THE BIRCH LANE PERSPECTIVE

Preserving and Growing Wealth
Volume 43, January 2025

"I keep six honest serving-men
(They taught me all I knew);
Their names are What and Why and When
And How and Where and Who."

– Rudyard Kipling

How to Prepare for the Coming Year

There are an incredible amount of developments going on at the same time as we enter 2025. The Ancient Greek saying by Heraclitus that "the only constant in life is change" continues to bear fruit, albeit at a seemingly accelerated pace. These are some of the key areas I am watching: geopolitics, artificial intelligence and robotics, the economy, the stock and bond markets, and tax law changes.

Geopolitics

There are three major, and somewhat interrelated, conflicts or potential conflicts in the world that could impact us:

1. **China/Taiwan.** China's Premier, Xi Jinping, used his New Year message to reiterate his belief that Taiwan is part of China and that "reunification" is inevitable. Assuming he acts on that, and depending on what form it takes, that has the potential to be the largest disruption and risk to both the economy and safety of the world.

2. **The Middle East.** Last year saw an acceleration in the conflict between Israel and the Sunni countries on the one hand and Iran and its mostly Shia-backed satellites (plus Hamas) on the other hand. There are many moving and contradictory parts to this which are hard to untangle, but for now there has been cooperation between Israel and the Sunni countries against Iran and the Shia satellites. Russia and China supported Iran and the previous Syrian government while the U.S. supported Israel and the Sunni governments. That's just painting broad strokes as there are movements on both sides. Toward the end of 2024, the tide turned dramatically against the Iranian side with the collapse of Hamas, severe weakening of Hezbollah, and fall of Bashar Al Asaad in Syria. The biggest open question is whether Israel and/or the United States will attack Iran's nuclear program and whether this will lead to a wider conflict if it happens.

3. **Russian/Ukraine.** This war continues as a war of attrition with heavy losses on both sides and little movement, which favors Russia the longer it goes on as Russia is the

larger country with more capacity to absorb losses. The West has increased the level of weapons provided to Ukraine and approved greater targeting within Russia, which has led to attacks inside of Russia. This risks greater escalation and a potential widening of the war. On the other hand, it is unclear how strong Putin's position is within Russia given the ongoing strains from the war. This conflict could really go either way: a truce or a widening conflict.

The great risk is that these three conflicts and potential conflicts become tied together and lead to a broader war between China and Russia on the one hand and the U.S. and its allies on the other hand. I believe cooler heads and diplomacy will prevail as it's in everyone's interest, but we cannot rule out a much worse turn of events.

Artificial Intelligence, Robotics, and Drones

We have all seen the rapid advancement of artificial intelligence and have just scratched the surface of its uses. Already it is able to replace many functions that required people before. While there has been some disruption to certain jobs, it's been more of a productivity enhancement than anything else.

The next level researchers are working on is called "artificial general intelligence" wherein machines become as smart or smarter than humans and, eventually, smarter than all humans put together. Fully functioning artificial general intelligence would be able to process any natural human language, remember what it learns and hears, answer questions and draw new conclusions, adapt to new circumstances and draw patterns, perceive objects with artificial vision, and use robotics to manipulate and move objects.

We're not there except in limited use cases based on the services that are available now, but it's quite possible that new developments will bring us there in the near future.

The militaries of the United States, China, and a few other countries are also actively investing in these technologies. We've all seen the amazing drone swarm shows and can easily imagine repurposing the technology for military and intelligence purposes.

Although the growth potential is exciting, it has tremendous disruption potential, the possibility of many new competitors, and a variety of risk (including societal risks). As with any major new technology, investors do not necessarily profit even when there is tremendous growth. Ultimately it depends on where the growth goes and how profitable the growth is.

The Economy and Inflation

While there has been some weakening of the economy and previous reported numbers have been revised downward, the economy still seems to be in reasonably solid condition. On the other hand, inflation has been persistent. The Federal Reserve cut short-term interest rates in December, but longer term rates quickly rose nonetheless.

This reflects concerns about inflation and the ongoing government deficits, with no realistic plans to cut deficits to a more reasonable level.

Although it's true that inflation is ultimately a monetary phenomenon (i.e., is created by newly printed money), we've seen from experience that when government debt gets too high to be serviced with taxation, the only solution is to print money to cover it. We may be at that point already, or soon will be if serious action is not taken.

The Bond Market

Short-term rates are a little above 4%, which should be enough to offset inflation (pre-tax). Long-term rates are now a little higher, but still below their historical average of 5-6%. Given inflation and interest rate risks, long-term bonds are still not appealing to me at current yields.

The Stock Market

The market has become very narrow in the sense that the strong performance of the S&P 500 has been driven by less than 10 huge companies. Rather than being a truly diversified index of 500 companies, almost 40% of the index is in just 10 companies.

Because of that, using traditional metrics to gauge market valuations is tricky. Looking at a basic valuation measure, price / earnings, the market is considerably higher than its long-term average. If it were to fall to its long-term average, that would imply about a 30% drop. If multiples drop 30% and earnings fall say 20%, then you could have one of those 50% market declines that happen periodically (e.g., 1970s, 2000-3, 2007-09). That probably won't happen if everything keeps humming along fine, but there is elevated risk.

However, the picture looks different if you exclude the Big Ten. The valuations of typical stocks, such as smaller stocks, dividend-oriented stocks, and non-tech stocks look within the range of normal. So it is quite possible to find investments that look promising.

There is also the possibility that all the technological developments we discussed will lead to faster-than-average earnings growth, which would justify the high valuations shown by Big Tech. So while the risk is elevated, there is growth potential as well.

Tax and Regulations

The current estate tax exemptions will expire at the end of 2025, so many more people will be have their wealth subject to estate tax beginning in 2026. There are ways to plan around this and take advantage of current exemptions, so make sure to talk with your estate planning attorney if you are worth more than around $7 million. We are happy to review your situation as well and point you in the right direction.

Given the new administration, there may be additional changes, most clearly in the area of tariffs. If used as leverage for the purposes of negotiations, this may be positive. However, if implemented crudely, this could have a negative impact. It's too early to tell how this will play out.

There will probably be a shift toward deregulation or more efficient regulation. Broadly speaking, this should be a positive for business, but, as they say, the devil is in the details.

With the very narrow Republican majority in the House, it is not clear if any major tax reform will pass. So I would plan for the current estate tax exemption expiring as scheduled, but that is possible that it may be extended or changed. At this point, I would not foresee a major change in capital gains, dividend, or income taxes.

Overall

While the future is unknowable, having good fundamentals will help us in almost any environment. While people naturally want to maximize their tax-efficient investment plans, it always makes sense to have emergency reserves in liquid accounts to handle the surprises life throws at us.

Once that is in place, investments ultimately grow due to increasing cash flows and profits. If you own an investment property and rents increase over the next 10 or 20 years, your property is most likely going to be worth more. Likewise, if you own shares in companies that grow earnings over the next 10 or 20 years, your investments would likely be worth more.

There is a lot of noise in the news that cause investors to lose the plot, but a focus on what's important for wealth building over time will keep you in good stead.

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.

2024's Winners and Losers

Winners	**Losers**
Crypto-currency	Long-term bonds
Big Tech	Metals & mining
Semiconductors	Biotechnology
Chinese stocks	Mexico, Brazil, and South Korea
Financials	Energy equipment
	Natural gas

2024 saw strong performance driven by a very narrow part of the market: the largest tech stocks. In fact, tech is now 39% of the S&P 500 and the largest 10 stocks are also 39% of the S&P 500. Aside the largest tech stocks, most other companies were closer to historical averages.

In one of the widest divergences we've seen in performance in some time, driven by Big Tech, the S&P returned 25.0% for the year vs. 15.0% for the Dow Jones Industrial Average and 11.5% for the Russell 2000 small cap index. One of the forces driving Big Tech performance, and that of semiconductors, was the strong growth in artificial intelligence, which is manifesting itself in many ways. Crypto-currency, Chinese stocks, and financials were also strong performers.

Long-term bonds performed poorly on rising long-term interest rates and persistent inflation. Aside from that, poor performers were a mixed bag: metals & mining, natural gas, energy equipment, biotechnology, and certain countries due to their own issues.

Stocks

	S&P 500	Dow Jones U.S. Select Dividend	Russell 2000	Bloomberg US Long Treasury
1mo Return	-2.4%	-7.5%	-8.3%	-5.3%
YTD Return	25.0%	16.6%	11.5%	-6.4%
10yr Return	13.1%	9.4%	7.8%	-0.6%
20yr Return	10.4%	8.2%	7.8%	3.4%
30yr Return	10.9%	11.3%	9.0%	5.4%

Source: FactSet as of 1/1/2025. 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.

Valuations of the largest companies are somewhat stretched, perhaps in bubble territory. There are legitimate reasons for this, given the ongoing growth potential of artificial intelligence. However, artificial intelligence could be a disruptive force as well. In any case, the high valuations of the S&P 500 at this point presents heightened risk if there are any economic or geopolitical disruptions.

If the S&P 500 were to return to the historical average valuation multiples but otherwise grow earnings at similar levels, I'd expect 10-year average annual returns of around 5-6% rather than the historical 8-10% level. In order to achieve historical returns, either valuation multiples need to stay elevated or earnings have to grow faster than average.

Outside of Big Tech, however, I am comfortable with the valuations available in the market and continue to find opportunities I find attractive.

	Large Cap Stocks	Dividend Stocks	Small Cap Stocks
Dividend Yield	1.2%	3.3%	1.6%
Earnings Yield	4.8%	5.9%	5.9%
Earnings Growth	10.0%	7.5%	14.3%
Return on Equity	17.4%	12.0%	10.2%
% Losing Money	5.0%	5.9%	38.3%

Source: FactSet as of 1/1/2025. 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

"Egyptian Pyramid" by Violet Oakley (1910-11). Source: WikiArt.org.

Income Investing

Interest Rates	
1yr Treasuries	4.3%
10yr Treasuries	4.5%
10yr TIPS	2.2%
Municipal Bonds (5yr AAA)	2.9%
Corporate Bonds (5yr A)	4.9%
30yr Fixed Rate Mortgages	7.4%

Dividend Yields	
Common Stocks	1.2%
—Top 25%	4.1%
—Next 25%	2.4%
Preferred Stocks	6.1%
Utilities	3.3%
Real Estate (REITs)	3.6%

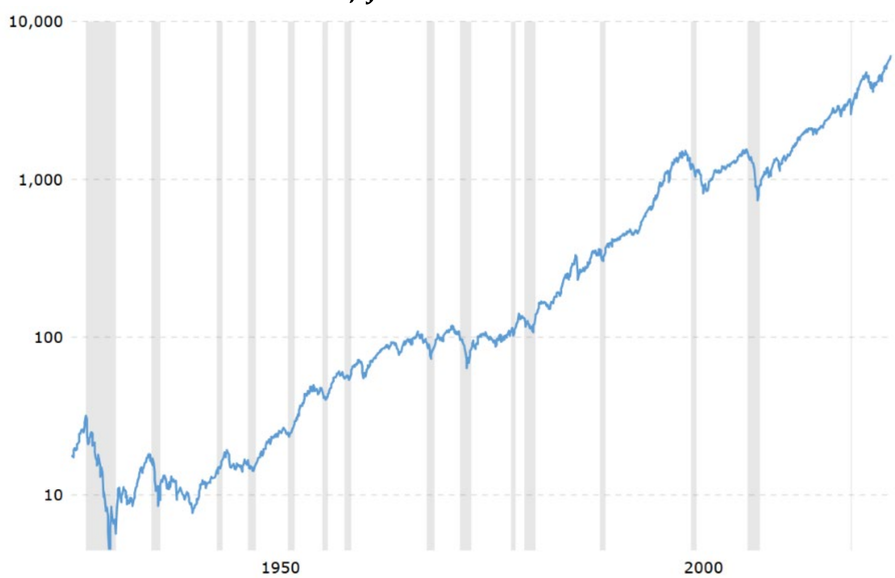
Source: Interest rates from Raymond James' Weekly Interest Rate Monitor as of 12/23/2024 and The Wall Street Journal as of 1/1/2025. Source for the Dividend Yields is from FactSet as of 1/1/2025. Common Stocks uses the estimated weighted average dividend yield for the S&P 500. The top 25% yield is the 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.

There has been a recent divergence in interest rates as well. The Federal Reserve lowered short-term interest rates, but long-term rates rose due to inflation concerns and the ongoing budget deficits.

In fact, rising long-term rates has led to negative 10-year returns for long-term government bonds. So much for the “safe” asset class. From my perspective, the only safe asset class in very short-term bonds, CDs, or cash equivalents. Everything else depends on the value you’re getting for the price you pay.

The Long View

S&P 500, Jan. 1928 to Dec. 2024



Source: MacroTrends.net

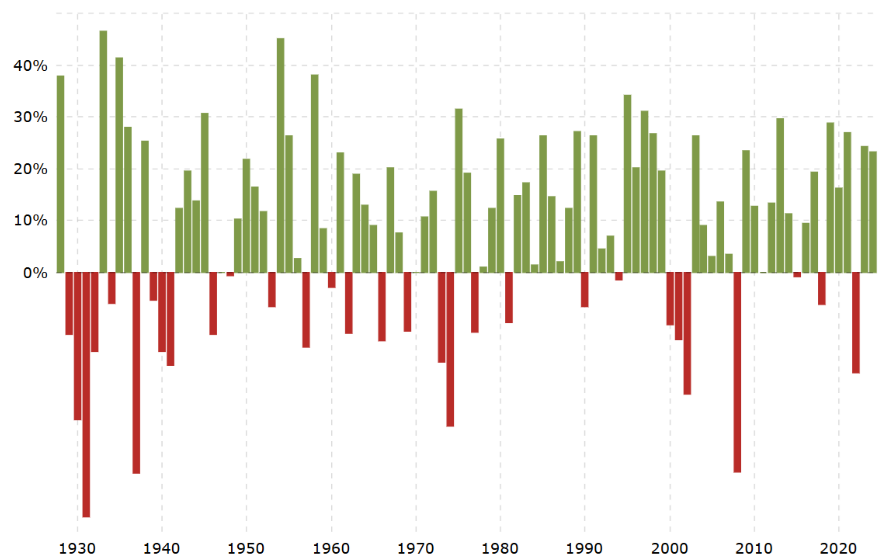
For the last 20, 30, and 100 years, stocks have averaged around an 8-10% annual return, driven by dividend yield, reinvestment of earnings, and earnings growth. Long-term bonds have yielded about 5% on average over the last century while inflation has been about 3%.

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 in general will average an 8-10% return over the next 10+ years. Large stocks have a wider expected range of 5-10% annual returns due to elevated valuation multiples, but also the possibility of higher-than-average earnings growth. 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.

Raymond James is not affiliated with any of the aforementioned organizations.

The Birch Lane Group of Raymond James

Raymond James held over $1.5 trillion in client assets as of 9/30/24, has been profitable for 147 consecutive quarters (since 1988), has equity research coverage of over 1,200 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®, CEPA®, Financial Advisor

Past performance is not indicative of future results. The information provide is for informational purposes only and is not a solicitation to buy or sell Raymond James Financial Stock.

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

Any opinions are those of Randall Watsek and not necessarily those of Raymond James. Expressions of opinion are as of this date and are subject to change without notice. There is no guarantee that these statements, opinions or forecasts provided herein will prove to be correct. Any information is not a complete summary or statement of all available data necessary for making an investment decision and does not constitute a recommendation. Investing involves risk and you may incur a profit or loss regardless of strategy selected. Past performance does not guarantee future results. Asset allocation and diversification do not ensure a profit or protect against a loss. Dividends are not guaranteed and must be authorized by the company's board of directors. Keep in mind that individuals cannot invest directly in any index. The S&P 500® includes 500 leading companies and covers approximately 80% of available market capitalization. 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. Raymond James is not affiliated with and does not endorse, authorize or sponsor any of the listed websites or their respective sponsors. Raymond James is not responsible for the content of any website or the collection or use of information regarding any website's users and/or members.

Raymond James & Associates and your Raymond James Financial Advisor do not solicit or offer residential mortgage products and are unable to accept any residential mortgage loan applications or to offer or negotiate terms of any such loan. You will be referred to a qualified Raymond James Bank employee for your residential mortgage lending needs. Raymond James & Associates, Inc. and Raymond James Financial Services, Inc. are affiliated with Raymond James Bank, N.A., member FDIC. Unless otherwise specified, products purchased from or held at Raymond James & Associates are not insured by the FDIC, are not deposits or other obligations of Raymond James Bank, are not guaranteed by Raymond James Bank, and are subject to investment risks, including the possible loss of the principal invested. Investing in small cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor. The prices of small company stocks may be subject to more volatility than those of large company stocks Raymond James and its advisors do not offer tax or legal advice. You should discuss any tax or legal matters with the appropriate professional.