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Panic Selling Exacerbates Bargains

Dear fellow investors,

This year feels so much like late in 1981, late in 1999 and late in 2008 to us. The first reaction by investors was to flush whatever they had left in economically sensitive stocks. Then, as if there hadn't been enough torture for value investors today, Saudi Arabia decided to chop the knees out from under the oil industry in the U.S. This has exacerbated the crisis in economic confidence to an even higher panic level. What would history suggest we do in the middle of this fairly violent decline in stocks and seemingly bottomless coronavirus circumstance?

As long duration investors, we believe the current panic selling needs to be understood in a historical context. History would argue that late in a long-term trend, tribulation punishes out-of-favor common stocks, laying the groundwork for superior forward investment returns. Let's review those three historical analogous situations and analyze the ten-year forward returns that followed each period.

1981

Inflation had run wild in the 1970's, triggered by two OPEC oil embargoes (Saudi Arabia sound familiar?) and massive baby boomer demand for products and services. Interest rates soared to double-digit levels, oil rose to $40 per barrel, gold was hot and common stocks were avoided like the plague. Inflation stocks were extremely popular and U.S. household equity ownership bottomed in 1981.

The medicine applied to cure the inflation only exacerbated an additional meltdown in stock and bond prices. Fed Chairman, Paul Volcker, tightened credit and gave us 18% three-month T bills. This caused 13% long-term Treasury bonds to become 15% bonds with capital losses attached. This was the final injustice to bond owners after decades of misery. It also triggered a 20% decline in stocks, which went from 8 times earnings to 6.4 times earnings from June to September of 1981.

You see, what was cheap got cheaper as Volcker's medicine broke the back of inflation. However, just like today, investors were panicked and fled both the 13% interest guaranteed for decades and the double-digit compounded common stock return seen for nearly four decades since. All this was done to avoid the temporary discomfort of getting clobbered until things settled out.

1998

In 1998, the tech bubble appeared to break. Unfortunately, a force as powerful as Paul Volcker's tight credit intervened called Y2K. It was feared that when the clock went to all zeros on January 1, 2000, older computers and servers would cause a worldwide panic. For this reason, every dot-com company and non-tech company bought all new computers, servers, routers, phone equipment, software and microprocessors. We believe this threw gasoline on an already hot fire and caused tech stocks to go berserk.

While the techs were working in 1998-1999, almost nothing else in the common stock market worked. Tech stocks lost 80% as a group in the next three years and many stocks either took 16-20 years to get even (MSFT, INTC, CSCO) or provided permanent heartache (Lucent, Sun Micro, etc.). Investors did exactly the opposite of what they should have done to get the best ten-year returns by avoiding the remainder of the underperformance.

2009

In the financial crisis of 2007-2009, there were four selling climaxes as the transmission system of the U.S. economy was damaged. This damage was huge and led to a complete recapitalization of the banking system. At the height of the financial crisis, four months before the market bottomed, the U.S. government bought billions of dollars of common stock in the largest banks at the height of the panic. Just as today, that medicine was not trusted by the market!

The inability of experts to see inside the balance sheets of the largest U.S. banks exacerbated fears which quickened the final selling of common stocks, especially banks. Those government investments in the largest banks became the poster children for everything that was wrong with the financial crisis (before the Occupy Wall Street movement). It lasted all the into 2012 when we got involved in Bank of America (BAC) and JPMorgan (JPM) in 2012, because they were still extremely depressed by the sheer terror which exacerbated the financial crisis. Stocks have produced terrific returns since 2009 and those bank balance sheet fears were the wall of worry which stocks climbed. The Federal government made a pile of money buying into those banks because they were greedy when others were fearful.

This brings us to the current decline which is crushing anything requiring economic optimism. Stocks were popular and expensive one month ago, thanks to the undying enthusiasm for the FAANG stocks (Facebook, Amazon, Apple, Netflix, Microsoft and Alphabet/Google) and the willingness of investors to pay very high price to earnings ratios for relatively non-cyclical growth stocks. Growth stocks have stomped value and the coronavirus-induced economic fears have exacerbated what was already a huge drubbing. This year feels so much like 2000 to me for that reason.

2020

We always remind ourselves in the middle of these exacerbated tribulation periods to stick to our eight criteria for common stock selection. Secondly, we will look at the economic facts going forward and seek the most future business success for the least amount of money. How can we find the upside which comes after this debacle?

The answer comes from certain economic facts. It is a fact that there are 36% more millennial Americans emerging in the 30-45-year-old age bracket the next ten years than there were Gen-Xers the last ten years. This group does most of the household formation, baby making, car buying and home buying. They carry a huge multiplier effect on economic activity.

What has the coronavirus and the Saudi oil stunt done to the fundamentals of economic activity of young families? Start your thoughts with the lowest interest rates on mortgages and car loans in my lifetime. Throw in very cheap gasoline for an extended time period. Leave everyone stuck at home or in apartments for a couple of months. Stop millennials from traveling and create massive pent up demand.

We like the home builders like Lennar (LEN). In *The Wizard of Oz*, Dorothy clicked her heels together and said, "There is no place like home." Once all of this debacle clears, we like the oil business. For balance sheet reasons, we favor Chevron (CVX). When the virus gets done, we believe we will see a huge rebound in banks like Bank of America (BAC), Wells Fargo (WFC) and credit card powerhouse, American Express (AXP). We see Discovery Inc. (DISCA) providing popular unscripted entertainment via HGTV, Food Network and TLC to millennial men and women viewed any way they want.

As you watch TV in the coming weeks, notice that a big part of the advertisements shown are for automobile insurance. Another fact we can add to our list is we're adding the most driver licenses in the U.S. in the next five years than we have in decades. Those automobile insurance companies are spending that money on those advertisements to be as smart about the future as the Federal government was when they bought the bank stocks in the middle of a huge one-in-70-years panic. In the middle of this panic selling, exacerbated by the coronavirus, remind yourself that this too will pass. What this means is many of the best opportunities could come from those sectors of the U.S. stock market which require economic optimism and have been punished the most in the current decline by the medicine that's being applied.

Warm regards,

William Smead