AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

Quarterly Investment Commentary

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This past fall, we believed that stocks represented good value and that the depressed level of interest rates made bonds relatively unappealing. We only make meaningful changes to our investment policy when sufficient evidence exists to suggest that such changes will be sure to enhance investment results. Three months ago, we didn't feel that stocks were cheap enough to pound the table, but we felt that they represented good relative and absolute value and were happy to retain a full to slightly overweight position. Bonds were inching closer to the point where we would consider a more significant move, but for the time being we resolved to slightly underweight the asset class going forward and begin to reduce duration (duration is a measure of sensitivity to interest rates; reducing duration reduces the amount a bond portfolio will fall for a given a rise in interest rates, thereby decreasing interest rate risk). Since late August, the stock market (as measured by the S&P 500) has returned over 20%. The bond market (as measured by the Citigroup 1-10 Year Treasury Index) fell -1.7% during the quarter.

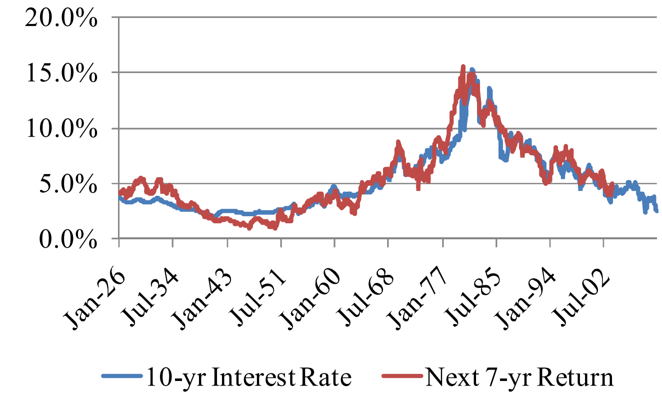
What has driven these returns? A few things, to be sure. Of particular importance was the implementation of the Federal Reserve's second round of Quantitative Easing (QE 2). QE 2 essentially consists of the Fed purchasing bonds in an effort to lower long-term interest rates and thereby encourage investment and consumption. What was interesting about the current Fed effort, though, was an explicitly stated goal of increasing stock prices to encourage consumers to spend more via a "wealth effect." In an editorial in the *Washington Post* in early November, Federal Reserve Chairman Ben Bernanke wrote:

> [H]igher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion.

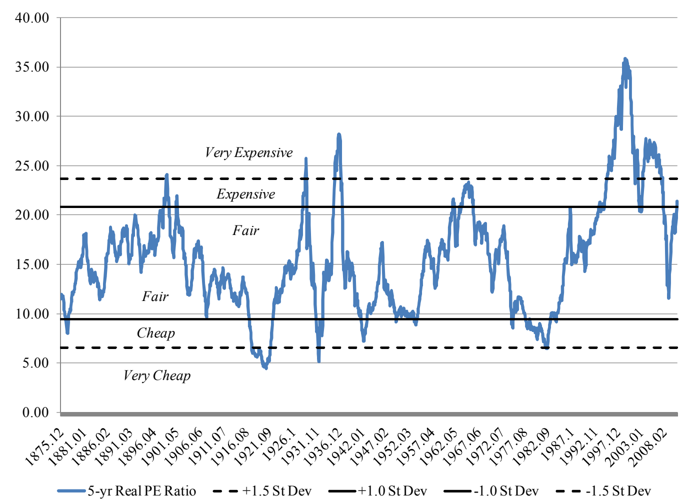
Grading economic policy of the Federal Reserve is not our forte, but we felt that the Fed's policy was misguided. Tampering with equity prices is dangerous policy and it seems plausible that lower interest rates also pushed commodity prices higher, acting as a tax on the American consumer. Further, research shows that stock prices, unlike housing, have a tiny effect on consumer spending habits (people typically don't respond to an increase in the value of their 401(k) by purchasing a car).

The Fed's policy certainly acted as a boon to risky asset markets like stocks and commodities. It is unclear how long this tailwind can persist, though. We believe that the fall in bond prices was directly related to the "risk-on" trade encouraged by the Fed. In other words, bond prices fell as investors cycled out of "safe" bonds and into "risky" stocks and commodities. We don't think that the day of reckoning is here for bonds yet and believe that the speculative rally in stocks and commodities could run out of fuel at some point in the first half of 2011.

Where does this leave us? First, we will continue monitoring our bond portfolios closely and likely proceed with our plan to gradually reduce bond exposure and decrease duration. Interest rates will not remain at such low levels for the indefinite future. It seems unlikely that investors will continue to accept 3-4% on Treasury bonds from a government running such a large deficit with long term inflationary risks. But we still think that such a shift will take some time to play out. The Fed continues to keep rates at low levels and while the economy is improving, it continues to be a gradual recovery. Regardless, the depressed level of current interest rates present investors with a poor asymmetric payoff – there isn't much upside in terms of potential return, but there is a lot of downside if interest rates rise. The following graph, presented in our recent white paper entitled *There is No Such Thing as a Risk-Free Bond*, shows the initial level of interest rates and the subsequent seven-year return on intermediate government bonds. The math is pretty simply – the bond bull market of the past 30 years, which has produced annual returns of 8%, will not continue.



This past fall, we were growing more constructive on stocks. A fall of over -10% since April of 2010 had made stocks more affordable. Additionally, corporate balance sheets remained clean, especially compared with consumers and governments, and earnings continued to recover while profit margins and cash flow remained robust. Yet a strong rebound in stock prices since that time has made us less enthusiastic. As Warren Buffett says, "Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down." Various valuation measures show that stocks aren't yet significantly overpriced, but are nearing the upper bound of their fair range:



If stocks continue to rise more quickly than the general rebound in corporate fortunes, they will breach the upper level of comfortable valuations. This should cause value-minded investors to think critically about stock prices and revisit their target allocations. Our most important input into stock valuation, though, remains our bottom-up work on individual companies (graphs like the one above are helpful, but can be misleading). We are now finding less attractive deals than we were a few months ago. In some cases during the quarter, we identified a strong company selling at a sizable discount to fair value only to watch the price run away from us before we could establish a sizable position. We would be enthusiastic buyers if those prices returned to lower levels. The stocks that we hold and track, for the most part, are still trading below our calculations of fair value. But the margin of safety – the difference between the current price and our estimate of fair value – has continued to compress and is not large enough for us to be enthusiastic buyers.

The market, however, has presented investors with an interesting divergence. During the recent "risk-on" trading movement, risky stocks and investments have outperformed safer, higher-quality investments, continuing a trend that began in the spring of 2009. Data from Ned Davis Research shows that stocks scoring high on market beta (sensitivity to the market, a proxy for stock risk), raw materials exposure and volatility have meaningfully outperformed those with high returns on invested capital and low or modest valuations. Accordingly, we feel comfortable holding on to stable, quality companies that trade at valuations below those of their lower-quality, riskier peers. While these high quality companies won't knock the ball out of the park, they may very well outperform all other asset classes over the long-term. (Remember, we never try to forecast short-term market movements – we believe that is a fool's game).

Our alternative investment portfolio consists of real assets (commodities, real estate, etc.) and absolute return strategies. A number of analysts, including ourselves, expected commercial real estate to exhibit signs of distress and price declines like those seen in residential real estate as a wave of commercial mortgages was scheduled to come due over the next few years. Yet the market has become bifurcated – high quality commercial real estate in major metropolitan areas has been supported by an inflow of investment dollars from institutional investors. In the face of low bond yields, such investors are happy to pick up real estate at current capitalization rates and receive an inflation hedge longer-term. Unfortunately, publicly traded Real Estate Investment Trusts (REITs) are trading at rich premiums to their underlying assets. The private market offers better value and therefore we are avoiding domestic REITs and researching other ways to invest in the space.

Lower-quality and speculative real estate (properties with low occupancy rates or projects still in the developmental stage) continues to struggle. Opportunities will exist over the next few years for the talented value investor, but volatility will remain high and patience required. Farmland has continued to post strong returns and the outlook for the agricultural sector remains solid, but cash flow yields are historically low and give us some apprehension. The economy would greatly benefit from rising housing prices, but a stubbornly high inventory and backlog of foreclosures suggests recovery will be slow and a double-dip in 2011 remains possible.

Commodity prices, spurred on by QE 2 and the strengthening global economy, rose in the fourth quarter. Longer-term, we are sympathetic to the argument that the prices of supply-constrained, industrial commodities necessary to developing countries, such as oil and copper, will continue to rise. The issue for investors, however, is figuring out a way to benefit from such trends in an effective and efficient manner. Futures-based strategies, the de facto commodities investment vehicle, have seen a huge inflow of investor dollars over the last few years which have pressured the return potential of such investments. Accordingly, we are researching more optimal ways to invest in base commodities and look to implement changes to our strategy in 2011.

Gold continues to be a focus of investors. A couple of years ago we added gold exposure as an insurance policy against financial catastrophe. Since then, gold has continued to post strong gains. We are naturally disinclined to be gold bugs – the precious metal does not lend itself to the rigorous, fundamental analysis that we conduct on other financial assets. Its price is driven by a few different factors (including central bank demand and jewelry production), but the key variable is investor sentiment, which is incredibly difficult to forecast. Further, it seems that investors have forgotten the penchant for gold to steadily increase and then rapidly post stunning losses. In the 1970's gold bull market, the bullion increased greater than 30% annually. Yet after peaking in the first half of 1980, the metal lost over half of its value within the next two years and has still yet to reclaim its inflation-adjusted high (around $2,000 per ounce).

It seems plausible that the potential for world governments to weaken their currencies could continue to support gold prices. Yet it would not surprise us to see a quick and sudden drop in the metal's price. When investors crowd into a room and someone yells fire, it can turn ugly quickly. Investors should remain cautious in the space. For our part, we have retained our exposure but placed stop-loss orders on a portion of our position.

In conclusion, nothing in the market really excites us. Investors would be well served to carry tempered expectations for financial market returns from current levels.

Our absolute return strategies are investments that we expect to show little correlation to either our core portfolio or macroeconomic variables. We monitor these like our other assets, conducting fundamental analysis and studying various valuation measures. Opportunities in the space will hopefully increase in 2011, spurred on by increased merger and acquisition activity, trending markets resulting from central bank intervention and performance divergence between high and low quality investments. We are comfortable with our current allocation to the space and believe it will add both value and protection over the long-term.

In conclusion, nothing in the markets really excites us. Investors would be well served to carry tempered expectations for financial market returns from current levels. We plan to reduce risk and exposure in our bond portfolios over time. If stock market valuations continue to rise at their recent pace, we will become less enthusiastic there as well.

Real assets warrant a place in investment portfolios, but identifying easily investable opportunities trading at a discount remains challenging. Absolute return strategies represent an important portfolio component but would benefit from an increase in the opportunity set. At times like these, investors benefit the most from being patient and disciplined. There is a tendency for investors to chase returns. Such activity at first may seem promising as trending markets provide positive feedback, but investors are susceptible to sudden, dramatic losses as fundamentals win out. Buffett writes:

> Inactivity strikes us as intelligent behavior…Our stay-put behavior reflects our view that the stock market serves as a relocation center at which money is moved from the active to the patient. [1996 and 1991 shareholder letters, respectively]

As we adjust to market opportunities, the most noticeable change in our portfolios will be a rise in cash balances. We historically have not liked to hold much cash, as rising markets penalize long-term investors who sit on the sidelines. But our view has shifted over the last two years for a couple of reasons. First, with interest rates so low the opportunity cost of keeping money in cash versus bonds has fallen. Second, a leveraged global economy has lead to heightened market volatility, which we believe will continue to present valuable opportunities to those with dry powder (i.e. cash or short-term bonds). We will remain steadfast in our approach – protecting value first and foremost and moving to enhance value only when superior, risk-adjusted opportunities present themselves.

As always, we thank you for your continued confidence.

Sincerely,

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Jacob D. Benedict
David J. Manger