Rothman Investment Management

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Socially distanced greetings to you. I hope you are safe and are capitalizing on the opportunity to spend more time with your close family and with great books. If you missed it, check out my Quarantine Reading List and let me know what you think.

Enjoy the latest installment of my monthly newsletter. It is broken into manageable chunks so you can find what interests you. I always love when people follow up with me on anything they read here.

Business update

This quarter I added two pieces of software to improve my efficiency. Calendly is an automated scheduling program that integrates with my calendar so clients and prospects can automatically schedule a meeting with me. This not only saves time from coordinating schedules, it also makes it easier for people to do business with me, as the scheduling link is on my website. LastPass is a password manager that allows me to improve my security by using longer passwords and dual factor authentication.

Personal Update

After not traveling anywhere for a few months, Nour and I got to go to Lebanon for her sister's wedding. Traveling was interesting, with airports being pretty empty. For our twenty hours of flying we had to wear both masks and face shields. I found that after a few hours the mask was not so bad. We were tested for COVID-19 before our trip and again at the airport in Beirut. The time in Lebanon was well worth the trip. We had a great time with family and the wedding was fantastic. It was easily one of the most beautiful and elaborate weddings I have ever seen, and the food was amazing. For some reason, the bride seemed too busy to eat much so I did

my best to compensate. We also got to do a little sightseeing, visiting some historic place I had not seen before. I also finally got to see the legendary cedars of Lebanon up in the mountains. The best part of the trip was getting to spend a lot of time with Nour and family. Nour and I celebrated our third anniversary by staying at the same hotel where we spent our wedding night.[1]

While in Lebanon, I was asked to speak at the church where Nour's brother-in-law pastors. He translated for me. (The last time he translated for me was when I asked Nour's father for his blessing, so I have a lot of confidence in his ability to convey what I meant to say/should have said.) Because of COVID, I had not even been to church physically in a few months, so it was a blessing just to go, and to get to share from the Bible was a double blessing.

Economic and Valuation Update

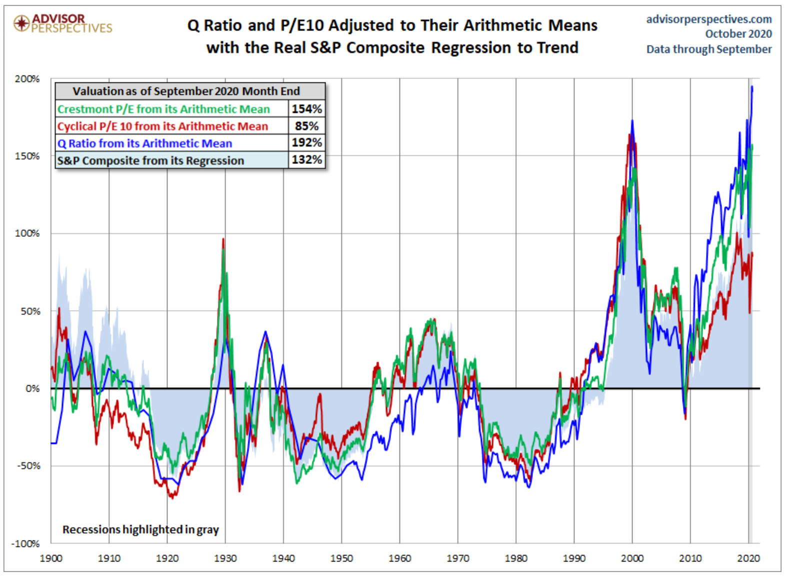
After the fastest bear market (stocks falling at least 20%) and a quick reversal from a humming economy to a steep recession in the first quarter, the economy has been rebounding nicely and the stock market has been on a tear. I expected consumers to be cautious and to defer any unnecessary spending such as home remodels, durable goods, etc. I underestimated Americans determination to keep spending money, as the exact opposite has happened. There are a few explanations for this. Most of the jobs that were lost were lower income jobs. While it is sad to see people out of work in hospitality and some of the service industries, the impact on the economy has not been as large as the raw unemployment numbers would suggest. Further, enhanced unemployment from the Federal government in addition to regular state unemployment meant that many unemployed people saw their income increase. Historically low interest rates have allowed people who still have jobs to lower their monthly payment by refinancing. Low rates have also fueled the housing market. There is a lot of uncertainty about how policy response to the pandemic will continue to impact the economy. The stock market is hoping for a fresh round of fiscal relief and is unconcerned about the long-term impact of trillions of dollars of increased federal debt.

Many investors are now focused on the upcoming elections, particularly the presidential election and the control of the Senate., but I do not believe investors should be overly focused on

[1] We were very fortunate in the timing of the trip. Lebanon has not been fortunate at all. Due to COVID, the only airport in Lebanon had been closed for months and opened only six days before we arrived. The massive explosion of Ammonium Nitrate in a warehouse in the port happened only a week and a half after we left. It damaged the hotel where we stayed, which is now closed indefinitely.

politics. First, the value of stocks is the discounted present value of all future cash flows, and elections happen every two years. Second, historically, stocks have not shown much correlation to political party. Finally, politicians say a lot of things when they are trying to get elected, but actually enacting policy is not easy. Probably the worst possible outcome is a contested election that causes people to lose faith in the system.

More important than politics for long-term returns is the valuation of stocks. As I check in on the most traditional metrics of stock market valuation[2], I see the trailing every one at a premium to its historical average. It is helpful to use many different approaches to valuation to try to get a full picture. If they are all pointing in the same direction, one can be more confident in the conclusion. Here are three more valuation metrics in a chart.



There is one metric I track that does not show stocks as overvalued. The earnings yield premium to the ten-year US treasury is around its average level. This metric inverts the P/E to see what the yield (in earnings, not cash flow) is on an investment in the stock market and then subtracts from this the US treasury rate to determine what is being paid to accept the risk of the market. This is also called the "Market Risk Premium". In business school we usually used 5-6% in our models. Currently it is just under 3%. This is with the US Treasury bond yield[3] of just 0.55%, the lowest in my data set, going back to 1871. While nobody is talking about raising rates any time soon, the idea of using an all-time low rate to discount cash flows into eternity strikes me as aggressive.

Objective data should be the starting point, but not the end. One should consider whether we are in a new era that will see unprecedented value creation, such that earnings growth will be

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[2] P/E is the price divided the earnings of the company, or in this case of all the companies in the index. The trailing P/E looks at the last twelve months of earnings, while the forward P/E (not used in this discussion) looks at the forecasted earnings over the next twelve months. Shiller P/E or Cyclically Adjusted P/E (CAPE) looks at the last ten years of earnings to smooth out market cycles. P/B is the Price divided by the total accounting book value. P/S is price divided by sales.
[3] The accepted proxy for the "risk-free rate"

better than anything our economy has ever experienced. Another alternative is that returns on capital will be permanently lower than what they were historically, and investors simply need to accept lower returns. In either case, the burden of proof should be why this time is different. Certainly, technology is developing quickly and cloud-based services are transformational and allow growth without significant capital. Other innovation such as 3D printing and Artificial Intelligence may also create tremendous value. What is unclear is whether the value will accrue to investors or whether it will be competed away and end up benefiting consumers. Historically, there have been many technological breakthroughs such as electrification, railroads, radio and then television, automobiles, air travel, the super-highway system, containerization, industrial computing, personal computers and the internet 1.0. Each of these created value for our economy and have significantly improved our lives. They are responsible for extraordinary growth in productivity and per capital GDP over the last couple centuries. Whether the current technological advancements will bend the curve upward even more than all of these remains to be seen, but I am skeptical. The data have not bourn this out yet.

Dr. John Hussman maintains a model to predict forward 12-year returns for the S&P 500. The model has been quite accurate (mostly in retrospect) since 1928. It recently started predicting a negative *nominal* return for the first time in its history.[4] Well-respected money management firm GMO maintains seven-year *real*[5]return of various asset classes. The long-run average for US equities is 6.5%. The model currently predicts -5.8%[6]. This is a 34% cumulative loss in purchasing power for large cap stocks, which is projected to be the worst asset class. The only asset classes with projected positive real seven-year returns are International Small and Emerging Value. While many people are sitting on large gains from this bull market and enjoying how easy it is to make money, the numbers suggest now may be a time for caution.

What is an investor to do? This letter avoids specific recommendations, but in general investors should have a plan. Selling everything and hunkering down may not be the best option right now. Even Dr. Hussman is not going to a completely risk-off positioning.

"Given the likely level of market volatility relative to the volatility currently reflected in index option prices, my inclination is to adopt an investment stance that is fairly neutral in response to 'local' market movements, keeps a strong safety net, but for now, refrains from a bearish response in the event of a further advance."[7]

Investors should be careful and should understand the risks they are taking. These risks should be aligned with their own goals and risk tolerance as part of a thoughtful financial plan. There are still opportunities. Let me know if you would like to discuss.

Read my full outlook report here.

[4] (Hussman, 2020)
[5] Nominal means without adjusting for inflation – the unadjusted dollar level. Real means inflation-adjusted – the actual spendable return.
[6] (Grantham Mayo Van Otterloo, 2020)
[7] (Hussman, 2020)

Educational Spotlight: The Basics of Exchange-Traded Funds (ETFs)

By Franko Jira

As described by famed author Eric Balchunas, “an ETF is a marriage between an index fund (passively managed with low-costs and diversification) with the trading features of a stock (intraday trading, price transparency).”[8] An ETF is a type of security itself, that includes a collection of other securities—such as stocks—that tracks an underlying index, different industry sectors, and/or commodities.[9] Once ETFs are listed on securities exchanges, investors can trade them during the day at market prices. This is the most significant difference between mutual funds and ETFs: Although ETFs are a basket-like investment that can hold/track thousands of securities, they are traded on the open market like stocks, and their price/value does not depend on NAV, but rather (like stocks) on supply and demand for shares. Additionally, since shares are sold and purchased on the open market like stocks, ETFs incur a transaction fee. However, the average asset-weighted fee of an ETF is less than half than that of a mutual fund.[10] As such, ETFs share attributes of both stocks and mutual funds.

Although the first ETFs were passive funds intended to track major indexes, such as the S&P 500, today’s ETFs have much variation in terms of their composition and what they track. The most common types of ETFs are:

1. Index-based ETFs – passively managed to replicate the returns of a traditional index (e.g. the SPDR funds, which track major indexes)[11]
Example: SPDR S&P 500 (SPY): The oldest surviving and most widely known ETF tracks the S&P 500 Index
Example: iShares Russell 2000 (IWM):
Tracks the Russell 2000 small-cap index

2. Sector ETFs – provide performance based on specific market sectors, e.g. energy, technology, financials, etc.[12]
Example: Technology Select Sector SPDR Fund (XLK)

3. Commodity ETFs – provide performance based on commodity futures prices.[13]
Example: crude oil (USO) and natural gas (UNG)

4. Country-specific ETFs – provide exposure to specific countries.
Example: Currency ETFs, a type of Country-specific ETF, invests in foreign currency such as the Canadian dollar or the Japanese Yen.[14]

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[8] (Balchanus, 2016)
[9] (Souza, 2019)
[10] (Balchanus, 2016)
[11] (Goodman, 2012)
[12] (Goodman, 2012)
[13] (Goodman, 2012)
[14] (Fidelity Investments, 2020)

5. Rules-based ETFs – passively managed to replicate the returns of a particular basket of individual securities.[15]
Example: select high dividend stocks, etc.)

6. Inverse ETFs – attempt to provide the inverse of a given index's return in order to earn gains from stock declines by shorting stocks. (Shorting is selling a stock, expecting a decline in value, and repurchasing it at a lower price).[16]
Example: ProShares short S&P 500 (SH)

7. Leveraged ETFs – aim to provide a multiple of returns on a given index using financial derivatives and/or debt. Traditional ETFs typically track the securities in its underlying index on a one-to-one basis, a leveraged ETF may aim for a 2:1 or 3:1 ratio. Thus, these types of ETFs are a double-edged sword, leading to either significant gains or significant losses.[17]
Example: TQQQ (3x QQQ exposure)

8. **A combination of the above** – e.g. a multiple of the increase or decrease in commodity prices, indexes, or other markets.

Advantages of ETFs

Tax Benefits
The main tax advantage that ETFs have over mutual funds is with regards to capital gains. Mutual fund managers must constantly rebalance the fund by selling securities to accommodate shareholder redemptions or to reallocate assets. This sale of securities within the mutual fund portfolio creates capital gains for the shareholders, even for shareholders who may have an unrealized loss on the overall mutual fund investment. This results in mutual funds incurring more capital gains taxes than ETFs. Further, the creation/redemption process allows ETFs to unload much of their gains without taxable events. Generally, ETF investors are taxed when their shares are sold.

Low Cost
In addition to having a low overhead, ETF companies also experience lower expenses in terms of notifications, transfers, and monthly statements. This saving is passed on to individual investors in the form of lower fund expenses. Additionally, ETFs have an absence of redemption fees, which are sometimes found with mutual funds. Thus, while a traditional mutual fund or index — such as the Vanguard REIT Index Fund Investor Shares (VGSIX)—has a ~ 1% redemption fee if held for less than a year, its ETF counterpart, The Vanguard REIT ETF (VNQ), shares an identical portfolio and no redemption fee.

Liquidity
In the modern economic and political climate, liquidity may be the most attractive feature of ETFs. ETF shares can be traded at normal trading hours, like a stock, allowing investors to take advantage of short-term changes in value.

[15] (Fidelity Investments, 2020)
[16] (Investment Company Institute, 2020)
[17] (Goodman, 2012)

“They say that as a customer you can only get two of these three things: fast/good/cheap. If it's fast and good, it isn't cheap. If it is good and cheap, it isn't fast. And if it's cheap and fast, well, it probably isn't that good. Turns out, I have found two things that prove this wrong: Vietnamese restaurants and exchange-traded funds (ETFs). Those are two times when fast, good, and cheap all tend to exist in wonderful harmony.” Eric Balchanus

Franko Jira is an intern at Rothman Investment Management. Bio

For a more detailed report on ETFs, check out www.rothmaninvest/resources

Personal Improvement

I continue to work on adding techniques to improve my focus. This quarter I continued to work on planning my day with 30 minute blocks. Once a day is planned, adjustments can be made, but it is helpful to know what to do next. This has been challenging to do, and challenging to stick with, but it’s coming along. I added journaling at the end of each day. It only takes 5 minutes or less and has been helpful to reflect on what I am doing and to remind myself every day to focus on “Quadrant 2” (important, not urgent) activities. I’ve been very pleased with the results and find myself doing better about consistently doing the things that are important to me.

First Things First Book Review

First Things First is a follow up to the classic, “The Seven Habits of Highly Effective People” by Steven Covey. Fans of the first book will recognize this as the third habit. Covey was joined by co-authors Roger and Rebecca Merrill. “People have an innate desire to control our circumstances, but we cannot control what happens to us. We can only control what we do and then principles control what happens as a result. First Things First replaces the “time management” approach to life with a principle-centered approach. The book illustrates the problem in many people’s lives by alluding to two important tools – the clock and the compass. The clock represents how we spend our time – all of our activities, appointments, etc. The compass represents the things that are important to us – our values, goals, relationships, etc. When there is a divergence between how we spend our time and what is important to us, we will be dissatisfied. The temptation is to rush from urgent task to urgent task being driven by the clock and to neglect what is truly important. Covey describes a four-cell matrix divided by urgency and importance. Quadrant I is urgent and important. These tasks need to be done and they need to be done now! Quadrant II is non-urgent and important. These things can have a material effect on our life, but either have no deadline or a deadline that is far in the future. It is the “quadrant of quality.” Quadrant III, “the quadrant of deception” is urgent, but not important. Quadrant IV, “the quadrant of waste” is neither important nor urgent. The key is to maximize our time in Quadrant II. Quadrant IV should be avoided or delegated. Quadrant III tasks should be either ignored or settled as quickly as possible. Quadrant II is where we should be deliberately spending our time. By taking care of things that are the most important and dealing with items well before their deadline we avoid the stress of overloading Quadrant I. "Quadrant II is the heart of effective personal management. It deals with things that are not urgent, but are important… like building relationships, writing a personal mission statement, long-range planning, exercising, preventive maintenance, preparation—all those things we know we need to do, but somehow seldom get around to doing, because they aren't urgent."

The Main Thing: To Keep The Main Thing the Main Thing. This is done through setting a personal mission statement and reviewing it each week while planning out the next week. By practicing the first things first habit with others, we realize the synergy of interdependence. When facing a decision of whether to stick to the plan or to respond to something that came up, tie the decision to your goals. Practicing a first things first lifestyle brings both power and peace. "Peace is essentially a function of putting first things first. Foundational to 'first things' are the four needs and capacities—to live, to love, to learn, to leave a legacy." Power comes from living according to our conscience and principles instead of the expectations of others.

Like many of the best things in life, the First Things First concept is both simple and very challenging. If we are willing to be introspective and to learn and change, it can yield tremendous fruit in all areas of our lives. We can stop trying to do more faster and instead focus on the few things that will bring about results we really care about. We go from managing ourselves and others to leading. We change our mentality from trying to rush around covering all of our responsibilities to living an integrated life.

To read the full book review go to: https://rothmaninvest.com/resources/first-things-first-book-review

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Disclaimers: