# NCM Capital Management, LLC
# Newsletter – August 2nd, 2017

To all clients and friends:

Reporting for second quarter corporate earnings is well underway and the news is quite positive. America's largest companies are on pace to post two consecutive quarters of double-digit profit growth for the first time since 2011. While Wall Street continues to wait for Washington to get its act together, strong corporate earnings may be the prime reason for the continued strength in global stock markets. As one strategist put it "You could argue that the stock market overestimated Trump but underestimated earnings." Corporate earnings, one of the key pillars for a strong stock market, continue to be a positive underpinning for the markets.

Perhaps, though, it is with respect to the bond market that we've seen the most interesting twist. Just a few weeks ago, Mario Draghi, the head of the ECB (European Central Bank) and Janet Yellen, head of the US Fed, were making quite hawkish statements, leading many to believe we were entering a period where interest rates would be headed higher globally. Global bond markets proceeded to sell off for a few weeks, and Ray Dalio, a well-known hedge fund manager, wrote, "Central banks' reversals signal the end of one era and the beginning of another." Basically, he meant that the message from the central banks was now "That's it, no more easy money; markets you are on your own!"

But then about a week later, Janet Yellen made a very surprising comment that has since settled down the global bond markets. In her remarks, she said, "The Federal Reserve may not be that far away from its neutral rate." This potentially means that the Fed may NOT have to raise interest rates that much further before getting to what it sees as the neutral rate! The markets loved this news, of course--as we know that generally low interest rates have also been a key positive underpinning in the markets.

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## Memo By Howard Marks

There are very few "global strategists" worthy of following in our opinion. Most have their own agenda….and, well, as we all know, it is quite difficult to outsmart the markets over time. Howard Marks, though, may be one of the few whom investors should pay attention to and whose viewpoint is widely well-respected. Marks is the founder of Oaktree Capital Management and has been very successful in navigating the markets. In the past, he has warned about stocks being overpriced, in early 2000 and then again in 2005 (which was about two years early). Last week, he published a 20+ page memo that gained a lot of attention on Wall Street.

To summarize, Marks raised the following concerns about the market:

- Some of the highest equity valuations in history;
- The so-called VIX index of fear is at an all-time low;
- The elevation of a "can't lose" group of stocks (The FANG stocks);
- The movement of more than a trillion dollars into value-agnostic investing (index funds);
- The lowest yields in history on "junk"-rated bonds and loans;
- Yields on emerging market debt that are even lower;
- The most fundraising in history for private-equity.

Now Marks has written about some of these same concerns years ago and he freely admits that his timing may have been premature. However, he maintains that it is far better to be early and sell—and thereby reduce risk and potentially miss out on further gains--rather than to be late and suffer large losses to capital.

Lately, Marks, like many fundamental, value investors, is puzzled by the indiscriminate buying of index funds. He warns that ETF's have yet to be tested in a major bear market, particularly in less liquid sectors like high-yield bonds. From his memo:

> "Here's what Barron's had to say earlier this month:
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> With cap-weighted indexes, index buyers have no discretion but to load up on stocks that are already overweight (and often pricey) and neglect those already underweight. That's the opposite of buy low, sell high. The large positions occupied by the top recent performers – with their swollen market caps – mean that as ETFs attract capital, they have to buy large amounts of these stocks, further fueling their rise. **Thus, in the current up-cycle, over-weighted, liquid, large-cap stocks have benefitted from forced buying on the part of passive vehicles, which don't have the option to refrain from buying a stock just because its overpriced."**
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> The article goes on to say:
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> **"Like the tech stocks in 2000, this seeming perpetual motion machine is unlikely to work forever.** If funds ever flow out of equities and thus ETFs, what has been disproportionately bought will have to be disproportionately sold. **It's not clear where index funds and ETFs will find buyers for their over-weighted, highly appreciated holdings if they have to sell in a crunch. In this way, appreciation that was driven by passive buying is likely to eventually turn out to be rotational, not perpetual."**

In the bond markets, Marks simply sees too much risk being taken for not enough return. He cited two recent examples.

- Netflix just issued bonds paying 3.625%. Netflix is an exciting company for sure. But they just burned through $1.8 billion of free cash flow last year. So Marks questions why any investor would buy bonds with a 3.625% upside ceiling for a company that burns through cash.

- Argentina just issued $2.75 billion of 100-year bonds at 8%. One would think this would be a hard bond to sell as Argentina has defaulted on its debt eight times in its history! Not the case at all; in fact, there were orders placed for $9.75 billion….well in excess of the offering.

In a nutshell, Marks thinks too many investors are being forced into this "pro-risk behavior." It's a long read and we just picked out a few parts of it to share, but Marks certainly gives investors plenty to think about. If anyone would like to discuss Marks's views or concerns and how your portfolio or retirement plan could potentially be impacted by any of them, please let us know and we will schedule time for a call or meeting.

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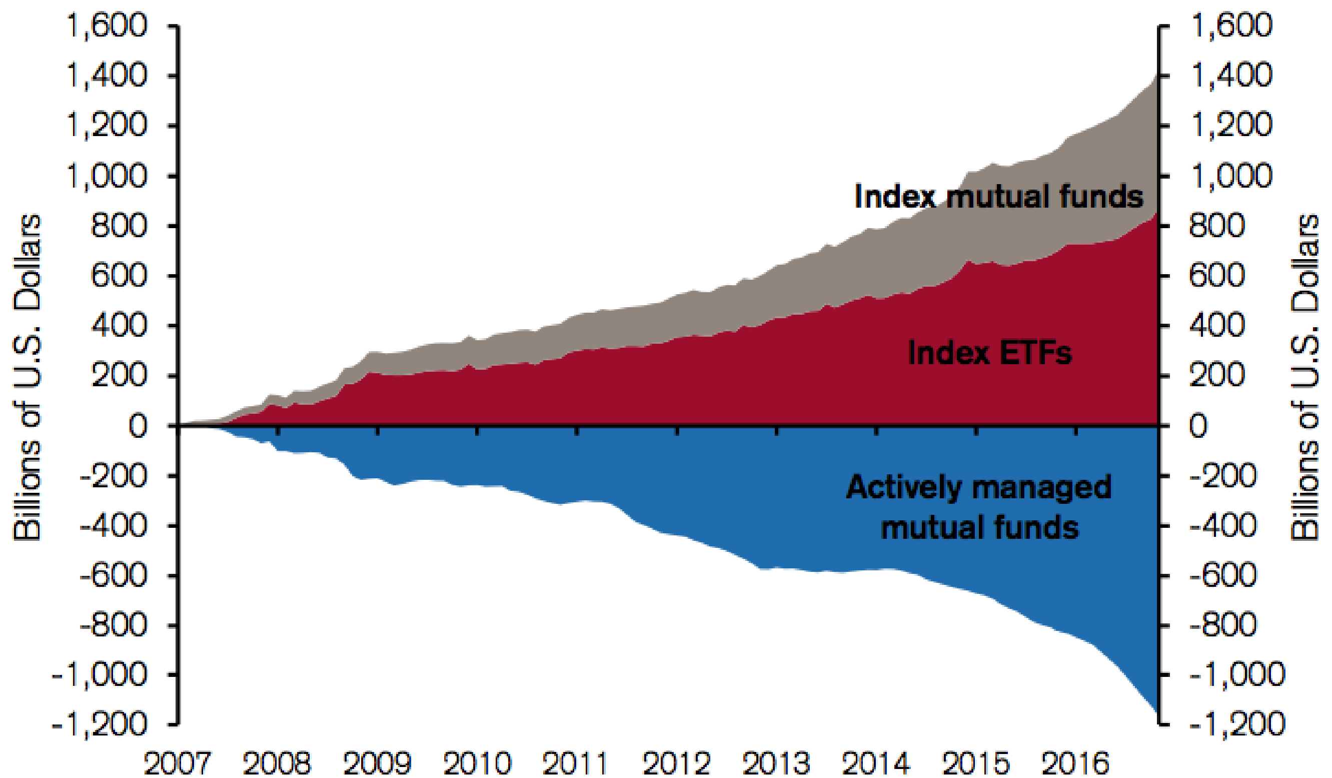
## Speaking of indiscriminate buying of index funds….

Take a look at the chart below summarizing the massive flow of investment dollars into index funds and ETF's and out of actively managed funds. This trend has been even STRONGER in 2017.

[We do caution investors, though, to not just act on cost alone when deciding on investing in either index funds or active funds. For example, as we have spoken about many times, there has been a huge difference in performance between active stocks funds and index stocks funds compared to active bond funds and index bond funds. As we have written,

stock index funds have better track records over the long term, but this is not necessarily the case in the bond market. Perhaps we will write about this in our next newsletter.]

**Exhibit 1: Flows from Active to Passive Funds in U.S. Equities**




*Source: Investment Company Institute; Simfund; Credit Suisse.*
*Note: U.S. domestic equity funds; 2016 figure as of 11/30/16.*

## 10 Things Successful Investors Don't Do

The above was the title of a great article that we just read in MarketWatch. Here is the list:

1) Successful investors don't start at random; they have a plan.
2) Successful investors don't plan to retire on the returns of their investments; they rely on money that they save.
3) Successful investors don't rely on one investment; they diversify.
4) Successful investors don't ignore how much they pay for investment advice; they control costs.
5) Successful investors don't let the ups and downs of the market throw them off course; they realize even bear markets are normal.
6) Successful investors don't continuously change course based on economic news or market performance.
7) Successful investors don't ignore risks that they take; they understand the downside, as well as the possible rewards of the investments that they make.
8) Successful investors don't expect miracles and don't base their plans on unrealistic expectations or hope.
9) Successful investors don't ignore taxes.
10) Successful investors don't get caught up following the media and listening to the advice "du jour."

All the best,

Nick

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