SMEAD capital management

Newsletter

SMEAD CAPITAL MANAGEMENT — 4TH QUARTER 2021 (12/31/2021)

Outlook 2022: Polar Opposites

There are three pillars of investing for us at Smead Capital Management. First, we must know the history of the stock market. Second, we must understand the mathematics of the stock market. Third, we must understand the psychology of the stock market. As we enter the year 2022, we believe the S&P 500 Index and the oil/gas Industry are at polar extremes on all three pillars.

North Pole

The table below reports the latest values of the eight indicators reported each month by Mark Hulbert from Marketwatch.com. These are the eight ways of measuring ten-year forward return which have been statistically meaningful, according to his research. These regression modules have the best long-term records predicting the stock market's 10-year returns. As you can see, it's not just the average household's equity allocation that is bearish about the stock market's longer-term prospects.

	Latest	Month ago	Beginning of year	Percentile since 2000 (100 most bearish)	Percentile since 1970 (100 most bearish)	Percentile since 1950 (100 most bearish)
P/E ratio	26.51	26.04	39.90	75%	85%	89%
CAPE ratio	39.28	38.08	33.76	100%	96%	97%
P/Dividend ratio	1.33%	1.30%	1.58%	96%	94%	96%
P/Sales ratio	3.18	3.12	2.76	100%	100%	100%
P/Book ratio	4.79	4.71	4.05	99%	98%	98%
Q ratio	2.36	2.31	1.98	99%	100%	100%
Buffett ratio (Market cap/GDP)	2.06	2.00	1.82	100%	100%	100%
Average household equity allocation	50.5%	50.9%	47.6%	99%	98%	99%

Source: Mark Hulbert - MarketWatch

Out of eight shots which demonstrate future 10-year returns, only a wild-eyed optimist below 40 years of age with a Robinhood trading account and a savings account loaded with "stimmy" checks would want to fight this statistical battle.

Largest Companies Globally by Market Cap

Rank	1980 Company	1980 10-Yr Fwd Return	1990 Company	1990 10-Yr Fwd Return	2000 Company	2000 10-Yr Fwd Return	2010 Company	2010 10-Yr Fwd Return	2020 Company	2020 10-Yr Fwd Return
1	IBM	10%	Nippon Telegraph & Telephone	(1%)	Microsoft	5%	PetroChina	(10%)	Apple	?
2	AT&T	16%	Bank of Tokyo-Mitsubishi	(5%)	General Electric	(6%)	Exxon Mobil	(2%)	Saudi Aramco	?
3	Exxon	18%	Industrial Bank of Japan [1]	(12%)	NTT DoCoMo	(8%)	Microsoft	26%	Microsoft	?
4	Standard Oil	10%	Sumitomo Mitsui Banking	(5%)	Cisco	(6%)	ICBC	4%	Amazon	?
5	Schlumberger	(0%)	Toyota Motors	10%	Walmart	2%	Walmart	13%	Alphabet	?
6	Shell	16%	Fuji Bank [1]	(10%)	Intel	(2%)	China Construction Bank	4%	Facebook	?
7	Mobil	11%	Dai-ichi Kangyo Bank [1]	(8%)	Nippon Telegraph & Telephone	(6%)	BHP Billiton	3%	Tencent	?
8	Atlantic Richfield	13%	IBM	14%	Exxon Mobil	8%	HSBC	(1%)	Tesla	?
9	General Electric	18%	UFJ Bank	(8%)	Lucent	(28%)	Petrobras	1%	Alibaba	?
10	Eastman Kodak	8%	Exxon	17%	Deutsche Telekom	(7%)	Apple	30%	Berkshire Hathaway	?
	Top 10 average	*12%*	*Top 10 average*	*(1%)*	*Top 10 average*	*(5%)*	*Top 10 average*	*7%*		
	S&P 500	*14%*	*S&P 500*	*17%*	*S&P 500*	*1%*	*S&P 500*	*14%*		

Source: @CharlieBilello, Bloomberg.
(1) Return for Industrial Bank of Japan, Fuji Bank and Dai-ichi Kangyo Bank is 12/31/1990 to 9/21/2000 (on 9/21/2000, these three banks merged to create Mizuho Financial Group).

Source: Bloomberg.

As you can see above, even if the regression analysis was in your favor, like in 1980, 1990 and 2010, owning the ten-largest-cap companies in the S&P 500 Index was a ticket to underperformance, and in many cases, stock market failure.

Prior Euphoria Episodes with difficult 10-year Regression Numbers

Here are the index results from prior financial euphoria episodes with regression numbers similar to today:

Roaring 1920s

Source: Bloomberg. Bloomberg. Data from 12/31/1928 – 12/31/1938.

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The Nifty-Fifty Stocks of 1972

Source: Bloomberg. Bloomberg. Data from 12/31/1968 – 12/31/1978.

The DotCom Bubble of 1999

Source: Bloomberg. Bloomberg. Data from 12/31/1999 – 12/31/2009.

While the Index appears to be at an extreme on all three of these pillars, how does this guide us as value investors? Can you make money in an elongated stretch of poor index performance? How can you be optimistic about energy when the crowd is bending over backwards to invest in every ESG initiative known to man and portfolio managers are embarrassed or ridiculed into avoiding the energy sector? To answer these questions, let's go to the evidence.

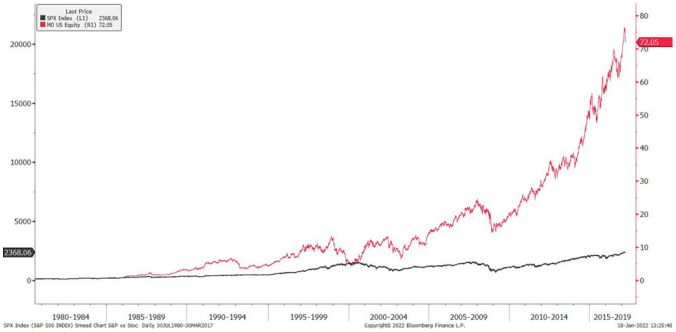
History of ESG Investing

Nixon Signs Bill Banning Radio-TV Cigarette Ads: April 2, 1970

The way we view it, this was the beginning of ESG investing. The government intervened in the free market and mandated that it was not good for our society to advertise cigarettes on radio and television. This led to consistent divestment of tobacco stocks by portfolio managers over the following decades.

Phillip Morris: The best performing stock in the entire NYSE

As you can see below, Phillip Morris (MO) was the single company which was to be the most negatively impacted by the government intervening in the cigarette industry. Ironically, it was the best performing stock of the next forty years and this chart shows its run from 1980 to 2017.



Source: Bloomberg. Bloomberg. Data from 12/31/1968 – 12/31/1978.

Mathematics of ESG Investing

Here is a list of the largest cap stocks in the iShares Global Clean Energy ETF which appear to give investors participation in the seeming ESG gold mine:

Company Name	Weight	Market Cap	2022 Forward P/E	P/CF
iShares Global Clean Energy ETF	**100.00%**	**662,161M**	**43.7x**	**20.1x**
Enphase Energy	8.54%	25,149M	60.7x	72.6x
Consolidated Edison	6.75%	30,132M	18.9x	11.5x
Vestas Wind Systems	6.63%	30,733M	46.2x	28.7x
Orsted	5.67%	53,425M	33.4x	15.8x
Plug Power	5.07%	16,622M	-	-
Solaredge Technologies	5.02%	14,829M	41.7x	97.5x
Iberdrola	4.58%	74,986M	16.3x	8.0x
EDP - Energias De Portugal	4.11%	21,709M	20.6x	17.9x
SSE	3.98%	23,765M	17.4x	9.8x
First Solar	2.96%	9,361M	41.9x	24.0x

Source: Bloomberg. Bloomberg. As of 12/31/2021..

When you sit down to play poker, if you can't figure out who the sucker is at the table, you are the sucker! Why does anyone believe that they can figure out who will win this game? Lastly, the psychology of the moment looks to us like the cartoon below:

We are willing to bet a big part of our ranch that the ESG motive is like buying an effort to find needles in the haystack. Yes, someone will probably be successful out of the hundreds of money-losing companies trying to satisfy morally-arrogant investors. However, the totality of what they will accomplish will look like Geo Cities, Lucent and Sun Microsystems did in 2000-2010, in retrospect. Here is how Warren Buffett describes the logic of the moment:

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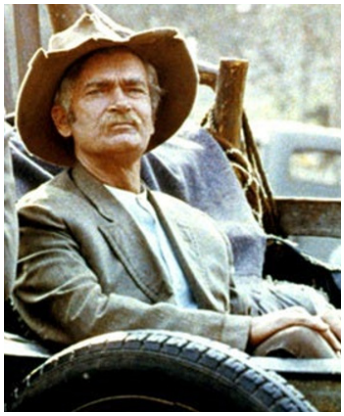
> *"The key to investing is not assessing how much an industry is going to impact society, or how much it could grow, but rather, determining the competitive advantage of any given company and, above all, the durability of that advantage."*

It is enough to make us want to put all this in the Metaverse; which is an extremely heavy energy consumption electronic activity.

Outlook 2022

The best way to understand where we are going is to look at the evolution of the most popular TV shows. In 1962, the "Beverly Hillbillies" debuted and was an instant comedy hit. It was the story of some folks from the country who discovered oil on their property, struck it rich and moved to Los Angeles. The show topped the charts and spawned a series of comedy shows like "Petticoat Junction" and "Gilligan's Island."



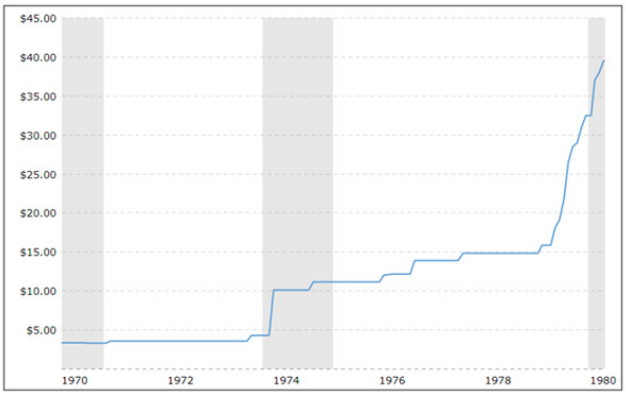
Jed Clampett, Source: Forbes

In 1981, the most popular broadcast television show of all time, "Dallas," was the story of a ruthless and mega-wealthy family (the Ewing family). The eldest son ran the business and was sleeping with women all over town. J.R. Ewing, played by the former astronaut in "I Dream of Jeannie" (Larry Hagman), was shot by someone and everyone had to tune in to find out who shot him. We believe it was the largest market share episode of TV prior to the advent of streaming.

JR Ewing, Source: TNT

You see, Americans were enamored and envious of oil people, because the oil business was the best way to get rich in the 1970s. See the oil price chart below:

WTI crude oil price per barrel from 1970 – 1980:



Source: MacroTrends.

Where are we now? There are no popular oil business TV shows and nobody wants to invest in the future of the business. Even most people who run oil and gas companies don't want to invest in future production or they are being brow-beaten into low levels of capital spending, while trying to please the ESG mafia.

Therefore, a massive amount of relatively inexpensive oil and gas is needed for auto transportation and to produce electricity for electric cars. Like Warren Buffett says, "The people who think we will make a quick transition away from carbon transportation and the people who think we will never transition away from carbon, are both crazy!"

The moral of the story for us is that we need to invest heavily in the attractive and unloved polar extreme of the oil and gas business. Second, we need to believe the overwhelming evidence that ten-year returns in an index, which is overloaded with what you should have bought ten years ago, is dismal. The companies which investors are most enamored with are Apple, Microsoft, Amazon, Alphabet, Facebook and Tesla. This reminds us of when the oil people had the most popular TV show. Remember this while you watch "Spiderman," "Billions," "Succession," and "Silicon Valley."

Thank you for investing with us and coming along for the ride. And, as always, fear stock market failure!

Bill Smead
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Invest With Us Today!

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