The ACM Journal

Farm Foibles

It has been a couple years since we have grown any real vegetables on our farm. The weeds always seem to grow faster than the crops, and who has the time to weed every day? However, over the winter I thought about how we might gain the upper hand.

The solution was raised garden beds. They would be elevated from the surrounding yard, and thus separated from the weeds. We would also bring in new soil, avoiding the weed seeds already in any soil we would till up. It was a brilliant idea, and should be easy to execute. After all, it is really just putting four pieces of wood together; how hard could it be?

So, I called several of the local lumberyards in search of cedar boards I could use for my new project. Most of them didn't have what I was looking for, and some even laughed at me, but I did eventually find fourteen-foot boards that would work. I knew they would be relatively expensive, but I couldn't use pine boards, as they would rot. Pressure-treated lumber seemed an obvious solution, but what self-respecting parent would let their kids eat vegetables grown in soil laced with arsenic leached from pressure-treated wood? It didn't occur to me at the time, but my kids don't really eat any vegetables at all, making this less of a concern.

continued on page 4

IN THIS ISSUE

REIT Valuations at All Time Highs

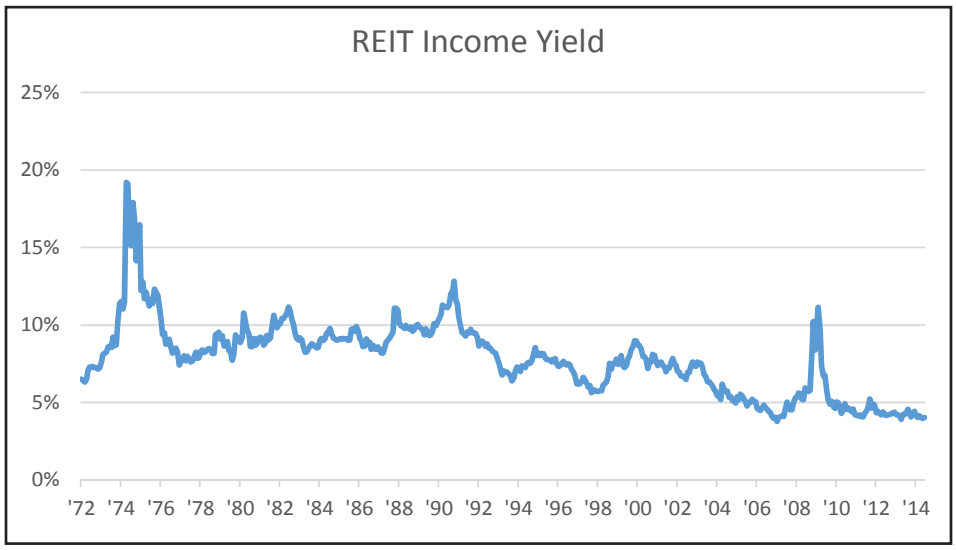
Real estate investment trusts (REITs) are stocks that invest in real estate and mortgages. We have used them in our portfolio since our inception, and likely will always have an allocation to this asset class. Historically, REITs have had a similar risk and return profile to large-cap U.S. stocks. However, REITs have had relatively low correlation to the stock market, making them an excellent tool for portfolio diversification.

As you all know, we don't do much market timing or tactical shifting of our portfolios. We set targets for each asset class, and commit to them over the long term. However, we will occasionally allow asset classes to fall below our target weights if they reach what we determine to be extreme valuation levels. Such is currently the case with REITs.

We have looked at a couple different valuation metrics in coming to this conclusion. The first is the income yield that REITs produce. If share prices are low, the dividend income REITs pay will be a larger percentage relative to their share price, thus providing a higher yield. If share prices are high, yields should be compressed. In the graph below, you can see that currently REIT income yields are as low as they have been since the inception of publicly traded REITs back in 1972.

The second valuation approach we reviewed was Price to Funds From Operations (FFO). REITs don't have traditional earnings like most stocks do, so there is no such thing as a Price to Earnings (P/E) ratio for REITs. However, Price to FFO provides similar information. We were not able to get data going back to 1972, but the graph on page 2 shows that even on a more traditional, price-based valuation basis, REITs appear to be richly valued.

continued on page 2



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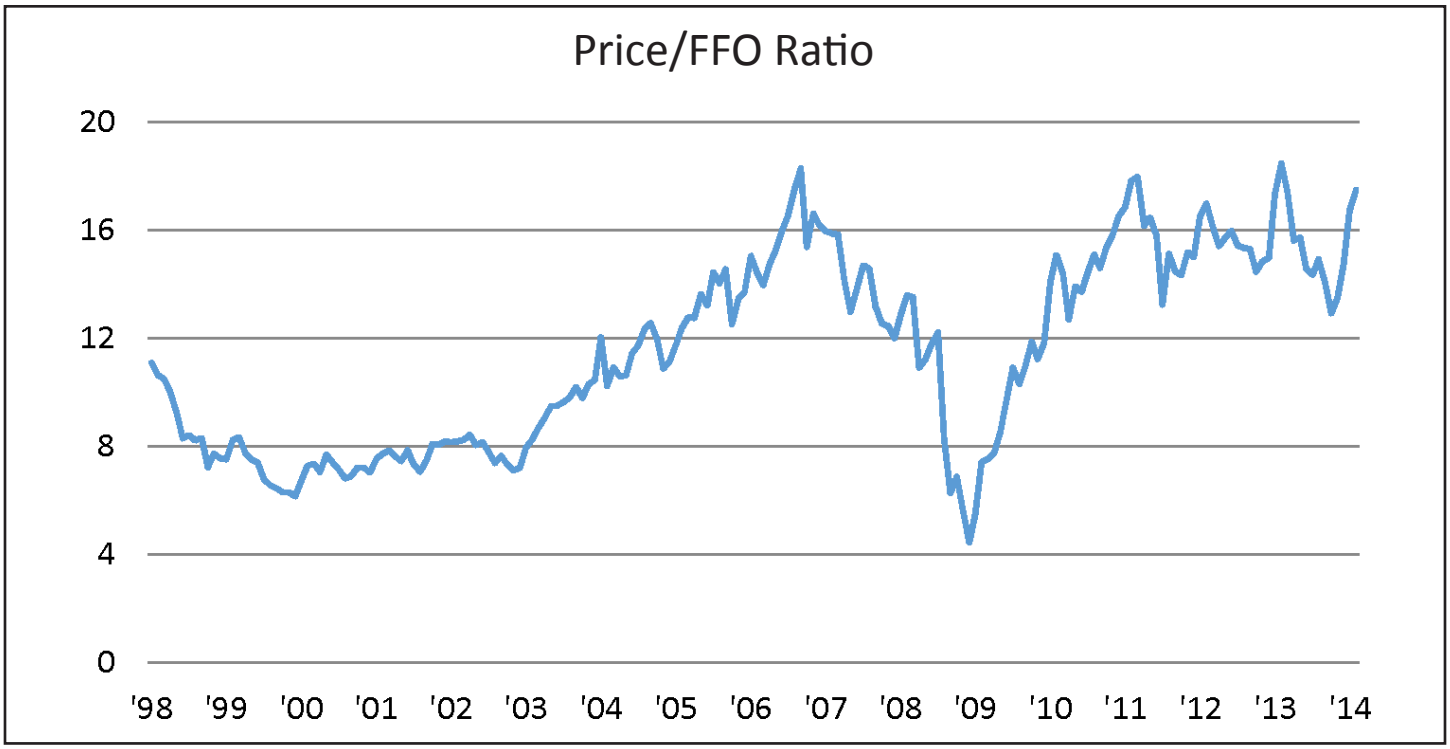


Valuation, with any asset class, tends to be predictive of returns over the long haul, but not so great over shorter periods. Indeed years can go by with valuations much higher or lower than most investors would think possible. Think how long the internet boom lasted in the 1990s. However, we think there are other reasons to be wary of REITs.

Primarily, the fundamental business underpinnings don't seem very strong. Commercial real estate, including office buildings, retail shopping space, and hotels, among others, is highly sensitive to the economy. The economic recovery that we have experienced since 2009 has been anemic. Without significant economic growth, corporations are hesitant to invest. Accordingly, employment has been weak, as has demand for office space.

A recent study by real estate research firm REIS found that only 52% of the office space that went vacant during the last recession has been released. Nationwide, the office vacancy rate is currently 16.8%, just a hair below the recessionary peak of 17.6%. In 2007, before the recession hit, the office vacancy rate was only 12.5%. Rent growth has also been weak across the nation. There are certainly hot markets, such as the coastal cities, but overall demand for commercial real estate has been weak.

There may be an unfavorable long-term trend in place as well. There is evidence that companies are occupying less space per employee than in the past. Technology firms are famous for cramming employees into close quarters in order to save money and spur collaboration. However, this seems to be spreading to other industries as well. If that is indeed the case, REIT fundamentals may not fully recover for many years. Flexible work arrangements, telecommuting, and on-demand inventory systems may also be a factor.

Interestingly, REITs have outperformed the stock market since the end of the 2008 bear market. However, I think this has more to do with investor preference for higher yielding investments than anything else. With bond yields at record low levels, income-oriented investors are looking for alternatives. REITs were a natural beneficiary of this, as even with historically low yields, they generally produce more income than other asset classes.

I have argued before that income investing generally doesn't make sense for most investors, with a few exceptions, such as trusts. Income investing doesn't increase your return, it simply increases your tax bill. So, I don't expect the recent trend of searching for high-income investments to last, which could ultimately bring REIT valuations back down to Earth.

We have been underweight REITs in most portfolios for the past year. As the graph on page 3 shows, that has worked against us so far this year. However, it has been the right move over the past 12 months. We will continue to monitor the situation, and will resume a full allocation to REITs when the value proposition is more compelling.

Portfolio Review

The second quarter of 2014 was a good one for investors. Every asset class posted positive returns, generally above historic averages. Accordingly, most segments of the capital markets are on track for significant gains for the full year.

Domestic stocks were again strong, with large-cap stocks outpacing smaller stocks. However, the range of returns has been quite small. All segments of the U.S. stock market have performed well, including growth, value, large, mid, and small. This egalitarian rally in stocks has many perplexed, and has left active stock pickers frustrated. Also interesting, is the lack of volatility. The stock market has been remarkably consistent the past few years, leading many to wonder when the next big drop will come.

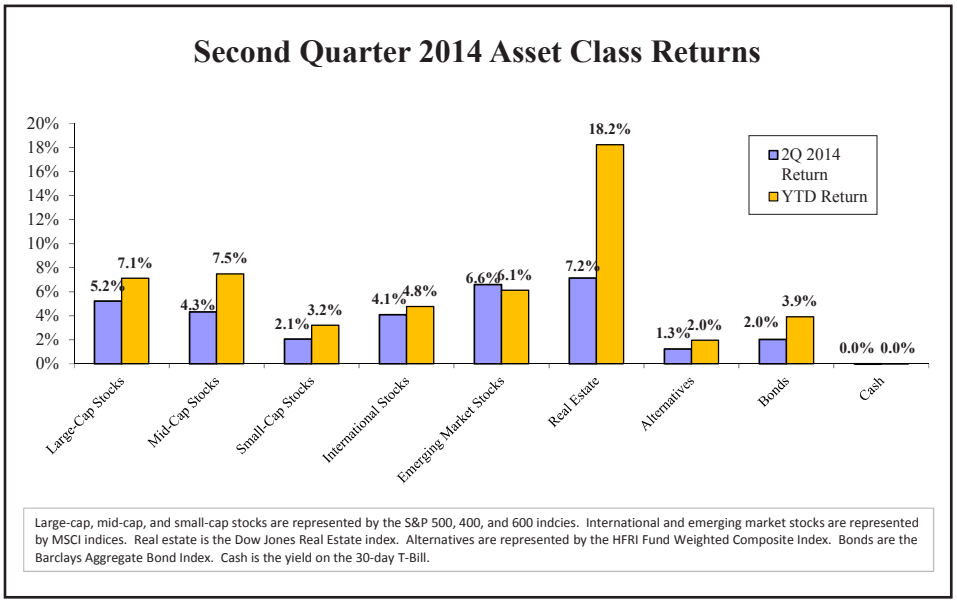
It is all but impossible to predict large market declines, but we aren't expecting anything imminently. It would not be surprising to see a pullback of 10% to 15%, but we would expect even that to be short lived. Honestly, that view is shared by most of the market participants these days, and when everyone expects something to happen, it rarely does. A slow, steady rise in stocks for another couple years is the alternative approach that no one is talking about. I'm hoping that's the path we're on.

International stocks and emerging market stocks have also performed well, reversing a trend of underperformance the past couple years. There are certainly economic issues to work out in Europe, but with stock market valuation so much lower overseas than they are in the U.S., I'm surprised that international stocks haven't performed even better.

Real estate has continued to perform well, outpacing stocks for the quarter, but trouncing them for the year-to-date period. We still struggle with real estate valuations, as we discuss in another article in this newsletter.

Alternative investments and bonds plodded along. Both performed their job of risk reduction admirably, and returned positive, if not inspiring, results in the quarter. Actually, the fact that bonds are providing positive returns at all is terrific, and somewhat unexpected. Everyone is waiting for interest rates to rise, which would be bad for bonds. However, interest rates, already at record low levels, contracted even further during the second quarter. A slowdown in economic activity in the early part of this year, as well as advancing stock market valuations, likely caused some investors to move to the safety of bonds.

The second quarter was solid, but dare I say, boring? The markets seem to move slowly toward new highs almost every day. Undue volatility is largely absent. The economy is anemic, but perhaps just right for continued stock market advances. Currently, all is good. Let's hope it lasts a while longer.



Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indcies. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Alternatives are represented by the HFRI Fund Weighted Composite Index. Bonds are the Barclays Aggregate Bond Index. Cash is the yield on the 30-day T-Bill.

Client Satisfaction Survey

The team at Armbruster Capital Management would like to extend its sincere thanks to those who participated in this spring's client satisfaction survey. We are proud to report that we had a high response rate, and very positive feedback overall. We appreciate the time and effort you spent to provide us with valuable feedback regarding our services, communication, and reporting. We will incorporate more electronic reporting for those indicating a preference for it, as well as other changes and suggestions you specified in the survey. Thank you again for your participation, and as always, do not hesitate to contact us with any questions or comments.

Farm Foibles *continued from page 1*

So, off I went in the pick-up truck to buy my cedar lumber. I was prepared for it to be expensive, but not for it to cost $300. The guy at the counter said I could buy a lot of vegetables for $300, but undeterred, I purchased the lumber, and headed home.

I sawed, and predrilled, and reinforced the corners, and used deck screws that won't rust. I was very proud of my industriousness. My son Amer even "helped" for a while, which slowed down progress, but made it more fun. By dark, I had finished one of the garden frames and put it into place. The next night I finished the other two.

We have an enormous pile of compost on my property from all the leaves we rake in the fall, and kitchen scraps throughout the year. I thought this would be an excellent filler for the new raised beds, and used several tractor-loads. However, there wasn't quite enough there, so I trucked down to buy a load of top soil. This also wasn't enough, but I had run out of day light again. That weekend, I got another load of top soil to finish the job.

Finally ready, I planted peppers, tomatoes, herbs, lettuce, and several squash. I then had to think about a way to mulch so those pesky weeds would be kept at bay for as long as possible. I saw on a web site that cut grass could be used as a mulch material. I had plenty of that around, and quickly raked up enough for a thick cover on all the beds.

The project finished, I proudly watered my new gardens each evening. One day, my neighbor, who is an expert gardener, came down to chat. Never one to hold back, he said "you shouldn't have used all that grass. It is full of weed seeds, which you just planted in your garden".

Sure enough, the weeds are back. My crops are doing ok, but I do have to spend a bunch of time weeding. All in, I spent just under $400 (if you don't count my time, or any gas for the tractor and truck), and many hours to get a bunch of vegetables the kids can complain about. I'm sure I could buy many years of locally-grown, organic vegetables for the money I spent, and I still have to build a fence to keep the critters out, but how hard could that be?

Speaking of critters, when we first bought our farm, we would joke that it was a home for wayward critters. We've taken in a number of stray animals, barn cats, a share cropper, and even a homeless friend for six months. However, we never imagined that we would be running a soup kitchen for the local fauna.

All the foxes in my neighborhood are starting to think of me as the Colonel. That may sound like the beginning of some off-colored movie, but I mean foxes in the literal sense. The past few months, I've been playing Colonel Sanders, by raising juicy, healthy, organic chickens, and the foxes have been dropping by for an all-you-can-eat buffet at their pleasure.

It started with our egg-laying chickens in the early spring. I forgot to close the door to the coop one night, and in the morning, there were no chickens to be found. We eventually pieced together the forensic evidence, most of which was strewn across our neighbor's yard, that a fox had finished off all 17 of our full-grown birds in one night. Quite the meal!

More recently, I had 35 young chicks that we were raising as our meat birds. We raise them with great effort, care, and expense. We feed them organic feed, we make sure they have access to chemical-free pasture, and we eventually process, freeze, and eat these birds throughout the year. As with my raised garden beds, the economics don't exactly work out, but we feel good about the quality of the food we raise. In the end, these chickens probably cost me around $15 each to raise.

Without any consideration for my expense, effort, or even feelings, one or more critters came by a couple weeks ago, opened the heavy barn door, and devoured all 35 of my birds. I've never had this happen before when the birds were securely in the barn, and I can't imagine what sort of animal could have opened the door.

I'm thinking maybe this was an elaborate plan, executed in coordination with many animals, perhaps even a multi-species effort. Maybe the opossum hung from the top of the barn, held the back legs of the raccoon, who, with his opposable thumbs, was able to grab the door and give it a good push. Then, the fox went in, did the dirty work, and all the animals shared in the spoils.

Whatever actually happened, I'm out a bunch of birds and a bunch of money. I'm not sure my farming enterprise is working out, but at least I've got an investment business to fall back on.

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