MARCH 24, 2020

Cole Smead, CFA
President
Portfolio Manager

Betting the Long Odds

Dear fellow investors,

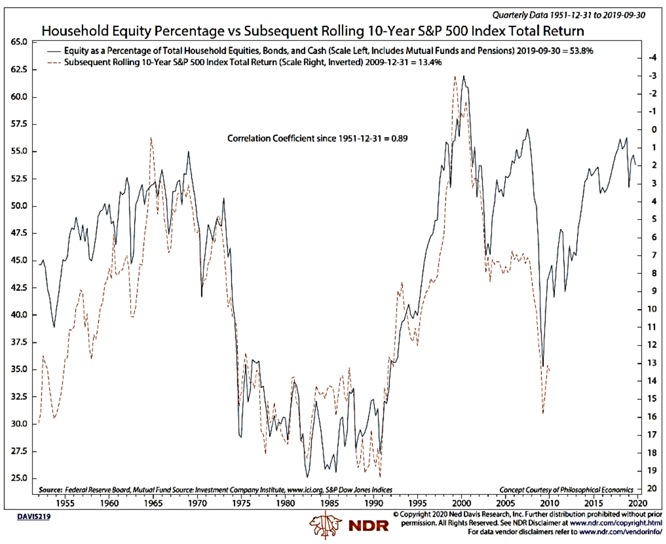
While the circumstances of today seem strange and awkward, they are in the probabilities of what we must be willing to live through as a capitalist society. We want to focus our time and energy on what this environment provides in opportunities for our clients, shareholders and our firm at Smead Capital Management. While we watched stocks that were considered economically-sensitive get pounded the last few weeks and watched the market coronate perceived winners from everyone hiding at home, our reading and thoughts from the past great buying opportunities started to ring in our ears and have caused our minds to pump with adrenaline and excitement.

I was personally reminded of Michael Mauboussin's book *Think Twice* and his storytelling of the fabled horse, Big Brown, who attempted to win the Triple Crown in 2008. Mr. Mauboussin shared with us that there were two ways of looking at the momentous effort by Big Brown: the inside view and the outside view. The inside view would be the betters, the breeders, the jockeys and people that could see the horse up close. They were wowed by Big Brown's first two races toward winning the triple crown. The horse's trainer gushed, "He looks as good as he can possibly look. I can't find any flaws whatsoever in Big Brown. I can see the prettiest picture. I'm so confident, it's unbelievable." The inside view caused the betting odds to place a 75% chance that the horse would win.

Quality at any price

Big Brown should help investors understand the overconfidence in the inside view today. Analysts, strategists and fund managers on Wall Street tend to agree on one thing: who the perceived winners are from the panic of 2020. Let's name a few. Costco (COST), because who knows when you'll leave your home. Netflix (NFLX), because who knows when you'll be entertained outside of your home. Microsoft (MSFT), because what business doesn't need software for working with clients remotely. Amazon (AMZN), because what isn't bought online right now. These are just a few of the examples of the current inside view. The valuation multiples that these companies have are some of the most expensive in stocks. The earnings consistency is the highest among these companies, too. Everything looks great.

The outside view would have you take a look at other factors instead of what can be easily seen. First, what will sales growth or like-for-like comps be for these businesses one year from now? If this is as good as it gets, where is the room for disappointment? Second, stocks now look far more volatile to investors. Will investors going forward pay the same multiples they did in the past for the best businesses? History argues against it. This is a real danger as we talked about in our piece, Beware Lazy and Sleepy Investors, when Coca Cola went from the penthouse in 1972 at 46 times earnings to the outhouse in 1980 at six times earnings. Lastly, adding fodder to the quality at any price mantra of many investors riding popularity or hoping the best companies succeed is that stock returns aren't going to be great. This isn't good for large S&P 500 weightings. Below is a chart by Ned Davis Research comparing household ownership of common stock as a percentage of household net worth and the 10-year forward S&P 500 returns.



What you'll quickly notice is that they are negatively correlated. High ownership among American households doesn't bode well for the index. Thus, it doesn't bode well for large holdings of the S&P 500 constituents. We don't have to wonder if Microsoft, Netflix, Costco and Amazon are becoming larger and larger market weightings. They've crushed the market's return in the panic of 2020.

Why the long odds?

The companies that have been impacted the most by the panic of 2020 have seen stock prices decline 50% to 75%. The more economically sensitive a company is, the more it has gone down in price. The smaller the market capitalization of a company is, the more it has declined in capitalization. The cheaper a company's valuation was, the steeper the decline. It's as if you can see the money leaving everything, except for the stocks that are quality at any price. Bill Miller, in an interview last week, called this one of the five greatest buying opportunities of his lifetime! He included 1974, 1981-1982, 1987, 2008-2009 and today in those five occasions.

We believe the long odds are that the businesses with the most punished stock prices are likely to produce the highest returns over the next three years, not because they are the best companies. The odds the stock market is giving you if these companies win just look so high, in our opinion. It's sounds like Peter Lynch commenting on three baggers in oil and gas in Barron's magazine, before the panic of 2020 began. If they win, they could create large wealth for a concentrated owner of the business.

Like Big Brown's 75% chance of winning, your payout for picking the favorite was low. You risked 100% of your capital and could only make a 30% gain, if you were right. If you're like most successful stock pickers, you'll only be right 70% of the time. That means a $16 bet ten times ($160 total) turns your capital into $145.60, a 9% loss.

The long odds will pay wonderfully even if you're only right on 70% of them. If you had to bet the field, your $2 bet on all remaining horses at the Belmont Stakes cost you $16 (eight horses). The average payout among those horses was 22.625 to 1. Thus, a $16 bet made you $47.25. Even if you are right only 4 in 10 situations like that, you make $189 or an 18% return. The longer odds paid you better with lower success rates.

Sir John Templeton, whose *point of maximum pessimism* is indelibly etched in our minds, tested this same theory at the outset of World War II. Templeton bought 100 shares in 104 companies that traded below $1 in 1939. In fact, he borrowed the money to purchase them. Penny stocks by nature are speculative and risky. You can call them long odds.

Of those companies, 34 went bankrupt, but Templeton made himself wealthy with the investments he made. It was rumored to be worth four times what he paid, despite the bankruptcies. What was later proven was the long odds businesses had large amounts of losses accumulated from the depression. When war spending picked up and the economy followed, the accumulated losses created amplified free cash flow for a long period of time. The takeoff in the economy from the war didn't enhance the after-tax cash flow for the owners of the best businesses like it did the owner of the long odds companies.

To belabor the point, Big Brown was given a physical exam after finishing dead last in the Belmont Stakes. He was healthy, or as his trainer Dutrow said, "He looks as good as he can possibly look." The best companies will look as healthy as they currently do in five years, but the one thing we believe will happen is they will finish at or near the back of the pack in common stock returns. Near this *point of maximum pessimism* in businesses tied to the economy, we'd advise you to be betting the long odds. You may fail in some investments, but we believe you will be rewarded for the risks you took. Listening to President Trump refer to the panic of 2020 as a war should leave you feeling just as Templeton did when the Germans crossed into Poland. The government spending will come as it did then, so who benefits the most?

Warm regards,

Cole Smead, CFA