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The Thermometer of the Stock Market

October 29, 2013

Dear Fellow Investors:

As long-duration owners of common stock, we believe it is the wealth created by the businesses which causes the owners to prosper. We have also been participants in the US stock market since 1980 and are very aware of big swings in enthusiasm for owning common stocks. So we thought it would be helpful to share our opinion on the current temperature of the market. To take the temperature of the market we need to examine the thermometer readings.

The first reading on our thermometer is initial public offerings (IPOs) of common stock and trading in the most glamorous and futuristic businesses. When the temperature of the stock market is low and people are fearful, there tends to be great hesitancy to buy young, untested companies. The future doesn't seem to matter when investors are fearful and investor time horizons are squeezed down from years to weeks. When the temperature of the stock market is high, investors seem to be rabid to buy the next great business concept and willing to stretch the time horizon to decades. We see numerous exciting companies getting funded in the public market and the supply of shares in the growth category is expanding dramatically. Today, the temperature of the stock market, based on trading in stocks like Facebook (FB), Netflix (NFLX) and Amazon (AMZN), along with the interest in the IPO of Twitter, looks high.

Sentiment polls and insider buying are the second reading on our thermometer. In the latest week (October 21-25), individual investors, as measured by the American Association of Individual Investors (AAII), and investment newsletter writers, as measured by Investor's Intelligence, were bullish by nearly a 3-1 ratio to bearish. There have been very few insider buys among the companies which fit our eight criteria. Insider selling has been large and consistent recently, especially among the kinds of titillating companies which the stock market participants clamor for. Currently, the short-term temperature based on sentiment looks high.

The price-to-earnings (P/E) ratio is a third way to measure the temperature of the US stock market. Large companies as represented by the S&P 500 Index trade for 15 times the 2014 First-Call consensus earnings estimate. From a historical standpoint, this is a fairly normal P/E ratio and poses little threat to the long-duration common stock investor, in our opinion. This is especially true in lieu of low inflation and interest rates. The Russell 2000 Index is trading at a P/E of 21 times the First-Call estimate. The courage invested in these more expensive and seemingly risky shares, demonstrates to us that the temperature of that part of the US stock market is high.

The fourth reading on our thermometer is institutional and individual ownership. Based on the NACUBO study of endowments and Lipper data on mutual fund and ETF money flows, we believe we are very early in the process of reaching more normalized ownership of US large cap equities by the largest pools of money in the US. The temperature reading for large-cap US stocks is still pretty low. On the other hand, we've observed institutions and asset-allocators burying small-cap managers with money and flooded new small-cap strategies with capital. As we read industry publications which list institutional requests for

proposal (RFPs), the number of small-cap equity manager RFPs have dwarfed large-cap requests over the last four years and has not changed recently. It is no coincidence that small-cap indexes have soundly outperformed large-cap indexes over the last 14 years. Not much heat on large-cap, but plenty on small-cap.

At the end of 1999, large-cap indexes were very expensive when compared to small-cap value, thanks to the popularity of tech/telecom stocks and the unpopularity of oil-related shares at low double-digit oil prices. International investing was also incredibly unpopular because few tech stocks were based outside the US. A huge bifurcation existed in the US equity market. Therefore, we believe—and because valuation matters dearly—anyone who emphasized US small-cap value and international/emerging stock markets significantly outperformed the S&P 500 Index over the last 14 years.

Eugene Fama just won the Nobel Prize in Economics. His academic work on efficient markets and long-term positive factors affecting equity performance are the academic work behind the success of many passive equity approaches. The small-cap and international bias was perfect for the end of 1999. Fama's victory lap on the Nobel Prize combined with the popularity of the “globally-synchronized trade” and small-caps, leads us to believe the temperature is high for over-weighting the same factors for the future that were successfully emphasized in the past.

From a large-cap standpoint, one might think the reading on the thermometer won't get high until we have an economy strong enough to cause the Federal Reserve board to tighten credit in the US. Sizable bear markets traditionally occur after the inversion of the yield curve in the US. This is where short-term interest rates exceed long-term rates as main street business borrows to fund economic activity and the Fed seeks to slow huge momentum in the economy to avoid inflation. This appears nowhere in sight and marks little heat on the thermometer.

The last point on the thermometer is anecdotal. The courage shown by investors during the government shutdown and their willingness to stick with more risky and volatile common stocks sends the mercury rising. We sense that folks we interact with who were once fearful of each dip have increased confidence now. In our view, most of the guests on CNBC and Bloomberg are bullish. On top of their bullishness comes their consistent support of cyclical stocks and international/emerging stock market participation. We would include Wall Street strategists on this list of those supporting what worked in late 1999 and looks over-cooked to us.

In conclusion, there appears to be a fever in high-flying momentum stocks. We believe the temperature is still very high among decelerating cyclical businesses like oil/commodities, heavy industrials and those companies with heavy exposure to the “globally synchronized trade”. The temperature continues to look very favorable on domestically-oriented US large cap equities which would benefit from the comeback over the next five years in the US economy and are under-owned by institutional and high-net worth investors.

Warm Regards,

William Smead

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