FRM
FOUNDATION RESOURCE MANAGEMENT

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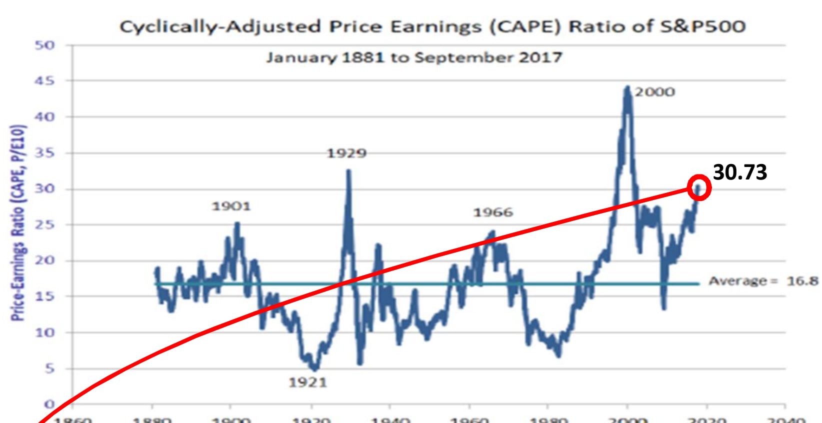
Quarterly Commentary

3rd Quarter 2017

We Are Not Optimists, We Are Not Pessimists, We Are Realists!

As investors for more than three decades, one lesson we have solidly learned is that things generally happen in cycles. It is exceedingly rare that markets, economies, businesses, and even investor moods go only in one direction. Our job as your investment manager is to "call it like we see it" by identifying when cycles have been taken too far in one direction and then find ways to capitalize. The chart below reflects how current valuations could lead to disappointing future returns. Our work over the last several years has led us to **appear** more pessimistic and cautious than the average investor, but it is only because of widespread optimism in the markets and based squarely on valuations. Because of the high valuations in the market today, we have had limited success in discovering new investment opportunities with high expected returns. Most investors today are complacent and exhibit a high risk tolerance. Stocks have been in a bull market for over 100 months without a 20% correction (second longest in U.S. stock market history), and the S&P 500 Index just completed its 8th consecutive quarter of appreciation, both very rare occurrences indeed.



Source: Robert Shiller

CAPE	Annualized Total Returns Per Year Over Subsequent 10-Year Period — Nominal (percent) Median	High	Low
5-10x	15.2	21.1	-0.2
10-15x	11.7	19.8	2.7
15-20x	8.0	19.3	-0.4
20-25x	6.0	11.7	-2.6
25-30x	7.5	9.2	-3.4
>30x	1.2	7.3	-4.0

Source: OFR analysis

Meanwhile, although interest rates have recently risen slightly from very low levels, the current bull market for bonds is more than 35 years old. Optimism in financial assets abounds.

More seasoned clients may need to be reminded, and it may be news to newer clients, but we probably **appeared** to be cockeyed optimists during the financial crisis nine years ago. Remember, this was a time of chaotic financial duress around the world, quite the opposite from today. In the 3rd and 4th quarter of 2008, the last bear market for U.S. stocks, we said:

> **"There are many opportunities today that, only six months ago, we thought we would never have the chance to purchase at our required levels. Do you remember last quarter when we said that there were numerous stocks that could provide a 6-7% annualized return, but that we were interested in stocks that could provide a 15% return? Well, guess what! We are now finding stocks that are at or near those levels. Can you hear the tone of enthusiasm in our voice?"**
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> **"When the investment community hears that stock prices are falling, we hear that the price of owning those businesses is getting more attractive."**
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> **"Currently, we are as bullish as we have ever been. We strongly believe that once the current credit contraction subsides, stock market participants will once again focus on the attractive fundamentals our companies represent. It is our opinion that if you have funds to add to equities for our management, you should do so immediately. Sir John Templeton, noted global value investor, always stated that the most profitable time to invest was at the point of maximum pessimism. We believe we are nearing this point. Historically, times of maximum duress in the market have been followed subsequently by large gains. While we do not want to imply that this is a certainty, we would not be surprised if this happened."**
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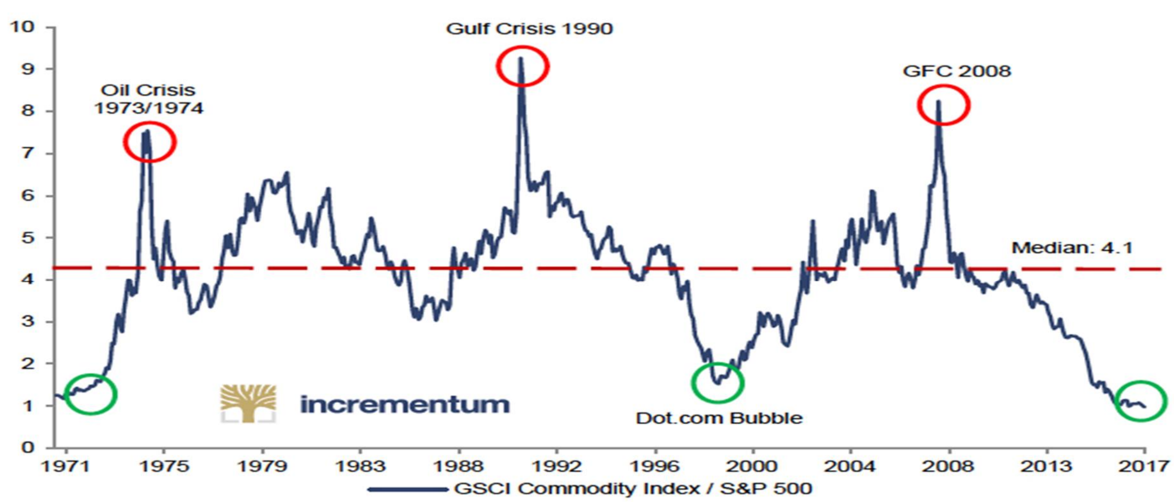
> **"As we opined to you at the end of the third quarter, we believe that security valuations currently reflect bargains that we have rarely seen before. Low valuations are the key ingredient to attractive future returns."**

During the 4th quarter of 2008 alone, we purchased five new stock positions and added to numerous existing positions. As we like to say, it was like drinking water through a fire hose. From the bottom of that market cycle through last quarter end, the S&P 500 Index has produced compounded annualized returns of over 16%. All of this is to remind you that we always attempt to be realists when it comes to how stock market valuations dictate future returns.

Conditions today are quite the opposite compared to what we experienced nine years ago. Valuations today are very high, future broad stock market returns are mathematically projected (at least by us) to be quite low, optimism is pervasive, speculation persists, and the driving ingredient, interest rates, are artificially very low. It is times like this where we are reminded of a quote from a very successful and outspoken value investor, Jim Rogers, who said the following: "When things are going right, we all need a 26-year old. There's nothing better than a 26-year old in a great bull market, especially a bubble. They're fearless. They don't know it will ever end. They will tell you why it will never end. So in the bull market, you've got to have a 26-year old. But when they end you don't want the 26-year old around…they make a lot of money. They don't know why they made money. So they don't know why they lose money. They don't know what happened." The cycles we have described ranging from extreme pessimism to extreme optimism reflect an old quote, "History doesn't repeat itself, but it often rhymes." Our role is to not get caught up in the optimism or pessimism of its time, but to be realistic about current conditions.

Where Are Today's Bargains?

The chart below is the kind of chart that gets our attention as a value investor. It is a 46 year chart that compares the price of a basket of diverse commodities (oil, gold, copper, soybeans, fertilizer, cattle, etc. represented by the Goldman Sachs Commodity Index) with stock prices (as measured by the S&P 500 Index). As you can see, there have been massive swings in the last 46 years when investors favor one asset class over the other. The range has been from 1 to 9 with a median of 4.1. Currently, commodities are the most under-valued they have ever been in



Source: Dr. Torsten Dennin, Incrementum AG

46 years when compared to stock prices. Just to get back to the median, commodities would have to appreciate 4 fold compared to stocks. As we said earlier, we take what the market offers, so this chart reflects why we are overweight the stocks of numerous commodity producers. We were encouraged that our strong performance this past quarter was primarily due to renewed strength in our commodity stocks. Low prices are the best cure for low prices by limiting supply and stimulating demand. We believe this is a rare investment opportunity, or as Warren Buffett talks about, a fat pitch right over the middle of the plate.

Electric Vehicles and Their Immediate Impact on Oil Consumption

We have, and you probably have also, read many articles recently about how electric vehicles will soon be making internal combustion engine-powered vehicles obsolete. As it pertains to worldwide oil consumption, we believe the facts conflict with this widespread belief. It is our opinion that the increased demand for car travel from the growing middle class in emerging economies will, for some time, overpower the effects of increased acceptance of electric vehicles. It is possible that one day electric vehicles (EVs) could eventually replace the global fleet of internal combustion engines. Over the next 20-30 years that could very well be the case, but it is unlikely within any reasonable time frame (ten years or less) for an investor.

First of all, automobile demand represents only approximately 20% of overall oil consumption. We believe that the facts challenge the belief that electric car adoption will even make a dent in oil demand growth near-term. The greater threat to oil consumption growth is likely to be improving mileage results from new internal combustion engines.

The global fleet of passenger vehicles is currently roughly 1.2 billion with electric vehicles representing only 0.25% of that number (3 million). On a sales basis, electric cars made up approximately 1% of annual sales last year. In order to make a material dent in oil demand 10 years from now (for example 10% of the global fleet in the next 10 years) electric vehicle sales would have to grow by approximately 44% per year each year for the next 10 years to get to 42.5 million EVs sold in 2027. This is versus only 753,000 last year. 42.5 million EVs sold would represent roughly 50% of the 2027 run rate of sales. Furthermore, over the time frame

What kind of growth would it take for Electric Vehicles (EV) to be 50% of new car sales 10 years from now?

Current Global Fleet: 1.2 billion — Current Electic Fleet: 3 million (0.25%)

Year	Total New Vehicles	Internal Combustion Engine	Electric Vehicle*	% of Total	% Growth
2016	68,470,000	67,716,830	753,170	1%	
2017	69,839,400	68,752,519	1,086,881	2%	44%
2018	71,236,188	69,667,737	1,568,451	2%	44%
2019	72,660,912	70,397,518	2,263,394	3%	44%
2020	74,114,130	70,847,883	3,266,247	4%	44%
2021	75,596,413	70,882,971	4,713,441	6%	44%
2022	77,108,341	70,306,490	6,801,851	9%	44%
2023	78,650,508	68,834,924	9,815,584	12%	44%
2024	80,223,518	66,058,890	14,164,628	18%	44%
2025	81,827,988	61,387,363	20,440,626	25%	44%
2026	83,464,548	53,967,184	29,497,364	35%	44%
2027	85,133,839	42,566,920	42,566,919	50%	44%
Total	918,325,784	781,387,228	136,938,556	15%	

Source: IEA, OECD, Foundation Resource Management Calculations *EV figures include both battery powered and plug-in hybrid reflected in the chart, approximately 781 million additional internal combustion vehicles compared to only 137 million EVs would have been sold. Therefore, there is no linear relationship between EV sales growth and oil demand erosion. The global fleet typically grows at a GDP type growth rate of 2% per year. By the way, our projection of consumer switching to EVs is extremely aggressive making our case even more probable. Virtually every forecaster we can find does not have EV sales representing 50% of total worldwide auto sales until 2040 versus 2027 as our model suggests.

Another factor that must be considered is that, to date, EV sales have been supported by government subsidies. Recently, when government subsidies ended, EV sales were severely impacted. In Hong Kong, Tesla sales dropped to zero in April of 2017 from 3,000 the month before as their government ended a tax break, which suddenly resulted in the car becoming 73% more expensive. In Denmark, government phase outs of EV subsidies led to a 60% year over year decline in EV sales. Tesla's $7,500 tax credit subsidy per vehicle sold in the U.S. is scheduled to be phased out next year when they cross the 200,000 vehicle sale threshold with the introduction of the new Model 3. We shall see whether sales trends hold up if subsidies are discontinued.

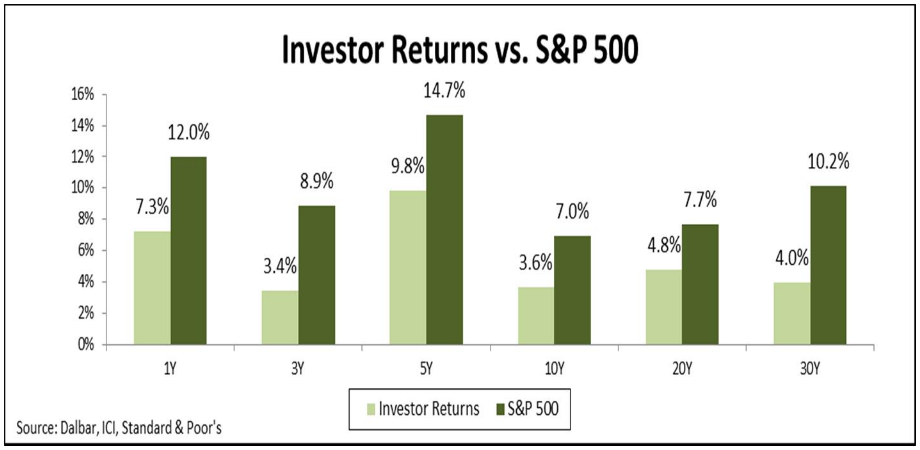
There are also some adoption challenges in countries with high electricity prices, such as is the case in Europe. It is estimated that in Germany, the "fuel cost" for an EV is actually higher than an internal combustion engine. What happens to electricity rates worldwide with the increased demand for electricity as EVs grow in popularity?

Another challenge for EVs is their large need for "rare earth elements" (REEs) both in batteries and permanent magnets. The market for REEs is highly vulnerable because currently 97% of mine production of many rare earth elements originates from one country – China. A large challenge for rare earth element production is having sufficient concentration of reserves to be able to economically produce them. Molycorp, America's largest rare earth element producer filed for bankruptcy in 2015 due to this economic challenge and was purchased by its largest creditor, Oaktree Capital Management. Industrialized countries with a substantial share of high-tech industries are impacted. The U.S. and many EU members are virtually 100% import-reliant. EVs have a significant makeup of such rare earth metals as neodymium, praseodymium, and lanthanum, which are all utilized in NiMH (rechargeable) batteries. The availability of these natural resources is far from secure, but without them supplied at reasonable prices, the EV market would have more difficulty competing.

No one truly knows how rapidly EVs will be adopted, but we believe over a reasonable investment time horizon it is unlikely that worldwide oil consumption will be demonstrably affected. This may be a case of when everyone is thinking the same, no one is really thinking.

DALBAR Revisited

DALBAR's "23rd Annual Quantitative Analysis of Investor Behavior," which reviews investor returns through year end 2016, was just published, and as we expected, the results continue to be disappointing. The data continues to reflect that investors generally are their own worst enemy when it comes to earning healthy returns. Their conclusion was, "No matter what the state of the mutual fund industry, boom or bust, investment results are more dependent on investor behavior than on fund performance." As you can see from the chart below, the difference is particularly telling over the trailing 30-year period. The average equity mutual fund investor earned approximately 4% annually while the S&P delivered more than 10%. As a reminder, the difference is primarily the result of the investor piling in when the market valuation is high and bailing out when the market valuation is low. Likewise, another major negative contributor is getting into the hot mutual fund and getting out of the cold mutual fund at exactly the wrong time. What is the hot mutual fund today? You guessed it, index funds and ETFs. We believe that new index fund and ETF investors are chasing performance, which this study would argue is the most penalizing and destructive behavior any investor can have.



All of these behaviors are counter-productive and extremely harmful to long term investment results. We see that a significant part of our role as your investment manager is to help protect our clients from making these common mistakes. That applies for the most sophisticated institutional client to the least knowledgeable private client. We believe strongly that most investors are in need of informed, rational, and objective investment counsel.

Security of Your Financial Information

By now, we're sure you've read or heard about the Equifax data security breach. It seems every week there is another data breach involving an operation that you would expect would be safe from such an event. As your investment adviser, we want you to know that we take the security of your personal financial information very seriously. We have employed various tools to aid us in the endeavor to protect your information such as data encryption, threat management software, and independent reviews of our information security position. We recognize that sometimes these tools can add an element of inconvenience, and for that, we apologize. Just know that we won't do anything without thinking of your best interest regarding the security of your information.

As we employ outside vendors to assist us in managing your accounts (e.g. outsourced IT services, cloud backup services, custodial data downloads, proxy voting service, email encryption), we also require assurances from these vendors that they have taken steps to protect your information such as independent reviews of internal controls and executed non-disclosure agreements, where applicable. Please contact us if you have any questions regarding the security of your information.

Here's an Update from Tom Hill about His Role at FRM:

"There's A Change in the Wind"

Any fan of Mary Poppins will recognize this quote by Mary when she senses things are changing at the Banks' house. Having raised four daughters I had no choice other than to all but memorize the entire movie! It's an apt quote for this season of my tenure with FRM.

Several months ago Greg, Mark and I discussed my desire to adjust my responsibilities at FRM. Since joining FRM, I have spent considerable time working with the next generation of leadership here in their various roles with an eye to future years of serving clients. With that in mind, my role is changing from Senior Portfolio Manager to one of Strategic Planning and Special Projects. I describe it as redeployment. This will provide more flexibility with my schedule but still allow me to stay engaged. My portfolio management and relationship responsibilities have been assumed by Zach Riley, Chris Fleischmann, and Meredith Moll in coordination with Greg and Mark. I have complete confidence in this transition.

You can still reach me at FRM. Feel free to contact me for any reason. Thanks to everyone at FRM for allowing me this opportunity! Now, if I could only get this darn umbrella open! (`a la Mary Poppins)

-Tom Hill