



Wayne Gretzky on Value Investing

April 5, 2011



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Dear Fellow Investors:

Wayne Gretzky was once asked why he thought he was such a great hockey player. He replied, “I skate to where the puck is going to be.” As the first quarter of 2011 ends, this seems like a very good time to look at where the puck is and hypothesize about where it is going to be.

Long-term value investing is about buying the most future success (where the puck is going to be) for the least amount of money. From a theoretical standpoint, academics have looked at attributes associated with being rewarded both absolutely and on a relative basis in common stock ownership. These studies (Fama-French, Bauman, Nicholson and Dreman) show that valuation matters. What you pay for the future success is a huge determiner of future returns. High quality was studied by Grantham Mayo from 1980 to 2004 and concluded that strong balance sheets, earnings stability, above-average returns on equity and below-average volatility are correlated with long-term investing success. In turn, high quality contributes to low turnover which reduces “frictional costs”. Mutual fund costs were measured by the Retirement Research Group at Boston College. They concluded that the average mutual fund in the US spends 1.44% of their returns on trading. This expense hurts both absolute and relative returns.

Today the puck is in Energy, Basic Materials, Heavy Industrial and Commodity-related common stocks. They were severely undervalued at the bottom of the 2000-2002 bear market as the Enron scandal and massive liquidation occurred in the energy sector. These sectors would have popped up in Fama-French on low price-to-book value (PB) and populated the lowest price-to-earnings ratio (PE) quintile of the S&P 500 Index back in 2002-2003. Few portfolio managers were over-weighting these sectors in 2003 and the ones who were leaned on the idea that we’d have uninterrupted growth in China. At the margin, the demand for everything having to do with the building of infrastructure in China has caused soaring prices for inputs and huge earnings gains for companies which satisfy the demand. The puck is also in gold and the currencies of countries whose economies are dominated by oil production, mining, basic material production and heavy industries. A few hours watching CNBC or reading articles at Morningstar’s web site shows all the players gathered around the puck right where it is now!

This cyclical phenomenon is very dangerous from a long-term investing standpoint. First, today's puck-holding favorites no longer populate low quintiles on the PB or PE ratios. Caterpillar trades at its highest price-to-book ratio in two decades at around 6 times book and Joy Global has a stratospheric PB of 9. The S&P 500 trades at an average of around 2 times book value. Second, they are missing key attributes GMO described in their high quality study. When business is great, their balance sheets are strong, but when business turns down in their industry their balance sheets automatically weaken. For example, Joy Global came out of bankruptcy in 2001 and was formerly known as Harnischfeger Industries. Like they use to say in Dragnet, "The names were changed to protect the innocent." Returns on equity are high in the boom, but disappear in many cases in the down cycle. The earnings are inconsistent and bounce around wildly based on exogenous forces like commodity prices and macro-economic trends. These stocks are volatile and incredibly difficult to own when their industry is out of favor.

Where would Wayne skate now so that he'd be where the investment puck is going to be five years from now? What sectors are deeply out of favor due to great difficulty in their industry? Where do you find numerous companies in the lowest PE quintile of the S&P 500 Index? Lastly, do any of them have the kind of characteristics described as "high quality" by Grantham Mayo's study? We believe the Pharmaceutical Industry fills these qualifications to a tee. For us this includes all "medicine" makers; Biotech, Generic, Big Pharma and Diversified Pharma companies. The PE ratios are universally low. The balance sheet strength is immense. Returns on equity are high even in all the political, legal and FDA challenges of the last five years. Profits are historically consistent and demand only grows for medicine as more people enter the world. These company's shares have been out of favor so long that even spectacularly good news on a new drug for treating cancer can't produce stock price volatility.

At this time, some of our favorites are Abbott Labs (ABT), Mylan Labs (MYL), Bristol Myers (BMY) and Amgen (AMGN). At Smead Capital Management, we'd like to think about all the capital gains that could be made when Wayne Gretzky and the puck show up in front of our goals.

Best Wishes,

William Smead

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