SMEAD capital management

Missive

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Investing Through Cold Stretches

Dear fellow investors,

We are approximately six to twelve months into a bear market in stocks and bonds. This bear market is the natural consequence of the financial euphoria episode which preceded it. How do wise long-term investors handle these cold stretches in the stock market? Why is it worth fighting through these stock market corrections? How should we as investors behave in a process which takes time, courage and patience?

My Dad, Captain Harold Smead, was what I'd call a successful poker player and gambler. As a ship pilot, he was paid to be risk-averse on behalf of the steamship companies he served. He was very conscious of what he called cold streaks and hot streaks. He had a set of behaviors that he kicked into gear when cold streaks came along.

Rule One: Look both ways twice when crossing the street! My Dad would become much more risk-averse during cold streaks.

Rule Two: Wait patiently for what Warren Buffett calls "Fat Pitches." In poker, it meant playing fewer hands, avoiding marginal hands and playing less often.

- Rule Three: Play through the cold stretches. You have no way of knowing when they will end, but he knew that most of the time he was going to benefit from playing as he competed with other poker players and gamblers.

Let's turn these rules toward the stock market.

Stock Market Cold Stretch Rules

Rule One: Be extra cautious in committing to new ideas or adding to existing holdings. Ask for an even bigger margin of safety than normal in stock selection. Expect former stock darlings to end up despised enough that they will become bargains much farther out in the future.

Rule Two: Hold more cash than normal. When the "fat pitches" show up it is preferable to buy from cash holdings rather than selling depressed existing shares. These existing depressed holdings could be leaders in the next bull market.

Rule Three: Even though this bear market doesn't look done to us, we are convinced that there is very little likelihood that we have a market timing advantage over other investors. We do have confidence in our stock picking discipline and our courage to gain long-term rewards from common stock ownership. We've made it through some pretty ugly bear markets in my 42 years in the investment business!

Rule Four: Find a game to play in which you have a bigger than normal competitive advantage. Thanks to Barry Bannister's research at Stifel Nicholas, we were clued in to a historic low in commodity/oil prices in May of 2020. It is likely that oil will perform well relative to stocks during the next decade, and we are attempting to take as much advantage of that as we can.

At the low, the energy sector bottomed at 2.01% of the S&P 500 Index and is currently 5.12%. Thanks to ESG investment popularity, we have pretty much had oil stocks to ourselves relative to indexes and large institutional pools of money since late 2020. We expect to reap massive benefits from meeting the worldwide economic need for the lowest cost energy source until someday when other forms of energy aggregate to massive scale.

In summary, we appear to be in a "cold stretch" in the stock market and navigating it requires greater than normal caution. There are practical disciplines that could defend our capital until someday when the next bull market comes along. Whether we are in a cold stretch or a hot stretch, we suggest that you fear stock market failure!

Warm regards,

Bill Smead
Chief Investment Officer

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