SMEAD capital management

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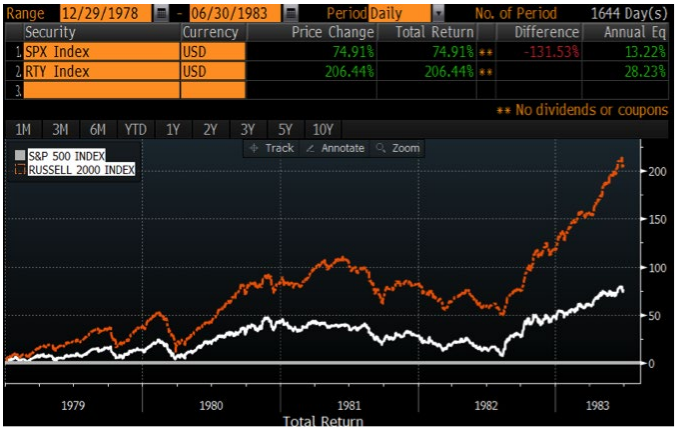
## 2014: Once more for '84

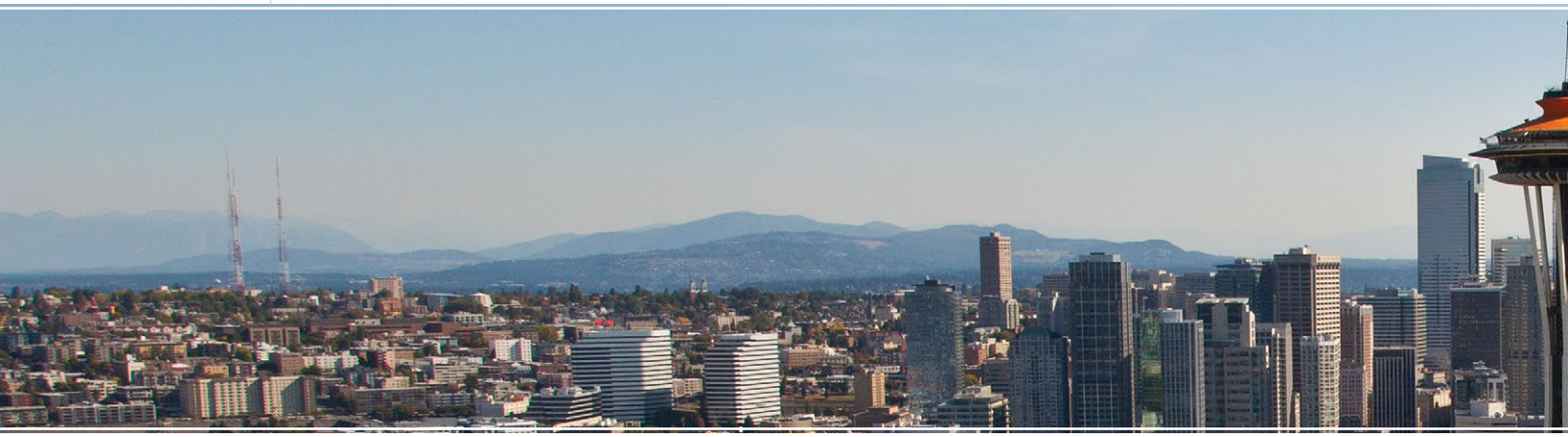
Since our thinking is always dominated by owning businesses which meet our eight investment criteria in a long-duration time frame, we continue to remain vigilant of the circumstances around us. To that end, we thought it would be helpful to review a similar historical situation and glean a feel for what was wise behavior back then and what might be wise behavior as we look forward to the year 2014.

The terrible US economy and high unemployment of 1980-1982 was the closest thing to 2008-2011's economy in the last 50 years. Unemployment exceeded 10% and baby boomers were flooding the job market from high school and college. The price of money (interest rate) was so high that sensible people felt that there was no possibility of the economy being any good until those rates went down substantially. (Stocks traded at extremely depressed prices due to high discount rates and the way that inflation had ravaged investor sentiment and attitudes in the prior decade.) Gold, oil, real estate and fast growing, small-cap stocks were all the rage because of the belief that they were the best way to benefit from those circumstances.

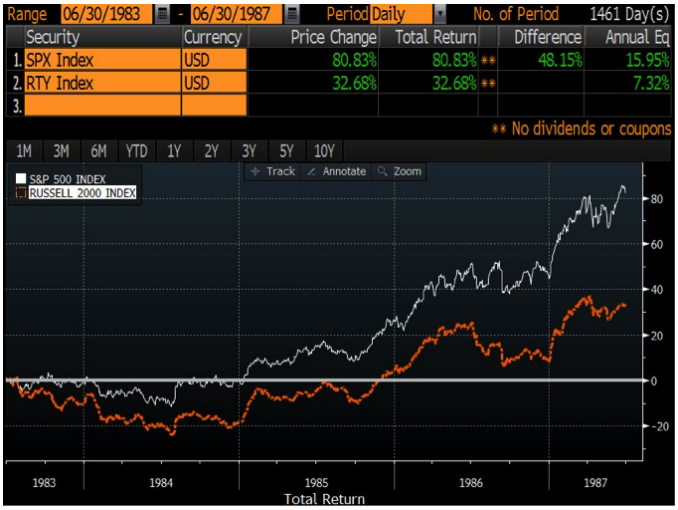
When the S&P bottomed at 102.42 in August of 1982, there were few—if any—optimists. The Dow Jones Industrial Average had made no headway since 1966's high around 1000 and stood below 800. The first leg up in the bull market which started on August 10th of 1982 took the S&P 500 to 173 and the Dow to 1200, peaking in June of 1983. Long-term interest rates bottomed around 11% and started a move to 14% in 1984. Bullishness was rampant and sentiment readings were some of the most optimistic that I've seen in my 33 years in the industry. Small-cap US equities had been hot even before the bull market took off because of their perceived higher growth rates and their seeming ability to outperform inflation. The market got nutty in the spring of 1983 and the lowest quality securities and riskiest investments were at the top of everyone's list. Below is the chart of the Russell 2000 Index as compare to the S&P 500 Index from the end of 1978 to the end of June of 1983:




Source: Bloomberg



What were the biggest risks in the stock market by the mid-point of 1983? At the time, it appeared that the biggest risk was that the crowds' agreement on the inflationary premises would get blown out of the water (it did). The second big risk seemed to be that all the air would come out of the small-cap enthusiasm and concept/risky stocks. See the chart below of the S&P 500 versus the Russell 2000:



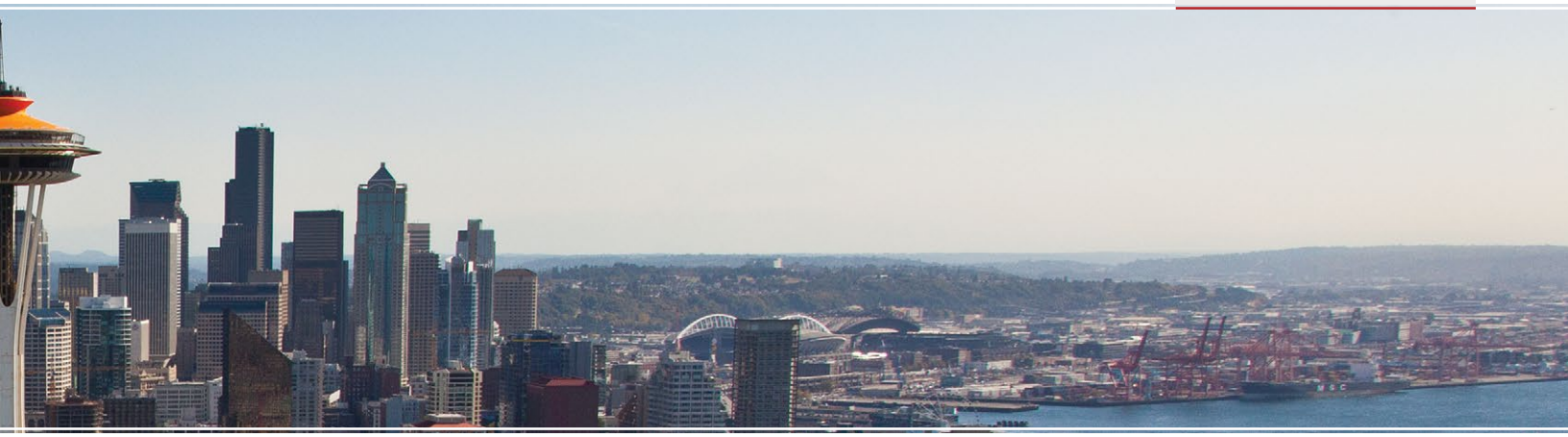

Source: Bloomberg

From the chart above, you can see that the US stock market corrected for 18 months. You can also see that small caps, as represented by the Russell 2000, suffered a bear market decline of greater than 20%. Worse than the bigger decline in the correction, small-caps lagged large-caps for the following three years, rubbing salt in the wound.

The long-term picture only added to investor grief as the S&P 500 Index was on its way to 368.95 at its peak in 1990 and 1469 by the end of 1999. The long-duration common stock investor would have been hood-winked by any urge to defend capital against the correction in large-cap stocks in June of 1983 to June of 1984.

Where are we today? In the eyes of Smead Capital Management, we are in a similar situation. The "real" economic recovery started two years ago as housing and auto production began to ramp up to meet the needs of the 86 million echo-boomers. Interest rates are rising like they did from June of 1983 to June of 1984. With the US population of 315 million people, echo-boomers are now a bigger economic factor than the baby-boom generation. The best performing domestic equity asset class in the last five to 15 years has been small-cap stocks, which were first boosted by owning most of the small energy companies in the US at the market lows of 2002. In the last five years small-cap equities have been boosted by institutional investors piling into them because of how well they had done in the prior years and the beauty of hindsight via rearview mirrors. Small-cap domesticity has also been a source of outperformance. Here is the chart of the Russell 2000 versus the S&P 500 since the low of the 2000-02 bear market:


Source: Bloomberg





You can see that small caps have been a big winner and the outperformance spread is currently the highest during the entire time period.

Today the Russell 2000 trades for 21.9 times First Call's 2014 earnings estimates and the S&P 500 trades at 15.3 times 2014's estimate. We suppose the board members of public companies, especially concept stocks, are so arrogant that they never split their stock prices to make them more affordable to individual investors. The Nobel Prize committee rained accolades on Eugene Fama for highlighting the long-term benefits of small-cap index investing. Money management firms emphasizing US small-cap stocks are being drowned in money. Price-to earnings ratios on today's popular glamour "new era" stocks are in the range of 60-100 time earnings and some of that is reflected in the S&P 500 Index through companies like Amazon, Zillow and Netflix.

It seems to us that one of the big differences between now and mid-1983 is that much of the mania associated with young, fast-growing concept companies resided in the small-cap Russell index, rather in large-cap companies. Today, the enthusiasm for futuristic and exciting concepts is a large-cap phenomena right from the get-go! Facebook, LinkedIn, Twitter and other recent IPO's have skipped over being part of the small-cap outperformance by having huge capitalizations on day one. They are joined by nearly uninterrupted "new era" excitement surrounding stocks like Zillow, Amazon, Netflix and the like. We believe that the huge spread from 1979 to June of 1983 in the small-cap versus large-cap indexes was magnified by it containing almost all of the nutty enthusiasm.

Therefore, what was the right thing to do in 1983-84 and what is the right thing to do now? We believe the following makes for good sense. First, it was smart to avoid frothy common stocks, regardless of market cap. Second, form a positive vision of the next seven to ten years in the US economy. Great demographics, affordable housing, low interest rates, strong banks, a cleansed economy, terrific household income statements and the humility handed out in the 2007-09 financial meltdown are what we believe are exceptional ingredients for the future. Lastly, ignore the urge to time the market. Trading a 10-20% downside in the near-term for 100% upside potential over the next seven to ten years is a solid risk/reward relationship, in our opinion. Getting involved with the companies you want to own for the next ten years seemed to pay off back in late 1983 through mid-1984, why not now?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