AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

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Michael D. Axel, CFA


Jacob D. Benedict, CFA


Ryan A. Kay, CFP®

Global stock markets continued to show strength through the third quarter. Domestic stocks are up 7.8% year-to-date,[1] while international developed stocks are up 2.2% and emerging market stocks 16.3%.[2] Bonds returned 3.3%.[3]

We were recently digging through some writings of an investment manager we highly respect and came across the following:

> In what may be the most sweeping economic comment we have ever made in these reports – we feel the world is worrisomely overborrowed. Legions of individuals, companies and governments have not heeded Shakespeare's, "Neither a borrower nor lender be," and consequently the financial system is strained.[4]

Many readers may nod in agreement. Yet there is an important fact that we omitted – these words were written in 1982. The economic environment *was* perilous then, with both inflation and interest rates above 10%. And it's perilous now. Indeed, it always seems perilous. The world is a complicated, dangerous and confusing place.

The question for investors is a straightforward one: What do we do with this kind of information? We've come to greatly respect the beauty and effectiveness of a simple approach. As Albert Einstein supposedly said, "Everything should be made as simple as possible, but not simpler." Does this apply to investing? Warren Buffett answers affirmatively: "We haven't succeeded because we have some great, complicated systems or magic formulas we apply or anything of the sort. What we have is just simplicity itself."[5]

It is unfortunate how complicated investors try to make investing. We've fallen prey to this ourselves from time to time. And nearly every time we've strayed from simple guidelines, we've regretted it.

Consider market timing. Investors and investment professionals alike are infatuated with debating when and why investors should jump into and out of markets. Theories abound, based on a myriad of factors such as global debt, the economic cycle, election dynamics, etc. But consider what Buffett wrote in 1992:

> The investment shown by the discounted-flows-of-cash calculation to be the cheapest is the one that the investor should purchase – irrespective of whether the business grows or doesn't, displays volatility or smoothness in earnings, or carries a high price or low [price] in relation to its current earnings and book value. Moreover, though the value equation has usually shown equities (i.e. stocks) to be cheaper than bonds, that result is not inevitable: **When bonds are calculated to be the more attractive investment, they should be bought**. [Emphasis added][6]

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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] Private source.
[5] *Seeking Wisdom* by Peter Bevelin.
[6] Berkshire Hathaway 1992 Shareholder's Letter.

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(260) 347-1281

Let's establish a simple principle based on this idea: An investor should determine his optimal long-term allocation to stocks given his own objectives and circumstances, and he should only deviate from that policy if high-quality bonds appear to offer superior potential long-term returns compared with stocks *going forward*.

As Buffett suggests, this is a rare occurrence. How rare? **Well consider that Buffett has only commented on the general stock market twice in the past three decades**. He suggested stock prices were too high in the late 1990's and too low during 2008-09 crisis.

In a speech given in 1999, Buffett suggested that given excessive stock valuations at the time, stocks might return 6% per annum in the years ahead, with potentially much worse results.[5] At that same time, ten-year U.S. Treasuries were yielding around 6% and a portfolio of high-quality corporate bonds over 7%.[6] So it appeared possible, perhaps even probable, that investors could generate equal or better returns on high-quality bonds than they could on stocks. This is the kind of environment where a long-term investor may consider underweighting stocks in his portfolio. (Over the next seven years, stocks returned just 1.8% per year versus 6.4% for bonds.[7])

Where are we now? Stocks have had a good run and look somewhat expensive relative to history. But interest rates are historically low. A high-quality bond portfolio might currently yield 2-3%. It's not hard to build a high-quality stock portfolio with an aggregate dividend yield of 2.5% or better. After you tack on earnings growth, it seems likely that stocks will do better than bonds over the next 10-15 years.

This result is by no means guaranteed, especially if interest rates rise markedly (something we don't currently foresee but which is no doubt possible). And the current environment doesn't preclude a major stock market correction in the years ahead. Further, stocks don't appear to meet the criterion required for an *overweight* position. But we just don't see the evidence needed to make the potentially risky decision to jump out of the stock market.

That being said, the current environment is much different from the one that prevailed in 1982. Although the headwinds at that time were severe, the stage was also set for a multi-decade bull market. Stock valuations were cheap and interest rates were high. In subsequent decades, as inflation and interest rates fell, corporate profits improved and valuation multiples skyrocketed, providing huge tailwinds for the stock investor. Additionally, although we downplay the impact of politics on investment markets, rising globalization was no doubt a boon to global corporations.

Today, the situation is reversed: interest rates are historically low, corporate profits are high and stock valuations are elevated. Recent political trends suggest free-trade policies may shift towards isolationist policies. Consider the fact that there are now over $15 trillion of global government bonds with negative yields![8] The tailwinds of the past three decades are much more likely to shift to headwinds. It will be a tough environment for investors. But no matter how much wishful thinking we employ, investors can't change the environment, they can only adjust accordingly. And as tempting as it may be, we see no evidence to abandon simple, time-tested investment policies like the one outlined above.

As always, we thank you for your continued confidence.

Sincerely,

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

[5] Carol Loomis in *Fortune*, "Mr. Buffett on the Stock Market," November 22, 1999.
[6] Federal Reserve. Corporate bond rates are calculated by adding the BofA Merrill Lynch US Corporate Master Option-Adjusted Spread to the Treasury rate.
[7] Bloomberg Financial data; based on the S&P 500 index and the Barclay's U.S. Aggregate Bond index, starting November of 1999.
[8] Bill Gross, Investment Outlook (Janus), "Doubling Down," October 4, 2016.