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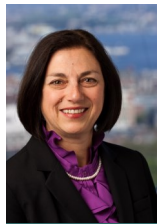
The Essex Exchange Newsletter

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Light at the End of the Tunnel—Are We Seeing the Return of Active Management?

By: Nancy B. Prial, Co-Chief Executive Officer & Senior Portfolio Manager

As active managers, we have seen firsthand the impact of the rise of passive investing over the past decade and a half. We have watched this phenomena with concern as to how we could effectively communicate our message that active management can add value over passive strategies without needing to make an either/or choice between the two elements of investing. Indeed, we have two core beliefs regarding the active/passive debate: firstly, that there is a cyclicality to the relative performance between active and pas-

sive investing and secondly, that there are specific sectors and investment styles that enhance the opportunity to add value through active focused stock selection. We will explore these two key points in the following piece.

S & P published a study in late 2016 that spoke to the relative outperformance/underperformance of actively managed funds against their respective benchmarks over a 15-year time horizon. As you can see in the chart below, passive strategies have outperformed across all funds over 1,5, and 15 years.

Fund Category	1 - Year (%)	5 - Year (%)	15 - Year (%)
All Domestic Funds	60.49	85.82	82.23
All Multi-Cap Funds	74.88	87.19	88.15
Mid-Cap Growth Funds	94.58	92.18	97.35
Small-Cap Growth Funds	95.96	97.64	99.43

Source: Essex Investment; July 2018

However, there is much more inconsistency when results are viewed on an annual basis. Based on these numbers, as shown in the chart below, the last three years (through 2016) have been on the high end of the trend lines.

Fund Category	2009	2010	2011	2012	2013	2014	2015	2016
All Domestic Funds	40.68	48.28	84.65	64.91	43.26	86.89	74.03	60.49
All Multi-Cap Funds	39.30	60.39	83.88	65.22	46.84	81.62	70.10	74.88
Mid-Cap Growth Funds	54.01	84.11	76.53	86.81	34.48	55.37	79.68	94.58
Small-Cap Growth Funds	31.34	62.25	94.12	62.91	55.25	63.98	87.50	95.96

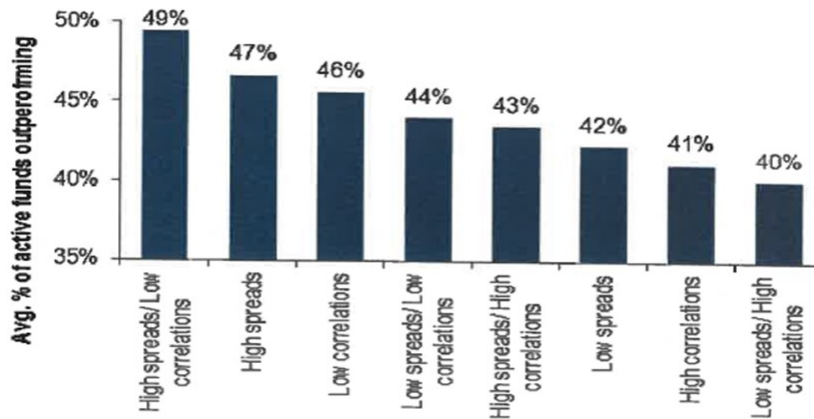
Source: Essex Investment; July 2018

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Many people have written about the reasons for the recent outperformance of passive over active strategies citing the above average return environment since 2009, consistently declining interest rates, the Fed pumping massive amounts of liquidity into the economy. Not surprisingly, these factors have made it more difficult to identify individual winners as the rising tide lifted all boats. The move towards increased indexing also led to some self-fulfilling actions as increased flows lead to increased performance across all stocks in the indexed funds. However, the headwinds from the above factors may be easing as we see tighter monetary policy with rising rates and potentially, rising inflation.

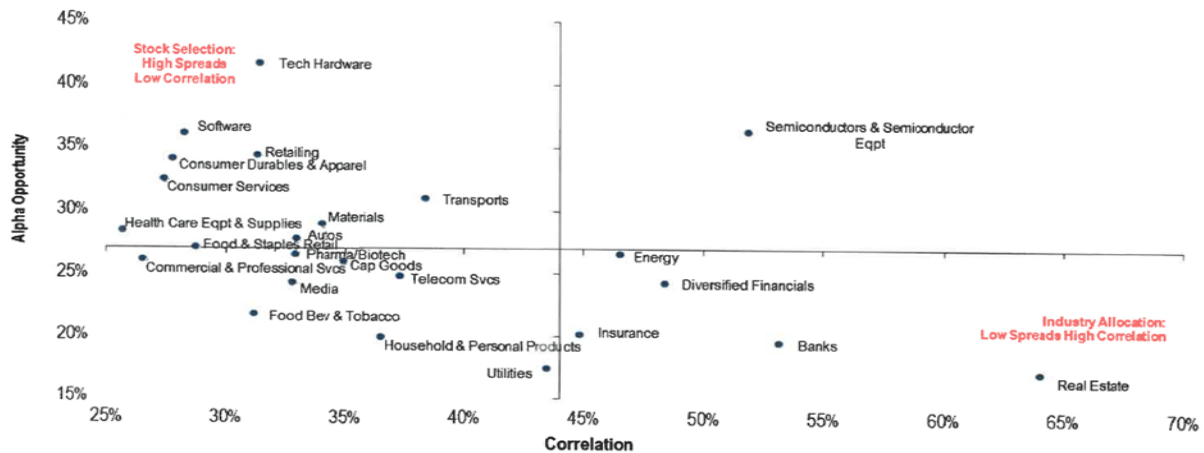
If we are correct, and we are entering a period of outperformance potential for active managers, what is the best way to capitalize on that trend? In short, we can add value by focusing on inefficient markets as well as by employing robust, consistent risk management. In an environment where correlations are lower and, even more importantly, dispersion is higher, our focus on finding stocks that are less- well known, less- well owned, and less- well understood can lead to outperformance both within sectors as well as overall versus our benchmarks. Indeed, B of A Merrill Lynch did a study that showed that active funds add the most value when both dispersion is high and correlations are low.



Source: BOA/ML; May 2018

Drilling down further, B of A Merrill Lynch shows that dispersion and correlation vary based on industry with the opportunity for alpha creation greatest in those areas with high spreads and low correlation. In general, those industries tend to be the areas that we have identified as the best growth opportunities within our portfolios, technology hardware, software, healthcare equipment and supplies, consumer services, and others as shown in the chart below.

Correlation & dispersion analysis for S&P 500 industry groups: Historical median intra-stock correlation vs. performance spread (2Q86-1Q18)



Source: BOA/ML; May 2018

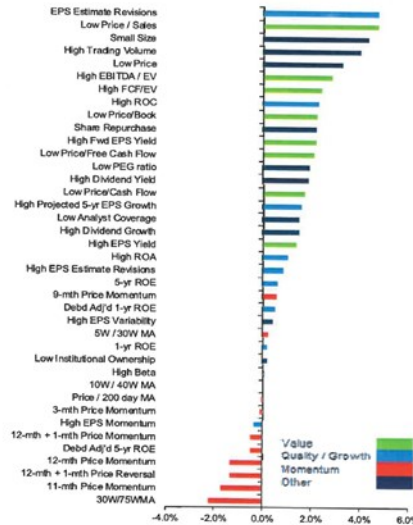
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We have long believed that we add alpha by the early identification of growth, when those future growth prospects are not yet fully reflected in the price of the stock. In fact, our strategies rely on the twin supports of high and improving growth with attractive valuation characteristics to identify compelling growth companies and industry exposures at a period when these companies and industries may not yet have been discovered by other growth investors. The evidence provided by B of A/Merrill Lynch in the following two charts, supports our investment philosophy that by trafficking in the less-well followed parts of our universe we have the opportunity to add significant value. Our process, which leads us to these neglected companies as their growth prospects are showing the early signs of fundamental acceleration, should be well-suited to capitalize on these phenomena.

Fundamental investment strategies in the less covered universe beat the benchmark almost across the board

Relative annualized total return performance (vs. equal-weighted S&P 500) of top quintile by each factor within the S&P 500 Sell Side Neglect universe, monthly rebalancing 3/2003-3/2018



Source: BOA/ML; May 2018

Value stocks (Low Price/Sales) within the Sell Side Neglect universe outperformed the benchmark

Cumulative relative total return performance (vs. equal-wtd. S&P 500 total return) of top quintile by Low Price/Sales within the Sell-Side Neglect universe, monthly rebalancing 4/2003-4/2018



Source: BOA/ML; May 2018

Stocks with highest return on capital (ROC) within the Sell Side Neglect universe outperformed the benchmark

Cumulative relative total return performance (vs. equal-wtd. S&P 500 total return) of top quintile by high ROC within the Sell-Side Neglect universe, monthly rebalancing 4/2003-4/2018



In closing, we are encouraged that the tides are shifting so that the time has come for active management to regain the opportunity to add value and outperform our benchmarks. We are pleased that the first half of 2018 validated this thesis with strong performance across most of our equity strategies. We believe that we are early in a cyclical change to lower correlations and higher dispersions as QE ends, leading to higher interest rates, tighter monetary policy, more differentiation between winners and losers, and higher variability in market returns. This environment is one where we believe our focus on finding previously undiscovered, under owned, underappreciated growth stocks is one that can shine.

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Essex Strategies

The Essex Micro Cap Growth, Small Growth and SMID Cap Growth strategies each share a common investment philosophy and process. Our team in Evanston is focused exclusively on managing long-only small growth strategies and has worked together for more than 15 years.

Micro Cap Growth: We look for under-followed, under-owned, under-appreciated companies & industries in early stages of acceleration.

Small Growth: The process focuses on identifying companies in an inefficient sector of the market at an inflection point where their growth rate is improving.

Small/Mid (SMID) Cap Growth: Our approach is to execute a systematic, fundamental process to find companies whose future growth prospects are not fully reflected in the price of the stock.

Global Environmental Opportunities Strategy (GEOS) operates at the nexus of environment and finance, investing in companies that enable greater natural resource and energy efficiency. GEOS is a listed-equity, global, all-cap strategy investing across nine environmental technology themes in long-only fashion with about 40 holdings. GEOS is clean technology and energy infrastructure-focused, with companies that exhibit generally-high growth rates.

Essex Research Strategy is co-managed by a team of investment professionals seeking growth equity opportunities across an all-cap universe. By employing fundamental top down economic and sector analysis with bottom-up stock picking skills, the strategy provides the investment team a wide framework in which to identify growth candidates regardless of market capitalization restraint.

Essex Global Life Sciences seeks capital appreciation by investing in both long and short positions of medical and life science companies. These companies are focused in the areas of drug discovery and distribution, the production of devices and instrumentation, delivery of health care services, and the development and implementation of medical information technology. Essex Global Life Sciences seeks to isolate the early signs of improving/deteriorating financial estimates and business conditions through a combination of fundamental research and overall industry expertise.

Growth Equity is an All-Cap strategy designed to provide investors with exposure to growth companies in a market capitalization range of \$100 million and up. The strategy is a concentrated portfolio of 50-70 companies diversified across domestic industry sectors that show accelerating earnings and sustainable revenue growth. Individual client portfolios are offered in two profiles: aggressive growth or growth and income.

Essex High-Technology is an aggressive long/short equity strategy that aims to maximize returns by utilizing both fundamental and technical analysis with an emphasis on thematic investing and tactical market positioning. Specifically, we aim to understand key themes within the dynamic technology sector to capture the growth in those trends and utilize short positions to both hedge portfolio risk and exploit specific stock mispricing's.

Please refer to our firm's website at www.essexinvest.com for more information about Essex and the strategies we manage.