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The Truth Will Set You Free
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Dear Fellow Investors:

Barron's ran an article by Tom Sullivan in the January 9, 2010 edition which focuses on a myth which has been perpetrated long enough that it is accepted as fact. A number of seemingly respectable market observers are quoted as saying that more money should go into emerging markets because of very high economic growth levels. And they argue that emerging markets are cheaper than developed markets like the USA stock market. In this Smead Capital Management Missive, I would like to invoke what we believe are truths from recent opinions we garnered from Mark Mobius, Jim Chanos and some research provided by Liz Ann Sonders of Charles Schwab. Our only caveat is that the truth takes time to unfold in investment markets, but when it does we believe it rewards those who believe and punishes those who don't.

Mark Mobius of Franklin Templeton fame, pointed out in an interview with Bloomberg last week that high levels of Initial Public Offerings (IPOs) of common stock are a typical warning sign of an overheated market. This article pointed out that emerging markets had out-raised developed markets in IPO capital in 2009 and how unusual that is. “When you look at the size of some of these IPOs, they’re pretty massive,” Mobius, 73, who oversees $34 billion of developing-nation assets at Templeton Asset Management Ltd., said in a telephone interview from Tokyo. “At the right price, the IPOs will be absorbed, but you’re going to have some hiccups. It’s too much supply coming out.” Massive increases in supply ultimately affect prices when demand declines. It can take awhile, but it is likely to happen.

Which brings us to Jim Chanos (the highly successful and celebrated shortseller who identified Enron), who is trying to bring truth to the subject of what will cause demand in emerging markets and cyclical/commodity piggyback markets to decline. As most of the world bets on China to help lift the global economy out of recession, Mr. Chanos is warning that China’s hyperstimulated economy is headed for a crash, rather than the sustained boom that most economists predict. “Its surging real estate sector, buoyed by a flood of speculative capital, looks like Dubai times 1,000 — or worse,” Chanos frets. He even suspects that Beijing is cooking its books, faking, among other things, its eye-popping growth rates of more than 8 percent. “Bubbles are best identified by credit excesses, not valuation excesses,” he said in a recent appearance on CNBC. “And there’s no bigger credit excess than in China.”

Since most investors invest in what has been doing well lately, they don't realize that they are investing in "the rearview mirror". These investors don't understand that supply and demand are working intensely against them. But for many, this argument is not enough to sway them. Adding further support to this idea, Liz Ann Sonders provided us with research that shows that high levels of economic growth coincide with lousy common stock investing results.

3/31/1960 – 6/30/2009	
Y/Y % Change of Real GDP	S&P 500 Annualized Gain
>6.0	-4.6%
0.5-6.0	7.1%
<0.5	7.5%

Source: Bureau of Economic Analysis, FactSet, Ned Davis Research, Inc., Standard and Poor's.

Liz Ann's research proves a theory I've seen played out in my nearly 30 years of being in the investment business. When economic growth is high, Main Street is creating significant wealth and the business and property owners are using massive amounts of capital to accomplish the growth. Much of that capital is brought out of common stocks or borrowed from banks. These activities drive up the cost of capital and PE multiples fall. We've been trained in the last ten years to believe that those forces are not at work in BRIC and emerging market countries. The building of infrastructure (buildings, roads, etc) is the driver behind high rates of economic growth in emerging market nations. Commodity producers, basic material manufacturers and heavy industrial companies benefit most from the creation of the infrastructure.

Once the infrastructure is in place and large middle class economic groups emerge in those countries the long term wealth is created by providing products and services to those folks. A large office building only needs to be rebuilt every 50-100 years. But a beverage, a pill or computer software gets used every day. The transition away from infrastructure to recession resistant products and services could happen soon. The premier companies in the world that provide those items are US large cap companies. Most investors have spent the last six years betting against that truth and when you are patient as an investor the truth will set you free!

Best Wishes,

William Smead

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