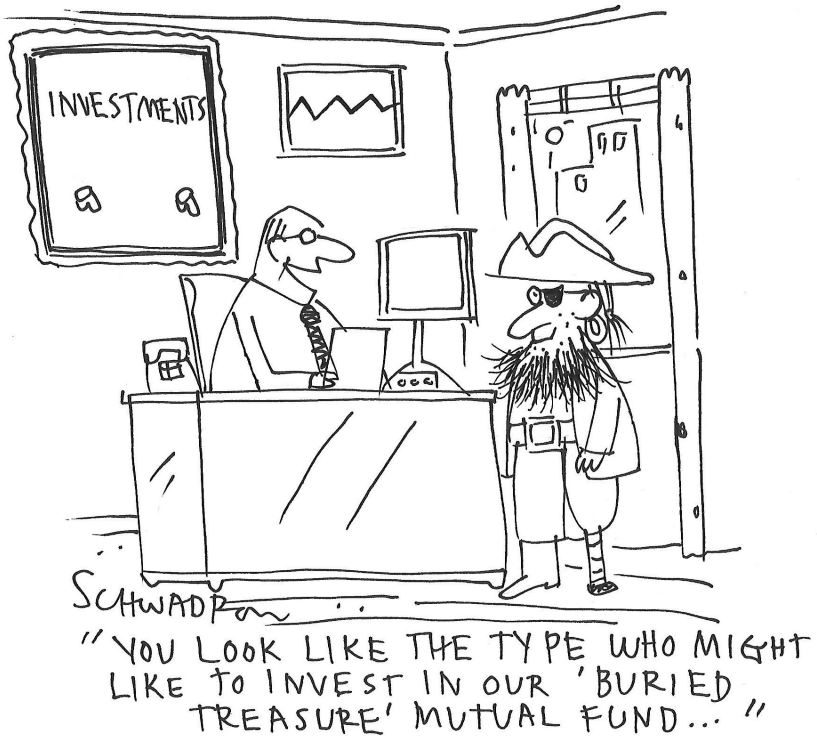
Setting the Stage for Long-Term Investment Success

"People are willing to get short-term gains at the risk of long-term choices." - Rick Rubin



This past year has been one of significant market turbulence, which have left many people feeling both cautious and concerned about the future. One of the most difficult things investors must come to terms with is that it is impossible to predict where asset prices will be in the weeks, months, and years ahead. As investors, we must become comfortable with the idea that we are not in control, and therefore can only first interpret, then react to information as it develops.

Given we cannot predict the market with certainty over any meaningful time horizon, it makes sense to first strip out what we can control and then build investment portfolios with this in mind. The idea is to increase the probabilities in favor of our clients' long-term success.

My father and I work together and make a good team. I am particularly fortunate to be able to draw from his extensive background in taxes. Prior to focusing exclusively on investment management and financial planning, my father ran and later sold his tax practice, which he built up from scratch over decades out of his Hayes Valley office in San Francisco. He is very good at taxes and enjoys the work, however due to a noncompete agreement he is no longer able to take on tax clients, even if he wanted to. With that said, tax planning strategies are frequently a focus when we get together to discuss investments and our clients' investment portfolios'.

This brings me to the two variables which we do have some level of control over - client expenses and taxes.

In many cases, the first thing an adviser can do to get costs down is to avoid mutual funds and instead invest in individual stocks, bonds, and low-cost index ETF's. Still, many advisers choose to utilize mutual funds which sometimes charge high expense ratios. If an investor is paying a high expense ratio of 0.75% or greater, plus a typical advisory fee of 1%, the investor must clear at least 1.75% annually before he/she begins to profit. To us, this does not seem like a good starting point.

Second, efficient tax planning strategies regarding portfolio management should also be incorporated into the process. Towards the end of each year, we comb through taxable portfolios to identify tax loss harvesting and capital loss carryover opportunities.

Tax Loss Harvesting entails selling an individual security that has experienced a loss and replacing it with a similar one to offset capital gains taxes, while maintaining an optimal asset allocation. As a result, a client could pay fewer taxes and increase long term compounded returns by staying invested.

Capital Loss Carryover is the net amount of capital losses eligible to be carried forward into future tax years. Capital losses that exceed capital gains in a year can be used to offset ordinary taxable income up to $3,000 in any one tax year. Additionally, capital losses can be carried over to offset capital gains in future years until the loss amount has been exhausted.

Every year is different, and depending on financial market conditions investment portfolios do not aways have capital losses to offset capital gains – this was an unfortunate but common situation for some clients in 2021. However, the silver lining of this extraordinarily difficult year is that many clients will not only be able to take advantage of tax loss harvesting strategies but will also likely have capital loss carryovers to offset future capital gains, thereby decreasing future tax.

No one can predict what the market may or may not give us in the future, however we can set the stage for long term success by working to decrease common drags on investment returns.
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I am skeptical this equity rally can hold up. Nevertheless, market positioning appears underinvested and offsides which could translate into further gains in the near term. I wouldn't be surprised to see the broad market rally another 5-6% from here but would consider lightening up positions further barring no significant developments from the Fed. I have low conviction but will not fight it.

The yield curve is the most inverted it has been since the early 80's and is signaling to financial markets all is not well. Positively sloped yield curves are the building blocks of the cash and carry trade (borrow short and lend long) as well as the secret sauce for both economic and financial growth. Currently, the Fed appears caught-up on lagging economic indicators such as the CPI and the establishment survey of employment, which tend to miss economic turning points. The divergence between leading and coincident inflation indicators along with the more divergent negative readings of the household survey on employment should be on policy makers radar. Choosing to brush off the divergence between real time market indicators and lagging historic data seems eerily familiar to the period just before the financial crises to me. I believe the Fed has overdone it with monetary policy tightening.

Intermediate and long-term US Treasury bonds appear to have printed their high yields for the cycle and are testing the market narrative of lower future growth and inflation. In the near term, I am wondering how much more rates can decline or invert further without new incoming economic data to confirm the move or a change in communication from the Fed.

In the meantime, money market rates haven't been this high in about twenty years. For risk averse clients with money on the sidelines and liquidity needs, 3-12m Treasury Bills are yielding greater than 4% on an annual basis, while I've seen high rated 1 year corporate paper yielding greater than 5%. Not bad, not bad at all.

ASSET CLASS & SECTOR OPINIONS		
OVERWEIGHT	**NEUTRAL**	**UNDERWEIGHT**
Cash	**International Developed Market Equities**	**Small Capitalization Stocks**
U.S. Treasury Notes & Bonds	**Emerging Markets Equities**	**Financial Services Sector**
Investment Grade Corporate Bonds	**Consumer Discretionary Sector**	**Leisure & Hospitality**
U.S. Real Estate & Related Equities	**Consumer Staples**	**Materials Sector**
Large Capitalization Technology	**Communication Services Sector**	**Energy Related Equities**
Healthcare	**Mortgage-Backed Securities**	**Leverage Loans (Floating Rate Debt)**
Aerospace & Defense	**Local Currency EMG Bonds**	**Treasury Inflation Protection Securities**
Utilities	**Gold & Gold Miners**	**High Yield Corporate Bonds**

Sincerely,
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