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3RD QUARTER 2014 (9/30/14)

You Ain't Seen Nothin Yet

Someone recently asked a group of us which band we saw at our first rock concert. My answer was the Canadian band, The Guess Who, in 1975. With hits like "No Time," "Undun" and "These Eyes," The Guess Who hit the perfect balance between my 17-year old testosterone driven aggressiveness and my urge to romance the woman of my dreams. The key members of the band in the 1960's and 1970's were Burton Cummings and Randy Bachman.

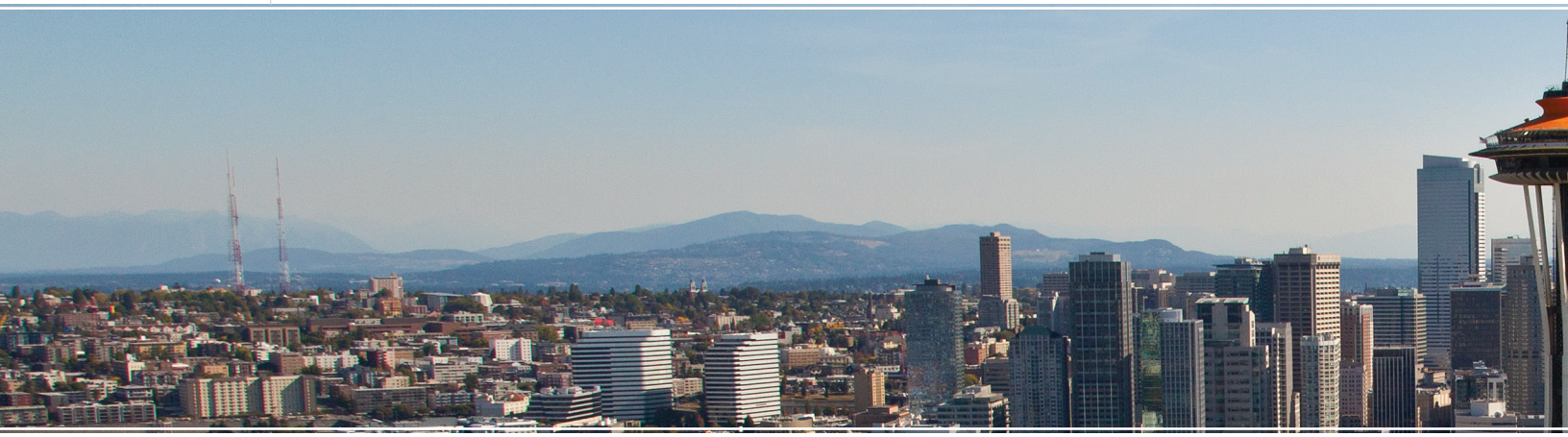
Today's equity market harkens back to the period 1983-1987 in the U.S. stock market

Fortunately for this writer, Randy Bachman left the band in the early 1970's to form Bachman-Turner Overdrive (BTO). Their two biggest hits were "Takin' Care of Business" and "You Ain't Seen Nothin' Yet." Today's equity market harkens back to the period 1983-1987 in the U.S. stock market which we alluded to in our 2014 outlook piece. As we look to the fourth quarter of 2014, we will quickly review what happened in the first nine months of the year, see how it compares with 1983-84 and consider what went on from 1984-1987. At Smead Capital Management, we believe "You Ain't Seen Nothin' Yet!"

By the middle of 1983, the U.S. economy was in the early stages of an elongated growth period. Small-cap stocks and fast-growing conceptual tech stocks were all the rage. Small-caps had a nine-year run of outperformance over large-caps under the idea that their earnings were more likely to grow faster than the persistently high double-digit inflation. From July 26, 1983 to June 30, 1984, the Russell 2000 small-cap index fell 20.21% from peak to trough and high-flying techs fell even further. The S&P 500 Index's peak loss was around 10%, a significant outperformance.

As we write this letter in late September of 2014, the S&P 500 has gained close to 9% and the Russell 2000 has lost over 4% year to date, a spread almost identical to the rhyme we drew on from history. We think investors were overcommitted to small-caps in 1983 due to the "well known fact" surrounding persistently high inflation. At the beginning of 2014, a new "well known fact" seemed just as entrenched in investors' minds: historically riskier small-cap indexes outperform the larger-cap indexes over long stretches of time.

At our firm, we believe valuation matters dearly and the historical advantage small-cap stocks normally have in the marketplace is very attractive. The advantage is that they are usually cheaper than their bigger and substantially more stable large brethren. By the end of 2013, we saw a 14-year run of small-cap domination come to an end. The great small-cap run was triggered by how much cheaper the Russell 2000 was in early 2000 than the S&P 500. Tech was all the rage and ridiculously expensive at the end of 1999. The Russell 2000's tech exposure was higher than normal, but didn't include the glamorous dot-com companies that traded at massive market capitalizations. Large traded at 27 P/E and small traded at closer to 15 P/E. A long period of success for small caps was bred.



As we entered 2014, the S&P 500 traded for around 17 P/E and the Russell 2000 was around 29 P/E. We aren't the only ones looking at the severe over-pricing and over-capitalization of smaller cap companies. Market Historian, Hayes Martin said this in a September 23rd, 2014 Marketwatch.com interview:

> *Valuation: The area of the market whose valuation is most troubling, according to Martin's work, is secondary stocks. His indicators, which focus on several valuation metrics such as the price-to-earnings and price-to-sales ratios, show the Russell 2000 index to be more overvalued today than at any time since it was created in 1984. In fact, Martin believes that, had the Russell 2000 index been around before 1984, you'd have to go back all the way to 1968 to find a time when secondary stocks were more overvalued than they are today. Martin adds, ominously, that 1968 was "the grandaddy of small-cap market peaks."*

Ironically, The Guess Who was making some of their best music in 1968. It is not just prices which tell the story of a "well known fact" and major over-capitalization. You need other evidence.

The largest private equity investment is in leveraged buyouts, transactions which are mostly likely to occur in small and mid-cap companies.

First, as we entered 2014, investments in hedge funds and private equity led to a massive over-capitalization in alternative investments led. We think hedge fund managers are much more likely to attempt to find an advantage in under-researched securities. The largest private equity investment is in leveraged buyouts, transactions which are mostly likely to occur in small and mid-cap companies. Since investors have drowned both of these alternatives with money (mostly coming from net liquidation of large-cap investments) it is easy to see how over-capitalization would occur. See the NACUBO study from the end of 2013 for the asset allocation of the nation's foundations and endowments totaling over 1 trillion in investable dollars as representative of U.S. institutional investors as a whole:

NACUBO-Commonfund Study of Endowments: Asset Allocation

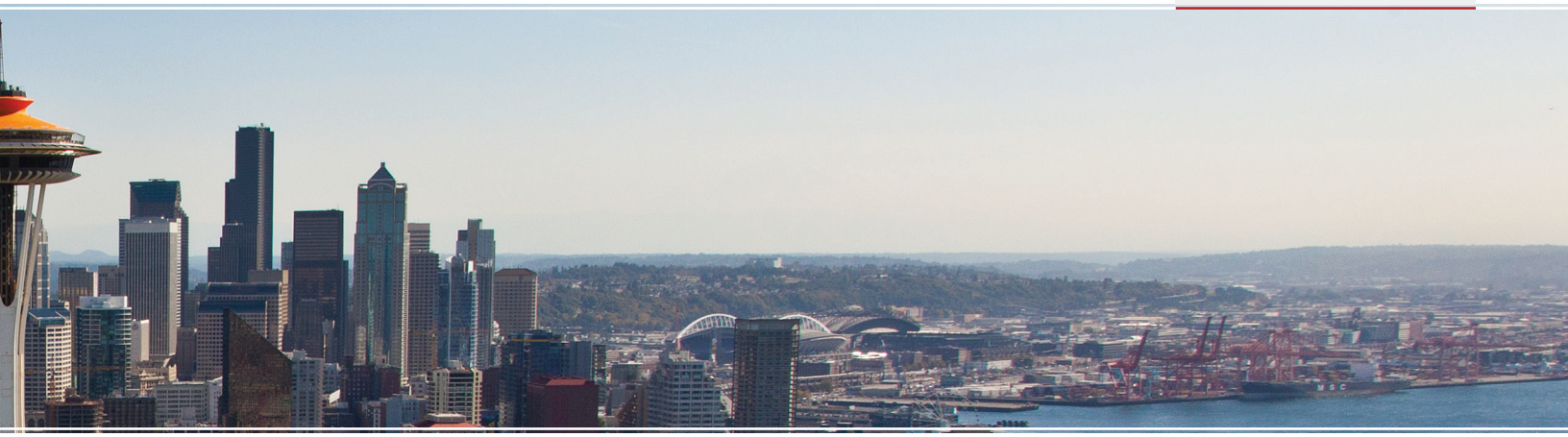
	Total Institutions					
	835	831	823	850	794	644
Asset Class	**'13**	**'12**	**'11**	**'10**	**'09**	**'02**
Domestic Equities	16%	15%	16%	15%	18%	37%
Fixed Income	10%	11%	10%	12%	13%	23%
International Equities	18%	16%	17%	16%	14%	13%
Alternative Strategies	53%	54%	53%	52%	51%	25%
Short-term securities/Cash/Other	3%	4%	4%	5%	4%	1%

** dollar-weighted averages*

Asset Class	**'13**	**'12**	**'11**	**'10**	**'09**	**'02**
Domestic Equities	31%	30%	31%	30%	31%	47%
Fixed Income	18%	21%	19%	21%	21%	27%
International Equities	18%	16%	17%	16%	15%	10%
Alternative Stragtegies	28%	28%	27%	26%	25%	12%
Short-term securities/Cash/Other	5%	5%	6%	7%	8%	4%

** equal-weighted averages*

Source: NACUBO



Second, to top the whole thing off and truly lay the groundwork for seven to ten years of small-cap misery, you needed the equivalent of the Sports Illustrated curse. This came in the form of passive investing guru, Dr. Eugene Fama, receiving the Nobel Prize in Economics for emphasizing the historical outperformance of small-caps in indexing and asset allocation. He is a big believer in the idea that active management is for the birds compared to passive investments, especially the "smart beta" passive indexes which his company propagates. Bachman-Turner gave you all the asset allocation advice you need in this set of thoughts:

> **And now I'm feelin' better**
> **'Cause I found out for sure**
> **She took me to her doctor**
> **And he told me of a cure**
> **He said that any love is good love**
> **So I took what I could get**
> **Yes, I took what I could get**
> **And then she looked at me with them big brown eyes**

Returning to 1984 and You Ain't Seen Nothin' Yet, we all need a "cure". The S&P 500 went on to beat the Russell 2000 by 48% in the four-year stretch from June 30th, 1983 to June 30th, 1987. Each up market move saw large beat small and each down market especially punished small-cap stocks. Interest was also significantly diminished in glamour techs, a warning sign for owners of today's exciting and frothy darlings. In our opinion, when the wholesaler promoting alternatives shows up at your office, you better claim to be on vacation. When the doctor with those "big brown eyes" comes trumpeting small-caps and "smart indexes," don't make eye contact. Smead Capital believes only meritorious and undervalued securities are "good love".

When the wholesaler promoting alternatives shows up at your office, you better claim to be on vacation.

We think investors should join CALPERS (who ditched hedge fund investments) in a pull back of capital (love) from hedge funds and reduce or eliminate commitments (love) to private equity while they wait for the big-time debacles to show. We believe this will lead to a mass exodus back to less expensive large-cap stocks, a process in the early stages. Some bear markets cure concentrated over-capitalization of asset classes like 2000-2003 and some clean out everything in total liquidation like 2007-09. We at Smead Capital believe the next cure will be centered in small-cap stocks, frothy conceptual tech stocks, hedge funds, private equity and high yield bonds/loans attached to them. Since we can't stutter in the process of writing, we'll share our last thought in BTO lyrics:

> **You ain't seen nothin' yet**
> **B-b-b-baby, you just ain't seen n-n-nothin' yet**
> **Here's something, here's something your never gonna forget**
> **baby, you know, you know, you know you just ain't seen nothin' yet**

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