AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

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U.S. stocks finished the third quarter near all-time highs. Year-to-date gains now exceed 20% after a 1.7% showing the past quarter.[1] International stock markets continue to trail the U.S., with developed international markets up 13.4% year-to-date and emerging markets up 6.1% after third quarter returns of -1.0% and -4.1%, respectively.[2] Bonds have had a strong year, returning 5.2% year-to-date and 1.2% in the quarter on the back of lower interest rates (bond prices rise when interest rates fall, and vice versa).[3]

Caution at the Margin: Corporate Bonds

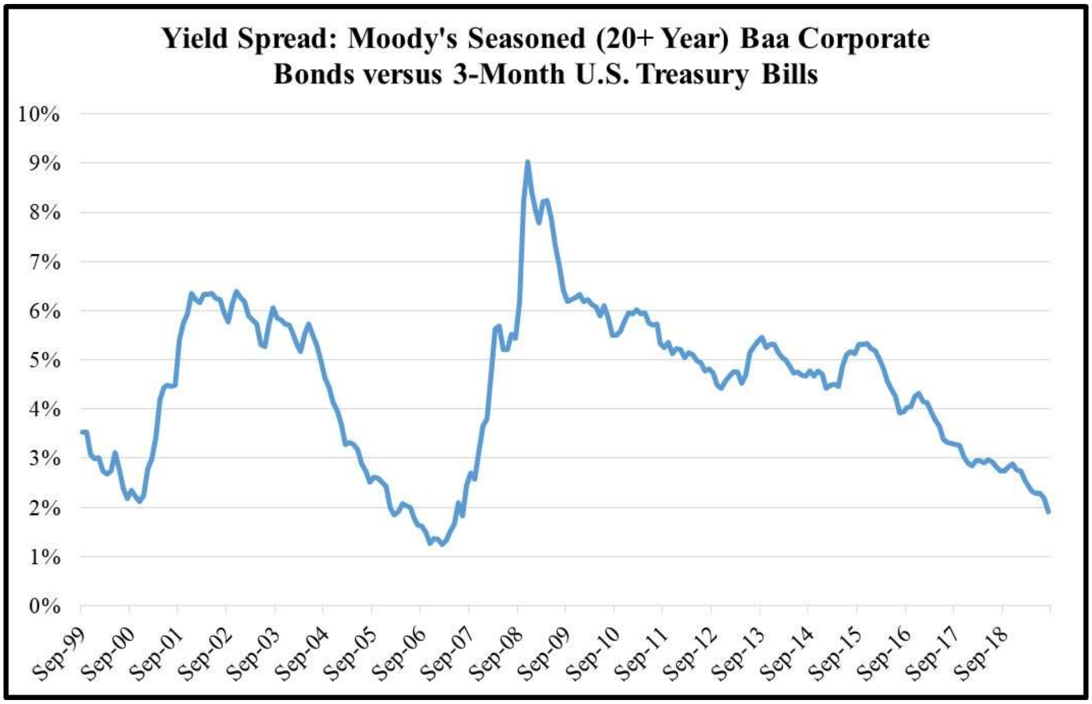
For over a year we've been citing the mantra offered by the investor Howard Marks: "go forward, but with caution." We quoted him in our quarterly commentary one year ago:

> 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…
>
> I'm absolutely not saying people shouldn't invest today…[our] 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.[4]

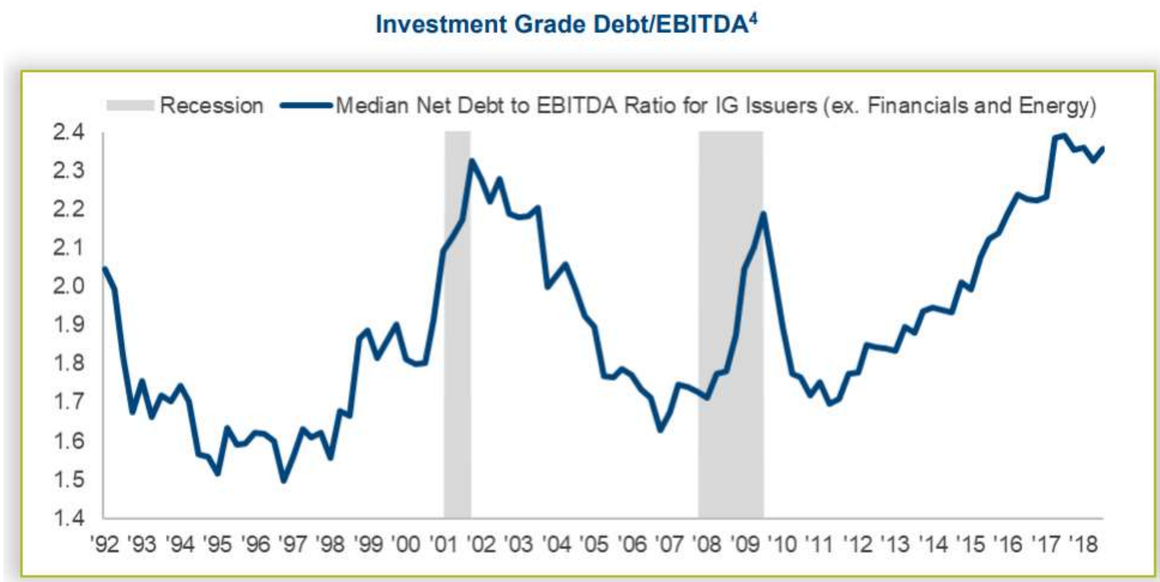
We've described this approach as "reducing risk at the margin." Consider one example. The following graph plots the difference in yield over the past two decades between two data sets maintained by the Federal Reserve:

- The Moody's Seasoned Baa Corporate Bond yield, which measures the yield (i.e. interest rate) available on a basket of corporate bonds rated Baa[5] with twenty years or more until maturity[6]
- The yield (i.e. interest rate) available on 3-Month U.S. Treasury Bills

[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] See "The Seven Worst Words in the World," September 26, 2018.
[5] The credit rating agency assigns bond ratings to all of the corporate bonds that it covers, from the safest (Aaa) to the riskiest (C, or in default). A rating of Baa is the lowest rating that a bond can receive and still be considered "investment grade."
[6] Note that AMI generally only purchases bonds with maturities of fifteen years or less for its bond portfolios given the inherent risk of bonds with extremely long maturities. Nonetheless we think the data shown here is illustrative and broadly applicable.



Only one other time during the past twenty years (in late 2006/early 2007) have investors been paid so little to take on both corporate credit risk and duration risk.[7] During a decent span of this time period, investors were paid 5% or more per year to accept the credit and duration risk of seasoned Baa corporate bonds. Today the margin is less than 2%. And this is despite the fact that the companies which make up the Moody's basket are likely riskier today than they have been in the past. The chart below shows the leverage ratio for investment grade bond issuers, with a higher reading indicating higher levels of leverage:[8]



[7] Duration risk refers to the risk that comes from holding a longer-duration bond. The longer a bond's maturity, the more its price will move relative to changes in interest rates. For instance, imagine that we have a bond due in 2 years and a bond due in 30 years that each currently offer a yield of 4%. If interest rates on both bonds rise to 6%, the price of the 2-year bond will only fall by 4% but the price of the 30-year bond will fall by nearly 30%.

[8] From *Risk is Where You're Not Looking*, FPA Funds (Steven Romick, Abhijeet Patwardhan, Thomas Atteberry), January 2, 2019. EBITDA stands for "Earnings before interest, taxes, depreciation and amortization" and is a crude and overstated measure of a company's earnings power. A higher debt-to-EBITDA ratio indicates a larger amount of borrowings for every dollar of earnings.

As a result, as our corporate bonds have matured we've been reinvesting the proceeds into bonds with little to no credit risk (such as U.S. Treasuries). Consider the fact that the price of a corporate bond that matures in twenty to thirty years and currently yields 4% could fall 25% or more if interest rates were to rise by just 2%. That sure doesn't seem like a low-risk investment! (We aren't saying that we necessarily expect interest rates to rise, only that we aren't thrilled about the downside risk in these types of bonds in the event that they do.)

We believe there will be highly attractive opportunities within the corporate bond market during the next period of financial stress. Indeed, changes in regulation since the last financial crisis have reduced the amount of liquidity in the corporate bond market, which may lead to more downside risk in corporate bond prices during the next recession.[9] But for now, we don't think investors are being paid sufficient premiums to accept certain types of credit and duration risk in corporate bond markets.

Value in Value?

What about stocks? Stock prices are near all-time highs and there are a long list of potential risk factors that could derail the bull market. Certain areas of the market, which we've discussed in recent missives, do appear a bit bubbly. But we are still finding what we believe to be reasonable investment opportunities in other areas of the stock market.

Many investors bifurcate the market into "growth stocks" and "value stocks." A simple explanation of the difference is as follows:

- Growth investors pay much more attention to the prospective revenue growth of potential stock investments and much less attention to the valuation of potential stock investments
- Value investors pay much more attention to the valuation of potential stock investments and much less attention to the prospective revenue growth of potential stock investments

As a result, growth investors often end up owning a portfolio of expensive but quickly growing stocks while value investors often end up owning a portfolio of slower-growth but much cheaper stocks.

To some degree, the classification is arbitrary. Both growth and valuation matter when investing in a stock. A company that grows faster than another company is worth more. We never buy a stock because it is either a growth or a value stock. Instead, we buy stock because we believe its current price underestimates its true value, which is based on our estimate of its potential future growth rate.

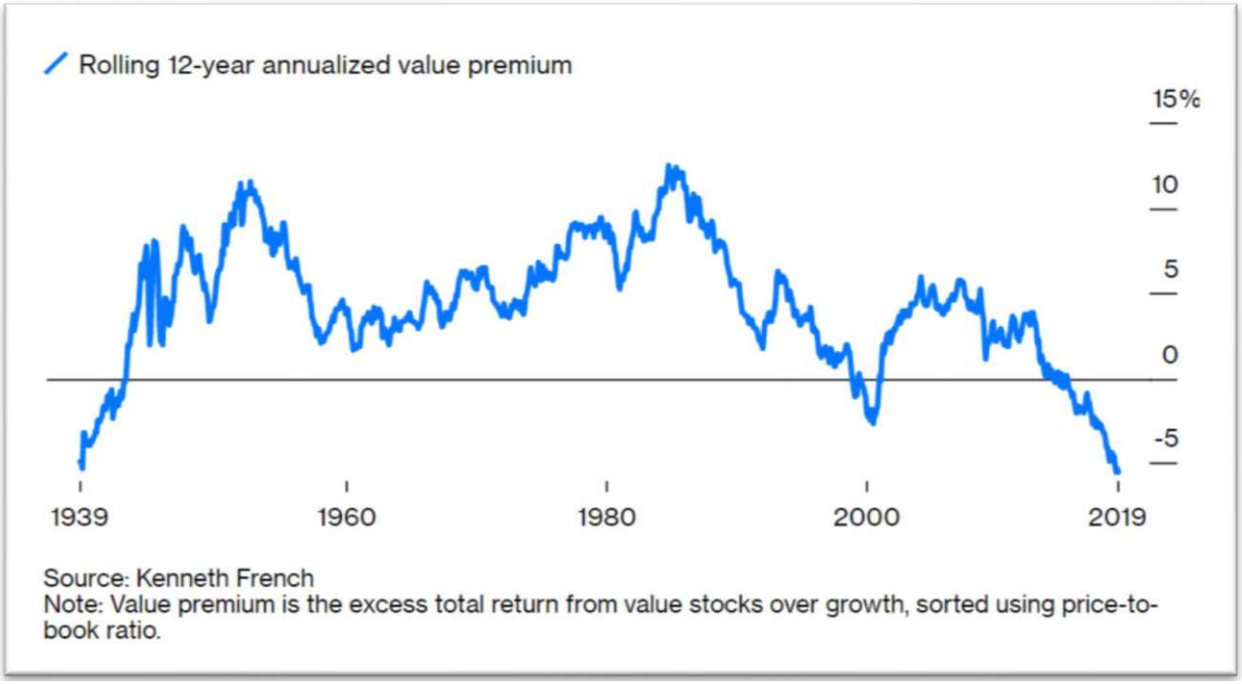
That being said, historically the enthusiasm that surrounds many growth stocks and the negative sentiment that surrounds many value stocks has led value stocks to outperform growth stocks longer-term. In short, investors have a tendency to get too excited about sexy growth stocks and accordingly bid their prices up too high and to become too negative about boring value stocks and accordingly bid their prices too low. This reality has historically led AMI's portfolios to lean heavily towards value stocks.

Over the last fifty years, value stocks have outperformed growth stocks by nearly 4% per year.[10] But this hasn't been the case lately. As the following graph shows, value is stuck in its third bear market relative to growth since the 1930's:[11]

[9] Regulations such as the Dodd-Frank Law have pushed investment banks to drastically reduce the amount of corporate bonds they are willing or able to hold on their balance sheet. In the past, investment banks could step in during periods of above-average volatility and thereby dampen price moves. This may not occur during the next recession. According to FPA Funds, net holdings of corporate debt by so-called "primary dealers" has fallen from nearly $300 billion in 2007 to just around $50 billion today.

[10] Data from finance scholar Ken French for the period September 1969 through August 2019. French sorts growth stocks and value stocks using price-to-book ratios, but other valuation approaches (such as price-to-earnings or enterprise value-to-EBITDA) have shown similar results.

[11] Broyhill Asset Management 2Q2019 client letter.



It's always natural to ask whether "this time is different." Indeed, growth stocks have been helped by the strong returns from some of the big technology companies, which have achieved impressive gains in their underlying businesses. Yet we still think that value stocks are too unloved and value should once again have its day in the sun. During the dot-com crash, many value investors actually fared okay even though the broader stock market dropped materially. [12] We do not mean to imply that value stocks will repeat the type of outperformance seen during the dot-com crash when the next recession hits. But we believe it is a good reminder to investors to think more about the stocks they own as opposed to the broader stock market. We continue to find reasonably valued stocks – many of which pay attractive dividend yields – in the current environment.

International Valuations

International stock returns have underwhelmed for over a decade now. This has been driven by several fundamental factors, including: the U.S. economy has outperformed international economies; U.S. companies have benefitted from a shift towards pro-business policies (including reduced corporate tax rates); and the U.S. has a greater share of disruptive global tech companies, which have helped drive markets higher in recent years. These fundamental strengths have led both to a stronger dollar and higher valuations on domestic versus international companies, which have exacerbated international investment underperformance.

We've always believed in domestic-heavy investment portfolios. We think the U.S. is simply a great, low-cost place to invest. And clearly international economies face risks, from growing pains in China to Brexit in the UK to demographic and fiscal challenges in Japan. (Although the U.S. economy isn't free of risks either.)

That being said, our research and experience have suggested that some degree of international diversification can be useful and international opportunities need not be dismissed out of hand. We've always admitted that we can't predict if and when international markets will outperform. Unfortunately, diversification can't work all the time. However there very well could be a time when international stocks provide a useful hedge to domestic investment portfolios, perhaps if domestic inflation takes off or the current pro-business policy climate in the U.S. shifts the other direction.

Importantly, we just seem to be seeing cheaper stocks in international markets. Now we are by no means international experts, but the data seems pretty clear. A recent analysis by *The Wall Street Journal* observed that, "Aside from the dot-

[12] During the period September 2000 through September 2002 (per Bloomberg Finance) the S&P 500 Index fell 45%, the tech-heavy NASDAQ Composite Index fell 70%, but the MSCI USA Small-Cap Value Index dropped only 8%.

com bubble, U.S. stocks trade at their biggest valuation premium over other markets since at least 1980."[13] The investment firm GMO forecasts potential future returns from emerging market value stocks well ahead of U.S. stocks.[14] And our occasional look into individual stocks headquartered abroad seems to corroborate these views.

We don't think that investors should shift a bunch of investment assets to international holdings. But we also don't think it's the right time to abandon international markets. Indeed, some of the bargains that appear to be currently available abroad could turn out to be important diversifiers to investment portfolios in the future.

Mean Reversion

At the beginning of his investing masterpiece *Security Analysis*, Warren Buffett's mentor Ben Graham quoted the ancient Roman poet Horace:

> Many shall be restored that are now fallen, and many shall fall that now are in honor.

Graham's point was that the concept of mean reversion is a hallmark of investment markets. In other words, those things that have recently underperformed may be more poised to outperform and vice versa. This trait isn't so strong that we can bet on it blindly: we can't just buy things because they've fallen in price and sell things because they've risen in price. But we must fight the ingrained human tendency to do the opposite: to flee from that which has underperformed (such as value stocks or international stocks) and run to that which has outperformed (such as long-dated corporate bonds or U.S. growth stocks).

There's an old saying in commodity markets: the cure for high prices is high prices, and the cure for low prices is low prices. When the price of a commodity rockets higher, it encourages commodity producers to bring on new supply, either through increased production at existing locations or via the exploration and development of new locations. New supply eventually floods the market, outpacing demand and thereby reducing prices. Similarly, when the price of a commodity crashes, commodity producers pull back on expenditures aimed at increasing production or finding new reserves. Eventually supply falls behind demand and the price rebounds. The same kind of mechanism operates throughout investment markets and runs counter to our own psychological tendencies. Our personal experiences often teach us to bet on recent winners, whether they be employees, sports teams, athletes, etc. We are seemingly hardwired to extrapolate recent trends. But in investments markets, this approach can yield disappointing results and increased risk. Investment value is often found in areas with little investor enthusiasm or support.

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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[13] "U.S. Stocks Are Super-Expensive, but for the Right Reasons," by James Mackintosh, September 24, 2019.
[14] See "GMO 7-Year Asset Class Forecast: July 2019," published on August 21, 2019.