



Rational Despair and Analogous Situations

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Dear Fellow Investors:

Randall Forsyth of Barron's wrote a piece on May 31st, 2012 called, "Irrational Exuberance's Flip Side Seen in Low Bond Yields". It reminded me of the following and wise joke. A younger person asks an older person, "How do you succeed in business?" The older person says, "Good Decisions". The younger person says, "How do you make good decisions?" The older person answers, "Through experience." The younger person asks, "How do you get experience?" The older person answers, "Bad decisions."

At Smead Capital Management (SCM), we are very respectful of the history of the US stock market and US economy. When faced with a difficult stock market juncture, we like to look back at the most analogous prior situations to see if we can learn more about the probable future outcomes. It just happens that we believe what Mark Twain said, "*History never repeats itself, but it does rhyme!*" Our job at SCM is to find the rhymes and trust the history. Randall Forsyth was writing about the period just after World War II and the parallels are significant. It was a time of rational despair for investors much like what we have today. Besides, Charlie Munger says, "*It is best to learn from the bad decisions of others.*"

Forsyth asks the question, "*What is the opposite of irrational exuberance?*" Alan Greenspan coined this phrase back in December of 1996 in a speech to the American Enterprise Institute. He said, "*But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?*" The tech bubble was already getting pretty nutty, even though it lasted another three years and four months. Therefore, irrational exuberance is a form of dangerous optimism and the opposite, rational despair, is a form of self-damaging pessimism. Here's how Forsyth explains rational despair and the choices driven by its pessimism:

"This mindset is sending investors fleeing from risk assets, which by most valuation metrics are relatively cheap, and toward safe-haven government bonds that, by any conventional scale, offer no investment value whatsoever at the lowest yields in history and unprecedented outside of Japan. Therein may lie a lesson, if not an investment strategy.

The 10-year U.S. Treasury note -- whose yield is a benchmark not only for various borrowing costs for dollar-based loans but also credit markets around the globe -- traded at a yield of 1.608%, shattering the previous record by five basis points. Only in the wake of World War II in 1946, when the Federal Reserve explicitly pegged Treasury bond yields to help finance the war effort, did the 10-year maturity fetch a little less than 1.67%. Five-year U.S. notes yielded as little as 0.684% and while seven-year notes yielded just 1.048%, also all-time lows."

Forsyth goes on to point out that the same kind of ridiculously low bond rates are true in Germany and Great Britain. It shows that the rational despair is worldwide and has probably been acted on by nearly anyone who could. He points out that even after the Federal Reserve took off its peg on Treasury interest rates in 1951, interest rates on 10-year Treasuries stayed down until 1953. From 1953's lowest rate to the 1981 peak at 15%, Treasury bonds were an investment nightmare. Bondholders got to spread a loss of principal over the top of anemic interest payouts like bad tasting frosting over a stale cake.

If this is a valid rhyme with the rational despair of the late 1940's and early 1950's, this is a great time to consider the similarities and attempt to set up favorable probabilities based on the 1951-53 playbook. Below are the similarities:

1. Big wartime budget deficits left the US Treasury with very high debt to GDP.
2. Marshall Plan and GI Bill kept huge stress on budget deficits
3. Federal Reserve capped long-term Treasury rates
4. Corporate Profits were near 10% of GDP
5. Stocks had been poor performers in the prior 14 years
6. Huge Bear markets had occurred in the prior 14 years which had been deeply damaging to risk takers
7. Stock dividends were higher than 10-year Treasury interest rates

What was the correct long-term strategy in the early 1950's? We believe it was to ignore the rational despair and be a cautious optimist. The Dow Jones Industrial Average rose from around 240 in 1952 to 995 in 1966. Bonds needed to be avoided for most of the next 30 years even though rates stayed down longer than expected. Never forget what Warren Buffett says, *"Be fearful when others are greedy and greedy when others are fearful."* But expect to be patient in all cases.

Best Wishes,

William Smead

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