AMI Investment Management
Registered Investment Advisor

Quarterly Investment Commentary

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U.S. stocks had an excellent first half, returning 13.8% year-to-date.[1] The second quarter was less of a contributor than the first, returning 2.9% versus 10.6%, but domestic stocks continue to exhibit relatively strong momentum. International stock markets weren't as fortunate, with developed markets returning just 4.5% year-to-date and emerging markets falling 9.5%.[2] Part of this divergence was driven by strength in the U.S. dollar (when foreign currencies depreciate relative to the dollar, the value of foreign stocks denominated in foreign currencies is adversely affected). Likewise, bond markets have posted a lackluster 2013 so far, falling 1.4%, as interest rates rose amid speculation that the Federal Reserve might move away from certain aspects of its highly accommodative monetary policy.[3] (Remember that bond prices have an inverse relationship to interest rates – as interest rates rise, bond prices fall, and vice versa.)

The economy continues to plod along, with several notable bright spots, including ongoing rebounds in housing and automobile demand, strong corporate balance sheets, improving consumer and government fiscal positions, strength in domestic energy markets and subdued inflation. Headwinds include near-term fiscal tightening by the federal government, economic strains among a number of our country's trading partners (Europe, China, etc.), and continuing softness in capital spending. Net-net, we don't see any reason to place particularly high odds on either a boom or a recession in the near term.

Recent efforts on the part of national policymakers to trim the deficit seem to miss the mark. Federal Reserve Chairman Ben Bernanke put it best in his recent testimony:

> The Congressional Budget Office (CBO) estimates that the deficit reduction policies in current law will slow the pace of real GDP growth by about 1-1/2 percentage points during 2013, relative to what it would have been otherwise… Although near-term fiscal restraint has increased, much less has been done to address the federal government's longer-term fiscal imbalances… To promote economic growth and stability in the longer term, it will be essential for fiscal policymakers to put the federal budget on a sustainable long-run path. Importantly, the objectives of effectively addressing longer-term fiscal imbalances and of minimizing the near-term fiscal headwinds facing the economic recovery are not incompatible. To achieve both goals simultaneously, the Congress and the Administration could consider replacing some of the near-term fiscal restraint now in law with policies that reduce the federal deficit more gradually in the near term but more substantially in the longer run.[4]

While Congress hasn't been able to muster much in the way of creative, innovative fiscal reform, the Federal Reserve has gone to great lengths in its efforts to help push the economy along with experimental monetary policy. Of course many worry they risk going too far. At a recent press conference, however, Chairman Bernanke floated the idea that the more experimental aspects of their efforts may start to wind down as soon as the end of this year. While the economic impact of the Fed's actions remains debatable, their change in tone had a clear impact on markets. The yield on 10-year U.S. Treasuries rose from 1.66% in early May to 2.73% on July 5th.

[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 Treasury index.
[4] Testimony of Chairman Ben S. Bernanke before the Joint Economic Committee, U.S. Congress, Washington D.C., May 22, 2013.

Some normalization in interest rates is a welcome occurrence. Most of our bonds are relatively short-dated (due within the next 10 years), meaning that the prices on these bonds move modestly in relation to changes in interest rates. We would welcome the opportunity to reinvest the proceeds at more attractive rates as these bonds come due. Additionally, the Fedõs willingness to let off the ñeconomic acceleratorò signals that they have some confidence in the economic recovery, though we expect any subsequent economic weakness from here could cause them to reverse course. That being said, a substantial move up in interest rates in the near term, to say 5-7%, would be a jolt to both stock and bond markets. We view such a movement as unlikely but of course possible.

In any event, our views on investment markets havenõt changed much since our last letter. Stocks have gotten a bit more expensive over the course of this year while bonds have gotten a bit cheaper, but we see no reason to alter our tune ï now is neither the time to swing for the fences or sit on the bench. In other words, we are sticking to our core, diversified, long-term asset allocation targets.

A young Warren Buffett, faced with a similar situation of low interest rates and relatively high stock prices, offered the following comments to his partners in early 1962, which we feel apply equally to today:

> I am certainly not going to predict what general business or the stock market are going to do in the next year or two since I donõt have the faintest ideas.
>
> I think you can be quite sure that over the next ten years there are going to be a few years when the general market is plus 20% or 25%, a few when it is minus on the same order, and a majority when it is in between. I havenõt any notion as to the sequence in which these will occur, nor do I think it is of any great importance for the long-term investor.
>
> Over any long period of years, I think it likely that the Dow will probably produce something like 5% to 7% per year compounded from a combination of dividends and market value gain.[5]

If we thought it possible to jump in and out of the stock market, reaping gains and avoiding losses based upon short-term forecasts, we of course would do it. But such an approach not only entails high costs but strikes us a foolish behavior doomed to failure. Instead, we focus our efforts on two avenues: (a) trying to buy companies that are underpriced relative to the market and that offer the prospect for strong long-term investment returns and (b) altering our allocation to stocks only when stock prices are exceedingly expensive or cheap. Benjamin Graham, the father of value investing, offered the following prescription:

> According to tradition the sound reason for increasing the percentage in common stocks would be the appearance of the ñbargain priceò levels created in a protracted bear market. Conversely, sound procedure would call for reducing the common-stock componentÉ when in the judgment of the investor the market level has become dangerously high.[6]

At this time, we do not believe that the stock market is at a dangerously high level. Nor do we have any crystal ball that would allow us to foresee future economic shocks that could lead to a market sell-off. Accordingly, we continue working on the first aforementioned point, finding underpriced stocks. Itõs admittedly been slim pickings recently, with stocks near their all-time high, but hopefully our efforts will continue to bear some fruit.

On the surface, international stock markets appear more attractively priced than the U.S. Yet we feel that the difference is largely justified due to material underlying risks abroad. Most of the *global* companies headquartered in Europe or Asia which arenõt overly tied to commodities are priced similar to their U.S. counterparts. Only commodity-related companies, those with poor balance sheets or those heavily tied to high risk countries, like Greece or China, *look* cheap. At this time, our investment partners in international markets donõt seem to feel that investment opportunities are plentiful enough to increase commitments to the space.

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[5] Buffett Partnership, LTD., 1961 letter, January 24, 1962.

[6] *The Intelligent Investor*, HarperCollins, 2006.

Outside of stocks and bonds, we continue to like our positions in arbitrage and distressed debt. We will soon post a new white paper to our online library outlining the fundamentals of the two investments, titled ñUnderstanding Absolute Return,ò and encourage you to read it if you are interested. We havenôt included it here because it is somewhat technical and lengthy and, since we *know* that you immediately read everything that we send you, we didnôt want to burden you with an unwanted task!

Weôve mostly stayed clear of commodities, gold and commercial real estate, for different reasons in each case. We feel that gold is a speculative investment and the year-to-date performance is a case in point ï with the precious metal down approximately 25% this year and 30% from its peak, we still have no idea if it is cheap or not. Weôd like to have some exposure to real estate, but weôve thought for some time that prices, at least in public markets, were too high, likely driven there by ultra-low interest rates. From May through quarter-end, publicly traded real estate investment trusts (REITs) fell approximately 10% on the back of higher interest rates. While we continue to watch the space closely, we would need a bigger move before committing any resources there.

We continue to work diligently to uncover new investment opportunities and look forward to updating you on our research efforts soon in our next *Notes from the Road*. Please donôt hesitate to contact us if you have any questions. We hope you have a great end to your summer and thank you for your continued confidence.

Sincerely,

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