Pavlic Investment Advisors

Client Review & Outlook

Dear Client,

We would like to start by thanking everyone for their participation in helping us move the custody of your assets to Charles Schwab. Between the thirty pages of paper forms per account or the small electronic print on DocuSign, it has not been a fun endeavor. Charles Schwab offers the best technology for our clients while also eliminating custody fees and most brokerage commissions. On average, this change will reduce total fees by about 20% while also improving the technological experience for clients. If you have any questions or concerns regarding this, please don't hesitate to contact us.

After rising roughly 5.0% in July-August, the market was down 5.0% in the month of September to end the quarter roughly flat. Similarly, our core equity strategy was roughly flat for the third quarter. A 5.0% drawdown in September, after reaching all-time highs at the beginning of that month, is perfectly healthy. In fact, historically speaking, we should expect at least a 10% drawdown every 18 months. Drawdowns are the price of admission for long term positive equity returns and we take advantage of them by putting any excess cash in your portfolio(s) to work. Our equity thesis from the beginning of the year remains intact: we still believe stocks will end the year higher than where they started, barring any exogenous shocks.

US Stock Index Performance

	3Q 2021	YTD 2021
S&P 500 Index	+0.4%	+15.4%
NASDAQ Index	+0.3%	+13.2%
Russell 2000 Index	-2.9%	+13.2%
Dow Jones Index	-1.3%	+11.3%
S&P 500 Value	-1.1%	+14.8%
S&P 500 Growth	+1.0%	+14.8%

During the quarter, there were very few bonds linked to any measure of inflation available for purchase and the availability of spread bonds has been limited as well. This gives credence to our strategy of buying bonds and holding them to maturity since we already hold many inflation-linked bonds. Although the debate on whether inflation is transitory or more permanent remains the hottest topic in the markets, we are maximizing returns in our bond portfolio due to our exposure to CPI-linked bonds as inflation continues to hover around 5%. We remain disciplined in only purchasing investment grade corporate bonds and our objective remains to maximize interest income. Despite limited inventory, we were able to purchase more variable rate spread bonds with yields ranging between 4.0-5.0%. This is substantially better than the yield on 10-year US Treasury bond, which currently sits at 1.5%, without taking on much additional risk.

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Quarterly Review

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Stock Market Review

After a robust first half of the year (approximately +7% equity market gains in each of the first two quarters), stocks struggled for direction in the third quarter. July and August were stronger while in September saw the largest drawdown of the year at roughly 6%. What sparked the drawdown was something not many could have predicted: one of China's largest property developers called Evergrande was (and still is) having issues making interest payments on their over $300 billion debt load. Although Evergrande is in serious trouble, we do not believe a default would cause systemic risk—or in other words bring down the global financial system. We see the risk as more isolated to the China banking industry and its large conglomerates. As a reminder, we only invest in US-based companies despite many having international operations. We have no direct exposure to China.

We cover **3 topics** this quarter, stemming from the questions we have been asked most frequently by clients:

1. **The Debt Ceiling.** Aside from inflation, the debt ceiling has been front and center in the political arena over the last few weeks. Although political football is exactly what it sounds like, we are most focused on what it means as it relates to the stock and bond markets. Historically speaking, the debt ceiling issue has created smaller drawdowns—generally of around 5% variety if not combined with other factors. When politicians show partisanship and eventually raise the debt ceiling, markets rebound and often very quickly. Our stance is that the debt ceiling will be raised yet again, and the proverbial can will, again, be kicked down the road. Using history as our guide, we believe sell-offs in the equity markets related to the debt ceiling issue will continue to be buying opportunities.

2. **Taxing the Rich.** Although we generally shy away from political discussions because we have found that investors can make careless decisions if they are too passionate about one particular party over another (stocks have had positive returns under both Democrat and Republican leadership), we do feel the need to address this trending topic of "tax the rich." Progressives continue to claim that free-market capitalism driven by the profit motive causes wage stagnation and results in both income and wealth inequality. To counteract this imbalance, they want the government to step in and redistribute income and wealth by increasing taxes on the rich and on corporations. The issue with raising taxes on the "wealthy" is that many of these households' own businesses that collectively account for the majority of jobs in our economy and are the primary driver of future job growth. To put some numbers to this, we found that C-corporations employ 56 million workers and S-corporations employ 35 million workers in the United States. In total, 90 million Americans are employed by these pass-through entities that would take on the brunt of the proposed tax increases. According to the Bureau of Labor Statistics, there are approximately 157 million workers in the United States. This means that small business jobs accounts for 57% of all jobs in the U.S.

   When companies have more profits, they hire more workers, build more plants, and spend more on equipment as well as on investments in R&D which drives innovation. The opposite is also true—unprofitable companies cut jobs, divest from unprofitable segments, and slash capital budgets. Innovation stalls. Profitable companies in the U.S. are good for you, the investor. We don't believe you can tax a nation into prosperity. Profitable businesses create the high paying jobs that we want more of in the U.S not less.

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Quarterly Review

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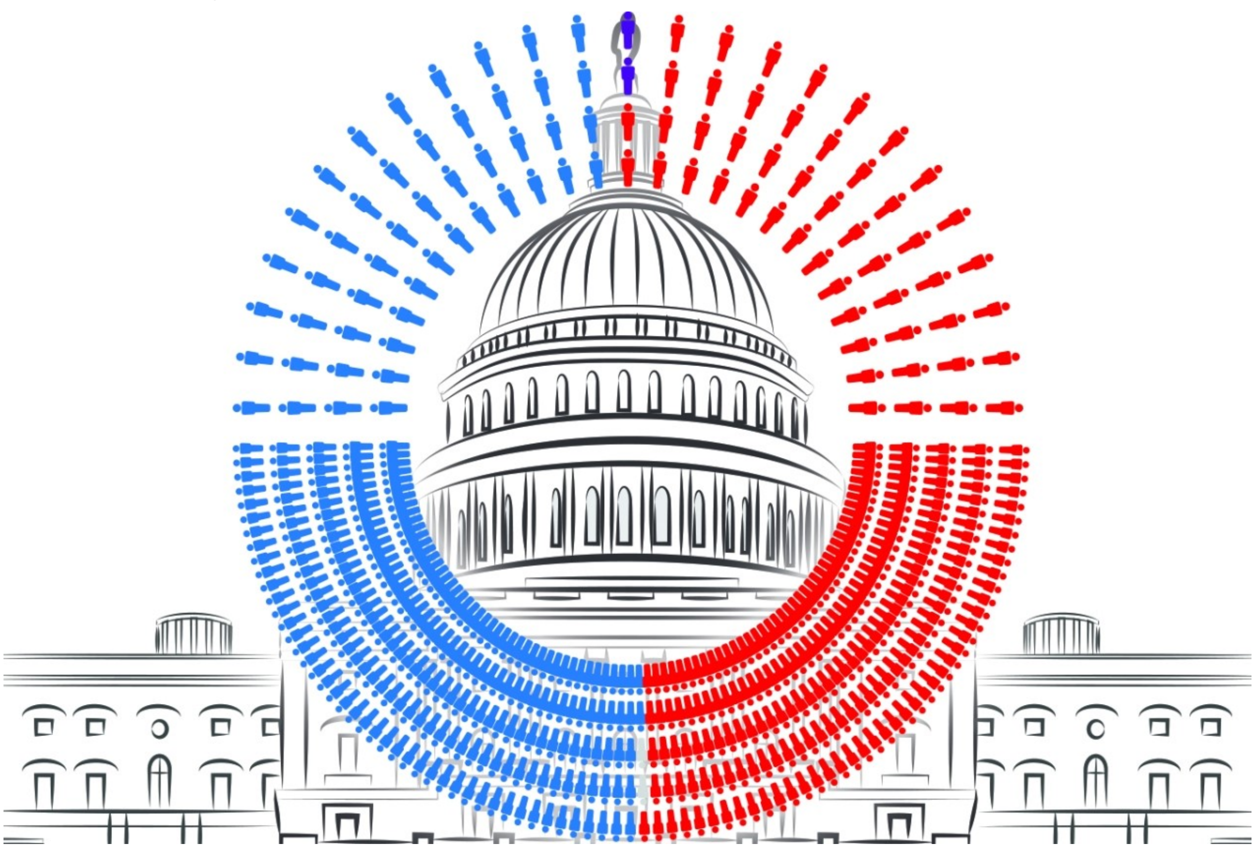
3. **Congressional tax proposals.** Although greatly in flux and changing by the day, this is a summary of proposed tax law changes that we are closely monitoring for our clients:

    - **Corporate tax rates.** Increase corporate tax rate from 21.0% to 26.5%.
    - **Capital gains.** Long term capital gains taxes (assets held > 1 year) would increase from 20% to 25% for couple's earnings more than $450k.
    - **IRA Reform.** Those who earn too much to directly contribute to a Roth IRA would no longer be able to make after-tax contributions to a traditional IRA and then convert those contributions to a Roth IRA, also known as the "back door IRA." This part of the rule would go into effect after December 31, 2021. Second, some employer plans allow individuals to contribute up to $38,500 on an after-tax basis to their employer's 401(k) plan and then roll over the after-tax portion of their 401(k) account to a Roth IRA. This would also be disallowed.
    - **Individual tax rates.** Increase top marginal tax rate from 37.0% to 39.6% for married filing jointly couples with income more than $450k. The higher rate would also apply to trusts and estates with taxable income of more than a mere $13,450.
    - **High Income surtax.** 3.0% surtax on individuals with >$5mm in income and for trusts or estates with more than $100k in income.



Source: khn.org

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Bond Market Review

The U.S. 10-year treasury rate (we view this as the “risk-free” rate of return) started the quarter at 1.48% and ended the quarter at 1.48%. During the quarter, rates dropped to a low of about 1.2% and then rallied back to end the quarter at right where they started. We view the 10-year treasury rate as the return an investor can make in fixed income assuming the U.S. government continues to make its debt payments. Although heavily debated today, the U.S. government has never missed a debt payment in its history, and we don’t see a debt payment being missed anytime soon. A 1.48% annualized return is nothing to get excited about—and our investment goal with our corporate bond selections is to maximize income while keeping our weighted average maturity under 5 years, and to avoid taking materially more risk than a U.S. Treasury investment. We do this by sticking to investment grade bonds with maturities of 10 years or less and selecting issuers that we deem to be extremely credit worthy borrowers.

Source: Yahoo Finance

Bonds that we purchased during the quarter include a Morgan Stanley variable rate bond maturing in 2031 with a current yield of 7.0%. Further, as the yield curve continues to steepen, these bonds will pay even greater rates of interest than currently. Our bond strategy assumes that the stimulus will lead to higher growth and that periods of higher inflation will last longer than policymakers expect. However we do not expect to see the hyperinflation of the 1970’s. We further assume that the Fed will keep short interest rates low until at least the fall of 2022. We believe that spread bonds that pay greater rates of interest when the yield curve steepens, or inflation rises, are excellent ways to take advantage of the current bond market environment.

2021 Outlook

The US economy continues to thaw from the COVID freeze of early 2020—and we have had an extraordinary amount of fiscal and monetary stimulus to get us out of the deep freeze. The stimulus has led to massive jumps in liquidity, and in general both businesses and consumers are flush with cash. Despite the end of some stimulus programs and supply chains that are being pushed to the brink, GDP will likely rise 6% this year and close to 5% next year. Earnings forecasts for the S&P 500 have moved up 15% since the beginning of the year from $175 to now $203, and in 2022, $240 is a reasonable estimate. Even though valuations are marginally above historical averages, we are buyers of high-quality stocks on pull-backs, preferring companies with growing cash flows at reasonable prices. In the bond market, we continue to look for inflation and spread rate bonds and our new custodian relationship with Schwab will allow us a bigger fishing pond to source bonds where we can maximize yield.

As always, if you would like to discuss your investments, please don’t hesitate to call or email us so we can arrange either a phone, video, or in-person meeting.