THE BIRCH LANE PERSPECTIVE

Growth Capital, Business Exit Strategies, and Preserving and Growing Wealth
Volume 34, April 2024

"Success usually comes to those who are too busy to be looking for it."
– Henry David Thoreau

The Main Source of Wealth

As much as I love investing, stocks, and thinking about opportunities and risks during most of my waking hours, I must admit that what I and other financial advisors do is not the main source of wealth for our clients. In reality, the best investment for most people is investing in themselves and their business.

Learning skills, making connections, developing clients, expanding markets, etc., are far more important for the greater part of your business career. The most successful business owners, executives, attorneys, and other professionals are the ones who create a valuable niche and expand their markets.

What I do as a financial advisor is help preserve and grow the fruits of the value you are creating. When appropriate, I can help my clients raise growth capital or explore their business exit options. With prudent investment strategies, tax efficiency, risk management, and compounding returns, the ultimate value can end up being many times the original value, but the source is always your own effort in the unique business you're building.

Most importantly, a good financial advisor helps manage something that's important to your life and family, but not core to the value you are creating. This frees up time, lowers stress, and reduces distraction so you can focus on the most important things in your life.

Raising Growth Capital

Many founders hit a wall when they reach the middle market stage (generally speaking, $10 million to $500 million in revenue, depending on the type of business). In order to get to the next level, they need to raise capital to upgrade research and development, production capabilities, sales and distribution, and create a deeper management bench. Pulling this off successfully can set the stage for significant wealth building and ultimately selling the business for a higher valuation or launching a successful initial public offering.

An investment banker can help you determine the right amount to be raised and how best to put it to work to meet your growth goals. They have the expertise and benefit of having seen what has worked with companies like yours and can help you apply it.

A good banking partner can help with a variety of these needs, ranging from project finance; bank, senior, subordinated, and mezzanine debt; all the way up to structured, preferred or common equity. Bankers can help you raise funds from a variety of sources, whether banks, other institutions, funds, or the public market. They can also help you structure deals to improve your liquidity, diversify your concentration risk, and incorporate tax efficient strategies.

Scattered Retirement Plans

Many people I talk with have worked for different companies. This sometimes leaves them with a crazy quilt of different plans with different strategies, not necessarily coordinated with each other and sometimes in contradiction to each other. Add to that inherited accounts and accounts opened at different firms at different times and it's too often the case that finances are in a mess and hard to keep track of.

Whether you manage your own investments or work with a financial advisor, I recommend keeping your assets with one or two firms unless there is a very good reason to use more. Perhaps one firm for your 401(k) plan and another one for your personal accounts. The best investing is simple, organized, and targeted to meet your short-term and long-term goals while managing risk.

Planning Ahead

If you would like to learn more about how we can help you raise growth capital, prepare to sell your business, improve tax efficiency, or organize your finances for a comfortable, confident, and stress-free retirement, 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.

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 needs, goals, and risk exposure

Last Month’s Winners and Losers

Winners	**Losers**
Value	Theme stocks
Profitability	Biotechnology
Crypto	Brazilian stocks
Gold miners	Indian stocks
Energy	
Housing	

Value stocks and profitable companies came back last month, outperforming the frothier types. However, crypto had another strong month, continuing its run since recovering from the 2022 downturn. Commodities such as gold and energy were also strong, as were homebuilders. Underperformers were more of a mixed bag, with weak performance turned in by theme stocks, biotechnology, and certain international markets.

Although one month is not a trend, the common denominator among some of the commodity-oriented winners is a concern for the persistence of inflation. As much as the market expects the Federal Reserve to lower interests rates in the second half of the year, and they may well do it due to political pressures, inflation has been persistently above long-term targets and feel, to many people, to be at levels not reflected in official numbers.

Stocks

	S&P 500	Dow Jones U.S. Select Dividend	Russell 2000	Bloomberg US Long Treasury
1mo Return	3.2%	6.6%	3.6%	1.2%
YTD Return	10.6%	6.1%	5.2%	-3.2%
10yr Return	13.0%	9.5%	7.6%	1.2%
20yr Return	10.2%	8.4%	8.1%	3.6%
30yr Return	10.7%	11.1%	8.8%	5.5%

Source: FactSet as of 3/30/2024. 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.

After lagging through much of 2023 and the first part of 2024, dividend stocks turned in a strong March. Dividend stocks tend to follow different cycles than growth stocks, but historically the long-term return has been in the same ballpark. For example, over the last 30 years, the S&P 500’s return has been 10.7% annualized, whereas the Dow Jones U.S. Select Dividend Index’s return has been 11.1%. That said, there can be wide differences from year to year.

From what I can see, the most stretched parts of the market from a valuation perspective are the Big Tech companies and anything that rhymes with Artificial Intelligence. These areas make up a large portion of the S&P 500, which makes the index a bit frothy, in my opinion. However, outside of those sectors, I believe that there are many quality companies trading at reasonable valuation multiples. For example, it's not hard to find quality dividend stocks or small cap stocks trading at a 6% earnings yield, which is well in line with historical averages.

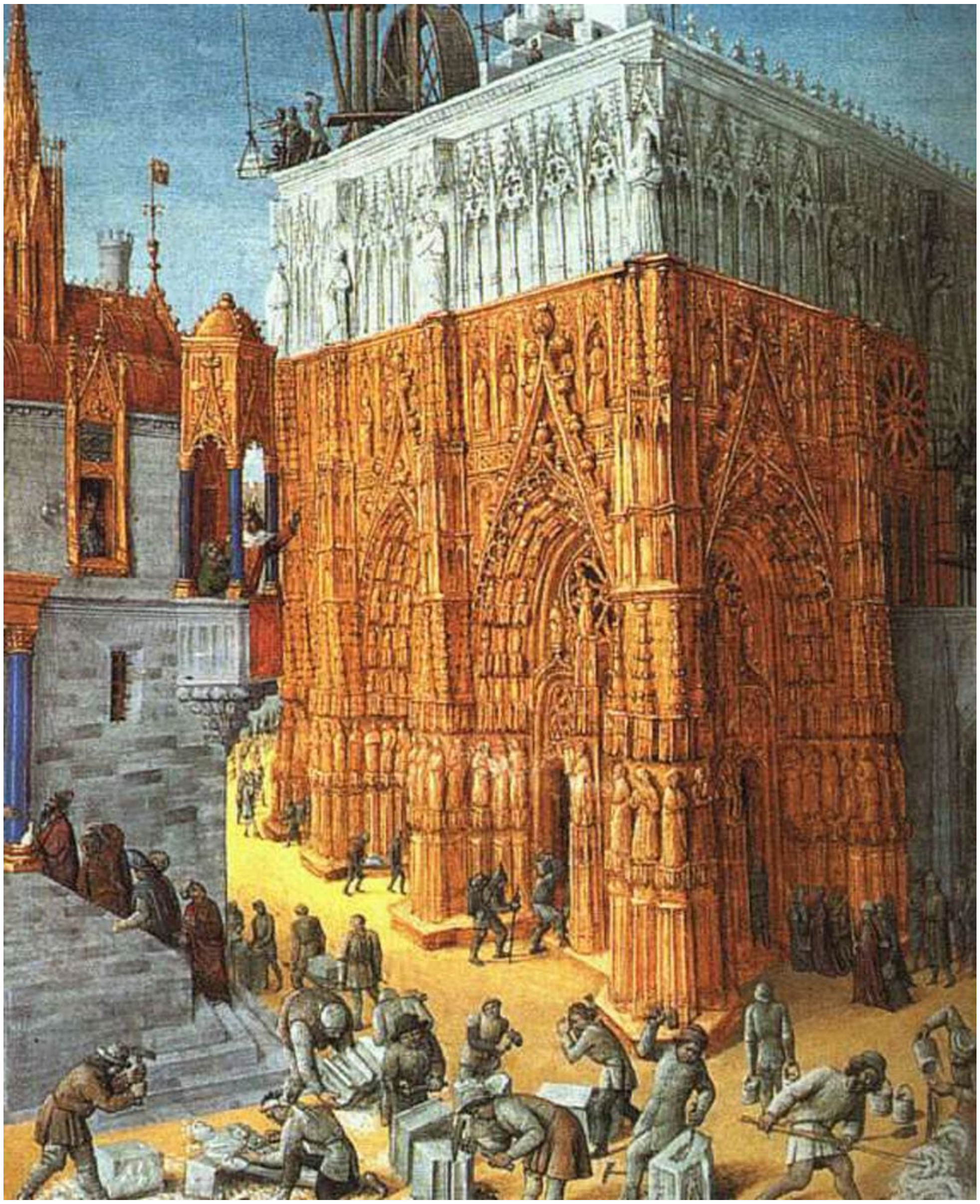
From my perspective, a good balance for equity investors is to be wary of the expensive part of the market, but open to finding value in the parts of the market left behind.

	Large Cap Stocks	**Dividend Stocks**	**Small Cap Stocks**
Dividend Yield	1.3%	3.3%	1.6%
Earnings Yield *	5.0%	6.2%	6.1%
Earnings Growth	11.8%	8.6%	17.2%
Return on Equity	17.1%	13.0%	10.4%
% Losing Money	6.6%	8.4%	40.3%

Source: FactSet as of 3/30/2024. 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.

** "Earnings yield" is an investor's share of earnings for every dollar invested (i.e., earnings per share / price per share). It's the same as the more famous Price / Earnings (P/E) ratio, but expressed as a yield rather than as a multiple. I use it to compare stocks more clearly with bonds and other asset classes. "Equity Risk Premium" equals the Earnings Yield minus the 10-year Treasury Inflation Protected Securities yield.*

Artwork



"Building of the Temple of Jerusalem" by Jean Fouquet (c. 1470). Source: WikiArt.org.

Income Investing

Interest Rates	
1yr Treasuries	5.0%
10yr Treasuries	4.2%
10yr TIPS	1.9%
Municipal Bonds (5yr AAA)	2.5%
Corporate Bonds (5yr A)	4.8%
30yr Fixed Rate Mortgages	7.4%

Dividend Yields	
Common Stocks	1.3%
—Top 25%	4.1%
—Next 25%	2.4%
Preferred Stocks	6.0%
Utilities	3.8%
Real Estate (REITs)	3.9%

Source: Interest rates from Raymond James' Weekly Interest Rate Monitor as of 3/25/2023 and The Wall Street Journal as of 3/30/2024. Source for the Dividend Yields is from FactSet as of 3/30/2024. 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.

Going back to my earlier comments on the persistence of inflation, the negative year-to-date performance of long-term Treasury bonds is further evidence of investors' concerns about inflation persistence. First, if investors expect higher inflation, they will demand higher yields (which require lower prices on existing bonds). This is necessary to earn a real return after inflation. Second, the government is issuing such massive amounts of debt that the Federal Reserve may ultimately be forced to buy the issuances with newly printed money, which could exacerbate inflation.

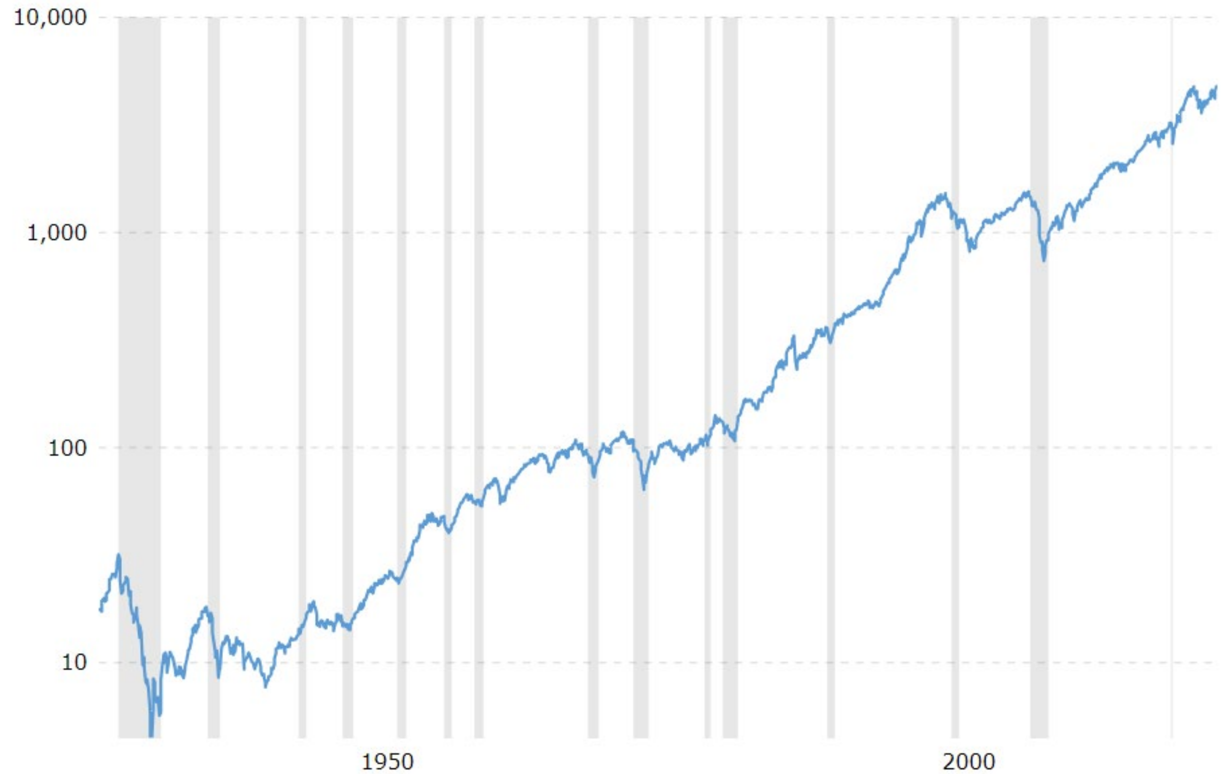
The latter risk is the hyperinflation scenario. So far, Federal Reserve assets have actually decreased steadily since April 2022 as they have worked to rein in inflation, with partial success. But Federal Reserve assets are still well above the pre-Covid levels due to the massive amount of money printed during that time. The real issue, though, is the ongoing federal deficits and the pressures to finance them with newly created money. While not happening now, investors are concerned about the risk that it will become unavoidable at some point.

Given those risks, I continue to believe that long-term interest rates are not particularly attractive. I am keeping my eye on short term instruments of less than one year maturity and dividend stocks that have the potential to increase dividends faster than inflation over time. Although commodities may offer a hedge, I prefer assets that produce independent sources of value such as earnings, dividends, and interest, rather than betting on a particular economic outcome.

** Implied inflation expectations are derived from taking the 10-Year Treasury rate and subtracting the 10-Year Treasury Inflation Protected Securities (TIPS) rate. For example, if the yield on 10-year treasuries is 4.3% and the yield on 10-year TIPS is 1.9%, they are roughly equivalent investments if inflation comes in at the difference (2.8% - 0.4% = 2.4%).*

The Long View

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



Source: MacroTrends.net

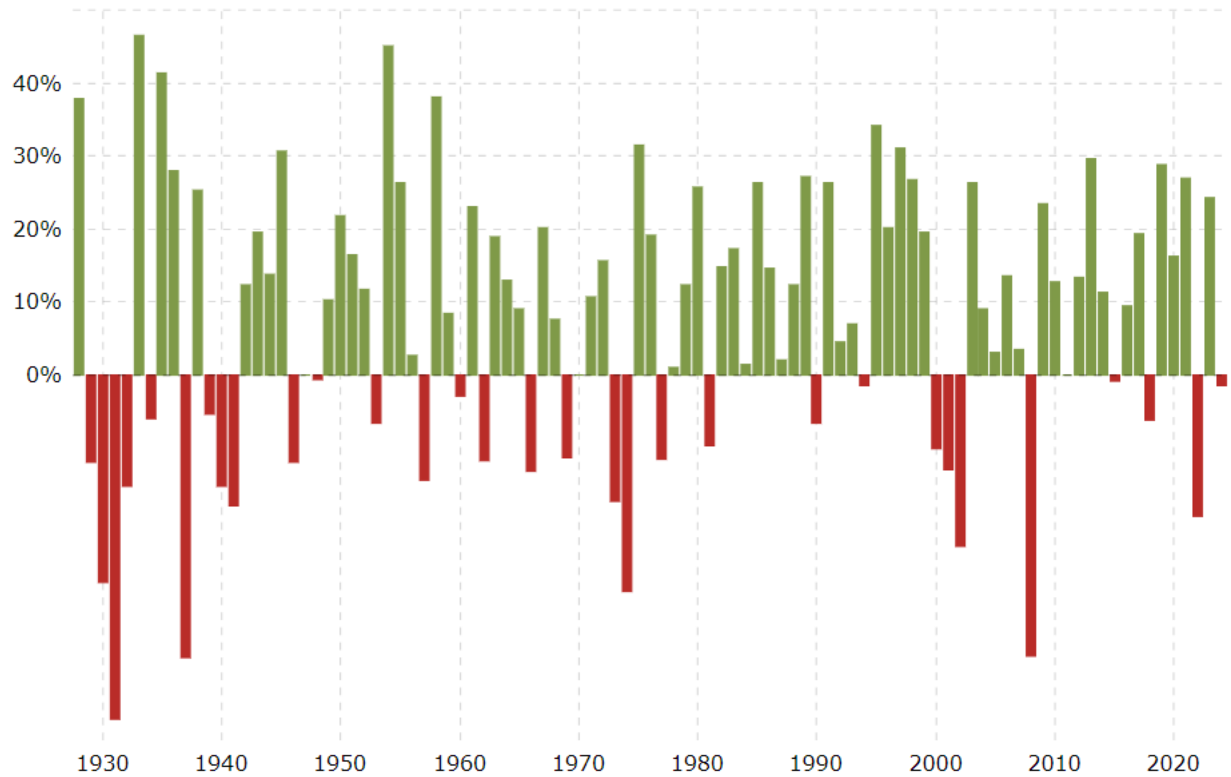
For the last 20, 30, and 100 years, stocks have averaged around an 8-10% return, driven by dividend yield, reinvestment of earnings, and earnings growth. Long-term bonds have yielded about 5% on average over the last century while inflation has been about 3%.

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 3-5% 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 my 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 retirement planning, executive compensation and equity interests, attorney practices, 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?
- What are the odds that you will run out of money?
- How will you handle unique circumstances, such as executive compensation, kids' college education, elderly parents, special needs children, and other elements of life?
- Should you change any savings or investing habits?
- Could you improve any of your current investment choices?

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

Also, I am also available to speak on educational topics such as retirement planning at events and lunch-and-learns you are holding, whether in person around the New York City area or by video anywhere in the country.

Biography

Randall Watsek and the Birch Lane Group currently maintain or advise on over $200 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. He leveraged this experience to start an investment advisory practice at Raymond James.

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.

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, Registered Client Service Associate
Randall Watsek, CFA®, CFP®, Financial Advisor