NCM Capital Management, LLC
Newsletter –June 27th, 2017

To all clients and friends:

Earlier this month the Federal Reserve raised interest rates for the second time in six months while announcing its plans for one more increase later this year. And in reiterating its intention to hike rates ANOTHER three times in 2018 and possibly, ANOTHER three times in 2019, the Fed also stated that it may begin paring back the $4.5 trillion of bonds it bought to help the economy recover from the financial crisis.

In and of itself, such a proposal would be logical. After all, the Fed took extraordinary measures to keep rates low and support the markets during the financial crisis; encouraging rates back to "normal" levels is both sensible and prudent especially given that the Fed will need monetary policy as a tool for any future economic downturn. However, what does seem curious is the context and timing in which the Fed is making these decisions.

Recently, we've seen economic numbers (including inflation) that are trending downward, not up. And perhaps as a more significant warning signal, the bond markets, which are usually a good indicator of future economic well-being, have shown a resiliency that very few predicted; in other words, the bond market is possibly reflecting concern for the economy.

So, it is quite surprising that while the Fed is raising the short-term Fed funds rate—ostensibly trying to push interest rates higher, longer-term rates have not only persisted in staying flat, but have actually declined. [As a refresher, the Fed can affect short-term rates, but if investors continue to buy longer-term bonds, it will push those yields, or longer-term rates, lower.) In fact, the 30-yr Treasury yield recently hit a seven-month low. By seemingly dismissing the recent weaker economic numbers, some economists and strategists are questioning if the Fed is now making a policy mistake.

In summary, we have the stock market indicating all is fine, we have a bond market perhaps indicating trouble ahead, and most surprisingly, we continue to have volatility at record lows.

Beware the dangers of "The Fear of Missing Out"

What is the "fear of missing out?" Wikipedia defines it as "a social angst characterized by the desire to stay continually connected with what others are doing."

One of the most compelling reasons for this fact has to do with the overreaction that investors feel both when the market moves higher as well as when it moves lower. Studies have shown that the higher the market moves up, the greater the need investors feel to add to it. Conversely, when the market declines, the more investors pull out. This type of yo-yo type behavior leads to illogical decisions, and ultimately detracts from returns.

I think a recent dinner with my family celebrating my brother's birthday was a classic case of investors' "fear of missing out." My mom started the conversation off with "Nick, do I own Apple?" "No, Mom, you don't," I replied. "Why not?" she then asked. "Well, everyone at the office is talking about how well the stock is doing and they all own it," she said. Of course, given that she has peppered me with many of these types of questions over the years, I knew why she was asking.

A classic example of my mom experiencing the fear of missing out. Now, my mom is going to turn 70 this year and is financially independent. She works part time in a family business because she wants to, and we both think she would be

a little too bored in full retirement. She also has a VERY LOW risk tolerance. When the stock markets go down, she will always say "We should get out of the market, I don't want to lose any money."

But that fear of missing out is very powerful! And she wanted an answer as to why she doesn't own Apple! So, I made my points to her…." First of all, Mom, you really do own it through your ETF's and funds. You own a technology ETF that is 20% Apple, and guess what? It has performed BETTER than Apple over the last 5 years. But even more importantly, Mom, owning individual technology companies does not fit with your risk tolerance and goals. I am not risking your financial independence on picking individual tech stocks for you."

Lastly, "Mom, please don't pay too much attention to the "water cooler" talk. It's just human nature for investors to only talk about their winners. Nobody will bring up their losing picks. If everyone was so smart with their stock picks then Why do we have this retirement crisis in the US? Why is the average 401k balance only around $100,000? Why is student debt such a big problem in our country? And Why do 90% plus of the actual professionals (Mutual Fund Managers) underperform their respective benchmarks?"

Ok my mom was done with her questions, but this dialogue gave my brother the confidence to speak up.
"Nick, I was watching TV the other day and they said the market was at all-time highs, so I checked my account and the account was down for the day, why?" I thought to myself that that actually didn't make sense as my brother has an aggressive portfolio and is heavy in stocks (and actually heavy in technology stocks) as he is at least 15 years away from retirement. So I asked, "What day was this?" Turns out the day was June 9th, when the Nasdaq index was down over 2% in one day. I explained to him yes, then it does make sense that his account was down that day as he has a high allocation to technology stocks and it was the Dow Jones that hit a high that day. Two entirely different indexes.

Again, these are classic examples of the fear of missing out. If both my mom and brother were managing their own portfolios, I would bet that my mom would have bought Apple on her own after hearing the water cooler talk and my brother would have made a change to his portfolio that day as he was probably frustrated that his account was down for a day while he heard about the market being at an all-time high.

Investors would be far better off if they can resist acting on the "fear of missing out" behavior. Put this in the "Easy to say and hard to do category." **Perception versus reality…such an important concept in investing**…but yet so hard to understand. In both cases, my mother and brother thought they were missing out (the perception) but in reality, they were or are not.

To be a successful investor, one must not succumb to the "fear of missing out." I would rank this right up there as one of the most important concepts in investing.

ETF's: Don't Judge a Book by its Cover

At NCM, we've been investing in exchange-traded funds (ETF's) for quite some time. The benefits that they provide are significant: tax-efficiency, low-cost, diversification and liquidity. However, given their spectacular rise in popularity, it is important to emphasize that these vehicles are not without their own set of issues which investors should consider when investing in them.

Perhaps one of the more important points revolving around ETF investing is "knowing what you own." Even for basic, index ETF's, many times investors may not be aware of how much risk they are actually incurring. One example which was recently highlighted in the Wall Street Journal involved the S&P Low Volatility Portfolio ETF. This fund's strategy is to hold the lowest volatility stocks of the S&P 500. However, within the last few years, an influx of technology stocks like Alphabet (GOOG) and Microsoft (MSFT) have been added to this ETF. With so many "loved" and widely-held stocks now in their holdings, this ETF may potentially face much more volatility than expected during a market sell-off. Technology is historically a very volatile sector and a reasonable assumption would be to not expect to see too much technology

exposure in a low volatility ETF. But this ETF now has 11% of its assets in the technology sector- a record amount for this fund. Investors who own this fund thinking that it has low volatility may be unpleasantly surprised by how it performs during a market correction.

Furthermore, as more ETF's change the make-up of their holdings, it changes the characteristics of the fund itself. So, while investors may be expecting to hold a set of more diversified positions through this S&P Low-Volatility Portfolio, for example, they may unknowingly be exposed to many overlapping holdings across their entire portfolio; that is, if they also own individual stocks or other sector specific funds which are the same underlying positions. For instance, as the WSJ article quoted one advisor speaking about his client:

> "One client had about 40% of his net worth in Apple, directly and across various funds, but he refused to diversify because of his experience with high returns, low volatility and his assumption Apple's rise would continue."

This, of course, raises a much broader question about the overall indexes, as well: If this type of complacency is widespread among many investors (which it clearly can be seen to be), how disruptive will the next broad sell-off be if many of the index funds, ETF's (and actively managed funds) are all generally holding many of the same positions?

Needless to say, investors need to be mindful of what they are investing in, how their portfolio is allocated and how much risk they are taking with each position. Long-term investors should strive for greater diversity in order to mitigate risk. Instead, in some cases, they are doing the opposite.

Financial Planning- A New Look for Reverse Mortgages

As independent fiduciaries to our clients, we want to be aware of any new products in the marketplace that can potentially help our clients achieve financial independence.

The characteristics of reverse mortgages have greatly improved over the years. It is now widely acknowledged among our peers in the independent, fee-only, and fiduciary world that reverse mortgages can be a viable tool for a retiree under the right circumstances.

For specific cases, we have seen where reverse mortgages do make some sense; for instance, during a time of illness or through a period of financial hardship, being able to draw from the equity in your home can be a very significant benefit. One other potential strategy is during a significant market decline, such as in 2008-2009. Instead of drawing from a declining market portfolio, potentially drawing living expenses from a reverse mortgage until the markets recover could be a good retirement strategy. Then, when the markets recover, pay back the "loan" taken. At various financial planning conferences I have attended over the years, this strategy is discussed often as a potential strategy financial planners will recommend when we get our next bear market.

As usual for us, it is case by case for each client. If we think a reverse mortgage is a potential tool for you, you will hear from us. From there, we will introduce you to a reverse mortgage specialist because like in everything else we do, we do not sell any products that pay commissions to us.

We wish you all a happy and safe 4th of July weekend.

All the best,

Nick

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