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July 9, 2020

Quarterly Commentary

2nd Quarter 2020

Intended Consequences

In the economic sphere an act, a habit, an institution, a law produces not only one effect, but a series of effects. Of these effects, the first alone is immediate; it appears simultaneously with its cause; it is seen. The other effects emerge only subsequently; they are not seen; we are fortunate if we foresee them. There is only one difference between a bad economist and a good one: the bad economist confines himself to the visible effect; the good economist takes into account both the effect that can be seen and those effects that must be foreseen. Yet this difference is tremendous; for it almost always happens that when the immediate consequence is favorable, the later consequences are disastrous, and vice versa.

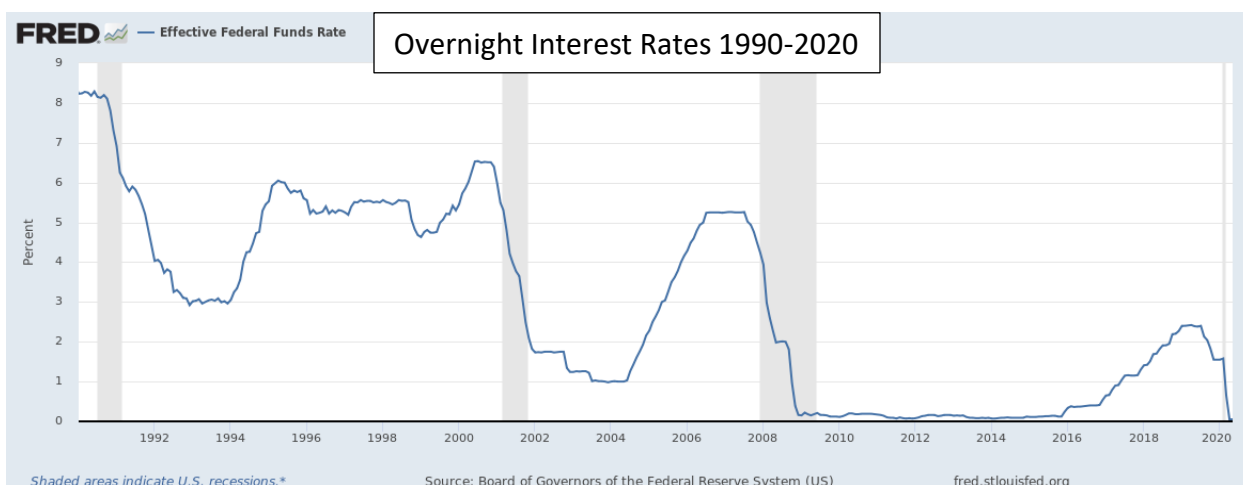
From an essay by Frédéric Bastiat in 1850, "That Which Is Seen and That Which Is Unseen"

Last quarter we wrote of some of the possible unintended consequences of policymakers' responses to the black swan of the global coronavirus pandemic. This quarter we will take a look at how some of the *intended* consequences of these policy actions might impact the economy and capital markets in the longer term.

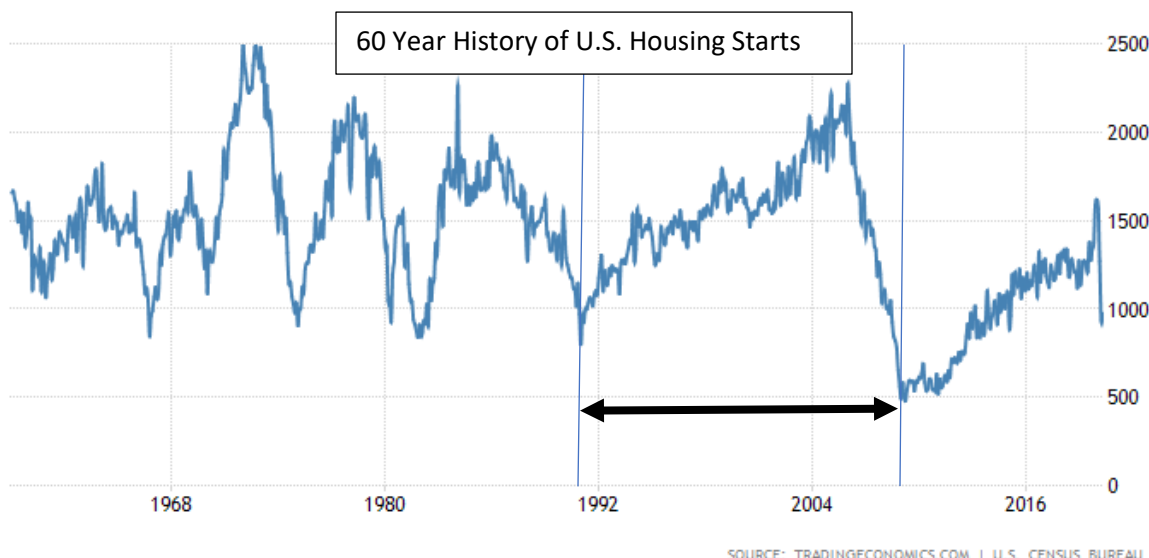
It seems that in today's world, for a policy response to be judged the correct one, it only needs to be expedient and well-intentioned. We believe that history reflects that the economy, capital markets and monetary structures are complex systems and as such should be treated with a certain degree of humility on the part of policymakers. History shows that frequent tinkering with complex systems can result in more volatility within them. Humility in managing them is certainly nowhere to be found in the current crisis.

A short review of the economic cycles and policy responses of the last 30 years is in order here. In this review, we focus on monetary policy because for at least the last 30 years, fiscal policy, both from the taxing side and the spending side, has been mostly non-discretionary. Tax policy has mainly been a function of which party was in power. Spending policy during this period has been changed mainly at the margins, with the exception of the 2009 stimulus package and the current programs aimed at getting the economy back on its feet. Interspersed are some important historical markings of FRM's portfolio management and resultant performance during those same cycles.

The founding of our firm almost 30 years ago was concurrent with the Federal Reserve’s policy response to one of the mildest recessions on record. That recession began in the late summer/early fall of 1990. It was barely noticeable and officially ended in March of 1991. Despite the almost non-event nature of that recession (which had been triggered by the invasion of Kuwait by Iraq), the Fed saw fit to begin cutting overnight interest rates and expanding the money supply, taking the overnight Fed Funds rate (see below chart with recessionary periods shaded) from 8.25% at the start of this recession all the way down to 3%. They continued to cut rates long after the very mild recession was over. Looking back with the benefit of 20-20 hindsight, we are not sure that we marked the Fed’s overreaction as a lesson for the future to the degree we should have.



That gross overreaction by the Fed “accomplished” at least three things. It set the stage for the largest speculative bubble that has ever occurred in the history of the U.S. stock market. That bubble finally deflated in the 2000-2002 period with the broad market losing roughly 50%. The second consequence was that it started a bull market in housing that finally crashed beginning in 2006, evidenced by the historical chart of U.S. housing starts below.



Finally, the third thing the drastic overnight rate cuts of the early '90s did was to teach the Fed what a powerful tool they had if they brought interest rates down to extremely low levels. They were just getting started.

FRM's value track record began during the early '90s. These first several years were marked by high productivity increases in the economy as the use of computer workstations became commonplace. Around the mid-'90s, the internet burst onto the scene. Our portfolios were broadly diversified in conglomerates, transportation, electronics and technology, chemicals, real-estate, energy and materials. We got off to a good start during this period. It was a good period for value investors in general.

The second half of the '90s made FRM stand out from the standpoint of its vast underweighting of internet, information technology and telecommunications stocks relative to the S&P 500 Index, which was growing rapidly in popularity in its use as a passive investment vehicle. Our absolute performance was 16.25% annualized for these five years, however our relative performance suffered as the technology favorites quickly rose to the top weighted positions in the index. When the bubble did burst in the aforementioned 50% correction, our portfolios produced positive returns during the period.

The September 11, 2001 terrorist attacks on this country brought about another short and shallow recession. While it was a scary time, the economy took the gut punch with a short stagger and then went right on. However, the Fed had to DO SOMETHING. The overnight rate, having re-traced about half of the cuts from the early '90s (3% to 6.75%) was brought down to 1% this time. That rate action was very similar in magnitude to the previous one, as you can see by referring back to the first chart. With rampant speculation in housing, the Fed finally woke up and began a series of rate increases in very short order that again retraced below the previous high rate (1% to 5.25%). Hopefully, you are starting to see a pattern here.

As the stock market began to reflate between 2003-2007, we increasingly found it difficult to add new value names to our portfolios. 2007 saw us sell numerous positions, which caused us to have the largest percentage cash position that we had ever held since the earliest days. As compared with today, we were receiving attractive yields on cash, though we neither considered that investment as an attractive income source or a way to time the market.

The aforementioned 15-year housing boom and Wall Street's financial house of cards that was built to feed it came tumbling down in the last half of 2007. This began the period commonly referred to as The Great Financial Crisis (GFC). We had begun to express concerns about the housing bubble as early as 2004. When the bubble burst, housing starts went to a level not seen in generations. Of course, the Fed came to the rescue and dropped overnight rates to zero. They also, for the first time, began buying mortgage backed securities of various structures in an attempt to keep the housing finance market and some of the major money-center banks afloat.

It was at this point that the Fed vastly broadened its mandate without any legal direction from Congress to do so. Previously focused on inflation and employment, the Fed expressly stated their *intent* to create a "wealth effect" by inflating asset prices. Said wealth effect would give consumers confidence to spend, thus bolstering the economy. The overnight rate was left at

zero for seven years, an intentional policy of favoring borrowers, investors, and speculators over middle-class savers, especially those that did not want any part of the stock market. Savers were punished severely by the Fed during this period and took their punishment lying down. That taught the Fed another lesson: that they could punish savers with impunity. During this time, we actually had a discussion with some of the staff at the Fed about how wiping out the interest income of retirees and other savers might actually be having a negative impact on the economy. We were put in our place right quick. Despite the fact that there is no proof that 0% interest rates have fostered economic growth (it sure has not worked for Japan in 30 years), the Fed continued to follow its course. We learned those folks are seldom wrong but never in doubt!

Our clients were rewarded for our patience (and theirs) when stocks made a 37% dive in 2008 and continued down another 20 % in the first two months of 2009. We acquired 15 new additions to the portfolios during the bear market, which made for very attractive returns 2009-2010.

We kept waiting for a return to normal capital markets during this time, however the Fed did not see fit to begin raising the overnight funds rate until late in 2015. Little by little the Fed began to make tiny increases in the overnight funds rate and also began to very slowly reduce the amount of bonds on its balance sheet that it had purchased during the GFC.

While not the only contributing factor, it should be noted that our best year of performance in the last five was 2016, the first full year that the Fed finally began to slowly normalize rates.

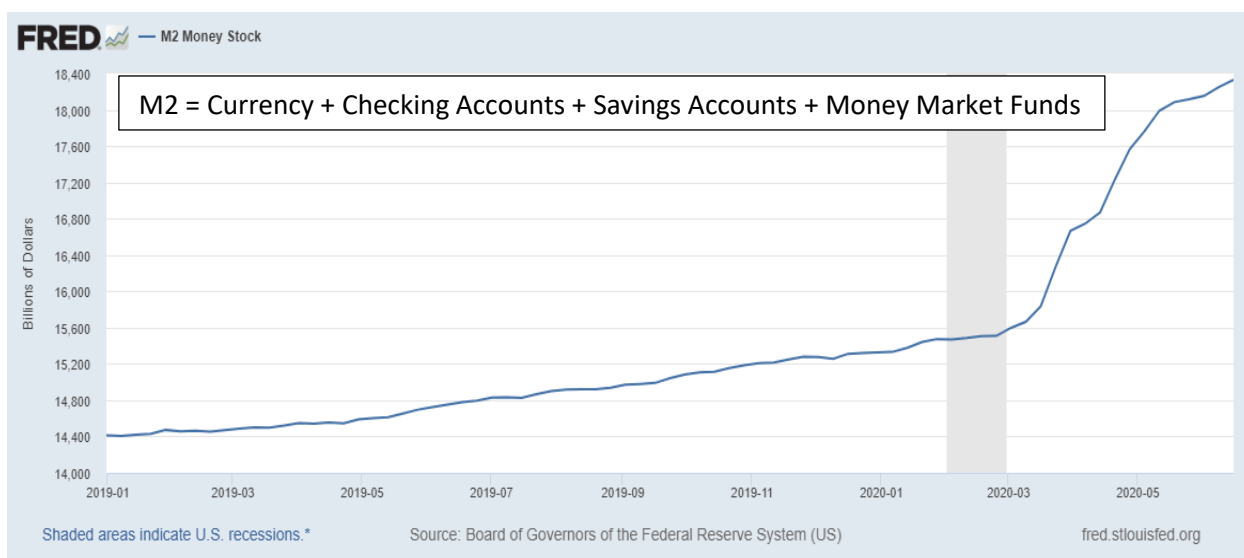
In the fall of 2018, the stock market headed toward the first bear market since 2008. It was way overdue for a major correction by historical standards. In spite of the economy showing good growth, the Fed felt the need to DO SOMETHING. They announced just prior to Christmas that the overnight rate increases that had just reached a whopping 2.5% were coming to a halt, as was the reduction of assets on the Fed balance sheet. They also stated that the next move in the overnight rate was probably lower. Good to their word, they started cutting in the first half of 2019. They took barely a pause at 1.75% before the pandemic hit, but when it did, boy it was really time to DO SOMETHING! Having employed radical monetary policy for the last 12 years, there was little room to move the overnight rate if they were going to stop at 0%. They made that move and then some.

As the pandemic's impact on the economy began to take hold, stocks took a dive and corporate and municipal bonds did too. Just as security prices were starting to come to a more historically normal risk/reward ratio, the Fed butted in. In an unprecedented action, on March 23 the Fed announced that they were going to support the following markets by expanding their balance sheet with open market purchases: Treasury bonds, mortgage backed bonds, investment grade corporate bonds, recently downgraded corporate bonds that were no longer investment grade (a.k.a. "fallen angels), and state and local government bonds. The Fed was peddling the idea that those bond markets "locked up" threatening businesses' and state and local governments' access to credit. What they really mean is access to **cheap** credit was threatened. They have also announced programs for direct lending through the use of

corporate credit facilities. Almost as an afterthought, the Fed governors decided that small businesses needed help too, and announced a lending program for them as well.

We understand that the pandemic was not the fault of the Federal Reserve and that the government probably does need to DO SOMETHING during an emergency of this magnitude. However, it was the Fed's unnecessarily radical policy of the last 12 years that put this country in a very weakened financial state when the pandemic came along. Excessively low interest rates have encouraged borrowers to borrow even more. The federal government is now expected to go from \$23.1 trillion in debt at the end of last year to around \$26 trillion by the end of 2020. Large corporations have piled on the debt too, mostly to finance non-productive stock buybacks. Their debt has more than doubled since the GFC as the cost of servicing the debt came down. Corporate debt now totals \$7 trillion. State and local governments have borrowed to pay the costs of some of the most lucrative employee benefit packages available in the employment arena. Their total debt (\$3 trillion) has not increased much over the last several years, but that does not include the huge unfunded portion of those rich employee retirement benefits. The most recent number we could find was for 12/31/17, which was slightly above \$4 trillion (you won't find this number on their balance sheet...they don't report it). That number is larger today and has some of the most indebted seeking a federal bailout. Consumer credit is at an all-time high as well. If you think there is no moral hazard in what the Fed has done to the capital markets in the last 3 months, just take a look at corporate investment grade, non-investment grade and municipal debt issuance since March 23. It has exploded. To sum, borrowers have been exceedingly encouraged by ultra-low rates to borrow more.

The Fed's magic money machine has been working overtime during this crisis (see chart of M2 money supply below).



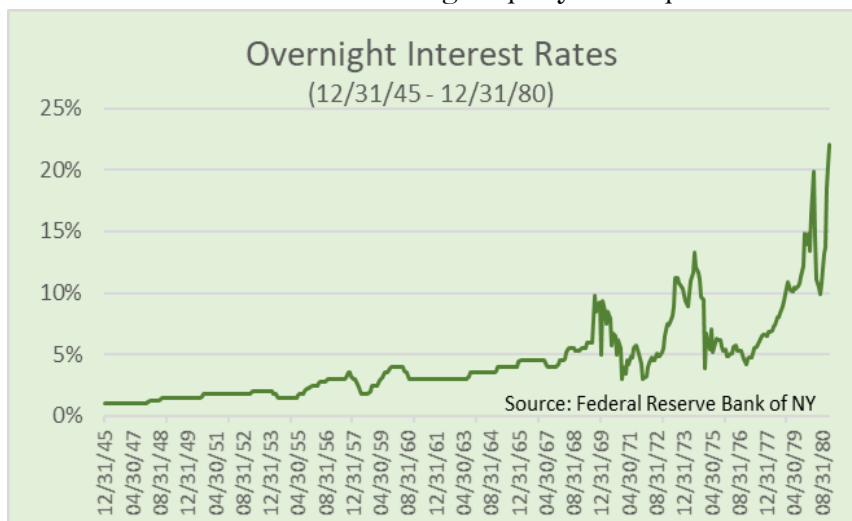
In addition to printing money at a huge rate of increase, we now expect the Fed to continue its radical course by other means, which will probably lead to more volatility in the markets and

the economy. They are doing a lot of talking about yield curve controls (managing the term structure of interest rates to force rates at various points along the yield curve into compliance), so we fully expect that to happen soon. At this point, we would not be surprised to see the Fed print more money to enter other markets. We are no longer surprised by anything they might do. They might go so far as to directly enter the market for highly-leveraged loans. Leveraged loans are loans issued to companies with so much debt that they are not considered investment grade and have been judged by third party ratings agencies to be “speculative” and “subject to substantial default risk.” Many of these loans fund business acquisitions by private equity funds and other merger and acquisition activity. This is one market that has not fully recovered from the economic reality of the pandemic. It would also not surprise us to see the Fed directly enter the stock market, because they have proven over the last 12 years that they want to keep it inflated at all cost.

The paradox of capital markets right now is that at a time when the demand for credit is extremely high, the price of credit (interest rate) is extremely low. This is artificial, only achieved through the Fed’s machinations. In our view it is unsustainable. Judgement day comes when the inflating manifests in such a manner that brings recognition and expected future inflation by the public at large. In the meantime, it distorts asset prices and makes the assessment of the price/value relationship ever more difficult.

At this point, capital market price discovery of risk/reward levels has been totally trampled upon. We believe that private enterprise and free markets have been proven to provide the highest standards of living when compared to controlled economies. Private enterprise and the market economy are complex systems that do not react well to tinkering. Please refer back to the top chart on page 2. Do those look like policy actions that have been made with humility and conservatism or expediency and arrogance? We think the latter. How might things have turned out if we had had a stable overnight rate throughout this period and borrowers were much more disciplined by the price of credit? Better, we suspect. We now see the Fed as desperate to maintain asset and credit markets at inflated levels with the need to paper over the out of control debt of the federal government. The conventional wisdom says the return to interest rate normalcy that we have longed for most of the last 10 years is a long way off at this point. While that may be, one thing that has changed significantly in recent months is the havoc that has been realized in the global supply chain. That could have a significant impact on inflation expectations going forward. Two phrases we are hearing to describe the state of affairs in the credit markets are “interest rate suppression” and “financial repression”. With those self-revealing expressions increasing in use in the financial press, perhaps it won’t be that long before the inflation the Fed so desperately wants will be manifested in the price of goods and services, not just assets. When that happens, we believe our portfolios are positioned to not only protect our clients, but to benefit them as well.

All of this then begs the question: what do we need to change or how do we need to adapt to this new reality? This has been the topic of much discussion at FRM over the last several years of extremely low interest rates. Prudence demands that we recognize that the current artificial interest rate structure could change rapidly. This prudence mandates the distinction between



investing and speculation that is based on the latest Fed policy intentions. One need only look back (see chart beside) to the interest rate caps and yield curve controls instituted in the decade following WWII and the easy money policies throughout much of the 1960's to see that those policies led to an inflation that eventually forced the

Fed into raising the overnight rate to 22% to finally get it under control. Who is to say that current monetary policies, which are **much** more aggressive than those employed back then, won't produce an inflation at least as bad if not worse? We are paid to invest, not speculate.

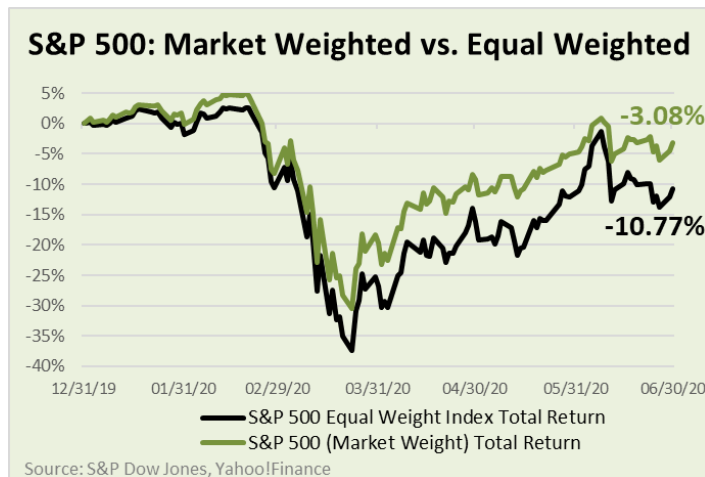
We still firmly believe that the best way to control risk and obtain above-average long-term returns is to be a price sensitive value investor. That said, with significant outside intrusion in capital markets, other factors beyond traditional ones will need to be given increased weight. For example, with the expectation of more volatility and instability in the economy and the markets, strong balance sheets will be even more important in the future. Also, while inflation is mostly contained currently in asset prices rather than consumer prices, we expect even higher amounts of inflating in the future. We will be assessing how that might impact particular companies going forward. These are only two examples of steps we are taking to address how we need to evolve our value investing approach as the Fed seeks to intentionally hyperinflate asset values. In less than 90 days, our equity investing track record will be 30 years old (more on that later in this commentary). The value investing discipline that we practice has a documented successful history of 68 years through all kinds of economic cycles and central bank policies. While certain aspects of it must change with the times, the central premise of it does not.

Party Like It's 1999

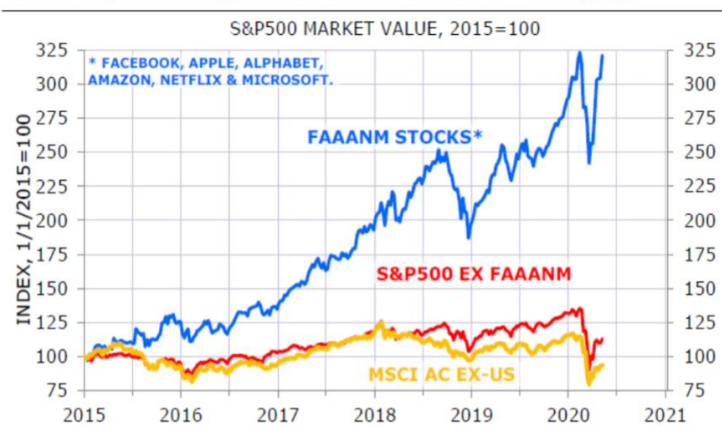
What pandemic? The equity markets look more and more like 1999. As Yogi Berra famously quoted (remember that great American pastime, baseball?) "It's like Deja Vu all over again". They say the stock market only looks forward, so if that is the case, we have absolutely nothing to worry about!

Although the broad market indices have rebounded sharply to near pre-Covid levels, a deeper look into market returns for this and recent years reveals something that most participants probably do not appreciate. We have mentioned before how the S&P 500 has and is being driven by the performance of six large companies. Much like in 1999, the performance of “the market” gets narrower and narrower, driven by the large companies at the top of the index and further fueled by the massive shift to index investing. As more liquidity is funneled into the index, that forces purchases by those funds of the largest components, regardless of valuation. Only a reversal of this process finally burst the bubble of the late ‘90s.

Because the commonly quoted returns for the market are capitalization weighted (i.e. the largest companies make up the biggest part of the return, while the smallest companies account for almost no weighting), Facebook, Apple, Alphabet (Google), Amazon, Netflix and Microsoft (FAAANM) have been an ever-increasing driver of the index. For example, if you look at the index on an equal weighted basis, returns look very different so far this year (see chart nearby).



The super 6 explain most of the return gap



We think the chart to the left says even more. Since the start of 2015, if you take out these six stocks, the performance of the domestic equity market looks entirely different. The red line on the chart is the S&P 500 return excluding the FAAANM stocks (slightly positive since the beginning of 2015) and the orange line is the Morgan Stanley All Country Excluding U.S. Index (slightly negative for the period).

Another resemblance to the late ‘90s comes in the form of a return to day trading. From what we read about the latest in this phenomenon, many young adults are now engaging in this activity as a form of entertainment as opposed to profit-seeking. Figure that one out! There apparently are a whole lot of folks with too much time on their hands. Robinhood is a favored no-cost broker of the millennial and Gen Z demographic. Bloomberg News reports that Robinhood opened more than three million accounts in the first four months of this year, more than half of which were to first-time investors. No surprise, a large portion of these

transactions occur on cell phones and do not involve trades in individual stocks, but exchange traded funds (ETFs). As pandemic related idleness increases, this activity has grown.

As broad equity market valuations have exploded in the past several years, we initially attributed it more to the lack of competition from low-yielding fixed income investments. For the first time in 20 years, we are now witnessing hyper-active investment activity at the retail level, just as we did in the late '90s. Now, as then, we do not expect that to end well.

GIPS

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Our adoption of these industry-leading standards involved a substantial investment of time and resources over the past few years to standardize our methodologies, document our policies and procedures relating to composite calculation and bring our presentation materials into compliance with the GIPS approach to performance presentation. **Though this process doesn't change any individual client's performance figures**, all of our clients should see this investment in our firm as a demonstration of our commitment to maintaining a high integrity investment operation for generations to come. We have always taken pride in maintaining a high level of fairness and transparency in how we operate and bringing our firm into GIPS compliance is a demonstration not only of our commitment to transparency but also to continual improvement in our firm procedures and internal controls.

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