

# Quarterly Client Update

2018 Q2

June 30, 2018



NorthCoast   
Asset Management

# President's Post

“Las Vegas is busy every day, so we know that not everyone is rational.”

- Charles Ellis



It occurred to me that I often talk about the importance of investment discipline and consistency in these letters but I rarely address the *why* behind it. Why are systems and models so critical when investing? The short answer is because we are human. Our ability to feel, think, hope, fear, love, and loathe defines us as humans but that same ability is also the root cause of investor malperformance. I feel very lucky that early in my career I detected the problem and then focused on systematic approaches to the markets.

In 1994 I was at Merrill Lynch doing what all new employees do . . . working long days, acting as a sponge and trying to make a name for myself. At that time Merrill Lynch had the second biggest mutual fund family in the country (behind Fidelity) and was a major force in the active management industry. Curiously though, few (if any) of the funds beat their passive benchmarks and this really bothered me. I didn't know the answer but I certainly recognized there was a long term problem – how can these mutual funds sustain themselves if they underperform less costly benchmarks over time?

It was at this time, thankfully, a small bond department at Merrill (called UITs) launched a strategy called the “Dogs of the Dow” that was based on the book, *Beating the Dow*, by Michael O'Higgins. In it, Mr. O'Higgins described a strategy of buying the top ten high yielding stocks from the Dow Jones Industrial Average and holding them for exactly one year, no matter what. At the end of the year, the investor would rebalance to then again hold the top 10 yielders for the next year. This process was to be repeated year-over-year, without waver. When I read the book and spoke to the team supporting the launch I became amazed. Why? Because this strategy had outperformed the S&P 500 Index every rolling decade back to 1928. What?! You mean our team in the mutual fund division was in the office 12-hours a day and underperforming, and this strategy called for coming in the office once a year and was outperforming?! This was my first introduction to factor investing and behavioral finance.

The system worked because (1) it executed on a simple model (buying big cap stocks with high dividends) and (2) it eliminated human bias. It was a big “aha” moment for me and from that point forward I became obsessed with trying to identify superior models and eliminating my own investment prejudice.

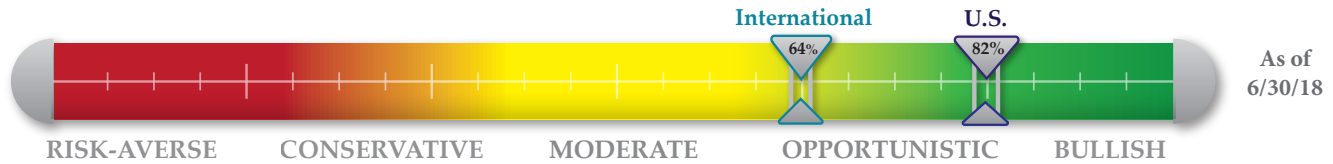
Humans carry all kinds of emotional baggage every day – loss aversion, overconfidence, mental accounting, herd mentality, and one of my favorites -- hindsight bias. You'll hear them all the time if you stop and listen - watch CNBC, talk with friends, or focus on your own words. It sounds like this today -- “value stocks don't work, this is a growth market” or “international stocks are terrible, let's change our allocation.” Well, of course, we *now* know growth stocks, led by the technology sector, had a better first half of 2018 and international stocks have trailed because hindsight is 20/20.

So you might often ask yourself what changes do I need to make in my portfolio in light of these recent trends. But the real question is why do anything? Doing nothing is often the right move. Try to avoid those short-term, reactionary conversations because in my opinion, they don't really matter in the long-run. What matters is determining what you are trying to achieve over the next 5 to 10 years – knowing *why you are investing*. Once you know that, select a portfolio strategy designed to deliver. I suggest you set up a plan that allows for all different types of market environments... bullish, bearish, growth, value, domestic, international, etc. Take a step back, consult with our team, and establish a portfolio that is geared to perform not just over the next ten weeks, but the next ten years. Then the big question becomes, are you willing to remove yourself from the equation? If so, I bet the more successful you'll be. I've done it since 1996 when I was first introduced to the Dogs of the Dow, and for my money, it's made all the difference.



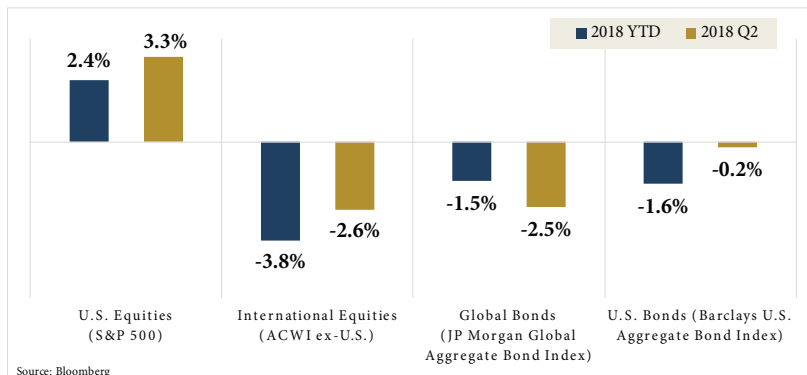
# NorthCoast Navigator

The NorthCoast Navigator is a market "barometer" displaying NorthCoast's current equity outlook. This aggregate metric is determined by multiple data points across four broad dimensions including Technical, Sentiment, Macroeconomic, and Valuation indicators. The daily result determines equity exposure in our tactical strategies.



## What happened in the 2<sup>nd</sup> quarter?

The second quarter began with a strong reporting season of Q1 earnings that reflected the benefit of the U.S. tax overhaul implemented last year. The U.S. also saw an uptick in inflation announced in April, which paved the way for the Fed to raise the target interest rate in June as expected. The economy continued to look strong throughout the quarter with positive jobs reports, strong GDP growth and rising consumer spending. Sentiment indicators remained largely positive throughout the quarter despite some concerns and uncertainty caused by trade disputes between the U.S., China and other countries. This news and rhetoric between the countries weighed on the equity market throughout May and June. However, the positive fundamental data championed as the major U.S. equity indices finished the quarter in positive territory.



## Moving into the 3<sup>rd</sup> quarter

The equity market wrestled with geopolitical tensions and headline risk in the second quarter amidst the positive fundamental data. Despite these tensions potentially dampening consumer and producer sentiment in the near-term, rising wages for U.S. consumers and positive economic data is bolstering overall domestic sentiment. All the while, macroeconomic and technical indicators remain bullish. The volley of tariffs between the U.S. and China and the upcoming reporting season will be important to watch and interpret in the coming months. We enter July 82% invested in our U.S. tactical strategies and 65% invested in our international tactical strategies.

Data as of 6/30/2018. Data provided by Bloomberg, NorthCoast Asset Management.

### VALUATION

Valuation indicators were unchanged in June. The average P/E and forward P/E ratios of S&P 500 companies ticked slightly higher to 20.7 and 17.1 respectively.

### TECHNICAL

The relative strength index, measuring general market momentum, slightly fell in June but the end-of-month decline provided a near-term buying opportunity. The general market index is 2% above its 200-day moving average.

### MACROECONOMIC

U.S. inflation hit a 6-year high in May at 2%, a key metric showing the growing economy is on a healthy trajectory. The unemployment rate dropped to 3.8%, an 18-year low.

### SENTIMENT

The University of Michigan Consumer Sentiment Survey was relatively unchanged at 98.2. Flows into the S&P 500 equity fund SPY were negative with the increased volatility in the market.

# Strategy Performance

NorthCoast offers a suite of active investment strategies designed to meet the individual goals and objectives of the investor. Our dedicated advisory team will work with you to construct a portfolio catered to your needs.

	STRATEGY	OVERVIEW	YTD	Q2
Risk-Adjusted "Tactical"	CAN SLIM <sup>*</sup>	Tactical All-Cap Growth	6.1%	3.3%
	CAN SLIM <sup>*</sup> <i>International</i>	Tactical All-Cap International Growth	-3.2%	-0.8%
	CAN SLIM <sup>*</sup> <i>Global</i>	50% CAN SLIM <sup>*</sup> / 50% CAN SLIM <sup>*</sup> International	1.5%	1.3%
	Tax-Managed	All-Cap U.S. Growth	4.3%	1.7%
	Tactical Growth ●	Tactical Global Asset Allocation	-1.2%	-0.8%
	U.S. Sector Select Hedged ●	Tactical U.S. Sector Allocation	3.5%	4.3%
	International Select Hedged ●	Tactical Country Rotation	-2.3%	-5.3%
Growth	Legends Value	All-Cap Value	-5.5%	0.9%
	United Portfolio	50% Legends Value / 50% CAN SLIM <sup>*</sup>	0.2%	2.1%
	Vista	All-Cap Growth	0.9%	1.5%
	Global Select ●	Global Country Allocation	-3.8%	-5.5%
	U.S. Sector Select ●	U.S. Sector Rotation	3.1%	4.7%
	International Select ●	International Country Allocation	-6.0%	-8.5%
	Emerging Market Select ●	Emerging Market Country Allocation	-11.2%	-14.1%
Core	Diversified Core ●	Global Asset Allocation	-1.2%	-0.6%
	Diversified Growth ●	Global Asset Allocation	-0.6%	-0.6%
	CAN SLIM <sup>*</sup> : <i>Growth &amp; Income</i>	75% CAN SLIM <sup>*</sup> / 25% Bond ETFs	3.9%	2.3%
	CAN SLIM <sup>*</sup> : <i>Balanced</i>	50% CAN SLIM <sup>*</sup> / 50% Bond ETFs	1.8%	1.3%
Income	Core Fixed Income ●	Conservative Income	-2.0%	-0.6%
	Tactical Income ●	Dynamic Income	-1.9%	-0.5%
	Aggressive Income	Aggressive Income	0.0%	0.1%
Alts	Zero Beta	Liquid Alternatives	-3.8%	-2.1%

● = ETF Managed Strategy

**PAST PERFORMANCE DOES NOT GUARANTEE OR INDICATE FUTURE RESULTS. INVESTING ENTAILS RISKS, INCLUDING POSSIBLE LOSS OF SOME OR ALL OF THE INVESTOR'S PRINCIPAL.**

Returns are presented net-of-fees. Net-of-fee returns are reduced by trading costs and the portfolio's actual management fee. Valuations are computed and performance is reported in U.S. dollars. A complete list of composite descriptions is available upon request. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. To obtain a compliant presentation for the associated strategy, please contact one of our advisors at 800.274.5448.

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