FOUNDATION RESOURCE MANAGEMENT

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Quarterly Commentary

3rd Quarter 2018

Slow is Smooth, and Smooth is Fast

Over the last decade or so, our firm has supported our country's military troops overseas by adopting units through an organization called **AnySoldier.com**. We ship them supplies on a monthly basis such as personal hygiene items, socks, books, magazines, food, etc.; anything to help make their lives a little easier and let them know that they are appreciated and not forgotten. If you have an interest for yourself or your organization, check out the website above. It is easy and has become a most-rewarding service project for the FRM family. We are inspired by the feedback we receive from these fine men and women soldiers. Some in our firm have also become involved over the last several years in helping support Special Operations military personnel returning from active combat to the states in order to heal both physically and emotionally from the stress of battle. In our time with the soldiers, we quickly realize that there is another language that they use to communicate succinctly, but that is absolutely unfamiliar to civilians like ourselves. Sometimes it involves acronyms that mean nothing to us but have a clear meaning to them. Other times it involves phrases that seem confusing or even contradictory when first heard, but whose meaning becomes clearer as it becomes more commonly used. Such is the title of this paragraph, "Slow is Smooth, and Smooth is Fast."

This term was created by U.S. Special Forces operators to describe an effective urban warfare strategy. Mobility is the key to modern infantry combat. If a soldier is unable to advance, they get pinned down by the enemy; however, if they move too fast, the soldier may get surrounded or might possibly out-run their supply and support chains. An effective team will advance slowly but steadily through an urban environment. An elite infantry team will advance at a pace somewhere between a walk and a run, constantly scanning the battlefield in every direction looking for anything out of place that could be a threat. This entire formation glides from point to point like the proverbial tortoise, made famous in the ancient Aesop's Fable story, "The Tortoise and the Hare."

Milo Winter (1919)

Do you remember the first time you read or heard the story of the Tortoise and the Hare as a child? Who did you relate to - the steadily plodding tortoise or the fast, brash, over-confident hare? As value investors, we naturally connect with the tortoise. Slow and steady wins the race. There are times when the hare races ahead, mocking the tortoise and anything in his path. There are investment times like now, as we are officially in the longest bull market in U.S. stock market history, that we see many hares speeding along the course soaking up the cheers of the fans. Companies like Tesla and WeWork (discussed later), whose valuations make no sense to us, are being led by charismatic leaders with whom investors have become enamored. Similarly, folks are frequently asking us about Canadian pot stocks much like Bitcoin a year ago which, by the way, is down over 65% from its peak price then. These are hares if we ever saw one. Stocks are about the only thing where most people become more interested - the higher the price goes. In today's immediate gratification investment world, patience is a rare commodity, but one that we value highly. Go tortoise, go!

Our role as your investment manager is to protect you against the threats that we observe as well as to take investment ground as steadily as possible. There are times when the threats are widespread, but not easily seen because investors are enthusiastically caught up in the moment and have dropped their guard. Likewise, there are times when threats may seem intolerable for investors, but because of their fear, they are unable to see the opportunities staring them in the face. It is always important for us to provide perspective so that when certain conditions exist, we are able to assess, recognize, and act in a prudent manner that is beneficial to your long-term financial well-being. As a long-term value investor, we truly believe that slow is smooth, and smooth is fast.

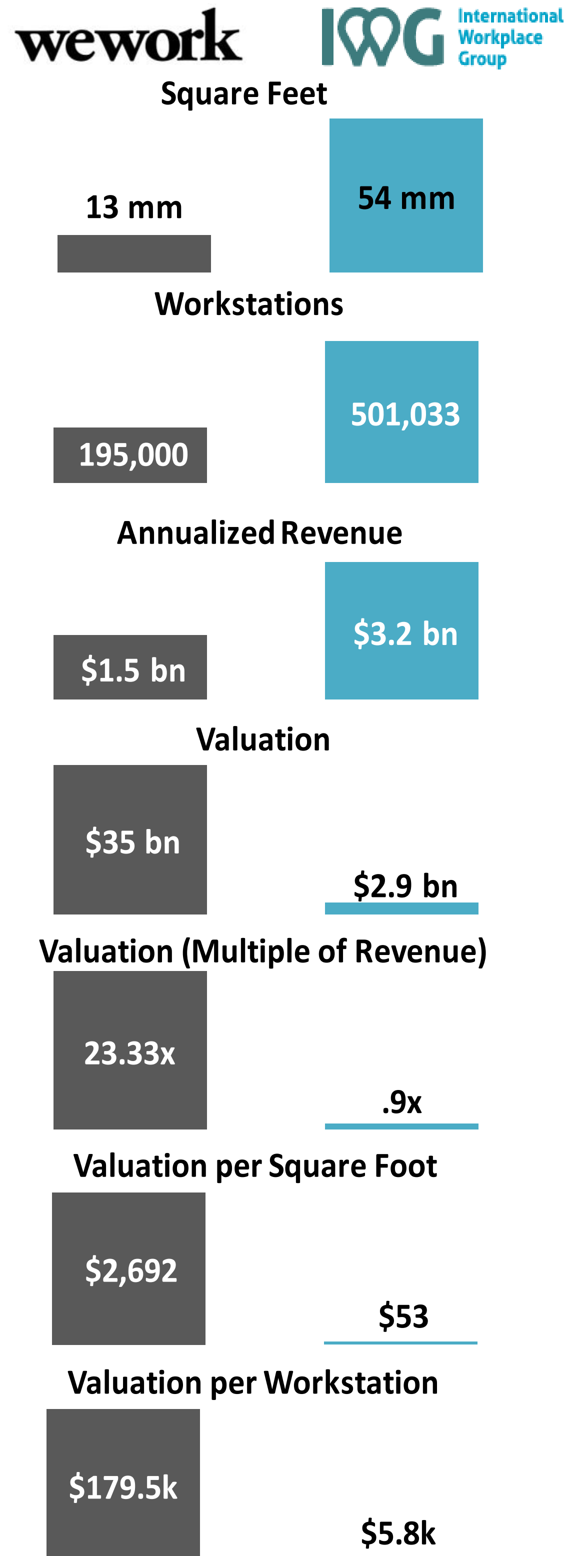
The Unintended Consequences of Global Central Bank Actions

For the last several years, we have expressed our concern about the unintended consequences that could result from the unprecedented, myopically aggressive, and synchronized behavior of the major central banks (U.S. Federal Reserve Bank, European Central Bank, and Bank of Japan). Since this coordinated activity is unprecedented, no one can say with assurance what the end result will be. As central banks have bought up assets, we believe they have artificially repressed interest rates, upwardly rigged asset prices for equities, bonds, and real estate and provided the fuel for the huge expansion of government, corporate, and personal debt that has occurred over the last two decades. 20 years ago, there was an estimated $40 trillion of debt in the world, and today there is approximately $250 trillion, which is approximately a 10% compounded annualized growth rate. In that same period, financial leverage has risen from 1.3 times income to 3.3 times. When money is free, or at the very least cheap, borrowing costs very little and is more widely accepted. By suppressing interest rates, central banks have inadvertently encouraged risk-taking and unbridled borrowing. Broadly speaking, financial discipline is reduced or even abandoned if/when interest rates are not allowed to float freely in the marketplace. Change is on the horizon, however, as the Fed has been slowly raising rates to reflect general economic strength and has only just begun to reduce its excessive balance sheet. It is anticipated that the other major central banks are likely to follow suit. This would argue for more normal valuations in all asset classes around the globe.

Valuations That Make No Sense

We previously mentioned WeWork Cos. as a current example of the unintended side effect of the current loose money environment. WeWork is a Silicon Valley-style start-up company that provides a "physical social network" for millennials. WeWork takes on long-term leases for raw office space and builds out the interior with flexible spaces and modern design that it then subleases for terms as short as a month. This reminds us a little of the old savings & loan industry model of borrowing short and lending long that ended tragically around 35 years ago. There is a complete mismatch between assets and liabilities. It works great until it doesn't.

WeWork is run by an extremely charismatic, hyper-promotional leader named Adam Neumann who is a rock star to his followers, wearing jeans and tee shirts and regularly drinking tequila with his tenants. He is a cool visionary, something investors seem to be looking for these days. Almost hare-like. Good old-fashioned tortoise-like profitability does not seem to be of much value to many investors these days. We guess that is a good thing for Neumann since WeWork, admittedly a young company, has never been profitable, and its prospects for such are not anticipated anytime soon. Our purpose in mentioning this company is to highlight it as a proxy for the mass speculation that proliferates in today's markets. Beside, you will see a comparison of estimates (based on a recent fundraising effort since the company is still private) of statistical measures of WeWork versus one of its much more experienced competitors, International Workplace Group (IWG). IWG went public 18 years ago, and their business is substantially bigger than WeWork but is valued in many ways at a minor fraction of WeWork. To us, WeWork's valuations make no sense. We guess that is another sign of us resembling a slow moving, but purposeful turtle.



Source: Company filings, news reports, Bloomberg

Which Company Would You Rather Own?

As a follow-up, we present below a comparison of valuations of two companies in the same industry and ask you which one you would rather own.

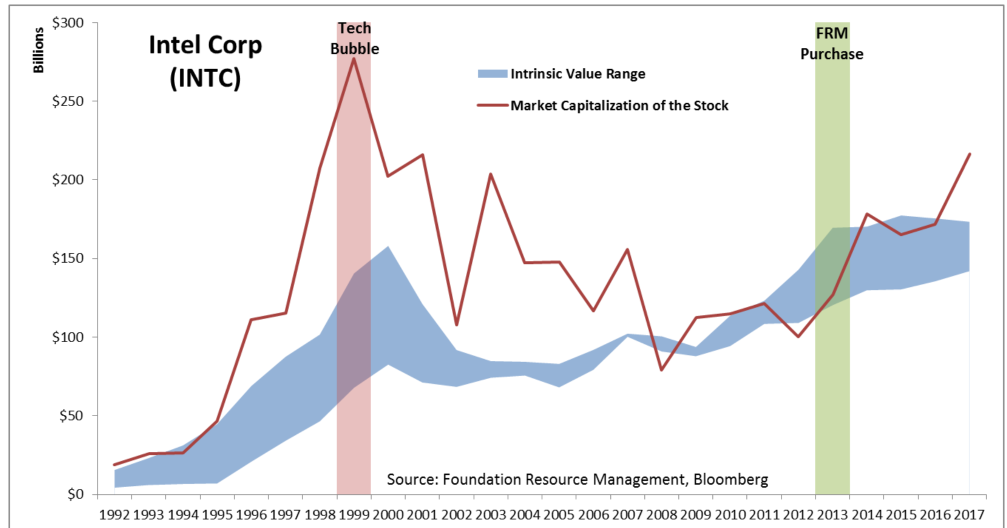
	Company One	Company Two
Market Value of Stock ($mm)	**$277,180**	**$127,155**
5-Year Average Revenues ($mm)	**$23,556**	**$47,760**
5-Year Annualized Revenue Growth	***20.6%***	***7.0%***
Multiple of Revenues	*11.77x*	*2.66x*
5-Year Average Earnings ($mm)	**$5,810**	**$9,880**
Multiple of Earnings	*47.71x*	*12.87x*
5-Year Average Free Cash Flow ($mm)	**$5,213**	**$9,252**
Multiple of FCF	*53.17x*	*13.74x*
5-Year Average Return on Equity	**32.4%**	**21.8%**
Multiple of Book Equity Value	*8.52x*	*2.18x*

Source: Foundation Resource Management, Bloomberg

If you picked #2, we would agree wholeheartedly with you. To make our point on valuation, we have been a little sneaky in comparing our two offerings. They are actually the same company, **Intel**. However, the time periods were different and the attitudes of investors were entirely different. In the first column, you see Intel's valuations during the "Tech Bubble" in late1999. Intel was considered one of the most successful companies of all-time in 1999, much like Apple and Amazon, the first two American companies to crack the trillion-dollar market capitalization club. In 1999, Intel was trading at obscenely high valuations (sounds eerily like our previous write-up on WeWork). We could not make sense of Intel's valuations then even though we acknowledged at the time that it was a great business, unlike our attitude about WeWork, which has never made a profit.

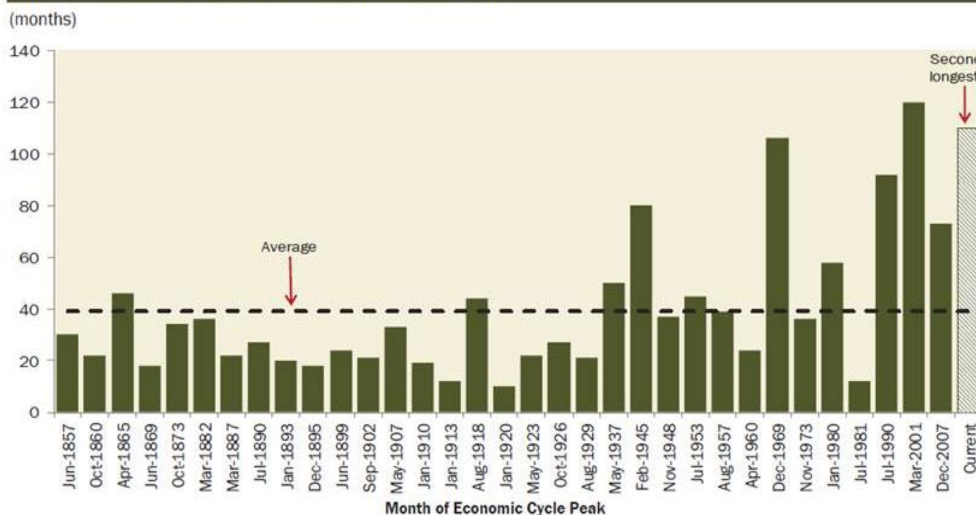
Over the next 14 years through 2013, Intel continued to be a great business and the chart on the next page reflects that the company continued to grow its intrinsic value. Meanwhile, the stock continued to decline. In 1999, we never dreamed that we would have the opportunity to own this great company at a great price. The graph shows that our patience paid off as the stock price finally dropped below our estimate of intrinsic value in late 2012 and 2013, which is when we purchased it for our clients. During that 14-year period of waiting, our estimate of the company's intrinsic value grew by approximately 38%, meanwhile, the stock price, which peaked at $75 per share in the summer of 2000, dropped by 70%. In the five years that we have owned Intel, its intrinsic value has grown by 15%, but the stock price has risen by 103%, which puts the stock closer to our sell price than our buy price. We have included this exercise to demonstrate that the price paid for a stock relative to its intrinsic value is critical in determining the ultimate success or failure of an investment.

We have spent our careers as security analysts in determining our estimate of the intrinsic value of a company and then comparing that estimate to the stock price to determine the potential for an investment in the stock to become a successful investment. It is generally a better exercise to value a company without even knowing the current stock price in order to avoid a potential bias. Determining the intrinsic value of a company is more of an art than a science. There are many factors useful in this exercise. We have included just three measures of valuation (Price to Book, Price to Cash Flow, and Price to Earnings) to create the blue shaded range of intrinsic value for our Intel example on the nearby chart. There are many other forms of valuation that we typically utilize which we have excluded from this example for the sake of simplicity. A great company at a high price will not likely make a successful investment, but a great company at a great price is the Holy Grail of investing. That is why we never gave up on Intel when its valuations were in the stratosphere. No true tortoise ever would.



Economic Cycles Have Not Been Repealed

Throughout our careers, we have recognized that the economic cycle and the stock market cycle are intertwined. Stock prices are generally considered a leading economic indicator predicting forthcoming good and bad economic times. Historically, an average economic cycle would occur within a three or four year period. This cycle would encompass an economic recovery followed by a period of economic prosperity, which would then become over-extended and lead to a recession. Much of our valuation work entails a decade of past activity so that we can consider how a company has performed in the past during good and



Source: National Bureau of Economic Research, Gluskin Sheff

bad economic conditions. As mentioned previously, we are now in the longest stock bull market in U.S. history starting in March of 2009. Likewise, as is shown in the graph on the previous page, we are now in an exceedingly long economic expansion, the second longest in U.S. history, only being surpassed by the 1990s expansion. Also from the chart, it is evident that economic cycles are getting longer. As a result, our traditional analytical exercise of including 10 years of historical data is about to inadvertently eliminate any general period of economic weakness for the U.S. economy. Unlike Janet Yellen, we do believe that we are likely to see another financial crisis in our lifetime, assuming the proverbial Mack truck does not take us out tomorrow. We will be amending some of our statistical parameters to continue to encompass periods of economic weakness as well as periods of relative economic prosperity. We do not believe that economic cycles have been repealed.

Important Disclosure Information

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by FRM), or any non-investment related content, made reference to directly or indirectly in this commentary will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this commentary serves as the receipt of, or as a substitute for, personalized investment advice from FRM.

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