

Quarterly Commentary

2nd Quarter 2015

When All Else Fails ...

In less than ninety days, our equity investment track record will span 25 years. We believe that the knowledge, experience and humility gained along the way will benefit our clients for years to come.

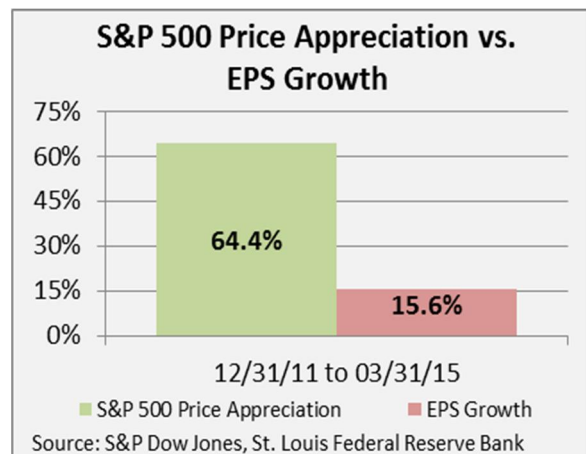
Throughout most of that quarter of a century and decades before, there has been somewhat of a normal business cycle in place. The normal business expansion would typically end when inventory build-up or an interruption in demand (e.g. when Saddam Hussein invaded Kuwait in 1990) would cause a back-up in the supply chain. Through the passage of time (possibly the most important ingredient), or the implementation of monetary and/or fiscal measures, the post-WWII secular growth trend would continue.

Political deadlock, bureaucratic waste and incompetence and now a huge debt overhang have made it more and more difficult to respond with timely and effective fiscal measures to spur growth. Since the financial crisis of 2008-2009, we have also had an anti-growth environment in Washington of increased regulation and increased taxes. Enter the Federal Reserve, ever more quick to respond and ever more confident in doing so. They remind us of the home plate umpire that becomes the game instead of inconspicuously calling the balls and strikes. Since the stock market crash of October 1987, the Federal Reserve has gotten more and more aggressive in addressing threats to the economy, both real and perceived (remember Y2K?). Any discussion of economic measures to aid the economy today seems to begin (and end) with monetary policy and what steps the Fed will take. The increasing number of economists attempting to dissect any clues from the Fed's most recent pronouncements is one of the few growth sectors in the job market. It seems that all of this attention has gone to its head, because the Fed seems more and more confident that they are in full control of interest rates and the economy. We are not convinced that is the case in the long-term.

Over most of the last decade, the federal government has tried to achieve economic growth by spending money like drunken sailors and by printing money at unprecedented rates. We are waiting for someone in Washington to admit that these tactics have not returned us to our long-

term rate of economic growth. The stimulus spending programs begun under President Bush and expanded under President Obama have added greatly to the total debt, which now stands at more than \$18 trillion. Since the Great Recession, the growth rate of GDP has experienced fits and sputters to the point that we have annualized 2.10% growth compared to our long-term average expansion growth rate of 4.56% for the post-war years. Growth rates in Europe have been significantly worse than ours during this period, while growth for China has slowed, leaving India as the primary bright spot for growth in the world economy over the last year.

As the stock market has continued to climb in this environment, it has made for an investment landscape that is fraught with risk. The complacency evident in the stock market today seems to ignore the fact that real economic growth and improving corporate fundamentals are necessary ingredients for long-term stock market wealth creation. Part of the Fed's admitted strategy has been to pump up asset prices so that consumers will have the confidence to spend more. This "wealth effect" desired by the Fed has only been partly achieved. The Fed has definitely been successful in driving up stock and other asset prices, but not so successful in producing economic growth and employment (see chart above). The result is increased investment risk in the form of very high valuations for stocks and bonds compared to historical norms (see 1st Quarter 2015 Commentary for a full discussion). Slow, sporadic growth has provided FRM with an investment headwind that has made performance difficult for us and for many other value investors as well. Prior to the financial crisis of 2008-2009, we could always count on a cyclically strong rebound in the economy to aid fundamental operating performance of our companies.



Given this backdrop of slow to non-existent growth, we have received several inquiries from clients in the last few months asking about our willingness to change what we are doing and whether we are just being dogmatic in sticking with our approach. Our answer is that we do spend much time trying to test or disprove our investment thesis and questioning what could go wrong prior to taking a position, while holding that position and when we consider its sale. Hopefully, our clients know us well enough to know that any perceived intransigence is not from arrogance or pride. We know that we have limitations, and we believe humility is a necessary ingredient for doing a good job for our clients. For that reason, we will always endeavor to maintain an open mind.

Our discipline is the most proven, time-tested, documented and successful methodology for investment selection. It is the only one we are trained in and the only one we are willing to employ for managing your assets. Any investment security analysis that goes beyond speculation must employ the formation of an analytical case in an Internal Rate of Return or Net

Present Value type framework. These models are taught in elementary finance to discern rewarding investments from those that are less rewarding or those that lack any promise at all. You may have heard the terms "hurdle rate" or "cap rate" being bandied about by certain finance types. The hurdle rate is simply the rate of return an investor demands below which he is not willing to invest. In the internal rate of return analysis, cash outflows and inflows derive the rate of return. The net present value analysis is simply the reverse of the internal rate of return analysis and employs the cap rate (capitalization rate or discount rate) to discount the anticipated cash flows to a present value which is then compared to the net present value of other investment alternatives. The lower the cap rate employed, the more risk the investor is undertaking by virtue of accepting a lower return.

It is in building these analytical frameworks that we do admit to being unwilling to compromise. As we have attempted to explain several times in the last few years, the Fed's rigged zero percent interest rate policy of soon-to-be 7 years (you may see this referred to as ZIRP) has caused many investors to lower their rate of demanded return used in these models. We witness cap rates in the neighborhood of 3% in stocks and hear anecdotal evidence of the same in commercial, multi-family and farm rental real estate. Investors that take on this type of risk are assuming that there will not be a reversion to, toward or above the mean historical average rate used in these models for many, many years to come. We are unwilling to accept that risk.

Any investment discipline is going to be hard-pressed to produce attractive results over the long-term in an environment where real economic wealth is stagnant or declining. Our country desperately needs to grow its way out of the debt that we have amassed over the last 15 years. At current count, there are 19 announced candidates for the 2016 election of President of the United States, with at least a couple more probable additions to the field. While it is still early and we are not yet bombarded with television and radio ads (count your blessings), we do not hear a lot of discussion about economic growth among the candidates. When all else fails, we hope someone will try growth.

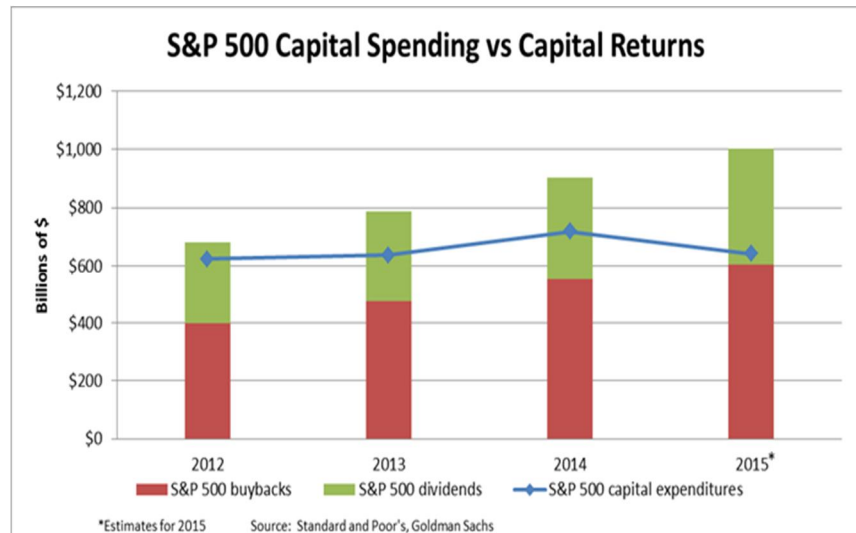
Financial Engineering and the Destruction of Capital

Hopefully that catchy heading made you curious to want to read more! We try to avoid using the lingo of our profession when communicating with our clients, both verbally and in our writings. We hope you will let us know when we are guilty of that. We always try to beat the competition when it comes to communication and service, the two areas of our business we can control. However, some of our work does involve financial concepts (see above) that we do our best to explain. We recognize that most of our clients do not sit around thinking about such things on a daily basis as we do.

A new one that has made its way onto our vocabulary radar screen lately is the term "financial engineering." The narrow definition of this concept (and the one we will stick with here) refers to something we have discussed with you before, the re-purchase of stock by public corporations

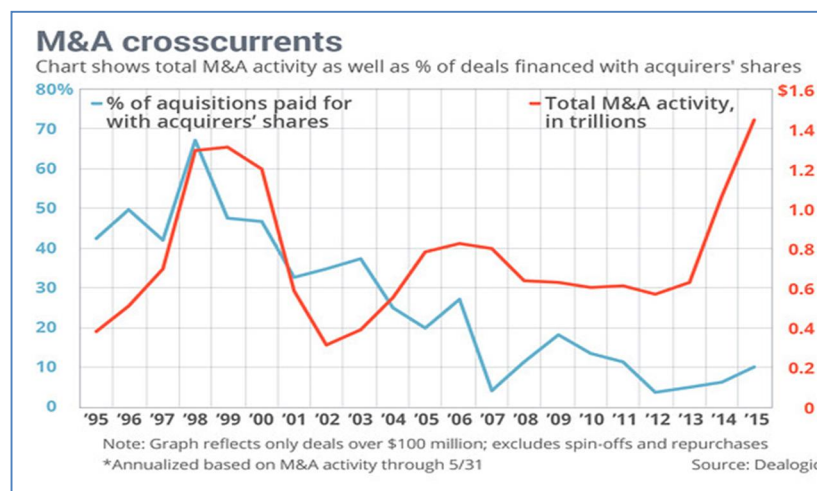
to boost earnings per share. It is a mathematical truism that if profits remain the same (numerator), but the number of shares is reduced (denominator), then earnings per share will rise, and voilà, the same price-earnings multiplier will result in a higher stock price. Is this a great country or what?

Unfortunately, it's not that simple, though it seems to be in today's market environment. Because most stock re-purchases are made when companies' operations are profitable and performing well, high stock prices usually reflect the good results that are being enjoyed. As we have discussed in the past, most managements have proven



to be totally insensitive to price when buying their own stock back (it just might have something to do with the fact that a large portion of their compensation is in company stock). They currently continue this practice at valuation levels that are very high at the expense of growing dividends or making capital expenditures, as the chart above reflects.

With the stagnation in the growth of revenues and profits for a large majority of public companies, managements have turned to mergers and acquisitions (M&A) for profit growth.



We often view M&A as another form of financial engineering. It seems to us that merger and acquisition activity is much more interesting to most managements of public companies these days than actually building and growing businesses internally. There is a lot of M&A business happening, and it is being done with low interest rate financing.

The preference is to borrow money and use the cash to make the acquisitions (see chart above).

The accounting for acquisitions works like this in its simplest form: the acquiring company almost always pays a price in excess of book value of the shareholder's equity in the company.

The excess is assigned to various tangible and intangible assets to bring them up to the fair market value of the assets. Most of the intangible assets may not have even been stated on the books prior to the acquisition (e.g. a proprietary customer list). Once all of these fair values have been assigned, the excess paid in the purchase price over these fair values is assigned to goodwill (a different form of intangible asset, but intangible nonetheless). Tangible book value of S&P 500 companies (excludes intangible assets) has increased by only 13.7% over the last three and a half years, while the intangible portion of book value for those same companies has increased 26.3%. In our experience, large assignments of value to intangible assets and goodwill are a red flag for past overpayment of the purchase price. Just by their subjective and intangible nature, values assigned to intangible assets and goodwill are dubious. Many of these values received proper scrutiny in the Great Recession. Huge charge-offs of these assets were taken at that time. It was evidence of their real value that corporate accounting types were finally willing to admit to the true value of their intangibles by charging them off at a convenient time when operating profits were already suffering. The charge-offs of 2008 and 2009 followed the time honored tradition of dumping all of the bad news into periods when the news was not going to be pleasant anyway. Thus overpayment for acquisitions is one way that many corporate managements are destroying capital today.

The insensitivity to price usually results in paying more than book value per share for the stock, usually multiples of book value per share. The impact on the financial statements is a reduction of cash and a reduction of book value. The reduction in shares at prices over book value reduces the book value for the remaining shareholders by a disproportionate amount. This destroys tangible capital and any intangible assets on the balance sheet increase relative to the amount of tangible assets. Additionally, debt relative to tangible assets increases.

As we go through the process of analyzing companies and updating our research, we are witnessing tangible capital destruction through buybacks and M&A many more times than we would like. We don't know where these financial engineers studied engineering, but it is not the kind of engineering that makes for a strong company. We've yet to see dividends paid or bonds redeemed using goodwill and intangible assets.