Not in My Lifetime
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Dear Fellow Investors:

Trends which have been in place for years and appear overcooked are hard to wrestle with. In the mid-1980's, a columnist for Forbes magazine, Shad Rowe, wrote a piece which included the following story:

A Texas oil and gas wildcatter was praying and asked God two questions. The questions were, "Will the price of natural gas ever go up again, and, if so, when?" God spoke to the oil man audibly from heaven. The answer to the first question was yes, but the answer to the second question was "not in my lifetime"!

You probably think that this is leading into a conversation about the current depressed price of natural gas and the huge spread between it and oil prices. Instead, we at Smead Capital Management (SCM) would like to talk about the despair associated with being a contrarian near the bottom of a bear market or the top of a bull market. Are there things which happen at these extremes which set the stage for a change in direction to the existing and powerful trend?

We believe at SCM that the bottom of a bear market or "point of maximum pessimism" comes when the sellers at the margin are market participants who would actually prefer to be buying. Whether selling to meet mutual fund redemptions or responding to margin calls, the seller at the bottom sells exactly the securities which they prefer to buy. A few examples might be helpful. The Bass family held a huge position in Disney (DIS) since 1984 when they served as the "White Knight" to Saul Steinberg's accumulation of a 6.3% position and a takeover threat. With a heavy investment from the Bass family, Disney paid Steinberg over $300 million to go away. Near the bottom of the 2000-03 bear market, the Bass family had to sell Disney shares at $15 to meet a margin call in their portfolio. Today it is around $40 per share.

Aubrey McClendon, the CEO of Chesapeake Energy (CHK), was hit by a massive margin call on his shares in October of 2008. This virtually wiped out his ownership in the company. He has rebuilt his position, some say at shareholder expense, but the stock is still dramatically higher today that at the lows.

He would have preferred to be a buyer. Recently, Bruce Berkowitz, the highly respected manager of the Fairholme Fund, was forced to sell many of his favorite financial stocks to meet mutual fund redemptions because of the nightmarish performance of financial stocks as investors capitulated in the second half of 2011.

At the top of a bull market, the buyer is a short seller being forced to cover an overvalued security or portfolio managers who are window dressing late in the cycle to preserve their jobs. When you are short at the end of a bull market, the old saying goes, "the market can stay irrational longer than you can stay solvent". Short sellers have unlimited downside risk. As a portfolio manager myself back in late 1999 and 2000, I was encouraged by friends to take 15% of our portfolios and put them into tech stock alternatives like Cisco (CSCO), EMC (EMC) and Microsoft (MSFT), so that my clients wouldn't fire me. I was stubborn, but a number of investors left us because they couldn't stand everyone around them getting rich quickly on tech stocks and Initial Public Offerings (IPOs) of dotcom stocks. US large cap equity managers were flooded with money from 1998-2000 and were forced to buy over-priced common stocks against their better judgment.

This brings us to where we are today in the investment marketplace. In early February of 2012, the US Federal Reserve Board revealed their intent to leave short-term Treasury interest rates near zero for as long as the end of 2014. The answer to the question is "not in my lifetime". The question is, "When will the Federal Reserve allow the open market to set short-term Treasury bill rates?" In other words, when will short-term rates gravitate to the level of inflation around 2-3%?

We at SCM felt like Ben Bernanke punched us in the stomach. We own companies which have strong balance sheets and produce very high levels of free cash flow. Our assumption is that the P/E ratios on the companies we own will move from the current discount to a premium as short-term capital becomes more expensive. We believe that when short-term interest rates are held artificially low the capital market participants overpay for shares in companies which are capital intensive, highly indebted and inconsistent producers of free cash flow. These "capital eaters" have been provided "free capital" and have been the place to be for the last five to ten years. Investors are like my father, who was a child of the depression. When he was a kid, food was hard to come by in the 1930's. When he walked into an all-you-can-eat buffet restaurant in the 1960's and 1970's, the owner shook with fear. He stayed for two hours and made sure he made up for the food he couldn't eat earlier in his life.

This "artificial" cost of capital has caused a long bull market in the stocks of capital intensive energy companies, basic materials producers and heavy industrial stocks. Long bull markets forced money managers and asset allocators to overweight "capital eater" industries. These industries have suckled on the "bounteous teat" of the emerging market economic growth story. These emerging market nations are themselves massively capital intensive with very high levels of GDP coming from fixed asset investments. Their currencies are boosted by "zero" interest rates in the US, even though their own interest rates are nothing to write home to mom about.

The weak dollar and international economic fears have sparked multi-year bull markets in gold, oil and most major commodities. This has forced asset allocators at the largest institutions, consulting firms, registered advisory firms and financial advisor networks to over-emphasize all aspects of the "capital eaters" and the longer-term Treasury bonds which compete for these dollars. In effect, the Federal Reserve Board caused the last of the unbelievers to give up in early February because it does not appear that rates will rise "in our lifetime".

Since we are not asset allocators or bond fund managers, we assume that all of those who agree with us felt like giving up on the idea that short-term Treasury rates will rise soon enough to give our thesis any benefit when Ben Bernanke made his announcement. The start of the year 2012 has seen a big move in the same kind of investments which have starred for ten years like gold, oil and emerging stock markets. The largest bond fund in the world, Pimco Total Return Fund has moved from shorting long-term Treasuries to a 35% long position recently. Our guess is that the buyers of securities in these markets are covering short positions or window dressing their portfolios due to “career risk” at the end of a bull market. They are doing this because Bernanke effectively told them that rates would rise someday, but “not in their lifetime”.

Best Wishes,

William Smead

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