AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

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"May you live in interesting times." – Ancient Chinese Curse

Interesting is one adjective that could be used to describe 2020. Sad is another. We pray that you and your loved ones are healthy and well. We extend our thoughts and condolences to any family that has been adversely impacted by the pandemic and we extend our best wishes to you in the New Year.

We also profess our long-term belief and optimism that no matter what challenges and divisions may confront us, America will persevere and prevail. Our country has faced trials before, but in the end we believe that the success of the American experiment will endure.

Our job is to protect and enhance the assets of our clients to the best of our ability. In that regard, 2020 was one of the more difficult and stressful years of our careers. Purdue University President and former Indiana Governor put it well in a recent quip: "It's hard to believe 2020 started just nine years ago." Imagine that we travelled back in a time machine to early 2020 and told you the following:

- The world would be engulfed by a global pandemic that would force economies to shut down and result in the death of over 350,000 Americans.
- U.S. GDP would temporarily drop by over 30% and unemployment would spike to nearly 15%.
- The federal government would be forced to borrow over three trillion dollars in order to support the economy during the year and the Federal Reserve would print another three trillion dollars in support of financial markets. (Analysts forecast that the federal government will need to borrow another two trillion dollars in 2021.)
- International relations among world powers would reach a relative low point, with the United Kingdom struggling to finalize plans to leave the European Union, the U.S. and China drifting further apart, China inflaming tensions within Asia by exerting control over Hong Kong, and Russia reportedly launching a major cyberattack on the U.S.
- Numerous U.S. cities would confront riots and the political winds would change, with an incumbent President being defeated for the first time since 1992, the Democratic Party taking control of both chambers of Congress and the White House, and rioters entering the Capital Building as Congress was in the process of certifying the results of the electoral college.

Armed with this information, your best guess for how stock prices would perform during the year might have started with a negative sign. Yet the S&P 500 – an index that tracks the performance of the largest 500 companies in the U.S. – generated a return of +18.4% in calendar 2020. This figure benefitted from a +12.1% return in the fourth quarter, as markets cheered the positive news around vaccine development and showed comfort with the outcome of the election (which persisted after the results of the Senate run-off election in Georgia). International developed stock markets (Europe, Japan, etc.) and emerging stock markets (China, Brazil, India, etc.) returned +8.4% and +18.5% on the year respectively,[1] while bonds returned +5.7%.[2] These results should give great hesitation to market prognosticators who believe they can predict future market returns.

[1] As measured by the relevant MSCI international indices.
[2] As measured by the Citigroup 1-10 Year Government Bond index.

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Despite the risks outlined above, several fundamental factors supported the rebound in stock prices, most notably:

- The pandemic hurt small companies much more than it hurt large companies. Indeed, the largest technology-oriented companies have benefitted from an acceleration of trends towards digital commerce. This has helped buoy stock prices, which are increasingly driven by the large tech companies. Consider the fact that the top five technology stocks now make up over one-fifth of the S&P 500 and generated a weighted-average return of +56% in 2020, while the other 495 stocks in the S&P 500 returned an average of just +11%.

- Interest rates reside at previously unimaginable levels. At year-end, a three-year U.S. Treasury bond yielded just 0.09%.; a ten-year U.S. Treasury bond yielded just 0.93%; and a thirty-year U.S. Treasury bond yielded just 1.65%. The European country of Austria has a one-hundred year bond that currently yields just 0.4%! Investment grade corporate bonds yield just 1.7%. Accordingly, investors have felt compelled to shift more of their investment portfolios into stocks in search of higher yields and returns, thereby pushing up stock prices.[3]

- The economy has been more resilient than some feared, snapping back at a relatively strong pace. Today's modern economy is different than past economies, focused more on services and technology as opposed to capital goods. That being said, it remains to be seen if the momentum will carry into 2021.

These observations risk making it seem like the strong snapback in stock prices from the March lows was a foregone conclusion. We don't believe that it was. Indeed, while we thought stock prices had become discounted in late March, we would not have guessed they would soon race back to record highs. Yet "Mr. Market" – the personification given to the stock market by Warren Buffett's mentor Benjamin Graham – can be a moody fellow. Risks that would potentially cause market sell-offs during past periods have been cast aside in favor of more positive interpretations.

While Covid-19 continues to exact a harmful toll on society, thankfully the news around treatments since last spring has been positive, with antibodies and now vaccines showing better-than-expected efficacy and mortality rates coming in below worst-case fears. This has encouraged stock investors.

Economically, the unprecedented action taken by the Federal Reserve this year was surely a large factor in the market's behavior. The Fed stepped in to support financial markets in a number of ways, but the most surprising was their decision to make direct purchases of corporate bonds, even so-called "junk bonds" – the debt of companies that are highly levered. Prior to the announcement of this program, many companies were staring into the abyss in the spring. Their revenues had dried up because of pandemic-related lockdowns and investor fear had made it difficult or impossible to access required financing. In other words, many companies needed money but couldn't get it. Former President George Bush's 2008 observation seemed appropriate: "If money isn't loosened up, this sucker could go down." So the Fed stepped in by literally printing dollars and using those dollars to buy corporate debt. This helped to quickly stabilize markets as investors became convinced that the Fed would do anything and everything in its power to make sure that companies were supported. As markets rebounded, investors became enthused and momentum pushed markets higher.

The Fed is supposedly barred by charter from making loans that have any possibility of default. Yet ever since the financial crisis of 2008-09, the Fed has increasingly found ways to get around this limitation. This isn't to say that the Fed's actions were wrong or misguided. They were faced with two ugly choices – risk letting the markets and therefore the economy spiral downward or take actions that could stop the spiral but potentially poison the effective functioning of financial markets and foster future risks.

Central banks around the world have become more and more interventionist over the past two decades, starting with excessively low interest rates following the dot-com crash (which potentially fueled the subsequent housing bubble) and leading to the past year when central banks literally printed money to buy stocks and bonds. Yes, you heard that right – stocks! While the Federal Reserve hasn't gone down this path (at least not yet), the Bank of Japan is now the largest holder of Japanese stocks, with a portfolio in excess of $400 billion.[4]

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[3] Yields are from the U.S. Treasury and Bloomberg.
[4] "BOJ Becomes Biggest Japan Stock Owner With $434 Billion Hoard," by Min Jeong Lee and Toshiro Hasegawa of *Bloomberg*, December 6th, 2020.

Watching this transpire over the past two decades is akin to the frog who is slowly boiled alive. We've gradually arrived at quite unprecedented levels of monetary intervention and it is unclear how things might unfold from here. Warren Buffett's long-time business partner Charlie Munger recently responded as follows when asked about the unprecedented levels of government deficits and central bank money printing:

> I've got a very simple answer and that is it's one of the most interesting questions anybody could ask. We're in very uncharted waters. Nobody has gotten by with the kind of money printing we're doing now for a very extended period without some trouble. I think we're very near the edge of playing with fire…
>
> It's unbelievably extreme. Some European government borrowed money recently for some tiny little fraction of 1% for a hundred years. Now that is weird. What kind of a lunatic would loan money to a European government for a hundred years at less than 1%?[5]

Historically, the "trouble" that Munger references is inflation. It stands to reason that governments shouldn't be able to solve their economic problems simply by turning on the printing presses. Yet despite the dramatic expansion of the Federal Reserve's balance sheet, economists' favored measure of inflation – the Consumer Price Index (CPI) – has remained benign. Indeed, the November reading was just 1.2% above the prior year's level.[6]

But we have seen inflation elsewhere – in asset prices. It seems that much of the money that the Fed has printed hasn't ended up in the real economy, but instead in financial markets, which is where we've seen the inflation. Government stimulus expenditures have gone into the real economy, but they've simply replaced part of the economic hole blown open by the pandemic. We have witnessed dramatic increases in the prices of stocks, bonds, real estate and other financial assets. In some pockets of the market, the price appreciation looks quite extreme.

A weird confluence of factors seems to have rebirthed speculative excesses not seen since the late 1990s: the temporary shutdown of sports betting; individuals quarantined at home with little to do and, if their employment situation was unchanged, a sudden increase in excess income due to a decrease in discretionary spending; the recent elimination of commissions on stock trades; a lot of excitement around new disruptive technologies such as electric vehicles or cryptocurrencies; and near-0% interest rates. Accordingly, we've seen a dramatic spike in the number of day traders who pay little attention to company fundamentals. According to Interactive Brokers, the number of daily trades on the company's online brokerage platform was three times higher than levels seen just one year ago. We are starting to hear anecdotes that take us back twenty years, such as day traders mortgaging their house to buy derivatives on risky technology stocks. We won't get into the details here, but pockets of the market strike us as dangerously overvalued and speculative. Just consider the fact that the median return on the 265 U.S. stocks that lost money in 2019 – before considering any adverse operational effects from the pandemic – was +73% in 2020.[7]

To sum up: The world has been confronted with extreme risks and events that have not yet receded or been fully mitigated. The Federal Reserve and other central banks have partaken in extreme monetary policies, alongside unprecedented levels of government borrowing. And the huge amount of liquidity dumped into the system has led to speculative excesses in parts of the market.

So what is the investor to do? Here we risk disappointing you, though it probably won't come as a surprise to long-time readers: We still think that the best bet for the long-term investor is a diversified portfolio of high-quality, reasonably-priced stocks. And despite some of the excesses in markets today, we still see a decent amount of fundamentally sound blue-chip companies trading at reasonable valuations with decent dividend yields, especially relative to historically low interest rates. There is no guarantee that this approach will generate good short-term returns or mitigate against some of the aforementioned risks. But we don't see nearly enough evidence to suggest now is the time to abandon this strategy, and even if some of these risks come to fruition, stocks will still probably be the best bet.

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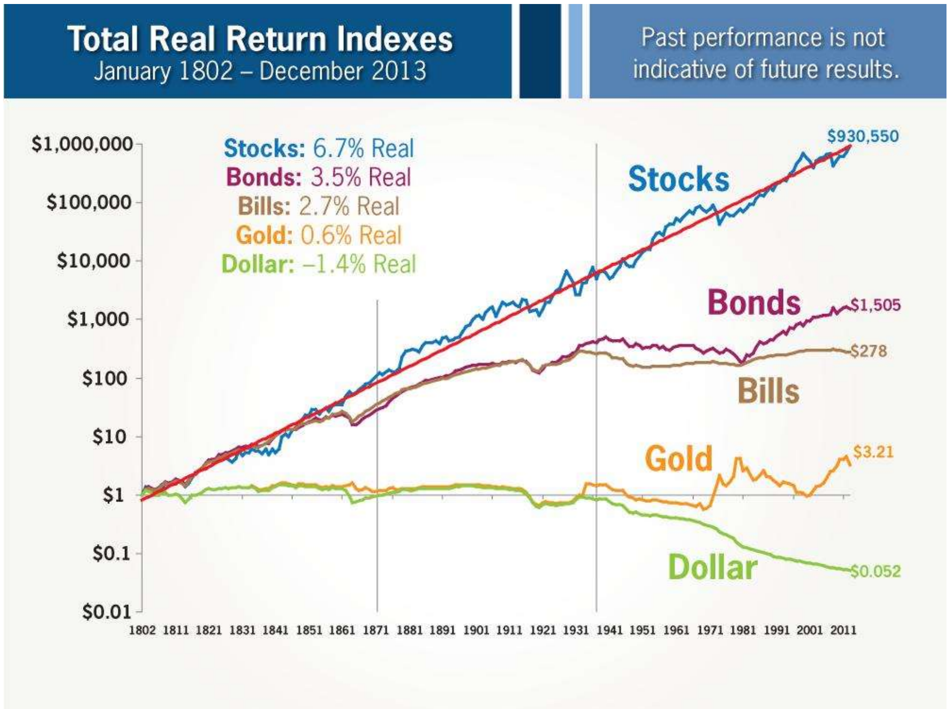
[5] Interview by Jean-Laurent Rosenthal of Caltech, December 14th, 2020.
[6] Federal Reserve.
[7] Results of a screen of companies in the Bloomberg database with a market capitalization of $1 billion or greater.

Consider some extreme examples. During the hyperinflation experienced in Germany prior to World War II (when monthly inflation rates surpassed 300%), cash, life insurance and bonds were decimated, while common stocks and high-quality real estate survived. And during the dot-com crash, many value-oriented stocks, such as Berkshire Hathaway, did fine, even though the Nasdaq fell by over 80% peak-to-trough. We've referenced the following graph many times, but we can't seem to find anything else that drives the point home better (it only goes through 2013, but the trend has continued):[8]



JPMorgan Chase's Chairman and CEO Jamie Dimon provided a reasonable take on the current state of markets in a recent interview ("quantitative easing" refers to the Federal Reserve printing money to buy bonds, as discussed earlier):

> The central banks of the world bought…$12 trillion of assets…and when they buy assets, those assets have to be reinvested and it lifts up [stock and bond] prices…
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> But when you look at markets, and this is a very important thing, if you said − if you sat around a table right now and said the base case is…we're going to get back to growth and unemployment under 5% by such and such [a date], bond spreads and most equity prices will be justified.
>
> If you said, oh, no, it's going to get much worse than that, they won't be. And since neither you nor I know it's going to happen, the market is an accumulation of all these probabilities of folks thinking through what's going to happen, and stuff like that. I think there may be a bubble in a small part of the stock market, not all of it. If you actually analyze it by segment…that's not true [that there is a widespread bubble]…
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> The other thing which is very important, there's also $10, $11 or $12 trillion of fiscal stimulation. Fiscal stimulation is completely different than Quantitative Easing [QE], okay?...[F]iscal stimulus is putting money in people's pockets to spend. And they spend it. Maybe not right away, but they spend it. That's why the GDP's stayed up, stuff like that. That by its nature is inflationary. QE by its nature may not be. And it's also even more inflationary when you give money – if the government finances it and the Fed buys the bonds. So, basically financing a deficit.

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[8] Jeremy Siegel.

> And now, of course, that interplay is in global recession, COVID, high unemployment. So of course, you're not going to see the effects of all that right away, but you might down the road.[9]

We don't mean to imply that we are standing still. We are actively looking for ways to enhance our bond portfolios with attractive yet still steady investment alternatives. We are working hard to minimize any exposure we might have to the parts of the market that seem excessively priced or fundamentally unsound. And we are re-examining our exposure to international stocks, where recent underperformance and the potential to hedge against domestic inflation has potentially provided investors with an opportunity to allocate additional funds. We don't take any of these actions lightly and we work hard to make sure that any steps we do take are firmly supported by our research.

The word unprecedented is probably overused, but the description seems apt for the current environment. Yet the beauty of man, as well as America and its economic system, is our ability to use challenging times as the fuel for future growth and innovation. Consider the fact that pharmaceutical companies have both developed and produced vaccines within a record amount of time in response to Covid-19. Indeed, the Moderna vaccine was actually already designed by January 13th of 2020, just two days after the genetic sequence of the novel coronavirus was made public. And now scientists have become hopeful that the work done to produce the Covid-19 vaccines could lead to universal vaccines for both the flu and the common cold.

As Warren Buffett counseled this past spring, it never makes sense to bet against America, you just have to be careful how you bet. Right now some investors appear to be making some dangerous bets and certain risks should not be ignored. But we believe that a portfolio of strong, resilient companies with reasonable valuations remains the investor's best long-term strategy.

As always, we thank you for your continued confidence and encourage you to reach out to us if you would like to discuss any of these topics.

Sincerely,

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[9] Presentation at the Goldman Sachs U.S. Financial Services Conference, December 8th, 2020.