SMEAD capital management

Missive

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Good Odds and Odd Goods

My father and I both attended a small liberal arts college that was one of the strongest academic institutions in its region and was tough to get into. While it sat far away from the amenities of a large city and was historically weak in sports, it produced a lot of success out of its powerful educational rigor. It was also highly likely for you to marry someone you went to school with. The paradox that this marriage potential created at the college was that the odds are good, but the goods are odd. This is the statement that can be made for common stock investing today.

Understanding the Odds

Gamblers are provided odds on wagers because the future is unknown, but bettors have perceived favorites. The bookmaker in any race or competition adjusts their odds on each outcome to balance the books, so they don't lose money. They want to accept enough bets that they collect a spread on the winner and losers. It doesn't always play out like this, but this is how it works in an ideal world. The favorite isn't always the winner. It's just the most likely winner based on the bets that are placed. The future stays unknown.

A great example of this was a Kentucky Derby party that my wife and I were invited to. We were told to bring cash to place our bets. When we arrived, I found that there were no odds being given on the horses at the party. You got paid the same for the horses that were least likely to be bet on as you did for the horses most likely to be bet on. In a world without odds, there is only one answer. You bet the favorites as you don't get compensated for taking extra risks. I bet what I saw at the time were the top four favorites to win (and advised others to do so as well). You got paid for the win, place and show. At the end of the race, I didn't pick the winner (Mage), who was a long-shot winner, but two of the heavier favorites that I bet on, Two Phils and Angel of Empire, took 2nd and 3rd. Based on the money in the pot, I made 10% on my bets, which was fine by me.

Bad Odds

In today's global stock market, the favorites are known. Below is a chart looking back at the favorites of the global stock market for the last five decades.

Largest Companies Globally by Market Cap

	1980		1990		2000		2010		2020	
Rank	Company	10-Yr Fwd Return	Company	10-Yr Fwd Return	Company	10-Yr Fwd Return	Company	10-Yr Fwd Return	Company	10-Yr Fwd Return
1	IBM	10%	Nippon Telegraph &	-1%	Microsoft	5%	PetroChina	-10%	Apple	?
2	AT&T	16%	Bank of Tokyo-Mitsubishi	-5%	General Electric	-6%	Exxon Mobil	-2%	Saudi Aramco	?
3	Exxon	18%	Industrial Bank of Japan (1)	-12%	NTT DoCoMo	-8%	Microsoft	26%	Microsoft	?
4	Standard Oil	10%	Sumitomo Mitsui Banking	-5%	Cisco	-6%	ICBC	4%	Amazon	?
5	Schlumberger	0%	Toyota Motors	10%	Walmart	2%	Walmart	13%	Alphabet	?
6	Shell	16%	Fuji Bank (1)	-10%	Intel	-2%	China Construction	4%	Facebook	?
7	Mobil	11%	Dai-ichi Kangyo Bank (1)	-8%	Nippon Telegraph &	-6%	BHP Billiton	3%	Tencent	?
8	Atlantic Richfield	13%	IBM	14%	Exxon Mobile	8%	HSBC	-1%	Tesla	?
9	General Electric	18%	UFJ Bank	-8%	Lucent	-28%	Petrobras	1%	Alibaba	?
10	Eastman Kodak	8%	Exxon	17%	Deutsche Telekom	-7%	Apple	30%	Berkshire Hathaway	?
	Top 10	12%	Top 10 Average	-1%	Top 10 Average	-5%	Top 10 Average	7%		
	S&P 500	14%	S&P 500	17%	S&P 500	1%	S&P 500	14%		

Source: @CharlieBiello, Bloomberg
(1) Return for Industrial Bank of Japan, Fuji Bank and Dai-ichi Kangyo Bank is 12/31/1990 to 9/21/2000 (on 9/21/2000, these three banks merged to create Mizuho Financial Group).

What this shows is that the favorites over 10 or 20-year periods don't provide enough compensation for the risks you take in public stock investing. They lose to the S&P 500, and they lose much larger when the S&P 500 has poor returns. You'd assume that if the world knew this, they would not want to overprice these types of businesses. However, people can tell you why these companies succeed despite the probability being so low. The odds are bad for successful bets on these securities. You'd need to go to places where they are good.

The Goods are Odd

Just like finding a mate at my alma mater, as you rake the market for bargains you learn that the good investments today are in odd places. Below is a breakout of the MSCI World Index by sector, showing the price-to-book (P/B) and return-on-equity (ROE) ratios.

Detail

	P/B	ROE
MSCI WORLD (MXWO)	2.82	13.75
Information Technology	7.70	23.14
Consumer Staples	4.51	15.43
Health Care	4.37	16.15
Consumer Discretionary	3.73	11.24
Industrials	3.19	16.72
Communication Services	2.69	9.86
Materials	1.97	16.36
Utilities	1.87	8.12
Energy	1.69	27.50
Real Estate	1.54	5.34
Financials	1.38	9.50

Good Odds and Odd Goods

Information Technology, which has been producing the higher ROE as a sector over the last decade, trades at the highest P/B multiple. Energy, in comparison, is producing higher ROE at 27.50%, but trades a fraction of the P/B multiple that Info Tech does. It's a 79% discount for higher ROE. To make up that differential, Energy ROE would have to decline significantly, the P/B of Energy would have to go up substantially or the P/B of Info Tech would have to decline enormously. It's odd that energy is producing such high returns, but that's why the odds are good.

The same thing could be seen as you compare the Materials sector with the Industrial sector. You pay 60% higher book multiples for Industrials compared to Materials. They produce similar ROE. How many people want to go to an investment committee and say they are willing to suffer at the mercy of a commodity in Materials versus saying they have a fantastic process and intellectual properties with an Industrial company?

If these two sectors sustain this ROE at this level, the spread in return would have to be about 5% in the advantage of Materials. These commodity-oriented sectors of Energy and Materials aren't very sexy. They don't require an IQ of 150. They are odd. They give you companies with 40% of their market cap in cash in some cases. They command large market shares while other people exit the industry, but they aren't the industries that others have wanted when looking back historically.

Buffett as a kid scoured the local racetrack Ak-Sar-Ben, which is now the home of the University of Nebraska-Omaha, to find winning tickets that gamblers had discarded for whatever reason. Maybe they had too many drinks. This is exactly what the investors of Smead Capital Management get to do today. Pick up advantages in places that others don't because it is beneath them. Owning oil and gas: nah. Buying mall REITS: ha. Purchasing thermal coal stocks: are you mad? The point of investing is to not be smart, sound smart, or look cool. This is what winning the prom king/queen in high school or homecoming court in college is for. Investing is all about making money. It is the realm where you go find out where the odds are good, even if the goods are odd.

Fear stock market failure,

Cole Smead, CFA
CEO & Portfolio Manager

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SMEAD capital management
smeadcap.com
2777 East Camelback Road
Suite 375
Phoenix, AZ 85016
Sales Desk US 877.701.2883
Sales Desk UK +44 (0)20.8819.6490
info@smeadcap.com