SMEAD
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It's Not What Happens That Matters

Late in 2008 and in early 2009, a group of what we like to call "brilliant pessimists" hit the airwaves with their economic theories. The prognosticators' vision of the future was and is predicated on the history of similar situations and the mathematical realities of the huge debt overhang from the prior ten years of profligate economic behavior. They put very effective names on their visions like "new normal" and "seven lean years". They marketed their visions incredibly well to the point of shaming anyone who might disagree with their theories. Their beliefs quickly became accepted as "well known facts" and filtered into the asset allocation of almost every well researched asset allocation portfolio.

We at Smead Capital Management believe that it is not what happens which matters, but rather what was anticipated to happen compared to what actually happens. We also believe the asset allocation of institutions and advisors at extremes matters dramatically more to what actually happens than what was expected to happen. This is why we put so much of our emphasis on psychology as a key portfolio management discipline.

A "well known fact" is a body of economic information which is known by everyone in the marketplace and has been acted upon by nearly everyone who would care.

We will start this thesis by reviewing a few past "facts" from history and compare what happened to what was anticipated to happen. We will then cover what we think are today's "well known facts" and hypothesize the investment outcomes.

In the late 1960's and early 1970's, the US stock market and economy began to struggle under the weight of two decades of prior success and a very expensive war we fought in Vietnam. The more the stock market struggled, the more capital left broad market ownership and gravitated toward a group of continuously successful growth

companies. These companies were thriving despite the economic difficulty and ultimately attracted an inordinate part of the total stock market capitalization in the US. The theory was that these were "one decision stocks" because the only decision you needed to make was to buy them in the first place. They eventually became known as the "Nifty Fifty" and sported PE multiples of 23 to 100 times earnings. Their PE multiples dwarfed the market averages all the way until the end of 1972. The "well known fact" was that these companies would be so consistently successful that it didn't make any difference what you paid to buy into their shares.

By the end of 1974, the US finished one of its worst bear markets of the last 70 years and many of the "Nifty Fifty" stocks fell 80% in two years. A number of those companies like Disney (DIS), Coca Cola (KO) and McDonalds (MCD) proved to be as successful over the next four decades as what was expected, but few humans are capable of sitting through 80% losses to get at that success. Warren Buffett reminded us in 1999 that US institutional investors had 74% of their portfolios in US equities at the beginning of 1973 and were down to 13% by the market bottom in 1974. The 74% ownership was dominated by concentration in the "Nifty Fifty", which is how the multiples got so high in the first place. The universal adoption of the "well known fact" doomed its theorists even though great wealth was created by the best performers among the "Nifty Fifty" over the following decades.

From the early 1970s, when the US divorced its currency from gold reserves, to 1980, the US economy became engulfed by double-digit inflation. Baby boomers were graduating from high school and college, getting married, having kids and buying houses in record numbers. This demand combined with accelerating inflation to fuel group think. "Brilliant economic pessimists" like Henry Kauffman and Albert Wojnilower (Dr. Death and Dr. Doom) forecast inflation as far as the eye could see and expected interest rates to rise dramatically higher than the 15% Ten-Year Treasury Bond peak and 20% bank prime customer interest rate. Market participants hung on every word that came out of Salomon Brothers and First Boston, their respective firms.

Commodities like gold and oil were all the rage.

The "well known fact" by the beginning of 1981 was that you either wanted to invest in something which benefitted directly from inflation or that any company you invested in must have very fast future growth in excess of the inflation rate to justify its purchase.

Simultaneously, Treasury bond interest rates rose and pummeled bond investors during the culmination of a 30-year bear market in bonds. Bond investments and slow but steady US Blue Chip stocks were neglected in a historically extreme way because they didn't fit the "well known fact". In this case, what ended up happening was just the opposite of what the "brilliant pessimists" thought (inflation peaked and soon declined swiftly), but even if they had been correct, there wasn't anyone with capital around who disagreed with them to pursue the agenda implied by the "well known fact".

Finally, a technology revolution was started by Apple and Microsoft in the early 1980's and exploded into public consciousness in 1995 when Netscape went public. Led by tech stocks, the S&P 500 index tripled in five years and the premier technology companies like Cisco, Sun Microsystems and EMC quickly sported PE multiples to match the old version of the "Nifty Fifty". A new era was upon us and those who pursued ownership of these tech stocks felt like pioneers and part of a major land grab. It wasn't a land grab; it was grabbing their share of cyberspace.

The "well known fact" quickly became: THE INTERNET IS GOING TO CHANGE OUR LIVES.

A group of "brilliant optimists" became media darlings, led by big picture thinkers like George Gilder and research analysts like Henry Blodget and Mary Meeker. Investors hung on every word. By 1999, the S&P 500 index traded at a stratospheric PE of 30 and technology stocks traded routinely at 50-100 times earnings, if they had any. It became unmercifully uncomfortable to sit out this mania for stock pickers.

Much like the "Nifty Fifty" episode of 1972-1974, the believers were right about the "well known fact". The internet has changed all of our lives. However, a bear market of over 40% occurred from March of 2000 and lasted until October of 2002. Tech stocks fell 80% and were well represented by the tech-heavy NASDAQ INDEX (which fell from 5047 on March 9, 2000 at the peak to 1114 at the low on October 9th of 2002, a loss of 77.9%). Today, George Gilder is never heard from, Henry Blodget is banned from the business of researching equities and Mary Meeker analyzes something besides dotcom companies. Nobody was left to apply capital to the "well known fact".

What have we learned from this exercise? First, once almost everyone with capital has committed to the "well known fact", it is useless to pursue the agenda. Second, the losses are just as high when you are right about the future as they are if you are wrong. Third, hardly anybody remembers the "brilliant" economic thinkers twenty years later whose words everyone hung on.

This brings us to what we believe are the current "well known facts". Today's list is unusual because it is long and completely intertwined with the most important current "well known fact". Here is our list:

1. **China's command economy is capable of avoiding recessions and depressions (The Most Important Well Known Fact of Today)**

2. **Emerging market countries will create a huge and growing middle class which will demand the same goods and services that folks in developed economies demand**

3. **Commodities have reached a permanently higher plateau**

4. **Wide asset allocators can succeed by diversifying into emerging market stocks and bonds, commodities and internationally-oriented high quality US multi-national companies to benefit from the first three "well known facts"**

5. The US economy and US stock market are cursed until the deleveraging process is finished by the "new normal" and the "seven lean years"

We believe the only possibility of China becoming the largest economy in the world would be if they accept the cleansing affects of a three to four-year recession/depressions. In our vision, they need to completely recapitalize their banking system (which is already overwhelmed by 2008-2011 stimulus losses), de-emphasize fixed asset investments and liberalize economic freedoms along with capital flows. The US grew 9% per year on average from 1800 to 1900 and we had 18 recessions, three depressions and three all-out panics. We flushed fraudulent investments, poor lending practices and re-balanced massive capital misallocation in the process. Those cleansings were foundational to the success of the US economy.

Most of the emerging markets suckle on China's success and sell them commodities. In our opinion, Brazil, Russia, Indonesia, Malaysia, Vietnam and other emerging countries are in a world of hurt in the next ten years because they are at the mercy of US investors' belief in China's uninterrupted growth. When China gets a cold, they may get pneumonia.

If China gets pneumonia, we expect the US to get calls for foreign aid.

You can put Australia and Canada in the same boat as commodity-producing emerging market countries, as well as US farmers and oilmen/women. We believe it won't matter that these sovereign governments started out with stronger fiscal finances, because their tax revenues will go off a cliff, just like tech IPO underwriting did in the tech wreck.

In our view, the permanently higher plateau in commodities is completely a function of the borrowed money the Chinese used from 2008-2011 to avoid the worst of the 2007-2009 recession. Fixed asset investment is massively capital and commodity use intensive. We believe unemployed construction workers in China won't buy a house, a car, a steak, a cell phone or much of anything else for a prolonged stretch once reality sets in. If we are right, commodity prices will plummet and the US economy will be stimulated by lower oil and input prices. We believe it will look very much like 1981-1999.

US institutional investors and high net worth individuals have organized their asset allocation around the first four "well known facts". If you go to a financial adviser in Havre, Montana, you'll get the same basic advice you would get from the most expensive high net worth shops in New York City. Healthy dollops of emerging market stocks/bonds, gold and significant commodity exposure directly and through US equities is essential for the crowd today. We believe they have extrapolated the last 13 years just like the "Nifty Fifty" fans of 1972, the inflation speculators of 1980 and the tech stock addicts did in 1999.

A perfect example of this is represented by the NACUBO study of the largest endowments and foundation investors in the US. In 2002, at the end of the year they had 36% of their dollar-weighted portfolios in US equities and by the end of 2010 had dropped down to 15%. Lipper and anecdotal evidence indicates that could be as low as 12%

now. The recipients of the money were emerging market stocks and bonds, commodities and alternative investments like farmland, real estate, private equity and hedge funds.

The SPDR Gold Trust ETF (symbol GLD) went from not existing in 2003 to holding more gold than the nation of China as of September of 2012. All gold ETFs and ETNs combined owned enough gold in September to be the third largest owner in the world among sovereign nations (only exceeded by the US and Germany). Convicted felons and washed up singers tell you all day long on TV why you should own gold. If we keep going with the gold bull market from here, the gold sales organizations might have to use audio-animatronics on their spokespeople the way Disney did with Abraham Lincoln in the exhibit, "Great moments with Mr. Lincoln". Their target audience is the over-60 crowd who think the US is "going to hell in a hand-basket".

Don't laugh at the older generation. Hedge fund managers have been drinking the same "kool aid" under the group think idea that US monetary ease will go on long enough to continue to de-base the US dollar. They do this as if they are by themselves in their belief and as if it is original thinking. Recently, a highly-respected hedge fund manager made fun of Warren Buffett about his disdain for gold investing in almost the same way that his lack of tech stocks in 1998-99 opened Warren up to criticism. All of this rhymes to us.

Lastly, we expect deleveraging to be a net drag on US economic growth, but we expect lower commodity prices and a huge housing cycle over the next 5-7 years to lead an economic recovery better than the "brilliant pessimists" see coming. There are 85 million echo boomers, average age around 28, who will want to marry, have kids and buy a house. The last time the US had a demographic set up like this was when boomers like me had an average age around 28 in 1984. Back then, the "brilliant pessimists" told us that until mortgage and other interest rates came down that the US could never have the kind of economy which would bring down structurally high unemployment left over from the deep recession of 1980-1982. They said to avoid stocks until all the problems were solved and they missed out on most of the 1982- 1999 bull market in stocks. Even if the pessimists are right, we've already learned that you can lose as much being right because it's not what happens that matters, it is what was expected that matters.

In summary, we feel the unanimity among owners of wealth and their asset allocation at extremes dooms them to poor performance and is proven by history. "Brilliant" prognosticators identify the episodes at the extreme. In our book, courageous investors can be well compensated for doing the opposite of what the "well known fact" would tell you. In our view, today's "well known facts" have the same characteristics prior ones had at the most important stock market junctures of the past 50 years. ■

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