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It's hard to believe that domestic stocks eked out a return of +2.1% in 2011 given the wild market swings over the past six months.¹ The market fell 20% – the definition of a “bear market” – from its peak in July through early October. It then promptly rallied 20% over the next 18 days, fell 10% the following 21 days and rebounded 8.5% the final 25 days of the year. It was a lot of movement to get back to roughly where we started in January of 2011. Absent the financial crisis of 2008-09 and the dot-com crash in late 2002, no other 6-month period has seen so many trading days register a market move of 3% or greater. From 1950 to 2007, a period of 58 years, only 115 days registered moves of 3% or greater; over the past 4 years, it's happened 85 times!²

Foreign stock markets were not so fortunate. The MSCI Europe, Australasia and Far East Index (EAFE), with ~65% exposure to greater Europe, fell 12% on the year and the MSCI Emerging Markets Index registered an 18% decline. The situation in the Eurozone went from bad to worse. We had written that Greece's problems seemed intractable but that the relatively minor size of its economy would likely limit potential contagion. The spread of difficulties to larger economies over the past several months (e.g. Italy), however, introduces greater risk. European economies, like the U.S., have stretched themselves too thin fiscally, spending more than they take in and building up a large debt load in the process. Unlike the U.S., though, members of the Eurozone don't have access to a printing press – the German-centric European Central Bank refuses to print money and purchase sovereign bonds.³ This impasse has resulted in increased interest rates on stressed countries, which, if allowed to remain elevated or rise further, creates additional strains on national budgets.⁴ The ongoing crisis in Europe is a fresh reminder of the importance of having a politically independent lender of last resort such as the Federal Reserve willing to step in during times of crisis. While the actions taken by Federal Reserve Chairman Ben Bernanke and company during the financial meltdown left a bad taste in the mouths of many citizens, we continue to think that the alternative would have been much worse.

Amid the slowdown in economic activity that occurred during the past year, bonds posted another strong showing, registering gains of +6.4%.⁵ The interest rate on 10-year U.S. Treasury Notes finished 2011 at 1.89%, up just a hair from their all-time low of 1.72% hit in September (remember that bond prices increase when interest rates fall and vice versa).⁶

Heading into 2012, a number of troubling questions still worry investors:

- How bad can/will the European crisis get? Europe likely has the *ability* to deal with their issues, but it isn't clear that they have the collective political *will*. They have yet to restore investor confidence that they can handle their issues, and until they do the situation will be tense and unpredictable.
- Will emerging markets, primarily China, be able to continue growing at above-average economic growth rates or do they risk undergoing a credit crash? China has fared well over the past few years, but this is in part due to the fact that they have relied on debt-fueled infrastructure spending to support economic growth. To the extent infrastructure and real estate projects turn out to be unproductive, loan losses could lead to a broader economic slowdown.

¹ As measured by the S&P 500.

² Data from *Bloomberg Financial Markets*.

³ The ECB did announce a 3-year liquidity program for banks in the region that will hopefully help alleviate some pressures, though it likely won't serve as the “bazooka” that investors have been hoping for.

⁴ Higher interest rates require higher interest payments, placing greater strains on national budgets.

⁵ As measured by the Citigroup 1-10 Year Government Index.

⁶ Data from the U.S. Treasury and Robert Shiller. Shiller compiled monthly data on 10-year Treasury rates back to 1871; the lowest rate he has on record prior to those seen in 2011 was 1.95% in 1941.

- If Europe and/or China do face increased difficulties in 2012, how will that affect the U.S. economy? Our portfolios have relatively modest direct exposure to core Eurozone countries and China, so contagion is the larger concern. Our view is that the U.S. economy and financial system are more resilient to potential overseas shocks than many people assume. Our banks have worked hard to recapitalize their balance sheets, consumers have started the process of de-levering and a stronger rebound in the markets for capital goods (primarily houses, but also autos) would be a big boon to U.S. GDP and employment. Yet it is difficult to predict how economies will fare when liquidity concerns arise.
- Will U.S. policymakers be able to find enough compromise to address the serious challenges facing our own country? While our fiscal difficulties are not quite the same as Europe's, the crisis across the pond should be a wake-up call to our politicians. But partisanship has been the bane of innovative solutions that could help us both keep the recovery on track and improve longer-term fiscal footing. Unfortunately, an election year will not make this work any easier.
- Will 2012 be another year of depressed interest rates, or will core inflation kick up and cause monetary policymakers to finally raise rates? We believe that deflationary pressures will continue, keeping interest rates and core inflation low, but that investors should consider how to prepare for an eventual rise in rates that may nonetheless still be a few years out.

So what does this mean for the stock market in 2012? In the illustrious words of J.P. Morgan, "It will fluctuate." And for the enterprising investor, that is not a bad thing. In the 1st and 3rd quarters of this past year, we wrote:

[T]he elevated level of debt present in developed economies should lead to heightened economic volatility, which will hopefully present future opportunities for favorable investments. We hope to employ this cash on an attractive basis when more favorable investment opportunities arise.⁷

What do we actually mean when we say this? Let us give a concrete example. On the next page is a price graph (since May) for a stock that we have followed for years.⁸ We believe that the company possesses a high quality franchise and robust profit outlook; nonetheless, short-term concerns in the markets led to a generally depressed stock price over the past few months (the company is in the financial sector). We have an internal estimate for this company's intrinsic value, call it \$P.⁹ Even

though we think the stock is worth \$P, however, we will only buy it at a price considerably less than \$P, typically $\$P \times 0.60$ (our "buy price"). This 40% discount (our "margin of safety") ensures that we will earn an attractive return even if our estimates turn out to be too rosy or we made a mistake in our analysis. If our estimates are spot-on, we should earn a stellar return.¹⁰

During the market sell-off this past fall, we used price weakness to build our position in this stock (see graph) as well as others. In other words, we were drawing down cash to buy stocks when we saw opportunities arise.

In the words of Benjamin Graham, Warren Buffett's mentor:

Basically, price fluctuations have only one significant meaning for the true [long-term] investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies.¹¹

We are bottom-up investors, meaning that we have no macroeconomic models or crystal balls that help us determine the "right" stock exposure. We instead buy companies that we follow and understand when they are trading at significant discounts to our estimate of intrinsic value and sell companies when they rise above our estimate of intrinsic value. When we find a lot of companies to buy, our total stock exposure rises; when a lot of companies rise above our estimates of intrinsic value, our stock exposure falls. Obviously not all of our purchases resemble the one depicted here, sometimes falling further instead of rising, but over time we expect such an approach will produce superior results. [Note that this is different than market timing, which tries to alter market exposure based on expectations for short-term market movements; our investment decisions are based on fundamental, long-term analysis, and we make measured as opposed to radical moves, such as completely exiting the stock market.]

In early October, there were a number of companies that we like selling at prices significantly below what we thought were their fair values, driven by investor fear amid reports of a possible double-dip recession and fallout from the European crisis. We used this "volatility" in stock prices to purchase companies.

investor purchased the stock at our price target \$P, she would earn returns of 10% per annum over the next 5-7 years.

¹⁰ A civil engineer who expects a bridge to see 2-ton trucks will design the bridge to withstand passage by significantly heavier trucks.

¹¹ *The Intelligent Investor*, Benjamin Graham, HarperCollins 2006, p. 205. The phrase "long-term" is our own addition; for the short-term investor, price fluctuations are a greater concern since she may be forced to sell during a period of depressed prices. The long-term investor need not worry about such forced selling.

⁷ See *First Quarter Investment Commentary*, AMI Investment Management, Inc., April 2011 and *Thoughts on Recent Market Volatility*, AMI Investment Management, Inc., August 2011.

⁸ Graph courtesy of *Google Finance*.

⁹ Our price targets for stocks attempt to embed a 10% annual return (i.e. discount rate); in other words, our working assumption is that if the



The market rallied through the end of the year and as of this writing our view is that while many of our companies still sell at a discount to our estimate of intrinsic value, the discount typically does not meet our margin of safety threshold. We would be able to purchase more stocks if we saw the market fall again, but for the time being we will remain patient (we are still finding some select opportunities, primarily in banking, building products, technology and natural resources). We still have a decent amount of cash set aside that we hope to continue to draw down as opportunities arise.

We believe that our stock portfolio offers attractive return potential over the next 3-5 years. Because of depressed interest rates, bonds will likely generate modest returns longer-term, though we don't expect rising rates to cause difficulties in the short-term. We are letting our interest rate exposure fall off gradually. We still believe that our core alternative investments, particularly in arbitrage and distressed debt, offer compelling value and diversification.

If you have any questions please don't hesitate to contact us. 2011 was an interesting year and 2012 is shaping up to be the same. We think that by adhering to our core investment principles, however, the current environment offers us the opportunity to build long-term portfolio value. As always, we thank you for your continued confidence.

Sincerely,

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