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Ben Graham's Mr. Market 2015

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Dear Fellow Investor,

In the Berkshire Hathaway 1987 Annual Report, Warren Buffett wrote the following:

> Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.
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> Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him.

As we enter 2015, we at Smead Capital Management would like to separate how unsuccessful investors use Mr. Market and how successful investors use his "voluntary" participation in the stock market.

Thanks to the popularity of passive indexes and a six-year run of positive returns in the U.S. stock market, investors now own billions of dollars worth of what we believe are unmeritorious common stock holdings. Price-to-earnings ratios (P/E) are above historical averages for U.S. stock indexes, especially the small-cap Russell 2000 Index. Thanks to the massive flows of funds into ETFs and passive mutual fund vehicles, there is less differentiating of quality among publicly-traded common stocks. All boats have floated.

Therefore, it might be wise for investors who are being trained to seek mediocrity in common stock investing to take advantage of Mr. Market's enthusiasm for every company in the index. By buying everything in every index to the tune of billions of dollars, Mr. Market is in an unusually "lathered up" position. Buffett goes on in the annual letter:

> Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.
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> But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, *you're* the patsy."

Unsuccessful investors not only are unlikely to be practicing a successful long-duration common stock discipline, but studies show repeatedly that they behave just like Mr. Market. They've been rabid to be on the Bakken Shale boom. They over-cooked their interest in commodities of all kinds in recent years. They underestimated how much countries like Brazil, Russia, Canada, Australia and Germany were connected to China's economic boom like leeches were to Humphrey Bogart in the movie, *African Queen*.

They chase excitement in technology, bio-technology, restaurants, yoga pants and anything else which make a person's blood pressure elevate. We are so grateful that investors do all of this as a completely "volunteer" army.

> Ben's Mr. Market allegory may seem out-of-date in today's investment world, in which most professionals and academicians talk of efficient markets, dynamic hedging and betas. Their interest in such matters is understandable, since techniques shrouded in mystery clearly have value to the purveyor of investment advice. After all, what witch doctor has ever achieved fame and fortune by simply advising "Take two aspirins"?
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> The value of market esoterica to the consumer of investment advice is a different story. In my opinion, investment success will not be produced by arcane formulae, computer programs or signals flashed by the price behavior of stocks and markets. Rather an investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behavior from the super-contagious emotions that swirl about the marketplace. In my own efforts to stay insulated, I have found it highly useful to keep Ben's Mr. Market concept firmly in mind.

Since this is the beginning of 2015, let me refresh you on today's esoteric wizardry. Smart Beta, quant strategies, hedge funds, liquid alternatives, leveraged buyouts (LBOs)/private equity and go-anywhere bond strategies are all formulated to confuse Mr. Market in 2015.

Successful investors use both quantitative and qualitative research to find meritorious businesses for long-duration holding periods. They use Mr. Market as a helper. He puts many of today's most attractive long-duration common stocks on sale, thanks to temporary difficulties for the company or industry involved. He is quick to give up on toll-bridge companies with addictive-customer bases due to these current trials.

Ben Inker showed in his landmark study from 1990 to 2004 that companies with certain qualitative characteristics produce alpha. We use his work on strong balance sheets, sustainably-high profitability and earnings stability among our eight criteria and find companies which fit them. Thanks to Mr. Market, we can patiently wait for him to lay these shares in our laps at favorable prices when trouble comes to these fine organizations. As Jim Collins pointed out in the book, *Great By Choice*, all companies have good luck and bad luck. Great companies, which have a tendency to show up in Inker's characteristics, have stretches of bad luck as well.

Where are Mr. Market's emotions getting the best of him as we enter 2015? We think he is afraid of bank fines and regulatory banking nightmares. He is afraid that new technologies will kill the local network-affiliated TV stations, cable television and news gathering organizations. He is afraid that Amazon will kill every other online shopping methodology along with every brick-and-mortar retailing establishment.

He is convinced that Millennials will never drive first-time home buying in a meaningful way and that they will never move to the suburbs and commute to work. In fact, it is possible that he thinks that interest rates will never normalize because he's convinced we are in an ongoing nightmare of anemic economic growth. Lastly, he is convinced that student loans are going to destroy the finances of helpless and naïve 18-30 year old Americans and contribute to a permanent debacle for our largest population group.

Please remind us to thank Mr. Market for all he does for the practice of long-duration common stock picking disciplines.

Warm Regards,

William Smead

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