AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

Quarterly Investment Commentary

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Stocks kept chugging along in the second quarter, returning 5.2%%, bringing the year-to-date tally to 7.1%.[1] International stocks also fared well, with developed markets up 4.3% for the quarter and 5.2% for the year and emerging market stocks up 6.7% and 6.1%, respectively.[2] Even bonds got in on the action, returning 0.9% for the quarter and 1.5% for the year thus far.[3]

What's next? Bill Gates, in an interview alongside Warren Buffett and Charlie Munger, best framed our view in response to a question on whether stocks (equities) are currently expensive:

> Well, relative to interest rates, equities are still a bargain. And, you know, so you've really got to have an opinion about interest rates to be an investor of any kind in this market. It's such a key factor. You know, by historical measures, yes, [stocks look expensive, but] interest rates were very different in most of those time periods.[4]

As we've discussed many times in the past, making big moves into or out of the stock market is difficult to do successfully over time. The well-known economist and highly successful investor John Maynard Keynes eventually concluded:

> [T]he idea of wholesale shifts [into or out of stocks] is for various reasons impracticable and indeed undesirable. Most of those who attempt to, sell too late and buy too late, and do both too often, incurring heavy expenses and developing too unsettled and speculative a state of mind.[5]

In select cases, we think that reducing stock exposure can make sense, if stocks are clearly and dangerously expensive. But note that the theoretically "correct" price of a stock is the sum of all of its future cash flows, discounted at an appropriate interest rate. This concept may be foreign to many readers, but simply remember the following: all else being equal, lower interest rates should lead to higher stock prices (in theory). This makes intuitive sense – at the margin, all investments compete with each other. If stocks offered much higher rates of return than bonds, investors would sell bonds and buy stocks, thereby pushing down bond prices and pushing up stock prices, correcting the discrepancy. In most periods, stocks will be priced to give higher long-term returns than bonds, but mostly due to the fact that stock returns are more volatile. In other words, on a *risk-adjusted* basis, one expects stock and bond prices to be fair relative to one another.

During periods of widespread fear or greed, this relationship can break down, and stocks can become either exceedingly cheap or expensive. But again, one must think about their value *relative* to other available investments, particularly the rate of interest that one can get on a bond investment. Yes, stocks currently look somewhat expensive when viewed in isolation, but relative to bonds that yield 3% or less, their price could be considered fair.

[1] As measured by the S&P 500.
[2] As measured by the relevant MSCI international indexes.
[3] As measured by the Citigroup 1-10 year Treasury index.
[4] Interview with Becky Quick on CNBC's Squawk Box, May 5th, 2014, Omaha, NE.
[5] John Maynard Keynes, "Memorandum for the Estates Committee, King's College, Cambridge, May 8, 1938" in Charles D. Ellis, ed., Classics: An Investor's Anthology (Homewood, Ill.: Business One Irwin in association with the Institute of Chartered Financial Analysts, 1989), 79-82.

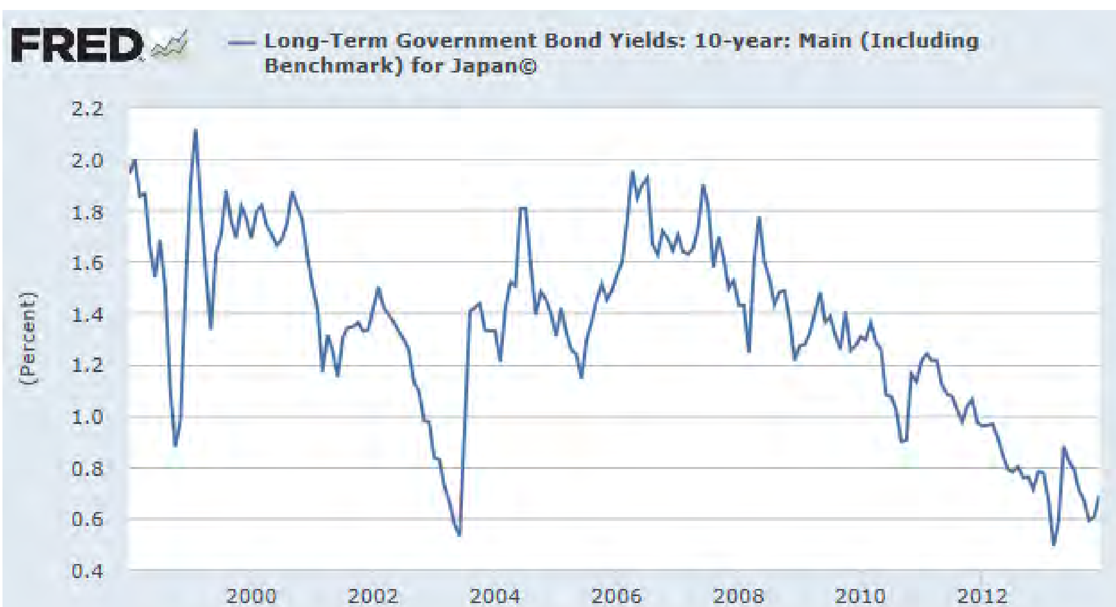
The situation was different in 2000 – stock prices were notably rich, but guaranteed 10-year U.S. Treasury Bonds yielded nearly 7% early in the year.[6] During the same period, real estate investment trusts (REITs), stock-like investments in companies that own real estate assets, yielded over 8%.[7] Now a 10-year U.S. Treasury yields just 2.5% and REITs just 3.5%.[8] So stocks, with a current earnings yield of 5.3%,[9] don't look particularly good or bad after adjusting for risk.

Which brings us back to Gates' original idea – what will happen to interest rates? If rates were to rise markedly – say the 10-year Treasury jumping well above 5%[10] – we believe that all financial assets would probably be adversely impacted. Stocks may hang in there if people ratchet up their expectations for economic growth, but we'd still be worried about equity valuations resetting lower. The only way to really escape the interest rate bogeyman is to sit in cash, but that's a risky endeavor with inflation running at 1-2% and the yield on cash reserves effectively 0%.

Of course forecasting interest rates is an incredibly difficult task. In our opinion, too many professional investors simply posit that the current rates are "abnormally low" or "artificial" without providing any substantial theoretical justification. It isn't clear if they even have a workable model to back-up their claims. A subset of economists, however, are seriously studying whether a lower "new normal" growth rate going forward will hold down interest rates for an extended period of time, no matter what the Fed does or doesn't do. Ben Bernanke, the former Chairman of the Federal Reserve, seems to have become an advocate for this viewpoint, according to a recent article in *Reuters*:

> In a series of quarter-million-dollar dinners with wealthy private investors, Ben Bernanke has been clearer than he ever was as chairman of the Federal Reserve on his expectations that easy-money policies and below-normal interest rates are here for a long time to come, according to some of those in attendance…
>
> At least one guest left a New York restaurant with the impression Bernanke, 60, does not expect the federal funds rate, the Fed's main benchmark interest rate, to rise back to its long-term average of around 4 percent in Bernanke's lifetime, one source who had spoken to the guest said.[11]

(By the way, you read that right: he's getting paid $250,000 to have dinner with folks. The work is good if you can get it!)



[6] 10-year Treasury yields hit 6.8% on January 20th, 2000. U.S. Department of Treasury.
[7] The FTSE NAREIT U.S. All Equity REITs index yielded 8.52% in January of 2000, according to NAREIT.
[8] According to the U.S. Department of Treasury and NAREIT.
[9] Standard & Poor's estimates trailing twelve months earnings per share for the S&P 500 as of 6-30-14 at $103.68. The S&P 500 closed at $1,960.23 on 6-30-14.
[10] An analysis by J.P. Morgan Asset Management suggests that yields and stock prices have negative correlations once the 10-year Treasury yield rises above 5% (J.P. Morgan Asset Management Market Insights, 2Q2014 Guide to the Markets, as of March 31, 2014).
[11] "At big-ticket dinners, a blunt Bernanke sounds the theme of low rates," by Jonathan Spicer and Svea Herbst-Bayliss, Reuters, May 16th, 2014.

Yes, interest rates are low, but that doesn't mean that a rise is imminent. Witness Japan, where rates have essentially hovered between 0% and 2% for over a decade (the figure on the previous page depicts the yield on 10-Year Japanese government bonds).[12]

So at this point, we just don't see the evidence needed to make material reductions to our stock holdings, although a retreat in stock prices is certainly a real possibility (as it always is). Or as Gates concludes:

> I do not think [stocks are] in crazy territory. But most of the time stocks have been in a zone of reasonableness over my lifetime. I think they're in the zone of reasonableness now.[13]

Going forward, it will be interesting to see if the economy can achieve so-called "escape velocity," thereby putting some upward pressure on interest rates. Evidence of this could include increased commercial lending (for capital spending, not acquisitions), wage pressure and improvement in the employment-to-population ratio. In the meantime, we are sticking to are guns and working hard to find individual investment opportunities, a couple of which surfaced during the first half of the year.

As always, we thank you for your continued confidence.

Sincerely,

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David J. Manger, CFA

[12] Sourced from Federal Reserve Economic Data; original data from the OECD.

[13] Interview with Becky Quick on CNBC's Squawk Box, May 5th, 2014, Omaha, NE.