SMEAD capital management

Missive

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The Good News: Einhorn is Finkle

Dear fellow investors,

In the 1994 comedy film, *Ace Ventura: Pet Detective*, Lt. Einhorn is the female leading the Miami police's investigation of the disappearance of the Miami Dolphin's mascot, Snowflake. Oddities come up with the investigation. The protagonist Ace Ventura, played by Jim Carrey, figures out that Ray Finkle has been plotting his revenge for his missed field goal kick in Super Bowl XVII ("Laces out Dan"). To his horror, he realizes that Lt. Lois Einhorn is actually the former 1984 Miami Dolphin kicker Ray Finkle. When he and his dog discover that the person investigating the case (Einhorn) was also the perpetrator (Ray Finkle), he declares his most famous line in the movie:

> *That's it. Einhorn is Finkle. Finkle is Einhorn. Einhorn is a man! Oh my God! Einhorn is a man! (He then runs to the restroom to vomit.)*

We think this comedy, which was one of the flicks that put Jim Carrey on the map, is important to revisit as there has been another Einhorn making waves more recently about the subject of value investing. Famed value investor David Einhorn recently did an interview with Bloomberg's Sonali Basak at the Robinhood conference where he said:

> *Relating to value investing, I don't know that value ever comes back. There are serious changes to the market structure. Pretty much most of the value investors have been put out of the business. So if value investing is trying to do security analysis, think about what companies are worth, think about why they might be misvalued or misunderstood and then do valuation analysis that tells you that, that in fact is true. There's just very a few of us left. Most market participants, these days, they either cannot do value. They're just not trained or experienced and knowing how to do valuations or they, they their structure doesn't allow them to. Like if they're an index fund or a passive thing, the last thing you're, you're doi'g is value or their system is a quantitative system or a trading system or an algorithmic system and or, or your style is to just buy things that are, have charts that go up into the right, right and none of those participants are really doing value. So it used to be you know that, that on every conference call of every company there were like dozens of analysts from all of these competing long-only hedge fund, long short people and stuff like that trying to hear what companies were doing and saying and trying to figure it out. And, and those staffs have been gutted because the world has moved passive and so there's just a lot less competition for what we do.*

We agree with some of the arguments that Einhorn makes in this interview. He's right that few investors have the structure today or the capital to go out and exact a value discipline. We thank our fellow investors for that ability. We also agree that most market participants can't do value or have no training to do so. As a 38-year-old millennial, I'm very lucky. I feel like I'm in Malcolm Gladwell's *Outliers*. I'm old enough that I can remember when value did well. Having a father, CIO Bill Smead, practicing this discipline since 1993 has shown me what our eight criteria can provide over long periods of time. I also know that this comes with frustrating periods, as well. I'll never forget the teachers trying to talk stocks with me when I was a sophomore in high school, while the tech bubble was raging. They knew my dad picked stocks. This is the advantage my dad's value investing discipline taught me about being a contrarian. It seemed paramount to success in investing.

To further agree with Einhorn's point, I'm also young enough to have the youthful energy to seek out attributes of companies in the market that aren't currently being worked on by others. Examples would be book value growth from companies buying back stock while they are trading at deep discounts to book. This is similar to return on equity (ROE). However, comes from the balance sheet, not the income statement. Using cost of replacement to understand the value of tangible assets in (yes, I'll say it) elongated run-away inflation. Lastly, finding companies whose bonds have such attractive financing that the stated book value per share of the company should be adjusted higher because you'd have to pay a banker a princely sum to get that financing today! In this respect, the stock market allows us to go back in time to find rates that we'd love to have personally today. These are all elements that are presenting themselves in this chaos that we call the stock market.

Further into the interview is where more of our disagreement builds with what Mr. Einhorn said. Sonali asked, "Well what does that mean for how you operate as an investor If you're saying that so much of the world has turned passive or quantitative, has that made your job fundamentally different as somebody who picks specific securities?" He answers:

> *It absolutely does. It used to be we could buy something at a reasonably low multiple, whatever we thought that was, think that the company would do somewhat better, benefit from it being somewhat better and realize that other investors would see what we saw six months later, a year later and, and, and would re-rate the shares. So you could buy something at 11 times earnings and maybe they would earn 10 percent more, but you'd get another three points on the multiple and you'd make 50 percent over two or three years. That, that*

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isn't happening anymore because there's nobody to notice what actually happens at these companies, so we have to be. The other side of that is, is nobody knows what anything is worth. So there's an enormous number of companies that are dramatically misvalued in ways that we haven't seen before. So as whereas before we might pay eight times or nine times or 12 times would seem like low multiples, but now we can buy a lot of those same companies at three times earnings or four times earnings. And if they're buying back 10 or 15 or 20 or 40 percent of their stock in some cases, eventually we're going to have to get paid by the company as opposed to having other investors figure out what we thought we figured out before them.

David Einhorn is saying that it used to be easier to be a value arbitrageur in the past and easier to find the proverbial fifty-cent-dollar. He would buy and wait for it to "rerate" and then go find a new one. We believe this is flawed. His view of stock ownership doesn't intensify the investor's focus on what companies you can own for a long time. Not all fifty-cent-dollar are alike. His view makes you less interested in Charlie Munger's great company at a fair price, but more importantly the eighth wonder of the world: compounded interest.

He's complaining that it is not easy throughout this interview presupposing that no one can do this anymore. Rather than this being the tyranny and the hopelessness of value as Einhorn explains it, this is the good news and future of value staring us in the face. As Buffet said in the 1998 Berkshire Hathaway meeting: The secret to life is weak competition. We shouldn't complain about how tough it is and how few people are willing to do this. We should celebrate the wealth (alpha) we can capture from this backdrop. We should intensify our work not on which stocks can rerate the quickest, but which businesses that we own can compound our capital inside their business without needing outside investors. It would be great, too, if other minority investors alongside us don't understand the value we see and are more than willing to sell their shares during the next buyback activities. This market is requiring investors to play for keeps.

Ultimately, we think Einhorn is wrong about value. Its day in the sun is here and should be just as fantastic as Ace Ventura's incredible insight that *"Einhorn is Finkle. Finkle is Einhorn."* Einhorn isn't excited and is perverting the opportunity in value, just as Finkle did. Like Ace Ventura, this logic makes us vomit because we believe the truth. What he is doing to scare people further is wrong, just like Lt. Einhorn did to hide the truth. If no one has told you, the future for value is bright. This is the good news.

Fear stock market failure,

Cole Smead, CFA
President & Portfolio Manager

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