SMEAD capital management

Missive

JANUARY 4, 2022

True Religion in Value

Dear fellow investors,

James 1:27. *Religion that is pure and undefiled before God the Father is this: to visit orphans and widows in their affliction, and to keep oneself unstained from the world.*

Most professionals who employ our strategy are wide-asset allocators. We fill a sleeve in the U.S. stock ownership category and for most, that is in the large-cap space. We compete with other value funds and ETFs, which represent themselves as value strategies. Using the James 1:27 test, how do we stack up at the beginning of 2022 with other value strategies and large-cap managers that are portrayed as value managers?

Pure

For those who seek a value strategy, the first test would be price-to-earnings ratios (P/E) of the portfolios. Morningstar gives a 2022 estimate of the P/E of our whole portfolio at 11.56 and measures us against a value index with a 15.35 P/E and a category average of 14.66. The irony is that we just had the best year in the history of our strategy and our portfolio is trading the cheapest versus our category, index, and the S&P 500 Index it ever has!

Undefiled

We made some very difficult decisions to reduce our holdings of big long-term winners like Disney (DIS), Accenture (CAN) and Starbucks (SBUX). First, we don't believe there are many companies whose stock price can overcome a 40-times P/E ratio over a ten-year time frame. Especially not mature companies which should have lower growth rates in the future than they have had in the past. We invest on behalf of people who we think are asking us to focus on 5-10-year performance. We take that so far as to say that if you are not going to stay with us for five years, don't come into our strategy at all!

Check our competitors to see how much of their portfolio is dominated by holdings among the most popular stocks in the S&P 500 Index. Are they defiling themselves or will they look as smart in three years as they look if they moved in three years ago? Warren Buffett and Berkshire Hathaway own a huge slug of Apple (AAPL). It trades for a 32 times consensus estimates and is no spring chicken. However, he offsets this risk with a massive cash position as large as his holding of Apple. Amazon (AMZN) and Netflix (NFLX) trade for 87 times and 52 times the 2022 estimates, respectively. Will they break the historical mold for another five to ten years?

Unstained

Anyone taken as an individual is tolerably sensible and reasonable—as a member of a crowd, he at once becomes a blockhead.
— Frederich Von Schiller as told by Bernard Baruch

In the book, *A Short History of Financial Euphoria*, the great economist, John Kenneth Galbraith, argues that euphoria episodes are as normal in the stock market as anything else. There is no way to stop price-momentum-dominated-investment markets or time them in the short run.

Features of the Speculative Episode

Some artifact or some development, seemingly new and desirable—tulips in Holland, gold in Louisiana and real estate in Florida—captures the financial mind or perhaps, more accurately, what so passes. The price of the object of speculation goes up. Securities, land, objects d'art and other property, when bought today, are worth more tomorrow. The increase and the prospect attract new buyers: the new buyers assure a further increase. Yet more are attracted; yet more buy; the increase continues. The speculation building on itself provides its own momentum.

Common Denominators

1. Extreme brevity of financial memory
2. Association of money with intelligence
3. Possession of large sums of money must be associated with some special genius
4. Something seemingly new in business in the way of financial instrument or investment opportunity

Today's Financial Euphoria

1. Ignores the Dotcom Bubble
2. Associate being a billionaire with intelligence
3. Treats today's success stories as geniuses (Gates, Bezos, Musk, Hastings, Page, Zuckerberg, etc.)
4. The internet monopolies, Bitcoin, young Robinhood traders, etc. are all symptomatically new in business

Summarized Galbraith Thoughts

> *The circumstances that induce the recurrent lapses into financial dementia have not changed in any truly operative fashion since the Tulipomania of 1836-37. Individuals and institutions are captured by the wondrous satisfaction from accruing wealth. The associated illusion of insight is protected, in turn, by the oft-noted public impression that intelligence, one's own and that of others, marches in close step with the possession of money. Out of that belief, thus instilled, then comes action—bidding up of values, whether in land, securities, or, as recently, art. The upward movement confirms the commitment to personal and group wisdom. And so on to the moment of mass disillusion and the crash. This last, it will now be sufficiently evident, never comes gently. It is always accompanied by a desperate and largely unsuccessful effort to get out.*

Galbraith's Conclusion

> *A further rule is that when a mood of excitement pervades a market or surrounds an investment prospect, when there is claim of unique opportunity based on special foresight, all sensible people should circle the wagons; it is the time for caution. Perhaps, indeed, there is opportunity. Maybe there is that treasure on the floor of the Red Sea. A rich history provides proof, however, that, as often or more often, there is only delusion and self-delusion.*

In conclusion, we pledge to investors that we will remain true to our value discipline and remain vigilant in protecting against the potentially damaging effects of getting defiled in a financial euphoria episode with the most popular and exposed common stocks. Everyone gets stained in a deep bear market, but we seek to own things which are meritorious through the cycles.

Warm regards,

Bill Smead
Chief Investment Officer

This missive and others are available at www.smeadcap.com.

SMEAD capital management

smeadcap.com

2777 East Camelback Road
Suite 375
Phoenix, AZ 85016

Sales Desk US 877.701.2883
Sales Desk UK +44 (0)20.8819.6490
info@smeadcap.com