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July 12, 2018

# Quarterly Commentary

2nd Quarter 2018

## Why Do We Have So Much Cash?

For equity clients, that is the question we get most frequently these days, so we thought we would address it by shedding further light on our stock research and selection process. We want our clients to fully understand why we make the changes to the portfolios that we do, and our current investment in U.S. Treasury bills and cash is no exception. You may remember that early in this decade, we began to hold the majority of our clients' cash in the form of 6 month Treasury bills. That was due to the realization that money market funds were taking increasing levels of risk (at that time, in the form of foreign bank deposits) in search of higher yields. We also recognized that it was impossible to know from one day to the next what investments were actually held by the money market funds, so we made the decision to move as much money as practical into the 6 month bills.

Over the last several years, we have been sellers of many more stocks in your portfolios than buyers. As we have explained previously, we build equity portfolios one stock at a time based on our fundamental research. We do not make a decision to be "bullish" or "bearish." The makeup of your portfolio is solely determined by the opportunities we see available from our work. Perhaps the easiest way to understand the reason for this is to analyze a couple of names in our research inventory that are representative of that universe.

There are currently 631 stocks in our active research process. What this means is that we have researched those companies beyond just knowing if they exhibit potentially good value for our clients. For the 631, we have performed detailed research sufficient to establish a "buy price" and a "sell price", as we explained in our 3<sup>rd</sup> Quarter Commentary from 2016. Amazingly, 57% of the stocks in our targeted research are not just above our "buy" price, but they actually trade above our "sell" price as well. Remember, these are stocks that were originally screened or selected for further research work based on one or more characteristics that indicated potential value at today's price. The fact that more than half of them are above our "sell" price reflects why we are having a difficult time finding stocks trading at or below our "buy" level.

We have selected two stocks from our research that we believe are representative of today's valuation levels. These examples illustrate the dearth of available names that are at valuation levels low enough to make the case for an attractive return on your investment. Trinity Industries (NYSE:TRN) is a company that we have actually owned previously. We generally continue to track names that we have previously owned, so that is the reason it remains in our database. Trinity Industries is a Dallas, Texas based manufacturer of railcars, inland barges, highway railings and wind towers. The company also has a railcar leasing division.

Trinity's stock currently trades at \$34.66 per share, down significantly from its high of \$50 in May of 2014, a factor that might have landed it on our research list had we not already been following it. The company has more than tripled its net worth since we sold the stock in 2006. Book value per share currently stands at \$30.01 as of their most recent quarterly filing of March 31, 2018. Therefore, the price to book value ratio is an interesting and generally attractive figure of 1.15. After subtracting goodwill of \$790 million, that leaves a tangible price to book value ratio of a still reasonable 1.40.



Debt has almost tripled since the end of 2006. Almost all of the increase (92%) comes from the growth in issuance of non-recourse debt associated with the railcar leasing operation. The leasing operation has grown from 9% of total revenues in 2006 to 23% last year, a factor to keep in mind. Other aspects of the balance sheet are very well managed. For example, the current ratio (current assets/current liabilities) is a very strong 3.14. Also, the recourse debt to total stockholder's equity is a very conservative 18%. On June 20 the company announced that it had issued \$482 million of asset backed notes secured by 7,090 railcars in their leasing portfolio. The proceeds were used to retire a similar amount of convertible notes.

Trinity's operations are very cyclical, and as one might suppose, highly dependent on a good economy. Other factors that can impact business include rail industry regulations, government spending for highway infrastructure, aging and replacement cycles of railcars and barges, and the relative attractiveness of rail and barge shipping compared to trucks.

In the past 15 years, Trinity's operating results have been all over the board. In four of those years, losses were reported. 2002-2004 each showed small losses near break-even. 2009 showed a loss of \$.90/share reflecting a \$325 million (\$2.04/share) goodwill impairment charge. In the other 11 years, earnings ranged from a low of \$.43/share to a high of \$5.08 in 2015. It should be noted that the company received a tremendous boost in its business from

the demand for crude oil transportation by rail. This demand came mostly from oil originating in western Canada and North Dakota. Rail shipments of crude oil within the U.S. have already begun to slow, as producers react to new market developments with increased pipeline transporting capacity. Trinity's average earnings per share over the last 10 years is \$1.90/share. The last five years earnings have averaged \$3.05, but that number includes two oil-driven years which probably will not be repeated anytime soon. The company pays a quarterly dividend of \$.13/share, for an annual yield at the current price of 1.50%, not great. Based on average earnings over the last 10 years, we need to buy the stock significantly below the current book value of \$30.01 to get an expected return that meets our hurdle requirement. At today's price of \$34.66, we would only be receiving an implied return of 5.5% (\$1.90/year in average earnings divided by today's price). That is not nearly enough to risk clients' capital. We just reviewed the company this past April and established a tentative buy price of \$19, a point at which more research would be warranted.

One might argue that the above analysis does not take the future growth of the business into consideration. **CORRECT!** As business owners, we do not want to pay for future business growth. Predicting growth in the future is highly uncertain and involves speculation. If future business growth takes place, we welcome the benefit, but we do not ever want to pay for it.

Trinity is planning a spinoff of its non-rail businesses for the second half of the year. We will be updating our research following the spinoff to track the valuations of the separate entities.

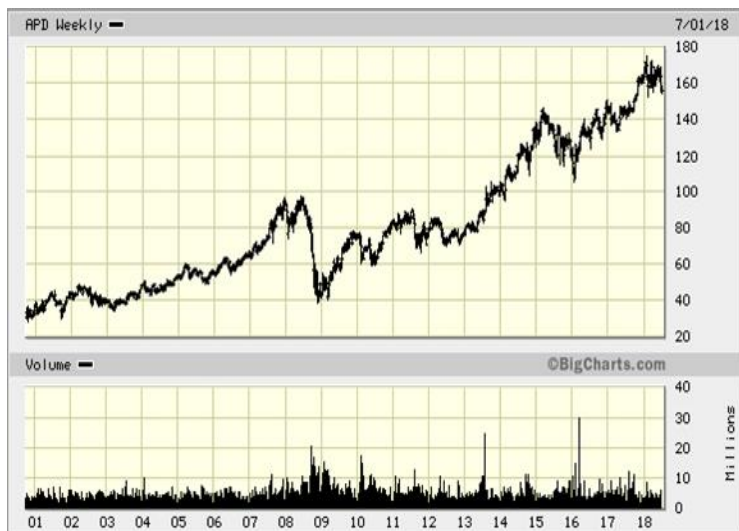
You may possibly remember a discussion from our 1<sup>st</sup> Quarter 2017 Commentary about having expanded our research outward to include great companies that we would love to own, despite the fact that they are not currently exhibiting value characteristics. We explained that we had begun to maintain a "wish list" for wonderful businesses such as these. Our second example comes from that list: Air Products and Chemicals (NYSE:APD).

We just updated our research on Air Products and Chemicals at the end of June. The company is a worldwide supplier of atmospheric and process gases to industrial, energy, healthcare and technology companies. APD has its headquarters in Allentown, Pennsylvania and has approximately 15,000 employees in 50 countries. It has been in business since 1940. Products include argon, carbon dioxide, synthetic gas from carbon monoxide, helium, hydrogen, nitrogen, oxygen, rare gases neon, krypton and xenon and other rare and specialty gases. The company also sells equipment used in gas production, storage, and handling. Additionally it offers services such as safety training, carbon dioxide capture from fossil fuel conversion, and engineering and consulting services.

APD currently trades at \$155 per share. The balance sheet of the company is very strong (Did you notice we always start with the balance sheet?). The company has plenty of cash, enough so that they could almost retire their entire balance of debt. The debt to equity ratio is a conservative 33.7%, and their net debt (debt minus cash) to total assets ratio is a very conservative 2.0%. The current ratio is almost the same as TRN's at 3.08. This type of balance sheet does not come along every day!

APD achieved much of the strength in their balance sheet by making two strategic moves in the last couple of years. Both of these moves were made with the decision to focus on the industrial gases business. In September of 2016 the company spun off its specialty materials business, Versum Materials (NYSE:VSM). This company sells specialty chemicals and delivery systems for use in the semiconductor manufacturing process. Of greater consequence to the balance sheet was the January 2017 sale of the company's Performance Materials Division (PMD) for \$3.8 billion in cash. Thus far, most of this cash has been used to build out the global industrial gases business, add liquidity to the balance sheet and retire debt. While the company has always maintained a strong balance sheet, the PMD transaction has had a large favorable impact. We will be watching for signs that the cash is managed to the benefit of the shareholders. It seems to us like a good time for a special one-time dividend payout, but nothing indicates that will happen at this time.

Book value per share is \$48.27 at the end of the first quarter of this year. Tangible book value is very close to the same, \$42.53, something we don't see very often these days. In the last few years, more and more of the companies we analyze have a high level of goodwill and other intangible assets making up their book value (see our discussion that begins the 4<sup>th</sup> Quarter 2015 Commentary). In the last several years, it is not at all uncommon to see companies with negative tangible book values.



The company is a very solid performer and has a strong track record of growing book value per share and intrinsic value. Dividends have grown every year for at least the last 15 years, and the stock currently yields 2.84% at its current market price of \$155. Gross margins on sales have grown over the last 10 years, something that will not continue forever. Net income from continuing operations has averaged \$4.66 over the last 10 years

and \$4.99 over the last 5 years. Unfortunately, we would need a much lower price to be a buyer of the stock based on current fundamentals, as the average historical earnings would imply future returns at today's price of little more than 3%. Obviously, the stock has plenty of room to come down (not implying it will) for it to be appealing to the extent that we would be willing to risk your capital. We have a "tickler" buy price if it hits \$76, but based on the historical fundamentals \$76 would only be a level that would increase the depth and frequency of our reviews.

APD is a great company that we would like to own someday. The company's stock is currently priced like a great company with nothing but milk and honey in its future (and plenty of it). A great company at an extremely high price is not our recipe for successful investing.

How can the company trade at such a high price relative to its current fundamentals? Remember, market price is determined by the last trade (a.k.a. the marginal trade or the trade at the margin). It is human nature, when seeing prices of stocks or other assets so far removed from one's assessment of value, to assume that those traders setting the current market price must know something that we do not know. At such times, many investors give in to the temptation to be with the crowd. Especially in times like these, it is important to remember one of Ben Graham's axioms of investing: "Market price reflects marginal opinion, not intrinsic value."

Hopefully, from these two examples you can see how we go about our work assessing potential risk and reward. It is through this process that we decide to invest or not, one company at a time. We would rather hold cash than risk your capital imprudently, even if the rewards of holding cash appear to be minimal or non-existent as has been the case for the last 10 years. We look forward to the day when value opportunities are abundant in the stock market, and current cash balances reveal their value. Until then, we will continue to build, expand and refresh our research in hopes of uncovering an opportunity that sufficiently rewards your capital.

### **Speaking of Treasury Bills**

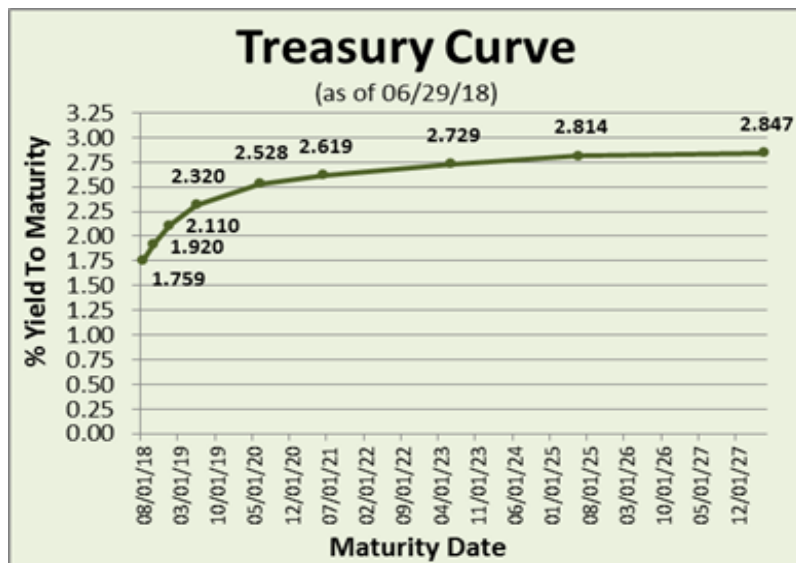
We have received a few questions about clients' account confirmations and statements that follow when we replace a matured Treasury bill with another. We always try to buy the replacement security on the business day prior to the maturity date of the one being replaced. Government securities have normal, or "regular way" settlement one business day after trade date. By purchasing the replacement the day before maturity, funds stay invested without missing a day's interest accrual. However, on the clients' statements, the purchase transaction posts against cash on trade date, making the account appear to be overdrawn. Because funds for the trade are not actually removed from the account until the next day, the account is not in overdrawn status, and the maturing funds satisfy the purchase of the new security.

We recently purchased Treasury bills maturing this coming December, replacing those that matured on June 14. You may have noticed that with the rise in overnight and short-term rates in general, the yield we are getting on the 6-month Treasury bill now exceeds 2%. That is not a great yield in our lifetime, but it exceeds money market funds in both yield and quality.

## Now That Interest Rates Are Rising...

We thought we would update you on our current assessment of the bond market as rates have finally trended upward, though they remain well below any level considered “normal” historically. We continue to expect overnight and short-term rates to rise. This is not a risky statement given that Fed Chairman Powell has stated his intention to bring overnight interest rates back to a level that would normally exist given current growth levels in the economy, unemployment and the inflation rate.

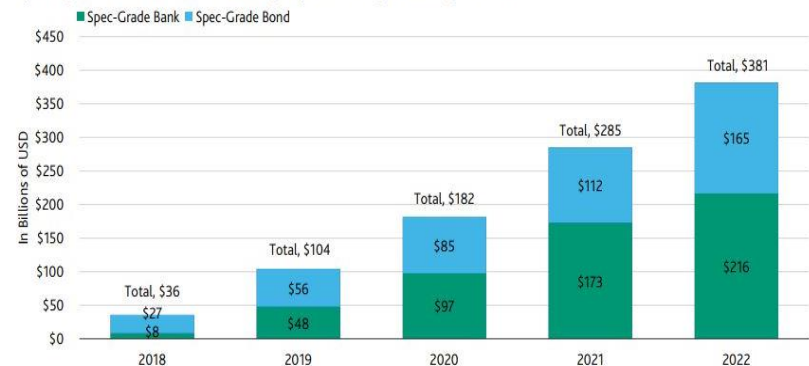
One tool thought to be used in setting interest rate policy by the Fed is known as the Taylor Rule (see our 3<sup>rd</sup> Quarter Commentary from 2015). Put simply, that rule says that the targeted overnight rate should be a function of the current inflation rate (let’s call it 2%) plus the Fed’s targeted real interest rate of 2%, plus an adjustment when the rate of growth in the economy differs from the long-term targeted rate of growth. Let’s call this adjustment 0% for purposes of simplicity in this discussion as the current rate of economic growth is not considered to be significantly different from its long-term potential at this point in time. So the Taylor Rule would currently argue for a 4% overnight rate give or take a little. According to the Federal Reserve’s website, June ended with an effective Fed Funds rate (the average rate at which banks loan to one another overnight) of 1.91%. Therefore, we have a long way to go to get to a more normal rate of interest on short-term lending. That being said, the yield curve (see nearby chart) has begun to flatten since the Fed ended its Zero Interest Rate Policy (ZIRP). While we do not have an inverted yield curve (short-term rates exceeding longer-term rates) the Fed will be watching market yields closely. Historically, inverted yield curves have been good indicators of upcoming recessions.



Corporate bonds have underperformed government bonds so far this year. There are probably several reasons for this. Corporates have outperformed governments for all but two years since the current recovery began, 2011 and 2015. Additionally, the duration of the current recovery is getting long in the tooth though recoveries have generally trended progressively longer since WWII. Finally, credit markets in general may be eyeing the upcoming refinancing requirements of non-investment grade credits in the next few years. As you can see from the chart nearby, maturities of bank loans and bond debt of speculative grade borrowers rise rapidly over the next few years.

We are still staying conservative with bond portfolio durations as we continue to see only small or negative after tax real returns at the yield level the markets offer today. Rising rates will definitely be a benefit to our clients.

**Spec-grade maturities to step up steadily through 2022**



Source: Moody's Investors Service

## Archives

Since we have referenced several past editions of our Quarterly Commentary, we thought we would bring it to your attention that we have archived all of them on our website, [www.frmlr.com](http://www.frmlr.com). A sure cure for insomniacs!

## 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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