Resources Management Corp

JANUARY 2018

MARKET COMMENTARY

The United States equity markets have performed well over the last year, with the S&P 500 returning 19.4% for the year ended December 31, 2017. This strong performance was spread across the majority of sectors, led by technology with a 36.9% return for the period. As can be seen in *Figure 1*, valuations appear to be reasonably full across all sectors by historical standards. The S&P 500 is currently trading at 18.5x median expected earnings for 2018, which is 2.5 turns higher than the 20-year historical average of 16.0x. These valuations, however, exist within the context of a historically low interest rate environment, an economy that has finally returned to GDP growth in excess of 3.0% and an unemployment rate that is at a 17-year low. Given that this strong performance has been driven by fundamental improvements at the company level and a strengthening economic landscape, we do not view current valuations as exorbitant.

After several years of underperformance, European equity markets performed well in 2017 returning 26.2% (as measured by the MSCI Europe Index), and global equity markets followed suit, returning in excess of 23.0%. Much like in the United States, these returns were driven by fundamental improvements in the economic landscape, coupled with monetary policy that has been, and is expected to remain, highly accommodative for an extended period of time. With the exception of the impact of BREXIT, which remains unknown, global economic outlook remains strong.

As we consider 2018 and beyond, the impact of tax reform will be in focus. The reduction of the corporate tax rate from 35%, which was among the highest in the developed world, to 21% will provide a clear boost to earnings in both the near and medium term. While it remains to be seen what the long-term impact of this reduction will be, it is our expectation that this will be a net benefit for the U.S. economy overall. The repatriation holiday will allow companies to bring back overseas cash at a rate of 15.5% compared to the 35.0% rate it was at previously. This has already begun to have an impact, which can be seen through the announcement of additional domestic investment, increased wages and the expectation of increased buyback activity. All of this should provide a near term boost to both economic and market activity.

Monetary policy will also continue to be front of mind as Jerome Powell succeeds Janet Yellen as chairman of the Federal Reserve. It is our expectation that Mr. Powell's approach to raising rates will be very similar to that of Ms. Yellen, with very measured changes that are sensitive to economic developments and shifts in inflation expectations. We would view slow increases that coincide with economic strength as positive developments for the market. While the Fed has been effective, thus far, in communicating and executing their strategy, a policy misstep that either raises rates too quickly or allows for outsized inflation could cause a serious disruption. We remain keenly focused on the evolution of the Fed's policy, and will continue to adjust our interest rate expectations accordingly.

Overall, we view the state of the economy as strong and valuations as reasonable given the current landscape. While there are certainly risks to the strong performance the equity markets have experienced recently, we continue to view the risk / reward relationship as favorable. It is always the unexpected that shocks the security markets, but portfolios that are structured with diversified exposures should allow for an adequate return profile to persist over the long term.

FIGURE 1

Global Equity Overview

January 2018

	Stock Performance			Current Valuation			20 Year Historical Average[1]		
	YTD	1 Year	5 Year	Trailing P / E	Fwd. P / E	Div. Yld.	Trailing P / E	Fwd. P / E	Div. Yld.
S&P 500	19.4%	19.4%	87.5%	24.7x	18.6x	2.1%	19.6x	16.0x	2.0%
Consumer Discretionary	21.2%	21.2%	108.8%	27.4x	22.4x	1.8%	19.3x	18.1x	1.4%
Consumer Staples	10.5%	10.5%	62.8%	22.5x	20.2x	2.6%	21.0x	17.1x	2.6%
Energy	-3.8%	-3.8%	0.1%	N / A	23.7x	2.6%	17.0x	17.4x	2.3%
Finance	20.0%	20.0%	109.7%	19.5x	13.7x	1.8%	15.5x	12.9x	2.3%
Healthcare	20.0%	20.0%	106.6%	25.5x	17.6x	2.0%	24.1x	17.6x	1.8%
Industrial	18.5%	18.5%	94.0%	24.0x	19.7x	1.8%	20.0x	16.3x	2.1%
Materials	21.4%	21.4%	59.5%	26.1x	19.0x	1.8%	19.4x	13.8x	2.6%
REITs	7.2%	7.2%	34.8%	38.8x	20.5x	3.7%	35.4x	15.2x	4.4%
Technology	36.9%	36.9%	138.5%	27.4x	20.0x	1.7%	25.6x	20.8x	1.0%
Telecom	-6.0%	-6.0%	13.7%	16.0x	13.2x	5.1%	20.3x	16.6x	4.0%
Utilities	8.3%	8.3%	50.5%	19.8x	16.5x	3.6%	15.8x	14.0x	4.1%
Dow Jones Industrial Avg.	25.1%	25.1%	88.6%	26.4x	18.5x	2.0%			
Nasdaq 100	31.5%	31.5%	140.4%	27.9x	21.9x	N / A			
FTSE 100	7.6%	7.6%	30.3%	20.8x	14.8x	3.7%			
Nikkei 225	19.1%	19.1%	119.0%	19.8x	18.3x	1.5%			

(1) Source: J.P. Morgan Asset Management

FEBRUARY 2018

Resources Management Corp

MARKET COMMENTARY

ON MARKET TIMING

"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves." - Peter Lynch

As we move through the ninth year of the current bull market, much of the public discourse in the investing landscape surrounds if and when we will have a meaningful correction. While it is a foregone conclusion that at some point the market (and the economy) will experience a material reduction in value, the timing of such a move is nearly impossible to predict. Over the long term, it has consistently been a mistake to bet against the performance of U.S. businesses in aggregate, but markets and economies move in cycles that include periods of both expansion and contraction. Despite the fact that the major drivers of the shift from one to the other are often obvious in retrospect, market participants tend to have a difficult time consistently predicting when the market will turn. Rather than basing an investment philosophy around misguided attempts to forecast broad market shifts, it has long proven more effective to make investment decisions that are grounded in a keen understanding of the intrinsic value of the underlying business that each security represents.

The economy as a whole appears to be operating in reasonably strong conditions, with unemployment at a 17-year low, GDP growth finally approaching long targeted levels, wage growth beginning to increase and inflation remaining in check. This environment, coupled with a Federal Reserve that has remained reasonably accommodative, has driven stocks, in aggregate, to values that appear to be high by many metrics. While broad exposure to U.S. business may come at a price that is higher than historical averages, there is ample opportunity to invest in high quality business at attractive price points. Rather than attempting to predict when the whole stock market will have a correction (or advance higher), we remain focused on deploying cash in securities that offer adequate risk-adjusted return profiles.

Capital markets participation was unique in 2017 with effectively all asset classes and geographies moving higher, including the S&P 500 returning 22%. All of this was done with historically low volatility of 7%, which is half of the historical average and the lowest level since 1964[1]. To this end, the largest pullback the market experienced was approximately 3%, which is the lowest that has been seen in over 20 years. Strong upside price performance with limited downside activity certainly offers an opportunity for capital appreciation, but it also creates an increased probability of market participants shifting their portfolios to riskier asset classes. When there is synchronized price appreciation across a wide variety of security types and countries, investors, as a group, can begin to behave as if the market cannot decline for any sort of extended period. Despite the numerous potential disruptions that exist as we enter 2018 (a monetary policy misstep, geopolitical issues, etc.), trading behavior has generally assumed a continuation of 2017's profile. We view this "it can only go up" mentality as flawed, and would actually welcome a reintroduction of warranted volatility as it would indicate a more fundamentally focused market.

While we make no attempt to predict when the indices will experience a contraction, we remain focused on the risk profiles and valuations of the securities that we own. By focusing on the long term, we aim to manage short-term volatility to drive sustainable capital appreciation over time.

[1] Source: J.P. Morgan Asset Management

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MARKET COMMENTARY

E.I.E.I.O. or THE RETURN OF VOLATILITY

2018 has finally delivered what 2017 failed to: the return of volatility in the stock market. According to the WSJ Market Data group, "the absolute daily percentage change for the Dow Jones Industrial Average was 0.31% in 2017. It was 0.30% for the S&P 500 and in both instances, that represents the smallest absolute daily percentage since 1964."[1] Similarly, the VIX, which is a measure of volatility in the market, closed at all-time lows multiple times over the course of the year. In the first few months of this year, however, the story has changed dramatically. Volatility has spiked to levels that have been unseen since 2015, and the daily movements of the S&P 500 and DJIA have frequently been large. Despite the feeling that this shift has increased the risk profile of equity exposures, markets like this provide more frequent opportunities to capitalize on disconnects between the market price and intrinsic value of publicly traded securities.

Many investors have the view that the potential for large moves in market prices makes holding stocks riskier than they were in an environment like the one that was experienced in 2017. For market participants who actually behave as long-term investors, however, this is certainly not the case. Day to day price changes have no actual bearing on the value of a security, and over time, the price of a stock is ultimately driven by the value of the underlying business. Rather than considering daily price movements as changes in the value of your investments, it makes more sense to approach volatility with Benjamin Graham's framework of "Mr. Market" - or for our purposes, "Old MacDonald."

Imagine for a moment that rather than owning publicly traded equity securities, investment was made in a working farm. Based on the farm's historical operations, you are able to construct a reasonable estimate of how much cash this farm will produce annually, acknowledging of course that there will be fluctuations from year to year as a result of changes in commodity prices, weather, etc. From these estimates, you are able to determine a reasonable valuation given the required rate of return that you would need to make this investment.

The farm next to this one is owned by Old MacDonald, who has a very reactionary personality. Every day, Old MacDonald shouts across to you a price for which he will either buy a piece of your farm or sell you a piece of his. Most days the price is reasonable, but occasionally Old MacDonald gets nervous about the weather patterns that have been unfolding or euphoric about a recent change in commodity prices. While Old MacDonald's mood certainly provides opportunities to expand your farm by purchasing pieces of his at a discount to fair value because he is nervous about short-term dynamics at play (and similarly sell pieces to him at prices that are far higher than the farm is worth), his offers have no bearing on the actual value of the farm.

Much like this example, the stock market offers a price to buy or sell a stake in a wide variety of businesses every day. These offers, however, frequently move independently of the intrinsic value of the businesses in question. Volatility is no different than Old MacDonald's offers moving more dramatically as a result of short sighted observations and should be treated accordingly. Volatility increases the potential for better opportunities to buy / sell "pieces of the farm" at prices that are lower / higher than fair value. By taking a long view of the businesses that we are investing in, we are able to capitalize on volatility, treating it is an opportunity rather than as something worth worrying about.

1 https://www.marketwatch.com/story/stock-traders-cheer-return-of-volatility-2018-03-02

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MARKET COMMENTARY

THE ROLE OF QUALITY IN INVESTING

The concept of "quality" is one that, as a society, we have a strong general understanding of, but have a difficult time capturing the full essence of in a single explanation. Merriam-Webster defines quality as the "degree of excellence" of something. This is certainly accurate on the surface, but it lacks the subtlety that an application of actually evaluating degrees of excellence would require. As investors, we are constantly judging the quality of a variety of assets and investment opportunities to identify the most appropriate places to allocate capital. This process, however, is not a rigid one, and the measures vary depending on whether business or investment quality is being assessed.

Given that our investment strategy is focused on identifying long term holdings, the quality of a security's underlying business is a core requisite for addition to a portfolio. Similarly, it is the fundamentals of the business that drive our continuous consideration of current holdings and whether they still meet our standards. While there is no "one size fits all" checklist of characteristics that make a business wonderful, there are several traits that tend to typify the types of businesses we look for. First, we prefer companies that have demonstrated a consistent ability to generate returns on the capital employed in the businesses that are above average (both on an absolute basis and relative to their peer group). There are many companies that have been able to generate strong returns in the short term, but competition quickly reduces these returns to more average levels if the business model is not protectable.

High quality businesses, however, are able to sustain high returns on capital as a result of what is functionally an "economic moat." This "moat" is a competitive advantage that allows the company to continuously perform at a high level for extended periods of time. A low-cost strategy would be an example of a moat that could allow a business to compete more effectively than its peers. In this scenario, either scale or proprietary processes (which can simply be just an extremely lean organization) allow the company to charge lower prices than its competitors, who are unable to replicate this cost structure. Lower prices for comparable products, naturally, give the company a competitive advantage that allows for exceptional financial performance. Dynamics such as these can be critical to ensuring that the business model is sustainable, making the company an appropriate holding for the long term. In addition to the aforementioned criteria, a highly competent management team and a well-capitalized balance sheet are critical to the long-term success of a business.

Despite these and other factors being suggestive of the quality of a business, they are not always indicative of a logical investment opportunity. Identifying a great business is an important starting point, but investment results are often driven by purchasing interests in companies at prices that are appropriate given the cash flow that will be produced in the future. Valuation frequently has the largest impact of any single variable on the outcome of an investment in that overpaying for an asset increases the odds of a poor outcome, while purchasing an undervalued asset makes a positive result more likely. History suggests that acquiring excellent companies at fair (or wonderful) prices provides strong risk adjusted returns over the long term. Our intention is to identify these opportunities and hold them for extended periods of time.

Building a high-quality portfolio requires a multi-layered evaluation of, first, the underlying business in question, followed by the valuation at which it can be acquired. Great businesses can be poor investments if purchased at the wrong price (just as average businesses can be excellent investments if purchased at a favorable price), so we focus on acquiring outstanding businesses at appropriate prices with the expectation that we will be holding it for the long term. Warren Buffett once pointed out that "time is the friend of the wonderful company, the enemy of the mediocre." We aim to keep this in mind as we deploy capital in the market.

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MAY 2018

Resources Management Corp

MARKET COMMENTARY

ON CORPORATE CAPITAL ALLOCATION

As shareholders of publicly traded securities, it can be easy to feel disconnected from the businesses that underlie a stock. Despite the fact that there is very limited contact between the executives of a public company and its shareholders, the primary role of corporate executives is to serve as stewards of shareholder capital. In this capacity, there are a variety of different ways that funds can be deployed: reinvesting in the core business, mergers & acquisitions (M&A), share repurchases and dividend payments. Each of these options, when utilized properly, can create value for shareholders. Far too often, however, management deploys funds in ways that do not generate the highest returns on shareholder capital over the long term. Rather than using broad generalizations to determine if a certain corporate action is appropriate, shareholders should review the actions of management more critically to determine how effective it has been at generating adequate returns for the owners of the business.

As can be seen in *Figure 1*, dividend payments and share repurchases are at very high levels relative to where they have been since 2000. Unsurprisingly, both of these uses of cash tend to be sensitive to market and economic performance. This tendency is generally due to management's propensity to deploy excess cash when they have confidence in the economy and their own businesses' prospects. While this is certainly logical with dividends, implementing share buybacks in this way does not necessarily make sense. Share repurchases are value creating for shareholders of a stock if the repurchases are made at sensible prices. Buying shares back at prices that are lower than they are worth creates significant shareholder value by increasing the proportion of the business owned by the remaining investors at a high rate of return. Similarly, however, repurchasing shares at prices that are higher than they are worth destroys value for the remaining owners. By overpaying for the reduction of shares, managers are effectively investing in assets that, at that time, offer a low rate of return.

Figure 1

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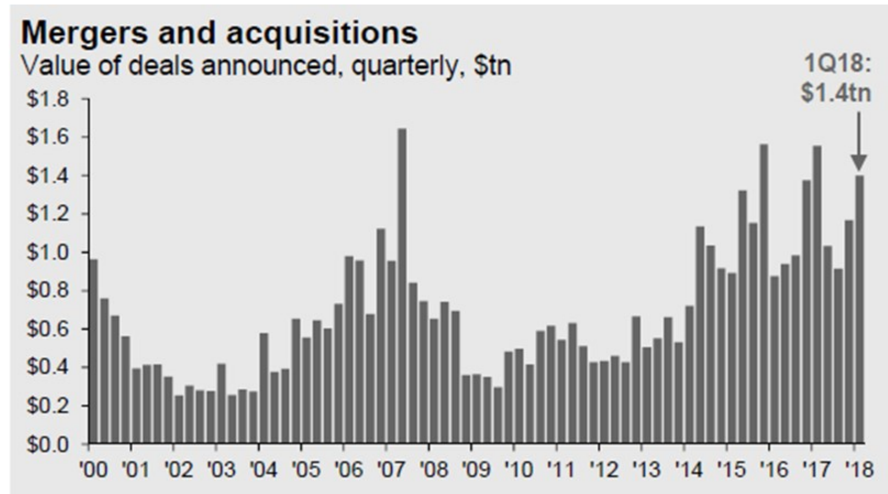
Much like the range of possibilities with share repurchases, deploying capital for large acquisitions can have a transformative impact of the businesses' performance over the long term, and this can be both a good or a bad thing. As can be seen in *Figure 2*, M&A in the first quarter of 2018 sat at around $1.4 trillion. This is not out of line with previous quarters but is substantially higher than the activity that was seen between 2009 and 2014.

Figure 2



While acquiring another company can certainly create substantial value for shareholders if the target is a good fit and the price paid is appropriate, far too often the acquiror will overpay, resulting in poor outcomes for investors. Growing an organization through acquisition can create a disconnect between the incentives for management and the desired outcomes for shareholders. Creating a larger organization increases job security, to some extent, by establishing a larger earnings base to support the executive team. Management can also be seduced by the idea of "empire building" and believing that they can cause target companies to perform better than they have historically. We are certainly not suggesting that these issues are present in all companies and in all acquisitions, but they create conflicts that can cause executives to overpay for a target.

Rather than viewing each individual use of shareholder capital as inherently good or bad, it is important to evaluate the management team on how effective they have been at creating value for their owners. Indiscriminate repurchases of stock, for example, should not be applauded, and managers should be encouraged to repurchase shares opportunistically only when they view the stock as undervalued. Shareholders should also carefully consider the long-term impacts of large mergers, especially when large cost saving are being used to justify the combination. It is our view that capital allocation is the primary job of the Chief Executive Officer of the businesses we invest in, and we seek only to entrust our capital to managers who have demonstrated discipline in deploying cash over time.

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JUNE 2018

Resources Management Corp

MARKET COMMENTARY

GEOPOLITICS & INVESTING

Much like globalization has permeated most corners of the U.S. economy, investing in the stock market has become more of an international venture than ever before. The S&P 500, which includes the 500[1] largest publicly traded businesses in the United States, has significant exposure to the global markets, with between 40% and 50% of aggregate revenue being generated internationally each year since 2000[2]. While this expansion abroad has allowed for substantial growth opportunities for U.S. companies, it has also increased the complexity of evaluating the fundamentals of the underlying businesses. Differences in business dynamics across various markets can create complications for investors, but geopolitical considerations tend to have a far more marked influence on stock prices in the short term.

There are ample examples of global events impacting U.S. markets, with the most recent being fears surrounding Italy's political situation. Without revisiting all of the details, the markets abruptly became very concerned that Italy would make a push to withdraw from the European Union, resulting in broader issues across Europe (not to mention within Italy itself). With a collapse in the country's debt structure being the largest financial impact at the forefront of investor's minds, the Italian bond market suffered the most, negatively impacting equities worldwide. The S&P 500, for example, dropped 1.2% from the previous week's close on Tuesday, May 29th in reaction to these fears. The market, however, regained all of this ground (and more) by the end of the next trading day as Italy's political situation diffused. Similarly, markets have made substantial moves in recent weeks as trade discussions with China (and the rest of the world) have dominated headlines. Fears of a trade war have sent the S&P spiraling, while optimism that tensions have begun to cool has sparked recovery.

In the midst of all this news (noise?), however, we have seen a relatively strong earnings season in which many key companies have topped analysts' estimates and raised guidance for the remainder of the year. Reported earnings, when evaluated over the long term, offer far more insight into an investment's prospects than reports of subtle changes to global dynamics do. This is not to say that the result of trade talks with China (and the many other countries the government is currently negotiating with) will not have an impact on the businesses we have selected, but that we are focused on building portfolios that are not dependent on any one particular outcome or economic backdrop.

Macroeconomic and geopolitical events, over time, drive the overall direction of the business atmosphere which, in turn, impacts the fundamentals of the businesses in which we invest. As events actually play out, we spend substantial amounts of time understanding how the long-term value of each business will be impacted. We do not, however, make portfolio adjustments based on rumors or unfounded predictions. Instead, we attempt to identify businesses that are positioned to be successful in a wide variety of economic and political environments and are run by high quality managers with experience navigating different business climates. By selecting a well-diversified mix of companies with these qualities, we aim to position all portfolios to achieve their respective investment objectives over the long term.

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AUGUST 2017

Resources Management Corp

MARKET COMMENTARY

ON MARKET EFFICIENCY

Much of what underlies modern financial theory, especially in academic circles, is based upon a theory popularized in the 1960's by Eugene Fama called *The Efficient Market Hypothesis (EMH)*. EMH is based on the idea that financial markets are inherently efficient, have rational participants and have prices that reflect all available information at a given time. This implies that future price movements are entirely unpredictable, and thus that all investors holding diversified portfolios will obtain comparable returns to the market (or worse) over the long term. The idea that securities are "perfectly priced" at all times, however, has frequently proven to be a flawed hypothesis given the periodic bubbles and busts that occur in financial markets. While financial markets do tend to prove effective at pricing securities over the long term, the psychological factors that underlie the price movements of securities markets in the short-term create inefficiencies that can be exploited by investors focused on the long-term fundamentals of the underlying businesses.

In recent years there has been a reasonably dramatic shift towards passive investing strategies that are largely based on the implications of EMH, conceding that outperformance is unlikely over the long term and accepting that achieving only the average return on the market is the most effective way to invest. The popularity of this line of thinking has led to Exchange Traded Funds becoming the most widely adopted tool for passive investing strategies, which now account for more than 30% of all US trading volume(1). As a result of the significant shift into these "passive" instruments, ETFs have ended up holding large positions in the majority of large stocks in the United States. Vanguard alone, for example, holds more than 5% of the outstanding shares in 491 of the S&P 500 stocks(2). Put another way, Vanguard now owns more than 5% of the float in 98.2% of S&P 500 stocks, compared with only 23.2% of the same in 2010. This recalibration of the ownership structures of America's largest corporations could have (if it hasn't already had) a profound impact on the efficiency of the market and corporate governance in American business moving forward.

Source: Credit Suisse Trading Strategy
Source: BofA Merrill Lynch US Equity & US Quant Strategy, FactSet Ownership

Given the nature of these instruments, increasingly large blocks of outstanding shares are controlled by what are generally disinterested participants in terms of the valuation of individual securities and the effectiveness of their management teams. In our view, the broad result of this dynamic change has been two-fold: a) valuations have been artificially driven higher in widely held securities as indiscriminate purchases have been made to meet the demand of ETFs; b) volatility has been driven to extreme lows as fewer participants properly evaluate and react to the events of the day, thus creating the oft cited efficiency that is critical to the long-term integrity of financial markets. In bull markets like the one we have been in for many years, the environment of low volatility and high valuations can persist in the absence of unanticipated negative events. The issue this creates, however, is that when the inevitability of an unexpected event occurs, widespread disposal of ETFs has the potential to create dramatic swings in the stock prices of companies in ways that have little relation to the underlying fundamentals of the businesses.

It has been said that, in investing, you can get in more trouble with a good idea than a bad one, and it appears that this is the situation we face today. The use of ETFs to achieve diversification with a long view is based in the sound theory that markets are efficient over the long term and that betting on the U.S. economy has proven to be a wise choice over time. However, much like has happened with wonderful companies or new technologies in the past, the market has a way of reminding investors that intrinsic valuation remains the key driver of returns when taken over any reasonable period. While there are many securities that are fully valued as a result of the previously discussed dynamics, opportunity has been created in less flashy markets that have strong fundamentals and compelling competitive positioning. Our strategy is, and always has been, to establish what we view as an appropriate valuation for a business and invest when "Mr. Market" presents us with an opportunity to do so at a fair price. When broad selloffs occur that create inefficiencies and disconnects between price and value, we will continue to invest confidently with an eye towards the future (as opposed to listening to the sentiment of the day), and we will heed the time-tested wisdom to be "greedy when others are fearful and fearful when others are greedy."

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SEPTEMBER 2017

Resources Management Corp

MARKET COMMENTARY

A LOOK FORWARD

Harbinger: noun - a sign, a signal, to herald, to foretell the future – (Webster Dictionary)

Daily, we look for signals in the marketplace. These signals often indicate the health of a company, the strength of the economy, or the position of the global marketplace. Sometimes the signals are clear and precise, but oftentimes they are more subtle in nature.

Leading economic indicators are considered to be important guides that look to the future. These leading indicators include housing starts, bond yields, unemployment rates, GDP, consumer confidence, and the stock market. A combination of these indicators can often provide clues as to where the economy is heading.

In July, we had an indication that the economy was growing, with sales at U.S. retailers rising 0.6%. This was better than expected, as Americans bought more cars, furniture, and home improvement supplies. Sales of online goods were also strong. Contributing factors seem to have been low unemployment, a strong stock market, and wages that outpaced inflation.

Stronger consumer spending has boosted profits for some discount retailers and home improvement centers. These profits have been buoyed by millennials moving into homes that need to be updated and equipped. However, this has come at a cost as more households have taken on debt to float the cost of home ownership and renovation. Yet while debt-service payments account for 10% of Americans' disposable income[1], total debt levels have not reached those of 2008 (which were a primary cause of the financial crisis). Any significant changes in the amount of debt-service payment levels would be an important signal about the health of the consumer.

It is a quandary why real wage growth has not occurred at this stage in the economic recovery. The employment rate in the U.S. is at its highest level in a decade, yet pay raises continue to remain modest. Meager wage growth has been somewhat offset by the increase in benefits paid to workers, with health care benefits topping the list. Perhaps, as the value of these benefits has risen, workers have been willing to accept more moderate wage increases. However, as the labor market continues to tighten, wage growth seems likely. As we near this intersection of full employment and rising wage growth, corporations may find the need to compete for qualified candidates.

Interest rates continue to remain at extremely low levels, and the Federal Reserve Board is split about when it will next raise rates. At its June 2017 meeting, the Fed had penciled in one more rate increase for the remainder of the year, as its inflation target of 2% remains elusive. The lack of inflation has puzzled the Fed, as strengthening employment typically leads to rising inflation. As a result, there is divergence within the Fed about the course of interest rate hikes, and interest rate increases are likely to occur at a much slower rate than the markets were anticipating just a few months ago. Based on the mixed nature of the market's signals today, we remain focused on business fundamentals and company valuations while continuing to monitor the broader economic backdrop.

1. Wall Street Journal 8/11/17

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OCTOBER 2017

Resources Management Corp

MARKET COMMENTARY

THE "WISDOM" OF THE CROWD

"Whenever you find yourself on the side of the majority, it is time to pause and reflect" - Mark Twain

Though Mark Twain was not much of an investor (he lost substantial portions of his net worth in a variety of ventures and stocks), his take on the wisdom of consensus views very much applies to security analysis today. Many investors, both professional and amateur, fall victim to what is known as "confirmation bias." Confirmation bias suggests that, rather than evaluating circumstances objectively, humans tend to place more weight on facts that support their initial or developed view of a matter. In practice, this applies not only to the financials of a particular security, but to the comfort of having a large portion of investors agree with a position. Rather than blindly taking solace in the fact that the broader market agrees with you, it is important to consistently evaluate whether or not the view continues to make sense.

Benjamin Graham is cited as saying "You're neither right nor wrong because other people agree with you. You're right because your facts are right and your reasoning is right - and that's the only thing that makes you right. And if your facts and reasoning are right, you don't have to worry about anybody else." The idea that facts and rationale need to be the fundamental drivers of investment decisions sounds obvious, but far too many market participants, many of whom are speculators as opposed to investors, decide whether to buy or sell based on what market sentiment seems to be. A similarly misguided approach is to take the contrarian view of the market at all times, disagreeing with current trends simply because they are in favor. While both of these strategies can incidentally be profitable (not all strong performers are dramatically overvalued; not all underperformers are poised for a breakout), the results of an investment will ultimately be determined by the underlying fundamentals of the security in question.

Historical stock price movements, in and of themselves, have no actual bearing on the merits of an investment. The price of a stock is nothing more than an offer from "Mr. Market" to buy or sell an interest in a business. The value of this interest is based on the expected cash flows that will be generated in the future, the present value of which should be compared to the price that is being offered in the market at that point in time. Whether or not the stock had been rising or falling in the previous days, weeks, months or years does not offer any indication as to whether or not the current price provides an adequate margin of safety to warrant an investment in the company. Similarly, hearing CNBC hosts discuss a security, either positively or negatively, does not provide any insight into whether or not it belongs in a portfolio, except to the extent that new facts are being presented.

In the highly connected world that investors face today, it can be difficult to not be influenced by the increasing levels of noise that surround the stock market. From the 24-hour news cycle to analysts constantly sharing their views on social media, the trap of searching for agreement is ever present. In evaluating investment opportunities, however, it is critical that we separate our thinking from outside opinions and consider only the facts and logic behind our analysis. In doing so, we will not only be able to make informed decisions at the outset, but will be able to endure, and potentially capitalize on, periods in which the market price of a stock is disconnected from the intrinsic value of the underlying business. At RMC, our strategy continues to be based around a keen understanding of the value of the businesses we invest in, and actively testing our rationale to avoid becoming caught up in the sentiment of the day.

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NOVEMBER 2017

Resources Management Corp

MARKET COMMENTARY

GROWTH OR VALUE?

Are you a growth investor or a value investor? Do you only invest in companies with low P/E ratios or do you leverage "alternative valuation" metrics? The modern investing environment seems to be obsessed with classifying funds and securities into strict buckets based on a few characteristics that have become viewed as completely defining qualities. The most stark comparison that is often made is that of designating a stock as "growth" or "value". As stated by Fidelity Investments, "growth investors are attracted to companies that are expected to grow faster (either by revenues, cash flows, or definitely by profits in the future) than the rest. As growth is the priority, companies reinvest earnings in themselves in order to expand, in the form of new workers, equipment, or acquisitions." These securities are considered to be more expensive and riskier as much of the valuation is driven by events expected to happen in the future. Value investing, on the other hand, "is about finding diamonds in the rough – companies whose stock prices don't necessarily reflect their fundamental worth. Value investors seek businesses trading at a share price that's considered a bargain, and as time goes on the market will properly recognize the company's value." These stocks are generally viewed as less expensive and less risky.

Aesop, in 1884, relayed the story of *The Hawk and the Nightingale* that teaches us that "a bird in the hand is worth two in the bush." Today, Aesop would have been classified as a value investor because of his unwillingness to consider what the risk adjusted value of birds in bushes is once we take into account how sure we are they can be retrieved. The problem with dividing securities into groups that are effectively "birds in the hand" (value) or "birds in the bush" (growth) is that it requires the incorrect assumption that these buckets require different investment criteria. Investing, however, is simply the act of deploying capital now with the expectation of a sufficient risk adjusted return in the future. To evaluate the appropriate price to pay for a security, we must consider several factors: how much cash flow is produced today, how much that cash flow will grow over the investment horizon, and how certain are we that our projections will materialize. Based on these three factors, we can estimate a range of values for the security by discounting the cash flows by the return required in consideration of the level of risk.

While growth and value are consistently portrayed as opposites, we would argue that they are both actually just factors that need to be evaluated in the investment process. Understanding how fast the earnings available to owners will grow over time is critical to assessing what the proper valuation for a company should be. Similarly, ensuring that the price paid is less than the intrinsic value of a security is a critical strategy in managing risk over the long term. Buying a stock simply because it has a high expected revenue growth rate over the next five years, for example, is essentially gambling if no thought is given to the price that is being paid for this growth (and the market has a history of overpaying for expected growth). To the same end, purchasing a stock that looks "cheap" relative to last year's earnings is highly irresponsible if the future of the company has not been properly taken into account.

So, do we look for growth or value stocks when building our portfolios? The answer is yes. We aim to be disciplined investors who consider the bird we are holding, the number of birds in the bush and how certain we are the birds can be caught. In this way, we are able to become owners of the current and future leading companies without undue exposure to a permanent loss of capital over the long term.

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