Hopelessly Devoted to You

A journalist from Fortune magazine once asked Andy Grove, the former CEO of Intel, for the best business advice he'd ever been given. Grove provided a simple quote from a former professor at City College of New York: "When everybody knows that something is so, it means that nobody knows nothin'." In other words, business people and investors become "hopelessly devoted" to a vision of the future which is erroneous from an investment standpoint. This strikes at the heart of a concept that we at Smead Capital Management call "The Well Known Fact". In this letter, we will explain what a well known fact is and what we believe investors are hopelessly devoted to today in their portfolios.

We define a "well known fact" as a body of economic information which is not only known to all market participants, but has been acted upon by anyone in the marketplace who wishes to participate. The best way to understand the concept is to show past well known facts:

1. **The well known fact in 1929 was that the invention of the automobile, airplane and radio were going to spur a "permanently higher plateau" in US equity prices.**

2. **The well known fact in 1981 was that inflation was going to cause interest rates up to 20% on long-term Treasury bonds and a 25% prime rate for bank top customers.** Also, the only investments which could fare well going forward were those which benefitted from high rates of inflation. Long-term bond investing and blue chip stock investing were considered a fool's game.

3. **The well known fact in 1990 was that emerging market sovereign debt from countries like Brazil was going to bankrupt a major money center bank.** Also, the S&L debacle of the late 1980's was going to ruin the US economy.

4. **The well known fact of 1999 was that "the internet was going to change our lives".** Also in 1999, the fact was that it

didn't make any difference what you paid to buy the most successful tech companies of that era.

5. **The well known fact of 2005 was that we never have a nationwide sell-off in housing.**

6. **The well known fact of early 2009 was that we were embarking on "seven lean years and a new normal" for the US economy.**

Like Sandy Olsson dreaming of Danny Zuko, we think too many investors find themselves singing the following refrain:

Guess mine is not the first heart broken

My eyes are not the first to cry

I'm not the first to know

There's just no getting over you

You see, today's investors don't have the "first heart broken."

We maintain that the well known fact is brutal in that it hurts investors worse when the fact is correct about the future than when they are wrong.

People were correct about the huge impact of the new technologies of 1929 on life and the US economy, but it took the Dow Jones Industrial average 25 ¼ years to get even on a price basis. They were right about the internet changing our lives. It has changed our lives. It didn't stop them from an 80% decline in tech stocks from 2000-2002 or participation in a "lost decade" for stocks from 2000 to 2010. Nobody today will be the "first to cry" over the downside which comes from playing an investment or business trend that is left with only downside regardless of the correctness of the theory.

You know I'm just a fool who's willing

To sit around and wait for you

But, baby, can't you see

There's nothing else for me to do?

I'm hopelessly devoted to you

As a market participant for 33 years, we have seen a number of these facts on an up close and personal basis. After each well known fact begins to get pulled apart, investors stubbornly hold onto the investments you wanted to own in the prior cycle. From our perspective, gold and oil investors from 1981-1986 and large tech investors in stocks like Microsoft and Cisco from 1999 to 2012 were a fool who's willing "to sit around and wait for you". They got sucked into the well known fact and felt like, "There's nothing left for me to do." They were "hopelessly devoted to you" and the well known fact was you.

But now there's nowhere to hide

Since you pushed my love aside

I'm out of my head

Hopelessly devoted to you

Hopelessly devoted to you

Hopelessly devoted to you

We think the best choices made from the categories which are overly popular don't do you any good because "there's nowhere to hide" when markets "push their love aside".

The rule seems to be that you have to get out of the way of the well known fact completely.

Somehow you need to eliminate the hopeless devotion. At the top of a market in 1929 and 1999, the market ran out of buyers. Joe Kennedy, the father of President John F. Kennedy, was a very successful investor. He decided when his shoeshine boy was giving him stock tips; it was time to get out in 1928. He missed the last part of the move in 1929, but it defended him from the nightmare of 1929-1932 as the Dow Jones Average fell over 80%. On the other hand, at the bottom of the bond and stock market in 1981, the bottom for financials and the US stock market in 1990, and at the bottom of the US stock market in 2009, there wasn't anyone left to sell.

> ***My head is saying, "Fool, forget him."***
>
> ***My heart is saying, "Don't let go.***
>
> ***Hold on till the end."***
>
> ***And that's what I intend to do***
>
> ***I'm hopelessly devoted to you***

We are sure you are dying to know what we believe is today's well known fact, so that your head can say, "fool, forget him". From our vantage point, the problem is much like it was in 1981. There is one main well known fact which we want to avoid and there are multiple asset classes twisted up in this fact. The well known, fact, as we see it, is that a huge pool of new middle class citizens in emerging market countries are being added to the worldwide population of middle class consumers in the developed economies. These additional emerging market country consumers will want all the things that US consumers have wanted, from beef steaks to fashion clothing to automobiles. This well known fact seems to be driven by the uninterrupted growth in China and the relatively uninterrupted growth in the countries like Indonesia, Singapore, Malaysia, Vietnam, Australia, Canada, Russia and Brazil, which have benefitted the most from China's boom. Here is an example of the bull case for middle class consumers from a respected money management firm in a Barron's online article called "Riding a Rising Global Middle Class" from June 18th, 2013:

> *"Emerging markets" is almost a misnomer. The emerging markets have arrived. They are a significant part of the global economy. In the past, investors would sort of be in the emerging markets, and then get out of the emerging markets, as more of a tactical play. But there's a long-term theme here. I think people underestimated the growth of the middle class around the world. This fund is for companies that access those consumers. And we try to make it a low volatility equity strategy. Our holdings don't have to be within emerging markets. They can be multinationals with significant revenues from there.*

China's boom and their lack of business cycles over the last 30 years have created "hopeless devotion" to this well known fact.

In a an article dated June 15th, 2013 called, “China’s Great Uprooting”, the writer for the New York Times, Ian Johnson, explains an effort afoot in China to move over 250 million people to cities from rural/agricultural areas. The theory is that these rural people, and the infrastructure projects which are created in the cities which receive them, can be force fed into society. The assumption is that out of all this comes the same kind of middle class advancement which occurred in the first twenty years of China’s participation in limited capitalism.

The problem with all of this is there is “nowhere to hide” if you don’t “push your love aside”. We believe you are “out of your head” if you stay in love with the well known fact and stay invested in emerging markets, gold/oil /commodities, multi-national consumer staple companies, energy, basic materials, international heavy industrial companies, and the sovereign debt and stock markets of commodity export nations like Australia, Canada, Brazil and Russia. We have learned that history shows that even if the fact ends up being correct, you lose and history says lose bigger! Warren Buffett says, “What the wise man does at the beginning, the fool does at the end.” Every asset class we’ve mentioned in this paragraph was a great idea in 1999. Oil was $11 per barrel, gold was at $250 per ounce and central banks around the world were selling it, and American investors had almost zero participation in emerging markets. After two years of relatively poor performance, will investors stay “hopelessly devoted to you”?

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