SMEAD capital management

Missive

MAY 2, 2023

The Game Has Changed

In the early 2020s, the stock market looked much like basketball used to: a big man's game. As examples, money management firms like Vanguard and Blackrock lumbered to higher heights of assets while the passive firms swallowed more market share. This big-man game flowed through to the constituents represented in the passive bucket. Today, Apple and Microsoft are 14% of the S&P 500 and the top five holdings represent 26% of the index.

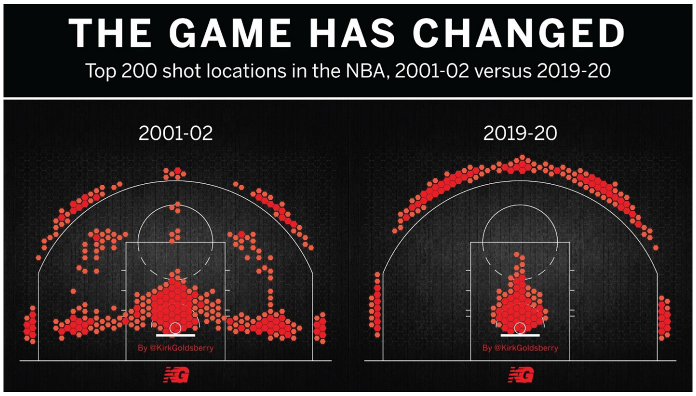
These large players in the money management business and the stock market are reminiscent of basketball prior to 1980. In the prior era, the famed big men were Bob Pettit, George Mikan, Wilt Chamberlain, Bill Russell and Kareem Abdul Jabbar. However, this did not hold as the NBA temporarily introduced the three-point line in the 1979-1980 season, only to never let it go.

The value of the three-point line is determined by the person shooting. If a shooter can make 50% of their two-point shots, they make one point per shot. This is the efficiency of their scoring. To be as efficient from three-point land, they would only need to make 33.3% of their shots because you get 50% more points. In other words, it's a riskier shot that may compensate you for that risk. When the three-point rule was first adopted, teams didn't naturally figure out how powerful it could be or train shooters for it. For young, strong shooters like Magic Johnson and Larry Bird, it was perfect timing.

In many respects, there is a three-point line that has arisen in the stock market, whether investors or money management firms recognize it. The higher percentage, two-point shots have come in the form of owning the S&P 500 Index or blue-chip quality American companies. However, the investors shooting these highly successful shots haven't won in the stock market recently, particularly over the last 15 months. Instead, it has been more cyclical, capital-intensive businesses, or as we think about it, higher risk, like the three-point line. Energy companies, commodity-oriented businesses and other lesser-known industries have been putting the most points up on the board.

The success of these higher-risk shots pushes the stock market further from its big-man game. As an example, we own one of the largest oil tanker businesses in the world, Frontline (FRO). It has looked like James Harden from deep over the last year, but the big-money management firms aren't present in the company. The simple reason: it's not big enough for Capital Group, Fidelity or Blackrock to sink $5 to $10 billion into it. Those same firms can feed the ball to the big men of the S&P 500 like Microsoft and Apple any day of the week. In the oil and gas business, we have found wonderful opportunities in businesses that are $8 to $20 billion in market cap like APA Corp. (APA) and Ovintiv (OVV). Yet, larger firms can't invest capital quickly enough, so they feed the ball to the more liquid majors in the oil business instead. Housing has had this problem for much of the last decade, trapping the largest investors and money management firms out at times. Again, the preference for the easier shot.

Below is a look at how the top 200 shots have evolved over the last 20 years in the NBA.



The NBA has moved to make its scoring far more efficient. How much more do you get compensated for shooting from 17 feet versus three feet? Nothing. How much do you get for shooting from 21 feet versus 23 feet? 50% more. Using the 2020-2021 season when Stephen Curry became the all-time three-point leader, the NBA shot three-pointers more efficiently than two-pointers.[1]

Where are the three-pointers today? At Smead Capital Management we have spent a lot of time with our investors talking about the likelihood of stock market failure in this era. We won't go into that in this piece, but you can gather this information from pieces of ours like A Sharpe Rebuke and Humpty-Dumpty Stock Market. In the chart below, we show who wins in the eras when stock markets are tough.

[1] https://www.basketball-reference.com/leagues/NBA_stats_per_game.html

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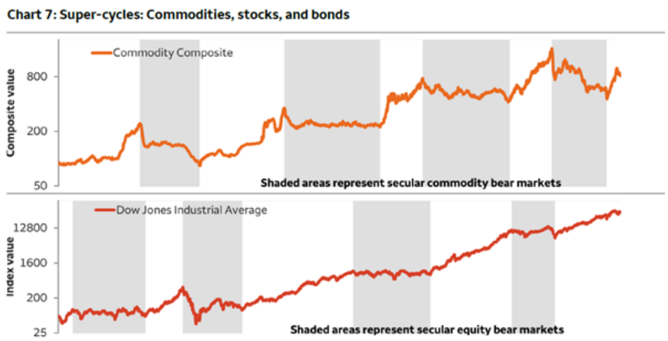

In an era where stock market failure is high, commodities put up good points for investors. Are these riskier businesses? Yes, but they can be a more efficient way to make good returns when the two-foot bank shot (the S&P 500) isn't winning the game.

This didn't just start yesterday. It began in the spring of 2020. We wrote a piece titled Betting the Long Odds that used the same logic as what has transpired with the three-point shot in the NBA. What we find strange is that more investors haven't recognized this yet as they all try to sit around debating whether the S&P 500 is cheap or if the tech names have had enough of a browbeating yet. Does that tell you to take insane risks? No, half-court shots don't reward you any more than 23 feet from the basket. If you can find a company with more cash than debt in an industry that most people think is too cyclical or ESG unfriendly or historically not a great business, don't worry that no one is interested in taking those shots. If you're not one of the big men of the stock market today, you're going to need to find a way to score more points from a lower launch height, as our investors already know.

Fear stock market failure,

Cole Smead, CFA
CEO & Portfolio Manager

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