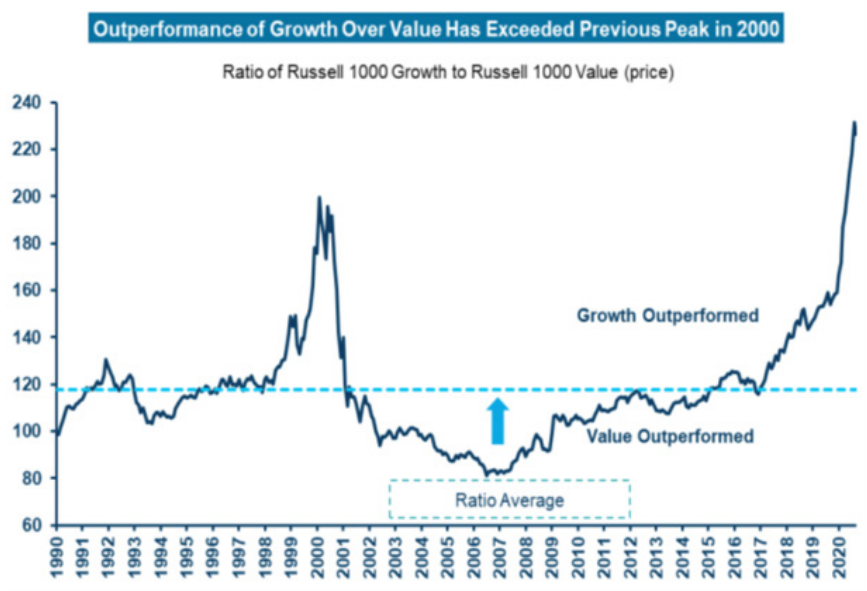
303.452.5986 office
800.578.9896 toll-free
www.TownsendRetirement.com

We recently initiated some changes to your investment positions to 1) take advantage of long-term opportunities; and 2) reduce risk due to some concerning developments in the wider world unfolding.

Our consistent goal is to earn you high average annual returns over time. To this end, we have shifted some of your investments to areas that we believe carry significant value and low risk of permanent losses --- areas that did not participate in the speculative runup or tech bubble of the last few years. Investments that we believe present excellent long-term upside.

Where is the value today and what does not carry large downside risks? Almost by definition value tends to be in investments that are under-owned, under-appreciated and widely shunned for one reason or another. As such, we added positions to more US value stocks, foreign stocks (developed and emerging markets), energy and gold. In other words, value is usually seen in the unpopular investments that very few people talk about or get excited about – not in the popular investments. Value is in the investments where prices have not been run by media hype, performance chasing, reckless behavior, cheap borrowing or index flows. It is in investments that have underperformed or businesses that are challenged, and where those challenges are well-known and priced-in.

Why value investments today? As shown in the chart below, growth stocks have outperformed value stocks for a very long period (14 years) and in dramatic fashion. What are 'growth' stocks? They can best be described as newer businesses, new technology, high revenue growth companies that put market share over profit. What are 'value' stocks? They can best be described as "desirable because underpriced". They tend to be overlooked, challenged, slow growth, profit-oriented and boring. Get-rich-quick types and speculators tend to love to chase growth-type stocks for fast returns. They don't care so much about risk. The investment industry itself also loves growth stocks since most money managers are engaged in the short-term 'performance derby' (constantly trying to outperform their peers). And most disregard valuations and risk because it is not their money, and they have been enabled by cheap credit.



The truth about markets is that prices eventually revert to the mean. In other words, under the surface of the market itself, there are cycles that repeat -- and the relative performance of growth vs. value stocks is one of them. Over the last 14 years, growth stocks dominated stock returns. Value stocks did not participate nearly as much in the Fed-sponsored runup. And, in our opinion, it is value stocks' time. For long-term investors, one of the most critical factors for investment success is being positioned on the right side of mean reversion, not on the wrong side.

We also strongly believe that to earn high average annual returns means avoiding large price declines (to the extent possible). Why? Because the simple math of investment returns makes this true. For example, if somebody is down 33%, they need to be up 50% to break even. If one is down 50%, they need to be up 100% to break even. Large losses necessitate huge returns to make up for the losses. And to earn huge returns means carrying huge risks. Therefore, a sensible goal is to own investments that do not carry significant downside risk in the first place because then you don't need to take big risks to try to earn the huge returns needed to make up for any large losses. You can hold a low-risk portfolio and still earn high average annual returns and not suffer huge swings in your balances.

What is concerning us today?

Large losses are more common in environments that occur after periods of excessive speculation (which we saw in 2019 – 2021): Environments characterized by high and rising credit costs, ebbing market liquidity (willing and able buyers), and without Fed support (interest rate suppression). These are also the environments where we tend to see dislocations such as the recent bankruptcy of FTX. As Warren Buffett says, "When the tide goes out, you find out who is swimming naked." We don't believe that large losses, at least permanent losses, will be likely in attractively priced stocks of strong stable companies.

When the Federal Reserve flooded the system with cash and easy credit (causing a credit bubble), it caused distortions. Distortions in pricing, distortions in perceptions and expectations, and distortions in behavior. We saw large scale capital misallocations. Periods during and after bubbles are periods, in our opinion, for long-term investors to be cautious. Because it takes time for the system (prices and behavior) to adjust and reflect economic reality.

In the late stages of the 2019 – 2021 credit bubble, many investment prices, such as tech stocks, cryptocurrencies, SPACs, private equity, meme stocks, etc., even residential real estate, became too expensive. Then, unexpectedly, inflation reared its ugly head. In response, interest rates went up and credit became more difficult and expensive to obtain. Investment markets and the economy are still adjusting to this new reality. Our belief is that due to the length and magnitude of the credit bubble being so large, it will take more time to rebalance the system. We have not seen any moments of panic or mass liquidations during this bear market and the ends of bear markets are often characterized by mass selling. We are not predicting a panic ahead, but we do believe it still makes sense to continue to invest with caution and that value stocks will outperform going forward.

As investors, there are always things to be concerned about. Besides the unwinding of the recent credit bubble, there are numerous challenges ahead and, as such, we want to avoid bad risks. The purpose is to avoid overpaying and avoid permanent losses. We want to put money in investments that have strong upside potential supported by a plausible investment case. And to use time to our advantage.

Best regards,

John Goltermann, CFA®, CGMA®
Senior Vice President & CIO
Townsend

We're open Monday through Thursday 7:30 a.m. - 5:00 p.m. and Fridays 8:00 a.m. to noon.

2761 West 120th Avenue, Suite 200, Westminster, CO 80234
Telephone: 303.452.5986 **Toll Free**: 800.578.9896 **Facsimile**: 303.452.5989