AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

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In our third quarter newsletter, we quoted the investor Howard Marks, who said that "market conditions make this a time for caution." Market conditions promptly validated this view, with the first bear market in U.S. stocks since 2011. A bear market is somewhat arbitrarily defined as a 20% drop in stock prices from the previous peak. U.S. stocks hit their highs on September 21st and proceeded to fall just over 20% through Christmas. But stocks quickly snapped back to close out 2018, rising nearly 7% in the last four trading days of the year.

The S&P 500 dropped 13.5% during the quarter but fell just 4.4% on the year – by no means great, but not terrible either. Yet if an investor "threw in the towel" after the market's rough day on Christmas Eve, their 2018 return would have been a much worse -10.4%, which just goes to show the potential perils of trying to time the market.[1]

International stocks continued to underperform domestic stocks, with developed international stocks dropping 12.5% during the quarter and 13.3% on the year and emerging markets dropping 7.6% in the quarter and 14.5% on the year.[2] Bonds, which serve as a ballast in investment portfolios, returned 2.2% in the quarter and 1.4% on the year.[3]

Select sectors and companies had even tougher showings. Consider the fact that approximately one-third of the stocks in the S&P 500 Index (made up of the 500 largest publicly-traded companies in the U.S.) *are down over 30% from their fifty-two week highs*, and nearly 60% of the stocks in the Russell 2000 Index (comprised of smaller publicly-traded U.S. companies) have reached that mark. Over one-quarter of the stocks in the Russell 2000 *are down over 50% from their fifty-two week highs*![4]

Of course financial news media outlets jumped on the opportunity to trumpet doom, with headlines such as "Stocks may try to bounce but are heading for worst December ever,"[5] and "The stock market just booked its ugliest Christmas Eve plunge – ever."[6] (The stock market doesn't care that it's December or Christmas Eve.)

This carnage and these headlines cause some investors to distrust the stock market as a long-term investment vehicle. Our reaction is different, as explained in our recent white paper "Mr. Market: Friend or Foe? (How the Long-Term Investor Should Think About Volatility)." Stock prices will move up and they will move down. But we – *nor do we believe anyone else* – has any ability to predict short-term swings in stock prices. What we do believe is that it is highly likely (though never guaranteed) that stock prices will be higher ten and twenty years from now, and the returns from investing in a diversified, low-cost, low-turnover portfolio of stocks will well outpace the returns from investment alternatives such as cash, bonds or gold. Indeed, as stock prices *fall*, future returns should *improve*.

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[1] All of this data is 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] Per our own Bloomberg analysis, with sample sizes of 505 and 2,024 stocks respectively.
[5] Per CNBC on 12-24-18.
[6] Per MarketWatch on 12-24-18.

What Caused the Market Sell-Off?
The evolution of the market sell-off that began in September is interesting. It really started on October 3rd, when the Chairman of the Federal Reserve, Jerome (Jay) Powell, said the following in an interview with PBS' Judy Woodruff:

> The really extremely accommodative low interest rates that we needed when the economy was quite weak, we don't need those anymore. They're not appropriate anymore.
>
> Interest rates are still accommodative, but we're gradually moving to a place where they will be neutral. We may go past neutral, but *we're a long way from neutral at this point*, probably.[7] [emphasis added]

As we've outlined in past commentaries, materially higher interest rates are a threat to both stock and bond prices. For example, if investors could earn 8-10% in a savings account at a local bank, they would likely sell stocks and move the proceeds to bank accounts, thereby depressing stock prices. When investors heard the Chairman of the Federal Reserve state that interest rates could go a lot higher, they panicked, even though the silver lining of his comment was that the economy was doing quite well. The day before Powell's interview, the yield on 10-year U.S. Treasury Notes was 3.05%. Within three days, it had moved up to 3.23%, a material jump over a short timeframe and the highest reading since 2011.[8]

Yet as stock prices fell, especially those of cyclically-oriented companies, investors began to worry that lower stock prices were sending a recessionary signal. Difficult trade negotiations with China added to fears of a global slowdown and subsequent economic data, while still strong, was somewhat disappointing. Housing markets seemed to stall in the face of higher mortgage rates. Stocks moved even lower. As investors started to price in a recession, they began purchasing bonds, causing interest rates to reverse direction and move lower. At the end of the year, the yield on the 10-Year U.S. Treasury had fallen all the way down to 2.69%!

So to recap:

- The Chairman of the Federal Reserve believes the economy is healthy and doing well, so he states that the Fed will keep raising interest rates.
- Investors panic that higher interest rates might depress stock and bond prices, so they sell stocks and bonds, pushing prices down.
- Investors start to fear that falling stock prices, along with difficult trade negotiations, are signaling a coming recession.
- As recession fears mount, investors sell more stocks, thereby further depressing stock prices, and invest in high-quality bonds.
- The demand for high-quality bonds like U.S. Treasuries pushes the prices of these bonds back up, and therefore pushes down the yield that investors can get.
- When it's all said and done, the initial concern – higher interest rates – gave way to much lower interest rates!

Now we've oversimplified this analysis and downplayed some legitimate fears that spooked the markets during the quarter. The market is typically smarter than any investor, as it aggregates a large number of informed and diverse viewpoints. But our point is this: investors often look for precise reasons why stocks go up or go down, and financial headlines often outline detailed rationale for market movements. Investors believe that daily movements in the stock market offer some divine meaning on future economic and market performance. But often, the best we can say is this: Stock prices fell because more people wanted to sell stocks than wanted to buy them during a given period, or stock prices rose because more people wanted to buy stocks than wanted to sell them during a given period.

Warren Buffett's mentor Benjamin Graham once observed: "In the short run, the market is a voting machine but in the long run, it is a weighing machine." Investors can't predict how popularity contests will turn out. But that doesn't change the fact that over the long-term, stocks should do fine.

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[7] "Powell says we're 'a long way' from neutral on interest rates, indicating more hikes are coming," CNBC 10-3-18.
[8] U.S. Treasury.

But Won't We Have a Recession?

Yes, we will have another recession. In fact, it seems clear that we are later in the economic cycle, so one could come sooner rather than later. And someday we will have another financial crisis, although we think that it is a mistake to automatically assume that our next downturn will rival the 2008-09 crisis (which may go down as a once-in-a-generation crash similar to the Great Depression) or to assume the next crisis will have a similar cause (banks and mortgage markets are much safer today; maybe the next crisis will come from underfunded government pensions or rising government deficits).

If a recession might be around the corner, shouldn't we be trying to read the tea leaves and predict its timing? Warren Buffett has a wonderful matrix that determines what he spends his time thinking about:

Is it knowable?

Is it worth knowing?		*Yes*	*No*
	Yes	**Focus your efforts here**	x
	No	x	x

Knowing when the next recession will occur is definitely worth knowing. But unfortunately, it's not really knowable. In a recent interview with CNBC, Jamie Dimon, the Chairman and CEO of JPMorgan Chase, was asked for his thoughts on the next recession. We loved his answer:

> I don't know. I mean you guys always ask that question, and no one knows, and I think it's actually almost a waste of time to guess.[9]

They have a worthwhile saying in investing: There is no difference between being early and being wrong. Unless you have the ability to accurately pinpoint *when* a recession or market downturn will occur, you likely won't be able to generate any corresponding insights for your investment portfolio.

At the end of the day, we strive to own great businesses. This is why we put so much effort into doing our own independent research on the stocks that we own. This may or may not lead to superior performance, but by knowing what we own, we have the conviction to stick with these companies even when the stock market becomes volatile or depressed. What matters to us is that (a) we own high-quality, enduring, and resilient companies and that (b) the current stock prices of these companies aren't too high or overextended. If we feel confident that our portfolio of stocks meets those two criteria, we try to tune out all of the short-term "noise" from the markets.

In his 2013 annual shareholder letter, Warren Buffett walked through two personal investment case studies – an investment in Nebraska farmland in 1986 and real estate near New York University (NYU) in 1993 – and concluded:

> Forming macro opinions or listening to the macro or market predictions of others is a waste of time. Indeed, it is dangerous because it may blur your vision of the facts that are truly important. (When I hear TV commentators glibly opine on what the market will do next, I am reminded of Mickey Mantle's scathing comment: "You don't know how easy this game is until you get into that broadcasting booth.")

[9] Interview with CNBC 12-6-18.

> My two purchases were made in 1986 and 1993. What the economy, interest rates, or the stock market might do in the years immediately following – 1987 and 1994 – was of no importance to me in making those investments. I can't remember what the headlines or pundits were saying at the time. Whatever the chatter, corn would keep growing in Nebraska and students would flock to NYU…
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> Owners of stocks, however, too often let the capricious and often irrational behavior of their fellow owners cause them to behave irrationally as well. Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits – and, worse yet, important to consider acting upon their comments.
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> Those people who can sit quietly for decades when they own a farm or apartment house too often become frenetic when they are exposed to a stream of stock quotations and accompanying commentators delivering an implied message of "Don't just sit there, *do* something." For these investors, liquidity is transformed from the unqualified benefit it should be to a curse.

Stock market investors were blessed with a mostly smooth and enjoyable ride from 2011 through mid-2018 (with just one mild hiccup in early 2016). It is not unreasonable to assume that the road may get a little bumpier over the near-term. But that doesn't mean investors should run for the hills. While caution may still be appropriate, it is important to focus on your long-term investment objectives and try to tune out the short-term noise.

As always, we thank you for your continued confidence and wish you the best in the New Year!

Sincerely,

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