ROTHMAN
Investment Management
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April 20, 2023

Please enjoy this latest installment of our quarterly letter, and let us know what you think and what questions you are grappling with now. Please be sure to congratulate Larson on earning his Enrolled Agent (EA) designation!

Personal Update

Jake: This has been a heavy travel quarter for me. I started the year in Lebanon, spending time with Nour's side of the family, and getting to see some new sights. While we were there, we missed record rainfall and flooding at home. We also made a trip to Florida for the Kingdom Advisors conference in Orlando. We hung around for the following weekend and spent a day in Disney's Animal Kingdom. That was our first time there, and it was wonderful. Seeing animals roaming around not in cages was very fun. Again, we missed extreme weather at home – snow that actually stuck. Meanwhile, it was 88 F in Orlando – unseasonably warm for February. While in that corner of the country, we made a quick trip up to South Georgia, where I used to live and got to visit friends and clients, and of course, enjoy great barbeque.

I was asked to join the Child Evangelism Fellowship International Board of Trustees, so we went out to Warrenton, MO for a two-day meeting there. I am very excited and honored for the chance to serve this wonderful organization in this way. CEF ministers to children in 201 countries around the world, reaching about 25 million kids per year face to face, in addition to a lot of multimedia outreach. Nour and I both are passionate about supporting this organization and its mission. We met through CEF, so it has been a blessing to us.

Larson: Larson: The first quarter has had a little bit of everything for Larson and Hannah. Larson spent some time in Florida for the Kingdom Advisors Conference, California to support Jake with a Taxes in Retirement Seminar series, and Texas to see Hannah's parents. Hannah and Larson also took an unplanned trip to Iowa for Hannah's grandfather's funeral. Larson finished the 3rd section of the Enrolled Agent exam and now officially has the EA designation. The next certification on the list is the CKA (Certified Kingdom Advisor) which is geared towards integrating Biblical principles into financial advice in practical ways. Unfortunately, the home construction is still ongoing. The new target finish line is the end of April. Hannah gets the most patient wife award for living in a camper in Wyoming all winter!

Business Update

Larson and I attended the Kingdom Advisors conference in Orlando in February. The sessions were uplifting, thought-provoking and educational. One of the reasons we went was to meet students who might be interested in an internship. We got a chance to meet several bright and motivated college students who are studying Financial Planning and to have follow up conversations with several. We also interviewed a couple of impressive Cal Poly students, and ultimately offered Spencer Stepanian our summer internship position. We are excited about him joining our team and giving us some help this summer. Spencer hails from the Fresno, California area and is currently a Junior at Liberty University.

In January, I did a Taxes in Retirement educational event in Cambria, and then in March I did another at Madonna Inn. The tax code is complicated and has been changed multiple times in the last few years, and there are many issues that affect retirees. It was gratifying to be able to highlight some issues people can plan for. It is also nice to meet people who we can help on an ongoing basis. Our orientation is toward service, not sales, so it is gratifying to be able to provide value for others and expand our reach at the same time. If you would like a tax planning strategy session, reach out to us.

Personal Improvement

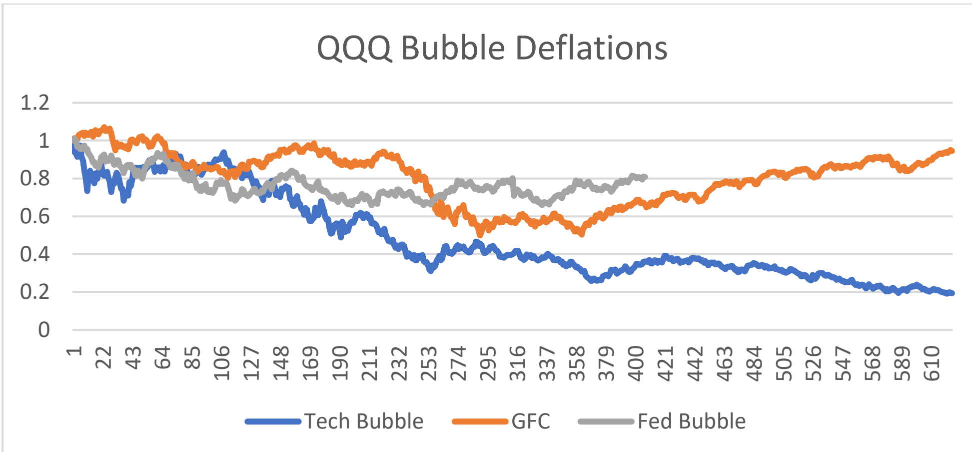
This quarter, rather than adding a new habit, skill or life hack, I tried to be more balanced. I have long believed that people who work an unreasonable number of hours do not get much more done than people who work less and are able to maintain a higher level of focus. It is possible to stretch for a week or a few weeks, but after time, the body and mind get tired and everything takes longer. This is a vicious cycle where ever-increasing amounts of time and effort are required to get the same amount of work done. I had been in that trap for a while. This past quarter, I figured out that fatigue was undermining my efforts, and made a deliberate effort to work less, sleep more and get back to exercising. I am already seeing results. After being tired for months, it felt great to be rested and energized. My strength at the gym is increasing, and my productivity and focus seem to be better. This is a constant battle for me, as I tend to push to get a little more done before calling it a day. I need to remind myself that borrowing energy from tomorrow to do a little extra work today after I am already exhausted carries a very high interest rate.

1Q 2023 Market Review

After a tumultuous 2022, 2023 has resembled 2021 with mania replacing depression. The S&P 500 advanced about 8%, and the Nasdaq about 17%. Glamor stocks did well: TSLA +68% (P/E 54x), NVDA +90% (P/E 118x). Even Bitcoin, which grew up on easy money, somehow advanced while crypto-related banks started collapsing, gaining 74% in the quarter. Not bad for a quarter with the second largest bank failure in US history, and the Fed still insisting it will raise rates further, while earnings are in decline.

According to my friends at Colrain Capital, three large tech stocks (Apple, Nvidia and Microsoft) accounted for 90% of the value increase in the S&P 500 last quarter. Add in (Meta, Tesla, Amazon, Alphabet, Salesforce and AMD) and nine stocks accounted for 160% of the gain. On average, the other 491 stocks lost money. Poor market breadth tends to be a negative harbinger for the market.

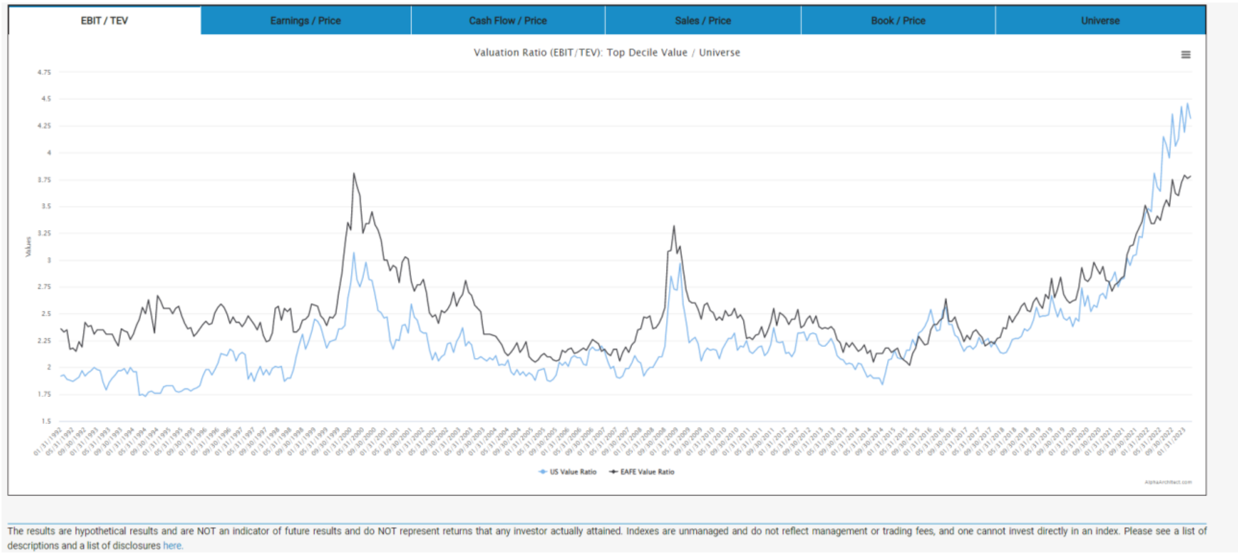
The NASDAQ started its decline at a higher level than the last two major bear markets, so I overlaid a chart starting with the highest monthly close.



Source: Yahoo! Finance, Rothman Investment Management

We do not comment on our specific recommendations in this note, but we will highlight certain trends that affect the way we invest. We use academically vetted investment factors to quantitatively construct portfolios. While plenty of studies have shown that low cost (value), positive trending (momentum), quality and small (size) stocks earn higher returns than the market over time, this extra return is by no means consistent. In the first quarter of this year, all four factors had [negative returns], with momentum doing the worst. This is a resumption of the prior long trend that favored stocks with interesting stories (both so-called disruptive innovation and late in the bull market, meme stocks) and ignored more traditional cash-producing companies.

I find it useful to see how discounted the cheapest stocks are. If we rank all the top 1500 stocks by Total Enterprise Value/EBITDA (this metric is a better for comparing companies with varying levels of debt), the valuation multiple for the market is currently about 4.5x that of the cheapest 10% of stocks. The long-term average is about 2x. The previous highs over the last 30 years were both about 3x in February of 2000 and February, 2009. Similarly, the average multiple in developed markets is about 3.8x that of the cheapest decile, comparable to February 2000 and higher than February 2009. After both of these instances, the cheap stocks went on to outperform the market by a wide margin over the following five years. Cheap stocks are historically cheap relative to the market. This explains the underperformance of cheap stocks over the last several years – the declining valuations have more than offset the higher earnings yield. Buying at an even steeper discount to the market should position us well going forward.



Source: Alpha Architect, used with permission

Momentum does not have the same built in catch-up mechanism, but short-term underperformance of the momentum factor is nothing new. Given the odd behavior of markets of late, it is unsurprising that what generally has worked over time has not done well lately. We remain convinced that the long-term studies of momentum and the other factors are still relevant, as human nature has not changed.

Some thoughts on bank failures

Thankfully, bank failures are rare in the US. Banks are essential to a well-functioning economy by taking deposits from savers who need to store there money safely and lending to businesses or other borrowers who need the funds to finance investment (and in some cases consumption.) Banks are one tool to enable capital to go where it is most efficient. By nature, banks should be conservative. They use very little of their own money, so small changes in the value of their investment portfolio (usually loans) can wipe out their equity. Further, depositors value safety above all else. If they want to take risk, they can do so elsewhere. Banks must maintain the confidence of their depositors, as the business model is to take in short-term money and to invest longer-term at higher rate. Banks keep a small amount of their money liquid to meet normal redemptions, while lending out most of their assets. Because lack of trust can ruin a bank, and because analyzing the safety of banks is beyond the skills of consumers (and maybe even bank analysts), the government insures deposits up to a limit. This is good for banks, and good for the economy as a whole. The Federal Depositors Insurance Corporation (FDIC) is funded by fees charged to banks, and thus ultimately to bank customers, not to taxpayers. If a solvent bank was forced to redeem too many depositors too quickly, it would have to sell illiquid investments, likely taking a loss to quickly convert to cash. This alone could ruin a bank.

Silicon Valley Bank (SIVB) had some interesting characteristics, but excellent risk management was not one of them. Relative to other banks, it had a much higher percentage of uninsured deposits. This is risky for a bank, because these deposits are likely to flee if there is a hint of bank trouble. Second, Silicon Valley Bank was also unusual in that it was undiversified. It was built to serve the start-up ecosystem. As funds flowed into Venture Capital and Private Equity in 2020 and 2021, they also flowed into SIVB, causing rapid growth. The bank stuffed this cash influx into government bonds when rates were at rock bottom yields. SIVB bought longer-term bonds to get a little extra yield. The bank failed to properly manage the interest rate risk, even after it was obvious the Fed would need to raise rates to fight inflation. When the Fed aggressively raised rates, these bonds lost value. As a result, SIVB had a high degree of losses relative to its Common Equity Tier 1 Capital Ratio. Sources I saw put this around 100% of the CET1 Capital. Good risk management would have avoided this situation by selling longer-term bonds that carry higher interest rate risk and moving shorter-term. One savvy investor figured out the loss-adjusted CETI1 Capital ratio and posted his finding online, which spooked depositors, who had large uninsured balances. As they began to pull their funds, SIVB had to sell bonds to raise cash. The accounting for the bonds had to change from “Held to Maturity”, which is not marked to market value to “Available for Sale” which is. As the bank recognized the unrealized loss on bonds (and the realized losses on bonds it sold) it generated large losses and a declining capital ratio. The bank run exposed the bank as insolvent.

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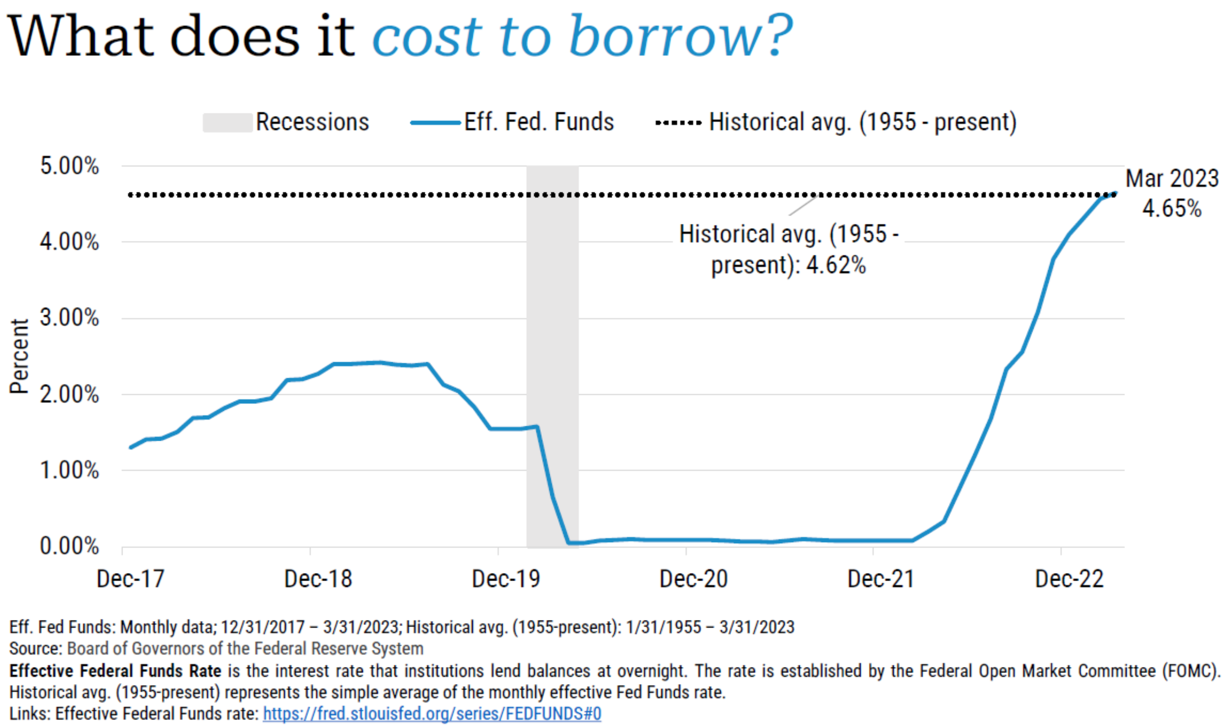
Interest Rates

After decades of low and falling interest rates that we came to believe was our birthright, rates have been rocketing upward. Danielle Park notes that we are in the midst of the most aggressive Fed tightening cycle in at least 30 years. (Inflation went to the highest it had been in forty years, so this sounds about right.) She points out that average interest rates on credit cards, used cars and new cars are 24.5%, 14 and 9%, respectively. Perhaps even more importantly, the household income needed to qualify for a mortgage on the median US home jumped from $47,232 in February 2020 to $86,736 today.[1]

Many think that interest rates must come down to somewhere close to 2021 levels. This certainly could happen, but perspective is important here. The aberration is not where rates are now, but where they were. The Fed kept interest rates artificially suppressed for over a decade, starting with the Great Financial Crisis. COVID brought rates down to effectively zero. The Fed’s aggressive tightening has only pushed the Fed Funds Rate back to its historical average.

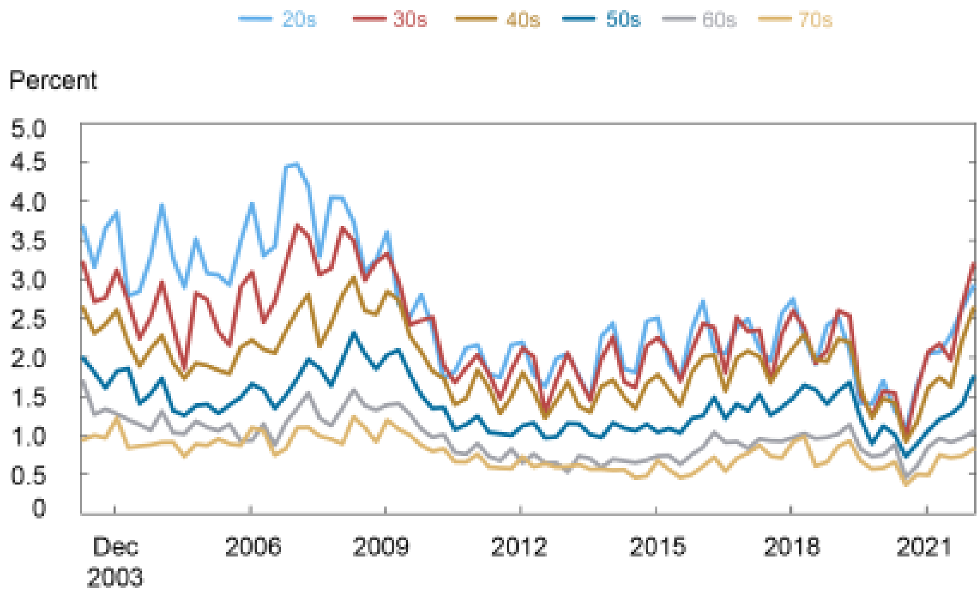
[1] (Park, 2023)



Source: Alpha Architect, used with permission

If rates are only average, what is the problem? There are many. First, years of dirt-cheap debt has encouraged borrowing by consumers and companies. Those lulled into complacency by near-costless debt may need to refinance at much higher rates. Consider, at the end of 2012, US Household debt was \$11.35T (\$2.75T non-housing and \$8.6T housing). Ten years later, at the end of 2022, it was \$16.9T (\$4.64T non-housing and \$12.26T housing). That is an increase of almost 50% in household debt in a decade, and close to 70% for non-housing, which tends to be much shorter term. These interest rates could be a serious drag on consumer spending. Not only does borrowing to spend become a more difficult decision, but the interest burden of existing debt will eat into household budgets. The New York Fed has already observed an uptick in credit card delinquency, particularly among borrowers in their 20's, 30's, 40's and 50's. While default levels aren't alarming yet, the rapid rise exceeds even that of the Great Financial Crisis (GFC). The New York Fed's Liberty Street Economics commented, "Surpassing the pre-pandemic delinquency rates isn't worrisome per se, because the pandemic recession ended what had been a historically long economic expansion. But the fact that more borrowers are missing their payments, particularly when economic conditions appear strong overall, is somewhat of a puzzle. This is particularly concerning for younger borrowers who are disproportionately likely to hold federal student loans that are still in administrative forbearance. Some of these borrowers are struggling to pay their credit card and auto loans even though payments on their student loans are not currently required. Once payments on those loans resume later this year under current plans, millions of younger borrowers will add another monthly payment to their debt obligations, potentially driving these delinquency rates even higher."[2]

Share of credit card borrowers transitioning to 90 days past due by age group



Source: New York Fed Consumer Credit Panel / Equifax.

Economic Outlook

Nothing lasts forever. We've been in economic expansion for all but a few months of the last twelve years or so, but this must eventually give way to recession. That won't last forever either. Such is the nature of economic cycles. How close is the next recession? While nobody knows for sure, it could be getting close. Neuberger Berman is concerned about a credit-driven economic tightening that would be self-reinforcing. "Credit is the oxygen of economic growth. If the economy turns increasingly recessionary in the coming months, we believe more banks will likely feel the need to shore up their balance sheets and further tighten lending standards, which could rapidly push up the cost of capital, reduce the availability of credit, and ultimately accelerate—and deepen—our anticipated decline in corporate earnings." The firm sees three causes for the recent rally: 1) China reopening, 2) relief from elevated energy prices, particularly in Europe, and 3) order backlog being converted to sales as supply chains recover. All of these are "likely to amount to temporary relief rather than durable growth." Further, earnings quality is very poor, and financial conditions have actually eased since the bank failures, but should tighten as credit quality comes into view.[3]

[2] (Andrew Haughwot, 2023)
[3] (Neuberger Berman, 2023)

Inflation has been a hot topic, after being dormant for decades. Common knowledge now seems to be that inflation is under control and rapidly falling. It takes time for rate hikes to work their way through the economy. When the Fed did finally act, it acted decisively, and it seems intent on seeing the job through. I humbly submit that rates may not come back down quickly, and that inflation might not be so easily slain. Labor is still in short supply, and wages could make inflation stickier, as workers demand raises to keep up with higher prices and employers raise prices to pass along higher wages. (Although with profit margins still very high, another possibility is that wages increase and prices don't, which would be good for workers and bad for investors.) Chris Yates, of Archeron Insights observes an ongoing "balance of power shift between labour and capital." The last four decades have favored capital, but once the system is too far out of balance, it starts to revert back in the other direction.[4] This could be a long, sustained driver of higher inflation and lower profit margins.

Energy is another factor that could push inflation back higher. Falling energy prices have provided a relief to consumers and producers and have helped lower inflation. How sustainable is the drop in energy pricing? It is hard to say for sure, but consider that while US production of 12.2 million bpd is up about 3% from a year ago, it is down about 7% from March 2020. Zooming out to the rest of the world, the IEA forecasts growth accelerating from 710 kb/d in the first quarter of this year to 2.3 mb/d in the last quarter and continuing at close to that pace next year. It predicts that non-OPEC+ will be able to keep up with the demand growth for the first half of the year, but fall behind later in the year. While the world seems to be fully supplied right now, after fears of losing Russian production have so far failed to materialize, risk still remains for prices to spike higher.[5] The oversupply was a result of the US SPR draw and OPEC+ increasing production to prepare for the Russian supply disruption.

In addition to wages and energy, deglobalization is likely a long-term driver of inflation, just as globalization depressed inflation for decades. While we may not see the extreme regionalization predicted by Peter Zeihan, global tensions have risen and globalization has at least slowed and probably reversed. According to the World Bank, global trade as a percentage of GDP peaked at 61% in 2008 and declined to 57% in 2021. This is inflationary, at least for wealthy countries.

Finally, the "Green" energy transition is inflationary. The Manhattan Institute estimates that meeting the IEA's energy transition goals would increase the energy sectors use of various metals from 10-20% of global production to 50-70% or more, driving prices higher. This is not for elimination of hydrocarbons, but just for the more conservative goals.[6] Yates projects electrification to require 9x as much copper, 10x as much lithium, and 14x as much nickel and aluminum by 2030.[7] Electric cars require far more of each of these minerals than internal combustion cars. Their charging stations also require metal-heavy infrastructure. Solar, wind and battery capacity also require vast sums of these resources. Energy transition is long-term inflationary.

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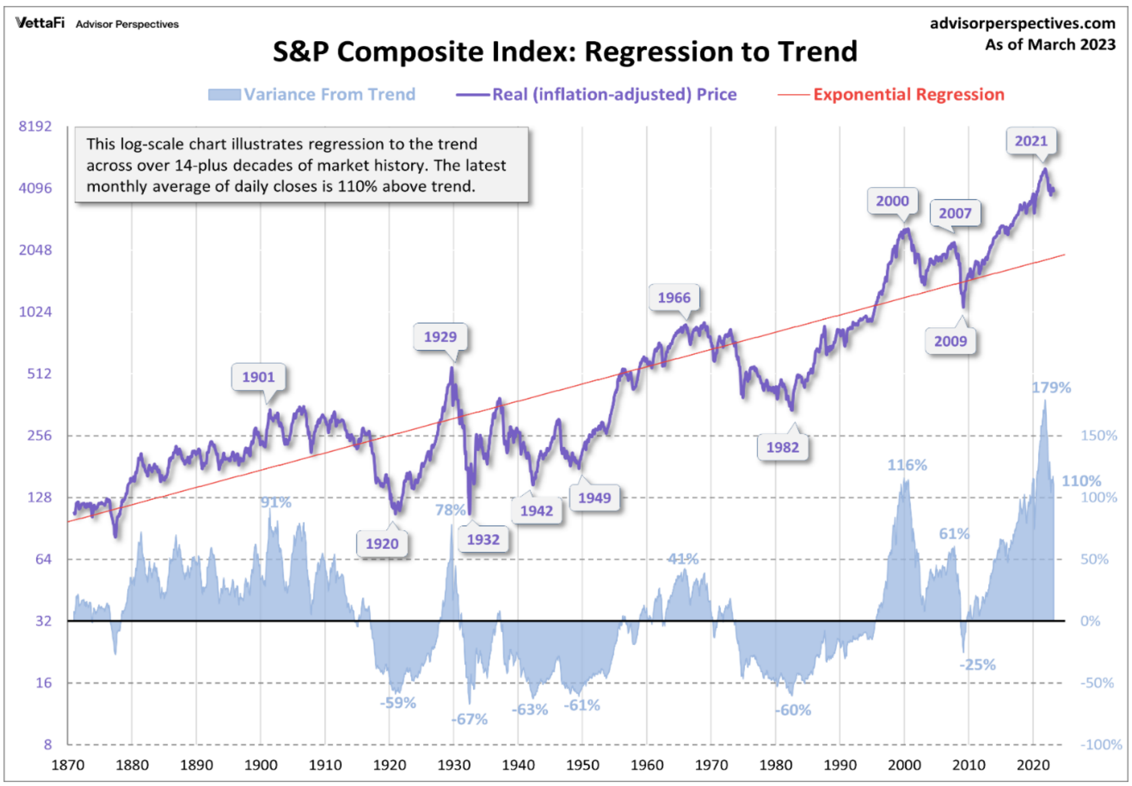
[4] (Yates, 2023)
[5] (IEA, 2023)
[6] (Milles, 2022)
[7] (Yates, 2023)

Valuation

My favorite valuation indicator, the Shiller PE, has declined from an all-time high (at least going back to 1886) of 39.6x at the start of 2022 to 29.4x as of March 31. This is a good start, but is still 39% above its fifty-year average. That means that the market would need an immediate drop of almost 30% just to get back to average. This is not a prediction, but simply a demonstration of where we are now. The Price/Sales ratio normalizes the effects of profit margin, which is highly cyclical. It shows an even more extreme level at 56% above the average valuation since 2000. From time to time, I talk with people who tell me that they were doing well until last year, and now they just need to wait out this dip, with the implication that once things get back to "normal" they will be in good financial shape again. This assumes that drops in stock prices are short-term trends that need to be reversed, while spikes in price are reflective of true valuation and not simply deviations in the other direction. This chart provides great perspective:



Conclusion:

I highlighted a few concerns – long-term inflation drivers that could make it hard for the Fed to contain inflation, bank liquidity issues tightening lending, the Fed committed to raising rates and keeping them higher than investors are willing to believe for longer, early signs of credit strain, and leading and coincident economic indicators pointing to a recession. While there are always issues generating uncertainty, our current slate of issues do not seem congruent with very high multiples on what appear to be bloated earnings. Investors should always use humility, never believing they know what will happen. Our current situation also warrants a healthy dose of caution.

The answer is probably not to sell everything and invest the proceeds in guns and gold, but it is also not to try to play a reprise of the wild days of 2021. That was driven by extreme and unprecedented fiscal and monetary stimulus, the likes of which we may not see again (let's hope) for a long time. Investors should be prepared for a return to normal conditions where valuation matters and companies that generate good old-fashioned cash flow do better than those that sell dreams. As always, risk is paramount, and having a plan that one can stick with is essential.

Read the full Outlook: https://rothmaninvest.com/resources/2023-q1-review-and-outlook

Educational Spotlight: What Can I Do With Income?

We are blessed with (too) many options for income that we receive, but these choices can be categorized into four broad categories: taxes, giving, living and saving.[1] Taxes are a natural consequence of living in a civilized society and having income or assets.

Taxes may feel inevitable, but there is plenty we can do to reduce our taxes, including contributing to a retirement plan, moving to a lower tax jurisdiction, investing in a tax-efficient manner, and engaging in activities for which the government offers tax breaks. Money saved on taxes can be applied to one of the other three categories, but tax reduction should be a means to an end and not an end in itself. Engaging in otherwise non-economic behavior to earn a tax advantage may not be wise. Tax preparers generally encourage tax deferral, as paying money later is often preferable to paying money today, but this is not always the case. Decisions undertaken for tax benefits should be considered in the context of a broader tax strategy that looks ahead throughout the taxpayer's life. Finally, we can minimize taxes by simply not having any income, but this is clearly not optimal. Rather than minimizing taxes, we should think about optimizing taxes. This may mean accelerating income when a taxpayer is in a low bracket to avoid getting taxed at higher rates later.

Giving is optional, unlike taxes, but it is an income allocation category that should be taken seriously. It is probably the most neglected category. People of faith believe that giving pleases God, who gives us everything we have, and brings us into His work of blessing others. Even those who aren't convinced of a personal God who seeks a relationship with them, giving offers many benefits. It breaks the grip that fear, greed and our possessions can have on us. It helps us to appreciate the things that we have. It reminds us of our place in the world and our ability to make a difference. Finally, it can bring much more contentment than buying one more thing or gaining one more experience. When I talk to generous people, I notice they tend to be content, even if they live a modest lifestyle. They do not express regret over what they have done to help others or wish they had spent more on themselves.

Spending, or living expenses are a mix of necessary, and optional. For those of us in the West, most of what we spend is discretionary. Even our food includes delicious items that we want and not just the minimum to keep us from starving to death. We can spend to meet our needs, spend to enjoy ourselves or spend to impress others. We live in a beautiful world, full of places to explore, activities to engage in, and delicious foods to eat. Unfortunately, we tend not to spend very wisely. We are impressed with things we think we want, many of which fail to live up to our expectations. We see others enjoying a certain lifestyle, unaware of what trade-offs they may be making to have what they do. Of course, there is a multi-billion dollar advertising industry dedicated to make us want what we do not already have. In his excellent book, “The Psychology of Money”, Morgan Housel observes the differences in how people spend versus what makes people happy. He recommends prioritizing experiences with other people over acquiring things, avoiding purchases solely to impress others, and living close to work, among other things.

Saving is the only category that does not prevent us from using the same money in another category. Spending can’t be unspent.[2] Giving can’t be ungiven, and good luck getting the government to reduce taxes already paid. Savings prepares us for the future, utilizing the ability God gave us to plan ahead. It allows us flexibility in spending and giving. Savings can even be invested to grow and provide for more giving and savings, and yes, probably more taxes. Money saved can be used in different ways, and the best place for savings depends on a person’s individual situation. Debt retirement reduces a repayment obligation and also lowers the cost of living by reducing interest expense. Investments can generate a return, allowing savings to grow more quickly. Investments can generally still be accessed if needed, though possibly at a cost. Retirement savings can reduce taxes, now or in the future. Cash savings maintain flexibility. Saving gives some great benefits. Perhaps the best is the peace of mind that comes with being prepared for the unknown. Life happens. Unexpected “one-time” expenses are all too common. Money saved up can be the difference between a crisis and a disappointment. Another great benefit of savings is optionality. Sometimes positive opportunities are presented. Having savings allows us to take advantage of these. Finally, there is independence. Even the most work-loving people will likely not be able to work their entire life. Life expectancy has increased, and people can live decades after their paycheck stops. Saving money while we are earning it, and then prudently investing those savings allows us to continue to take care of our needs once the paycheck stops.

Like any paradigm, the taxes, giving, living and saving model is a generally useful way of looking at where our money goes. There are a few ways we can spend that may blur the lines. Is a donation that secures some benefit like the right to purchase season tickets, spending or giving? What about home improvement projects that increase the value of our home? Some discretion can be used, but we should guard against rationalization, which is a sneaky enemy. Sales professionals know that phrasing a purchase as an “investment” decreases resistance.

If we plan proactively, we can try to divide our resources well among these four categories. Without adequate planning, we will probably spend too much, pay too much in taxes and not save and give enough.

[1] Some people would add debt payments as a fifth category, but this truly is a sub-category of savings. Whether we use an incremental dollar to put in our bank account, add to our investment account or pay down debt, if we have not used that dollar for spending, had it taxed away from us or given it away, we have increased our net worth by $1.

[2] It is true that we can sell something we bought, but this usually entails some loss of value.

Book Review: Ask By Dan Solin

Ask begins in an unexpected place – looking at what makes us happy. Dan Solin cites a study showing that 40% of our happiness is within our control. He suggests focusing on what we can control and making an effort to do the things that make us happy. Further, he suggests variety and freshness over routine. Happiness takes effort, and we should focus on what works for us. Further, practice gratitude, disconnect from devices and get enough rest.

Most people find a conversation engaging if they are engaged in it, but this is backwards. We should seek for the other person to be engaged, which is only done when they are talking. We can process about 400 words per minute (wpm), but only speak at about 100 wpm, so 75% of our brain is disengaged while we listen. This means even though most dynamic speaker will not be able to keep an audience engaged for long with a monologue. A Microsoft study found "we start to lose our ability to concentrate after eight seconds". That's one second shorter than a goldfish! The solution is to ask good questions, and to listen attentively and actively. We show we are listening by asking follow-up questions, not by moving on to the next topic. Expert interviewer Terry Gross recommends starting a conversation with the question, "Tell me about yourself."

It's important to know how we best interact, and who we are talking to. There are a lot of differences between introverts and extroverts, which drive how they interact with others and which situations make them comfortable. It's much more nuanced than people neatly falling into two groups, and many of us are "ambiverts" who can "tap into both side of our personality as needed. (I see myself as an ambivert, needing both some alone time and some time with people to feel energized.) Understanding ourselves and the people we are talking to can be helpful for effective listening.

Sincerity is at the heart of the "Ask" approach. Using questions and effective listening as a manipulative tool is likely to be discovered. You can't fake sincerity, but you can develop curiosity.

Solin observes that there is a question deficit. The way to develop close relationships is to ask open-ended questions, and to not expect to talk much. Let other people be heard. Asking good questions is an important skill. Rather than trying to get specific information, let the other person talk about what they want. Pivot questions from the other person back to them. Often there is information embedded in their question that can lead to a good question. Open-ended questions usually start with who, what, when, where and why. They are intended to open a conversation, not to narrow it down. Nicholas Epley, who studied the difference between perspective taking and perspective getting said, “The secret to understanding each other better seems to come not through an increased ability to read body language or improved perspective taking but rather through the hard relational work of putting people in a position where they can tell you their minds openly and honestly.”

At the end of the book Solin lists the most important things we can do right now: “Don’t try to be the most interesting person in the room. Be the most interested. Get in the habit of starting sentences with, I’m curious… Use these five words more frequently: Tell me more about that. Retrain your brain to elicit information rather than convey it. Remember, there is no more compelling evidence of kindness than empowering people to talk about themselves.”

Read the full book review: https://rothmaninvest.com/resources/book-review-ask

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