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April 11, 2019

Quarterly Commentary

1st Quarter 2019

“Imagine how much harder physics would be if electrons had feelings!”

This quote, from noted physicist, Richard Feynman, was brought to our attention recently in Howard Marks’ new book, Mastering the Market Cycle. This book emphasizes the influence of human emotion on the cyclicity of markets. In today’s world of mechanical index investing, robo-investors, and artificial intelligence, many are arguing that the days of cycles are over. This is potentially an easier argument for others to make today, especially as we have just passed the 10th anniversary of the current bull market for stocks in the United States. That makes this bull market the longest ever in our country’s history. Likewise, in only a few months, our current economic expansion would become the longest ever in United States history. Some investors have become confident that economic and stock market prosperity will be omnipresent.

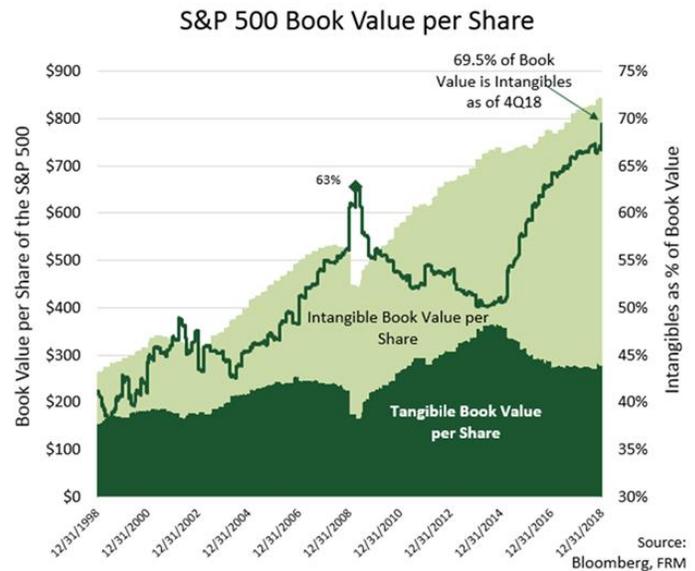
We, on the other hand, fully concur with Marks because we believe the human factor in investment decision-making is now, and will always be, present in the investment world. Ultimately, a human being, subject to emotion, will be the determining factor in when, how, where, or with whom funds are invested. Whether it is the actual owner of the funds, the board overseeing the investment of an organization’s funds, or the advisor of the funds, the human touch and emotion will always be involved. We do not know how to separate the two. Fear, greed, and their magnified impact on the financial markets will always exist, leading to some form of cyclicity.

If you have been reading our quarterly commentaries, you are aware that we have observed that most stocks specifically, and the broad stock market in general, are very highly valued today. We would categorize most markets today as “sellers’ markets” more than “buyers’ markets.” Our research process has clearly confirmed this. Our weekly research meetings have lately borne less fruit than we would prefer since many of the companies we research are priced for perfection (low margins for safety) with very low expected returns and often weaker balance sheets than desired.

On the subject of balance sheets, we are more focused today on the quality of our companies’ balance sheets than ever before. In companies we analyze for potential investment, we have emphasized limited or decreasing debt levels and have preferred longer-term debt over shorter-term debt, which helps reduce the refinancing risks of companies during challenging times. To reflect this focus, our

clients' equity portfolios have a debt/equity ratio of 48.74% on 3/31/19 versus 118.46% for the S&P 500 Index.

Just as importantly, we are scrutinizing the quality of the asset side of the balance sheet with a strong bias towards tangible assets. Increasingly, we are seeing more companies accumulating intangible assets, mostly goodwill. There are generally two activities causing this worrisome increase in intangible assets. First, companies have been aggressively buying back their own stock at inflated prices well above book value. Second, companies have been making numerous acquisitions of other companies similarly at prices well above book values creating intangible assets out of thin air. As you can see from the chart nearby, intangible assets made up 69.5% of the S&P 500's book value as of 12/31/18, the highest level in over 20 years. We have run the same calculation for our clients' portfolios and, on average, intangible assets only make up 34.5% of our companies' book values. Our primary concern about intangible assets is that the bull market is being driven more by air than the growth of real assets. We learned from the Global Financial Crisis 10 years ago that intangible assets could evaporate into thin air just as quickly as they are created into thin air during an acquisition.



While we have found several specific pockets of immense value opportunity in which we are very enthusiastic, we have clearly identified many signs of overvaluation that give us reason to avoid

unnecessary risk with your capital. While we never know with certainty where the stock market is going, it is extremely important that we recognize where we are.

Referring back to the theme of market cycles with which we began this commentary, Howard Marks has put together numerous timeless indicators of stock market peak and trough characteristics that should always be acknowledged. Nearby we list several of them, and they are almost universally signaling a reason to be more cautious today than usual. That helps explain why our clients' equity portfolios probably look less like the overall market than at any time in our past. It also is why lately we have been selling more stocks than buying as stock prices have been reaching intrinsic values more frequently. These circumstances have caused us to accumulate more cash than normal.

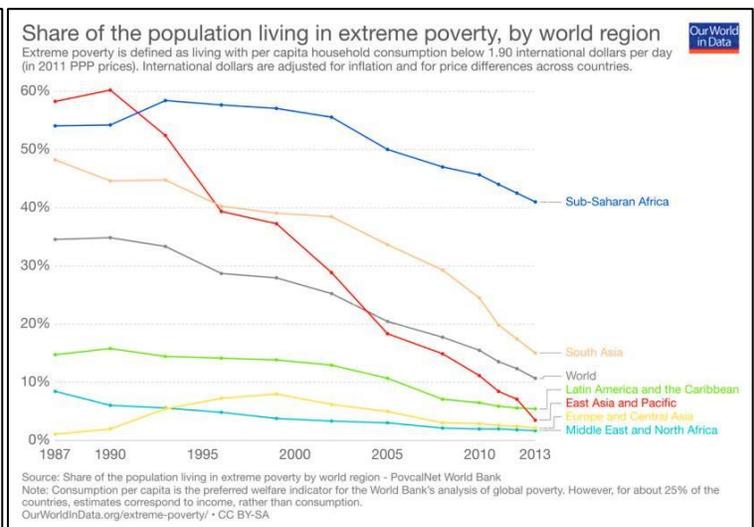
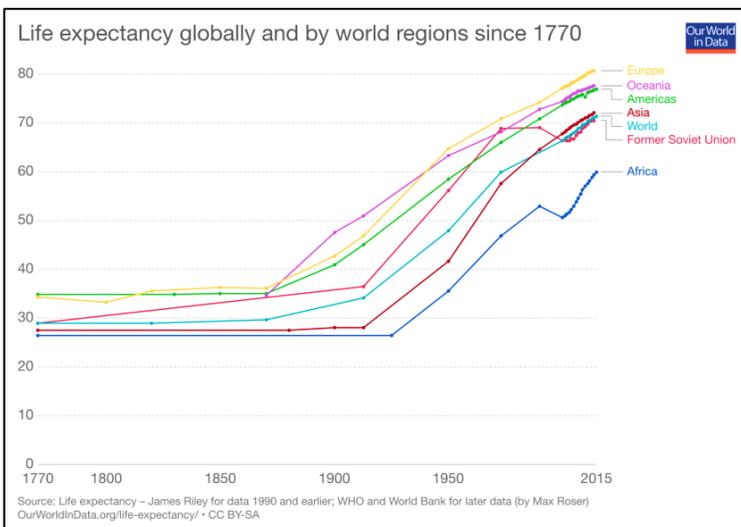
	Market Peaks	Market Troughs
Economy:	Vibrant ✓	Sluggish
Lenders:	Eager ✓	Reticent
Capital markets:	Loose ✓	Tight
Capital:	Plentiful ✓	Scarce
Terms:	Easy ✓	Restrictive
Interest Rates:	Low ✓	High
Yield Spreads:	Narrow ✓	Wide
Investors:	Optimistic ✓	Pessimistic
Asset Owners:	Happy to hold ✓	Rushing for the exits
Sellers:	Few ✓	Many
Markets:	Crowded ✓	Starved for attention
Recent performance:	Strong ✓	Weak
Asset prices:	High ✓	Low
Prospective returns:	Low ✓	High
Popular qualities:	Aggressiveness ✓	Caution and discipline
Available mistakes:	Paying up ✓	Walking away

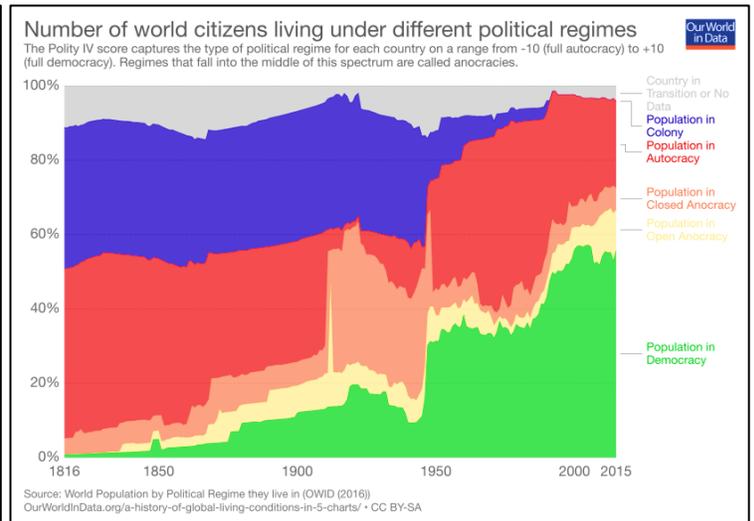
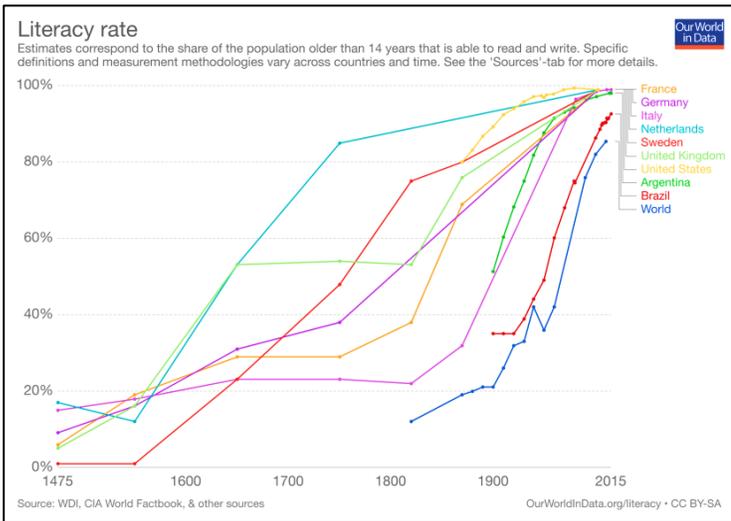
Source: "Mastering the Market Cycle" by Howard Marks

So What Are We Optimistic About?

You may be surprised that this is an easy question for us to answer with, “How much time do you have?” We know from some of our recent client meetings that we have been rightfully accused of sounding a little like a Debbie Downer when it comes to the lofty conditions of the financial markets. Likewise, most journalists are programmed to focus on adverse events or negative perspectives on various topics. It is important that we put all the bad news we hear daily into proper perspective. In that vein, we have not lost sight of many of the incredibly positive things going on around the world, our nation, and even at the local level. So, we will address the question by breaking out those three areas.

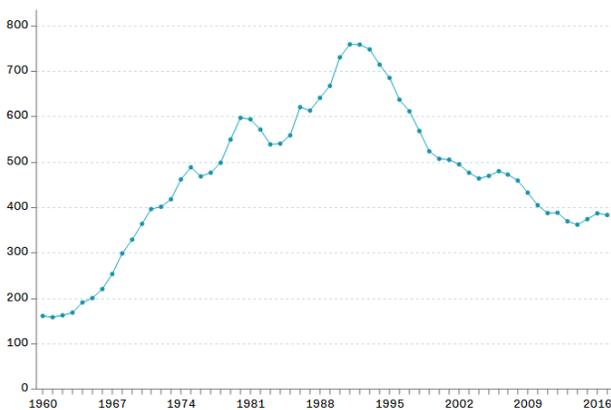
- 1.) The World – If you live in the developed world like most of us do, most people surveyed would tell you that the world is getting worse. The opposite is true if you ask people in the developing world. The facts are very clear that on virtually all of the key statistics of human material well-being – life expectancy, poverty, literacy, health, and freedom- the world is an extraordinarily better place to live. If we told you that income inequality is declining, you would probably think we were insane. That is because we generally have an American perspective on issues. While income inequality within certain countries such as the U.S. has gone up as a result of globalization, income inequality on a global scale has been on a steady decline for decades. This is primarily a result of developing countries such as India and China, where hundreds of millions of people have seen improving living conditions. In fact, for the first time since the Industrial Revolution, approximately half of the world’s population can be considered middle class from a global perspective. A number of the companies in which we have invested are part of the improving conditions we are seeing worldwide in some of these categories. The charts below and on the following page clearly reflect many of these improvements.





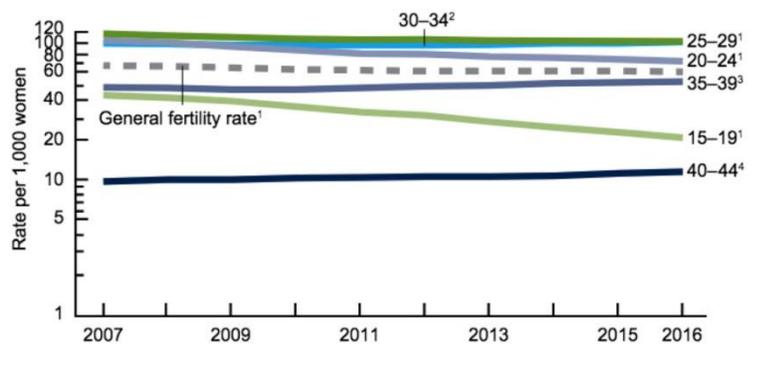
2.) Our Nation – Economically, one can't miss the telltale signs of a long- albeit muted-economic expansion. We have the lowest unemployment rate in our lifetime, and inflation, as currently measured, is modest. We know that there is presently a wide prosperity gap in the U.S., but we are encouraged that wages are beginning to rise, which should help begin to level the playing field between the haves and have-nots. Homicide deaths, in spite of what you read in the press, are down. One reason for this that we had not thought about until a physician raised our awareness on this topic may be because medical treatments have improved significantly, so there could be just as much extreme violence, but survival rates have meaningfully improved. However, on a per capita basis, U.S. violent crime rates have definitely declined. Another improvement that may be somewhat surprising is that teen pregnancy rates in the U.S. have halved in the last decade.

The US violent crime rate per 100,000 people



Sources: [FBI](#) and [more FBI](#)

Figure 1. General fertility and age-specific birth rates, by age of mother: United States, 2007–2016



- 3.) Locally – One of the things that we are most optimistic about is our younger generations. We informed you last year that our two principals sold a minority interest in our firm to five of our “next generation” employees. They are all in their 30’s and 40’s. Having worked with them all for periods ranging from 4-17 years, we are blown away by their skills, thirst for knowledge, drive, and most importantly, their integrity. We truly have learned as much from them as they have from us. While we have more gray hair and the battle scars of experience, they have different ways of thinking and processing information that is efficient and decisive. We could not be more optimistic about the future of FRM. Likewise, we have intentionally spent more time with young people professionally over the last few years. Admittedly, at least one of us had the preconceived idea that there was grade-inflation and that many college students lacked the work ethic that “our” generation had. Well, that person (I) could not have been more wrong. We now recognize that many of today’s college students are light years ahead of our generation when it comes to their drive for knowledge and work ethic. Whether it is the improving quality of our summer interns or the college students we have come to know through involvement with our alma maters, we are so encouraged by what we see. We are exceedingly confident that the future is very bright.

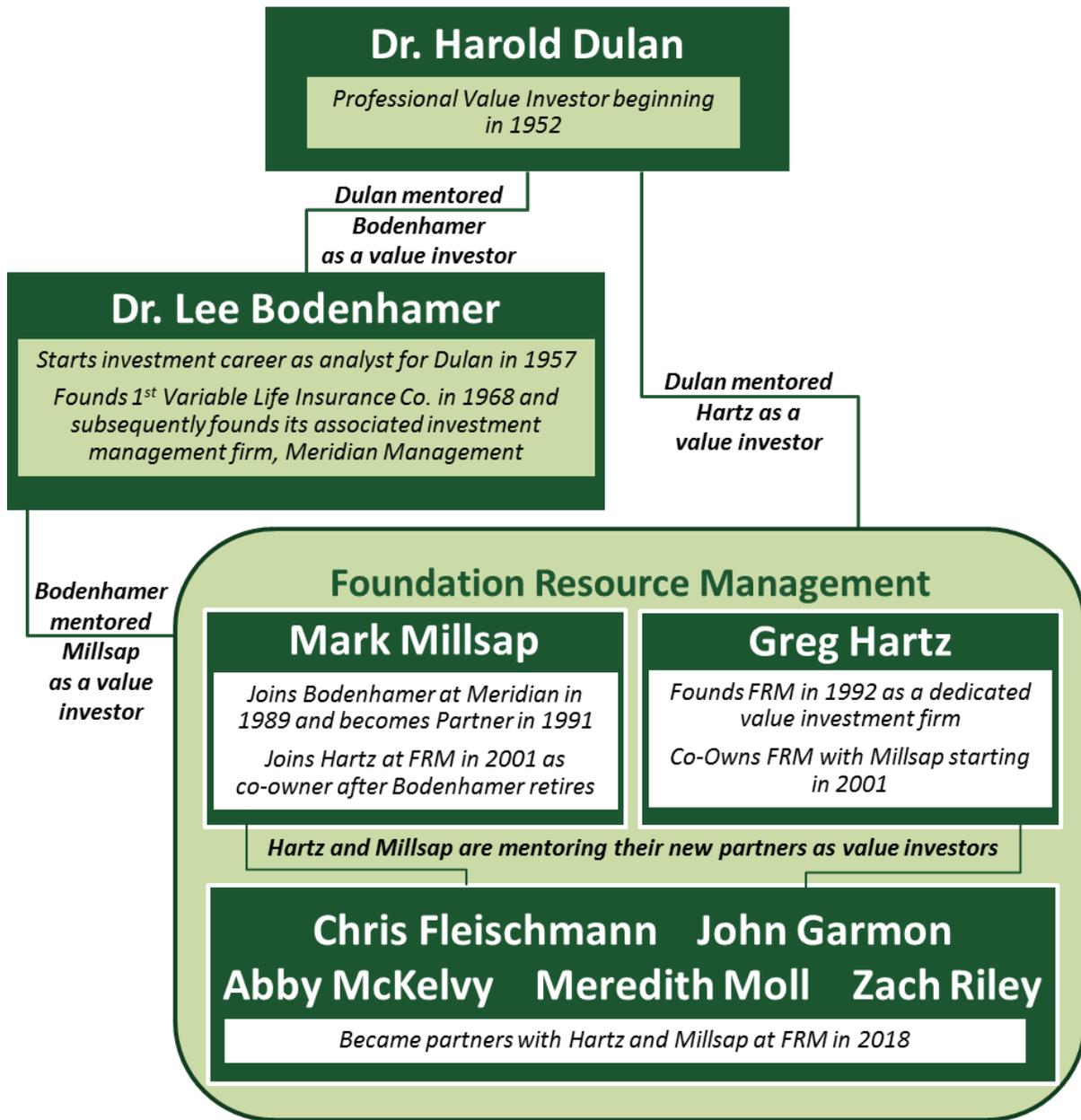
Consistent Application of Our Value Discipline

We have mentioned previously in past commentaries that the two principals of FRM were the beneficiaries of invaluable mentoring from two standouts in the value investing world, Harold Dulan and Lee Bodenhamer. We have truly had the career opportunity of a lifetime to stand on their shoulders by learning the value investing discipline and then carrying it forward. We acknowledge that professionally it was the equivalent of being born on third base.

We recently had the opportunity to refresh our memories by looking backward at the consistent application of this discipline for various clients covering a period of 67 years. When Harold Dulan started his documented value investing career in 1952, we were not even on the scene. In doing this exercise, we realized that we have never provided the full professional family tree that describes this journey (see the following page). Looking back on those 67 years gives one an appreciation for being a disciplined value investor.

While we at FRM cannot claim credit for the successful track records of Dulan and Bodenhamer, we can confidently state that this value investing discipline has been implemented for clients consistently for 2/3rds of a century. Likewise, it has come to our attention that, with the recent initiation of our long term succession plan, our younger new owners could quite possibly be extending this approach to the 100 year mark, the Lord willing and the creek don’t rise. That gives us great pride to be carrying on this discipline probably long after many of us are gone. There are few things in life that we would consider non-negotiable. Professionally, our commitment to this value investing discipline is one of our primary non-negotiables. We believe in cycles and that this discipline will serve our clients well, although not each and every year. We recognize that investing is more of an art than a science, so we know we will never have it mastered. However, we are always striving for improvement with consistency in our application.

Foundation Resource Management’s Family Tree



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

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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