"Real" Career Risk

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Dear Fellow Investors:

Jeremy Grantham is a brilliant asset allocator, writer and thinker. He works for an organization (GMO) of great people in those disciplines. He released his quarterly letter to the public recently entitled "My Sister's Pension Assets and Agency Problems". In the process of describing the "career risk" of being a contrarian value investor in the asset allocation world, he left out a more important discussion about what we consider "real" career risk. At Smead Capital Management (SCM), we have been subject in our own careers to the career risk that Grantham described. We think that avoiding the career risk he left out is more important to today's professional investors.

I come from a small town in the state of Washington. There are approximately 14,000 residents. Let's assume there are three plumbing and heating businesses in town which employ 20 plumbers in their business. We will also assume that something causes a boom in the plumbing business in my home town and 100 plumbers move there. Seven of those 100 are the type of person who start their own plumbing company. You now have 10 firms employing 120 plumbers. The first thing that happens, even if the boom continues, is the existing pool of business gets divided and diluted. The second thing that happens is whatever caused the boom eventually disappears and those 120 plumbers are left to make a living in a town which only supported 20 plumbers in normal times.

"Real" career risk is too many people doing what you do for a living. Grantham's problem is that every day three million brilliant people get up and spend most of their waking hours trying to practice wide asset allocation. Most of those three million brilliant people have incredibly strong backgrounds in economics and lean on their ability to make macroeconomic predictions. Too many people are doing the same thing at the same time for a living. Therefore, much like the plumbers who moved to my hometown, they need to either move to another town or wait patiently for most of the other bright people to take up another profession.

To understand how we got here you have to understand where we came from. A booming stock market from 1982-1999 in the US culminated in the tech bubble. By 1998, most financial professionals either picked stocks directly for folks or guided their clients to stock pickers via mutual funds and separately managed accounts. This reached a pinnacle of concentration in US equities which the world will probably never see again. Most of the great tech firms of that era were US companies, so capital came from around the world to get at the boom. The way to get the most out of the boom was to pick stocks and to concentrate your assets. In 1999, virtually every other asset class was starved for capital except US large cap equity. Returns of 20% compounded were realized in that category and quickly became expected. Three million brilliant financial professionals got up every day to think like George Gilder and figure out the next revolutionary technology and the company which was going to make you rich from it.

When the 2000-2002 bear market in US stocks stripped 80% of the value of the Tech-Heavy NASDAQ stock index and 45% out of the S&P 500 index, the financial professionals suffered "real" career risk. Nobody wanted them to do what they did for a living any more. They recognized the sin of concentration very quickly and between 2003 and 2007 morphed themselves into the world of wide asset allocation. Everybody wanted to be David Swensen or Jeremy Grantham and execute something similar to the Yale-Endowment model. Since the other asset classes were starved for capital, this created a multi-year bull market in everything from gold to oil and emerging markets to international bonds. It spawned the urge to reduce your equity risk through employing hedge funds. It caused institutional folks to move heavily into alternatives like commodity indexes and private equity funds (where prices aren't printed in the newspaper every day).

As if the early decade bear market wasn't enough to get the lesson, the financial meltdown of 2007-2009 reinforced the wide asset allocation urge and motivated those who do it to use a heavy dose of economic analysis. It was official. As an institutional or individual investor you had to practice wide asset allocation and employ some of the greatest macroeconomic thinkers in the world in the process.

Today, if you walk into the office of any financial advisory firm in any small town in the US, you are likely to get a similar set of macro-economically steeped advice and shepherded through the same kind of asset allocation which you would get from a brilliant man like GMO's Ben Inker. My friends, in my opinion, there are too many wide asset allocation plumbers and it has ruined the forward returns of effective wide asset allocation. If you've been around 32 years like me, you can read the frustration in Jeremy Grantham and Ben Inker's letter. *"We (GMO) are going to play for mean reversion sooner rather than later"*. They are avoiding risk because there is very little value to add by taking any in the late stages of a boom in your profession. There are too many smart people attempting to do the same thing that GMO does for a living!

In a recent piece called "Diversification Remains Difficult", Richard Bernstein makes our argument in a slightly different way. He explains that US Treasury bonds are the only "uncorrelated" asset class. He included a chart that shows back in 2002, real estate, gold, commodities, high grade and municipal bonds were inversely correlated with US equities and today they move in tandem with them. Here is how he explains the current situation: *"In particular, we remain quite concerned that investors appear grossly under-diversified," he writes. "Diversification is not dependent on the number of asset classes, but rather it depends on the correlations among those asset classes."* By everyone in the institutional and individual investor world becoming closet economists and wide asset allocators, most of the ways to actually diversify have disappeared.

At our firm we are guessing that this is a very good time to be a long-duration stock picker or to employ good long-duration stock picking in your asset allocation process. We don't believe there are even three thousand brilliant people who wake up each day in our profession and attempt to compete with us. In that way, we believe we are avoiding the "real" career risk.

Best Wishes,

William Smead