The Parable of the Stock Market Sower

William Smead
Chief Executive Officer
Chief Investment Officer

Dear Clients and Prospective Clients:

One of the most famous parables in the Bible can be found in the book of Luke, the Seventh Chapter. Jesus compares the Kingdom of God to farming. The farmer spreads seed around the land. Some falls on the path, gets trampled and eaten by birds. Some lands on the rocks and does not grow due to a lack of moisture. Some grows up among the thorns and gets choked in the process. Some falls on good soil and yields 100 times itself.

In the long run, the stock market is the same as farming. Most investors use an approach designed to produce short-run success. Some use momentum models designed to get on the hot path, only to get eaten up by paying too much for future success. Some invest in concept stocks and buck such low probabilities that their losers rob all the moisture from their winners. Some seek to predict the economy or use wide asset allocation and choke on errant macro-economic predictions or faith in obscure or illiquid asset classes. Some rely on wide moats and the generation of ample and long lasting free cash flow that can make many times their original investment over many decades.

At Smead Capital Management, we'd like to focus on the successful part of the farming analogy. It refers to "good soil". What is good soil for an investor? We believe it is buying shares of an outstanding business for less than its intrinsic value and holding it for years as the company continues to succeed. We believe we are more likely to do that in companies which will survive and prosper much longer than other companies. The most important factors in longevity for a public company are balance sheet, product necessity and strength of moat.

To understand why we think this way we would like to refer you to the writing of Brett Arends of the "Wall Street Journal" in a May 11th article called, "How to Value Stocks? Ignore Economic News". In it he chronicles the work of Ben Inker, Director of Asset Allocation at contrarian fund company Grantham Mayo Van Otterloo & Company (GMO). Inker points out that the present value or intrinsic value of a company is the discounted value of all future cash flows and dividends. And Inker can't understand why people put so much emphasis on what is going on in the stock market right now or in the economy next year when they seek to analyze common stocks. He thinks they are mistaken for two reasons.

> *First, because most of the value of shares really depends on the cash they will generate many years, even decades, ahead. The next few years are only a minuscule part of the equation. "Since stocks do not have an expiration date and dividends grow over time," Mr. Inker argues, "the duration of stocks is extremely long. If we assume that half of the return from stocks in a given*

year comes from the dividends and half from the growth in dividends, most of the value of stocks comes from cash flows in the distant future."

How distant? Using Mr. Inker's hypothesis, it turns out that about 75% of the value of shares is actually based on dividends that will be paid more than eleven years from now. Half the value is based on dividends to be paid after 25 years, and a quarter on those to be paid after about 50 years.

In other words, when you look at the market today, three quarters of its true value is based on what companies will earn and pay out after 2020 and half is based on what they will do after 2034. So really, how much attention should you pay to next quarter's earnings?

We at SCM love his logical and mathematical conclusion. Since most of the current value of a company comes from discounting cash flows and dividends coming years and decades from now, our analysis should be spent trying to ferret out the companies which can survive at high levels of profitability the longest. It reminds us of why Warren Buffett paid an astounding 18 times trailing earnings to buy a large stake in Coca Cola back in 1988. When asked why Buffett answered, "'Let's say you were going away for ten years,' he explained. and you wanted to make one investment and you know everything that you know now, and you couldn't change it while you're gone. What would you think about?'" He knew that he could discount cash flows and dividends thirty, forty and even fifty years out and Inker proves that those future flows make up most of the current or intrinsic value of a stock.

His second reason is that economic performance follows a fairly consistent long-term path and gravitates towards the mean. If the economy has been terrible, it is likely to revert back to acting better. If it has been terrific for quite awhile, it is headed for difficulty. At SCM we are asking whether the current economic trouble is making our companies more or less likely to survive and prosper for many decades? We think the overwhelming answer is that the current circumstances are making the kinds of companies we like to own more likely to survive! Six Flags declares bankruptcy and Disney gets stronger. Washington Mutual disappears and Wells Fargo gets stronger. Nobody wants to finance young biotechs, so Merck and Pfizer will buy most of the great future science. The list goes on and on. The economic cleansing of the last two years has done more to strengthen and widen the moats of strong balance sheet companies with powerful brands and distribution chains than any phase in history in our opinion. However, since these facts are long term in nature, the marketplace actually discounts these virtues rather than giving them their usual premium. We believe that the next few years could very well rectify the under valuation of the most valuable franchises in business and our companies could turn out to be "good soil". We will leave investments on the path, on a rock or in the thorns to someone else.

Best Wishes,

William Smead

The information contained in this missive represents SCM's opinions, and should not be construed as personalized or individualized investment advice. Past performance is no guarantee of future results. The securities identified and described in this missive do not represent all of the securities purchased or recommended for our clients. It should not be assumed that investing in these securities was or will be profitable. A list of all recommendations made by Smead Capital Management with in the past twelve month period is available upon request.

This Missive and others are available at www.smeadblog.com.