Q3, 2025 Letter

December 1, 2025

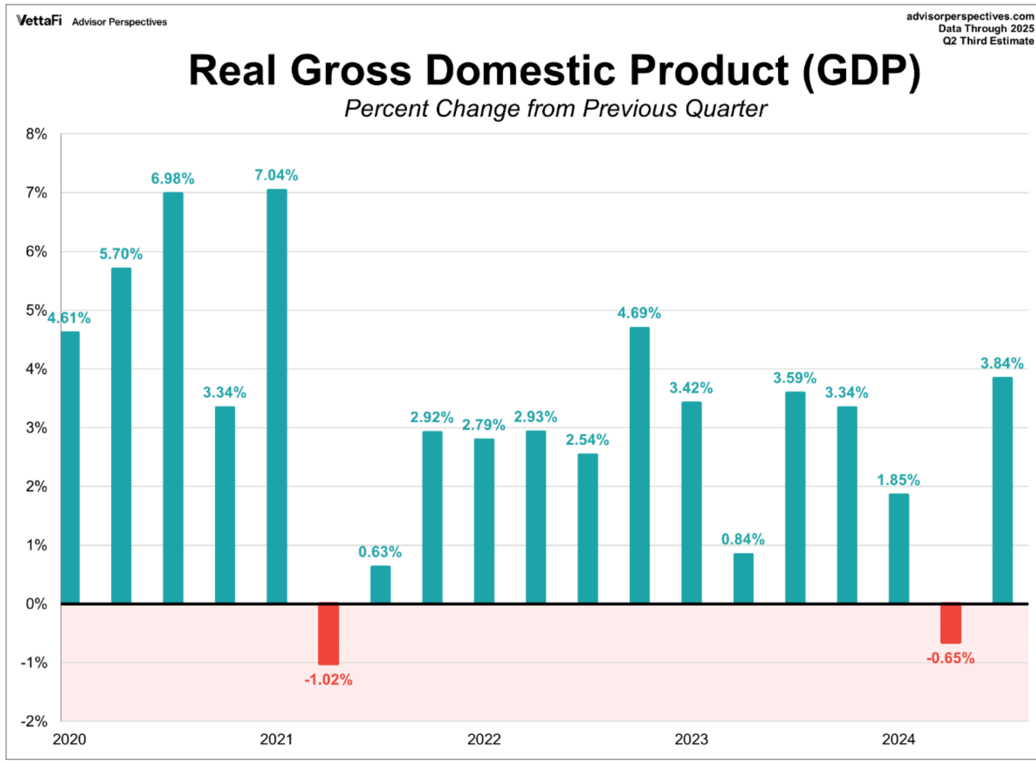
Dear Friends,

While I usually try to get this letter out within a month of the end of the quarter, the last few months have been particularly challenging schedule-wise, both because of some great business developments (keep reading) and adjusting to life with a new baby. I hope you enjoy reading these quarterly letters, but I also realize that there are other important things in life. After enjoying a wonderful long Thanksgiving celebration with family, I do want to speak for myself, Larson and Jennifer in saying that we are very thankful for you. We realize that entrusting your family finances to us is a big deal, and we don't take that responsibility lightly.

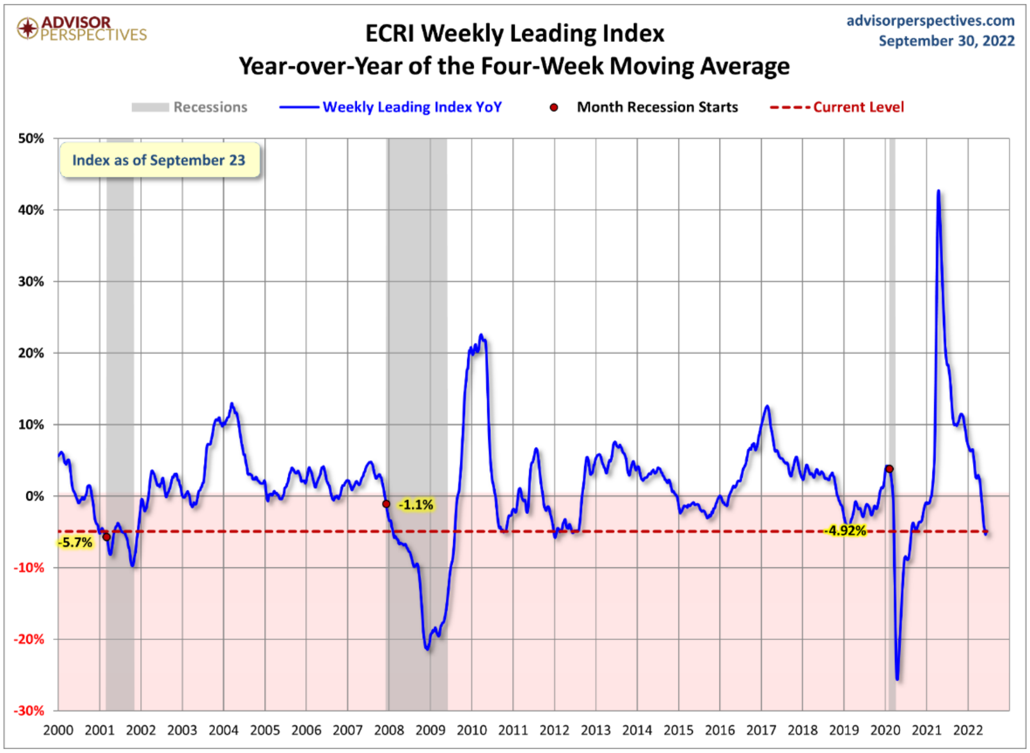
Keep reading and please reach out with any comments or questions.

2025 Q3 Market and Economic Update

Economic Update

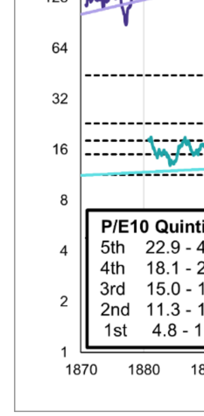


After a negative year-over-year change in GDP (adjusted for inflation) in the first quarter, growth rebounded strongly to 3.8% in the second quarter, which was the strongest quarter in almost two years. It's probably appropriate to think of the first two quarters of the year together, as some of what might have been done in the first quarter was likely pushed back into the second quarter. The average year-over-year growth for the first two quarters was 1.6%, which is weak growth, but still growth. One could reasonably conclude that uncertainty drove weakness in the last quarter of 2024 and first quarter of 2025. We will have to wait and see. Clearly, we do not have a booming economy, though. We will have to comment on the third quarter GDP later, as the finally finished government shutdown has delayed data.



Weekly leading indicators continue to fall sharply and are now lower than they have been since 2021 at -4.92%. While these are not flawless, they are a relevant data point.

There has been some talk about fifty-year mortgages coming to the rescue of housing prices. As we've learned over the last few years, anything can happen, but I don't see this as a game-changer. First, I think banks will rightly be reluctant to offer these. Second, even if they come out, they won't make that big a difference. Consider that a 30-year mortgage generally carries a rate about 0.5% higher than a 15-year mortgage, and a 50-year would probably be about 0.5% above that. A 30-year mortgage, using recent rates, saves about 25% off the monthly mortgage, which makes the difference for many people on whether they can afford the house. Adding another 20 years, and another 0.5% only saves an additional 5%. If we were to include all other costs of home ownership (tax, insurance, maintenance) the difference would be even less. Put another way, if all homes were priced off of 50-year mortgages instead of 30 years, with an average 20% downpayment, this would only justify a 4% increase in home prices, and that's assuming buyers ignored other costs. Charlie Bilello found that there is a 57% affordability gap, which is based on the current vs. historical relationship of the median income vs. median home price.



The Fed is still mulling an interest rate cut despite hot inflation (about 3%) and record asset prices. This could be appropriate if we are about to enter a recession, but this should not excite investors. Fed watching has been an exciting endeavor recently, and stocks seem to bounce around based on whatever the latest Fed governor hint.

Loan delinquencies are becoming a concern, with credit card delinquencies continuing to climb, now higher than any time since 2011, and rising. Auto loans delinquencies are also rising, particularly for subprime borrowers.

Market Update

The US stock market continues to be strong, despite some wobbles recently. My favorite valuation metric, the CAPE, or P/E 10 ratio is now above its 2021 peak, so only the tech bubble had a higher valuation.

Some have argued that we are in a different market. Artificial intelligence will revolutionize the world, and most of the market capitalization is now in intellectual property companies, not industrial companies. While I appreciate that knowledge-based companies can scale further and faster than goods manufacturers, I'm not sure that is what is happening here. Other than Apple, the biggest tech companies (I don't include Tesla as technology) have been more software driven, which is very scalable. Servicing 1 billion users was not nearly one thousand times as expensive as servicing 1 million. As the companies grew, their incremental margins were extremely high. Artificial intelligence is different. It takes physical assets and electricity to power the computations. The high-end processors being used to build out data centers have a short shelf life. The big tech companies are spendings tens of billions of dollars each on capital expenditures for rapidly depreciating assets to drive growth in a business line that is currently a money-loser and looks to be highly competitive. "This time is different" is always a dangerous argument, and a common one when valuations reach extremes.

We continue to be cautious. We are not making any blanket recommendations about avoiding stocks, but we think it is always important, and perhaps now more than ever, to know what you own and why.

Educational Spotlight Section 351 Exchanges

For generations, real estate investors have relied on IRS Section 1031 to do "exchanges" of their investment real estate without causing tax realization. This feature has been one of the pillars that have made real estate investing with taxable (non-retirement) money attractive. Investors can adjust their portfolio to reflect their current needs and the present opportunities while still deferring taxes. What if equity investors could do the same? Now, they can.

To set up this article, let's look at the background of equity investing and taxation. US income taxation is based on "realized" income, meaning there has been a transaction, such as interest or dividends paid or a sale. Investors who sell one stock to buy another owe taxes on any gains realized. The sell is the taxable transaction. Buy-and-hold investors can defer taxes for a very long time. Mutual funds are pass-through vehicles, which distribute capital gains to their investors, who are then responsible for the taxes on the gains based on the fund's holding period, not their own. When a Mutual Fund sells shares for a gain, its current investors realize taxable income. Exchange Traded Funds (ETFs) are more tax efficient, because they are able to buy and sell without generating taxable events for their investors who are only taxed when they sell the fund – same as a stock. Targeting a long holding period of individual stocks and ETFs is a good tax deferral strategy, but what happens when divergent returns cause one investment to become a disproportionate part of the portfolio? Investors with highly appreciated investments in taxable accounts are in a quandary. They purchased those securities at much lower prices, and may not buy them today at current prices. Further, the portfolio allocation has drifted as certain stocks or sectors appreciated far more than others. The portfolio is now concentrated in stocks whose valuation may be stretched. If the investor trims these positions and rebalances the portfolio – a historically sound strategy – there will be significant taxes due. A Section 351 exchange can solve this problem.

What is it?

Section 351 has been around for a long time, and was set up to allow investors to contribute in-kind for business equity. If a person wants to contribute equipment needed by a company for ownership in the company, rather than selling the equipment to the company and generating a taxable gain and then buying equity in the company, the equipment owner can swap the equipment for equity, and the new equity has a tax cost basis carried over from whatever the cost basis of the equipment was. This tax code section works for stocks going into an Exchange Traded Fund as well. Investors can trade their shares in individual stocks for shares in newly formed ETF and carry over their basis without realizing gains, as long as the ETF manager is willing to accept the shares instead of cash. Mutual Funds have used this Section to convert mutual fund shares to ETF shares. Now, a few ETF sponsors are launching new funds to facilitate the contribution of shares into the ETF.

How does it work?

Just like a 1031 exchange for real estate has rules which must be followed precisely, so does a 351 exchange. First, the securities must be contributed to a newly formed ETF. This means an investor wishing to do a 351 exchange must find a newly launching ETF willing to participate in the exchange. Second, there are concentration limits on what can be contributed. No one security can be more than 25% of what is contributed, and the top ten must be less than 50%. Contributed ETFs are treated on a look-through basis. For instance, if an investor contributes SPY, which has an 8% weight in NVDA, 8% of the SPY contribution would count as NVDA, etc. Finally, contributed securities need to be accepted by the ETF the investor is exchanging into. If it is an equity fund, it may not accept fixed income or international equity ETFs.

What are some use cases?

While the 351 exchange won't help an investor with a portfolio of five highly appreciated stocks and nothing else, it can be a great tool to reduce concentration in a handful of highly appreciated positions.

Consider a hypothetical investor with fifty individual stocks, with the five biggest positions comprising 50% of the portfolio. The investor will not be able to exchange the whole portfolio (the numbers 6-10 positions would have to have a cumulative weight of zero), but can strategically contribute a large portion of those five biggest positions, along with the other positions to exchange into a more diversified fund. If the next five biggest positions totaled 20%, for a total concentration of 70% in the biggest ten securities, the investor would have to keep about a third of investment in the top ten securities, and could swap the rest.

An investor with a mix of some individual stocks and some ETFs has more flexibility. This can be a bit of a puzzle if the ETFs have large positions in the same securities, but if there are different ETFs that aren't completely overlapping, the contribution can be optimized to come close to the limits without exceeding them.

An investor with funds that have concentrated positions, such as a technology fund, growth stock fund or even the Nasdaq, can swap those funds for a 351 eligible fund with a very different mix, getting instant diversification. For instance, the Vanguard Information Technology Fund (VGT) has a 43.6% concentration in its top three positions, but only 14% in the next seven. On its own, it is too concentrated, with about 58% in the top ten stocks. The Vanguard Growth Fund (VUG) has 33% concentration in the same top three, and 60% in its top ten, so it would also not qualify. The two funds have 51% overlap, with almost all of that overlap being in the top five stocks. An investor could contribute a mix of these two funds with a small amount of other stocks or funds with low overlap to come just inside of the thresholds and achieve a significant improvement in portfolio diversification. At the time of this writing, SPY – an S&P 500 Index fund – has 39.4% of its value in ten stocks (nine companies), most of which are highly correlated with each other. While this is considered a diversified portfolio, its returns over the recent years are mostly driven by what happens with this small subset of stocks. If one exchanged from SPY or another S&P 500 index fund into an equal weighted ETF targeting the 500 largest companies, the weight of these biggest nine companies would drop from 39.4% to 2%.

Any cash contributed to a 351 exchange does not count toward the diversification requirements, but an investor could take cash to buy a non-overlapping fund, such as a midcap fund to help meet the diversification requirements.

A Section 351 exchange can provide instant diversification, but is limited to what the replacement fund holds – if it is also concentrated, then the diversification goal may not be fully met. The tax cost-basis carries over, so an investor will probably want to hold or only slowly divest the new fund, which means it is really important what the composition, strategy and fee structure of the new fund is.

Conclusion: A Section 351 Exchange is a good tool to help investors diversify from a basket of highly appreciated stocks or from sector or strategy ETFs that have had a strong run and now present concentration and valuation risks to the portfolio. They can't diversify a single stock position or an extremely concentrated portfolio – for that the investor could use an Exchange Fund, or a Charitable Remainder Trust, or a Qualified Opportunity Zone if a move into real estate is acceptable. For many investors, though, Section 351 presents a great opportunity to move away from the narrow sliver of stocks that have driven most of the stock market return over the last several years and now trade at nosebleed valuations.

Implementation can be tricky, and choosing the right replacement fund is essential, so working with a good financial advisor who understands the rules and the process is prudent.

Book Review: The Behavioral Portfolio by Phillip Toews

Summary – The Behavioral Portfolio was written for financial advisors, but would also be useful for engaged individual investors. It covers a lot of ground. The biggest takeaway is that investors should be prepared for much worse than they probably are. We tend to base what could happen on what has happened in the fairly recent past, but this is not representative of everything that could happen. Even going back multiple generations only shows what did happen, not what could have happened. Toews posits that investors discount the Great Depression as something that could never happen again, but really much worse could happen. Investors should be prepared mentally for a worst-case outcome and should also have their portfolio prepared to sustain them even in a very bad market.

The book starts out with a fictional narrative that is very representative of what likely happened often. A high-income client with little investment knowledge finds a very knowledgeable financial advisor who helps her construct a portfolio to get her to retirement. When the market crashed during the Great Financial Crises, he continued to urge her to be patient, but she finally reached her breaking point. He then repositioned her to a very conservative portfolio – right before the market made a strong recovery. The gist of the story is that it is very difficult for advisors to keep a client in a good long-term portfolio, as strong market moves up and down cause even smart, rational clients to react to past trend rather than to stick to a long-term plan. Advisors not only have their own biases, but also need to respond to client's demands in order to keep the business. Toews relates a 2009 study that showed that "advisors tended to lower returns, raise portfolio risk, increase the probability of losses, and increase trading frequency and portfolio turnover." Advisors, on average, are not doing a great job of keeping clients invested in sound long-term strategies after these strategies underperform for a few years.

Stocks are riskier than many believe. Toews notes that each of the last twelve decades have had at least one bear market (20% loss), with the average of two per decade, and the average loss per bear market of 36%. Even the Great Depression was not an extreme outlier – other countries have had similar or even worse crashes. Readers may be tempted to shift some of their stock allocation to bonds, but Toews goes on to show how risky bonds are. Defaults are more common than one might think, and inflation is the secret killer for a bond portfolio. Bonds may be even riskier than stocks for a retiree because of inflation. Rebalancing typically helps mitigate risk and even improves returns, but it can turn negative in a prolonged downturn for one asset class, such as stocks experienced in the Great Depression. Stocks started falling in 1929 and didn't bottom out until 1942 after losing 84%. Two years later, bonds entered a bear market that would last thirty-six years. Toews chillingly notes that while this is the worst that has happened so far, this is not the limit on how bad things could be. "Markets are unbounded."

The solution – Toews lists the criteria to consider when building "behavioral portfolios": address risk of extreme negatives, provide long-term growth in excess of inflation, participate in rising markets, preserve gains, seek consistency of returns and include "primarily reliable, understandable sources of growth and/or income." He sees the way to do this as starting with a traditional 60/40 portfolio (60% stocks, 40% bonds) and making the bond allocation "adaptive fixed income", and making half of the equity allocation hedged equity. Adaptive fixed income means funds that give managers the ability to move around among various sub-asset classes within fixed income to seek the best risk-adjusted return for any current environment. Hedged equity means stock funds that buy options as downside protection to lessen losses in a very bad market. These have lower returns over time than traditional equity funds, but a narrower dispersion of returns. The book makes the case that investors should be content with a lower return in exchange for less downside risk.

One interesting observation is that dollar-cost averaging helps boost returns during an investor's accumulation phase (when adding to savings) and the more volatile the portfolio, the more it helps. The opposite is true once a retiree is drawing from the portfolio. While traditional investment advice is to avoid volatility, all else equal, young investors should actually pursue more volatile portfolios.

The book ends with a section on how to communicate to clients about what to expect and how to emotionally prepare.

Critique: there is much to like about this book, which identifies a major weakness in both retirement planning and financial advisors' relationship with clients. The book does a great job of looking at historical precedents that investors should consider. It highlights how much more extreme losses can be than most people expect. It stresses the importance of being prepared for very bad outcomes so that one isn't taken by surprise. I have just a few concerns. First, while preparing for very bad outcomes sounds reasonable, there was no consideration of the probability of the bad outcomes – only the severity. Buying homeowner's insurance is generally prudent, but buying flood insurance if my house is situated somewhere that would only flood once every five hundred years may not be the best use of funds if the policy is priced too high. This is a minor quibble, as I agree with the author that most people underestimate the likelihood of another Great Depression-like loss in the US stock market. My bigger issue is with the solution of putting half of the portfolio in hedged equities, which in general have a dubious track record. It is questionable how helpful they would be in a very bad, prolonged negative market, as hedges would run out and need to be replaced with much more expensive options contracts (pricing rises during times of uncertainty) at lower strike prices. And with rebalancing, a prolonged bear market would still subject the investor to selling the more stable hedged equity to buy the falling unhedged equity. (Remember, rebalancing generally helps, as markets are mean-reverting, but in prolonged trends it can hurt.) Finally, the book ignores or dismisses other options such as trend-following, factor-based investing to boost returns and get exposure to other risk premia, and adding non-correlated or lowly correlated assets. The book mentions commodity investing, but sees it as unhelpful, as the average commodity return is less than inflation. While this is true, holding a basket of commodities and rebalancing can produce a positive inflation-adjusted return due to the rebalancing effect – commodities tend to be trend-following in the short-term and mean-reverting in the intermediate and long-term. Adding a trend-following filter to commodities historically would have reduced drawdowns and improved returns. The book also states that managed futures have a zero return before fees and a negative return after. The actual managed futures index tells a different story – returns have been positive even after fees, and correlation to stocks and bonds is virtually zero. Fees for managed futures funds or other uncorrelated assets are definitely an issue, but the same can be said for hedged equity funds. Working with a good financial advisor who is sensitive to fees can help an investor navigate this space.

Conclusion:

This book is a great read, and every financial advisor should read it, as should more ambitious individual investors. It does present an innovative solution, which is worth consideration, but unfortunately, it ignores some other potential solutions that should be compared side by side.

Business Update

We are grateful that our business has continued to grow through the third quarter and beyond, and our pipeline continues to look strong. We realize that there are many choices for financial advice. We strive to be the best through providing excellent comprehensive financial planning, thoughtful investment management and savvy tax strategy. Last quarter, Jake went to Future Proof Festival, which may be the largest conference for financial advisors in the world. I understand there were over 6,000 people there. The "festival" has been going for a few years, but this was my first time attending. It is held outdoors along the beach in Huntington Beach. Most attendees wore shorts and short sleeves. One interesting feature was the opportunity for various service providers and financial advisors to meet. There was a giant tent with about 600 tables and two chairs at each. We were scheduled 15-minute meetings, just to see whether there was potential for further conversations. It was a good way to get exposed to a lot of opportunities and then figure out what I want to pursue further. There were also many booths throughout the conference with financial service providers. I got some great ideas, and have a lot to continue thinking about. We added a research platform, YCharts, which will help with both research and reporting. As a business, we have just added a couple of investment tools that will be helpful for clients. One is a Section 351 Exchange, which is the topic of this quarter's educational spotlight. Another is tax-aware long-short investing. This is a portfolio overlay that is designed to both add uncorrelated returns and save money on taxes. It is only for taxable (non-retirement) accounts, and there is a $1 million minimum, so it doesn't apply to everyone, but we see it adding great value for current and future clients. Finally, we are working on a portfolio lending solution for taxable accounts that allow clients to borrow money against their portfolios at rates more attractive than current mortgage or home equity loans.