NIEMANN
INVESTMENTS

July 19, 2022

Fellow Investors:

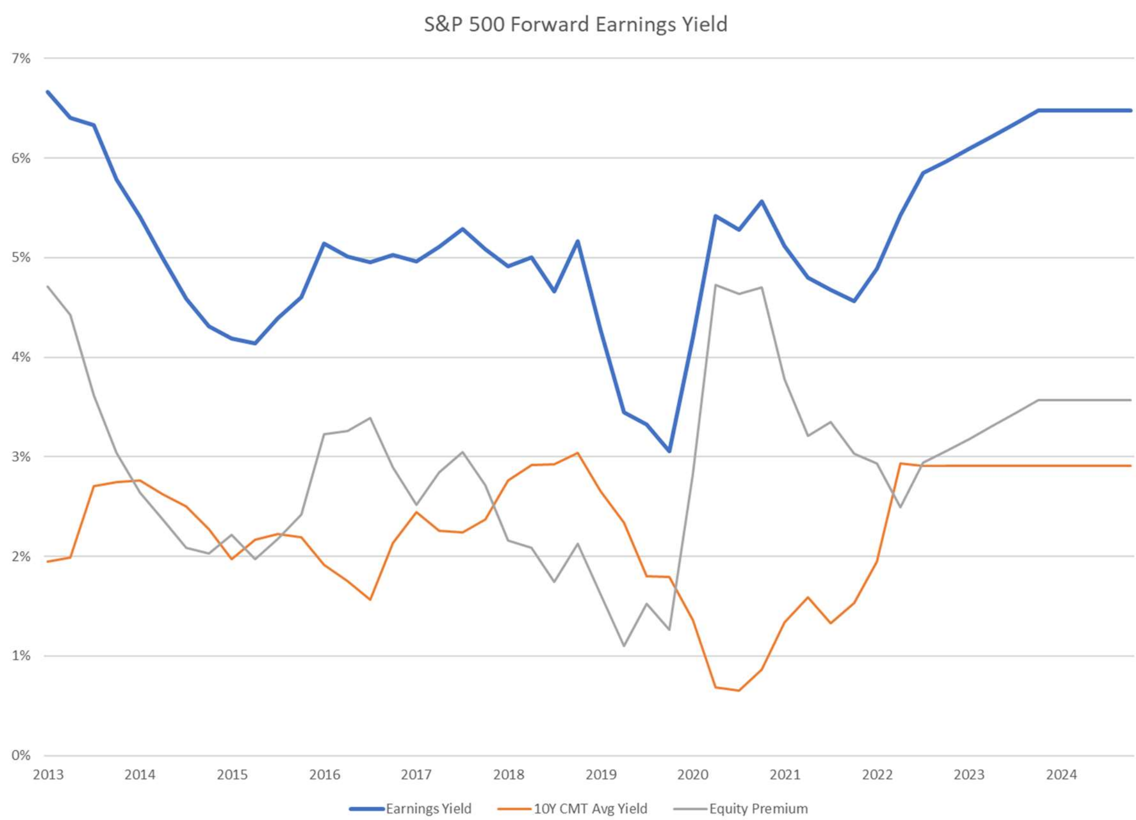
Welcome to all the new investors who have joined since my last letter. The client list continues to grow steadily, entirely through referrals. Thank you to all existing investors for making this happen.

Recent Market Developments

The last three months in the markets have been eventful, and not in a good way. I'll let the news outlets cover the details, but in summary, stocks are down significantly, and unfortunately your portfolios were not spared. Unpleasant at it may be, this is simply part of the process when investing in stocks. In fact, losses should be expected approximately every three years on average. If we knew the timing of these declines in advance, we could of course avoid them, but we do not. Therefore, the best approach is to take a long-term view (five years or more) and remain invested in good companies. Or, even better, use times like these when the market is down to add to your portfolio at lower prices. The market usually recovers and moves on to new gains before too long. It may be small consolation, but my personal portfolio largely holds the same stocks as your portfolios and likewise is down significantly.

While there are still many troubles on the economic horizon, most investors I speak with mention inflation as their largest concern. In Q2, inflation was a major reason for the significant price declines of both bonds and stocks. While inflation may be the largest economic headwind of 2022, I do not expect it will be in 2023. Most economic forecasts and market implied measures of future inflation show a return to approximately 3% in the next 12 months or so. This generally aligns with my expectations.

The chart below shows the forward earnings yield on the S&P 500, which is one of my preferred measures of market valuation. The blue line is the earnings yield (next year's expected earnings divided by today's price), the orange is the 10-year US Treasury bond yield, and the grey is the difference between these two. The higher the grey line, the better for buyers of stocks. You may recognize this chart from a previous version included in my Q2 2021 letter. At the time, I stated that valuation levels were not unreasonably high. Since that time, stocks rose, then fell by about 20% and are now again near or slightly below the same levels they were in early 2021. Given changes in interest rates and earnings, I still think the market is not unreasonably high at today's levels. In other words, it's a fair time to be buying stocks. Nevertheless, we should remember that stocks can always go lower. I make no attempt to call the bottom of the market; however, I will say that several years from now, stocks will very likely be higher and today's prices will generate good returns.



Short-Term vs Long-Term

Many investors, especially new investors, struggle with the volatility of the stock market. The daily gyrations can be difficult to watch. However, it should be remembered that volatility is generally a short-term issue. For the patient investor, over long time horizons, stocks have been reliable generators of positive returns.

I've attempted to illustrate this idea numerically in the table below, which shows return statistics on the S&P 500 Index over various time periods from daily to 5 years, using data from 1950–2022. The daily column, for example, shows a mean return of 0% and standard deviation of 1%. These statistics imply a 51.4% chance of a positive daily return—little better than a coin flip.[1] However, as we move out to longer time periods, notice how the probability of a positive return increases dramatically, and is nearly 90% over five-year periods. The takeaway is that the longer you can hold on to your stocks, the better returns you are likely to see.

	Daily	Monthly	Quarterly	Annual	5 Year
Median	0.0%	1.0%	2.9%	11.6%	55.6%
Mean	0.0%	0.7%	2.2%	8.9%	47.6%
Std Dev	1.0%	4.2%	7.8%	16.7%	42.8%
Probability of Positive Return	51.4%	56.8%	61.1%	70.3%	86.7%

Conclusion

In my Q1 2022 letter, I mentioned that cash balances were higher than usual. At the time, I had trimmed some positions and exited others when valuations seemed too high and prospects less bright. In hindsight, I should have done much more trimming than I did. Nevertheless, this excess cash is now being invested at much better prices. As stated above, I expect the future will show these were good decisions.

One final note: I had some T-shirts made with the logo at the top of this page. If you would like one, please reach out with your size preference. As always, I'm available to talk and address any questions you may have. Otherwise, stay the course!

Kind regards,
Todd Niemann, CFA

[1] This analysis assumes a normal distribution, which is not strictly true for stock returns, but is, nevertheless, useful to demonstrate this idea. More precisely, stock returns have a left skewed distribution (median is higher than the mean).