FRM
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April 13, 2020

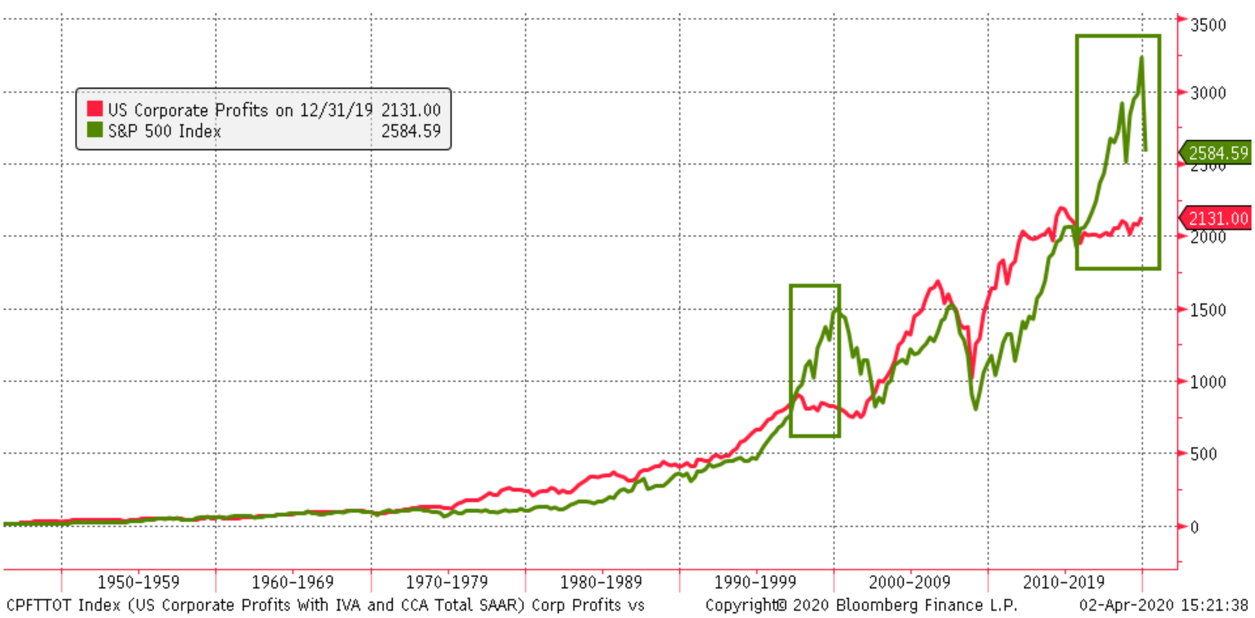
Quarterly Commentary

1st Quarter 2020

A Historical Perspective

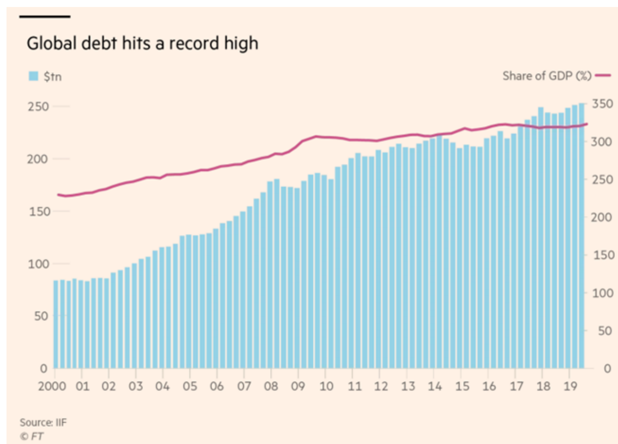
"You can't know where you are without knowing from where you came!"

As most of you know, we have been concerned about broad stock market valuations for several years. This was demonstrably evident to us in our research efforts searching for attractive security values. The chart below displays why our research efforts have felt so unproductive over the last few years. The stock market had separated itself from corporate earnings over the last five years, much like it did 20 years ago. This was a function of artificially low interest rates. Investors were willing to pay markedly higher prices for earnings that generally were not growing. After a record-setting 11-year bull market, this established the potential for an unforeseen catalyst to cause significant financial revaluations.



The term "Black Swan" was made famous by Nassim Taleb in his 2001 book, Fooled By Randomness. "Black Swan" became a common expression for an unpredictable event that, due to its randomness, had a disproportionate impact on financial markets. It became evident as the first quarter progressed that the Coronavirus was the "Black Swan" event that no one, including us, saw coming. Phrases like COVID-19, Pandemic, Flatten the Curve, Shelter-in-Place, Social Distancing, and Zoom Conferencing have suddenly become part of our daily vocabulary.

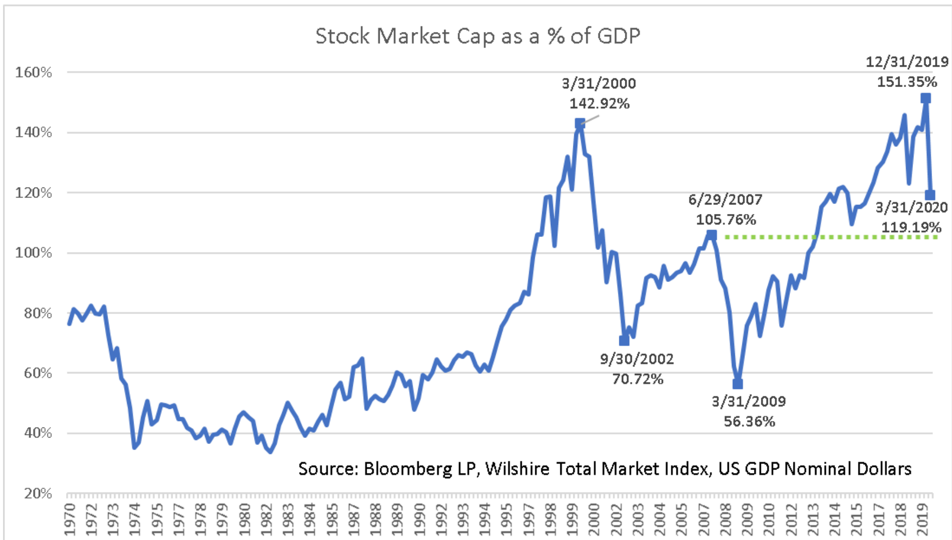
What is most important about unpredictable events is that the magnitude of the financial impact generally is proportional to the conditions that are present upon recognition. In other words, a Black Swan event will have a more extreme effect when risk factors are greatest or are not heeded by risk-takers. Forest fires are much worse and deadly if there is plenty of dry fuel in the forests. We have been concerned about higher than normal risk factors present for some time which, until lately, have been brushed off by many investors as insignificant. The massive levels of debt (public, corporate, personal) have been our greatest concern. Current world-wide debt to GDP ratios of 323% are higher than at the previous peak prior to the 2008-2009 Great Financial Crisis. This is a reflection of the high levels of financial risk in the world. These high debt levels are a direct result of artificially low interest rates orchestrated by the world's central banks. This concern is why we have been so fixated on stressing quality balance sheets of our invested companies.



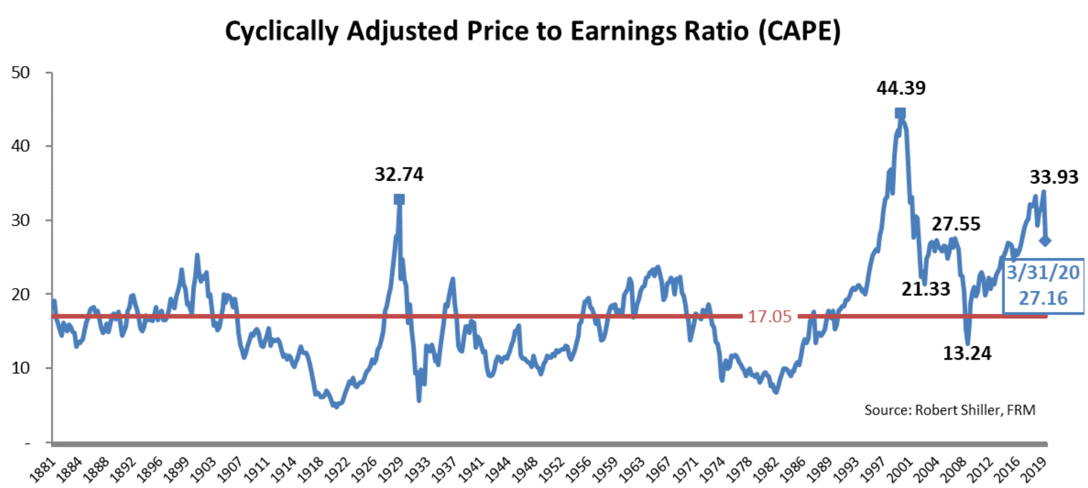
Our criticism of the Fed is not what they have done during economic hard times, but what they did not do during times of economic prosperity. They refused to normalize their policies after three, five, seven, nine, and even 11 years of economic expansion. Prior to this pandemic, the national unemployment rate reached a record-low of 3.5%. Fiscal policy produced a "double whammy" as we were running trillion-dollar annual federal budget deficits during the longest economic expansion in U.S. history. So now our fiscal and monetary ammunition are not what they could be when they are most needed. The prior two recessions started with the Fed Funds rate at 6% and 5¼%, respectively, as opposed to 1½% this time. Traditionally, that has not been much ammunition to work with. One month into economic hardship, the Fed has already dropped interest rates to zero. That does not allow much bang for the buck.

So, where are we now that the stock market has sold off by 20% this quarter? We have had a number of conversations where the common statement to us was, "Well, you must be finding this as a tremendous buying opportunity!" Thankfully, we started this period with more cash and gold stock holdings than normal for most of our clients. Clearly, our research work has gone into over-drive. We are energized. Rather than weekly, we have been meeting at least daily and sometimes multiple times per day. We have been working around the clock with our research process. We are encouraged that risk in stocks and corporate bonds are **beginning** to be priced more accurately and attractively. However, we have to stress only **beginning**.

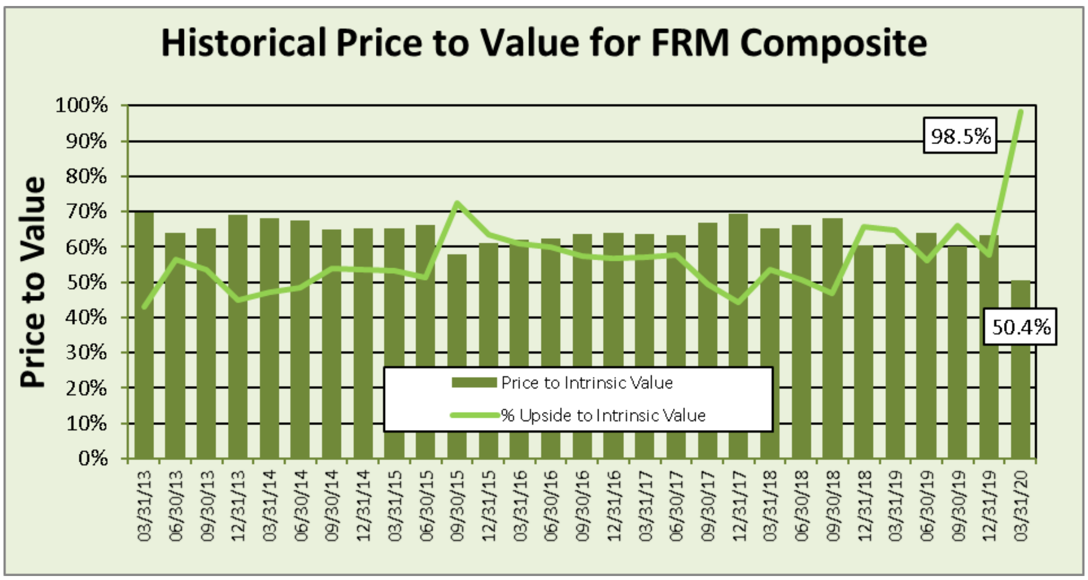
As you can see below, we have updated two charts that we, and many investors, use to help determine broad stock market valuation levels. The first chart showing levels of Stock Market Cap to GDP, has commonly been called the "Buffett Indicator" because it has been cited by Warren Buffett as "the single best measure of where valuations stand at any given moment." While the levels of stock Market Cap/GDP have clearly declined, we are not yet even back down to the peak levels prior to the last bear market in 2007. That was a stock market that declined almost 60% from that level. And by the way, if anything, this indicator is probably under-stated since GDP is surely projected to decline in the near future.



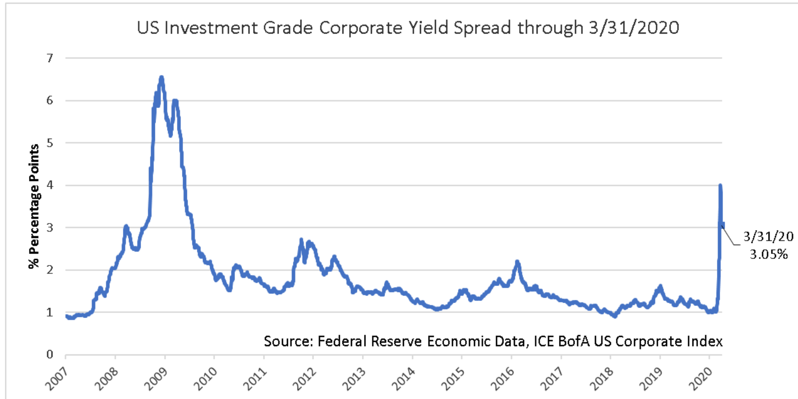
The Shiller CAPE ratio is one that we have displayed before. We like it because it smooths out cycles by averaging earnings over 10-year rolling periods, generally a period long enough to incorporate good and bad economic conditions. Again, it has come down substantially, but has a long way to go before even reaching average valuations. We have adjusted the denominator of this calculation to the average earnings since the last recession because looking backward over the last 10 years currently does not include any recessionary environments. That is probably soon to change, though, as it is almost certain that we will be entering a recession soon if we are not already in one now.



As we told you via one of our intra-quarter emails, we will be both disciplined and patient. We are diligently searching for diversification while taking this opportunity to upgrade our holdings. We are actively re-researching our "Wish List" of great companies that we have always wanted to own when their stock prices got to an attractive level. As reflected in the Price/Value chart below, conditions are definitely improving for the prospects of higher future returns for stocks in our portfolio. We measure the current price of our stock holdings as compared to our estimation of their "Intrinsic Value," or the value of owning the cash flows generated by their businesses. As you will note, the upside potential to this "Intrinsic Value" based on our current holdings has jumped to over 98%. We are invested generally in companies with low debt, few near-term obligations, with good dividends, that are run by experienced leaders who have successfully negotiated business cycles.



Finally, Yields are Beginning to be More Attractive!



For the last decade, investors have been starved for yield. The unprecedented Central Bank policies of low interest rates over the last decade have been skewed strongly in the favor of debtors and have sacrificed savers in the process. If we had told you a quarter ago that you would have dividend yields of high-quality stocks in some cases at 6-7% (more details to follow) and investment grade corporate bond yields of 4-5%, wouldn't you have been thrilled? Well that is what bear markets can create. Unfortunately, you never get great valuations like high dividend yields when everything economically is great. While not enjoyable for many of our current holdings, the prospective opportunities are looking up for purchases.

Likewise, in the bond market, credit spreads (see chart above) have widened for investment grade corporate bonds, which are more accurately reflecting credit risk today. The corporate bond market has frozen up in March due to investors' liquidity concerns. This is finally starting to shift the advantage to buyers of corporate bonds from sellers.

Bob Farrell's Ten Rules to Remember

35 years ago, on his first research trip to NYC, one of our more (ahem) seasoned investment professionals had the great opportunity to meet one-on-one with Bob Farrell in his office at Merrill Lynch. Farrell, a Columbia graduate, and in his early years a disciple of noted value investors Benjamin Graham and David Dodd, had an extremely successful 50-year career on Wall Street. One of the things that he was most known for was his 10 investment rules to remember. It is times like the present when we think it wise to dust off these rules that highlight the importance of having and sticking to a discipline. So, we are glad to share a little wisdom to help keep current events in proper perspective.

	Bob Farrell's Ten Rules To Remember
1.	Markets tend to return to the mean over time
2.	Excesses in one direction will lead to an opposite excess in the other direction
3.	There are no new eras — excesses are never permanent
4.	Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways
5.	The public buys the most at the top and the least at the bottom
6.	Fear and greed are stronger than long-term resolve
7.	Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names
8.	Bear markets have three stages — sharp down, reflexive rebound and a drawn-out fundamental downtrend
9.	When all the experts and forecasts agree — something else is going to happen
10.	Bull markets are more fun than bear markets.

NOPEC+

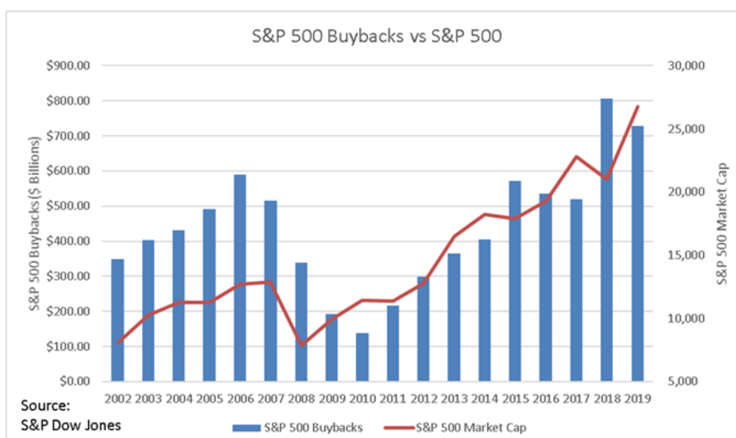
On March 6th, just as the Coronavirus pandemic was taking off around the world, OPEC's pact with Russia to coordinate simultaneous production cuts fell apart. The three-year pact between OPEC and Russia ended in hostility after Russia refused to support deeper oil production cuts to contend with the COVID-19 outbreak. In reaction, OPEC responded by eliminating all limits on its own production. This amounted to a large-scale game of chicken between OPEC and Russia with the real target on the backs of U.S. producers who have grown production in an unchecked fashion for several years. These events have led to an unprecedented simultaneous supply and demand shock leading to oil prices dropping by 66% for the quarter. It probably goes without saying that this was unanticipated bad news for oil producers. However, the amount of capital spending cuts announced and implemented in the following weeks will set the stage for future oil shortages once demand begins to recover whenever the pandemic is behind us and things return to some degree of normalcy. We are likely to see a tangible decline in U.S. oil production. These events should allow for a natural clearing of the market for U.S. shale production. Meanwhile, we believe that Saudi Arabia is very limited in its spare capacity to raise production meaningfully. One consequence of these events is that with lower oil prices, there is less financial incentive for switching to electric vehicles.

Top 5 Announced Capex Cuts by North American Oil Producers (as of 4/7/20)

	2019 Capex	2020 Guidance Previous	2020 Guidance New	% vs 2019
ExxonMobil	31,148	33,000	23,000	-26.2%
Chevron	21,000	20,000	16,000	-23.8%
Occidental Petroleum	6,355	5,300	2,800	-55.9%
Diamondback Energy	3,703	2,900	1,700	-54.1%
EOG Resources	6,200	6,500	4,500	-27.4%
	68,406	67,700	48,000	-29.8%

Source: all figures came from company press releases.

Merited Attention to Stock Buybacks



It has come to our attention in our research meetings that numerous companies have similar characteristics. Over the last decade, many have minimal sales growth, negligible net income growth, increased debt loads, reduced shares outstanding, and increased earnings per share (EPS) due to the reduced share count, not increased earnings. We have brought this up before in previous commentaries by identifying the primary reason for the EPS growth as financial engineering, not improving operating profits. It has taken a pandemic leading to the first bear market in 11 years to shed light on the risk of companies leveraging their balance sheets with debt and buying back stock. When conditions get tough, what do you have to show for this kind of action? You get a lot of debt and also cash wasted on unproductive assets. This is becoming more apparent to the public as corporate bailout decisions are beginning to be discussed.

Corporate stock buybacks have been the primary source of stock purchases over the last decade. As you can see from the chart above, we have highlighted the apparent poor timing of stock buybacks over the years. Companies generally buyback more stock at high prices and less stock at low prices. We are reminded of that today as many companies race to cut their stock buybacks when times are tough, but also when stock prices have declined. The financial bailout, which has brought Democrats and Republicans together, at least temporarily, has increased the scrutiny and likely forced discipline on corporate leaders to restrict stock buybacks in concert with rich stock option programs.

Coronavirus – Unanticipated Consequences

This pandemic the world is currently experiencing is tragic. It has changed behavioral patterns, in some cases, possibly permanently. However, there will be unanticipated consequences of this changed behavior that we need to explore. One thing that has come to our attention is very preliminary data from the CDC on overall deaths in the U.S. While the death toll from COVID-19 has steadily increased and accelerated in recent days, the overall death toll from **ALL** causes of death has, at least preliminarily, begun to decrease. The recent decline in **ALL** deaths potentially suggests that this may be an unanticipated consequence of COVID-19 due to people adjusting their lifestyles. As people focus more seriously on hygiene and physical exposures, lower incidences of pneumonia and influenza may be the outcome. Likewise, as people stay at home more, incidences of crime and travel-related accidents are showing some signs of decline. Our intention is not to minimize the severity of this world health crisis, but to cause us to think more broadly of the overall impact and the resultant unanticipated effects. They may not all be negative.

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) 534-2675.

Important Disclosure Information