Stock Picking in a World of Profit Margin Mean Reversion

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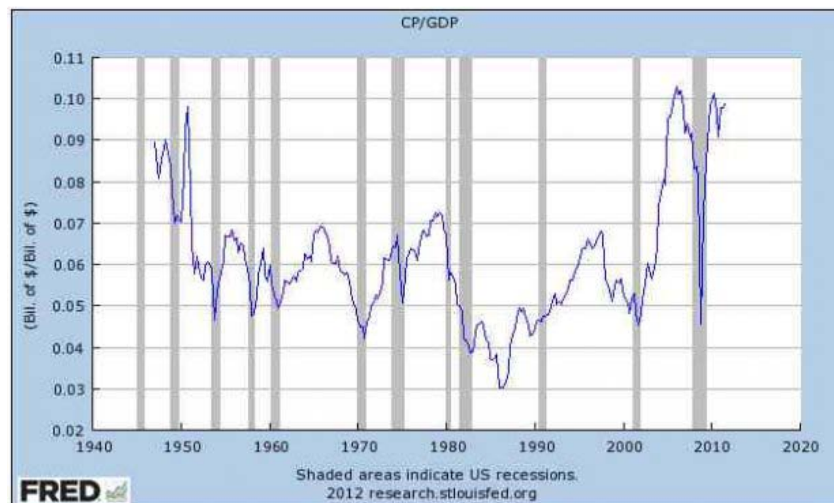
Dear Fellow Investors:

We at Smead Capital Management admire the great thinking and research done by people like Warren Buffett and Jeremy Grantham. We also admire thoughtful writing by professional journalists like Martin Hutchinson from Reuters and Charles Stein from Bloomberg. They've all written or commented on the affect that corporate profit margins have on stock price performance in the US. Buffett, in his speech to the Allen and Company gathering at Sun Valley back in 1999, and Grantham more recently, remind people that there are finite limits to corporate profit margins. They also repeatedly remind us that there are limits to corporate profitability as a percentage of Gross Domestic Product (GDP). Below is a chart of corporate profits as a percentage of GDP:



We first want to answer the question, "Is there something we should do in our portfolio to adjust if these historically high profit margins revert to the mean?" Second, we want to ask if there is a huge difference in what you do with this information if you are an asset allocator or a stock picker. Third, we would like to discuss the

forces which might lead to a reversion to the mean in the ratio of corporate profits to Gross Domestic Product (GDP) on this chart.

Mr. Grantham has pounded the table on why the reversion to the mean on profit margins means significantly lower stock prices. As recently as late November, Grantham called for a decline in the S&P 500 index from the then 1158 to his estimate of fair value between 950 and 1000. As I review this piece on March 26th, 2012, the S&P 500 is trading intra-day at 1400. Even though Grantham seems to some investors to be permanently bearish on US stocks, this is a big disconnect for someone who is supposed to be among the most highly-rated asset allocators in the world.

Hutchinson made the same case as Grantham in a piece called "E Not PE", which was repurposed on the New York Times online website. Here is how Hutchinson explained it:

"There's a bubble in U.S. stocks - but it's in profitability, not valuation metrics. The S&P 500 Index trades at 14 times historical earnings, so the valuation multiple isn't excessive. But a measure of domestic U.S. profit margins stands 50 percent above its long-term average. Global profitability has soared even higher. This is unlikely to last long."

The main forces which affect corporate profit margins are interest rates, labor, productivity enhancement-technology, globalization-emerging markets and commodity prices. We would hypothesize that understanding those forces could play a big part in being successful in either asset allocation or stock picking during the next decade. Most folks who are interested in this topic expect the mean reversion to be very bearish for the overall stock market. We disagree and believe profit margin mean reversion is at the core of our belief in a bifurcated US stock market over the next ten years.

In his Sun Valley speech, Buffett pointed out how massively important interest rates were to both profit margins and stock price performance from 1964-1981. Interest rates affect corporate profitability in multiple ways, but two obvious ones are by affecting borrowing costs for companies (a direct expense) and borrowing costs for customers (an indirect reduction in demand). Ultimately, very high interest rates greatly impacted economic growth by the late 1970's. This all culminated in the very low level of corporate profitability in the early 1980's.

When it comes to stock prices, interest rates instantly affect discounting models of future earnings and cash flows. The higher the rates, the lower the present value, the lower the rates, the higher the present value. Secondly, high interest rates on more secure "currency" investments like CDs, money market funds and Treasury Bills/Bonds proved to be stiff alternatives to common stocks. All of these corporate profitability and stock price forces peaked in 1981-1982. Interest rates hit their highs and stock market PE ratios hit their lows.

When comparing what happened in the US stock market from 1964-1981 to the period from 1981-1998, Buffett noticed that corporate profitability as a percentage of GDP rose from 4% to over 6%. He also noted that interest rates on long-term Treasury Bonds had fallen from 13% to 5%. He then talked about how ridiculously over-optimistic investors were at that time. The 30 PE multiple for the Fortune 500 was used as a reference point of how expensive and over-priced stocks were in 1999. Buffett argued correctly back then that equity returns would be historically poor going forward. The only way that he felt that he could be wrong was if a huge decline in interest rates occurred and /or corporate profitability climbed markedly to historical extremes. **The irony of it all is that his prognostication was spot on even though the profit margins did soar and interest rates did plummet!** This could certainly explain his recent bullishness on US large cap stocks when you factor in a trailing PE multiple of 14.1 on the S&P 500 index.

As we discuss the forces which could lead to a mean reversion for profit margins, we at SCM want you to know that we are in the camp which agrees that a reversion is coming. First, interest rates today are very similar to the early 1950's, the last time that profit margins approached 10% of GDP. Long-term Treasury bonds have averaged 5.5% since 1926 (Ibbotson). With the ten-year T-bond at 2.28% and the thirty-year T-bond at 3.36%, there is plenty of reverting to do. We believe that interest rates will rise significantly over the next ten years. We've written about this in missives titled "Out of Bondage" and "Not in My Lifetime". We believe bond prices

will tumble once the fear of a new major meltdown dissipates. Profit margins would be impacted by the result of those higher interest rates.

Charles Stein, a writer for Bloomberg, wrote a terrific piece on November 27, 2011 discussing the forces which affect corporate profit margins. The discussion on labor resulted in this quote:

"The globalization of the workforce and a U.S. jobless rate of 9 percent last month have given management the upper hand in dealing with labor, Zandi said. Wages and salaries as a share of national income fell to 49.4 percent in the third quarter, the lowest since the government began collecting the numbers in 1948, Moody's data show."

High unemployment rates and high US government expenditures on unemployment compensation/welfare also contribute to high profit margins. A person who is unemployed and buying things anyway adds to revenue without being a labor expense. As a firm, we believe that an improving economy, lower government expenditures as a portion of national income and higher wages in the emerging world will help reduce profit margins absolutely and as a percentage of GDP.

We believe the number one thing affecting employment in the US is the depression in home building. Housing and related industries are blue-collar heavy. As "echo" boomer children of baby boomers turn 30 years of age in droves the next five years, we expect they will begin to buy houses without abandon. Rents have moved up dramatically, but the large stack of foreclosures and short sales has not yet been overwhelmed by household formations. In his 2011 shareholder letter for Berkshire Hathaway, Warren Buffett said, *"Wise monetary and fiscal policies play an important role in tempering recessions, but these tools don't create households nor eliminate excess housing units. Fortunately, demographics and our market system will restore the needed balance – probably before long. When that day comes, we will again build one million or more residential units annually. I believe pundits will be surprised at how far unemployment drops once that happens. They will then reawake to what has been true since 1776: America's best days lie ahead."*

In a CNBC interview on the 27th of February, 2012, Buffett added, *"Well, if I thought I was going to live-if I knew where I was going to want to live the next five or 10 years, I would, I would buy a home and I'd finance it with a 30-year mortgage, and it's a terrific deal. And if I literally, if I was an investor that was a handy type, which I'm not, and I could buy a couple of them at distressed prices and find renters, I think that's and again take a 30-year mortgage, it's a leveraged way of owning a very cheap asset now and I think that's probably as an attractive an investment as you can make now. But I think equities are very attractive compared to anything else."* Over the next two to three years, we see housing rebounding, labor participation rising and the government pulling back from its Keynesian demand strategy. This would put pressure on profit margins.

Technology improvements and the affect they have on productivity will be an offset to the totality of labor's improved position. Whether using the "cloud", allowing employees to work from home or using technology to reduce paperwork, productivity is being enhanced and profit margins are benefitting. We see it all the time in the results of the companies in our portfolio of stocks. Nordstrom (JWN) has seen a big part of its growth come from its online sales in the last five years. Online sales are labor and capital un-intensive. Many businesses are selling through smart phone apps like Ebay (EBAY). Imagine how many employees are getting usurped by these efficiencies.

The next two forces affecting profit margins are globalization-emerging markets and commodity prices. We at SCM like to refer to this as the "Global Synchronized Trade". Emerging markets like Brazil, Russia, India and China have seen huge and relatively uninterrupted GDP growth the last ten years. The kingpin of this growth has been China. They appeared to even be oblivious to the steep recession of 2007-2009! With massive fixed asset investment stimulus, fed by the four large government-owned banks, China jumped right back up to the 10% GDP growth level in 2010 and 2011.

All the economic history we have studied and the history studied by professors like Michael Pettis from Peking University in Beijing, shows that most all emerging market nations get to the point where the only way they can

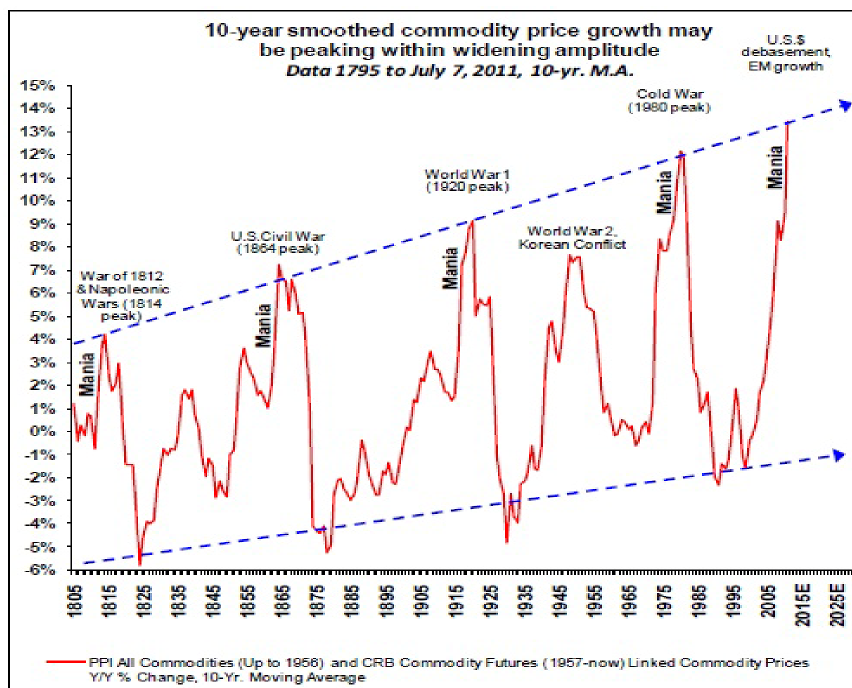
maintain high growth rates is to manufacture GDP growth through unsustainably high fixed asset investment levels. Here are his latest thoughts in a recent NPR appearance:

"China's economic miracle is just the latest, largest version of a familiar story. A government in a developing country funnels tons of money into construction. This increases economic activity for a while, but the country ultimately overbuilds — and the loans start going bad."

"In every single case it ended up with excessive debt," Pettis says. "In some cases a debt crisis, in other cases a lost decade of very, very slow growth and rapidly rising debt. And no one has taken it to the extremes China has."

In the phase of heavy fixed asset investment, countries are incredibly inefficient in their level of commodity use as a percentage of GDP produced. Professor Pettis has estimated that China used nearly 40 percent of all the major input commodities consumed in the world in 2010 to produce 9.4% of the world's GDP. Brazil and Russia effectively suckle on the "bounteous teat" of the China Boom, so their growth has been tied directly to the affect that China has had on commodity prices, especially oil. India's growth has had a very large impact as well on commodity use as they have also built a great deal of infrastructure in the last ten years.

Therefore, any country like Australia or Canada which has also suckled on China's "bounteous teat" or US company which has anything to do with designing, engineering and building infrastructure has had a boom themselves. Simultaneously, any US company which is involved in the production of commodities has not only had a boom, but they've had it while interest rates are historically low. Profit margins for these US companies are the backbone of the historically high profit margins. Here is what the 205-year chart of ten-year commodity price performance looks like from a US standpoint:



Source: Stifel Nicolaus Mid-2011 Macro Outlook Slide Deck, July 7, 2011

Without going into great detail, we believe that China's coming recession will trigger a huge multiple-year bear market in commodities. The profit margins of those who have suckled will get crushed, in our opinion. Hutchinson might have written it best: *"Globalization is one factor driving up profit for companies in the United States. According to a March 2011 paper by the Bureau of Economic Analysis, foreign earnings represented 40 percent to 45 percent of total profit between 2008 and 2009, against around 20 percent in the 1980s."*

We believe that foreign earnings could back off to closer to 30% of profits by ten years from now. This would come from the combination of the slowdown around the world coinciding with the rebound in US housing and the explosive affect lower commodity prices would have on US economic growth and confidence.
Therefore, a summary of the forces affecting US profit margins over the next ten years is needed at this point. We believe that interest rates will rise. We believe the unemployment will decline as the economy picks up steam. This will negatively affect margins, but be somewhat offset by significant GDP growth. We also see productivity enhancement through technology maintaining some of the profit margins reduced by other factors. Lastly, we see international fixed asset investment declining rapidly and commodity prices plummeting. The positive side of this would be the stimulative affect it would have on US GDP growth.

What do we think this means for asset allocators? Currency investments (interest bearing) have trapped investors both institutional and individual. They will prevent another 2008, but they will volunteer you to lose purchasing power over the next ten years. Commodities are a ticket to losses, in our opinion, led by oil and gold. Emerging markets will be a big disappointment for both stocks and bonds. Once the bloom comes off the rose, a number of the emerging markets like China and their suckling countries will see their credit quality questioned. In the US, stocks and residential real estate should outperform, as long as you avoid the companies who have benefitted from the prior boom.

From a stock picking standpoint, we believe the US should be a great place to be in retail sales and consumer services. We like Ebay (EBAY), Nordstrom (JWN) and H&R Block (HRB), as examples. Banks, which are loaded down with under-water residential real estate, should rebound. Higher interest rates could help spreads for the likes of Wells Fargo (WFC) and Bank of America (BAC), two very domestically-oriented banks. The media companies should enjoy a more prosperous US economy and benefit stocks like Disney (DIS), Comcast (CMCSK) and Gannett (GCI). Lastly, Americans will be able to afford quality healthcare though the most inexpensive part of the healthcare system, pharmaceuticals and biotech. We like Merck (MRK), Pfizer (PFE), Amgen (AMGN) and Mylan Labs (MYL) in that area.

We feel investors should avoid capital intensive companies which are tied to commodities or emerging markets. As interest rates rise and capital becomes dear, those who eat capital lose and those with strong balance sheets and who generate high and consistent free cash flow, win. As Buffet, Grantham, Hutchinson and Stein pointed out, someone loses in the reversion to the mean of profit margins when compared to GDP. Lastly, don't be fooled by those who are bearish on the stock market because of their belief in profit margin reversion. The Dow Jones average rose from 260 in 1952 to nearly 1000 in 1966 while profit margins plummeted from near 10% of GDP to 5% in the recessions of 1953-54, 1957-58 and 1960-61. Profit margins dropped to 5% when our economy melted down in 2008, but stocks have rebounded nicely.

Best Wishes,

William Smead

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