AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

Quarterly Investment Commentary

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The economic recovery stalled in the third quarter of 2010, although that didn't stop equity markets from advancing 11.3%. We weren't surprised by the prospect that a strong, V-shaped recovery might not be in store. Indeed, when you pull away massive government stimulus it isn't unusual for the economy to react negatively (i.e. when you stop paying people $8,000 to buy a house, they buy fewer houses). The so-called "new normal," typified by slower economic growth and increased volatility in developed nations, appears rational to us. We never feel comfortable forecasting any permanent changes in economic fundamentals. The "new economy" of the late 1990s that was thought to justify astronomical valuations on tech stocks turned out to look a lot like the old economy that had been around since Adam Smith. But our interpretation of the new normal is not that the rules of the game have completely changed, but that in a world with a massive amount of debt outstanding and an effort on the part of economic participants to reduce that debt, economic growth will indeed slow.

Perhaps the rules have changed for policymakers, though. It increasingly looks like there will be a shift of power in Washington in the coming months, but the problems of this economy are bigger than this administration and the last. There are three fundamental players in the economy – consumers, corporations and governmental entities. Consumers, racked with mountains of debt from years of under-saving and over-purchasing, are paying down credit cards, driving their cars a little longer and forgetting about the next size home for the time being. Corporations, on the other hand, maintain healthy balance sheets – our research indicates that nearly 30% of American corporations with over $1 billion in market capitalization have more cash than total debt. Yet they remain nervous about prospects for consumer spending and government regulation. Accordingly, they continue to conserve cash, restrict new hiring and delay big-ticket capital expenditures. That leaves the government to pick up the pieces. Unfortunately, the government's policy options appear limited.

State and municipal budgets are in horrible shape, having drastically under-funded promised pension benefits for years and built state spending programs on the back of a property bubble. They remain a problem area that we monitor closely and may very well be the next participants forced to ask for a federal bailout.

Historically, the key answer to such a precarious economic environment has been monetary easing by the Federal Reserve. But the Fed finds itself in a dreaded liquidity trap. With short-term interest rates at 0% already (up against the "zero bound" in Fed-speak), what more can they do? The proposed solution on the table if the economy worsens further is called QE2, the second phase of so-called quantitative easing. That is a fancy way of saying that the Fed will purchase long-dated treasuries to push down long-term interest rates, which are not at 0%. But with the 10-year Treasury at 2.5% and mortgage rates at all time lows, it seems unlikely to us that a further drop in interest rates will be the lever that gets consumers and corporations spending again.

Thus, the ball drops to fiscal policymakers. Stimulus programs become the leading policy tool to combat liquidity traps (because we have a floating exchange rate, we don't have the option to devalue our currency, although we are putting pressure on China to do that for us). But surprise – the federal government's balance sheet isn't too clean itself and the populace isn't thrilled by the idea of taking out more collective debt. There also remains the possibility that in the future investors won't be so willing to finance deficit spending at such low interest rates (countries like Spain and Ireland, who aren't as highly regarded in the marketplace as the U.S., are starting to confront this reality). That leaves the country in a difficult situation with no clear answers as to how to dig ourselves out of this hole.

Investors have responded by largely forsaking stocks and piling into bonds. Over the last four months, data from the Investment Company Institute show that investors pulled nearly $60 billion out of equity mutual funds and plowed nearly $100 billion into bond mutual funds. With interest rates so low, investors who believe that the 30-year bull market in bonds will continue are likely to be disappointed. While we don't expect interest rates to shoot up anytime soon, such low yields are hardly encouraging.

The typical pension plan assumes a rate of return on plan assets of 8% per annum. With interest rates at rock bottom levels, PIMCO's Bill Gross estimates that equities would have to return 12% a year to meet that bogey (assuming a traditional 60/40 stock/bond mix). Can stocks rise to the challenge?

We first note that what drives our investment decision-making process is bottom-up research based on individual valuations, not macroeconomic or policy viewpoints. The economy could be in dire straits, but if businesses are selling at overly attractive prices relative to a conservative estimate of their cash flows or net asset value, we are happy to invest. Our most recent "View from the Portfolio Manager's Desk," titled *Bottoms-up – The Importance of Fundamental Analysis*, details this core tenet of our investment philosophy.

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Based on our bottom-up research, we believe it is possible to construct a portfolio of high-quality businesses with strong balance sheets trading at 10-14x earnings, historically attractive levels. What's more, some of the more compelling valuations continue to be placed on high quality, large-cap companies. Pat Dorsey of Morningstar Equity Research notes that the lowest deciles in terms of size in the S&P 500 have outperformed the largest by nearly four-to-one year-to-date. Yet stocks likely aren't at levels where investors can expect to earn returns reminiscent of past bull markets, which would likely require a portfolio of quality names trading at less than 10x earnings.

Accordingly, we are sticking to our long-term asset allocation targets and preparing to take advantage of any future opportunities in the market presented by above average market volatility. We believe it makes sense to deviate from long-term allocation policies only when clear, compelling opportunities exist. Benjamin Graham, when discussing asset allocation in *The Intelligent Investor*, cautioned that the investor should only increase his stock exposure relative to his long-term target when "he has strong confidence in the soundness of his stock position and is sure that he could view a market decline of the 1969-70 type with equanimity," and likewise reduce exposure only when, "the investor is disquieted *in his own mind* about the current market level, and will be satisfied also to limit his participation in any further rise to, say, 25% of his total funds."

We stress that our investment stance is driven by our efforts to find stocks and bonds of great companies quoted at attractive prices. If we feel confident that our core portfolio of purchased businesses carries strong franchises and sizable margins of safety, we will be enthusiastic investors regardless of external factors that we largely deem irrelevant. Indeed, Warren Buffett counsels that investors should be "greedy only when others are fearful."

This past quarter, AMI unveiled a new website. We encourage you to visit it and send us any comments or suggestions. This site presents our core tenets of investment philosophy and we are building a library of white papers that explore relevant investment topics in-depth. We hope that you find the site of value.

As always, we thank you for your continued confidence.

Sincerely,

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David J. Manger