In Season and Out of Season

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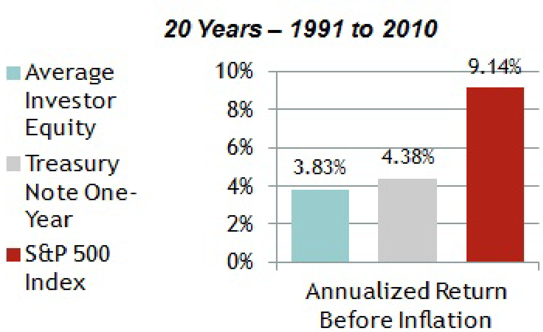
Dear Fellow Investors:

In the opinion of Smead Capital Management, computers, cable TV, the Internet, 24-hour news and a variety of other forces have greatly affected successful participation in the US stock market. These forms of information gathering attempt to push people away from the most important fact that exists in common stock investing. The fact which we believe matters more than any other is that owning all or part of an outstanding company for many years is one of the simplest ways to attain wealth and compound liquid assets at high rates of return. In today's missive, we will look at how far "out of season" the fact we believe in is and think about how important it is to be ready for the season to come.

The Ibbotson Group has been kind enough to share statistics on the returns from liquid asset classes since 1927. Treasury bills have returned about 3% per year, Long-Term Bonds have earned about 5.5% and US common stocks (as represented by the S&P 500 Index) have averaged around a 10% return. Running parallel to these statistics are the studies (including the one provided below) which show how poorly investors actually do who participate in the stock market compared to how the market itself does. As you can see, about 58% of the return from stocks gets lost in the poor timing decisions of owners by adding to their stock portfolios at high points and selling at low ones.



"Average Investor Equity" is represented by the mutual fund inflows and outflows over the corresponding time period to simulate the behavior of the average equity investor. Average equity investor results are calculated using data supplied by the Investment Company Institute. Investor returns are represented by the change in total mutual fund assets after excluding sales, redemptions and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses and any other costs. After calculating investor returns in dollar terms, two percentages are calculated for the period examined: total investor return rate and annualized investor return rate. Total return rate is determined by calculating the investor return dollars as a percentage of the net sales, redemptions and exchanges for the period.

Source(s): Index Fund Advisors, from Dalbar, Inc. report QAIB (Quantitative Analysis of Investor Behavior)

Computer access leading to internet provided information is drowning the average amateur and professional investor. How much computer time do you need to know that Disney (DIS) is the world's number one baby sitter? How many Walgreen's (WAG) locations do you need to see or visit to conclude that they have a very consistent business? What number of hours online causes you to appreciate the branding power of the Aflac (AFL) duck? Investors only need a little drink of water in the way of information, but instead, they get drowned in a fire hose of info.

Thanks to 24-hour cable TV news, investors have a constant stream of bad news. This world of 7 billion people is kind enough to provide us a daily disaster and to teach all of us more about macroeconomics and scarcity than any college under-grad would ever want. As Jim Collins has pointed out in his new book, "Great by Choice", the great companies are not considered great because they existed in a world where bad things never happened or bad luck never occurred. Rather, it was that they did the things that they could control and assumed that the circumstances around them would be chaotic and difficult along the way. In the Jim Collins world, it does you no good to predict economics or natural disasters. It is much more important to own part of a very strong organization which expected numerous possibilities and scenarios.

Why is our view of the world "out of season"? Most investors do their investing in the rear-view mirror. They look at what has been successful the last 5-10 years and expect more of the same. They see that emerging market investments, commodities and related industries have boomed since ten years ago. They see Caterpillar (CAT) selling gigantic machines to China, Joy Global (JOYG) helping miners dig up copper and gold, and major oil companies/oil service organizations going gangbusters to satisfy an insatiable demand for crude oil and its derivatives. In the month of October which just finished on Monday, basic materials companies were the best performing category in the huge rally off of the early October lows. They've only been "in season" for about ten years.

Second, they see that the US stock market has made no meaningful headway since 1998. The last 13 years has been a poor stretch from a historical standpoint and those who sought to become wealthy by owning outstanding, non-cyclical companies struggled compared to history. Those who traded the market swings successfully are well reported on TV and through dissemination online. This market timing is always admired after years of range-bound markets. Unless I've missed something, there are few market timers in the Forbes 400 wealthiest Americans. However, most of those on the list got there by owning successful businesses for a long time and did it in a concentrated way. They never checked to see how the folks on TV or online thought about holding on to their company.

Third, those who gorge on stock market information currently see unbelievably high correlations among risk-oriented assets. One study shows that since 2008, oil and US stocks have been positively correlated. For the thirty years prior, the correlation was negative by almost that exact same degree that it's been positive lately. This is ludicrous! Unless you are a massive net exporter of oil, higher oil prices are a nightmare. We are watching for those correlations to move back to normal in the near future. Recently stocks in the US have traded more persistently in tandem than nearly any time within the past forty years , with the possible exception of the 1987 crash. High correlations are "in season", but history shows that they have always reverted to their mean.

Lastly, the most damaging aspect of these forces which provide too much information is that they produce activity. Activity is the enemy of those who own all or part of an outstanding company. Ignoring the crowd and temporary problems eliminates trading costs, reduces IRS access to your wealth and allows you to gain the benefit of dividends and dividend growth. Most studies show that over very long periods of time (30-50 years) that dividends make up 40% of that 10% return which Ibbotson calculates for US stocks.

The great irony of today is that most of the companies which fit our eight proprietary criteria for selecting stocks sell at a PE ratio at or below the S&P 500's average. In addition, at the end of October the S&P 500 traded at 12.9x trailing earnings, well below its median of 18.1x over the prior twenty years. The nice thing about being in the business for 31 years is getting to see that the seasons of investing do change. In our opinion, the next season could last a long time.

Best Wishes,

William Smead

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