



401 West Capitol Avenue • Suite 503
Little Rock, Arkansas 72201
(501) 604-3190 • www.frmlr.com

January 10, 2019

Quarterly Commentary

4th Quarter 2018

Capital Formation and Prudence in a World of Funny Money

The common law establishment of the Prudent Man Rule (now also referred to as the Prudent Person Rule) dates back in English history to 1754 in the case of *Belchier v. Parsons* and in U.S. history to 1830 in *Harvard v. Amory*. According to Wikipedia, Massachusetts Justice Samuel Putnam in *Harvard v. Amory* ruled that in the absence of specific direction relative to investing, a trustee or fiduciary was charged “to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.”

We had to look it up, but the word “prude” (French) **is not** derived from the word “prudent” (Latin). However, the words have felt synonymous over the previous five years. Anyone not participating and at least tracking the returns of the roaring bull market was thought to be a prude **and** imprudent, a kill-joy, a Debbie Downer. No longer. It is hard to believe, but as recently as September 20, 2018 the S&P 500 Index was recording new highs. This latest dip in the market follows years of a calmer than normal, one directional market (up). Only when overnight interest rates began to rise by any meaningful amount did volatility return.

This brings us to consideration of Jerome Hayden “Jay” Powell, the 16th Chairman of the U.S. Federal Reserve Bank. We do not know Mr. Powell, but perhaps someone reading this does know him and would like to give us his/her opinion. In the absence of direct experience to the contrary, he strikes us as a prudent man, one that takes measured, gradual steps. No doubt President Donald Trump and the U.S. Senate thought so when they appointed and confirmed Mr. Powell as Chairman in 2017. If only Mr. Powell had had his current job back in 2003-2007 when housing prices then stock prices bubbled up, only to come crashing down in the financial crisis that brought about The Great Recession. Though not an academically trained economist like his four immediate predecessors, we are confident that Mr. Powell could have foreseen rising valuations in real estate and the financial markets at that time and would have taken prudent, gradual measures to prevent the dangerous bubble that eventually did great harm to the economy.

Alas, if you listen to President Trump and many on Wall Street, Powell's gradual move away from 0% overnight interest rates has monetary policy on a reckless course to kill the current economic expansion. It is a measure of how ingrained into the public psyche radical monetary policy has become when a 2.5% overnight interest rate is seen as dangerous to the economy. Historically, overnight rates have typically ranged two to three percentage points above inflation. If the current economy cannot withstand interest rates that are still very close to 0% after inflation (to say nothing of taxes), where do we go from here? Right back from whence we came? It is looking more and more possible every day.

Make no mistake; Mr. Powell is trying to navigate uncharted waters made turbulent by his three predecessors and a federal government that shows no sign of reigning in its appetite for spending. It seems obvious that the Fed and recent White House administrations have become very sensitive to trying to support the stock market. In a sense, Mr. Powell's two most recent predecessors were hugely successful in their attempts to create a "wealth effect" in asset prices. However, it seems that there was no consideration given to how we would eventually return to normal times when asset prices would not be so inflated. The huge fiscal stimulus and economic growth over the last several quarters has given the Fed a small window in which to try to gradually wean us off funny money and establish normal pricing of credit risk and business ownership risk. Let's just hope that window continues to stay open (read we can avoid recession).

Capital formation, whether for a family, a charitable endeavor or a profit-seeking enterprise, is never easy. It almost always involves hard work, sacrifice and self-denial. Once formed, capital is always under "attack" by the desire for current consumption, inflation, taxes and the risk of mal-investment. Investment capital has historically been prudently deployed (we would say most prudently) using a value investment approach that employs a margin for error when performing security valuation analysis. The further current monetary practices have gotten into the realm of funny money, the more difficult the prudent deployment of investment capital has become. In the present environment, many value investors have thrown up their hands in surrender to momentum investing, growth stock investing or indexing. In other words, they have chosen to be with the "market." Many excuses are offered: "We are in a new era of technology," "Old techniques don't fit the new economy," "There has been a paradigm shift to a new ecosystem," and "Low interest rates are here to stay" are just a few of the reasons being offered for throwing in the towel on value investing. In many instances, this is doublespeak for "our investment management business or our egos cannot stand to miss out on this roaring bull market." As we have previously quoted, one of our predecessor colleagues in the field of value investing, Sir John Templeton, once said that "the most expensive words in the English language are: this time is different."

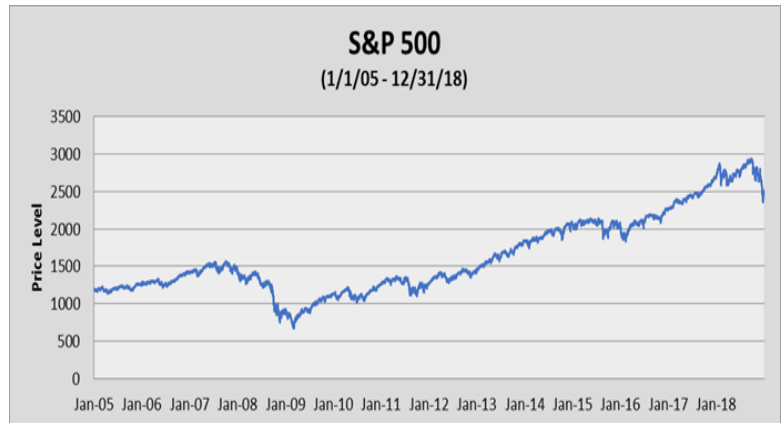
You may have noticed that we almost never discuss short-term market action in this commentary. However, with the downdraft of almost 20% in the S&P 500 Index that occurred between September 20th and Christmas Eve, we have received a number of questions about whether we have been buying bargains galore. Actually, no. As we discussed in our 2nd Quarter 2018 Commentary, more than half of the stocks in our research base have traded **above our sell price target** this year. Usually, our purchase price target ranges between 50%-60% of our sell price target. So while we

are seeing a few new stocks that warrant short-term attention, most are considerably away from a level where we see a prudent margin of safety.

It may help to go back in time to put our view of a prudent margin of safety in context. Between 2004 and 2007 we were experiencing rising valuations, though they did not reach the level they have in the recent bull market. Once the housing market began to freeze up, stocks began to drop in the 4th quarter of 2007. Stocks continued to drop throughout 2008.

On October 10, 2008, with the S&P 500 down 43% from its high, we sent a letter to our clients saying that we were seeing more bargains than we had ever seen in our careers. Many clients had cash in reserve not under our management. They had told us if there came a time when we were seeing great opportunity to let them know so that they could add to their accounts. In

testament to how difficult it is to be aggressive in big bear markets, only 3 clients responded positively, roughly 2% of our clients at that time. Stocks continued to fall until March 10, 2009, another 14% down from the high, or a total of 57%. As you might imagine, our clients' equity portfolios became fully invested during this time.



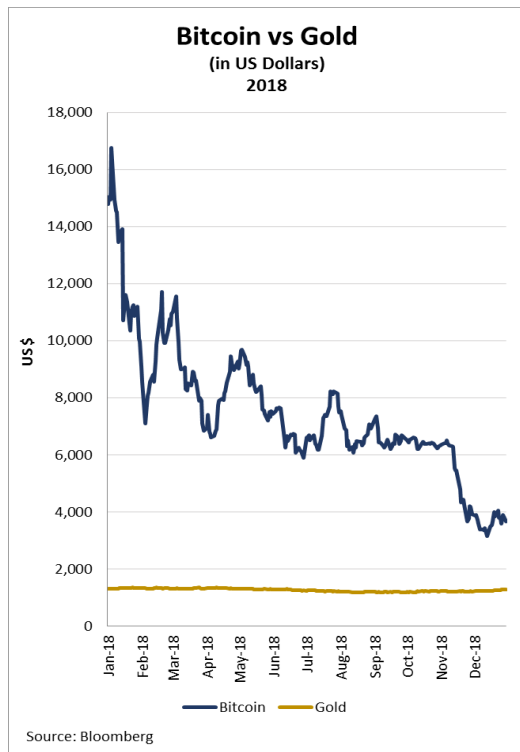
The discussion above illustrates how much prices in the two most recent bull markets have soared above levels we deem to be prudent as an entry point. However, that does not mean that it takes a drastic market correction for us to find bargain opportunities as they present themselves individually. Our two most recent equity investments are great examples of what we mean. In June, we added a long followed financial services company to portfolios at a price that was over 46% down from its high reached in 2014. Later in 2018 we purchased another company in the same industry at 50.8% of its 10-year high and about 38% below where it began 2018. We believe these two purchases illustrate that the pricing pendulum often swings too far in both directions. Howard Marks, noted value investor and founder of Oaktree Capital, put it another way. "In the real world things generally fluctuate between pretty good and not so hot. In the investing world, perceptions often swing from flawless to hopeless."

Hopefully, you can tell from the above discussion that a consistently applied discipline is being followed in analyzing the equity securities for your portfolios. We believe that this has become the exception rather than the rule in the investment world. Because the way we go about our daily work is so rare, one consultant actually referred to us as dinosaurs! Be that as it may, the laws of finance cannot be repealed. Future investment performance cannot be known. We believe a consistent methodology conservatively applied is our only hope for prudently deploying capital in a world of funny money. We never lose sight of how difficult the formation of that capital was to begin with.

Other Money

The person that referred to us as dinosaurs may have looked into our portfolios and noticed our commitment to gold mining companies. Not only do the current fundamentals and economics of gold mining companies appear better than they have in a long time, we believe our gold stock positions have great defensive potential if valuations in the overall market ever come back down to earth.

Gold has a recorded history of filling a monetary role for at least the last 2,700 years, as opposed to bitcoin, which has been around for 8. In a fiat money world, both gold and bitcoin have been



sought out as an alternative to funny money. Gold is tangible, has industrial and other practical uses (if you consider jewelry practical, as do many of our family members) and is very stable in quantity. Bitcoin is intangible, made by man, not by God. There are now 1,657 cryptocurrencies other than Bitcoin as of this writing!

The World Gold Council (WGC) estimates that 190,000 tons of gold exists above ground, almost half of which is in the form of jewelry. The rest is mostly owned by private investors, central banks, and governments. Belowground reserve estimates are a function of the current price of gold and the economics of producing it. Current estimates of underground reserves by the WGC stand at 54,000 tons. Generally, only about 2,500 tons are produced each year. An interesting fact to know: A metric ton of gold is roughly the size of a cube measuring 15 inches on all sides. The current value of that is \$45,503,000!

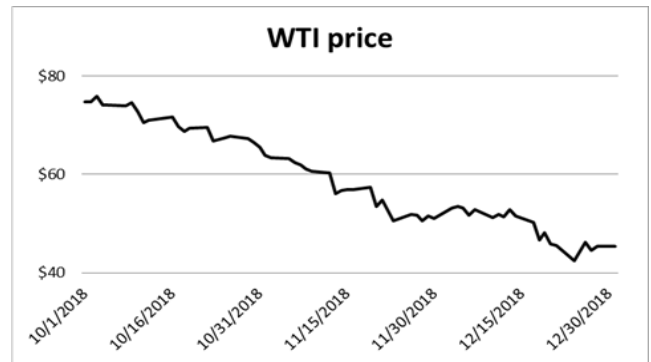
So, why are we telling you this? To emphasize that the amount of gold available for trading worldwide is relatively fixed. We believe, and history has shown, that gold and gold stocks have defensive potential in bear markets for stocks. Part of the reason may be that gold is often discounted in bull markets for stocks. During the aforementioned 57% decline from the high in stocks in the bear market of October 9, 2007 to March 9, 2009, Newmont Mining, our largest gold stock position then and now, was down “only” 17.9%. In the 4th quarter of last year, Newmont was up 15% while the S&P 500 Index fell 13.5%. Physical gold was up almost 8% during the same period.

Today’s mania over alternative asset classes such as pooled money private equity funds, hedge funds, real-estate funds and the like has not extended to gold. You almost never hear gold discussed in institutional asset allocation settings. If you were a CFA level III exam candidate, you sure would not want to propose an allocation to gold as part of a model portfolio in your answer, because you would probably lose points on that one. Warren Buffet has stated that he does not like

gold because it does not make money, and all you can do with it is look at it now and again. We think he is missing the point. For us, gold **is** money. It has a history of protecting the owner against the debasement of fiat currencies (see 4th Quarter 2009 Quarterly Commentary for a more detailed discussion). As shown above, it has also demonstrated asymmetric returns in asset portfolios. We believe that is especially important in asset markets of very high valuations when compared to the past. We may be dinosaurs, but we think we are prudent dinosaurs when it comes to gold!

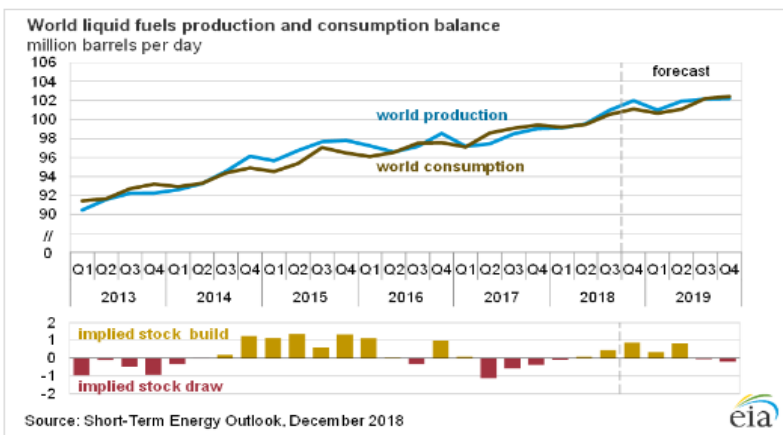
Withering Oil and Whither Oil

If you thought the stock market was nuts in the 4th quarter of last year, consider the oil market. The quarter began with domestic light sweet crude trading at just below \$75. It finished the year on a rallying note to close at \$45 and some change. This pummeled the oil and gas portion of your portfolio. While you owned the two best performing asset classes for the year, cash and gold, energy was the worst performing sector in the stock market and kept us from being able to report positive absolute returns in a down market. What happened?

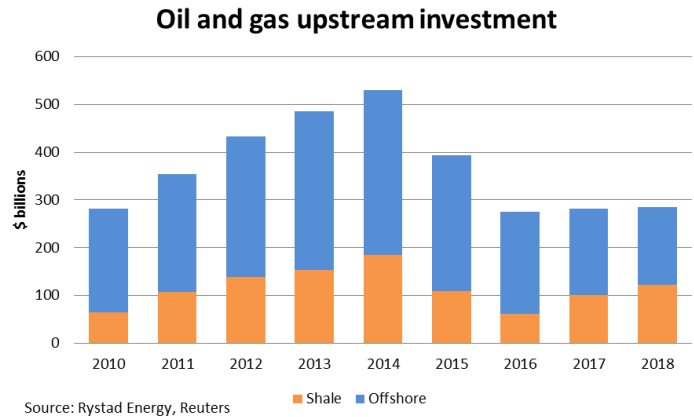


The main event involved the anticipated economic sanctions against Iran in the form of the prohibition of purchasing Iranian crude oil. These were sanctions that Washington had been pushing in order to punish Iran for continuing to pursue nuclear weapons and intermediate and long-range missile capabilities. In the lead up to the sanctions taking effect, Saudi Arabia, the rest of OPEC and Russia had begun to move away from the production cuts they had agreed upon in late 2016. They jumped the gun in an effort to grab the market share that Iran had been supplying. At the last minute, with this new production in full swing, President Trump announced that the U.S., purportedly in an effort to keep prices from spiking, was granting a six-month exemption to eight countries heavily dependent on imported oil. A market that had been expecting near-term tightness was suddenly flooded.

We believe that it is important to put this unexpected supply in context. We are talking about 1.5 million barrels of oil per day in a market where demand now exceeds 100 million barrels per day. That means a 1.5% increase in supply resulted in over a 40% decrease in the price. Fascinating stuff, but not where we are focused.



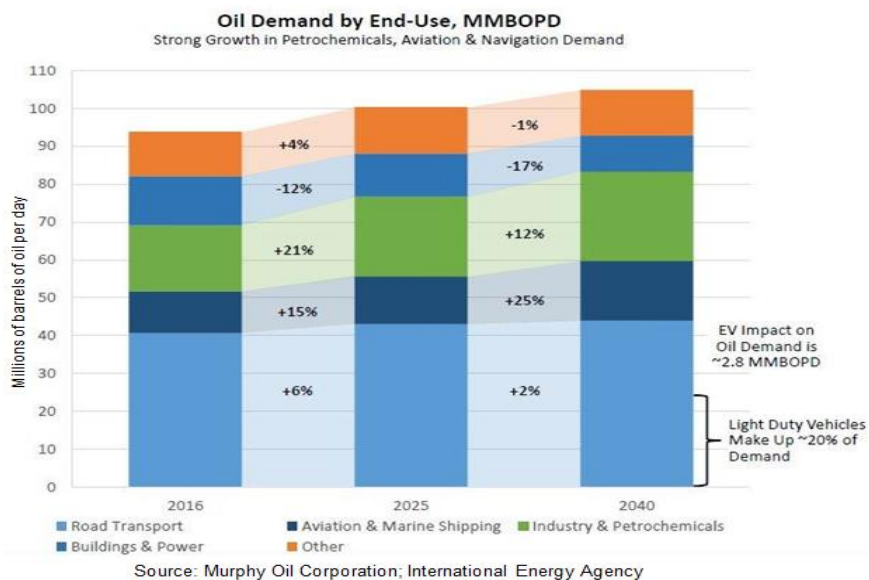
The chart nearby depicts the drop-off in capital spending by the largest and most well-financed oil companies in the world since 2014. That spending has never recovered. We know also that major producing governments like Saudi Arabia, Venezuela, Russia and Brazil have major fiscal issues facing them that potentially restrict their capital spending on energy development during periods of low prices (see our 4th Quarter 2015 Commentary for an expanded discussion).



It takes capital spending to keep the flow of oil going. We believe that the lack of available cash flow for capital spending by upstream development companies and producing governments will lead to restricted supply in the intermediate and long-term.

The long-term projections from several sources anticipate that the demand for oil will continue to grow, along with alternative energy, over the next 25 years. The nearby chart reflects growth in demand coming from almost all current areas of end-use, except for the burning of oil for the generation of electricity, which is anticipated to continue declining.

Admittedly, the short-term setback we have experienced in these investments in the 4th quarter is very trying. However, the nature of commodity markets is volatile. The companies we own have experienced this kind of volatility in the past. We anticipate that companies like Exxon Mobil, Chevron, ConocoPhillips, and others will return to their superior long-term returns on equity. We expect to be rewarded handsomely if they do.



Milestones

We earlier told you about Zach Riley's engagement to Taylor Neeley. On the evening of October 27, 2018 Zach and Taylor became husband and wife in a beautiful outdoor ceremony high above the Arkansas River west of Little Rock. The bride was glowing and beautiful, and Zach could not stop grinning. The weather could not have been more perfect. Zach and Taylor are living in North Little Rock. Taylor finished her Doctor of Pharmacy program in the spring and is currently working as a retail pharmacist. Zach just had his 11th anniversary at FRM (he started when he was 14, or at least he looked it).

Earlier in the year, Emily Anna Sanders was born to our Lauren and husband Will Sanders. She met big brother James on January 27, 2018 and came into the world weighing 6 lbs. and 14 oz. She may be the youngest person we know to own a passport. Hopefully, Santa left her a suitcase under the tree, because her parents are going to keep her on the go!

Meredith Moll and husband Tommy welcomed their first child into the world on October 17, 2018. Catherine Humphrey Moll (nobody ever kept a name secret better than Meredith and Tommy) weighed 6 lbs. and 13 oz. Catherine continues the tradition of all girls in the Humphrey family. With those genes, Tommy might want to start mentoring under Tom Hill on how to survive a house full of girls!

On October 11, 2018 Charles Fletcher Hartz arrived on the scene, more than 5 weeks early. Nicole and Ben were so very thankful to meet him, nevertheless. Charlie was only 4 lbs. 11 oz., but he has quickly caught up and is already over the 11 lb. mark and doing well. Big sister Caroline is bursting with pride and ready to have her picture taken holding Charlie at a moment's notice.

As you can see, we have had many blessings this past year. We strive to make FRM like a big family, and it is. One gift we are always so thankful for is the relationship we have with each of you. From our family to yours, may 2019 be one filled with good health, happiness, and many more blessings to come.

Important Disclosure Information

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