Quarterly Newsletter

Roth FINANCIAL PARTNERS

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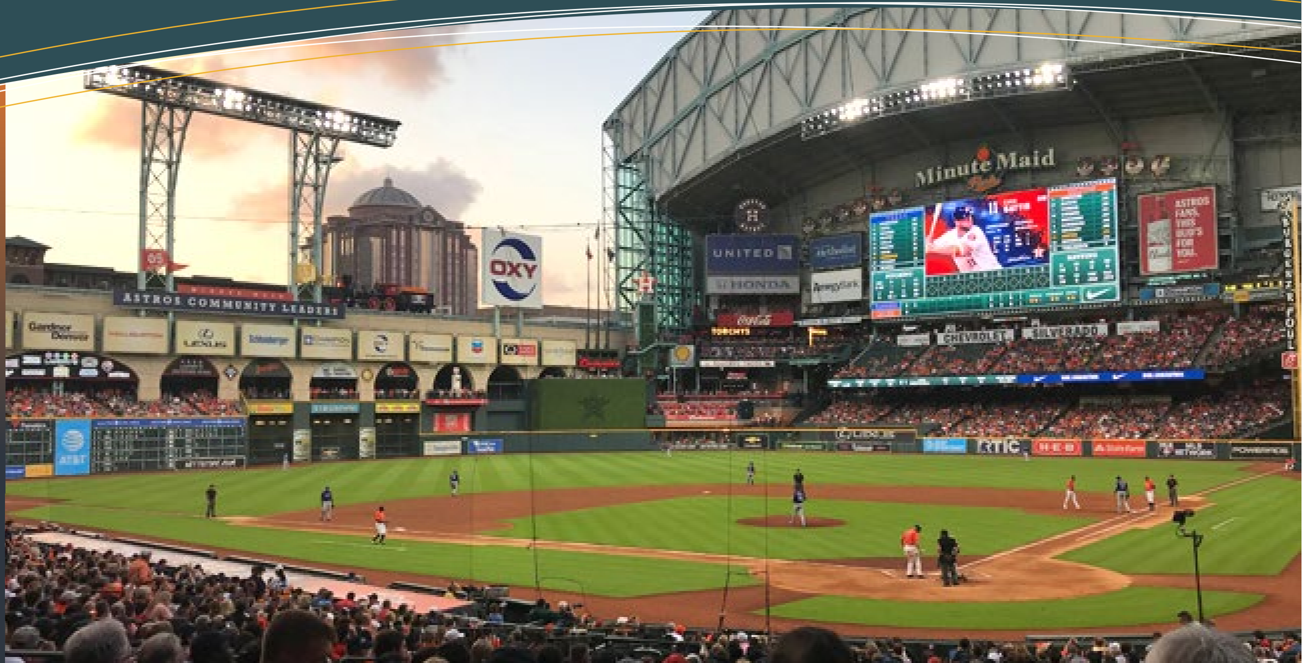

October is Here!

By: Eric Johnson
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October is here: in Houston, the heat (finally) gives us a slight reprieve, folks start walking in their neighborhoods again, and radio stations get their Christmas music playlists ready. More importantly (at least in my eyes), it is the beginning of Major League Baseball's playoffs and as we have become accustomed in the area, an exciting playoff run by the Houston Astros. To be frank, Astros fans have become spoiled by the team's recent success (five consecutive American League ["AL"] Championship Series berths with three AL championship victories and one sweet and not-at-all controversial World Series ring in 2017.) As the team enters the playoffs this year as the #1 ranked team in the AL, expectations are high for another deep run.

As a diehard Astros fan, you would think that the playoffs are a time of pure elation for me, especially given their recent run of success. However, if you asked my wife about my emotional state in October each year, you would be surprised to learn that though

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there are fits of joy sprinkled about during the playoffs, I usually find myself pacing in a nervous manner or even sitting in a slumped bit of defeat. I admit that I am not the most fun viewing partner when it comes to watching Astros playoff baseball.

Why am I such a “Debbie Downer” in October? Three reasons come to mind:

1. When you win a World Series championship, that becomes the new high bar going forward. Anything less becomes a disappointment. Imagine telling a Seattle Mariners fan how disappointed you are that your team has been to the World Series three times in the past five years but lost twice, while their team had not even been to the playoffs in over twenty years (until this year!)

2. Before the Astros recent run, they were in the dregs of the league – and I loved every minute of it. I had hope for the future and little victories felt huge. When they lost, it was not a new phenomenon and because the city did not have “Astros fever,” others around me did not have a level of disappointment or really care that much.

3. In a strange way, I try to protect my emotional state by feeling the worry/disappointment early so that when the Astros lose or a bad event happens (inevitably, in my assumption), I am not as crushed. This pessimism is a drain, especially when the bad event that I am assuming will occur does not actually come to fruition. It is easy to convince myself to be negative about what is going to happen.

It should not be a surprise to you that I am about to compare my playoff emotions to where we stand from a financial markets perspective. There is no getting around the fact that it has been an ugly year so far in terms of investment returns for (most) financial assets. With three months left in 2022, multiple incredibly surprising events would have to occur for the calendar year to be one that ends positive. Looking at recent returns colors our viewpoint for the future – if there have been recent losses, we assume that losses will continue. After positive years, we are filled with optimism. There is no denying that we all fall prey to the recency bias in both directions.

I am thankful that I can keep a much more level head as it relates to financial markets compared to my Astros fandom. Here is how I am fighting those three “Debbie Downer” sets of thoughts going forward in investment portfolios:

High Bar

On Monday January 3rd, 2022 (the first trading day of the year), the S&P 500 index (the index we use as a solid representation of U.S. stocks) closed at a level of 4,796.56. The next day, the index slightly dropped by less than a tenth of a percent. We could not have known that through the end of the third quarter of the year (9/30/2022), we would not see a value in the index that high again and instead would be see a drawdown of over 25% year-to-date (not including dividends.) As investors, we have become used to seeing all-time highs and (mostly) positive returns from U.S. stocks – here is a table showing annual returns since 2013 and the number of days in which an all-time high was established in the S&P 500:

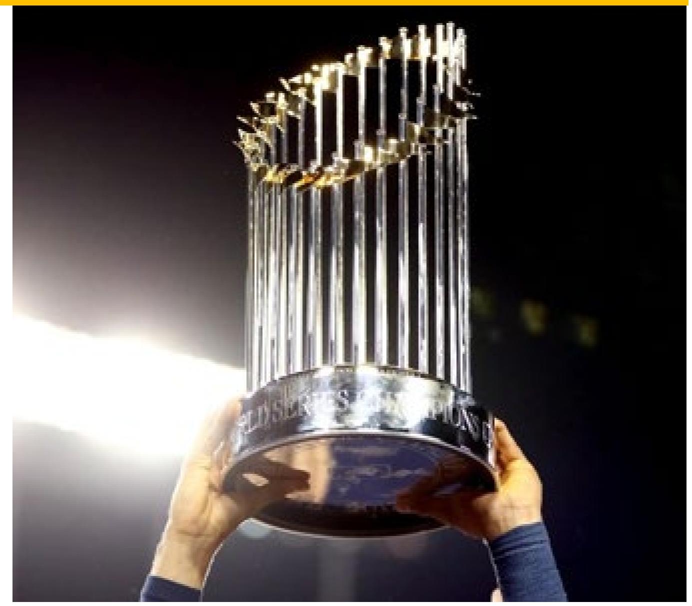
Year	Annual Return	All-Time Highs
2013	32.39%	49
2014	13.69%	56
2015	1.38%	12
2016	11.96%	22
2017	21.83%	67
2018	-4.38%	21
2019	31.49%	35
2020	18.40%	38
2021	28.71%	80
Avg (2013-2021)	17.27%	42

Being in a drawdown (i.e., being less than the all-time high) is not enjoyable and can feel defeating; however, let us repeat the chart above with one more column:

Year	Annual Return	All-Time Highs	# of Days in Drawdown
2013	32.39%	49	203
2014	13.69%	56	196
2015	1.38%	12	240
2016	11.96%	22	230
2017	21.83%	67	184
2018	-4.38%	21	230
2019	31.49%	35	217
2020	18.40%	38	215
2021	28.71%	80	172
Avg (2013-2021)	17.27%	42	210

Whenever you are not at an all-time high, you are technically in a drawdown (being less than the all-time high). In the extra column, I took the number of trading days in the year (usually 252 days, with certain years slightly higher or lower) and subtracted the number of days with all-time highs.

On average, in the nine years (2013-2021) in which there were 380 days in total in which the S&P 500 reached an all-time high and the index averaged **over 17%** a year, investors spent over 83% of trading days under the high point. If the all-time high is your "bogey," then you are going to be disappointed almost all the time when you're comparing with that high mark. Similarly, if you are only going to be happy with a World Series championship, then most years you are going to be disappointed when another city hoists the trophy.



Comparisons

The price of a stock is a function of the millions of dollars of trades that exchange hands (or electronic accounts) each day. When a stock is sold, it must also be bought ("duh," you may say, but it is an important idea to remember.) Investment professionals sometimes use a model called the "Dividend Discount Model" to calculate what the price of a stock should be based on the "sum of all of [a stock's] future dividend payments when discounted back to their present value." To peel back the onion a little more, dividends are payments to shareholders of accumulated earnings of a company. Therefore, earnings are key to the future payment of dividends and thereby to the price of a stock.

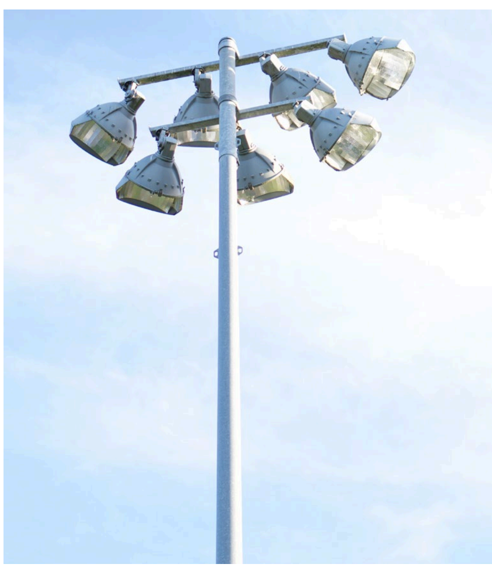
A stock's price, on a very high-level, can be broken down into two parts: the earnings of a company ("E") and then the valuation of a company, or how cheap or expensive at which the company's stock is selling. Here, we will use a valuation metric called the "Price/Earnings ratio" or "P/E" as a representation of cheapness/richness. Bear with me quickly for an example: Company A has a stock price of $100/share on Day 1 and the market expects future earnings for the company in 2023 to be $5/share (since markets are forward-looking, future earnings are often used for valuation purposes.) Using quick math, we can calculate the P/E ratio to be the price per share ($100) divided by the earnings per share ($5), equaling a P/E ratio of 20. If the stock price increases to $105/share (a 5% increase) on Day 2, what has changed?

	P/E	Future Earnings	Price
Day 1	$20	$5	$100
Day 2	?	?	$105

Well, based on this high-level assumption, it must mean that either A) investors are willing to pay more for a stock (the P/E ratio goes from 20 to 21), B) earnings expectations have increased (expected 2023 earnings go from $5/share to $5.25/share), or C) a mix of the two.

	P/E	Future Earnings	Price
Day 1	$20	$5	$100
Day 2 (A)	$21	$5	$105
Day 2 (B)	$20	$5.25	$105

From 12/31/2021 through 9/30/2022, the expectation for earnings growth in the next twelve months for the S&P 500 has increased around 5%. If the P/E ratio (valuation) for the companies in the index had stayed the same from the beginning of the year through the end of the third quarter, then we could be looking at a healthy ~5% return year-to-date (not considering dividends.) However, instead of a steady or increasing P/E ratio (valuation), the valuation has decreased by almost 30% (from 21.4 to 15.1)! Why is that the case? Multiple reasons, including the increase in interest rates (most likely the biggest difference maker), changes in projections of even further out earnings, and pure investor sentiment (fear).



However, decades of history have shown that we are more likely to have higher returns in the years ahead when you start off with lower valuations. Compared to the beginning of the year, stocks are being bought at a lower valuation. There is no guarantee that valuations cannot become lower in the near term but investing with lower valuations usually pays off in the long-term. Though it may feel like being in the dregs, the future is usually brighter than it seems in the present.

Another comparison to be made is between asset classes. Almost all major asset classes have been struck by consternation in 2022. Compared to U.S. stocks, international stocks (both developed markets, like Japan and the U.K, and emerging markets, like China and India) have also dealt with a headwind of a strengthening U.S. dollar, with a common basket of currencies drawing down a bit more than 17% compared to the dollar through 9/30/2022.

More strikingly, fixed income (bond) yields continued their upward climb in Q3 2022, with the ten-year Treasury yield increasing to 3.83% as of 9/30/2022. Compared to year-end 2021 and even Q2 2022, it has been an incredibly quick increase in rates and thus in the near term, a decrease in the value of fixed income (bond) assets.

	12/31/2022	**6/30/2022**	**9/30/2022**
10 Yr. Yield	1.52%	2.98%	**3.83%**
	Increase	1.46%	**0.85%**

Just like when a whole city feels the sting of an Astros loss, feeling surrounded by asset classes that are in a drawdown weighs heavier, as if there is nowhere to hide from the drubbing. Fixed income has, until recently, played a role as a ballast in a portfolio – when equities get hit, fixed income usually acts as a stabilizer. Inflation and its heavy impact on interest rates made fixed income draw down as well so far this year. However, as discussed in last quarter's letter, fixed income returns can be calculated more precisely than equity returns, and the beginning yield of bonds has an even stronger relationship to future returns than the beginning valuation of stocks. Our expected return assumptions for fixed income have increased markedly in the past nine months, which plays a significant role in modeling out cash flows for those who are in the decumulation phase of their portfolios.

Easy to Be Bearish

It is quite easy to point out the events/actions that have occurred in the past nine-to-twelve months that have negatively impacted investment returns. By recounting those things, from an emotional point-of-view, it feels rational to feel negative about the future. Using my baseball example, if the Astros give up three runs in the first inning, it is easy to throw my hands up and decide that the next eight innings of baseball are pointless or could even get worse. You would think I would learn my lesson by now, after seeing so many come-from-behind victories!

However, the challenging thing to grasp about markets is how much of a forward-looking mechanism they are. The stock market and bond market *already know* that things are bad. We can quibble all we want about whether we are currently in a recession or not or how deep of a recession could be upcoming. All that matters going forward, though, is how good or bad things are compared to expectations (or to dive a level even deeper, how good or bad things are *compared to expectations* of market participants' expectations – it gets complex quickly.) This also makes it so much harder to "time the markets" – markets will turn before the news does.

From a planning perspective, regardless of how we feel about where markets currently are, we assume that markets will be choppy in the near-term. This is why we seek to know about future cash flows (with time to spare) so that we ensure clients have the cash/liquidity available for the gifts, items, or experiences that clients use their savings for and not have to worry about any events that could make markets move.

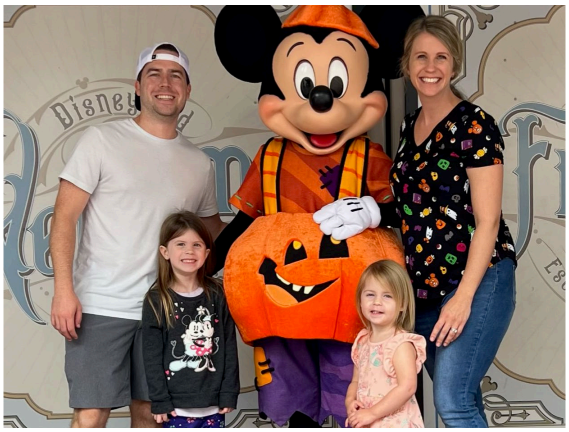
The recent ride in markets has not been fun and we do not know how long this drawdown will last. Based on market history, solid returns have previously been provided following such downdrafts when considering the following years (not necessarily months or quarters.) We believe strongly that the human spirit will prevail through chaos and that innovation will continue to reign in capital markets. We cannot ask you to change your emotions, as we believe that God created us as emotional beings. However, we are thankful for the opportunity to work with you and walk with you as you carefully consider those emotions as it relates to your financial picture.

Around The Office Updates

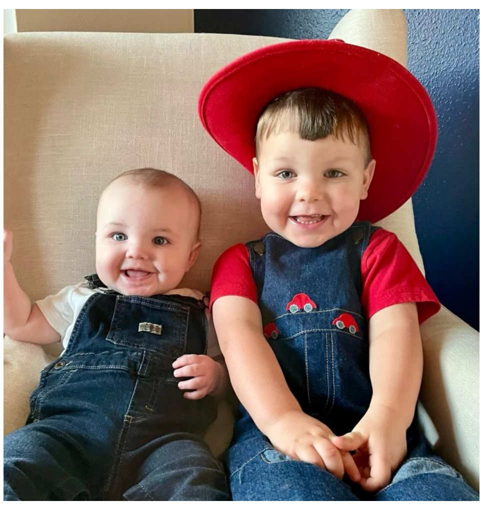
Looking Into Q4

Copies of Tax Returns

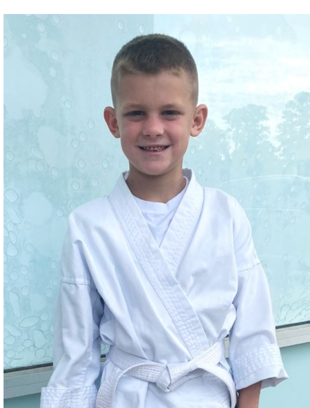
If we have not already received a copy of your 2021 tax return, we would like to get a copy from you at your convenience. This allows us to maintain updated information as it relates to your financial plan.

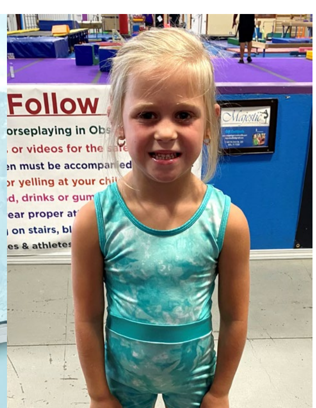


Jimmy and Sandi recently took the girls to Disneyland, where they got to meet every character and princess possible. (They also rode "It's a Small World" just under 10 times). The trip was filled with lots of laughs, good food, and fireworks. Kaylee, who turns 5 this month, has already asked if she can go back for Christmas.



As the temperatures drop and the air gets a little drier, the Johnson crew has been enjoying lots of evening walks. Abe (2 ½) and Jonah (9 months) like to play outside as often as they can. With Halloween quickly approaching, they are in the thick of deciding which costumes they will wear and what neighborhood route they'll be taking. Overall, it's an exciting time!





Stephanie's grandchildren, Eli (almost 8) and Georgia (6), are ever-busy with their weekly activities. Eli has recently gotten into Taekwondo and will be breaking boards in no time! Meanwhile, Georgia is flourishing in both dance and gymnastics. Who knows, maybe they'll both compete in the Olympics one day!