FRM
FOUNDATION RESOURCE MANAGEMENT

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Quarterly Commentary

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Money for Nothing – What Can We Learn from History?

As we all experience life in so many ways, it is common for one to think that a particular situation has never occurred before. More times than not, at some point in the past a similar condition has been present. It may not be exactly the same, but it is likely that some permutation of the past is occurring today. Human nature is such that patterns of behavior often repeat themselves. It is our job to learn from the past so that we can avoid the common mistakes that have occurred. Author Andrea Wulf says it well, "How enlightening history can be. There is no excuse not to learn from the past." Likewise, nineteenth-century Danish philosopher, Soren Kierkegaard, taught that life is lived forward but can only be learned backwards.

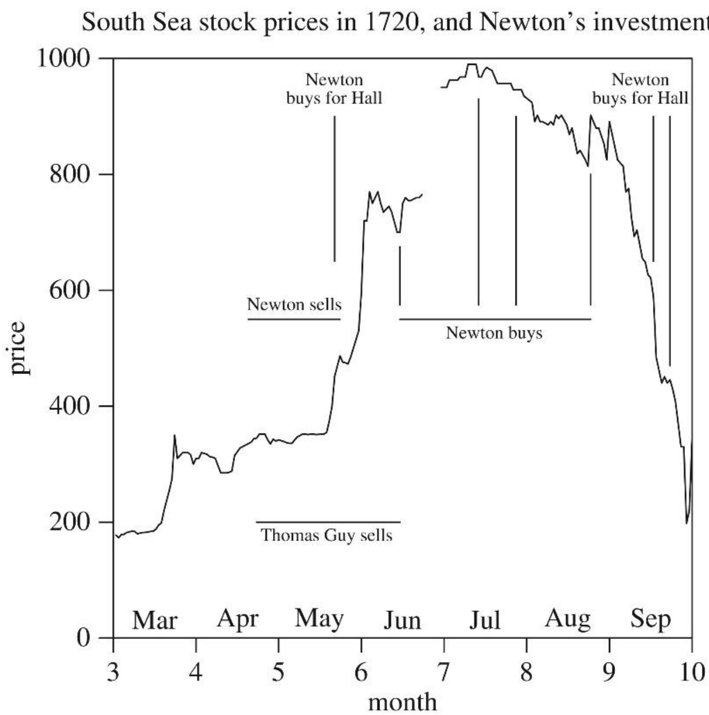
A timely book that just came out with the catchy title, Money for Nothing, by Thomas Levenson, does a great job of documenting the South Sea Bubble, which has its 300th anniversary this year. Many of the conditions in 1720 are quite prevalent today. In that day, Britain was broke having accumulated an astounding amount of debt (sound familiar?) to finance numerous wars. The debt became so massive that the country's creditworthiness was called into question. Consequently, its borrowing cost rose to a full 200 basis points above traditional loans to businesses and consumers. It is hard to imagine government bonds actually yielding two percentage points **more** than corporate bonds or consumer loans.

The South Sea Company opened for business in 1711. It attempted to replicate the trading prowess of the highly successful East India Company, a trading company of commodities such as spices, silk, tea, cotton, and even opium to the New World roughly 100 years prior. The South Sea Company was established originally to develop trade to South America as it became settled by the Spanish. However, it never fully managed to successfully trade with South American ports as its name implied.

A "scheme" was established by British politicians and bureaucrats to attempt to use the shell of the South Sea Company as the solution to its government's heavy indebtedness. This financial manipulation scheme would solve the British debt problems once and for all. If done successfully, it would also make investors rich. This would be a win-win in anyone's book. The Treasury would take the entire British government debt, amassed over a series of seemingly never-ending wars, and turn it into shares of a private company, the South Sea Company. The shares would be traded on the new Exchange Alley, the predecessor to its stock exchange.

Those investors compelled to exchange their risky, possibly even worthless, government debt would receive shares in a going concern. The company would make its profits, and, if successful, its stock price would rise as it pursued what was imagined to be incredibly profitable trade overseas. This was not a totally unique strategy as only a few years prior John Law had initiated a similar scheme in France with shares of the Mississippi Company. Between May and December of 1719, shares of the Mississippi Company moved from an initial price of 500 livres to a peak of over 10,000, about twice the South Sea Company's eventual gain.

Much of the British government's debt was owned by wealthy aristocrats, some of whom are recognized even today. One name was Edmond Halley, famous for discovering Halley's comet. Halley was less well-known (but arguably more impactful) as the inventor of the mathematics behind life insurance, now better known as actuarial science. The most famous name, however, was Sir Isaac Newton who is best known for his scientific and mathematical discoveries. Newton also was the first Warden and then Master of the Royal Mint. It has been documented that Newton initially became wealthy investing early in the South Sea Company and then selling at a huge profit. However, he could not resist buying back in at ever higher prices prior to their collapse. A chart below reflects this. As a result of his painful experience with the South Sea Bubble, Newton's most famous financial quote is, "I could calculate the motions of the heavenly bodies, but not the madness of crowds."



Source: "Newton's Financial Misadventures in the South Sea Bubble" by Andrew Odlyzko *Notes: Source for prices: Course of the Exchange (adjusted for stock dividend). Sources for investment dates: records at the Bank of England, London Metropolitan Archives and King's College Cambridge. The vertical lines for Newton's purchases denote some of the purchases (the first one surmised, others firmly documented). The horizontal lines denote periods of sales, estimated for Newton and precise for Guy. The three lines marked 'Newton buys for Hall' represent the earliest and last purchases in a series for an estate, where Newton was just one of the executors. The gap in prices at the end of June comes from the stop to transfers until the end of August, so that prices switched from those for immediate cash settlement to what were effectively futures deals, and are not strictly comparable.*

In 1720, virtually every Briton would hear of the South Sea Company, and many with wealth bought into this "get rich quick scheme." Much of Europe would as well, and for many it would end in financial ruin. It reminds us of a great quote almost 200 years later in 1907 by J.P. Morgan who said, "There's nothing in this world which will so violently distort a man's judgement more than the sight of his neighbor getting rich."

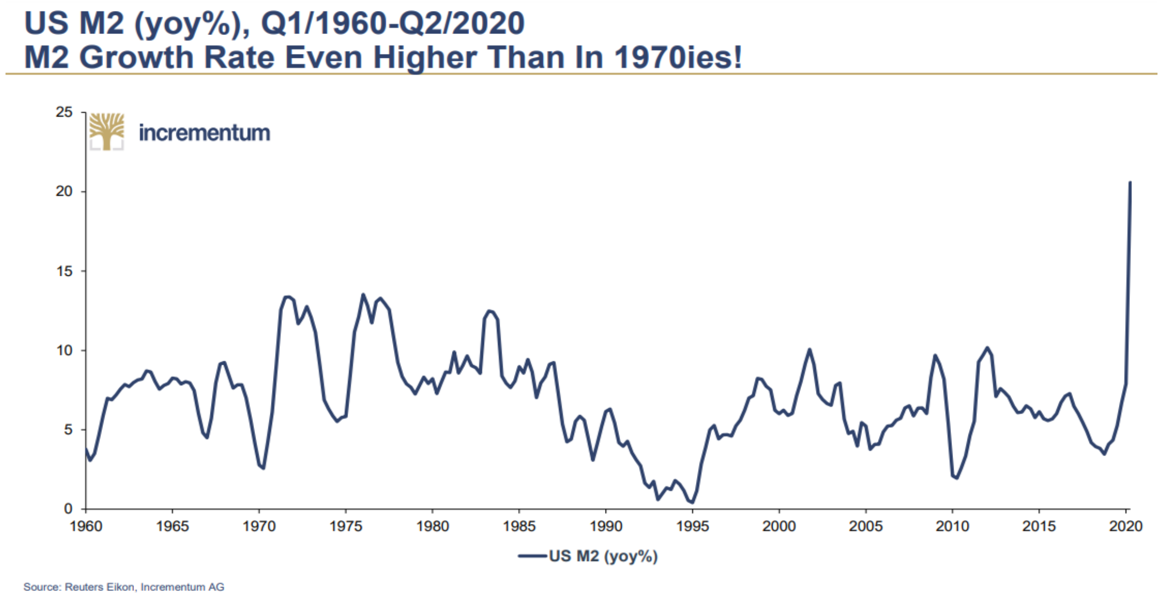
We came across a more modern-day reflection of this same phenomenon from famed hedge fund manager, Stanley Druckenmiller, who has one of the most successful long-term investment track records, first working with George Soros at Quantum Fund and then on his own at Duquesne Capital. His intriguing account (see below) in an interview of his experience during the internet bubble 20 years ago is both candid and self-deprecating.

> **"So, I'll never forget it. January of 2000, I go into Soros's office and say I'm selling all tech stocks, selling everything. This is crazy. This is nuts. Just kind of as I explained earlier, we're going to step aside, wait for the next fat pitch. I didn't fire the two gun-slingers. They didn't really have enough money to hurt the fund, but they started making 3 percent a day and I'm out. It is driving me nuts. I mean like their little account is up 50 percent on the year. I think Quantum was up seven. It's just sitting there. So, like around March I could feel it coming. I just - I had to play. I couldn't help myself. And three times during the same week I pick up a – don't do it. Don't do it. Anyway, I pick up the phone finally. I think I missed the top by an hour. I bought $6 billion worth of tech stocks. And in six weeks I had left Soros and I had lost $3 billion in that one play. You asked me what I learned. I didn't learn anything. I already knew that I wasn't supposed to do that. I was just an emotional basket case and couldn't help myself. So, maybe I learned not do it again, but I already knew that."**

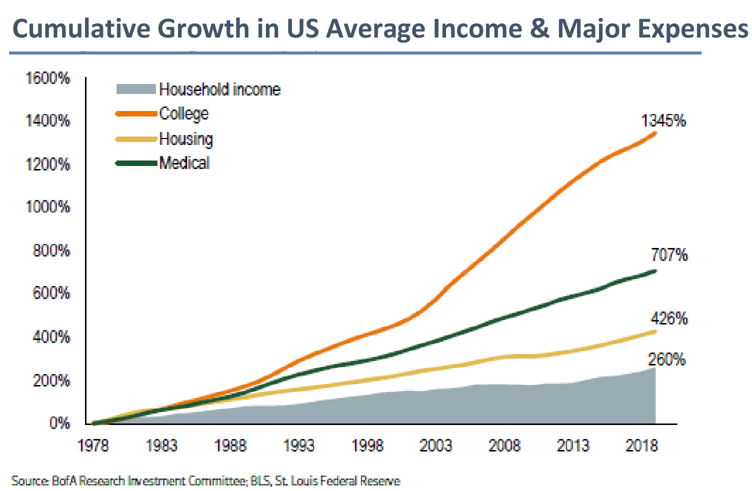
So, what is the lesson that we learn from such experiences? Errors in judgement and human emotion do not need to be made over and over, but often are. It is much easier to diagnose such conditions in hindsight than in advance. Ignorance, however, cannot be an excuse.

The purpose of sharing the South Sea Bubble experience from 300 years ago is to acknowledge common traits we see today. In fact, money for nothing, or as we so often hear today, "free money" is with us here and now in most developed economies including our own. It is the intention of the Federal Reserve that the U.S. has free money for a minimum of several more years. The Federal Reserve has been fallible in their projections before. Free money today is thought of primarily as a monetary term. The Federal Reserve is holding short-term interest rates at or close to zero and buying new government debt by the trillions. Can't get much freer than that! What is the harm? Those lower yields reverberate throughout all financial assets. For example, with stocks, lower interest rates pull down the discount rate investors use to calculate the present value of an income stream. Put another way, it makes future corporate profits more valuable so investors are more willing to pay higher prices for stocks. One big issue with this formula is that when you have <u>very</u> low interest rates like today, it creates ridiculous results. As the discount rate approaches **zero**, the present value of an income stream approaches **infinity**. This condition creates distortions especially for fast-growing companies that are unprofitable or marginally profitable. Artificial money prices incite investment error. And if we do not have real markets, we have no true price discovery.

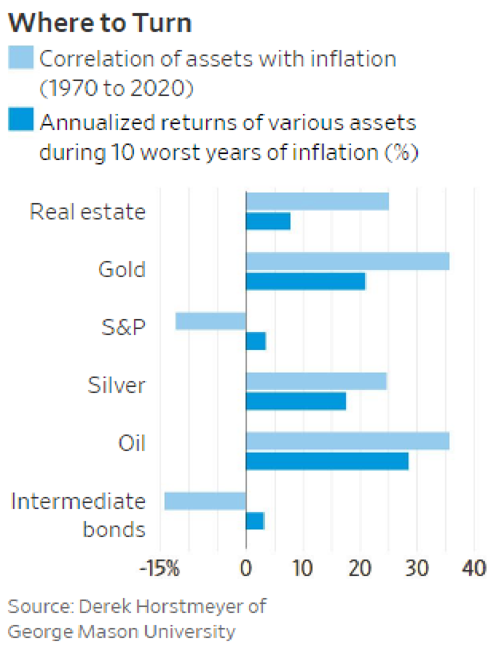
From a fiscal standpoint, the pandemic has led to extreme budgetary actions. The federal deficit for the first 11 months of fiscal 2020 exceeded $3 trillion, more than doubling the previous full-year record of 2009 during the Great Financial Crisis. As you can see from the chart below, we are in uncharted waters when it comes to money supply growth as a result of the government flooding the pandemic-hit economy with "free money." Never in our country's peacetime economies have we ever seen money growth at its current rate.



Money for nothing has created, in our opinion, a much higher risk of rising measurable inflation. We believe that higher inflation is already present, especially for the things that consumers actually want to purchase such as groceries, medical care, recreational items, and home entertainment. Have you tried to buy a bicycle or a gas grill lately? Our suspicions are confirmed by the chart to the right. Meanwhile, the prices of the things we are no longer demanding such as airline tickets or hotel rooms, are in decline. The laws of supply and demand help explain the division between the things we want and those we no longer demand. The pandemic has also created inflationary pressures by restricting supply in certain areas.



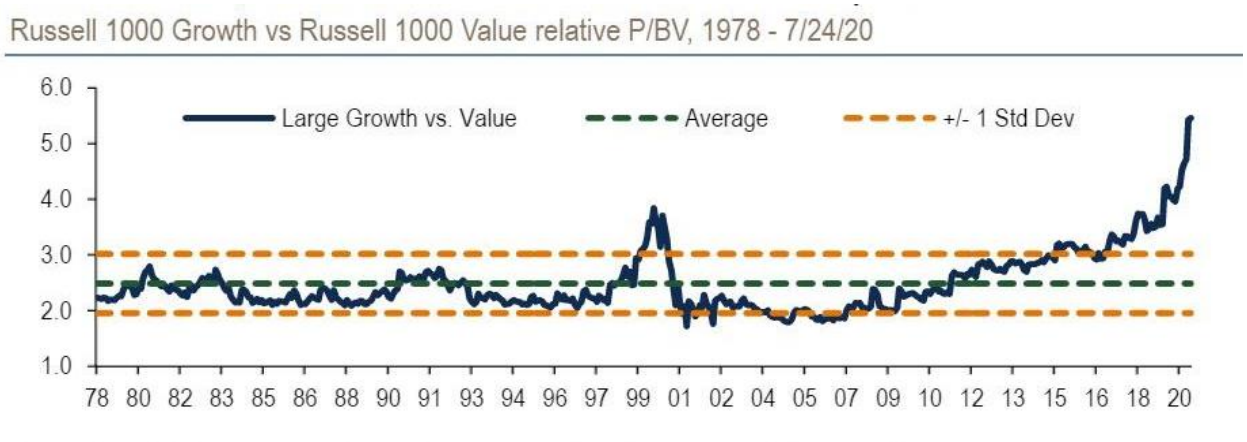
On August 27, chairman Jerome Powell introduced the concept of symmetrical inflation targeting, or allowing measured prices to rise beyond 2% for sustained periods prior to any policy tightening in response. We believe that this not only raises the possibility of measurable inflation, but also creates the likelihood that the Fed will be slow to hit the brakes when it does arrive. The below study reflects that the three asset classes with the highest correlation to inflation between 1970 and 2020 are gold, oil, and real estate, in that order. This helps explain why we have positions in all three of those industries. For sure, we would not have taken positions in the various companies in those industries if their stocks were not heavily under-valued. In fact, they have some of the lowest valuations we have seen of any stocks we have followed in our careers. These low valuations serve as additional confirmation to us that the market has a much more complacent attitude about future inflation than we do.



Source: The Wall Street Journal

Where do we go from here? Money for nothing has clearly, in our view, created major market distortions that only seem to be accelerating in specific areas. That is how you get certain implausible conditions such as Apple's market cap being larger than the entire Russell 2000 Index and also larger than the FTSE 100, an index of the largest U.K. companies. Amazon's stock is now bigger than the entire CAC 40 (France's large-cap market); Microsoft's stock is larger than the DAX 30 (Germany's large-cap index); and Alphabet is bigger than the SMI (the Swiss large-cap market). These are all signs of concern, and it is not coincidental that we do not own any of them, probably much to some of our clients' chagrin. What concerns us is that they all are part of the same sector (information technology), are beginning to compete with each other in many over-lapping businesses, and are already subject to increased regulatory scrutiny.

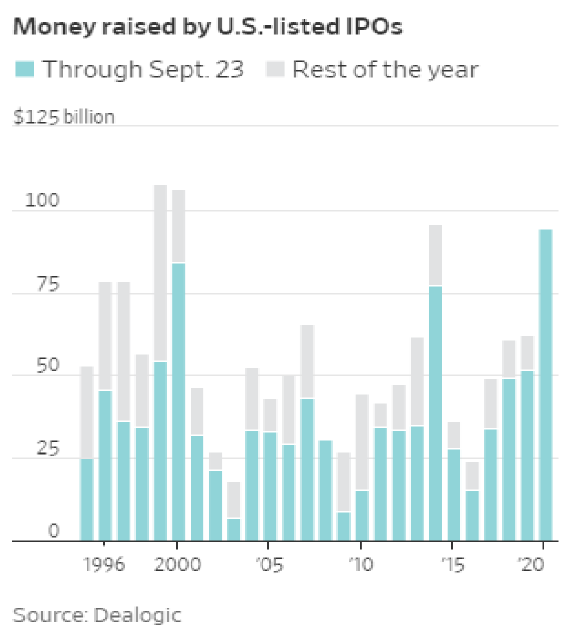
On the other hand, there are numerous companies and industries that are very attractively priced, they just don't seem to be in the information technology industry like today's leaders. Value stocks in general have been left behind by growth stocks as reflected below in the chart of relative Price/Book ratios. Never in our cumulative careers as value investors have we seen this wide a price discrepancy between value and growth stocks, not even in the Internet Bubble in 2000. When this trend reverses (and we are confident it will), we are positioned well to benefit on your behalf. We believe it is a great time to invest with FRM and a very risky time to invest in the broad stock market. We are confident that value will win out as it has in the past.



Source: BofA US Equity and Quant Strategy, FactSet, Compustat, FTSE Russell

Record-setting Initial Public Offerings

In our first quarter 2019 quarterly commentary, we had a section on the traditional characteristics that tend to be present at periods of rampant stock market optimism and high valuations. Virtually all of them were present and continue to be with us and still expanding. The one item that was missing 18 months ago was an exuberant market for initial public offerings (IPOs). That is no longer the case. Today's IPO market is the hottest it has been since the tech boom in 1999 and 2000 when investors excitedly bought internet stocks before they plummeted to earth. Year-to-date more money has been raised in IPOs in the U.S. than in any prior comparable period (see chart). Likewise, this year's IPOs are posting their largest gains during their trading debuts since 2000 (24% versus 22%). Don't forget that we have been in an economic recession with high levels of unemployment, so this strength in IPOs is dissimilar to all other past boom cycles. Clearly, these conflicting conditions coexist because



Source: The Wall Street Journal

the current pandemic has caused an accelerated shift in the economy more toward the virtual world with consumers, students, governments, and businesses relying increasingly on technology than ever before.

According to Dealogic, more than 235 companies have gone public this year. While this has not yet reached the record of 439 in 2000, the dollar amounts raised are much larger now. The current euphoric state of the IPO market is a giant turnaround from where we were less than two years ago.

The 2020 Election

Every four years, we seem to receive more questions and concerns about the upcoming presidential election, so we decided to address it head-on in a totally unpolitical way. As long-term investors, we do our best to keep our eyes on the horizon, which is generally the unique long-term investment goals of each of our clients. The first time we remember really experiencing an unusually large number of client concerns pertaining to a presidential election was in 1992 when Bill Clinton was elected. We actually had some clients wanting to liquidate their equity portfolios. Had someone liquidated their equity portfolio, they would have missed a compounded 17.24% annualized return for the S&P 500 Index during his first 4-year term (four calendar years from 12/31/92 – 12/31/96). Our firm's gross equity composite was slightly higher. Strangely enough, during Clinton's second term, the annualized return for the stock market was exactly the same 17.24% per year, and our firm's gross equity return this time was slightly below the market.

Then in 2000, we had the "hanging chad" election where we did not know for five weeks who would be our next president. Bush was elected over Gore, and there was great consternation during the process. Many pundits fear that we may have a similar, if not worse, timely renewal/transition of government this election cycle. The first 4-year term of Bush produced a -0.52% annualized return for the broad market and our firm's annual gross equity composite was double digit positive. Bush's second term culminating in the Great Financial Crisis experienced a -5.22% annualized return, and our firm's gross equity composite return was positive by a similar amount.

Fast forward to Obama's transition to leadership. During his first term, the broad market was up 14.61% annualized, and our firm's gross composite annualized return was similar to the market's. Obama's second term saw an annualized return of almost an identical amount of 14.36%, and our firm's gross equity composite return was well below that.

And finally, during Trump's first three calendar years, the broad stock market has experienced a 15.27% annualized return while our returns are well below those.

We raise this point to hopefully help explain that moving in and out of the market is incredibly difficult to do well, and oftentimes, is counterproductive. Anyone who has been a stock market investor through both Democrats and Republicans during the periods mentioned above would have earned a 9.91% annualized return for the broad U.S. stock market. We attempt to be unemotional in making our investment decisions on your behalf because frankly our emotions are probably no better than anyone else's. We have no acumen whatsoever in market timing, and we know of no one who has consistently been successful at it.

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