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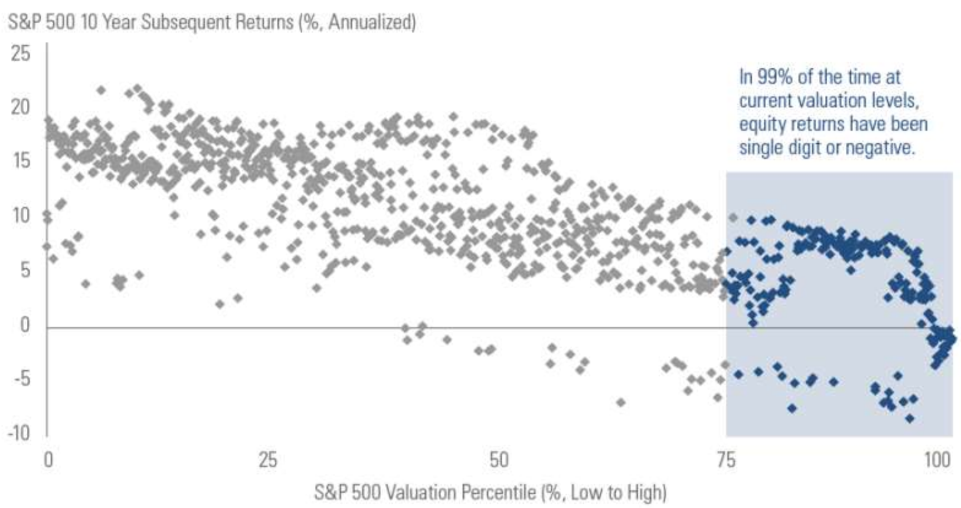
U.S. stocks continue hitting new highs, with the S&P 500 up 4.5% on the quarter and 14.2% on the year.[1] International stocks have also turned in a strong year-to-date performance, with foreign developed stocks up 20.5% and emerging market stocks up 28.1%.[2] Bonds, reflecting low interest rates, have produced returns of 1.5% thus far in 2017.[3]

Living in a Low-Rate World

Stocks are expensive, but as we've pointed out in past missives, that doesn't mean they are in a bubble. Fueled by low interest rates and an eight-plus year bull market, essentially all investment classes – stocks, bonds, real estate, etc. – look expensive. This is simply the reality that comes with living in a low-interest rate world. This doesn't mean that these investment classes are destined for a big fall, though that is always possible. But it does mean that future returns from current levels will likely trail recent returns.

Consider the following chart from Goldman Sachs. It plots the S&P 500's valuation percentile against its subsequent 10-year annualized returns. (When valuations are higher, stocks are considered more expensive.) The message: the more expensive stocks are, the lower their subsequent returns. From today's valuation levels, it is unlikely that stocks can produce double-digit returns over the next decade.



However, it's also clear that in many cases the S&P 500's returns are still positive over a ten-year period, even when beginning valuations are elevated. And that's why we are so hesitant to make material shifts out of stocks. If interest rates remain low over the next decade – which is a definite possibility – there is no reason stocks can't produce *relatively* attractive returns. For instance, in a world of 1-2% inflation and yields on bank accounts of 0-1%, annual returns from stocks of 5-7% wouldn't be that bad, even though such levels are below historical returns of around 9-11%. (This is not a forecast, but an illustration.)

[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.

As Warren Buffett explained in a recent interview:

> Stock valuations make sense with interest rates where they are…In the end, you measure laying out money for an asset in relation to what you're going to get back, and the #1 yardstick is U.S. [Treasury bonds]. And when you get 2.3% on the 10-year [U.S. Treasury], I think stocks will do considerably better than that. So if I have a choice of the two, I'm going to take stocks at that point. On the other hand, if interest rates on the 10-year were 5% or 6%, you'd have a whole different valuation standard for stocks. And we've talked about that for some time now…I would have thought back in 2009 that rates would not be this low eight years later, but it's been a powerful factor, and the longer it persists the more people start thinking in terms of something close to the rates they've seen for a long time…Everyone expects interest rates to change, but they've been expecting it quite a while.[4]

So in what scenario would we recommend reducing exposure to stocks? It's actually not too complicated: if we could find more attractive returns for equal or lesser-risk elsewhere. The year 1999 is an illustrative case study. Stock valuations were at all-time highs, with dividend yields on stocks just above 1%. But investors could generate 7-8% yields in high-quality corporate bonds and real estate investment trusts (REITs).[5] That's not the case today – yields are low across the board.

Six Choices

In a recent memo, Howard Marks, the Co-Chairman of Oaktree Capital, frames the choices available to today's investor:[6]

1. Invest as you always have and expect your historic returns.
2. Invest as you always have and settle for today's low returns.
3. Reduce risk to prepare for a correction and accept still-lower returns.
4. Go to cash at a near-zero return and wait for a better environment.
5. Increase risk in pursuit of higher returns.
6. Put more into special niches.

Marks explains that #1 is "sheer folly…[w]ith the risk-free rate of interest near zero and the returns on all other investments scaled based on that, I dare say few if any asset classes will return in the next few years what they've delivered historically."

#4 strikes us and Marks as too costly. While elevated valuations could possibly yield a major stock market correction, such a correction could also never materialize. Investors sitting in cash would be heavily penalized for their election.

Finally, #5 doesn't strike us or Marks as prudent or sensible. In an investment environment that seems riskier, why would we want to increase our risk?

That leaves #2, #3 and #6. Like Marks, we believe all three warrant consideration.

- First, we are communicating that go-forward returns will likely be below historical returns. While disappointing, there are potential caveats. For instance, inflation is also running lower than historical levels, so real returns – returns after inflation – may not be as effected.

- Second, we are working to find ways to reduce risk where we can without sacrificing much in the way of returns. What does that mean? For instance, when we purchase bonds, we always compare what we can get in corporate bonds – which come with credit risk – to what we can get on safer bonds such as secondary CDs,[7] which carry essentially no credit risk because of FDIC insurance.[8] That difference – called the "spread" – has become quite

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[4] CNBC interview with Becky Quick, 10-3-17.
[5] As measured by the Moody's Seasoned Baa Corporate Bond yield and dividend yield on the NAREIT All-Equity REIT Index.
[6] "Yet Again?" by Howard Marks, 9-7-17.
[7] Certificates of Deposit.
[8] The Federal Deposit Insurance Corporation (FDIC) provides insurance on principal up to $250,000 per issuing bank.

narrow as investors have lowered their risk aversion and focused more on liquidity than credit risk. Accordingly, we have gradually been increasing the credit quality of our bond portfolios, thereby lowering our risk, without sacrificing much return.

- Third, we are always on the hunt for interesting investment opportunities. We've had some luck finding select opportunities in small-cap and international stocks the past year, but it is a tough environment for finding underpriced investments. After an eight-plus year bull market, a lot of rocks have already been turned over by the investment community.

Stock investors have enjoyed a great ride the past eight and a half years, with U.S. stocks up nearly 17% per annum.[9] It seems unlikely that stocks can keep up this pace, and it is true that higher stock prices mean higher risk for the stock investor. But in today's low-rate environment, we just don't see the evidence that would be required for long-term investors to make a wholesale shift out of stocks. That being said, it is important for investors to be comfortable with the stock risk in their portfolio and set their expectations accordingly.

A Few Notes of Interest

Tax Reform

Republicans are pushing hard to get tax reform passed by year-end. While some early details have been released, any successful legislation will likely look much different than the current form as Congress works through the legislative process. The key question for us is whether this has any impact on our investment decisions.

Well, we don't know what the probability is that tax reform passes, although after failing to reform healthcare the Republican Party will likely push hard to get this legislation over the finish line. The final version, if successful, would likely include some decrease in the corporate tax rate. Some of this is probably already priced into stocks and some of the benefits may be passed onto consumers in the form of lower prices. Many of the stocks that we own that are regarded as potential beneficiaries have seen strong returns since last fall's election. So, at least at the current time, we don't see major impacts on our investment process. However, we are taking a wait-and-see approach on capital gains – we should know in the next month or two whether the capital gains tax rate will be reduced, and in case it is, we will try to push any potential gains into next year, assuming the legislation isn't retroactive, and harvest losses this year. Of course we rarely buy or sell any investment solely for tax purposes, but tax considerations certainly factor into our thinking when managing taxable investment accounts.

Equifax

During the quarter, Equifax, one of the three major domestic credit reporting agencies, announced that they had been the victim of a large cyberattack. As a result, if you have a credit report, your information may have been compromised. The company's response to-date has been heavily criticized and the CEO has resigned. There are various responses that you may or may not choose to take, from signing up for credit monitoring services (including complimentary services from Equifax) to freezing your credit reports. Consumers can find useful information at the Federal Trade Commission or in articles written by *The Wall Street Journal*. We simply wanted to make sure you were aware of the situation and encourage you to call or email us if you have any questions or you would like to discuss. (Just to be clear, this issue has no connection to AMI.)

Solar Panel Investments

A few different people recently discussed with us the potential investment returns from installing solar panels at their home or business. Based on the assumptions they were using, we agreed that it appeared to be an interesting personal investment opportunity. The numbers looked even better if financed with low-cost mortgage debt (of course leverage always makes good investment projections look better, but also makes bad investments look even worse). We aren't in a position to recommend one action or another, as such an analysis is subject to a wide variety of unique considerations, including: the tax credits available to the project owner, the potential power that can be generated at the specific installation site, the price the local power company agrees to pay for power sold back into the grid, etc. Further, it is important to note that the return on investment is highly sensitive to the assumptions made, specifically those regarding

[9] Per Bloomberg, from March 31, 2009 through September 30, 2017.

lifetime maintenance costs and the future path of power prices, which may be hard to forecast. Our point here is simply to highlight that it may make sense for some individuals and business owners to explore such an investment if they are so inclined. The price of installing solar power has continued to drop and some tax credits might still be in place, making some onsite solar investments potentially compelling.

Welcome to Maya and Parker!

The AMI family has grown by two this year! Just as Erica and Mike were sending their daughters off to college the past two years (Butler University and the University of Alabama, respectively), Jacob and Ryan both welcomed baby daughters into the world. Jacob and his wife Lauren welcomed Maya Louise back in May, and Ryan, his wife Kristen and their two-year old Caleigh welcomed Parker Joanna in September. Moms and babies are doing well! We are already hard at work teaching Maya and Parker the wonders of compound interest.

As always, we thank you for your continued support.

Sincerely,

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