AMI Investment Management
Registered Investment Advisor

Quarterly Investment Commentary

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Michael D. Axel, CFA
Jacob D. Benedict, CFA
David J. Manger

Stocks gained 12.6% to start the year, registering their strongest first quarter in over a decade. From their low hit on October 4th of last year, stocks have returned in excess of 30%. This performance is less reflective of a robust recovery or strength in corporate earnings and more reflective of the fact that the market had priced in a doomsday scenario last fall which failed to materialize. Bonds posted a subdued quarter, falling 0.5%, as the collective sigh of relief exhaled by investors led to lower demand for safe assets like U.S. Treasuries and therefore higher interest rates (which led to lower bond prices).

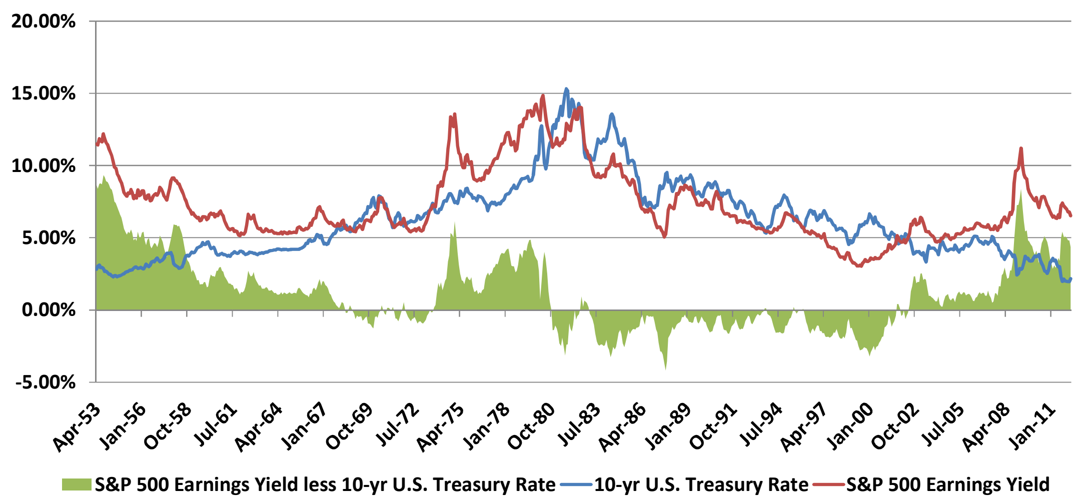
Last fall, a number of commentators were making dire predictions – odds of a recession in the U.S. greater than 50%, a global financial crisis stemming from a Greek debt default, bankruptcy of U.S. financial institutions. We felt that these viewpoints were misguided. There were some worrying tail risks if a large Eurozone nation (e.g. Italy or Spain) experienced a funding crisis. But actions taken by the European Central Bank (specifically the LTRO[1]) have meaningfully reduced this risk, at least in the short-term. We further believed that:

- The U.S. recovery, while somewhat tepid, was nonetheless resilient and would likely keep chugging along.
- The market had been expecting a Greek default for some time and would likely manage such an event in an orderly, contained fashion.
- U.S. financial institutions were much better capitalized than the market believed.

Over the past six months, these beliefs appear to have been validated. The U.S. economy has posted strengthening jobs numbers and data trends in automotive production and housing starts have been encouraging. Greece executed a bond restructuring and the market didn't seem to blink. Finally, the Federal Reserve put large U.S. banks through a rigorous stress test that included hypothetical conditions even worse than those experienced during the financial crisis and the results confirmed that these institutions have some of the strongest capital levels in their histories.

We used the weakness in the stock market during the 3rd and 4th quarter to draw down cash and purchase stocks that we felt were undervalued by the market, including investments in our banking and building thesis.[2] These moves were rewarded quickly as the stock market rallied and banking and building companies led the way. With the recent strength in stocks, we are finding fewer companies priced at large discounts to our estimates of intrinsic value. That being said, we still think stocks, both domestic and international, represent good value.

At our recent 2-day offsite investment retreat, we thoroughly reviewed each asset class and our overall investment portfolios, identifying areas of both opportunity and risk. As part of the prep work for that retreat, we put together the following figure:



[1] The Long-Term Refinancing Operation (LTRO) instituted by the European Central Bank consisted of lending money to European banks on advantageous terms in order to boost their liquidity.
[2] See our June 2011 *View from the Portfolio Manager's Desk* entitled "Banking and Building – Is There Value?"

This graph compares the earnings yield on the S&P 500 (stocks) to comparable earnings rates on 10-year U.S. government bonds.[7] The earnings yield measures the amount of profit an investor can access per dollar of stocks purchased. For instance, if you can buy stocks that earn a profit of $10 a year for a purchase price of $100, the implied earnings yield is 10% ($10 / $100).[8] The shaded area shows the difference between the S&P 500 earnings yield and the interest rate available on 10-year U.S. Treasuries. For example, if the interest rate on 10-year U.S. Treasuries is 3%, the graph would display a value of +7% (10% minus 3%).

The earnings yield on stocks is at the highest level it's been *relative* to bonds since the late 1970's, absent the financial crisis. Though not shown on this graph, the same can be said for stocks relative to the earnings yield on publicly traded real estate.[9] In other words, the gap between the earnings generated by an investment in the stock market and the earnings generated by purchasing bonds or publicly-traded real estate is at a three-decade high. Now this comes with some caveats:

- This is a measure of *relative* attractiveness. It could be the case that even if stocks are relatively better than bonds or real estate, they could still be unattractive from an *absolute* basis. In other words, if Investment A returns -3% and Investment B returns +1%, the investor still may not be pleased if he purchased Investment B, even though it did 4% better than Investment A. As can be seen from the figure, the earnings yield on the S&P 500, when viewed in isolation, is close to its average historical value.
- Further, this graph only shows the historical relationship between these investment classes, not the "correct" relationship. For instance, it could be that stocks should be priced cheaper than bonds and the last few decades were just an unnatural state.
- Profit margins of the companies in the S&P 500 are higher than they have been historically. Some analysts argue that margins will eventually revert to the mean as the recovery strengthens, competition and capacity increase and the U.S. government reduces its deficit. Accordingly, they argue that the quoted earnings yield on the S&P 500 is artificially high.

For our part, we do not believe that stocks are really cheap at current levels, but we don't think they are expensive. They look attractive relative to both bonds and real estate. Profit margins probably will come under pressure, but we think that there are companies available that possess resilient margin profiles. While bonds and real estate are still an important part of an investment portfolio, hedging against deflation and inflation respectively, we believe that long-term risk-adjusted returns in those asset classes will be lower than those found in stocks.

International economies are under more pressure than the domestic economy, yet foreign stock markets are also cheaper than the S&P 500 and therefore seem to represent good value as well.

Stocks have had an abysmal 10 years. Despite retreating from the extremely negative views found last fall, investors are still more attracted to investment alternatives, including real estate, bonds and more esoteric investments. Interestingly, in 1979, the last time stocks were priced at such an attractive spread to bonds and real estate, *BusinessWeek* published an article entitled "The Death of Equities" which essentially argued that stocks were permanently damaged and would never generate the kind of returns they had during past periods.[10] Subsequently, the stock market went on to stage its greatest ever bull market over the next two decades, returning in excess of 17% per annum. Howard Marks, Chairman of Oaktree Capital, recently discussed the misguided call and concluded:

> What's the lesson here? Not that history always repeats, or that it never repeats. And not that stocks can only do well or only do poorly. But rather that the trends that lead up to a point in time have a profound effect on people's thinking and on the environment, and thus on the trends that will occur thereafter. That price gains increase danger and price declines increase opportunity. And that most investors and observers tend to be too positive at the top and too negative at the bottom…
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> The story [being told about stocks now] isn't as hopeless as it was in 1979, but it is uniformly negative. Thus, while I don't expect an equity rally anything like what followed on the heels of "The Death of Equities," I don't find it hard to conjure up positive scenarios.[11]

All of this isn't to say we are pounding the table on stocks. We are simply pointing out that after a decade where stocks disappointed investors while other investment classes surprised investors, we think the roles could reverse over the next decade. In a world where financial advisors are trying to sell products that help investors avoid stocks, we think it pays to be contrarian. To be sure, results will be volatile and numerous economic risks remain. But as we frequently remind our clients, volatility is the friend of the patient, disciplined investor.
As always, we thank you for your continued confidence.

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict, CFA
David J. Manger

[7] Sources: S&P 500, Robert Shiller, Federal Reserve of St. Louis. The S&P 500 earnings yield uses peak earnings in the numerator.
[8] Note that the earnings yield is different from the dividend yield; dividends are what corporations pay out to investors from earnings.
[9] Using adjusted data from NAREIT.

[10] The article was published on August 13, 1979.
[11] *Déjà vu All Over Again*, Memo to Clients, Howard Marks, March 19, 2012.