AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

Quarterly Investment Commentary

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Stocks built on their strong start to the year, returning 4.3% during the quarter to bring the year-to-date tally to 18.5%.[1] Stocks have more then recovered from their late 2018 swoon and ended the quarter near all-time highs. Foreign developed stocks and emerging market stocks are up 14.5% and 10.7% year-to-date respectively, both respectable showings yet still behind their U.S. counterparts.[2] Bonds also have turned in a strong performance year-to-date, up 4.0%.[3]

Stocks and bonds are often uncorrelated, but both asset classes responded favorably this year to lower interest rate expectations. After hitting a high of approximately 3.25% last fall, the yield on ten-year U.S. Treasuries has fallen back down to 2.00% (amazing!), illustrating the extreme downward pressure on global interest rates. It is a bit interesting to observe the stock market's recent logic:

- Stock prices fell materially last fall when a strengthening economy seemed to suggest the Federal Reserve would aggressively raise interest rates
- Stock prices more than recovered this year as the Federal Reserve seemed to reverse course over worries that the economy couldn't handle higher interest rates.

At first glance, one might think that a stronger economic outlook is good for stocks and vice versa, but that hasn't quite been the case the past twelve months (although the story is a bit more complicated than this). These developments just illustrate the extreme power that interest rates yield over financial markets, something we've written about regularly over the past several years.

We've now experienced the longest economic expansion and bull market in history. Aren't we due for a pullback? What happens if geopolitical tensions boil over into damaging trade wars or even outright conflict? The yield on a three-month U.S. Treasury is now above the yield on a ten-year U.S. Treasury, which has historically been a warning sign of an impending recession. (An inverted yield curve has preceded every recession since 1960, although it's also given two false warnings.) If and when will the nation's growing debt burden create spillover effects in the economy? (The U.S. has never witnessed such large government deficits this late into an economic expansion.[4])

We aren't sure how any of these risks will ultimately play out, but ultimately this kind of analysis can be problematic. There are always serious risks for the investor to worry about. Just look at the past century, which has included multiple wars, presidential impeachments, recessions (even depressions), internal conflict, supply shocks, and many other challenges. Despite these challenges, the country still managed to produce outstanding gains in wealth and incredibly strong stock market returns. The best course of action was to invest in a diversified basket of good companies and ride out the occasional storms. We think it is likely the same will hold true over the next century.

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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] The federal government's fiscal deficit relative to Gross Domestic Product (GDP) reached 3.8% in 2018, up from 3.4% in 2017 and 3.1% in 2016. The country has seen larger fiscal deficits during the post-war period (starting in 1948), but never during such a strong economic environment. Indeed, outside of the 2016-18 period, the government has averaged a fiscal *surplus* of nearly 2% during periods when the unemployment rate was below 5% (it was 3.9% in 2018). Conversely, fiscal deficits above 3.8% have only occurred when the unemployment rate was approximately 7% or higher. Sourced from the Federal Reserve.

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Analysts and commentators frequently try to predict the next spark that might ignite a recession or financial crisis. In his book *The Black Swan*, author and former trader Nassim Taleb conceded that rare and unpredictable outlier events drive human history. But he also pointed out that trying to predict them is a fool's errand. The key isn't to predict the unpredictable, but to be prepared for the possible.

We naturally think about many risks that might damage our investment portfolios. But we believe the much more important analysis is to survey the investment environment to see how vulnerable it is to potential hiccups (and in turn, how prepared we are).

Most entrances to national parks and forests include a warning sign like the one pictured above. Park rangers aren't able to predict what event might spark the next forest fire – a campfire gone wrong, a fallen electrical wire, etc. But they can survey the grounds to see how conducive the environment is for turning a spark into a raging forest fire. As Smokey the Bear explains, the risk of fire increases as the time without a fire passes:

> As more time passes without fire, excessive litter builds up on the forest floor, trees and shrubs grow larger, vistas close, the forest gets denser and darker, and few new species can prosper….
>
> When unplanned fire is finally introduced, either through a lightning strike or someone being careless, it finds enough fuel to turn into a wildfire that burns intensely and rages out of control.[5]

We think about investment markets in a similar way. The investor Howard Marks breaks a bull market down into three stages:

> [T]he first, when only a few forward-looking people begin to believe things will get better; the second, when most investors realize improvement is actually underway; and the third, when everyone concludes that things can only get better forever.[6]

If possible, we want to tilt towards being aggressive during the first stage and towards being cautious during the third stage. Rarely if ever are the risks so extreme that we believe it is prudent to make material changes to long-term asset allocation targets, such as dramatically reducing one's exposure to stocks (we wrote about the rare exceptions to this rule in a white paper last year titled "Market Timing: The Rule and The Exception"). However, Marks observes that, "Just about everything in the investment world can be done either aggressively or defensively. In my view, market conditions make this a time for caution."[7]

What exactly does a tilt towards caution mean? Here are some examples:

- Paying down personal debt with excess cash as opposed to investing it.
- Favoring higher-quality bonds such as U.S. Treasuries over lower-quality bonds such as corporate-backed issues and so-called "junk" bonds.
- Approaching the stocks of cyclical and/or levered companies with caution.
- Being cautious when putting "new money" into stocks (i.e. money that hadn't previously been invested in the stock market).
- Avoiding the temptation to be pulled into newer, hotter areas of investment markets where investor interest/demand is high and capital is abundant.

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[5] www.smokeybear.com
[6] "This Time It's Different," June 12, 2019.
[7] "The Seven Worst Words in the World," September 26, 2018.

None of this will be a panacea if and when markets falter. And if the bull market continues unabated, these kinds of decisions could cost the investor a bit of upside. But we think they are prudent given the current market environment. As Warren Buffett famously observed:

> The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.

Stocks as a whole still don't strike us as dangerously expensive relative to the current level of interest rates. (Of course this doesn't mean that stocks can't fall from here!) It is possible to assemble a high-quality group of growing companies that trade at reasonable multiples to their underlying earnings and carry an average dividend yield north of 4%. In a world where a ten-year Treasury yields only 2%, this is quite attractive.

That being said, we are starting to observe more late-cycle behavior in certain areas of the market. Venture-backed companies are coming public with valuations in the tens of billions of dollars and little in the way of profits. Like past periods of excess, new catch words are attracting waves of investor money. In the late 1990's, a company could increase its value by billions of dollars simply by attaching "dot-com" to the end of its name. Today's buzz words include cryptocurrency, cloud software, subscription-based revenues, software-as-a-service, and marijuana, among others. Like past episodes, there will be some huge winners in these areas, but it will be hard to pick them out in advance and we worry that the subsequent aggregate record won't match the current hype. When investors throw money at a given theme without much discernment, bad results often follow.

Consider a recent article in *The Wall Street Journal* analyzing the privately-held real estate brokerage company Compass.[8] Compass, launched in 2013 and backed by venture investors such as Japan's SoftBank Group, has amassed a cash pile of $1.2 billion from private investors and is currently valued at $4.4 billion. The firm intends to disrupt the real estate brokerage industry, but critics have argued that their only strategy so far has been a willingness to pay brokers higher splits on commissions, which has resulted in losses for the company and doesn't appear economic longer-term. In response, the company's Chief Operations Officer said, "We're not yet at a stage where I have a very clear monetization strategy because we haven't really talked about it," and the Chief Executive Officer noted, "Short term profitability is something that many of the more modern companies are not as focused on." In other words, a company over five years old valued in excess of $4 billion hasn't actually thought about how it might ultimately make money![9]

We rely on our own in-house research when we construct our investment portfolios. Many investment advisors have "outsourced" this work, relying instead on outside outfits or packaged investment products. It is true that investment markets are competitive, that doing our own research is time-intensive, and that there is no guarantee that our work will result in above-average returns. But we believe it is fundamentally important to know what we own, not necessarily because it will lead to outsized returns, but because it could occasionally save us from costly mistakes. By insisting on understanding, following, and valuing our investments, we hope to avoid being caught up in the occasional bubbles and fads that grip markets, when investors throw caution to the wind and buy what they don't understand in the hopes of finding quick riches like some of their peers. This kind of behavior usually ends in tears. As always, we thank you for your continued confidence!

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict, CFA
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[8] "Compass's Free-Spending Ways Capsize Real Estate Business," by Katherine Clark and Laura Kusisto, April 23, 2019.

[9] Note that over the last decade, private investment markets have matured to a point that many of these venture companies remain private much longer than they used to, with backing from corporate, private equity and venture capital outfits. For instance, the ride-hailing firm Uber recently went public with an astounding day-one market capitalization of $75 billion. Prior to that, the company had sourced billions of dollars from private investors to support its build-out and continuing losses. A wave of these private venture-backed companies are currently exploring the prospect of coming public. It will be interesting to see how this plays out over the next one to two years and whether there may be any spillover to broader public markets.

Get to Know AMI: Spotlight on Shelby Carmichael

Shelby Carmichael joined AMI in 2016. Shelby graduated from Purdue University (Fort Wayne) with a Bachelor of Arts degree in Interpersonal and Organizational Communication. Prior to joining AMI, Shelby served as a fundraising coordinator for the Muscular Dystrophy Association, managing the MDA's fundraising programs and communicating their healthcare and research programs throughout Northern Indiana. Shelby serves as a Client Service Representative at AMI, where she helps clients with service requests and account action items. Many of you have probably had the chance to speak with Shelby on the phone and can vouch for her positive, can-do attitude! Her favorite part of her job is the opportunity to interact and build relationships with AMI's clients.

Outside of AMI, Shelby uses her background in gymnastics and dance to teach tumbling and dance at TC Dance and judge area high school gymnastics meets. A former Miss Limberlost, Shelby also serves as the Co-Director for the Miss Limberlost Scholarship program. She has volunteered as a Big Sister in the Big Brothers Big Sisters Program.

Shelby enjoys hiking and other fitness activities, being outdoors, and spending time with family. She tackled a huge project renovating a lake house on Big Turkey Lake in LaGrange, where she now enjoys various water sports in her free time. Her favorite movie is Forest Gump, her favorite food is pulled pork with macaroni and cheese, and she's enjoyed trips to Lake Cumberland and Florida with dreams of someday traveling to Turks and Caicos. We are lucky that Shelby is part of our team!

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