AMI Investment Management
Registered Investment Advisor

Quarterly Investment Commentary

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After a slight drop in the first quarter, U.S. stocks generated a 3.4% gain in the second quarter, bringing the year-to-date tally to 2.7%.[1] International stocks fared worse, with developed markets dropping 0.9% in the quarter and 2.4% on the year, and emerging markets dropping a steep 7.8% in the second quarter and 6.6% for the year.[2] Bonds have returned –0.7% year-to-date, as rising interest rates have created a headwind for fixed income investments.[3]

While stocks have been more volatile this year, last year actually feels like the outlier, with stocks exhibiting an uncharacteristic calm in 2017. That being said, concerns over a potential global trade war have appeared to put investors on edge the past few months. We have no insight into how current negotiations may end, but we do believe a large-scale reversal in global trade would have an adverse impact on both economic activity and stocks, at least in the short run.

Without any ability to handicap potential outcomes, we don't plan to make any fundamental changes to our portfolios. However, our research process scrutinizes companies that derive a material portion of their revenue from products produced in one country but sold in another. Such a position can be risky to a company's economics given potential changes in both exchange rates and trade agreements. Note that this situation is different from global companies that utilize global production networks.

During the quarter we completed a comprehensive research project on attempts to time the stock market. Due to the paper's length and technical nature, we don't plan to distribute it widely (though if you are interested in reading it, please feel free to reach out to us). But we thought we'd include an excerpt from the paper that highlighted the key question we were attempting to answer and our subsequent findings. The excerpt is still a bit technical, but we thought the takeaways were worth presenting.

Excerpt from "Market Timing: The Rule and The Exception," a White Paper authored by AMI in April of 2018

Market timing refers to the attempt to time your exposure to the stock market based on forecasts for future stock market returns. We present both a rule and an exception based on the quote, "The young man knows the rules, but the old man knows the exceptions."

The rule is this: Don't try to time the market. It is difficult if not impossible to forecast stock market returns – especially short-term returns – with any accuracy. Although stocks will be volatile from year-to-year, the odds are high that *long-term* returns from stocks will outpace returns from less volatile assets like cash or bonds. So the investor is best served by investing as much of his portfolio as he can and is comfortable with into stocks, based on his own specific goals and risk tolerance, and attempting to ignore the short-term noise of the market. In 2012 Warren Buffett wrote:

[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.

> American business will do fine over time. And stocks will do well just as certainly, since their fate is tied to business performance. Periodic setbacks will occur, yes, but investors and managers are in a game that is heavily stacked in their favor…
>
> Since the basic game is so favorable, Charlie and I believe it's a terrible mistake to try to dance in and out of it based upon the turn of tarot cards, the predictions of "experts," or the ebb and flow of business activity. The risks of being out of the game are huge compared to the risks of being in it.[4]

The history of the stock market clearly shows that those investors who made a major commitment to stocks and simply stuck to their knitting through thick-and-thin came out way ahead compared to those who have tried to jump in and out of the market. The ride may be bumpy at times, but the long-term results have more than made up for the bumps. As Buffett wrote this past spring:

> 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.[5]

In other words, the probability is high that in the next several years, there will be days, weeks and years where stocks will materially underperform less volatile investments like bonds. But over an extended period of time, say one to two decades or longer, it is also highly likely that stocks will well outpace bonds and inflation. So for the truly long-term investor, the best course of action is to commit a material portion of their portfolio to stocks and try their best to ignore the short-term noise of the stock market, which is largely unpredictable.

But notice that Buffett added a qualifier at the end of the most recent statement: "assuming that the stocks are purchased at a sensible multiple of earnings relative to then-prevailing interest rates." Herein lies the potential exception. The vast majority of time, stocks are priced in a range of "fair value." This doesn't mean that stocks are guaranteed to perform well, but instead that we have no pre-existing reason to predict relative market returns to be above or below-average.

But every so often investors succumb to periods of irrational exuberance and bid stock prices up to dangerous levels. Ever since investment markets were established there have been occasional bubbles, beginning with Tulip mania in the 1600s.[6] More recent examples include the Nifty Fifty in the 1970s, dot-com darlings in the late 1990s and speculative real estate in the 2000s. (Perhaps cryptocurrencies like Bitcoin will join this list.[7]) One could argue that these periods of speculative excess belong to a class of their own, fundamentally different from the usual noise of the stock market…

[Consider] a trivial claim: If we had three data points at any point in time – the initial earnings yield on stocks,[8] the ending earnings yield on stocks, and the interim growth rate of corporate earnings – we could forecast with a high degree of accuracy the return on stocks over the subsequent decade. Indeed, we carried out this "clairvoyant" analysis from 1950 through mid-2008, and our model accounts for over 90% of the observed variation in returns…

So why is this claim trivial?...Well, our claim is a bit like saying that we can predict the winner of a basketball game if you just tell us which team will score the most points. We can directly observe Buffett's indicated variable in real-time (i.e. the difference between the earnings yield on stocks and the yield on bonds). But the two additional variables are unobservable in real time. We will only know their value at the *end* of our forecast period. If we know the growth rate in

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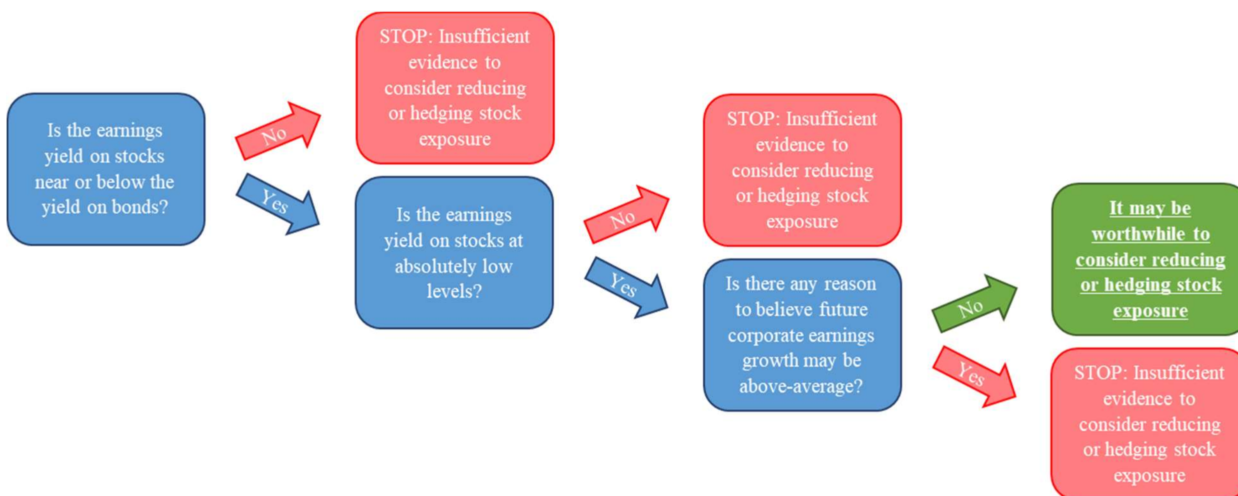
[4] Buffett, Warren. 2012 Shareholder's Letter. Berkshire Hathaway. March 1, 2013.
[5] Buffett, Warren. 2017 Shareholder's Letter. Berkshire Hathaway. February 24, 2018.
[6] Per *Wikipedia*: "Tulip mania was a period in the Dutch Golden Age during which contract prices for some bulbs of the recently introduced and fashionable tulip reached extraordinarily high levels and then dramatically collapsed in February 1637. It is generally considered the first recorded speculative bubble."
[7] In an editorial we penned on December 7, 2017, we suggested that Bitcoin seemed to resemble other speculative bubbles. Since our editorial, the price of Bitcoin has fallen by nearly 45% and is now down over 50% from its peak (www.coindesk.com through April 24, 2018). See "Investment versus speculation" by Jacob D. Benedict, CFA in the *Greater Fort Wayne Business Weekly*.
[8] The earnings yield is calculated by dividing the current aggregate earnings of stocks by the current stock price.

earnings and the yield applied to those earnings at the end of our forecast period, we would essentially know the ending value for stocks, which makes forecasting returns essentially trivial…

"A good forecaster is not smarter than everyone else, he merely has his ignorance better organized."[9]

We cannot forecast these two additional, presently unobservable variables with much precision. But we aren't trying to make precise forecasts. Remember our initial rule: We understand that trying to time the market is largely a fool's game. Instead, we are looking for situations where the evidence is clear and compelling. Good forecasters don't make a ton of forecasts; instead, they wait until the "stars are aligned" to make the ever rare, but prescient, prediction.

Along those lines, while we can't precisely forecast the exit earnings yield or subsequent earnings growth, we can potentially establish *reasonable bounds or ranges* for expectations of future developments. And then we can wait to reduce or hedge stock exposure until *unreasonable* assumptions are required to justify stock prices. Consider the following decision tree:



We recognize that this is a bit complicated and subjective. But it should be. As Charlie Munger observed, "It's not supposed to be easy. Anyone who finds it easy is stupid."…

Interestingly enough, we are aware of just three instances throughout his nearly seven-decade career when Buffett appeared to make a major call on the broader stock market:

- Buffett shut down his original investment partnership in 1969, writing to his investment partners that he was "not attuned to this market environment,"[10] which had become overly exuberant.
- Buffett made a speech in 1999 arguing that stock prices were dangerously high.
- Buffett wrote an article in 2008 arguing that stocks were attractively priced.

Now look at Buffett's calls and compare his timing to the chart displayed above [not pictured here]. See the correlation?

Let's take a look at the facts on the ground in 1999, when Buffett warned that stock prices might be too high, with the facts observable today:

[9] Anonymous.
[10] Lowenstein, R. (2008). *Buffett: The making of an American capitalist*. Carlton North, Vic.: Scribe Publications.

	Oct-99	Mar-18
Earnings Yield on Stocks	3.4%	4.2%
Yield-to-Maturity on Intermediate-Term Government Bonds	5.9%	2.5%
Yield Advantage for Stocks Over Bonds	-2.5%	1.7%
Is the earnings yield on stocks near or below the yield on bonds?	*Yes*	*No*
Earnings Yield on Stocks	3.4%	4.2%
Is the earnings yield on stocks at an absolutely low level?	*Yes*	*Yes*
Is there any reason to believe future corporate earnings growth may be above-average?	*No?*	*Tax Reform*

As you can see, the environment in 1999 appeared to meet all of the hurdles in our decision tree outlined above. Today, despite the fact that the absolute level of the earnings yield on stocks is quite low, it still outpaces the yield on bonds. Additionally, corporate tax reform may give a nice boost to corporate earnings growth the next few years. So despite a strong run in stocks the past nine years, we still don't see the evidence that we would need to make the decision to reduce or hedge stock exposure.

Please note that we are not saying that stocks can't perform poorly from here. Surely they can. Indeed, that possibility *always* exists, and the presently low earnings yield on stocks may suggest that future stock returns might trail recent returns. But in order to make the risky decision – at least from a *long-term* investment perspective – to reduce exposure to stocks, a high hurdle should be utilized. And today's environment doesn't appear to clear that hurdle, although this could change if (a) interest rates keep rising relative to the earnings yield on stocks and (b) corporate tax reform fully filters through corporate earnings…

Investors are well-served to recognize that although stocks will be volatile over short time periods, they offer the best odds of protecting and building wealth *longer-term*, and that the regular gyrations of the market are largely unpredictable and should be ignored as much as possible.

However, there is a potential exception: On rare occasions stocks can become irrationally overpriced and recognized as such, giving even a long-term oriented investor the opportunity to defensively position his portfolio. Getting this call right is no easy feat, but we outlined a three-step process for identifying when such a climate might be in effect. In this case, it might make sense to reduce or hedge stock exposure, although the investor has to be prepared to look foolish for some time before potentially being vindicated.

As always, we thank you for your continued confidence.

Sincerely,

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