THE BIRCH LANE PERSPECTIVE

Risks and Opportunities in the Prudent Accumulation of Wealth

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Cutting Losers

> "The first loss is the smallest loss."
> —Wall Street proverb

One of the things I often see is people is holding onto losers. It's understandable in a sense because it can feel like the losses are not real if we don't recognize them.

But there are real costs to holding onto an underperforming investment. The most important of these is that we prevent ourselves from deploying that capital in something else that might do better. In other words, we might feel better waiting for a stock to go back to what we paid for it, but that might be a long wait. And in the meantime, we might have missed out on something else that could have done a lot better. Besides that, there are significant tax advantages to realizing losses in a taxable account.

At the core, I think, is accepting a certain amount of humility when it comes to investing. It is painful to recognize a loss because it hurts our pride. We feel like we were wrong. And if only it comes back to the price we paid, then maybe we weren't wrong after all.

But I don't look at it that way. Investing is always about probability and there is always a good chance of being wrong. There's no guru, no matter how brilliant, who is right all the time. There might be some that are right more often than average, and that allows them to do well. But even so, they are still wrong much of the time. By accepting that and moving on when we're wrong, we have the potential to improve the quality of our investments over time.

So how do we know when we're wrong and it's time to move on?

I would not follow hard-and-fast rules such as a fixed percentage or a stop-loss rule. Everything is about context and using judgment. There is truth to the other side of the coin: if a company is a good value at $20, it might be a better value at $10. This, of course, assumes that it's just as good a company as we thought it was originally.

But that decline is a signal that maybe, just maybe, we got it wrong or that the business deteriorated. At a minimum, it's time to reevaluate the business fresh and consider whether we would buy it now if we did not already own it. But this is difficult as we have a habit of changing our stories to justify holding onto a stock we don't want to sell for emotional reasons.

If there is any doubt, I would err on the side of selling the loser and moving on. The fact is that there are many good companies out there and perhaps dozens of great companies. Why miss out on the opportunity to own one of them by having money tied up in a company that has disappointed?

Personally, I believe this habit can save investors from having small mistakes become bigger mistakes and opens the door to better opportunities.

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, goals, and risk exposure

Financial Planning

If you would like to learn more about how we can help you 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.

Last Month's Winners and Losers

Winners	**Losers**
Large cap	Small cap
Value	Dividend stocks
Profitability	Risk
Capital efficiency	Silver
Momentum	Chinese stocks
Semiconductors	Theme stocks
Tech stocks	Regional banks

Last month favored better quality companies—large cap stocks, profitable companies, capital efficient companies, and companies with less debt. Tech stocks continued to shine with strong earnings reports.

Losers for the month were riskier companies, such as small cap, unprofitable businesses, highly levered businesses, regional banks, and theme stocks. Dividend stocks also underperformed, as did Chinese stocks.

Stocks

	S&P 500	Dow Jones U.S. Select Dividend	Russell 2000	Bloomberg US Long Treasury
1mo Return	1.7%	-1.8%	-3.9%	-2.2%
YTD Return	1.7%	-1.8%	-3.9%	-2.2%
10yr Return	12.6%	9.3%	7.0%	1.5%
20yr Return	9.7%	8.1%	7.7%	3.9%
30yr Return	10.1%	10.5%	8.3%	5.2%

Source: FactSet as of 2/3/2024. 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.

Most areas of the market were down, with underperformance among small caps and dividend stocks. However, strength among the Big Tech companies and other large, profitable companies drove the S&P 500 to a positive return last month.

Looking at the characteristics of different equity markets, they seem appealing to long-term investors. Earnings yields average around 5-6%, depending on which segment of the market you're looking at, and earnings growth expectations range from 7% to 13%, depending on the segment. When I look at individual stocks, I am not having a problem finding ones I think are appealing from a value perspective.

	Large Cap Stocks	Dividend Stocks	Small Cap Stocks
Dividend Yield	1.4%	3.5%	1.6%
Earnings Yield *	5.3%	6.6%	6.3%
Earnings Growth	10.0%	7.5%	12.8%
Return on Equity	16.9%	13.3%	10.2%
% Losing Money	6.4%	7.9%	40.4%

Source: FactSet as of 2/3/2024. 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.

** "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

"Flying Carpet" by Viktor Vasnetsov (1880). Source: WikiArt.org.

Income Investing

Interest Rates	
1yr Treasuries	4.8%
10yr Treasuries	4.2%
10yr TIPS	1.8%
Municipal Bonds (5yr AAA)	2.5%
Corporate Bonds (5yr A)	4.6%
30yr Fixed Rate Mortgages	7.2%

Dividend Yields	
Common Stocks	1.4%
—Top 25%	4.6%
—Next 25%	2.8%
Preferred Stocks	6.0%
Utilities	4.1%
Real Estate (REITs)	3.8%

Source: Interest rates from Raymond James' Weekly Interest Rate Monitor as of 12/18/2023 and The Wall Street Journal as of 2/3/2024. Source for the Dividend Yields is from FactSet as of 2/3/2024. 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.

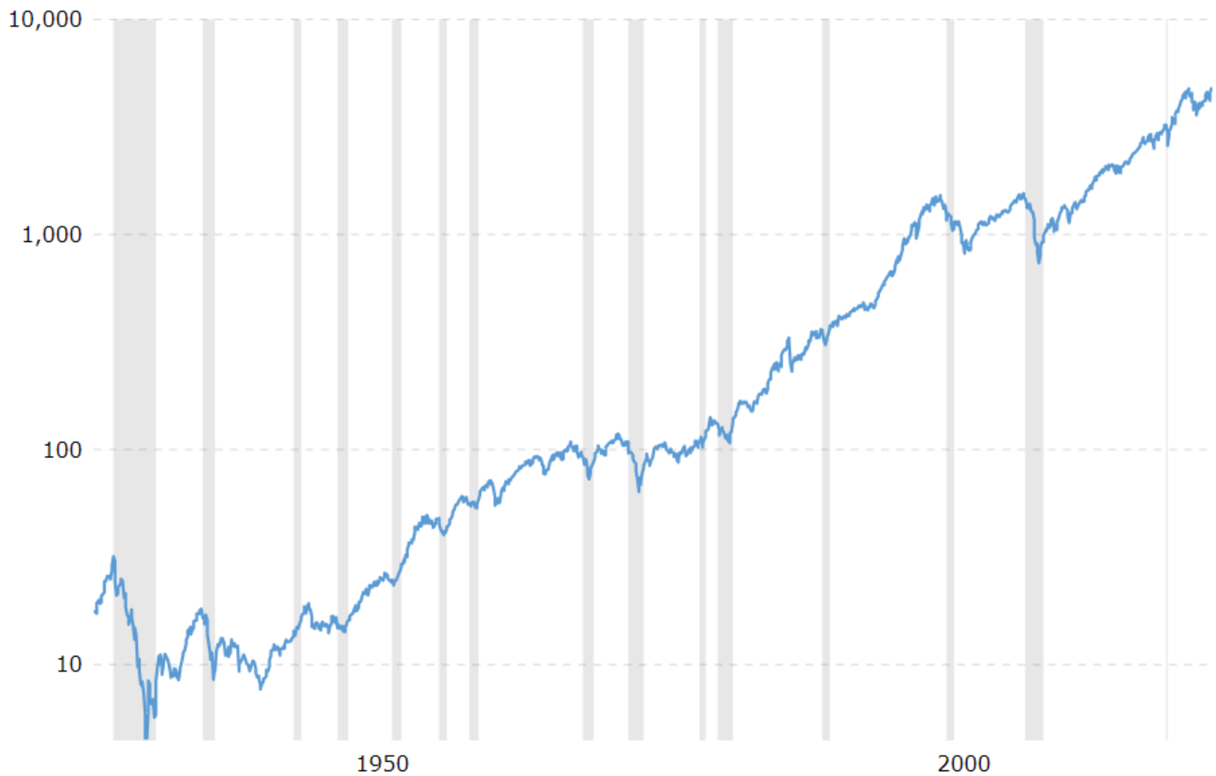
Core inflation continues to come in at the 3-4% level and has not really improved over the last twelve months. Given the Federal Reserve's target of 2% inflation, this implies that it will not ease rates soon. For some reason, this surprised the market and drove negative performance among interest-sensitive sectors when the Federal Reserve suggested this. However, it really should not have been a surprise given the lack of evidence for inflation coming in further.

I continue to believe that long-term interest rates are not particularly attractive given persistent inflation. For that reason, I would stick with short term instruments of less than one year maturity or invest in dividend stocks that have the potential to increase dividends faster than inflation over time.

** 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

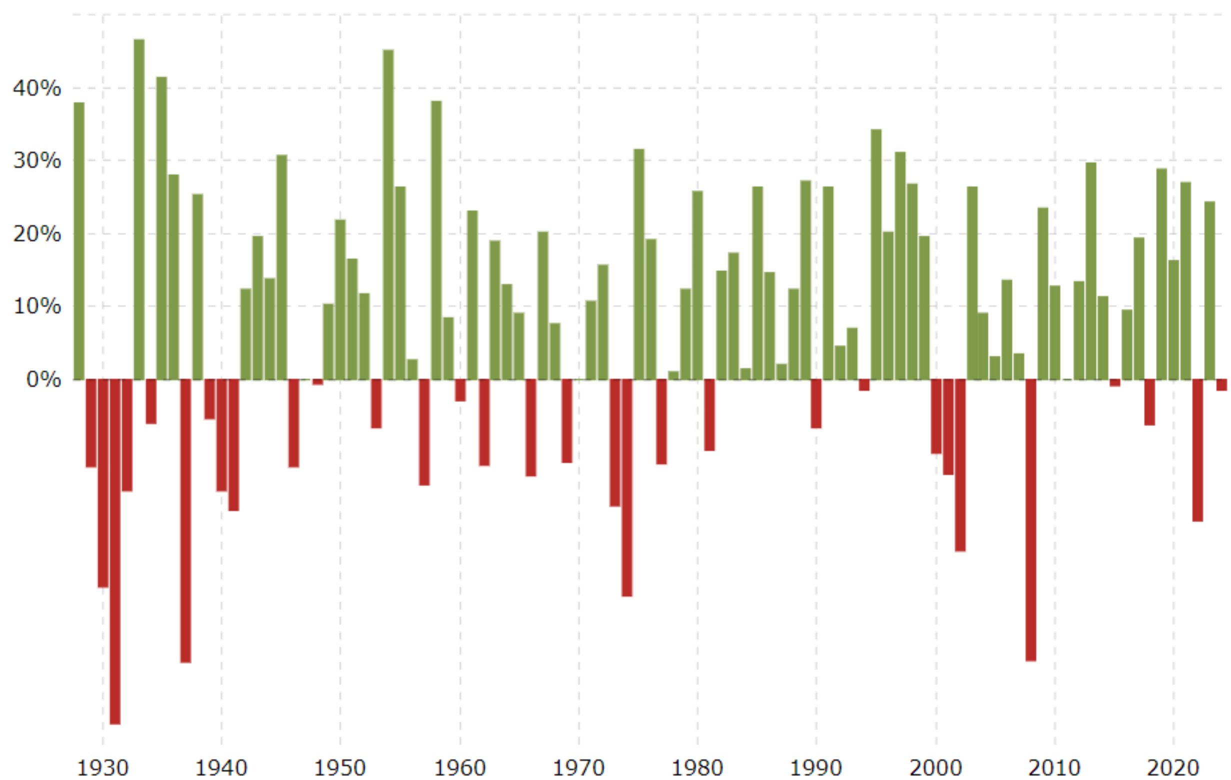
For the last 20, 30, and 100 years, stocks have averaged around an 8-10% return, driven by dividend yield, reinvestment of earnings, and earnings growth. Long-term bonds have yielded about 5% on average over the last century while inflation has been about 3%.

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 2-4% 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, though we will probably slip into a recession this year.
- 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 $200 million in assets. The team consists of:

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

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.