# THE BIRCH LANE PERSPECTIVE

*Preserving and Growing Wealth*
*Volume 40, October 2024*


*"Although our intellect always longs for clarity and certainty,*
*our nature often finds uncertainty fascinating."*
*– Carl von Clausewitz*

## What Is Your Number?

Many business owners and executives have a number in mind for how much wealth they need for financial independence. Others have no idea. There are rough rules of thumb people use sometimes, such as expenses should be 4% of wealth.

That's a good starting point, but there are three key things to consider when coming up with a number that's realistic and resilient to market conditions:

1. **Your personal situation.** While the "4% Rule" might apply to the broad population of retirement age people with steady expenses, it doesn't apply to any individual. A safe number depends on your age, risk tolerance, goals (especially the expensive ones), asset allocation, and other factors. What works for a 40-year-old early retiree is a lot different than what works for a 70-year-old retiree. If you're building a $2 million dream retirement home, your needs are a lot different from someone living the same way as always. Likewise, if you have kids with special needs, medical issues, a potential need of long-term care, etc.

2. **Resilience to bad timing.** Anyone who says they can predict future returns is lying. We all have expectations, but those come with huge caveats and plans need to consider things not going according to expectations. For example, if you had retired right before the Dot.com crash, the market subsequently went down by 50% over the next three years. If you had been taking out an initial 4% rate, that would have increased to 8% when the market was down, seriously depleting your savings and making less available for a market recovery. Then there was the Great Financial Crisis a few years later, causing the same issue. Over that 10-year period, the market was essentially flat, but was negative for much of the time while you would have been taking out money. The right number incorporates the potential for a bad market.

3. **Asset allocation.** Potential returns and risk vary by asset class. Even within asset classes, there are different levels of potential returns and risk. For example, short-term bonds have a quite different return/risk profile than long-term bonds. Emerging tech stocks have a different return/risk profile than growing dividend-paying stocks. The right mix is different for everyone, and the mix is important in determining your "number."

Finally, once you have a realistic number in mind for your situation, you need a **roadmap** on how to get there. Will savings in retirement plans and liquid investments be enough? The average business owner probably has around 80% of wealth tied up in the business. Most owners and executives are focused on day-to-day business needs, so are not necessarily thinking about how to maximize the value of their business.

Value and earnings are related, but not the same. Most businesses sell in a range of multiples, but where in the range they fall depends on how attractive the business is from the buyer's perspective compared to similar companies. If you can improve both your margins and the multiple of your business value, there is a huge potential increase in value.

Whether you can hit your "number" depends to a large degree on how well you're maximizing business value.

## 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. These resources include 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 no obligation consultation. The earlier you start planning, the better prepared you'll be.

# Last Month's Winners and Losers

| **Winners** | **Losers** |
|---|---|
| Large size | Value stocks |
| Profitable companies | Crude oil |
| Momentum | Brazilian stocks |
| Precious metals | Japanese stocks |
| Crypto currency | Biotech |
| Chinese stocks | Regional banks |
| Consumer discretionary | |

Last month was a mixed bag without a strong theme uniting differing performance. Large, profitable companies did well, continuing the overall trend over the last 15 years. However, some risky areas of the market did well and other risky areas did poorly, so it wasn't a typical market cycle favoring or disfavoring risk. Instead, each sector followed its own dynamics.

# Stocks

| | **S&P 500** | **Dow Jones U.S. Select Dividend** | **Russell 2000** | **Bloomberg US Long Treasury** |
|---|---|---|---|---|
| 1mo Return | 2.1% | 2.0% | 0.7% | 2.0% |
| YTD Return | 22.1% | 18.8% | 11.2% | 2.4% |
| 10yr Return | 13.4% | 10.5% | 8.8% | 1.1% |
| 20yr Return | 10.7% | 8.7% | 8.5% | 3.9% |
| 30yr Return | 10.8% | 11.3% | 8.9% | 5.8% |

*Source: FactSet as of 9/30/2024. 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.*

The market continued to turn in a strong performance this year, with the large tech stocks that dominate the S&P 500 leading the way. Dividend stocks are that far behind, having turned in a very strong third quarter performance. While small cap stocks have lagged this year, they still turned in double digit returns year-to-date.

Longer term its not clear which will do better; if you had looked at the same record 30 years ago, small cap would have been ahead of large cap. Profitable small cap companies also trade at a more attractive valuation than large cap stocks and some of them have higher potential growth. However, we have moved into a "winner take all" world to some degree where you have a handful of companies with trillion-dollar market caps. To the degree that trend continues, it would favor large caps.

Returning to valuation, large cap stocks, especially those of the mega cap tech stocks, are in mild bubble territory. They could still do well as long as there are no negative economic surprises, but their valuation makes them more vulnerable to a correction if there is a hiccup. On the other hand, dividend-oriented stocks and small cap stocks trade closer to their historical norms, so I believe there are plenty of reasonably attractive values available to stock pickers.

| | Large Cap Stocks | Dividend Stocks | Small Cap Stocks |
|---|---|---|---|
| Dividend Yield | 1.2% | 3.1% | 1.5% |
| Earnings Yield | 4.8% | 5.7% | 5.9% |
| Earnings Growth | 10.8% | 8.1% | 16.1% |
| Return on Equity | 17.6% | 12.5% | 10.3% |
| % Losing Money | 5.6% | 5.9% | 38.2% |

*Source: FactSet as of 9/30/2024. 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 Mothers" by Kathe Kollwitz (1919). Source: WikiArt.org.*

## Income Investing

| Interest Rates | |
|---|---|
| 1yr Treasuries | 3.9% |
| 10yr Treasuries | 3.8% |
| 10yr TIPS | 1.6% |
| Municipal Bonds (5yr AAA) | 2.3% |
| Corporate Bonds (5yr A) | 4.5% |
| 30yr Fixed Rate Mortgages | 6.9% |

| Dividend Yields | |
|---|---|
| Common Stocks | 1.2% |
| –Top 25% | 3.8% |
| –Next 25% | 2.3% |
| Preferred Stocks | 5.9% |
| Utilities | 3.2% |
| Real Estate (REITs) | 3.3% |

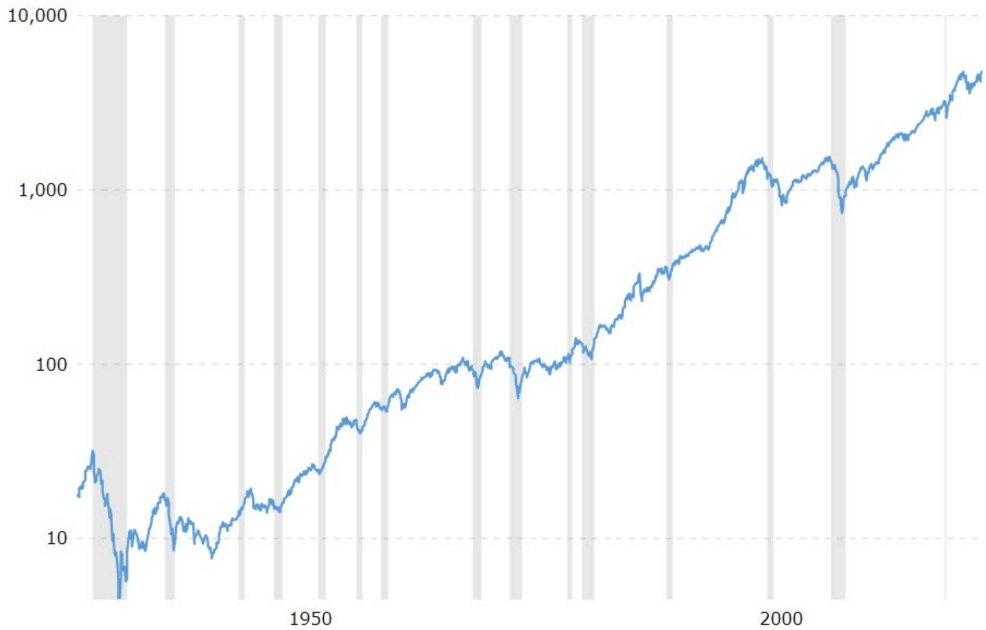
*Source: Interest rates from Raymond James' Weekly Interest Rate Monitor as of 9/30/2024 and The Wall Street Journal as of 10/1/2024. Source for the Dividend Yields is from FactSet as of 9/30/2024. Common Stocks uses the estimated weighted average dividend yield for the S&P 500. The top 25% yield is 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 have come down substantially following the Federal Reserve's rate cuts and the market's anticipation of future rate cuts. That said, I believe it is best to design your overall asset allocation based on your personal needs, timing, liquidity requirements, and risk tolerance rather than base it on market interest rates.

Within the bond allocation I continue to favor shorter term. While inflation has come down somewhat and the Federal Reserve is likely to cut rates further, government debt and deficits are still high and likely to remain high regardless of who wins the election. I believe this contributes to long-term inflation and interest rate risk. Long-term bonds do not yield enough to compensate investors for that risk, in my opinion, so I believe it would be best to stick with short-term bonds despite the low interest rate for the portion of your money that you'd like to invest conservatively.

# 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% annual 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%.

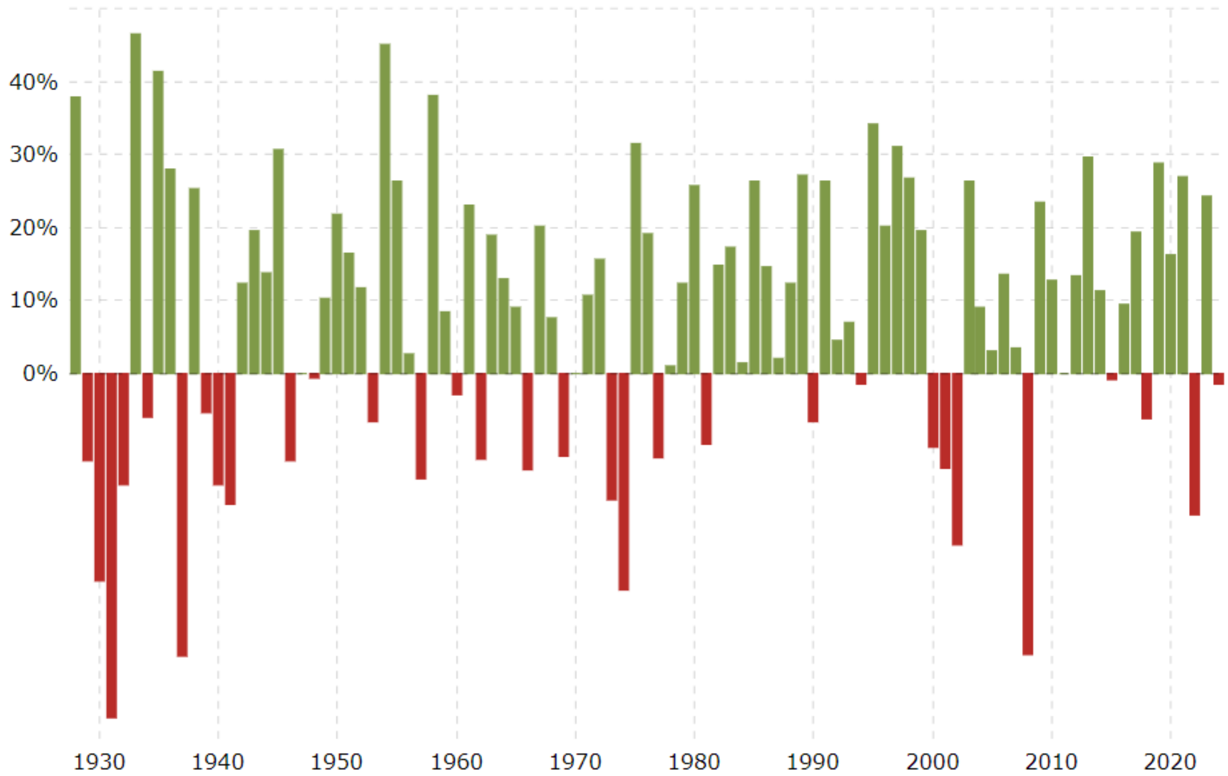
Throughout this period, there have been major upheavals, such as the Great Depression, World War II, The Korean War, The Vietnam War, dropping the gold standard, 1970s high inflation, 1987's Black Monday Crash, the Dot.com bust, the 9/11 terror attacks, the Global Financial Crisis, and the Covid Crash, 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 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 Comprehensive 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 market conditions are poor?
- Do you have a comprehensive risk mitigation strategy to incorporate business and career risk, concentrated wealth risk, market and economic risk, personal and family liability, liquidity needs, debt service, intergenerational risk, and unexpected death or illness?

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

Raymond James held approximately $1.48 trillion in client assets as of 6/30/24, has been profitable for 146 consecutive quarters (since 1988), has equity research coverage of over 1,100 companies, and maintains investment grade credit ratings by Moody's and S&P.

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

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