FRANK VALUE FUND

UNCONSTRAINED INVESTING IN US EQUITIES

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Q4 19 LETTER TO SHAREHOLDERS

The Frank Value Fund Investor Class returned 1.82% in Q4 2019 compared to 9.07% for the S&P 500 TR Index. Please see the end of this letter for more performance information.

Generally, there are two types of investor meetings a value investor will endure in 2019. First, is the like-minded sympathizer. This is long-time friend or client, supportive to the fundamental-value point of view, but this person has been beaten into submission by the relentless gains in the market. Head slowly shaking, a thousand-yard-stare in their eyes, this investor digests all the data showing the speculative frenzy currently frothing in markets, but cannot, for fear of career or reputation risk, contribute any more money to value investing. In fact, they are being forced to move more money into a passive investing strategy. The meeting concludes with the following zinger, "I agree with your data, but I see no signs of excess that would stop the market's advance."

The other type of investor meeting is hostile. The investor has the feverish sheen of speculation in their eyes, and scoffs at bearish data. After making 30% in 2019 this investor feels invincible and their recent gains are evidence of their intellectual superiority. Value investing, in the eyes of the modern speculator, is an archaic practice, its effectiveness eliminated by quantitative, passive, and artificial intelligence-based investing. The value investor is shamed and defeated and leaves the meeting doubting principles that have worked for nearly 100 years. As the meeting ends, the speculative investor sneers, "I disagree with your data, and I see no signs of excess that would stop the market's advance."

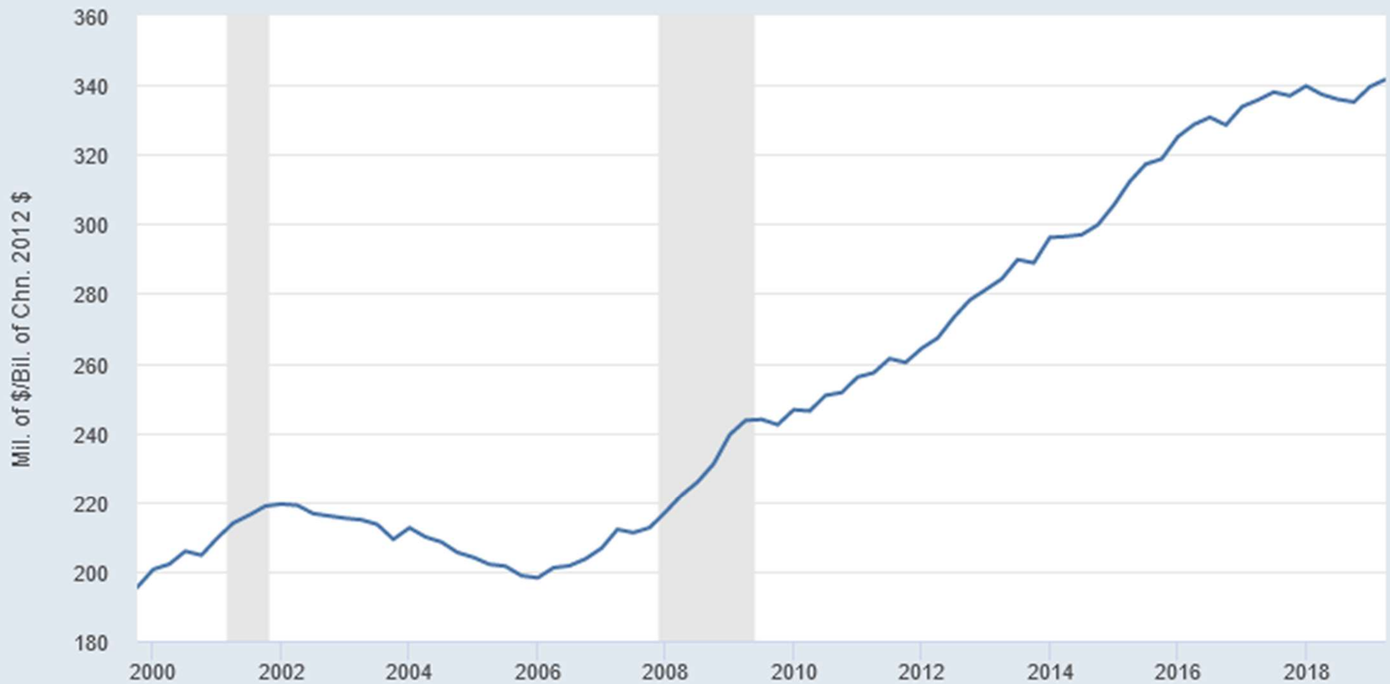
Here, for the record, are the major signs of excess that will stop the market's advance and exacerbate its eventual decline.

Yale professor Dr. Robert Shiller is a Nobel Prize winner, author of the seminal book on asset bubbles *Irrational Exuberance*, and creator of one of the more accurate long-term stock market indicators, the Cyclically Adjusted Price to Earnings Raito, or CAPE. Shiller is more qualified to talk about asset prices and excess than most others in the world. On January 2, 2020, Shiller published an [opinion piece in the New York Times] with the following statement on the degree of market excess:

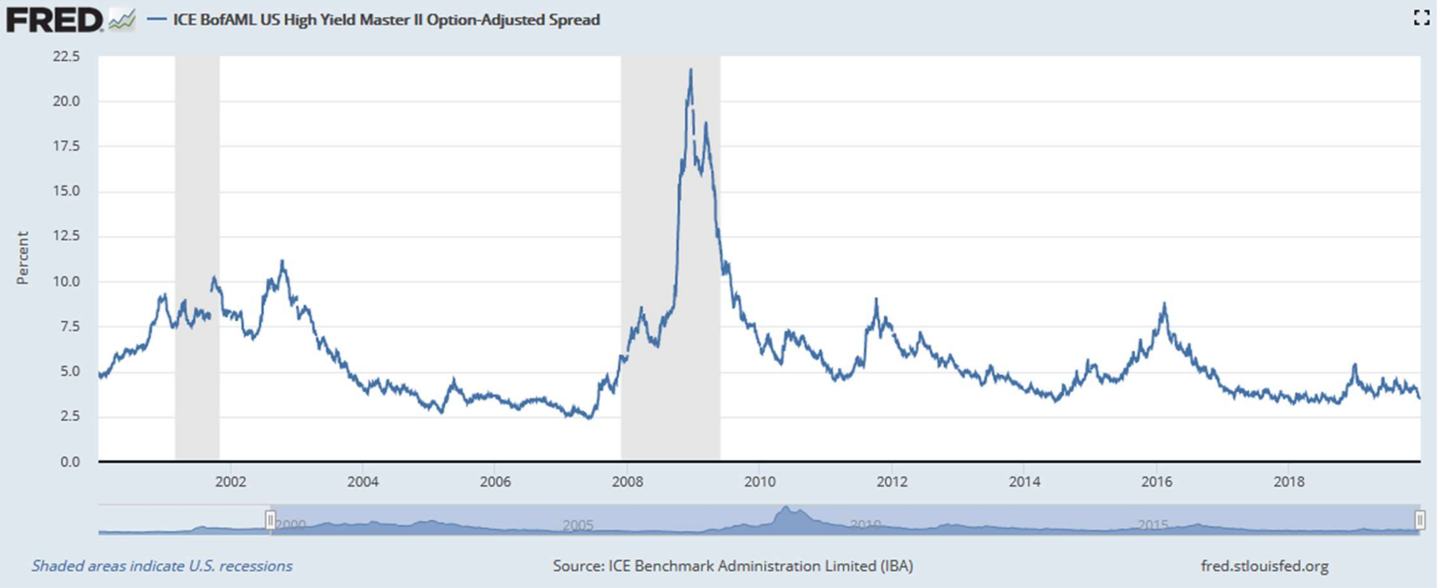
> CAPE reached 33 in January 2018 and is almost as high now, at 31. That number might seem meaningless in itself, but it is significant when you consider that it has been as high or higher on only two occasions: 1929, just before the 85 percent stock market crash ending in 1932, and in 1999, just before the 50 percent drop at the beginning of the new millennium.

Shiller goes on to state that one of the hallmarks of bubbles are individuals shunning warnings from experts and refusing to see signs of excess. Whatever the reasons for the high valuation, the outcome is clear – a steep decline in stock market returns from these levels. You can ignore the beleaguered value investor, but should you ignore the Nobel laureate for asset prices who wrote the book on bubbles?

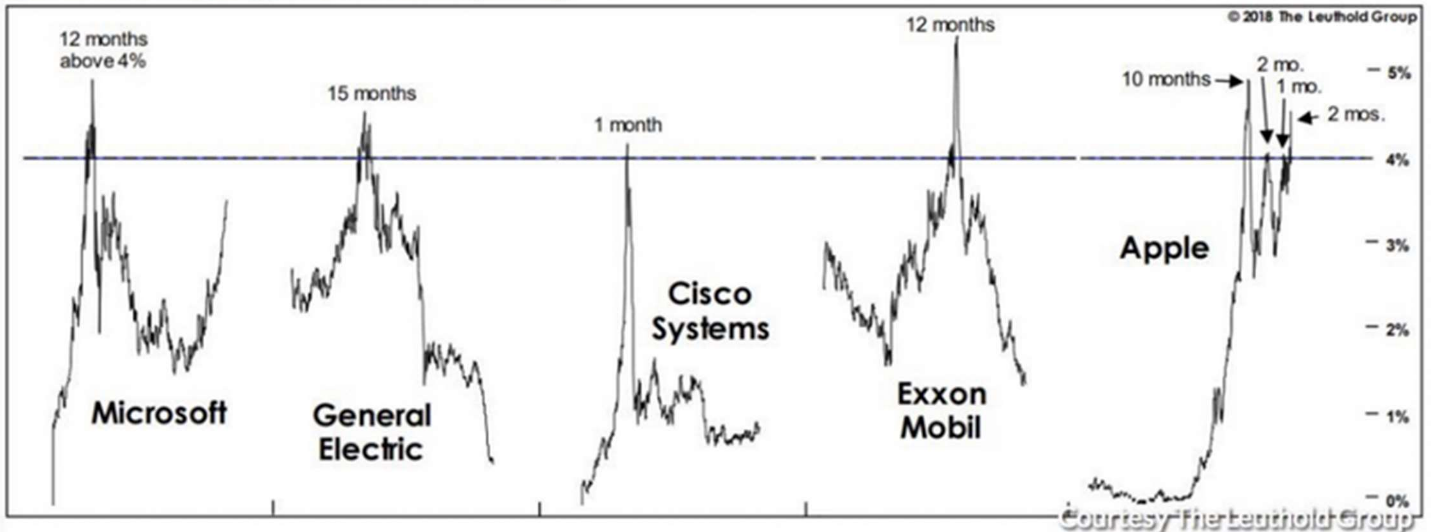
The exciting stock repurchase frenzy by companies is frequently cited as a reason for the unrelenting advance of US stocks. Below shows the cost. Non-financial corporations have more than 1.5 times more debt than before the global financial crisis of 2008. Unless corporates eliminate stock repurchase programs and dividends to repay debt, this debt is unlikely to stay financed at the same low interest rates. Both higher interest rates and higher debt balances mean less profits to equity holders.



The Federal Reserve has lowered rates and will mostly likely continue to cut aggressively in the face of future economic weakness. However, the corporate bond market vacillates wildly around the Fed level depending on investor risk tolerance. The below chart shows investors are willing to accept nearly the lowest premium to US treasuries for BBB rated debt this cycle. You can also see in the previous two recessions, this level spiked to at least a 10% spread. If companies have record debt right now and are accumulating more debt instead of paying it back, they are doomed to suffer higher interest rates at some point. Investors accepting such a low premium to treasuries for low-rated debt is one of the clearest signs of excess in this market. Take in the below chart with the previous one and you get a recipe for a blowout in corporate interest payments and rates. Note that 2007 marked the tightest spread of the previous cycle, just a few months before the top. Spreads in early 2020 are near the lows for this cycle as well, a sign of excess.



What would a value-investing letter be without a discussion of valuation? Below is a chart from The Leathold Group showing all the times in history a company has achieved a weighting of 4% in the S&P 500. Each time previous, this proved to be a pyrrhic victory, with the darling company declining precipitously from that point. Former Frank Value Fund holding Apple now holds the distinction. Clearly, another sign of excess.



On the micro level, here are some stats on VF Corp (NYSE: VFC) which according to Thiel Macro's Mike Green is exactly in the middle of the S&P 500 in terms of price/revenue valuation. This company is average – it is not part of the high growth top decile nor is its business under threat or declining making it part of the "cheap" 10% of the S&P 500. VF Corp is a great example of excess because it is not a sexy corporation. The company makes apparel and footwear and has no

budding technology or subscription service investors can use to justify its dangerously high valuation. In fact, growth has slowed in recent years. Compared to the last twelve years, VFC now trades at a free cash flow yield about 50% more expensive than its highest levels. On operating income, the company is about 25% higher than its richest high valuation. Given that operating margin and revenue decline in a recession and the US manufacturing index has now contracted five months in a row, a prudent investor might discount the valuation for a drop in earnings rather than send it to its highest premium ever. VF Corp is excessively valued on any metric, and investors are likely to suffer losses in the long-term from these levels.

This letter merely points out the excess in the largest company in the S&P 500 and the median company in the S&P 500. Please do not mistake it as an endorsement for every other stock. Instead, our research is showing nearly every US-listed issue to be dangerously above its fair value. This is the broadest level of speculation we have ever seen, for even in bubbles like 2000 and 2007 there were some ignored stocks boasting high potential future returns. For whatever reason, Federal-Reserve-worship, high passive-share, volume domination by quantitative trading, there is excess everywhere in US stocks. There is so much excess it won't fit in this letter. I am co-authoring a paper is deep on details and reasons for the bubble in US stocks. Please contact us if you are interested in a copy.

Frank Value Fund holdings are dominated by gold miners and the limited ignored yet profitable companies we can find, and we believe these companies will generate positive returns as the rest of market at some point experiences material historical losses. Gold returned roughly 18% in 2019 and we believe there is still material upside. Gold and gold-mining stocks currently represent 16% of Frank Value Fund holdings. Should the Federal Reserve cut its rate to 0% and threaten to go negative, we would increase this level to 20%. Though most of our holdings are still in cash and cash equivalents like short-term US treasuries, we have occasionally found opportunities in the corporate bond market. We recently purchased a bond in the energy space with a yield-to-maturity over 7% yet the fundamentals of the business are sound, and revenue is expected to increase in 2020 along with free-cash-flow. This bond represents about 3% of our holdings. Despite all the complaints about excess and valuation, we are still diligently searching for opportunities, but thanks to the excess, our reject rate is over 99%.

Some investor meetings conclude with professionals accusing value-investors of "rooting" for a recession or a bear market. Instead, the value view is the higher stocks get ahead of fundamentals, the larger the drop will be to return to normal. This is written in the profits companies generate. In every other cycle in US history stocks have reconnected with fundamentals, and value investors merely use this knowledge to sell high and protect gains. It's like rooting for 2 + 2 to equal 4 instead of 10 in the current environment. The signs of excess are plainly visible for those who wish to look. Those who choose to ignore fundamentals will eventually be shocked when the 10 in their account turns into a 4.

Thank you for your investments.
Sincerely,
Brian Frank
Frank Value Fund Lead Portfolio Manager

Performance as of 12/31/19	Average Annualized Total Returns			Total Return
	5 Yr. %	10 Yr. %	Since 7/21/04 %	Since 7/21/04 %
Investor Class	-0.79	6.19	5.65	133.61
Class C (FNKCX)	-1.52	5.44*	4.90*	
Institutional Class (FNKIX)	-0.53	6.44*	5.90*	
S&P 500 Total Return	11.70	13.56	9.43	302.42

* Represents an estimate based on the performance of the fund's oldest share class, adjusted for fees.

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