



Lemmings

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Dear Fellow Investors:

One of the most excruciating and entertaining things to watch in nature is a group of lemmings going off the cliff together. In truth, this rarely happens in nature. What really does happen is that the population of lemmings gets too concentrated in a geographic area and the lemmings scatter to get a better supply of food. Thanks to a couple of great pieces written by E.S. Browning in the July 12th Wall Street Journal, we can see that investors and money managers operate the same way that lemmings do.

His first piece on the front cover of the Wall Street Journal was titled “Small Investors Flee Stocks”. It pointed out that individual investors have been consistent net liquidators of US common stocks for three consecutive years. In fact, they have been the most negative on stocks in 2007-2010 as at any time since a similar bearish stretch from 1979-1981 according to the Investment Company Institute. The lemmings have fled to money market funds, CDs, Treasury Bills and Bonds, high grade and junk bonds and gold. Much of the bond ownership has come through bond mutual funds which have had as great popularity and inflows as the Investment Company Institute has ever seen.

The second piece on the front of the Money and Investing section was titled, “The Herd Instinct Takes Over”. The research team at Birinyi and Associates, led by Jeffrey Yale Rubin, analyzed the correlation of the price movements of individual stocks in the S&P 500 Index to the Index itself. Very low levels of correlation means there are a large number of stocks resisting the market’s direction. High levels of correlation mean that everything is moving the same direction at the same time. The recent decline in stock prices saw the highest correlation number (81%) as had been seen since the stock market decline from late August of 1987 through the crash day on October 19, 1987. Back then it hit 83%. Even in all the super nasty declines of 2008, the correlation never exceeded 79%. As we wrote recently in a missive we called “Mini 2008”, the fear in the last few weeks ranked right up there with our fears of depression and abyss in the fall of 2008 when a wide variety of indicators showed that our financial transmission system had broken down temporarily.

When correlations are low it means a significant amount of value can be added by good stock picking. When correlations are high it means that whatever discipline you are using to pick stocks isn’t doing you any good. We at Smead Capital Management call high correlations, “throwing the baby out with the bath water”. Browning correctly identifies the culprits in all this with the help of the folks like Mr. Rubin at Birinyi.

“It is an indexing market and not a market for stocks. On good days everything goes up, and on bad days everything goes down. Everyone talks about baskets or sectors. It is harder for individual investors and even for mutual fund

managers to distinguish themselves by doing individual stock picks. They might get the product right and the earnings right, but the market goes down and the stock goes down as well.”

Through passive investments, Exchange Traded Funds (ETFs) and computerized trading, a massive group of lemmings (and wealthy individuals who have put their money with them) have come to dominate the market as much as program trading and portfolio insurance did in 1987. We thank E.S. Browning for such great work.

What does this all mean to SCM and to you as investors and/or money managers? First, there is very little food value in bonds and the individual investor lemmings are due to scatter. They have massive cash and near cash with which to scatter elsewhere and any part of that could drive stocks higher. At least in 1979-81 those individual investors were fleeing stocks to receive double-digit interest rates. We believe this time the returns from high quality bonds are set up to be negligible.

Second, a potential future curse for market timers and long/short hedge funds would be a consistent Bull Market in US stocks, especially one led by household names. The primary reason that small to mid-cap stocks have outperformed over the last ten years was that they were cheap in 1999 when large caps were expensive and offered a great deal of food value to the lemmings back in 2000. The length of their outperformance has outlasted their nutritional value. We believe the lower PE ratios and food value is in large caps. The trend persists because of how dominant hedge funds, ETFs and go anywhere mutual funds have become as individual investors have retreated and poor performance among stock picking disciplines has dragged away massive amounts of capital from long only portfolio managers.

Ask yourself, what should investors have done back in 1982 after liquidating stocks for three straight years? They should have bought and enjoyed a huge five-year bull run. What should they have done in the aftermath of the high correlation in 1987? Pick good stocks to buy or find a strong discipline through a portfolio manager to pick good ones for you. The S&P 500 Index rose from 225 on October 19th, 1987 to 1527 by March 24th, 2000 and good stock picking could have enhanced those returns. We think the lemmings are about to disburse seeking better nutrition and we'd like you to get your share.

Best Wishes,

William Smead

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