Incentives Pivot from Greed to Fear

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Dear fellow investors,

The talk of inflation today looks much like housing did in 2007. Evidence is mounting everywhere that this is a real long-term problem that is only getting worse. You can read this in the media, but yet security prices don't reflect how damaging this may be. Bond investors' pivot from greed to fear could crush seemingly safe investments. Equity investors could be hurt by the stock market failure of an elongated equity euphoria that finally got the dumbest investors on board (millennials). This would be damaging to net worth for individuals and institutions alike. It just goes to show how powerful incentives are. What we will learn is how swiftly they can change.

When we think of the power of these incentives, we are reminded of a talk Charlie Munger gave at Harvard in the 1990's. Over the years, Munger has captivated investors with his plain-speaking common sense. He would explain it as his determination to practice ignorance avoidance. Charlie pointed out in his Harvard talk that incentives increase good or bad behaviors, based on the incentive structure.

> *One of my favorite cases about the power of incentives is the Federal Express case. The heart and soul of the integrity of the system is that all the packages have to be shifted rapidly in one central location each night. And the system has no integrity if the whole shift can't be done fast. And Federal Express had one hell of a time getting the thing to work. And they tried moral suasion, they tried everything in the world, and finally, somebody got the happy thought that they were paying the night shift by the hour and that maybe if they paid them by the shift, the system would work better. And lo and behold, that solution worked.*

Understanding incentives is hugely valuable for investors. When interests align, it can cause powerful change in a business, an industry, investment returns or in life. At Smead Capital Management, one of our criteria speaks to this directly: strong insider ownership. We think this criterion aligns our interests with the people that run a company. We admittedly know that you can't always get this in every business you own. For example, the bigger the company and the older it is, the less likely you are to find it. All things equal, you'd want to see strong insider ownership, so that you know the risk to your net worth is the same for the people running their businesses. In the modern era of handing stock compensation out like candy to executives in the name of incentive and alignment, understanding the executive ownership and its genesis continues to be a growing field of study for us and our investors.

One of the most common questions we receive from our current and prospective investors is around inflation. As investors at Smead, we believe we are staring at an era of price increases. Why isn't the bond market pricing any of this in? Further, looking at Treasury TIPS (Treasury Inflation-Protected Securities) or breakeven rates, why are there no implied problems with inflation? Lastly, why isn't inflation being priced into equity markets if this is truly coming down the pike? We believe all of these questions should be pondered deeply.

Now let's flesh out the incentives for the participants. Is it in the best interest of the investors or the issuers in the bond market to recognize higher inflation? No. Investors would lose money as bond prices would likely decline and the issuers don't have an interest in paying higher rates. Does the stock market, both its investors and its issuers, have an interest in recognizing higher inflation? No. Investors would wake up with a situation where fewer new investors may be interested in paying today's valuation for stocks with today's news of inflation causing a change in what someone may pay. Further, companies would be valued lower based on this, in aggregate, leaving the stock compensation schemes of the U.S. stock market needing adjustments as executives wake up to less personal incentives from lower stock prices.

Many people can understand this incentive structure, but what investors really want to know is, "when?" You can know whether. You can't know when. However, we know that investors can, for periods of time, look beyond the facts of the situation to come up with erroneous prices under incentive structures that don't align with correct prices.

To get a hint of why timing is so hard, especially at extremes like today, we would direct investors to an excerpt from Michael Lewis's book, *The Big Short*. Michael Burry and his lawyer, Steve Druskin, were buying insurance on CDOs to profit from their default. These were synthetic securities that would make money if mortgages began to fall behind on their payments and default. The odd thing to them was the news of hedge funds failing, that owned mortgage paper, and homeowners in trouble were already being written about in the media.

> *"One of the oldest adages in investing is that if you're reading about it in the paper, it's too late," he said. "Not this time." Steve Druskin was becoming more involved in the market—and couldn't believe how controlled it was...It was as if Wall Street had decided to allow everyone to gamble on the punctuality of commercial airlines. The likelihood of United Flight 001 arriving on time obviously shifted—with the weather, mechanical issues, pilot quality, and so on. But shifting probabilities could be ignored, until the plane did or did not arrive."*

This was an extreme in the belief of the housing market never going down. We know all these stories from Mr. Lewis's book and the movie that followed. Why did the incentives eventually change, despite the evidence that could be seen long before?

Incentives did broadly change. Bank CEOs went from wondering how much money they were making, to whether or not they would survive. Investors went from being as long real estate as they had ever been on borrowed money, to walking away from homes at record levels and sending housing into a depression. To put into the words of a contrarian investor, incentives pivoted from greed to fear.

Fear stock market failure,

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