THE BIRCH LANE PERSPECTIVE

Preserving and Growing Wealth
Volume 38, August 2024

"Society is held together by duct tape."
– Tim Dillon

A Leveraged System

In early August markets began falling around the world. The immediate trigger seems to be the Bank of Japan raising rates from 0% to 0.25%. It turns out there were investors borrowing in Japanese Yen at a low rate and investing in other countries at a higher rate. However, the rise in borrowing costs in Yen made the trade less attractive, so investors were forced to sell, which triggered a global selloff.

No one outside of a few specialized traders could have predicted something like this. But that does not matter.

We live in a leveraged and (perhaps) over-optimized system. A few examples: U.S. public debt to GDP is near historic highs, Big Tech companies trade at high multiples of earnings, and our supply chains are spread out and subject to shocks. Remember during the pandemic, how basic household goods were sometimes not available for weeks or months? More recently, we have had trouble producing enough precision weapons for the Ukraine-Russia war.

Having a high debt, assets trading at a high multiple, and a lean supply chain might work when everything is going smoothly. But all it takes is one thing going wrong that can start a chain reaction. Usually those things are unexpected. In 2007, it was mortgage securities being poorly or deceptively packaged. In 2020 it was Covid coming out of nowhere.

We have a system that has worked marvelously over time and produced tremendous growth, but it is fragile to shocks.

So how do we survive or even thrive in a system like this?

The key, I believe, is to design your personal and business planning to not only be resilient to shocks, but even to potentially benefit from them. If there is a shock and you're the last person standing, there is a world of opportunity.

However, you don't want to miss out on growth either if there is no shock. One can never predict these things. So it takes a balanced perspective in making investments for growth, but maintaining both liquidity and balance sheet strength to survive downturns and potentially buy assets cheap when others are forced to sell.

That is an art and it takes time to develop. Perhaps more importantly, it also requires cultivating the right temperament and emotional strength.

Key Wealth Principles

- A foundation of good habits is more important than fancy techniques
- Invest in quality businesses at an attractive price
- Build a portfolio of good businesses in different industries
- Maintain appropriate reserves and income sources
- Consider your financial circumstances, liquidity and timing needs, goals, tax considerations, and risk exposure

Building Your Resource Network

Steve Jobs wrote an email to himself a year before he died to remind himself that he did not create many of the things that he relied on to innovate and grow. Things like the food supply, a legal system to protect his rights, medicine, technologies, math, etc. The fact is we all succeed by building on the efforts of others.

We can help directly with tax planning, estate planning, financial planning, asset allocation, and investment management.

To further help our clients, we have built a network of resources both internally and externally. This includes M&A advisors, M&A attorneys, SBA lenders, fractional CFOs, CPAs, bookkeepers, business consultants, estate attorneys, mortgage lending, high yield savings, and more.

If you are looking to grow your business, considering a business exit in the next five years, or just want to preserve and grow your wealth, we are happy to talk. The conversation is no obligation and we may be able to help you, either directly or by introducing you to someone in our network.

To learn more, please visit my calendar online at Calendly or email me at Randall.Watsek@RaymondJames.com for a free consultation. The earlier you start planning, the better prepared you'll be.

Last Month's Winners and Losers

Winners	**Losers**
Capital efficiency	Large cap
Value	Profitability
Small cap	Momentum
Housing	Crude oil
Bonds	International
Gold	Semiconductors

There was a reversal in the last month where many of the areas that had been working, such as large cap growth stocks, underperformed and areas that had been weak, such as dividend stocks and small cap stocks, outperformed. Interest rates also fell, which benefited bonds and housing stocks. Related to the weakness in large cap growth, semiconductor stocks were notably weak, partially correcting for high valuations and partially due to shifts in which companies were successfully competing.

Stocks

	S&P 500	**Dow Jones U.S. Select Dividend**	**Russell 2000**	**Bloomberg US Long Treasury**
1mo Return	1.2%	7.6%	10.2%	3.6%
YTD Return	16.7%	13.0%	12.1%	-1.6%
10yr Return	13.2%	10.0%	8.7%	0.9%
20yr Return	10.5%	8.7%	8.8%	3.9%
30yr Return	10.7%	11.1%	9.2%	5.5%

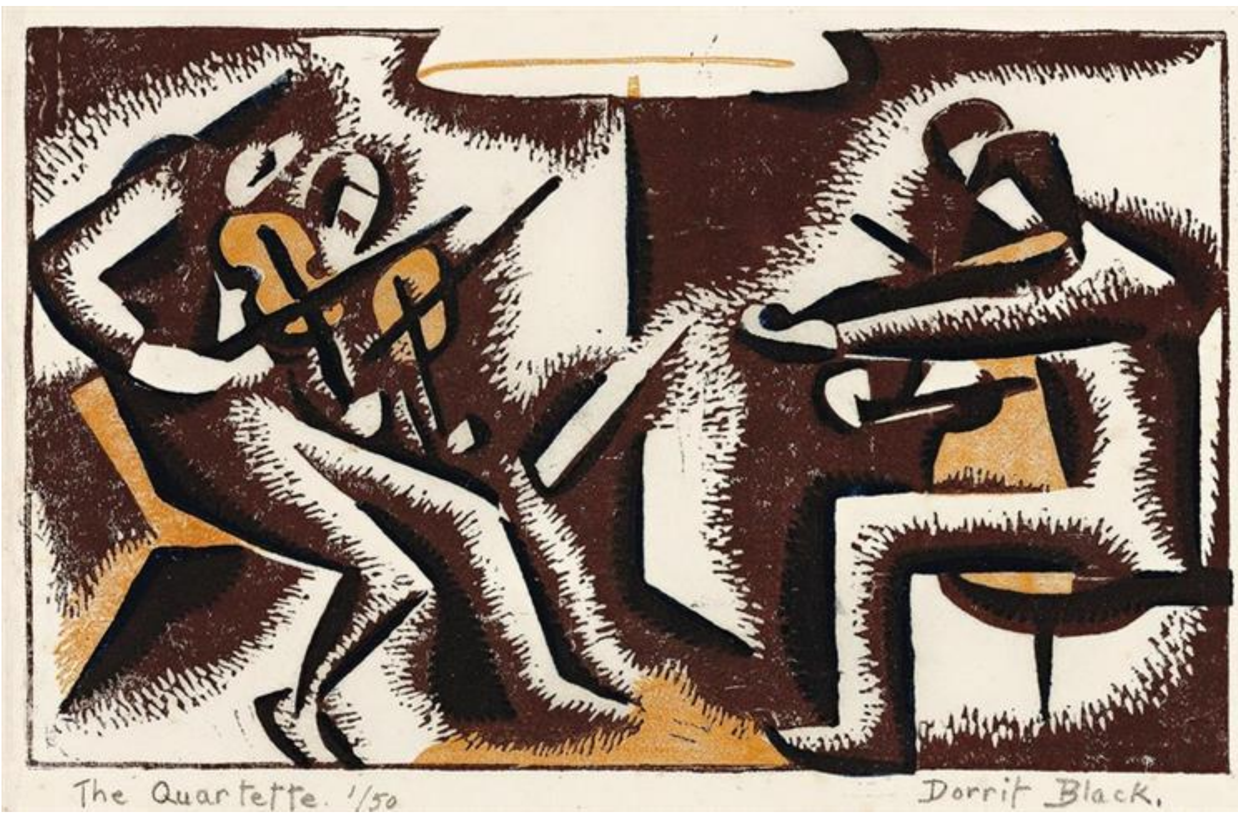
Source: FactSet as of 8/3/2024. We use the S&P 500 index as an illustration of the performance of large cap stocks, the Dow Jones U.S. Select Dividend index as an illustration of the performance of high dividend stocks, the Russell 2000 index as an illustration of the performance of small cap stocks, and the Bloomberg US Long Treasury index to illustrate the performance of treasury bonds with maturities greater than 10 years out.

With the sharp reversal in performance between large cap growth stocks vs. dividend stocks and small cap stocks, the value differential is not as large as it was a month ago. However, the big tech stocks remain expensive in my opinion and it is easier to find reasonably valued stocks outside of Big Tech. That said, the market is a bit expensive overall, even excluding Big Tech.

	Large Cap Stocks	Dividend Stocks	Small Cap Stocks
Dividend Yield	1.3%	3.3%	1.5%
Earnings Yield	5.0%	6.0%	6.2%
Earnings Growth	11.2%	8.5%	17.3%
Return on Equity	17.6%	12.4%	10.5%
% Losing Money	6.6%	6.4%	38.8%

Source: FactSet as of 8/3/2024. Dividend Yield is an estimate based on the weighted average of all companies in the category (by market cap). Earnings Yield, Earnings Growth, and Return on Equity are estimates based on the median profitable company. The % Losing Money statistic represents the percent of stocks with negative earnings in the preceding 12-month period. Large Cap stocks are defined here as the stocks in the S&P 500, according to FactSet. Dividend Stocks are defined here as the stocks within the S&P 500 that pay an above-median dividend yield, according to FactSet. Small Cap stocks are defined here as U.S. stocks ranked 1,001 to 3,000 in market capitalization, according to FactSet.

Artwork



"The String Quartette" by Dorrit Black (1935). Source: WikiArt.org.

Income Investing

Interest Rates	
1yr Treasuries	4.8%
10yr Treasuries	4.2%
10yr TIPS	1.9%
Municipal Bonds (5yr AAA)	2.7%
Corporate Bonds (5yr A)	4.7%
30yr Fixed Rate Mortgages	7.0%

Dividend Yields	
Common Stocks	1.3%
—Top 25%	4.2%
—Next 25%	2.5%
Preferred Stocks	6.2%
Utilities	3.4%
Real Estate (REITs)	3.5%

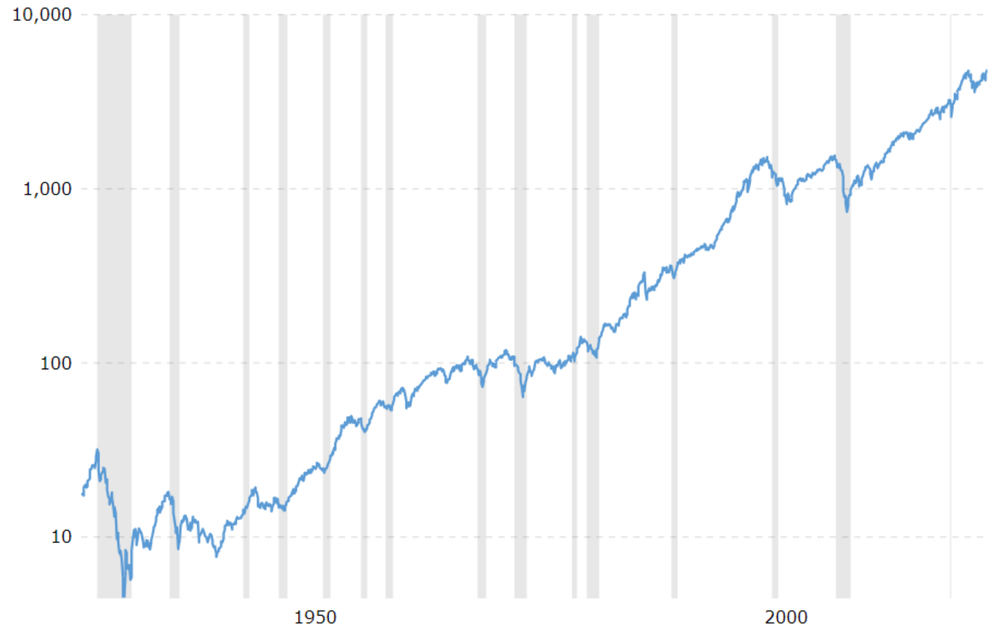
Source: Interest rates from Raymond James' Weekly Interest Rate Monitor as of 7/29/2024 and The Wall Street Journal as of 8/4/2024. Source for the Dividend Yields is from FactSet as of 8/3/2024. Common Stocks uses the estimated weighted average dividend yield for the S&P 500. The top 25% yield is the median yield of the top quartile of dividend-paying stocks out of the largest 1,000 stocks. The next 25% yield is the median of the second quartile. Preferred Stocks is the median dividend yield of the 100 largest traded preferred stocks (by dollar volume, per FactSet). REIT and Utilities dividend yields are the median of those sector stocks included in the 1,000 largest common stocks.

Interest rates fell last month, particularly for maturities greater than one year out. They continued falling in the first week of August. If the economic tremors we've seen worsen, I would expect interest rates to fall further as the Federal Reserve becomes more likely to cut rates. Core inflation has fallen in the last two months to the Federal Reserve's target range. Although not yet a trend, it will make it easier for the Federal Reserve to cut rates.

That said, there are long-term structural issue favoring inflation, such as continuing government deficits and public debt to GDP being historically high. At some point, it will become difficult to pay for the debt service through taxation and spending cuts, which could encourage money printing and subsequent inflation as the solution.

The Long View

S&P 500, Jan. 1928 to Dec. 2023



Source: MacroTrends.net

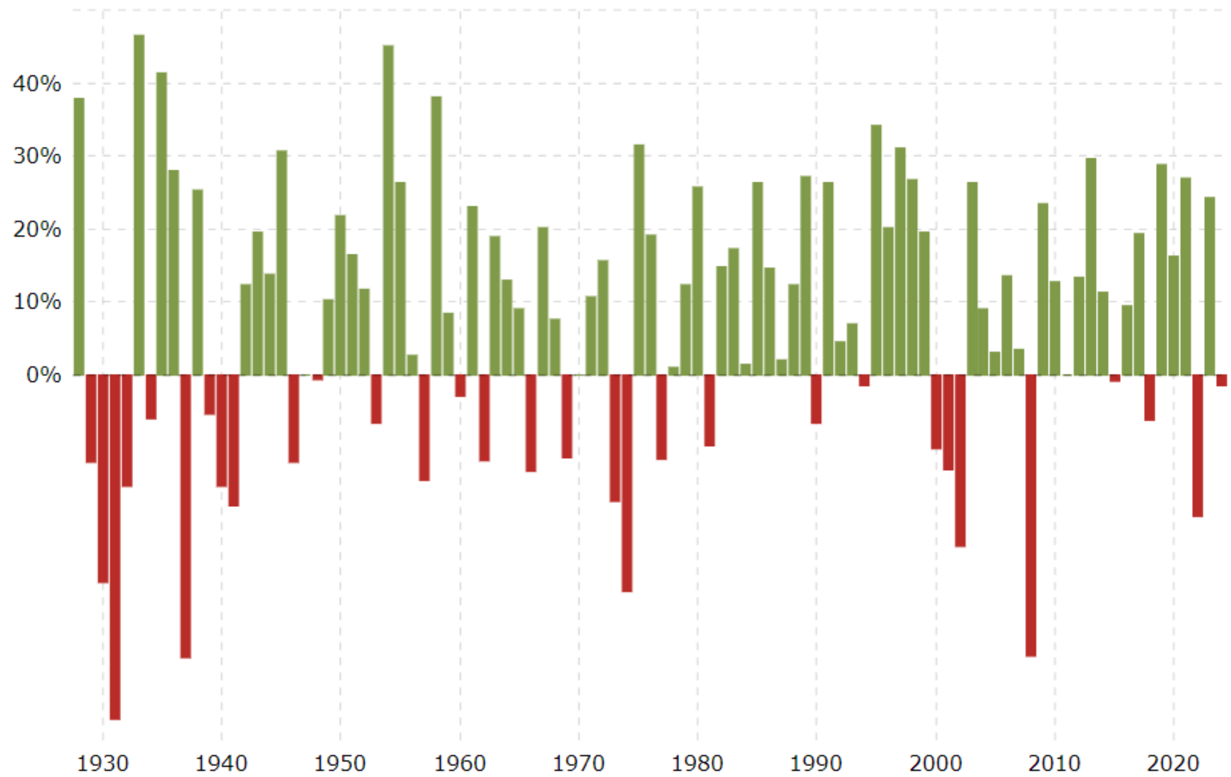
For the last 20, 30, and 100 years, stocks have averaged around an 8-10% return, driven by dividend yield, reinvestment of earnings, and earnings growth. Long-term bonds have yielded about 5% on average over the last century while inflation has been about 3%.

Throughout this period, there have been major upheavals, such as the Great Depression, World War II, The Korean War, The Vietnam War, dropping the gold standard, 1970s high inflation, 1987's Black Monday Crash, the Dot.com bust, the 9/11 terror attacks, the Global Financial Crisis, and the Covid Crash, among others.

These events led to severe market downturns about once every decade, with a median price decline of 33% and a median time to recover back to the previous high of 3.5 years. If we were to include dividends, the recovery to previous highs is actually a little faster. *

Meanwhile, a 3% inflation rate results in a 59% decline in the value of a dollar over 30 years. Meaning that people who retire at 60 years old on a fixed income face a high risk of a lower quality of life as they get further into retirement. *

The Price of Market Returns: Significant Volatility



S&P 500 Yearly Returns, 1928 to 2024. Source: MacroTrends.net

** Source: Morningstar Direct via cfainstitute.org, FactSet. Past performance is not necessarily indicative of future performance. Depreciation of the dollar: $1 / (1 + 3%)^30 = $0.41 real value 30 years later.*

Market Outlook

Now I'll put on my "Nostradamus Hat" and make some predictions, for whatever they're worth:

- Inflation will average 2-5% over the next 10 years.
- Interest rates will fall in the 3-6% range for 10yr Treasuries over the next several years, in line with inflation and historical experience.
- The economy will grow 2-3% in real terms over the next several years.
- Stocks will average an 8-10% return over the next 10+ years. After subtracting inflation, this will translate into about a 5% real return, in line with the estimated earnings yield on the S&P 500. There is likely to be at least one big decline every decade or so.

From the standpoint of where you and your family will be in 30 years, none of this matters. What matters is finding good quality investments that are likely to grow over the decades. For this reason, I largely ignore my own general market forecast and invest whenever I find a business that I am confident in and that trades at an attractive valuation.

Help Secure Your Golden Years

I first began managing money in the late 1990s, right when the Dot.com boom was taking off. People who didn't know anything about business were making money buying whatever stock was being hyped on TV. Wall Street firms were overflowing with profits by selling stocks to the public they knew were worthless. One notorious analyst earned $12 million a year, while privately putting down the stocks he was promoting.

Then it all came crashing down.

Most of the Internet stocks of that era went bankrupt or lost most of their value. The market went down for three straight years from 2000 to 2002. Millions of investors lost a huge chunk of their retirement savings.

Did people learn the right lessons? Only a few years later, we had the Great Financial Crisis from 2007 to 2009. Again, Wall Street was selling worthless financial instruments. This time it took down the real estate market too. Again, millions of investors lost a large portion of their retirement savings.

We want our clients to hold positions of real value, so we **personally research** all the positions in our strategies and review them regularly.

While it may surprise you, we believe this commitment to personal research and investment management sets us apart from other advisors. The vast majority of advisors outsource research to fund managers or their firm's cookie cutter options.

Instead, we personally research each position to develop the confidence that it is right for you. This commitment to research develops the trust, for us, that all the strategies we recommend are the right ones for our clients, in line with their risk tolerance, time horizon, and future goals. **Your finances are too important for a cookie cutter solution.**

At The Birch Lane Group of Raymond James, we work as a team to provide our clients with personal service, custom financial planning, and investment management tailored to your needs. I specialize in working with business owners, executive compensation issues, retirement planning, and investment management. Donna Colucci also does extensive financial planning, with expertise in life transitions, divorce planning, estate planning, and long-term care insurance. Tricia Jones works tirelessly on client service, trading, and account management.

We are dedicated to helping you achieve financial independence and a comfortable, stress-free retirement.

What Can a Financial Plan Do for You?

Having a well-designed financial plan and investment strategy is important for your financial future. It can help improve your security, confidence, and comfort. It can answer questions like:

- How much will you need to be financially independent?
- Are your assets structured in a tax-efficient manner?
- Does your estate planning protect you and your family from liability, the consequences of unexpected death or illness, and excessive death taxes?
- How will you handle unique circumstances, such as executive compensation, kids' college education, elderly parents, special needs children, and the other elements of life?
- Should you change any savings or investing habits?
- Could you improve your asset allocation or current investment choices?
- What are the odds that you will run out of money?

If you have never had a financial plan run for you or have not reviewed yours recently, we would be happy to create a financial plan and investment strategy for you.

To set up a time, please visit my calendar online at Calendly or email me at Randall.Watsek@RaymondJames.com.

Sincerely,
Randy Watsek

P.S. If you know anyone who might benefit from the information in this letter, please pass it along.

Biography

Randall Watsek and the Birch Lane Group currently maintain or advise on over $250 million in client assets. He has managed money for over 25 years, first as a credit portfolio manager at City National Bank and then as an equity research analyst, sector portfolio manager, and quantitative researcher at DGHM, a quality value boutique managing money for pension funds, endowments, businesses, and high net worth individuals. He leveraged this experience to join Raymond James and advise business owners and executives.

Watsek earned an MBA from the University of Chicago in Analytical Finance and Accounting, and a BA from Claremont McKenna College in Economics and History. He also earned the CHARTERED FINANCIAL ANALYST (CFA®) and CERTIFIED FINANCIAL PLANNER (CFP®) designations.

Watsek has been quoted in a variety of publications on investing and personal finance topics, including *MarketWatch*, the *Wall Street Journal*, *Investor's Business Daily*, *Money Magazine*, the *Arizona Republic*, *ThinkAdvisor*, *The Business Journals*, and *ReThinking65*.

Watsek is the father of two young children and lives in Westchester County, New York.

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The Birch Lane Group of Raymond James

The Birch Lane Group advises clients collectively holding over $250 million in assets. The team consists of:

Donna Colucci, CFP®, Associate Vice President
Tricia Jones, AAMS®, Registered Client Service Associate
Randall Watsek, CFA®, CFP®, Financial Advisor

Raymond James & Associates, Inc., member New York Stock Exchange/SIPC

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Inclusion of the S&P 500 index is for illustrative purposes only. Index performance does not include transactions costs or other fees, which will affect actual investment performance. The Dow Jones U.S. Select Dividend Index aims to represent the U.S.'s leading stocks by dividend yield and measures the performance of 100 high dividend paying companies, excluding REITs, meeting specific criteria for dividends, earnings, size and liquidity. The Bloomberg US Long Treasury Index measures the performance of US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with a maturity greater than 10 years. The Russell 2000® Index measures the performance of the small-cap segment of the US equity universe. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. Inclusion of these indexes is for illustrative purposes only. Holding investments for the long term does not ensure a profitable outcome. International investing involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. Gold and silver are subject to the special risks associated with investing in precious metals, including but not limited to: price may be subject to wide fluctuation; the market is relatively limited; the sources are concentrated in countries that have the potential for instability; and the market is unregulated. Be advised that investments in real estate and in REITs have various risks, including possible lack of liquidity and devaluation based on adverse economic and regulatory changes. Additionally, investments in REIT's will fluctuate with the value of the underlying properties, and the price at redemption may be more or less than the original price paid. Bond prices and yields are subject to change based upon market conditions and availability. If bonds are sold prior to maturity, you may receive more or less than your initial investment. There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices rise. Treasury Inflation-Protected Securities (TIPS) provide protection against inflation by adjusting their principal amount annually based on the Consumer Price Index (CPI) and then paying interest on that new amount. The principal amount is readjusted every year based on the prior year's CPI, meaning it can go down as well as up. There are special risks associated with investing with bonds such as interest rate risk, market risk, call risk, prepayment risk, credit risk, reinvestment risk, and unique tax consequences. To learn more about these risks and the suitability of these bonds for you, please contact our office. Bitcoin issuers are not registered with the SEC, and the bitcoin marketplace is currently unregulated. Bitcoin and other cryptocurrencies are a very speculative investment and involves a high degree of risk. Certified Financial Planner Board of Standards Inc. owns the certification marks CFP®, CERTIFIED FINANCIAL PLANNER™, CFP® (with plaque design) and CFP® (with flame design) in the U.S., which it awards to individuals who successfully complete CFP Board's initial and ongoing certification requirements. The foregoing information has been obtained from sources considered to be reliable, but we do not guarantee that it is accurate or complete, it is not a statement of all available data necessary for making an investment decision, and it does not constitute a recommendation. Any opinions are those of Randall Watsek and not necessarily those of Raymond James. Links are being provided for information purposes only. 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