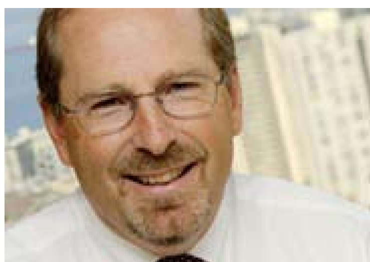
Math, History and Psychology - Part 2

July 3, 2012



William Smead
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Dear Fellow Investors:

Last week we wrote about the math of common stock investing and the effectiveness of mathematical discipline to portfolio management. This week we will focus on history and the importance of that academic discipline to us as common stock portfolio managers here at Smead Capital Management (SCM).

Edmund Burke said, "Those who don't know history are doomed to repeat it." We at SCM like to think in terms of taking advantage of what we know about history to make money owning good quality common stocks. Mark Twain said, "History doesn't repeat itself, but it does rhyme!" We believe these are the most important statements on how history should affect portfolio management decisions. In our opinion, you must know the history of the markets and you must trust the "rhymes" to be effective and successful.

We will use some historical examples to back up Burke and Twain's argument. History shows that there have been regular bouts of financial euphoria. In his book, "A Short History of Financial Euphoria", John Kenneth Galbraith used the Tulip Mania of the 17th century and the "South Sea Bubble" of the 18th century to help people understand how dangerous excessive optimism is in business. The aftermath of these speculative episodes was drastic and debilitating losses. Here is how Galbraith described the lead up into the height of the euphoria:

"The price of the object of speculation goes up. Securities, land, objects d'art, and other property, when bought today are worth more tomorrow. This increase and the prospect attract new buyers; the new buyers assure a further increase. Yet more are attracted; yet buy; the increase continues. The speculation building on itself provides its own momentum.

This process, once it is recognized, is clearly evident, and especially so after the fact. So also, if more subjectively, are the basic attitudes of the participants. These take two forms. There are those who are persuaded that some new price-enhancing circumstance is in control, and they expect the market to stay up and go up, perhaps indefinitely. It is adjusting to a new situation, a new world of greatly, even infinitely increasing returns and resulting values. Then there are those, superficially more astute and generally fewer in number, who perceive or believe themselves to perceive the speculative mood of the moment. They are in to ride the upward wave; their particular genius, they are

convinced, will allow them to get out before the speculation runs its course. They will get the maximum reward from the increase as it continues; they will be out before the eventual fall."

History shows that these speculative episodes will happen and those who know history are to avoid participation in these episodes. It was tulips in the Netherlands, common stock in the South Seas, Western Railroads in the 1860's and 1870's, technology like cars, planes and radios in the 1920's, the internet in the late 1990's and residential real estate in 2005. We believe you must understand and know the history of these events and avoid participation in them once they get speculative!

Folks have wondered why we believe that China's economy and their miraculous last thirty years of economic growth aren't sustainable. The answer is simple. CHINA HAS ALREADY QUALIFIED AS THE BENEFICIARY OF A SPECULATIVE EPISODE. THIS KIND OF UNINTERRUPTED ECONOMIC SUCCESS HAS ALWAYS ENDED BADLY IN ALL RECORDED ECONOMIC HISTORY! China has not had an economic contraction in thirty years. As Galbraith pointed out, China is in a new world of greatly, even infinitely increasing returns and resulting values. In China, it's all about GDP growth, because their internal stock market broke down four years ago and even that has not stopped the euphoria associated with China's future. The speculative episode just moved to houses from stocks in China.

The most successful economy of all time, the US economy, grew 9% compounded from 1800 to 1900. However, there were 18 recessions, 3 depressions and 3 all-out panics. The economy was cleansed of its sins by regular economic contractions. As Warren Buffett says, "Only when the tide goes out do you discover who is swimming naked." In China, the tide has never been allowed to go out. Bad loans, fraud and poor investments have never been exposed and the masses have not been forced to learn and improve their economic behavior.

This is why Twain's quote about history rhyming is so important. Every time that one of these episodes comes along, investors and professional portfolio managers focus on the difference in the current episode to the past ones. History repeats itself, but not identically! Therefore, the temptation is to focus on the difference and repeat the mistakes. This is true at both positive and negative extremes. A few examples might be helpful.

We were in a deep recession with as high as 10.8% unemployment in 1981-82. Incredibly high interest rates crippled the economy and smokestack America. Budget deficits were high and the US national debt grew immensely. Stocks were out of favor and 1981-82 was a great time to buy many good quality common stocks.

Along came the meltdown of 2007-2009, with a deep recession which included 10% unemployment. Very few professional investors were buyers or holders of good quality common stocks back in late 2008 or early 2009. The 2009 market bottom was triggered by too much debt and the massive deleveraging which has occurred since then. Everyone told us not to buy because, "It's different this time." In 1981-82 it was the price of money which crippled the economy and in 2009 it was the huge principle balances which crippled it.

Fortunately for us and unfortunately for those who couldn't sense the rhyme, 2009 was a great time to buy good quality US common stocks. Those who focused on the differences and ignored the rhyme missed the entire comeback the stock market has made since March of 2009. It grieves us to see the massive amount of capital which resides in doomsday-oriented mutual funds and ETFs, whose path to success would be our country's failure to make a full comeback in this deleveraging process. So far, the optimists have outperformed and the 1982 playbook proved to be effective.

We believe the latest history to trust is the rhyme between the US economy and stock market in 1952 and today. In both cases, the US economy had high unemployment, huge government debt, massive recent stimulus, the Federal Reserve Board capping long-term interest rates, historically high profits as a percentage of GDP and what we believe are cheap large-cap stocks. Back then we funded the Marshall Plan to help Europe and Japan, as well as the GI Bill. Today, it is enormous unemployment compensation and deficit spending. Despite all those headwinds and a reversion to the mean in corporate profits as a percentage of GDP, the Dow Jones Industrial Average rose from 260 in 1952 to near 1000 in 1966. Those who ignored the headwinds created wealth and those who sat on the sidelines or hoped to make money from the misery of others ended up poorer. Will those circumstances play out differently this time? Or will this situation rhyme with 1952? At SCM, we are paid to trust the rhymes!

Here is how Galbraith concluded his thesis on the history of euphoria:

"At the risk of repetition—restatement of what one hopes is now evident—let the lessons be summarized. The circumstances that induce the recurrent lapses into financial dementia have not changed in any truly operative fashion since the Tulip Mania of 1636-37. Individuals and institutions are captured by the wondrous satisfaction from accruing wealth. The associated illusion of insight is protected, in turn by the oft-noted public impression that intelligence, one's own and that of others, marches in close step with the possession of money. Out of that belief, thus instilled, then comes action—the bidding up of values, whether in land, securities, or, as recently, art. The upward movement confirms the commitment to personal and group wisdom. And so on to the moment of mass disillusion and the crash. This last, it will now be sufficiently evident, never comes gently. It is always accompanied by a desperate and largely unsuccessful effort to get out."

Next week we will talk about psychology.

Best Wishes,

William Smead

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