

INVESTMENT OVERVIEW

ARE ETFs EXACERBATING EQUITY MARKET EXTREMES?

There is mounting evidence supporting the theory that *exchange-traded funds* (“ETFs”) may be contributing to outsized swings in equity markets, such as the sharp sell-off in U.S. equities during the fourth quarter of 2018 (“4Q18”) and the corresponding year-to-date (“YTD”) rally across U.S. equity markets through the first three months of 2019.

REQUIRED READING: [ETF ETIQUETTE](#)

ETFs reached **±15.8%** of total net assets across registered investment companies in the U.S. as of year-end 2018, making them an increasingly important consideration in portfolio management, necessitating a fundamental understanding of ETFs.* The September 2016 edition of [INSIGHTS](#) provides a detailed, in-depth analysis of the underlying mechanics of ETFs, the exponential growth and proliferation of the ETF industry over the past **±20 years**, as well as a summary of the relative pros and cons of utilizing ETFs in the portfolio construction process. The subsequent pages recap these rudimentary fundamentals of ETF investing, while highlighting the growing influence these investment tools are wielding on the market.

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*Source: Investment Company Institute® (“ICI”)

WEALTH ADVISORY OVERVIEW

FAFSA - UNDERSTANDING THE FREE APPLICATION FOR FEDERAL STUDENT AID

Every year, the U.S. Department of Education (“DOE”) gives over \$120 billion in federal grants, loans and work-study funds to more than 13 million college students, making it the largest provider of student financial aid in the country. Federal grants do not need to be repaid, federal student loans have low interest rates and work-study programs can be a convenient way to simultaneously fund an education and build a resume. In order to determine eligibility for financial aid, families must complete the Free Application for Federal Student Aid (“FAFSA”).

FASFA determines a student's eligibility for a myriad of grants and aid for all income levels. It can also determine eligibility for federal subsidized and unsubsidized loans, which can be more affordable alternatives to other types of loans.

WHO SHOULD COMPLETE THE FAFSA FORM?

All college-bound high school seniors and returning college students should file the FAFSA. This applies to both dependent and independent students. You do not need to know which school you will be attending to file. You can list the colleges to which you are applying on the FAFSA and you can always edit your list later by simply logging in to your account.

Many families choose not to apply for FAFSA because they think

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SPECIAL POINTS OF INTEREST

- [Monthly Index Review](#)
- [Stock & Strategy Spotlight](#)
- [Around McShane Partners](#)

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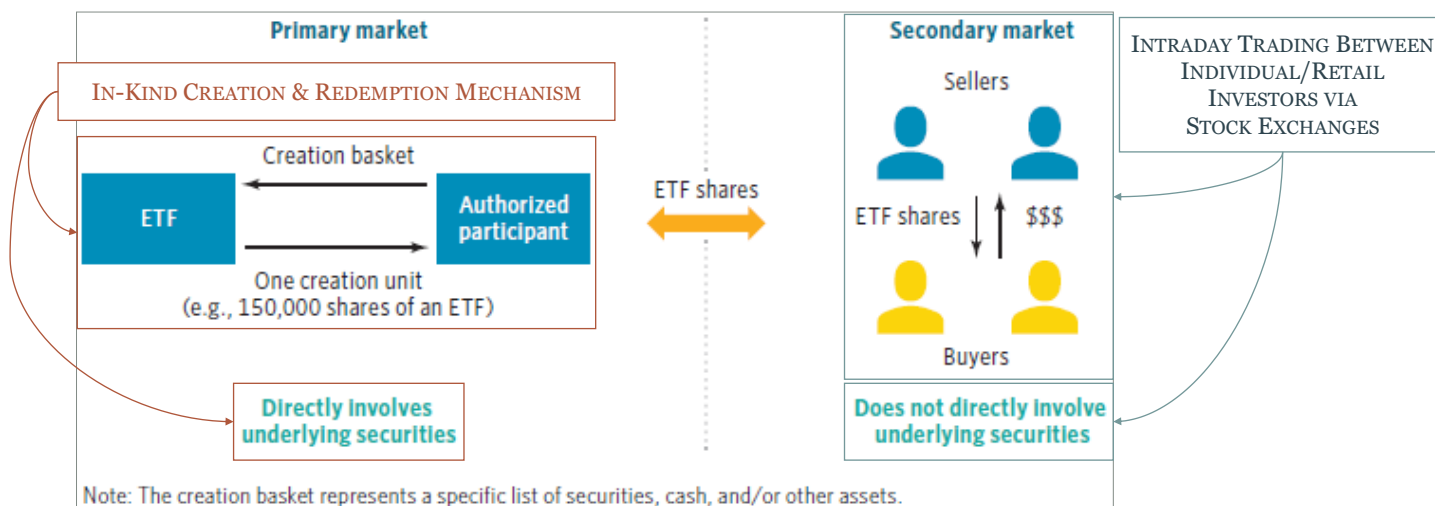
ETFs 101

ETFs are *pooled investment vehicles*, typically structured as *open-end funds* that invest in a basket of securities, representative of an index or specified investment mandate, whose shares trade intraday on a stock exchange. ETFs have rapidly grown in popularity as investment vehicles predominantly because they offer investors access to inexpensive *systematic risk* (i.e., *beta*), with significant tax, cost, and trading advantages relative to mutual funds. ETFs should be used as *complementary* portfolio management tools that, when used correctly, can accentuate *risk-adjusted performance* by reducing internal expenses, diversifying risk, and providing efficient, general market access and exposure to particular sectors or trends across client portfolios.

The construction mechanism and secondary market trading of ETFs remain esoteric obscuring true *liquidity risk* inherent in the basket of assets compromising the ETF. ETF vendors claim that there is “unlimited liquidity” due to the *in-kind creation and redemption mechanism* outlined below in Chart I. The concern is that the trading activity in the secondary market is separate and disconnected from the trading capacity inherent in the primary market. In the U.S., *authorized participants* (“APs”) are usually large financial institutions, registered as *self-clearing broker-dealers*, that enter into legal contracts with the fund company or sponsor to create and redeem ETF shares and have the ability to process all required trading activity on their own accounts (*Source: 2018 ICI Fact Book*). ETFs tend to be *more tax efficient* than mutual funds due to the aforementioned mechanism, which circumvents the

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CHART I: IN-KIND CREATION & REDEMPTION MECHANISM



Source: 2018 Investment Company Fact Book, The Investment Company Institute® (“ICI”)

MONTHLY INDEX REVIEW
USD TOTAL RETURN

DATA AS OF MARCH 31 ST 2019	MARCH 2019	2019 YTD	2018	2017
S&P 500®	+1.94%	+13.65%	-4.38%	+21.83%
Dow Jones Industrial Average	+0.17%	+11.81%	-3.48%	+28.11%
NASDAQ Composite	+2.70%	+16.81%	-2.84%	+29.64%
Russell 2000	-2.09%	+14.58%	-11.01%	+14.65%
MSCI Emerging Markets	+0.86%	+9.95%	-14.24%	+37.75%
MSCI EAFE	+0.74%	+10.13%	-13.36%	+25.62%
Bloomberg Barclays U.S. Aggregate Bond Index	+1.92%	+2.94%	+0.01%	+3.54%

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inherent flaws of the *net asset value* (“NAV”) pricing model of traditional mutual funds wherein the aggregate redemption activities of the pooled investor base can trigger adverse, turnover-related taxable events for each individual investor.

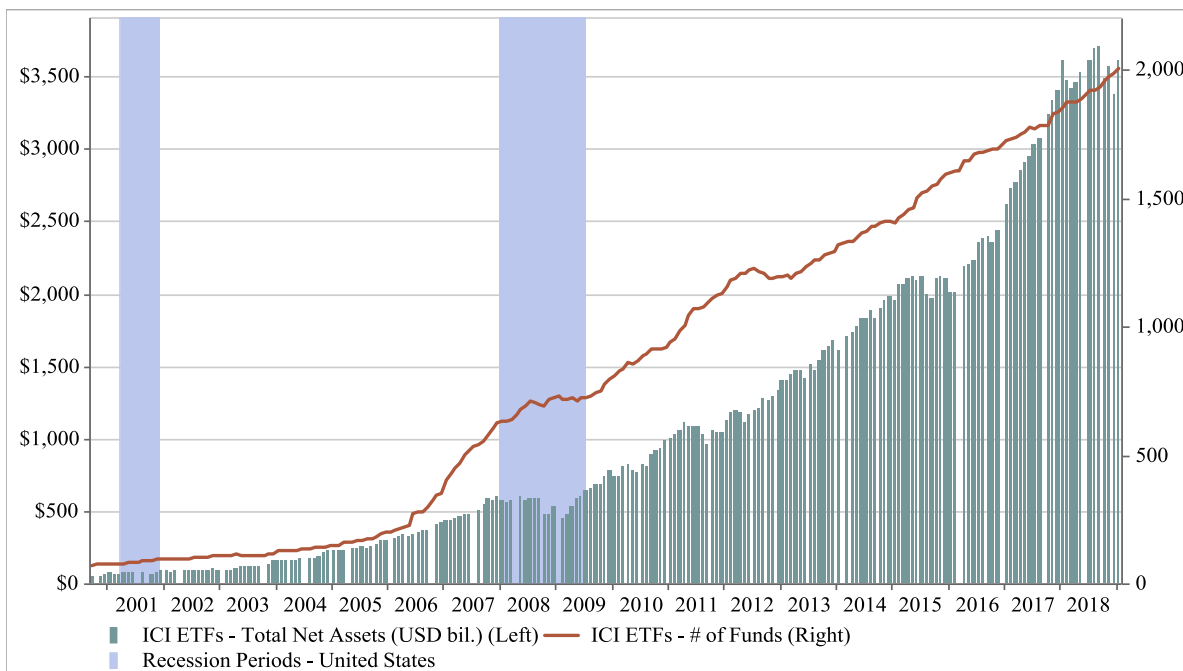
ONGOING EVOLUTION & EXPONENTIAL GROWTH OF ETF INDUSTRY

The first ETF, the SPDR® S&P 500® ETF (“SPY”), was launched on January 22nd 1993 by State Street Global Advisors (“SSGA”) with the straight-forward investment objective of providing: “investment results that, before expenses, correspond generally to the price and yield performance of the S&P 500® Index.” Since that time, as depicted in Chart I, the ETF industry has grown exponentially over the past **±19 years**, with over **\$3.6 trillion** in *net assets under management* (“AUM”) across **±2,000** different ETFs: since September 2000, the aggregate net AUM invested across all U.S. ETFs has grown at a *compound annualized growth rate* (“CAGR”) of **±26.4%**, while the total number of U.S. ETFs has grown at a comparable CAGR of **±19.4%**. The U.S. mutual fund industry, however, has seen total net AUM grow at a considerably slower CAGR of just **±5.93%**, while the total number of U.S. mutual funds has exhibited negligible growth at a CAGR of **±0.03%** over the past **±19 years**.

Given the proliferation of ETFs, it is becoming increasingly difficult to navigate the ever-growing universe of ETFs, especially as the ETF industry continues to expand beyond conventional *passively managed, index replication* investment strategies to include not only *illiquid* asset classes, but also relatively complex and exotic strategies. As a result, the selection of the appropriate ETF to deploy within a long-term, diversified investment portfolio can be just as complicated and involved of a process as determining which mutual fund manager to invest with or constructing and managing a dedicated equity portfolio of individual stock holdings.

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CHART II: EXPONENTIAL GROWTH OF ETF INDUSTRY



Source: FactSet Research Systems - McShane Partners

ABOUT
MCSHANE PARTNERS

McShane Partners is an experienced, boutique registered investment advisor dedicated to independent, comprehensive wealth management. Founded over 30 years ago, the firm, from its inception, has had a singular focus: to provide highly customized investment management and financial planning solutions to clients.

Boutique Firm:

Being a boutique wealth management firm allows us the flexibility to provide more personalized service and offer unique investment solutions to clients in a Fee-Only environment.

Team Approach:

Because each client’s situation is different, the team of advisors is hand-selected to ensure areas of expertise are appropriately aligned with the client’s specific needs and interests.

Proprietary Investment Research:

The differentiating factor of our portfolio management process is the proprietary investment research driving the portfolio construction. All investment research and analysis is done entirely in-house by our Investment Team.

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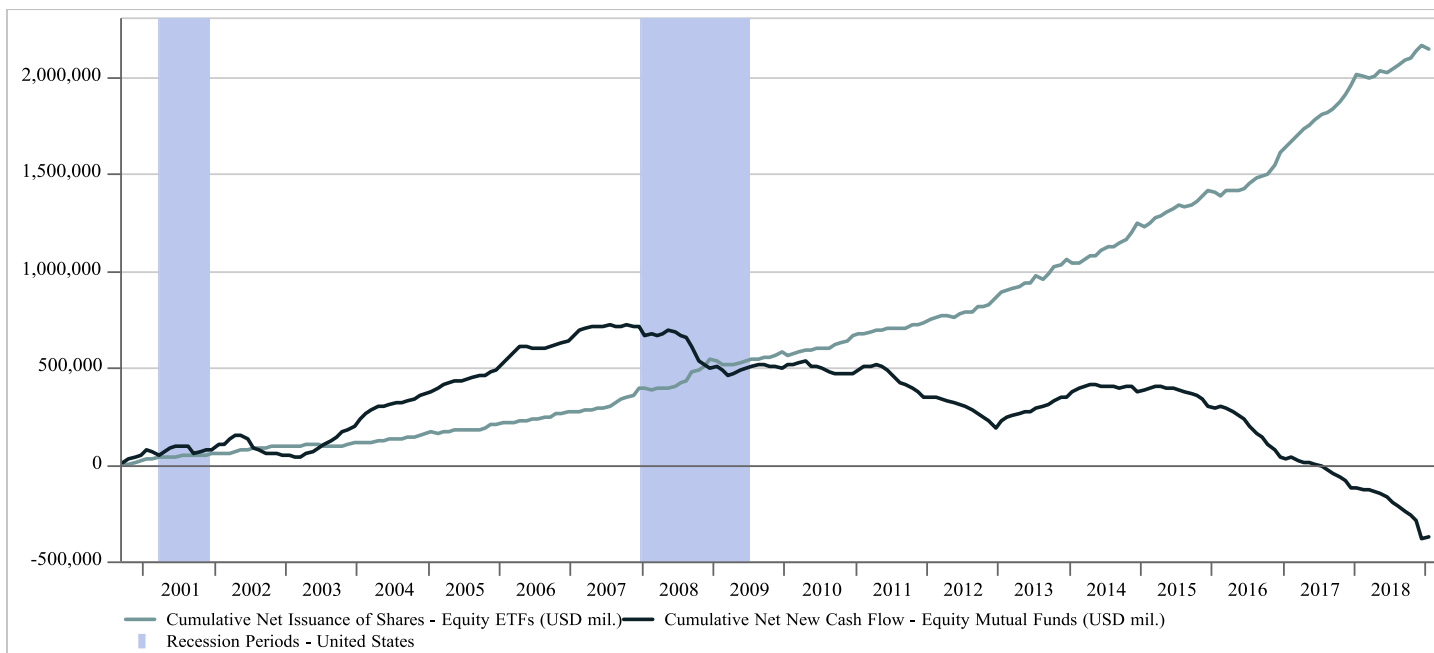
APPROPRIATE USE IN DIVERSIFIED INVESTMENT PORTFOLIOS

The Investment Team believes the best role for ETFs within long-term, diversified investment portfolios is index replication with dedicated, strategic beta exposure to specific trends, sectors, or asset classes. The foundation of index replication (i.e., *indexing*) was predicated on the precept of *market efficiency*, wherein market-determined prices of the constituent securities included in an index *fully* and *instantaneously* reflect the securities' *intrinsic values* due to the availability and incorporation of *perfect information* (i.e., *informational transparency*). The basis of this transparency is that investors access and assimilate the available information immediately, but an argument can be made that this breaks down as the investor universe become *more passive*, consequently paying *less attention* to the fundamentals and valuation of individual companies. The Investment Team identifies *efficient markets* with sufficient underlying liquidity, such as large- and mid-cap U.S. equities where ETFs are effective, while relying on actively managed investment strategies in *inefficient markets*, where an active manager should have a higher probability of generating excess relative *risk-adjusted returns* (i.e., *alpha*) through superior knowledge acquisition or technique, such as hedge fund strategies, alternative and high-yield fixed income, as well as emerging market (“EM”) equities. Furthermore, we believe there are still inefficiencies in the market that we can exploit through a methodical, value-based, contrarian approach to individual stocks. **In fact, the Investment Team believes the emerging presence of ETFs in the marketplace forces investors to own many of the same assets creating an opportunity to capitalize on the potential outsized returns associated with investing in increasingly overlooked assets with limited ETF exposure.**

For example, 2018 was a particularly difficult year for EM equity investors on a relative and absolute basis: for investors in the iShares MSCI Emerging Markets ETF (“EEM”) - one of the largest EM equity ETFs - 2018 was a particularly volatile year, exposing the EEM to *underperformance* relative to the MSCI Emerging Markets Index, trailing by **-1.07%** (Source: FactSet Research Systems). Even after adjusting for EEM’s expense ratio of **0.67%**, the residual relative underperformance of EEM in 2018 highlights how utilizing a passively managed indexing strategy in

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CHART III: SECULAR SHIFT IN NET NEW CASH FROM MUTUAL FUNDS INTO ETFs



Source: FactSet Research Systems - McShane Partners

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inefficient markets can result in the *unintended risk* of potential divergent performance vs. the respective benchmark, as mandatory rebalancing can force extreme trading at inopportune times.

ACTIVE VS. PASSIVE: SECULAR SHIFT IN FUND FLOWS

The exponential growth in AUM enjoyed by the ETF industry over the past two decades has largely come at the expense of traditional mutual funds and other conventional investment vehicles, which have seen their relative share of aggregate financial assets *decline* as a direct result of the secular proliferation of ETFs. As can be seen in Chart III ([page 4](#)) equity mutual fund strategies in the U.S. have experienced cumulative net cash *outflows* of **-\$361.2 billion** since September 2000 vs. cumulative net cash *inflows*, as measured by net share issuance, of **+\$2.1 trillion** for equity ETFs in the U.S.: furthermore, after peaking in February 2007, the total number of all domestic equity mutual funds in the U.S., including both actively managed mutual funds, as well as passively managed, index-based mutual funds, has fallen by **-14.0%** from **±3,749** to **±3,223** as of January 2019. While mutual funds are still responsible for overseeing and managing a significant percentage of investable assets across the U.S., the seismic shift in investor preference from mutual funds to ETFs and from active to passive have had a *direct* impact on the composition of the asset management industry.

“If [ETF] absorption capacity has indeed been reached, flows should continue to moderate. This takes out one form of price support that has existed for the past seven years. If you take momentum away, then the investment case becomes a story of fundamentals. If fundamentals break down, or investor psychology shifts to risk-aversion, the resulting reversal of flows could prompt an even bigger correction than we experienced in [4Q18].”

- Michael Cuggino, President of the Permanent Portfolio® Family of Funds

Given the duration and magnitude of the equity bull market enjoyed by investors over the past 10 years and relatively subdued levels of volatility, the potential ramifications of these structural changes in the asset management industry (toward a more passive investment approach using ETFs that have not been stress tested) on broader financial markets is not fully understood. Of particular concern, is the possibility that investor flows in and out of ETFs could ultimately overwhelm the price discovery mechanisms creating liquidity mismatches with no fundamental active buyers to offset computed trading triggering ETF redemptions which don't consider liquidity factors across global financial markets - in other words, instead of ETFs offering passive exposure to a market index, could ETFs ultimately unduly influence the performance of the market index itself by arbitrarily influencing the pricing of the underlying constituent securities simply because they are components of the ETF with no consideration for valuation or the fundamentals of the company. The reduction in countervailing market participants (i.e., active management) willing or able to intercede to correct the mispricing of securities relative to their fundamental, intrinsic values could result in deviations in valuations, as well as violent short-term swings in market values resulting from *herding behavior* propagated by ETFs.

4Q18 & 2019 YTD: EXAMINING ETF EFFECTS

As the Investment Team mentioned in its November 2018 edition of [INSIGHTS](#), an article published in October 2018 by *The Wall Street Journal* (“WSJ”) highlighted how the growth in ETF AUM has coincided with a considerable increase in late-day trading activity (i.e., trading volume) across stock exchanges, implying that ETFs tracking an equity market index have been waiting until the final hour(s) of the trading day to execute trades in order to adjust for deviation relative to their portfolio's corresponding index due to extreme intraday price volatility. **According to WSJ, trading volume in the final hour of the trading**

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day as a percentage of daily trading volume on the New York Stock Exchange (“NYSE”) increased from $\pm 17.0\%$ in 2012 to $\pm 26.0\%$ in 2017 (Source: WSJ - “Late-Day Trading Activity Continues to Increase”). As a result, surges in late-day trading volume from passive indexing investment vehicles may have amplified market declines, as portfolio positions were sold to replicate the corresponding declines across the respective equity market indexes.

“If everybody indexed, the only word you could use is chaos, catastrophe. The markets would fail.”

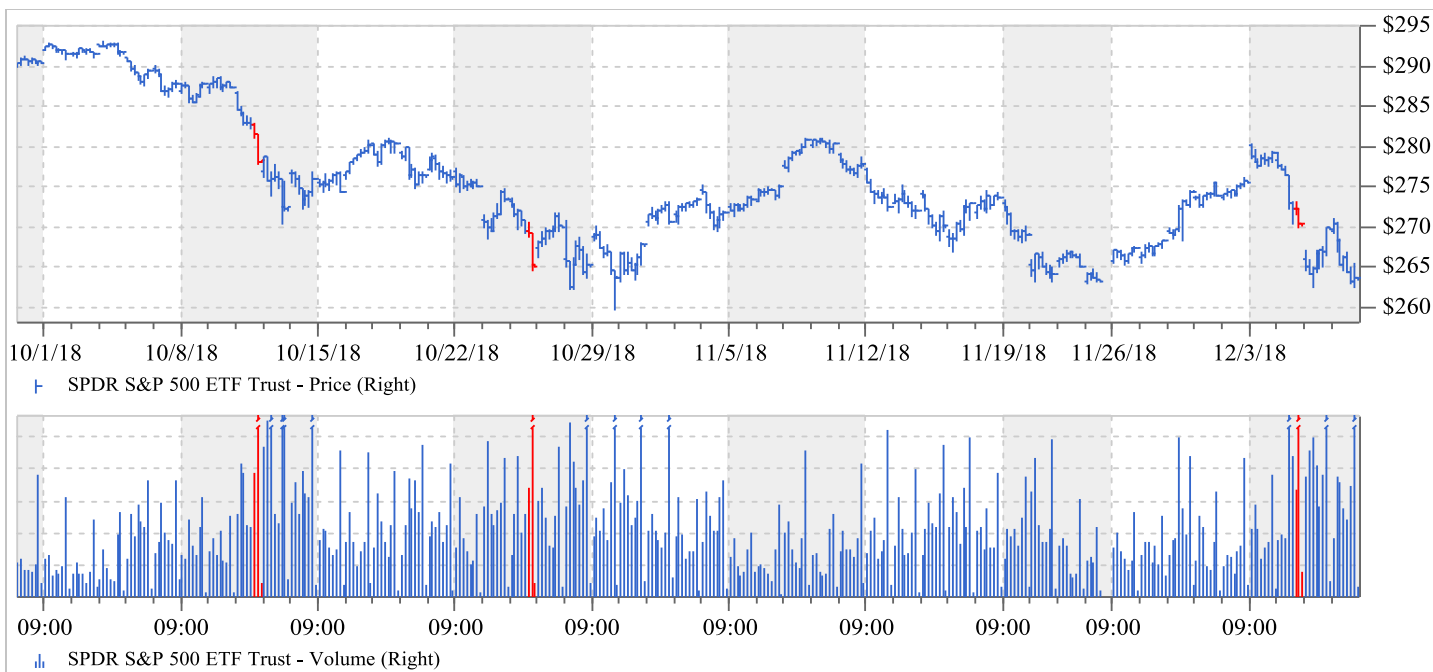
- John “Jack” Bogle

As can be seen in Chart IV, below, there is a noticeable increase in late-day trading volume in shares of SPY on the three worst trading days, in terms of price declines, for the S&P 500® Index in 4Q18: October 10th (-3.29%), October 24th (-3.09%), and December 4th (-3.24%). For instance, during the third quarter of 2018 (“3Q18”), the average daily trading volume for SPY was approximately ± 61 million shares: during the final hour of the trading day on October 10th, however, trading activity in SPY spiked significantly, with more than ± 57 million shares traded via U.S. stock exchanges - in other words, roughly $\pm 85.6\%$ of its 90-day moving average trading volume (“90-day MAVG”) in SPY was processed in the final hour of the trading day on October 10th (Source: FactSet Research Systems).

Triangulating this to the impact on individual stocks in Table I on the next page illustrates the potential price manipulation that can occur when ETFs are guided to manage to the index. On October 10th, trading volume in shares of the second-largest underlying position in the SPY - Microsoft Corp. (“MSFT”) - experienced a similar surge in late-day trading, with trading volume in shares of MSFT hitting $\pm 77.7\%$ of their 90-day MAVG during the final hour of the trading that day. While MSFT began 4Q18 as the second-largest position in the SPY, it ended up becoming the largest position at the end of 4Q18, as shares of Apple, Inc. (“AAPL”) declined significantly throughout the quarter following disappointing quarterly earnings results - released on November 1st 2018 - which

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CHART IV: ETF LATE-DAY TRADING VOLUME ON DOWN DAYS



Source: FactSet Research Systems - McShane Partners

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triggered a sharp rotation out of the stock, probably exacerbated by mandatory ETF rebalancing, as well, to reflect the stock's reduced position sizing in the S&P 500[®] Index after the share price decline.

Table I shows the noticeable similarities in trading activity in the SPY and shares of MSFT during late-day trading on the four worst trading days, in terms of price declines, for the S&P 500[®] Index in 4Q18. In particular, both the SPY and shares of MSFT experienced concentrated trading volume during the final hour of trading each of these days, as measured in the "% of Daily Volume" column, as well as relative to the 90-day MAVG, as measured in the "% of 90-Day MAVG" column, leading the Investment Team to believe that the day-to-day performance of large components of widely followed indexes, such as MSFT, may be alarmingly linked to the mechanics of the trading and rebalancing activity of ETFs tracking those indexes.

TABLE I: TRADE VOLUME ANALYSIS - SPDR[®] S&P 500 ETF ("SPY") VS. MICROSOFT CORP. ("MSFT")

DATE & TIME	SHARES TRADED VOLUME	% OF DAILY VOLUME	90-DAY MOVING AVERAGE VOLUME ("MAVG")	% OF 90-DAY MAVG
<u>October 10th 2018</u> ⇒ <u>3:00 - 4:00 PM EST</u>				
SPY	57,594,849	±26.8%	67,289,515	±85.6%
MSFT	19,785,091	±56.8%	25,449,561	±77.7%
<u>October 24th 2018</u> ⇒ <u>3:00 - 4:00 PM EST</u>				
SPY	49,978,560	±28.1%	75,632,642	±66.1%
MSFT	18,498,339	±29.0%	26,783,097	±69.1%
<u>December 4th 2018</u> ⇒ <u>3:00 - 4:00 PM EST</u>				
SPY	45,062,614	±25.3%	88,836,340	±50.7%
MSFT	14,099,975	±31.2%	30,299,069	±46.5%
<u>December 24th 2018</u> ⇒ <u>3:00 - 4:00 PM EST</u>				
SPY	35,862,216	±26.8%	104,013,366	±34.5%
MSFT	13,093,494	±29.8%	34,879,345	±37.5%

Source: FactSet Research Systems, Inc. - McShane Partners

STOCK & STRATEGY SPOTLIGHT

NAME	TICKER	2019 YTD
Berwyn Income Fund	BERIX	+3.79%

DESCRIPTION & INVESTMENT THESIS

On February 28th 2019, Chartwell Investment Partners, investment advisor to the Berwyn Income Fund ("BERIX"), announced the resignations of BERIX's two Senior Portfolio Managers, George J. Cipolloni III and Mark J. Saylor. After speaking with a member of the incoming portfolio management team, the Investment Team determined that the change in leadership at BERIX deviates from the Investment Team's initial investment thesis, as BERIX's stellar track record and history of delivering attractive risk-adjusted returns during periods of heightened equity market volatility - specifically, the net performance of BERIX from 2008-2009 - were primary considerations in the Investment Team's long-term investment thesis for BERIX and are now no longer representative or reflective of the portfolio management team currently in place. The Investment Team is actively looking for complementary investment strategies to incorporate into existing Hybrids allocations and effectively replace BERIX. Until such a strategy is found, however, the Investment Team will continue methodically rotating out of BERIX and, as a result, will maintain a slight tactical *underweight* to Hybrids across client investment portfolios.

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that they will not qualify for federal aid. When students do not apply for FAFSA, many revert to private student loans, which often have high interest rates and lack the consumer protections afforded by federal student loans. By completing the FAFSA form, students can make sure that they are taking advantage of the best student loan options available.

WHEN SHOULD THE FAFSA FORM BE COMPLETED?

October 1st 2019 is the first day that students can fill out the FAFSA, in order to receive their share of funds for the 2020-2021 school year. The deadline for the 2020-2021 FAFSA is midnight, Central Time, June 30, 2021. What many students and parents may not understand is that a large portion of financial aid is distributed on a rolling basis. Therefore, the earlier you apply, the more grant money you are likely to receive. Filing early also helps to ensure you do not miss FAFSA deadlines for state and college aid, which may differ from the federal deadline.

FAFSA FORM CHANGES

One change to the FAFSA form allows students to use income from two prior years, as opposed to prior-year income. The advantage is that you do not have to wait until your family's current-year tax returns are filed in order to complete your FAFSA. You could submit the form for the 2020-21 academic year as early as Oct. 1, 2019 using 2018 income reported on your tax return. Under previous rules, families would have to wait to submit the FAFSA until after they had filed their income taxes for 2019 to get their household's prior-year income figure. Or they would submit the form with an estimated income figure, and then go back and update the form with the finalized income amounts.

Another change to the FAFSA form allows users to be able to pull in their family's tax information directly from the IRS using the IRS Data Retrieval Tool. The benefit of using this tool is that data is transferred directly from the IRS and automatically populates the form, which saves time and ensures greater reporting accuracy. In addition, according to the IRS, using the tool reduces the likelihood that the school's financial aid office will select your form for verification requiring the student's family to supply additional documentation for the information reported on the FAFSA.

HOW OFTEN DO I NEED TO COMPLETE THE FAFSA FORM?

The FAFSA needs to be filed every academic year. Eligibility for student aid does not carry over from one academic year to the next. Additionally, variables such as your family's income level in a given year and the number of family members enrolled in college at the same time will affect the amount of aid a student is eligible to receive.

WHEN WILL I RECEIVE NOTIFICATION INFORMING ME OF THE AMOUNT OF AID FOR WHICH I AM ELIGIBLE?

The DOE processes your application within 3-5 business days and then sends it electronically to the schools listed on your FAFSA. The schools use this information to package your financial aid offer. Sometimes, the schools are required to obtain more information before they can proceed and they will notify you if that is the case. The schools will also notify you when your award offer is ready for you to review and respond. This will happen at different times since schools are not required to send your award offer to you at the same time. This can take anywhere from one week to several months depending on the size of the school. The award offer will tell you exactly what and how much aid you are eligible to receive.

AROUND MCSHANE PARTNERS

WOMEN'S IMPACT FUND

McShane Partners is proud to sponsor Women & Wisdom. The focus on this year's event was how collective action impacts social capital.

At the evening's event a panel of civic leaders discussed how to "become" your best philanthropic self through strategic and impactful giving. This panel was designed to bring together community leaders from various disciplines in the greater Charlotte region, with the hopes of informing members on major issues and ideas that affect us as individuals, and as a granting organization.



preparedness, job acquisition, employment retention, financial education and career advancement services. Nearly 80% of the women served are single heads of households with two children; 10% of clients are parenting their grandchildren.

There is a fiendish twist to the event. In addition to teams of walkers participating in the 5k family friendly Walk, a.k.a. The Stroll, a stalwart group of men – namely, Elliott Van Ness- will participate in a “Stiletto Swagger” .

We are proud to support Elliott on the red carpet! If you are interested in supporting this great cause you may visit Elliott's page at <https://www.crowdrise.com/elliottvanness>.

Also, you may join us on the 11th by registering to walk – event details and registration information can be found here: <https://www.crowdrise.com/o/en/campaign/stiletto-swagger-2019>.

MICHAEL VAN NESS | "GENERAL IN COMMAND" BOOK

A resplendent navy wool tunic and a silver scabbard. A West Point cadet's "boat cloak;" pristine riding boots; photos with "Ike" and Winston Churchill. All help tell the story of a heroic American. He not only witnessed history, he helped make it.

Dr. Michael Van Ness, grandson of the late Maj. Gen. John B. Anderson, has made it his mission to ensure the two-star Army general won't soon be forgotten.

We are thrilled to recognize a recent accomplishment of one of our clients and yes, Elliott's father, on his new book, *General in Command: The Life of Maj. General John B. Anderson, From Iowa Farm Boy to Command of the Largest Combat Corps in World War II*.

DRESS FOR SUCCESS - SHAKE, SWAGGER & STROLL

On Saturday, May 11th Dress for Success Charlotte will hold its 8th Annual "Shake, Swagger & Stroll featuring The Stiletto Swagger." The event, at Freedom Park, will raise funds to allow the organization to continue its mission of helping women break the cycle of poverty by preparing them for the job market. It does this by providing job



MCSHANE PARTNERS

Wealth management is our only business; therefore, our attention is undivided and our intentions are transparent.

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