AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

Quarterly Investment Commentary

Second Quarter | **July 2016**

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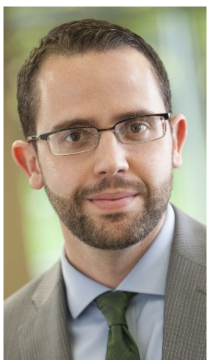
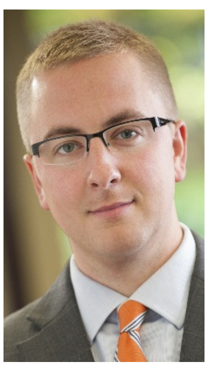


Jacob D. Benedict, CFA

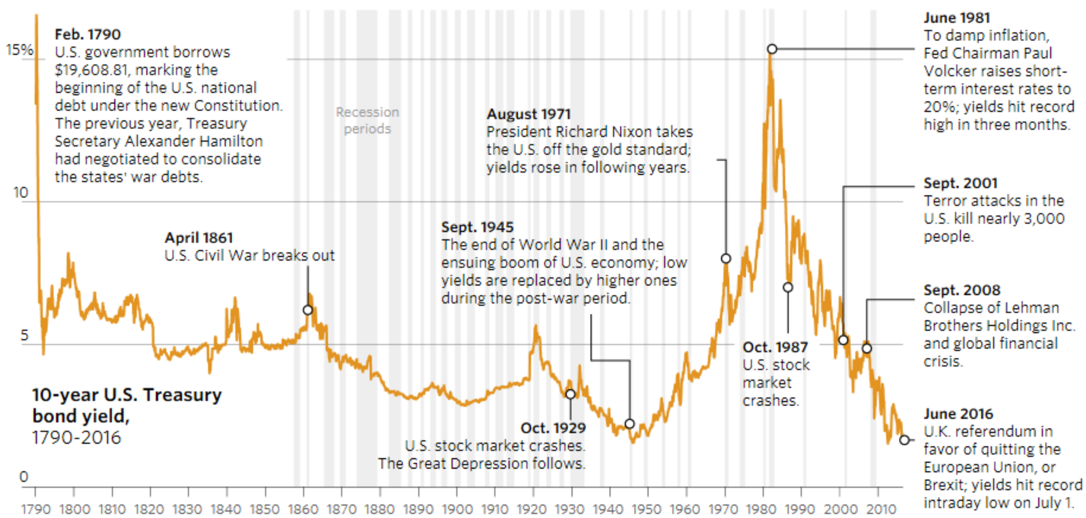


Ryan A. Kay, CFP®

U.S. stocks posted a 3.8% return through the halfway mark,[1] yet the headline result belies the bumpy ride. The S&P 500 began the year with a 10% drop, promptly made up that ground and then some, sold off in the wake of the Brexit vote, and then quickly snapped back. Such is life in markets. It was the renowned J.P. Morgan, who, when asked what the stock market will do, replied wryly, "It will fluctuate."

International developed stocks understandably fared poorer, dropping 4.0% in the first half on Brexit concerns and weakening currencies. Emerging market stocks, however, have had a strong showing, rising 6.5% on the year after a tough 2014-15.[2] Bonds are up 3.6% despite record low interest rates.[3] This performance comes from a continued drop in the level of interest rates, which pushes up bond prices *but reduces future bond returns*. At quarter-end, the 10-year U.S. Treasury yielded less than 1.5%, meaning bond returns over the next decade will surely be subdued. *The Wall Street Journal* recently produced a fabulous graph that plots the yield on 10-year U.S. Treasuries all the way back to 1790; it reveals that we live in an unusual world.[4] Yet while the current level of rates is somewhat unprecedented, the 1890-1945 period shows that rates can remain depressed for an extended period of time.

Historical Yield on the 10-Year U.S. Treasury Bond



We tackled the Brexit – Great Britain's historic vote to leave the European Union (EU) – in a recent *View from the Portfolio Manager's Desk*; if you didn't have a chance to see it, it is posted on our website (www.AMIinvestment.com). In this commentary, we'd like to take a brief detour into one of the economic policy concerns that underlies Brexit fears. Bear with us.

[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] *The Wall Street Journal* and Global Financial Data. "Treasury Yields Touch Historic Lows Amid Brexit Fallout," by Sam Goldfarb, Jon Sindreu and Min Zeng, July 4, 2016.

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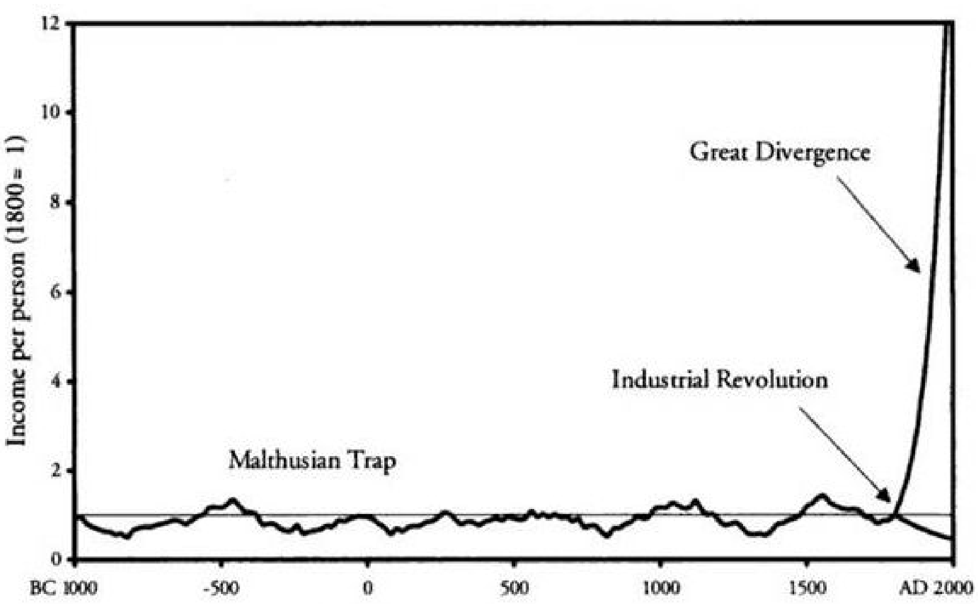
Imagine that you and one other individual are stranded on an island. In order to live, you need food, water, and shelter. Initially, both you and this other individual – call him John – fend for yourselves. You try to gather berries and catch fish, you collect and boil water, and you piece together wood and leaves to fashion a shelter. Over time, you notice that John is much better at collecting food than you, but he struggles to collect a sufficient amount of water. You meander over to his side of the island and propose a trade – John collects the food and you collect the water. You both decide to *specialize*. John discovers that he can actually harvest row crops, in part because you are able to supply him with a sufficient amount of water for irrigation. You are able to work exclusively on accessing an underground aquifer and supporting its development. Within a few years, both of you are eating and drinking multiples of your early results.

A couple of months later, you are surprised by a visit from a third individual – call him Bob – who happens to live on another island just a few miles away. A master carpenter, Bob built a boat and set sail for your island. You and John haven't had much luck fashioning acceptable shelters, so the three of you strike up a deal: Bob will build and maintain the shelters on your island, while you and John supply Bob with food and water. You've just engaged in international trade, much to your mutual benefits.

This concept of trade and specialization was first laid out by Adam Smith, author of *The Wealth of Nations* and the father of economics, in the 18th century. Smith understood that specialization increased economic growth via enhanced efficiency. But this concept goes back way before Smith. In *A History of the World in Six Glasses*, author Tom Standage explains that civilization itself was built on the power of trade. Humans were hunter-gatherers until around 10,000 BC, when they discovered the concept of agriculture. Humans started to gather for the first time in permanent settlements, leaving behind nomadic lives in order to harvest wheat and grains. These "cities" discovered that they could rise above subsistence living by building surpluses; in other words, not everyone had to toil the fields or hunt for game to survive. The surpluses allowed certain members of society to engage in non-farming activities. These activities were initially focused on religious duties, particularly sacrifices to appease the gods. Indeed, these religious leaders were the first incarnation of today's modern politician (who no doubt engaged in a similar practice of promising things they couldn't deliver). But several thousands of years later, Egypt and Rome used this same concept of trade to enable individuals to serve as construction workers, engineers, teachers, philosophers, soldiers, etc.

Adam Smith's lucid understanding of the power of trade and specialization, however, helped usher in the modern era of capitalism. Capitalism unleashed specialization to an even greater degree, resulting in the hockey stick chart of economic growth often shown in economics textbooks:[5]



[5] Gregory Clark, *A Farewell to Alms: A Brief Economic History of the World (The Princeton Economic History of the Western World)*, Princeton University Press: 2007.

Modern economists, a fickle and rancorous group, agree on few things. Yet nearly all of them support the claim that the gains from freer trade are much larger than the costs.[6] So if free trade is so great, why are there so many critics? Brexit polls show that isolationism was an important factor and all of the serious contenders in the U.S. presidential primaries have railed against our country's trade programs.

Free trade is one of those thorny issues where the benefits are large but diffuse (spread out over a wide population) while the costs are real and acute (focused on specific groups). It is easy to see the casualties of free trade, such as lost U.S. manufacturing jobs and lower wages for industries subject to import competition. It is much harder to see the benefits, such as high-paying tech jobs in the U.S. or potentially higher overall economic growth. Further, increasing globalization may have yielded disproportionate benefits to the wealthy versus the poor. Trade is sometimes messy and foreign countries can fail to play by the rules, leading to understandable frustration on the part of domestic competitors. Finally, during periods of disappointing economic performance, trade is an easy target on which to blame economic problems.

Yet trade is one factor that can lead to increased economic productivity, which, over time, is what fuels increased living standards. Warren Buffett discussed the more general topic of productivity in his 2015 letter to Berkshire Hathaway shareholders. Buffett cited the fact that in 1900, a "staggering 40% of the total [population] worked in farming," producing 2.7 billion bushels of corn annually. Today, farming five million less acres, our country produces 13-14 billion bushels while devoting just 2% of our workforce to the task. "Thus, improved farming methods have allowed tens of millions of present-day workers to utilize their time and talents in other endeavors, a reallocation of human resources that enables Americans of today to enjoy huge quantities of *non-farm* goods and services they would otherwise lack." Instead of working on farms, these individuals were freed up to work on things like life-saving drugs, air conditioning, automotive technology, the internet, etc.

While this transition has no doubt been good for society, it was incredibly tough for the millions of workers whose livelihood consisted of working on farms. The same can be said for industries disrupted by trade or technology today, such as journalists, domestic manufacturing laborers, taxi drivers, etc. While we don't have objective proof, it sure seems that today's disruptions are occurring at a quicker pace than yesterday's disruptions. Hence the political trend towards isolationism, as workers understandably seek to protect their livelihoods. This is and will remain a thorny political issue, and the seventy year trend towards greater openness and cooperation in trade post-World War II may reverse.

The purpose of this discussion is not to advance a "pro-trade" position. We are simply attempting to explain the economic realities of an important and difficult issue as we understand them. But, alas, we aren't economists, so take what we say with a grain of salt. Much more pertinently: What are the ramifications for investors?

If the world swings to a full-on protectionism, we generally believe this would be a headwind for most global businesses. Consider the immense profit Coca-Cola has generated taking its sugary syrup around the world. Coca-Cola products are now sold in over 200 countries and prior to acquiring their U.S. bottling operations, 75% of sales came from abroad.[7] This has no doubt been a boon to Coke shareholders and the country at large. Any political movement creates winners and losers in industry, and more protectionism would be no different – benefitting some industries at the expense of others – but on the whole, increasing protectionism around the world would probably qualify as a headwind for U.S. stockholders.

But this statement doesn't do much good, does it? It's a bit like telling a man standing in the rain that he'd be better off with an umbrella. We've noticed an increasing amount of this kind of talk in the financial world: a lot of people love to speak for hours about the rain that's coming, but we don't see anyone handing out umbrellas. For instance, a lot of commentators like to fret about the stock market. But what's their umbrella? Should we sells stocks to sit in cash, earning 0%, or buy bonds offering a sultry 1.5%? Should we load up on high-yield bonds or emerging market debt that might offer higher returns but appear to be fundamentally riskier?

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[6] Megan Mcardle, "4 Politically Controversial Issues Where All Economists Agree," *The Atlantic*, April 9, 2012.
[7] See Coca-Cola's 2008 Annual Report.

A successful businessman that we highly respect likes to say, “To understand is to know what to do.” We don’t have any easy answers, but we think the best course is to look for fundamentally strong companies that can weather the storm and are commanded by good managers who are both *able* and *willing* to act boldly during periods of turmoil. This company, for example, built its competitive advantage by expanding during recessions while his competitors retracted. He would hire his competitor’s best employees and go after his competitor’s top customers while the competitors cut talent and short-changed clients. He cites John D. Rockefeller: “The strong feed during depressions.” The goal is to try as best as you can to keep up during the good times, but be ready to attack when the inevitable drought occurs.

Warren Buffett is Example A. He has built Berkshire Hathaway by investing boldly when the majority of managers and investors were running scared. He invested upwards of $50 billion during the 2008 downturn.[8] Leading banks Wells Fargo and J.P. Morgan, pioneered by strong and conservative CEOs, struggled amidst the toughest banking environment since the Great Depression, but still came out stronger on the other side as competitors folded, retrenched, or were purchased.[9] While their competitors fell by the wayside, these companies were extending their competitive moats. (This general idea is the main topic of Nassim Taleb’s interesting and informational book *Antifragile: Things That Gain from Disorder;* see the postscript below.)

The global economy faces challenges, the retrenchment of trade being just one of them. But guess what: It’s always faced challenges, just like we’ve always faced inclement weather. Our research and experience suggests the winners aren’t the ones who stand around trying to predict the rain nor the ones who lock themselves in the basement. Instead, the winners are the ones who favor a conservative, consistent approach but stand willing to act boldly when opportunities arise. As Howard Marks has said, “move forward, but with caution.”

As always, we thank you for your continued confidence.

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict, CFA
Ryan A. Kay, CFP®

Postscript: Nassim Taleb on Antifragility
By grasping the mechanisms of antifragility we can build a systematic and broad guide to *nonpredictive* decision making under uncertainty in business, politics, medicine, and life in general – anywhere the unknown preponderates, any situation in which there is randomness, unpredictability, opacity, or incomplete understanding of things.

It is far easier to figure out if something is fragile than to predict the occurrence of an event that may harm it…This provides a solution to what I’ve called the Black Swan problem – the impossibility of calculating the risks of consequential rare events and predicting their occurrence…

In every domain or area of application, we propose rules for moving from the fragile toward the antifragile, through reduction of fragility or harnessing antifragility. And we can almost always detect antifragility (and fragility) using a simple test of asymmetry: anything that has more upside than downside from random events (or certain shocks) is antifragile; the reverse is fragile.

[8] Whitney Tilson presentation on Berkshire Hathaway.
[9] Wells Fargo purchased Wachovia and J.P. Morgan purchased Bear Sterns and Washington Mutual at attractive prices, although subsequent litigation would make those prices less attractive.