Short Term Pain for Long Term Gain
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Dear Fellow Investors:

It appears that the sharp increase in Oil prices occurring in reaction to the unwinding of dictatorships in the Middle East has possibly triggered a correction in the US stock market. The theory holds that higher energy costs could cause lower consumer spending and possibly inhibit consumer confidence. Those of us that have been around for decades expect a 10% correction in the stock market yearly and a bear market (a 20% or greater decline) every five years. Considering that the S&P 500 Index rose sharply since last summer's low and has made a big comeback since March of 2009, is it any surprise that some folks might want to take profits? How do effective portfolio managers deal with market corrections if they are interested in creating wealth by holding outstanding businesses for a long time?

First, we will deal with what we know. In a recent white paper, RS Investments points out that low portfolio turnover promotes better results. Using Morningstar data, RS screened actively manage funds between the end of 1999 and the end of 2009. They found that funds in the lowest turnover quartile outperformed in all three capitalization categories (Large, Mid and Small). The study found that risk adjusted returns were also better for those portfolios which were in the least active quartile. What is especially attractive about this study is that the stock market performed poorly during the decade and confirmed that the benefit of low turnover is not just a bull market phenomenon.

Second, we are reminded of Ben Inker's research at GMO in February of 2009 which concluded that 75% of the intrinsic value of a business comes from cash flows more than 11 years from now and 50% from cash flows more than 25 years out. In his study, he pointed out that the minor differences in earnings during the next two years make up a tiny part of the intrinsic value of a business. Think of it like this. Starbucks announced that higher coffee prices will probably cost the company $.20 of their earnings in the current fiscal year. If those coffee prices stay elevated forever and aren't offset with retail level price increases by Starbucks, it is meaningful to today's intrinsic value. If it is temporary or matched by price increases, it means 20 cents less value in a present value calculation.

Warren Buffett recently told the Financial Crisis Commission what he thought was the most important aspect of the businesses he likes to own. His answer was that he likes companies which have such a strong hold on customers that they can raise their prices. In effect, he is saying that he likes companies which you can hold through thick and thin because they have the ability to prevent exogenous variables from affecting long-term intrinsic value. Wall Street research firms, active traders and hedge fund managers treat these short-term variables as important whether their implications are long term or not. As the New York Stock Exchange statistics show, holding periods for stocks have fallen below one year for the last three years. Poor equity performance from the end of 1999 to the end of 2009 has modified the behavior of most market participants. After all, why would you want a low turnover portfolio in a market going nowhere?

Third, the RS Investment study also looked at portfolio concentration. The Morningstar database shows that those actively managed portfolios with less than 50 stocks outperformed those which held more than 50 as well as the average of all actively managed funds in each capitalization category! We believe in owning no more than 30 stocks in our portfolios at Smead Capital Management.

Lastly, the RS Investment study showed that combining high concentration with low turnover gives you what they call "High Conviction Investing". The outperformance in the large-cap category was about 1.25% annualized over the ten-year period. It was higher in the mid-cap and small-cap categories, but it appears to have been affected by a much better decade for the mid and small-cap indexes. In other words, the more money made in the decade, the greater the benefit to concentrating and keeping turnover down.

We are two years removed from the most difficult bear market in the US stock market since the 1930's and the deepest recession since 1982. Economic recoveries coming off of deep recessions have lasted more than five years on average, which means we are in the early innings. Higher oil prices would be a negative to GDP growth and earnings if the move higher holds for an extended period of time. However, those portfolio managers who sell long-term holdings for market timing reasons or to capture small discrepancies in intrinsic value to avoid short-term pain have proven to underperform those who don't. At Smead Capital Management we don't think it is going to be any different this time.

Best Wishes,

William Smead

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