AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

Quarterly Investment Commentary

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Domestic stocks returned 32.4% in 2013, their best calendar year showing since 1997.[1] International stocks trailed the U.S., as developed international markets returned 23.6% and the emerging markets everyone couldn't get enough of a few years ago were down 3.7%.[2] Bonds largely treaded water, falling 1.3%.[3]

For investors that have remained disciplined with regard to their long-term asset allocation targets, the past few years have been kind. After the carnage of 2008-09, some thought investors would forsake stocks and other risky investments for the indefinite future. Instead, we've seen a steady march upward, with stocks hitting all-time highs, up over 200% from the March 2009 lows and approximately 35% from the pre-crash high of October 2007.

Of course you're probably more interested in the question that naturally follows – what happens next? We kindly offer our "expert" opinion: we don't know. There is a hot debate now between those who think stocks have run too far and are due for a "correction" and those that believe we are still in the early innings of a new bull market and stocks are poised to move higher.

Before we wade into that debate, a reminder of how we manage investment portfolios: We establish long-term asset allocation targets that are tailored for each individual investor (asset allocation targets constitute what percentage of the portfolio we should normally have invested in stocks, bonds, etc.) and we deviate at the margin from those targets *only* when we believe that a given asset class (i.e. stocks, bonds, etc.) is *exceedingly* cheap or *dangerously* expensive. Meanwhile, we go to work within each asset class finding individual investments or investment managers that we believe offer superior risk-adjusted returns. For example, we set a target percentage of the portfolio to be invested in U.S. stocks, and then we focus our time digging, studying, snooping around for underpriced stocks with good, understandable businesses, trustworthy managers and cheap prices.

So let's say that based on discussions, we jointly decide with a specific client to invest 60% of their portfolio in stocks (based on that client's ability and willingness to take investment risk). When will we decrease that amount, say to maybe 50% or less? Again, only when we become convinced that stocks are *dangerously* expensive. What does dangerously expensive entail? We consider three factors, in order of importance:

- Factor #1: Are we or the investment managers that we work with unable to find individual stocks that meet our buying criteria?
- Factor #2: Does market data suggest that stocks, as a whole, are well above theoretically justifiable prices?
- Factor #3: Are investors displaying bubble-like tendencies?

A year ago, while we didn't feel stocks were necessarily cheap, we felt comfortable rejecting these three factors. We had found a handful of individual stocks that met our buying criteria in the fall of 2012, we didn't think the stock market as a whole looked too expensive and we hadn't seen many signs of a bubble mentality. Exiting 2013 we aren't as sanguine, yet we aren't to the point where we believe the triggers have been flipped.

[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.

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Factor #1 – Can We Find Individual Investments That We Want to Buy?

It probably helps to first explain how we manage stock purchases and sales. We maintain a stock log that includes a large group of stocks we have conducted due diligence on and would be willing to purchase at the right price (the log includes the stocks that we already own). For each stock, we have a buy price and a sell price. The buy price is typically 65-70% of our estimate of the intrinsic value of the stock, while the sell price is usually 100-110% of this estimate. These ranges incorporate our margin of safety and hopefully provide us the opportunity to generate above-average risk-adjusted returns over time.

When a stock hits our buy price, we buy it, assuming there aren't any outstanding research questions that we need to cover first. If a stock hits our sell price, we trim or exit the position. It's rare to find many new ideas to buy – great investments shouldn't be easy to find! Our hope is to find 2-5 new stocks each year. We'd been able to do this the past few years, but this year we found just one new position. However, we did have the chance to add to several of our existing positions. We exited a handful of investments that hit our price targets. Yet while pickings were slim this year, the majority of the stocks we own still trade for less than what we think they are worth. We estimate that our stock portfolio is priced at slightly less than 90% of what we think it is worth, and a couple of stocks that we own and a select few that we don't own but follow are around 10%, or less, away from our buy price. In conversations with the external stock managers that we work with, we believe they feel similarly about their investment portfolios.

It's been tough to find new stocks to buy because there aren't many "pockets" of opportunity. The last few years we found value in places others loathed – housing, commercial trucking, banking, etc. (see our piece titled "Banking and Building – Is There Value?" in June of 2011). In the current market, there just don't appear to be such pockets, at least in fields where we are comfortable investing. That being said, our stock log doesn't yet suggest that investors should be running for the hills.

Factor #2 – Is the Overall Market Priced Above Theoretically Justifiable Levels?

The key focus of our analysis is always on finding individual investment opportunities. But when we step back and take a look at the market as a whole, does it look overly expensive? The measure that we prefer to evaluate is the earnings yield of the overall stock market. Like most measures, it isn't perfect, but we believe it offers the best representation of the kind of value the market offers. As a reminder, it is a simple measure that is constructed by taking the current earnings per each share of the aggregate stock market and dividing it by the price of one share of the market. For instance, if you could buy a business for $100 that generates $10 of profit each year, that would produce an earnings yield of $10 / $100 = 10%. We simply do this for the entire market as a whole. The earnings yield measures how much profit an investor gets for every dollar used to buy stocks at prevailing stock market prices. For a given level of earnings, a *rising* earnings yield means that stock prices are *falling* – assuming earnings haven't changed, stock prices must fall to produce a higher earnings yield – and vice versa. This level can be compared to an interest rate you could get on a CD at the bank; there are key differences, but the concept is the same. The higher the earnings yield, the better prospects investors have to enjoy higher returns going forward, all else being equal.

Right now, the earnings yield on the S&P 500 sits at 5.2%. The average for the past 25 years is 5.9%, for the past 50 years 7.4% and for the past 100 years 10.0% (we like data!). It stood at 6.2% one year ago and 11.6% at the depth of the financial crisis. So it's below the long-term average though closer to what we've seen more recently. But what is the "right" level? A few key points to ponder:

- As we said, the measure isn't perfect. Chief among its problems is that the earnings yield doesn't look at how stocks stack up *relative* to other investments or economic variables. For instance, if inflation and interest rates are lower, then we expect the "right" level for the earnings yield to be lower. For instance, in the early 1980's inflation was running above 10% and interest rates were also high. In that kind of environment, investors will rightfully demand a higher earnings yield on their stock investments; 5% just won't cut it when inflation is 10%. Presently, however, inflation is running very low (not much above 1%) and interest rates are at rock bottom levels. So a lower earnings yield relative to fundamentally different historical periods seems appropriate.
- A related consideration: many people are concerned about the so-called artificial prices being introduced by drastic actions from the Federal Reserve. We think that understanding the implications of the Fed's actions is a difficult endeavor – there are a lot of variables and unknowns. The key question is "what will happen to inflation and interest rates in the future?" If inflation and interest rates were to skyrocket, the earnings yield on stocks would also have to

increase, based on our comments above, which would drive stock prices lower (assuming the earnings figure wouldn't change, stock prices would have to go down in order for the earnings yield to go up). While the Fed actions have likely had a market impact, we still believe that interest rates and inflation will remain depressed for the near future. Financial crises like the one the U.S. suffered typically produce similar results (witness Japan the past couple of decades) and economic activity would probably need to improve markedly to stoke inflation. As long as interest rates stay below 5%, they shouldn't have too adverse an impact on stock prices. However, investors should be cognizant of the fact that falling inflation and interest rates are a boost to stock prices, rising inflation and interest rates a headwind. Witness the outstanding stock returns of the 1980's and 90's that accompanied falling inflation and interest rates. With inflation and interest rates at such low levels presently, investors won't get that tailwind going forward.[5]

- Finally, the earnings yield is clearly based on what level of earnings one assumes. We use prior peak twelve month earnings and normalize them if we think profit margins are abnormally low. Yet the converse is happening now – corporate profit margins are at all-time highs and well above historical averages (we don't presently normalize for this). Accordingly, if profit margins were to fall back to their historical averages, earnings would also fall and stock prices would follow. We've been involved in the debate regarding peak profit margins with various industry participants, which we won't produce here (sorry, we know you were itching for it). We respect the opinions of those who think earnings are poised to revert to their long-term mean, but for our part, we don't see a return to the historical average as *predestined* or *imminent*. For various reasons, we think that the current level of earnings is the best case to use going forward, but we will keep a close eye on any developments.

So that is a long way of saying that we don't know what the right level for the earnings yield is, but that while 5.2% is on the low side, we don't think it's wholly inappropriate given the current economic environment. If interest rates/inflation shoot up or corporate profit margins fall dramatically, stock prices would come under pressure. But we don't find current stock market levels above possible theoretical justifications.

Factor #3 – Is There a Bubble Mentality?

The third factor is much more subjective – to what extent are investors exhibiting euphoria, or stated differently, can we detect a madness in the crowds? The dot-com bubble had numerous examples of such behavior, such as individuals quitting well-paying jobs to day-trade internet stocks and start-up web companies receiving billion dollar price tags despite having no revenue or profits. Perhaps the peak was the $164 billion merger between AOL and Time Warner, dubbed the "biggest mistake in corporate history."

At this point, we don't think such behavior is prevalent, though at the margins some questionable activity has arisen. A number of high-flying stocks, such as Tesla, 3D printing stocks and Twitter have raced to valuations that seem stretched in light of the underlying companies' revenues and profits. At one point during the year, Tesla, the maker of electric cars, was worth almost half of General Motors, even though the former will build just twenty-thousand cars this year versus over nine million for the latter. Even Tesla's CEO, Elon Musk, warned that "The stock price that we have is more than we have any right to deserve." Despite a handful of examples, however, we don't think that the phenomenon is widespread or that investors are acting overly irrational. That being said, the trend bears watching.

Conclusion

In sum, our feelings are similar to those of investor Howard Marks, who recently wrote:

> Over the last 2-3 years, my motto for Oaktree has been consistent: "move forward, but with caution." I feel the outlook is not so bad, and asset prices are not so high, that it's time to apply maximum caution…But by the same token, the outlook is not so good, and asset prices are not so low, that we should be aggressive. That's the reason for my middling stance.
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> Having said that, however, there's no doubt in my mind that the trend is in the direction of increased risk, and I see no reason to think that trend will be arrested anytime soon. Risk is likely to reach extreme levels someday – it always does, eventually – and great caution will be called for. Just not yet.

[5] In technical terms, investors are faced with an asymmetrical risk.

Stocks are more expensive, interest rates are still low, cash pays nothing…in short, the investment environment on a *go-forward* basis continues to be tough. But we don't presently see the evidence that we would need in order to stray from our long-term asset allocation targets. We will continue to focus on what we think is most important – hunting for attractive individual investments and working with investment partners that we trust and respect.

As always, we thank you for your continued confidence and we wish you many blessings in the New Year.

Sincerely,

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