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Political Punching Bags

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Dear Fellow Investors,

The United States has one of the most successful biotech/pharmaceutical industries and arguably the premier banking institutions in the world. During the current presidential race, populist politicians on both sides of the aisle have gained a great deal of popularity by turning these two industries into political punching bags.

Consider the characteristics of a punching bag: its composition, strength and durability.

A punching bag is built with a cylindrical shape and has a very strong exterior cover. It is composed of materials which absorb the blows of a boxer or a martial arts specialist. The outer covering stretches while the interior materials give way to protect the puncher's fists, arms, feet and legs. Despite the abuse a punching bag takes, it returns to its normal form after numerous daily assaults.

At Smead Capital Management, our eight criteria for stock selection look for a certain composition, strength and durability in a company. To qualify for our portfolio, a company must meet an economic need and have significant barriers to entry to ward off potential competitors. The company has to have a history of high profitability, consistent free cash flow generation and be available at a bargain price compared to the last five to ten years of trading. We also prefer companies which have a strong balance sheet, have a history of shareholder friendliness and have significant insider ownership, preferably with recent insider purchases.

These eight criteria allow the companies in our portfolio to take punches over the years from potential competitors and government regulators — and take political kicks in the face from populist candidates. They are strong and durable just like a punching bag.

Bernie Sanders, Hillary Clinton and Donald Trump have been racing to see who could give away the most healthcare freebies. Even though prescription pharmaceuticals are only 10% of the cost of healthcare in the U.S., these politicians would like voters to think that political pressure on 'Big Pharma/Biotech' would solve all our healthcare expense problems.[1] It reminds me of Pedro running for class president in the movie, *Napolean Dynamite*. In the movie, Pedro told his fellow students, "Vote for me and all your dreams will come true."

Investors act like this is the first time these companies have been punched. From 2003 to 2011, the regulatory, political and legal environment for Amgen, Merck, Pfizer and others was miserable. The Food and Drug Administration was tight as a drum, the populists were out in force and Vioxx lawsuits were large and fresh in investors' minds. If these companies weren't as strong as a punching bag, their mouths would have been bloody and their teeth would have fallen out. Fortunately, they have seen their moats get bigger and their future get brighter as improving science has led them to breakthrough medicines needed by an ever-growing population.

Amgen might be the most superior company we've ever run through our screens. They have more cash than debt and high return on equity. They expensed 19% of revenue for long-term research and development, have shrunk their shares outstanding by 42% in 13 years through stock buybacks and have paid dividends since the summer of 2011.[2] Their dividend is $4.00 this year, a nearly 3% yield.[3] For it to trade at a sizable discount to the S&P 500 Index is just the kind of travesty we crave as common stock holders. This is the cheapest Amgen and the other three largest biotech companies have traded to the index in the last ten years.

The banks are as well capitalized and risk adverse as they have been since I entered the investment business in 1980. They have seen lower oil prices, regulatory criticism (CCAR, etc.) and political populism (Bernie Sanders and Elizabeth Warren) more recently than they ever have. Wells Fargo is over 160 years old, JPMorgan is 121 years old on the Morgan side and Bank of America was originally started as the Bank of Italy in 1904. It is safe to say they have been punched many times and in many ways before. Now popular culture is also kicking them in movies and at the Oscars podium. The result is the chart below, which comes from Michael Hartnett at Merrill Lynch:

Chart 4: US bank stocks relative to US market since 1941

Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg, Global Financial Data (GFD)

Investors are avoiding these companies because they will be the subject of populist rhetoric for the next eight months leading to the election. The conventional wisdom is to wait until there is light at the end of the tunnel. John Templeton, the great mutual fund manager said, “If you can see the light at the end of the tunnel, you are buying too late.”

We don’t think that history will treat these wonderful companies in medicine and banking any different in the future than they have in the past. They will take the recent blows by stretching on the outside and absorbing impact on the inside. We believe their profitability and moats will grow along with their free cash flow and dividends. Over time, we believe the regulators and politicians will exhaust themselves and move on to punching a different set of companies.

Warm Regards,

William Smead

[1]Source: Centers for Medicare & Medicaid Services. *NHE Fact Sheet.* https://www.cms.gov/research-statistics-data-and-systems/statistics-trends-and-reports/nationalhealthexpenddata/nhe-fact-sheet.html
[2]Source: Bloomberg
[3]Source: Bloomberg

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