AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

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U.S. stocks, alongside a robust economy, posted a strong third quarter with returns of 7.7%, bringing year-to-date returns to 10.6%.[1] International stocks have fared less well, with developed stock markets up just 1.4% in the quarter and down 1% year-to-date and emerging stock markets down 1% in the quarter and down 7.5% year-to-date.[2] Jason Zweig, a long-time reporter at *The Wall Street Journal*, recently wrote an insightful article pointing out that the difference between the returns of U.S. and international stocks has historically exhibited long cyclical patterns.[3] Unfortunately, there is no reliable system to forecast when the tide might turn again. Bonds returned -0.1% in the quarter and are down 1% year-to-date, reflecting higher interest rates, which improve future returns but depress bond prices in the short-term.[4]

Analysis or a Book Report?

A friend recently lamented the fact that most of the investment analysis that he read didn't actually say anything of substance. He called it "corporate speak." Missives read more like a book report as opposed to in-depth investment analysis that actually *says something*. The situation calls to mind Ronald Reagan's plea for someone to send him a one-handed economist, since each time one of his economic advisors would tell him something, he'd immediately follow it up with, "on the other hand…" We aren't necessarily immune to this charge.

A mentor of ours has a short but powerful statement: "To understand is to know what to do." Investing is done looking through the front windshield, not the rearview mirror. Now of course in order to know what to do we must be able to understand cause and effect relationships in markets. But it is vital to remember the "Noah Rule," as summarized by Warren Buffett: "Predicting rain doesn't count; building arks does."

Much of the ink spilled covering investment topics doesn't contain much substance. This isn't because the authors are uninformed, unintelligent, or misguided. Instead, it is because it is simply hard to say something original and insightful on a frequent basis. As humans, we are biologically wired to demand that the world exhibit clear cause-and-effect relationships that are understandable and ultimately predictable. But in reality, the world – and investment markets – are much, much more random and unpredictable then we'd like to admit.

We always chuckle when we check the news at the end of the day and see a headline like this: "Stocks fall 0.1% as concerns over trade disagreements between the US and China overshadow strong corporate earnings." A much more accurate headline would read as follows: "Stocks fall 0.1%, and we aren't really sure why, as a lot of stuff happened today and the stock market is really complicated."

[1] As measured by the S&P 500 index.
[2] As measured by the relevant MSCI international indices.
[3] "The 'Dumb' Money Is Bailing on U.S. Stocks. That's Smart." September 28, 2018.
[4] As measured by the Citigroup 1-10 Year Government Bond index.

Predicting is Hard

The Wall Street Journal ran a fascinating article earlier this year titled, "How Do Pundits Never Get It Wrong? Call a 40% Chance."[5] In the piece, the authors analyze the so-called "40% Rule":

> Former British Prime Minister Tony Blair said last month there's a 40% chance that Brexit will be reversed; Citigroup Inc. analyst Jim Suva wrote that there's a 40% chance Apple Inc. buys Netflix Inc.; and Nomura Holdings Inc. economist Lewis Alexander said there's a 40% chance NAFTA gets ripped up.
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> The nice thing about 40% is that you never have to say you were wrong, says Peter Tchir, a market strategist at Academy Securities. Say you predict the Dow Jones Industrial Average has a 40% chance of hitting 30,000 before year-end.
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> "Get it right and you can say 'See, I was telling everyone it could happen,' " he says. "Get it wrong and you can weasel your way out: 'I didn't say it was likely, I just said it was a strong possibility.' "…
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> "Pundits and gurus master the art of going out on a limb without going out on limb," says Philip Tetlock, a professor at the University of Pennsylvania who has made a career analyzing which people forecast well, and why.[6]

The truth is that predicting things accurately is *hard*. The world is complicated. An old Danish proverb warns: "It is difficult to make predictions, especially about the future." Over time we've learned that the great predictors are the ones who have learned to predict only rarely, when the "stars align." Warren Buffett once wrote: "Our stay-put behavior reflects our view that the stock market serves as a relocation center at which money is moved from the active to the patient."[7] Too often, activity is defined as productivity or progress. This is often a mistake.

Thinking About Thinking

"Some problems are so complex that you have to be highly intelligent and well-informed just to be undecided about them." *– Laurence Peter*

"Wise men talk because they have something to say; fools, because they have to say something." *– Plato*

"Only one who has learned much can truly appreciate his ignorance." *– Louis L'Amour*

"Real knowledge is to know the extent of one's ignorance." *– Confucius*

"The whole problem with the world is that fools and fanatics are always so certain of themselves, but wiser people so full of doubts." *– Bertrand Russell*

So if the world is complicated, if it's hard to actually say anything original or insightful on a regular basis, and the opportunity to make bold predictions arises only rarely, then why do we write these newsletters in the first place?

Mental Models

Often times, people think of intelligence as raw intellect that can produce visionary insights on demand. We picture Albert Einstein sitting at a desk conjuring up the theory of relativity, Isaac Newton inventing calculus or Steve Jobs dreaming up the iPhone. Perhaps investors believe this is how good investing is done. A genius like Warren Buffett sits in his office and one day screams "Coca Cola" and buys a bunch of Coca Cola stock.

Yet the reality is that while some insights do arise in this kind of manner, most of what we consider intelligence comes from the disciplined study and mastery of mental models that can be used to understand the world.[8] We don't teach fourth graders to memorize the answer to *14 x 17 = ?*. Instead, we try to equip them with mental models that can help them answer all types of such problems. [The argument that intelligence should really be built on the deployment of consistent, reproducible mental models and algorithms has been well explained and advanced by the psychologist Daniel Kahneman[9] and the investor Ray Dalio[10] in recent works.]

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[5] By Rolfe Winkler and Justin Lahart, March 10, 2018.
[6] If you are so inclined, we highly recommend Professor Tetlock's books.
[7] Berkshire Hathaway Annual Letter, February 28, 1992.
[8] It might be unfair to suggest two different kinds of intelligence. Often times, brilliant insights are achieved by taking a model from one field and originally applying it to a problem in a seemingly unrelated field.
[9] See "Noise: How to Overcome the High, Hidden Cost of Inconsistent Decision Making" from the October 2016 issue of the *Harvard Business Review*.
[10] See Dalio's book *Principles*.

When we write our newsletters and white papers, we are certainly *not* attempting to tell our clients what the stock market will do next month or next quarter. We wish we could do that, but we can't. And we are not trying to waste our clients' time by simply reporting what happened last quarter. Instead, we are trying to outline the models that we use in our efforts to protect and grow their wealth. And by writing about these models, we are actively engaged in building, improving and testing them.

For instance, in our second quarter newsletter we wrestled with the question, "When, if ever, should we actively reduce our allocation to stocks out of a fear that stock prices are too high?" The answer was not simple, and it didn't give us insight into whether stock prices will rise or fall next quarter. But we do believe that it presented a useful model for thinking about stock allocations and cycles.

We also discuss faulty models prevalent in the financial industry or the financial press that we believe should be discarded or treated with caution. For instance, in the fall of 2012 we wrote about our belief that investment decisions should not be based on the outcome of the presidential election.[11] Earlier that year, we authored a white paper explaining what we believed to be severe flaws in popular commodity-focused mutual funds.[12]

We've become a big fan of writing things down, or better yet, "writing them up" as one of our friends describes it. Writing up our models requires us to fully hash out our ideas, thereby exposing any potential flaws in the process. After reflecting on the questions that provided the impetus for this missive, we discovered the need to be even more articulate and purposeful in future writings.

Okay, so what does this mean in practice? Say one of our clients asks us a simple question: "Should we buy stock XYZ?" Or perhaps: "Should we sell our stocks in order to get more conservative?" Our answer should *not* rely on some genius insight about XYZ or the outlook for stocks over the next three to six months. Instead, we *should* reference a robust underlying model that can be used to think about such questions. Our answer should say something along the lines of, "XYZ may or may not be a suitable investment candidate because it does or does not pass the hurdles used in our model," or "our models don't indicate that there is enough evidence to reduce our stock exposure at this time." Our job is to come to work every day and focus on improving and employing our models (which must incorporate both quantitative and qualitative inputs). And if we've done our job, we've effectively communicated these models in our writings.

We often quote the investor Howard Marks, the Chairman of Oaktree Capital Management, in our newsletters. Marks serves as a role model for our writing efforts, using his frequently-written memos to describe the models that he uses to think about markets and investments.[13] Marks' writings are sometimes criticized as too subjective and his ideas are often over-simplified in the financial press. People are prone to demand either bold predictions or simple formulas that can pave the way to wealth. But Marks points out that "people who think it can be easy overlook substantial nuance and complexity…anyone who thinks it's easy to achieve unusual profits is overlooking the way markets operate."[14]

Current Market Conditions
We try to use all kinds of models in our daily investment work. As Charlie Munger points out:

> Well, the first rule is that you've got to have multiple models – because if you just have one or two that you're using, the nature of human psychology is such that you'll torture reality so that it fits your models, or at least you'll think it does…It's like the old saying, "To the man with only a hammer, every problem looks like a nail."[15]

What do some of our investment models tell us about the current investment climate? Well, we don't see the evidence needed to abandon stocks. Stocks look somewhat expensive, but so does everything else, and we believe that investors

[11] See "Investment Markets and the 2012 Election," October 2012.
[12] See "Thoughts on Investing in Commodities," January 2012.
[13] None other than Warren Buffett said, "When I see memos from Howard Marks in my mail, they're the first thing I open and read. I always learn something."
[14] See "It's Not Easy," September 9, 2015.
[15] Charlie Munger speech at the USC Business School, 1994, titled "A Lesson on Elementary, Worldly Wisdom As It Relates To Investment Management & Business."

should only consider reducing their stock allocations from their long-term targets if they believe they can be rewarded with more compelling returns elsewhere. That doesn't seem to be the case, even if safer, lower-yielding investments turn out to be a better choice in hindsight a year or two from now.

But this does not mean that stocks can't fall nor that everything is rosy. Howard Marks described current conditions well in his most recent investment memo [emphasis added]:

> Assuming you have the requisite capital and nerve, **the big and relatively easy money in investing is made when prices are low, pessimism is widespread and investors are fleeing from risk…this is not such a time**...
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> Conditions overall aren't nearly as bad as they were in 2007…But I do think this is the kind of environment – marked by too much money chasing too few deals – in which **investors should emphasize caution over aggressiveness**…
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> **I'm absolutely not saying people shouldn't invest today**…Oaktree's mantra recently has been, and continues to be, "move forward, but with caution." The outlook is not so bad, and asset prices are not so high, that one should be in cash or near-cash. **The penalty in terms of likely opportunity cost is just too great to justify being out of the markets**. But for me…investors should favor strategies, managers and approaches that **emphasize limiting losses in declines above ensuring full participation in gains**. You simply can't have it both ways. 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.[16]

What does caution look like? For us, it entails a shift in bond portfolios towards higher-rated securities such as U.S. Treasuries, since the spread between riskier corporate debt and safer Treasury debt is much narrower than it was a few years ago. It entails stock funds that are defensively postured. It entails a cautious eye towards companies that are highly cyclical or that have a highly-levered balance sheet. None of these activities will insulate a portfolio from difficult market conditions. And if the good times continue, these decisions may cost us some upside. But if markets and economies do hit a rough patch, they should hopefully help protect us to some degree. Given the fact that we are in the late cycle of the current economic expansion, we believe it is prudent and justified to act with more conservatism then we may have several years ago when investment securities were more attractively priced.

As always, we thank you for your continued confidence.

Sincerely,

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

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[16] See "The Seven Worst Words in the World," September 26, 018.

Get to Know AMI: Spotlight on Ryan Kay

AMI and our clients were blessed when Ryan Kay joined the firm in 2014. He previously worked for an independent wealth management firm in Fort Wayne and ran his own branch office for a national brokerage firm prior to that. Ryan first became interested in investing in 8th grade when he read the book "The Automatic Millionaire." He still keeps copies of the book on his desk to hand out to students interested in saving and investing. Ryan is originally from Indianapolis but Fort Wayne has been his home for the last 25 years. He focuses on delivering planning strategies and investment advice to our clients. His favorite part of his job is interacting with clients.

Ryan has been married to his wife, Kristen, for eight years and they have two daughters, Caleigh (3) and Parker (1). They enjoy traveling as a family and are looking forward to an upcoming trip to Charleston, South Carolina this fall. Ryan's favorite vacation spots are Aruba and the western coast of Lake Michigan. He would like to visit the Almalfi Coast in Italy someday.

Ryan was honored as one of the class members of *Greater Fort Wayne Business Weekly's* Forty Under 40 class of 2017. He currently serves as the Treasurer for the Board of Directors of the Power House Youth Center and has taught classes on financial planning through both Purdue University Fort Wayne and Fort Wayne Community Schools.

Ryan is a member of the Purdue Alumni Association Board of Directors along with 24 other Purdue alumni from across the nation. He is an avid Purdue sports fan and coordinates an annual golf outing fundraiser each spring to raise money for a local Purdue scholarship fund. His other hobbies include playing golf, listening to podcasts and trying new restaurants.