NCM Capital Management, LLC
Newsletter –May 10th 2017

To all clients and friends:

1st quarter earnings season is winding down. Overall, we've seen companies report fairly good numbers, and perhaps more importantly, forward guidance has also been solid. As stock valuations are elevated (by historical standards) and worries over geopolitical issues are still high, this type of positive sentiment around earnings is significant. In fact, it appears that this has been the best earnings season since 2011.

However, risk still remains. First, markets are still awaiting many of the policies promised by the new administration. There was a small step forward for the repeal of the Affordable Care Act, although a number of hurdles remain before it is finalized. Trump's tax plan is another topic that many are forecasting as a positive for the markets, although much of that plan may rest with what happens with the healthcare situation.

Second, the markets will be monitoring the economic data as it is reported; the consensus among most investors is that the economy will continue to improve and growth will accelerate into the second half of the year. To be sure, we have already seen a boost in global economic health as European companies have seen a recovery in their earnings and are on pace to grow revenues the strongest since 2012.

Lastly, the Fed's decision on interest rates still looms as the market predicts IF and HOW FAST the Fed will move in their upcoming meetings. Most believe that the Fed will continue to be cautious and less aggressive in raising rates as they wait for a more detailed agenda of the new administration. Of course, if economic data worsens then the Fed may actually resist hiking rates, and the market may, in turn, view the negative news as a positive for stocks….and for bonds! We'll be back to: Bad economic news = good news for the market.

One other significant topic at the upcoming Federal Reserve meetings is what to do about the massive $4.5 trillion bond portfolio the Federal Reserve owns after all the years they spent buying bonds (quantitative easing). The Fed wants to unwind this portfolio, but how and when? Not easy questions. Consider this potential scenario: What if the Fed continues to raise rates, starts to unwind this balance sheet by selling these bonds—or possibly even just does not reinvest the bonds that mature-- AND Washington passes a large infrastructure spending plan? This could end up severely pressuring the bond market, which in turn could potentially pressure the stock market.

A Few Stocks Carry the Averages

We've seen this in the past (for example in 2015) when just a handful of companies significantly impact the performance of the equity averages. A few years ago, an acronym was created to name them: "FANG" which stands for Facebook, Amazon, Netflix and Google (now Alphabet). Now, currently, we are witnessing a similar phenomenon. According to Fundstrat Global Advisors,

> "Through mid-April, large stocks have powered nearly 53% of the S&P 500's YTD return. Almost a third of that return was driven by only three companies: Apple, Facebook and Amazon."

The simple reason for this is what we have written about previously: Because the S&P Index is weighted by market capitalization, those companies that are the biggest will have a disproportional effect on performance of that index. This, in turn, has further implications as to which sectors within the S&P carry the most influence. For example, technology—which is where most of these "high-fliers" are positioned—now represents over 20% of the S&P.

The main takeaway from this centers around the notion of "know what you own." First, it is paramount to understand the underlying holdings from a risk standpoint. As the largest sector in the S&P, technology can carry a greater amount of volatility and downside potential than say, a utility or consumer staple company. Second, our practice at NCM is to balance the overall holdings for our clients, recognizing that an individual may actually have exposure to these "higher-growth" companies through positions either in ETF's (Indexes) or mutual funds…and may not need to buy them separately as individual positions.

A perfect example of this point involves one of our core large-cap holdings. This fund manager is a big believer in the tech sector and actually owns a number of these top performing stocks. In fact, about 25% of this fund is in a handful of them (Facebook, Apple, Google, Amazon, Netflix, Microsoft). So, for investors who want to own any of these big names, our clients understand that they already do own them…. either through this large-cap mutual fund or through an ETF. Going further, we own a technology ETF as well, and guess what? **Half of its assets** are in Apple, Microsoft, Google, and Facebook. How about VTI- the Vanguard Total US Stock Market ETF? This ETF owns 3,615 companies. 10% of it is in these few tech stocks!

Ok, VTI is not as concentrated as the tech ETF and the fund we previously mentioned, but hopefully our point is clear: Do diversified investors really need to also go out and buy these names individually? Yes, it does make for better "dinner" conversation at the weekend BBQ to tell our friends that we own Apple and Facebook, etc, etc! And who really wants to go through the lengthy explanation of "*Well, I have a diversified portfolio, and through my core holdings I own a large cap growth fund that IS heavily weighted in tech and does own 25% of these same stocks everyone is speaking about."* That doesn't sound nearly as exciting……. but it is the truth, and for most, it is a more prudent path to investing.

(IMPORTANT NOTE: For some NCM clients with the appropriate risk profile, we actually do own a few of these names as separate holdings; however, we do weigh those risks and have determined that the additional exposure is acceptable for these accounts only).

Speaking of Volatility—There Hasn't Been Any!

The beginning of 2017 represents "the least market volatility to start a year in several decades," remarked a derivatives strategist at Deutsche Bank recently. Volatility can be considered the barometer of fear in the market, and right now, it has been falling continuously. According to a recent article in the Wall Street Journal, the Volatility Index—called the VIX— on May 8th hit a 25-year low!!

For many investors, the market's fear metric (i.e., the VIX) is a contrarian indicator: The greater the worry in the market, the better chance it has to rally; conversely, the calmer the behavior, the larger the risk of a potential downturn. That said, the VIX has been steadily declining for months, if not years. And quite a bit of money has been lost in the many new VIX products/ETF's that were launched after the 2008-2009 financial crisis. Looking back, it was akin to buying the insurance after the storm has passed.

The potential reasons for this are many. The economy has improved dramatically from the 2008-09 recession years; markets have benefited greatly from lower interest rates and central bank quantitative easing. And more recently, more investment professionals have been "selling" volatility through complex strategies thus putting pressure on the price (as reflected in the level of the VIX).

Given today's political environment and geopolitical landscape, it is mystifying for many investment professionals to see such complacency in the market...and for such an extended and consistent period of time. Some are calling this the calm before the storm (although we know how meaningless market predictions are.) Nonetheless, our view is that we are shocked to see market volatility at 25-year lows and there really is no easy explanation for it.

“Diss-ing” Vanguard?

Morgan Stanley has just announced that it will no longer be offering Vanguard mutual funds to its customers. Going forward, advisors of this firm cannot buy mutual funds from Vanguard for their clients. In describing the policy, a spokesperson from the firm is quoted as saying, “(our) goal is to close out under-performing and less popular funds.”

Wait….Did the spokesperson say “Under-performing and less popular funds”????

In John McEnroe’s words, “You cannot be serious!” This firm’s statement is baffling not only relative to its factual content, but also for the implications it makes on how this firm is compensated.

Simply put, in our opinion this decision was made because of the pressure that fee compression is having on the industry. Of course, few on Wall Street will admit this. What many investors may not know is that funds may have to pay for shelf space. Meaning that in order for firms like Morgan Stanley to sell outside funds, they want to be paid to do so. In this case, Vanguard, as the 800 pound gorilla that they are, refused and did not agree to pay for selling their funds. Who can blame them? They don’t need anyone’s help to sell their funds. They are doing quite well on their own!

Whose best interest is this decision being made for? The clients’? or Morgan Stanley’s?

From our perspective, this is why NCM Capital Management is an independent, fee-only firm unaffiliated with any brokerage firm. We will not allow anyone to tell us what we can or can’t offer to our clients. That would represent a conflict of interest in our opinion.

To be fair, any custodian or brokerage firm could make this same decision Morgan Stanley did. Fidelity Investments has been our primary custodian since NCM was formed in 2009, however, they could make this same decision (to stop offering Vanguard funds on their platform)----and they certainly wouldn’t consult with us first! For this reason and many others, we have recently added a 2nd custodian, Charles Schwab., so we can now offer two of the best 3rd party custodians to our clients, just in case one of them does something similar to which we are opposed.

All the best,

Nick

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