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**April 18, 2022**

# Quarterly Commentary

**1<sup>st</sup> Quarter 2022**

## **Margin of Safety**

Remember knocking on a friend's door and hearing, "Come on in. It's unlocked." One of our partners recalls regularly visiting a favorite neighbor's house when no one was home. It was not a coincidence that this neighbor kept a cookie jar well stocked with Oreos. As break-ins around the United States became more common, forgetting to lock doors nearly became an unforgiveable sin. No matter what, if our partner heard a parent shout, "Who left the door unlocked?" the answer was a reflexive, "NOT ME!" Experience impacts how we approach risk. The probability of a negative event occurring and the degree to which it causes pain or loss leads us to create large or small margins of safety. Consequently, the uneventful passage of time can lead to dropping of one's guard.

By not locking doors, the margin of safety against a would-be burglar was diminished. The family could have gone to extremes purchasing reinforced steel doors and a monitored security system with cameras (very expensive in the 70s). These precautions would have created a formidable margin of safety; however, in light of the expense of raising and educating several children, they settled for a Labrador Retriever and a devotion to locking doors. A string of violent attacks, rather than simple break-ins, would have called for a greater margin of safety.

Investors are not immune to this short-sighted behavior. For decades, globalization has been tantamount to society leaving its economic doors unlocked as we have pursued efficiency and convenience over localized supply chains with more resilience or a margin of safety. Before COVID-19 disrupted the world, investors willingly paid sky-high valuations for securities issued by companies carrying record levels of debt, facing stiff competition, rising regulatory obstacles and deteriorating demographics. In the investment world, a margin of safety means purchasing a security for a discount to what you believe it is worth. This discount guards against the risk that our assessment of intrinsic value is too high. In recent years, broad market valuation levels have climbed, and investors have been willing to pay more and more for the same dollar of earnings. The higher multiples go, the less of a margin of safety investors are demanding for risking their capital. This is despite a concurrent trend where companies are increasingly dependent on a fragile supply chain and a fragile supply of capital from the debt markets. While investors temporarily adopted price discipline in the most confusing days of

the pandemic, government bailouts, necessary or not, created an overconfidence that the Fed always can and will come to the rescue.

The prospect of adverse events, foreseeable and unforeseeable, is why we demand a margin of safety for our clients' capital. A margin of safety protected our clients from the internet bubble of the late 1990s. A margin of safety enabled us to regain ground lost during the 2008-2009 financial crisis by the end of 2009. A margin of safety is why we look for balance sheets capable of weathering a large storm or pandemic. A margin of safety is why we purchased three new positions during the deep sell off in late February of 2020. Valuations had dramatically declined, creating a margin of safety such that above-average future returns were no longer reliant on flawless execution in a perfectly calm environment. More opportunities likely would have presented themselves had the government not tacitly guaranteed all debt which saved the stocks of many over-indebted companies. As a result, the valuations of all securities rebounded on the policy change and limited the number of bargains available to investors. A margin of safety at the time of purchase allowed our clients' to experience impressive stock returns in 2021 and strongly positive returns during first quarter of 2022 while the broad market was down.

*“It may be the greatest collective error in the history of investing to pay extreme multiples for extreme earnings that reflect extreme profit margins and extreme government subsidies, while imagining that those multiples also deserve a ‘premium’ for depressed interest rates that reflect depressed structural economic growth.” – December 17, 1959 speech by Benjamin Graham, author of *The Intelligent Investor**

Prior to the pandemic, we had been growing cautious about an accumulation of risks that included extreme equity valuations, highly-levered corporate balance sheets, degrading credit protections for bondholders, near 0% interest rate monetary policy and quantitative easing (a term the Fed uses to avoid admitting to money printing). As value investors, the accumulation of risks demanded that we remain disciplined. We continued to build a margin of safety into the purchase price of any security under consideration rather than succumbing to FOMO (fear of missing out) and chasing after inflated Wall Street darlings.

Experience teaches that the result of a decision in investing and many other aspects of life should not be the basis for judging the quality of the decision. Sometimes good things happen even as the result of a bad decision. When states first began to require seatbelts under threat of fine, many of our older relatives (as well as some of us who were small and wiggly), stubbornly protested such blatant governmental overreach into our personal rights. Protestors might recount tales of fortunate survivors who, thanks to their refusal to wear a seatbelt, were thrown from what should have been a fatal car wreck. We doubt anyone would argue that the decision not to wear a seatbelt in that instance was wise. Lucky, yes. But not wise.

Requiring a margin of safety has made many value investors appear to be unwise over the last decade as they have underperformed the incredible returns generated by passive indexing. The average buy and hold mutual fund investor may not realize how much they have benefitted

from extraordinarily aggressive monetary policy. The Fed-created tailwind may have inspired overconfidence in buy and hold indexers as well as speculative traders. It seems that 40-year high inflation will be the disciplinarian that forces the Fed to raise rates and reduce its practice of bailing out bond and stock markets at the first sign of trouble. Given that long-term inflationary trends had been waning for decades, at least by government measures, it is not surprising that investments that might benefit from inflation had been priced for failure. A generous margin of safety gave them significant upside relative to expensive, priced-for-perfection stocks. While the war has contributed to inflation, numerous inflationary forces were growing prior to Russia's invasion of Ukraine:

- Grain reserves were historically low
- Fertilizer prices were high while supplies are limited and new supply takes years to develop
- Oil and natural gas demand was outstripping supply, draining inventories
- Oil and natural gas producers had been investing in new resources at historically low levels
- Copper, cobalt, lithium and zinc prices had risen dramatically and demand is expected to accelerate upon transitioning to alternative power sources
- New mines take more than a decade to design, develop and receive regulatory approval
- Ore grades for new mines have been declining for years
- Semiconductor shortages have been an anchor on supply chains while new semiconductor manufacturing facilities are expensive and take years to build
- Transportation costs were rising due to a lack of trucks, trailers and drivers

Our clients' portfolios include producers of most of these items that benefit from the rising prices, and they were purchased with a significant margin of safety to our assessment of intrinsic value.

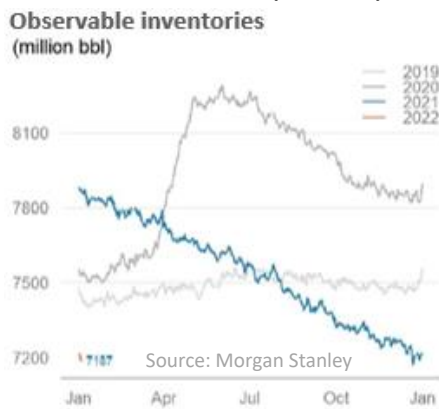
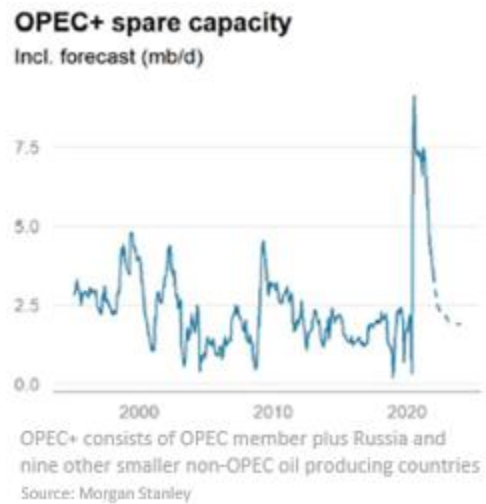
### **Is There Value Left in Energy Stocks?**

Last year, Energy was the best performing sector in any broad market index with the S&P 500 Energy Index rising 47.7%. Year-to-date, the S&P 500 Energy Index is up 37.6% (as of 3/31/22). This begs the question, "Is there much value left in energy stocks?" First, know that our affinity for these companies stems solely from the margin of safety and return potential based on our assessment of each company's fundamentals. Our approach is the same for stocks in any sector. When we feel a stock is fully valued or if it is becoming too big of a position, we will begin to reduce the position. We also will manage our exposure to the sector so that we begin to reduce positions if the sector weighting in a portfolio becomes too large. This is an important practice for controlling risk.

Now to address the question, "Is there much value left in energy stocks?" We believe there is, though not as much as a year ago. Our companies have been improving their long-term outlooks by focusing on shareholder returns in the form of dividends and share repurchases rather than pursuing the old, capital-intensive strategy of maximum production growth. In the

past, chasing production growth at any cost led to negative cash flows and bloated balance sheets. Publicly traded oil and gas companies have taken heed of vocal shareholders and spent the last two years repairing their balance sheets. Once the balance sheets reached a conservative level of debt, it became palatable to buy back shares and raise dividends. The exploration and production companies in our clients' portfolios are among the lowest cost producers in the world.

Additionally, supply should remain tight even if renewables take market share from fossil fuels due to the low levels of spending on finding and developing new oil and natural gas reserves. Most industry experts believe the world will need to spend at least an additional \$500 billion per year on exploration and development in order for production to keep up with demand. The **Capital expenditures** chart (right) illustrates the dearth of new dollars that have been devoted to finding and bringing new oil production online. It seems the trend is unlikely to vary to any great degree as the world's oil



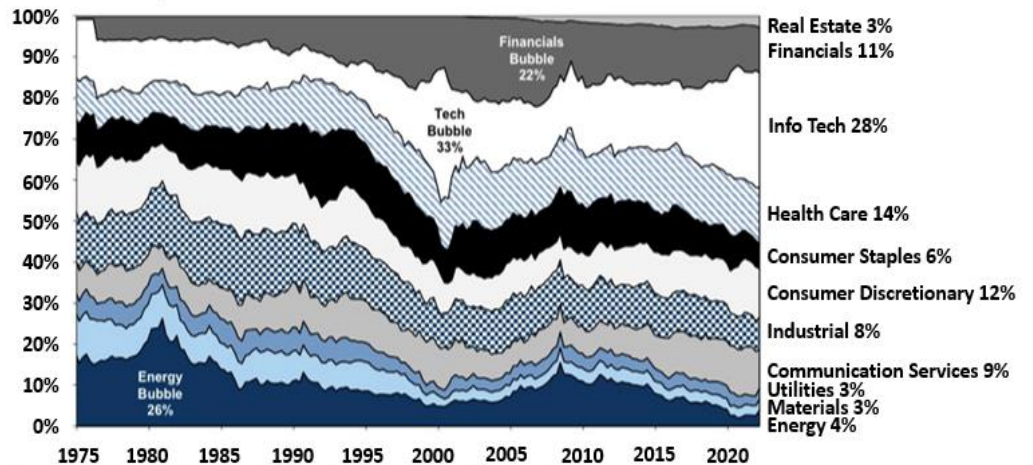
producers fear significant new production may antagonize OPEC into a repeat of 2014's supply glut. The expected lack of supply should be more than enough to offset even some of the highest predictions of new capacity from renewable power sources. Meanwhile, as can be seen in the **Observable oil**

**inventories** chart (left), global oil inventories are historically low, and OPEC does not appear to have the spare capacity to make a long-term dent in pricing (see **OPEC+ spare capacity** chart above).

Consequently, the

**Sector composition of the S&P 500 by equity capitalization, 1975-2022**

As of March 31, 2022



world is coming to grips with the fact that the transition to an economy without fossil fuels is going to take longer than many hoped. More on this below in the Energy Transition Realities section.

Another fact to consider is that many investors have little exposure to companies in the oil and natural gas value chain. The chart at the bottom of the previous page shows that the Energy Sector weighting within the S&P 500 has varied from around 25% to as low as 2%. While the sector's weighting has rebounded to 4%, there are a large number of investors that have avoided the sector simply because it had poor returns in past years and concern that fossil fuels would go the way of the buggy whip. These dollars are likely to flow back into energy stocks as more investors come to realize that the world still needs fossil fuels.

Finally, the attempt to transition to alternative energy sources too quickly has caused utility bills to gap higher in the European Union (EU) as the more reliable fossil fuel sources of energy are being sourced increasingly from Russia due to the EU's failure to adequately invest in its own oil and natural gas resources. This makes for poor positioning in the West when trying to sanction Russia. Recently, the U.K. and Germany seem to be reversing course on eliminating nuclear power, and France has announced plans to further increase its use of nuclear power. Some EU delegates are even pushing to include natural gas among the list of "sustainable" energy sources. After a brush with blackouts, growing public support for a restart of Japan's 40 idle nuclear reactors could bolster Western energy security by allowing Japan's liquified natural gas (LNG) imports to be redirected to Europe.

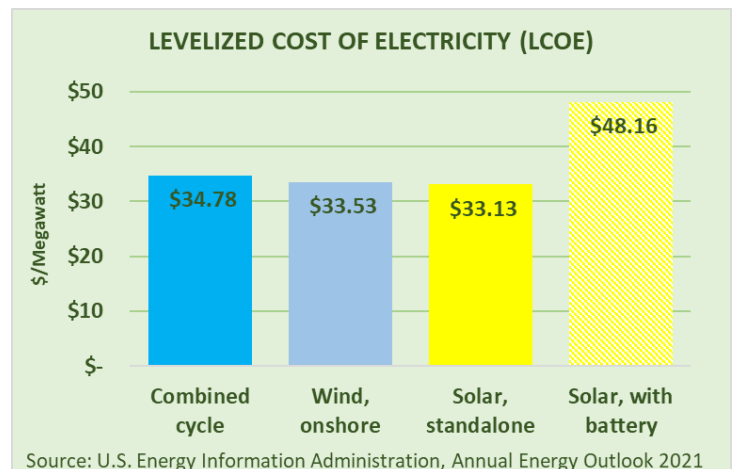
## **Energy Transition Realities**

Harnessing electricity and democratizing its use was a game changing advancement in humans' quest to maximize the efficient use of energy. While the existence of electricity was known and had been studied for over a hundred years, the first power station for distributing electricity among buildings did not appear until 1882. Throughout human history, each transition from one energy source to another resulted in a more efficient use of energy. While none of the old energy sources were totally abandoned, they became more of a niche energy source based on their availability, dependability, safety and cost. Clean natural gas has become the primary non-transportation fuel source in the developed world while dung is still burned in the poorest corners of the world. Fortunately, the staggering increase in the standard of living made possible by the more efficient use of energy has also given us the ability to limit the pollution that accompanies these energy sources. Also, many developing nations have been able to adopt advanced energy technologies without having to reinvent the wheel. It is no coincidence that concern for the environment increases as a society's wealth increases. When you are destitute, you don't have time to worry about the environment. Your first goal is for you and your family to survive the day. As standards of living increase, humans begin to be more concerned with the world around them and plan for the future.

*“If you are on the wrong road, progress means doing an about-turn and walking back to the right road; and in that case, the man who turns back soonest is the most progressive man.” – C.S. Lewis*

The war in Ukraine has made evident the lack of focus on the national security aspect of energy policy and the importance of pursuing an “all-of-the-above” energy strategy globally. Many European Union members and the United Kingdom have pursued energy transition policies in recent years that drastically reduced efforts to tap their own fossil fuel resources. At the same time, they reduced their nuclear power capacity and doubled down on more expensive power sources such as windmills and solar panels. These policies caused them to become increasingly reliant on oil, natural gas and coal imports from Russia. Since the beginning of the war, their tune has changed. Boris Johnson is calling for an increase in nuclear energy’s share of the U.K. power mix from today’s 16% share to 25% by 2050. Germany planned to shut down all nuclear plants by the end of 2022 (three are still operating) and phase out all coal-fired plants by 2038 at the latest. However, all 16 German states’ economic ministers have called for studies to determine the potential for increasing the operating lives of both coal and nuclear power plants. The West must balance security needs, reliability and costs with climate concerns when forming energy policy.

There have been claims that wind and solar are cheaper than coal, natural gas and nuclear energy. As of today, this claim is not true, when comparing unsubsidized costs and the inconsistent availability of wind and solar. A computation known as levelized cost of electricity (LCOE) is used to compare energy costs of various power sources on a cost-per-megawatt-hour basis. Based on the table to the right, the LCOE for wind (\$33.53) and solar (\$33.13) appear to be cheaper than a combined cycle natural gas-fired generator. However, the wind does not always blow, and the sun does not always shine. In order to make an apples-to-apples comparison, we need to add the cost of battery storage to solar which raises its LCOE to \$48.16. Unfortunately, we couldn’t find a calculation for wind paired with battery storage. The lower LCOE of solar without storage compared to combined cycle’s LOCE and the predictable nature of its lack of availability makes solar a good power source to couple with baseload capacity from natural gas fired plants. In certain geographies where wind is fairly predictable, windmills paired with traditional baseload capacity may also be economically attractive. This supports the idea that an all-of-the-above approach for energy makes the most economic sense.

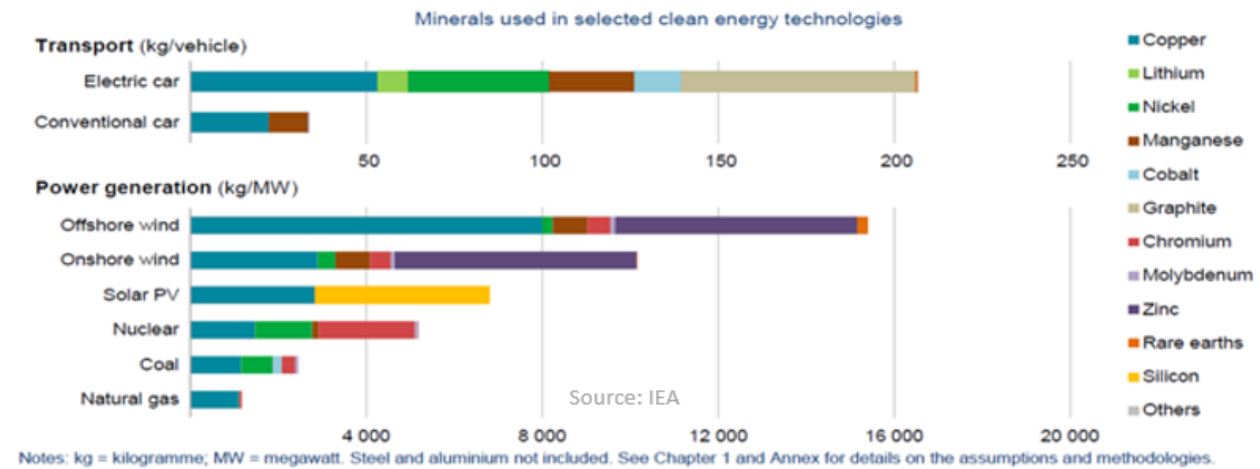


From an environmental aspect, it is important to note that while the pollutive aspects of fossil fuels are generally known, production of electricity from wind and solar are neither entirely

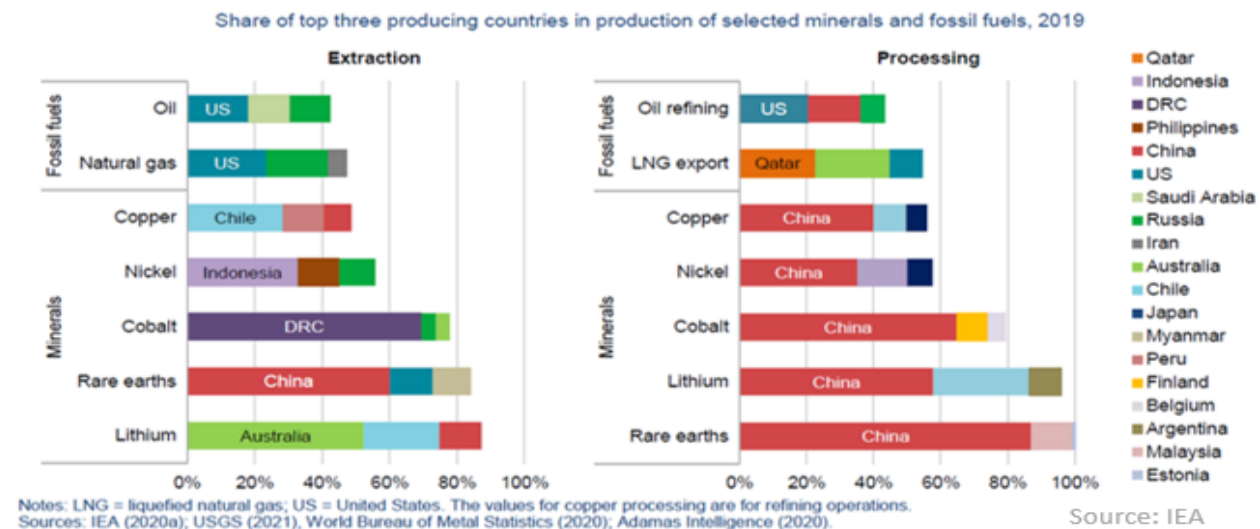


renewable nor entirely carbon neutral. Windmill blades, turbines and solar panels require maintenance, and they have a limited life (approximately 20 years), as do the batteries that might be paired with them. This raises important disposal issues and associated costs. Furthermore, these alternative energy sources require immense amounts of materials and metals that must be mined and processed, typically by fossil fuel powered equipment.

The International Energy Agency (IEA), a strong advocate of wind and solar, published [The Role of Critical Minerals in Clean Energy Transition](#) in May of 2021. Page 5 (7 of the PDF) of the 287-page tome reports that the “typical electric car requires six times the mineral inputs of a conventional car, and an onshore wind plant requires nine times more mineral resources than a gas-fired power plant. Since 2010, the average amount of minerals needed for a new unit of power generation capacity has increased by 50% as the share of renewables has risen.” (See chart below for mineral intensities.) It’s important to note, most mines take about 16 years to design, pass regulatory approval and construct before the first shovel of dirt is extracted.



Finally, from a national security perspective, fossil fuels currently have the advantage over wind and solar. While OPEC and Russia are able to strongly influence oil supply, the United



States has enough reserves to maintain its independence, if necessary, and Canada also has vast reserves that they likely would be willing to sell to us if we needed additional supply. As for natural gas, it seems we have enough for us and plenty left over to export. Unfortunately, the chart at the bottom of the previous page (also from [The Role of Critical Minerals in Clean Energy Transition](#)) shows that China is one of the largest suppliers or processors of many of the metals and minerals necessary for the large-scale adoption of wind and solar power as well as electric vehicles (EVs). Access to these raw materials could easily be exploited if we become overly reliant on alternative energy sources before we develop a more secure supply chain for their inputs.

If our investments in fossil fuels leave you feeling that we are anti-alternative energy and pro-fossil fuels, we'd like to reiterate that we are pro-all-of-the-above. Fossil fuels have their drawbacks as well, and having the country's sources of power more widely disbursed, as with wind and solar, helps with energy security in terms of grid integrity. Unlike most fossil-fuel powered grids, wind and solar can be more widely distributed geographically. Distributive power protects large swaths of the population from being dependent on a handful of large generators. The concept is similar to flying a plane with one big engine or four smaller engines. The four smaller engines provide a better margin of safety. An all-of-the-above approach will increase the margin of safety for our electric grid.

Hopefully, natural gas and nuclear will continue to be used at least until research and development progress lowers the cost of wind and solar power paired with battery storage to be on par with natural gas-fired power. Limiting solar and wind deployment to geographies and situations where they are most advantageous, and pairing them with traditional baseload power would help avoid driving up the prices of the rare earth metals and other necessary wind, solar and battery power inputs. Additionally, new nuclear small modular reactors (SMRs) that are built into the ground and store spent fuel rods inside the reactor container can be a great help in supplementing and diversifying our energy mix as well as reducing CO<sub>2</sub> emissions.

To summarize, taking our time to transition from predominantly fossil fuel-powered generation to alternative power sources will allow research to reduce wind and solar costs and find efficient ways to lower fossil fuel's carbon intensity through carbon capture and storage. Moreover, a slower transition will give the United States and friendly countries time to develop new sources for the metal and mineral inputs necessary for wind and solar but are currently controlled by less friendly nations. Certainly, it is preferable that we mine the raw materials for wind and solar at home where environmental standards are high and within our control, rather than source them from the predominant polluters of the world.

No matter the manner in which energy policy evolves, our clients' portfolios should benefit greatly from an all-of-the-above approach to energy policy due to investments in oil and natural gas producers; miners of copper, silver and zinc used in windmills, solar panels and EVs; as well as a uranium miner and fuel rod manufacturer. Also included in most clients'

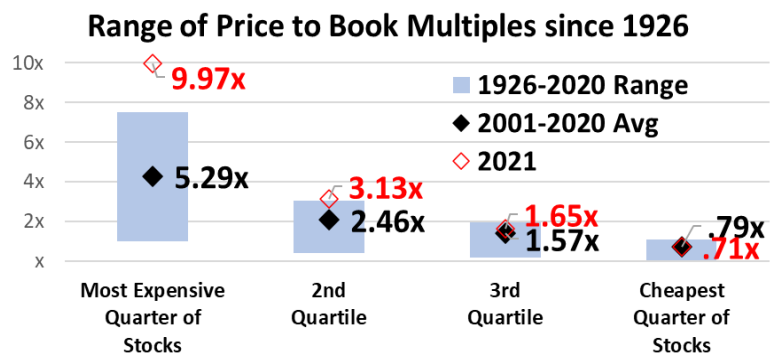


portfolios is one of the largest owners of wind and solar capacity in the United States. We are excited about the future of energy. We hope you are too.

### “Air” in Valuation Levels

Most of our clients are surprised to hear the optimism in our voices during recent annual reviews. It is counterintuitive that we would be optimistic about our portfolios when the broad market remains very highly valued, even despite some minimal sell-off so far this year. We came across some data that illustrates how it could possibly be that we were finding opportunity when the broad market remains so expensive.

Kenneth French is a professor at Dartmouth who compiles and publishes a tremendous amount of data on stock market valuations over time. One of the data sets he publishes each year is the average price to book multiple of stocks in the broad market by each 5th percentile. We used this data to put



Source: Created by FRM with data from Kenneth French  
[https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data\\_library.html](https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html)

today’s valuation levels into context compared to the average valuation ranges by quartile since 1926. The most expensive quarter of the market has traded between 1x book value and 7.5x book value from 1926 to 2020. The 20-year average multiple of book for this quarter of the market was 5.29x. At year-end 2021, this group traded for 9.97x book value. To return to the 20-year average, stocks in the most expensive quarter of the market would have to decline by 47% on average. This illustrates to us how much of the “air” in broad market valuation levels is concentrated in this most expensive quarter of the market. Interestingly, however, the cheapest quarter of stocks – where FRM is shopping for you – actually trades below its 20-year average multiple. So, these stocks would have to *increase* in value to trade at their 20-year average multiple.

In a world where 0% interest rates have driven many investors to emphasize relative attractiveness of their investments compared to very low return alternatives, we believe our clients’ portfolios remain at attractive absolute valuation levels compared to the stock market historically.

### “Not so Fixed” Income

We talk a lot about dividends. This is because dividends are a substantial component of the total return for stock market investors. Dividends bring forward the average duration of the return on your investment, provide income for any client who has regular distribution needs and also serve as a steadying baseline for total portfolio returns. While we wrote in our 1st Quarter 2021 Quarterly Commentary about the recent “Underappreciated Growth” in the

dividends paid by companies in our portfolio, we recently took note of the fact that our dividend yield continues to grow despite a large increase in the value of our portfolios. At year-end 2019, our equity composite dividend yield was 2.64%. By year-end 2021 our dividend yield had grown to 2.99%. But what is fascinating is that over this time our composite was up 30.1% cumulatively, net of fees. So, a client who had a \$5,000,000 portfolio at year-end 2019 would have been earning \$132,000 per year in dividends. That same client's portfolio would be worth \$6,506,786 by year-end 2021, but their annual dividends would then be \$194,553 – a 47% growth in dividend income over two years! This annualizes to 21% growth. Not only are either yields (2.64% or 2.99%) well above the yields available in high quality corporate or government bonds, but these yields are growing, something you will not see when you purchase a “fixed income” instrument such as a bond. Like the old saying “a bird in the hand is worth two in the bush,” we are glad to be paid dividends while we wait for the market to recognize the value we see in our portfolio companies. And in a world of high and rising inflation where real interest rates are substantially negative, we are proud to be increasing our clients' portfolio income well above the rate of inflation.

## **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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