MARKET COMMENTARY

While monetary policy has taken center stage for years, it was fiscal policy that defined the fourth quarter of 2017. The successful passage of the Tax Cuts and Jobs Act, which will cut business taxes and change the individual tax codes starting in 2018, was well received by the market and drove interest rates higher as well as equities.

Focusing on the performance and narrative within the fixed income market, the Bloomberg Barclays U.S. Aggregate Bond Index finished the quarter with a positive 0.39% return led by the corporate bond sector. Despite corporate bond spreads starting the quarter at the tightest levels in over a decade, the sector continued to experience strong demand from investors pushing prices higher and spreads tighter. The government bond sector, which is mainly comprised of U.S. Treasury bonds, had a positive 0.05% return, with longer duration U.S. government bonds posting positive quarterly returns while short to intermediate duration bonds posting negative returns. The main driver to the mixed performance within the government bond sector was the Federal Reserve raising the fed funds rates another 25 bps, to 1.5%, causing shorter term securities to drop in price.
The U.S. economy appears to be on solid footing with GDP greater than 3%. In addition to growth, the job market continued to improve with the unemployment rate, as measured by the Bureau of Labor Statistics, dropping to 4.1% in October and November.

Equity markets in the U.S. proved resilient in their climb to record highs. The S&P 500 posted a return of 6.64% led by the technology and consumer discretionary sectors. The Dow Jones Industrial Average recorded even better returns posting gains of 10.96% during the quarter. The positive returns were fueled by the passage of the new U.S. tax bill which will cut the corporate tax rate to 21% from a previous rate of 35%. Other factors contributing to returns were stronger company fundamentals, growth in earnings, and a U.S. economy which has picked up momentum this year as indicated by multiple economic indicators.

4Q 2017 Commentary
CRA Qualified Investment Fund

PORTFOLIO COMMENTARY
In the fourth quarter of 2017, the CRA Qualified Investment Fund CRA Shares (CRAIX), Institutional Shares (CRANX) and Retail Shares (CRATX) returned -0.12%, 0.08% and -0.10%, respectively, on a net of fees basis, underperforming the Bloomberg Barclays U.S. Aggregate Bond Index (“Benchmark”) return of 0.39%.

The Fund’s largest sector, agency commercial mortgage-backed securities (CMBS) returned -0.10%, underperforming the U.S. Government / Government-related subsector return of 0.06%. The higher income profile of the Fund’s agency CMBS relative to U.S. Government and government-related securities helped relative returns; however, the composite sector lacks exposure to the long end of the curve, which rallied during the quarter.

The Fund’s second largest sector, single family agency mortgage-backed securities, returned 0.23% in the quarter, outperforming the U.S. MBS sector return of 0.15%. The sector’s slower prepayments were the main reason the sector outperformed on a relative basis.

4Q 2017 Commentary
CCM Alternative Income Fund

PORTFOLIO COMMENTARY
The CCM Alternative Income Fund finished the year on a decent note returning 1.04% and distributing 1.20% for the quarter, bringing the year total return to 5.01% and distributions to 4.60%.

We are modestly content with these returns. The Fund exceeded the Bloomberg Barclays Aggregate’s return by 1.47%, while maintaining a negative correlation to interest rates. Our fixed income portfolio posted excellent returns with exceptionally low volatility. The long/short dividend equity component returned positive returns despite the difficult backdrop of growth equities outperforming value by substantial margins yet again.

We remain concerned by high valuations and low yields across asset classes. In light of the near constant rise and flattening of the U.S. Treasury yield curve, we would expect some questioning of yields (or lack thereof) of certain investments, especially if one cares about risk.

2017 might well go down, however, as one of the most risk insensitive years ever. From credit spreads to equity earnings multiples, the traditional measures of risk/reward seem to have fallen by the wayside particularly for large index components. At the farthest end of the greedy risk taking spectrum, with Bitcoin and other “cryptocurrencies”, we believe we are witnessing a bubble that will be discussed for centuries to come with all of the hindsight wisdom now associated with $10 per dozen tulip bulbs.
We have mentioned our misgivings with the high price/low yield of many risk assets ad nauseam. We might not have put it in the best historical context though. A major outgrowth of the rise of quantitative investing is the term factor based investing, which is another way of grouping investments that exhibit similar traits.

We believe free cash flow to be gravitational in nature. You go long enough and eventually it exerts itself in the ultimate value of things. It should come as no surprise therefore that the biggest driver of North American equity performance over long periods has been free cash flow yield.\(^1\) You can see proof below.

There are shorter periods of time though, when such concrete factors such as cash flow give way to flimsier metrics. Sales growth, momentum, or “sentiment” factors can have brief moments in the sun.

Proof of this dynamic is evident below where no cash flow metric is a top ten factor in the past year.

\(^1\) As defined in this case by FCF/EV (free cash flow divided by Enterprise Value, where free cash flow is Operating Cash Flow – Capital Expenditure) and FCF Yield (free cash flow as a percentage of market value of equity, where free cash flow is Operating Cash Flow – Capital Expenditure).

\(^2\) Data as of 1/13/18 representing factors impacting North American equities compiled by Bloomberg. LTM = Last Twelve Month. Sharpe ratio is defined as the average monthly returns divided by standard deviation.
In fact, last year, the free cash flow factors that drove returns for the 10 year and 15 year periods cited above fell to 149th place!

Indeed, it seems an overarching factor in risk assets over the past year and especially since start of the year has been fear of missing out (FOMO). The rise of some securities, particularly large components of indexes that have attracted cash, has been stunning. The main fear seems to be not owning enough of something that attracts investors and seems to go up every day. If one looks closely though, there are some cracks.

We mentioned in the last letter that we wondered whether a rise in shorter dated interest rates could change the dialogue in some corners in the investment world. Specifically, would a 2% yield in the two-year treasury make people question holding certain investments? We are seeing that answer right now.

A few days ago, the two-year treasury yield crossed 2%. This level is by no means some ominous, irreversible crossing of a Rubicon. However, some things such as longer duration fixed income and stocks that are viewed by some as bond proxies (utilities, REITs, consumer staples) have underperformed shorter duration, higher yield fixed income and U.S. equity indices respectively since the beginning of the fourth quarter.

If rates continue their trajectory we would expect this trend to continue or accelerate. After all, the risk/reward of a 3% dividend yield or long-term bond yield is questionable when one can earn 2% virtually risk free if holding the two-year treasury note to maturity. An even larger issue might arise if broadly higher interest rates cause investors to begin valuing investments with higher discount rates.

We believe we have positioned the CCMNX portfolio well for a higher interest rate environment. The Fund has run a small negative correlation to the Bloomberg Barclays Aggregate since inception. We own a lot of investments that should benefit or be relatively unaffected from higher short-term interest rates. Additionally, we have sought to hedge the interest rate exposure of our longer duration assets. At the same time, the Fund’s 30-Day SEC yield ended 2017 at 5.84% (the unsubsidized 30-day yield was 5.69%). As we have seen, over the short term anything can happen. The value of free cash flow can be ignored temporarily in lieu of extreme greed or irrational fear. But it can’t be suppressed forever, much like valuations cannot expand infinitely. Something eventually brings everyone and everything back to earth.