AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

Quarterly Investment Commentary

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Michael D. Axel, CFA

Jacob D. Benedict, CFA

David J. Manger, CFA

The U.S. stock market continued its upward march, returning 1.8% in the quarter and touching an all-time high right before quarter-end.[1] Domestic stocks continued to outperform their international counterparts, as developed international markets returned 0.8% and emerging markets were down 0.5%.[2] Unlike U.S. markets, international markets still sit below their pre-crisis highs. The bond market registered an increase of 0.6%.[3]

In an effort to change things up a little bit, we thought we'd offer up some rapid fire thoughts and reflections on random topics circling the world of finance the past quarter:

- We've spent a lot of time the past year **reading about thinking**. That may sound odd, but there is a rich vein of literature detailing the numerous ways human thinking succumbs to irrational biases. Perhaps the most damaging of these biases is the frequent overestimation of our knowledge and abilities. In an endeavor with as much uncertainty and forecasting as investing, not recognizing this "overconfidence" bias can be disastrous. In our efforts to continually approve, we've been critically examining the proper level of confidence to attach to each different line item on our investment checklists. You've probably heard us quote Mark Twain before: "It ain't what you don't know that gets you into trouble; it's what you know for sure that just ain't so."

- The **Ukraine situation** is no doubt worrying. We don't have any special insights, but don't think investors are well served by taking drastic actions in response. As Warren Buffett likes to point out, the last century has seen numerous wars and conflicts, yet the stock market has continued to march upward (even in the midst of sustained hostilities). This isn't to say bad things won't happen, but we don't feel the odds favor betting against this country.

- At the risk of **sounding like a broken record**, we don't think stock prices are cheap, but we also don't think they are drastically overpriced. Stock prices seem, to us at least, to be in the neighborhood of fair value, assuming (a) interest rates remain low and (b) corporate profit margins don't materially contract. Of course both of these assumptions are subject to a lot of current debate, but we've not yet been convinced that higher interest rates or lower corporate profit margins are predestined outcomes in the near future. While reversion to the mean is a powerful force, we think both rates and margins could be appropriate given the current economic environment. While we could no doubt be wrong, we think the burden of proof falls heavily on those recommending drastic action based on imminently higher rates or lower margins.

- **Speaking of "bubble"**…We think the term has become drastically overused by market commentators. Two giant bubbles in the past fifteen years – dot-com stocks and residential housing – have introduced the concept into the popular vernacular. But as Cliff Asness recently pointed out in an essay, "to have content, the term *bubble* should indicate a price that no reasonable future outcome can justify."[4]

[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] "My Top 10 Peeves" by Clifford S. Asness, Financial Analysts Journal, Volume 70, Number 1, January/February 2014.

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(260) 347-1281

A bubble, evident in hindsight, entails a permanent capital loss – i.e. a large drop in value without a recapture of previous highs within a reasonable timeframe. While there may be select bubbles in corners of today's financial markets, we struggle when commentators label large broader indexes, like U.S. stocks or bonds, as bubbles. These asset classes may offer reduced or below historical average returns going forward, but this is different from saying they are in bubble territory.

- Though maybe you could **call Bitcoin a bubble?** Actually, we have no idea because it's essentially impossible to value. The price of Bitcoin peaked at close to $1,200 but has rapidly fallen below $400 in just a few months. Jacob was recently interviewed for an article on the subject in the *Greater Fort Wayne Business Weekly* (apparently, there actually is some demand for commentators willing to say "I don't know").[5] But we have in fact looked briefly at the subject, which is quite interesting.

  First of all, we don't think bitcoin should be labeled a currency. A currency operates both as a means of transaction *and* as a store of value. While bitcoin is gaining some traction as a means of transaction, there is no evidence that it is a reliable store of value. This was further cemented by the IRS ruling that bitcoin will be taxed as property and Warren Buffett's terse advice to just "stay away."[6] That being said, bitcoin is a potentially interesting means of transaction (notwithstanding the IRS ruling). Right now, the dominant and growing way to pay for goods is to pull out a piece of plastic and either swipe it or type a pin number into an online form. But this system is by no means perfect – there are security concerns (see Target data breach) and high costs to retailers and ultimately consumers (around 2% per transaction on average). Bitcoin is one payment technology receiving a lot of funding from Venture Capital investors trying to upend the payment industry. It is supposedly secure, efficient and cheap and could potentially be used at point of sales systems. So while we've spent no time considering bitcoin as an investment and we don't really understand the technology, we have started to consider the potential adverse competitive effects to the established payment ecosystem, which includes card companies (Visa, Mastercard), payment processors and even the big banks.

- Although we don't think stocks are dangerously overpriced, that doesn't mean we are having an easy time finding companies to buy. We continue to be **confronted by slim-pickings**. Most sectors and companies appear to us to be efficiently priced. We've recently been spending research time on high-quality, global, consumer-oriented companies. While our work in that space still continues, we were able to purchase one such name in the first quarter. High quality, consumer-oriented, global companies have historically traded at a premium to the market, but now many trade in-line or even at a discount. This reflects concerns about international markets and slower global economic growth. To be sure, these companies face real challenges, as consumers focus more on price in the face of sustained economic weakness and emerging markets are confronted by a rough patch. But longer-term, companies with understandable and necessary products, strong, defensible brands, above-average management teams, and reasonable valuations represent fertile ground. If we are right, subsequent returns won't be astounding, but they should be satisfactory on a risk-adjusted basis. We are actively searching for opportunities in this space, though as always, we set a high bar.

- For those of you who are fans of *60 Minutes* (David doesn't miss an episode), you may have seen their recent profile of Michael Lewis' new book on the perils of **high-frequency trading**. Lewis is a well-known and talented author whose works have included *Liar's Poker, Moneyball, The Blind Side* and *The Big Short*. Lewis' new book, *Flash Boys: A Wall Street Revolt*, profiles how so-called high-speed computer trading firms are distorting stock market prices. We've read analysis on this topic over the past couple of years and an excerpt from the new book, but it's not been at the top of our research agenda because, as

[5] "The New Coin of the Realm" by Doug LeDuc, *Greater Fort Wayne Business Weekly*, January 30, 2014.

[6] Interview with CNBC on March 14, 2014. He said "The idea that it [bitcoin] has some huge intrinsic value is just a joke in my view."

long-term investors, we trade so infrequently. The supposed tax from high-speed traders really only shows up for investors that frequently buy and sell securities in large amounts (we neither trade often nor trade in large amounts). We nevertheless applaud the increased focus on the issue and look forward to improved financial markets in the future.

That being said, we feel that Lewis and *60 Minutes* went too far in sensationalizing the issue when they claimed that "the stock market is rigged." First, the stock market functions via the intersection of three parties: buyers, sellers and middlemen. For the last century, financial markets have continually experienced increased liquidity and lower "frictional" payments to middlemen. It isn't clear that high frequency trading isn't just part of that evolution, which some argue has further increased liquidity and actually reduced costs when bid-ask spreads are included. We aren't defending the system because we don't have the requisite expertise, but simply saying it should be put into the proper context. Hopefully Lewis' work, and the work of the disruptors he profiles, just signals further evolution towards an even better market making system.[7]

Secondly, saying the stock market is rigged suggests to investors that stock prices are fake or artificial, and we don't believe that is the point opponents are trying or should be trying to make. Yes, transaction costs when buying or selling a stock might be higher than they could or should be, but buying a stock still represents a minority ownership in an actual business and for long-term, buy-and-hold investors, these small transaction costs aren't a huge concern.

Even Jack Bogle, the founder of Vanguard and a frequent critic of Wall Street, responded that Lewis' claims were "too extreme…Main Street is the great beneficiary…We are better off with high-frequency trading than we are without it."[8]

The risks that concern us most about high-frequency trading aren't the potential transaction costs per trade, which have minimal effect on us, but the increasing reliance by our financial system on complicated technological systems.[9] Hopefully, regulators will focus on the robustness and safety of trading markets and not be distracted by sensationalized finger-pointing. Yet even if the increased reliance of financial markets on complex technological systems has increased systematic risk, we still feel comfortable owning shares of high-quality, well-run businesses as long-term investors. We don't view our ownership positions as pieces of paper, but instead as minority positions in actual companies.

That's our version of "around the financial world in 60 seconds." We look forward to updating you again soon, including notes from our upcoming trip to the Berkshire Hathaway annual meeting in Omaha. If you have any questions or want to discuss any of the aforementioned topics, please don't hesitate to contact us. As always, we thank you for your continued confidence.

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict, CFA
David J. Manger, CFA

[7] Indeed, the firm Lewis profiles as a potential solution, IEX, was recently highlighted in an internal memo by Goldman Sachs, which stated, "While we think that a regulatory response may be needed to address these market structure issues, it would be best for the overall market if IEX achieved critical mass, even if that results in reduced volumes in our U.S. dark pool, Sigma X."
[8] Interview with CBS MoneyWatch on April 3, 2014.
[9] This is highlighted by a recent technical glitch at the CME that halted commodities trading for a couple of hours.