INSIGHT FROM POLEN CAPITAL

Does a Diversified Index Protect You?

Executive Summary

The fear of large losses often clouds the perception of risk. Investors often misperceive concentrated portfolios as riskier due to the concern that a severe decline in a large holding will have a significant negative impact on portfolio returns. In this context, the diversification offered by index products can appear to be an attractive alternative. But while the math behind this fear is accurate, it overlooks the fact that experienced investment managers can mitigate the risk of large losses through a sound investment approach. A historical analysis of Polen Capital's Focus Growth Portfolio shows clearly that the frequency of large losses, both absolute and relative, has been far lower in the Portfolio when compared to the frequency of large losses in the S&P 500 Index.

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As a concentrated equity manager, we feel we have a responsibility to help dispel the main misconception about concentrated portfolios: that they have a higher risk profile. The concerns that are voiced to us about concentration are logical enough and seem rooted in the human psyche's innate desire to avoid loss (not just risk). Our Focus Growth portfolio (the "Portfolio") has individual portfolio weights as high as 10%, which prompt a knee-jerk reaction from investors as they quickly do the risk calculus in their heads: if that 10% position declines 50% the result is a 500bps reduction in their returns, which is a mathematically correct statement all else being equal. The natural tendency at this point is for the investor to compare that potentially unsettling scenario with the possibility that a diversified index, where no single holding may comprise much more than 5% of the fund, may help to avoid a similar fate. In many cases it appears that the investor concludes that the index route is a safer path forward; recent flows into passive index funds would seem to confirm this bias.

But while the math behind this conclusion may be accurate, it ignores two crucial points. The first is whether or not the concentrated portfolio's investment approach can significantly *reduce* the likelihood of a large loss in one of its holdings. The second is that having a diversified index, while reducing the probability that an individual holding may negatively impact the portfolio, doesn't necessarily reduce the probability that dozens (if not hundreds) of holdings may negatively affect the portfolio at the same time and thus produce the same (or even worse) adverse outcome the investor was attempting to avoid in the first place.

One way to convey this message through data is to look at the actual losses produced each year in our Portfolio compared to a diversified index, in this case the S&P 500 Index (the "Index"). The charts in Figures 1 and 2 compare the losses incurred in our concentrated Portfolio (on average 20 holdings) with the Index for each calendar year since 2001 -- in terms of percentage weight in the fund as well as number of actual holdings.[1] If indeed our concentrated Portfolio was riskier, the frequency of severe losses would be higher relative to the Index. Instead, we see the opposite with the Index producing more instances of significant losses on a year-by-year basis. In fact, our Portfolio has only had one holding suffer an absolute loss greater than 50% in any calendar year over the past 16 years.[2] Even more remarkable is the fact that during the past 16 years, at least some portion of the Index (albeit very small in some instances) has suffered a 50% or greater loss in value in *every single calendar year.*

Figure 1: Absolute loss of 50% or greater for any individual holding (percent weight of portfolio)

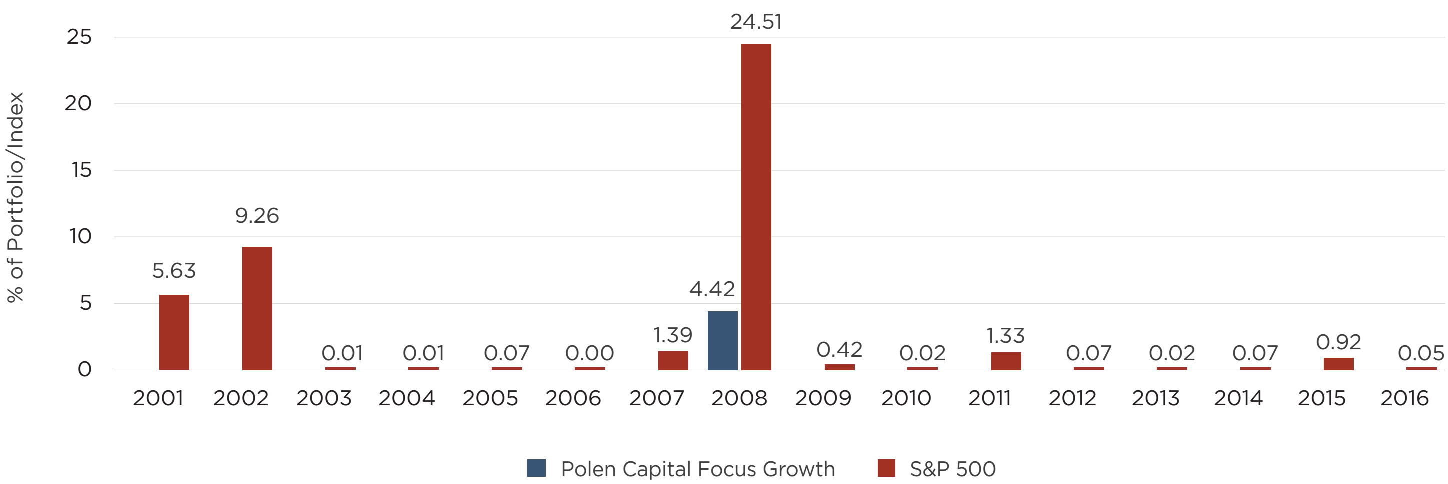
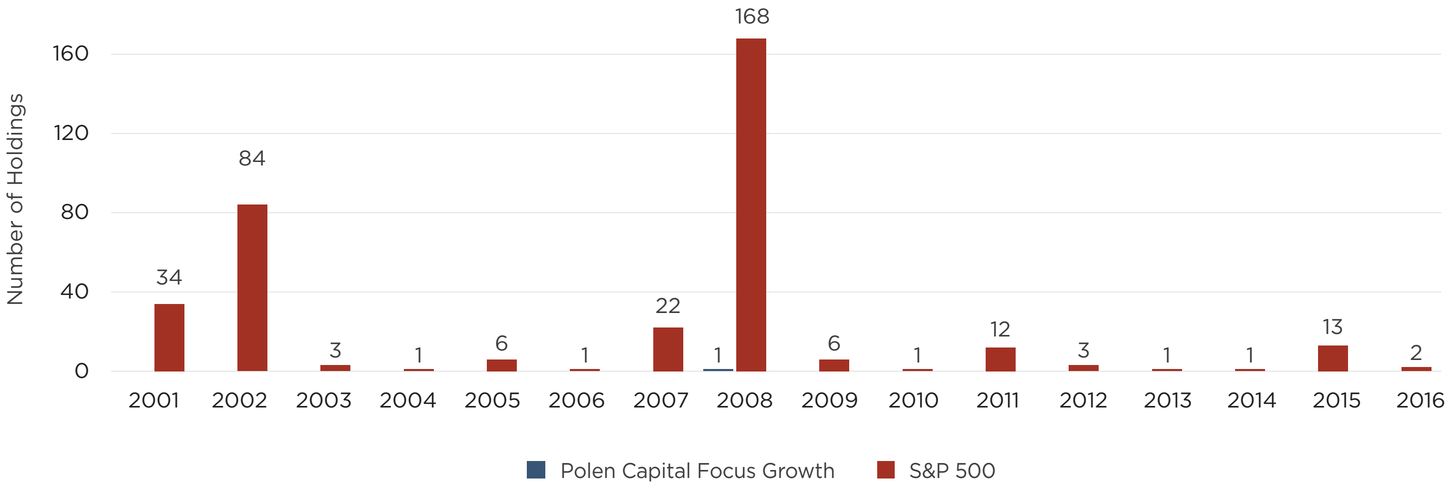


Figure 2: Absolute loss of 50% or greater for any individual holding (number of holdings)



1 For all charts presented herein, the holdings data for the Polen Focus Growth portfolio includes cash. S&P 500 holdings are derived from the iShares Core S&P 500 ETF. Portfolio weighted calculations use the average weight for each holding in the portfolio or index during the calendar year. All data sourced from FactSet.
2 Autodesk in 2008.

Even on a relative performance basis, which allows us to capture instances where an individual holding may have underperformed in a big "up" market, the trend still holds. Thus, during the past 16 years no single holding in our Portfolio has underperformed the Index by 50% or greater in a single calendar year (see Figures 3 and 4). While this might not seem heroic, consider that in *every year* over the same timeframe some portion of the Index underperformed the benchmark by that amount or more. Even in 2008 when the Index declined by more than 35%, nearly 15 holdings (roughly 1.5% of the Index in weighted terms) underperformed the Index by 50% or more that year -- *i.e., an absolute decline of at least 85%!*

Figure 3: Relative underperformance of 50% or greater for any individual holding (percent weight of portfolio)

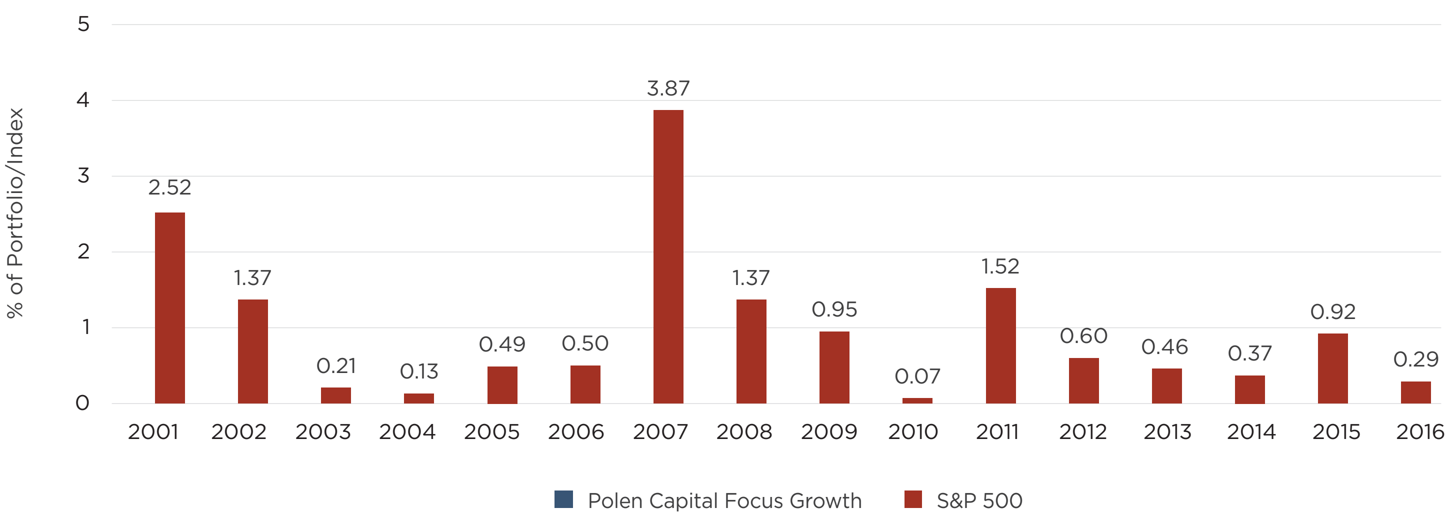
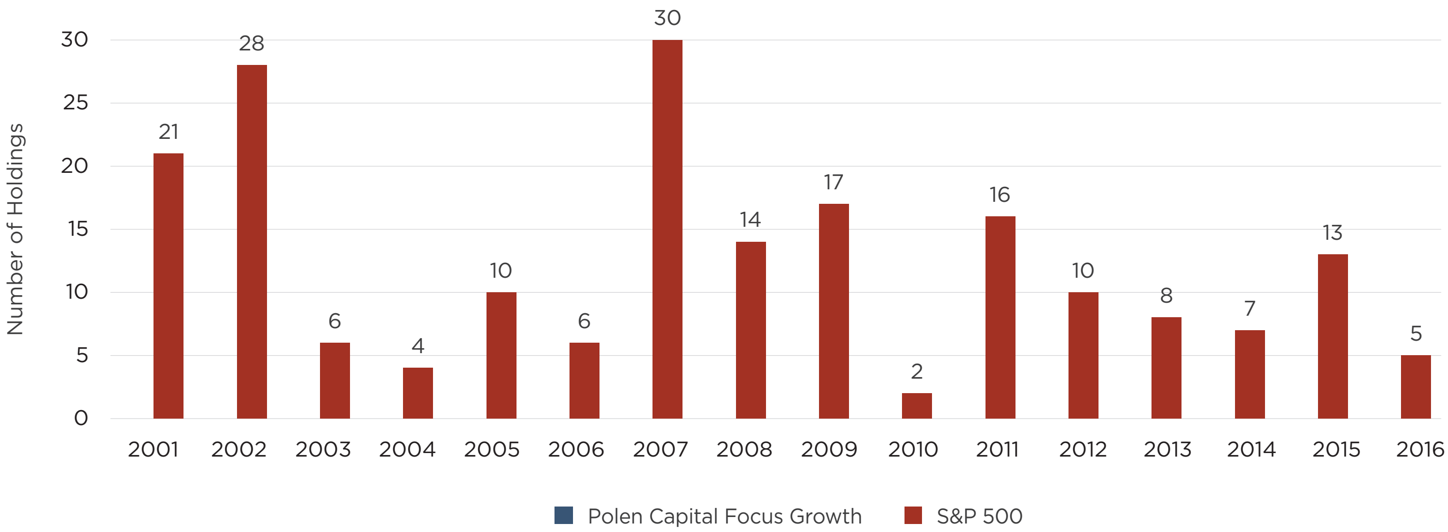


Figure 4: Relative underperformance of 50% or greater for any individual holding (number of holdings)



To the extent that using a 50% threshold is considered too extreme, we present the same data in Figures 5 and 6 using a 35% cutoff. The trend in absolute losses remains the same, with our Portfolio only registering two years out of 16 that any holdings declined more than 35%, and even so at a much smaller proportion of the total Portfolio compared to the Index.

Figure 5: Absolute loss of 35% or greater for any individual holding (percent weight of portfolio)

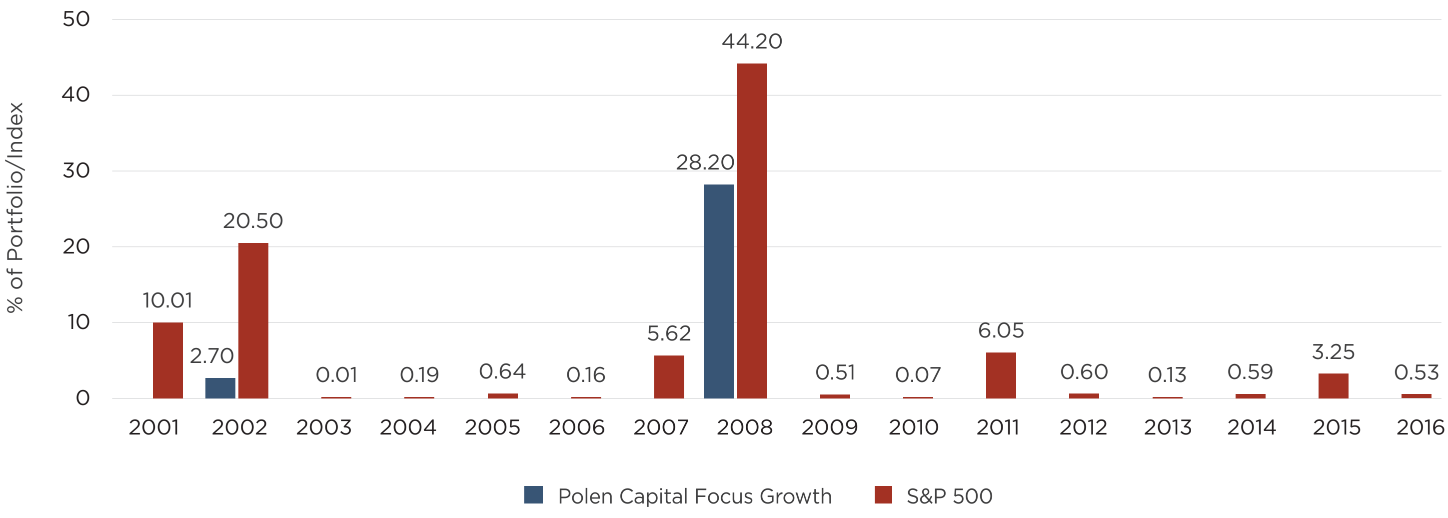
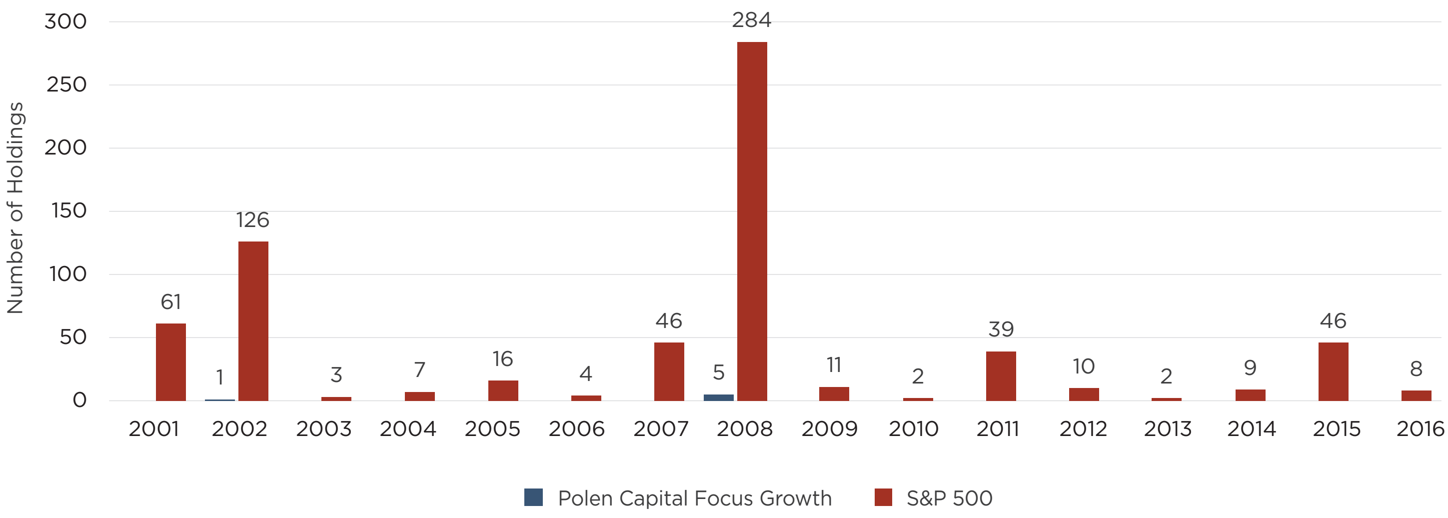


Figure 6: Absolute loss of 35% or greater for any individual holding (number of holdings)



The relative underperformance of 35% or greater does present a slightly different dynamic with four calendar years registering at least one holding in the Portfolio that underperformed the Index by a minimum of 35% (see Figures 7 and 8). In three of those years (2010, 2013 and 2016) the proportion of our Portfolio with holdings that declined 35% more than the Index was higher than that of the Index. It should be noted, however, that these three calendar years were all strong years for the market with the Index returning 15%, 32% and 12%, respectively. It's not uncommon for our performance to lag in strongly rising markets and, though we would never be pleased with any individual holding underperforming the Index by 35% or more in a calendar year, we would certainly prefer that outcome than to have any portfolio holding substantially underperforming during a *declining* market.

Figure 7: Relative underperformance of 35% or greater for any individual holding (percent weight of portfolio)

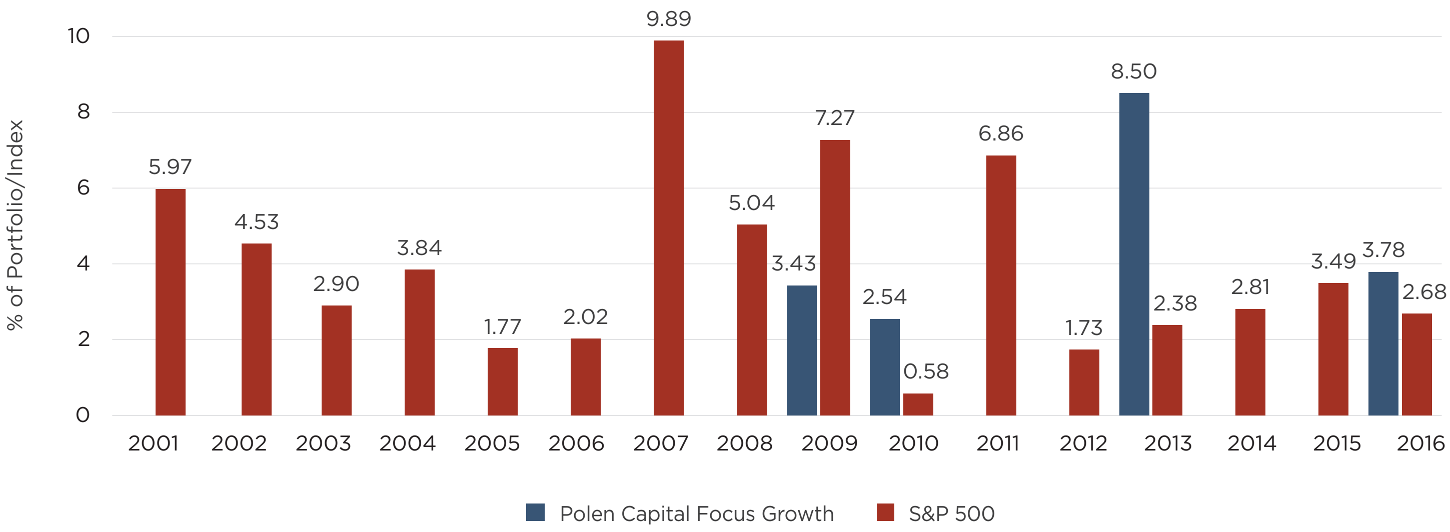
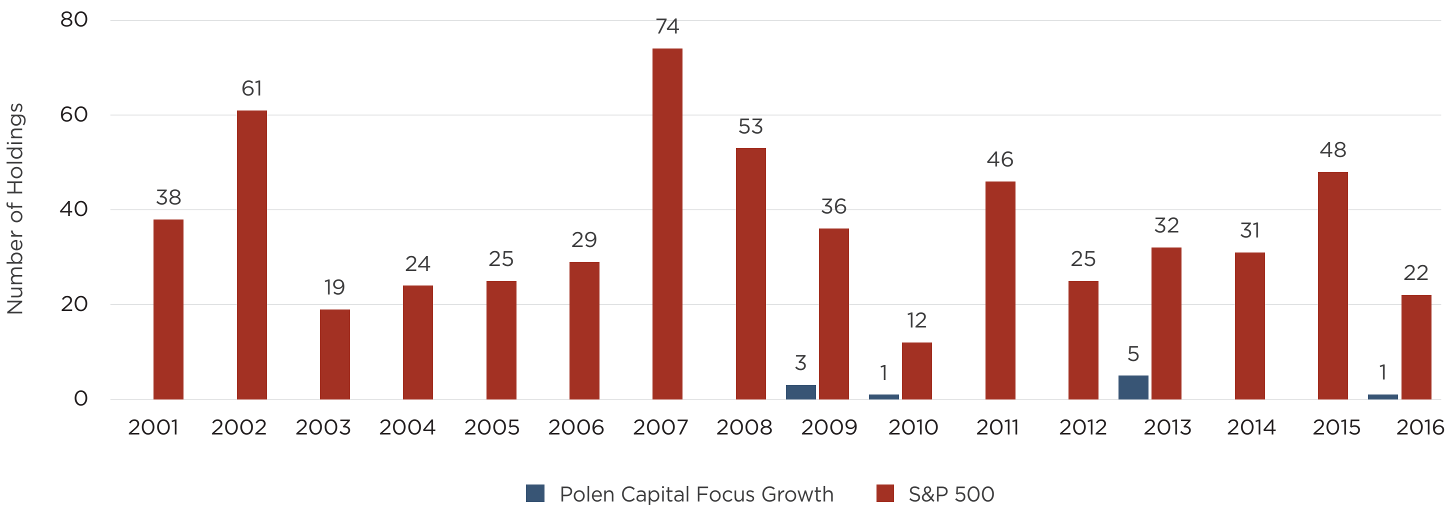


Figure 8: Relative underperformance of 35% or greater for any individual holding (number of holdings)



Conclusion

The fear of large losses often clouds the perception of risk. We certainly encourage investors to focus on the probability of loss when evaluating any investment (please see our company's mission statement).[3] However, we remained concerned that diversified indices may be lulling investors into a false sense of security. While a diversified index may appear to have a lower likelihood of severe losses when compared to a concentrated portfolio, such as the ones we manage at Polen Capital, the reality is quite different. In fact, the frequency of large losses, both absolute and relative, has been much lower for our concentrated Portfolio in comparison to the Index. It is critically important that investors pay less attention to the number of holdings in a particular portfolio and instead *focus more on the manager's investment approach and the portfolio's history of protecting client capital, particularly in declining markets.* At Polen Capital we continue to believe that our insistence on investing in only the highest quality businesses for our portfolios is the primary reason behind our demonstrated long-term track record of preserving client wealth across market cycles.

3 http://www.polencapital.com/mission

About The Author

Stephen Atkins, CFA, Portfolio Strategist & Analyst — Large Company Growth, joined Polen Capital in 2012 after a 12-year tenure as a portfolio manager at Northern Trust investments—including eight years as a mutual fund co-portfolio manager. Mr. Atkins also spent two years at Carl Domino Associates, LP. He received his B.S. in Business Administration from Georgetown University and a General Course degree from the London School of Economics. Mr. Atkins is a CFA Charterholder and a member of the CFA Institute and CFA Society of South Florida.

About Polen Capital

Founded in 1979, Polen Capital is a global investment management firm that provides high value-added quality growth investment strategies to sophisticated clients around the world. The Firm is committed to attracting experienced, disciplined investment professionals to add value to client portfolios. Polen Capital's Large Company Growth Team oversees a global equities universe of high-quality growth companies and manages the flagship Focus Growth strategy, as well as the Global Growth and International Growth investment strategies. The Firm also has an autonomous Small Company Growth Team that manages a U.S. Small Company Growth strategy. Polen Capital's strategies are offered through various investment vehicles to accommodate a broad range of client mandates. For more information visit **www.polencapital.com** and connect with us on **LinkedIn.**

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Past performance is not indicative of future results. There can be no assurances that any portfolio characteristics depicted herein shall be replicated in the future. The S&P 500® Index is a widely recognized, unmanaged index of 500 common stocks which are generally representative of the U.S. stock market as a whole.