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Quarterly Commentary

4th Quarter 2017

The Competitive Madness

You might think the topic line refers to college football coaching salaries, especially if you live in the South of these United States. It definitely could! College football programs and their fans (derived from the noun “fanatic”) have continually upped the ante in search of just the right person to bring gridiron glory to their alma mater. These folks rank right up there with farmers as some of the most optimistic people we know. Apparently, the ever-rising level of competition is easily financed by television money and the willingness of supporters to pay for the privilege of buying tickets. The end-result has been an escalation in college head coaching salaries to a level that now rivals that of CEOs of many public companies. Who would have ever predicted **that** 25 years ago?

In a similar way, investing has become a competition driven by the madness of crowds. As we assess the current bull market in stocks that began in the spring of 2009, we see an investing public that is caught up in the excitement of almost daily new highs, much like in 1999. It is human nature to want to be a part of this and for those not participating, to feel like they are missing out.

In analyzing individual securities, our job is to assess the risk and the potential return for our clients’ portfolios. Risk can only be weighed by looking forward into the future, which is unknown. During times such as the current bull market, the public’s expectations about investment returns are heavily influenced by what has taken place in the recent past (looking through the rear-view mirror). The same thing happens in bear markets. In bull markets, most people look forward into the unknown and see the promise of continued gains, in spite of current market valuations. We believe this is happening at this very moment, as evidenced by Merrill Lynch’s Fund Manager Survey at the end of the year. This survey showed a sharp increase in the percentage of fund managers that felt they were taking higher than normal risk over the last three months (see chart on the next page).

Exhibit 1: Record number of FMS participants taking higher than normal risk



Source: BofA Merrill Lynch Global Fund Manager Survey

The tendency for investors to look forward into a bull market and expect unrealistic gains has a way of making investors lose sight of their original investment objectives. We witnessed this personally in the late '90's, in 2007 and again recently.

Investment objectives should be statements of goals to work toward through investing.

Depending on the type of investor, they can include: meeting the long-term earnings assumption of a pension plan, maintaining asset quality and proper liquidity for an insurance company, living a comfortable life in retirement for a retired couple or maintaining and growing inflation adjusted granting capacity for a charitable foundation.

All of these goals are absolutes and do not hinge on relative performance. Notice that none of the above objectives includes “matching or exceeding the benchmark” or “beating the market.” However, this is what much of investing has become, an effort to always be near the benchmark return (at a minimum) or a competition to see who can beat the market or obtain bragging rights to being at the top of the heap today. Do not take this last comment to mean that we do not wish to beat the market over the long-term or exceed benchmark returns. We do. **We just know that prudent investment management, by definition of valuation cycles, requires that there will be times when we do not achieve these long-term aspirations.**

The problem of over-focusing on index returns has been facilitated by the information age and the ability to create indices and update returns as often as desired. The natural progression to excess is that there are now indices for every facet of life it seems (see 2nd Quarter 2017 Commentary). In fact, there are now more indexes than there are public company stocks (see chart beside).

As we mentioned at the end of the second quarter, there has been a huge movement of investment dollars to index funds and ETFs that track various indices and away from professional management. The chart below reflects this

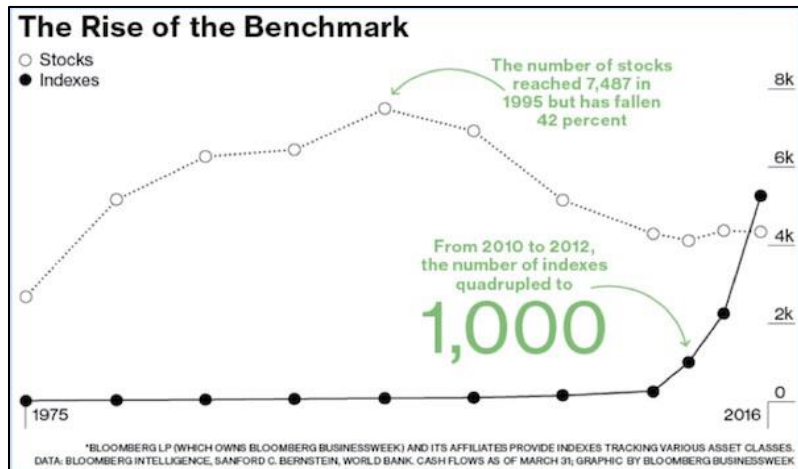
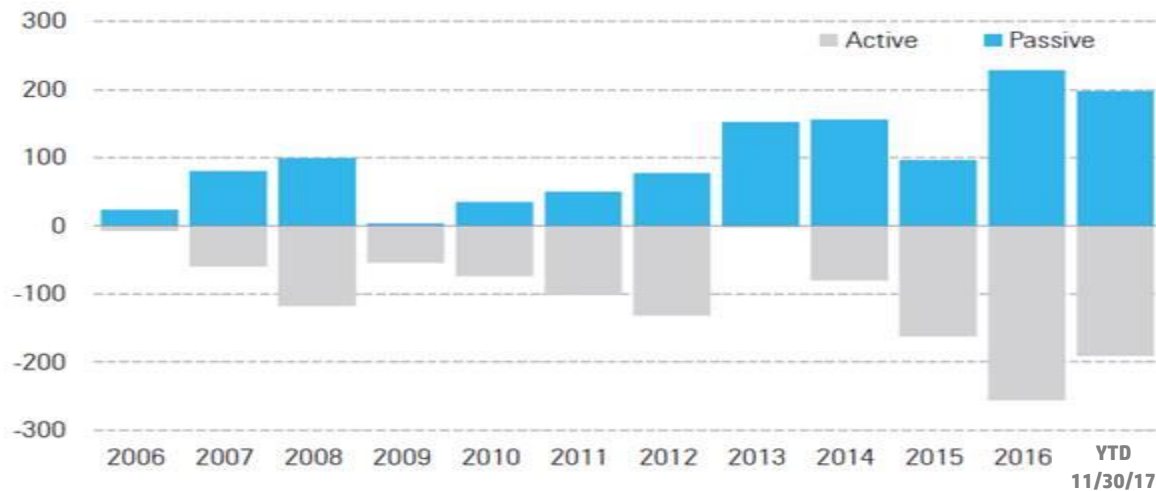


Exhibit 4 U.S.-Equity Flows, Active Versus Passive (\$ Billion)



Source: Morningstar Direct Asset Flows.

change. Growth of investment vehicles that track the market has occurred in each of the last 12 years. As the movement gained momentum, valuations across a broad spectrum of assets became highly overvalued, and that is where we are today. However, it can be fun being with the crowd...until it is not.

We have probably been guilty of over-focusing on benchmarks and short-term relative performance by introducing benchmark indices to new clients, even where there was no mention of a desire for them. We should be and will be spending more time assessing whether our clients' goals and objectives are being achieved and less time on discussion of short-term returns. There is nothing wrong with measuring long-term performance against a benchmark. To repeat, over the long-term we definitely hope to excel against these markers. However, these measurements are not the be-all and end-all. The most important thing is that our clients achieve their long-term investment objectives, and we believe we have done a good job over the last 25 plus years in helping them do so.

A Visit to La La Land

We have steadfastly held tight to our buy and sell discipline as risk, in the form of valuation expansion, has proceeded upward. However, during this time we have grown our research inventory in hopes of finding value where it might not appear at first glance. We currently have roughly 700 stocks that our team has evaluated and established a buy and sell target.

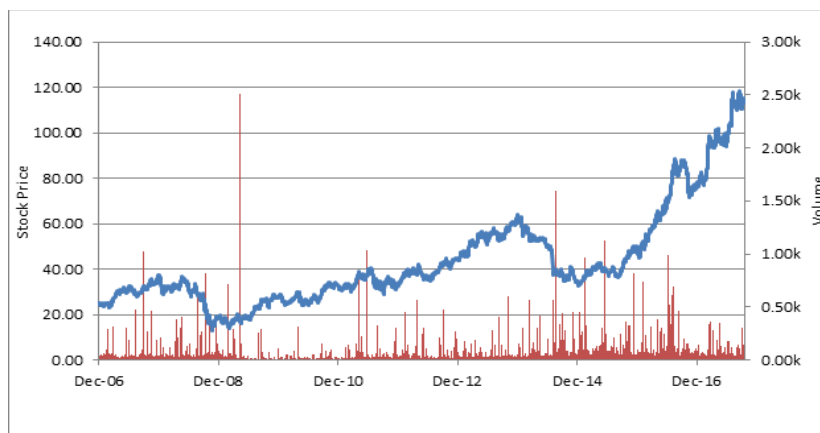
What follows is an analysis we performed on a particular public company, but we have initially presented it in relational terms to a small business so that all readers might more easily put the numbers in context. You might want to try to guess the stock that is presented.

Imagine you own a business selling consumer goods. You have owned the business for the last ten years. After all of your expenses, this business earned you \$202,000 on average per year. In the best year, you earned \$283,000 and in the worst year, you earned only \$90,000. (Assume for simplicity's sake that you are not an employee of this business so you don't take a salary.) The demand for your products is stable, but to produce this stability you must pay prominent people to star in advertisements for your products. This can be very expensive. You also have plenty of competitors, which contributes to the fact that your net profit margins (after taxes, interest and everything else) are slim – only around 4.3% on average - so in any given year you have to sell over \$4,400,000 of your product to produce the average \$202,000 of earnings.

Let's say you received a call one day with a buyer who was interested in buying your business. They make an offer for \$11,331,000, all in cash. Would you sell? It would take you 56 years to recoup this same amount of money out of the business at that pace. We would be long gone at that price!

Now for the real numbers as made available to the public. The public company we evaluated had 10-year average earnings per share of \$2.02, with a 10-year high of \$2.83 and a low of \$0.90. Net profit margin had averaged 4.3% over the past 10 years. The company had a good balance sheet with very little debt, but as we described above, they were in a very competitive, consumer-driven market. When we evaluated this company, the market was assigning a price of over \$113 per share!

Can You Guess This Company?



Hint: Think apparel.

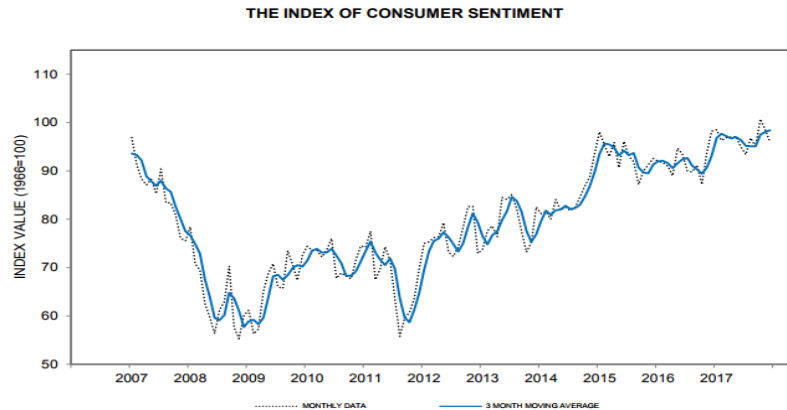
This example is typical of what we see over and over again in our search for prudent risk/reward tradeoffs in this highly priced stock market. See back page for the name of this high flyer.

Change is in the Air

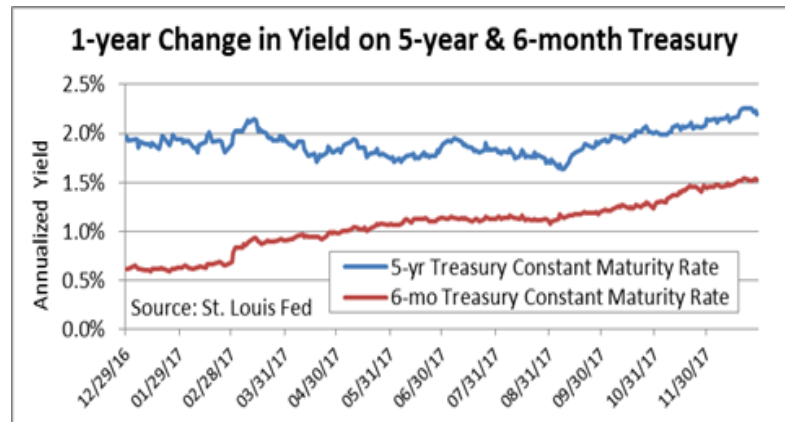
We led off our 2nd Quarter 2016 Commentary with the subject title “The Coming End of the Malaise”. While we disavowed any idea of when the general business uneasiness would end, we boldly predicted that end it would at some point. While it is too early to make a definitive statement, change is in the air.

The University of Michigan’s Consumer Sentiment Index

recorded its highest average monthly reading this year since 2000, though the index was actually falling in the last few months of the year. Only in the long economic expansions of the 1960’s and 1990’s was this indicator of consumer confidence higher.

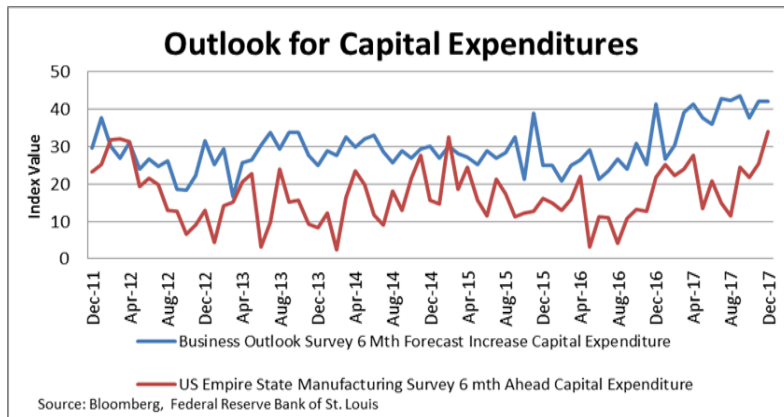


Source: Survey of Consumers, University of Michigan, to December 2017



The five-year Treasury note is closing the year yielding 2.22%. That yield is higher than at any time since 2011. Additionally, the 6 month T-bill was yielding 1.53% at the end of the year. While not attractive at all compared to our lifetime experience, those yields are much better than where we have been lately, and that should help stimulate some modicum of confidence and spending among retirees.

Along the same line as interest rates, the Fed has finally committed to a plan of reducing its balance sheet that exploded in size in the years following the financial crisis. The new chairman of the Federal Reserve, Jerome Powell, is expected to follow the current plan of gradual retrenchment. However, Powell is thought to favor less financial regulation than Yellen, and he has the most diverse experience of any of our last four chairmen.



Surveys of planned capital spending for the next six months look very promising. This important segment of the economy has been a laggard for many years. Capital expenditures were somewhat propped up by domestic development of new oil and gas plays until 2015 when the bottom dropped out of the energy markets. Increased capital spending is one of the

most encouraging signals that change is in the air. There are currently signs of tightening manufacturing capacity around the world due to upticks in demand. It will be interesting to see whether this higher level of demand is satisfied through price increases or added capacity.

Although the tax package recently passed by Congress and signed by the President has yet to take effect, it has generated great expectations in some circles. Hopefully this proves to be a growth engine for the economy. If it does not, look out below, because the stock market has already priced in a significant benefit many times over in our view. We would anticipate that the pickup in economic growth over the last two quarters would eventually aid value stocks should 3% growth continue. Nothing has been harder on cyclical stocks and done more to draw investors to growth stocks in the last several years than artificially low interest rates and anemic economic growth.

Many encouraging signs point to a promising economy in 2018. As we said earlier, the market appears to us to have already priced in a very rosy scenario for most stocks. While nothing seems to be on the horizon that would finally reverse this raging bull market, those things that wreak havoc in financial markets, while foreseeable, are almost never foreseen. We expect the next chapter will be no different. **The Laws of Finance do not change. Valuation always matters. The difference between investing and speculation is the allowance for a prudent margin of safety in case the rosy scenario fails to materialize.**

On the Upswing

We saw a vast improvement in the fundamentals of natural resource related stocks through 2017. In general, commodity prices are benefitting from the general increase in demand (mentioned above) and supply constraints. You would not know it from most of the articles we see relating to alternative energy sources, but the consumption of natural gas and oil are making new highs around the world. Almost across the board, capital spending in the natural resource sectors has been downtrodden for several years, crippled by low commodity prices and the resultant decline in cash flow. These companies have spent the last several years getting

their balance sheets in order and cost structures reduced. While we have not seen a lot of positive reaction to these sectors in the stock market (see our previous Quarterly Commentary), we are encouraged that the fundamentals finally seem to be turning.

In Closing

While 2017 was a very challenging year in many respects, there were some wonderful milestones to report.

Harper Elizabeth Ivory was born in August to Elizabeth Millsap Ivory and Wes Ivory of Little Rock, weighing in at 7 pounds and 6 ounces and measuring 20.5 inches. She's a looker like her mom. Rumor has it that Wes is already getting Harper outfitted for all of the hunting paraphernalia she is going to require.

Another exciting event in the Millsap family took place when Gray Millsap and Maggie Sims wed in September. Maggie is the daughter of David and Libby Sims of Houston, the planned venue for the nuptials. However, Hurricane Harvey had something to say about those plans when it made landfall on August 25, three weeks before the wedding. Days and days of torrential rain followed, and it became evident that if the wedding were going to take place on September 16, it was not going to be in Houston. Maggie and Gray had decided to make their new home in Dallas, so Maggie, Libby and Mary got into overdrive and in a matter of a couple of weeks had arranged for a Dallas wedding weekend that could not have been nicer. Mark and Dr. Millsap just showed up at the appointed times and did what they were told. If Maggie had any lingering disappointment over her original wedding plans, it was soon remedied when her beloved Astros took the World Series for the first time in franchise history.

On the forefront, baby James Sanders is expecting a little sister in February. Lauren and Will have probably already figured out how to accumulate mileage points for her before she is even born. Rest assured that she will have her passport prior to her first birthday. We will give you an update next year at this time. Also, romance is in the air at FRM, but it is too soon to make a report, as things tend to move very slowly in that department around here.

Unfortunately, early in the year we were reminded how quickly our lives can turn and how precious and fragile life really is. However, we were also reminded of just how many good, caring and generous people there are in this world and how extraordinary is the power of prayer. A very heartfelt thanks to all of you that have kept all of us in your prayers. May God bless you for that.

May 2018 exceed all of your hopes and expectations for you and your families. It is our privilege to be able to serve you, and it is our goal to excel in this endeavor. We always want to hear from you if there is a question you have or if there is a better way that we might meet your needs. We look forward to working with you in the years ahead.

Answer to the Quiz: Adidas (OTC:ADDYY)