Tarheel Advisors Newsletter

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20,000 Leagues Over the DOW

Congratulations! If you're reading this you've successfully navigated a tumultuous 2016 and made it to the New Year. Regardless of your political affiliations I think we are all ready for a non-election cycle year.

Year in Review—After making New Year predictions for nearly a decade, I finally have a report card with straight A's (it is going on the fridge). While the politics of 2016 got most of the headlines, the true market driving force of last year was in the commodities markets. It was our understanding of that market that guided our successful predictions for the year.

Commodities were in the midst of a multi-year bear market, and we predicted that bear market would finally bottom out in 2016, which it did in the first quarter. We foresaw oil going below $30/barrel, and it did just that hitting a 13 year low at $27/barrel. From the lows, oil bounced back and ended the year nearly doubling in value to over $50/barrel.

From an investment standpoint you probably liked where you ended up in 2016, but you may not have enjoyed the ride to get there. It seems like eons ago now, but the first 10 market days of 2016 were the worst start in market history. Contagion from the bear markets in commodities ended up hitting all asset classes, and even corporate bonds felt significant pain to start the year.

While market returns were a hair over 10% for 2016, the volatility in the stock market managed to yet again handcuff the Federal Reserve. We only saw a single interest rate increase of 0.25% in December, which was identical to what we saw in 2015.

2016 Score Card

High Market Volatility	A
Market Returns of 10%	A
One Interest Rate Change	A
Commodities Bottom Out	A
Oil ends year over $50/barrel	A

2017 Predictions—Where to now? I'm not sure exactly where we're going yet, but I do know our current mode of transportation—The Trump Train. Markets have spiked since the Trump win in mid November, and as I write this, the DOW is eyeballing the 20,000 mark for the first time ever.

Whether you agree with Trump economic policy or not, the Trump Train has generated some undeniable and significant market momentum. In our view, this momentum has the potential for propelling the markets the next 12-18 months. While we are at all-time highs, consider this: it took almost 18 YEARS for the DOW to double from the 10,000 mark it first hit in March of 1999. That is only a 4.1% annualized return over nearly two decades. Thus, it is hard to make a case that the markets are wildly out of control. For 2017 we are looking for around 10-15% gains in the equities markets.

We foresee GDP growth exceeding 3% in 2017, and this will pressure the Federal Reserve to increase interest rates at a faster pace. For the coming year we are looking for two rate hikes for a total increase of 0.5%.

The Fed says they want to raise rates faster than this, but for the past decade I've always felt they secretly have little interest in high interest rates. Increasing rates in the US will cause further Dollar currency appreciation, and our expectations are that this will be the limiting factor for any significant rate increases. While the US is performing relatively well from an economic standpoint, the rest of the world hasn't followed suit yet. Plus there's that small dirty detail—we as a country are the biggest debtor in the world with $20 trillion in debt, so low rates are in our "best interest".

For my last prediction I'm going out on a bit of a political limb. My expectations are that in 2017 we

2016 Market Wrap

S&P 500	**+11.96%**
DOW	**+16.50%**
RUSS 2000	**+21.31%**
MSCI World	**+5.63%**
BONDS	**+2.65%**
GOLD	**+8.69%**

Mortgage Rates

15-Year	**3.25%**
30-Year	**4.09%**
5/1 ARM	**3.39%**

Did You Know?

* Just Don't Do It–Nike was the worst performing stock in the DOW for 2016 losing 18%.

* The best performing "investments" of 2016 turned out to be commodities, with natural gas leading the way up 57.6%.

* Since 1944, the market has averaged a 6.2% rise in the first year of a new president's term, according to S&P Global Market Intelligence.

20,000 Leagues Over the DOW-Cont.

see a significant overhaul to Social Security in order to sure up its future solvency. This is a subject that has been near and dear to Paul Ryan in Congress for over a decade, and he finally has the numbers on his side to do something about it. While it is impossible to say exactly what this will look like, if I had to guess it will include a full retirement age increase to age 70 for millennials and benefits being fully taxable versus the current 85% taxability threshold for current beneficiaries.

As we enter the first 100 days of the Trump administration we are sure to still see a significant amount of political headlines in the year to come. We have been telling clients for the past year to divorce their investment strategies from political views. I am of the opinion that politicians don't have the impact on the economy and stock market that they profess to have. Now is as important as ever to not build a wall around your future investment returns. **-Ryan Glover, CFP®**

The Great Fund Debate

Those in financial circles have long been debating the question of which method of investing is better: passive or active. Basically, is it better to put your money in an index fund or under the guidance of a professional mutual fund manager? The jury may still be out, but the numbers suggest that passive management is definitely taking the lead in performance and in monetary flows. 2016 marked another victory for passive management as now 22 of the last 26 years have seen the indexes beat more than 50% of active managers. Obviously, all active managers aren't created equal, but the growing popularity of passive funds and an increased investor focus on fees is really starting to put pressure on stock and bond pickers.

According to Morningstar, over the last 12 months investors have pulled a net $358.8 billion out of US-based actively managed mutual funds, while at the same time putting $478.8 billion into passive funds. This trend may in large part be due to fees. As investment products have become more transparent, investors are starting to notice the impact to their portfolios. For example, the average actively managed large-cap fund has an expense ratio of 1.14%, compared to less than half that for passively managed funds, with some even going as low as .03% for the broad-market exchange-traded funds (ETFs). In fact, the fee discrepancy is so large that actively managed funds are aggressively trimming their own fees so as not to lose clients to lower cost rivals. According to a recent Wall Street Journal article, stock fund fees declined by 4.8% in 2016, which is the most severe decline since at least the 1990s. Meanwhile, the average asset-weighted fee for bond funds fell more than 6%. This is of course a positive trend for investors who would like to see more of their money working for them rather than lost in administrative fees.

It sounds like I'm lining up a pretty good case for moving all the chips in the indexing camp, but there are still plenty of reasons that active management makes sense. As I mentioned earlier, passive funds have outperformed in the majority of recent years but, in times of volatility, active management shines. Looking back to the large market declines in 2000 and 2008, we can see that during a downturn 66% and 53% of actively managed funds respectively outperformed the index. Again, this is the whole fund universe, which includes thousands of different mutual funds and ETFs. They are certainly not all created equal. In my opinion, many fund companies are bloated with way too many funds that consistently lag their benchmark. However, finding the right company, with the right portfolio manager, with a reasonable fee structure can be a great addition to your portfolio. Finding those managers can be difficult in a universe that is so big, but one thing to look for is what

has become know as "active share". In a study led by Martijn Cremers at Notre Dame, research demonstrates that funds with high active share (a measure of how much a portfolio deviates from a benchmark), are most likely to beat the market. Of course, being different from the benchmark is obviously the only way to beat it, but the manager must also be right more than wrong. One criteria that Ryan and I look for is for a manager that has a more concentrated holding list. If you look under the hood and the manager has 200 or 300 individual positions, then he is likely just a closet indexer and is unlikely to beat his benchmark. Funds with fewer holdings, let's say 30-100, and lower annual turnover, show more conviction and stand a better chance of adding true value and diversification to your portfolio.

For those trying to put together their 401(k) allocation, our recommendation would be to try and find a nice mix of both active and passive managers. The styles marry well together to reduce overall fee levels and volatility. If you can't find an active manager that has consistently beaten the benchmark index over the last 3,5, &10 year increments then go with the index. Alternatively, if there is a manager with a proven track record of exceeding the benchmark and justifying their fee, stay active. From our experience it seems that active management shines more in the bond fund universe and some of the other harder to invest in asset classes involving internationally domiciled stocks or currencies, etc. **-Walter Hinson, CFP® , AIF®**

Our Advisors

Walter Hinson, CFP®, AIF® (919) 439-0383

walter_hinson@tarheeladvisors.com

Ryan Glover, CFP® (336) 510-7255