TD&Co.

THOMPSON DAVIS ASSET MANAGEMENT

THE INVESTOR INSIGHT

APRIL 2023

INSIDE:

The Fed's Balancing Act *(continued)*

BACK COVER:

The Secure Act 2.0: Making 529 Plans More Valuable

CELEBRATING 20 YEARS AS AN INDEPENDENT RIA

Q1 Commentary

The Fed's Balancing Act

As we ended the first quarter of 2023, investors find themselves grappling with yet another (Fed induced, in my opinion), problem: Bank failures. As of the writing of this commentary, we have had three domestic and one foreign bank either fail or need to be taken over by a stronger competitor. Our supplemental commentary a few weeks ago got into the weeds more on why each failed or had to be gobbled up. In short, it is our view that the Fed and its overly aggressive actions do have some fingerprints on what has broken parts of the banking system and continues to impact the economy, as well as the markets. Both stock and bond investors have endured a dreadful two and a half years, where there were little places to hide, and over the past year, the Fed has hammered away at what it perceives as sticky global inflation.

The bank failures certainly resurrected the ghosts of corrections past (e.g., the 2008–2009 Great Recession), sending investors fleeing to cash at the fastest pace since the onset of COVID. A recent Bloomberg article ("BofA Says Investor Rush to Cash is Fastest Since Covid Hit") reports on the record-breaking surge in money market funds assets, which has surpassed $5 trillion for the first time ever. Even more interesting, in our view, was the finding that the last two comparable upsurges in the rush to cash came just as the Fed Funds target rate totally collapsed (meaning the Fed rate hike cycle had gone too far and it reversed course rapidly). Readers of these commentaries over the past year know all too well my feelings on the Fed's aggressive moves—its historical norm of starting late, going too far, and then having to reverse course when something finally breaks. This belief seems to be becoming more widely held. Several prominent figures, including Jeremy Seigel, Professor of Finance at the Wharton School at University of Pennsylvania, also agree that the Fed's current policy seems misguided.

Indeed, there is much to fret about when looking at the events of the decade so far: COVID now in its third year (much longer than anyone expected); massive supply chain disruptions, which persist in some areas even today; inflation spiking to its highest level since the early 1980s, prompting the Fed to move rates from zero to 5% in less than a year; Russia's invasion of Ukraine grinds on into a second year; and now, worries yet again about the stability of the global financial system. As the markets are forward looking, it is entirely possible that these events are "priced into the markets." However, we think it is also good to remember the following two perfectly complementary—and not the least bit contradictory—assertions.

1. The U.S. stock market is perfectly capable of declining by half—at any moment, for any reason or combination of crises. Anyone born since 1973 has been alive for three such episodes. Indeed, those born since President's Day 2000 have been alive for two of the three.

2. As a whole, mainstream American common stocks remain by far the safest investments in the world— provided one defines "safest" as the highest real long-term total return

–continued inside–

over time. Looking back at #1, the three episodes mentioned provided the best buying opportunities of many people's lifetimes. But while the current market correction (with the latest banking crisis spooking investors and reminding them of one of the three episodes) could certainly lead to further downside, in my opinion anyone thinking they can time such an episode correctly is foolhardy.

The S&P 500's long road to nowhere over the past 2 ½ years:

The broader market's half decade of no returns:

During periods like this and the many that have come before it, investors really have **three** paths to take. The **first path** is to do little and ride the inevitable corrections that will occur. For example, take the period between September 25, 2008 (the day Washington Mutual failed and arguably launched the 2008–2009 Great Recession) and the bottom of that correction on March 9, 2009. Those who took the first path in that scenario would have found that, exactly one year and 42 days later, the markets had recovered all of what they had lost during that time.

The **second path**, and the most fruitful over time, is to not only hold through these periods but also add to holdings. This obviously takes a great deal of intestinal fortitude, but remember Warren Buffett's contrarian advice: be greedy (buy) when others are fearful because "you pay a high price for a cheery consensus."

The **third path**, and unfortunately the one followed by most investors, is panic and sell. In my 33-year career, this has been the most painful to watch. To avoid this, it is imperative for investors to not let the gray matter between their ears (our brains and the emotions they can cause) push them to give up and sell, AFTER the bad news comes out and is already priced into stocks. This is the time when value abounds, so maintaining the aforementioned intestinal fortitude to choose the second path can yield opportunity.

As you can see from the two charts adjacent, it has been a long, grueling bear market for both stock and bond investors. I often mention that there are two kinds of bear markets. The first is like when COVID hit—the markets dropped quickly but recovered rather quickly. The other is like the meat grinder we find ourselves in now, where the markets decline over long periods of time. The first chart illustrates the "road to nowhere" for the S&P 500 for the past two and half years. It's even worse for broader markets, which have seen no return for the past half a decade (the second chart).

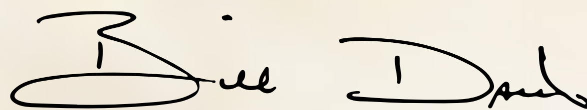
Three-plus decades in this business does give one some perspective. In my opinion, we are now in a period where we see company valuations that rarely occur, and when they have occurred in the past it has been near a bottom. This has happened only four other times in my career: (1) 1990, following the Savings and Loan Crisis; (2) the 1998 Asian Crisis, also when Russia defaulted on its debt (which would be the equivalent of the U.S. defaulting on its debt); (3) the 2000 Tech Bubble; and (4) the 2008–2009 Great Financial Crisis.

Does that mean we are at the exact bottom (or have already bottomed)? No one can accurately time the market to that degree, and it's a fool's game to try. But when you start to find good companies selling at or below book value, at or below replacement cost, insider buying at these levels, stock buybacks at these levels, these have been—at least during my tenure managing money—the hallmarks of a period near the bottom, and thus great opportunities for investors.

> ***"History never looks like history when you are living through it"***
>
> ***– John W. Gardner***

Going forward, the path will not be linear. It never is. But we are already seeing inflation decline dramatically, with the latest banking scares likely proving to be deflationary, as they have in the past. This should give the Fed cover to (at the very least) halt the rate hiking cycle that was likely coming to end even before the latest banking failures. While the headlines could certainly worsen, it is key to remember that equities are leading economic indicators, looking not backward at what has already happened, but forward 6–9 months (or longer) at the future cash flows of companies. With the valuations we are seeing in many parts of the markets, we think the Fed is likely to move to at least a neutral stance (if not outright cutting rates), and thus the backdrop for some, not all, equities looks better now than it has in some time. While we expect to maintain our core long-term positions as we believe the long-term thesis there remains intact, we also hope to pursue the second path mentioned above—adding positions that are selling at those historically low valuations that tend to happen only after long and pronounced bear markets like the one we find ourselves currently navigating.

Kind regards,



William D. Davis Jr.
CEO and Portfolio Manager

The Secure Act 2.0: Making 529 Plans More Valuable

Signed into law late last year, The SECURE Act 2.0 is a piece of legislation that seeks to expand and enhance the retirement savings opportunities for individuals in the United States. One of the provisions pertains to 529 plans, which are tax-advantaged investment accounts designed to encourage families to save for future college expenses. The problem arises when funds go unused—they may end up stranded in your child's 529 plan, and/or incur penalties if the funds are used for something other than education.

Money Stranded in a 529 Plan?

Say your daughter gets enough scholarship money that she doesn't use up the full balance of her 529 plan, or perhaps she decides not to go to college at all. In both of these scenarios you have just a few options, and none of them are great:

- If your daughter finished college, she may want to use the remainder of the funds in her 529 plan for graduate school. This is the best-case scenario, and funds are used until they are depleted.
- You can change the beneficiary of your daughter's 529 plan to another family member (another child, a grandchild, your spouse, yourself, brother, sister, niece/nephew, etc.). However, it may be difficult to find a relative who (1) wants to go to school, (2) doesn't already have their own 529 plan, and (3) to whom you want to provide this sort of financial support, so this isn't as helpful as one would hope.
- You can bite the bullet and use your daughter's 529 plan balance for any non-qualified expenses, in which case they'll incur the regular income tax rate plus a 10% penalty. Again, not great.

The SECURE Act 2.0 and 529 Plans

Under The SECURE Act 2.0, the rules governing 529 plans have expanded to allow for more flexibility and increased contributions. One new option is the ability to convert a 529 plan into a Roth IRA. Beginning in 2024, 529 plan beneficiaries can transfer 529 plan funds into their own Roth IRA without paying taxes or penalties. Key points:

- The 529 plan must have been open for a minimum of 15 years.
- The owner of the Roth IRA must be the beneficiary of the 529 plan.
- The lifetime limit for rollovers is $35,000.
- Contributions made to the 529 plan in the last five years, including the associated earnings, are ineligible for a tax-free transfer.
- Transfers you make from a 529 to a Roth IRA count against your yearly Roth IRA contribution caps, which currently top out at $6,500.

Many people ask how they can fund Roth IRAs for their children, but they're usually out of luck unless a child has earned income. However, this new provision allows parents to not only save for a child's education but also give them a leg up on retirement savings. The new law provides parents with a wonderful additional retirement savings strategy for children, in addition to a welcome release valve for over-funded 529s.

— Brant Jones, CFP®

Phone: (804) 644-6380 www.ThompsonDavis.com 9030 Stony Point Parkway, Suite 100 Richmond, VA 23235

Securities offered through Thompson Davis & Co., Inc. Member FINRA and SIPC. Advisory Services offered through Thompson Davis Asset Management, a Division of Thompson Davis & Co., Inc. No content published here constitutes a recommendation of any particular investment security, portfolio of securities, transaction or investment strategy. To the extent any of the content published may be deemed to be investment advice, such information is impersonal and not tailored to the investment needs of any specific person. Consult your advisor about what is best for you.