AMI INVESTMENT MANAGEMENT
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After a rough fourth quarter, stocks came roaring back in the first quarter of 2019. U.S. stocks jumped 13.7%,[1] international developed stocks 10.2% and emerging market stocks 9.9%[2] to open the year. Bonds also posted decent returns, netting 1.6% year-to-date as interest rates continued to fall from their October highs.[3] U.S. stocks now sit just below the all-time highs reached in the third quarter of 2018.

The Ten-Year Anniversary

Things felt a bit precarious at the end of last year as stocks dropped 20% from their highs. But it never makes sense to let the market dictate your behavior. Indeed, the disciplined investor is better served by channeling an inner *contrarian* streak, or as Warren Buffett once said, "Be fearful when others are greedy and greedy only when others are fearful."

The last ten years are a powerful case study of this wisdom. The U.S. stock market bottomed out on March 6, 2009. At the time, the country was dealing with its worst financial crisis since the Great Depression and investors were openly wondering whether the financial system might collapse. Fear ran rampant, and many investors fled the stock market.

We hit the tenth anniversary of the nadir of this panic during the first quarter. From the bottom tick ten years ago, stocks have returned 17.6% per year![4] $100,000 invested in the stock market on March 6, 2009 would be worth over half a million dollars today.[5] The results have been nothing short of outstanding. Those who stayed put or doubled down have been rewarded. Those who fled have been penalized.

Rational Optimism

Despite this outstanding ten-year run, the financial headlines have nonetheless been continually dominated by skeptics. We've even shared in this chorus from time-to-time. What accounts for this skepticism, and is it rational?

The investor Morgan Hounsel had a wonderful take on the topic last year in a post titled "The seduction of pessimism in a world where optimism is the most reasonable stance." He wrote:[6]

> Historian Deirdre McCloskey says, "For reasons I have never understood, people like to hear that the world is going to hell."
>
> This isn't new. John Stuart Mill wrote in the 1840s: "I have observed that not the man who hopes when others despair, but the man who despairs when others hope, is admired by a large class of persons as a sage."
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> Part of this is natural. We've evolved to treat threats as more urgent than opportunities. Buffett says, "In order to succeed, you must first survive."

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1 All of this data is 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 Per Bloomberg data, from March 6, 2009 through March 31, 2019.
5 These figures do not include any tax adjustments.
6 *The Psychology of Money*, June 1, 2018.

Hounsel continues:

> But pessimism about money takes a different level of allure. Say there's going to be a recession and you will get retweeted. Say we'll have a big recession and newspapers will call you. Say we're nearing the next Great Depression and you'll get on TV. But mention that good times are ahead, or markets have room to run, or that a company has huge potential, and a common reaction from commentators and spectators alike is that you are either a salesman or comically aloof of risks.
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> A few things are going on here.
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> One is that money is ubiquitous, so something bad happening tends to affect everyone, albeit in different ways. That isn't true of, say, weather. A hurricane barreling down on Florida poses no direct risk to 92% of Americans. But a recession barreling down on the economy could impact every single person – including you, so pay attention. This goes for something as specific as the stock market: More than half of all households directly own stocks.
>
> Another is that pessimism requires action – Move! Get out! Run! Sell! Hide! Optimism is mostly a call to stay the course and enjoy the ride. So it's not nearly as urgent.
>
> A third is that there is a lot of money to be made in the finance industry, which – despite regulations – has attracted armies of scammers, hucksters, and truth-benders promising the moon. A big enough bonus can convince even honest, law-abiding finance workers selling garbage products that they're doing good for their customers. Enough people have been bamboozled by the finance industry that a sense of, "If it sounds too good to be true, it probably is" has enveloped even rational promotions of optimism.
>
> Most promotions of optimism, by the way, are rational. Not all, of course. But we need to understand what optimism is. **Real optimists don't believe that everything will be great. That's complacency. Optimism is a belief that the odds of a good outcome are in your favor over time, even when there will be setbacks along the way**. The simple idea that most people wake up in the morning trying to make things a little better and more productive than wake up looking to cause trouble is the foundation of optimism. It's not complicated. It's not guaranteed, either. It's just the most reasonable bet for most people. The late statistician Hans Rosling put it differently: "I am not an optimist. I am a very serious possibilist." [Emphasis added]

This "seduction of pessimism" is by no means restricted to the financial world. In his book *Enlightenment Now*, the Harvard professor Steven Pinker writes:

> In *History of the Idea of Progress*, the sociologist Robert Nisbet [observed]: "The skepticism regarding Western progress that was once confined to a very small number of intellectuals in the nineteenth century has grown and spread to not merely the large majority of intellectuals in this final quarter of the century, but to many millions of other people in the West"…
>
> Are they right? Is pessimism correct? Could the state of the world, like the stripes on a barbershop pole, keep sinking lower and lower? It's easy to see why people feel that way: every day the news is filled with stories about war, terrorism, crime, pollution, inequality, drug abuse, and oppression. And it's not just the headlines we're talking about; it's the op-eds and long-form stories as well. Magazine covers warn us of coming anarchies, plagues, epidemics, collapses, and so many "crises" (farm, health, retirement, welfare, energy, deficit) that copywriters have had to escalate to the redundant "serious crisis"…
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> [But] the peace researcher John Galtung pointed out that if a newspaper came out once every fifty years, it would not report half a century of celebrity gossip and political scandals. It would report momentous global changes such as the increase in life expectancy…

> [H]ere is a shocker: *The world has made spectacular progress in every single measure of human well-being*. Here is a second shocker: *Almost no one knows about it*.

Pinker goes on to document the astounding gains humankind has made over the past four centuries in life, health, wealth, inequality, the environment, peace, safety, terrorism, governance, knowledge and happiness.

Now we don't want to be Pollyanish and we don't mean to downplay the significant challenges that face financial markets. There are various ways of measuring progress which may produce different interpretations, and progress itself can create unintended hazards. But our point is that humans seem biologically hardwired to favor a pessimistic view of the external world. We fear losses more than we value gains, and accordingly we focus on perceived or impending threats.[7] Those sounding alarm bells are often given megaphones, even if they stand on feet of clay.

It is hard to see the forest for the trees when standing at a single point in time. We struggle to comprehend the huge impacts that small, incremental progress can generate over an extended timeframe. The physicist Albert Bartlett once remarked, "The greatest shortcoming of the human race is our inability to understand the exponential function." This often leads to an overly pessimistic view.

Warren Buffett reflected on this topic in his most recent annual letter to Berkshire Hathaway shareholders. Buffett shares the fact that he bought his first stock on March 11th, 1942, investing $114.75. Despite the fact that the country suffered through several wars (including World War II), absorbed double-digit inflation, and saw its national debt *increase by 40,000%*, his initial purchase would have grown to $606,811 as of January 31, 2019 if it was simply invested in the general U.S. stock market (before taxes). That's a gain of 5,288 to 1! A similar investment in gold would have only grown to around $4,200.

It is easy to see the problems and challenges in front of us, but hard to see the potential solutions or steady, incremental progress that will confront those challenges. The authors of the popular book *Freakonomics* offer a wonderfully entertaining illustration of this in their sequel. Because of length, we've relegated it to the Appendix, but we encourage you to take a look at it!

The Stockdale Paradox

We can't be blind or eternal optimists though. We've sometimes described our jobs as professional worriers. Every day we spend most of our research hours worrying about what could go wrong in the investment world generally and in our investment portfolios specifically. We've told students we've mentored that skepticism is one of the most important attributes of a good investor. How does this square with rational optimism?

In his book *Good to Great*, the author Jim Collins profiles the Vietnamese Prisoner of War (POW) James Stockdale. Collins attributes Stockdale's ability to survive a nearly eight-year imprisonment to his specific coping strategy (as described here by Stockdale):

> I never lost faith in the end of the story, I never doubted not only that I would get out, but also that I would prevail in the end and turn the experience into the defining event of my life, which, in retrospect, I would not trade….[Who didn't make it out of Vietnam Prisoner Camps?] Oh, that's easy, the optimists. Oh, they were the ones who said, 'We're going to be out by Christmas.' And Christmas would come, and Christmas would go. Then they'd say, 'We're going to be out by Easter.' And Easter would come, and Easter would go. And then Thanksgiving, and then it would be Christmas again. And they died of a broken heart…This is a very important lesson. **You must never confuse faith that you will prevail in the end – which you can never afford to lose – with the discipline to confront the most brutal facts of your current reality, whatever they might be.** [Emphasis added]

[7] The famed psychologists Daniel Kahneman and Amos Tversky first identified this human phenomenon and labeled it "loss aversion."

Collins called this paradox – the belief you will prevail in the end but the ability to see current reality and its associated challenges as they really are – the "Stockdale Paradox."

The Stockdale Paradox relates specifically to personal and organizational survival. But in a similar vein, our job as investors is to continually analyze the risks that confront the long-term investor: debt, inflation, political crises, technological disruption, changes in consumer tastes, recessions, economic shocks, interruptions in supply bases, shifts in regulatory policy, poor or misaligned management behavior, extended valuations, etc. These are real and potentially worrisome challenges. But we must be careful not to easily forsake our core belief that the best long-term investment has been and will likely remain a material, diversified commitment to stocks. Bad things will happen. And we aren't saying that optimism is always the right stance. But we do believe that a long-term bet on U.S. stocks makes sense, and that a reversal or unwinding of that bet – either temporary or otherwise – should be approached with great caution.

We believe the best way to balance these dual roles of skeptic and optimist is to attempt to build our portfolios around *robust* companies – companies that can survive, or even thrive,[8] during periods of stress and upheaval. This concept harkens back to an old business dictum: Don't have plans, have principles. And it explains the primary reason we spend so much time researching the companies that we own: We want to know, understand, and have confidence in what we own in our portfolios.

What is a robust company? Its business possesses significant competitive advantages. It provides a product or service that we believe will continue to be demanded by its customers and not disrupted by technological innovation or changes in customer tastes. The company isn't overly reliant on a handful of suppliers or customers. They possess a fortress-like balance sheet. The management team is talented, aligned with shareholders, and focused on long-term success. The business is resilient against changes in macroeconomic factors such as interest rates, exchange rates, commodity prices, etc. The company has a win/win relationship with all of its counterparties: employees, customers, suppliers, owners, regulators, and local communities.[9] Few companies will clear all of these hurdles, but our goalposts are clear.

A Case Study in Insufficient Skepticism

We reference a lot of business books in our work, but we rarely recommend them here. The recent investigative work *Bad Blood* by business reporter John Carreyrou is an exception. The book details the rise and subsequent fall of the Silicon Valley venture company Theranos. Built by a Stanford University drop-out named Elizabeth Holmes, the company claimed to have invented technology that could diagnose hundreds of diseases with just a prick of blood. The company's valuation reached $9 billion, they secured partnerships with Safeway and Walgreen's, and Holmes recruited luminaries such as George Schulz, Henry Kissinger and James Mattis to the Board of Directors before whistleblowers and reporters revealed that the company's technology couldn't come close to accomplishing what it had proposed. The book is a fascinating read and a wonderful illustration of the dangers that arise when optimism goes too far and drowns out healthy skepticism.

At the end of the day we need to adopt a Stockdale-like attitude. We have to combine the ability to rationally and realistically appraise current and potential threats to our investments and our portfolios with a recognition of the fundamental attraction and protection that comes from a long-term investment in well-run companies.

As always, we thank you for your continued confidence.

Sincerely,

Michael D. Axel, CFA
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[8] The former trader and author Nassim Taleb calls this "antifragility."
[9] A friend and mentor notes that there are three types of relationships: win/win, win/lose and lose/win. Only one is sustainable!

APPENDIX: Excerpt from *SuperFreakonomics* (by Steven Levitt and Stephen Dubner)

When the world was lurching into the modern era, it grew magnificently more populous, and in a hurry. Most of this expansion took place in urban centers like London, Paris, New York, and Chicago. In the United States alone, cities grew by 30 million residents during the nineteenth century, with half of that gain in just the final twenty years.

But as this swarm of humanity moved itself, and its goods, from place to place, a problem emerged. The main mode of transportation produced a slew of the by-products that economists call negative externalities, including gridlock, high insurance costs, and far too many traffic fatalities. Crops that would have landed on a family's dinner table were sometimes converted into fuel, driving up food prices and causing shortages. Then there were the air pollutants and toxic emissions, endangering the environment as well as individuals' health.

We are talking about the automobile – aren't we?

No, we're not. We are talking about the horse.

The horse, a versatile and powerful helpmate since the days of antiquity, was put to work in many ways as modern cities expanded: pulling streetcars and private coaches, hauling construction materials, unloading freight from ships and trains, even powering the machines that churned out furniture, rope, beer, and clothing. If your young daughter took gravely ill, the doctor rushed to your home on horseback. When a fire broke out, a team of horses charged through the streets with a pumping truck. At the turn of the twentieth century, some 200,000 horses lived and worked in New York City, or 1 for every 17 people.

But oh, the troubles they caused!

Horse-drawn wagons clogged the streets terribly, and when a horse broke down, it was often put to death on the spot. This caused further delays. Many stable owners held life-insurance policies that, to guard against fraud, stipulated the animal be euthanized by a third party. This meant waiting for the police, a veterinarian, or the ASPCA to arrive. Even death didn't end the gridlock. "Dead horses were extremely unwieldy," writes the transportation scholar Eric Morris. "As a result, street cleaners often waited for the corpses to putrefy so they could more easily be sawed into pieces and carted off."

The noise from iron wagon wheels and horseshoes was so disturbing – it purportedly caused widespread nervous disorders – that some cities banned horse traffic on the streets around hospitals and other sensitive areas.

And it was frighteningly easy to be struck down by a horse or wagon, neither of which is as easy to control as they appear in the movies, especially on slick, crowded city streets. In 1900, horse accidents claimed the lives of 200 New Yorkers, or 1 of every 17,000 residents. In 2007, meanwhile, 274 New Yorkers died in auto accidents, or 1 of every 30,000 residents. This means that a New Yorker was nearly twice as likely to die from a horse accident in 1900 than from a car accident today. (There are unfortunately no statistics available on drunk horse-drivers, but we can assume the number would be menacingly high.)

Worst of all was the dung. The average horse produced about 24 pounds of manure a day. With 200,000 horses, that's nearly 5 million pounds of horse manure. A day. Where did it go?

Decades earlier, when horses were less plentiful in cities, there was a smooth-functioning market for manure, with farmers buying it to truck off (via horse, of course) to their fields. But as the urban equine population exploded, there was a massive glut. In vacant lots, horse manure was piled as high as sixty feet. It lined city streets like banks of snow. In the summertime, it stank to the heavens; when the rains came, a soupy stream of horse manure flooded the crosswalks and seeped into people's basements. Today, when you admire old New York brownstones and their elegant stoops, rising from street level to the second-story parlor, keep in mind that this was a design necessity, allowing a homeowner to rise above the sea of horse manure.

All of this dung was terrifically unhealthy. It was a breeding ground for billions of flies that spread a host of deadly diseases. Rats and other vermin swarmed the mountains of manure to pick out undigested oats and other horse feed – crops that were becoming more costly for human consumption thanks to higher horse demand. No one at the time was worried about global warming, but if they had been, the horse would have been Public Enemy No. 1, for its manure emits methane, a powerful greenhouse gas.

In 1898, New York hosted the first international urban planning conference. The agenda was dominated by horse manure, because cities around the world were experiencing the same crisis. But no solution could be found. "Stumped by the crisis," writes Eric Morris, "the urban planning conference declared its work fruitless and broke up in three days instead of the scheduled ten."

The world had seemingly reached the point where its largest cities could not survive without the horse but couldn't survive with it, either.

And then the problem vanished. It was neither government fiat nor divine intervention that did the trick. City dwellers did not rise up in some mass movement of altruism or self-restraint, surrendering all the benefits of horse power. The problem was solved by technological innovation. No, not the invention of a dung-less animal. The horse was kicked to the curb by the electric streetcar and the automobile, both of which were extravagantly cleaner and far more efficient. The automobile, cheaper to own and operate than a horse-drawn vehicle, was proclaimed "an environmental savior." Cities around the world were able to take a deep breath – without holding their noses at last – and resume their march of progress…

When the solution to a given problem doesn't lay right before our eyes, it is easy to assume that no solution exists. But history has shown again and again that such assumptions are wrong.

[An interesting aside: The automobile industry would turn into one of the great growth industries of the twentieth century. But that didn't mean it was a great opportunity for the long-term investor. In fact, 2,000 or more automobile manufacturing companies were formed in the last century in the U.S., and only two have managed to avoid either filing bankruptcy or being taken over. One of those two, Ford, barely survived the last recession, and the second, Tesla, is a relative newcomer that hasn't really been tested by a recession yet. The fate of the airline industry, also a huge growth industry over the past one hundred years, has arguably been even worse, leading Buffett to once proclaim, "The net wealth creation in airlines since Orville Wright has been next to zero. If a capitalist had been at Kitty Hawk and shot him down, he would have done us a huge favor." Industry growth does not directly translate into attractive investment returns. The calculus is more complicated than that.]