SMEAD capital management

Newsletter

SMEAD INTERNATIONAL VALUE — 4TH QUARTER 2023 (12/31/2023)

Recognizing Change

As we end 2023, the world looks very different than it did a few years ago. The one thing inevitable in life is change. As investors, we are required to spend a lifetime of learning. One of the things we should recognize over time is how to take advantage of change. In this newsletter, we hope to explain current phenomena that weren't predicted or present just a few years ago. We hope that reminding ourselves of this will bring more clarity to the opportunities for investors ahead.

I was born in 1983. In my childhood, the Cold War was waning and ending, followed by a period of peace globally that is historically rare. There were conflicts over the last 40 years, no question, but not the type of conflict that engulfed current and former world powers against each other more directly. General David Petraeus, co-author of the book *Conflict*, teaches readers that most wars were proxy wars. We fought many proxy wars with Russia but never fought them directly. Now Russia has decided to take a direct approach to picking fights in Ukraine.

The West has still taken the role of a proxy war, providing weapons, money, and support. However, it is unwilling to directly involve itself in the conflict. While this has stopped Russia from blitzing Ukraine, it has done little to stem the tide of war. Putin is playing a long game, no different than what the North Vietnamese army did with the US in Vietnam. He knows that Ukraine can get support from the West, but the democracies eventually become tired and their politics moved to some other near-term issues, leaving Ukraine exposed. It is unprecedented to have a former world power like Russia seeking to fight their own wars. This is not a proxy game like in the past.

In the 2000s, European banks traded for three to four times their book value. In the following decade, they lent money to places that had great short-term profits. These borrowers evaporated with the 2008-2009 financial crisis. Rather than admitting their true problems, European financial institutions decided to delay and wait to recognize their asset problems. While this didn't affect their book value, these poor assets would be exposed in the return they produced.

In the 2010s, European banks began their descent from book value to eventually massive discounts to book value during the pandemic. By then, they had actually admitted their mistakes and recognized that the return on their assets or book value was important. They saw their American peers doing well and decided to be more pragmatic about how to run banks. The return on equity in banks is running across the industry typically at high single digits to high teens percentages. The change that has taken place is that banking is a higher return business than in the 2010s, but the multiples are still very depressed. Investors are in disbelief and are very disinterested in banks. This is not bad banking with low multiples like in the past. It's much better banking with still low book value multiples. The dumb banks were in the US in 2023, not Europe. My, how the wheel of change spins.

The 1970s were a nightmare for America as two oil embargoes tormented the economy and caused inflation to be worse on a headline basis. From then on, particularly in the last 20 years, America transformed into an OPEC-sized producer of oil and gas products. This isn't your grandmother's oil and gas business. While we proved we could produce oil and gas, we didn't prove we could do it profitably. Oil and gas producers commonly used more than 100% of their operating cash flow on capital expenditures; drilling holes. This continued to grow supply, but the 2010s were a terrible time to be invested in the oil and gas business globally. Then Saudi Sunday happened in the spring of 2020. American producers decided to quit drilling new holes, and the returns for investors exploded as stock buybacks and dividends rained in from operating cash flow. Investors never thought America could be a major producer. They are now. They never thought oil and gas producers would be rational with their capital allocation at any point. They have been and we must take these changes at face value, rather than as improbable events in the not-too-distant future. This will help us recognize change when others may not.

These are all important things to note and recognize because many people don't. There are others we could have listed, like the disbelief in longer-term higher interest rates, the strength of the labor markets compared to the past, or the amount of government largesse over the last four years compared to any other era of American history! All of these should cause fellow investors to recognize that other investors are thinking about what has changed. They are still fighting the last war while they chase the S&P 500 and the Magnificent Seven. We must understand the change and then recognize its value to what we are seeking to profit from in the businesses we own.

In a world teetering on direct wars becoming increasingly more prevalent, tangible assets are showing their teeth. Look no further than our oil tanker company Frontline (FRO NO). While conflicts grow, the value of dependable oil shipping is worth more. When bond markets get hurt and banks disappear, spreads for banks taking simpler risks go up. Bawag Group (BG) is a Viennese bank that trades close to book value with mid-teens returns. They were one of those former bad banks transformed through great management and capital allocation. When was the last time someone pitched you a great Austrian Bank? Don't worry, it's the same as us, never. We will continue to look for ways to make money from the change that has already taken place that few recognize or are willing to make adjustments in their investment portfolios based on. We must recognize change and seek to profit from it.

Warm Regards,

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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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