FRM
FOUNDATION RESOURCE MANAGEMENT

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October 12, 2016

Quarterly Commentary

3rd Quarter 2016

FRM Research Process – From Soup to Nuts

As we have stated since the end of 2012, the fundamentals of most companies have not kept pace with the valuations the market is placing on those fundamentals. Accordingly, bargains in the investment universe have been hard to come by, which has led to more of a sellers' market than a buyers' market for stocks. For example, the third quarter of 2016 will likely produce the sixth consecutive quarter where earnings for the S&P 500 Index have declined year over year. Meanwhile, the stock market has been broadly rising during this period. This is the definition of valuation expansion.

When you look back over history, the difference between the average prices per dollars' worth of earnings that investors are willing to pay is amazing. In the hard times, investors generally are more fearful and might only be willing to pay single digit multiples for a dollar's worth of earnings. On the other hand, during more optimistic and speculative times, investors may throw caution to the wind and be willing to pay 25 or more times the same dollar's worth of profits. Currently, we are at the very high end of that spectrum, which would easily put this current market in the top 5% of all-time high valuations. The chart below is a sample of securities reflective of this valuation expansion. We display these examples in disparate industries (you can't get more dissimilar than guns and butter) to reflect this broad-based expansion of valuations for which, we believe, there is very little justification.

Raytheon	2011	2015	% Change
Sales	24,857	23,247	*-6.48%*
Earnings	1,867	2,061	*10.39%*
Earnings Per Share (EPS)	1.72	2.68	*55.81%*
Price to Earnings (PE Ratio)	8.9	16.2	*82.02%*

Campbell Soup	2011	2015	% Change
Sales	7,719	8,082	*4.70%*
Earnings	846	831	*-1.77%*
EPS	2.54	2.65	*4.33%*
PE Ratio	13.7	17.0	*24.09%*

Lockheed Martin	2011	2015	% Change
Sales	46,499	46,132	*-0.79%*
Earnings	2,667	3,605	*35.17%*
EPS	7.82	11.46	*46.55%*
PE Ratio	9.9	17.7	*78.79%*

General Mills	2011	2015	% Change
Sales	14,880	16,563	*11.31%*
Earnings	1,652	1,765	*6.85%*
EPS	2.48	2.86	*15.32%*
PE Ratio	14.7	18.6	*26.53%*

Northrop Grumman	2011	2015	% Change
Sales	26,412	23,526	*-10.93%*
Earnings	2,086	1,990	*-4.60%*
EPS	7.41	10.39	*40.22%*
PE Ratio	8.3	16.1	*93.98%*

Kellogg	2011	2015	% Change
Sales	13,198	13,525	*2.48%*
Earnings	1,231	1,258	*2.19%*
EPS	3.38	3.53	*4.44%*
PE Ratio	15.8	18.7	*18.35%*

Source: Valueline

We tell you all of this to say that lately FRM's research process has had very little visible evidence of fruitfulness. A year or so before the Financial Crisis began in 2008, we faced a similar challenge, and so this is not unique.

While we did add one new equity position during the quarter and began adding a second one on the last day of the quarter, there is little to show for our recent efforts. On the surface, to an outsider, it might look like we are not working very hard to identify and act on investment ideas. That is not the case at all. We thought it would be helpful for us to explain more in-depth what our research process looks like and the natural rhythm of weekly activity and effort on our part so you will know what we have been doing behind the scenes.

10 years ago, FRM had a two-person investment team (our two principals only) that consisted of a good deal of experience and knowledge but not a great deal of ability and know-how to gather and analyze large quantities of important financial information in a timely manner. The flow of information for us was slow and comparatively random. Fast-forward to today, and FRM has a seven person investment team (seven CFA's of which two are CPA's) that spends a great deal of time and effort each week analyzing and reviewing companies and their securities for investment opportunity. With one exception (sorry Tom Hill), we "youthanized" our firm by adding four very talented, energetic, and value-committed young folks to our staff. If you haven't hired any young people lately, we encourage you to do so. Their thirst for knowledge, hard work ethic, and their ability to harness technology is tangible and valuable.

Our weekly research effort eventually culminates in our Wednesday afternoon research meeting. We often say that time stops at FRM for our Wednesday research meeting which we consider sacrosanct to our firm's investment discipline. We sequester ourselves in our conference room with reams of research and data for this weekly exercise. If you ever need to reach one of our investment team, Wednesday after 3pm might be challenging. Research wise, FRM is on a Wednesday fiscal week, so to speak. Wednesday afternoon, however, is just the conclusion, not the beginning of our weekly research process.

Our research week actually begins on Thursday morning when our investment team is distributed a list by one of our members of securities ranked by their valuations and where their current prices compare to our estimate of each's intrinsic value as well as very specific data about each of these securities. The purpose of this information is to keep us all updated on various securities that we have valued and monitor. Currently, we have analyzed and monitor approximately 650 companies. This list consists of some semblance of under-valuation and reasonable market capitalization and trading volume.

By Thursday or Friday, we have each selected a stock that we would like to analyze. Each selection might come from our list distributed on Thursday morning, it might surface because someone has read a recent article that has piqued his or her interest, or it might come from an area in which someone has become particularly intrigued. Also, we **formally** review each existing portfolio holding at least annually, if not more frequently. Typically, as a team we will research five stocks per week. Once the five selections are made, our analysts begin assembling packets for each company to be distributed to each of the investment team members. These packets consist of very specific data we have pre-determined to be useful. This data has been tweaked over many years of performing this process. Much of the data comes from SEC filings including 10-K's, 10-Q's, proxy statements, and information from the company's website. We also have created templates for unique data that is of interest to us which is derived from the company's balance sheets, income statements, and cash flow statements. These packets are typically distributed by Friday afternoon.

We are each responsible for researching not only the company we have selected, but also the other four selected by others. Generally this will take many hours of reading and analysis per company, so weekends, and Monday and Tuesday nights, along with available office time during the day are utilized for this work. In each case, we independently determine a buy price and a sell price based on the fundamentals of the company. All five companies are presented before the group at our Wednesday afternoon meeting by each person who selected it. The investment team has complete freedom to ask any question they would like to the presenter and challenge any assumptions. Once the presentation of the security has been made by the presenter, each team member submits buy and sell targets to determine where the stock stands in relation to a potential purchase. Based on qualitative factors, a buy selection generally presents a fundamental case for a 15% annualized rate of return (hurdle rate), and a sell typically connotes a mid-to-low single digit annualized rate of return.

A few years ago after reading a book about famed value investor, Peter Cundill, called <u>There is Always Something to Do</u>, we instituted a new concept to our research process that we call our "Silver Bullet." Each investment team member has the ability to override the group's average price once per rolling year by selecting a stock to buy where the group determined a lower buy price than the current price. If a "Silver Bullet" is deployed, the two principals of the firm have the final say as to the size of this commitment in the portfolio. To date, there have only been a handful of "Silver Bullet" selections in our clients' portfolios, and almost without exception, they have been successful investments. The theory behind the "Silver Bullet" process is that, should an investment team member have such a high conviction as to override the team's valuation work, this must be something that someone believes in wholeheartedly. This helps us avoid groupthink. We are glad that we instituted this concept. Our clients have definitely benefited from this practice.

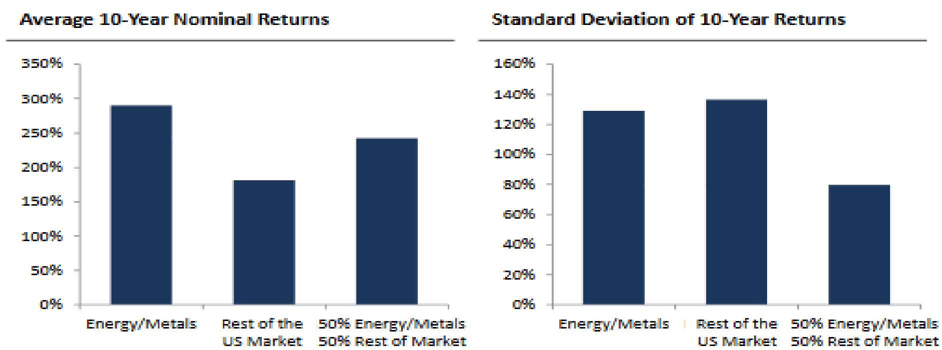
Much like a duck swimming on the water, our output that is visible to our clients may not accurately reflect our research effort.

<u>So Where Are Today's Bargains?</u>

One might think that, were the overall stock market valuations near all-time highs, all stocks would be in that shape. Not so! As the title to the aforementioned book about Peter Cundill, <u>There is Always Something to Do</u>, might suggest, bargains usually exist somewhere. Sometimes it requires a little more effort on our part to find them.

The Holy Grail in investing is higher returns with less volatility. We think there is a unique case to be made for natural resource equities today that is hard to refute, and we are positioned to take advantage of this opportunity. This "Tastes Great, Less Filling" combination is what excites us in this environment of broad market overvaluation that exists today.

While we have owned resource stocks for a while, we recently came across a series of charts from GMO that effectively drives our point home. As you can see from the chart below, since 1970, which includes diverse periods of both high and low inflation and high and low stock market valuations, resource equities have produced higher 10-year nominal returns than the rest of the market while achieving lower volatility (10-year standard deviation) than the rest of the market. Shorter term volatility for resource stocks has actually been higher, but tends to smooth out over

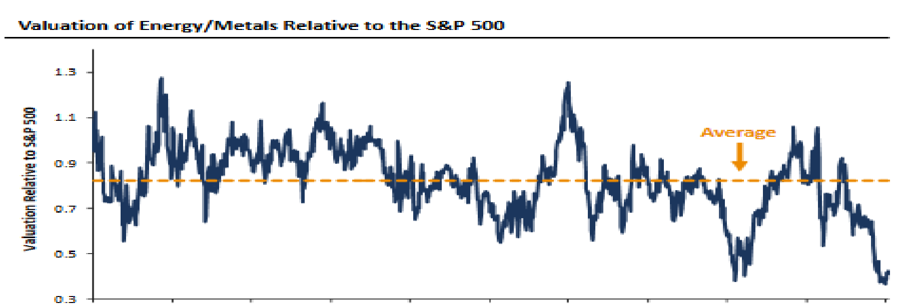


(1970 – 6/30/2016)

Source: S&P, MSCI, CRSP, GMO

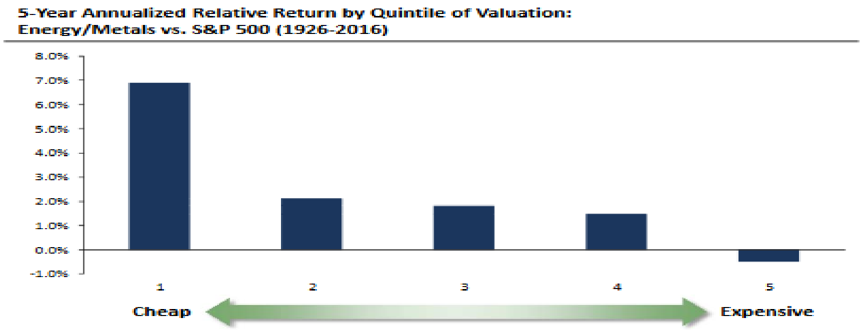
longer time periods. In the far right bars of each side of this chart, the benefits of utilizing resource equities in an equal weight to all other equities has boosted returns and substantially dampened long-term volatility. Now that's what we mean by the Holy Grail of investing!

Ordinarily, should any investment tactic such as this be proven effective over a long period, the out-performance would have already been priced into the stocks, thus eliminating the potential on which to capitalize. However, as you can see from the chart supplied by GMO below, this is not the case. Valuations for resource equities (Energy/Metals) stand at the lowest level in 90 years and would have to double in price just to get back to average valuation relative to the S&P500 Index. Keep in mind, however, that resource stocks are cyclical and can also get overvalued such as they did in 1980.



As of 6/30/16
Source: S&P, MSCI, Moody's, GMO
Valuation metric is a combination of P/E (Normalized Historical Earnings), Price to Book Value, and Dividend Yield.

On a more immediate basis, GMO has calculated in the chart below the subsequent 5 year **outperformance** of Energy/Metals stocks versus the S&P500 Index based on the then current quintiles of valuation. As you might suspect, the quintiles when these particular stocks are the cheapest (lowest 20%) such as now, have produced the most outperformance over the subsequent 5 years (7% per year **incrementa**l return).



As of 6/30/16
Source: S&P, MSCI, Moody's, GMO
Note: Due to the need for five years of forward-looking returns, the last five years of returns are not equally represented in this data.

Over the last 90 years, resource stocks have represented, on average, approximately 13% of the S&P 500 Index weighting. You can see below that factor has dropped to approximately 6% today, which would be very near the all-time low weighting over this entire period.

As of 6/30/16
Source: S&P, MSCI

We believe that resource stocks currently offer a very compelling case for excess returns while providing attractive diversification benefits, and as a bonus, inflation protection, which possibly may not be needed, but sure is nice to have. It should come as no surprise that our bottom-up research effort strongly confirms the attractiveness of resource stocks.

What is also very encouraging to us is that, during the most recent downturn in the business conditions for most resource companies, new managements have impressed us with their focus on cost-cutting, cash generation, debt reduction, and their overall financial discipline, which was lacking under old regimes preceding the 2011 cycle peak. Managements tend to make hard decisions when they have no choice, and over the last five years, many in the resource areas have had no choice.

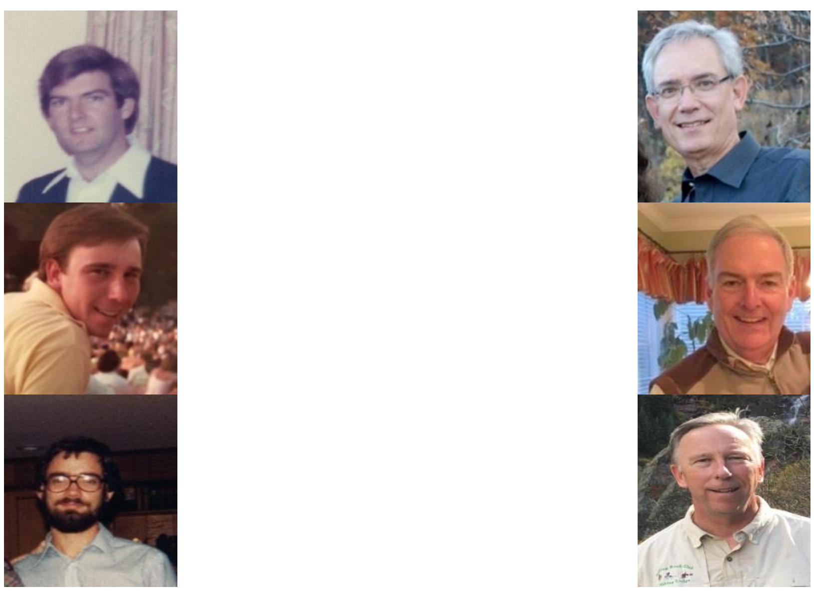
Is the Value Cycle Finally Turning?

While we are experiencing better absolute and relative returns this year, we cannot **yet** declare victory that this elusive sea-change has begun. We hope that it has, and almost all of the value benchmarks are doing better in 2016, but there is not enough evidence **yet** to make this claim. We believe the markers of just such a turn will be threefold: 1.) Interest rates returning to "normal" levels, 2.) The bursting of extreme overvaluation in popular stocks such as Facebook, Tesla, Netflix, Amazon, Google, etc., and 3.) Value stocks having an **extended** period of outperformance. The first two markers are still a no-show in the current cycle, and the third marker has not **yet** shown enough evidence for proof that the cycle has turned. The fact is that it will likely be several years after the fact before we can be assured that the value cycle has resurfaced.

What Does a 35 Year Cycle Look Like?

This month marks the official 35^{th} birthday of the current bond bull market (declining interest rates). We decided an effective way to emphasize to you the extreme duration of a 35-year cycle is displayed below. We have taken the liberty to pictorially display the before and after of a 35-year cycle and the effects such a cycle can have on human beings (I guess calling money managers human beings is the second liberty we have taken in this exercise). Originally, we were going to display this impact on all seven of our investment team members, but two of them were not even born when this phenomenon began. Therefore, we decided to just include the three of us who were actually in the workforce at the time.

Can you match the before and after?



There is not a lot more that we can say about this bond market and ultra-low interest rates that has not already been said. We were going to say, "Onward and downward is not possible." However, since interest rates in some countries have already gone below zero for the first time in world-wide recorded bond market history dating back some 5,000 years, that phrase, unbelievably, cannot be uttered.

Since it is football season, we will use a pigskin analogy for the interest rate world. We believe the Fed and central bankers around the globe are utilizing inappropriate approaches to accomplish their goals of healthy economic growth. We would liken it to utilizing a "prevent defense" in football. A prevent defense is a defensive strategy that seeks to prevent the offense from completing a long pass or scoring a touchdown in a single play and seeks to run out the clock. Many football experts would say that the only thing a "prevent defense" prevents is a victory. How many times have we seen a team deploy their traditional game plan that succeeds for 3 ½ quarters to give them the lead, only to change to the prevent defense in order not to lose and subsequently watch their defeat be snatched from the jaws of victory.

We believe the Fed's policy of maintaining ultra-low interest rates has not recognized the law of unintended consequences much like the prevent defense strategy. Historically, when interest rates fall, people spend more and save less. Low rates for this long (eight years) have actually intensified the savings urge of investors rather than stimulated the spending urge from consumers and businesses alike. Over the same period that the fed funds rate has declined from 4.25% to 0.25%, the savings rate has almost doubled. The aging demographics in the U.S. and other developed countries are leading savers to realize they cannot count on interest income to provide for retirement, so saving additional principal is the only answer.

Congratulations, Meredith!

In late July, Meredith Moll received the great news that she passed the CFA Level 3 exam. Since this is the last of a three part exam process, most importantly, Meredith is getting her life back. She has already made plans for her long Memorial Day holiday weekend for 2017 since she has not been able to enjoy that weekend and the preceding six months leading up to it for three years of her life. We are very proud of her and all of our other investment team members since we can now say that all seven of our investment team members are CFA charterholders.

FRM Email Reminder

A number of years ago, we decided that the original email domain for our firm was entirely too long, so we shortened it from foundationresourcemanagement.com to **frmlr.com**. Until this point, we have continued to receive emails with both domains, but it is time to let the old girl go. From now on, we will only be receiving emails with our first initial followed by our last name, which must now be followed by **@frmlr.com**. Most of you have already made this change, probably because your fingers got tired typing in the old domain name. Please check your email addresses for those of us with which you communicate and make this change in your contacts list. Otherwise, we may not seem like our old responsive selves in the future.