Newsletter

SMEAD US VALUE — 1ST QUARTER 2025 (3/31/2025)

Looking Both Ways Through a Cold Streak

My Father was a financial risk taker in zero-sum and negative-sum gambling endeavors. He used to say, “When your luck is running cold, look twice before you cross the road!” He was a big believer in cold streaks and hot streaks. As the saying goes, we like to say that we aren’t superstitious, but we are a little stitious.

As we finished the first quarter of 2025, Dad would’ve said we were on a cold streak. However, when you run a buy-and-hold portfolio of meritorious companies with an average holding period of six years, you aren’t able to adjust what you are doing in common stock investing in the same way that a successful zero-sum gambler does. He would just play way less often until his luck changed. Our investors invest with us to seek to get quality, well-selected, common stock ownership, and we go to battle daily on their behalf.

Our cold streak is directly tied to facts we have great confidence in. First, stocks, as represented by the S&P 500 Index, are historically overpriced and overly popular! Second, investors are expecting what worked for the last ten years will work for the next ten years. Lastly, we believe the forces of scarcity and inflation will be the most important factors in equity returns over the five-to-ten-year haul.

We are not shocked that stocks are getting beat up. Household equity ownership and speculative market participation were at record levels and should be unwound in the long term.

Ironically, our Main Street economic enthusiasm has been torpedoed by the political winds of tariffs and pervasive economic bearishness. As T. Rowe Price said, “The only thing certain in investing is change.” The great civil rights leader, Martin Luther King, Jr., used to say, “Change does not roll in on wheels of inevitability, but comes through continuous struggle.” Fighting through the best 15 years of tech/momentum investing in U.S. history has been a struggle, but we have acquitted ourselves quite nicely despite the constant headwinds.

The best-performing categories in recent years have been tech, growth, and high-quality, wide-moat stocks. In my 45 years, it has never worked to over-pay for your success as you look into the rearview mirror.

We continue to like the economics of scarcity in the oil and gas business, as well as solving the lack of single-family residences via our home builders.

If you take D.R. Horton’s (DHI) average selling price of ~$350,000, they build an average home at a cost of ~$260,000, or a 25% gross margin. If you were to raise the price by $10,000-$20,000, this is a price increase that could be easily passed on to the consumer. As low-cost producers with scale advantages, DHI, Lennar (LEN), and NVR could also choose to take a haircut on gross margin to drive market share. The rougher the environment in the short run, the better it may be for the large-scale, wide-moat homebuilders in the long run.

Mortgage rates, which are tied to the 10-year Treasury bond interest rate, are the big driver of new home affordability. Aside from recent price action, Secretary Bessent has made driving down 10-year rates a top priority, which should, in turn, improve housing affordability even with a higher cost of goods sold.

Therefore, this does not change our thesis that the homebuilders’ underlying business models are improving. There is structural-demographic demand for new homes, and the largest industry players will realize operating leverage through the advantages of scale.

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In energy, we have never had specific commodity price targets, though we do believe mid-cycle prices will be higher than they have been historically, driven by secular underinvestment in new supply and rising global demand for energy as standards of living steadily improve. Our thesis is underpinned by the economics of oil and gas structurally improving, as management teams only reinvest discretionary profit dollars in value-creating projects or simply give the money back to shareholders via buybacks and dividends.

The irony and economics of what President Trump is attempting in the oil business are not only odd but also extremely painful. He is driving down prices via economic fear-mongering (tariffs). Lower prices starve oil companies of reinvested profits and scare away private investors who would provide capital at higher oil and gas prices. Therefore, he is defeating his goal of making oil less scarce. Scarcity creates higher prices and Trump is crushing industry confidence. This lack of confidence will only drive further underinvestment and higher prices in the long run. Industry leaders, including Harold Hamm, support this view, who recently highlighted on Bloomberg that the industry would need oil prices at $80 per barrel – not $50 – to “drill baby, drill!”

In our mall REITs, Simon Property Group (SPG) and Macerich Holdings (MAC) are consumer-facing businesses that will undeniably be negatively impacted by a decline in consumer spending. However, the Class-A and outlet asset base of Simon makes up some of the most evergreen shopping real estate worldwide, and the Simon family has a track record of using the company’s strong balance sheet to invest countercyclically and grow net asset value per share during downturns. Meanwhile, under the leadership of CEO Jackson Hsieh, Macerich continues to repair its balance sheet, upgrade the quality of its portfolio and improve leasing efficiency in its remaining Class-A properties.

Stock market popularity comes and goes, but meritorious businesses like the ones we own have a history of rewarding owners over the long haul. It’s all about having the courage and patience to stand with these companies during a cold streak when the stock market’s random walk is working against us. During these challenging times, we will continue to look twice before crossing the road, but we remain confident that we will reach our destination safely.

Play the Long Game,

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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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