Dreamer-Nothing But a Dreamer

William Smead
Chief Executive Officer
Chief Investment Officer

Dear Fellow Investors:

The current circumstances in the U.S. stock market remind me of one of my favorite bands from college, Supertramp, and their song “Nothing But a Dreamer”. It appears that individual investors and many of the financial advisors that take care of them “have their head in their hands, oh no!” This was pointed out to us in one of Mark Hulbert’s columns in the New York Times on Nov. 8th and in a piece put out on Nov. 12th by Hays Advisory’s Mark Dodson.

Mark Hulbert’s column explained that the lack of buying interest (in fact recent net selling) of U.S. equity mutual funds and Exchange-Traded Funds could be useful as a short-term contrarian indicator, but is disconcerting from the standpoint of his long-term view of the market. His research, assisted by Ned Davis’s research, concludes that this bull market must see net inflows into equity funds and ETFs at some point to be anything more than the bounce-back rally from the steep decline of October 2007 to March of 2009. The research showed that the stock market generally performs better after inflows into equity funds.

In his missive, Mark Dodson calls stocks “Public Enemy No. 1”. His charts show that we had fund flows in October (Bond flows compared to stock flows) similar to the bear market lows of 2002-03. Combined with the continued steepness of the yield curve, his research shows that any little pullback in the stock market sends many investors scurrying for the exits because “now they’ve got their hand in their heads, oh no!”

How will this contradiction get resolved? Will individuals not get any confidence back in common stock ownership for five to ten years? Will the yield curve stay steep and rates stay incredibly low for an extended period of anemic economic growth (the “New Normal”)? Is this the biggest and best bear market rally in history or was March a historic low that could hold for the rest of my career?

We at Smead Capital Management could be called “Dreamers”, but we like to stack the probabilities heavily in our favor as we dream. Here is a list of some of our observations that lead us to be very excited about owning our portfolio of large cap quality U.S. common stocks:

1) Amazingly good negative psychology to create a continued “Wall of Worry”
2) Discounted price-to-earnings ratios on large cap stocks
3) Hardly anyone talking or writing about a three to five-year bull market
4) Crowded trades in Oil, Gold, Emerging Markets, Commodities, Treasuries, CDs, etc.

5) Negligible investor zeal for common stocks
6) Near universal negative brainwashing among the most popular experts in 24-hour news and internet outlets
7) Massive cash sitting on corporation balance sheets
8) Companies are buying companies (Berkshire bought Burlington, Hewlett Packard buying 3COM, Stanley Works buying Black and Decker)

This Bull Market has gone up 60% from its low of March 2009 with little or no support from net inflows into equity funds and ETFs. What might happen if those flows kick in at some point is a multi-year Bull Market similar to the ones which followed past "deep recessions". As Supertramp said in the song, "You know, - Well you know you had it comin' to you".

We'd like to think that patient common stockholders do have it coming to them.

Best Wishes,

William Smead

The information contained in this missive represents SCM's opinions, and should not be construed as personalized or individualized investment advice. Past performance is no guarantee of future results. The securities identified and described in this missive do not represent all of the securities purchased or recommended for our clients. It should not be assumed that investing in these securities was or will be profitable. A list of all recommendations made by Smead Capital Management with in the past twelve month period is available upon request.

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