The Value of Sentiment Polls
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Dear Fellow Investors:

We at Smead Capital Management (SCM) have made the case that the poor performance of the US stock market from the end of 1999 to the end of 2008 has caused most institutional and individual investors to dramatically shorten the duration of their equity investments. In many cases, we are hearing that institutions and individuals want their advisors to help them insulate or "prevent" them from having another 2008. In a world of short duration common stock investing, sentiment polls have an increased importance. We like to say that an eye on the crowd is important if you have one foot out the door at all times. Professional investors have been forced by the power of the rebound in the stock market since March 9, 2009 to get invested, but they haven't trusted the durability of this rebound along the way.

Individuals and financial advisors practice short duration through go-anywhere managers, exchange-traded funds and low-cost trading of individual common stocks. Institutional investors have done this by allocating a large part of their asset base to equity managers who attempt market timing and alternative investments in the hedge fund world. Studies show that the money in "alternative strategies" now dwarfs what is held in US long-only equity. See the chart below:

2010 NACUBO-Commonfund Study of Endowments

Asset Allocations for Fiscal Year 2010

Size of Fund	Domestic Equities %	Fixed Income %	International Equities %	Alternative Strategies %	Short-term Securities/ Cash/ Other %
Over $1 Billion	11	10	15	60	4
$501 Million to $1 Billion	18	14	17	45	6
$101 Million to $500 Million	25	17	17	35	6
$51 Million to $100 Million	31	21	18	24	6
$25 Million to $50 Million	35	24	16	17	8
Under $25 Million	40	27	13	12	8
All Public Institutions	21	15	16	44	4
Public College, University, or System	18	14	16	48	4
Institution-Related Foundation	21	17	17	39	6
Combined Endowment/Foundation	26	15	17	39	3
Private Non-Profit College or University	14	11	15	55	5
Dollar-weighted Average	15	12	16	52	5
Equal-weighted Average	30	21	16	26	7

All data are dollar-weighted unless otherwise specified.

Alternative strategies are categorized in the NCSE as follows: Private equity (LBOs, mezzanine, M&A funds, and international private equity); Marketable alternative strategies (hedge funds, absolute return, market neutral, long/short, 130/30, and event-driven and derivatives); Venture capital; Private equity real estate (non-campus); Energy and natural resources (oil, gas, timber, commodities and managed futures); and Distressed debt.

In a wonderful April 1, 2012 article in the New York Times, Julie Creswell presents the facts about pension fund performance in relation to how committed plans are to alternative investments:

"Searching for higher returns to bridge looming shortfalls, public workers' pension fund across the country are increasingly turning to riskier investments in private equity, real estate and hedge funds.

But while their fees have soared, their returns have not. In fact, a number of retirement systems that have stuck with more traditional investments in stocks and bonds have performed better in recent years, for a fraction of the fees."

What Julie describes as "riskier" investments have also contributed to these very low levels of participation in long-only US stocks and especially long-only US large capitalization strategies.

When you breakdown the long-only participation, it is spread between US large cap, US mid cap and US small cap. Since small and mid-cap strategies have outperformed since the peak of the US stock bubble in 1999, it is safe to assume that institutions are the most committed to small-cap and mid-cap long-only strategies relative to the total equity long-only mix as at any time since the 1990's. You can see this in Request for Proposal (RFP) mandate notices for small cap managers in periodicals like Emerging Manager Monthly. Institutional investors seem to like to close the barn door after the animals have run out. After ten years of outperformance by small-mid strategies, they are vigorously looking to increase their participation. Since small and mid-cap strategies are historically more volatile than large-cap strategies, this triggers an additional urge to time the market and has increased the importance of sentiment polls.

The Investor's Intelligence (II) poll of investment newsletter writers is the oldest of the major sentiment polls and is the one I have followed during my nearly 32 years in the investment business. Our general view at SCM, as long-term investors by nature, is to not be interested in changing what we own based on 6-12 month stock market gyrations. For this reason, our view is that the sentiment polls are only useful at extremes. Therefore, everything that happens in between the extremes is just noise.

This week's II poll showed that those writers who are bullish total 50.5% and those that are bearish equal 22.6% of the newsletter writers. Our observation is that it is very meaningful historically when the bullish sentiment reaches 60% or greater. In August of 1987, at the end of a run up in the Dow Jones Industrial Average from below 800 in August of1982 to over 2700, bullish sentiment broke 60%. By October 19th of the same year, the Dow fell to 1738. In February of 1999 and in February of 2001 at around 1240 on the S&P 500 index, bullish sentiment exceeded 60%. The S&P 500 index fell to 761 in October of 2002, a decline of 38.6%.

If history is any guide, it would take a large additional spurt to the upside in today's US stock market to trigger a 60% bullish reading. We feel this could only come through a dramatic increase in long-only institutional large-cap US stock market participation and/or an end to the massive move into bonds made by US individual investors over the last four years. The bond market devotion would have to be replaced by a very meaningful move into US equities.

In 1987, institutions got heavily committed because of the comfort that derivative -related "portfolio insurance" provided many of them. The insurance was designed to protect against "normal" bear markets, not a drop in the Dow Jones average from 2700 to 1700 in 78 days! Both of these instances (August 1987 and February 1999), where the 60% bullish sentiment marker hit an extreme, saw price-to earnings (PE) ratios at historic highpoints. Warren Buffett, in his Allen and Co. talk at Sun Valley in the summer of 1999 mentioned that the Fortune 500 traded at 30 PE.

In our opinion, those who are very bearish about the US stock market need a substantial price increase to trigger historically extreme newsletter writer sentiment. Those who are optimistic should prefer a temporary correction or sideways movement to reinforce fear on the part of the crowd. This would cause the bullish and bearish readings to gravitate to toward each other and remove the risk of having some temporary "hell to pay" for those of us who seek to practice long-duration common stock investing.

Best Wishes,

William Smead

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