SMEAD
capital management

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Will Buffett Be Right on Wells Fargo?

July 23, 2013

Dear Fellow Investors:

A long time friend once said, "Bill, on the stocks that worked it didn't make any difference what you paid!" What he was referring to were the stocks which rose to many times your original purchase price and the investors who participated over the long run in the shares ended up happy and wealthier. Is Wells Fargo (WFC) one of those companies and will Warren Buffett's recent purchases get vindicated? As we enter the second half of 2013, this is a great discussion point for long-duration common stock investors in a market which has been strong since September of 2011. What matters most, stock market fluctuations or long-term ownership discipline?

A mentor early in my career told me this adage about stocks, "in the short run, 70% of stock performance is market related, 20% is industry related and 10% is company related." He went on to say, "over ten years, stock performance is 70% company specific, 20% industry specific and 10% is market related." We believe we are among the other 100% of market participants who are incapable of adding value via market timing. Based on this ideology, we analyze companies based on ten-year time frames where 90% of the results are dictated by stock and industry selection. We can't know or care to know what the stock market will do in the next year.

Peter Lynch back in the 1980's championed the idea of performing long-term research on stocks to find what he called ten-baggers. Ten baggers to him were shares of stock which could appreciate more than ten times your entry price over longer term time frames. He was looking for a company with economic dynamics that could lead to explosive long-term earnings growth, possessed an attribute which would prevent extreme popularity and had company characteristics which indicated long-range quality in the business (balance sheet, free-cash flow, etc.). His two favorites were Phillip Morris and Fannie Mae. He liked the economics of Phillip Morris and knew that regardless of how well the business did; a large group of investors would dislike the company intensely. In other words, it would never get popular. Fannie Mae was the same way back then, it had a great business and most investors never understood them in the 1980's and 1990's.

If you buy a stock and hold, it for 15 years and it goes up ten times what you paid for it, it is highly unlikely any investor would be upset that they didn't buy at the bottom. There is an old saying in the investment business, "Only liars buy at the bottom." If a stock goes from $30 per share to $300 per share in twenty years, we believe it doesn't make much difference to you if you paid $30 or $36 or $42 along the way. A good picture of the how this plays out in real time is found in an article from the Motley Fool about Warren Buffett:

> "Recalling the days in early March when Wells Fargo (NYSE: WFC) slipped below $9 a share, Buffett -- without the slightest hesitation -- stated, 'If I had to put all of my net worth into stock, that would be the stock.'"

Considering that his favorite holding period is "forever", what can we say about his long-term view of the stock market potential of Wells Fargo (WFC) back then? Also, what do the constant additional purchases by Berkshire Hathaway every quarter since then at higher and higher prices say about the long-term potential for the stock price?

We believe the answer is that Buffett is a subscriber to my friend's theory: “it doesn’t make any difference what price you pay.” First, because Buffett earned a return of over 25% compounded from 1969 to 1999 on his stock portfolio, we could hypothesize that the long-term potential of Wells Fargo at $9 per share was as good as any of his best possibilities during that time period. If Wells Fargo compounded at 25% over the twenty years ending March of 2029, each $9 dollars invested would grow to $832 of value from a combination of appreciation and common stock dividends. We have even left ourselves a margin of safety, because Buffett wouldn’t have said that in 2009 if he didn’t believe that Wells Fargo at $9 per share ranks among his best ideas over the decades.

For this reason, paying $44.65 (intraday July 19th, 2013) per share looks very attractive, if you find truth in our thesis on Buffett's original statement. A purchase here with nearly 16 years left until 2029 looks very appealing to us if the ultimate result comes anywhere near our hypothetical analysis of $832 per share of wealth created on the $9 original investment. Our view of this is that the move from $9 per share to $44.65 is a splendid start on our thesis and leaves a wonderful amount of wealth creation for those of us who “tell the truth” because we didn’t buy all of our shares at the bottom. In the aftermath of the financial meltdown, stress-test related capital restrictions appear to be causing most of the dividends and dividend growth in the Wells Fargo story to be back-end loaded.

In our opinion, this fits Peter Lynch's discipline quite well. It seems like everyone from Senator Elizabeth Warren to the average person on the street hates banks because of their part in the 2005-2009 real estate meltdown and because they are back to lending only to those who can pay the money back. Wells Fargo never lost that discipline, but as they explained a few years ago, when you demand 20% down and a house falls 35%, Wells loses money and recognizes the loss. If you can't borrow at today's great rates, it is easy to hate banks. WFC has seen its market share grow, moat widen and could see its profitability explode if the US economy makes a full comeback.

We are more than happy to accept the risk of temporarily lower share prices from among our holdings coming from the heavy sway the overall stock market has on short-term equity pricing. We believe we are mimicking some of the investment behavior and logic of historically great investors like Peter Lynch and Warren Buffett.

Best Wishes,

William Smead