SMEAD capital management

The Gestalt of the 2020's

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Dear fellow investors,

Today's atmosphere is one that we rarely see as investors. This is not like junk bonds in the 1980's or the run up in Valeant Pharmaceuticals and the other generic drug companies in the 2010's. There is not a narrow way of looking at today. It is broad. To explain what the psychology is, someone would have to explain an opinion on central bank policy, inflation, crypto currencies, ventures, gamified trading and SPAC-money raising. Our issue with the psychology is that this era is being treated like these things all add up to something greater than the sum. In other words, we are on the steps of something that we've never had before.

We find the psychology to be very troubling as one plus one doesn't equal three. When banks, economists and investors coronate permanence to situations, we get nervous. Ultimately, this gestalt mood is infected by the cost of money being far too cheap. This causes some to make reckless decisions to gain returns. This also may cause people to take incredible American businesses and pay the highest valuation multiples for them ever. These same investors hate what the bond yield will prospectively pay them. They may also be misreading the inflationary pressures lying ahead, like any typical unknown future.

To help investors understand this, we'd like to look at a recent exercise we performed in a former holding of our investors: Accenture (ACN). Wall Street believes that Accenture will grow their earnings at roughly 10% going forward. Ben Graham's revised formula values a business that doesn't grow at 8.5x earnings. Graham felt that growth was worth twice as much in valuations (2 times growth rate). In Accenture's case, this would leave someone with 28.5x earnings. The last thing needed in the Graham formula is to adjust for prevailing interest rates. Graham witnessed 4.4% for most of his years. To adjust for this base rate, he divided that long-term rate by the AAA corporate bond yield. This stands at roughly 3%, which would change the multiplier from 28.5x to 38x. If we take the 2021 fiscal-year earnings (8/31 fiscal year), Accenture produced $8.80 earnings per share. This would leave an investor willing to pay $334.40. As of this writing, Accenture is at $346.

This leads us to two primary points. First, Accenture is a great business, but these are the types of businesses that are being overpriced today. The over-confidence in their ability to grow in the future may be wrong. As we said, the $334 valuation assumes 10% growth. The second point that we draw from Accenture is that the price of their stock is at the mercy of interest rates. This is a more important factor for investors than whether they will succeed in the 10% earnings growth. If the AAA corporate bond yield goes to 4%, Graham's revised formula would say that Accenture is worth $275. This interest rate sensitivity has never been a bigger potential problem for stocks.

Is this the first time American investors have bought blue-chip stocks and lost money in the decade ahead? No. They did it in 1972 and they did it at the beginning of the 20th century as well. As Zachary Karabell wrote in his new book *Inside Money*, about the history of Brown Brothers Harriman:

> *The average investor in 1936 (who statistically would have been in the upper echelons of income) would have, according to Lovett, held a portfolio of blue-chip names such as American Radiator, Anaconda Copper (closely associated with Brown Brothers), General Motors, Sperry Corporation, Standard Oil of New Jersey (now Exxon), Consolidated Edison of New York, and others. Given conventional wisdom in 1936, that portfolio looked solid. That is the problem with most investing. What looks solid in the present often proves to be foolish in the future, and you know that only in hindsight. Take a similar snapshot of a portfolio in 1901. At that time, fewer people owned stocks and corporate bonds and fewer companies sold shares to the public, but using the records kept at Brown Brothers, Lovett demonstrated that a portfolio of diversified, dividend-paying stocks equivalent in quality would have performed disastrously. 'After having his capital at risk for thirty-five years of enormous industrial progress and national growth, our investor would show an aggregate loss of about 25 percent.'*

Let's repeat that. An investor owned a common stock portfolio for 35 years and lost 25% during that period!

We highlight current and historical examples because these types of events are not new to wealthy investors. Today's gestalt is similar to those of the past. The same spirits crop back up in humans from prior periods. The 1920's had its own gestalt. It was the radio, the automobile and the transatlantic flight all making the era far greater than those things on their own. It invaded the belief and psychology of the average person and the average investor.

The gestalt of the 2020's is no different. SaaS (software as a service) businesses have unlocked a revolution of managerial choices and adjusted-book value accounting. SPACs have revolutionized the IPO process. Bitcoin has made gold look antiquated. Stock investing is as easy as buying or selling 500 stocks in the press of a button on your phone with confetti exploding in your eyes. While all these feel very new, we must, in a matter-of-fact way, recognize that all these things are coming among the lowest rates in the history of the bond markets and at the lowest real yields.

We believe these individual pieces should sound just like the pieces they are. Many investors blend these together and it produces the Gestalt of the 2020's. We pray that prevailing interest rates don't change too abruptly, causing economic damage to the myriad of these parts. We recognize that is a possible outcome. Looking forward a couple of decades, we could see quite a few of these blue-chip stocks produce poor returns and torment long-term holders. The torment from the Gestalt of the 2020's could lead to stock market failure.

Fear stock market failure,

Cole Smead, CFA

President
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