a home or car, or to apply for a new cell phone contract).

The truth is, as scary as identity theft and fraud is, we have many laws and protections in place for the consumer, and the simple steps above can help protect you. Although identity theft can be very stressful and time consuming to repair, most victims are reimbursed for the majority of their loss, with the average out of pocket expense ranging from $50 to $2,000. The amount of damage (both in time and money) can be greatly reduced by taking appropriate protective measures in advance, diligently monitoring your accounts and records, and quickly reporting anything out of the ordinary.

Don't be afraid, be diligent.

ECONOMIC SNAPSHOT

MARKET SUMMARY – THIRD QUARTER 2017 INDEX RETURNS

All areas of the market were up in the third quarter, with emerging market and international developed stocks showing the strongest returns.

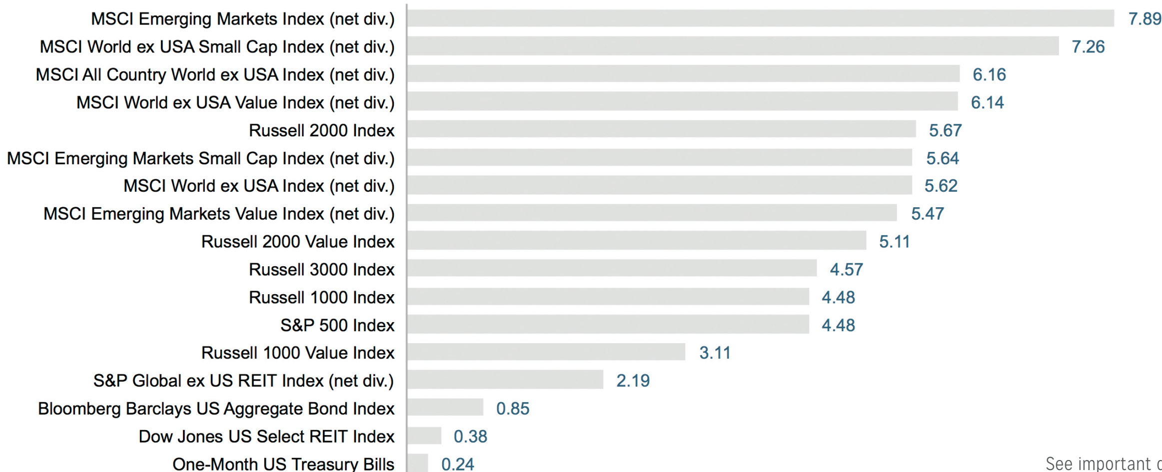
Q3 2017	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
	STOCKS				BONDS	
	4.57% ↑	5.62% ↑	7.89% ↑	1.13% ↑	0.85% ↑	0.70% ↑

Since Jan. 2001	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Avg. Quarterly Return	1.9%	1.6%	3.1%	2.7%	1.2%	1.1%
Best Quarter	16.8% Q2 2009	25.9% Q2 2009	34.7% Q2 2009	32.3% Q3 2009	4.6% Q3 2001	5.5% Q4 2008
Worst Quarter	-22.8% Q4 2008	-21.2% Q4 2008	-27.6% Q4 2008	-36.1% Q4 2008	-3.0% Q4 2016	-3.2% Q2 2015

See important disclosure information

WORLD ASSET CLASSES - THIRD QUARTER 2017 INDEX RETURNS (%)

With broad market indices used as proxies, emerging markets outperformed developed markets, including the US, during the quarter. The value effect was positive in non-US developed markets but negative in the US and emerging markets. Small caps outperformed large caps in US and non-US developed markets but underperformed in emerging markets.



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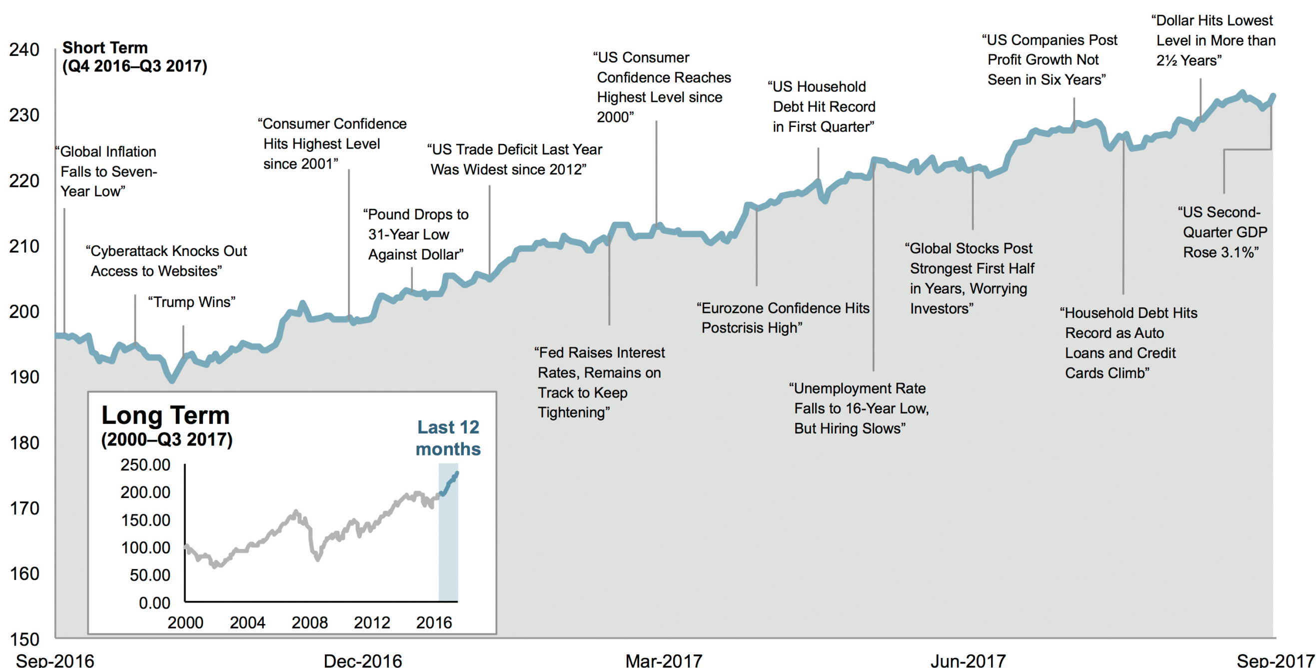
WORLD STOCK MARKET PERFORMANCE

MSCI All Country World Index with selected headlines from past 12 months.

These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.



Graph Source: MSCI ACWI Index [net div.]. MSCI data © MSCI 2017, all rights reserved.
See Important Disclosure Information.

BOOK REVIEW

GRIT: THE POWER OF PASSION AND PERSEVERANCE By Angela Duckworth

Native talent or hard work? Nature vs. nurture? We all have different beliefs about how overachievers seem able to do so much more than the rest of us. Angela Duckworth, in her bestseller Grit: The Power of Passion and Perseverance, clearly lands on the side of continuous hard work rather than native genius or talent. She first came upon this answer when trying to determine why so many West Point cadets dropped out within two months of starting school, when every cadet had to be an overachiever just to get in in the first place. For the first two months, every cadet goes through "Beast Barracks," a nonstop barrage of physical, intellectual and emotional challenges designed to toughen (or weed out) cadets right away. Interestingly, while the West Point admissions process focused on the "Whole Candidate

Score," a combined analysis of SAT or ACT scores, high school academic rank, expert appraisal of leadership capabilities and physical fitness measures, to determine who should be admitted, a higher Whole Candidate Score bore no relation to the odds that a candidate would succeed in getting through "Beast." Ultimately, what mattered was a "never give up" attitude.

After working with West Point cadets, Duckworth went on to interview leaders in business, arts, athletics and other pursuits. Regardless of their field, the highly accomplished are dogged in their pursuits. They keep going after failure. Although they never feel good enough, they are always "satisfied being unsatisfied:"

> The highly successful had a kind of ferocious determination that played out in two ways. First these exemplars were unusually resilient and hardworking. Second, they knew in a very, very deep way what it was they wanted. They not only had determination, they had direction.

This Duckworth defines as "grit."

She notes early on the bias we all seem to have for talent. Employers seek it, and we all talk about how little there is of it. But a high level of performance is really a long series of mundane acts. Instead of analyzing that process, however, we promote the "cult of genius," because if we think of brilliant performance as something magical, it lets us off the hook: we don't need to compare and find ourselves lacking.

In fact, if talent counts, effort counts twice. In Duckworth's reckoning, talent times effort equals skill, and skill times effort equals achievement. Talent simply dictates how fast we improve in a skill. But it has no bearing on achievement.

The grittiest quote in the book comes from the musician and actor Will Smith:

> The only thing that I see that is distinctly different about me is: I'm not afraid to die on a treadmill. I will not be outworked, period. You might have more talent than me, you might be smarter than me, you might be sexier than me. You might be all of those things. You got it on me in nine categories. But if we get on the treadmill together, there's two things: You're getting off first, or I'm going to die. It's really that simple.

The rest of the book is just commentary.

Duckworth is not content simply to explain Grit. The book contains a self-quiz to determine how gritty the reader is, and goes on to describe coach Pete Carroll's (very gritty) life philosophy by way of comparison, describing the goals hierarchy of Carroll, Warren Buffett and others. She also spends a chapter describing how grit grows (so those scoring low on the test can take heart).

Perhaps the most important chapter is the one devoted to practice. High achievers engage in "deliberate practice," focusing not on the amount of time practicing but on the quality of time practicing. Experts, rather than focusing on what they already do well, strive to improve specific weaknesses. And while doing so, these high achievers often feel like quitting, because deliberate practice is hard. So it's the result of practice, not the practice itself, that drives them.

The chapters entitled, "Hope," and "Parenting for Grit" describe ways in which parents can help teach their children to persevere. She examines the experience of Super Bowl Champion Quarterback Steve Young, whose parents instilled grit and helped him pursue excellence without being authoritarian. Finally, Duckworth addresses the culture of grit, under which individuals within organizations, and the organizations themselves, become grittier.

It's hard to write book reviews without resorting to clichés. But this is a truly informative, surprising and inspiring book. It's useful for business leaders, parents, artists, athletes; anyone who wants to move forward.

IMPORTANT DISCLOSURE INFORMATION

INVESTMENT AND INSURANCE PRODUCTS ARE: NOT FDIC Insured | NOT Bank Guaranteed | MAY Lose Value.

Past performance is not a guarantee of future results. Asset allocation does not guarantee better performance and cannot eliminate the risk of investment losses. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.

Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index [net div.]), US Bond Market (Bloomberg Barclays US Aggregate Bond Index), and Global Bond ex US Market (Citi WGBI ex USA 1-30 Years [Hedged to USD]).

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