# Math, History and Psychology

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**William Smead**
Chief Executive Officer
Chief Investment Officer

Dear Fellow Investors:

In my 32 years in the investment business, success in common stock investing seems to come down to math, history and psychology. At Smead Capital Management (SCM), we have built our investment discipline and our eight proprietary criteria around these academic subjects. With the stock markets gyrating wildly the last few weeks, we thought it would be helpful to see where we are today in each of these disciplines. We will start this week with our view on the math section.

We believe the math of common stock investing is pretty simple. Without leverage, you can only lose your original investment. Your gains can be unlimited over the longest term (long duration). Most of the benefit (90%) of diversification is reached by owning a twelve-to-eighteen stock portfolio. Valuation matters dearly to portfolio results. Stocks purchased at depressed prices (as a group) outperform those which are more expensive over both shorter (1 year) and longer-run time periods.

Turnover creates expense and is the enemy of performance. Long-term common stock performance fits on a bell curve. In a portfolio of well-selected common stocks, most of the long-term gains are going to come from 20% of the portfolio. This is only true if the most successful shares are held to a fault. Every stock which goes up ten-fold, must have first doubled, tripled and quadrupled. The only good reason to sell shares in a successful common stock of high quality is if it gets what we call “maniacal” pricing or if it no longer meets our eight proprietary criteria. Maniacal pricing to us means a PE ratio more than two times the average of the prior ten years.

One hundred percent of the stocks that go to zero fell by 20%, 40% and 60% before ultimately losing 100% of their value. Poor stock price performance among our portfolio holdings requires us to refocus on the fundamentals to preserve capital. Other than maniacal pricing, worrying about price performance of fundamentally strong businesses is damaging to performance and success.

Our observation over 32 years is that no one can consistently predict either the stock market or the US economy. Therefore, breaking any of the mathematical disciplines mentioned above, based on stock market or economic predictions, has the potential to ruin the benefit of common stock investing. Paying someone to make directional stock market or economic predictions automatically reduces portfolio results by its cost. Stocks, as measured by

Ibbotson and Associates, have outperformed the other major liquid asset classes over long stretches of time (30-50 years). However, to get this added return you must accept some extreme variability of returns.

In the view of SCM, most of the best mathematicians in the investment business spend their time trying to predict the direction of the stock market or the size of the GDP of the US economy. This over-crowded playing field should function like all other crowded playing fields have over the last 32 years. Use of macroeconomic forecasting should make for very low returns in the stock market and in asset allocation because too many people are “trying to squeeze blood out of a turnip”. We believe individual security analyses is as unpopular as it just about ever gets and will have a much easier time than it normally would in providing additional return for those who use math to practice it.

Best Wishes,

*William Smead*

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