A Little Doubt Might *Still* Serve

Houston AAII Retirement SIG
Rohit Millstein
Sept 14, 2023

Caveat Emptor!

I am a Registered Investment Advisor Representative of Millstein Advisors, LLC, a Registered Investment Advisor.

This presentation <u>is not</u> a recommendation for any particular tactic, strategy, purchase, sale or other transaction. <u>This presentation is informational</u>.

The following are some ideas you may find useful. It is impossible for me to know whether any of these ideas are appropriate for your particular situation. As Members of AAII, I fully expect that you will be able to make that judgment for yourself.

Overview

Buffering … Do it Yourself versus available ETFs

Some thoughts on evaluating markets

And let’s revisit our doubts from June last year

Buffer Overview

- An increasing number of sponsors have created ETFs of the sort
  - Cap your gain at X% for the next year in return for downside protection of Y%
    - For example: Gains for the next year are capped at 19%, but you won't lose anything in a market down 9% or less.
- We'll look at just one sponsor, Innovator
  - No particular reason; just happened to get their email first

Innovator Buffer Choices for Sept 1

September Buffer ETFs				
Ticker	**Ref. Asset**	**Buffer**	**Term**	**Starting Cap**
BSEP	SPY	9%	12 mos.	19.76%
PSEP	SPY	15%	12 mos.	14.97%
USEP	SPY	30% (-5% to -35%)	12 mos.	14.63%
ISEP	EFA	15%	12 mos.	19.30%

- This should be read as "If I invest at the inception of the PSEP, I will be protected against a market drop of 15%. In return for this protection, my gain for the year is limited to 14.97%"
- These outcomes are achieved using options. Innovator uses customized "FLEX" options allowing them to provide protection of exactly 9% or 15%, etc.
- Their claim is that these options are bought and sold in such size that the result is better than what one can do with the public markets.
- Let's check out that claim....

Do It Yourself Buffer

- On 8/31, SPY closed at 450.35
  - 9% down = $409.82
- The public market does not have an August 31, 2024 expiration date
  - We have to use Sept 20, 2024 or 386 days rather than 365
- Purchase downside protection with puts
  - Buy the Sept 2024 445 puts
  - Sell the Sep 2024 410 puts (8.96% below the current SPY price)
  - Cost is $8.40
- Pay for the puts by selling Sept 2024 $520 call for $7.45
- We paid $0.95 more for the puts than we got for the calls
  - But the last SPY dividend was $1.63 and we'll get four of them = $6.52

Do It Yourself Buffer - Outcomes

- What can happen as of Sept 20, 2024?
  - SPY is at $450, down $0.35 from where we bought it
    - All the options are worthless. We lost $0.95 on the set up
    - But we earned ~$6.50 in dividends
      - Net profit ~$5.50
  - SPY is at $410, down $40.35 or around 9%
    - The calls we sold are worthless, but the 445/410 put spread is worth $35
    - Add the dividends to the put spread, and we have $41.50
    - We have a slight profit:
      - SPY = 410 + 41.50 from options & dividends = $451.50
        - We paid $450.35 for SPY plus $0.95 for the options = $451.30
      - We made $0.20 (woohoo!) while SPY fell 9%
  - SPY goes up
    - If SPY goes up, the puts will expire worthless
    - We pocket any gain up to $520, the strike price of the calls we sold
      - Plus the dividend
    - Upside with dividend is $520 + $6.52 - $0.95 = $525.57 = **16.7% upside**

Innovator Is Right!

- For a 9% downside buffer
  - Innovator provides upside of 19.76%
  - Our DIY version is capped at 16.70%
- For a 15% downside buffer
  - Innovator provides upside of 14.97%
  - Our DIY version is capped at 12.14%
- The DIY version allows you to keep the dividend
  - And for some modest moves up or down, DIY therefore beats Innovator

Last Thoughts on Buffer ETFs versus DIY

- Available Buffers
  - SPY is widely available as ETF. Innovator has EFA as well. IWM is likely, too
  - DIY can be deployed on anything with sufficiently liquid options
    - SPY, IWM, EFA, EEM, IYR (I have current positions in all these)
    - Other possibilities: GLD, S&P industry ETFs such as XBI (Biotech), even BRKB or NVDA
  - For truly liquid things like SPY & IWM
    - A variety of ETFs, but generally with the same time frame
    - For DIYers, you can choose
      - E.g. Currently have some buffers which run past the 2024 election
  - Mid Course Adjustments
    - Not clear to me whether "extra" profit may be squeezed from ETF
      - Though I imagine the IRR can be increased by selling early in a rally
    - In our example, if SPY rallies, one might choose to "lift" the bottom of the buffer for an additional credit
      - We started with 445/410. Maybe roll to 445/425 if SPY is up 30 or 40 points from our purchase

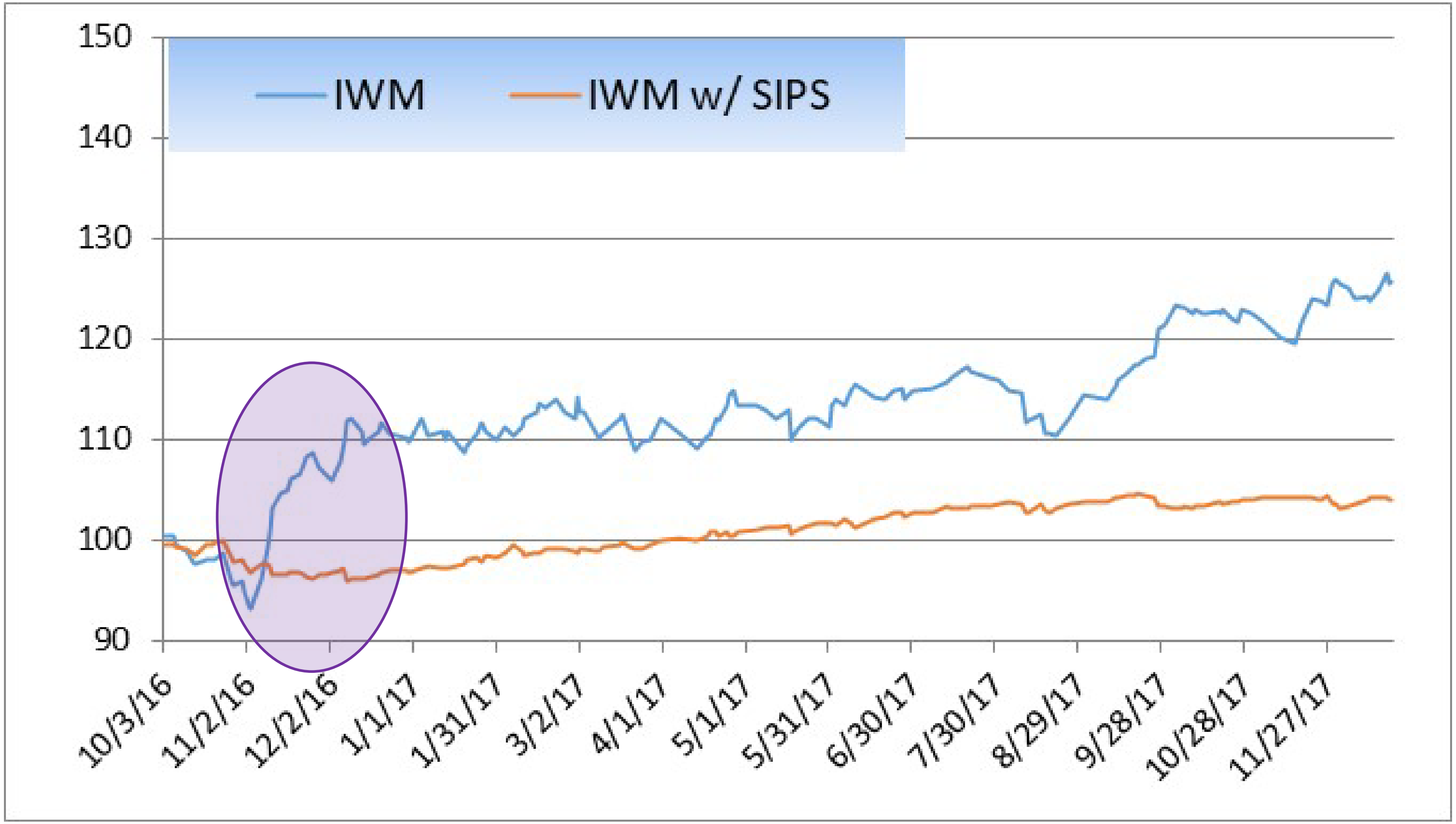
Buffered Out?

Questions/Thoughts on Buffers?

Thoughts on Evaluating Markets

- On Oct 1, 2016, I opened an investment fund that would invest exclusively in IWM and SPY
  - Both investments would be hedged using an options method I invented
    - Method = “SIPS” for Steady Investment Performance Strategy
  - This method allows upside and crushes volatility
- You might remember a strange thing happened late in 2016
- Here’s what fund did….

Opening Days Of Lisson Grove Steady Growth



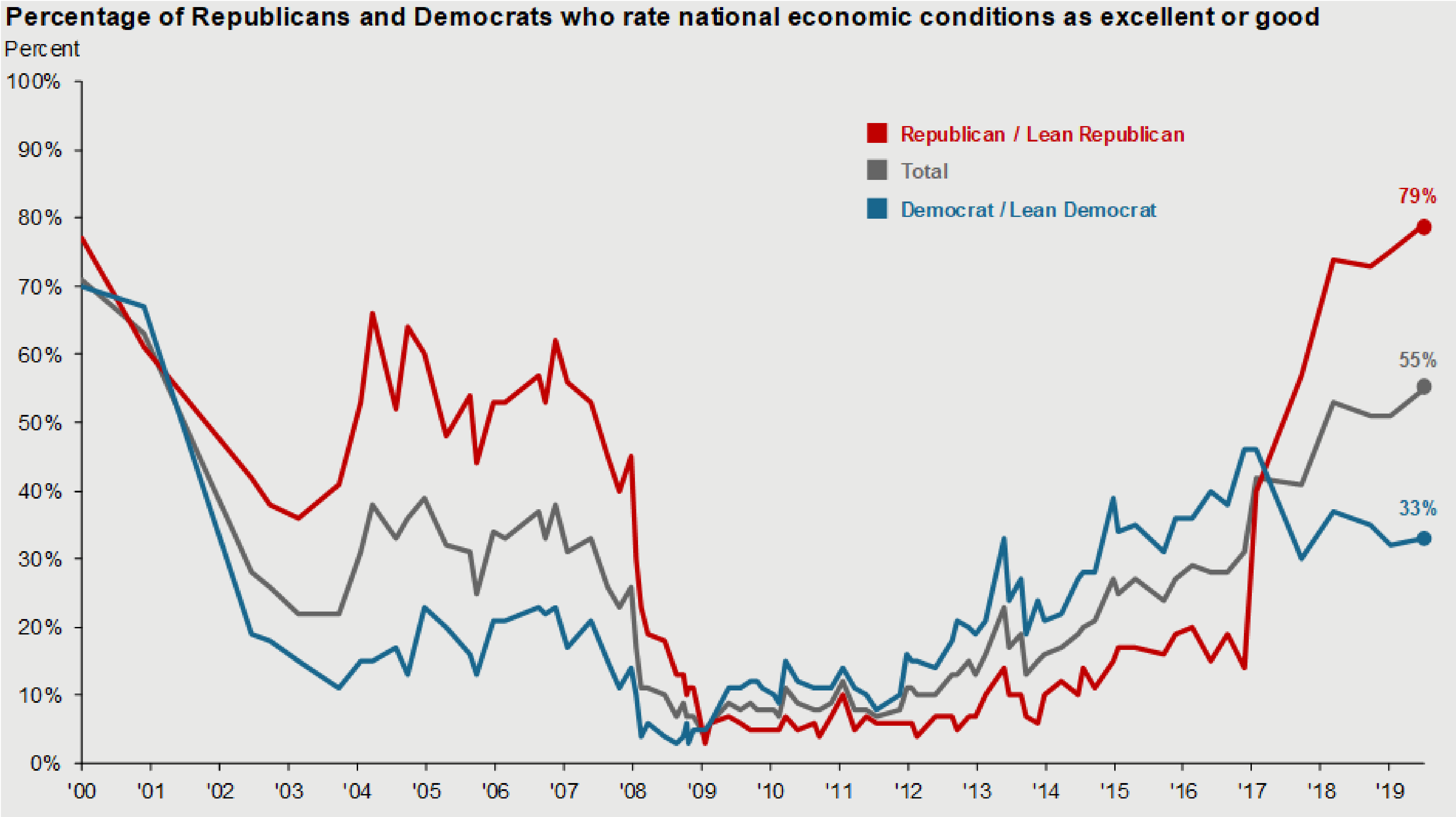
Me Thinks Me a Bit Blind

- Trump was elected and I was certain, certain!, the market would tank
- Icahn famously left a party in the middle of the evening to purchase a billion dollars worth of futures.
- He was right
  - S&P 500 TR Index was up 1.11% on Nov 9, 2016
    - And another 1.81% by month end
  - Russell 2000 TR Index was up 3.10% that day
    - And another 7.42% **(!)** by month end

Blind Means I Can't See

- Over and over again, I broke the trading rules for SIPS
  - After all, the market was going to crack
    - I "knew" this was true
- Then I read a WSJ article about how many conservative investors had missed the entire rally of the Obama years
  - Market bottomed on March 6, 2009, S&P 500 = 666 briefly
  - Closing low was 676 on Mar 9
  - Closed election day 2016 at 2140
  - A gain of 217% or, roughly 16.4% annualized
  - (Barron's graph)
- Only then did we return to SIPS trading rules…and things improved

It Wasn't Just Me



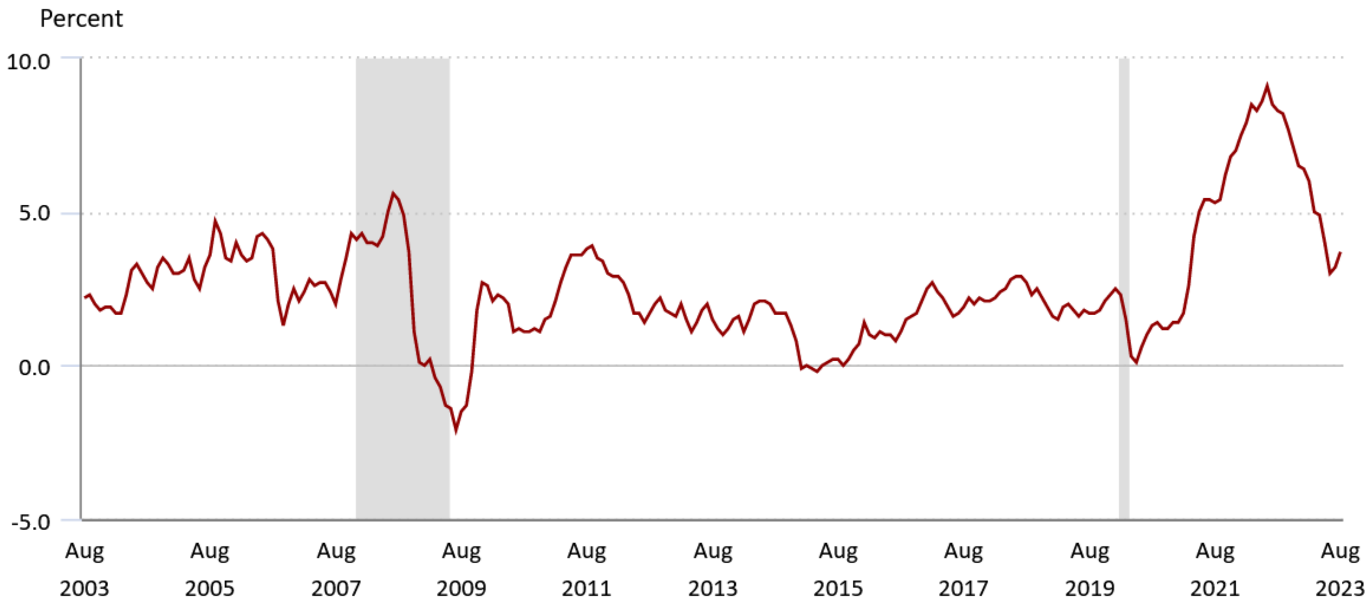
Source: Pew Research Center, J.P. Morgan Asset Management. Pew Research Center, July 2019, "Public's Views of Nation's Economy Remain Positive and Deeply Partisan." Question: Thinking about the nation's economy, How would you rate economic conditions in this country today… as excellent, good, only fair, or poor?
Guide to the Markets – U.S. Data are as of November 30, 2019.

J.P.Morgan
Asset Management

How Blind Can One Be?

- How about this nugget received Saturday from Hillsdale College?
  - “Inflation is on the rise in America. And there’s no sign of it slowing down.”
- What planet did this come from? After all, here’s YoY inflation

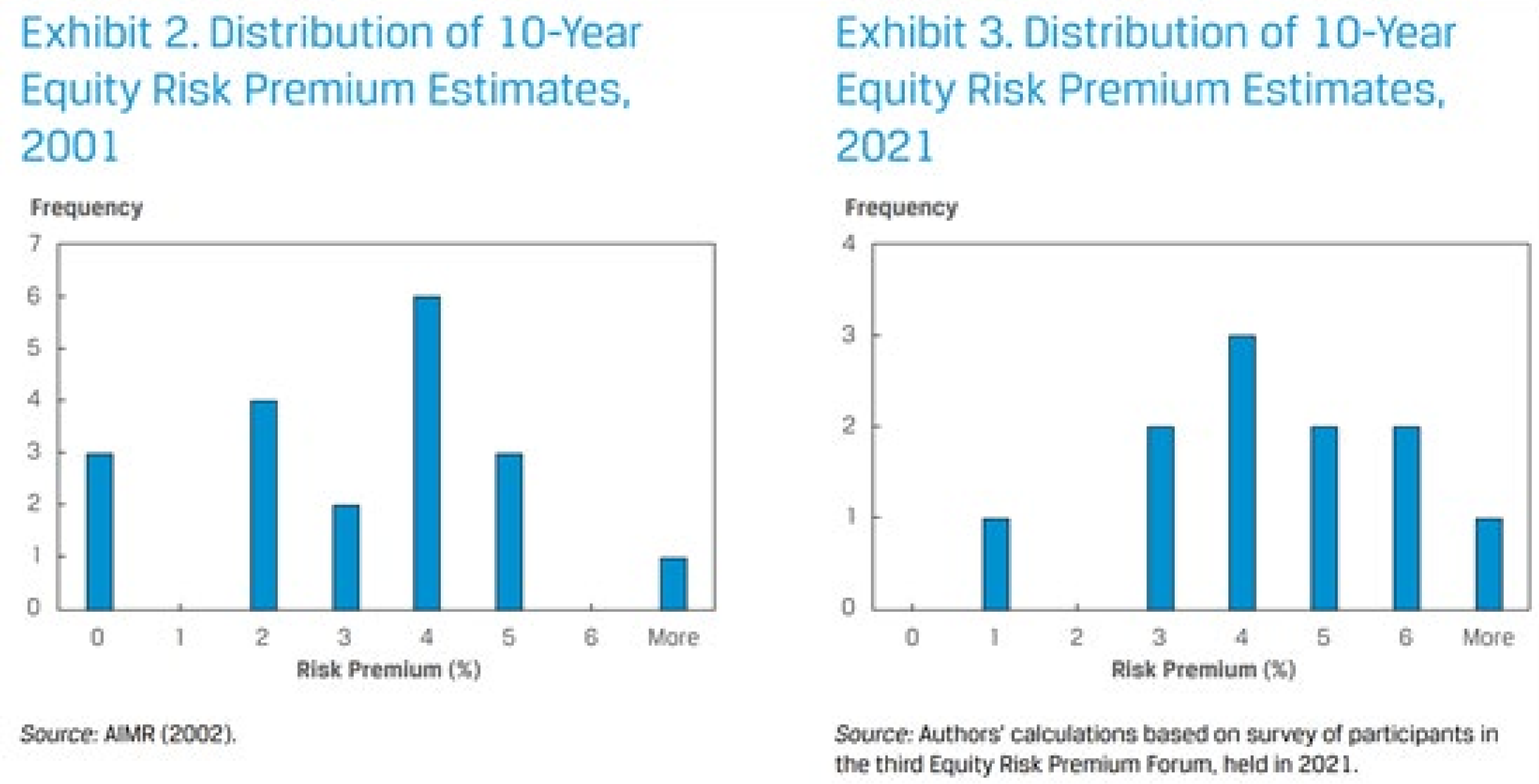
12-month CPI %-change, not seasonally adjusted



Hover over chart to view data.
Note: Shaded area represents recession, as determined by the National Bureau of Economic Research.
Source: U.S. Bureau of Labor Statistics.

Seeing Too Clearly?

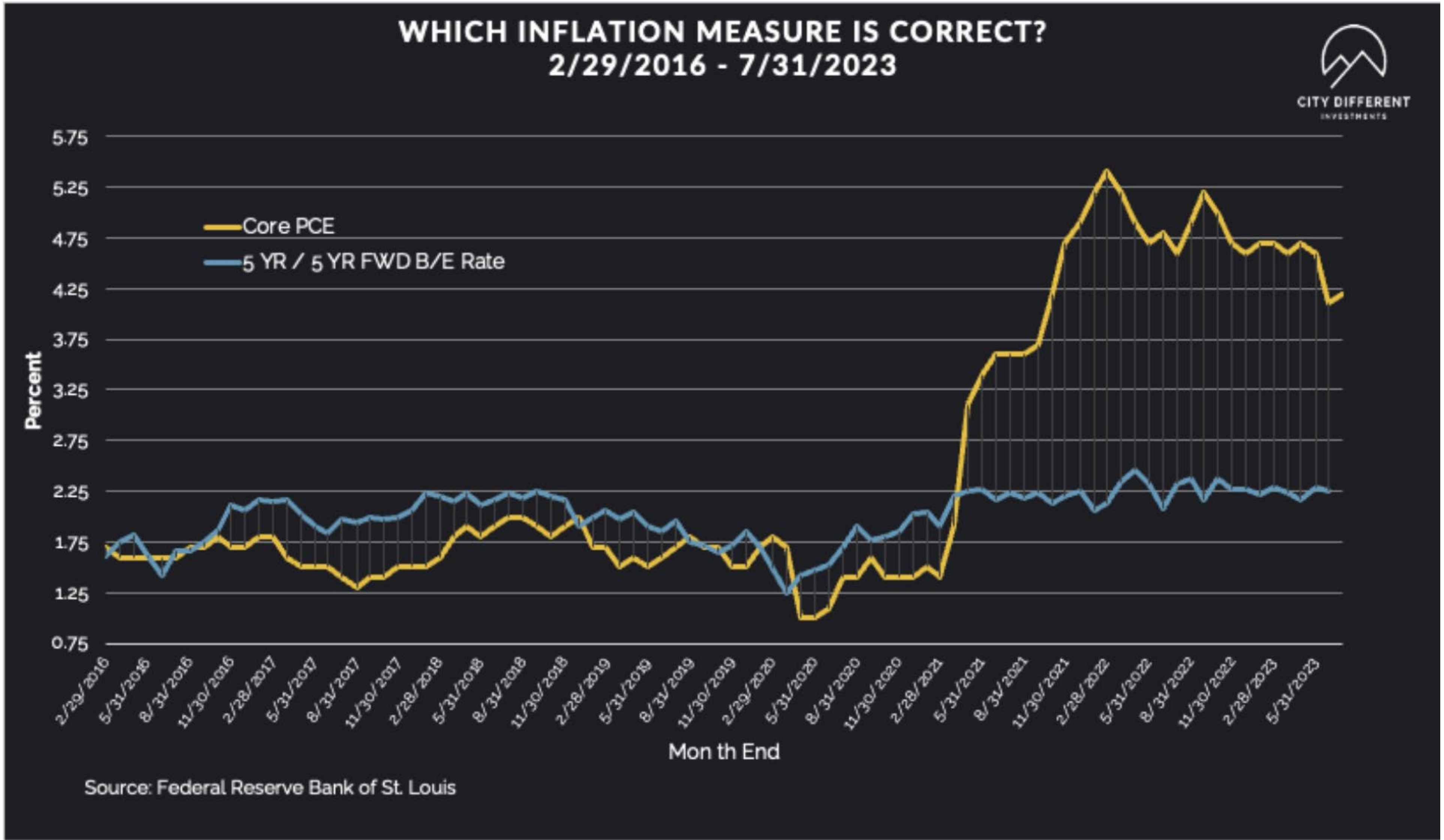
- The Equity Risk Premium is the extra return you get from taking the risk to own equity versus the supposedly safer bonds.
- All sorts of financial modelling require that the ERP be specified.
- However …from an John Authers newsletter (via Bloomberg)



And Who Am I, Anyway?

- Had a fund 10+ years ago doing covered calls on individual stocks
  - I picked the stocks and things often didn’t work out
- Now use Parnassus Core Equity
  - 5*, Gold according to Morningstar
  - One of four managers that beat the S&P 500 for 25 years in old Barron’s article
  - Their holdings are available within about 10 days of month end: https://www.parnassus.com/parnassus-mutual-funds/core-equity/full-holdings
  - 11.03% annualized return since Aug 31, 1992
    - S&P 500 return was 10.14%
  - Sell puts based on their holdings
  - If they’ll own it, surely I can sell OOTM on the same stock, right?
- They *loved* NVDA. “Great company”, they said on several quarterly calls
  - In March 2023, with stock up from about 150 to 225 YTD, they cut their stake in half
  - Stock now around 450-ish

Do You Sincerely Believe the Crowd is Better?



Thinking, Fast and Slow

- Who am I?
  - A machine for sub-optimazation
    - Recency bias
    - Anchoring
    - Political and economic views/biases
    - The seductive quality of coherent stories
    - Innumeracy – and I'm a pretty numerate fellow (classroom example)
    - My SIPS model was an upper bound on my performance
- My favorite not quite quoted line
  - "These studies have been done across all sorts of cultures and age groups. Sooner or later, you are going to have to admit that they are true. And, more poignantly, that they are true about you."

An individual has been described by a neighbor as follows:

“Steve is very shy and withdrawn, invariably helpful but with little interest in people or in the world of reality. A meek and tidy soul, he has a need for order and structure, and a passion for detail.”

Is Steve more likely to be a librarian or a farmer?

Let’s do a poll……

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Is Steve more likely to be a librarian or a farmer?

There are more than 20 male farmers for each male librarian in the United States. Would that fact have changed your vote?

Was Doubt Worth it Last June?

- Last June, the zeitgeist was…
  - Market is down YTD and it's getting worse
  - Forget soft versus hard landing: a painful recession is nigh
  - Look out below!!!
- What happened?
  - My suggestion on June 16 was that perhaps we didn't know what was up
  - S&P 500 Total Return Index = 7937 that day
    - Last Friday = 9604 = 21% gain. Low was 7589 on Oct 12. (down 4.38%)
  - Russell 2000 Total Return Index = 8802
    - Last Friday = 9823 = 12% gain. Low was 8653 on Sep 26 (down 1.69%)
- The question back then was, and remains
  - When will the recession come and how deep will it be?
  - Beats the bleep out of me

Ask An Expert

- Goldman Sachs now sees less of a chance the US will slide into recession as cooling inflation and a still-resilient labor market suggest the Federal Reserve may not need to raise interest rates further. The bank now sees the probability of a US recession at 15%, down from 20% previously and well below a Bloomberg consensus of 60%. Why so optimistic? “First, real disposable income looks set to reaccelerate in 2024 on the back of continued solid job growth and rising real wages,” says Jan Hatzius, chief economist at Goldman. “Second, we still strongly disagree with the notion that a growing drag from the ‘long and variable lags’ of monetary policy will push the economy toward recession.” Bloomberg % Things you need to Know to Start Your Day 9/5/23

From Bloomberg's 8/1/23 Evening Briefing

In 2019, while working as a senior economist at the Federal Reserve, Claudia Sahm published a measure to show when the US has fallen into a recession. What came to be known as the Sahm Rule is elegant in its simplicity and has been praised for its accuracy. It holds that the economy is contracting when the three-month moving average of the unemployment rate rises by 0.5 percentage point relative to the low point during the previous 12 months. As of June, Sahm's indicator was nowhere near the threshold. As the US continues to defy a year of incorrect recession forecasts, Sahm has become part of growing number of economists who concede that the economy is headed for a soft landing—meaning Fed Chair Jerome Powell's interest-rate hikes will succeed in subduing inflation without a downturn that causes unemployment to spike. Sahm says there's never been a more pressing time for economists to be humble. "Everyone who is a macroeconomist, including myself, has made some very big errors thinking about the economy since the pandemic showed up," she says.

Remember My Top Income Suggestion?

- In Mar 2021, I presented 8 income ideas. We revisited in Jan 2022
  - The central challenge for both presentations: rising yields
- The first idea was DNP, a closed end fund
  - Yield Mar 2021 = 7.6%
  - Yield Jan 2022 = 7.2%
- Yield when I started this presentation last Thursday night was
  - 7.16%
  - Yield as of Friday, 9/8 = 7.79%
- Dividend is unchanged at $0.065 Still unchanged
- Who was betting DNP would go up in price? Now finally down, but not much
  - *Perhaps a little doubt might serve….***INDEED!**

Where are the Markets Headed?

- That's a euphemism for whether we'll have a recession.
  - Of course, we will
  - But when? Raise your hand if last June you thought we'd wait 15+ months
- What follows are a lot more examples of things like DNP
  - Increasingly, my view is that we're all like Yogi Berra:

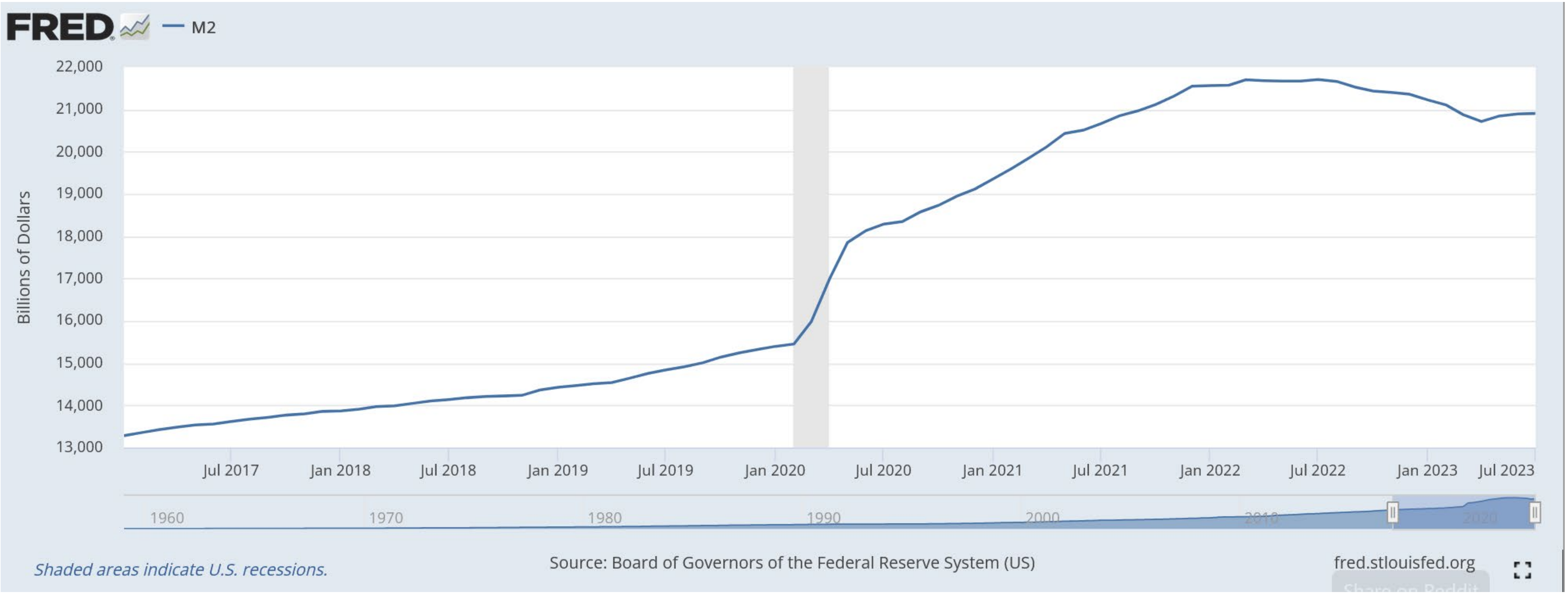
    "It's tough to make predictions, especially about the future"
- Observations will come in no particular order
- Your alternative explanations are welcome

Inflation

- *Inflation is always and everywhere a monetary phenomenon*

  -- So said (roughly) Uncle Miltie, as we called him, Milton Friedman

- And we have incontrovertible facts like this chart of M2:



What is Monetarism

- Investopedia: Monetarism is a macroeconomic theory which states that governments can foster economic stability by targeting the growth rate of the money supply. Essentially, it is a set of views based on the belief that the total amount of money in an economy is the primary determinant of economic growth.
- Actually, it sort of has a formal definition:

MV = PT

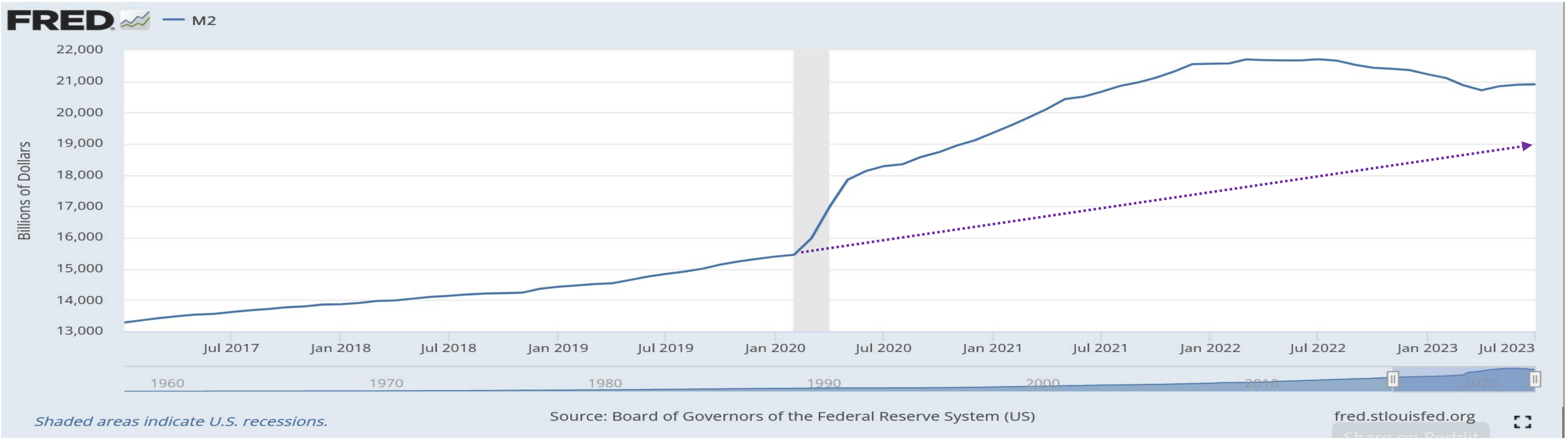
Where M = Money supply
V = Velocity of Money
P = Average Price of all Transaction
T = Number of transactions

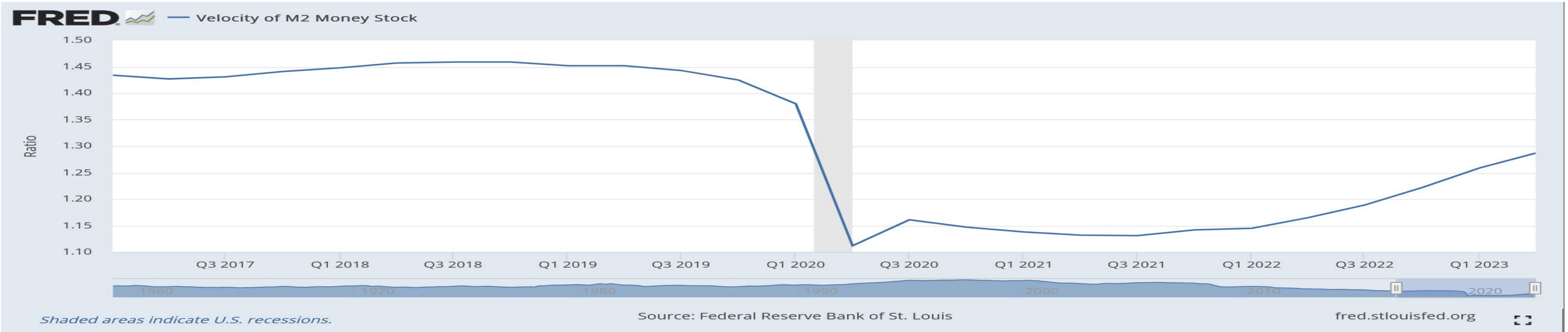
In other words, a tautology

- So note that the absolute level of money supply is ***not*** the *only* determinant of economic growth, but rather the product of the supply of money and its velocity.

Here's the Recent Dance of M & V – last June

Here's the Recent Dance of M & V – Current





What’s Their Product ??

	M2 (Trillions)	Velocity	Product	Annualized Growth
7/1/2012	10.05	1.612	16.20	From prior row
7/1/2019	14.83	1.441	21.38	4.04%
1/1/2021	21.66	1.122	24.30	5.27%
7/1/2023	20.90	1.287	26.90	4.15%

While M2 has certainly grown a lot in the last 2-1/2 years, given the drop in velocity, it seems a stretch to argue that all of a sudden, the incremental growth rate in MV has led to an explosion of P.

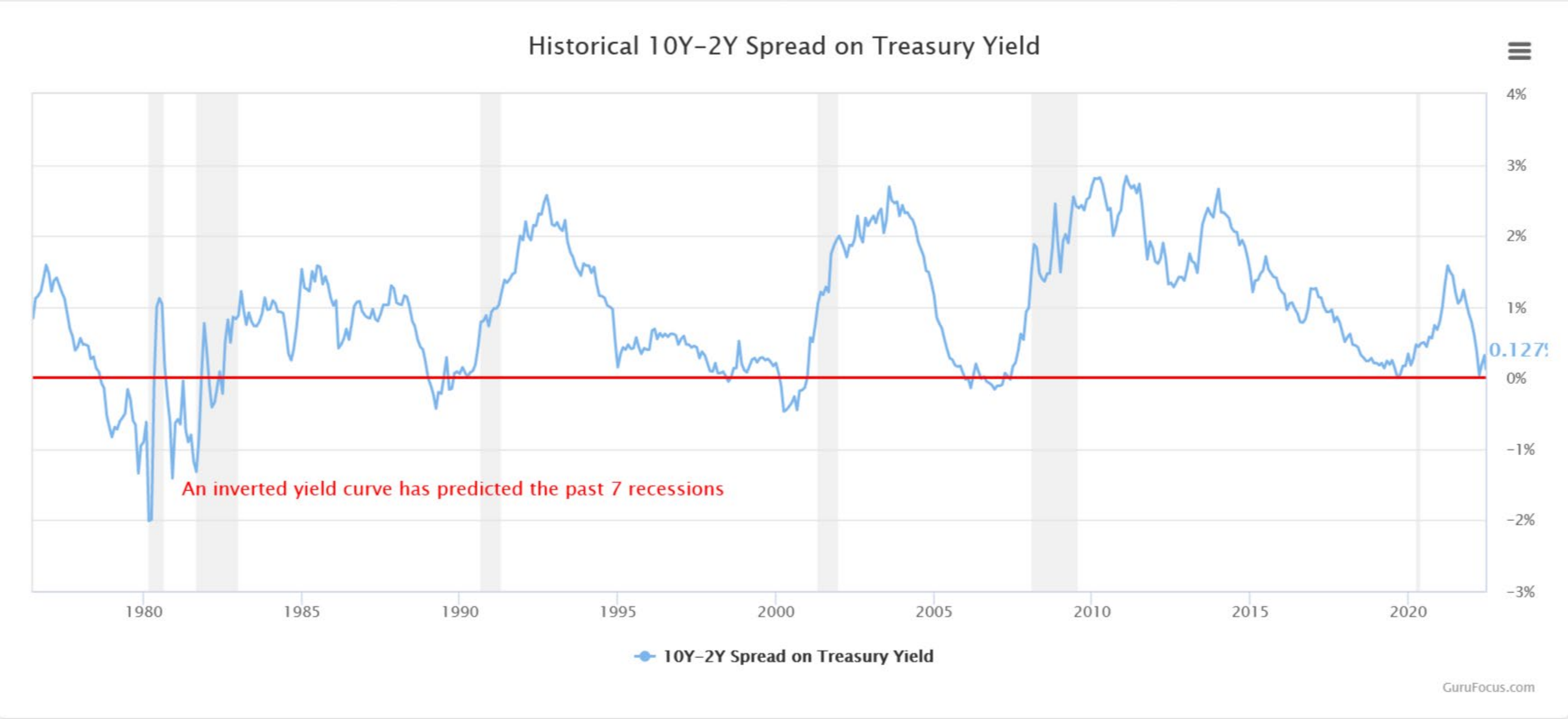
Rather, it would seem that the “stories” – bottlenecks, supply chains, the unexpectedly quick and decidedly uneven reopening of the economy, Ukraine, etc – have a lot to do with the inflation we are seeing.
Seems to me that this is turning out to be quite true….

Will that mean that raising interest rates won’t do the trick?...meaning that interest rates might not be the right lever for reducing inflation

Expectations Haven't Changed Much

Actually dropped off since last June

Is A Recession Coming?

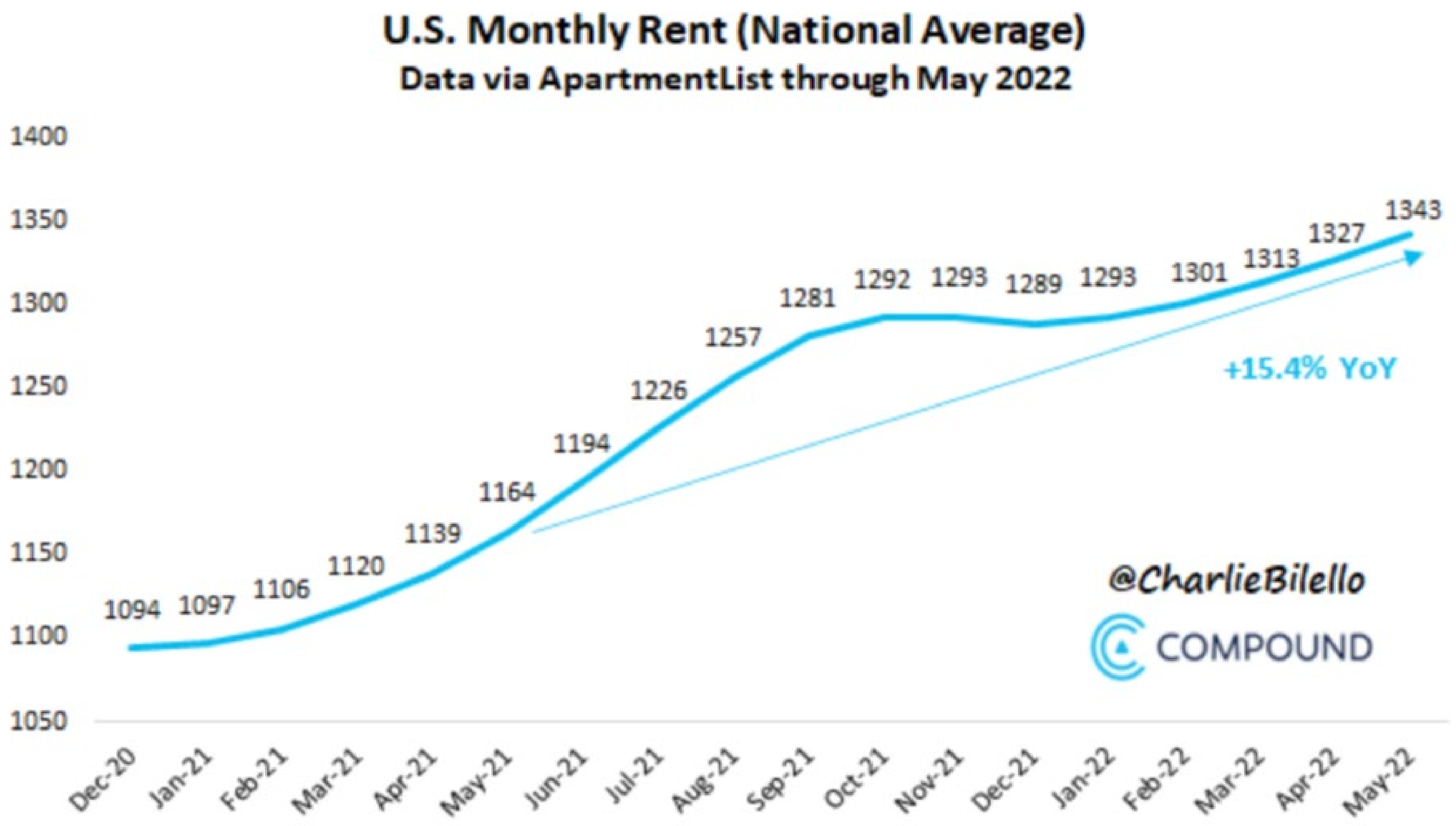


Yes, says the 5- versus 30-year inversion

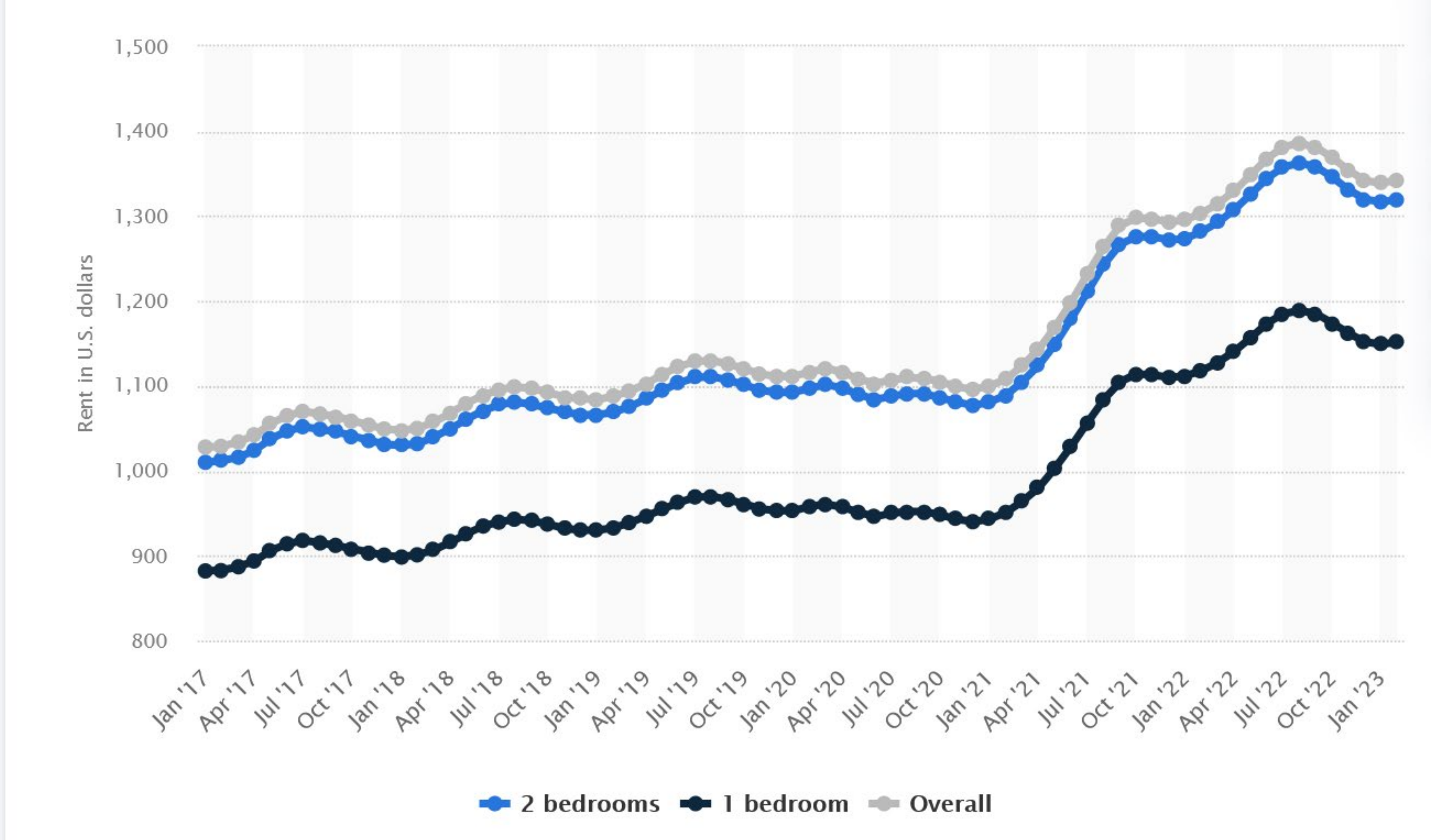
On the Other Hand

- The general idea of raising rates is to slow down durable goods purchases, from washing machines to houses
- Well, we all know what's happened since
  - Housing prices continued to rise, despite mortgage rates
  - Supply chains have mostly healed….
    - The majority of disinflation has been driven by expanding supply rather than decreasing demand. Decomposing price and quantity changes for 123 core PCE items, I find 73 percent of all core items, and 66 percent of services, see prices falling with quantities increasing—a sign of expanding supply. - Mike Konczal of Roosevelt Institute via Bloomberg
  - Was inflation mostly transitory ??

No Slowdown Visible Here



Updated Using Statista



Yet look at the multi-family REITs….

Equity Residential

Yesterday's close = 62.50

AvalonBay Communities

Yesterday's close = 180.00

Dec 10, 2021: Upgraded to Outperform at BMO Capital
Jan 3, 2022: Upgraded to Buy from Hold at Deutsche Bank

Camden Property Trust

Yesterday's close = 102.07

December 07, 2021: Camden Property Trust started at buy with $192 stock price target at Stifel Nicolaus
December 21, 2021: Apartment Owners 'Golden Age' Primed to Continue in 2022 The Wall Street Journal Interactive Edition

Is It Yield Over Growing Rents?

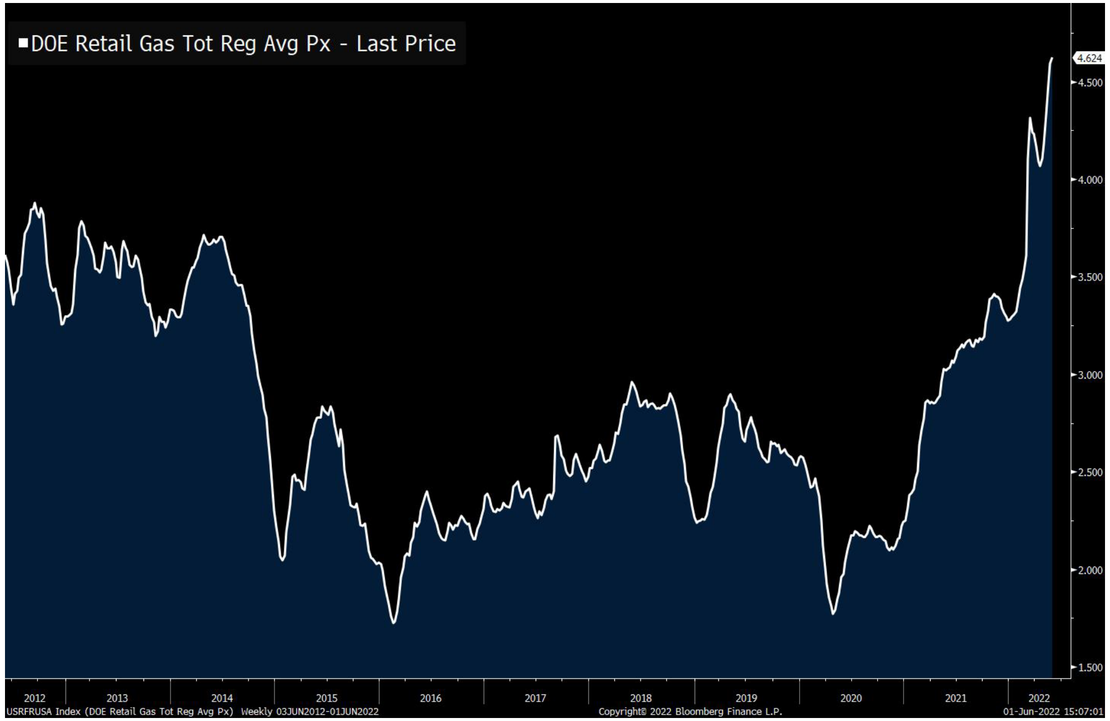
- Yield on these REITs, even at their new (even) lower prices, are rather modest given that the 2-year Treasury is now around 3.25% now 4.96%
  - Equity Residential 3.63% 4.24%
  - Avalon Bay Communities 3.43% 3.67%
  - Camden Property Trust 2.98% 3.92%

Maybe this is going to kill housing….

Conversely, cash buyers – funds – abound. Rents are rising.

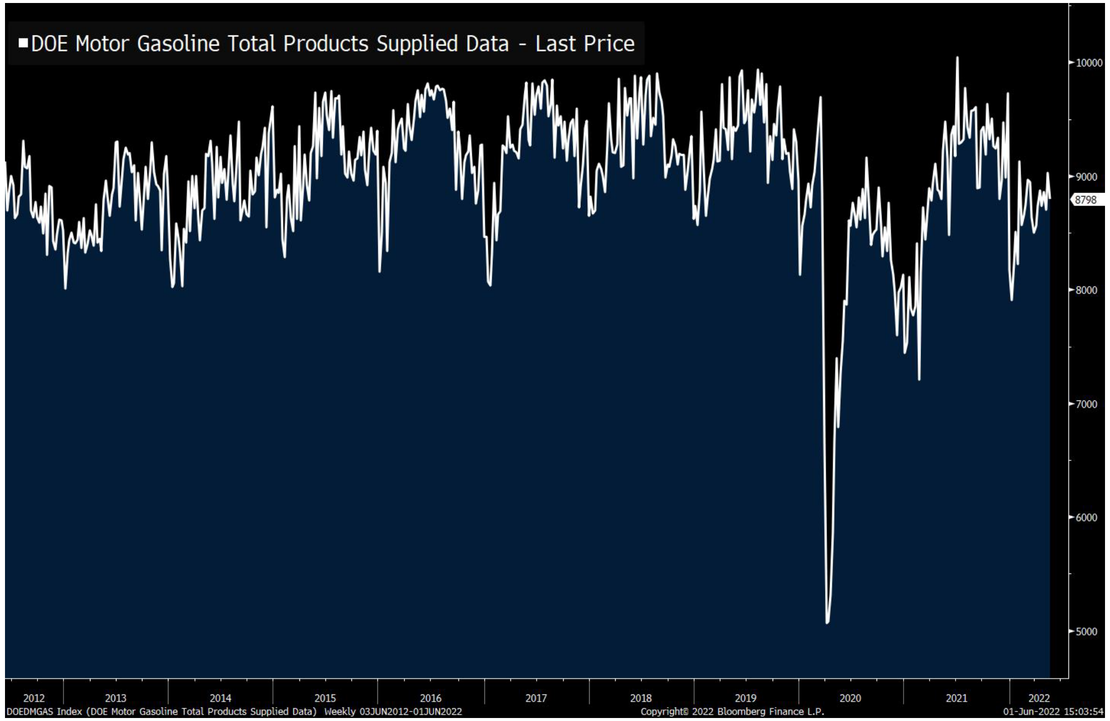
Will it crash – despite the need described by the Century 21 CEO?

Gasoline Prices



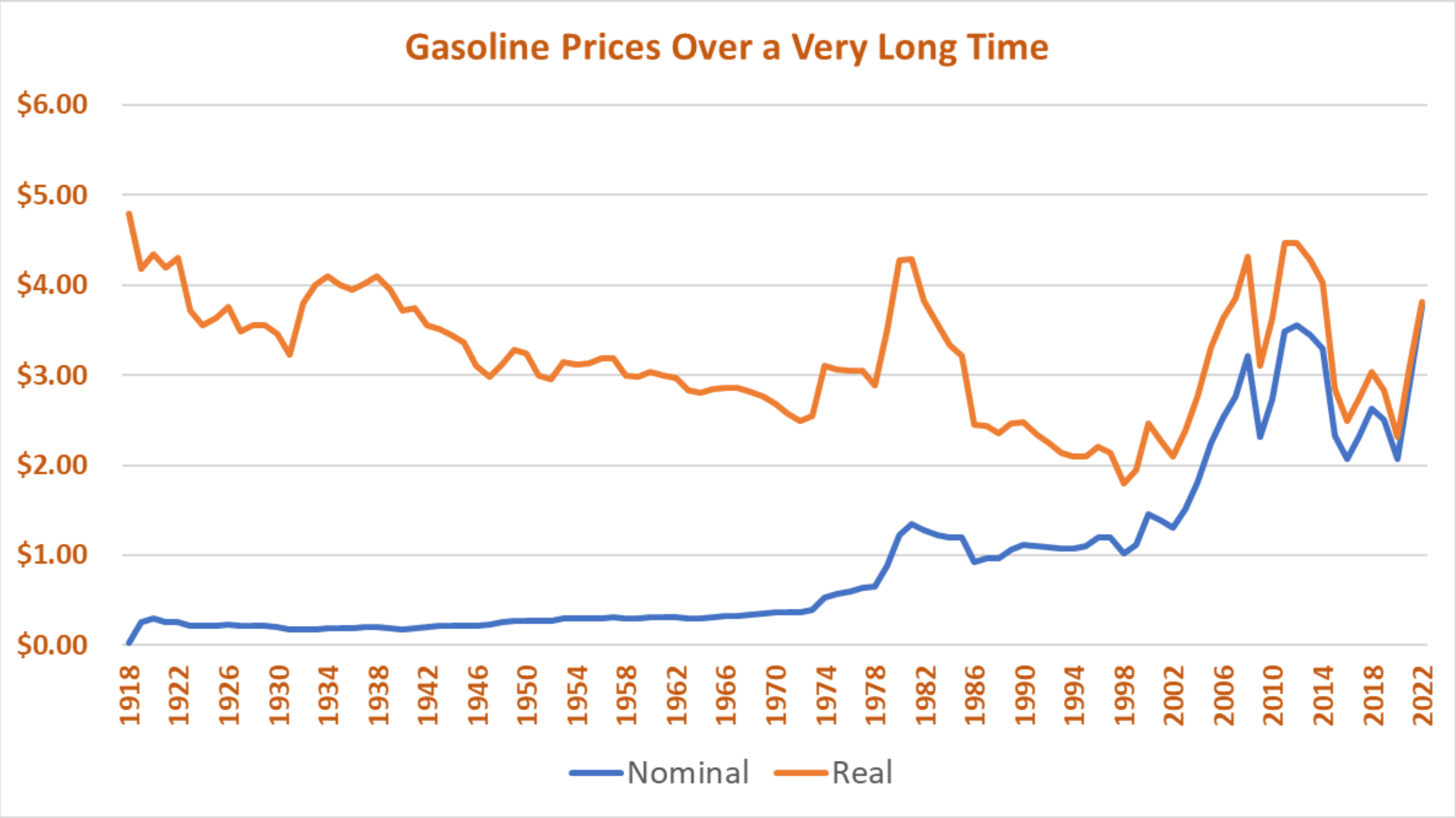
Everyone knows the price is up. A lot. Is this from too much M2, or even M2 x V ??

Gasoline - Consumption

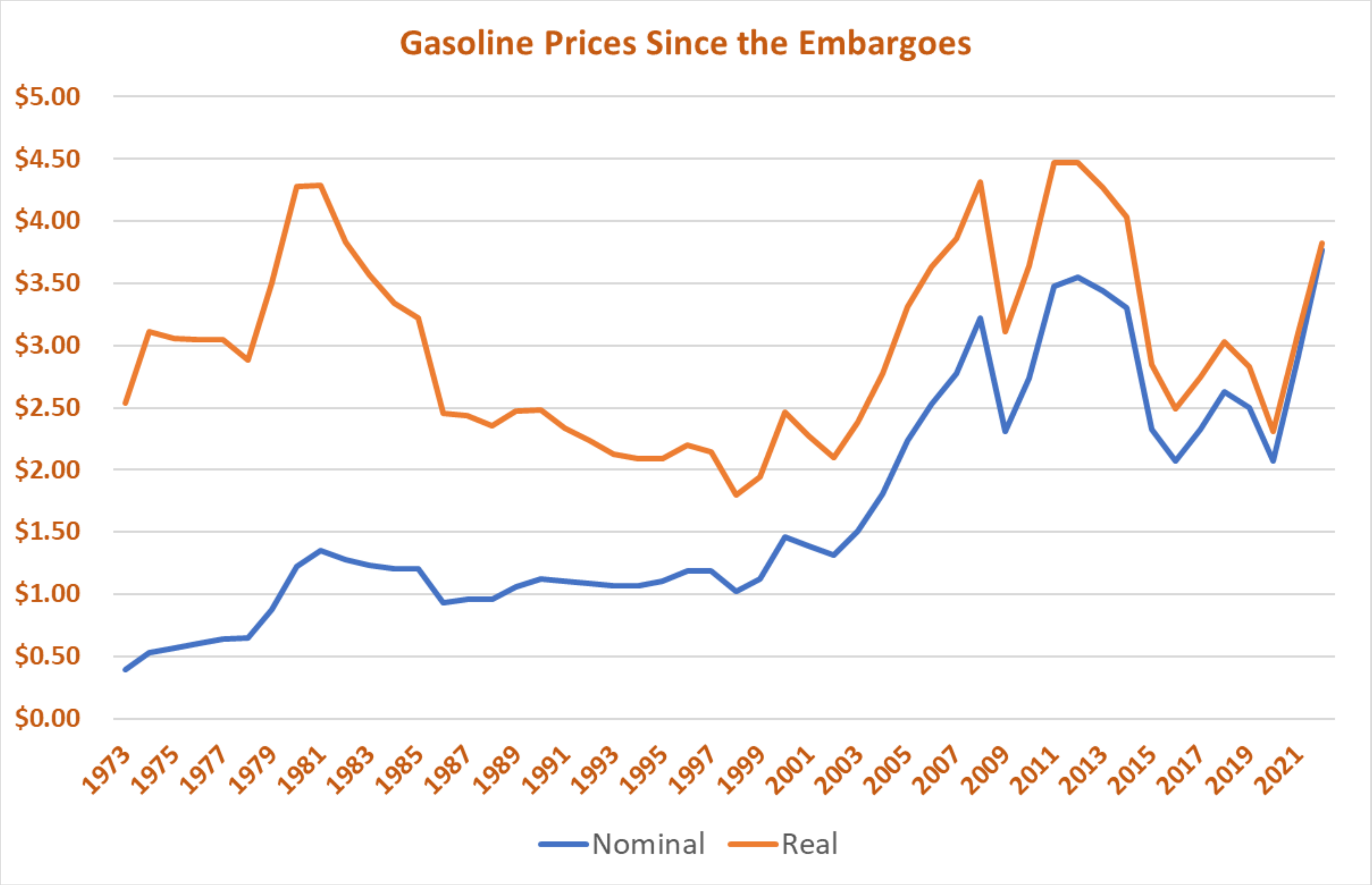


Gasoline Consumption "remains below 2019 levels. Here's a 10-year chart of weekly consumption based on DOE data" (Courtesy of Bloomberg "5 Things…" Note)

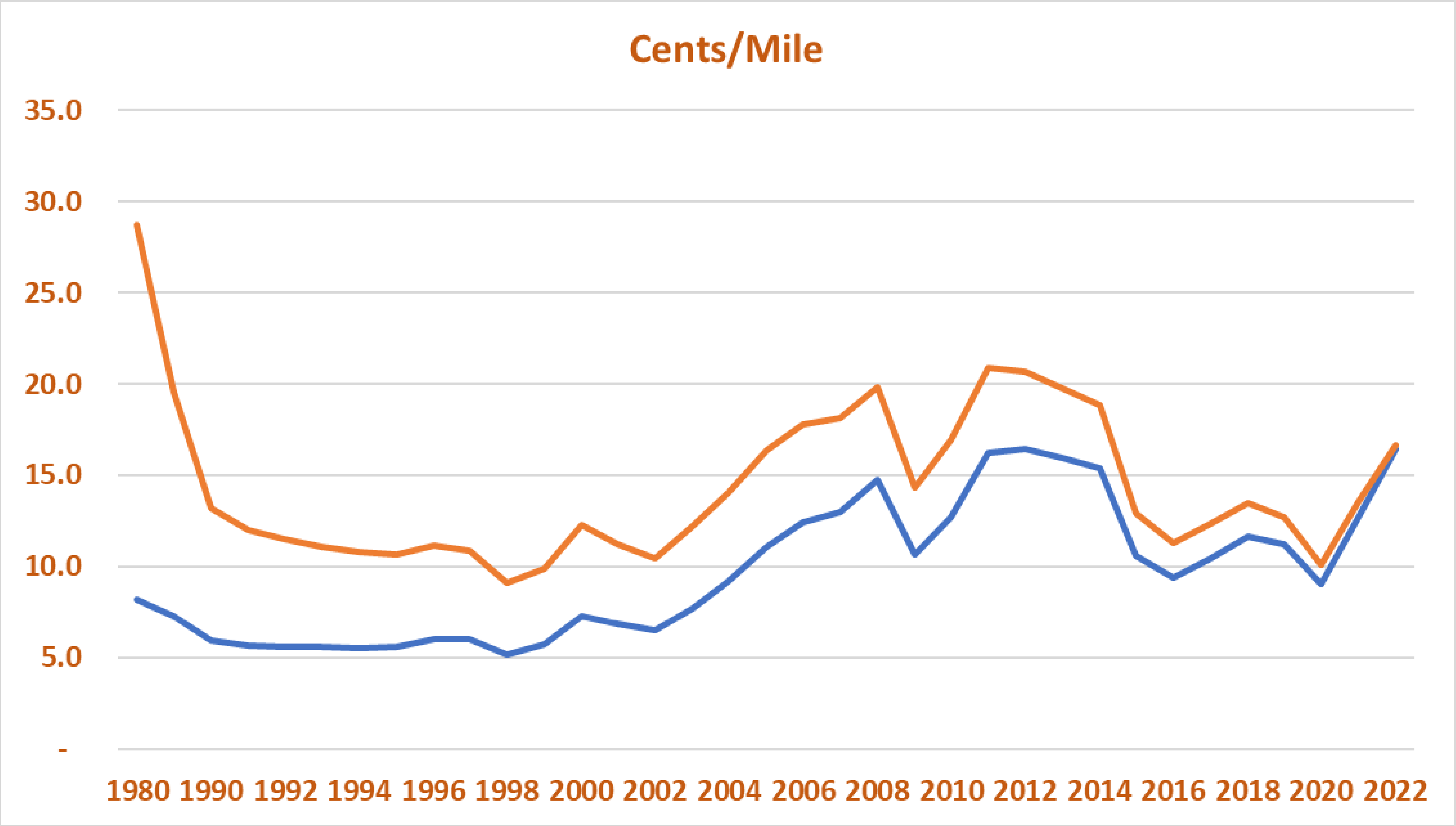
Actually, Prices Aren't Even *THAT* High



If We Consider Only Post-Embargo Times

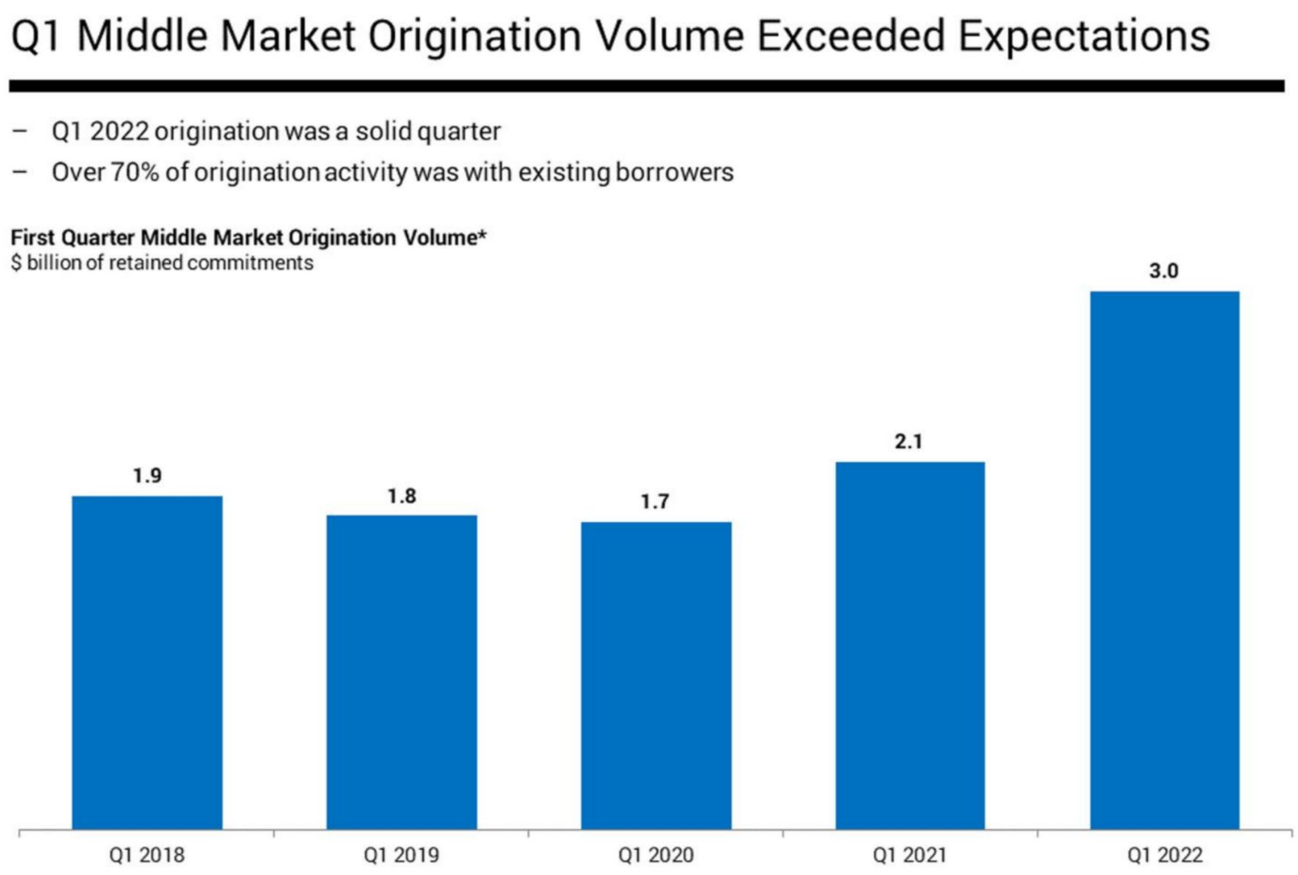


What About Improved Mileage?



Note: Last fleet mileage reading was 22.9 for 2020. Same figure is used for 2021 & 2022 although it is almost certainly higher (2019 was 22.2), so this chart very likely *overstates* the latest costs/mile.

Are We Heading To Recession?



Just the view from one BDC, Golub Capital. They have been firing on all cylinders

Really, Are We Going to Have a Recession?

The headline reads:

Nobel Laureate Shiller Sees 'Good Chance' of a US Recession

The subtitle reads:

Downturn could result from a self-fulfilling prophecy, he says

While the body of the article reads only that:

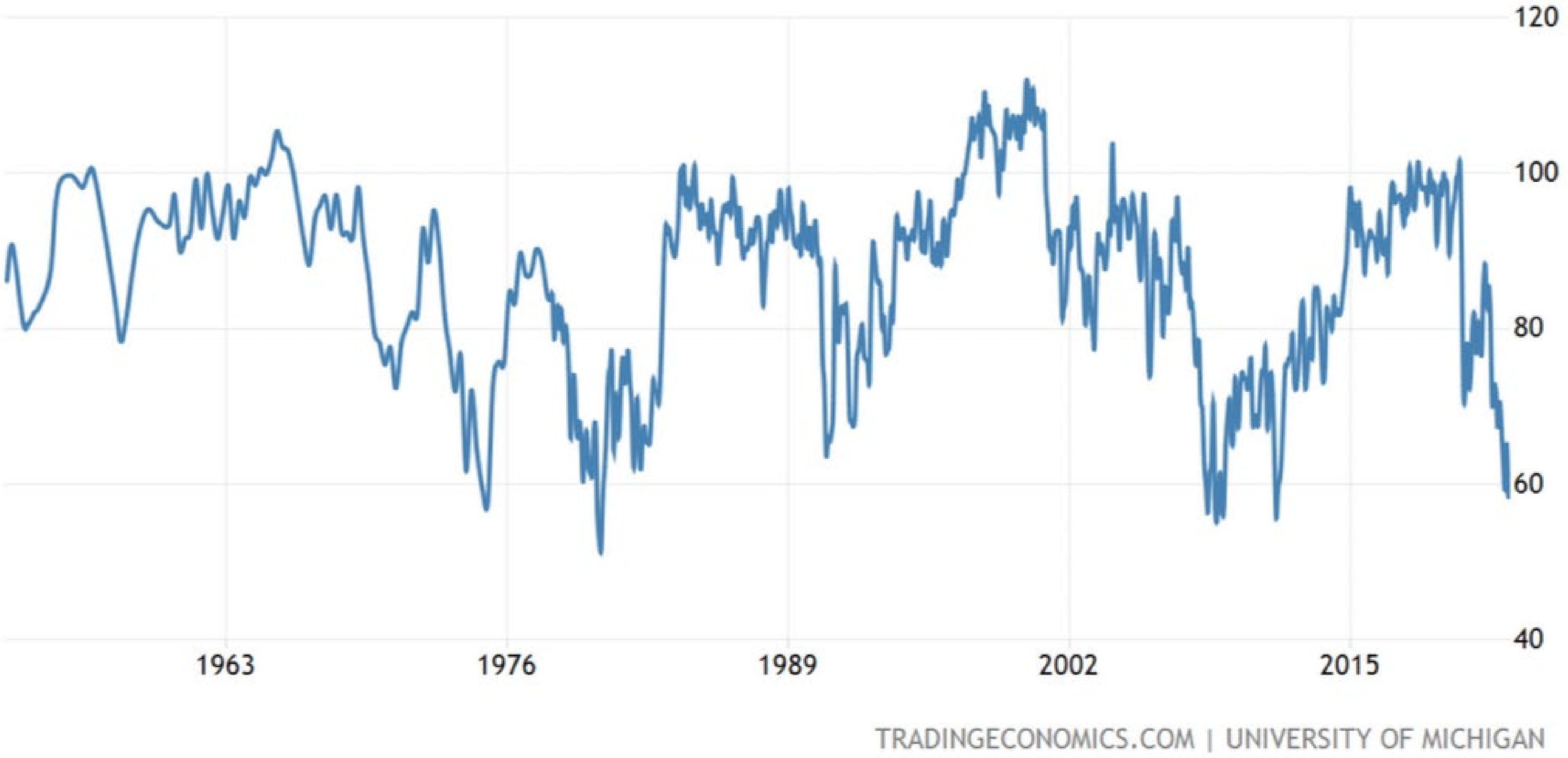
Nobel laureate economist Robert Shiller sees a "good chance" of a US recession that's at least in part the result of a "self-fulfilling prophecy" as investors, companies and consumers grow increasingly worried about a downturn.

"The fear can lead to the actuality," said Yale University professor Shiller, author of the 2019 book "Narrative Economics: How Stories Go Viral and Drive Major Economic Events."

Consumer Sentiment

"…an increasing number of US households say the economy is headed in the wrong direction. That…could lead consumers and companies to turn more cautious, planting the seeds of a downturn…"

We have been here before though…



Employment & Politics

- Since 1940 – when BLS data are readily available –

Growth in Employment has averaged 120k/month

However

Under GOP Presidents:	67.7k
Under Dem Presidents:	170.3k

That’s for calendar years. If you use the first Oct 1 after the election:

Under GOP Presidents:	78.5k
Under Dem Presidents:	158.0k

https://www.bls.gov/webapps/legacy/cesbtab1.htm

A Pattern in Previous Recessions

- The recessions since WW II have at least two patterns. Can you spot them?

July 53 to May 54
May 57 to Apr 58
Apr 60 to Feb 61
Dec 69 to Nov 70
Nov 73 to Mar 75
Jan to Jul 1980
Jul 81 to Nov 82 – Double Dip
Jul 90 to Mar 91
Dec 07 to Jun 09
May to Apr 2020

- https://www.history.com/news/us-economic-recessions-timeline

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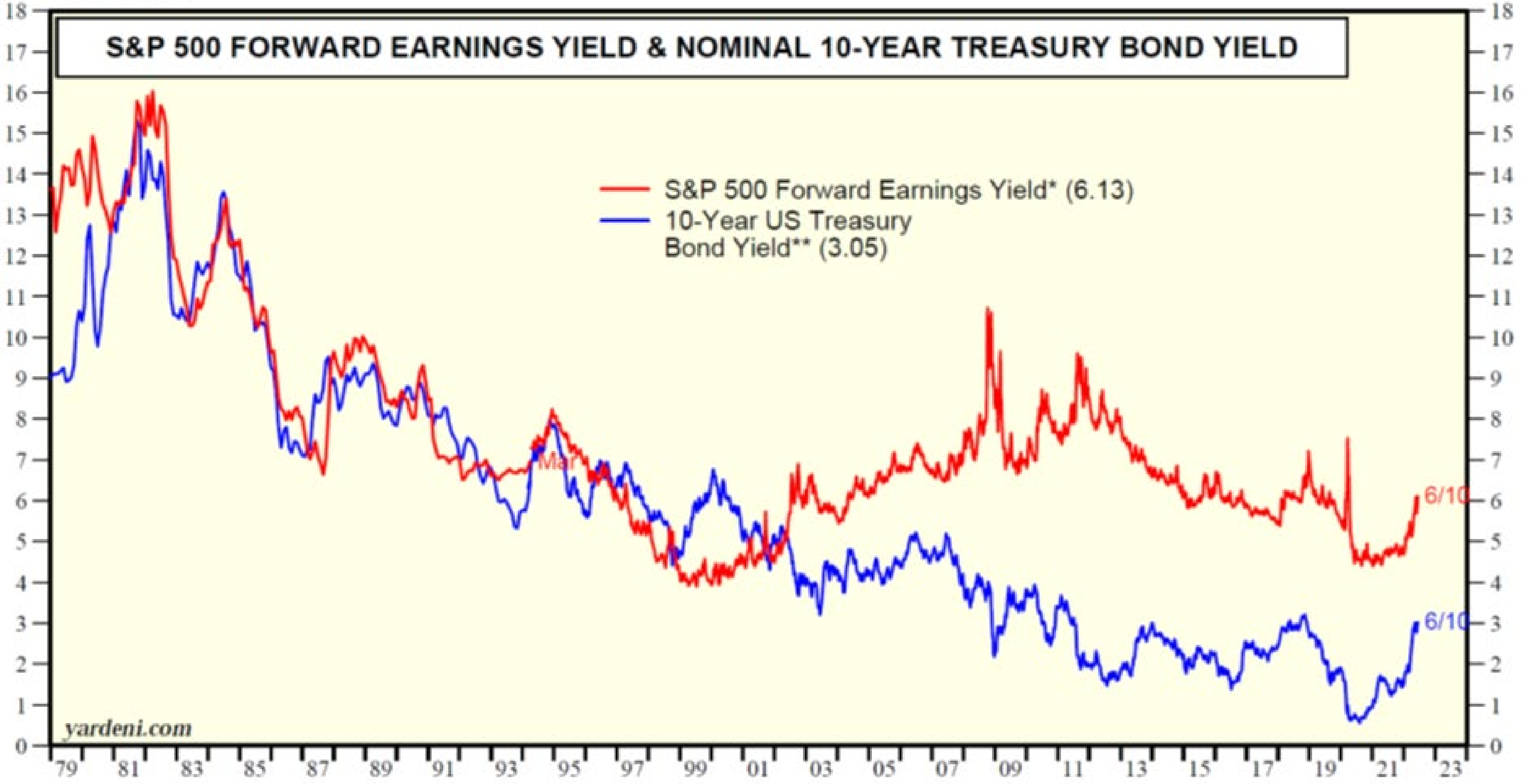
Where to Stocks: The Fed Model

- Earnings Yield (inverse of P/E) compared to 10-year Treasury yield

Figure 1.



* Year-ahead forward consensus expected earnings divided by S&P 500 stock price index. Monthly through March 1994, then weekly.
** Monthly through March 1994, then weekly.
Source: I/B/E/S data by Refinitiv and Federal Reserve Board.

From early 2020, spread has dropped from ~4.5% to about 3.0%

At least on average

Fed Model – Home Depot

- P/E for HD = 17.68 (Tuesday's close, TTM earnings) Now 20.34
- Earnings yield, E/P = 5.66% Now 4.92%
- HD 2.375% of 3/15/51 YTM = 4.43% (Wednesday morning) Now 5.27%
- Premium to take on equity risk is now 123 bps
- End of 2021:
  - EPS was $11.94
  - Price was 415.01 (Tuesday's close was 278.67 !)
  - Earnings yield was 2.88%
  - Bond yield was 2.81%
  - Premium was just 87 bps
- For HD, equity is now considerably more attractive compared to bond
  - Closed last night at 325.88. Nice gain since last June (17%) !
  - But equity is now more costly than bond!!

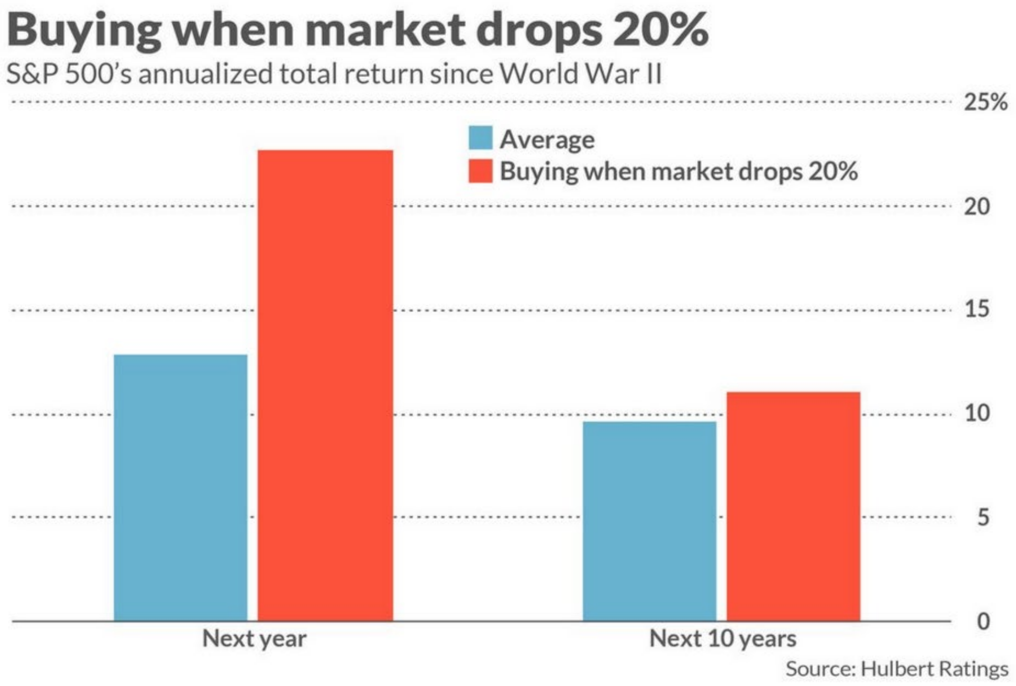
Fed Model – Alphabet

- P/E for GOOGL = 19.31 (Tuesday's close, TTM earnings) 28.33
- Earnings yield, E/P = 5.18% 3.53%
- GOOGL 2.25% of 8/15/60 YTM = 4.18% (Wednesday morning) 4.75%
- Premium to take on equity risk is now 100 bps
- End of 2021:
  - EPS was $112.20
  - Price was 2897.04 (Tuesday's close was 2134.31 !)
  - Earnings yield was 3.87%
  - Bond yield was 2.69%
  - Premium to take on equity risk was 119 bps
- For GOOGL, equity is a bit less attractive now than before
- Price was 136.71 last night = 2,734 on old stock
- Like HD, a nice gain since last June (28%), but now the bond might be better.

Fed Model – Electronic Arts

- P/E for EA = 46.14 (Tuesday's close, TTM earnings) 37.56
- Earnings yield, E/P = 2.17% 2.66%
- EA 2.95% of 2/15/51 YTM = 4.67% (Wednesday morning) 5.56%
- Equity risk *costs* 250 bps Now 290, even though P/E contracted a lot
- End of 2021:
  - EPS was $2.67
  - Price was 131.90 (Tuesday's close was 127.37)
  - Earnings yield was 2.02%
  - Bond yield was 3.20%
  - Cost to take on equity risk was "only" 118 bps
- Just buy the bond? Hmmm….
  - Perhaps the message is that high P/E stocks need to come down compared to bonds
- Stock closed last night at $121.68 – DOWN from last June
- At least the bond has a coupon, though it's down too.
- Stock dividend yield ~ 0.65%. Current yield on bond now ~4.65%

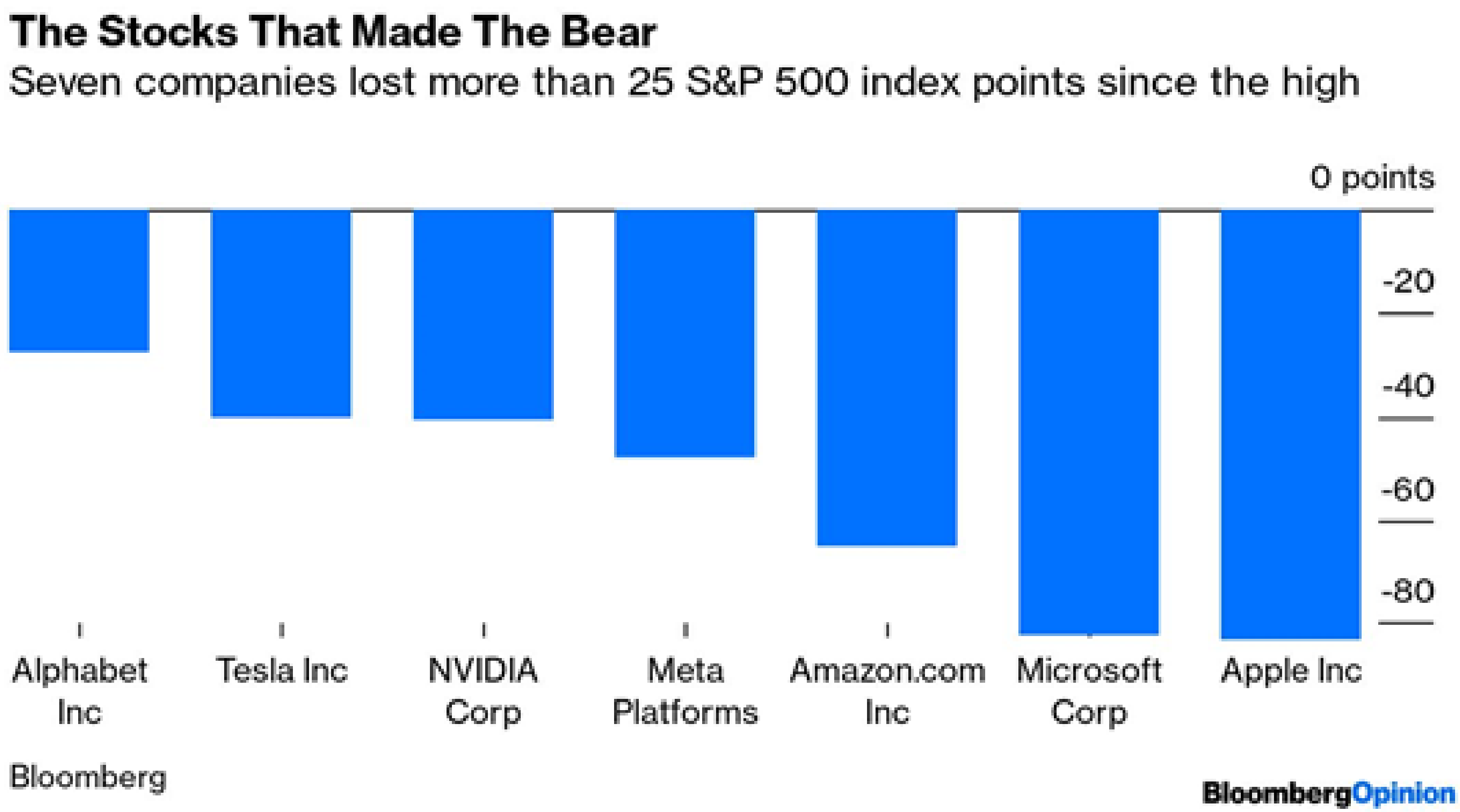
Mark Hulbert is less Equivocal



"I analyzed how you would have done if, in every bear market since World War II, you bought stocks on the day the S&P 500 closes below the 20% loss threshold. Sometimes that day came near the end of the bear market, and in other cases the market continued falling before eventually turning up. But on average you would have done very well.

And you wouldn't have had to wait that long to do so. Over the 12 months following your buys, your average total return would have been 22.7%...more than double the stock market's long-term average…"

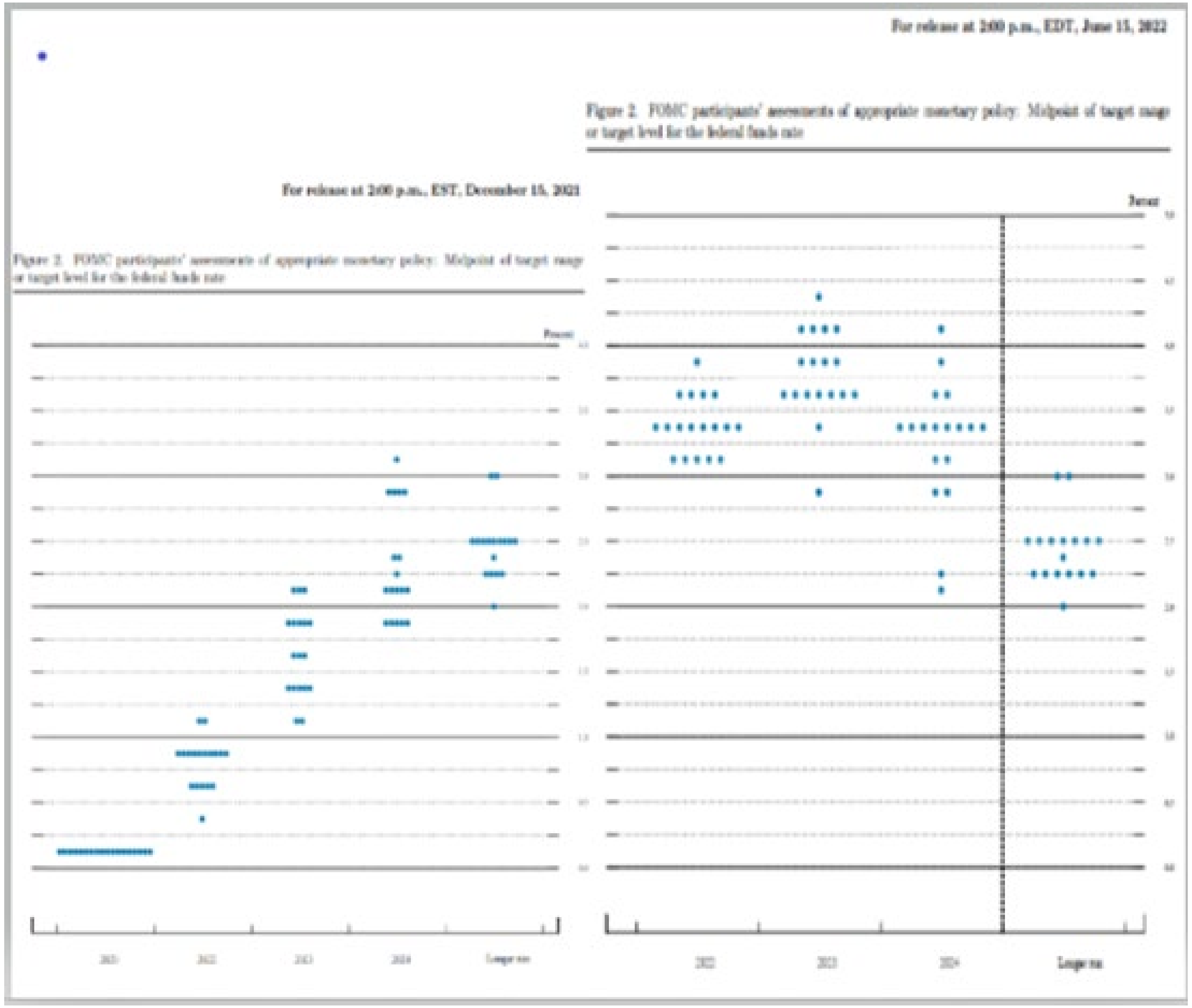
Was it all Cathy Wood's Darlings?



Don’t Fight The Fed

The dot-plot from the Dec FOMC mtg

Only one member predicted the Fed funds rate above 1% in 2022 and only one above 2% in 2023



The dot-plot from yesterday

Everyone is above 3% by the end of 2022. But it goes no higher.

Denial?

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