Newsletter

SMEAD US VALUE — 1ST QUARTER 2024 (3/31/2024)

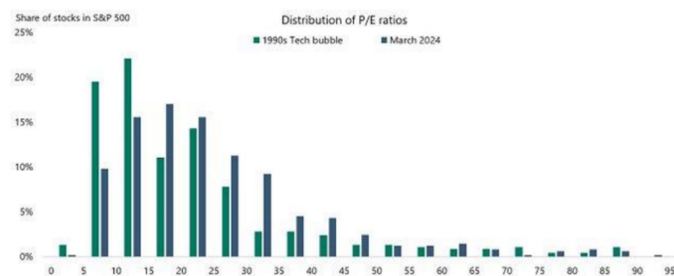
Common Stock Psychology Matters

There are four main educational disciplines that are important to us in the investment process. We believe investors need to understand economics, the history of the stock market, the mathematics of investing and the psychology of investing. At the end of the first quarter of 2024, we'd like to expound on the psychology of today's U.S. stock market.

A few caveats are needed on this subject. First, the psychology of the stock market tends to be useful at extremes. Extreme levels of optimism (greed) or pessimism (fear) are what are useful in stock picking/portfolio management and a great deal of our 43 years of investing have been spent between these extremes. Second, we stay fully invested over the years and don't use psychological circumstances for market timing purposes. We are more interested in what Charlie Munger called "ignorance avoidance."

With those caveats in mind, we will declare that we believe the extremes of euphorically positive psychology among everyone from aggressive younger investors to baby-boomer retirees currently have reached a level that will lead to disappointing results for owners of the S&P 500 Index over the next ten years!

The psychology of today's market can be measured in a variety of ways. We will start by comparing what people are willing to pay to buy the most popular stocks today compared to the nuttiest point of the Dotcom Bubble:



Source: Apollo. Data as of March 31, 2024.

In a majority of these percentiles, today's stocks are much more euphoric than in the year 2000. Now we can look at the median price-to-earnings (P/E) ratio of the ten largest stocks and the bottom 490 stocks in the S&P 500 Index.

Median PE of the largest 10 stocks took out the 2000 highs, but so did the smallest 490.

Source: NDR. Data for the time period 1/31/1972 – 2/29/2024.

Anyone feeling comfortable because they own the "safe" large-cap growth stocks should be very uncomfortable when this kind of uniform enthusiasm exists. We wonder if investors know how much can be lost through P/E contraction when the positive psychology disappears in the next set of bear markets. From August 25, 1987, to October 19, 1987, the S&P 500 went from a 24x P/E to 14x in 78 days. The market declined 43% in those 78 days!

Ironically, there was barely an economic ripple over the following year from the crushing loss of stock market wealth, despite the economic doomsday that came out of pundits. Remember, because stocks had done so poorly from 1968-1982, equity ownership as a percentage of household net worth was still at historically low levels. The pessimism (fear) of the early 1980s was still protecting common stock investors.

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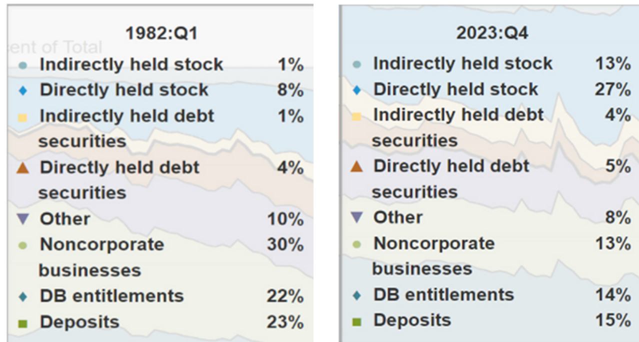
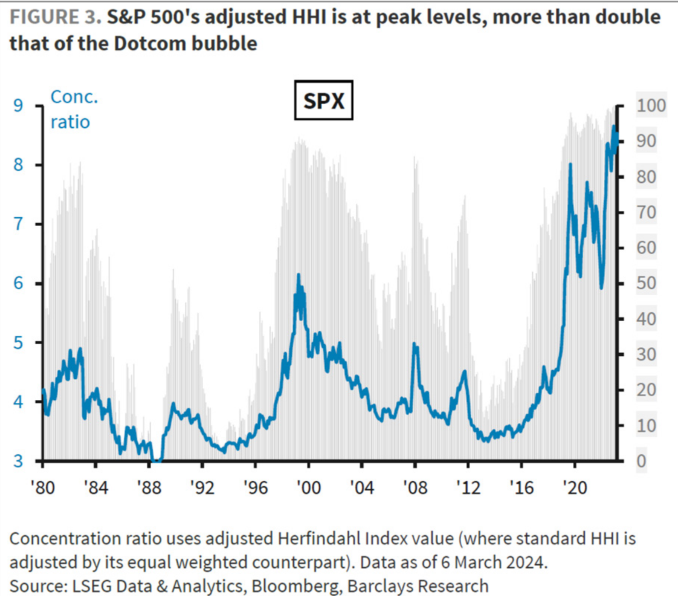


Source: Federal Reserve z1 report Data for the time periods ending 3/31/1982 and 12/31/2023.

In 42 years, American investors have moved from 9% direct and indirect ownership of common stocks to 40%. No part of that can be explained by a reduction in defined benefit assets held for them by their employer because defined plans have increased their common stock ownership from 30% of assets to 50%. Only in the 1960s did companies and Trust departments at banks move away from fixed-income instruments as the primary investment of choice in retirement assets.

These facts then lead us to look at the most euphoric episodes from the past where optimism for common stocks drove the aggregate brain of investors. Today's enthusiasm makes the year 2000 bubble look like a piker when it comes to concentration in the stock market's most popular securities.



Source: LSEG Data & Analytics, Bloomberg, Barclays Research. Data for the time period 1/31/1980 – 12/31/2023.

Lastly, the greed associated with U.S. technology stocks has made the spread to stocks in the rest of the world look bubbliscious. However, most stock market sectors look euphoric compared to history even if they are not as threatening to investors' net worth as the glam tech stocks.

Source: ASR Ltd. & LSEG Datastream. Data for the time period 1/31/1980 – 12/31/2023.

Therefore, what does a common stock investor like us do in an environment where there are psychological risks and value risks? We believe the answer is to invest at much lower P/E multiples in industries and countries that have avoided the euphoria. Energy is 3.9% of the S&P, while oil and gas stocks are 3.5% of the index. The oil and gas companies throw off 7.9% of the free cash flow of the S&P 500 Index. They do this by providing the addictive legal drug (fossil fuels) that powers our world.

A movement away from common stocks could cause the Millennials and Gen Z folks to become more enamored with home ownership and less enamored with common stocks. Our home builders exist to meet that economic need, and their market share of newly built and homes for sale could be a blessing for the next decade.

In conclusion, we believe that caution is warranted when euphoric greed is dominant in the stock market. This could well be one of those moments in history and another good reason to fear stock market failure.

Warm Regards,

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Chief Investment Officer

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CEO & Portfolio Manager

Invest With Us Today!

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