

April 12, 2017

# Quarterly Commentary

1<sup>st</sup> Quarter 2017

## Sign, Sign, Everywhere a Sign

For those of you who are unfamiliar with it, Interstate 40 between Little Rock and Memphis has to be the most heavily trucked interstate in the country. It is not unusual to see five 18-wheelers for every car on that road. As a result, there is constant highway construction that can cause frequent delays. Recently, one of us was cruising down that interstate thinking about investing ideas and market valuations when he suddenly had to hit the brakes for a traffic jam. As he found himself sandwiched in stopped traffic, he could not help but notice the warning sign on the right.

As traffic finally began to move, he began to think about similar signs in the stock market that might be staring us boldly in the face. We know that broad market valuations can go further than anyone thinks in either direction, but usually the more extreme valuations become, the larger future adjustments will be in the other direction.

Today we see stock market overvaluation that is very broad-based and stock market undervaluation only in relatively narrow pockets of unique opportunity. This is vastly different than other periods of extreme overvaluation. For example, early 2000 still holds the record for the highest overall valuations in U.S. stock market history. Back then, overvaluation was in a very narrow segment of the market (technology and telecom), but almost all other sectors, industries, and companies were undervalued or, at worst, fairly-valued. The only investment strategy an investor needed to deploy for future success was to avoid overvalued tech stocks and other large-cap stocks that were inflated by the indexing craze at the time.

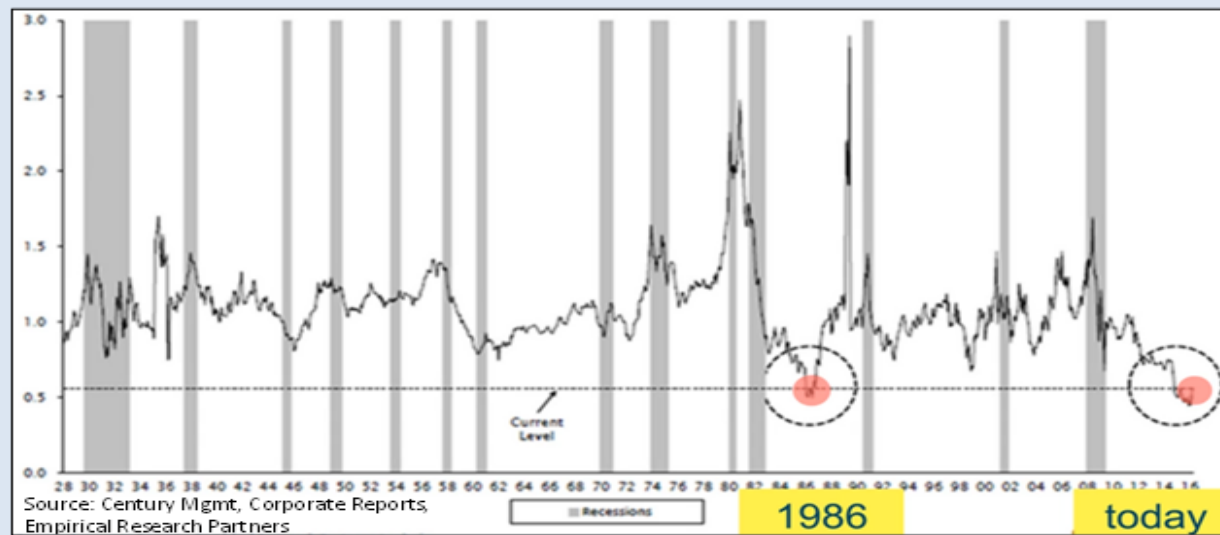
Currently, our portfolios look less like the market from a sector weighting standpoint than almost any time in our careers. We have roughly a 40% weighting in the two sectors that are



demonstrably undervalued (energy and materials) while the weighting of these two sectors only currently represent around 11% of the S&P 500 Index. If you look at the chart on energy stock valuations (below), you can see why we are so enthused about this investment opportunity. The only other time in the last 90 years that energy stocks were this undervalued was in 1986 when oil prices plummeted briefly below \$10 per barrel. This proved to be an opportunity of a lifetime, and we are back to those types of relative valuations again.

## We Believe Energy Stocks are Trading at Historic Valuations

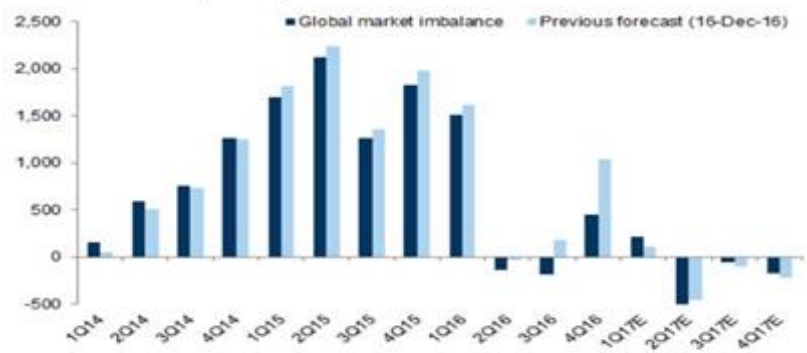
*The chart below shows the relative price-to-book ratio of the Large Cap Energy Stocks in the S&P 500 vs. the S&P 500 Total Index (1928-2016)*



While there appears to be a glut in oil inventories today, particularly in the U.S., there has been a massive reduction in worldwide energy capital spending over the last three years. Combine that with the natural depletion rates of worldwide energy fields on the order of 3% annually (higher for shale), and growth in daily worldwide demand of approximately 1.5% annually, and you have a much tighter energy market in the near future. The IEA chart to the right reflects their forecast of a tightening oil market. At the same time, OPEC, led by Saudi Arabia, has done a good job of temporarily cutting production, and it appears that OPEC and non-OPEC production cuts may be ongoing throughout 2017. Saudi Arabia

### Exhibit 3: We continue to forecast a global oil market deficit from 2017 onwards

Global market imbalance (identified supply minus identified demand, thousand barrels per day)



Source: IEA, EIA, JODI, OPEC, GTT, National Sources, Goldman Sachs Global Investment Research

has announced its intention to bring ARAMCO, their national oil company, public in the foreseeable future. For that reason, we believe the Saudis have an inherent desire to keep oil prices higher so they receive a higher price for their ARAMCO shares. Meanwhile, unprecedented fiscal deficits by many oil producing nations would call for stricter compliance in restraining future production in order to raise oil prices.

We expect a tighter market in copper as well, which is reflected in the chart to the right. The same can be said for gold, zinc, fertilizer, and metallurgical coal. There have been numerous mining operations that have been closed or furloughed as capital spending reductions in these industries have begun to take effect and restrict supply. Meanwhile, demand growth continues as the world economy continues to grow.

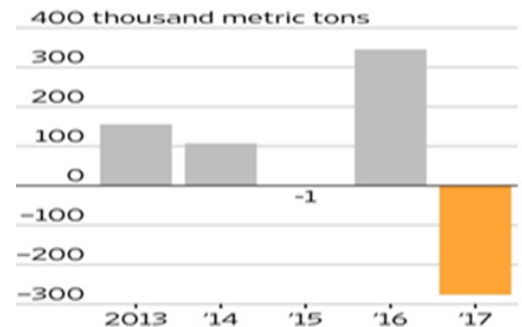
We have had some clients ask why we do not have more of their cash invested in energy and materials stocks if they are such a unique investment opportunity. Our answer is simple – risk control. We know that we can be wrong. We believe that we have enough exposure in these two sectors to make a sizable difference in your future returns. While the overall market might be expensive, our holdings are generally very inexpensive. Expected returns for many of our holdings are exceedingly high unlike the broad market's offerings. Currently, our larger than normal cash position is purely a function of not finding enough attractive investment

opportunities elsewhere in many other sectors of the market.

## Balancing Act

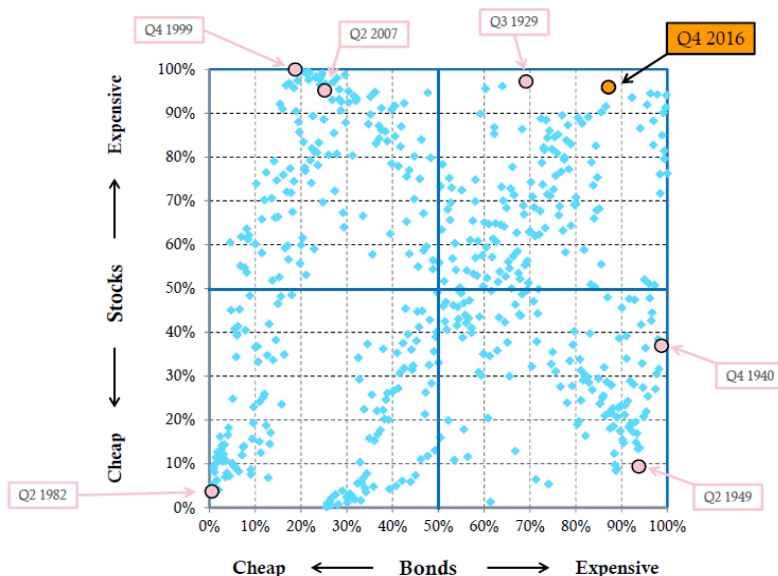
Global copper demand is expected to outpace supply this year.

### Copper surplus/deficit



Source: Wood Mackenzie  
THE WALL STREET JOURNAL.

## WHERE ARE VALUATIONS TODAY?



\*Historic ranked percentiles based on cyclically adjusted price/earnings ratios and 10 year treasury yields. Data from Robert J. Shiller, Yale University. Quarterly figures from 1881 to 2016. Source: Leavell Investments

By viewing the data points plotted to the left, you can see that the U.S. stock market and bond market are in the extreme top right corner of valuation reflecting expensive levels for both. This graph has its source from Robert Shiller's quarterly observations from 1881 to 2016. Some well-known investors have recently tried to make the case that the current stock market is not overvalued, given the current low level of interest rates. To us, that is like saying that the \$6 price you paid for a bottle of water at the movies is not that expensive compared to the \$8 Coke.

There are many ways to measure historic valuations, but virtually all measures would reflect that the current stock market valuations are in the top 2-3% of all-time observations. Put another way, if you were lucky enough to live to your 100<sup>th</sup> birthday, you currently are in one of the 2-3 years of your entire lifetime that would see overall stock market valuations this high. However, trying to time the market's peaks and troughs is a loser's game destined to failure. The far better approach is to remain a long-term investor in stocks searching for under-valuation wherever it exists.

There are numerous other warning signs. Historically, there have been predictive common markers that are present at stock market tops and most of them are present today. Low mutual fund cash levels, investors shifting from active to passive management, low interest rates, high margin debt on stock purchases, high insider selling of stocks, high consumer confidence, high risk investor attitudes (low risk premiums), and free-flowing credit are all present today. One other area that has been relatively lacking until very recently is high levels of initial public offerings (IPOs). The Snap IPO in the last month is reflective of investors' current attitudes to taking on more risk. The parent of Snapchat had 2016 sales of roughly \$400 million, 2016 losses of \$500 million, and a market cap of approximately \$25 billion right after the offering.

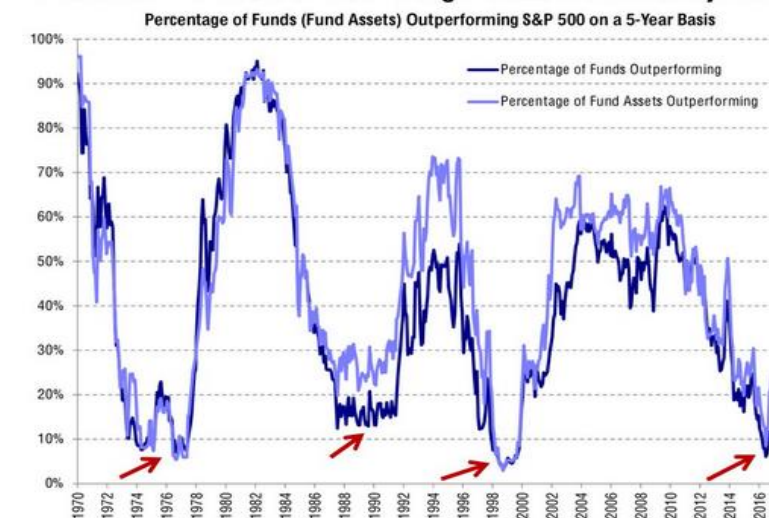
We are very thankful that we are not required to be invested in the broad stock market like passive investors who own everything in the index. Ironically, as the stock market becomes more expensive, investors have become more infatuated with indexing. According to the

Baupost Group, 11.6% of all outstanding stock in the S&P 500 is owned by index funds, up

from 4.6% a decade ago.

The flow of investor cash into indexing and passive investing through index funds and Exchange Traded Funds (ETFs) is exacerbating this over-valuation. As can be seen from the chart beside, this is not the first time that heavy money flows into passive investing has led to outperformance of index funds over active managers. This, in turn, has led to future strong performance by active managers once the cycle

#### We Have Been Here Before – Each Trough Has Been Followed by Recovery



Note: For details, see Fig. 1 on page 2. Source: CRSP, Bloomberg, Robert Shiller data, Instinet research

reverses. The more popular indexing becomes and correspondingly investors shun active management, the more inefficient the market is likely to become, which favors active management.

Often in investing, the easiest thing to do (going with the crowd) is the most dangerous thing to do, and the hardest thing to do is the most prudent. The crowd is running towards indexing due to late-stage performance chasing. We are reminded of a talk that value investor, Whitney Tilson, gave a few years ago. He told the story of a man who walked the entire length of a dynamite factory holding a lit torch. When the man miraculously came out the other end of the factory without any explosion, he was asked what he had learned. His answer was that it was safe to walk through a dynamite factory holding a lit torch. In other words, he never realized how much risk he was taking in his journey. As Benjamin Graham, the father of value investing, once said, "Speculators often prosper through ignorance." We would argue that the same is happening today with indexing.

Index funds and index tracking ETFs are required to be fully invested at all times. By their nature, index funds must buy more of the largest and often most overpriced stocks with these money flows. The five largest stocks in the S&P 500 Index measured by market capitalization are all technology stocks: Apple (\$754 billion market cap), Alphabet/Google (\$576 billion market cap), Microsoft (\$505 billion), Amazon (\$409 billion), and Facebook (\$409 billion). Is there any doubt why these five stocks have been strong outperformers lately? The total of all five is approximately \$2.6 trillion, which is roughly 10% of the market value of all U.S. stocks. Even in the tech market bubble of 2000, the top five largest stocks were not all tech stocks. GE and Wal-Mart were in the top five back then.

## **What Do You Think About the Trump Rally?**

Practically every client meeting we have had in the first quarter of 2017 has started with this question from our clients. The best answer we can give is to put some hard numbers to it. Since the election last November, the total U.S. stock market has appreciated approximately 10%, which is the equivalent of \$2.5 trillion of increased market value for public companies. It is assumed that most of this appreciation has come as a result of investors' expectations that corporate tax rates and business regulation will decline, which could free up more capital for businesses to grow. Putting the corporate tax rates into perspective, according to the CBO estimate, the U.S. will take in \$320 billion of TOTAL corporate income taxes in fiscal year 2017. This includes ALL corporate taxes paid by both public and private corporations. Therefore, if the entire corporate tax were completely ELIMINATED, not just reduced as the Trump plan proposes, the market has priced that in by roughly 8 times in the first 150 days. This is quite a market move for a tax plan that has not yet come up for a vote. With the current administration coming face-to-face with the political realities in Washington, it is not a given that Trump will be able to advance his tax recommendations through Congress. We would say that it appears the market is ahead of the fundamentals. The strongest counter to this opinion,



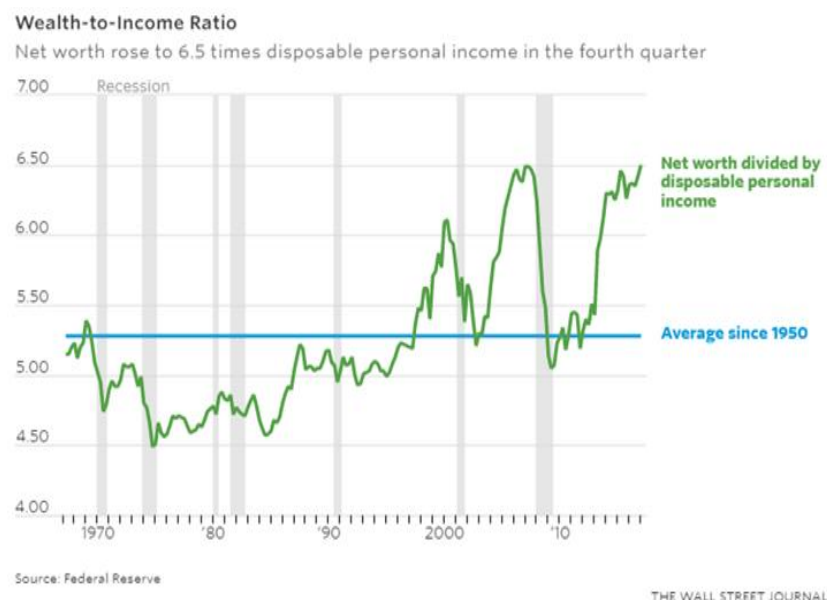
however, could be if Trump's pro-business attitude takes off throughout the economy and ignites the "animal spirits" of the business world creating a renaissance of economic activity, corporate earnings, and personal income. Only then would the strong, positive stock market reaction be justified.

Regardless of how you may have voted last November, the new administration's policies are still not yet fully defined. After all, Trump is a brand-new politician. Yet, since his election, the stock market has been anything but uncertain. The stock market just completed 55 trading days without even a 1% move in either direction. It went 109 trading days before having its first 1% or greater decline. On a very short-term basis, we recently had 12 consecutive up days in the market, which was the first time in 30 years that had occurred. All of these recent records come on the back of a just completed eight years without a 20% decline (bear market). This is the second longest bull market in U.S. stock market history – only the 1990's-2000 bull market was longer. This tells us that while volatility is extremely low, the risk of higher volatility is high. To us, volatility creates opportunity.

When asked our opinion about the Trump rally, we have often said that today we are more bullish on Main Street than Wall Street. The chart below reflects that since the financial crisis, Wall Street (represented

by net worth which includes the value of financial assets and real estate) has far outpaced Main Street (represented by the disposable personal income of the average person). It would not surprise us to see a reversal of that trend with a period of reasonable profitability for corporations and growing income for workers at a time when valuations on those earnings might

decline. For the last five years, on a GAAP basis, there has been almost no earnings gain for corporations while the market has basically doubled in price. Therefore, all of this appreciation has come from valuation (P/E) expansion. We would expect reasonable earnings growth, but little, if any, valuation expansion from very high current levels. This is why we are more positive about Main Street's prospects than Wall Street's.



## **Investment Activity**

This past year, we implemented an exercise that we read about from Lauren Templeton, the great-niece of legendary value investor, John Templeton. When valuations are high, and it is difficult to find attractive investment opportunities, a good exercise is to create a “Wish List” of stocks that you have always wanted to own, but the price is just too high to make them worthwhile investments today. These are the “cream of the crop” companies that are superbly managed with proven track records of effective capital allocation. At some point, the market may give you that opportunity to become an owner, and so it is advantageous to be prepared, stay current, and continue to monitor the stocks. The benefit to this exercise is that, when the broad market declines or an individual stock sells off, it allows an investor to remain calm, focused, and be quickly opportunistic rather than getting caught up in the emotion. FRM just went through this exercise recently, and we currently have 22 stocks on our “Wish List” out of the 600+ companies we actively follow. We actually have one stock that has recently approached our buy target, and when this stock was placed on our “Wish List,” it was not even close to our buy price. Let’s hope that more of our “Wish List” companies reach attractive enough valuation levels that we can add them to your portfolios.

Finally, there is good news on the dividend front for our holdings. We have recently had 10 of our stock holdings increase their dividends, but to be fair, one of our newer holdings did recently cut their dividend. However, we will take that 10:1 favorable ratio all day long. Over the last decade or so, we have seen many more companies initiate stock buybacks while dividend increases have taken a back seat. We are encouraged by this latest dividend activity.

## **Form ADV**

We recently updated our Form ADV Part 2A and 2B informational brochure and reported no material changes from the previous version. If you would like a copy of this brochure, please contact our Chief Compliance Officer, Abby McKelvy, at (501)604-3190 extension 3.



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