SMEAD capital management

Missive

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Tombstone of High Returns is High Volatility

Dear fellow investors,

A couple of weeks ago, we gave a presentation at the first annual Smead Investor Conference near our headquarters in Phoenix. Our goal in the presentation was to help frame how investors think about volatility, or what investors really worry about, drawdowns. We feel it is important for our investors to think about this because our industry and the academics that try to produce thought leadership frame returns purely in the light of risk, also known as volatility.

In my 15-year career in the investment business, I don't think there has been nearly as much weight to making money as there has been in limiting volatility. This creates a good picture of what investors will focus on. It also leaves the stock markets with a problem. If stocks have more volatility than in the recent past, investors will pay less for a broad basket of stocks like the S&P 500 Index, regardless of its underlying economics. Again, they've only been trained to pay for or reward strategies and assets with less volatility.

In a *Bloomberg* article titled "Days of Easy Speculation Look Numbered in War-Shaken Stocks," writer Katie Greifeld lays out the newly-volatile situations investors weren't pricing in just a short time ago. "First, it was inflation. Then came shaky tech earnings. Now Russia. Slowly, then all of a sudden, forces are gathering that threaten to wring out the excesses that defined the post-pandemic era in markets."

These are all risks that weren't comprehendible one year ago. She goes on to say, "Put together, however, they are sowing a sense of exhaustion among traders, sapping sentiment as investors struggle to find reasons to be bullish." This exhaustion is what happens when volatility increases.

Authors Tim Lee, Jamie Lee and Kevin Coldiron argue that this lack of volatility happens over a carry regime in their book *The Rise of Carry*. Carry is a term commonly used when talking about carry trades. These authors write:

> *A currency Carry trade involves an implicit bet on the exchange rate for the borrowed currency in terms of the investment remaining relatively stable. Even for the most attractive of currency carry trades a large adverse move in the currency exchange rates can easily wipe out the interest rate spread. So the currency carry trade is, in essence a bet on the exchange rate volatility being low, at least relative to what the market might expect. It can therefore be thought of as a "volatility-selling" trade—a bet on volatility declining or at least being low relative to market expectations.*

Thinking about investment arenas in light of volatility is very important for us because that is where investors thinking about stocks ultimately go over time.

We can see this practice over longer periods of time in stocks. Peter Bernstein, in his book *Against the Gods*, argues for this view of volatility, or lack thereof, being a premium to extract.

> *From 1926 to 1945—a period that included the Great Crash, the Depression, and the Second World War—the standard deviation of annual returns (income plus change in capital values) was 37% a year while returns averaged only about 7% a year. That was really risky business!*

With higher volatility, investors paid less for stocks. Also, due to the volatility, there was a loss of lending and liquidity as we went from a 10-to-1 margin requirement on stocks to 2-to-1 during that period. Just like a levered carry trade falling apart, as Lee, Lee and Coldiron argue, the stock market watched a drop in leverage, liquidity and valuation from the change in the carry regime. These volatile eras drive investors away from stocks in the same way the 1970s did with its two oil embargoes, stifling inflation and the 2000s with its two nasty bear markets. Investors saw big stock volatility and no real returns during those decades. No wonder households didn't own stocks at the bottom in 2009 even though they were so cheap!

What these eras begat is the pendulum swinging to the opposite end psychologically. As Bernstein goes on to say in his book:

> *Investors brought that memory bank to the capital markets in the late 1940s and on into the late 1950s. Once burned, twice shy. A renewal of speculative fever and unbridled optimism was slow to develop despite a mighty bull market that drove the Dow Jones Industrial Average from less than 200 in 1945 to 1000 by 1966. From 1946 to 1969, despite a handsome return of over 12% a year and a brief outburst of speculative enthusiasm in 1961, the standard deviation of total returns was one-third of what is had been from 1926 to 1945.*

Hello! Does that sound familiar to us as stock investors looking at the S&P 500 since the decade of the 2000s ended? As volatility declined in the passive index (S&P 500), investors paid more for stocks. However, do not confuse brains with bull markets. The S&P 500 represents average investors by definition. If volatility goes up, the average investor does worse. Like then, 1969 was the highest household ownership of common stocks up to that point, as noted by Federal Reserve data. Today, it's the highest ever.

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Do we believe there are things different than the past? Yes. The Federal Reserve's willingness to fund this carry regime makes it unlike the past. It has affected all assets, but not in the same way. Prior to the pandemic, the Federal Reserve's liquidity helped stocks, bonds and other assets like private equity and venture capital. Now, the Fed liquidity is causing consumers, commodities and the economy to boom unlike the prior carry regime of the 2010s. This influence is beginning to force the hand of the Federal Reserve to think a lot about their two mandates: employment and prices. Unemployment is low and we can't find workers: check. Inflation is running rampant: problem.

The prior carry regime of low rates helping stocks can be called the 'buy the dip' era. Every time investors did it, they were rewarded. How much of the last 10 years was masked by the Fed's liquidity subduing the volatility that would have otherwise been wrought on stock investors? This is an answer that we, like John Maynard Keynes, prefer to be "roughly right than precisely wrong." We unequivocally think the liquidity of central banks has affected asset prices, but the easiest way to think about this is volatility. We didn't have a single bear market in the 2010s, enough said. Compare that to other markets around the world. They had more volatility. Thus, returns were worse.

Wonderfully, Bernstein gets us to how we should question the S&P 500 in terms of forward volatility versus the market expectations today.

> *In other words, what do we mean by "normal"? How well does any particular average describe normal? How stable, how powerful, is an average as an indicator of behavior? When observations wander away from the average of the past, how likely are they to regress to the average in the future? And if they do regress, do they stop at the average or overshoot it?*

The volatility ahead, like all carry trades ending, will likely bring higher volatility, lower liquidity and lower assets values than implied today! This makes recent money made look more like nickels in front of a steam roller for passive investors. Our investors recognize how psychological this is as we have reiterated in our recent pieces like The Gestalt of the 2020s, Inflation is a Wolverine and A Dr. Lecter Market. To paraphrase Wyatt Earp, in a Smead way, in the movie Tombstone: you tell them stock market failure is coming and volatility is coming with thee.

Fear stock market failure,

Cole Smead, CFA
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