1983 Revisited

April 27, 2010

William Smead
Chief Executive Officer
Chief Investment Officer

Dear Fellow Investors:

If the year 2010 gets any more like the year 1983 in the stock market, it will be us at Smead Capital Management saying "It's déjà vu all over again," not Yogi Berra. First, we will recount what happened from 1972 to 1982 in the economy and stock market. Then we will compare it with 2000-2009. Lastly, we will compare the 1983 stock market with 2010.

In 1972 at the end of the year, a group of growth stocks called the *Nifty Fifty* commanded incredibly high PE ratios. For that reason, large cap stocks became massively over-priced in relation to small and mid-cap stocks. The economy was preparing to go through a nasty recession in 1973-74, exacerbated by the first Oil Embargo, which drove energy costs dramatically higher. Stocks got crushed in 1973-74, led by the Nifty Fifty, but at the stock market bottom of late 1974, small caps were cheap in comparison to their large-cap brethren. The second Oil Embargo in 1979 contributed to the incredibly high inflation and interest rates of 1980-81 and an inverted yield curve was produced by Fed Chairman Paul Volcker. This tight credit laid the groundwork for the worst recession in the US since the 1930's. At its depth, the 1981-82 recession produced unemployment well above 10% nationwide and decimated "smoke-stack" American industry. Credit was unavailable to the masses because interest rates were too high (20% Prime Rate and 15% Mortgages) for businesses and home buyers to afford. The economic experts at the time said there was no way that the US economy could grow until those high interest rates had come down for years. A Bear market in stocks started in June of 1981 and lasted until August of 1982. At the bottom in August of 1982, large-cap stocks were very cheap in relation to their small cap brethren. However, investors didn't want to own mature companies with slower and more consistent earnings growth patterns back then, because the feeling was that double-digit inflation required well above double-digit earnings growth. Only small cap growth stocks could provide 20% plus earnings growth in the late 1970's and they were favored with high PE multiples.

In early 2000, a group of tech stocks commanded incredibly high PE ratios. The success of the large cap growth mutual funds which owned these tech titans caused the funds to get deluged with capital. To reduce risk, the portfolio managers bought non-tech large cap consumer staples and healthcare companies, which in turn inflated PE ratios in those sectors to over 30 times earnings per share. Large cap growth became massively over-priced in relation to small caps and just about any other asset class which existed. When the tech bubble burst from 2000-02, a recession occurred. Unfortunately, we were attacked by Al-Qaeda on 9/11/01 and it was politically unfeasible to allow the natural economic cleansing of a recession to take place. We then used cheap money from the Federal Reserve Board (led by Alan Greenspan) to spur an enormous borrowing binge tied to housing. From 2005 through

2008, energy prices soared and triggered the deepest recession since the 1930's. The recession included over 10% unemployment as all industries tied directly to residential real estate and the financial service companies serving the mortgage industry, contracted from 2007 to 2009. Stocks got crushed from October of 2007 to March of 2009, falling over 50% for the first time since the 1930's and creating one of the worst ten-year stretches in the stock market since 1972-1982 and one of the worst in the history of the US stock market. Economic experts say that we can't have strong economic growth until the high levels of household and government debt are reduced drastically. In their estimation, that will take years.

In the bull market of 1982-87, small cap stocks outperformed during the first nine months. A company called Apple Computer went public in 1980 and bottomed at around $1.45 in July of 1982 (adjusted for stock splits). It led the charge in the first stage of the 1982-83 bull market by quadrupling to over $7 per share. Small caps had been the place to be from the stock market bottom in 1974 to the top of the first leg of the 1982-83 bull market, an up move in the S&P 500 Index of 70%. Large caps had rarely been so cheap in comparison on a PE ratio basis. From June of 1983 to August of 1987 large caps were the place to be in the US stock market as the Dow Jones Average rose from 1200 to 2700.

In the bull market which started in March of 2009 and has stretched at least to today (April 24th, 2010), the S&P 500 Index has risen about 80% and has been led by the more than doubling in price of a stock named Apple. Small caps have dramatically out-performed large caps since the tech bubble broke in March of 2000. In fact, almost every asset class or stock market sector on the planet has out-performed US large cap stocks since then. Small caps have also outpaced large caps since the market low as reported by Brian Belski, chief market strategist at Oppenheimer Asset Management, in a Marketwatch report on April 23rd, 2010 when he said "But the recent rally we've enjoyed in small-caps is running at a rate three standard deviations above the historical average; fundamentals don't support the upside." Indeed small caps are trading at 27 forward PE and large caps trade for 16 times earnings.

We at Smead Capital Management believe circumstances exist for large-cap recession-resistant quality US stocks to out-perform all other stock market sectors and asset classes over the next five to seven years. If the playbook keeps getting revisited, it would be surprisingly strong US economic growth triggering a rise in short term interest rates. This would lead a transition to cash-rich large-cap stocks, which trade at much lower PE multiples than their small cap brethren.

Best Wishes,

William Smead

This Missive and others are available at www.smeadblog.com.