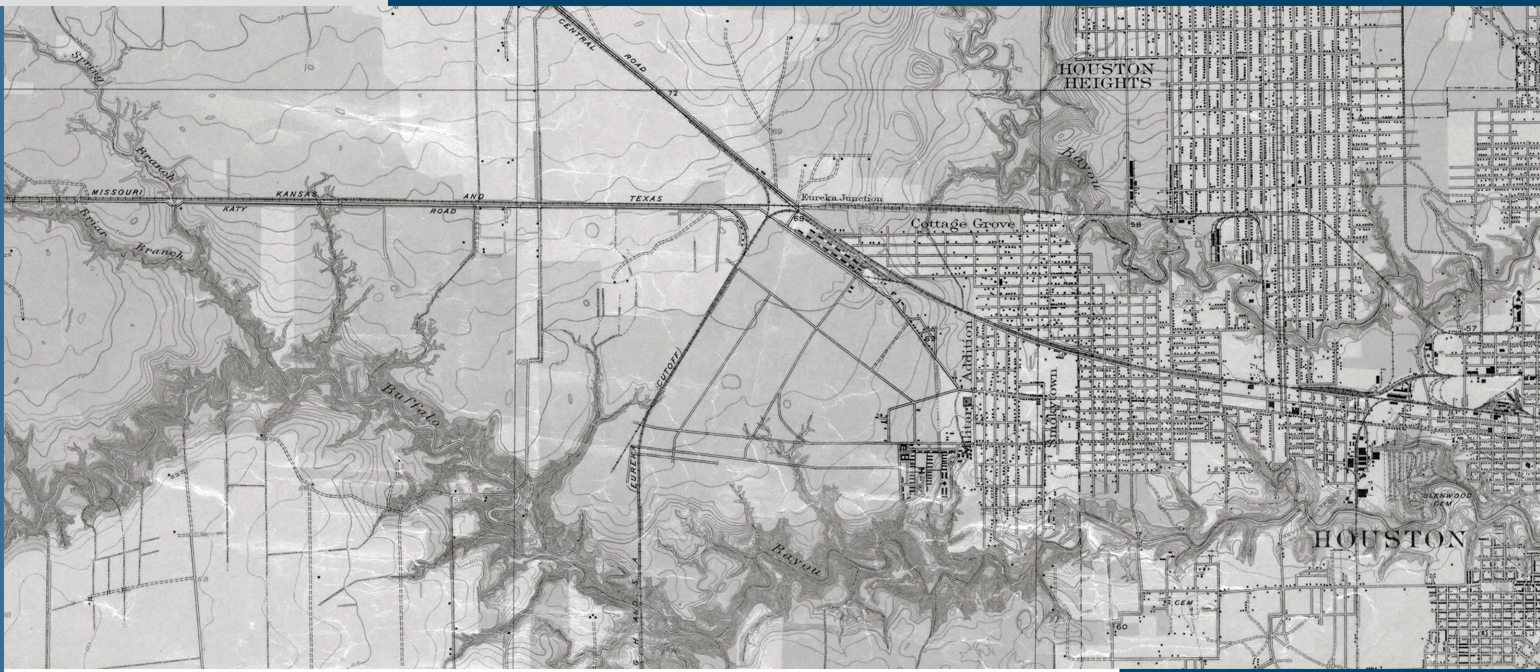
HOUSTON TRUST COMPANY

VIEWPOINTS



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Our Approach to Equity Investing

The ongoing debate between active versus passive management (also called “indexing”) in the context of equity investing may never be fully resolved. While the purpose of this Viewpoints is not an attempt to resolve the debate, we will briefly touch on the differences between these two approaches and the reasoning behind our approach to equity investing. At Houston Trust Company, we believe both approaches have merit, and each may be useful in achieving a given client’s needs and overall portfolio objectives. However, for the vast majority of our clients, we believe core holdings of high-quality, individual stocks managed (at reasonable cost) by independent, third party investment professionals offers a greater degree of flexibility, control and transparency, and can deliver competitive returns over long periods of time with lower volatility than passively managed index mutual funds.

Indexing and Active Equity Management Defined

In theory, passive equity investing entails simply replicating the holdings in an underlying index by purchasing the same securities in the same weights as the index. In practice, however, what the investor actually owns is a financial instrument, the return of which reflects the return of the particular index (S&P 500, EAFE, etc.) that the instrument is designed to replicate. This is not necessarily a bad thing, but we believe in “knowing what one owns,” and owning an index fund is fundamentally different than an ownership interest in the underlying businesses of real operating companies, in our view.

Active equity management, in contrast to indexing, seeks to exploit perceived market inefficiencies in an attempt to outperform the underlying index, or benchmark, over time. The degree of outperformance is commonly referred to as a manager’s “alpha” (i.e. the value-added return in excess of the appropriate benchmark which is attributable to the manager’s skill). In simple terms, long-only active equity managers will attempt to earn positive excess returns by overweighting underpriced securities/industry sectors while avoiding overpriced securities/industry sectors. “Active” management includes a wide range of strategies, from low cost, low turnover to expensive, trading-oriented approaches.

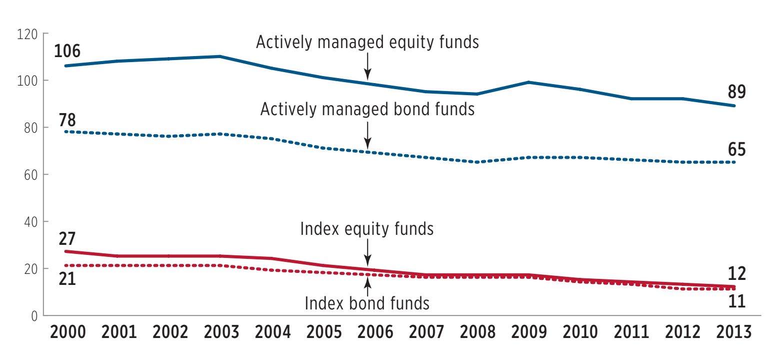
Map image courtesy of the University of Texas Libraries, The University of Texas at Austin.

Advantages of Indexing

Low Cost

The low cost nature of passive equity management is, in our view, a compelling benefit that this style of equity investing has to offer. Management fees for passively managed investment vehicles can be found for less than 10 basis points, which is simply a level (in terms of fees) where most active managers cannot compete. For example, the chart below, taken from the 2014 Investment Company Institute Fact Book[1], shows that the average actively managed equity fund's expense ratio is approximately seven times higher than the average index equity fund's expense ratio:

Expense Ratios of Actively Managed and Index Funds
Basis points, 2000–2013



Note: Expense ratios are measured as asset-weighted averages. Data exclude mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds.
Sources: Investment Company Institute and Lipper

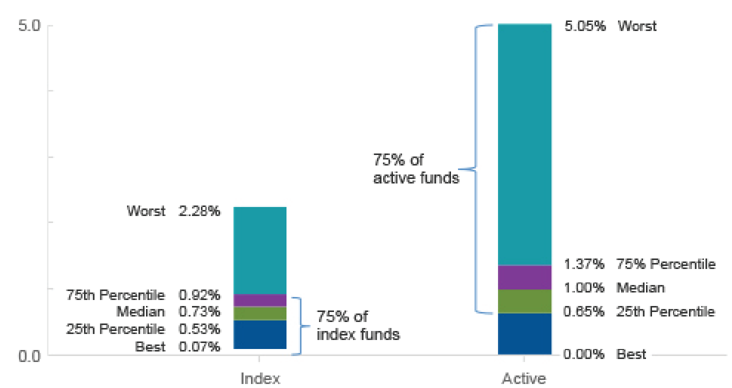
Investors, in return for paying very low fees, can expect to earn a market-level rate of return with market-level volatility.

Tax Efficiency

Passively managed index funds also tend to have a low degree of turnover in the underlying holdings of their securities. This low turnover also leads to a greater degree of tax efficiency, in general, for passively managed funds when compared to the tax efficiency of the average actively managed fund. A recent Vanguard study helps to illustrate this point, whereby they conclude that "The median tax cost of domestic actively managed funds was 27 basis points higher than that of domestic index funds."[2] The chart below depicts this difference in observed tax efficiency between active and index funds from 1998 - 2013:

One point to keep in mind is that not all "active" managers are alike. Some employ high turnover trading strategies, generating frequent realized short-term gains, while others might take a more tax-efficient, buy-and-hold approach, generating infrequent tax bills and, generally, long-term capital gains. Some managers are "closet indexers" (charging a higher fee for index-like exposure), while others might construct highly concentrated portfolios. Some active managers charge higher fees, while some do not. Thus, it is important to consider the distinguishing features between different active managers, as the term "active management" comes in many different flavors.

The tax cost of U.S. stock mutual funds: 15 years ended October 31, 2013
Comparing the difference between before-tax return and preliquidation after-tax return



Notes: Tax cost = (Before-tax return) – (Preliquidation after-tax return).
Number of active funds = 1,863; number of index funds = 99
Sources: Morningstar, Inc., and Vanguard; calculations assume account is not liquidated at the end of the period. Analysis excludes balanced funds, bear-market funds, long-short funds, and specialty funds. Index funds include ETFs.

1 Investment Company Institute, "2014 Investment Company Fact Book 54th Edition," www.icifactbook.org

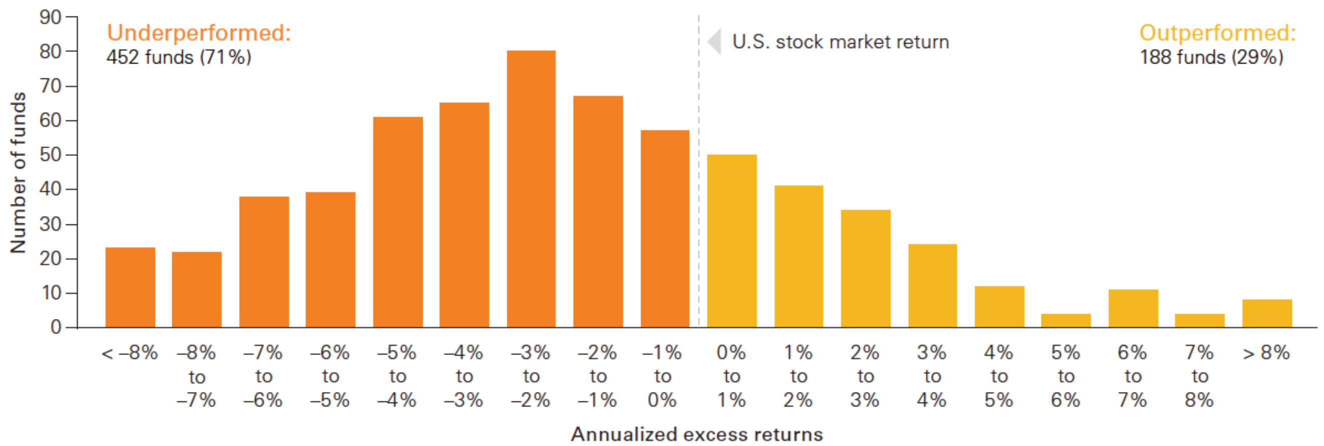
2 The Vanguard Group, Inc., "Tax Efficiency: A Decisive Advantage for Index Funds," December 26, 2013

Performance

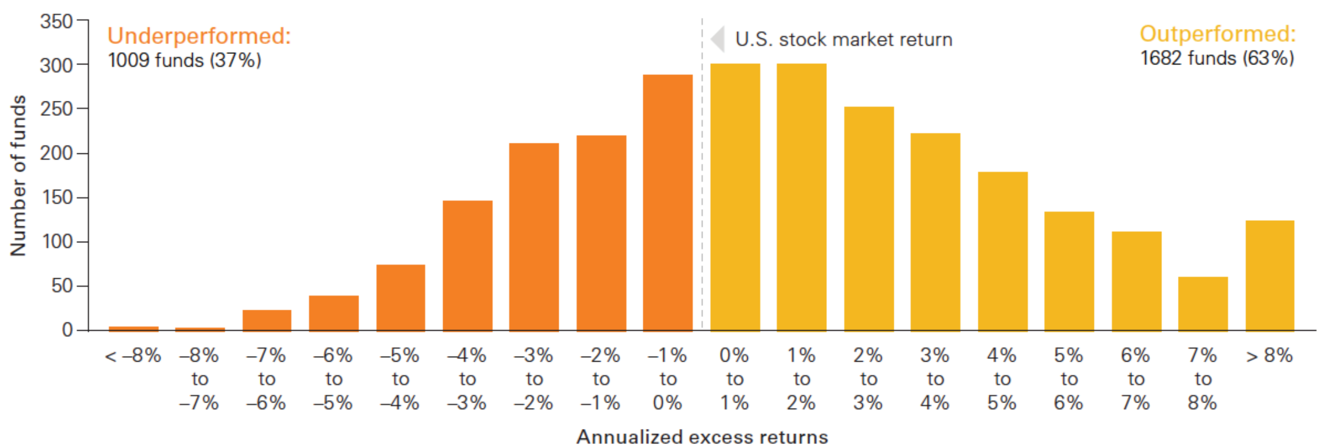
There is no denying the research that most active equity managers fail to outperform their respective benchmarks, net of fees, over rolling periods of time. For example, a recent CNN Money article cited, "A staggering 86% of active large-cap fund managers failed to beat their benchmarks in the last year… Nearly 89% of those fund managers underperformed their benchmarks over the past five years and 82% did the same over the last decade."[3] Thus, as these statistics suggest, it is quite difficult to pick a manager, ex-ante, who will consistently outperform their respective benchmark over the long term.

It is interesting to note that the performance advantage tends to fluctuate, cyclically, between active and passive management. This cyclicality is most likely driven by the overall market environment which tends to favor active equity managers in periods of low correlations within the broader equity market, and vice versa for passive indexing. As the charts[4] below show, different time periods contain significantly different distributions of excess returns in the large-cap active management universe:

a. Distribution of active manager net excess returns versus benchmark: Ten years ended December 31, 1999



b. Distribution of active manager net excess returns versus benchmark: Ten years ended December 31, 2008

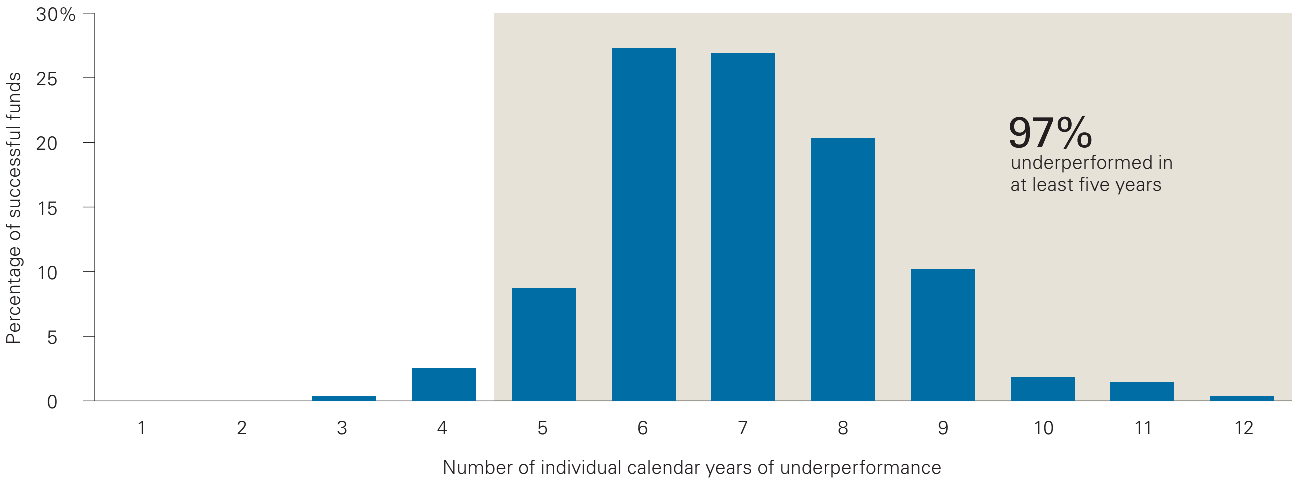


3 Egan, Matt, "86% of Investment Managers Stunk in 2014," CNN Money, March 12, 2015

4 Philips, Kinniry Jr. and Walker, "The Active-Passive Debate: Market Cyclicality and Leadership Volatility." Vanguard Research, July 2014

Furthermore, a recent Vanguard study[5] shows that even for the managers who outperform their benchmark over a period of 15 years, 97% underperformed their benchmark in at least 5 years with the majority underperforming for a period of 6-8 years:

Distribution of the 275 successful funds by total calendar years of underperformance, 1998–2012



Note: Successful funds are those that survived for the 15 years and also outperformed their style benchmarks.

Source: Vanguard calculations using data from Morningstar.

Constraints Using Active Management

The efficient utilization of active equity management can sometimes become constrained due to the capacity, and investability, of a particular strategy. Using small-cap managers as an example, the investment capacity (dollars under management) of a particular manager is limited by the relatively small universe of liquid, readily tradable securities in the small-cap universe of publicly traded equities. As such, it is common for highly skilled managers in the small-cap space to "cap" the amount of investor assets in their respective investment strategies. This capacity constraint, in turn, creates another set of issues for one to consider, particularly in regards to forced manager turnover. Using the above example, assume an investor has allocated capital to a highly skilled small-cap equity manager who in turn, has imposed a cap on the small-cap strategy's assets. The investor now needs to find a new, highly skilled, small-cap equity manager with larger capacity should the investor wish to add additional assets, or increase one's allocation, to small-cap equities. Even if such a manager can be found, this "forced" manager turnover creates added costs for the investor in the form of higher portfolio turnover and, in turn, reduced tax efficiency.

Passive equity investing has many compelling advantages, as we have illustrated above. We are absolutely open to utilizing low cost, tax-efficient index funds for our clients where it makes the most sense relative to the readily available alternatives in the form of active management.

Advantages of Active Equity Management

In our experience, certain approaches to active equity management can be accomplished in a low cost, tax efficient manner. Additionally, active management can incorporate volatility reduction which can lead to superior risk-adjusted returns relative to the broad equity market.

[5] Wimmer, Chhabra, Wallick, "The Bumpy Road to Outperformance," Vanguard Research, July, 2013

Tax Efficiency Coupled With Low Turnover

Active investing is not necessarily active trading. In today's day and age, where terms such as "high frequency trading" are regularly discussed in the financial media, it may be worthwhile to take a moment and differentiate between active trading and active investing. Active trading, as the term implies, can result in high portfolio turnover, often recognizing a large tax burden in the form of short-term capital gains, thereby delivering potentially poor after-tax returns to the investor. While there may be some trading strategies which generate respectable returns, despite the large turnover, we do not engage, or seek to engage, in these types of strategies on behalf of our clients due to the taxable nature of our trust accounts and the much lower odds of success for active trading.

It should also be noted that many passive investment strategies are quite active on the trading side. As new stocks enter and exit an index (i.e. termed index reconstitution), the passive index fund must adjust the underlying portfolio of securities, accordingly, regardless of the fundamental merits of the new and exited positions.

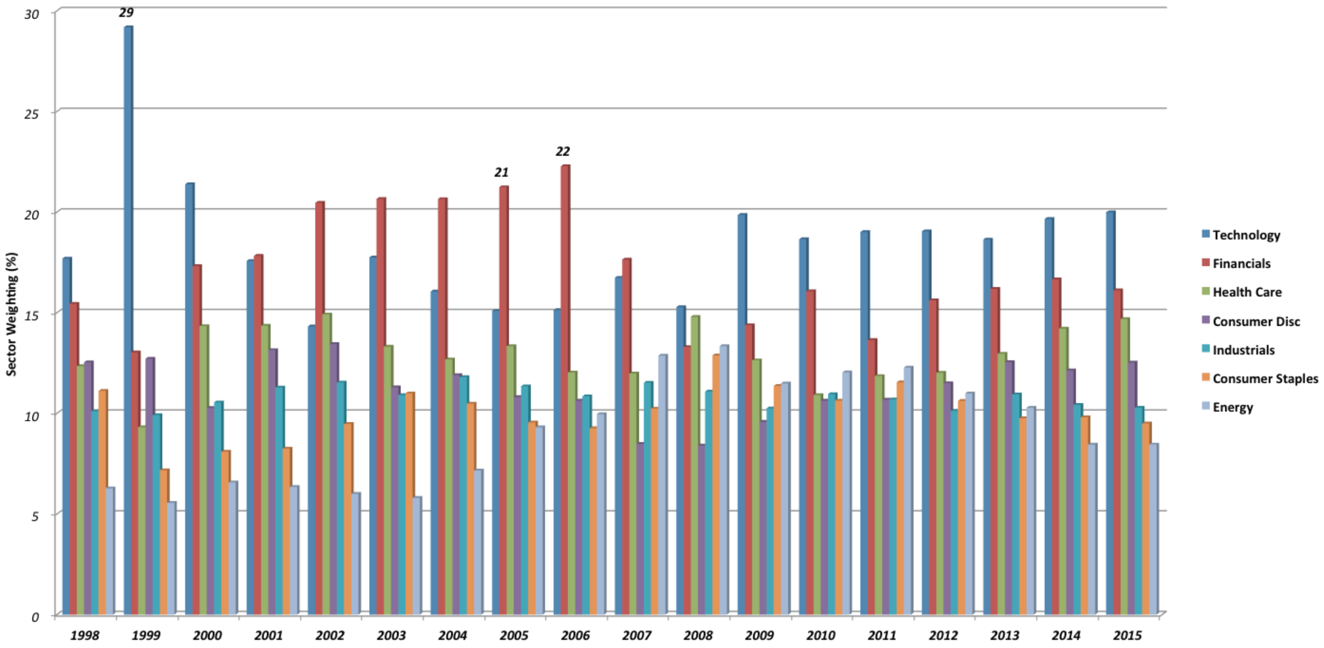
Houston Trust Company takes a long-term approach to equity investing, which is reflected in the low turnover and long holding period of the stocks owned in our client portfolios. We, as well as the outside managers we work with, tend to view equity investing as buying an ownership interest in real operating businesses. As a result, we generally do not sell securities unless we believe there has been a material, and generally permanent, change in the quality of the business' assets or a reduction in its competitive position within the market in which it operates. This long-term approach to equity investing makes the annual turnover of our client portfolios comparable to the turnover experienced in many passively managed index funds, which in turn, provides favorable after-tax growth in our clients' assets.

Active equity management in the form of individual stock holdings also offers the opportunity to "build-around" low-basis, legacy positions in order to achieve increased diversification in the portfolio. For example, suppose a client wishes to build a diversified portfolio around a highly appreciated security, such as Exxon Mobil (ticker: XOM), using a relatively small amount of existing cash. Diversification could be achieved quite efficiently through a separately managed account by constructing the portfolio around the existing concentrated position. In this case, our equity managers would exclude stocks from the energy sector, and energy-related businesses, when investing the available cash. Alternatively, and using the same aforementioned scenario, if one simply purchased an index mutual fund which tracks the S&P 500, the already large energy weighting would become even larger as the index fund would have close to an 8.50% weighting to energy (based on 12/31/2014 S&P 500 index sector weights). Furthermore, if the concentrated stock position is included in the index (as is the case in this example), one would essentially increase the already large exposure to the existing security by purchasing the index mutual fund. As such, one might inadvertently increase the concentration, and hence, increase the overall risk, of the portfolio; while simultaneously attempting to diversify and reduce the risk of the concentrated position.

Prudent and Disciplined Portfolio Management

The benefits of using active management are readily apparent when we look historically at some of the more recent "bubbles" that occurred in the U.S. equity market. The chart below depicts the historical sector weightings of the top three sectors which comprise the S&P 500 index. When looking back in 2005 and 2006, just before the most recent financial crisis which began in 2007-2008, the financial sector comprised over one-fifth of the entire S&P 500 index (spurred largely from the profits booked by many large financial institutions who participated in the underwriting and market making activities of mortgage-backed securities and derivatives).

Similarly, at the peak of the internet bubble, often referred to as the "tech wreck," which occurred in the late 1990's to early 2000's, we find that the technology sector made up nearly a third of the market capitalization within the entire S&P 500 index.



During this period in time, many technology stocks with little to no revenue or earnings were trading at very rich valuations. A case in point would be Cisco Systems (ticker: CSCO). The table below breaks out Cisco Systems' representation in the Russell 1000 index relative to its P/E Ratio and overall economic impact on the economy (as measured on the basis of several key accounting measures):[6]

	Holding Data as of March 31			
Tech Bubble	**1999**	**2000**	**2001**	**2002**
Cisco Systems				
Percent in Russell 1000® Index	1.7%	4.1%	1.1%	1.3%
Percent of Economy	0.1%	0.2%	0.3%	0.4%
P/E Ratio	81.8	181.9	25.1	22.0

Cisco Systems was one of many stocks in the technology sector trading at double digit to triple digit P/E ratios during this time period, best characterized by high investor euphoria within the overall technology sector as a whole.

When underlying securities, such as Cisco Systems, become more overvalued, their representation in the index increases proportionately. As a result, capitalization-weighted indices, such as the S&P 500, are prone to market bubbles and their corresponding risk and return characteristics can become overly influenced by overpriced securities, and the resulting sectors, which comprise the overall index. In this sense, investing in a passive index is similar to following a momentum based strategy (i.e. owning more of a security when its value rises, and vice-versa).

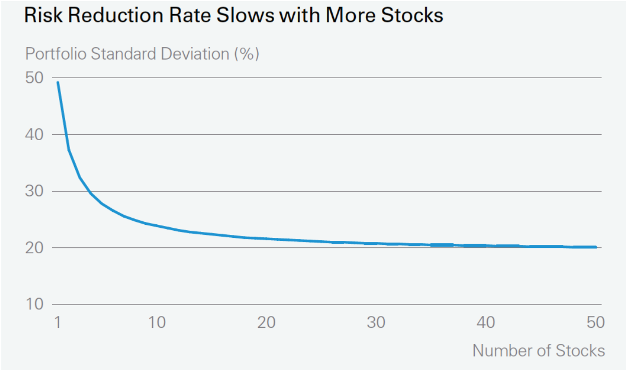
At Houston Trust Company, we outsource the equity management of our client assets to independent, professional investment management firms who take a fundamental approach to security selection. Our equity managers take a deep dive into the research process of all stocks that are ultimately owned in the portfolios of our clients. As a result of this prudent approach to equity investing, our managers avoided the many companies which failed during the tech wreck, along with the Enrons and AIGs of the more recent past. By choosing to invest in financially sound and growing businesses for the long-term, our clients are better protected from the risk of a permanent impairment in wealth once these aforementioned bubbles inevitably "pop."

Volatility Reduction

We evaluate our equity managers not only from a return, but also from a risk standpoint. We believe that active management can incorporate important risk reduction benefits into our clients' portfolios. While our equity managers tend to build diversified portfolios of high-quality stocks for our clients, there is a diminishing marginal return to the number of securities included in a portfolio.

[6] Kalesnik, Vitali PhD, "The Second Generation of Index Investing," Smart Beta, 2014

As the chart[7] below illustrates, the benefits offered by diversification begin to decrease dramatically once the number of stocks held in the portfolio reaches 10-20:



This concept brings us to another important tenet of our investing philosophy, which is, *what you don't own in your portfolios is just as important as what you do own.* In an attempt to own the entire index, one may be at risk of "overly diversifying" a portfolio which achieves little in the way of risk reduction once the portfolio contains over 10 to 20 different stocks. To reiterate a previous point made in this paper, by choosing to own the index, one is making the active decision to own *all* of the securities held in the index, without regard to quality or future growth prospects. Active managers, by having the discretion and flexibility to build highly diversified portfolios using a fraction of the securities contained in the index, can reduce the level of market risk in their portfolios relative to that of an index fund. This reduction in volatility can, in turn, offer investors a higher level of compounding when the investor is taking regular, periodic distributions from their portfolio.

Our Approach to Equity Investing

At Houston Trust Company, we operate under certain assumptions regarding equity management. The first assumption is that, over time, equities offer the best real return, and that this return is going to be in the general range of the long-term historical return of 9.60% per annum.[8] One may do better or worse, but returns of this order of magnitude are what can be expected. This return, compounded over long periods of time, will result in significant wealth creation or growth of the capital base. If the rate of return for the asset class is treated as "given" (more or less), then aside from proper allocations to the asset class, the next most important thing is the control of what can be controlled; namely, the expenses related to management fees and capital gains taxes.

All of this would lead to the conclusion "why not index?" and we do not disagree. We are, however, able to utilize good performing active management at a low cost, and with managers with whom we have long and significant relationships. Furthermore, active management promotes greater control in managing both the timing and magnitude of taxes incurred. We have also found that some active managers, over long periods of time, produce alpha (excess return) with a lower sensitivity to the movements in the broader equity market (beta). This is beneficial to long-term compounding of a portfolio, especially when cash is flowing in and out of the portfolio. Finally, there is the psychological preference for "knowing what one owns" in the portfolio.

So we incorporate both approaches to equity management in our investment process. For smaller accounts and allocations to specific market sectors (like small cap value) we use indexing. For larger accounts with large embedded capital gains and (often) concentrated low-basis legacy positions, we employ low cost, tax-efficient active management.

Conclusion

At Houston Trust Company, our objective for our clients and beneficiaries is to preserve their purchasing power over the very long term (often from one generation to the next). This requires growth of the capital base in real (inflation-adjusted) terms, and among financial asset classes, equity investments are the best means to achieve this. In pursuing this goal, for the equity allocation, we do not believe there is a "silver bullet" or a "one-size-fits-all" approach. Rather, we find both indexing and active management to offer their own respective advantages.

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[7] Less Is More: A Case for Concentrated Portfolios, Lazard Investment Focus, Lazard, February 12, 2015

[8] Damodaran, Aswath, Stern NYU, "Annual Returns on Stock, T. Bonds and T. Bills: 1928 – Current," January 5, 2015