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**July 11, 2019**

# Quarterly Commentary

**2nd Quarter 2019**

## **Throw the Book Out?**

In his annual, highly anticipated letter to shareholders this year, Warren Buffett broke with tradition and excluded from his first paragraph the percentage change in the book value per share of Berkshire Hathaway common stock for the year. For almost three decades, this statistic highlighted the opening as a way of approximating the annual increase or decrease in economic or intrinsic value of a stockholder's investment in Berkshire. One of the reasons Buffett cited for the change: "it is likely that - over time - Berkshire will be a significant repurchaser of its shares, transactions that will take place at prices above book value but below our estimate of intrinsic value. The math of such purchases is simple: Each transaction makes per-share intrinsic value go up, while per-share book value goes down. That combination causes the book-value scorecard to become increasingly out of touch with economic reality."

This change created quite a stir in the investment community, particularly in the value investing community. It has been value investors that have traditionally used the ratio of price/book value as a measure of potential attractiveness (the lower the better).

At FRM, we long ago recognized the problems associated with relying on book value, as presented in a company's balance sheet, as a trustworthy measure of a company's worth. Many accounting conventions and business transactions have caused book value to stray further and further from intrinsic value. You may recall that last quarter we highlighted the fact that business acquisitions and stock buyback activity at prices above book value per-share (though seemingly never below intrinsic value) were increasing the share of intangible assets relative to tangible assets in the broad market.

Further in his letter, Buffet goes on to make the statement that, "In future tabulations of our financial results, we expect to focus on Berkshire's market price. Markets can be extremely capricious... over time, however, Berkshire's stock price will provide the best measure of business performance." Many business pundits jumped on this to proclaim the "death of book value" leaving the impression that Buffet considers it a useless tool.

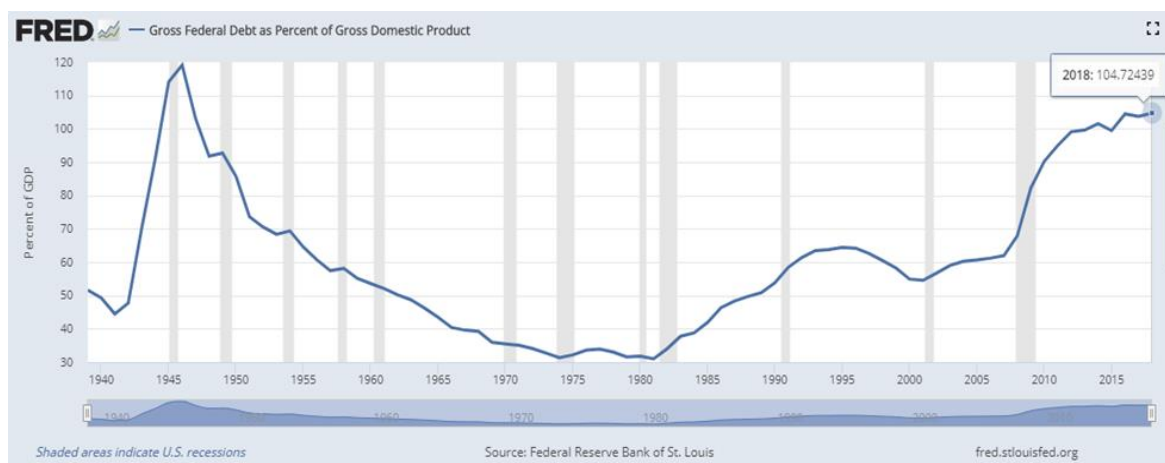
The fact is accounting is not an exact science. Not even close. Worldwide, there are two primary accounting systems at work, U.S. Generally Accepted Accounting Principles (GAAP) and the International Financial and Reporting Standards (IFRS). In our work, we must recognize the strengths and weaknesses (too boring to expound upon) of these two systems in coming to our own estimation of intrinsic value. We absolutely do not rely on published book value or market value to tell us what a company is worth.

If we may be so bold to assume that you are still awake at this point, you may be wondering why we are headed down this rabbit trail. In visiting with some of our clients, the question has arisen as to whether we are changing our approach to keep up with the changing times, the implied assumption being that we are not. **Our answer would be that we absolutely are. Over the years, we have had to change and evolve how we measure intrinsic value as business, business accounting and all the forces influencing security valuations become more complex.** One example is that we historically used 10 years of past data when assessing operating performance, but 10 years has become less useful since we have not experienced a recession since 2009. Therefore, while our work has greatly changed, the way we implement value investing on your behalf has not. In other words, we continue to believe that public stocks should be bought on the basis of their underlying business and financial fundamentals. In doing so, we will always demand an analytical case for an above average return on your equity that provides a sufficient margin for error.

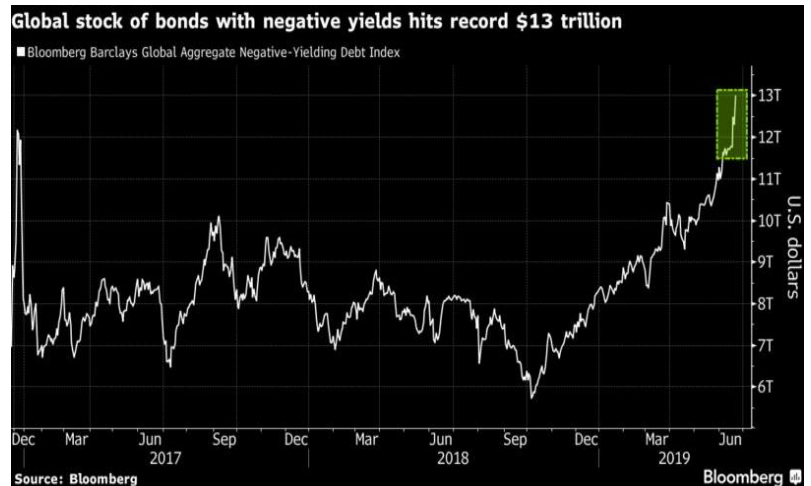
## A Strange New World

At the risk of dating ourselves with the title of this section (1970's Sci-Fi), we thought that we would continue the topic of the changing environment in which we assess public securities. It is definitely A Strange New World! We recently began compiling a list of fiscal, monetary, market and economic weirdness for which we were never trained nor could we have ever imagined. The longer these things exist, the more normal they seem to the public, but not to us. They include:

- \$22,483,000,000,000 in U.S. Government debt and counting—more than double since the financial crisis of '08; an 8.1% growth rate during that period versus a real GDP growth rate of only 1.7% (the last seven digits of the debt clock are changing so rapidly you can't even get them written down!)



- \$13,000,000,000,000 in foreign sovereign government debt, mostly in Europe and Japan, trading at a negative interest yield (it is still hard for us to get our minds around that one)
- Negative real (after inflation) short-term interest rates in the U.S. for more than a decade
- Open market purchases of European corporate bonds by the European Central Bank

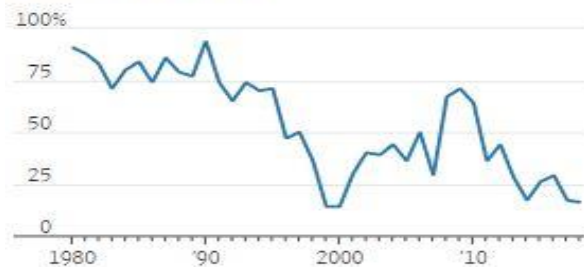


- Japan and Swiss central banks, in an unprecedented move, have purchased common stocks over the last few years, with the Swiss directly investing in U.S. common stocks. The Bank of Switzerland is among the largest shareholders of several of the stocks in our research pipeline. At least one former chairperson of the U.S. Fed has publicly mentioned the purchase of U.S. corporate stocks and bonds as a potential Fed monetary policy tool. No one can see the potential problems from that?
- As an emergency measure, the Fed began paying interest on banks' reserves on deposit with the Fed in '08. The Fed is still paying interest on \$1.4 trillion of these reserves today. This "emergency" action created an incentive for banks to retain their capital as excess reserves at the Fed instead of using them to extend loans to the public. That behavior by the banks offset much of the inflationary risk the Fed was creating through its purchase of treasuries and mortgage backed securities. It makes one wonder if we still have an emergency. If this sounds a little like smoke and mirrors, join the club!
- Hundreds of public companies in the U.S. have negative tangible book values, many of which also have negative total book values (see first topic discussion above).
- We are in the longest bull market for the U.S. stock market in history without a 20% correction (stocks can go down, right?).
- The market for initial public offerings again looks like it did in the late 1990's. As you can see from the chart, the percentage of technology companies going public that are profitable has declined to under 20%, a level last seen in the Tech Bubble.

### Loss Leaders

Fewer than 20% of tech companies filing IPOs in recent years are profitable, the lowest such number since the dot-com bubble burst in 2000.

### Share of technology companies going public that are profitable

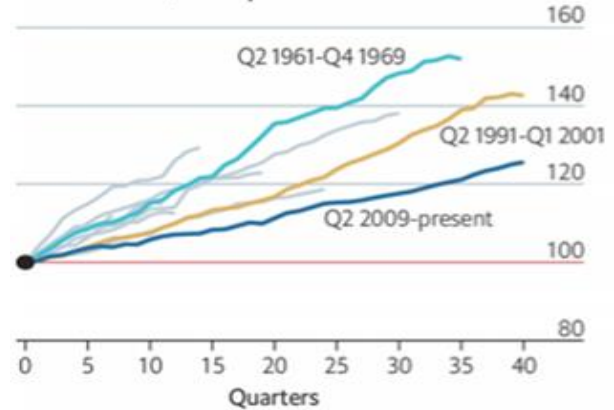


Source: Jay Ritter, Professor of Finance, University of Florida and Wall Street Journal

- The longest (and weakest) expansion of the U.S. economy since WWII (see nearby chart)
- Attempts to micro-manage the stock market and growth of the economy by politicians and the Federal Reserve is unprecedented in our lifetimes. Does anyone doubt that the December Fed reversal had something to do with the correction in the stock market we were experiencing in the fourth quarter of 2018 and President Trump's badgering of the Fed for lower interest rates?
- Modern Monetary Theory is gaining acceptance as a valid and viable monetary policy, espousing the idea that the government should create all of the money it "needs" and the amount of the federal deficit and debt doesn't really matter as long as the currency remains sound. And how long would that be? **Hello!!!!** On the brighter side of future monetary practice, we see the nomination of Judy Shelton to the Federal Reserve Board as a positive (though some of her most recent interviews have us scratching our heads). We know of no other monetary economist who has written more about the need for a stable monetary unit. She would bring to the job a healthy cynicism and humility about the Fed's ability to pull all of the right levers at the proper time.
- In the race between growth and value investing, growth has gone on an unprecedented tear, as you are painfully aware. Growth has outperformed value six out of the last seven years. **Barron's** recently proclaimed the death of reversion to the mean and value investing. More on this below.
- The death of inflation has been announced recently on the cover of **Bloomberg Business Week**. No mention of asset price inflation (see bond market, stock market, real estate market, and collectibles market to name a few). By the way, we are seeing the phrase "it's different this time" more and more often.

Economic expansions, first quarter=100

United States, 1949-present



Sources: BEA; NBER; OECD; *The Economist*

*The Economist*

In this rapidly changing environment that evolves in ways that are unpredictable, it is incumbent on us to understand these changes and how they potentially impact security analysis and portfolio risk management. The world is growing in complexity. Current fiscal and monetary practices around the world are completely unhinged from any evidence of discipline.

Though the future is unknowable, **many of the items listed above have and will generate future financial system instability.** The history of the world of finance is that the world bounces from one financial adjustment to the next. These adjustments are often seen and referred to as financial crises. While we do not know when the next crisis will take place, it is our responsibility to position our clients in a manner that we might protect and, if possible, benefit our clients post adjustment. In this environment, we believe we are currently doing a better job than ever before on behalf of our clients. We are working for our own families in exactly the same manner as we are for you.

### Growth vs. Value

As promised above, we want to address the growing divergence between growth and value investing over the last several years. Before beginning, realize that this comparison was historically more of a focus in the world of institutional investing as performance benchmark indices became defined and redefined as either growth or value. While such comparisons have their place, we believe that the achievement of client investment objectives should never be overshadowed by a preoccupation with benchmark index results.

As we have discussed in past commentaries, the last several years of outperformance by growth benchmarks has primarily been the result of a large valuation expansion of technology and other growth industries. We believe that the two main contributing factors to this valuation expansion are excessively low interest rates that foster speculation and indiscriminate passive investing as practiced by index funds, exchange traded funds and corporations that purchase their own shares (the largest source of demand in recent years). As you probably remember, the late 1990's were also a period that found favor with passive investing. That resulted in huge losses by a broad portion of the investing public and very disappointing results when measured over the following decade.

The extreme valuation of growth companies has contributed to the broad market's similarly stretched valuation multiple. The price to operating earnings for the S&P 500 is currently at a very high 16.3x compared to the average of 12.4x since 1990. In addition, the average operating margin for a company in the S&P 500 is at a very elevated 13.47% compared to the historical average of 11.64% since 1990.

	S&P 500	
	Trailing 12 Months	Average Since 1990
Annual Sales Growth	5.1%	3.9%
Price to Operating Earnings	16.3x	12.4x
Operating Margin	13.47%	11.64%

Source: Bloomberg and Standard & Poor's

Even if you expect these elevated multiples and margins to persist for the next decade, it still requires some very aggressive growth assumptions to earn a fair return on an investment in the broad market. The following chart shows that if you buy the S&P 500 today and expect to achieve a 10% annualized return from your investment, by definition you must believe that the average company in the S&P 500 will be able to grow its revenues by 10% per year. Revenue growth of 10% is 2.6 times the 24-year average of 3.9% for the S&P 500!

## Sales Will Have To Grow 2 to 3 Times The Historical Average for an Investment in the S&P 500 To Generate 10% Annualized Returns Over The Next Decade

	Sales Growth Required	Multiple of Avg Sales Growth*
No Change in Multiple of Price to Operating Earnings (PE) or Operating Margin	10.0%	2.6x
Price to Operating Earnings & Operating Margin Return to Long-Term Average	14.6%	3.7x

Source: Bloomberg and Standard & Poor's

\*Multiple of Average Sales Growth since 1990

If you instead believe that operating profit margins and price/earnings multiples will both revert to historical averages, you would need the average company in the S&P 500 to grow its sales by 14.8% per year or 3.8x the long term average level in order for you to achieve a 10% average return on a purchase of the S&P 500 today. If you believe all of that, you may have already purchased some swampland in Florida. Paying above average prices almost always leads to below average results.

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