FRM
FOUNDATION RESOURCE MANAGEMENT

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April 13, 2021

Quarterly Commentary

1st Quarter 2021

Origin of a Name

As we discussed last quarter (see the section "Our Continued Commitment to You in the Current Environment" of our 4th Quarter 2020 Commentary), we keep our stewardship commitment to our clients front-of-mind. As we move from one investment cycle, economic cycle, industry cycle, or political administration to another, we strive for a consistent, humble, and logical approach to stewarding your hard-earned capital. Our ambition has been to increase our research capacity and improve our ability to turn over more rocks in our search for investments with sustaining value at a good price. The origin of our name, Foundation Resource Management, reflects this stewardship commitment to our clients. We recently reworked our website where we decided to share the story. (Check it out here: https://www.frmlr.com/) Some of you may know this story, but our guess is that many of you do not. The younger folks here have never witnessed a public retelling. As we detail on our website:

> Our firm name, Foundation Resource Management, originates from the agricultural term of art, the *foundation seed*, a genetically pure seed from which commercially viable seed is propagated. Foundation seed has strict quality requirements given its role as the long-term resource from which many millions of crop acres will descend. Similar to the high standards required of foundation seed growers, we view ourselves as stewards of our clients' foundational resources. Our clients have accumulated capital for use in funding future liabilities, fulfilling a charitable mission, providing for a comfortable retirement or passing wealth to a future generation. It is our mission to be responsible stewards of that capital. For like foundation seed, we view our clients' foundational resources as irreplaceable.

Many of you will realize exactly how Greg Hartz knew of the analogous role of the foundation seed. The foundation seed for soybeans in Arkansas had been the cornerstone of his family's business, Hartz Seed Company, from the 1920s – 1980s.

Pictured: Hartz-Thorell Seed-Processing Plant circa 1940, originally built in 1926

Markets

We write here in awe of properly functioning markets. The price discovery mechanism is important to a properly functioning market and by extension to the economy as a whole. We believe this is true for all goods and services, including capital-raising markets for credit and equity. Stock markets provide liquidity for buyers and sellers, reducing frictional costs such as time taken to pair buyers and sellers, hiring a broker or consultant to find a desirable business at a desirable price, or fees paid to lawyers to finalize the deal. These benefits in turn lower the cost of capital, making it easier for businesses to raise capital to fund growth and hire people. All of this contributes to a virtuous cycle of economic growth benefitting society.

What brought this subject front-of-mind was the recent GameStop (NYSE: GME) phenomenon and its impact on perceptions of the stock market and its efficient functioning. We were asked about the price movement in GME stock more than we have been about many other subjects. We suspect this is because of the allure of fast money, with the stock up 1,100% in mere days. The price moved from $43.03 on January 21 to $483.00 at the high on January 28 with no noticeable change in the company's business prospects. Much of this move was promoted and driven by hype on the social news and discussion website, Reddit, with amateur commentators outlining their aims and goals including "crushing" the Wall Street short sellers. However, looking back on the event, it seems it was more about chasing momentum than it was about punishing hedge funds or winning one for the little guy/gal. Did anyone give a thought to the little guy/gal left holding the bag? For every buyer in a market, there is a seller and for every seller there is a buyer. This means someone bought GME at $483, the all-time high.

Despite the apparent chaos surrounding GME and several other stocks, the market for GME shares still performed its function of price discovery. The market allowed ownership to freely transfer between parties at different prices reflecting disparate levels of knowledge, varying motives and a diverse range of opinions about the value of the company. (We took advantage of the Reddit-fueled hysteria to exit one of our long-term positions.) We recently reviewed GME's fundamentals including earnings, creditworthiness, and future business prospects. In the case of GME, we do not concur with the old adage, "everything is worth owning at the right price." Our analysis leads us to believe that GME has a significant risk of bankruptcy barring a radical change in business prospects, not just a post-COVID-19 reopening of the economy. However, a rising stock price has provided a lifeline in the form of a $1 billion stock offering on April 5. While markets may become chaotic in the short-term, a long-term perspective and focus on fundamentals helps investors avoid being the one holding the bag.

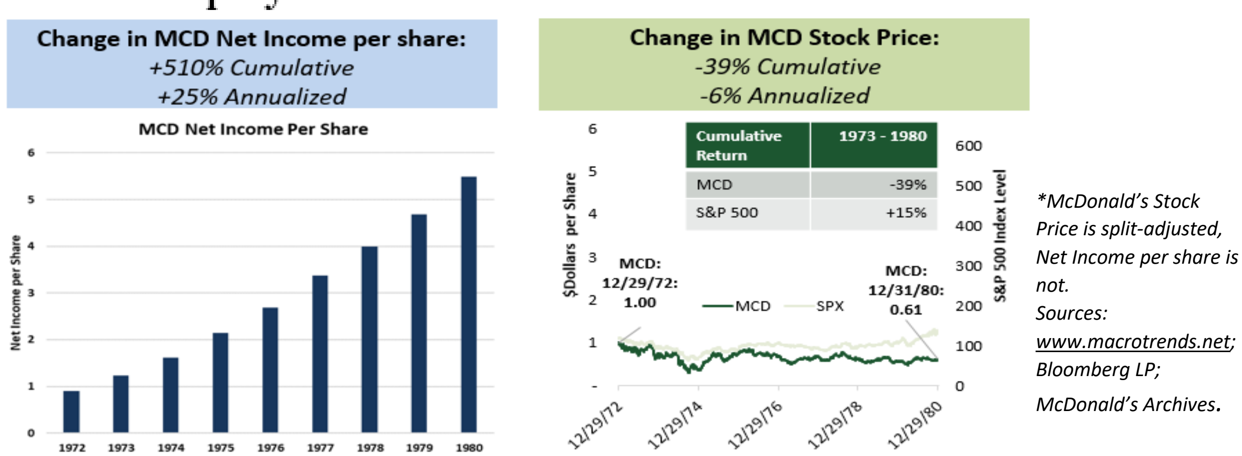
Value and Quality and Growth, Oh My

We have seen many articles and papers over the last several years addressing growth investing versus value investing. We have also read our share of articles, papers, and pronouncements that price should not matter when buying high quality businesses with potential for future growth. Most of this mindset has been driven by the outperformance of the "growth" segment of the market versus the "value" segment in recent years. (Up until September 2020, that is- here's hoping seven months makes for an enduring trend back to value.) We weigh in on all of these debates with two simple thoughts: that an attractive valuation and a quality business are not mutually exclusive and that price is still the most important variable of the investing equation. The lower the price relative to a conservatively calculated value of the business, the larger the future return potential and the larger the margin of safety.

Accurately projecting the future size of any market for a good or service or the future market share of a company providing that good or service is very difficult. Even if those projections are accurate, there are many examples in financial market history of great and growing businesses that turned out to be very poor investments for public shareholders. One example we have been citing lately is McDonald's Corporation (NYSE: MCD) following the Nifty Fifty Era. We chose this example because it was one of the first lessons taught by a mentor to one of our senior partners at the beginning of his career.

The Nifty Fifty was a group of 50 large market capitalization stocks in the 1960s and early 1970s that were regarded as "one-decision" stocks. The widely held belief was that an investor could buy them at any price and hold them indefinitely for an assuredly good result. They were viewed as extremely stable and high-quality companies, many of which were the technology and trend leaders of their day. Most of them are still recognizable today, including Coca-Cola, Eastman Kodak, IBM, Polaroid, Xerox, and, of course, McDonald's. McDonald's had gone public in 1965, its franchising model having been proven and its growth buoyed by the continued rise of the automobile, suburbanization, and the interstate highway system. When the Nifty Fifty era (read: Bubble) peaked in late 1972, MCD shares were selling with a lofty Price to Earnings (P/E) ratio of 71 times. Optimism abounded for McDonald's future business prospects. This optimism proved to be deserved as McDonald's net income per share grew steadily at 25% a year for the following 9 years, 510% cumulatively! Who wouldn't want to own that business? Despite that income growth from 1972 – 1980, MCD shares were down cumulatively -39% over the period versus the S&P 500 return of +15% over the same time

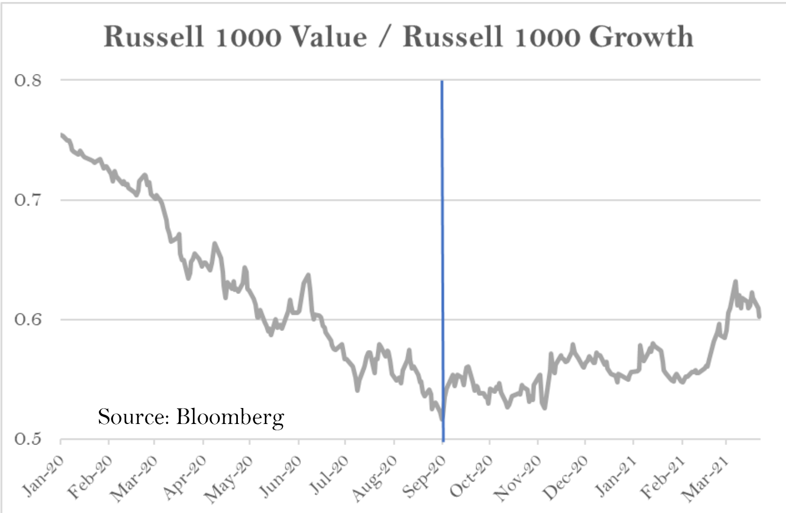
Great Company ≠ Great Stock: McDonald's from 1972-1980



frame (see charts on previous page). MCD ended the period with a P/E ratio of 9 times. You may recall the 1970s was an inflationary period. This decline in P/E multiple illustrates how rising inflation can negatively affect valuations when higher inflation raises the average investor's required return. We see this as an important example that price *always* matters.

<u>**Where are we now?**</u>

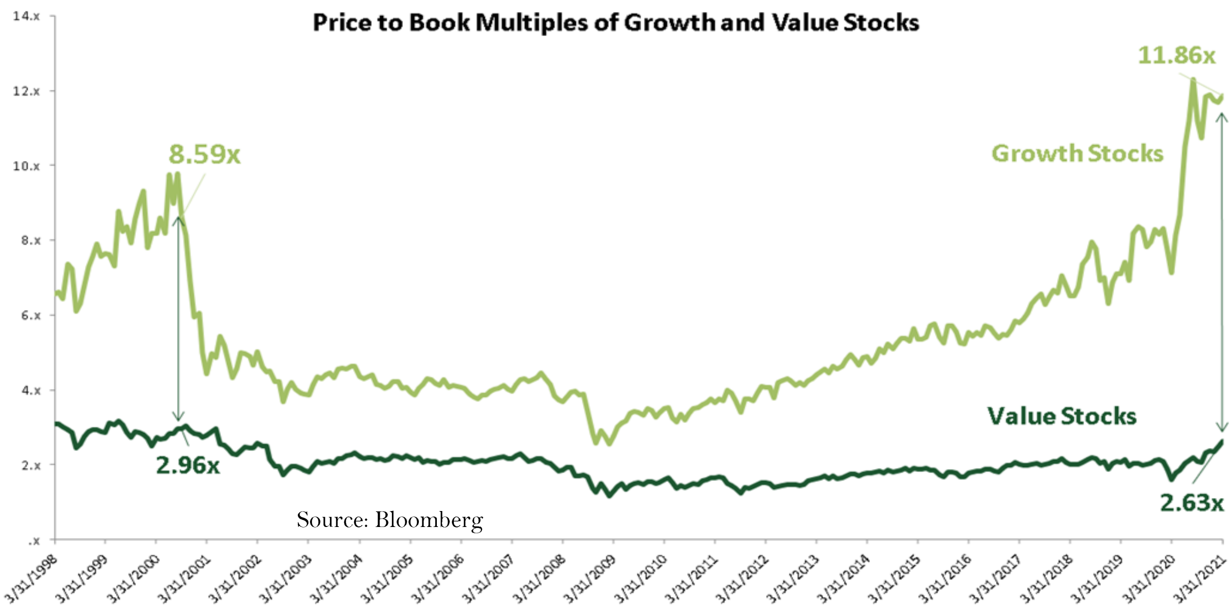
As we mentioned in the section "Change is in the Air" of our [4th Quarter 2020 Quarterly Commentary](), value stocks have continued to steady themselves after getting up off the mat.



Value stocks have done so in a big way, dramatically outperforming growth to start 2021 (see chart beside). With the continued progress on vaccinations (The NY Times estimates that 596 million doses have been administered worldwide as of March 31), the world has started to look forward to economic growth driven by a more "normal" future. For instance, The Conference Board forecasted in early March that U.S. Real GDP growth could be 5.5% year over year in 2021. Goldman Sachs put out an even more optimistic note with an expected growth rate of 8% this year. Either of these would be the highest U.S. GDP growth since 1984! Along with the progress against COVID-19, the U.S. Government recently passed a $1.9 trillion stimulus package and has floated plans for a $2.3 trillion economic plan focused on infrastructure to follow. This combined with the previous growth in M2 Money Supply (over 25% year over year) has led to increasing inflation expectations. Inflation expectations have risen to 2.6% this quarter, up from the depths of below 0.5% in March of 2020 (see chart beside). This has resulted in rising interest rates with the 10-year U.S. Treasury Note closing the quarter at 1.74% up from 0.93% at the start of the year and a low of 0.58% in April of 2020. At current low rates, these are big moves,

up 87% over the quarter. U.S. Treasuries recorded the worst quarterly performance since 1980 according to Bloomberg Barclays indexes. Bloomberg Barclays U.S. Corporate Bond Index had its worst quarterly return since 2008.

Rising interest rates tend to benefit value stocks and hurt growth stocks whose valuations are derived from distant future cash flows. Even after their recent comeback, value stocks remain as attractively valued as we have seen since the early 2000s, particularly relative to growth stocks (see chart below). We don't know exactly where all of this leads, but we do think the increase in bond yields is warranted and believe more could be on the way. Over the last 60 years, the 10-year U.S. Treasury Note has yielded 2.2% over the inflation rate. The current negative real yields (interest rate minus inflation) are very rare historically.



The recognition of the Fed's inflating is by no means a foregone conclusion, but it is a real risk to bond and stock investors. We have seen more written recently about a coming commodity super cycle driven by commodity producers of all stripes underinvesting in new production as a response to very low prices over the last five years. If a supply shortfall meets a pick-up in demand from the previously mentioned GDP growth, all of the newly printed money could wind up chasing commodity prices higher. It is something that the world has seen before. In our 3rd Quarter 2020 Quarterly Commentary, we discussed real assets that have historically protected against inflation, including gold and oil. Our portfolios are well-positioned to protect our clients from inflation with the composite portfolio having significant weightings in gold miners and in oil and gas producers at March 31, 2021. Conditions are such that real assets are attractively valued and represent a low price for ownership of well-managed commodity producers. While these are not our largest sector weightings (financials are the largest weighting), these natural resource companies are an important part of the portfolio.

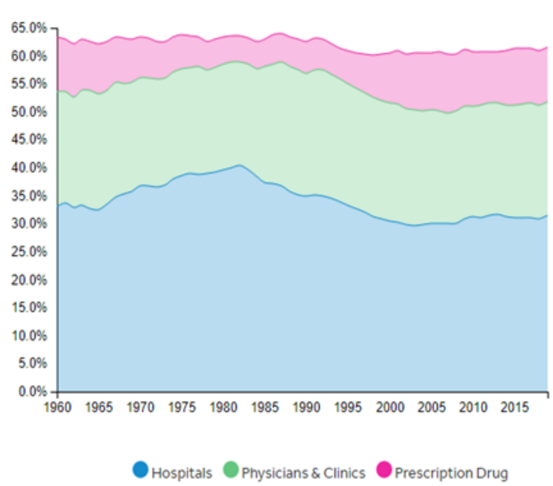
U.S. HEALTH EXPENDITURES 1960 - 2019

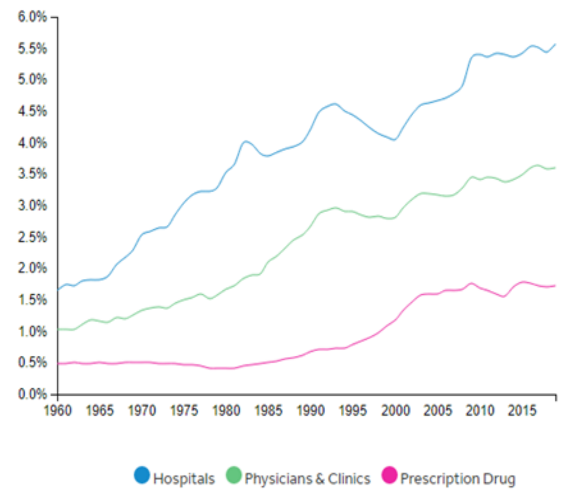
On Hospitals, Physicians & Clinics, Prescription Drug, As a Percent of Total National Health Expenditures

U.S. HEALTH EXPENDITURES 1960 - 2019

On Hospitals, Physicians & Clinics, Prescription Drug by All Sources of Funds (As a % of GDP)

Source: Peterson Center on Healthcare and Kaiser Family Foundation





Another area of your portfolios we are excited about is our large pharmaceutical stocks. Pharmaceuticals continue to be an important part of health care expenditures in all phases of treating, managing, and curing diseases and other medical issues. We believe pharmaceuticals are often the most attractive treatment option for doctors to prescribe, both medically and economically. While spending on pharmaceuticals has grown, it is still a relatively small part of overall U.S. health expenditures (see charts above). We have owned several of these companies for over a decade and continue to be encouraged by the advances they are making. Each company that we own has a strong balance sheet and pays an attractive (and generally growing) dividend. We wrote in our 4th Quarter 2010 Quarterly Commentary; "It is important to keep in mind that research and development is somewhat of a 'hidden asset' in these companies. We say that because research and development expenditures are expensed under generally accepted accounting principles. These outlays obviously have some cumulative, unknown future value that does not appear on the balance sheet, thus the term 'hidden asset'." When that was written, we had no idea these companies would advance cancer treatment with immunotherapies or develop mRNA vaccines for a global pandemic on the fastest timeline in human history. We did believe that their investments into research and development could have attractive future returns based on their history of innovative developments. We believe that is still the case and look forward to future developments.

Underappreciated Growth

Lastly, we want to highlight the dividend yields of our portfolios and the growth these dividends have recorded over the last several quarters. We believe that dividends and the prospects for dividend growth are a very important part of our clients' expected return in equity portfolios. Many in the equity investing world don't consider dividends at all when selecting companies to own. One of our principals recently sat through several presentations on stock ideas and not one mentioned the dividend! However, a study of equity investing returns over the last century will show that dividends have made up somewhere around half of all equity returns. We also like the cash discipline that dividends force on management teams, since there always has to be enough cash at quarter end to pay the dividend.

Of our 33 "core" positions (those with a higher than 0.50% weighting in our overall stock portfolio), 31 pay a dividend. Nineteen (or 58%) of these 33 companies have increased their annualized dividend since year-end 2019, with the weighted average increase being 29%. Our overall equity portfolio yield has gone from 2.64% at 12/31/2019 to 3.31% at 3/31/2021. Our clients have also benefited from a number of special dividends or returns of capital over the last 12 months. Generally, our equity portfolios are yielding more than our bond portfolios, and the income stream is growing. Needless to say, we are pleased with these developments on the dividend front.

FRM Updates

We have some great news on the personnel front at FRM. Trina Boyd is back! Welcome back, Trina. Back in 2014, when Trina and family moved to Omaha, Nebraska, we told you "We will miss Trina greatly." Well, we did. We are very excited to have Trina's pleasant personality and hard-working attitude back in our office. She started back on March 29 as a Portfolio Accountant, and the transition has been seamless. You can find her and the rest of our team on our new website (mentioned previously) with updated pictures.

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.

Disclosure

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