The Optimistic Investor

FOCUS ON WHAT REALLY MATTERS

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Welcome Back

Welcome to our third edition! Thanks again to all who continue to share feedback and let us know you're enjoying these memos.

This quarter we'll build on our previous discussion of the benefits and struggles of owning companies. The main essay discusses a concept called the "equity premium" and the important role it plays in keeping our financial plans on track. There's also a new section called "Team Kooman Corner," which you'll see when we have exciting news to share about our team members.

Happy reading!

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The Importance of Earning the "Equity Premium"

Our last edition set the stage for this essay by discussing two complimentary principles of successful investing.

The first principle was that the most reliable way to capture the financial benefits of largescale innovation is to own a diversified portfolio of companies. It's extremely difficult, if not impossible, to predict which businesses will thrive or fail. So, rather than speculating on the prospects of individual companies, we want to be broadly diversified and let the capital markets work for us. Markets are very good at directing capital to companies that are succeeding and taking it away from companies that are failing (*i.e.*, identifying winners and losers); we just need to give them time to let that process play out.

The second principle was that we don't need to change our investment strategy in response to current events. The professional managers who run the companies we own adjust ***their*** strategies to preserve enduring values and future opportunities in the face of constant change and shocks to the economic system. That allows us to set a long-term plan based on our unique goals and needs, and then continuously ***act*** on the plan rather than ***reacting*** to current events.

Both of these principles embody the idea that patience and discipline are essential to successful investing. More than anything else, it's our willingness (and ability) to bear the uncertainty of letting markets and corporate managers do their thing over time that allows us to capture the economic benefits that flow from owning great companies.

In this edition we want to build on these concepts in two ways. To begin, we'll review the long-term premium return that's generated by ***owning*** companies and why it's important. Once we've done that, we'll discuss why most investors fail to capture as much of that premium return as they should.

What is the Equity Premium?

In almost every client meeting, we talk about ownership of companies generating premium returns that drive long-term growth of wealth. What do we mean by that?

At the simplest level, investors must decide whether they want to ***own*** companies (*i.e.*, purchase equity/stocks) or ***loan to*** companies (*i.e.,* purchase debt/bonds). When we talk about premium returns, we're describing the fact that ***owners*** make out much better than ***loaners*** over time.

How much better? JP Morgan tracks that very thing in its *Guide to the Markets*. It summarizes the returns produced by stocks and bonds from 1950 through 2022, and the figures will surprise you.[1]

Total Returns: 1950-2022

Category	Annual Average	Growth of $100k
Stocks	11.1%	$818,078
Bonds	5.5%	$292,662

Data source: JP Morgan, Guide to the Markets

[1] The data in the table that follows comes from slide 65 of the Guide to the Markets. You can access the entire Guide, including the applicable disclosures, at https://am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/guide-to-the-markets/.

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As the table shows, for the past 73 years the average annual return from stocks has been just over double that from bonds. And, because of the way compounding works, the value of a hypothetical $100,000 stock investment grew to roughly 2.8 times the value of the same investment in bonds. This is the premium return that comes from ***owning*** companies, which we call the "equity premium."

You may be thinking this doesn't matter for you because you don't have a 73-year time horizon. But the equity premium has a positive expected value every single day; and you can see it clearly in the returns for periods that are much shorter than 73 years. The data for the most recently completed 5-, 10- and 20-year timeframes is shown in the table below.[2]

Average Annual Returns - US Stocks vs. US Bonds

Category	5-Year 2018 - 2022	10-Year 2013 - 2022	20-Year 2003 - 2022
Stocks (S&P 500)	9.4%	12.6%	9.8%
Bonds (Bloomberg US Aggregate)	0.0%	1.1%	3.1%

Data source: Dimensional Fund Advisors, 2023 Matrix Book

These numbers really drive home that ***owners*** do much better than ***loaners*** in the long run. Why is that so important? Because two things are very likely to erode your wealth over time: inflation and the fact that you need to spend your money to live.

Inflation has been in the news recently, but it usually eats away at your purchasing power in the background. Over the last 20 years it has averaged 2.5% (as measured by the US Consumer Price Index).[3]

If you were a ***loaner*** during that 20-year period and earned the 3.1% return shown above, your "real" return (*i.e.*, what you made after inflation) was 0.6%. There are very few people who can live comfortably withdrawing only 0.6% of their portfolio each year. For everyone else, being a ***loaner*** means your wealth will decrease in retirement, because your returns can't make up for both inflation and your withdrawal needs. That introduces a risk of running out of money, which no one wants to experience. Thus, most of us need the premium return that flows from ***owning*** companies to reduce that risk.

> ***We need the equity premium to help us overcome inflation and reduce the risk of running out of money.***

Earning the Equity Premium

The equity premium is well known, so why do investors shy away from owning companies and fail to capture as much of the premium as they should? We think there are two contributing factors – one external and one internal.

The external factor is the way the media and our society at large understand and talk about risk. In common parlance, "risk" is used to describe the possibility of a decline in value. Markets and stock prices regularly go through periods of decline; in a typical year we expect to see a 10-15% "correction" at some point, and every few years we run into a bear market where prices decrease much more. Those declines are larger and more frequent than those we generally see in bond prices. That's why investing via stocks (***owning***) is widely perceived as "riskier" than investing via bonds (***loaning***).

The problem with this perception is that it totally fails to distinguish between ***temporary*** price declines and ***permanent***

[2] The data in this table comes from page 11 of the 2023 Matrix Book published by Dimensional Fund Advisors.

[3] Dimensional Fund Advisors, 2023 Matrix Book, pg. 11.

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losses of value. Those are two very different things that should not be lumped together.

Failure to distinguish temporary decline from permanent loss causes most investors to experience lower long-term returns.

The risk of temporary price declines is important to be aware of, but it can be managed in pursuit of superior long-term returns. The risk of a permanent loss, on the other hand, is something that can derail a long-term financial plan and should generally be avoided.

As we discussed last quarter, in times of economic and market distress, uncertainty and fear often cause a divergence of stock prices and long-term enduring values. But in ***every*** historical instance, the underlying issue was eventually resolved, prices and values realigned, and companies went on innovating and generating premium returns for their owners. There has ***never*** been an event that resulted in a permanent decline in the value of a properly diversified portfolio of companies.

One of our favorite quotes about diversified stock portfolios is that "[p]ermanent loss in such a portfolio is ***always*** a human accomplishment, of which the market itself is incapable."[4] In other words, when we're properly diversified, broad market declines are inevitable, but they're only temporary unless ***we*** do something to make them permanent.

That leads to the internal factor in why most investors fail to capture the benefit of the equity premium. As human beings, our brains are wired with a "fight or flight" mechanism that makes it hard to be a good long-term investor. When a shock hits the system and market prices are falling, it ***feels*** like risk is increasing and the value associated with owning companies is decreasing. In such times, our first instinct is that we need to move away from the perceived risk, by selling shares of specific companies or shifting away from our stock holdings more broadly.

Of course, we know from last time that good investors ultimately resist this temptation to change course. They stick to their long-term plan and let the managers of the companies they own react and adjust on their behalf. But that doesn't change the fact that making those good decisions in the face of adversity is counterintuitive.

Tempering and overcoming our instincts and emotions in this way takes courage and discipline. It's something that should be celebrated, because history has repeatedly demonstrated that most investors are unable to do it (and suffer inferior returns as a result).

"Permanent loss in [a diversified] portfolio is always a human accomplishment […]."

~ Nick Murray

The key insights that allow good investors to be successful are that *value is actually increasing as prices fall, and increased uncertainty presents a long-term opportunity*.

The best description of this mindset comes from legendary investor Warren Buffet. In

[4] Murray, Nick. *Nick Murray's Scripts*. The Nicholas Murray Company, Inc., 2019, pg. 36 (emphasis added).

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his 2016 letter to Berkshire Hathaway's shareholders, Buffet wrote:

> Charlie and I have no magic plan to add earnings except to dream big and to be prepared mentally and financially to act fast when opportunities present themselves. ***Every decade or so, dark clouds will fill the economic skies, and they will briefly rain gold***. ***When downpours of that sort occur, it's imperative that we rush outdoors carrying washtubs, not teaspoons***. And that we will do.[5]

This quote is central to understanding why Buffet is the greatest investor of our lifetimes. He achieved success through decades of patience and discipline ***and*** by fully embracing the (sometimes massive) uncertainty that comes with investing in great companies.

Embracing that uncertainty takes different forms for different people. For some, it means pulling together extra cash to invest when a shock hits markets and prices fall. For others, it might mean changing their monthly distribution source from investments to cash reserves to give the portfolio time to recover (and let dividends reinvest at subdued prices while that happens). But for everyone, it requires a recognition that uncertainty is what drives the equity premium and ultimately allows us to generate returns that can outpace inflation and grow our wealth. In other words, we need the rough stretches in markets to produce the long-term returns that keep us on track to achieve our goals.

At the risk of piling on with another quote, we'll leave you with one more. Nick Murray often refers to the equity premium as a "miracle" that provides continued growth of wealth and financial independence for those who can capture it. But he warns that the "miracle does not come to people who need it, nor even to people who want it. It comes only to people who deserve it, through the exercise of a superior temperament."[6]

Our team is here to make sure you're one of the deserving few who can demonstrate that temperament. Building a plan to achieve your long-term goals. Structuring your portfolio to meet your unique needs. Sticking with the plan in the face of uncertainty. And experiencing the "miracle."

> ***"The miracle [...] comes only to people who deserve it, through the exercise of a superior temperament."***
>
> ***~ Nick Murray***

Financial Planning News & Updates

Catch-up contributions. The Secure Act 2.0 caused ambiguity about the ability of people over 50 to make so-called "catch-up" contributions in their 401(k) plans after this year. Fortunately, last month the IRS determined that such contributions will be allowed in the future. The IRS also clarified that high earners can continue to make pre-tax (as opposed to Roth) catch-up contributions through the end of 2025.

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[5] Emphasis added. This quote comes from page 4 of the letter, which is available in its entirety at: https://www.berkshirehathaway.com/letters/2016ltr.pdf.

[6] Murray, Nick. *Around the Year With Nick Murray*. The Nicholas Murray Company, Inc., 2016, pg. 222.

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Innovation & Good News

1) Researchers have discovered a way to store electricity in cement that may allow the buildings and roads of the future to act as massive batteries. This could revolutionize the energy industry by allowing for mass storage of electricity from sunlight and other renewable sources.

2) Scientists are using artificial intelligence and machine learning to develop and refine antibodies that can fight specific diseases. This approach allows research and testing to be done in a fraction of the time (and much more efficiently) than by human trial and error.

3) There have been two recent breakthroughs in using CRISPR (gene editing) to potentially reduce the risk of Alzheimer's disease.

4) A new development in ultrasound technology is enhancing the efficacy of medicines in fighting cancer, and it may also have potential in treating Alzheimer's and Parkinson's.

5) Brain implants have allowed a paralyzed man to regain some use of his hands. Simply amazing.

Team Kooman Corner

This summer three of our team members celebrated major life milestones:

- Kyle Moerschbacher passed his exam and became a CERTIFIED FINANCIAL PLANNER™ professional. This was an achievement that required years of hard work, so please join us in congratulating Kyle!
- Justin Best passed his Series 65 licensing exam and joined K&A as a Client Service Associate. Welcome to Team Kooman, Justin!
- On a personal note, Madi Bayne got married on July 4th. We're all excited for Madi and her husband and wish them many years of happiness!

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A copy of the K&A's current written disclosure brochure (Form ADV Part 2A) discussing our advisory services and fees is available for review upon request or at www.kooman.com.

Please remember to contact us in writing:

- If there are any changes in your personal/financial situation or investment objectives, so we can review, evaluate and/or revise our previous recommendations as needed; or
- If you would like to impose, add or modify any reasonable restrictions on our investment advisory services.

Unless and until you notify us, in writing, to the contrary, we will continue to provide services as we do currently.

Please also remember to advise us if you have not been receiving account statements (at least quarterly) from your account custodian.

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