

**April 12, 2016**

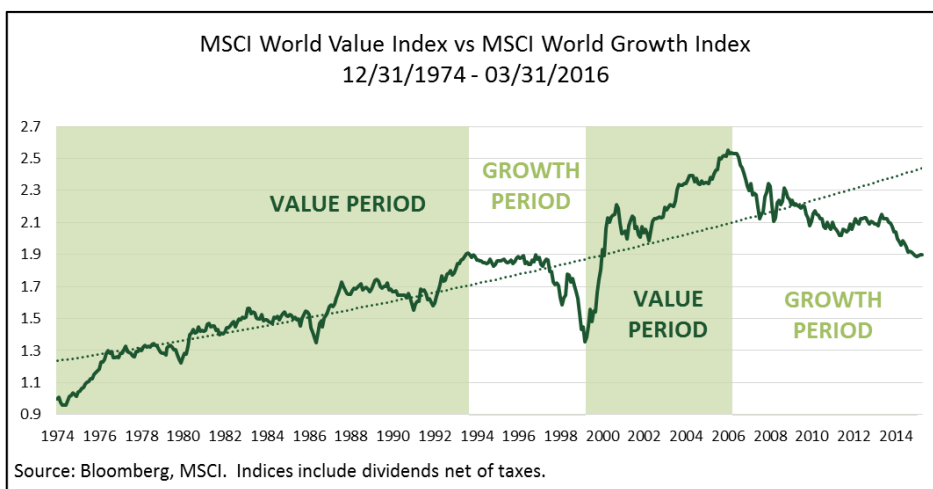
# Quarterly Commentary

**1st Quarter 2016**

## Which Comes First – The Chicken or the Egg?

Many times throughout our careers, we have been asked why we are value investors. Our short answer has typically been, “Because it works.” Why does it work? Because in the long run, market prices ultimately come to reflect the fundamentals of businesses. This does not mean that value investing is easy, however. As Rob Arnott of Research Affiliates recently said, “Buying out of favor investments is darned uncomfortable.” If it were easy to do, everyone would do it and the results from value investing would decline. As has been said, one doesn’t get into value investing for the group hugs.

The chart below shows the cumulative performance of value versus growth styles of equity management since 1974. The upward sloping trend-line illustrates that, while value does not outperform growth year in and year out, it has performed significantly better over long periods.

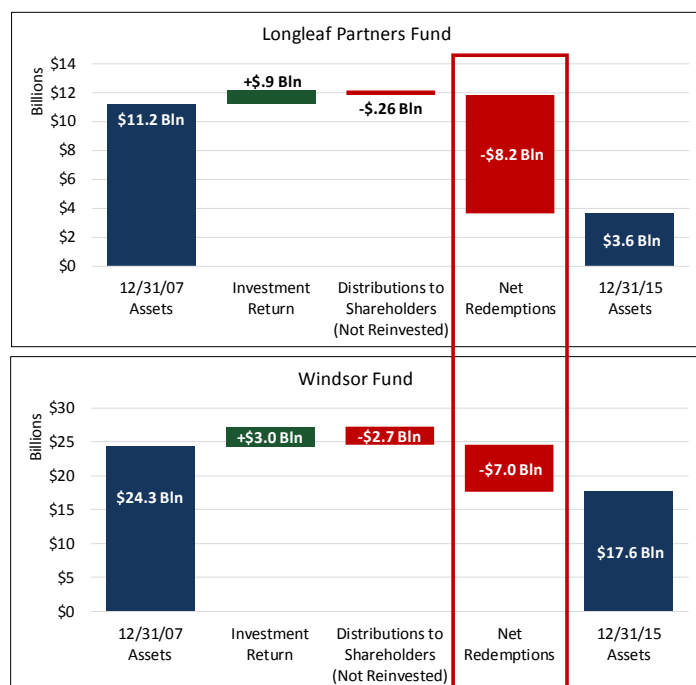


However, it can’t be ignored that the current value underperforming cycle of the last several years has been a doozy, bringing the outperformance below trend-line, albeit still well ahead of growth over the full 41 years. It should be noted that FRM’s current underperformance cycle did not begin until 2011.

When undervalued assets are purchased, they do not usually outperform immediately. Sometimes they just keep getting cheaper. What is most important is to stay the course. What

is crucial is to not throw in the towel on value strategies when they are out of favor. We recently saw reference to a study by Ashvin Chhabra, head of Euclidean Capital and author of The Aspirational Investor, that said that for the 30 year period from 1984 to 2013, the S&P 500 Index returned an annualized 11.1%, but the average return earned by investors in equity mutual funds over the same period was “a paltry 3.7% per year, about one-third of the index return.” We have seen a multitude of DALBAR, Inc. studies over the years that make the same point. The average investor’s underperformance was a direct result of pulling money out of the funds at exactly the wrong times. By letting fear and greed take over their emotions, investors have underperformed both the markets and the same funds in which they were invested.

In today’s investment world of performance chasing, evidence abounds that investors have been firing low and hiring high. We have assembled a chart of two sound value investors that have some of the best long-term performance records in the business. We have a great deal of respect for both of these organizations. It is painfully obvious that their investors have been “throwing in the towel” at a rapid clip recently. As a result, these fund managers have been forced to sell stocks at a time that their “springs are coiled” and arguably offer the greatest upside potential. This is what is known as a negative feedback loop. So which is it? Is money fleeing these managers because of underperformance or are these managers underperforming because they, and many other value managers like them, are being forced to sell undervalued stocks to meet client redemptions?



Source: EDGAR Mutual Fund Filings, Foundation Resource Management

|   | Fiscal Year End | Fiscal Year End |
|---|-----------------|-----------------|
| <b>Value Mutual Fund Exodus During the Tech Bubble</b>                                    | <b>1999*</b>    | <b>2000*</b>    |
| Net Redemptions from Longleaf Partners, Windsor Fund and Oakmark Fund I (billions)        | -\$6.563        | -\$5.177        |
| <b>Subsequent 5-Year Annualized Longleaf Partners Fund Outperformance vs. S&amp;P 500</b> | <b>14.29%</b>   | <b>8.10%</b>    |
| <b>Subsequent 5-Year Annualized Windsor Fund Outperformance vs. S&amp;P 500</b>           | <b>3.10%</b>    | <b>1.40%</b>    |
| <b>Subsequent 5-Year Annualized Oakmark Fund I Outperformance vs S&amp;P 500</b>          | <b>7.72%</b>    | <b>10.80%</b>   |

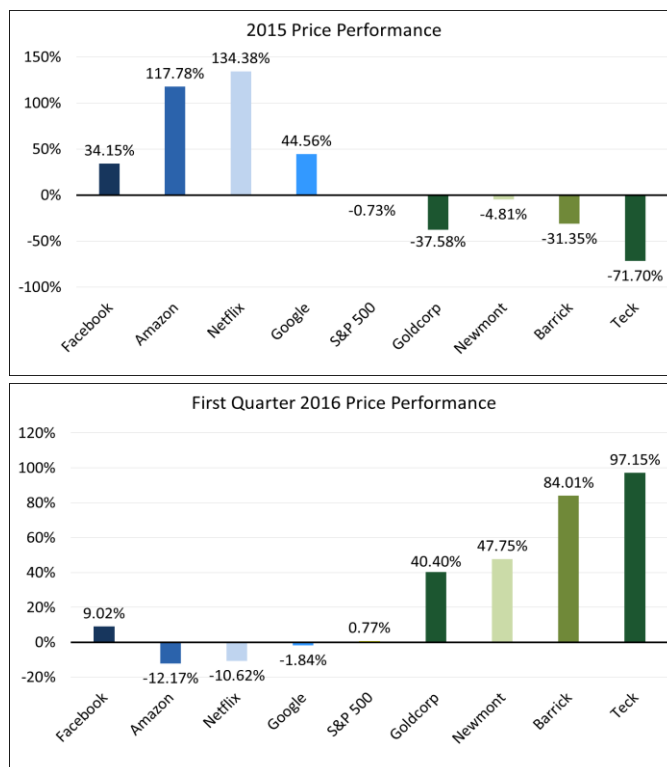
\*Fiscal year ending 12/31 for Longleaf, 10/31 for Windsor and 9/30 for Oakmark  
Source: EDGAR Mutual Fund Filings, Foundation Resource Management

It is not the first time we have seen this phenomenon. The same thing was happening 16 years ago at the peak of the Internet Bubble represented on this table to the left by the large redemptions from value mutual funds in 1999 and 2000. This signified the trough of these value firms’ respective performance cycles. While this type of investor behavior can inflict short-term performance pain to other investors and managers alike, it is also an encouraging sign to us because it has historically been a marker of a turning point in market leadership.

Seth Klarman, long time successful value investor at Baupost Group, recently said on this topic, “For an investor to overcome the desire to sell at the bottom and to take advantage of Mr. Market’s erratic movements, they must think not about what the market will pay for the securities today, (the stock price) but rather the true value of the securities you own.” In the long run, the research and analysis we perform should overcome market forces; the fundamentals ultimately matter. However, in the short run, markets can trump good judgment and insight.

The more out of favor, the more coiled the spring of stored value is for future out-performance. The recoil can be profound when it turns. We have assembled a chart that helps show how quickly sector rotation can occur. We have a comparison of last year’s winners that have been referred to as the FANGs (Facebook, Amazon, Netflix, and Google) and compared them to several of our worst performers last year that we will call GNATs (Goldcorp, Newmont, American Barrick, and Teck) – actually, American Barrick is just Barrick now but we can’t have a cute acronym with only consonants. What a difference a year makes. We do not want to make too much out of short-term reversals other than to use this as an example of the speed with which sector rotations can occur.

### *Sector Rotation Can Happen Quickly*

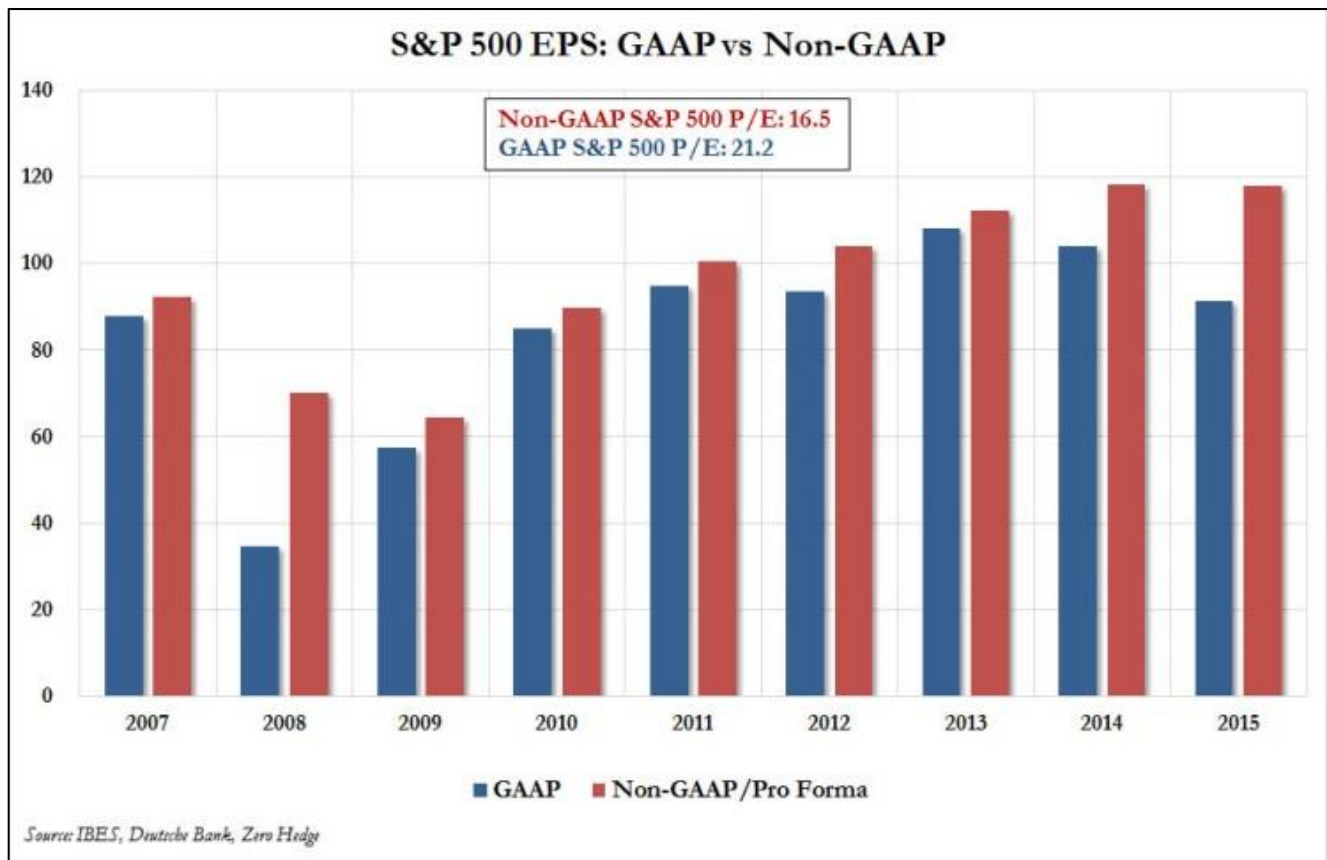


Source: Bloomberg

While we are on the subject of FANG stocks, we have also noticed lately that some of these popular, over-priced stocks are beginning to show up in some traditional value investors’ portfolios. We were recently surprised to see a webcast interview of a long respected, value mutual fund manager that had significant positions in Facebook, Amazon, and Google. The interviewer expressed shock in this discovery and the manager was doing verbal backbends to justify the holdings. This is disturbing to us, although not unprecedented. This is a sign of capitulation indicating we might be near a turning point in market leadership. The same phenomenon occurred at the Internet Bubble peak in 2000. At that time, aggressive growth stocks like Microsoft, Qualcomm, Nortel, Oracle, AOL, and EBay found their way into value investors’ hands who decided to join the crowd, rather than lose their clients. This performance pressure is not unique to value investors, by the way. It also occurs to growth stock investors when they are suffering tough times. Traditional value stocks sometimes begin to show up in growth managers’ portfolios with similar lengthy justification for their inclusion.

## GAAP or Gap

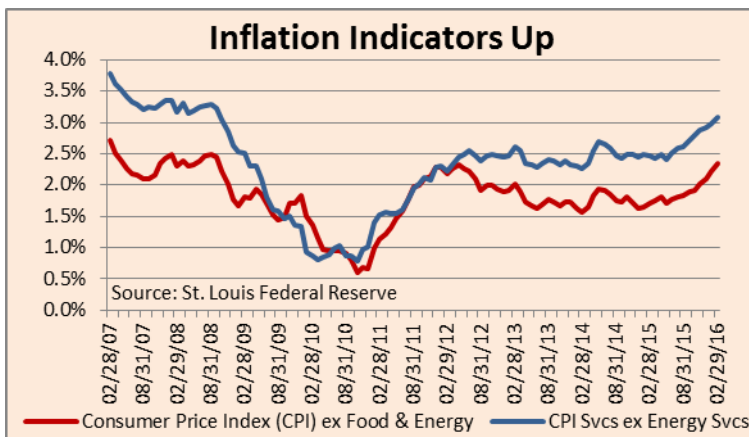
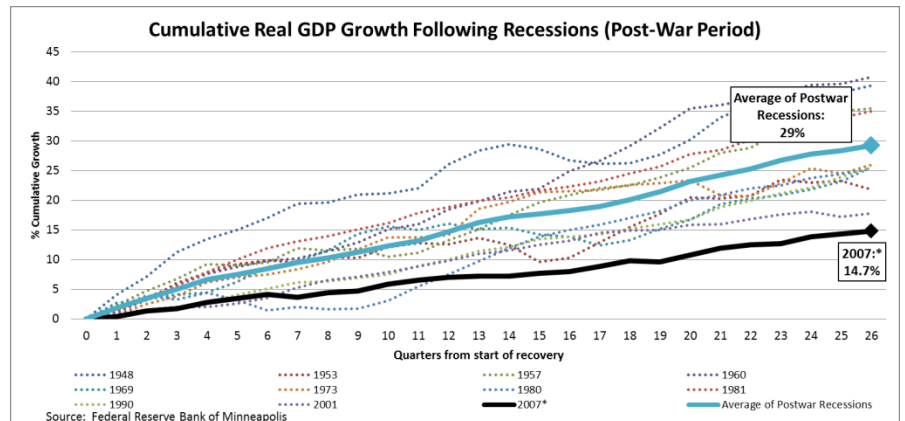
Last quarter we focused on the importance of accounting for tangible assets versus goodwill and intangible assets. At the risk of putting our non-accountants to sleep, we believe it is equally important to **briefly** discuss the increasing practice of companies emphasizing earnings on an adjusted basis rather than a GAAP (Generally Accepted Accounting Principles) basis. While GAAP is not perfect, it would be considered the “gold standard” in conservative accounting methods. The chart below reflects the increasing gap between GAAP and non-GAAP earnings of S&P 500 companies. The primary reason is that adjusted calculations make it easier for companies to manipulate their earnings and make profits appear higher than they really are. Typically, non-GAAP earnings do not include such fairly common things as asset write-downs, discontinuance of a business unit, or charges associated with acquisitions of another company. To put it in perspective, the fourth quarter 2015 GAAP earnings were approximately 24% lower than the non-GAAP earnings for the S&P 500 index for the same period. Historically, the gap between GAAP and adjusted earnings has been around 13%. When that gap widens it is often a sign that companies’ managements are becoming more aggressive in their “adjustments” in order to meet earnings targets. It may not be circumstantial that the last time we saw a comparable gap was in 2008.



## ZIRP Could Turn to NIRP

For over seven years now, we have made it clear that we believe that the Fed's choice to manipulate interest rates to near zero (ZIRP - Zero Interest Rate Policy) would not be without consequences. Under quantitative easing, the Fed has purchased an unprecedented 61% of all Treasuries issued, and at the same time, virtually quintupling the size of its

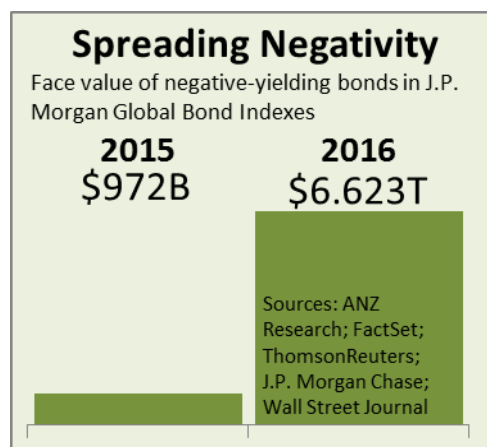
balance sheet. We believe that 0% interest rates are a tax on wealth. They are a tax on the prudent, the thrifty, the savers, and investors. 0% interest rates are a transfer mechanism to shift wealth from savers and investors to spenders (e.g. the federal government). When it comes to macroeconomic growth, we believe government spending is rarely, if ever, as productive as private sector spending. You cannot have growth without investment. If investment is discouraged by manipulating interest rates to 0%, you are virtually guaranteeing that long-term economic growth will be discouraged. Therefore, we argue that 0% interest rates (ZIRP) has been a poor long-term economic policy choice. However, it does seem to artificially inflate the markets for stocks, bonds, real estate, and other asset classes. Why does this happen? Simply, if you create free money, it will flow into capital markets rather than long-term initiatives that could bear fruit in terms of stronger economic growth. So when we see charts like the one above that show the current period of U.S. economic expansion is the weakest in the post-war period, we should not be surprised. We believe ZIRP has been a terrible economic policy, although understandable, because it is also terribly tempting.



Inflation expectations around the world are incredibly low, yet we have central bankers cranking up their printing presses. Japan, Europe, the U.K., and the U.S. are all targeting 2% inflation. Are they going to have their way? We would say yes, eventually they will. The graph on the left reflects the recently growing rate of inflation in the U.S. When inflation expectations are low, rising inflation can take investors by surprise. We just do not know when

that is likely to happen. Inflation could manifest at any time, even immediately. We want to be in those securities that are undervalued, averaging in, so that we have significant protection when inflation turns.

As if ZIRP is not bad enough, now we have Fed members talking about NIRP (Negative Interest Rate Policy). There appears to be a widespread belief among central bankers that if 0% interest rates are not creating sufficient economic growth, then negative interest rates will surely be the cure. At right is a chart of the worldwide outstanding foreign government bonds that are currently quoted with negative interest rates. The concept of actually paying someone to hold your money is difficult to grasp. Is it coincidental that governments around the globe are contemplating eliminating large denomination bills from the outstanding currency at the same time that negative interest rates are being implemented? The stated argument to justify this currency change is to make “black market” activity such as the drug trade and money laundering more difficult by eliminating larger denomination bills, and there is some merit to this argument. However, it would also make it more difficult for savers to retain cash rather than having to pay a financial institution to hold their money. “Just sayin’,” as the millennials like to exclaim.



### **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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