On the Couch[1]

August 2019

In our second quarter investment commentary, we included the following observations:

> We've now experienced the longest economic expansion and bull market in history. Aren't we due for a pullback? What happens if geopolitical tensions boil over into damaging trade wars or even outright conflict? The yield on a three-month U.S. Treasury is now above the yield on a ten-year U.S. Treasury, which has historically been a warning sign of an impending recession. (An inverted yield curve has preceded every recession since 1960, although it's also given two false warnings.) If and when will the nation's growing debt burden create spillover effects in the economy? (The U.S. has never witnessed such large government deficits this late into an economic expansion.)

This list wasn't comprehensive. Stock prices recently hit all-time highs. Some recent and upcoming Initial Public Offerings (IPOs) are reminiscent of the dot-com bubble, with profitless companies being valued in the billions of dollars. Iran and North Korea have both recently undertaken more aggressive stances. The probability of a no-deal Brexit has increased.[2] The Federal Reserve just cut interest rates for the first time since 2008, and with interest rates so low it's unclear how much fire power they will have to fight the next recession. It's possible that some of the political winds that have appeared to help stocks the past few years – such as reduced corporate tax rates – could blow the other way in the future.

Warren Buffett famously told investors to "be fearful when others are greedy, and greedy only when others are fearful." With all of these ominous signs and with stock prices near all-time highs, shouldn't we be fearful?

Our job is to be an objective partner for our individual and institutional clients. But even we feel the pull to "batten down the hatches" and prepare for the next storm. Yet our training, research and experience tell us that the aforementioned observations are not sufficient to justify a material reduction in an investor's targeted long-term allocation to stocks.

[1] We borrowed this title from a memo Howard Marks of Oaktree Capital wrote on January 14, 2016.
[2] Brexit refers to the United Kingdom's pending withdrawal from the European Union. The UK and the EU have been working on a framework for withdrawal but so far no agreement has been made.

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Warren Buffett frequently cites his mentor Ben Graham as one of the most important factors in his development as a professional investor. Graham's key foundational insight was this: Stocks aren't pieces of paper and the stock market is not some large, amorphous organism. Instead, a stock is an ownership interest in a business and the stock market is simply the aggregate of all of those ownership claims. When you own a stock, you have an ownership claim on an actual business, no different than if you owned part of a local apartment building or farm. The fact that "Mr. Market" gives you a price quote everyday – sometimes rational, sometimes not – should help you, not hurt you. (See our white paper "Mr. Market – Friend or Foe?" for a deeper discussion of this idea.)

In the white paper we published last year titled "Market Timing – The Rule and The Exception," we outlined three criteria that can be used when trying to identify a stock market bubble in real-time:

1. The earnings yield[3] on stocks is at or below the yields available on bonds
2. The earnings yield on stocks is at an absolutely low level
3. There is no reason to believe future corporate earnings growth will be above-average

We would concede that #2 and #3 apply today. But #1 is clearly not met – stocks continue to yield much more (on an earnings basis) than alternative investments such as cash or bonds. And although we believe this exercise is fruitful and worthwhile, it can potentially distract us from our real job as investors – buying and owning good businesses at reasonable prices.

The stock market in 1999 clearly met all of the hurdles listed above. It was a stock market bubble. But even then, there were still a number of reasonably attractive investment opportunities, such as publicly traded Real Estate Investment Trusts (REITs).[4] In late 1999 REITs carried a dividend yield of 8.7%[5] versus the S&P 500's dividend yield of just 1.2% and went on to return over 18% per annum over the next seven years versus just 2.5% for the S&P 500.[6]

Consider the fact that even though the stock market, as measured by the S&P 500, is just 3% below its all-time high (at the time this piece went to the printing press), nearly one-third of the companies that make up the S&P 500 are off 20% or more from their recent highs.[7]

We don't mean to imply that it is easy to find investments that will outpace the broader stock market in the future. It's not. But our point is that even if stocks look expensive and the world looks scary, there may still be attractive investment opportunities. Our first and most important job when investing is to find and acquire good businesses trading at reasonable prices. This task is not dependent on the environment – we don't give up when the world looks scary. At AMI, we still do our own fundamental research on the companies that we purchase.

There is no guarantee that our research will result in above-average investment performance. Indeed, that's a tough feat to achieve. But we think that it is fundamentally important that we know what we own. First, it can help us avoid the bubbles and fads that pop up in markets from time-to-time. While we won't go into details here (although we do touch on the subject a bit in Appendix C), we think some current investing fads are dangerous and could lead to investor disappointment down the road. Second, by knowing what we own, we have the conviction to stay the course in good times and bad. We think this is a potentially powerful attribute. In nine out of ten years, this might not matter. But in that tenth year, when weird or crazy things happen in markets, the fact that we know what we own might help us keep our heads while those around us lose theirs.

It has admittedly gotten harder to find good businesses trading at reasonable prices after a ten-year bull market. We usually find investment opportunities in unloved areas of the stock market, and there aren't too many of those today. We aren't finding investment opportunities today that rival the ones we found during 2009, 2011 or 2016. But that doesn't

[3] The earnings yield is defined as the amount of earnings a company generates dividend by the company's current stock market value.
[4] A REIT is simply a company whose primary business purpose consists of owning and operating income-producing real estate. Qualified REITs generally avoid taxes at the corporate level as long as they pay out at least 90% of their taxable income as dividends to shareholders.
[5] National Association of REITs REIT Index, December 1999.
[6] For the period December, 1999 through December, 2007, per Bloomberg Finance (Dow Jones U.S. Equity REIT is used to measure REIT returns).
[7] Bloomberg Finance as of August 22, 2019; measured using 52-week highs.

mean we are totally devoid of ideas. As an illustration, we've included write-ups on two stocks that we've recently been purchasing in client accounts in Appendix A and Appendix B.

We thought these write-ups might be a helpful way to remind our clients what they actually own: interests in underlying businesses. When you view stocks this way, the day-to-day variations in stock prices become less disconcerting. The key question is this: Will this stock be worth more in five or ten years? If we are confident that the answer is yes, then our job is to hold on and largely tune out the short-term noise of the markets.

These write-ups also demonstrate why we think it is important that we fundamentally know and understand what we own. If we truly believe in a given company and we think that it's stock is worth $X or more, then we won't be tempted to cut bait and run if the market goes haywire and temporarily reduces the stock price to just half of $X. Because we've done the work, we are prepared to stand by our convictions. This gives us the strength to be a port in the storm and avoid costly knee-jerk reactions.

The two ideas we outline here won't be grand slams. But we think they offer the prospect for annual returns that are much better than cash with modest downside risk longer-term (anything can happen in the short-term). Of course the regular disclaimer is always needed: We could be wrong.

In Appendix C, we briefly touch on some areas of the market that have been hot of late but which we think might hold danger for the investor going forward. Most of our time is spent trying to find good businesses we understand that are trading at reasonable prices, but we thought it was worth highlighting some potential counterexamples in the current environment. This discussion also highlights why it can be misleading to think of the stock market as just one large, single organism as opposed to a collection of different businesses and investments.

These write-ups get down into the nitty-gritty details about how we think through the value of the companies that we own. We understand that this might be interesting reading to only some of our clients. But we at least wanted to highlight the kind of fundamental research that we do to all of our clients. We hope you enjoy these case studies and please feel free to send along any questions or comments.

[Note: We ask that you please keep this information private and confidential since it reflects AMI's proprietary research.]

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The appendixes to this piece include AMI's proprietary research which is only available to AMI clients.

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