Money Manager Pride Goeth Before Destruction

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Dear Fellow Investors:

At Smead Capital Management we have made it a high priority to pay attention to the investors who have proven over decades that their work proves worthy of great respect and admiration. In baseball, you can make the All-Star team with one great season, but to make the Hall of Fame, you need a long career at very high levels of success to be inducted. Our industry is wonderful because we can look very closely at the investments and writing of these people we have great respect for.

All great money managers reach a point in their career where adulation and self confidence detracts from their better judgment. This interruption in judgment usually coincides with the discipline in use becoming the most popular discipline in the marketplace or the investing style being overdue for a three to five-year correction. Studies of the equity managers with the best long term records show that the best underperform the S&P 500 Index 35% of the time. The pride associated with multi-decade success and the reinforcement of an army of folks enjoying your work is probably the most dangerous thing that can happen in the money management business.

To understand these phenomena, we will review the work of Warren Buffett, Bill Miller and Kenneth Heebner on a backward-looking basis. Then we will examine Jeremy Grantham and Bill Gross looking forward. Our supposition is the following. These men make up a short list of five of the best money managers of all time! However, there is a point in their career when their pride can get in the way of their better judgment and capital can get destroyed.

Warren Buffett is the most successful money manager of all time, in our opinion. His long-term compounding of book value at a rate in excess of 20% is legendary. To this day, I'd rather be a fly on the wall in his office than one in anybody else's office in money management. In 1998, he was uniformly admired by the media, by a slew of book writers and by a huge army of professional and individual investors. He wrote in his 1996 annual shareholder letter that stocks like Coke (KO) and Gillette (now part of Proctor and Gamble) were the "inevitables". In Buffett's eyes, these companies had such dominant moats, sustainable profit margins, strong balance sheets and other strengths that he could ignore the fact that they reached PE multiples of as high as 57 times trailing earnings. These stocks were "maniacal" and were trading at PE multiples which doomed their stock prices for ten years. Coke peaked at around $88 in 1998 and bottomed in 2009 around $38 per share. Warren's big mistake list is so small that you need a magnifying glass to read it. I believe that everything going on around him in 1998, the adulation and the uninterrupted success got the better of him. His popularity dropped in 1999 as the Tech Bubble went into its highest gear. By early 2000, many writers were asking if Warren Buffett's investment discipline was old-fashioned and out-dated.

Bill Miller beat the S & P 500 Index for 15 years from 1991-2005. He has the unusual ability to recognize deeply out of favor stocks in widely diverse industries and then has the constitution to hold his winners for many years. He specializes in high reward and volatile positions and is unafraid to average down far longer than most admirable money managers. By the end of those 15 years his streak was followed heavily by the media, his parent company (Legg Mason) boomed and financial advisors nationwide poured billions of dollars into the two funds that he manages. We at SCM believe that he is as brilliant a thinker and money manager today as he was in 2005. He's only out-performed the market once since 2005 in the year 2009. His five-year numbers are 99th percentile in his category. We assume that the circumstances brought pride into the picture and that these last five years have been incredibly humbling.

Kenneth Heebner manages money in a way that is unfathomable to this writer. He takes concentrated positions based on strong opinions and analysis. He had the best 15-year track record among mutual fund managers in 2008. He produced stunning results in the first eight years of the decade of the 2000's. However, he turns his portfolio over aggressively and constantly. In May of 2008, he was called "the best money manager around" and featured on the cover of Fortune magazine. Enormous adulation was heaped on him by the media and billions flowed into his mutual funds. At the top of the commodity markets in the late spring of 2008, Ken Heebner was massively over-weighted in energy, basic materials and heavy industrial companies. He immediately went from there to an aggressive over-weighted position in financials. His performance over the three years since the overwhelming adulation has been dismal. He is one of the most talented managers of money, but pride temporarily got the best of him.

Jeremy Grantham and Bill Gross are Hall of Fame money managers. Grantham leads the firm of Grantham Mayo Van Otterloo (GMO) which is a leading strategic wide-asset allocation firm. He has been unusually accurate in his long-term predictions in everything from lumber to large caps and emerging markets to energy. His firm is drowning in new money and his specialty area, asset allocation, is the darling of institutions, registered investment advisors, consulting firms and financial advisors. Even stock pickers like us pay attention to Grantham's thoughts on asset allocation and GMO's 7-year prediction for inflation-adjusted forward performance expectations. He has been spot on and his research director, Ben Inker, has done some of the best investment research in the marketplace. Grantham is currently known for his "7 lean years" thesis and in his latest quarterly letter titled "Danger: Children at Play" he nearly exhausted himself taking victory laps around the nine pages and an addendum. This comes just three months after Grantham boldly predicted that commodities were in a "paradigm shift" and had , in effect, reached a "permanently" higher plateau!

Bill Gross is the most successful bond mutual fund manager in history. His company, PIMCO, manages over $1 trillion for institutions and individual investors. During the bull market in bonds from 1981 to today, he has handled every environment well and produced a market beating track record. His monthly missives are followed closely by the same crowd which feasts on Grantham's quarterly letter. The bond bull market in the US has culminated the last three years in an avalanche of money drowning bond managers like Bill Gross. Those investors, advisors and institutions will recite statistics about how much better bonds have done than stocks the last 10 and 20-year periods. Bill Gross even has a very similar forward thesis to Grantham's which he calls the "New Normal". It is a relatively negative belief that the US has more than a decade of penance to pay for the financial and real estate sins of the decade from 1998-2008. His firm travels around the world explaining how they are looking for bonds in countries which benefit from emerging market growth to protect against both currency declines and to get a decent rate of interest. When Bill Gross and other major players at PIMCO are on CNBC, the world seems to stop to find out what the markets wisest players have to say. The adulation from all corners is thick enough to cut with a knife and the pride in PIMCO's opinion continues to rise.

If this piece were a trial rather than a missive, it is safe to say that Jeremy Grantham and Bill Gross are in a very similar and guilty position compared to the Hall of Famers we mentioned in the beginning. Buffett stumbled when his favorite kind of stocks (large-cap/wide moat/strong balance sheet/powerful brands) were wildly popular. Bill Miller became the most respected equity mutual fund manager at the height of eclectic stock picking. Kenneth Heebner headed into the tank right after he got unusual media attention and his "go anywhere" discipline squeezed every dollar out of the marketplace it could. They have been in Jeremy and Bill's shoes.

Therefore, what could happen to ruin the party for these two great money managers? They would have to have a very rough three to five years of performance and the thesis they are operating on would have to be wrong. We believe bonds will never be more popular in the next thirty years than they are now. We believe that so many people are practicing wide asset allocation that it will be a "nightmare" the next five to ten years. We believe that a bear market has started in oil and commodity indexes which will embarrass today's bulls. Lastly, we believe that the ability of the US economy to heal itself is being badly underestimated by these two great money managers.

As contrarians, we can't run away from the opinion of these great money managers fast enough. This is not because they aren't deserving of Hall of Fame status, but because they are trapped in today's two most popular disciplines with all the same adulation and pride that our other great managers had before them. Both favor emerging markets over the US, have confidence in commodities, assume China's economy will grow uninterrupted; both think the US consumer is dead for years and both think that the US is a political disaster area. We will still admire them when those who fawn over them today no longer have respect for them. This will be after the "pride that leads to destruction" turns into humility in the marketplace.

Best Wishes,

William Smead

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