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After six years of relative calm (save a hiccup in 2011 when Congress toyed with default), U.S. financial markets finally saw some turbulence. U.S. stocks were down 6.4% in the third quarter. They've now lost 5.3% on the year. U.S. government bonds, seen as a global safe-haven, have returned 2.0% for the year. Given global economic uncertainty, the Federal Reserve once again punted on raising short-term interest rates, which helped push up bond prices. Returns get uglier the further afield you go. Developed international markets fell 10.1% in the quarter and have lost 4.8% year-to-date. Emerging markets lost 17.8% in the quarter and 15.3% year-to-date, fueled by concerns over recession risks in Brazil, China and Russia. Stocks of companies with a lot of debt, high-yield (junk) bonds, and anything related to commodities have absolutely taken it on the chin this year.

Below we walk through some current questions and offer a few of our thoughts:



Jacob D. Benedict, CFA

1. *Are stock prices going to drop 20-30% over the next year?* Longtime readers should already know our answer: We don't know. This outcome is certainly possible, and investors should always question whether they can handle that kind of downside in their investment portfolio. But even before the recent correction, we thought that stocks were in a range of fair value, though slightly expensive relative to history. After falling 10% (and much more for certain industries), stocks look that much more attractive. We still don't think stocks are screaming bargains, but we've started to see more intriguing investment opportunities. We simply don't know how to forecast short-term market movements and we have never met anyone else who got rich doing so. Instead, we try to focus on making sure we don't overpay. But even if stocks are cheap, they can still fall a great deal in the short to intermediate term. Regardless, we don't see any reason for long-term oriented investors to do anything but stay the course.



Ryan A. Kay

2. *Are we going into a recession?* We don't know the answer to that one either. Global economic growth sure looks pretty weak as China deals with overcapacity and a pending commodities glut shakes out. Even though only 9.3% of U.S. GDP comes from exports, with much less tied to China, we can't go it alone.<sup>1</sup> Lower commodity prices are putting pressure on U.S. energy and equipment companies and a higher dollar is hurting our exporters. These things matter, and they surely put some downward pressure on recent jobs numbers. Corporate credit spreads have widened despite low interest rates, signaling some concern. It is unclear whether we might tip into recession, although most economists don't reach that conclusion. That being said, our *guess* is that any potential slowdown won't be like 2008-09. Corporate and personal balance sheets look much healthier and "once every fifty year" recessions like the one we had in 2008-09 are supposed to happen, well, once every fifty years or so. But beware of anyone's recession predictions; few saw 2008-09 coming.

3. *When will the Federal Reserve raise interest rates?* We respond with a question: Does it really matter? Our view has been that global economic growth, and the corresponding rate of inflation, are simply too slow and too low to support an environment of materially higher interest rates. Even if the Fed were to raise short-term rates by 0.25%, would that really have that big of an impact? Are long-term interest rates going to shoot up as a result? We doubt it. Jamie Dimon, the CEO of JPMorgan, recently said, "It's a lot of chatter about nothing... wherever I go, I ask

businesses, consumers, small business, large business, will it affect you if rates go up 25 basis points?"<sup>2</sup> Though investors seem to fret over every word that emanates from the mouth of a Federal Reserve official, over the long term rates will be determined by the overall economic environment.

4. *Commodities – buy or sell?* We don't know where commodity prices are headed over the next five to ten years, so we are hesitant to make investment commitments to the space. If anyone tells you to buy an oil stock because the price of oil is going higher, ask them if they also predicted oil would hit \$40 a barrel. We doubt they did. So why will they be right this time around? Successful investments are predicated on the ability to predict earnings and cash flow five to ten years out. Arguments that support the idea that oil will go back up to \$70-80 a barrel or more often sound convincing, but history simply hasn't been kind to long-term commodity bulls (the Bloomberg Commodity Index, which tracks a basket of commodities, is virtually unchanged from 25 years ago). Human ingenuity seems to find a way to produce energy and materials for less. We wouldn't bet against commodities, especially at these levels, but it's unclear to us where we go from here or when. Further, we believe that investment funds that invest directly in commodities by purchasing futures contracts are fundamentally flawed investment vehicles. We do own some companies that are adversely affected by lower commodity prices, and it's hard to predict when their fortunes will reverse.
5. *Emerging markets – buy or sell?* We are by no means experts on emerging markets, and with such a broad group of countries and companies, it's hard for anyone to be an expert. We've historically limited our exposure to international stock markets, not because we are fundamentally negative on them, but simply because we like the U.S., where companies are run for the benefit of shareholders (usually), investment expenses are low and the rule of law is attractive. Foreign revenues account for over 40% of sales of S&P 500 companies, so domestic investors still get international exposure.<sup>3</sup> Further, a large overweight to foreign stocks can create a lot of volatility from currency exposure, and we don't believe that major currencies are a source of long-term return. Finally, contrary to what mutual fund salesmen might tell you, studies have shown that higher economic growth is *not correlated* with higher stock market returns. So while some institutional investors put up to 50% of their stock portfolio in foreign markets, we target less than half of that, split evenly between developed and emerging markets. This has helped us the last few years (relative to having a higher allocation), though we would have been better off with 100% in domestic stocks. But it could hurt us the next five years if foreign stocks do much better than domestic stocks. All that being said, we find it hard to predict which markets will do better over time since there are so many relevant and hard-to-predict variables. Some markets, like Russia, appear very cheap, but are heavily tied to commodities and lack an attractive rule of law. China specifically seems to be burdened by several serious growing pains. But longer-term, there are surely intriguing opportunities in places like China. Economic growth is built on gains in productivity, and China still has a ways to go. So we are happy to have core long-term investments in places like China, but they will probably remain modest for the time being.

Readers probably feel a bit like President Harry Truman, who once proclaimed, "Give me a one-handed economist!" after growing tired of hearing his advisors say "on the other hand..." Unfortunately, the world is a confusing place and forecasting is a difficult game. Yet volatility brings opportunity, and we are on the lookout for high quality investments whose prices are unfairly punished. So far, though, most of the carnage has been in risky areas of the market that are difficult to handicap. Remember, though, that the best course of action is almost always to ignore the noise and stick to a sensible long-term investment plan appropriate for your own circumstances.

We thank you for your continued confidence.

Sincerely,

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

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<sup>2</sup> Jamie Dimon presentation at the Barclays Global Financial Services Conference, September 18, 2015.

<sup>3</sup> S&P Dow Jones Indices.

## APPENDIX: Headwinds for Value Investors

In 2014, less than 13% of actively managed U.S. stock mutual funds beat a broadly diversified, passively constructed index.<sup>4</sup> While it's not surprising for active funds to trail their lower-cost brethren, this margin was especially wide.

Value investors in particular have had a tough go of it. During the period 1927 through 2014, value stocks<sup>5</sup> produced annual returns of 12.8% per year versus 10.3% for growth stocks.<sup>6</sup> But since the end of 2013, the S&P 500 value index has returned just 2.3% versus 7.7% for the broader S&P 500 and over 12% for the S&P 500 growth index.<sup>7</sup>

The website [www.dataroma.com](http://www.dataroma.com) tracks a list of so-called “superinvestors,” most of whom belong to the value investing camp. Below are the results versus the S&P 500 since year-end 2013 for the ones on the list that run a publicly-traded, open-end mutual fund:<sup>8</sup>

Ticker	Name of Fund	Return	vs. S&P 500	Ticker	Name of Fund	Return	vs. S&P 500
FEVIX	FIRST EAGLE US VALUE FUND-I	-0.62%	-7.95%	MPGFX	MAIRS AND POWER GROWTH FD	-1.27%	-8.60%
OFAFX	OLSTEIN ALL CAP VALUE FUND-A	2.74%	-4.60%	TWEBX	TWEEDY BROWNE VALUE FUND	-4.75%	-12.08%
CFIMX	CLIPPER FUND	5.78%	-1.56%	YACKX	AMG YACKTMAN FUND-SVC	0.25%	-7.08%
SSHFX	SOUND SHORE FUND INC-INV	0.77%	-6.56%	JCVIX	JOHN HANCOCK CLASS VAL FD-I	-2.14%	-9.48%
MVALX	MERIDIAN CONTRAIAN-LEG	-2.01%	-9.34%	LMNVX	CLEARBRIDGE VALUE TRUST-INST	1.65%	-5.69%
TORYX	THE TORRAY FUND	3.04%	-4.29%	FPPTX	FPA CAPITAL FUND INC	-15.40%	-22.73%
SEQUX	SEQUOIA FUND	9.67%	2.34%	WVALX	WEITZ VALUE FUND-INV	3.73%	-3.61%
HRSVX	HEARTLAND SELECT VALUE FUND	-6.16%	-13.50%	HCMAX	HILLMAN FOCUSED ADVANTAGE	5.26%	-2.07%
LLPFX	LONGLEAF PARTNERS FUND	-19.23%	-26.57%	ARGFX	ARIEL FUND	-1.24%	-8.57%
WGRIX	WINTERGREEN FUND-INST	-10.35%	-17.69%	FPACX	FPA CRESCENT FUND	1.60%	-5.74%
AKRIX	AKRE FOCUS FUND-INS	8.28%	0.94%	JNVIX	JENSEN QUALITY VALUE FUND-I	-1.12%	-8.46%
TVIFX	THORNBURG VALUE FUND-I	10.10%	2.76%		80th Percentile	4.96%	-2.38%
CHOEX	CHOU OPPORTUNITY FUND	-16.47%	-23.80%		Median	-0.62%	-7.95%
FAIRX	FAIRHOLME FUND	-5.63%	-12.97%		20th Percentile	-6.06%	-13.39%

The median fund underperformed by almost 8%. Even the 80<sup>th</sup> percentile still underperformed by 2.4%, and only three of the twenty-five funds beat the S&P 500 over the time period. What is going on here?

This time period is way too short to judge investment performance, and surely these results are simply burdened by the fact that value investing has been out of favor of late. The market has also penalized manager decisions to hold cash, invest in international stocks or favor small cap stocks.<sup>9</sup> For the last several years, large-cap growth stocks have been the place to be, and, accordingly, most active managers have trailed the index. Indeed, as Jeremy Grantham once noted, “90% of what passes for brilliance or incompetence in investing is the ebb and flow of investment style.”<sup>10</sup> Like all things that ebb and flow, these headwinds should someday turn to tailwinds.

<sup>4</sup> SPIVA U.S. Scorecard for Year-End 2014, compiled by Aye M. Soe.

<sup>5</sup> Value stocks and growth stocks are differentiated by their market price relative to some fundamental measure of value, such as earnings or book value.

<sup>6</sup> Mauboussin, Michael J. and Dan Callahan, “Animating Mr. Market,” February 10, 2015.

<sup>7</sup> Morningstar.

<sup>8</sup> While we frequent the site, we don't have a view on whether all of these investors are truly super; instead, we just use it as an objective 3<sup>rd</sup> party list of value investors.

<sup>9</sup> In a paper entitled “Is Skill Dead?” dated February 12, 2015, authors Neil Constable and Matt Kadnar show that the percentage of funds that beat their benchmark is closely related to the performance of international stocks, small cap stocks and cash relative to large cap stocks.

<sup>10</sup> “Is Skill Dead?” by Neil Constable and Matt Kadnar, February 12, 2015.

Investors who overreact to short-term underperformance commit a grave mistake. An analysis by Dalbar and Lipper found that by selling underperforming funds and buying funds recently on fire, the typical investor in stock mutual funds cost himself 4.7% *per year* during the period 1992 through 2011.<sup>11</sup> Markets are often mean reverting, meaning the funds that recently performed poorly may be in store for better times ahead. Studies of the “manager ferris wheel” show that the underperforming funds that institutional investors fire typically outperform the new managers hired to replace them.<sup>12</sup> There are various approaches to investing that have merit, but frequently jumping from one approach to the next is a seriously flawed investment strategy.

That being said, the markets have grown increasingly efficient and it’s hard to beat low-cost, well-diversified index funds longer-term. Especially in the late stages of a bull market it becomes difficult to find stocks that are both cheap and safe. Accordingly, the “superinvestors” have only three options: (a) sit in cash and wait for better opportunities, (b) temporarily set aside their value philosophy and pay up for the least expensive growth stocks or (c) buy cheap but risky stocks. All strategies have their dangers and only time will tell which path proves correct.

Above all, the investor is best served by focusing on the following key components of his/her investment strategy:

- Do you have the right long-term allocation targets for stocks and bonds?
- Keep fees and expenses reasonable.
- Don’t overreact to short-term performance by trying to get into and out of the stock market or abandoning long-term investment strategies because of recent headwinds.

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<sup>11</sup> Davis Advisors. “Avoid Self-Destructive Investor Behavior.” Corporate pamphlet, undated. Citing *Quantitative Analysis of Investor Behavior* by Dalbar, Inc. and Lipper. March 2012.

<sup>12</sup> “The Rise and Fall of Performance Investing” by Charles Ellis, *Financial Analysts Journal*, July/August 2014.