HODGES ★ CAPITAL

Thank Goodness for ETF's!

An Active Manager's Perspective on Passive Investing

Eric J. Marshall, CFA, Director of Research

Considerable dispute exists between passive and active management of equity portfolios. This paper seeks to discuss the idea that active investment strategies focusing on individual stock selection can benefit from the market inefficiencies that have been produced by the widespread adoption of exchange-traded funds (ETFs).

"If you buy the same thing they buy, you will get the same performance they get." - Sir John Templeton

The Obvious Benefits of ETFs

ETFs offer investors many unique features that may help facilitate certain top-down investing strategies. Such features include quick diversification across a market or sector. Since ETFs hold a basket of stocks or bonds that are often tied to an index like the *Standard & Poor's 500 Index®*, investors can systematically gain exposure to certain segments of the market by purchasing a single issue. Such passive strategies may be especially beneficial in gaining exposure to international securities, where the lack of available information may make individual security analysis impractical or ineffective.

Unlike closed-end funds, ETFs offer market pricing that is closely tied to their net asset value. Since market makers use their ability to exchange creation units with their underlying securities, ETFs trade on stock exchanges and generally provide individuals with a high degree of liquidity.

ETFs can also offer tax advantages. Generally, ETFs are tax-efficient because of the way they are created or redeemed which allow the investor to pay most of his capital gains on the final sale. Transaction costs are typically low for most ETFs due to the costs associated with passive management and the absence of front-end charges or redemption penalties. ETFs are charged commission fees on each trade.

The Potential Hidden Benefits of ETFs

While investors can use ETFs to execute top-down strategies in sectors such as oil, gold, financials, or semiconductors, these investment considerations often do not give much thought to stock specific fundamentals. Usually, when large groups of investors engage in broad investing decisions without giving much consideration to the unique fundamentals of each individual stock, we believe inefficiencies develop and opportunities are created for active managers.

Because ETF transactions generally involve baskets of stocks, we believe this type of investing can create a herd-like mentality that often translates into naïve buying or selling pressure on a group of stocks. Furthermore, any market activity that ignores the individual fundamentals underlying each company can result in temporary mispricing in the market. Individual equities represent different investment merits based upon future earnings prospects, various unique business risks, financial profiles, management talent, and long-term growth prospects. Such competitive advantages may allow one enterprise to thrive at the expense of a weaker competitor in the same sector or industry group.

Therefore the wholesale buying and selling of stocks in a given sector can result in a disconnect between the underlying fundamentals, which represent reality, and the market's perception of the fundamentals of an individual security. We believe mispricing in individual stocks can be summed up into a simple equation; *Reality - Perception = Profit or Loss*. If an investor perceives an ETF to be a good bargain and chooses to invest, the reality is that not every stock represented in that ETF's basket of securities may be an attractive value. Therefore certain stocks in a group may become overvalued due to naïve buying pressure in a given ETF. Such a circumstance can provide an opportunity for a prudent investor that has insights into the specific fundamentals to capitalize on selling an overpriced security.

The inverse of this action can also occur. When widespread selling exists in an ETF, an unwarranted price decline may occur regardless of positive underlying fundamentals in a given security. We would also point out that a market or sector can be fairly valued even when some of the underlying stocks are temporarily mispriced.

"...Reality - Perception = Profit or Loss."

While there is little dispute that markets are efficient over the long-term, we believe inefficiencies do exist in the short-term. We view the short-term trading volatility that individual stocks exhibit on a daily basis as ample evidence that such inefficiencies exist. Furthermore, we believe the trading and pricing mechanics of ETFs may amplify short-term market pricing inefficiencies and increase volatility in individual stocks. The common use of leverage and complex derivative instruments in ETFs may further exaggerate short-term swings in individual stocks. A prudent investor that obtains specific knowledge about the underlying fundamentals of an individual stock can often see through the trading noise created by such market volatility and identify opportunity. While we do not advocate short-term trading or speculation based on these circumstances, these conditions may present attractive entry or exit points for active investors.

Abnormal pricing activity usually occurs when a stock is added or removed from a stock Index, such as the *S&P 500®*. As ETFs make it more convenient for investors to passively invest in almost every indexed equity class, short-term pricing inefficiencies may result from the simple fact that such funds are forced to buy or sell a stock to minimize tracking error against the performance of an index. Furthermore, we believe the effects of ETF investing on short-term pricing discrepancies may be inversely correlated to the size in terms of market capitalization and trading volume of the sector or group represented. Returns in small cap stocks are also more sensitive to asymmetric information that active managers may exploit. Such participation is limited among ETFs.

Conclusion

While ETFs may represent a logical investment vehicle for passive investors pursuing top-down investment strategies, we view the widespread adoption of ETFs as an opportunity for active investment managers to capture excess returns in individual stocks. The methodology required to capture these excess returns, relative to their risks, requires nothing more than research, research, and more research. It is our opinion that nothing can take the place of good, old-fashion due diligence. In most cases, this means going straight to the sources of information in an effort to truly understand what's going on in the underlying, unique businesses. These efforts require the in-depth analysis of financial statements, the interviewing of management teams, visits with customers & suppliers, as well as the studying of competitors. Such activities are difficult to replicate in academic formulas or computer models.

Wherever free market capitalism reins, investors will always find new and innovative ways to invest in equity markets. We acknowledge that there are many ways to achieve excess returns in the stock market, some more creative or complex than others. However, we would argue that strategies pursuant to bottom-up analysis of company fundamentals are a sound approach for most long-term investors.▪

Disclosures

The S&P 500 measures the value of stocks of the 500 largest corporations by market capitalization listed on the New York Stock Exchange or Nasdaq.

Investments in ETFs are subject to additional risks that do not apply to conventional mutual funds, including the risks that the market price of the shares may trade at a discount to its net asset value ("NAV"), an active secondary trading market may not develop or be maintained, or trading may be halted by the exchange in which they trade, which may impact a Funds ability to sell its shares.

Correlation is a statistical measure of how two securities move in relation to each other.

Tracking error is the divergence between the price behavior of a position or a portfolio and the price behavior of a benchmark.

Diversification does not guarantee a profit or protect from loss in a declining market.

It is not possible to invest directly in an index.

Any tax or legal information provided is merely a summary of our understanding and interpretation of some of the current income tax regulations and is not exhaustive. Investors must consult their tax advisor or legal counsel for advice and information concerning their particular situation. Neither the Fund nor any of its representatives may give legal or tax advice.

Active investing has higher management fees because of the managers increased level of involvement while passive investing has lower management and operating fees. Commissions are charged on every trade, regardless of whether active or passive management is employed. Investing in both actively and passively managed mutual funds involves risk and principal loss is possible. Both actively and passively managed mutual funds generally have daily liquidity. There are no guarantees regarding the performance of actively and passively managed mutual funds. Actively managed mutual funds may have higher portfolio turnover than passively managed funds. Excessive turnover can limit returns and can incur capital gains.

Mutual fund investing involves risk. Principal loss is possible.

The Hodges Funds are distributed by Quasar Distributors, LLC.

The funds' investment objectives, risk, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the Hodges Funds, and may be obtained by calling 866-811-0224 or visiting www.hodgesfunds.com. Read it carefully before investing.