NCM Capital Management, LLC
Newsletter – January 17th, 2018

To all clients and friends:

THE MARKETS

The first few trading days of 2018 seemed to pick up where 2017 ended: Investor confidence high, greater money flows into equities and market averages hitting new highs with each positive uptick. Blackrock is taking in $1 billion a day of new investor cash! Extraordinary! And anyone want to take a guess where that money is being invested? Where else but index funds and ETF's! 67% of it went to their iShares business. Blackrock and Vanguard are no longer eating their competitors' lunch---they have moved on to dinner! Meanwhile, volatility remains extraordinarily low, nearly non-existent and continues to surprise many market historians.

Take, for example, Jeremy Grantham who is one of the most successful long-term, value money managers and who correctly called the 2000 and 2008 market declines. He recently said:

> "I recognize on the one hand that this is one of the highest-priced markets in U.S. history. On the other hand, as a historian of the great equity bubbles, I also recognize that we are currently showing signs of entering the blow-off or melt-up phase of this very long bull market. This melt-up can take stocks dramatically higher within the next 6-12 months. And "if there is a market decline following a melt-up, it is quite likely to be a decline of some 50%."

And even the well-known portfolio manager, Jeffrey Gundlach, stated last week:

> "All recession indicators are flashing no recession, which means it's priced in (to the market); This is why I say S&P down after a pretty decent run early in 2018."

Despite these comments made by some of the market's brightest minds, there is still extraordinary bullish sentiment: As of the third quarter, Morgan Stanley reported that households and nonprofits held over 35% in stocks (*This is the 2nd highest ever--the only other time higher was during the 2000 the dot-com bubble), while institutional investors are, according to Morgan, "loading the boat on risk…with long/short gross leverage as high as we have ever seen it." In fact, Bill Miller, who is renowned for his market performance, commented that he believed the market could "melt-up" 30% in 2018!

Other noted investors comments recently:

Warren Buffett: "Markets are not richly valued relative to where interest rates are."

Noted hedge fund manager David Tepper: "The Market is as cheap as it was a year ago. The market can't go down until the bond market gets hit."

Of course, we must be careful not to let anyone's predictions on the markets significantly influence our long term investment strategies for our clients.

The reason for this market's "euphoria" is never easily explained, but some of the factors contributing to it may include: new investable funds from pensions and 401k money, momentum trading, along with the pure fear of missing out by many investors (aka FOMO), the positive outlook for upcoming business earnings, and last--but certainly not least, the confidence in the new tax plan which many perceive will push economic growth towards levels we have not seen in quite some time.

From our perspective, global economic growth and corporate earnings growth looks solid enough to support rising stock prices. The flip side of that is this may be already reflected in stock prices--- valuations are on the high side historically. What happens in the bond market may be the deciding factor in where stocks go from here. A 2.5% 10-year Treasury bond yield is not much competition for stocks. Sentiment appears to be moving into the "Euphoria" stage with tremendous short-term momentum. Later on in 2018 too, we may finally have the end of global quantitative easing. That to us, could be something that rattles the bond markets.

New Tax Law

Last month, we sent out a letter to NCM clients indicating some of the changes which will come with the 2018 tax bill as well as some strategies to implement going forward. Here is a short list of the changes that are included in the new laws:

- Lower tax rates for most income brackets;
- Marriage "penalty" for those married-filing jointly is largely eliminated, except for couples earning more than $400k;
- Standard deduction doubles for most filers, while personal exemption has been eliminated;
- Capital gains rates—NO CHANGE, but short-term gains may change with changes to the income tax rates;
- Expanded Child Tax Credit;
- Expanded use of 529 college savings plans to include levels of education other than college;
- Mortgage interest deduction limited to $750k; interest on home equity will no longer be deductible;
- Deductions for state and local taxes limited to $10k.

What is the appropriate time frame to use to evaluate an investment?

It is January-so this is the time of year when investors look at all the performance scorecards that get touted in the media. There is no shortage of articles like "2017 Best ETF's!"; "This will be 2018's top stock or sector!" or "The best and worst funds from 2017!" And unfortunately, many investors will act on this misleading data. The WSJ had a nice piece on this recently called "The Year's fund returns are in. Do they matter?" The short answer is no.

S&P Dow Jones Indices found that "an inverse relationship generally exists between the measurement time horizon and the ability of top performing funds to maintain their status." In other words, as you focus on shorter and shorter time periods, there is a higher and higher chance that the top performer in one period will be a bottom performer the next.

Clearly then, it makes more sense to evaluate a fund's performance over a longer time period. How long? Well, the WSJ's analysis indicates that only after measuring performance over 15 years were there better than 50% odds that a top performer would repeat. Well, let's be honest: how many investors nowadays are willing to be that patient?
For us, it's a minimum of 3-5 years of data before we can make any reasonable assessment of how good or bad an investment is.

So, this research prompted us to take a fresh look at how some of our core funds measure up.

We compared our core US large value stock fund to the universe of surviving large value managers and found that over the last 5-year time period, 97% of the surviving large value managers underperformed our value fund by an average of 3% a year.

Furthermore, the Vanguard value index trailed this fund over the last 10 years by 1.6% annually. And our fund costs a whopping .09% more per year----further proof that investing is just not all about expense ratios.

Short term performance-and yes, one year is short term- is just so misleading, but it attracts eyeballs and attention and that's what the media and financial salespeople need. Someone was on CNBC last week touting how Valeant Pharmaceuticals stock is up 50% in the last 6 months. Sounds exciting right? Well, how about the fact that the stock is at the same price now that it was in 2010? Does that mean anything?

What few will tell you is that Wall Street is all about short-term performance and sales results.

Noted value investor Seth Klarman put it well when saying,

> "It is understandably difficult to maintain a long term view when, faced with the penalties for poor short-term performance, the long term view may well be from the unemployment line"…

Take a look at a recent article in the Wall Street Journal titled "Discount Brokers Push Pricier Services" as just another example of the pressures in the industry. With Blackrock taking in $ 1 billion a day, the pressure just keeps intensifying. In our view, there is no better time to be an independent firm---free from all of these conflicts and pressures. There is nobody walking into my office every quarter questioning sales results!

Where should investors invest their non-stock money????

This is a question being asked today by investors, advisors, money managers...basically everyone. The traditional way of investing has always been to just divide your money between stocks and bonds. In its simplest form, figure out how much risk you are willing to take and allocate a certain percentage to stocks and then invest the rest in bonds. Because of the record low interest rates and general consensus that there isn't much money to be made in the bond market, many professional investors have been allocating more and more of their non-equity money to the emerging "alternative asset class."

It's a controversial asset class to say the least. Some are even suggesting to avoid the bond market entirely. Dare I mention one more time the gentlemen who runs a firm that manages $16 billion that proclaimed "bonds will go down 40% !" days after the 2016 election when we had another one of those mini-bond panics. We wouldn't agree with that view, but we are also not allocating as much to our bond positions as we normally have historically. We do think there is a place in client portfolios for alternative assets. But investors must be very careful with how they allocate to these types of investments. They can be quite complicated.

In our opinion you are just not going to miss much return in the bond markets in the future. Even just looking at the recent past, you haven't missed much in returns in high quality bonds; the average return for the Vanguard Total Bond Index fund over the last 3 years was a whopping 2.19%. And that's in a generally declining (favorable) interest rate environment. Now, it is also true that prudent and experienced investors realize that investing in the bond market is not done just for investment return; it is done for risk reduction, liquidity needs, and various other reasons. But our general view is investors may not need to have the same percentage allocation to bonds as they have in the past.

An interesting area within the alternative asset class that may be worth a look now is commodities.

A few reasons an investor may want to consider an allocation:

-commodities are usually a good hedge against inflation

-commodities usually perform well in a late cycle economy
-commodities have a low correlation with the stock market
-commodities have performed poorly for the last several years (buy low, sell high)
-commodities may be as cheap relative to stocks as they were at turning points in previous cycles that began in the 70's and the 90's.

Again, as with any alternative asset class investment, investors must be careful with how they allocate to commodities. As with any alternative asset, I certainly would not recommend to pick the cheapest ETF to buy commodities. Much research and due diligence should be done to evaluate the best strategy to use to get the type and degree of exposure the investor seeks.

Please let us know if you would like to discuss commodities or of course, any other aspect of your investment or financial planning.

All the best,

Nick