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**October 29, 2022**

Fall is finally here in the Central Coast. The crisp air and changing leaves are wonderful. It has been a busy year for us so far. We hope you enjoy this letter. Please reach out to us with anything you would like to discuss from this letter or anything else.

### **Personal Update**

Jake:

The third quarter is my favorite. Almost everyone loves summer, but for me it is extra special because I get to run Life Camp. This five and a half day overnight Bible camp for kids is the highlight of my year, and kids and their parents tell me it is the highlight of theirs as well. We usually do our camp the second week of August, as we did this year. This year was particularly hectic leading up to camp, making for a very exciting summer. Nour's sister and brother-in-law came to visit from overseas and we went to Yosemite. I hadn't been there in decades. The awesome grandeur of that canyon with the massive rock faces, giant waterfalls and gargantuan trees is like nothing else. It's quite a perspective changer to stare up at all that and realize how small we are and how brief our lives are. Nour and I also got to volunteer at Camp Good News, another children's Bible camp. This was their first overnight camp since 2019, so the excitement level was very high. Right after that camp, we did a big party for Nour, celebrating her citizenship. This was our first time to use the new deck and to have a big group in our new back yard. We're very thankful for the friends and family around us.



Larson:

The 3rd quarter was busy for Larson and Hannah! They closed on their home in Texas and started construction on a property in Wyoming. An extended stay with family in California during July was both refreshing and productive. Hannah started a new position as a Special Ed Teacher in Sheridan, WY as well as a master's program. Larson is studying for the EA (Enrolled Agent) designation to better serve clients on their tax strategy needs. The weekends are filled with studying, hiking in the Bighorn Mountains, and making new friends at church.

### **Business Update**

We started doing educational seminars last year. I enjoy education and public speaking, and there is so much in finance and taxes that is confusing. I like the combination of being able to help people and introducing people to the business at the same time. It's much better than trying to sell to people. This quarter, we outsourced the promotion and registration so we could get more people to come to educational workshops. I presented twice in August and twice in September on how to manage taxes in retirement. The presentation is a fast-paced, information-packed one hour workshop. I'm very pleased that people came from sixty-two households across the two months, and several are in the process of becoming clients. I plan to offer the presentation for clients and their friends soon.

We are pleased to continue growing, with a solid pipeline and about 35% growth in the assets people have entrusted to us so far this year. Larson completed his first year with the firm. He sat in on many meetings and helped clients in a supportive role. He is now lead advisor for some client relationships, doing an excellent job serving clients, while I support him. We love the team approach that makes the best of what both of us offer available to clients.

One opportunity we are focusing on now is helping clients to lock in their real estate gains and move funds to a more stable real estate investment while deferring taxes. See our recent articles:

<https://rothmaninvest.com/resources/is-it-time-to-sell-the-rental-house>

<https://rothmaninvest.com/resources/what-you-need-to-know-about-dsts>.

### **Personal Improvement**

This quarter I worked on eliminating distractions by copying online articles into spreeder.com or Save to Pocket, where I can read them later without ads. It's easy to get distracted by article after useless article when reading online and these are ways to minimize that.

## Economic and Market Outlook

A strong summer rally gave some hope that the bear market was over, and we could all get back to making copious amounts of money. The month of September put an end to that hope. The S&P 500 fell 9.3% in September, taking the quarterly returns negative for the third month in a row. The fund that tracks the broad bond index (AGG) fell another 4% in the quarter, bringing year to date losses to over 15%. This has been a frustrating year for many, as diversification generally has failed to provide stability, and conservative investors have done roughly the same as aggressive investors. The reason for this is that this year, almost everything has lost value – US large, mid and small cap stocks, International stocks, bonds of every variety – even including inflation-protected bonds, real estate and gold. Commodities had a nice run to start the year, but they have been mostly negative for the last couple of quarters as well. Mark Hulbert [noted](#) that the standard 60% US stocks/40% US bonds portfolio is on track to have the fifth worst year since 1793<sup>1</sup>. The exceptional characteristic of this year is not the stock market value drop – it is not that extreme... yet. It is the fall in bonds and the correlation of the two major asset classes that historically diversified each other. Going back to 1928, the worst year for treasury bonds was -11.1% in 2009. T-bonds had [only lost more than 5% three times](#) in ninety-three years. This year they are down 18%.<sup>2</sup> Add in high inflation eroding the nominal value of a portfolio and it is even worse.

One indicator that has been good about calling recessions in advance is the “yield curve”. Usually, the longer an investor commits capital, the higher the return. When the ten-year T-bond pays a lower rate than the two year (inversion), that is a signal that a recession is coming. This has called each of the last six recessions. Generally, recessions have started within about 6-18 months. The curve inverted briefly in April and then more deeply in July.



The S&P 500, the proxy for the US stock market, enjoyed a whopping 16.6% average return for the decade ended 2021. Such exceptional returns for so many years dimmed investors memories of the

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<sup>1</sup> (Hulbert, 2022)

<sup>2</sup> (Kurbegovic, 2022)

tech bust and the Great Financial Crisis. Younger investors have only known double digit returns. A 2021 Natixis study found that US equity investors expected annualized returns of 17.5%.<sup>3</sup> I first became aware of the stock market in the 1990's, so I can relate. I, too, thought that stock investing earned 12% per year or better. Two crushing bear markets in ten years taught me otherwise. It is instructive to deconstruct what drove such delightful returns for this recent golden decade. The WSJ [cites](#) a Semper Augustus study showing that sales growth and dividend yield – the (mostly) non-cyclical part of returns – combined for about 5.5% annual returns. An expansion of profit margins added 4% and an expansion of the price/earning ratio added another 6% per year. Corporate profit margins of 9.4% were not low at the start of the period.<sup>4</sup> If profit margins and earnings multiples returned to where they were at the end of 2011 (two and a half years after the market bottom), and if revenue growth from 2022-2031 equaled that of 2011-2021, total returns would be negative.

It is impossible to know what will happen in the near future, but the signs are not positive. Recessions are a normal and healthy part of economic cycles. As long as inflation was very low, the Federal Reserve intervened to try to stave off or shorten every recession this century. It no longer has that luxury. If the Fed holds its course, a recession will likely occur. How severe it will be is hard to guess, but the market is still priced as if revenue growth and high profit margins will continue unabated. Expecting the exceptional returns of 2010-2021 is unreasonable, and the market could easily decline further to get back to average valuations. Investors would be wise to have a plan based on reasonable assumptions, and to continue to favor defense over offense.

Read the Full Outlook here: <https://rothmaninvest.com/resources/2022-q3-market-and-economic-update>

### **Educational Spotlight – Why do interest rates matter for stock prices?**

When stock price multiples got to extreme high levels, many justified them based on interest rates. Likewise, the stock market decline is blamed on rising interest rates, among other things.

Investments are priced based on risk. Theoretically, government bonds, held to maturity, have no risk – the government can always print the money to pay off the bond. This makes them the “risk-free asset” off of which everything else is priced. Investment grade corporate bonds need to offer a little higher yield to compensate for the risk of downgrade or default. High yield, or junk bonds, need a higher yield still. Stocks represent the ownership of the residual cash flows of a company. Bond holders get paid first, and shareholders get whatever is left over. For this reason, stocks should be priced to earn a higher return than bonds to compensate for the higher risk. The price/earnings ratio is a common way to value stocks, but really this is a shorthand method. The value of any stock is the value of all future cash flows, discounted to today at whatever the discount rate is. For a riskier stock that rate will be higher. For instance, let's assume a risky stock is expected to earn \$1.00 next year and to grow earnings at 30%. Assuming a 10% discount rate, the \$1 in a year is worth  $\$1.00/(1+10\%) = \$.91$ . The following year's earnings is worth  $1*(1+30\%)/(1+10%)*(1+10\%) = \$1.07$ . The sum of all future cash flows should equal the current price. Note that I am using earnings as a shortcut, but it is actually cash

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<sup>3</sup> (Jakab, 2022)

<sup>4</sup> (Jakab, 2022)

to the investor that matters. Mathematically, the stock's valuation multiple falling is the same thing as the discount rate rising. (See <https://rothmaninvest.com/resources/estimating-future-returns> for the other side of this math.)

As government interest rates fell from the early 1980's until 2021, the expected yields of everything else fell with them. Price moves inversely to yield – a higher price today for the same cash flows in the future pushes the yield lower. Not only did the expected yield of everything fall along with the risk-free rate, but the price of risk (risk premium) also fell, as investors were pushed to take on more risk to try to achieve the returns they need. This “double whammy” pushed the price of risky assets much higher, enriching investors – at least on paper. At some point, the price momentum took on a life of its own, drawing in new ~~investors~~ speculators who wanted to get in on the easy money.

Here is an example. If the ten-year treasury yield is 1%<sup>5</sup>, and the equity risk premium (the return expected by investors for accepting stock market risk) is 2.5%, stocks should be priced to earn 3.5%. This equates to a price about 30 times one year of earnings. If the treasury yield rises to 4% and the equity risk premium rises to 5%, investors will demand a 9% expected return, which means stocks will trade at about 11x earnings. If a recession causes just a 10% decline in corporate earnings, stocks would lose over two-thirds of their value in this example.

One final note – rising (falling) interest rates hurt (help) growth stocks more than value stocks because growth stocks have cash flows further out in the future. In the bond world, this is called duration – the average time outstanding for future cash flows. Just as longer dated bonds lose more value on rising rates, so longer-horizon companies stand to lose more value as investors discount those far off cash flows at a higher rate.

### **Book Review: How to Think About Money by Jonathan Clement**

Clement seeks to simplify how we approach money. Money is confusing to many people, but at a basic level, building wealth is not complicated. “We save as much as we reasonably can, take on debt cautiously, limit our exposure to major financial risks, and try not to be too clever about our investing.” He gives five basic steps to make our money a source of satisfaction rather than an area of stress.

The five steps are to spend our money carefully, bet on a long life, avoid the common money mistakes, think big, and win by not losing. Most spending does not bring the lasting satisfaction we expect. Rather than buying things to impress others, we should focus on spending for freedom and shared experiences. Be careful about comparing ourselves to others -this causes dissatisfaction. Save early. Setting ourselves up for flexibility later will keep us from feeling trapped in a job we hate. Invest in stocks early, seeking to build a financial asset that replaces the earnings potential asset. As we age, we can shift to more reliable bonds. Clement lists twenty-two common money mistakes people make, mostly based on common errors in thinking. It is best to think of our lives in an integrated manner, rather than viewing each financial decision in isolation. Clement notes, “Retirement should be redefined so that it is viewed not as a chance to relax after four grueling decades, but rather as an opportunity to

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<sup>5</sup> The ten-year treasury yield got down to 0.62% on 7/1/2020, and was between 1% and 2% for most of 2021. As of 10/28/22 it is 4.02%. See [https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily\\_treasury\\_yield\\_curve&field=tdr\\_date\\_value=2022](https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily_treasury_yield_curve&field=tdr_date_value=2022)

take on new challenges, without worry about whether those challenges come with a paycheck.” Finally, pay attention to the little things that bleed our finances – investment fees, small recurring costs, etc. Pay attention to the big ways of losing as well – not carrying adequate insurance, buying at the top of a market and selling in a panic in down market.

The book concludes with a brief recap – twelve admonitions. The last sums it up well: “The goal isn’t to get rich. Rather, the goal is to have enough money to lead the life we want. We shouldn’t put that at risk by incurring excessive investment costs, straying too far from a global indexing strategy and failing to buy insurance against major financial risks.” Following the advice of this book is simple, but it is not easy. It is worthwhile, however, and should lead to freedom, satisfaction and meaningfulness.

Read the full book review here: <https://rothmaninvest.com/resources/how-to-think-about-money-book-review>

Thanks for reading our quarterly letter. Please let me know if you have any questions or suggestions for future letters.

Jake



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