



**August 12, 2025**

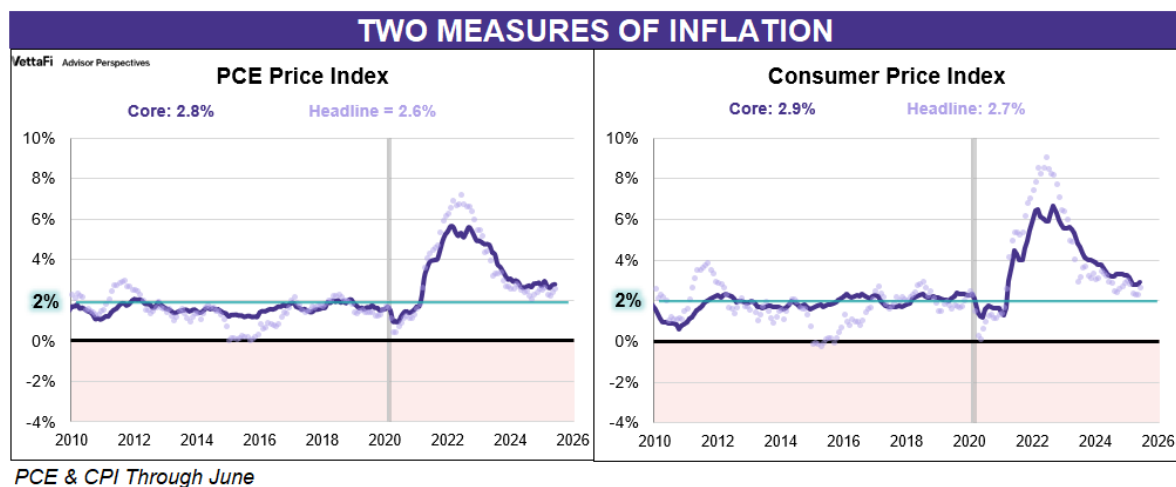
Dear Friends:

Welcome to our Q2 letter. Feel free to reach out with any questions.

### **Economic and Valuation Update**

The US economy officially grew at 3.0% in the second quarter, a significant rebound from -0.5% in the first quarter, with swings in imports being the main driver. This likely was due to companies ordering ahead of tariffs in the first quarter and then working off inventory in the second quarter. It is best to smooth out the results and consider the first half of the year, which was 2.5% growth from fourth quarter of 2024. This is an annualized real growth rate, which means after adjusting for inflation, economic growth averaged 1.25% in the first half of this year. This is a deceleration from 2.5% in 2024 and 3.2% in 2023. Unemployment remains low at 4.2%, but job openings continues to fall.

Inflation is stubbornly staying above the Fed's 2% target, with the Fed's preferred measure, Core PCE staying steady around 2.8% for about a year. Inflation hasn't been below the 2% target in over four years.



The S&P 500 rebounded 10.8% in the quarter, mostly on valuation expansion, as the Schiller P/E (price based on inflation-adjusted earnings over the last ten years) jumped 9.8%. At 37.9x, it is 72% above its 50-year average, and 41% above its twenty-year average. The Tech Bubble peak was about 44x. Other long-term valuation metrics show the S&P 500 more than 100% above its average historical valuation. Investors should understand that while stocks can keep going higher, a 50% drop in the market would only put it around average historical valuation. This is merely an observation, not a prediction.

### **A note on investment returns**

“If you’re so smart, why aren’t you more successful?” It’s never asked quite like that, but I’ve been getting some version of that question for a while, and it’s never fun to be on the receiving end of that. I want to take a stab at why investments results haven’t been commensurate with the level of training and effort that has gone into them.

In many fields, there is a very direct and consistent link between input and output. If an electrician wires a house properly, the lights will work. Every time. An engineer who correctly designs something which is then produced faithful to the design will have a product that does what it is supposed to do. Other fields are less consistent, but still have a strong link. An athlete who trains well and practices enough will experience some variation in performance, but will generally realize success according to talent and preparation. Finally, other fields have results that are more probabilistic, especially when looking at smaller sample sizes. Doctors diagnose and prescribe based on information that is sometimes incomplete or ambiguous, but is all that is available. Each body is a little different and responds differently to a particular treatment. Success rates may be very high, but there are a lot of factors at play, and not all are within the physician’s control. Business is even more variable, as one’s success is impacted by potential customers’ response, changing societal trends and competitive reaction.

In investing, there is no surefire way to succeed every time. Investing is an exercise in probability. One safe approach is to follow the herd. Investors can passively invest by replicating an index that is the average of all other investors. This does not guarantee that one will make money in any given period, but it does mean an investor will keep up with the aggregate returns of all investors. This is a fine approach, but we believe there are better ways. A traditional index sizes stock positions based on the value of all of the stock of a company relative to all other companies. “Bigger” companies get a bigger spot in the portfolio. Size is not based on sales, headcount or profit, but on what the sum of all investors are willing to pay. This approach necessarily holds more of popular (and faddish) stocks and less of contrarian, out of favor stocks that may represent great value.

Simply arguing against market-capitalization weighting for a portfolio is not enough. We believe in observing data. In this case, the data are clear. An equal weighting of the 500 stocks (which would have 2% of the portfolio in the ten biggest stocks vs. almost 40% currently) has historically outperformed the market capitalization weighting by a statistically significant amount going back about a century.<sup>1</sup> Emphasizing stocks trading objectively cheaper has done even better over most timeframes I've examined. "Indexing" or passive investing is a great way to minimize fees and avoid costly mistakes made from overconfidence or cognitive biases, but it is not the best way to capture returns. I have done significant research over the last decade on how to quantitatively, or mechanically capture strong risk-adjusted returns. There is plenty of academic research on these investment "factors", and compelling data that spans decades and geographies, such that this type of investing is called evidence-based investing.

If there are better ways of investing than just following the crowd, why doesn't everyone do it? One has said, "the markets can stay irrational longer than you can stay solvent." In most areas of life, repeating something that isn't working is stupid. We are trained to abandon what doesn't work and to keep doing what works. This is pragmatic, but in investing, nothing works all the time, and we have a time horizon mismatch. We can chase the latest hot trend, but at some point, it's likely to crash hard, wiping out years of gains.

The problem with trying to capture excess returns from investment factors is that they represent another risk, in addition to market risk. In other words, while on average the returns of these quantitative, or factor-based, strategies are positive, in any given period they can be negative. While there are different ways of measuring value and growth, a study by stock market researches Fama and French found that the value factor outperformed growth investing in 62% of one rolling one year periods and 93% of rolling fifteen-year periods.<sup>2</sup> While those are good odds, worthy of our investment capital, investors tend to measure returns in quarters or years while academics measure in decades or generations. Put differently, the data show that over the last century, value investing lagged over a full fifteen-year period 7% of the time.

Advisors who know about evidence-based investing have little incentive to implement it due to the career risk. Financial advisors generally won't get fired for being average at investing, but risk losing clients if performance lags, which it will at some point if they deviate from the index. Even the greatest investors had periods of time where they fell far short of their benchmarks. Warren Buffett [trailed the S&P 500](#) by about fifty percentage

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<sup>1</sup> (Rabener, 2021)

<sup>2</sup> (James Royal, 2024)

points in the tech bubble.<sup>3</sup> In 2019 and 2020 he [trailed by 37 percentage points](#).<sup>4</sup> The point is that when you do something different than the crowd, there will be times when it works well and times when it fails to keep up. Warren Buffett can persist, but your average investment manager or financial advisor risks being out of a job for such performance.

In a world where investing is driven by enthusiasm rather than math, we expect a widening valuation chasm between the stocks that capture the public's imagination and those that simply trade at an attractive valuation to their fundamentals. In previous such cycles, math reasserted itself violently, and the stocks that were truly good quality and good value held up while the "story" stocks crumbled. Current valuations on the largest stocks make it hard for them to provide a reasonable return to investors. Since the largest ten companies make up about 38% of the S&P 500, there is a lot of risk to the "diversified" index.

In conclusion, while it is a terrible time to have been a factor-based investor, we believe that it is a great time to be one from here, as the historic run of the largest companies has driven them to valuations that will present extreme challenges to prospective returns.

## **Educational Update: Interest Rates**

Interest rates have been a hot topic, with the President consistently complaining that rates are too high, and even suggesting we should have a rate of 1%.

The first thing investors should understand about interest rates is that the Federal Reserve Board (Fed) only sets the Fed Funds Rate, which is the very short term. The rest of the rates are set by the free market, based on expectations of future rates, as well as supply and demand. The most important rate for the economy is the ten-year rate, as mortgages are loosely based on that, and this is often considered the base risk-free rate for equity valuation. In general, when the Fed lowers rates, and particularly when it hints at lowering rates even further in the future, the whole curve will move down. It tends to be flatter when investors expect rates to stay low or fall and steeper when they expect rates to rise. Sometimes, future expectations can move opposite of the Fed's actions. Observe what happened between 9/16/24 and 1/14/25: the spread between the ten-year rate (set by the market) and the Fed Funds Rate went from -1.7% to 0.46%, a swing of 2.16%. This pushed the ten-year rate from 3.63% to 4.79%, even as the Fed cut rates by a full percentage point.

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<sup>3</sup> (Stephen Goddard, 2025)

<sup>4</sup> (Rosenbaum, 2021)

Investors were concerned that the rate cut would revive inflation, forcing the Fed to raise rates higher than they were before the cut.

While inflation has been steadily falling for some time, it has remained above the Fed 2% target (which some people say should be 0%) for over four years. The primary effect of tariffs should be a one-time jump in prices for goods, and the US economy is more service—based, so that should not create problematic inflation. The secondary effect could be less trade, driving up prices, along with service industries needing to raise prices to pay people more to cover higher priced good. This all remains to be seen. The other open question is that of demand for an ever-increasing US debt. If investors fail to increase their purchases of US Treasuries at a rate that keeps up with the massive deficit spending, long-term rates would rise. This could happen due to de-dollarization, credit concerns, or other capital demands being more competitive.

I don't understand the argument for lower rates, other than it tends to pull growth forward, supercharging the economy until it overheats, and it reduces the Federal deficit. The latter seems a worthy cause, but it is at the expense of savers who rely on the interest income. Inflation is still above the target, employment is still strong, stock market valuations are near all-time highs, and so is real estate. The balance of risk still seems to be toward overheating the economy. As argued above, I'm skeptical that a lower Fed Funds would have the President's desired effect anyway. On the other hand, if politicians remove the independence of the Fed, they will inevitably wield the power of monetary policy to goose growth during their tenure at the expense of those who come later. This is already happening in a major way with Fiscal Policy, as we've seen the largest non-recession peacetime deficit spending in history lately, with no appetite for serious reductions. We will have to wait and see how the Trump-Powell drama unfolds, but investors would be wise to not put their hope in a presidential takeover of the Federal Reserve to create limitless wealth.

## **Personal Improvement**

Each quarter I like to pick a new habit to try to build into my life. This quarter I've just been trying to survive. I suppose as a person who loves routine, what I've been learning is how to be flexible and to just go with the flow. Being the father of a newborn has already taught me about sacrifice and committing to a cause when I don't feel like it- particularly when I just entered REM sleep and get woken up by a little man who needs something

NOW. The great thing, is it isn't as hard as I would have thought because love makes us do hard things without questioning whether we want to.

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