Resources Management Corp

MARKET COMMENTARY

ENOUGH WITH THE VOTES, I'LL USE THE SCALE

The Dow Jones Industrial Average (DJIA) was first calculated on May 26, 1896 by Charles Dow to measure the performance of major public companies in the United States. At that time, the DJIA consisted of only 12 stocks, of which General Electric is the only company that remains. Though the composition of the index has evolved substantially since its inception, the nature of the DJIA has not. Investors across the U.S. track the performance of the Dow 30 to get a gauge of how American business is performing. The average was first calculated to be 40.9, and today, the DJIA is approaching 20,000. While milestones like this can provide an interesting perspective of the development of the American economy over time, the crossing of arbitrary thresholds such as this one offers no unique insights into the long-term future of the stock market or the economy.

All-time highs and notable "milestones" such as *Dow 20,000* are often pointed to as inflection points for the stock market. Television pundits continuously discuss this number and others like it as though it actually holds some bearing on the prospects of the stock market or economy. Despite the media's insistent focus on the implications of the Dow crossing above 20,000, it is critical to not lose sight of what really drives equity values over time. Stocks represent real ownership claims on the assets of their underlying businesses and, as such, should derive their value from the cash flows they are expected to generate in the future.

Historically, stock exchanges have proven reasonably effective at allocating funds to the companies that are able to produce the highest return on capital for shareholders. In the short term, however, there can be a disconnect between the intrinsic value of a business and the price it is trading at in the market. Benjamin Graham, the father of value investing and Warren Buffett's mentor, once stated, "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." In our investment process, we aim to make decisions using the "weighing machine" that evaluates the fundamental characteristics of a business such as earnings power, quality of management, competitive dynamics and valuation, while maintaining a keen focus on the effect the "voting machine" is having on stock prices.

In considering the outlook for 2017, it is far more effective to use the "weighing machine" rather than trying to predict what the short run "voting machine" will have to say (voters have proven themselves to be quite unpredictable recently). From *Dow 20,000* to the potential for interest rate hikes by the Fed, there will be plenty more for the market to "vote" on over the next twelve months. Instead of trying to predict what the initial market movements will be in reaction to these events, we are focused on identifying high quality businesses that will offer strong returns on capital for years to come.

MARKET COMMENTARY

WHY BALANCE IS IMPORTANT

On a recent trip to the grocery store, while walking past the strawberries, I was reminded of the impact that global trade has on everyday life. Have you ever considered what our grocery stores would look like if we did not have the consistent supply and variety of produce that we have come to enjoy?

With all the talk about trade agreements, NAFTA in particular, this question came to mind: what would the renegotiation of this agreement mean for those of us in the US? When NAFTA was enacted in 1994, the intention was to create free trade flow between Canada, the US and Mexico by eliminating the majority of tariffs between the new trading partners. The result was the generation of trade flows to and from the US to Canada and Mexico. What does NAFTA have to do with strawberries? Take a closer look at the label. In many cases, Mexico is the country of origin where strawberries are grown this time of year.

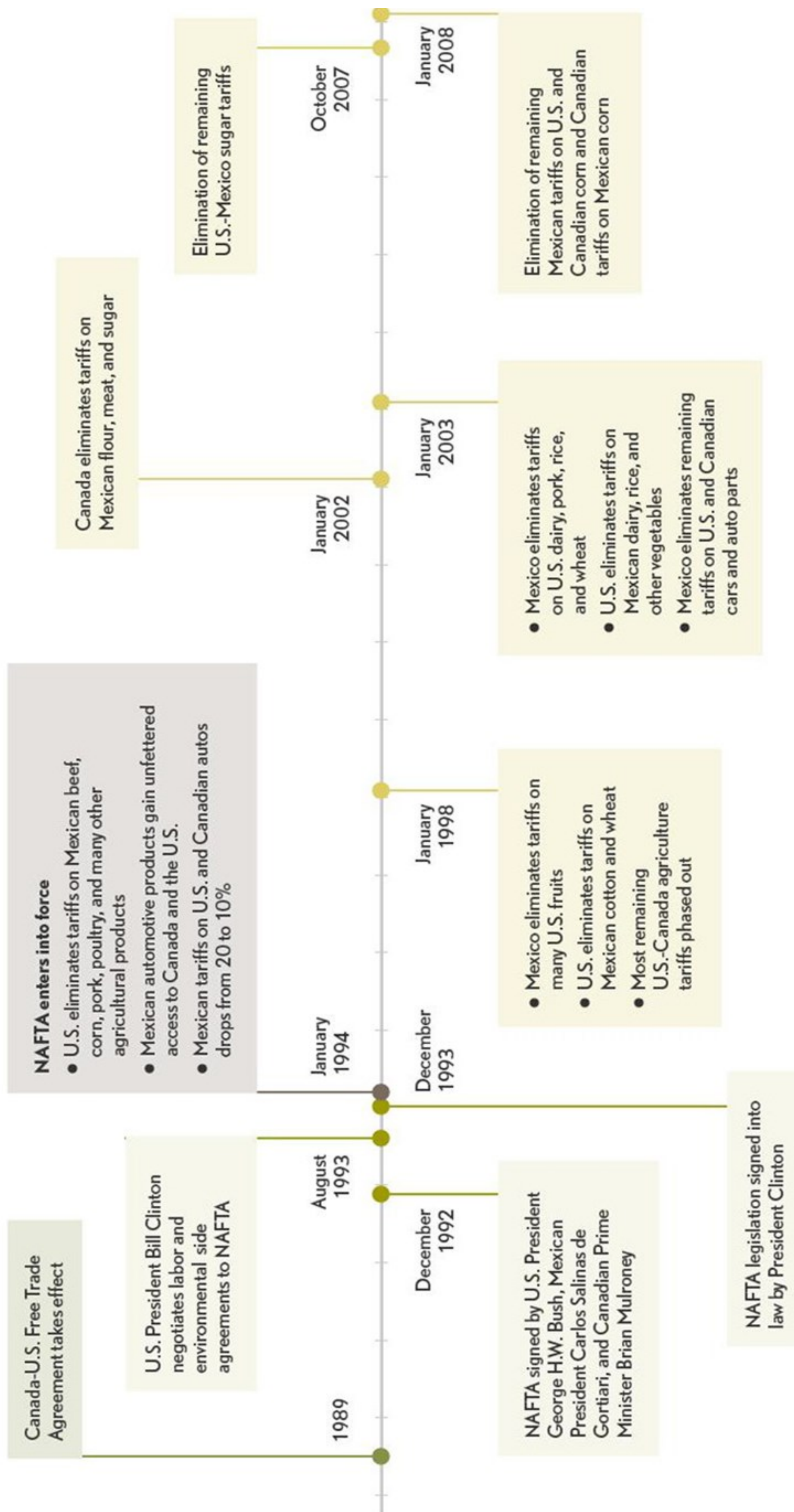
To better understand some the impact of NAFTA, here are a few facts. "In 1995, the amount of US direct investment into Mexico was $15 billion. Today that investment stands at $100 billion, while exports from Mexico into the US have grown 370% during the same time". (Northern Trust) See the chart on the following page for more facts on NAFTA.

The cross-border trading with Mexico has resulted in lower consumer pricing for the US, which has been beneficial for our economy. At the same time, it has created better corporate profits, leading to higher stock prices. In addition, the Mexican consumption of American goods has escalated. Finally, approximately 5 million American jobs depend on trade with Mexico.

A common theme regarding NAFTA's negative impact on the US is the number of jobs lost. Since the implementation of NAFTA, there has been a decline in American manufacturing jobs. While there are certainly many examples of US jobs being lost to factories in Mexico, automation is an equal threat. Despite the auto industry often being mentioned when discussing NAFTA, the primary driver of job loss has been the advancement of robotics and the overall automation of the production of cars. Driven by the need for profits, the assembly line in automotive manufacturing has employed technology to improve the product while at the same time driving down costs.

What could happen if NAFTA is undone? For starters, the Mexican economy would most likely contract. The peso has already rapidly declined in value this year, and interest rates in Mexico have begun to rise. "America is the destination of 80% of Mexican exports sold. That . . . represents 27% of the economic activity in Mexico". (Northern Trust) As consumers of those exports, we benefit from lower prices on cars, food, produce, and clothes, to name just a few. A prolonged contraction of the Mexican economy could have a negative economic impact on the US.

On the other side of the trade ledger, American companies have also benefited from the establishment of supply chains in Mexico. These supply chains have assisted US corporations in remaining competitive on a global pricing scale, while maintaining competitive quality.



NAFTA MILESTONES
1989
Canada-U.S. Free Trade Agreement takes effect
December 1992
NAFTA signed by U.S. President George H.W. Bush, Mexican President Carlos Salinas de Gortiari, and Canadian Prime Minister Brian Mulroney
August 1993
U.S. President Bill Clinton negotiates labor and environmental side agreements to NAFTA
December 1993
NAFTA legislation signed into law by President Clinton
January 1994
NAFTA enters into force
• U.S. eliminates tariffs on Mexican beef, corn, pork, poultry, and many other agricultural products
• Mexican automotive products gain unfettered access to Canada and the U.S.
• Mexican tariffs on U.S. and Canadian autos drops from 20 to 10%
January 1998
• Mexico eliminates tariffs on many U.S. fruits
• U.S. eliminates tariffs on Mexican cotton and wheat
• Most remaining U.S.-Canada agriculture tariffs phased out
January 2002
Canada eliminates tariffs on Mexican flour, meat, and sugar
January 2003
• Mexico eliminates tariffs on U.S. dairy, pork, rice, and wheat
• U.S. eliminates tariffs on Mexican dairy, rice, and other vegetables
• Mexico eliminates remaining tariffs on U.S. and Canadian cars and auto parts
October 2007
Elimination of remaining U.S.-Mexico sugar tariffs
January 2008
Elimination of remaining Mexican tariffs on U.S. and Canadian corn and Canadian tariffs on Mexican corn
COUNCIL on FOREIGN RELATIONS
Sources: "Nafta Revisited" (Hufbauer/Schott), NAFTA treaty text, US Trade Representative, The Wilson Center
Credits: James McBride, David Foster

March 2017

Resources Management Corp

MARKET COMMENTARY

ASSESSING RISK

John Kenneth Galbraith once stated that "there are two kinds of forecasters: those who don't know, and those who don't know they don't know." In the process of evaluating the multitude of investment opportunities that the market presents us with on a daily basis, we must necessarily consider what the future holds for each company. Far too often, however, investors and speculators alike get caught up in the delusion of "false precision." While a keen understanding of a company's sensitivity to the drivers of growth, value and secular shifts is inherent to any successful investment operation, the outputs of detailed financial models frequently get mistaken for facts, disregarding their limitations. In today's uncertain market environment, it is especially important to consider more fully all possible macroeconomic and company specific outcomes when analyzing the securities. From interest rates to earnings expectations, investors would be wise to weigh the probabilities and potential impact of a variety of scenarios rather than becoming fixated on what their model suggests as a sure future.

Within the world of investing, information about the future can be classified into three distinct categories: the important and knowable; the important and unknowable; and the unimportant. As it relates to the vast majority of forecasting, much time is spent "figuring out" the future of the important and unknowable category. Rather than attempting to precisely predict the exact nature of the future, it is far more prudent to weigh the complete spectrum of possibilities to understand what the impact on a particular investment would be. One obvious example of this relates to interest rate increases by the Federal Reserve. Many experts purport to know the number and timing of these rate increases over the next year, and they have adjusted their investments accordingly. This approach can prove to be effective if their assumptions are correct, but even the most astute forecaster lacks a true crystal ball. Not even Janet Yellen can say with certainty what interest rates changes may occur this year, and as such, investors should shift their focus to constructing a portfolio that is not solely dependent on consensus expectations of these changes.

Benjamin Graham rightfully defined a true investment as an asset which "upon thorough analysis, promises safety of principal and a satisfactory return." Financial bets based upon "certainty" surrounding one particular outcome do not adequately meet the standards of an investment in that they do not promise the safety of principal that belongs as the foremost requisite for consideration as an investment. While returns should certainly be top of mind when managing a portfolio, risk management has long proven to be the primary key to realizing adequate gains over the long term. Viewing risk as the potential for the permanent loss of principal (as opposed to volatility, the most common proxy for risk) forces an investor to consider the impact that all possible versions of the future could have on a portfolio. The purchase of a security becomes speculation when the realization of value is completely dependent on a particular assumption or outcome. Irrespective of how certain an outcome may appear (in 2005 "housing prices always rise" was added to the catechism), forecasting should always be used as a tool to understand sensitivities rather than as a pursuit of a certain answer.

In a political and economic environment that is categorized by uncertainty, it is important not to get caught up in any one assumption about changes to fiscal and monetary policies. As we continue to consider the future of the market, RMC's focus is on weighing the impact of a wide range of policy changes as they relate to our investments. By searching for investments that can succeed in a variety of scenarios and are not reliant on any one particular outcome, we aim to achieve safety of principal and a satisfactory return profile.

If you would prefer to receive future Market Commentaries electronically, send an email to kitty@resmgtcorp.com.

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April 2017

Resources Management Corp

MARKET COMMENTARY

A RITE OF SPRING

"With so many trees in the city, you could see the spring coming each day until a night of warm wind would bring it suddenly in one morning. Sometimes the heavy cold rains would beat it back so that it would seem that it would never come…In those days, though, the spring always came finally but it was frightening that it had nearly failed."

– Ernest Hemingway, A Moveable Feast

Each spring the daffodils arrive, rising from their long dark winter slumber. No matter how cold or stormy a winter is, their bulbs will eventually break the soil's surface. The timing varies upon the climate with a February arrival in Southern California, and an early April arrival in New England. Some years, the revival is stopped right in its tracks by a late season blizzard or frost which can kill a freshly minted bud and wilt the stem. However, like a phoenix rising out of the ashes, the daffodils will almost always bloom again the following spring if one is patient.

Through the darkest of market downturns like the Crash of 1929, the 2000 Tech Bubble and the Financial Crisis of 2008, the US stock market has prevailed. While a flower might have an annual cycle of rebirth and growth, the market's cycle could take years, sometimes longer than a decade, often hitting some roadblocks along the way, like a late spring snow storm. But just like a golden forest of daffodils, the US stock market has proven itself resilient one time after another fighting back from its downturns and rising again, especially over longer time periods.

While the market can be volatile, this volatility is lessened over long time periods. A short-term perspective can feel like riding a roller coaster without a seat belt on. In looking at a chart of one year returns from 1926-2016, the market averaged an annualized return of 10% (source: Ibbotson Large Company Stock Index which is comprised of the S&P 90 from 1926-1956 and the S&P 500 from 1957-present), despite being negative 27% of the years. In addition, the market's return often strayed significantly from this average, only coming within two percent of this average five times. Extending it out a bit, and looking at five year rolling returns, they have been negative only 14% of the time. Using ten year rolling returns, the markets have been negative a mere 5% of the time; and using fifteen year rolling returns, there are no negative periods! Thus proving that over longer time periods, the volatility and downside risks diminish.

As we are bombarded with 24/7 news from the gauntlet of news sources, it is quite understandable how so many investors are nervous. From international to domestic issues, from North Korean missiles to extreme partisanship at the federal level, there is no shortage of potential headwinds to the market. But when a patient investor has a long-term investment horizon, time is often on his or her side, and over time the market has proven itself over and over again. Couple this philosophy with buying and holding quality companies with long-term growth prospects, repeatable and proven business models, and proven management teams, a well-built, diversified portfolio should not only prevail, but grow over time when given time to blossom.

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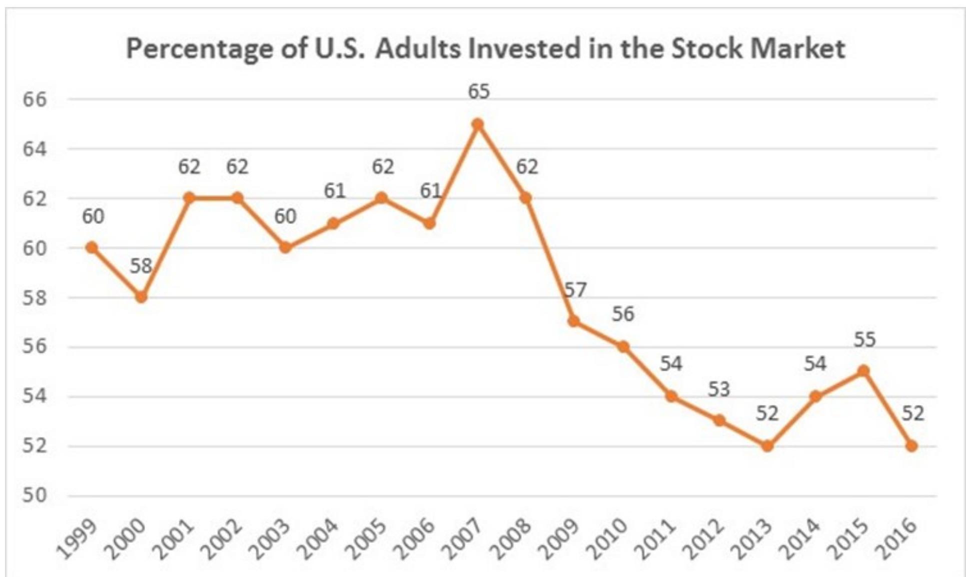
May 2017

Resources Management Corp

MARKET COMMENTARY

STOCK OWNERSHIP (PART I) A PARTNERSHIP WITH MANAGEMENT

A large portion of Americans today own publicly traded equity securities. According to Gallup polling, more than half of Americans either personally, or jointly with a spouse, have money invested in the stock market (as can be seen in the chart below).



Despite the fact that this number has been falling since 2007, higher levels of liquidity and ease of access to public markets has generated broader participation in the prosperity of America's largest companies. This dynamic, however, has created a shift in the perception of what a stock represents. Watching real time price updates of stocks on CNBC and listening to the "analysis" that pundits provide makes it easy to get caught up in the idea that these securities move in patterns separate from the performance of the underlying businesses. While sentiments like these can certainly influence price movements in the very near term, it is the actual enterprise alone that dictates value over the long term (see our January commentary for a further discussion on this topic).

Rather than being viewed as a stream of blips moving across a screen that periodically rise and fall, stocks need to be understood as ownership interests in businesses. This interest is effectively no different than being an owner of a private business, with the only exception being that a valuation is provided on a daily basis. If investors were to collectively adopt this viewpoint (as opposed to simply giving lip service to the idea), there would be a dramatic change in the relationship dynamics between shareholders and management.

Management teams are charged with serving as the "managing partners" in the business, with the Board of Directors representing the interests of shareholders (the "limited partners"). All too often, however, the long-term goal alignment that generally exists in private enterprises is lost as management teams become encouraged to exclusively pursue short term goals, frequently at the expense of long-term stakeholders. This reality that has become ubiquitous in corporate America is exemplified by the frequent dramatic stock price movements immediately following the release of quarterly filings. Reporting earnings per share that are one cent below average sell-side analysts' estimates, for example, can send a stock plummeting with very little regard for what the actual long term implications are for the company. To this end, the incentive packages given to high-level executives are commonly focused on things such as growing the business quickly, as opposed to total returns on capital employed (which is what should truly matter to shareholders). This vicious cycle that has both created and resulted from the pursuit of "fast money" can only be halted by a realignment of objectives on the part of both shareholders and their management teams.

The U.S. stock market has proven to be an efficient allocator of capital over extended periods of time, however, which creates opportunity for investors who focus on understanding the fundamentals of the businesses they own. This means ensuring that all actions are based on a conservative estimate of intrinsic valuation and being measured in any reaction to the news flow of the day. At RMC, we strive to capitalize on the short-sightedness of many market participants and only invest with a long view. Our approach is that of a private owner in the identification of high quality businesses with exceptional management teams. Purchasing securities with these characteristics has long proven to be a successful strategy, and we do not expect this to change.

Individuals and professionals whose approach to investing is focused on being "businesslike," coupled with a redirecting of management's compensation packages toward returns on capital, will continue to raise the quality of American businesses and increase the wealth of the many participants in the public equity markets. Inefficiencies will always appear in a market system, and only those who stick to the proper principles can consistently compound capital.

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JUNE 2017

Resources Management Corp

MARKET COMMENTARY

VALUING STOCKS: A RATIONAL METHOD *REVISITED*

We were recently perusing a few of our market commentaries that were written in the early 2000's, and we were struck by how closely the values espoused in these writings matched the approach to investing taken at RMC today. The long-term, valuation centric approach that is the core of our investment philosophy today is the same as it was in 2002 and at our founding. Upon reading a particular commentary from May 2002 titled "Valuing Stocks: A Rational Method," we felt compelled to revisit this topic, as the tenets outlined are equally important in the bull market of today as they were in the aftermath of the technology bubble. Excerpts from the original commentary will be included in *italics*, and we will expand on several of these subjects.

Several issues ago, we addressed the function of placing a realistic current value on stocks. This is an essential function since it can be demonstrated that consistently paying more than value for a stock diminishes appreciation potential.

We explored the use of historical price-to-earnings ratios (P/E) for valuations. Since history covers periods of varying interest rates and inflation, to cite but two important variables, a historical P/E ratio may be inappropriate or even irrelevant for today's valuation.

We are more persuaded by a system that is based upon current variables. The system is based upon the fundamental assumption that an investor is interested in buying the future profits of the company…The difficulty in evaluating/valuing future earnings is two-fold: (1) in making a conservative, probability adjusted projection *of the company's earnings or profits over the ensuing years and (2) in adjusting future profits to reflect their value today* and the risk surrounding the assumptions made in these projections.

<u>*Future Earnings*</u>:
The only certainty that we have in an analysis like this *is the historical earnings of the company.* Through thorough analysis of these earnings and a clear understanding of what the key drivers will be moving forward, a range of reasonable projections can be established and sensitized as appropriate. *Parenthetically, there are companies that have remarkable steadiness in their ability to* generate returns*; these are preferred by our firm.*

<u>*Discounting to Present Value*</u>:
Let us explore this concept by using a familiar example. If one wins $1 million in the Connecticut Lottery, the winning ticket cannot be sold for its face value. In reality, the winner has won the right to earn twenty annual payments of $50,000 each. The process of determining the "intrinsic value" of this stream of cash flows is the same as that for a stock (albeit with fewer variables underlying the major assumptions). Much like with a stock, we could potentially be interested *in purchasing this ticket, but* not *at its face value,* which would require waiting 20 years for a complete return of principal. Additionally, we would receive no real return on our investment, and would actually lose money in terms of purchasing power due to the impact of inflation.

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After determining what a conservative estimate of the future cash flows could be (which in the case of the lottery ticket does not require much work), an appropriate required rate of return must be determined. This return must reflect a combination of the level of certainty surrounding the future cash flows and a base return to simply compensate for the inability to spend this money today. In evaluating the intrinsic value of the lottery ticket in this case, let us assume a required rate of return (or discount rate) of 10%. Applying this rate to the stream of 20 cash flows yields an intrinsic value of $425,678.

The following table details the process for arriving at this value.

Annual Payments:			*$50,000*		
Discount Rate:			*10%*		
Present Value of 20 Payments:			*$425,678.19*		
As a % of 50 Payments:			*43%*		
Year	***Present Value***	***Cumulative***	***Year***	***Present Value***	***Cumulative***
1	*$45,455*	*$45,455*	*11*	*$17,525*	*$324,753*
2	*$41,322*	*$86,777*	*12*	*$15,932*	*$340,685*
3	*$37,566*	*$124,343*	*13*	*$14,483*	*$355,168*
4	*$34,151*	*$158,493*	*14*	*$13,167*	*$368,334*
5	*$31,046*	*$189,539*	*15*	*$11,970*	*$380,304*
6	*$28,224*	*$217,763*	*16*	*$10,881*	*$391,185*
7	*$25,658*	*$243,421*	*17*	*$9,892*	*$401,078*
8	*$23,325*	*$266,746*	*18*	*$8,993*	*$410,071*
9	*$21,205*	*$287,951*	*19*	*$8,175*	*$418,246*
10	*$19,277*	*$307,228*	*20*	*$7,432*	*$425,678*

This process is applicable to our determining the intrinsic value *for a stock. First, we have to determine a* required rate of return *that we would be willing to accept. There are three steps involved:*

1. *We would first turn to the current return or reward for investing in* what is widely considered to be a safe security - the 10 Year U.S. Treasury Note. This security (along with the other treasury issuances) can be considered the "risk-free rate" available in the market.

2. *Obviously, the Note is risk-free and we would demand a* higher rate of return in the stock market *in order to be* adequately *rewarded* for the incremental risk incurred. The difference between the risk-free rate and the return that would be required to invest in stocks is called the "Market Risk Premium."

For those companies whose earnings are *more volatile and less predictable,* additional return would be required for the extra risk being taken. The proxy for risk broadly used across the industry would be the stock's beta, which measures the volatility of a stock relative to the broader market.
These three components are added to form the discount rate. This discount rate is applied to the estimated earnings for the company, which then produces the "fair value" of the stock. The investor then compares the "fair value" against current market price to determine the degree to which the stock is overvalued or undervalued and makes a final investment decision.

We believe that this is a rational approach to valuation. Changes in interest rates will affect the return; this is realistic in that higher interest rates do reduce the valuation of stocks when considered on a relative basis. *Finally, the use of generous "Equity Risk Premiums" to raise the* required return *from the stock is a conservative approach to* properly create a "margin of safety" to account for the inherent futility in attempting to predict the future. We approach this process with humility, and make investments only in situations in which we feel there is ample security in the valuation's underlying assumptions.