

AMM

AMERICAN MONEY MANAGEMENT, LLC

SEC Registered Investment Advisor

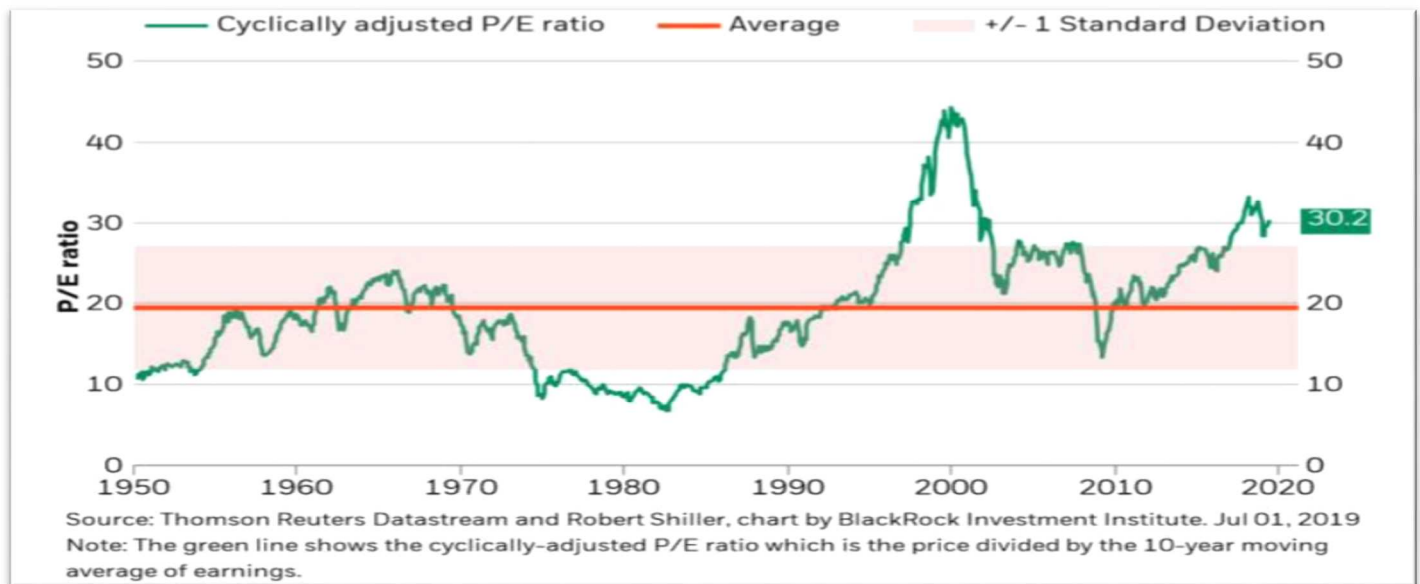
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THE BIG PICTURE ~ THE MARKET CYCLE

"History doesn't repeat itself, but it often rhymes." - Attributed to Mark Twain

This summer marks the 20th anniversary of AMM! And, while we are not marking the occasion with much fanfare, it does provide a chance to step back and reflect on the last 20 years of market history. The launch of our firm in the summer of 1999 coincided with the publication date of *DOW 36,000* by a matter of months. The authors of *DOW 36,000* suggested that the DOW was "undervalued" and would rise from around 11,000 to 36,000 by 2002-04. Twenty years on the book has become the poster child for the irrational mania of the times. The cyclically adjusted P/E ratio (CAPE P/E) of the S&P500, a widely followed barometer of broad market valuations, traded at more than 2 standard deviations *above* its long-term average in 1999 (Exhibit A): as sure a sign of *overvaluation* as the stock market has ever seen! As of this writing, the DOW has another 9,000 points to go to reach 36,000 – about 15 years behind schedule.

Exhibit A



Shortly thereafter, the technology bubble burst and, following the double whammy of 9/11 and a recession, by the fourth quarter of 2002, stocks were down nearly 50% from their 2000 highs. After this complete washout, stocks began to rise again in 2003 and experienced a mini-bull market through the fall of 2007, only to be met with a second major market collapse in the same decade: the bursting of the housing bubble and subsequent recession. By March of 2009, stocks had again fallen more than 50% from their prior highs. While stocks began to recover in the latter half of 2009, by December of that year, the S&P 500 had annualized at a *negative* 1% rate of return over the prior 10 years, a lost investment decade.

10 years into our trip down memory lane, the mood of investors could not have been worse. Fashionable investments of the time were those that provided a return *of* capital not a return *on* capital. Aggressive investment postures were eschewed by most in favor of conservatism; never mind that interest rates were so low and stocks were now trading at inexpensive valuations. Hedge funds or other alternative assets that sought "uncorrelated" returns relative to the stock market were en vogue, though they generally came with a high price tag. After having lived through one of the worst decades in market history, you cannot blame investors for being a little gun shy. ***But, if market history teaches us anything, it is that future returns are higher when starting valuations are low and lower when starting valuations are high.***

THE GREAT WALL OF WORRY

Perceiving that they had been burned by markets, investor attitudes remained conservative for some time following the great recession of 2008/2009. Flows into more conservative bond funds skyrocketed from 2009-2012, while flows into stock funds rose at a fraction of the pace even though stocks were now attractively priced. While some flows into bond funds were for legitimate asset allocation reasons, it seems clear to us that the high velocity of flows into these funds in the years following the great recession was also related to investor fear/worry. Market historians refer to “climbing a wall of worry” as the ability for markets to rise in the face of a host of negative factors. Climbing the wall of worry is a key feature of bull markets. Since there is always bad news, markets that can digest this bad news and continue to rise exhibit above average strength.

The second decade of the new millennium saw plenty to worry about. There was an event dubbed the flash crash in 2010 in which the DOW dropped nearly 9% intraday, only to recover much of the loss by the close. In 2011, the US Government debt was downgraded, which reverberated through markets and caused a 19% intra-year drop in stocks that year. A consistent source of investor indigestion seemed to revolve around the Federal Reserve: would they remove the punch bowl of low rates and easy monetary policy too early? Interest rates rose dramatically in 2013 in an event dubbed the “taper tantrum” after investors learned that the Fed would be putting the brakes on its accommodative asset purchase program. And, as recently as Q4 2018, markets again dropped nearly 20% as it appeared that the Fed might be raising rates a little too aggressively in the face of slowing global growth even though the US economy appeared to remain on solid footing.

However, as we sit here in mid-2019, the S&P 500 has now annualized at 14.7% over the last ten years. Fashionable investments today are very much about return *on* capital. Investors seem more than willing to take a chance on untested businesses in “hot” industries like Cannabis and digital currencies. While flows continue into bond funds, partly a function of an aging developed world population, flows into stock funds began to jump significantly in 2013 (4 years after market lows). Passive or index funds, which seek to match the “market return” irrespective of price or individual security fundamentals, have ballooned from 20% of all US stock assets under management in 2007 to 45% today. Some large institutional investors like CALPERS have eliminated most of their hedge fund investments. Why pay hedge fund fees when passive funds return 14% per year? The memory of the lost decade appears to have been purged.

ACTIVE ASSET ALLOCATION

What we have tried to concisely describe above is a 20 year snapshot of the market cycle, from peak to trough and back towards peak again. There is no exact or agreed upon definition of what constitutes the market cycle. For our purposes, we would describe the market cycle as a continuous wave that rises, peaks, then falls, eventually troughing and then rising again. This cycle refers specifically to prices of assets like stocks and bonds and is separate and apart from other “financial cycles” like the economic, credit or housing cycles – though they are all logically interrelated.

Market cycles do not move according to some specific calendar and may be driven as much by emotion and psychology as they are by hard data like earnings, GDP growth, etc. The intelligent investor has two options when dealing with the market cycle:

- 1) Ignore the Cycle – Passive Asset Allocation: There is a simplicity to ignoring the cycle. Do not worry about it; just invest. For professional money managers and investment advisors, there is an additional benefit: safety in numbers. So many professionals choose option 1: if things go wrong, they will have gone wrong for many of their competitors too. While there is plenty of financial risk in ignoring the cycle, the career risk is lessened with the herd.
- 2) Respect the Cycle – Active Asset Allocation: Respecting the cycle is the attempt to identify, within some reasonable margin of error, the current location of the market in its cycle and to invest accordingly. This means periodically positioning portfolios defensively (near cycle highs), neutrally (mid-cycle) or offensively (near cycle lows).

At AMM, we are primarily active asset allocators. We take this option not from the confidence that we can predict the future, but rather from the simple view that if we pay attention to the environment we are in, we can make active asset allocation decisions in an effort to maximize returns and minimize risk.

To be clear, active asset allocation is fraught with the potential for error and sub-optimal outcomes. This could mean misreading the cycle, becoming too defensive too early when confronted with the “wall of worry”, or staying too aggressive when markets become irrational so as not to “miss out on more upside”. Faced with these possibilities, we can understand why some investors choose to ignore the cycle. However, as asset managers, we have a hard time arguing that one should be positioned exactly the same whether the P/E ratio in Exhibit A is above 40 or below 15. Clearly, one level calls for caution and the other for aggressiveness, and this has been validated by market history.

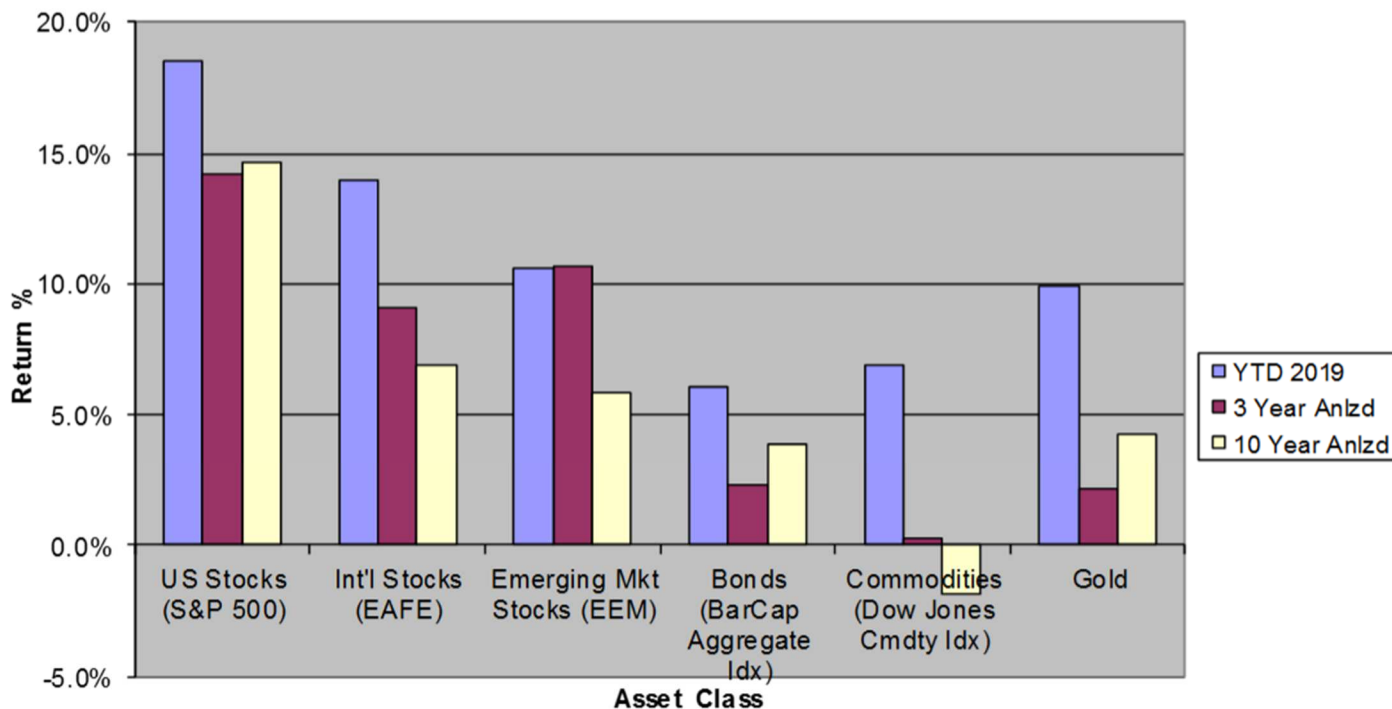
Importantly, active asset allocation is NOT about predicting the future. Rather, it is about understanding today and then positioning portfolios accordingly. Are we in an environment of extreme aggressiveness, high valuations, low credit spreads and generally exuberant markets as we were in 1999? That was clearly an environment that called for caution, and the negative annualized returns 10 years on bore that out. On the other extreme, when no one wants to own risk assets, and investors are generally glum and afraid as they were in 2009, then the odds are in your favor to shift to a more aggressive posture. This too has been proven true by the above average market returns 10 years on.

A final note on our approach to cycles: the descriptions of the cycle high in 1999 and low in 2009 represent the two extremes of the cycle. Most of the time, markets are not at those extremes and, therefore, most active asset allocation decisions are not extreme all/or nothing decisions. These decisions include slightly overweighting or underweighting certain assets relative to our clients long-term targets weights, buying or selling individual securities based on their specific fundamentals and valuations (i.e. not based on a broader market view), shifting within certain assets that we would deem to be more favorable within their respective asset category in the current environment, and rebalancing portfolios back to their current target weights periodically. These are the bunts and base hits of day to day portfolio management and a core part of our role as your portfolio manager and investment advisor.

MID-YEAR 2019 REVIEW

Through 6/30/19, domestic stocks (S&P 500) increased 18.5%, developed international stocks (EAFE) increased 14%, and emerging market stocks (EM) were up 10.6%. Bonds (Bar Cap Agg Idx) increased 6.1%, commodities increased 6.9%, and gold increased 9.9%. We have updated our asset class return chart below.

Asset Class Returns (as of 6-30-19)



Following a weak 4th quarter of 2018 when nearly all major asset classes declined in value, the first half of 2019 has provided solid returns across the asset class spectrum. US and International stocks have led the way, apparently on hopes of a renewed cycle of monetary easing. This is a double edged sword: Monetary easing helps by reducing the cost of money which should thereby increase the supply of money and credit, thus helping to support economic growth; however, the fact that central bankers feel the need to ease means that they have serious concerns about future growth and the possibility of a recession.

All of this is occurring against a backdrop of fairly “expensive” US stocks as measured by the CAPE P/E ratio in exhibit A as well as already historically low rates. For this reason, we continue to take a fairly cautious stance by marginally underweighting domestic stock exposure in our asset allocation portfolios. We continue to hold neutral/target weight exposure to international stocks, in part because valuations are less demanding in these markets. In fixed income/bonds, we continue to keep duration exposure on the shorter end and are generally avoiding riskier below investment grade bonds at this point in the cycle. But, overall fixed income exposure is being maintained at target weights since this asset class would likely benefit from a flight to safety trade in the event of a broader market correction.

Finally, in the diversifying asset portion of asset allocation portfolios, we continue to hold positions in both gold and a broad based basket of commodities. Positions in both of these holdings are modest yet offer uncorrelated returns to more traditional assets like stocks and bonds.

**Individual accounts will vary based on a client's stated objectives, risk tolerance and time frame. We manage several different portfolio strategies, so not every client has exposure to the securities, asset classes or investment strategies discussed above. In addition to growth and/or income oriented asset allocation strategies, we also manage more concentrated equity portfolios that generally carry a higher degree of risk and volatility.*

HOUSEKEEPING ~ AMM FINANCIAL PLANNING

We recently launched a financial planning retainer service for clients of American Money Management. Over the years, we have provided a wide variety of financial planning guidance to clients, including retirement probability and income analyses. We consider these items to be incidental to the investment process and will continue to provide these services as part of our advisory agreement. However, for clients seeking a more comprehensive written financial or retirement plan, we are now offering a more formal financial planning arrangement via an annual Financial Planning Retainer Agreement.

We have amended our Form ADV part 2 filing with the Securities and Exchange Commission to reflect this new offering. Included is a document that itemizes this new offering along with other material changes to the last amended brochure. We can provide you a full copy of the ADV filing at your request.

Should you have any questions regarding your investment account(s) and personal financial plans, or if there have been any recent changes to your investment and/or retirement objectives, please do not hesitate to contact our office to speak with one of us at your convenience.

As always, we thank you for entrusting AMM to help you achieve your investment and retirement objectives.

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Portfolio Manager

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