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April 11, 2018

Quarterly Commentary

1st Quarter 2018

Life and Investing are Often Like the Chinese Bamboo Tree

One of the most prolific trees in the Far East is known as the Chinese bamboo tree. This tree is different than almost all other trees in that it does not grow in the standard fashion. Most trees grow in a steady manner over a period of years. The Chinese bamboo tree has no observable signs of growth for the first four years of its life, and then in year five an amazing thing happens – the tree begins to grow at an astounding pace. In fact, in just a five week period, the tree can grow to a height of 90 feet.

In many ways, investing often works that way. Perseverance is often rewarded with handsome returns that can occur in short bursts. Prem Watsa at Fairfax Financial, in his 2009 annual letter to shareholders has been quoted to say that he would prefer a lumpy 15% annualized return over a smooth 12% annualized return over the long-term. We agree. A good company acquired at a low price can appear to be a fallow investment for stretches with few visible signs of progress. Then all of a sudden, and often inexplicably, the price takes off. The market finally begins to recognize what you saw in your original investment thesis.

Perseverance is the hardest part about investing. We all get excited about the new investment that has been made. It is difficult for us to wait for the investment to blossom. Often we become discouraged when an investment appears to lay dormant for long periods, and we begin to second guess ourselves and our investment abilities.

We have been keeping a file of value investors recently throwing in the towel and capitulating to the massive momentum forces they have been standing against. It gives us no pleasure to see good investors succumbing to market and client pressures. As value investors, we saw this kind of activity immediately prior to the bursting of the Internet Bubble in early 2000, and we are witnessing it again today. Over the years, we have provided in our commentaries a plethora of extremely successful long-term investors that have gone through some of these fallow seasons.

Sometimes, in our doubt, we want to dig up our seed and plant it somewhere else, in the hopes that it will rapidly grow in more fertile ground. This becomes more common when you see your neighbors having more visible success with their trees (investments). It is easy to throw in the towel and give up; never completely reaping the investment's full potential. Perseverance is hard, but necessary, in becoming a successful long-term investor.

At FRM, we are willing to wait patiently as long as we can still see that the value of a security significantly exceeds the current trading price and that the company has the financial staying power to endure a challenging period. We believe our patience at FRM and our ability and willingness to invest for the long-term are huge competitive advantages in our field. These skills are becoming rarer in an investment world that seems to currently emphasize immediate gratification at all cost. The Bitcoin and crypto-currency craze is just a current example of the hyper-speed high that is sought after by investor junkies.

Today's stock market environment reminds us of other periods when investors ignored risks, chased momentum, and paid little to no attention to valuations. The "Nifty Fifty Era" of the early 1970's, "The Portfolio Insurance Blow Off" of 1987,"The Internet Bubble" ending in early 2000, and "The Housing Bubble" which led to the Great Financial Crisis of 2008-2009, were all periods, like today, of government-induced speculation in the stock market. For investors like FRM who are focused on first preserving, then growing our clients' capital through fundamental research, investing in an over-valued market is especially challenging. That is, until something changes. And change it will, we just never know when.

Statistical Characteristics of Our Clients' Portfolios as of 3/31/18

The chart on the next page shows that we hold true to our value discipline – no Amazons or Googles here. It is clear that the stocks we own are selling at significant valuation discounts to the broad stock market. What really catches the eye, however, is the balance sheet quality that we emphasize with a debt/equity level roughly half of the overall market.

Valuation Levels at 3/31/2018	FRM	S&P 500
Price to Earnings	20.14	21.24
Price to Book Value	1.44	3.23
Price to Cash Flow	7.97	14.12
Price to Sales	1.30	2.15
Enterprise Value to EBITDA*	9.49	12.93
Dividend Yield	2.49	1.95
Debt/Equity	51.45	118.59

**Enterprise Value is Stock Market Capitalization plus Net Debt and EBITDA is Earnings before Interest, Taxes, Depreciation and Amortization*

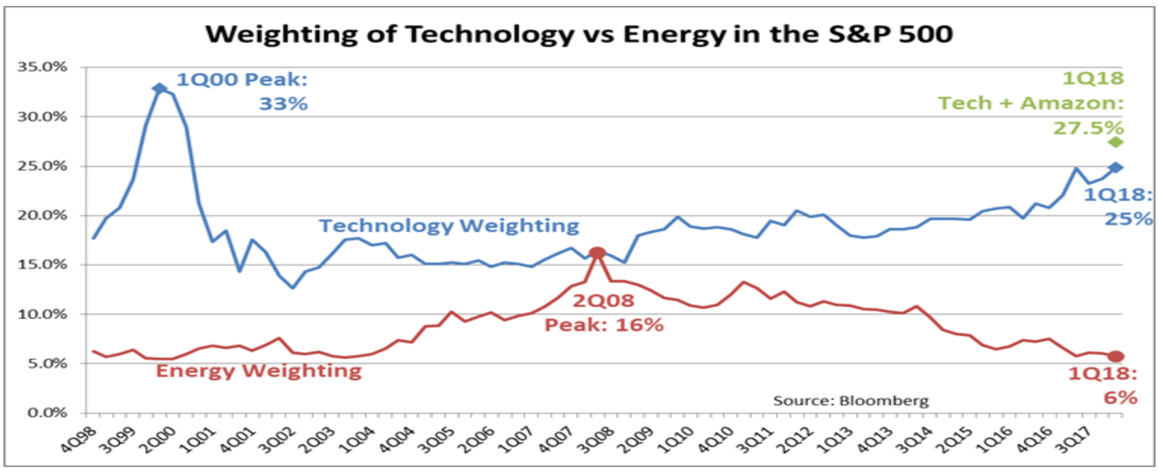
The First Shall Be Last, and the Last Shall Be First – Technology vs Energy

There is no question that the technology sector has been the bell-cow of the stock market. Currently, the technology sector makes up 25% of the S&P 500 Index, by far the largest sector, distantly followed by financials at 17%. If you included Amazon as a technology stock rather than a consumer discretionary stock, which we would, the technology sector weighting goes up to 27.5% for the index.

Robert Arnott, head of Research Affiliates, recently performed a study on the world's largest market capitalization companies. What he found was that, in the peak of the Internet Bubble of early 2000, **five** of the largest eight market cap companies on the planet were technology companies. This signified an unusually heavy domination of the top tier of the market by one sector - technology. Amazingly today, **seven** of the largest eight are tech companies. Five are U.S. based (Apple, Google, Facebook, Microsoft, and Amazon) and two are China based (Tencent and Alibaba). They collectively represent over $4 trillion of market cap. Arnott has done a very in-depth historical study on the likelihood of a "Top Ten" company remaining in the "Top Ten" of market cap a decade later. The odds are remarkably against a market leader remaining a market leader ten years out. On average, eight of ten drop off the list completely, one stays on the list but drops, and then one ascends on the list roughly half the time, and descends on the list about half the time. He concludes his study with the question, "What do you do when you see a list of assets that history says are going to underperform with 95% confidence?" Answer: "Avoid them."

While we do own a few technology companies, they currently sell at very low valuations compared to the rest of the sector with all sporting dividend yields of 2 ½% or higher. All of these companies were the tech highfliers 20 years ago during the tech bubble, but they continue to be largely ignored participants in the new technology resurgence. In short, they lost their allure. However, their intrinsic values have all grown handsomely while their stocks are selling at lower prices than their highs 18 years ago.

At the same time, the energy sector has shrunk to become a much smaller component of the broad market indices. You can see from the chart below that since 2008 the two sectors have been going in the opposite direction from a market domination standpoint. Yet it is energy where we find the greatest opportunity.

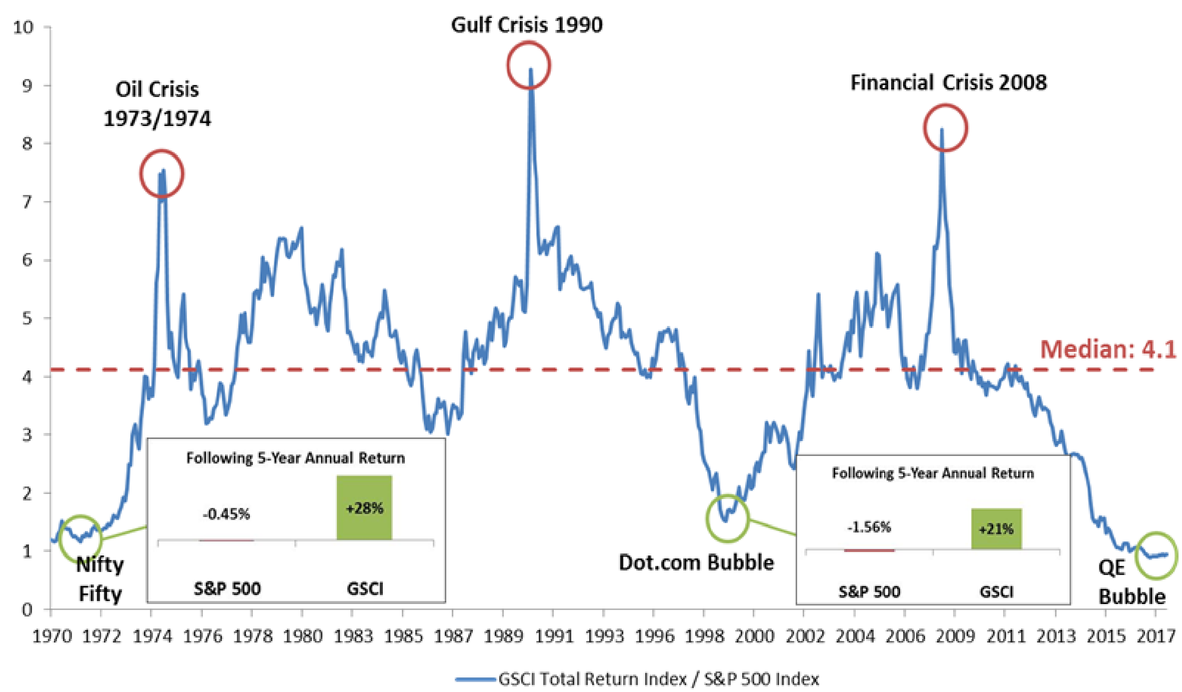


Currently, energy stocks represent over 25% of our clients' equity portfolios while only 6% of the broad market index. Even though oil prices have risen by approximately 150% from their bottom in February 2016, the energy weighting of the S&P 500 Index has actually declined during that period and remains 40% below the average level since 2000. We believe there is clear evidence that the energy markets are undergoing a significant long-term trend towards structural tightness. This tightening started almost two years ago, and while it continues to gain momentum, investors remain skeptical and unconvinced. This pessimism, combined with strong underlying tightening trends that are becoming harder and harder to reverse, present investors with an extraordinary buying opportunity. Confirming this point is the fact that the **earnings growth for the energy sector for the first quarter of 2018 is by far the highest of all 11 sectors, while at the same time, it is the third worst in stock price performance**. Our analysis has made us more convinced than ever that oil has entered a bull market, and that oil-related investments represent one of the best investment opportunities of our lifetime. Bullish fundamentals combined with continued lack of interest by equity investors make oil-related investments our highest conviction investment theme in early 2018.

<u>**The Case for Precious Metals Stocks Today**</u>

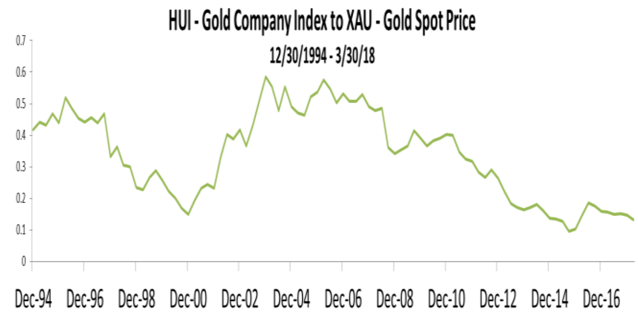
Our clients' equity portfolios generally have approximately a 10% weighting in precious metals stocks today. As the nine year stock bull market began to reach an apex last year, precious metals stocks lagged and penalized returns as they often perform counter to the broad stock market. For example, during the Global Financial Crisis ending in early 2009, the S&P 500 Index was down approximately 60% from top to bottom and during that same time, Newmont Mining stock was up 60%. More importantly, precious metal miners provide protection against the effects of aggressive central bank policy. We find these precious metals stocks extremely under-valued and likely to be some of your best performers when their improving fundamentals finally become recognized, regardless of the future direction of the overall stock market.

Two quarters ago, we presented the chart below to visually make the positive case for being exposed to commodities. Precious metals make up approximately 5% of the Goldman Sachs Commodity Index (GSCI). We have updated this chart and also included the future returns for commodities represented by the GSCI compared to the S&P 500 Stock Index. In the past, when price differentials have become this skewed, commodities have dramatically outpaced stocks. This gives us reason for optimism.

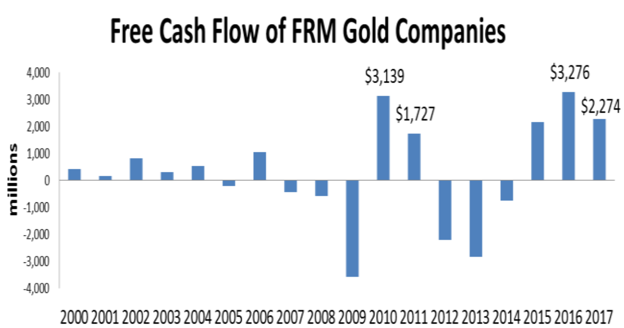


Source: Dr. Torsten Dennin, Incrementum AG

Going further, we have a chart of the gold stock index (HUI) compared to the actual price of gold to reflect how depressed the precious metals stocks are compared to the actual price of gold. This gives us confidence that there is a significant margin for safety and a strong argument for owning these stocks purely on a price basis. However, price is not the only factor, albeit important.



If it were the only important characteristic, we would own nothing but low-priced stocks selling under $1/share. What determines investment value is comparing the price of the stock to the company's ability to generate profits and free cash flow. On that point, we have included a chart reflecting the free cash flow generation of your gold mining holdings. They have recently been at higher levels of free cash flow generation than they were when gold prices peaked seven years ago at approximately $1,900 per ounce. Meanwhile the HUI Gold Stock Index is down 63% from its 2011 peak level. Today, gold prices are only around $1,330 per ounce. What this signifies is that the managements of the gold mining companies that you own have done an excellent job of reducing costs and increasing their efficiency, while the stock market has failed to appreciate this clear improvement. At the same time, managements of these companies have been emphasizing paying off debt and improving their balance sheets with this excess free cash flow rather than expanding at any cost. We believe it is only a matter of time before the market recognizes this significant improvement.



Exciting Developments at FRM

Ten years ago, the two principals and equal owners of FRM, Greg Hartz and Mark Millsap, began the process of identifying, hiring, and mentoring the next generation of investment talent for our firm. This started in January of 2008 with the hiring of Zach Riley followed shortly in August of 2008 with Chris Fleischmann coming aboard. In February of 2014, we brought on John Garmon to lead our business development efforts. Then, in January of 2015, we hired Meredith Moll to round out our investment team. All four of these young(er) people are Chartered Financial Analysts (CFAs) just like our two principals and have displayed to us and our clients tremendous investment acumen.

Greg and Mark, who are now 63 and 58, respectively, are very proud of the investment team they have assembled. So last year, the principals began to formulate a plan of **beginning** the process of allowing the younger members of our investment team to become minority owners of FRM. In the very first discussion that the principals had on this subject, they made the decision that there was one other vital component to adding new younger talented owners to the firm. That person was Abby McKelvy, our firm's CFO and Chief Compliance Officer. Abby, who is a CPA, was the first person hired after Greg and Mark joined forces in October 2001. The principals told Abby back then that they needed to be focused on their clients' portfolios, but they needed her to run the day-to-day operations of the company. She has done an outstanding job doing just that for over 16 years.

Accordingly, effective 3/28/18, Greg and Mark each sold a minority interest of FRM to five younger professionals of the firm. Their ages range from 33 to 48, and we will let you guess who is the oldest and the youngest.

So what does this mean for Greg and Mark? ABSOLUTELY NOTHING! In fact, they are confident that their best investment years at FRM are ahead of them. Greg and Mark love working for you, our clients, and nothing will change in that regard as a result of this transaction. Greg and Mark combined will continue to retain the majority ownership of FRM. What has been accomplished is that they have identified the next generation of owners of the firm and have formally **begun** that transition process. They wanted the younger professionals to think like owners, and the best way to accomplish that was to make them owners.

As you have heard so many times from us, our senior advisors have been the products of strong and generous mentoring. One of those senior advisors, Tom Hill, deserves a great deal of credit in getting us, as a firm, to this point. Tom has worked very closely with our next generation in preparation for this transition. Now is the right time to formally begin this process to take FRM to the next level. It has always been our principals' desire to transition the ownership of our firm internally rather than shopping the firm externally to the highest bidder. We believe this is the best approach for you, our clients. We are confident and excited for what the future holds. Please join with us in congratulating our firm's next generation of owners.

Romance is in the Air-Revisited

Last quarter we gave you a teaser about a budding romance within our firm. It is official. Zach Riley is formally engaged to marry Ms. Taylor Neeley this fall in Little Rock. Normally we wait until the year-end commentary to disclose personal celebrations, but we were bursting at the seams to share the good news.