ROTHMAN
Investment Management
9700 El Camino Real, Suite 302, Atascadero, CA 93422

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Thank you for reading my quarterly newsletter for the fourth quarter of 2020. This is an outlet for me to post updates, my view of the investing environment, an educational piece, and a book review. This quarter, we have a guest post for the educational spotlight. The letter is broken into sections for ease of use. Please reach out and let me know what you think or challenge me on my conclusions.

2020 4Q Market and Economic Outlook

The year 2020 was a wild ride and the last three months capped the year appropriately. Many were happy for a turn of the calendar, but so far 2021 has had more of the same. Politics dominated the quarter, but if an had investor known in advance exactly what would happen, it probably would not have helped to get better investment returns. None of the twists and turned seemed to matter. Stocks staged an impressive rally in the final quarter, with the S&P 500 returning 12.1%, and the S&P 600 31.2%.[1] Fourth quarter GDP growth remained strong, coming in at 4% annualized quarter over quarter growth, exactly in line with estimates.[2] This would normally be excellent growth, but coming off of the massive disruptions experienced there is an element of getting back to normal that is transitory, so all economic readings should be taken with a grain of salt.

More important than where we have been is where we are going from here. Many people believe that there is significant pent-up demand among consumers, who are eager to get back to normal and will use the money they have been unable to spend once the consumer economy reopens. Certainly, there is merit to this – who isn't eager to travel, go out to eat or go to an entertainment event? Economist David Rosenberg takes issue with this argument for an especially robust economy, as the segments of the economy that have been most affected – travel, dining and personal services – are not a huge part of the overall economy. Most of that consumption is one time. A person may be eager to go get a manicure, or go out to eat, but nobody will get twelve manicures or order multiple meals to catch up for a year of missing out. Further, behavior has changed as people become more self-reliant and learn to cook and do other things for themselves. He further argues that stimulus money and cheap credit have led people to overspend on big purchases such as cars and home improvement, such that the appetite for these may be satiated for a while.[3] This is an interesting debate, and both sides have merit. I see a slow recovery where it takes a couple of years to get back to where we were before the pandemic.

While politics and economic trends matter, they are always changing. The price paid for an investment today discounts all earnings from that investment into perpetuity. Price paid is the most important factor for determining investment return. Currently, prices for most stocks are very high.

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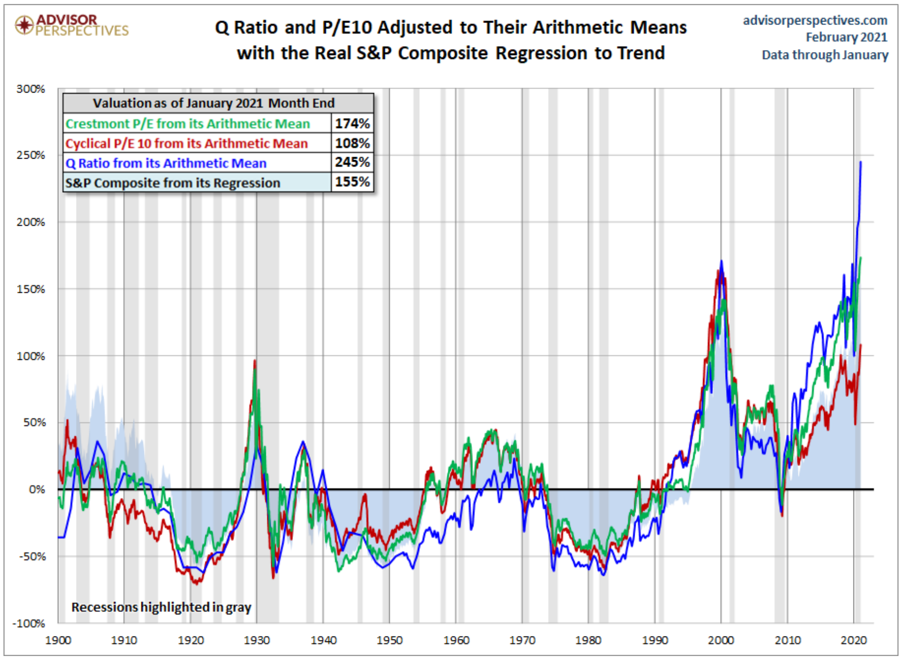
[1] Data from finance.yahoo.com. I am using SPY and SLY as the proxies for the S&P 500 and S&P 600, respectively.
[2] (Mislinski, 2020)
[3] (Rosenberg, 2021)



John Mauldin notes that the expansion in stock market valuations has coincided with an explosion of fiscal stimulus. The US Federal Reserve alone has increased its asset base (i.e. created new money) from a little over $4T at the start of the recession to over $7T by the end of 2020. Other major Central Banks have followed suit, adding over $7T of liquidity into the world. He also shows that on fifteen different valuation metrics, the current environment (mid-December) is at 100th percentile on eleven metrics and 91st or higher on the others.[4] While temporarily depressed earnings would skew some of these metrics somewhat, others are based on book value or longer-term metrics.

Lance Roberts calls attention to the extremely bullish positioning of retail investors, as well as record low levels of cash holding by pension funds and mutual funds.[5] Meanwhile, small trader purchases of call options (a leveraged and highly aggressive bullish bet) have rarely topped $5B, but recently spiked to $44.4B.[6] It seems the only group doubting current stock prices are the people who run publicly traded companies. Insider buying spiked last March, but now is at extreme low levels.[7] The level of margin debt has increased rapidly and is now at all-time highs.[8] This shows how aggressive investors are by borrowing to invest. This raises a relevant question for today. Who is left to buy?

Strength in the market is no longer widespread, but is focused in certain narrow areas. Stocks that have performed the best in recent months are those with no earnings and those that are most heavily shorted.[9] Roberts cites a Goldman Sachs chart showing the fifty most heavily shorted stocks have

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[4] (Mauldin, Stock Market Party, 2020)

[5] "Record" over the duration of the data set, which goes back to 1965. There may have been lower levels before this. These numbers matter because pension funds and mutual funds hold a large percentage of the overall investment markets, and have some discretion on how aggressive to be. When cash levels are high, so is potential investment, which could boost asset prices. Relative to historic levels, these are already fully invested.

[6] (Roberts, Market Review: Bull Mania And The Charge Of The Light Brigade, 2020)

[7] (Hulbert, 2020)

[8] (Mislinksi, 2021)

[9] (Hussman, 2021)

returned over 250% in the last few months.[10] Jesse Felder [shows](#) the number of S&P 500 components trading at greater than ten times sales has recently spiked to all-time highs.[11] Divergence of performance is often viewed as a sign that market strength is beginning to wane, but it also means there are opportunities outside of the popular areas. Another sign of an extended market is a rush to access capital markets. Not only have IPOs spiked, but direct listings and SPACs are taking off. Businesses see this as an attractive market in which to sell equity.

What is an investor to do? One could hold cash and lose value to inflation. One could invest and just endure the waves and any potential economic storm, knowing that eventually investments should generate a positive return. Or one could systematically try to manage risk to avoid most of the large moves down while looking for relatively attractive asset classes in which to invest. This is like a sailor tacking with the wind and avoiding the worst of the waves.

Simply buying and holding can work for people with long-term horizons. An investor contributing monthly gets to purchase lower after a market crash and wait for a recovery. The problem is people at or near retirement may not have a decade to wait for asset values to return to their starting level. They are relying on annual returns from their portfolios. Our current valuation starting point has historically yielded ten-year real returns of -3.9% - 4.4%.[12] GMO now projects negative seven-year real (inflation-adjusted) returns in most asset classes, including -5.8% for US Large Cap, and -3.4% for US bonds.[13] Similarly, Dr. John Hussman predicts a -2.15% annual nominal (including inflation) return for a 60/30/10 portfolio over twelve years.[14] If these estimates are anywhere close to being right, planning to ride out the storm is a dangerous proposition.

Jeremy Grantham is one of the world's foremost bubble expert. While he has been bearish on this market for some time, he resisted using the "bubble" label. Until now. "The long, long bull market since 2009 has finally matured into a fully-fledged epic bubble. Featuring extreme overvaluation, explosive price increases, frenzied issuance, and hysterically speculative investor behavior, I believe this event will be recorded as one of the great bubbles of financial history, right along with the South Sea bubble, 1929, and 2000." He further warns: "But this bubble will burst in due time, no matter how hard the Fed tries to support it, with consequent damaging effects on the economy and on portfolios. Make no mistake – for the majority of investors today, this could very well be the most important event of your investing lives."

The third option is seek out relatively better priced opportunities, invest cautiously and manage risk closely. This is harder than it sounds. I have spent much of the last year seeking out opportunities as well as ways to systematically manage risk to try to avoid major drawdowns. The markets rarely move in straight lines, and returns over a business cycle are made up of smaller moves up and down. While no system is fool-proof, having a plan in place and systems to employ beats reacting under duress. To learn more about how I am positioning clients in this market, reach out to me.

Read the full outlook [here](#).

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[10] In general, heavily shorted stocks are troubled companies, and their prices underperform. That these are not only the best performing stocks, but have realized hundreds of percentage points of gains suggests a speculative mania.

[11] (Felder, "What Were You Thinking" Part Tres, 2021)

[12] (Basmajian, 2020)

[13] (GMO Asset Allocation Team, 2020)

[14] (Hussman, 2021)

Business Update

I attended two conferences this quarter, both virtually. The first was the Money Quotient Retreat. While virtual was certainly not the same thing as being there, the format worked reasonably well, and we were able to participate and ask questions. We covered topics like values-based investing, how to manage a virtual practice, the future of the financial planning profession, and my favorite, how to deal with behavioral biases through client engagement. It was good to reconnect with other advisors and to learn from each other. I also attended the virtual annual National Association of Personal Financial Advisors (NAPFA) conference. This was much larger and I did not know anyone associated with the conference, so it was harder, but it was also much more convenient to be not be fully out of the office. I did a few hours of live meetings daily and then spread out the on-demand meetings over the next couple of weeks. There were a couple of great sessions on charitable giving.

It has been gratifying to see business growth accelerate. Sales is not a strength of mine, but as I have built a platform for being able to serve and help people with their finances, I have become more interested in letting people know about what I am doing. While it has taken time, it is finally bearing fruit. The number of conversations I have had with new people about their finances in the last quarter was more than in the prior few years combined. Thank you to all of you who have told others about me.

Personal Update

In October, Nour and I were able to go two weddings – one for my favorite sister and one for my best friend. Both were outdoors and smaller and more spread out than they otherwise would have been. Nevertheless, in this challenging year, it was wonderful to celebrate some positive new beginnings with very dear people. Thanksgiving was a small family affair. I smoked a turkey, which turned out well. In early December, I contracted the flu from Wuhan, which I very unkindly shared with my wife. This made for a very different Christmas time. As unpleasant as being sick is, watching a loved one suffer discomfort is worse. Unfortunately, her symptoms were much worse than mine. We are thankful our cases were not worse. The whole year felt strange, as most of the things I love either did not happen or were dramatically changed, so it was fitting to end the year sick with COVID. Still, there is so much to be thankful for, and Christmas is about more than traditions and special time with family. I look back on 2020 with gratitude for lessons learned, joyous times experienced and a relationship with God that can overcome any trials.

Educational Spotlight

"Wildfires causing disruption in California insurance market"

By Drew Lewis, Broker, California Meridian Insurance Services, Inc.

December 2020

Recent wildfires have seared the property insurance market for some homeowners and businesses in the Golden State. According to the California Department of insurance, in 2017, for every \$1 of premiums collected for homeowner's insurance coverage, \$2.01 was paid in out in claims, a loss ratio of 201%. In 2018, the loss ratio was 170%. This number does not account for administrative costs, including commissions, so the real damage is considerably worse. For reference, insurance carriers generally prefer a less ratio below 50-60% so they can still turn an underwriting profit after adding in administrative costs.

The reaction from the insurance market has been to pay claims and reassess their underwriting exposure and rate structure. The current underwriting model no longer works in California and has made the Golden State a more complicated place to write property insurance. Insurance carriers are being more strategic as to where they want to offer homeowners insurance and will continue to turn away from writing properties in higher risk areas. This has led to a wave of policies being non-renewed (235,274 dropped policies in 2019, a 61% increase vs. 2018) and many homeowner's now having to find replacement coverage at a significantly higher rate.

Ricardo Lara, the California Insurance Commissioner, issued the first ever statewide non-renewal moratorium in late 2019 which offered some limited protections to homeowners in certain affected areas. Mr. Lara will continue to be under pressure to do more for consumers as the 3.6 million California householders in the "wildland urban interface" face insurance challenges in the future. Dropped consumers who cannot find suitable coverage have been forced to turn to the California FAIR Plan, an insurance pool established in 1968 which is backed by capital and surplus of all insurance companies writing property insurance in California. The FAIR Plan is writing more business than it would like to, with enrollments up 225% in 2019.

Wildfire losses have pinched the balance sheets and income statements of insurance carriers and has led to the insolvency of a small regional insurance carrier, Merced Mutual. Large, diversified insurance carriers benefit from writing other lines of business which have performed relatively well, such as Worker's Compensation coverage and other casualty lines. Wildfires and increased insurance costs hurt housing affordability in California and may make it more difficult to sell a property if reasonable insurance cannot be obtained.

The model of our industry is to turn an underwriting profit and make money through conservative investments. With interest rates at historic lows, the underwriting profit of an insurance carrier is even more important as there is less money to be made via conservative investments. The fires of 2017 almost wiped out the insurance industry's profits in California from 2001 to 2016, according to a RAND Corporation report from 2019. This leaves insurance executives with a lot on their minds and pressure to take rate increases to recoup losses. Continue to expect property insurance rates to increase for the foreseeable future.

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Personal Improvement

My focus for this past year has been focus. I ended 2019 by starting a book on focus, *Indistractible*, which was very helpful and inspiring. I continued with a couple more books on focus and set out to do something to be more focused each quarter. For the last quarter, my personal improvement project was to accumulate pomodoros. A pomodoro is a 25-minute period of uninterrupted work. It sounds simple, but it is difficult to execute. I set my stopwatch (or use tomato-timer.com) to twenty-five minutes and then try to work on whatever I am doing without break or distraction until it is done or the time goes off. If I finish, I move on to the next thing on my list. If I complete the time without distraction, I count that as one pomodoro. If I get distracted, I try to get back to work quickly and do the best I can, but the period does not count as a successful pomodoro. I did not count meeting times. Most days I would only get about two pomodoros, but I could see my focus improving as I practiced. I read that we spend our whole lives practicing distraction, so we should not be surprised that it takes a while to learn the skill of focus.

DIY Financial Advisor Book Review

This great book is divided into two parts. The first part of the book explores how experts can be beat. It is full of stories, studies and statistics of experts in various fields underperforming simple models. "The academic evidence is unequivocal: systematic decision making, which depends on models, outperforms discretionary decision making, or experts."[15] DIY does not argue that experts are worthless. Rather, it breaks the decision-making process down to three steps: 1) Research and development, 2) Systematic implementation, 3) Evidence-based assessment. Experts are useful for the first and last steps – building the system and assessing its continued effectiveness. Models are better for implementation because they are not subject to the myriad cognitive biases that afflict humans.[16] The book explains five dangerous cognitive biases: anchoring, framing, availability, physical state and overconfidence. Alarmingly, even people with knowledge of how these biases work cannot avoid including them in their thinking.[17]

The second part of the book is on how to beat the experts using quantitative systems. It starts by looking at why people trust their financial advisors and then suggests that based on what we learned from section 1, we should not trust ourselves to accurately assess whether an advisor is trustworthy. DIY introduces the FACTS framework: Fees – what are the all-in fees? Access – how easy is it to get to your money if you need to? Complexity – "complexity does not equal value". Taxes – what is the after-tax return? Search – how much cost and effort does it take to find the managers? Investors should understand what they are paying and what they are getting for their fees. Money should be accessible, or at least have a legitimate business reason for a lack of accessibility. The investment strategy should be as complex as necessary, but no more so. Funds should be invested to maximize after-tax return, not for pre-tax returns. The system should be designed to minimize headaches and maximize confidence in the search process.[18]

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[15] (Wesley R. Gray, 2015), 9
[16] (Wesley R. Gray, 2015), 11
[17] (Wesley R. Gray, 2015), 33-47
[18] (Wesley R. Gray, 2015), 75-86

The book examines various diversified asset allocation recommendations and concludes that diversification, and not one precise allocation is the important factor. It uses Meb Faber's "Ivy 5 Portfolio".[19] This is an even split of domestic equity, international equity, real estate, commodities and fixed income.[20] The second step is risk management. After exploring various techniques to improve downside risk, the book settles on an equal blend of two momentum gauges. It demonstrates over a 39-year study period that both systems improved downside risk across asset classes, without giving up return.[21] The third step is security selection. DIY presents the compelling evidence for value investing. This works because growth rates are mean-reverting, but stocks are priced as if current growth (or lack thereof) will last indefinitely. The book cites a 50+ year study showing a value-weighted portfolio outperformed the S&P 500 by 4.2% per year, annualized.[22] Next, momentum investing is explored. This is simply buying stocks that are already going up more than others. This is based on people's initial underreaction to companies' improvement (anchoring bias) and eventual overreaction (confirmation bias, herd effect). Over 87 years, the top momentum stocks outperformed the S&P 500 by 7% per year.[23] Combining value and momentum would have done better than either alone (1963-2014) due to the diversification benefit. Over the test period, this outperformed the S&P 500 by 7.5% annualized, with comparable risk.

Finally, the book tests the system, using a 39 year backtest (1976-2014). The total results were impressive. The moderate portfolio outperformed the 60/40 by almost 3% annualized, with a comparable volatility and just over half the max drawdown (1992-2014)[24, 25]

Conclusion: DIY Financial Advisor is a great book for investors who are considering managing their own portfolio or for professional investment advisors. It presents a great system- one that is accessible to those with time and interest, but it is still somewhat technical and complex. It ignores much of the value a financial advisor provides, such as financial planning and behavioral coaching and focuses solely on investment management. Still, the book is a treasure in presenting the challenges investors face and a great system for dealing with these. Whether an individual decides to self-implement this strategy or to hire an advisor, this book arms investors with knowledge of what pitfalls to avoid and a robust, evidence-based approach to investing.

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[19] This is based on The Ivy Portfolio by Meb Faber, which is a similar book and a great read.
[20] (Wesley R. Gray, 2015), 98-104
[21] In US large-cap equities the total return using the risk management tools was identical to buy and hold, while each of the other four asset classes had higher returns with the risk management, while volatility for each asset class declined by 20-30%. (pp. 114, 116)
[22] (Wesley R. Gray, 2015), 134-140
[23] (Wesley R. Gray, 2015), 140-146
[24] The moderate risk DIY had a CAGR of 12.02%, standard deviation of 8.86% and worst drawdown of 13.81% compared to the 60/40: 9.23%, 8.47%, 25.29%.
[25] (Wesley R. Gray, 2015), 170

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