FRM
FOUNDATION RESOURCE MANAGEMENT

April 13, 2015

Quarterly Commentary

1st Quarter 2015

Have the Laws of Financial Physics Been Repealed?

Investment trends happen all the time. They typically start with little notice by the general investment community. As they gather steam in either direction, there becomes a growing awareness that a trend is in place. Articles are often written and endorsements are frequently made. “Experts” that have been on the right side of the trend are often immortalized. Sponsorship grows and that helps extend the trend beyond a normal trajectory. The concept of reversion to the mean is based on this observation. First, there is a normal condition, but then when things are abnormally positive or negative for an extended period, there is usually a gravitational pull back to trend-line. This reversion to the mean or gravitational pull is what we refer to as financial physics.

Trends typically sow the seeds of their own destruction, primarily due to the pricing mechanism resulting from changing supply and demand (Yes, Econ 101 was important). This is exactly what turns trends into cycles.

Let’s look at a full cycle from trough to peak and back again. The bottom of a cycle is characterized generally by a product, service, or asset class whose price falls below the industry’s average production costs. Typically, no productive capacity is added when prices are this low. Production typically declines as high cost production is idled or scrapped. Low cost producers restrict expansion in this environment.

The utility of the product, service, or asset class increases to the customers as the price decreases, and the customer begins to increase consumption. Prices begin to increase as decreasing supply meets increasing demand. These events improve producers’ profit margins. Wall Street begins to notice. The higher prices and increased investor attention sets the stage for the cycle’s upturn. Investment capital flows into the industry and the industry invests that capital into more productive capacity, thus increasing supply. At the peak, higher prices begin to erode the product’s utility to its consumers, thus reducing demand. This time, prices begin to decline as growing supply meets shrinking demand. Profit margins begin to shrink, and its investment image declines. Generally, share prices fall below what would be rational given the assumption of an eventual recovery. Only a few investors have the interest to notice and the courage to act.

The hard part for the investor is that you usually do not get to invest inexpensively when everything is smooth sailing.

Eventually, trends end. Most die a quiet death, but some end with great fanfare. Extreme trends are often called bubbles or depressions, depending on the direction of the trend. Their reversals can create major dislocations in the investment community.

To a value investor, well-established trends are at least questioned, and frequently challenged professionally. Some people would say that extreme long-term trends to a value investor are like a red cape to a bull. A true value discerner will at least question the general wisdom of the trend-followers. For most folks, it is often emotionally easiest to just go with the flow of the trend, but a good value investor would never invest just because others, even other purported "value investors," are following the trend. Independence of thought is highly prized by a value investor.

It seems today there are more financial trends in place than normal, and some for much longer periods than normal. Listed below are several current trend observations:

- S&P 500 Index has risen 6 consecutive years
- No 10% correction in the S&P 500 Index in 3 ½ years
- S&P 500 Index has risen 9 consecutive quarters, longest period in 17 years
- Certain U.S. stock market valuations are at highest level ever
- Interest rates are at the lowest level in almost 70 years
- Recently, gasoline prices dropped 123 days in a row, a record
- Currently, the U.S. has the highest stockpile of crude oil in over 80 years
- U.S. jobless claims are the lowest in 15 years
- U.S. margin debt is at the highest level ever
- U.S. corporate profit margins are at highest level in the country's history

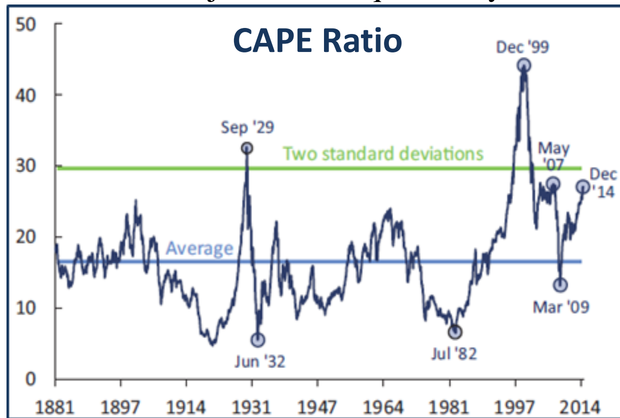
We do not believe that the natural laws of financial cycles have been repealed. Generally speaking, at turning points of trends, doing the right thing from an investment standpoint looks like the wrong thing, and doing the wrong thing typically looks like the right thing. We have observed that throughout our careers, many of our best long-term investment decisions have generally bloomed immediately after our short-term performance made us look the most foolish.

FRM Stock Research Gleanings

In the first quarter of this year, the FRM investment team performed a thorough analysis on more than 50 stocks. We typically review five per week and have, in total, performed in-depth research on almost 600 companies. Most of our stock research this quarter was on companies that we had never analyzed before but that had piqued our interest either by standing out from a statistically low valuation perspective or from information that we had found uniquely interesting on the company. A few of the companies we analyzed during the quarter were either companies that we

had previously reviewed or were current stockholdings that we reviewed for possible changes in the fundamentals. We found no stocks this quarter that were worthy of a new commitment of your capital. Only a few of the stocks that we analyzed were at truly attractive valuations, but these were within industries to which we already had sizable exposure, and we ultimately preferred our existing holdings over these newcomers. While no research effort is wasted, we find it challenging that attractive valuations of individual securities are so rare today. Why is that?

Recently, we have referred to numerous stock market valuation charts that make the case that stock prices are generally high. The updated chart on the Cyclically Adjusted Price to Earnings (CAPE) is below. As a reminder, the CAPE ratio uses the average trailing 10-year earnings adjusted for inflation to calculate the price to earnings ratio instead of using the standard trailing 1-year earnings. This chart reflects that the current stock market CAPE ratio is at the third highest level in the last 135 years. The current level would project a very unattractive nominal and inflation-adjusted subsequent 10-year annualized return.



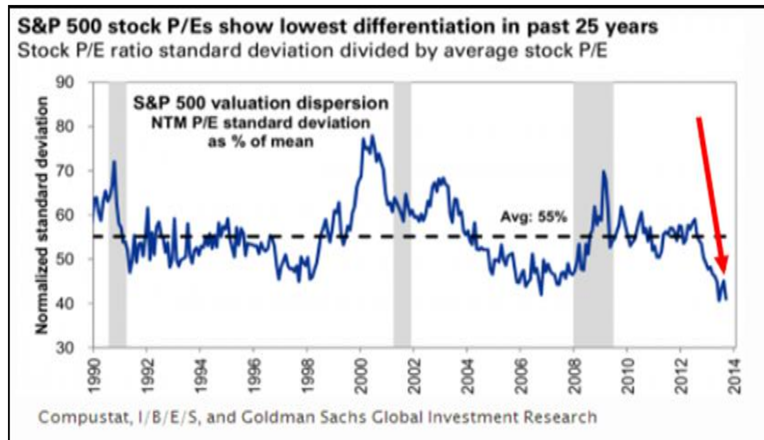
Source: Robert Shiller, Office of Financial Research

High CAPE Implies Low Future Returns

CAPE	Annualized Total Returns Per Year Over Subsequent 10-Year Period					
	Nominal (percent)			Real (percent)		
	Median	High	Low	Median	High	Low
5-10x	15.2	21.1	-0.2	11.0	20.0	1.8
10-15x	11.7	19.8	2.7	7.7	17.6	-4.1
15-20x	8.0	19.3	-0.4	6.1	16.1	-4.6
20-25x	6.0	11.7	-2.6	3.9	9.0	-4.0
25-30x	7.5	9.2	-3.4	4.9	6.5	-1.2
> 30x	1.2	7.3	-4.0	-1.1	4.5	-5.9

Source: Robert Shiller, Office of Financial Research

We would guess that you have noticed that the concentration of individual securities and, especially specific industry groups, is more than normal in your portfolio today. We believe there is a good explanation for that, but until recently seeing the accompanying charts, we had not fully grasped the macro trends that were part of the cause. While our focus is almost completely at the security level (bottom up), it is always important to comprehend the statistical makeup of the universe of companies we are exploring. While the chart beside has a strong statistical makeup, it can be rather easily explained. This chart reflects the dispersion of the stock market's



price to earnings ratio (P/E) over the last 25 years between the highest valuation stocks and the lowest. We are currently at a 25-year low, which means that there is very little differentiation among the P/E ratios of individual companies. Because valuation dispersion is very low today and overall valuation is very high today, there are fewer areas exempt from today's overvaluation.

Median price/earnings multiple for U.S. stocks*

*Based on all NYSE stocks with positive earnings for the last fiscal year calculated in June of each year since 1951 through 2014

Source: Wells Capital Management

If you look at the next chart, you will see that the **median** P/E multiple for all NYSE stocks with positive earnings is at the highest level in 65 years. This chart reflects that the current high valuation of stocks is broadly based. At the peak of the Internet Bubble in early 2000, it was relatively easy to reduce extraordinary valuation risk simply by not owning the largest sector, technology. Not so today. There are many fewer stocks and sectors today that exhibit attractive valuation characteristics resulting in a much narrower hunting ground. Accordingly, the concentration of sector weightings in our clients' portfolios has gravitated to those areas.

These charts help us understand that high stock valuations are more broadly present today than at any time in the last 65 years. This also confirms what our research effort has been telling us. The valuations of U.S. stocks are a great deal higher today than is generally perceived. The danger today is that concentrated extremes in the past tended to be more sensationalized than today's widespread high valuations. Even though a larger percentage of the stock market is aggressively priced, it has not attracted as much attention as, say, the Internet Bubble peaking in March 2000, and that would help explain current investor complacency. It is much like the frog in the kettle story. How do you boil a live frog? He will just hop out if the water is initially too hot. However, if you turn up the heat gradually, he will grow accustomed to it until eventually he is boiling.

Finally, we always try to make observations when we are seeing common activities as we explore companies in our research process. One thing that is widespread today is companies that we would say are "manufacturing" earnings per share via the stock buyback route. Every week it seems that we are looking at many companies that have not increased sales or net income markedly over the last 10 years. However, their respective share counts have declined noticeably due to buybacks, which has led to higher earnings per share. This is a form of financial

engineering and to date, there has been no major penalty for managements leveraging their balance sheets and paying too high a price for their share buybacks. We know some companies that have been extraordinarily good over long periods in their allocation of capital through timely debt issuance and share buybacks. However, when we see company after company doing the same thing at the same time, especially at a time when valuations are very high compared to historical levels, it gives us pause. The future will prove how effective this broad-based strategy has been.

One final financial observation is that we have begun to notice that when business combinations such as acquisitions are announced, both the acquiring and acquired company's stock have often been rising on the news. This phenomenon has not normally occurred throughout most of our investment careers. Typically, it is normal that the acquired company's stock rises due to the premium price offered to entice their shareholders to want to sell. However, normally the acquirer's stock sells off to reflect the premium they have to pay to make the acquisition. For us, this recent occurrence is another sign of the general optimism that pervades the financial markets today. Most investment studies reflect that the majority of acquisitions actually fail to add value for shareholders. Generally, that is because the seller knows more about what is being sold than the buyer knows about what is being bought. Caveat Emptor!

Form ADV

FRM is required by the SEC to provide to our clients a summary of material changes to our Form ADV Part 2A and 2B since our last update on March 26, 2014. If you would like to receive a complete copy of the brochure, you may request it at no charge by contacting our chief compliance officer, Abby McKelvy, at (501)604-3190 extension 3 or by emailing amckelvy@frmlr.com. See below for the Summary of Material Changes to our Form ADV Part 2A and 2B, which was updated on March 31, 2015.

Summary of Material Changes Form ADV Part 2A, Disclosure Brochure

Item 5 – Fees and Compensation

The Fees and Compensation section was updated to reflect the removal of consultation services from the fee schedule.

Summary of Material Changes to Form ADV Part 2B, Brochure Supplement

This section was updated to include the biographical information of Meredith Moll, research analyst, hired on January 1, 2015 and to include the biographical information of Abby McKelvy, chief compliance officer and chief financial officer.