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**February 7, 2023**

 I apologize for this being so late. It’s been an exciting and full last couple of months. Enjoy this latest letter and let me know if you have any questions.

**Personal Update**

Jake: The fourth quarter wrapped up a very busy year for me. I love the last quarter of the year for two of my favorite holidays – Thanksgiving and Christmas. Thanksgiving reminds us to be grateful for all the blessings we have, while Christmas gives us hope for the future. This year, I smoked a turkey for the family Thanksgiving feast, and the family spent a lot of time together. This year, I got to go to Lebanon to spend Christmas and New Year’s with Nour’s family. After not going for over two years, it was great to get back there again. I’m also thankful that Larson is able to handle things while I am out of the country. Christmas in Lebanon was wonderful, with the country decked out with beautiful Christmas decorations. We traveled around the country and saw amazing sights. Most importantly, Nour and I got to spend wonderful time with family. I love my work and I love working hard, but it is also important to rest and to celebrate and to spend time with loved ones. I am now feeling energized and ready to take on some new projects for the new year.

Larson: The fourth quarter was full of travel, developing relationships, and furthering professional education for Hannah and Larson. Larson made trips to Texas, Iowa, and California to see friends, family, and clients. Time with Larson’s family in San Luis over Christmas was lovely. Larson successfully passed section two (of three) of the Enrolled Agent exam and Hannah is making progress on her master’s program. She has about a year left. Progress on their home has been slower than expected, but should be completed by the end of March. They are excited to resume hosting people in their home! Hannah has a new kitten named Doc. Doc loves to play fetch, take naps, and get into EVERYTHING. A small group Bible study on Thursday nights has accelerated building community in Sheridan.

**Business Update**

 In October, I (Jake) got to go to the Ed Slott Elite IRA Advisor program in Las Vegas. It was a two-day intensive conference on taxes, particularly related to retirement accounts. The program was tremendously informative and fast paced. The environment was beautiful, but ironic. It was held as Caesar’s Palace. Walking around Las Vegas made me think – inside is all the glitz and glamor of beautiful buildings and high-end retail stores, but this is only an illusion offered by the gambling industry. Outside on the street were broken lives – the result of foolish choices. This made me grateful for the opportunity I have to guide people to wise and prudent decisions with their spending and investments. Saving carefully and investing wisely may be as excited as watching grass grow, but the end result is a life of security and significance. It also reminds me of a quote by Rory “Hard choices, easy life. Easy choices, hard life.”



Jake Rothman and Ed Slott

 We added two new software tools to our toolbelt. The first, is a tax analysis software. This scans tax returns and then highlights opportunities. We believe helping clients plan ahead to minimize taxes over their lifetimes is an important service we can offer, and having this software streamlines and enhances our process. Reach out to us about how we can help you as your tax strategist. The second software is a research platform called Morningstar Advisor Workstation. This has detailed information on stocks, mutual funds and ETFs. This will allow our investment research to be faster and deeper. It also has a risk assessment tool, which we will be rolling out to new and existing clients.

 Finally, we did a Client Appreciation dinner at Madonna Inn in December. If you were not able to make it, or want to view the presentation again or share it with someone else, it can be accessed here: <https://rothmaninvest.com/resources/investing-in-a-volatile-market-environment>

**Market and Economic Outlook**

 After a rocky 2022, bonds are yielding a reasonable return again, at least if you ignore the effect of inflation on the real value of your investment. Stock valuations are at levels not sustained since way back in 2014, as measured by the popular price/earnings ratio (trailing twelve months of earnings). As of 12/31/22 the ratio was 19.8x, 1% below the fifty-year average of 20.0, and about 20% below the twenty-year average. How did we get here? Ben Carlson [notes](https://awealthofcommonsense.com/2023/01/2022-was-one-of-the-worst-years-ever-for-markets/) that the stock market had its seventh worst year on record, at -18.1%. Three of the worst years were in the Great Depression, with the Great Financial Crisis, the Dot Com Crash, and 1974 rounding out the worst years.[[1]](#footnote-1) That’s bad enough, but what made this year especially destructive was that bonds had their worst year on record. Usually diversifying between stocks and bonds protects a portfolio, but not last year. Carlson further notes that a standard 60/40 portfolio (60% US stocks and 40% bonds) had its third worst year, trailing only 1931 and 1937. That sounds bad, but it gets worse. In 1931, [the inflation rate was -9%](https://www.in2013dollars.com/inflation-rate-in-1931). The purchasing power of a 60/40 portfolio declined by 20.8% when accounting for deflation. In 1937, [inflation was 3.6%](https://www.in2013dollars.com/inflation-rate-in-1937#:~:text=The%20inflation%20rate%20in%201937,CPI%20in%201937%20was%2014.40.), so the purchasing power of a 60/40 portfolio declined by 22.5%. In 1974, inflation was 11%, so the 60/40 purchasing power loss was 23.15%. In 2022, the official [inflation rate was 6.5%](https://www.usinflationcalculator.com/inflation/current-inflation-rates/#:~:text=The%20annual%20inflation%20rate%20for,ET.), pushing the loss of purchasing power to 22%, just barely behind 1931 for the worst third worst year ever. If you thought 2022 felt bad, it’s because it was bad.

 

Source: Ben Carlson, NYU

Source: Michael Gayed via Twitter

Does this present a wonderful buying opportunity? Let’s put the loss in context. Professor Aswath Damodaran [states](https://seekingalpha.com/article/4571595-data-update-2-for-2023-rocky-year-equities?mailingid=30330232&messageid=macro_view&serial=30330232.24165&utm_campaign=nl-macro-view&utm_content=macro_view&utm_medium=email&utm_source=seeking_alpha&utm_term=30330232.24165): “During the course of 2022, US equities collectively lost $11.6 trillion in market capitalization, but for balance, it is also worth noting that US equities are still holding on to a gain of $6.9 trillion on their market capitalization at the end of 2019. Given that we endured a pandemic, multiple political crises, and wars in the three years since that is almost a miracle.”[[2]](#footnote-2)

Valuations have become much more reasonable than in recent years, but are still stretched according to the metrics I find reliable. For instance, the Shiller Price/Earnings ratio is still well above its long-term average, while the Price/Sales ratio for the S&P 500 is 50% above its average of this century. Valuations are moving back toward reasonable levels, but are not there yet.

Source: [www.multpl.com](http://www.multpl.com), calculations: RIM, as of 12/31/22

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There is still much to be concerned about, starting with the expectation that the Fed will go back to the very easy money policy of the last few years, rather than realizing that it is an aberration. Yes, rates will likely go back down, but to what level? Will the Fed risk another major asset bubble by repeating its mistake of the past? Maybe, but maybe not.



Source: US Federal Reserve

At the start of 2023, we see speculation is still alive and well (imaginary money is rebounding, Meme stocks and low-quality story stocks are coming back), even if not as strong as it was. Take, for example, niche auto-maker Tesla, which has risen 55% this year as of February 7, as just one example. Market corrections often start with the biggest areas of concern and then work their way to the less ridiculous stocks. This does not work in a straight line, and speculators see drops in value for their speculative darlings as buying opportunities. Generally, the market does not bottom until almost everyone has given up.

Despite all the uncertainty mismatched with generally high valuations, there are opportunities. Value stocks still make sense. There are different ways to measure value, and some have worked better than others in the past. We prefer using Enterprise Value (market capitalization plus debt minus cash) divided by EBIT or EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) or Free Cash Flow yield. The first method normalizes capital structure so that debt isn’t ignored, benefiting highly leveraged companies. The second looks how much cash the company is generating divided by the value of the company. Both are finding great opportunities to buy quality companies at steep discounts to the market. We expect that as the “everything bubble” continues to deflate, solid cash-producing companies will come back into demand. International diversification finally seems to be working, and we expect it is prudent to have an allocation to less expensive foreign markets. Having a system for risk management and sticking with it is key in a volatile environment like this.

While the ride is not smooth, investors can take solace in knowing that lower prices for their investments today means better returns in the future. Economic cycles will happen, as will booms and busts in the markets. Rather than trying to predict (guess) every squiggle in the long-term charts, we prefer to own solid investments at good prices and wait out the fluctuations, while employing systematic risk management to smooth out the returns.

Access the full Outlook here: <https://rothmaninvest.com/resources/4q-2022-economic-and-market-outlook>

**Education Spotlight: Which is the better charitable giving technique – QCD or appreciated stock donation:**

Is it better to donate highly appreciated securities or to make direct IRA contributions?

              While it is not true that making charitable contributions doesn’t cost the donor anything because they can just “[write it off](https://www.youtube.com/watch?v=XEL65gywwHQ)”, there are tax advantages available for making charitable contributions.  My favorite tax opportunity is donating long-term securities (held at least one year) that have appreciated.  By donating these directly rather than selling the investments (generally stocks, but other investments could qualify), the donor gets a tax deduction for the full fair market value as of the date of the donation, and is never taxed on the unrealized gain.  This is a double benefit intentionally placed into the tax code to encourage both long-term investing and charitable contributions, both of which are good for society.  Let me illustrate how this works.  Let’s say you bought 100 shares of ABC in 2009 for $15/share, and held them until today.   You’ve realized substantial appreciation, as the shares are now worth $60 each.  You want to make a donation, so you donate the shares to your favorite charity.   You get a tax deduction for the $6,000 of value that you donated, and you avoid taxes on the $4,500 of gain you would have realized if you sold the shares.  Assuming you are able to itemize your deductions and that you are in the 24% Federal Income Tax bracket, you would save $1,440 with the deduction, and avoid capital gains tax of $846 by not selling the shares.  Depending on your state, you may save money on state income tax as well.

              A second great opportunity for charitable giving is the Qualified Charitable Distribution (QCD).  Taxpayers who are at least 70.5 years old can make a donation directly from their IRA account to a qualified charity through a QCD.  The gift is not deductible, because it gets even better treatment – it is not included in Adjusted Gross Income (AGI).  There are several tax thresholds tied to AGI, and none of them are good for the taxpayer.  These include taxability of Social Security, Medicare surcharges, net investment tax, and deduction phase outs.  Further, with the increased standard deductions from the Tax Cuts and Jobs Act, most people no longer use itemized deductions.  If a taxpayer is not above the threshold, there is no benefit for having an itemized deduction.  State and local taxes are capped at $10,000/per year, and retirees often have modest mortgages or no mortgages at all.  This means that for many retired couples who are charitably inclined, they get no benefit on their first $18,000 of charitable giving.  This makes the QCD a great option.  QCDs also count toward the IRA owner’s Required Minimum Distribution.

              Which is the better technique – donating appreciated securities or using QCDs?  It depends.   Until a taxpayer is 70.5 years old, a QCD is not allowed.  RMDs don’t start until age 72.  Taxpayers who are old enough for QCD’s and don’t itemize generally will be better using the QCD, especially if their capital gains rate is much lower than their income tax rate.  Taxpayers who already itemize and have very large gains in taxable positions are probably better off donating the shares, particularly if they want to sell them anyway.   There are also limits to consider.   Donated appreciated property can only be deducted up to 30% of AGI (20% if donated to a Private Foundation), while QCDs are limited to $100,000 per person per year and cannot be given to Donor Advised Funds or in fulfillment of a legally binding pledge.  Finally, estate planning issues should be considered.   Taxpayers who hold shares they plan to leave to their heirs can just wait for the step-up in basis (wiping out any unrealized gains) in their estate.  Appreciated property is the best thing to leave in an estate, while a traditional retirement account is the worst – it gets taxed at the heirs’ ordinary income tax rate, and they generally have ten years or less to withdraw the entire amount.

Finish reading here: <https://rothmaninvest.com/resources/which-is-the-better-charitable-giving-technique-qcd-or-appreciated-stock-donation>

**Book Review: Reducing the Risk of Black Swans**

    The book is thought provoking from start to finish.   For context, readers should understand the concept of a “Black Swan”, introduced in the brilliant Nassim Nicholas Taleb’s book, “Fooled by Randomness” and expanded on in “The Black Swan.”  The idea is that we tend to assess risk based on what has been observed in the recent past, rather than on what could or could have happened.   Some events may be so rare, that there is no record of them occurring… yet.  These could be extremely impactful.  The term has been expanded (inappropriately in my opinion) to mean very rare events generally.  Swedroe and Grogan examine how to protect a portfolio against large declines in value.

              In the Foreword, Ross Stevens lists exceptionally low interest rates as a major factor in how people approach risk.  Not only do low rates push investors into riskier assets seeking a return on investment, but low rates themselves create additional risk in fixed income, which is generally considered a safe asset class.   He notes that the duration (a measure of how long your money is committed) has increased from 3.7 years to 6.0 years in the aggregate bond index, effectively levering up the portfolio by 62%.  In simple terms, the average interest rate risk in the bond market is much higher, at the same time interest rates got to extremely low levels.

              The authors start by explaining why historical stock returns are unlikely to continue.  The price paid per dollar of earnings has increased tremendously over time, particularly since the start of the 1990’s.  This is not only unlikely to continue, but it makes future returns harder as investors get less earnings per dollar invested.

              The authors look at ninety years of data, Over that period, the total stock market earned 8.4% per year more than government bonds.  The smaller half of companies returned 3.3% per year more than the larger half, and the cheapest 30% of stocks made 5.1% per year more than the most expensive 30%.   There is more risk in smaller and cheaper stocks, but the point is that by taking different risks uncorrelated to market risk, as long as the risks are compensated, investors can reduce exposure to just market risk.  Importantly, for risk diversification to work, the risks can’t be correlated to each other.  In this case, the risk factors have shown to be independent over time.  However, in order to stick with a portfolio exposed to multiple risk factors, investors must be willing to endure periods of lagging the market return.  The authors then demonstrate using historical data, how a portfolio with size and value exposure can take less market risk and attain a similar return with less total risk.  This is important because in a large market crash the investor will have less exposure to stocks.  This is a different way to think about diversification.  Rather than diversifying across all asset classes and styles, this approach diversifies across risk factors, seeking exposure to factors that have historically generated returns with low or no correlation to the market.

              In part two of the book, the authors examine alternative investments to seek returns that are uncorrelated to the equity market.   These are interesting, but not always practical.

              Conclusion: Reducing The Risk of Black Swans looks at how to go beyond just a stock/bond portfolio to reduce risk of major loss by taking exposure to other, uncorrelated risks.  Investors would do well to gain exposure to time-tested risk-factors that are relatively uncorrelated to stocks such as value, small companies and momentum.

              Overall, the book is a great exploration of how to reduce risk in a portfolio without reducing expected return through an insightful and effective way of viewing diversification.  Investors should carefully consider the recommendations offered in this book.

Read the full book review here: <https://rothmaninvest.com/resources/book-review-reducing-the-risk-of-black-swans>

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1. (Carlson, 2023) [↑](#footnote-ref-1)
2. (Damodaran, 2023) [↑](#footnote-ref-2)