SMEAD capital management

Missive

MARCH 21, 2023

Funding Unprofitable Growth

Dear fellow investors,

We have been reminding everyone that we believe we are unwinding a financial euphoria episode that Charlie Munger called the biggest of his career, "because of the totality of it." In the process of its unwinding, the sins committed during the euphoria episode will have a price to pay. Many investments got over-capitalized by nearly free money.

> *"For the near term that's gone," he said, adding that another trend coming to an end is a willingness to fund growth at all costs. "You could call it the SoftBank Vision Fund era, where there was just unlimited amounts of capital to fund losses and growth in unprofitable business models, and I think that's gone." — G. Raymond Zage III*

The current tribulation is closely associated with a myriad of startup companies in everything from tech to clean energy. The Federal Reserve tightened credit by taking short-term rates to 4.75% from nearly zero. In the process, we are now learning that the regional banks most closely associated with new technologies have severe problems and a few have been shut down by the government. The flow of funds to venture capital investments and profit-less growth businesses could possibly come to a halt.

Here is the irony. The on-the-ground real economy is very healthy due to favorable demographics and pent-up demand for goods and services. This is true even while the tech sector, which had been the main driver of the weak economic recovery of 2009-2019, begins to deal with a significant cost of capital in the form of higher interest rates and lower stock prices. Why is the stock market so anxious to buy the dips in their tech stock favorites and treats them as "safe/quality?"

We at Smead Capital Management believe it is because they don't understand how manias unwind. Let's go back to the DotCom bubble, which broke in 2000. We remember at that time that there was very little understanding of the food chain that runs from the venture capital world to the stock market and the mainstream economy.

The tech bubble of the 1990s could have died in 1998 when Long Term Capital Management collapsed. At that point, the stock market declined 20% quite swiftly. Instead of that decline following through to something worse, an explosion of tech spending by corporations, governments and nonprofits to prepare for the Y2K changeover put the tech sector in hog heaven for an additional two years. This spending was designed to stop a worldwide meltdown and disguised a saturation in the marketplace for all things tech related.

Fast forward to today. The Covid-19 lockdown restrictions and the massive U.S. government stimulus triggered an explosion in tech-related equipment, software and connectivity devices for everyone working or learning at home. It also made money free and exacerbated a mania for all things tech and clean energy. Just like in the year 2000 (post-Y2 K turnover), the Silicon Valley Bank failure, ushered in by the Fed tightening credit to fight inflation, is now exposing the way capital will back away from the venture eco-system and further unwind the tech mania.

The poster child for hanging on too long was Lucent Technologies. When it saw its business slowdown in 1999, as the Fed tightened credit back then, Lucent resorted to lending their customers the money to buy more equipment to keep up the façade that they were growing earnings. Lucent crashed and burned in the 2000-2003 bear market and is nowhere to be found today. **At the end of 2000, it was one of the ten largest cap companies in the world.** In addition, Cisco and Intel were among the top ten at the end of 2000, and they haven't seen that high point since.

Therefore, which companies are the vendors to the startups besides the lenders, and who have suckled on the bounteous teat of the free money and unlimited budgets of the startup world? Look no further than cloud services, online advertising, Apple devices/computers and a host of startup businesses that exist to service these startups.

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We are more confident in our shares of Bank of America (BAC) than we are in the glam tech "safe quality" stocks which investors seem to have a big appetite for in this bear market. The fact that they have this appetite leads us to believe that we should continue to fear stock market failure.

Warm regards,

Bill Smead
Chief Investment Officer

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