AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

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The domestic stock market kicked off the year with a bang, returning 10.6% during the first quarter to finish at an all-time high.[1] International results were mixed, with developed markets up 5.3% and emerging markets down 1.7%.[2] Bonds turned in a mundane quarter, returning 0.1%, reflecting the low interest rate environment.[3]

It has been a good few years for investors. Since the depths of the financial crisis in March of 2009, the U.S. stock market is up 133% on a cumulative basis and intermediate term government bonds have returned 15%. Even from the previous market peak in October of 2007, an investor with 35% in U.S. government bonds and 65% in U.S. stocks would have generated 4% annual returns through the end of the first quarter of 2013, a reminder of the importance of staying the course during rough waters.[4]

Of course the more important question is what will markets do going forward? To paraphrase the great J.P. Morgan, they will fluctuate. (Credit to our friend Larry Doyle of Campbell and Fetter Bank who recently offered the same response when asked for his thoughts on interest rates.) Our advice to investors who are encountered by an advisor who purports to be able to forecast what the market will do is to stay far away.

Shorter-term forecasts are the most dangerous. It is mind-boggling how much time, energy and money is spent on Wall Street trying to predict year-end stock market levels. If investors could see the historical record of such forecasts, they may be more likely to turn a deaf ear. Longer-term forecasts, say 7- to 10-years, arenôt as irresponsible, but they are still subject to unforeseen variables that make accuracy elusive.

Consider an analogy ï you are asked to forecast the average margin of victory or loss for a middle-of-the-road major league baseball team over the following intervals: (a) a couple of innings, (b) a few games and (c) an entire season. Over a couple of innings, anything can happen and any guess would be nothing more than a wild conjecture. Over a few games you might be able to improve the accuracy of your prediction, as the team may have a good bullpen and based on their upcoming opponents you think the odds are decent that they could win a couple of games by a few runs. Nevertheless, the results of your prediction will still be spotty. For the entire season, if you do enough research on the teamôs players, coaches, divisional opponents, etc., you might develop some strong opinions about how the team will fare and the accuracy of your estimate could improve. Yet the teamôs performance could still easily deviate from your expectations, especially if unforeseen circumstances arise, such as injuries or trades.

Now translate this to investment markets ï equate a couple of innings to a year, a few games to a couple of years and a season to a 7- to 10-year period. Forecasting short-term results is pretty much useless. Forecasting longer-term results may lead to better accuracy, though unanticipated developments could drastically alter the expectations that underpin your forecast.

[1] As measured by the S&P 500.
[2] As measured by the relevant MSCI indexes.
[3] As measured by the Citigroup 1-10 Year Government Index.
[4] As measured by the S&P 500 and the Citigroup 1-10 Year Government Index. All figures assume monthly rebalancing.

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If forecasting investment returns is so hard, then how do we formulate investment policy? Letõs return to our baseball analogy ï suppose that instead of a middle-of-the-road major league team, you are given the worst team from last season who also carries the lowest payroll in the league. You are asked if the team will make the playoffs this season. You do some research and realize that the bullpen has actually deteriorated and the current team manager has a poor track record and an underwhelming approach. At the end of spring training, their best player suffers a season-ending injury. You still canõt predict with much accuracy what will happen over a few innings or a few games (the worst team last season, the Houston Astros, still won 55 games). However, while there is no guarantee that you would be right (you could be given the Cleveland Indians from the 1989 film *Major League*), you would probably feel confident predicting that the club wonõt make it to the playoffs this season.

Investing is all about the future and forecasting is unavoidable. When you buy a stock, you are necessarily forecasting that stock will do better than others. But the best investors are the ones that only forecast when the odds are *heavily* in their favor. In other words, itõs not so much that they are great forecasters, but instead that they know *when* to rely on their forecasts. They insist on a sizable ñmargin of safetyò to cover large potential forecasting errors; that way, even if they are wrong about the future (which they inevitably will be to at least some degree), their course of action will still yield acceptable results. Warren Buffett cites the great baseball hitter Ted Williams, who would only swing at pitches that were right in his ñsweet spot.ò Buffett goes on to note that unlike baseball, however, investors donõt strike out, but can instead continue to wait for a ñfat pitch.ò

We certainly donõt know what investment markets will do this year or next. Over the next 7- to 10- years, we have some educated guesses about what markets may do, but they are nothing more than that. We try to think in ranges when considering long-term market returns. If the range of returns we are forecasting for an asset class or security is much lower than competing investments, we avoid it. If it is much higher, we embrace it (after accounting for risks).

With interest rates so low, long-term bond returns will be grounded. This says little about short-term returns, which are driven by changes in interest rates. The beginning level of interest rates is like gravity, though ï you can escape it for a while, but not forever. Yet while we have been holding slightly higher cash balances, we are still purchasing bonds even at low interest rates. The vast majority of our bond purchases are for securities maturing in less than ten years. This means that if and when interest rates increase, our bonds will soon come due, allowing us to redeploy the proceeds into more attractive bonds at higher interest rates.

We believe our bond portfolios are high-quality and ready to withstand a storm. Sitting in cash is a costly endeavor with a low but ever-present inflation rate of 2%. We will not, however, stretch for higher yields by taking on more risk within our bond allocations. Nor will we overweight some other asset classes, such as real estate or high yield bonds, where we think investors arenõt appropriately compensated for the additional risk they are bearing. There is a time and place to take greater risk, and now is neither the time nor the place.

For those interested, we discuss our framework for thinking about stock market returns in the appendix to this quarterõs commentary (the material is a bit technical). The recent run-up in stock prices has made it more difficult for us to find individual stocks that we are excited to purchase. That being said, we still think that there are high-quality companies available at prices that should yield solid long-term returns. In other words, the margin of safety isnõt as large as weõd like it to be, but itõs still there.

We continue to hold core allocations to arbitrage and distressed debt within the alternative investment space, where we hope returns will be acceptable across a range of investment environments. Credit-sensitive investments that are tied to interest rates, like real estate and high-yield bonds, look expensive to us and we have little participation there. Likewise, investments that are typically associated with hedging against inflation, such as farmland, TIPS and commodities, also look pricey to us.

It will be a tougher investment environment going forward with low interest rates and higher stock prices. But we donõt think stock prices are too high yet nor do we feel suddenly increasing interest rates are on the near-term horizon. Accordingly, we believe it best to stay the course. Itõs neither time to swing for the fences or to sit on the bench.

Weõve been active on the research front. Our recent *Notes from the Road* missive, a new effort we started this year (and available on our website), chronicled Jacob and Davidõs recent trip to New York and Mikeõs recent trip to Los Angeles to meet with various fund managers. David and Jacob recently spent the morning at a sizable farming operation learning more about the agricultural industry and as this piece was going to press Jacob had just returned from a trip to Los Angeles. He headed out for a family event but used the opportunity to meet with several mutual fund managers. David is planning to attend ñWoodstock for Capitalists,ò the annual Berkshire Hathaway meeting in Omaha, NE, in early May. This will be Davidõs first trip to the holy grail of value investing and we are looking forward to some great stories and enthralling notes. Weõve charged him with getting a picture for the wall with Warren Buffett; itõs a pretty much impossible feat, but then again David is a determined guy. We are also planning to make some on-site visits to some of our stock holdings this coming spring and summer. We will make sure to keep you updated with future *Notes from the Road* editions.

As always, we thank you for your continued confidence.

Sincerely,

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

Appendix – Breaking Down Stock Returns
AMI has a framework for thinking about the prospects for long-term returns within each asset class that we invest in. We donõt forecast returns, but we do consider the drivers of those returns and possible ranges given varying assumptions. For many investors, domestic stocks comprise a sizable portion of their investment portfolio. Long-term stock returns are harder to forecast than some other asset classes (due to variability in earnings and the lack of a maturity date). Stock returns can be broken down into three buckets:

- (a) The initial dividend yield.
- (b) The subsequent earnings growth rate.
- (c) The annualized change in the price-to-earnings (P/E) multiple over the investment period.

The return yielded by stocks over a 7- to 10-year period will be very close to the sum of these three variables (see the table at the bottom of the page).[5]

As you move down the list of three variables, forecasting becomes increasingly harder. The initial dividend yield is readily observable ï right now, stocks pay on average a 2% dividend yield.[6] As can be seen in the table, this yield has gone down over time. This is in part due to the fact that corporations have elected to retain more of their earnings as opposed to paying them out to shareholders in the form of dividends. If intelligently deployed, these retained earnings should theoretically translate into higher earnings growth rates so that total returns stay relatively stable (one variable decreases while another increases). Unfortunately, this hasnõt quite been the case; our theory is that too many management teams have wasted shareholdersõ cash on silly investments (bad acquisitions, golden parachutes, misguided investments, etc.). Too often management teams arenõt properly aligned with their stockholders.

The next task, forecasting the earnings growth rate, is obviously more difficult, though over the past half-century results have tended to be somewhat stable in the 5-6% range. The table below does show strong earnings growth during the 1970õs, but that was a result of high inflation, which was not a welcome development for stock investors.

	(a) Initial Dividend Yield	(b) Next Ten Years EPS Growth Rate	*Initial P/E Multiple*	*Ending P/E Multiple*	(c) Annualized Change in P/E Multiple	(a) + (b) + (c) Sum of Dvd Yld, EPS growth, & Change in P/E Multiple	Actual Annual Return
1950 to 1960	6.89%	4.40%	*6.89*	*16.01*	8.79%	20.08%	19.34%
1960 to 1970	3.10%	4.79%	*16.01*	*15.47*	-0.34%	7.55%	7.81%
1970 to 1980	3.47%	9.70%	*15.47*	*7.25*	-7.29%	5.87%	5.88%
1980 to 1990	5.24%	6.76%	*7.25*	*12.19*	5.33%	17.33%	17.55%
1990 to 2000	3.17%	5.36%	*12.19*	*29.66*	9.30%	17.82%	18.21%
2000 to 2010	1.15%	5.83%	*29.66*	*13.08*	-7.86%	-0.88%	-0.95%
Current	2.00%	???	*17.66*	*???*	???	???	???

[5] Data from Robert Shiller, Standard and Poorõs and Bloomberg Financial Markets. The table is constructed with an earnings figure adjusted by AMI that utilizes peak earnings and sets a floor for corporate after-tax margins.
[6] Based on the S&P 500.

Some may reason that we are in a low-growth world and consequently future earnings growth rates will be much lower than they have been historically. Perhaps surprisingly, it has been well documented that earnings growth isnôt actually that correlated to overall economic growth. In fact, historical data shows that stock market returns are actually negatively correlated to a countryôs GDP growth![7]

So what would make the earnings growth rate deviate from historical norms? There are several variables, but we will focus on just two here. If after-tax corporate profit margins move meaningfully one way or the other, the earnings growth rate could be affected. Right now, margins are at an all-time high, giving us some cause for concern. There are competing theories as to why they will be stable versus why they may revert (an active area of research for us), but we wouldnôt forecast margins to continue increasing. On the other hand, corporate balance sheets are in the best shape they have been in for some time, and this is yielding increased stock repurchase activity, which can drive earnings growth rates higher. A *Wall Street Journal* article on March 7, 2013 observed that ñAmerican corporations also announced plans to buy back $117.8 billion of their own shares in February, the highest monthly total in records dating back to 1985.ò[8] By driving the total share count lower, stock repurchases lead directly to earnings growth (with fewer shares of stock outstanding, remaining stock owners are entitled to greater earnings per share). Cleaner balance sheets could be used to increase future borrowing for corporate investments or further stock repurchases, which could potentially offset dilution in profit margins.

At this point, we donôt feel strongly enough to venture any forecast of future earnings growth. With an initial dividend yield of 2%, if earnings growth rates were in-line with the recent historical record (5-6%), stocks would return 7-8% annually before any change in the P/E multiple. In a world of 1-2% inflation and low interest rates, this isnôt bad. As always, we would try to improve on this figure by selecting individual stocks that we think offer superior return potential, though of course our success is not guaranteed.

The third bucket, P/E multiples, is the most difficult to forecast. The P/E multiple measures how much investors are willing to pay for $1 of corporate earnings. Historically, the multiple has ranged between 5x and 30x. Multiples are based on how investors act, and it is futile to forecast the behavior of such a fickle crowd. The lower the multiple, the less investors like stocks and the cheaper they are (we like to buy cheap stocks, which are accompanied by low multiples). Interestingly, over a really long time period, say 50 years, changes in P/E multiples will have little effect on total stock market returns. This is because any change, even if sizable, will be spread out over a really long time (i.e. the annual growth rate in the P/E multiple that we add to the other two variables will be quite small). Over the short to intermediate-term, however, changes in P/E multiples have a huge impact on stock market returns, as can be seen from the earlier table.

As we discussed earlier, we try to only forecast things when the evidence grants a large margin of safety. In the case of P/E multiples on stocks, we think they look quite cheap when they approach 10-12x and quite expensive when they rise above 20x. Within this range there are varying opinions on what the ñrightò P/E multiple is; we think it is better to think in a range as opposed to a precise estimate (as John Maynard Keynes said, it is better to be vaguely right than precisely wrong). At quarter-end, the P/E ratio on the S&P 500 was 17.7x. This is towards the high-end of our ñfair valueò range, but justifiable given the current environment (particularly low interest rates and inflation).

How this multiple develops over the next several years will have a large impact on stock market returns. We, nor do we think anyone else, can predict with accuracy where the multiple will go. Longer-term, however, with a starting multiple within a ñfairò range, the impact should be limited.

By now youôve probably surmised that we will not be providing an estimate for stock market returns. There are too many moving parts and unanticipated future developments that will render any precise forecast misguided. However, if stocks become *exceedingly* expensive or cheap, we would consider taking appropriate action to protect or enhance the value of our portfolios. We donôt think current conditions call for such action, nor do we believe that competing asset classes provide a compellingly superior investment alternative.

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[7] See *Reports of the Death of Equities Have Been Greatly Exaggerated: Explaining Equity Returns*, by Ben Inker of GMO, August 2012.

[8] *Firms Send Record Cash Back to Investors*, Telis Demos, Steven Russolillo and Matt Jarzemsky, *The Wall Street Journal*, March 7, 2013.