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Insatiable Demand for Safety

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Dear Fellow Investors,

Marketwatch.com writer, Ellie Ismailidou, wrote an interesting article on July 5, 2016 proposing that the drop in the U.S. 10-year Treasury Bond Yield below 1.4% represents an "insatiable demand for safety." As contrarians, we love these kinds of well-written thoughts as the media makes folks more and more aware of what has worked in the stock and bond markets this year. We thought it would be helpful to put today's circumstances into a historical context and look at clues for the best possible behavior for investors in the past and in the future.

Bond prices have soared despite the lack of long-term return potential. It is unequivocal that a buyer who holds for ten years will make less than a 1.4% return and is likely to lose purchasing power in the process. The only way to make good money is for the rates to move lower and to sell to a bigger fool who comes along with their own "insatiable" fears. Here is how Marketwatch.com told the story:

> *"Demand for safe assets is 'insatiable,'" said Aaron Kohli, interest-rate strategist at BMO Capital Markets, pointing to widespread pessimism and uncertainty in global markets. "Investors are on the lookout for risk and problems," Kohli said.*[1]

An intense fear has set in on investors and the British vote to exit the European Union was the latest catalyst. The dictionary describes "insatiable" as being something which can't be satisfied. Is it different this time?

Bonds are not the only investments catching money based on fearful investors seeking safety. Gold has soared this year as the fear exposes itself in bigger fool theory in the yellow metal. Above-average dividend yields in utility, telecom and staple companies pushed their shares significantly higher as investors chased absolute dividends from economically insensitive businesses. This has driven staples and utilities to price-to-earnings (P/E) ratios not seen in years, putting them at a big premium to the average stock and a massive premium to anything economically sensitive. We agree that it looks "insatiable."

In the last year, technology growth stories like Amazon, Tesla, Netflix, Alphabet and Facebook seem to have had an "insatiable" demand for their shares coming from growth investors seeking the "safety" of reliable revenue growth. It smacks of the "Nifty-Fifty" growth stocks of the early 1970's, which got bid up because of their reliable earnings growth. They peaked at P/E multiples of 60-80.[2] Think Polaroid and Simplicity Pattern. Does this sound familiar? It ended in vicious losses in the 1973-1974 bear market (which took ten years for the average "Nifty-Fifty" stock to recover from) if you sought that "safety."

In my career, there have been numerous periods of "insatiable demand" for investments based on fear and a need for safety. In 1980, gold, oil and other commodities were all the rage. The "insatiable" demand came from wanting to make your money "safe" from the ravages of inflation. It reached a peak with oil at $40 per barrel and gold at $850 per ounce. They bottomed close to each other in 1999 at $11 per barrel and around $260 per ounce on gold.

There seemed to be no end to the "insatiable" demand for technology stock investments in the late 1990's. In 1999, a new company went public almost every business day and investors doubled their money overnight, if they were able to get shares of the IPO. Only one major tech or telecom company, Northern Telecom, was domiciled in Canada. It peaked in early 2000 at 33.5% of the capitalization of the entire Toronto Stock Exchange.[3] At the end of 1999, the S&P 500 Index reached its highest P/E ratio of the last 50 years on the back of 60-100 P/E multiples in the darling tech and telecom stocks.[4] It ended in a bear market from 2000-2003, with the tech-heavy NASDAQ Index losing 80% from peak to trough.[5]

Investors had such "insatiable" demand to buy houses in 2005 that they lied about their incomes and found banks willing to condone the lies. These subprime mortgages were deemed to be "safe" because houses had never gone down nationwide since the 1930's. The loans were packaged into bond tranches for diversification purposes and sold to investors with AAA ratings. This unquenchable urge to buy a house or multiple houses and the boom it created crushed our economy when the game of musical chairs ended in 2007. Our worst recession since the 1930's followed and took us into a financial meltdown. It was all because demand was "insatiable" and houses were viewed by the masses as "safe."

In 2011, we became very bothered by an "insatiable" worldwide obsession to make money from the new 400 million middle class citizens being created by the boom in China and the emerging markets which suckled on their boom. Those middle class folks were all supposed to want the same things Americans want and we were told that commodities like oil and gold would rise for a long time. Everyone received data on how many people got their first car in China and oil rose to an astounding $145 per barrel in 2008. Gold approached $1,800 per ounce as the newly wealthy in China were limited to real estate and gold as their primary growth investments. The demand was "insatiable," as many Chinese Nationals owned numerous condos in their own country and bought up property in select foreign cities like Vancouver, B.C.

Oil is now around $45 per barrel and gold has rallied to $1,330 (as of July 18, 2016). Oil and gold investments always appear "insatiable" to us because we would hate to have our success predicated on the price movements of an inanimate object and the old way of making a car move. Those 400 million new middle class citizens only made $8,000 dollars per year and their demand for consumer goods will come in decades, not in a few years.

Where does this "insatiable" demand for "safe" investments take us? Warren Buffett compares it to the story of Cinderella. The party is great until the clock strikes midnight and everything turns into pumpkins and mice. It takes us to losses for the pumpkin-like Treasury bonds. Those who owned the popular stocks, which investors have committed to out of fear, will run around like mice. This "insatiable" demand, which is based on fear and can't be satisfied, could and should lead to the same kind of misery which all previous episodes produced.

What we do at Smead Capital Management is not called fearing, it is called investing. We believe you should stop trying to avoid risk and try to take good risks. Where is there very little demand for

meritorious companies at exceptional prices? We like financials hurt by the low interest rates and biotechnology stocks which are very profitable, but whose growth has slowed. Finally, we like old media stocks with copious free cash flow and sticky advertising mediums. In fact, we have an "insatiable" urge to be very patient and avoid the risk of being late to a party which includes a dangerous pursuit of "safety."

Warm Regards,

William Smead

[1]Source: Marketwatch.com, *Treasury yields plunge to all-time lows on 'insatiable' demand for safety*, http://www.marketwatch.com/story/treasury-yields-tumble-to-record-lows-as-brexit-fears-resurface-2016-07-05
[2]Source: USA Today, *Remember the Nifty Fifty?*, http://www.usatoday.com/story/money/business/2014/04/01/ozy-nifty-50-stocks/7156447/
[3]Source: CBC News, *Nortel and the TSE 299*, http://www.cbc.ca/news/business/nortel-and-the-tse-299-1.230333
[4]Source: Bloomberg.
[5]Source: Bloomberg.

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