

## Live for Today and Plan for Tomorrow

# IPO PERFORMANCE DEMYSTIFIED

Pssst. Do you want to buy a sexy investment?

**T**he Wall Street brokerage community, and brokers themselves, are paid handsomely to “take private companies public,” which is another way of saying “sell the shares that a privately-held company has created” to investors, usually making the company’s founders wealthy in the process. For their sales activity, the brokers and their firms will make roughly seven percent of the total proceeds, which, in the case of a \$1 billion initial public offering (IPO), would come to \$70 million. That’s on top of the shares that the firm keeps for itself or doles out to favored customers. Last year, Goldman Sachs workers, top to bottom, received bonuses (above their salaries) averaging \$404,000, and the traders who sell IPOs were paid much more for their sales activities.

When somebody is being paid to recommend a particular investment, there’s a good chance that it isn’t what an objective observer would call the best possible option. Brokers create a mystique around the new shares, talk up the sexy story of the firm’s start-up phase and prospects, and collect their commissions on the way out the door. This is not a small business. Ac-

cording to statistics collected by researchers at the University of Florida, between calendar 2011 and 2022, some 1,597 IPOs saw their shares sold to the general public. An astonishing 72% of them were unprofitable at the time of the sale, meaning that their earnings per share were less than \$0.

But how do the investors fare from this arrangement? The U. of Florida researchers have collected IPO return data going back to 1980, looking at the aggregate gains or losses of new public companies with annual sales ranging from under \$10 million on up to over \$100 million, broken out by size. They found that the average first-day return for all IPOs—that is, the change in share value after the end of the first trading day of the stocks—was a sexy indeed 18.9%. For one day. The conclusion is that if you can get your hands on an IPO and sell it later that afternoon, you can generally make a nice tidy profit.

However, the IPOs turned out not to be great long-term investments. After three years, including dividends and capital gains, 9,089 IPOs in aggregate posted returns that were 18.7% lower than the market overall. There were obviously some discrepancies in the returns based on size; the small-

est new offerings underperformed by 47.4% (under \$10 million in revenues) and 38.1% (\$10-\$20 million) respectively, while IPOs of firms with over \$500 million in revenues underperformed by just 3%. These returns would not be considered even moderately attractive.

Of course, Wall Street brokers are not likely to disclose these gloomy statistics when they’re telling potential investors that the sparkling new IPO could be the next Apple Computer, Microsoft or Netflix. In the market environment we live in, investors have to protect themselves from bad advice, and the IPO data suggests that bad investment advice typically doesn’t come cheap.

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## INVESTMENT ACCOUNT PROTECTIONS FROM INSTITUTIONAL INSOLVENCY

**T**he current uncertainty in the banking industry has famously caused some depositors to pull their money from their lending institution, even though their money is insured up to \$250,000 per account. But many custodians and brokerage firms also have lending arms. If they run into trouble, it's fair to ask whether brokerage accounts are protected.

The short answer is yes—up to a point. The banking assets are protected by the Federal Deposit Insurance Corporation (FDIC), while brokerage assets are comparably protected by the Securities Investor Protection Corporation (SIPC). SIPC's coverage limits are twice as high as the FDIC's—up to \$500,000 per securities account.

When does the protection kick in? If a custodian becomes insolvent, then SIPC will ask the court system to appoint a trustee to liquidate the firm. In

most cases, however, investors will recoup their investments because the government will broker the sale of the custodian or broker-dealer to another party, which will take over custody of the accounts and render them stable again. In addition, brokerage firms are required to keep customer funds in accounts separate from their own, which serves as a backup check and balance against insolvency losses.

As a result, if someone has more than \$500,000 in one brokerage account, chances are high that they won't lose any money even if the custodian or brokerage firm is forced into liquidation. However, if the firm is unable to self-liquidate or there are no buyers on the horizon, then SIPC will be the guarantor of last resort.

Note that SIPC insurance doesn't provide protection against investment losses, or

losses due to account hacking. And it is irrelevant to claims against bad or inappropriate investment advice, which are typically handled through arbitration proceedings. The FINRA arbitration system, which handles such claims against brokers, generally hears more than 3,500 complaints against brokerage representatives every year, including 4,998 in 2021. The message there is that investors should fear bad or predatory advice from brokers far more than custodial insolvency.

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# STUDENT LOAN FORGIVENESS ON THE DOCKET

**Y**ou probably know that the Biden Administration's student loan forgiveness plan has been tied up in the courts for months, due to a lawsuit by the state of Missouri and two private individuals. Legal scholars are somewhat perplexed, since none of these parties has claimed a direct injury (the individuals seem to believe that they wouldn't get as much money as they'd like), but nonetheless the Supreme Court agreed to hear the case, and a ruling is likely to be against forgiving college-related loan obligations.

The forgiveness plan, if allowed to go forward, would cancel up to \$10,000 in student debt for single borrowers earning less than \$125,000; \$250,000 for married households. Borrowers who received low-income Pell Grants would be eligible for an additional \$10,000, for a combined

\$20,000 in loan forgiveness.

Meanwhile, there is a moratorium on government student loan payments that has continued since 2020, and this also means that interest is not accruing on the debt. The Department of Education says that payments will resume 60 days after the Supreme Court issues its ruling; if there is no ruling, then payments will resume in late August.

What to do? Since payments and interest are still suspended until the ruling, people who are eligible for debt relief, who owe less than \$10,000 (or \$20,000, if applicable) risk nothing by waiting to see what happens. If the Biden Administration wins the case, there is no reason to pay down debt that may ultimately be forgiven. People who owe more than the eligible amounts, or are not eligible for forgiveness, could pay down their debt while interest is not accruing.

The moratorium gave many recent graduates who were living under crushing amounts of debt to get themselves on a sound financial footing, and the result has been a surge in home buying, new births, retirement savings and new business formation. Economists have calculated that every 1% of student debt correlates with a 3.7% decrease in household spending; when the moratorium ends, and there is no debt relief, the impact will ripple through the economy, and could add to the possibilities of recession.

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# TAX-SMART CHARITABLE GIVING

There's a persistent misnomer in the minds of some financial consumers that charitable giving can actually benefit the giver from a tax standpoint, if the gifts are carefully structured to avoid capital gains taxes and generate tax write-offs. But in fact there are no clever strategies which make it profitable to give away money or assets.

However, there are ways to make gifts and donations less expensive on an after-tax basis, which means that people can be more generous to their charity, church or educational institution by leveraging the tax code a bit. The simplest tax-advantaged giving strategy is to give appreciated stock, real estate or other assets from a taxable account (not a traditional or Roth IRA) instead of writing a check. This allows the donor to transfer the full value of the assets without ever having to pay capital gains taxes on the amount of appreciation. Their donation can be up to 20% higher than a cash donation, and yet come out equally on an after-tax basis.

Donors can also, of course, claim a tax write-off on their charitable contributions. For appreciated assets, this is generally limited to 30% of their adjusted gross income. A more serious write-off obstacle is the high standard deduction: currently \$27,700 for married couples filing jointly. If the donation plus other deductions doesn't exceed

that threshold, it makes more sense to simply claim the standard deduction—which means there is no tax benefit (or write-off) from the amount given.

The solution? A savvy donor could bunch multiple years of contributions into one year, putting a larger contribution into a donor-advised fund. This pushes the contribution in the current year beyond the standard deduction, recovering the tax write-off by itemizing deductions, and then the donor could make his or her usual annual charitable gifts from the donor-advised fund.

Another tax-aware giving strategy for people who are taking required minimum distributions (RMDs) from their IRAs is to make use of qualified charitable distributions (QCDs). Individuals age 70 1/2 or older can have up to \$100,000 per year go directly out of their IRA to a charitable organization, which would satisfy the RMD requirement, and never have to pay taxes on the distribution.

And then, of course, there are a variety of trust vehicles which offer tax advantages. Donating to a charitable lead trust provides income payments to a charity for a fixed term of years, and when the donor dies, whatever is left in the trust will be passed on to the heirs. This can be structured to generate an initial write-off or to eliminate estate taxes on the inheritance.

If the donation is made to a charitable remainder trust, there is an immediate tax write-off, and the trust will provide income to the donor for a fixed period of time or life, and upon death the remaining assets will go to the charity of the donor's choice. The amount of the write-off is determined by the size of the income the donor receives. Charitable gift annuities work in a similar fashion; there is an up-front tax deduction and a lifetime stream of income payments flowing back to the donor until death, at which point the charity takes full possession of the remaining assets.

The simple point here is that the U.S. tax code encourages and even helps leverage charitable activities, even if it doesn't go so far as to make them profitable. Tax-smart donors can give more, and have more impact.

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# 2023 FIRST QUARTER INVESTMENT REPORT

Were last year's market losses an illusion? We've now experienced two consecutive quarters of healthy market gains, the long-predicted recession hasn't materialized despite rising interest rates and the Fed reducing its balance sheet--and oil prices have stabilized. So why are investors still so worried?

The market gains in the first three months of the year were spread fairly evenly across all sectors. The Wilshire 5000 Total Market Index—the broadest measure of U.S. stocks—gained 7.26% in the first quarter. The comparable Russell 3000 index is up 7.18% so far this year.

Looking at large cap stocks, the Wilshire U.S. 2500 Large Cap index is up 7.40% in the first quarter. The Russell 1000 large-cap index has gained 7.46% so far this year, while the widely-quoted S&P 500 index of large company stocks gained 7.03% during the year's first quarter.

Meanwhile, the Russell Midcap Index is up 4.06% in the first quarter.

As measured by the Wilshire U.S. Small-Cap index, investors in smaller companies received a 4.02% gain for the most recent quarter. The comparable Russell 2000 Small-Cap Index posted a 2.74% gain over the past three months. The technology-heavy Nasdaq Composite Index, the biggest loser in 2022, came roaring back in the first quarter, posting a 16.77% return.

Foreign markets moved in lock-step with the U.S. The broad-based EAFE index of companies in developed foreign economies gained 7.65% in the first quarter of 2023. In aggregate, European stocks were

up 7.95% in the past three months, while EAFE's Far East Index delivered a positive 7.08% performance. Emerging market stocks of less developed countries, as represented by the EAFE EM index, gained 3.54% in dollar terms in the first quarter.

Despite the rise in interest rates (and higher loan costs), real estate securities produced decent returns. The Wilshire U.S. REIT index posted a 3.25% gain in the first quarter of 2023. However, other alternative parts of a diversified portfolio were not so fortunate. The S&P GSCI index, which measures commodities returns, lost 5.91% of its value in the most recent three months. Utility stocks posted a 4.94% loss in the first quarter.

Bond rates rose dramatically last year, but that trend seems to have moderated. 30-year U.S. government bond yields are down slightly, from 3.96% at the end of last year to 3.65% currently. 10-year bonds are yielding 3.47% while, interestingly, 5-year government securities are yielding a higher 3.57%, 2-year Treasuries are yielding 4.03%, one-year government bonds are yielding 4.59% and 6-month securities are now yielding 4.86%. Whenever shorter-term bonds are paying bond investors more than their longer-term counterparts, it is called a yield curve inversion. Rarely will you see one as dramatic as this.

Municipal bonds are a bit less chaotic at the moment but there is still inversion going on; 30-year munis, on average, are yielding 3.38%, but the inversion can be seen in 10-year (2.28%), 5-year (2.23%), 2-year (2.41%) and 1-year (2.47%).

So... What about that recession that everybody keeps predicting? Are banks safe

anymore? Will the war in Ukraine jump the borders and lead to something more dangerous? When will inflation finally moderate? Behind the nice returns, it's possible to find a world of uncertainty, and the narrative threads are undeniably complicated.

Start with the banking sector, where the run on assets at Silicon Valley Bank was followed by problems at Signature Bank, First Republic Bank, Zions Bank and Credit Suisse. This narrative is actually pretty simple; many lending institutions were sitting on unprecedented amounts of deposits due to the Fed's response to the Covid pandemic, and some of them parked that extra money in bonds. Since they weren't getting paid on short-term securities, they bought into the longer maturities, and then suddenly rates went up and their bond investments dropped in value. The Federal Reserve Board has taken extraordinary measure to make sure banks have access to capital when they need it, and all depositors are insured up to \$250,000 per account. You may read about other banks with troubled balance sheets, but it appears that this is not the recession trigger that it was once feared to be.

One might think that banking woes would have zero impact on the inflation rate, but in fact the two are connected. Inflation is running at a 5.4% rate over the past year, and seemed to gain steam in January. These across-the-board price increases are well above the 2% rate that the U.S. central bank is targeting. In response, the Fed was expected to raise its lending window rate by half a percent, but decided, in light of the banking issues, to moderate the raise and in effect cut it in half. Its effort to fight inflation may be put on hold until the banking issues are straightened out.

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Meanwhile, the 3.4% unemployment rate is the lowest we've seen since 1969. Labor markets are so tight that there are two jobs available for every unemployed worker right now--and workers are demanding, and receiving, salary increases. This dynamic will push up inflation by raising production costs.

Finally, market watchers have noted the disparity between the Nasdaq returns and the market as a whole. Probing further, it has been noted that most of the gains posed

by the U.S. indices are the result of a small number of stocks--Nvidia, Meta (Facebook), Tesla, Warner Brothers Discovery and Advanced Micro Devices--showing outsized gains of between 50% and 87%. Most of the rest of the market is actually about even (zero gains, zero losses) for the first quarter of the year.

What does this mean? The future is always unknown, but the view ahead today is unusually cloudy. Even so, the first quarter of the year might contain a hidden

lesson. Economists have been predicting a recession for half a year now, and anyone who believed that those people with Ph.Ds on their resume possessed working crystal balls, and jumped out of the markets, would have missed two quarters of nice returns. Long-term investors who don't jump at every prediction took their gains to the bank.

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