



Newsletter

SMEAD INTERNATIONAL VALUE — 2ND QUARTER 2022 (6/30/2022)

The Rhythm of the Night

Corona's 1995 classic "The Rhythm of the Night" rings in our ears as we stare at the circumstances that are likely to expose the darkness of the 2020's. We saw the light in the 2010's and will see the night in the 2020's. Our aim for this letter is to give an understanding to investors of the rhythm of what we are likely to see in the road ahead.

*This is the rhythm of the night
The night, oh yeah
The rhythm of the night*

The cost of capital rising is the rhythm we must think about as investors. Below is the 10-year Treasury yield since 1962. Humans eat, sleep and extrapolate, according to Jim Grant. We extrapolated out low rates to be an end-all over the last three to five years. In reality, it was a lift-off period for the cost of money going higher. Thus, mean reversion takes the drum to get the rhythm back to where normalized levels of interest rates have been over decades. The cost of money rising hurts all assets, but for some assets, it could be a bad ending in the night.



*This is the rhythm of my life
My life, oh yeah
The rhythm of my life*

Since we have millennials sitting on our investment team, we know the rhythm of their life has been pretty basic. Low inflation, cheap delivery, whatever goods they want and a shared economy. This was the rhythm of their life. What we now see is persistent inflation,

delivery costs rising with energy and labor prices, a shortage of goods available to consumers and the value of ownership increasing by the day. This value of ownership is increasing on tangible assets like homes or in asset heavy companies. It is tough to compete buying a home when you don't own one already. It will be tough to compete in the car business when others already have the assets to build cars in a scalable way. Asset-intensive businesses could be winning in the stock market for the first time in "my life, oh yeah."

*You could put some joy upon my face
Oh sunshine in an empty place
Take me to turn to
And babe I'll make you stay*

What could put some joy on the investors' face is businesses that benefit from inflation. Some have dubbed these "inflation proxies". Below is a chart looking at an inflation proxy index (SGI) relative to the FTSE Developed Index, a composition of stocks in the developed stock markets of the world.



Businesses benefiting from higher inflation have been punished in the last month of the 2nd quarter. We saw this firsthand in the businesses that we own. Banking, lumber, oil and UK homebuilding companies have all dropped swiftly in value during this same period. We are willing to ride this volatility out as investors have fewer things "to turn to." Wealthy households are getting poorer as we write this. We don't want to take the risks that most institutional and individual investors are taking. Instead, we want to take the type of risks that could "make you stay" wealthy.

The Rhythm of the Night

*Oh I can ease you of your pain
Feel you give me love again
Round and round we go
Each time I hear you say*

Once investors finally accept inflation into their hearts and minds, its stickiness will be very problematic for central bankers. The zeitgeist this causes could trigger a large change in the companies that investors want to own to “ease you of your pain.” Asset-heavy, inflationary-oriented businesses may become the most popular parts of the stock market globally.

As an example, energy as a sector reached 11.49% of the MSCI All Country World ex-US Index on 6/30/2008 while oil prices were sprinting toward \$150 barrel and the price of money was diving to the floor. At recent Brent prices of \$120 and money getting more expensive from every word that central bankers utter, this same index stands at 6.11% as of May 31, 2022. This weight has backed off in the last month, but as the song says, “round and round we go.” While some postulate that the central bankers may “ease you of your pain,” all we know is that stock market investors who under-owned these energy stocks may need to feel to give them some love again.

It seems contrary to say that a world awash in ESG and carbon fears would want these energy businesses so quickly after avoiding them at all costs. It would be strange for a world in love with asset-light businesses to want asset-heavy companies. It would be crazy to see a world that believed that we’d never see inflation again love inflation proxy stocks. These vast movements in price and psychology are shifting right under our noses. After all, “This is the rhythm of the night.”

Fear stock market failure!



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The recent growth in the stock market has helped to produce short-term returns for some asset classes that are not typical and may not continue in the future. Margin of safety is the difference between the intrinsic value of a stock and its market price. The price-earnings ratio (P/E Ratio or P/E Multiple) measures a company's current share price relative to its per-share earnings. Alpha is a measure of performance on a risk-adjusted basis. Beta is a measure of the volatility of a security or a portfolio in comparison to the market. Growth investing is focused on the growth of an investor's capital. Leverage is using borrowed money to increase the potential return of an investment. Momentum is the rate of acceleration of a security's price or volume. The earnings yield refers to the earnings per share for the most recent 12-month period divided by the current market price per share. Profit margin is calculated by dividing net profits by net sales. Quality is assessed based on soft (e.g. management credibility) and hard criteria (e.g. balance sheet stability). Value is an investment tactic where stocks are selected which appear to trade for less than their intrinsic values. The dividend yield is the ratio of a company's annual dividend compared to its share price.

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