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Quarterly Commentary

4th Quarter 2020

The Investment Environment Circa 2021

We can think of no better way to introduce the above topic than by including the following two short paragraphs from our assessment of the investment environment in January of 2007. Though it was unknown at the time, it was written on the eve of the Great Financial Crisis, a time when we were expressing caution and finding few opportunities for investing in new bargains.

As we close out another year and look to the unknown future, we think it important that we consider the current investment landscape. We understand that most people spend little or no time weighing the issues we will discuss, as they are involved in the industry of providing a living and/or raising a family.

Our work of security analysis and portfolio management is carried out in at least two realms: the world economy and its subset, the world of finance and investments.

Perhaps now more than ever before, the work of understanding and successfully negotiating these two realms must involve gaining an understanding of the rapidly evolving and potentially bewildering nature of money and credit. It is our assessment that nothing has impacted the world economy, finance or investing to the order of magnitude as has the rapidly inflating world monetary order.

Only 18 months ago we introduced our readers to Modern Monetary Theory (MMT), a concept that was beginning to attract attention. As we understand it, MMT espouses 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 (soundness, no doubt, being a relative term). It was probably no coincidence that this construct was the topic of increasing discussion as government deficits around the globe became more irreconcilable. Fast forward to today. It turns out, the amount of money the government “needs” is quite a lot! MMT seems to have been adopted wholeheartedly by governments and central banks around the world, though most would not admit to it. Heightened government demand for credit of the current magnitude would have raised interest rates back in the good old days of, say, 15 years ago. No longer. Central banks, with the U.S. Federal Reserve leading the way, are

buying this debt in order to suppress interest rates, thus monetizing the debt (using money creation as a permanent source of financing for government spending). By doing just this, the U.S. Fed doubled the size of its balance sheet in 2020 (see chart nearby in which periods of economic recession are shaded).

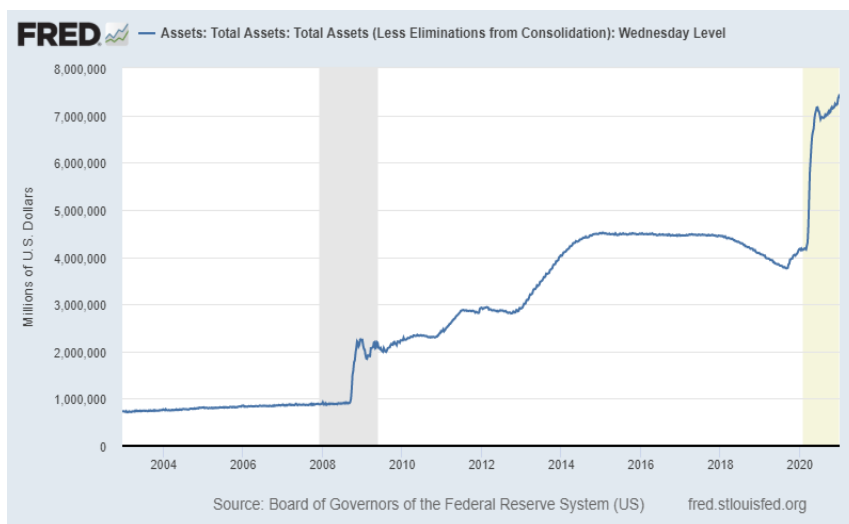
No small portion of the debt that was financed by the Fed this year was used to facilitate the direct stimulus payments in an amount never contemplated before (\$1,200

per single adult, \$2,400 for a married couple). With the Payroll Protection Program (PPP), an enhanced \$600/week federal unemployment supplement, and other stimulus, the bill for the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) came to \$2.2 trillion (this on top of a projected \$1 trillion annual budget deficit before the pandemic was even a thing). This money, for the most part, was put directly into the hands of the American people, as witnessed by the vertical rise in the M1 definition of money (coin, currency and checking deposits in circulation) as shown below. This was a much faster and more direct method of getting money into consumers' hands than was used during the Great Financial Crisis when a lot of the money ended up sitting idly in bank reserves. More Covid-19 relief money was on the way at year-end.

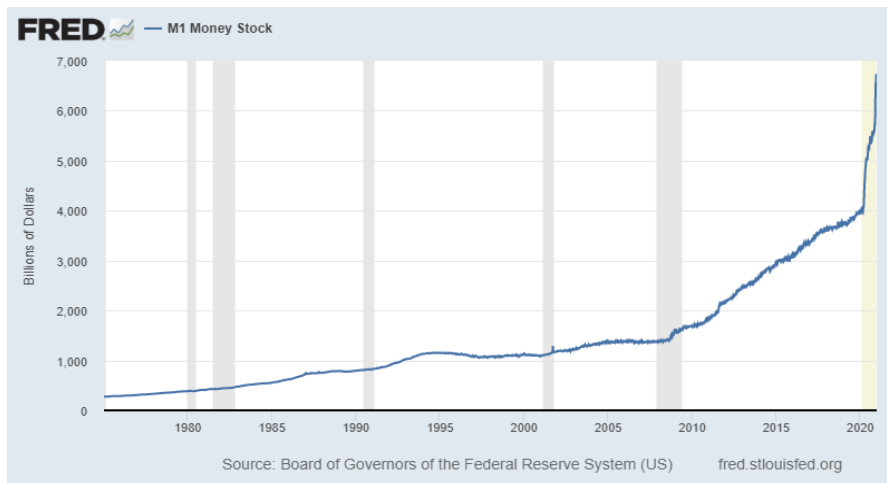
Note that on the first page, we described modern money as evolving, inflating, and potentially bewildering. From the charts nearby, one can see that monetary practice is evolving rapidly. Also, it is easily seen that for more than a decade, the quantity of money has been inflating at an unprecedented pace. It is the lack of apparent consequences of Fed policy that has most folks bewildered.

Many money-savvy and suspicious observers tend to express this bewilderment that can be summed up in three questions. Our short answers follow.

U.S. Federal Reserve's Epochal Credit Expansion



Money (That's What I Want)



Q: Why are inflation and interest rates so low?

A: Cost-of-living inflation is impossible to measure precisely. We do know that it is in the federal government's interest to have low inflation statistics because that reduces the statutory increases in cost-of-living adjustments on transfer payments. However, many major household expenses have been inflating at a high rate, as we discussed last quarter. Interest rates are so low because much of the lending in the economy is not done from a finite source of savings as in the past, but from a seemingly infinite source of credit creation by the Fed (refer back to the first chart).

Q: Where does all of this money come from?

A: The U.S. Treasury issues the debt through contracts with its primary dealer banks throughout the country, which currently number 24. These banks **must** sell the Treasury's debt. The Federal Reserve has been out-bidding other potential buyers, thus pushing down interest rates. The Fed cannot buy directly from the Treasury, because the Federal Reserve Act states that the Fed can only buy and sell Treasury securities in the "open market." Take out the middlemen (the primary dealers), and in effect, direct buying has been taking place.

Q: How long can this go on and will the government's debt ever be paid back?

A: No one knows how long the Fed and the federal government can continue this practice without having long-term negative effects on the U.S. dollar's value vis-à-vis other currencies. We have now accumulated a level of federal debt that will almost certainly be repudiated by the government or paid back with seriously inflated dollars. **A form of repudiation is already taking place at the expense of savers with the intentional (and we would say immoral) artificial suppression of interest rates** by the Fed's huge expansion of the credit supply.

Due to the policy actions described above, so many forms of traditional investing for current income have now been made unattractive. Cash yields are practically zero, and government and investment grade corporate bonds yield zero or below after inflation. This environment seductively beckons those with capital to rush to equity investing, regardless of valuation, in the hope of generating total returns from dividends and stock price appreciation. This is referred to as the "TINA" approach or "There Is No Alternative". This acquiescence ignores the fact that investors with shorter time horizons cannot prudently invest in equities. We strongly believe that one cannot rely on liquidity in the stock market always being maintained by monetary machinations at the critical time when cash is needed. The TINA approach has fostered an emphasis on potential growth that has driven growth stocks to absolute valuation levels and valuations relative to value stocks that are at all-time highs (more on this later).

Our Continued Commitment to You in the Current Environment

Our firm recognizes that each and every one of our clients has worked hard, sacrificed and foregone immediate gratification in order to save and form capital. Capital formation and the building of financial strength of an entity is never easy. This is true regardless of whether that entity is a family, a retirement plan, an insurance company, a hospital or a charitable foundation. We do not choose to lower our risk and return requirements that make up our margin of safety. This makes us different from most in the modern investing environment. We believe that investing inherently involves dealing with unforeseen circumstances that life throws our way. This past year offers a perfect example of that.

We recognize that it is rare in a lifetime of work that someone has the opportunity at a second chance to form capital. Our commitment to you is that we will always do our best to protect and nurture our clients' savings. Our GIPS® compliant track record (see *Quarterly Commentary, 2nd Quarter 2020*) of more than 30 years shows that we do not stray from the discipline we bring to our work. We do not chase the latest fads (e.g. ESG investing, momentum investing), and we do not wander off into investment products that are offered within the financial jungle.

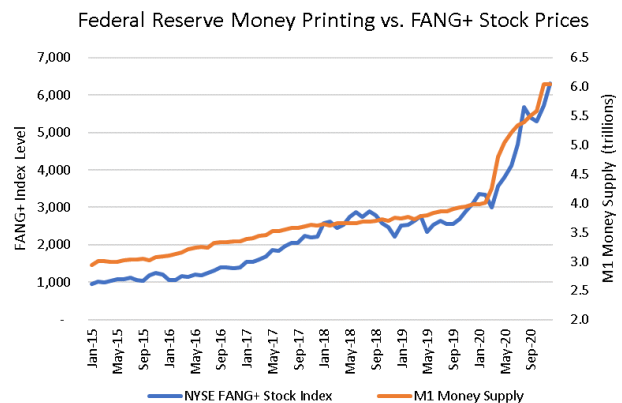
We check our egos at the door and try to recognize what we know for a fact and what we do not. We look in wonder in this age of constant information and data flows at how the latest observation becomes the current proven fact. So much seems to be known for certain that is not really known for certain. The rapidly changing "science" around the current pandemic is an excellent example of that. We learned long ago that sometimes "I don't know" is the best answer one can give. We love the phrase, introduced to this firm by one of its principals (not the writer), "if you aren't humble in this business, you are getting ready to be."

FRM has an internal policy factor that serves to align our clients' interests with our own like no other arrangement in modern investing. We buy and sell for our clients' portfolios only those stocks that we buy and sell for ourselves. In other words, we eat our own cooking, and we never "go out to eat." Those purchases and sales for our own portfolios can only be made after all of our clients' transactions have been completed. In this manner, we not only align our incentives with you, but we also align our disincentives as well. We can think of no other policy that serves to strengthen the alignment of interests with our clients than our insistence that our own portfolios mirror those of our clients. We find that having this policy makes us very different than most in the modern investing world.

As we go forward into the new world monetary order and bubbling markets, we reflect that much has changed in the world of finance and investing. However, we firmly believe that the practices and policies we have reviewed here will hold our clients' capital in good stead for many years to come.

More Evidence of the Liquidity-Driven Investment Mania

The short-term performance mania that has infected modern investing is currently producing tremendous pressure on professional managers to lower their margin of safety and go with the flow. It is also encouraging retail investors to dive into speculation in a way that has not been seen since the technology bubble of the late 1990s. That “flow” is being aided and abetted by the Fed’s policy actions in response to the pandemic. As in every crisis and potential crisis of the last 30 years, the Fed’s answer has been... “more money.” In spite of a deep worldwide recession caused by the pandemic, broad stock market indices had a huge year in 2020. The more speculatively one was positioned, the better was the result. The nearby chart shows one aspect of how the Fed’s money printing has bled over into the stock market. The FANG+ Index contains many of the most popular and speculatively valued stocks. The concurrent rise of this index with the expansion of money and credit was almost totally the result of stock market valuation expansion, not improved fundamentals.



Source: Bloomberg LP, FRM.
FANG+ Includes: TSLA, GOOG, AMZN, NVDA, NFLX, TWTR, BABA, BIDU, AAPL, FB

Another indicator that speculation is running rampant is the amount of borrowed money at brokerage firms being used to “play” in securities markets. These types of accounts are referred to as margin accounts, and the loan balances used to finance the security positions are called margin balances. Margin balances stood at a record level at the end of November, \$722 billion. Even more eye-catching is the fact that that figure was up 9.5% for the month of November alone. Whatever you do, don’t try that at home!

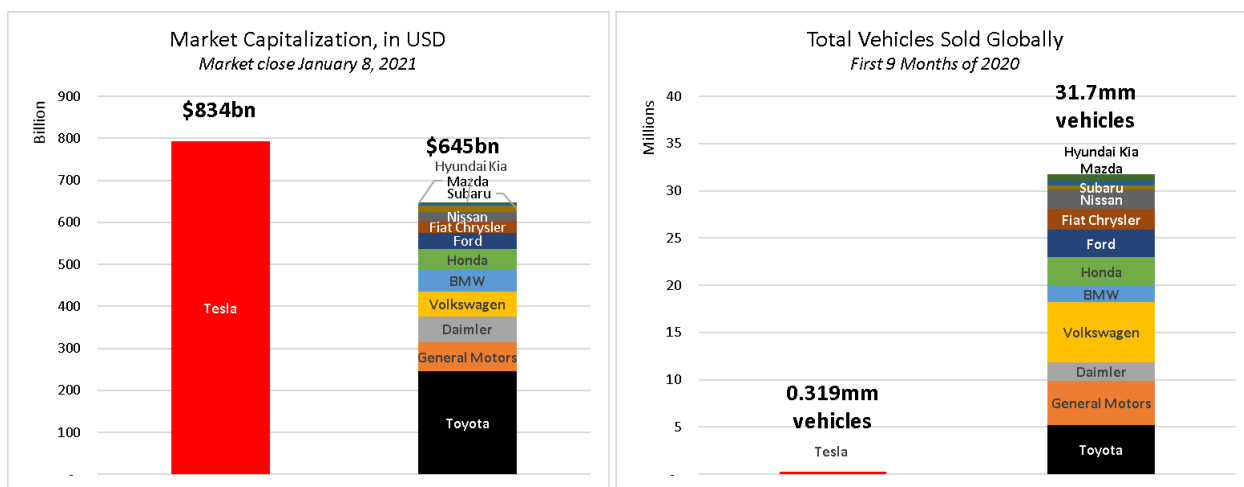
Also, initial public offerings (IPOs) of stocks broke records in 2020. According to *The Wall Street Journal*, IPOs totaled \$178 billion in 2020, breaking a record that goes back to the 1999 technology bubble. That year IPOs reached \$167 billion. IPOs have historically been a good indicator of market euphoria because the sellers who are exiting the private business realm know much more about what they are selling than the buyers know about what they are buying. Insider selling within public companies is also setting records.

But there may be no better indicator of wild speculation in stocks than the recent change to the S&P500 Index. Go back to 1999 (again for a moment). 1999 and 2000 were years of dozens of changes to the S&P 500 Index. Most of the changes added “new economy” names to the index (read internet, technology and telecommunications) with “old economy” names being replaced (you can probably imagine what those were). The unsuspecting public never realized what was

happening to the supposedly passive index, and the result was a technology-heavy weighting right at the peak of the technology bubble. This spelled doom for the S&P 500 returns for the next decade.

We see a similar activity going on recently. Tesla was added to the S&P 500 in December, despite the fact that they only put four quarters of profitability together for the first time at the end of September. Note that one of the stocks contained in the FANG+ Index (above chart) is also Tesla. Though we have done no research on it, this has to be the most astronomically valued addition to the S&P 500 in its history. According to our friends at *Grant's Interest Rate Observer* (they refer to all of their subscribers as friends), the impact of adding Tesla, trading at more than 1,000 times 12-month trailing earnings at the end of the third quarter, would singlehandedly take the approximate capitalization weighted price/earnings ratio of the S&P 500 from 38 to over 56. Please note that the long-term average price/earnings ratio for the index is roughly 15. These calculations were made in the second week in December when Tesla boasted “only” a \$535 billion market capitalization. The stock ended the year with a market capitalization of \$669 billion and has added over \$160 billion in the first few days of 2021! That easily makes it the sixth largest in the index with a 2.02% of total weighting, thus almost sure to make the above estimates fall on the low side.

To gain perspective on what this valuation represents, the left chart below reflects that shortly after year's end, the market capitalization of Tesla exceeded that of the world's 12 largest auto manufacturers combined. Try to suppress a laugh when checking out actual vehicles sold in the first nine months of 2020 (chart on the right). From what we know about Tesla, the company's recent attainment of profitability is mostly, if not entirely, derived from the selling of electric car sales offset credits to the other auto manufacturers. General Motors, Ford and the like must purchase Tesla's excess offset credits in order to meet government mandates on the production of electric vehicles. While we sure would not bet against CEO Elon Musk, neither would we bet on Tesla at these valuation levels.



Source: Bloomberg LP, companies, Foundation Resource Management

Change is in the Air

We used this exact heading at the end of 2017 to discuss how economic growth and employment were starting to pick up. We use it in a different vein this time.

All but our newest clients are painfully aware that growth indices have outperformed value in 13 of the last 14 years. We have done some better than that, as we outperformed growth in 5 of those years. It has been the most difficult period of our careers, nonetheless. As we stagger into 2021, this brings us to the point, one that we frankly never thought we would see again following 1999 (there is that year again), where the stocks we own look to us like a second-in-a-lifetime opportunity.

Change is in the air. Very recently we have seen a sudden increase in the ten-year Treasury bond yield, an increase in the most quoted broad commodity index, and a reduction in the value of the dollar against other currencies. Also, value stocks have begun to get up off the mat in recent weeks. These changes reflect that the investing landscape may be shifting from a disinflationary environment to an inflationary one. It may just be that all of the monetary inflating that has been carried out in an intentional effort to produce a cost inflation may be taking effect after all. We believe your portfolio is equipped to tolerate inflation and perhaps even benefit from it.

2020 Milestones

The highlight of the year was July 23rd when Zach and Taylor Riley announced the arrival of one of God's greatest gifts, a beautiful little girl they named Zoe Elise Riley. Zoe, no doubt a future soccer star to watch for, tipped the scales at six pounds and seven ounces. She was 19 inches tall (in keeping with the Riley genetics). According to her dad, Zoe is an all-star sleeper, which no first-time parent really deserves.

On the operational front, as soon as the pandemic hit, we were faced with the transfer of 140 accounts to a new custodian. This transfer was mandated by the fact that Merrill Lynch, whom many of our clients had used as their custodian for over 20 years, decided to exit the asset custody business for investment advisory firms. Perhaps you were one of those clients. Hopefully you were pleased with how the transfer went. Stephanie Hills led the paperwork charge for us, with an assist from Lauren Sanders. In spite of all the stress associated with this change, we never saw them break a sweat (well, almost never). We appreciate your help and patience while this was happening.

We already bragged at mid-year about our claiming compliance with the Global Investment Performance Standards. Since then, our compliance was verified by an independent third-party firm that specializes in that work. Hats off to Meredith Moll, Gail O'Donnell, Lauren Sanders, Stephanie Hills, John Garmon, Chris Fleischmann, Zach Riley and Abby McKelvy who worked tirelessly on this project. If ever patience was required for an undertaking, that was it!

One of our corporate values is to have fun at work. Nothing can be less fun than compliance training, however our Chief Financial Officer and Chief Compliance Officer, Abby McKelvy, led us in a continuing education session using the *Kahoot* app that won't soon be forgotten. *Kahoot* is a Q and A polling software that allows respondents to answer via their cellphones. Speed and accuracy are both rewarded when answers are entered. It seems the wheat was separated from the chaff when Abby switched the questions from compliance to grammar and proper vocabulary usage toward the end of the competition. This was a fun way to review and learn. If you think you might have a training application in your workplace that would fit *Kahoot*, Abby would be glad to walk you through it.

Fortunately, we have only had one staff member test positive for Covid-19, and that person remained asymptomatic until testing negative after several days. That happened the Friday before Christmas, and so Christmas week was the only time we have all worked from home since the pandemic started. Everyone else tested negative, and we were back at it from our office the Monday after Christmas. We know that like us, some of your family members, loved ones, friends or acquaintances have also had brushes with this terrible virus. We pray for efficacy of the vaccines and a quick end to the pandemic while remembering those whose lives have been changed forever.

As we hurtle into what is hopefully a better 2021, we look forward to the day when we can see you face-to-face again. As you saw from our Christmas picture, some of us look better on the computer than others! Seriously, we are much more comfortable with in-person meetings. In the meantime, we never forget that you are the most important part of the FRM team. Thank you for letting us serve you. May God bless you and your families with health and happiness in the new year.

Disclosure

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