The Great Scarcity: Stockpicking

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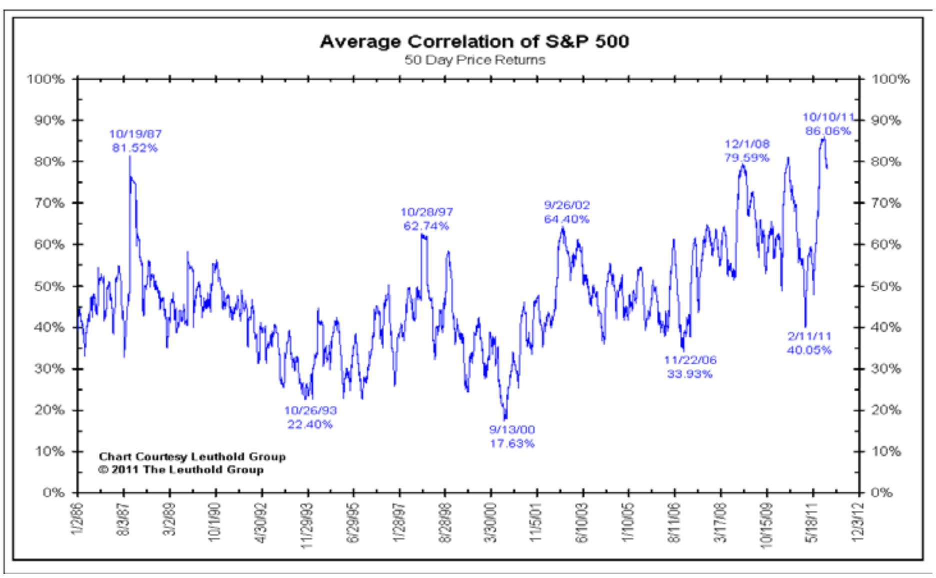
Dear Fellow Investors:

As the chart below shows, correlations among the S&P 500 Index companies was the highest on October 10th of 2011 as it has been for 25 years.



In the opinion of Smead Capital Management, this means that more investors are participating in market directional strategies, macro-economic strategies and tactical portfolio strategies than at any time in US history. John Maynard Keynes was a great investor, as well as a famous economist, and he said, "Investing is the only sphere of life where victory, security and success go to the minority, and never to the majority"! As it does every time, Wall Street creates new instruments to satisfy the demand that comes from individual and institutional clients to pursue what was successful in the prior five years. These directional investments come mostly in the form of Exchange Traded Funds (ETFs). The tactical portfolios come from go anywhere mutual funds, which have become immensely popular and the macro-economic investments have been the domain of the hedge fund world. They are all designed to fit into the wide asset allocation models which are being employed by almost everyone in the wealth management world.

Wayne Gretsky, when asked why he was such a good hockey player said, "I skate to where the puck is going to be". We believe that the correlation chart is screaming for reversion to the mean. It tells us that stock picking will never get more out of favor in the investment business than it was on October 10th. In other words, there is an over-capacity of asset allocation and a scarcity of stock picking. Large-cap stocks in the US have done poorly since 1998.Those who moved away from US large-cap stocks between 1998 and 2003 to other asset classes took advantage of inexpensive asset classes and made a smart shift. By 2007, the shift was nearly complete and has only been exacerbated by 2008's cataclysmic decline in stocks. After two 40% or greater stock declines in one decade, stock picking became overwhelmingly out of favor. The assets under management gravitated from the large cap US funds to the directional, macro -economic and tactical strategies, where we stand today.

Alas, all of this came to a peak in 2011. The asset classes like commodities and emerging/global markets ended up with a massive amount of money and US large cap suffered record setting net liquidation. We believe the commodity and emerging market asset classes have entered a terrible bear market for the next five to ten years. Fortunately, two of the best stock pickers have rung the bell for everyone. Warren Buffett announced that he is an aggressive open-market buyer of individual large-cap stocks and Legg Mason punctuated the cycle by nudging Bill Miller out the door as CIO and lead manager of the Value Trust Fund. (see link)

As large-cap value managers and stock pickers, we are very excited about the next three to five years as all the chips have moved to the other side of the table and stock picking has become a scarce resource.

Best Wishes,

William Smead

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