NCM Capital Management, LLC
Market Update – June 15, 2015

To all clients and friends:

2015 so far has been a year of lackluster returns for the US stock and bond markets. The bond market, as defined by the aggregate bond index, is showing a negative return for the year as of June 12th. In fact, much of the action lately has been in the global bond markets. As we have written time and time again, global stock markets are addicted to extremely low interest rates. The recent shakeup in the bond markets has led to what so far is a “mini correction” in stock prices. Global bond markets are currently going through their worst selloff since the “taper tantrum” we had in the middle of 2013. However, demand for bonds is still extremely strong.

Consider this -- Petrobras, a large Brazilian energy company that is rated as a JUNK bond by Moody’s, recently sold $2.5 billion of 100 year bonds that yield 8.45%. Not only is this company rated junk, they also are dealing with a corruption scandal involving bribery and price fixing allegations and are the world’s 3rd most indebted non-financial company. But yet, there were $13 billion in orders placed for this $2.5 billion issue! If this doesn’t illustrate the yield starved environment we are in, I don’t know what else can. There are serious concerns about this company but investors are willing to buy 100 year bonds for a maximum return of 8.45%? And of course, the maximum potential loss is 100%. Not too good of a risk/reward situation in my opinion...

Back in the US, recent stock market malaise has been mostly because of the shakeup in the bond market. The latest economic data has led the market to start expecting the first increase in interest rates in September. What also is causing some angst lately has been a lack of liquidity in the bond markets and concerns that if the selloff in the bond market continues, the lack of liquidity could cause more sudden and violent moves. There is much debate going on about when the Fed should raise interest rates and what the impact may or may not be on global markets.

Jonathan Clements recently wrote a nice article titled “Dividend Stocks beat Bonds for Retirement Income.” The takeaway from this article is that due to current low interest rates and lack of inflation protection, bonds may not be the best way to generate retirement income. High Dividend stocks can, in many cases, provide a higher current income stream compared to high quality bonds.

Perhaps more importantly and a fact that I think is often overlooked by investors is that over the last 50 years the S&P 500’s dividends have grown an average 5.7% per year. Dividend stocks provide a rising income stream, bonds do not. Retirees need a rising income stream to offset inflation.

We believe dividend stocks need to be a part of any investment portfolio. There are different ways to invest in dividend paying stocks. There are mutual funds that invest in just dividend stocks, ETF’s that do the same, and of course investors can own the dividend stocks outright themselves.

There was an interesting study written in the review of asset pricing studies on target-date funds recently. The study examined the choices managers of target date funds made in selecting underlying funds. The researchers conclusions were as follows and I quote them:

- “Managers chose an abnormal number of funds which have been in existence for a short period of time.”
- “Some managers seem to be maximizing fund family objectives rather than shareholder objectives.”

The lesson for investors: Don’t just pick any target date fund. It is worthwhile to analyze the underlying funds and question the selection. Target date funds are potentially a good solution for young investors who are just starting out and do not have enough money yet to diversify or for those who do not have other good alternatives in company retirement plans. Other than that, we are not fans. Besides the fact that they keep increasing their allocation to an overvalued asset class (bonds), the fund selection is very questionable.

Lastly, I’d like to briefly describe 3 recent client case studies involving annuities and life insurance to help demonstrate our philosophies and strategies regarding financial planning and investing.

Client #1 was just referred to us and her primary goal is generating guaranteed retirement income. Preserving principal is a secondary consideration -- it is more important to this client to ensure an income stream that will meet all of her expenses for the rest of her life. Although we have been clear that generally speaking we are not fans of annuities, this is one of the few cases where an annuity can potentially be part of the solution for the client. We are currently in the process of crunching the numbers and assessing whether an annuity and what type of annuity makes sense, if at all.

One type of annuity this client is considering is an annuity that provides a minimum 5% guaranteed income stream for life. Again, in today’s low interest rate environment 5% guaranteed doesn’t sound so bad. However, as with all annuities you must dig deeper and fully understand these complicated products before investing in them. Upon further examination I expressed my concern to this client about what could potentially happen to the principal invested. Her principal would be invested in a balanced mix of higher cost actively managed mutual funds and 40% of the portfolio will be in bond mutual funds and cash. The cost of the annuity is 1.9% plus the underlying fund fees of close to 1%. The hurdle is 5%. If the client does not get a 5% net return then her principal will slowly erode. Add in the 1.9% insurance expense and now the hurdle is really 7%. So my concern is how is a portfolio that is 40% in bonds and cash going to average 7%? The 30% in bond funds yields less than 2% -- so you would need an almost mathematically impossible increase in the prices of those bond funds to achieve that return. Otherwise the stock funds will have to average approximately 14%, significantly higher than the long term average of the stock market. So now when you think about getting a 5% guaranteed return knowing the likelihood of also a declining investment, does it still seem as attractive? Ultimately some type of annuity may still make the most sense for this client because it is not total return that is most important to this client -- it is peace of mind and a guaranteed income stream. The takeaway here is to make sure you understand all the bells and whistles of annuities before investing.

Client #2 is retiring this year and has a non-qualified annuity coming due now where a decision has to be made on what to do with it. The client only has 3 options:

1. Renew it for 7 more years;
2. Cash it out and realize a large taxable gain in tax year 2015; or
3. Annuitize it.

I do not like any of these 3 options for this client. Here again is another problem with annuities -- the lack of flexibility. Insurance companies want to find ways to lock you in for years. The “best” choice for this particular client is to renew for 7 years. I do not want to see the client add a large taxable gain to their income in the exact same year that the client is retiring and thus will already be in a high tax bracket. And I do not want to annuitize in a year where the client does not need extra taxable income. So we defer for now and probably cash out in retirement down the road where we can perhaps manage the clients' tax bracket more effectively.

Client #3 joined us already owning 3 whole life policies with cash values built up. There is no longer a need for life insurance as the client is single with no children. The clients' goal is generating enough retirement income to live a comfortable retirement. So we had decisions to make on what to do with this life insurance, when to start taking social security and how to invest his retirement portfolio. The optimal solution was to exchange those cash values into an income stream for 5 years and this allows the client to defer social security and withdraw less from the retirement portfolio. If the goal for any client is to protect against outliving assets and inflation, deferring social security can make a lot of sense.

All the best,

Nick