



## Quarterly Commentary 1<sup>st</sup> Quarter 2005

**In-fla-tion** \ in-fla' sh?n\ n 2: an increase in the volume of money and credit relative to available goods resulting in a substantial and continuing rise in the general price level

For several years, we have seen clear evidence that the world's central banks have generally been in an inflationary mode. This inflation particularly accelerated after the 9/11/01 attacks. Because Foundation Resource Management had little company in our inflationary opinion over the last several years, we have been fortunate to take advantage of some excellent investment opportunities consistent with this view. In other words, the securities that we discovered to be the cheapest by a wide margin also had the potential to benefit from an accelerating inflation environment.

### **The Changing View of Inflation**

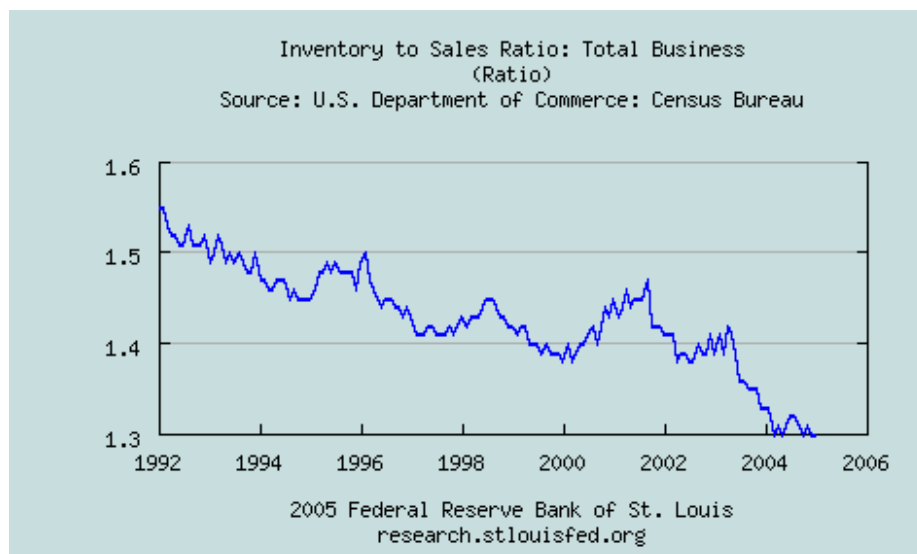
There has been a recent change on the inflation front, an increasing awareness worldwide of inflation manifesting itself in areas other than securities prices and real estate. The costs of raw materials, intermediate goods, and finished goods have been rising considerably faster than the Consumer Price Index. When commodity prices began rising last year, many businesses that previously lacked pricing power chose to eat the costs and attempted to offset them by working more efficiently or cutting back elsewhere. We believe that most productivity improvements have been achieved. Now businesses are starting to pass their rising costs on to customers in the form of higher prices. That means that prices are rising throughout the manufacturing chain, and the results are beginning to show up on store shelves.

A good example is fuel prices. Virtually any good that you purchase must ultimately be transported through the manufacturing chain to the end consumer. We are witnessing an increase in fuel surcharges by shippers to help defray transportation cost inflation. Even though fuel prices have risen rapidly in the last year, there continues to remain surprising complacency. How so? When was the last time you saw next year's oil price forecasted higher than this year's price? As an example, at the time of this writing, the spot oil price for West Texas Intermediate crude oil was \$56 per barrel while the December 2010 futures contract was quoted at \$49.20 per barrel. This condition of backwardation, a period when near-term futures contract prices exceed long-term futures contract prices, has existed for some time now.

We can think of no better example of a sea change of inflationary behavior resulting from higher fuel prices than the airline industry. Over the last ten years, there has probably been no single industry that has struggled more with passing on price increases to customers than the airline industry. As airline travelers, we have benefited greatly from this trend, but we believe those days are waning. In March, U.S. airlines finished raising round trip ticket prices four times during a five-week period by an average of \$60. An industry that was once considered the textbook example for lacking pricing leverage over consumers now is displaying amazing boldness in a unanimous fashion. There is nothing like an industry being on the brink of financial insolvency to shift the balance of pricing power.

### **Not-In-Time Inventory**

All of this pales in comparison to what we believe is the biggest issue regarding changing views on the subject of inflation. We believe that we are exiting a period of Just-In-Time inventory management to a fear of Not-In-Time inventory conditions. For the last twenty years, the primary inventory technique that has been broadly adopted by purchasing managers worldwide has been the Just-In-Time inventory management technique advanced by the Japanese. This method seeks to both maximize efficiency and minimize inventory holding costs by only taking one's manufacturing raw material inputs on an as-needed basis. CFOs during the last twenty years have been able to take this approach because the prices of almost all commodities were in decline from 1980-2000. Occasionally, there were brief flare-ups during this period in specific markets, but for the most part, prices of "stuff" were in decline. It is simple to de-stock your raw material inventory to minimum levels when you are virtually certain that the resource will not only be cheaper, but also plentiful in the near future. See the chart that follows as evidence that the relationship between inventory and sales has been in decline for many years.



By the end of the 1990s, essentially the entire raw material supply chain had witnessed a complete dearth of capital investment as the economic returns paled in comparison to the white-hot technology and telecommunications sectors. It was generally thought by investors that “old economy” companies would be supplanted by “virtual economy” companies. This was occurring at the same time that substantial Asian economic growth was overtaking that of traditional economic forces. The one thing these rapidly developing countries lacked was raw materials. But the system was now de-stocked and was demanding volume increases from the very industries that had been taken for granted. The world economy was demanding that certain industries ramp up production when they had little spare capacity to do so. This resulted in extreme shortages in a number of key global commodities such as steel, oil, coal, copper, cement, etc. This was not just a case of spot shortages. In some instances, logjams in the supply system prevented delivery at any price.

In the past, falling prices and available product were simply taken as the purchasing manager’s gospel. The concept of vertical integration was considered heresy. Most companies no longer wanted to be in the production business, but rather preferred to become “virtual” production companies focused primarily on marketing. Short supply lines and Just-In-Time inventory management work well in a static world with little competition for one’s commodity base. We do not believe this is indicative of tomorrow’s competitive global landscape. We believe that future companies and even countries will revert towards more, not less, vertical integration. We are already witnessing Chinese companies, which in most cases are an arm of the government, attempting to take equity stakes in the oil and base metals sectors in an effort to gain adequate supply. These actions only force competitors to act in a similar vein from a defensive standpoint.

It does not take a great deal of imagination to see how this behavior could snowball even further. The spot shortages that we have recently experienced worldwide could force companies to lay on more inventory than they might have in recent history. This change in psychology could trickle down throughout the entire economy. If you think something will be more expensive next month, you would only be rational to accelerate your purchase before the eventual price increase. The incremental demand that results from this behavior on a macro scale is tremendous.

Even though we were well-positioned overall to take advantage of this situation of raw material constraint, some of our companies have been hurt by this phenomenon. In particular, companies like **Trinity Industries** (steel), **Steelcase** (steel), **Goodyear** (oil and rubber), **CP Ships** (oil) and **Alcoa** (electricity) have reported very unsatisfactory earnings due to their failure to hedge against rapidly rising commodity costs. This has been disappointing and something that we definitely underestimated. You can be assured that CFOs are now being asked by managements about their specific hedging strategies. Those questions are certainly coming from institutional investors during the quarterly conference calls that we have

attended. The result of this change in inventory management philosophy is that inventory is now being valued as an asset to be actively managed. The previous twenty-year period consisted of commodity prices hitting lower lows and lower highs. We believe the days of complacency on the part of CFOs and purchasing managers over commodity prices are a thing of the past.

### **Liquidity Leads to Speculation**

The Federal Reserve did little to prevent or at least dampen the stock market bubble of the late 1990s. Following the stock market downturn and the 9/11 attacks, the Fed gave an increasingly common response during times of economic strain. They flooded the market with liquidity. Case in point, the short-term interest rates that the Federal Reserve controls have been below the inflation rate for the last three consecutive years. This approach does have a therapeutic affect on the economy's immediate challenges. However, as we know from our recent research in the pharmaceutical industry, therapies can often cause unintended side effects. If only **Merck** sold a drug that inhibited excessive speculation.

We have mentioned our concern for the unbridled speculation we are witnessing in the residential housing market. On a national level, median sale prices for homes last year rose 8.3%, the fastest pace in a decade. Some select markets actually appreciated over 20% last year. Home prices have risen almost 40% since 2000. Part of this rise is due to an increase in housing speculators. The National Association of Realtors found that a recent record 23% of homes purchased in 2004 were bought by investors, not residents. Another 13% of homes purchased last year were vacation homes. There are widespread reports of buyers "flipping" homes for quick short-term gains similar to stock market day-traders in the late 1990s. One notable difference, however, is that housing speculators can purchase real estate on 100% margin and in some circumstances borrow even more than 100% of a house's value, whereas stock speculators are limited to "only" 50% margin. David Berson, Fannie Mae's chief economist, confirms that the level of **investor** ownership of housing has not been this high since the late 1980s, which ultimately led to a downturn in housing prices. Further evidence of homeowner speculation comes from the Mortgage Bankers' Association, which confirmed that in March the share of homeowners taking out more risky adjustable-rate mortgages hit an all-time record of 36.6%.

Another phenomenon that has caught our attention is the number of bank branches that are proliferating across the country. Five years ago, the anticipated trend was that the banking industry would be shifting to "virtual banking", and we must admit, we liked that idea. Our need for trips to the local bank branch has been markedly minimized due to the proliferation of internet banking. So why is there such a need for a bank on every corner? The only answer we can come up with is that banks are, to some degree, speculating on commercial real estate similar to individual and corporate speculators in residential real estate. The line of thought seems to be that money is cheap, the property can always be sold for more than its cost, and

other competitors are doing it. None of these reasons, we would surmise, are good reasons for making any investment.

### **The Conundrum Becomes Recognized**

In the last nine months, the Federal Reserve has begun to join us in recognizing the potential threat of future, if not present, inflation. What amazes us is that the bond market remains so sanguine. The Fed has raised the benchmark Fed Funds rate seven times in the last nine months (the longest streak in more than 25 years). Even so, who would have thought that the current Fed Funds rate would still be below the previous low Fed Funds rate of 3% back in 1993? Not only that, but we would also still have negative real interest rates. We are equally perplexed that long-term bonds would still yield less than when the Fed began to raise rates nine months ago. Surprisingly, the thirty-year Treasury is yielding about ½ a percent **lower** than it did when the Fed began to raise rates. Even though long-term interest rates have increased slightly in the last six weeks, the complacency shown by the bond market had Greenspan referring to it as a “conundrum”. At least the Fed has finally acknowledged that inflationary risks do exist. We believe that bond investors and particularly mortgage borrowers have only just begun to take note.