Money Manager Newsletter

June 30, 2018

Investment Consulting Group, Inc.

"Knowledge Born From Actual Experience Is The Answer To Why One Profits; Lack Of It Is The Reason One Loses"
Gerald Loeb (EF Hutton)

Brian Reynolds has been an unrelenting bull. Here he argues that pension funds continue to pour money into credit, which will allow buyouts, buybacks and, by extension, the bull market to continue. Of course pension funds are going further and further out on the risk spectrum to achieve the returns that they need, so ultimately this is going to end very badly. Brian believes that the bull market has another 2-3 years left.

When we talk with our equity clients, they often ask us what question other clients ask us the most. The answer we give varies depending on the near-term environment. During one of the 34 brief panics of this bull market, we are most often asked about the worry du jour. Outside of those panics, we are most often asked about when and how this credit-led equity bull market will end. This credit-led bull market is a product of financial engineering. Since shadow bankers try not to be transparent, their actions often make the workings of US credit boom and bust cycles as clear as mud. To counter that opacity, we try to shine as much sunlight as we can. Here is what we found in just the first two weeks of June:
The New York Common Fund is putting $500 million into real estate funds and $418 million into private equity funds. The Pennsylvania State Employees' pension is investing $50 million in a private credit fund and $75 million in a buyout fund. The Connecticut pension is placing $25 million with a buyout fund. The South Carolina pension is investing $223 million in private equity funds. The Tallahassee pension is putting $40 million into value-added real estate funds. The Texas Employees' pension is investing $50 million in a private real estate fund, $50 million in a real estate fund, and $30 million in a buyout fund. The Texas Permanent School pension is putting $21 million into an enhanced credit fund, $75 million into an opportunistic real estate fund and $60 million into a real estate fund. The Texas Teachers' pension is investing $200 million in real estate funds. The Louisiana Teachers' pension is putting $75 into a hybrid private equity and private credit fund. The Nashville pension is investing $80 million in a direct lending fund, $25 million in a mezzanine debt fund, and $20 million in an opportunistic debt fund. The Arkansas Teachers' pension allocated $30 million to a real estate fund, $30 million to a buyout fund, and $30 million to a private equity fund. The Minnesota pension is putting $250 million into real estate funds, $575 million into buyout funds and $650 million into private equity funds. The South Dakota pension is placing $100 million into a private equity fund. CalPERS is putting $100 million into a high-yield bond fund $353 million into a buyout fund, and $300 million into a private equity fund. The Oregon pension is investing $450 million in buyout funds and $250 million in a private equity fund. The New Mexico Public Employees' pension is placing $50 million with a private equity fund. The New Mexico Public Employees' pension is placing $50 million with a private equity fund. The Hawaii pension is investing $60 million in opportunistic real estate funds. We know that equity investors are skeptical about the durability of this bull market. However, our nation's public pensions which are not the dominant global investor, are focused on meeting their outsized return assumptions. They are bringing in fresh new tax money with which to do and are allocating it more aggressively. Those flows should continue to produce more buybacks and M&A designed to boost stock prices until two years after the yield curve inverts.
Brian Reynolds, CFA Canaccord Genuity LLC

Leadership is the ability to hide your panic from others. Lao Tzu

06/30/2018	Growth Median P/E	Historical Growth Avg.	Value Median P/E	Historical Value Avg.
Royal Blues	31.5x	24.9x	14.4x	11.6x
Large Cap	21.8x	20.0x	11.8x	10.9x
Mid Cap	26.9x	23.6x	12.4x	12.1x
Sm Cap	28.0x	27.7x	12.9x	12.1x

How Bad Off Is Social Security
The Social Security system has just come out with the latest report. Since 2010 spending has exceeded taxes paid into the system. That deficit was smaller than the interest earned. Starting in 2018 spending will exceed the revenue stream (tax and interest) and will eventually cause the trust fund to run out in 2030's. How will US society address expected aging. 10 years ago, 12% of Americans were 65 or older, that number today is 16% and projected to increase to 21% by 2030. The trustee's believe the large drop in birthrates in the last decade will reverse once the economy recovers (employment = increase contribution tax).
The question is productivity. The more each worker produces per hour the easier it will be to transfer real resources from workers to retirees. (smaller share of a bigger pie) The US can provide reasonable pensions even as its society gets older. How to split the cost of aging between retirees and workers, especially if the assumptions about fertility, immigration and productivity are too optimistic.
Matthew C. Klein—Barron's

Explain Government Spending
Please explain the difference between entitlement spending and discretionary spending and the difference between national debt and deficit.
Entitlement spending is government spent funds that cannot be changed without violating the rights of individuals who claim those funds including (2017 numbers): Social Security $945 billion, Medicare $597 billion, Medicaid $705 billion, and Welfare $444 billion. Totals $2.7 trillion. Reducing any of these would be political suicide.
The total dollars spent of $4.1 trillion after subtracting entitlements of $2.7 trillion leaves $1.4 trillion called discretionary spending. This goes to Army, Navy, Marine Corps and Air Force, followed by the agencies: SEC, EPA, ATF, NASA, VA, CBO, SBA, CFTC, HHS, DOT, DOJ, BLM, FEMA, HUD, CIA, FBI, IRS, NLRB, TSA, NTSB, ICE, NRC, OMB, DOL, the Secret Service, Homeland Security and Library of Congress. The list continues for pages. As listed above the government spent $4.1 trillion, but collected only $3.6 trillion in taxes. The difference of $500 billion is the deficit. The deficit is the amount of money our government borrows (selling treasuries) to cover the difference between the spending and taxes collected. All those deficits added up make the national debt in 2017. The National Debt exceeded $20 trillion. In 2017 we paid over $470 billion in interest on our debt. If interest rates continue to climb, it could be very scary. Malcolm Berko

Are Value Stocks About To Grow?
For seven of the past 11 years, value stocks and many of the people who own them have languished. It's getting tiresome even for those famous for patience. Value investing should work. At it's most basic, it's buying stocks that are cheap and holding until the rest of the market realizes great companies are selling at bargain prices.
Eugene Fama and Kenneth French using decades of data determined buying cheap stocks and selling priciest was one of three factors to outperform. The growth investors are enthusiastic saying "this time is different." Value stocks are trading at 13.5 times forward earnings. Meanwhile the FANG stocks trade almost double at 24 times earnings. Kenneth French, finance professor at Dartmouth College with Fama helped make price/book a classic gauge for value, maintains that price/book is still the best measure of value. "We have tested the hypothesis several times and haven't been able to convince ourselves that another measure or combination is better. Ultimately, the key is patience."

By the numbers Value vs Growth:

9/1988 to 12/1991 — Value 47%, Growth 97%
10/1993 to 2/2000 — Value 136%, Growth 323%
8/2006 to 4/2018 — Value 118%, Growth 233%

Reshma Kapadia—Barron's

DJ IA	Nasdaq	S & P 500	Russell 2000	MSCI EAFE	Crude Oil	Euro	10 yr Treas.	Fed.Fund Rate	Prime Rate
24271.41	7510.30	2718.37	1643.07	7942.24	74.15	0.8560	2.85	1.75-2.00	5.00

The Supply-Side Salesman Pitching Trumponomics

Larry Kudlow is a different breed. He isn't afraid walking up to the White House after replacing Gary Cohn (#2 at Goldman Sachs). A few major points: "Tax cuts, smaller government, King Dollar." "Growth is always good. There is no downside." It's a message he has recited ever since he was chief economist at President Reagan's Office of Management and Budget. Kudlow says, "Trump and Reagan are very different people, but their politics are actually similar."

A trader, Guy Adami said, "A lot of times, things work in a classroom, in a textbook, but that doesn't necessarily mean it's going to work in real life." "The fact that Larry doesn't have a Ph.D. doesn't concern me, but he did it (economics) for so many years."

What Kudlow knows, he learned on the job. He seems to have one favorite prescription, tax cuts. For a supply-sider the 21% corporate tax is still too high. "If POTUS, Mnuchin, and Steve Moore had not argued for 15%, we would have got 28% tax. This is POTUS at his best." Kudlow still wants 15% and he may get his wish. Mary Childs—Barron's

Cruisin' for a Bruisin' With Target Date Funds (TDF)

TDF providers, Vanguard, T Rowe Price and Fidelity (the big three) do anything they want, anytime they want with 63% of the $1.7 trillion in assets of target date funds. They hold 55% equities during the Risk Zone that spans 5 years before and after retirement. This is way too high for upcoming retirement. The reason…

1.) Fiduciaries should set objectives for TDF's. They believe that any QDIA will do and you cannot go wrong with the big 3. The Hippocratic Oath of TDF's should be "Don't lose participant savings."

2.) TDF's should match workforce demographics. All participants have one thing in common—lack of financial sophistication.

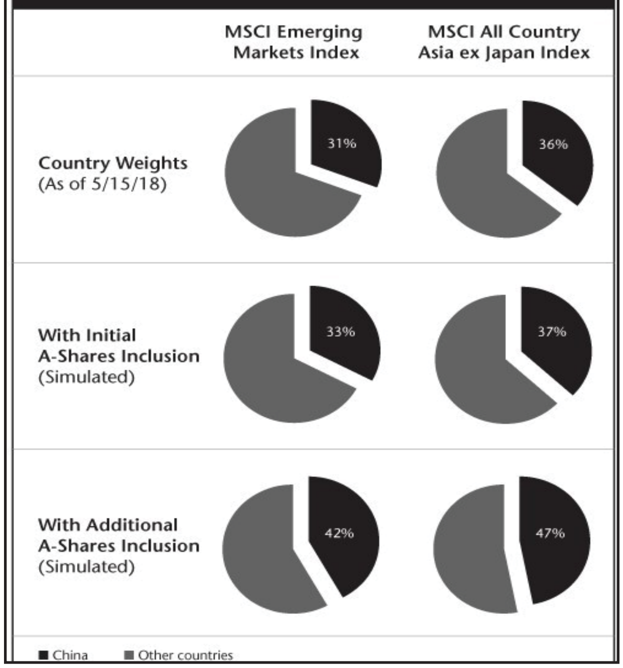
3.) Beneficiaries want the assets protected. Their preference for safety over growth is paramount at 15 years before retirement. The vast majority (75%) prefer growth over safety, but at retirement only 17% prefer growth (83%) prefer safety.

4.) Investment Advisors prefer safety. Out of 77 firms surveyed, safety was preferred.

5.) The average IRA is 55% equities regardless of age. Most Boomers are taking more risk than they should. Don't forget, if they panic and sell a substantial amount that they control ($30 trillion), it will cause a market correction. Can Society support tens of millions of Broke Boomers. If Boomers lose, we all lose. Ron Surz

"It takes a long time to understand nothing." Al Meyer—Business Agent L.U. 25 (5/16/2018)

Figure 1. CHINA'S GROWING ROLE IN BENCHMARKS



Treasury Market Yields	6/30/2018	12/31/2017	12/31/2016
2 Year	2.52%	1.89%	1.20%
5 Year	2.73%	2.20%	1.93%
10 Year	2.85%	2.40%	2.45%
30 Year	2.98%	2.74%	3.06%
SP 500	1.91%	1.89%	2.07%
Commodities			
Oil ($bal)	$74.15	$60.42	$37.04
Gold ($/oz.)	$1251.30	$1306.30	$1060.30
CRB Index	$200.39	$193.86	$176.27

A Dedicated Allocation to China

A dedicated allocation to China can help investors fine-tune and recalibrate how they gain access to the world's fastest-growing economy, while improving global diversification. As a core portfolio holding, China equities can comfortable sit alongside such a portfolio staples as U.S. and EAFE (Europe, Austrailasia and the Far East) investment strategies. Looking ahead, we expect earnings growth in China to be increasingly driven by innovation and consumer-driven sectors. As the spending power of China's middle class continues to grow, sectors such as health care, travel and leisure and consumer services will play a much greater role in fueling China's economic engine. Asia Insight—Matthews Asia