Quarterly Investment Commentary

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Well it's clear that 2018 will be a different year for the markets than 2017. In our fourth quarter newsletter a few months ago we commented on the extreme calm witnessed in markets last year, the first calendar year in history where stocks increased *every single month*. The first quarter of this year has been quite different. After a strong start out of the gates in January, both February and March posted negative returns, with stocks ultimately finishing the quarter down 0.76%.[1] International developed markets were down 1.58%, while emerging markets finished up 1.24%.[2] Bonds dropped 0.74%.[3] The fact that stocks and bonds both fell during the quarter illustrates the danger of living in a low-rate environment. When interest rates rise from very low levels, it's hard to find anywhere to hide.

Obviously a 1% drop in stocks during the quarter should not be regarded as a calamity, especially after an outstanding 2017. But after several years of incredibly calm markets the recent movements in stock prices *feel* material. So what is bothering markets? We always approach this question with a great deal of caution. The media loves to declare with confidence the precise reason why stock prices went up or down by as little as 0.1% in a single day. The stock market is a big, incredibly complicated system and supposedly clear-cut cause-and-effect relationships are often overly simplistic. That being said, a few developments did appear to give investors pause, including a concern that trade negotiations could spill over into trade wars and that wage inflation could accelerate, resulting in higher interest rates which in turn might pressure both stock and bond prices.

Of course after an incredibly strong run for stocks the past nine years, a lot of investors and commentators claim to be unsurprised by a setback in stock prices. It isn't uncommon to hear things like: *"They can't go up forever / The market was due for a pullback / I saw this coming."* We've spent a lot of time studying markets and we can say one thing for certain: we've yet to encounter anyone who can consistently call the market's tops and bottoms. We get nervous after stocks have had a strong run too, and in part this is justified, since more expensive stocks are riskier. But that doesn't mean we have the evidence needed to get out of the market.

There is a cautionary observation well-known on Wall Street: "There is no difference between being early and being wrong." Some investors thought stock prices were too high at the end of 2016. Yet stocks returned nearly 29% through the end of January 2018.[4] Even if stock prices fell 22% from the recent peak, they would still be slightly above their year-end 2016 levels. These cautious investors might argue that they would have been right, but corporate tax reform boosted stock prices. This is similar to the refrain from investors that have remained overly cautious all the way back to 2009, who argue they didn't know the Federal Reserve would be so aggressive supporting markets. These rationales aren't unfounded, but they miss the forest from the trees: in a complex system like the stock market, there are *always* unforeseen developments, both positive and negative. The key isn't to attempt to forecast these, but to acknowledge their inevitability and be humble about what you can actually forecast.

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[1] As measured by the S&P 500 index.
[2] As measured by the relevant MSCI international indices.
[3] As measured by the Citigroup 1-10 Year Government Bond index.
[4] Morningstar data for December 31, 2016 through January 31, 2018.

Take for instance the last two presidential elections.[5] In both instances, we heard investors express concerns about what the election would mean for stocks and whether it was time to get out. We made no fundamental changes to our portfolios, not because we had any particular political or economic insights, but because we didn't! In both cases, stocks did better than fine, rising 27% the next year in the first case and 24% in the second case.[6]

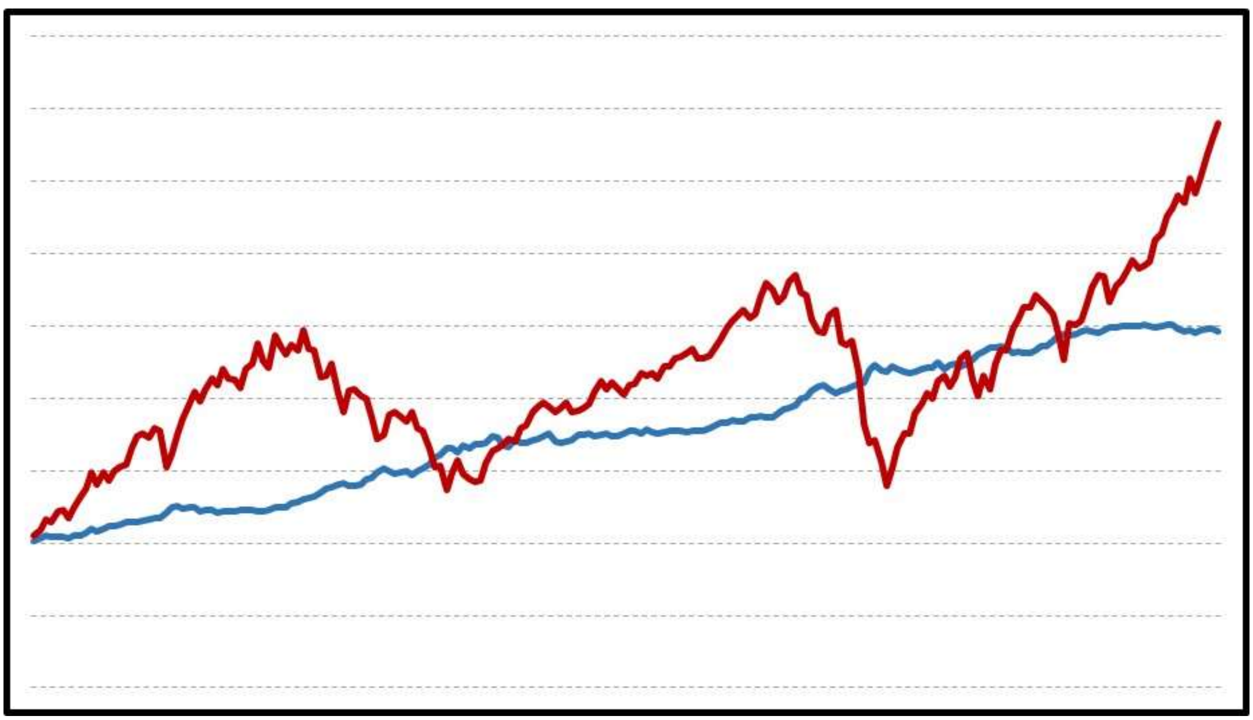
In our last two missives, we've quoted the investor Howard Marks, who has urged investors to be cautious in the current environment. Unfortunately, the financial news media translated his this as "Get out of stocks!" Marks later explained:

> [T]here are two things I would never say when referring to the market: "get out" and "it's time." I'm not that smart, and I'm never that sure.[7]

We continue to agree with Marks that the current period is a time for caution. This also means that future returns may be modest compared to recent returns. And of course bad things can always happen to stocks, no matter what the near-term picture looks like. Yet that doesn't mean investors should flee stocks.

Financial institutions often build complicated financial models to simulate potential returns. But a simple stress test can serve investors well – it is always possible, though not necessarily likely, for stocks to drop 50% (or more). If you take 50% multiplied by the percentage of your portfolio invested in stocks and stock-like investments, you'll get an estimate for how much your portfolio might be down in such a difficult environment. Could you handle this? If not – either because you might need the money that is invested in stocks for some near-term expenditure or you simply wouldn't be able to sleep at night – than it makes sense to reexamine how much you currently have invested in stocks *now*. If you can handle this, than its best to simply try to ignore the daily gyrations of the market.

Look at the graph below and ask yourself which line you would prefer to be on (and remember that we never have the foresight to know for certain that the red line will end up being higher at any future point in time):[8]



[5] Barack Obama was re-elected President on November 6, 2012. Donald Trump was elected President on November 8, 2016.
[6] Data for the S&P 500 for the next twelve months beginning on November 6, 2012 and November 8, 2016.
[7] "Yet Again?" by Howard Marks, Oaktree Capital, September 7, 2017.
[8] This chart is simply meant to be an illustration of potential stock and bond returns, not a historical reflection nor a forecast.

There isn't a right or wrong answer. Some investors, either because of their own temperament or because they may need the funds in their account to pay for a near-term expenditure, prefer the smooth ride of the blue line, i.e. bonds and similarly low-risk investments. But for investors with a long time horizon and the willingness to accept some lumpiness in their results, the red line, which represents stocks and stock-like investments, is highly likely – though not guaranteed[9] – to produce far higher returns over the truly long-term.

Accordingly, Warren Buffett wrote the following in his recently released letter to Berkshire Hathaway shareholders:

> I want to quickly acknowledge that in *any* upcoming day, week or even year, stocks will be riskier – far riskier – than short-term U.S. bonds. As an investor's investment horizon lengthens, however, a diversified portfolio of U.S. equities becomes progressively *less* risky than bonds, assuming that the stocks are purchased at a sensible multiple of earnings relative to then-prevailing interest rates.[10]

So there it is. If you are comfortable with the annual lumpiness of stock returns, your best course is to put as much as you can into stocks over time and avoid the short-term noise of both stock prices and the financial news media. Although monthly and annual results will be lumpy, you likely have a greater chance of preserving and growing your wealth *longer-term*.

Should the investor ever temporarily reverse course, or favor the blue line over the red line for a period of time even though he or she is a long-term investor? Our answer comes straight from the last line of the Buffett excerpt presented above: We would only advocate considering such a move if stocks were *not priced* "at a sensible multiple of earnings relative to then-prevailing interest rates." This occurs very rarely, and does not appear to be the case today given still low interest rates. Again, this does not mean that stock prices can't drop from here, just that we don't have the evidence needed to deem stocks *too* risky or *too* expensive in light of the current set of facts.

As always, we thank you for your continued confidence.

Sincerely,

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[9] If stocks were guaranteed to do better than bonds, then they wouldn't be riskier. That being said, history and theory both suggest that it is highly likely that over an *extended* time period, stock returns will outpace bond returns and do a better job of outpacing inflation.
[10] Berkshire Hathaway 2017 Annual Shareholder Letter.

Get to Know AMI: Spotlight on Erica Gulick

Erica Gulick is AMI's Operations Manager and Chief Compliance Officer. Erica joined the firm in 2008 and has worked in the financial services sector for nearly two decades. Erica is originally from Kendallville, Indiana and attended Indiana University Purdue University-Fort Wayne.

Our longstanding clients can attest to Erica's value and importance at AMI. She directs AMI's back office operations, handles customer service requests, and directs our regulatory compliance activities. She has a client-first service mentality and comes to work every day with an incredibly positive attitude.

Erica has been married to her husband Chad for 18 years. Erica is most proud of her two successful children. Her daughter is a sophomore at Butler University studying political science. She will return to the Miss Indiana pageant for the second time this summer. Her son, who like his sister is an accomplished thespian, will start college this coming fall.

Given Erica's recent and much overdue vacation (we've been on her for years!), her favorite hobby is walking on a nice beach. Her other interests include baking, decorating and spending time with her family. Her favorite movie is *Bridesmaids*, favorite sports team is Butler Basketball, favorite food is Italian and favorite type of vacation is tropical.

We, and our clients, are incredibly fortunate to have Erica on our team.