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Dear Friends:

This year is going by very quickly, but certainly not quietly. In addition to natural disasters and ongoing wars, news headlines have been blaring the latest moves of the new Administration in Washington, and speculation about the actions or inaction of the Fed. It's been an interesting time to be in our field as stock and bond markets have struggled with how to deal with the news flow. We have done our best to stay on top of stories that can drive markets, without getting overly caught up in the noise around the ever-changing state of political negotiation. We are glad that our investing is process-driven rather than a subjective attempt to predict the future. We are grateful for patient clients who are willing to trust the process.

Please pardon the lateness of this letter. I hope it was worth the wait, and if not, maybe you didn't notice that it hadn't come out yet.

As always, please reach out on anything you'd like more clarification about, and please suggest topics for future discussion.

Business Update

This year started with us continuing what we were working on in late 2024 – Elite Resource Team training for Jake, Erin Botsford training for Larson, and getting better at using our Advyzon software for both of us. We are also working on updating our business entity, going from an LLC taxed as a sole proprietorship to one taxed as an S-Corporation. After ten years, we are finally going to be able to pay out some owner income in addition to our salaries. We are a real business! We are also working on launching a webinar to educate real estate investors on using Delaware Statutory Trusts as replacement property in a Section 1031 Exchange. We learned more about Section 351 Exchanges and are ready to help clients do the stock market version of a Section 1031 Exchange to better diversify their stock portfolios while deferring taxable gains. We learned about tax-aware long-short investing as a way to earn a little extra investment return and offset taxable gains so that we can help clients reposition a portfolio with large unrealized gains. We are also

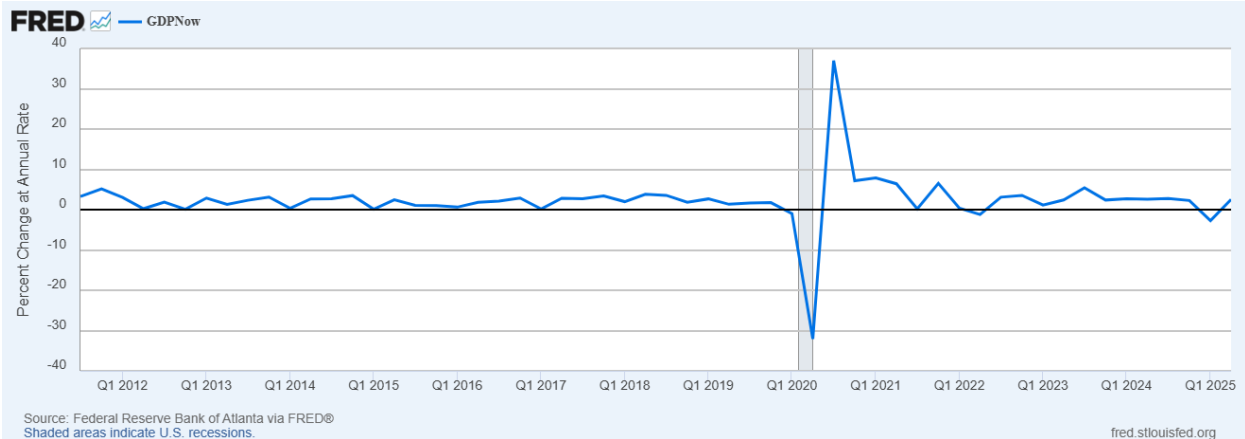
strengthening our knowledge of alternative investments. Larson went to the Blue Vault Alternative Investment Summit in Dallas in March, and Jake went to the FactRight Alternative Investment Conference in Scottsdale the following week. We are proceeding with caution, but are excited about expanding into alternative investments, hoping to sift through the sand to find the rare pearl here and there.

2025 Q1 Market and Economic Update

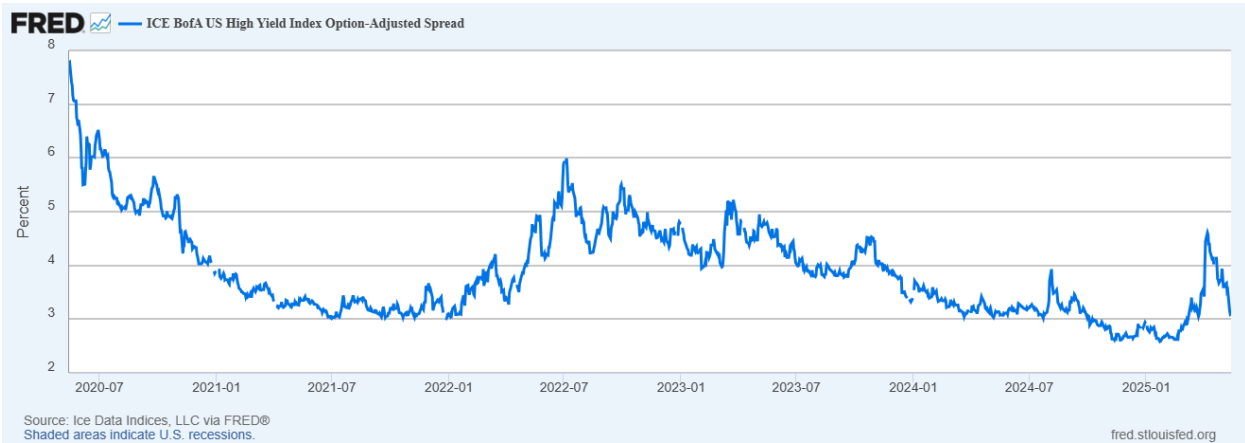
Economic Update

The big topic this year has been international trade, and specifically tariffs. On “Liberation Day” when Pres. Trump rolled out tariffs on America’s trading partners, the US stock market initially crashed, expecting devastating economic contraction and inflation. I initially commented that it was too early to determine what would happen. I still think it’s too early. I don’t want to get into a political discussion, but I do believe that taxes and barriers to trade (both domestically and internationally) reduce wealth creation. This massive tax that was rolled out on the American consumer does threaten to raise prices domestically while slowing global economic growth, or even causing contraction. This is the logical outcome to large tariffs, but it doesn’t have to turn out that way. The situation could still resolve favorably if negotiations end with trade partners giving the US more favorable treatment in exchange for the US dropping its new tariffs. It could also turn out poorly if both sides dig in and maintain or escalate protective trade policies that ultimately impoverish everyone by reducing comparative advantage trade.

GDP growth in the first quarter was negative, but this was before severity of the tariffs was known. The Fed’s real-time estimate shows the economy has already bounced back. This could be people accelerating their purchases to get ahead of tariffs. It’s complicated.



One good indicator of stress in the economy is the high yield spread, which is the extra yield investors demand to hold junk bonds. When the spread is low, it indicates investors are comfortable that riskier companies will be able to make their debt payments. This spread was spiking earlier this year, and then quickly reversed course. This implies that investors are confident that the trade deals will get worked out without major damage to the economy... for now.

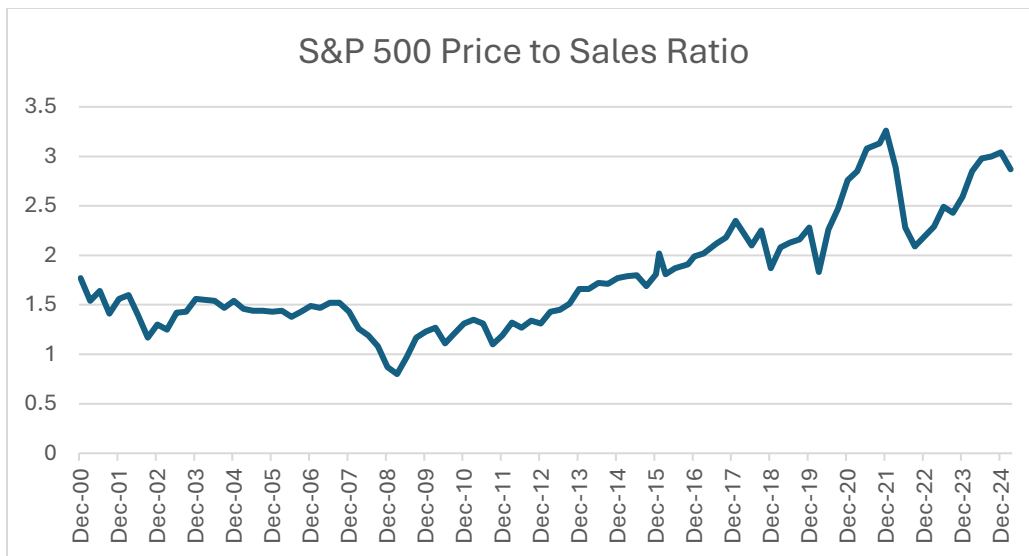


Predicting the economy is hard, and clearly views can change quickly. Whether you agree with what the current administration is doing or not, it is engaging in an aggressive campaign to make some substantive changes. This is a messy process. Communication based on posturing for negotiations or gaining political support makes the situation even harder to read. Rather than predicting which direction the lines on the charts will go next, investors should be ready for anything, with a good plan in place that balances all of the future possibilities.

Market Update

While economic cycles come and go, it is important to remember that as investors we own real companies. The value of the company is based on its future cash flows over the very long-term. The two determinants of return are the future performance of the company and the price we pay today. The first is unknown, but can be estimated. When expectations get too high, the current price rises to a level that demands perfection for way off into the future to generate a good return. Looking at the price of stocks based on today's earnings is a short-cut way of understanding embedded expectations. Even with all the turmoil around recent headlines, embedded expectations are very high.

While I usually share an earnings-based chart, this time I want to look at price to sales. Ultimately, earnings are what investors get to keep, but looking at price/sales is interesting for an entire market because it removes profit margin, which is very cyclical.¹



Source: multpl.com

We follow four equity risk factors (stock selection criteria that have historically been indicative of higher returns) – value, momentum, quality and size. The last several years have been a very challenging time for factor-based investing. This year has been a little better, but still unfavorable. Value and quality have more or less kept up with the S&P 500,

¹ Simplistically, Earnings = Sales * Net Profit Margin. When net profit margin surges higher for various reasons, earnings rise faster than sales

while momentum and size have lagged significantly.² Smaller companies are more at risk to tariffs, as they tend to be more domestic and don't have the benefit of international diversification. They also have a harder time adjusting supply chains because they lack the scope of a bigger company. Momentum is challenged when headlines whipsaw markets. Momentum investing holds companies that have been experiencing the best stock performance over the recent history. When headlines suddenly change what investors hold, trends are more likely to be broken. We expect times when these strategies fail to keep up with the broader market and we are invested for the long-term, trying to always keep the odds in our favor, and fully realizing we won't win every day. We also diversify across strategies.

The reason factor-based investing or almost any sort of strategy that attempts to add value through stock selection has struggled in recent years is that the biggest stocks have done the best. The S&P 500, the most-used proxy for the US Large Capitalization stock market, weights each company based on its market value. Bigger companies have greater representation. Size is measured not by earnings, but by market value, so a relatively small company with a very high earnings multiple (e.g. Tesla) will carry a much higher weighting than a larger company with a small multiple (e.g. Ford and GM). A recent [article](#) noted that the top ten stocks make up 37% of the S&P 500, but only 28% of earnings.³

Index investors have enjoyed a lucrative time of exceptionally high returns with mostly low volatility for about sixteen years. Even sharp market pullbacks have been quickly reversed, teaching a generation of investors to buy the biggest and best companies, buy the dip, and buy what everyone is talking about. These may have been the wrong lessons to learn, because historically, none of these strategies have worked well.

Educational Spotlight

What's your investing paradigm?

This is perhaps the most exciting time of the year. Where I live, the temperatures have climbed back out of the wintry 60s, and the hills are green from rain. Life abounds everywhere, as flowers are blooming. But maybe most exciting of all is that baseball is back. Coming off their convincing World Series victory somehow won with only two

² These are general comments and not an evaluation of funds held in client portfolios. There are different ways of constructing portfolios with exposure to these factors and some have done better than others in the recent environment.

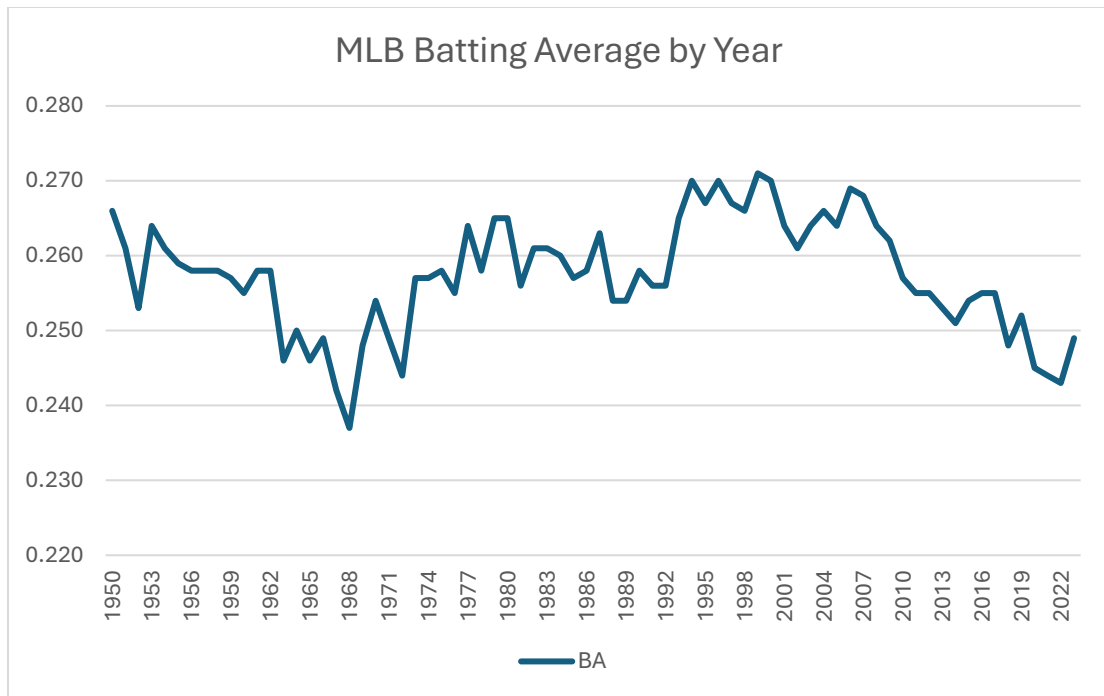
³ (Pauley, 2025)

uninjured starting pitchers, my Dodgers are even stronger this year, and look to challenge the 2016 Mariners for the most wins in a season. As a lifelong (so far) baseball fan, I find the changes in the game very interesting.

Baseball fans have lived through big changes in how performance is tracked. For generations, Batting Average was probably the most important statistic for a hitter, followed by home runs and Runs Batted In (RBI). Nothing came close to those three. Players competed for the batting title (except in the 80's when everyone already knew Tony Gwynn and Wade Boggs would win for their respective leagues.) A slightly lower honor was to become the home run champ. And every once in a while, someone would make a run for the triple crown – leading the league in all three major categories. Evaluating hitters was simple, except for the rare occasion when someone had a particularly low batting average, but prodigious power and the trade-off was unclear. Along came data analytics, first deployed by Billy Beane and his team, of [Moneyball](#) fame. They analyzed what actually led to run production and found that On-Base Percentage (the percentage of the time a hitter successfully reached base) was more important than Batting Average. Players who were good at drawing walks were systematically undervalued, because a walk did not improve a hitter's batting average. The surprising success of Beane's low-budget Oakland A's spurred the rise in [Sabermetrics](#), which was only enhanced by Statcast – the system that measures everything that happens on the baseball diamond. Other changes to the game such as [the greater size and strength of players](#), have led to lower batting averages, more strikeouts and a greater reliance on home runs to score runs. Batting average has given way to On Base plus slugging (OPS) as the best single data point to measure the effectiveness of a hitter. As such, some current players with batting averages that would have been considered disgraceful in the past are rightly recognized as highly productive hitters due to a combination of elite power and an exceptional ability to draw walks.⁴ Changes in the game, advanced measurement capabilities and the application of extensive data analytics have revolutionized the baseball world's paradigm of what to look for in a player and how to put a team together.⁵

⁴ Kyle Schwarber is a great example. In 2022, he was an All Star, won a Silver Slugger award and finished 16th in MVP voting despite a .218 batting average, and a league-leading 200 strikeouts. He led the National League with 46 home runs and drew enough walks to have a league average OBP, despite his batting average being 12.5% below average.

⁵ 2022 saw the lowest average MLB batting average since The Year of the Pitcher, 1968. This is probably partially due to the increased difficulty of getting hits off of today's more effective pitchers, and partially due to sluggers with lower batting averages but higher power numbers being allowed to play more. 2024 equaled the 2022 BA.



Source: <https://www.baseball-reference.com/leagues/majors/bat.shtml>, RIM

Burgeoning scientific learning and the application of data analytics has changed more than just sports. Take something as simple as eating. The USDA's [Food Pyramid](#) used to be ubiquitous. Now there are a lot of nutritional paradigms. Ultimately, it's all about getting the right balance (whatever that might be) of macronutrients – protein, carbohydrates and fat, and micronutrients – vitamins and minerals. While there is widespread disagreement on what is the optimal diet, everyone seems to agree that the food pyramid is no longer the gold standard.

This brings us to the world of investing. Perhaps related to the success of the Food Pyramid, the [Investment Pyramid](#) became a popular paradigm to think about one's portfolio. The base of the pyramid called for a large helping of safe investments, such as cash and equivalents and government bonds. The middle of the pyramid holds riskier assets, such as high yield bonds, stocks and stock funds and real estate. The top of the pyramid is the smallest part, by far, and can be invested in very risky investments such as options, futures and collectibles. The biggest advantage of this paradigm is that it is easy to understand. It makes some intuitive sense. Start by generating some income and having reliable assets that can be used for needs or goals. Move on to prudent growth investments, and only once both categories are generously supplied should pure speculative investments be introduced to create more potential upside. The Mutual Fund

industry thrived on the pyramid. From most conservative to most aggressive, this includes: Money market funds, tax-exempt bond funds, taxable bond funds, balanced funds, equity-income funds, growth and income funds and growth funds. An investor can easily build out a pyramid based on the descriptions.

While the mutual fund industry embraced the pyramid, finance academics look at investing differently. Investments are divided into [asset classes](#), such as US large company stocks, US mid company stocks, US small company stocks, International developed markets, real estate, government bonds, high grade corporate bonds, high yield corporate bonds and cash. There is a little variation in exactly what people consider the menu of asset classes. This approach has been widely adopted in industry – particularly among institutional investors, but the pyramid is still being used by some individuals. Which is the best way to think about a portfolio? To answer this question, we need to consider measurement statistics.

Different investors have different goals for a portfolio, but measuring success is important for all investors. Just like batting average was the primary metric used to judge hitting performance, investment return is the primary metric for investing performance. Astute investors understand that risk is also important, so portfolios are commonly judged by historical return, volatility (a measure of risk) and [Sharpe Ratio](#), which combines return and risk into one number that shows how well risk was compensated. The [diversification benefit](#) of holding multiple asset classes means that a properly constructed portfolio will have a Sharpe ratio higher than the weighted average Sharpe ratio of its components. This is a result of lower risk, as some asset classes will do better when others are at their worst.

Simplicity is the quality that makes the Investment Pyramid attractive, but it is also what limits its usefulness. It forces some diversification, but is nonspecific about what assets to hold in each layer. It ignores the diversification benefit of holding assets that are uncorrelated to each other, and instead assumes risk is reduced by including a large helping of “low-risk” assets. A government bond portfolio lacks the diversification of other asset classes and is loaded up on interest rate risk and inflation risk, for instance. The approach is not easily measured, as it is not well-defined. Nor is the paradigm easily adaptable to different needs. The pyramid fails to account for which risks matter to the investor. A young investor with a high savings rate increases shortfall risk by loading up on government bonds instead of assets more likely to appreciate. The pyramid is also confusing, as investors may think “growth” investments means growth stocks, even though growth stocks tend to have a lower return than the broad stock market. Finally, the pyramid assumes that riskier investments will earn a higher return, but this is often not the case. Small cap growth stocks, for instance, have historically had a lower return than large cap

value stocks, despite carrying much higher risk. Most new businesses fail. Buying call options is very risky, and investors can expect to have a negative return. Lottery tickets are the ultimate high-risk gamble, with a very negative return on average. Rather than focusing on total portfolio return for a given level of portfolio risk, the pyramid suggests using a lot of “safe” assets regardless of return, and only risking a small part of the portfolio. Investors may do better by eliminating the top layer and shrinking the base to focus on the middle layer, if that is where the best risk-adjusted return lies.

An asset class, or asset class and style approach to portfolio construction moves beyond the vague notions of risk and return in the Pyramid. It estimates, based on historical data⁶, return, volatility and correlation to other investments. Asset classes (and styles) can then be blended to maximize return for any given level of risk, taking into account the dampening effect on volatility of diversification. This is called the Efficient Frontier in [Modern Portfolio Theory](#). Assets are weighted based on their risk-adjusted contribution to the portfolio. The portfolio can be built to the risk level of the client, who understands that for that given level of risk, a maximum expected return⁷ is attained. Even this is an oversimplification because it only considers market risk. Financial planners realize that clients have other risks, such as liquidity risk (can they get to their money when needed?), interest rate risk, inflation risk and shortfall risk (the risk that their portfolio does not earn a sufficient return to fund their needs.)

The Investment Pyramid has doubtless helped many individual investors to spread out their investments and gain a sense of comfort with their portfolio. It is not useless, but it is deeply flawed. While the mutual fund industry still uses it for its simplicity and ability to sell products, the academics and institutional investors have a better paradigm. Asset class and style diversification enables portfolios to target specific risk levels based on individual client needs while maximizing expected returns for that risk level.

⁶ When we look at statistics, we are looking at a historical record of what did happen. Last year’s MVP may not be a great player this year. Advanced metrics increase predictability, but there are still a lot of variables that can affect performance. Still, players with high Wins Above Average (WAR) in one season can be expected to be productive players in the next season. Not so with investing. Cyclicity and mean reversion cause short-term outperformers to be more likely to underperform in the next year. Investors should be careful to use very long-term trends to develop long-term expectations, and to avoid speculating on what will happen in the next year. By using long-term asset class statistics – return, risk and correlation – investors can develop expectations about what reasonably should happen on average over time.

⁷ We can only build a portfolio for *expected* risk and return, as we do not know what the future holds. If we knew the actual return, there would be no risk.

Book Review: Investing Amid Low Expected Returns by Antti Ilmanen

Dr. Ilmanen's first book, "Expected Returns" is one of my favorites, and a book that I keep handy as a reference, so I was excited when I learned he wrote a second book. "Investing Amid Low Expected Returns" is more than an update of what has become a classic. In this smaller, but packed book, Ilmanen lays out his case for why it is reasonable to expect future investment returns to trail historical ones (the book was published in 2022) and what investors can do about it.

In the introduction, Ilmanen lays out his investment beliefs. Investors should consider their investing beliefs. I happen to agree with Ilmanen's list of beliefs. The last line sums up the section: "In sum, my investment beliefs favor humble forecasts and bold diversification."

The Case for Low Returns

The best predictor of an investment's long-term return is its current yield – for fixed income that's the effective interest rate and for stocks it's the earnings yield. As of September 2021, both were lower than they had been in over a century. Ilmanen notes that after four decades of very good investment returns, investors have come to expect higher than normal returns instead of the lower-than-normal expected returns corresponding to today's price levels.

The two main responses to a low expected return environment are to take more risk and to increase the savings rate. Ilmanen estimates that savings rates must be double what they used to be to support future spending goals. It is no surprise that many are stretching for extra return by taking more risk.

Investing premia are what investors expect to earn for taking risk in an investment, and is in excess of Treasury-Bills. Ilmanen starts with liquid asset classes – stocks, fixed income and commodities. Interestingly, he mentions the Fallen Angel bond strategy – a favorite of mine – and found that since it has become widely known, it has maintained the same 2.3% per year edge over the high yield index as it had before. Commodities have generated excess returns (vs. cash) of 3-4% per year since 1877, despite the average for a single commodity being 0%. This is the power of diversification!

The book goes on to discuss various sources of return, such as illiquidity premium (he's skeptical), style premium, and Alpha (also skeptical). Ilmanen looks at why excess returns sources exist, and the importance of diversification. He found that risk management via trend-following has worked much better than buying put protection.

Conclusion: This book is technical and packed with information that is very useful to people who construct portfolios and manage risk. Ilmanen makes a good case for that returns of almost all assets are likely to be lower in the future than they have been in the past. Investors can still try to enhance returns through capturing non-market sources of return, but should be careful. Not all risk premia are likely to continue to outperform public equities. Capturing style premia – value and momentum, and their cousins carry and trend, as well as quality and low volatility – still looks promising. Illiquid investments are likely to disappoint relative to past performance. And finally, we all should be saving more than people in the past saved, as we will probably not get to ride the wave of continuously richening asset valuations and may have to suffer through a reversion back to normal valuations, which would take a bite out of our investment returns.

Thanks for reading our letter,

Jake and Larson

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