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Our Abusive Parent Leads to Lots of Experts at Extremes

As portfolio managers, we feel like the children of an abusive parent. The parent spent the last 29 years teaching us the difference between right and wrong. We in turn have been executing the behaviors that are preferred by the abusive parent. Unfortunately, the abusive parent chooses to abuse us financially and psychologically. Many have rightly fled the household of the abusive parent and gone to investment shelters until the abusive parent is arrested or in some other way is stopped from inflicting pain on its family. All of this abuse has laid the groundwork for there to be lots of experts at this extreme in the stock market.

Here is a list of some of those right behaviors:

- 1) Buy and hold Blue Chip stocks for the long haul.
- 2) Buy companies with strong balance sheets and strong brands.
- 3) Add to stocks at points of "maximum pessimism."
- 4) Use insider buying as an indicator of future business success by those who know the company best.

The only times that long-term investing hasn't worked has been if you bought in at a major high point. The bad news is that the end of 1999 and beginning of 2000 was just one of those historical high points. In the American Association of Individual Investor's sentiment poll in early 2000, their members peaked with 72% bullish one week and two weeks later saw only 6% bearish on the stock market. This total belief and participation caused ridiculously high prices and effectively ruined

the normally virtuous behavior. Our look back over the last ten years makes us recognize how abusive this greater than 50% decline has been as a snapshot in time, as ten years of the stock indexes losing money has successfully convinced a majority of the remaining participants to seek shelter.

To understand how balance sheet strength has been turned on its head, just look at Jeff Immelt, the CEO of General Electric, attempt to defend its AAA rating as the stock fell to the \$6 to \$7 level per share recently. There has been about \$300 billion lost in the prior 17 months by owners of this former blue chip. Is that any way to treat people you are supposed to reward?

When it comes to "maximum pessimism," just look at point number 3. There have been at least four cataclysmic selling waves since October of 2007. Each

would have qualified as the “point of maximum pessimism” in 80% of our experiences over the last 29 years. Each effort to be optimistic on our part has just been another good excuse to get bashed around by our abusive parent, the U.S. stock market.

If anything, the insider buying (which has been at record levels for months) has been a contrary indicator. Almost every time a sizable buy or series of buys are made, it seems that a curse has been attached to it. When you buy a financial stock with a strong history and an outstanding management team after an insider buying spree, it is like you bent over and said, “Hit me.” Our abusive parent has been glad to do so.

When will we stop getting abused in the stock market for right behaviors? The good news is it could be soon. In the same A.A.I.I. sentiment poll taken March 5th 2009, the members were 70% bearish and only 18% bullish. It is a record level of bearishness in 21 years of polling each week. The highest prior reading to now was 67% bearish at the bottom in October 1990 in the middle of the bank and S&L Crisis. More importantly from a psychological stand point, the magnitude of today’s negativity could be as good an indicator as 2000’s ridiculous enthusiasm was. It topped out one of the greatest bull markets of all time.

When a market has been strong as it was in the late 1990’s, there is no limit to the number of people who will tell you how good it is going to be for the foreseeable future. When a market has gone down for a long time and our parent has been this abusive, a multitude will tell you how far down it will go and how long the downtrend will last.

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At Smead Capital Management we have developed a term for this that we call a “Well-Known Fact”. By definition (Smead Unabridged Dictionary), a “Well-Known Fact” is a body of economic information which is known by all market participants and has been acted upon by nearly everyone who could care or has the financial wherewithal to care to act. It is best understood through the comments of former Intel CEO, Andy Grove, who said that the best advice he ever got in business came from a professor at the City College of New York. The professor said, “When

everyone knows that something is so, nobody knows nothin’.” By nothin’ the professor infers nothing that could do you any good. When everyone believes a fact and has acted on it to an extreme, nothing good can come to you from believing it.

Here is a series of “Well-Known Facts” from recent history. Also noted are the assets that were purchased to act on the fact and the end result of the extreme:

Fact 1: The Internet will change our lives.

Asset Purchased: Tech Stocks — Result: From the peak of early 2000, tech stocks fell 80% in 2.5 years.

Fact 2: Residential Real Estate only goes up.

Asset Purchased: Homes in sunshine states of Arizona, Florida, Nevada and California. — Result: 40-50% price drops and a majority of the nation’s foreclosures.

Fact 3: Brazil, Russia, India and China (BRIC) will grow faster than the industrialized world.

Assets Purchased: Commodities and Emerging Market Mutual Funds. — Result: Commodities drop 60-80% and Emerging Markets fall 50-70%.

At the extreme, whatever value that is connected to the assets involved with the “well-known fact” doesn’t matter in either direction and there is no shortage of both expert and non-expert opinion on where asset prices will go. Henry Blodget saw the moon for Internet stocks in 1999. No shortage of cable shows taught you to “Flip this House” in 2005. And in 2008, Goldman Sachs’ Oil analyst put a \$200-250 price possibility on a barrel of oil. Not to mention T. Boone Pickens, who has been attempting to talk oil prices up since it peaked at \$147 per barrel!

In the opinion of SCM, here is the new “Well-Known Fact”.

Fact 4: The massive amount of borrowing attached to homes and personal finances in the U.S. over the last ten years dooms us to a three to four-year recession/depression which is not treatable by policy makers and could ultimately cause a total collapse of our financial system.

Assets Purchased: U.S. Treasury Bills, Notes and Bonds; Gold and “virtuous non-U.S. currencies”. — Assets Sold: Common Stocks including the finest companies in America. — Experts: Nouriel Roubini, Jimmy Rogers, Marc Faber, etc., etc. etc.

The T-bills and gold are easy for us to see through. There is

a bubble of fear and uncertainty. Therefore, any asset which seems to give protection against fear and abuse should get way over-priced at the height of the fear. I drove by a guy on Pima Road in North Scottsdale on March 8th selling safes on the side of the road. Gun sales are through the roof. These actually make more sense to me than the money-market funds, savings accounts, CD's and T-bills paying less than 1% interest. If the premier U.S. companies don't survive and prosper, there will be no tax revenue to insure deposits, back money-market funds and redeem government debt. If our Disney, Abbott Labs and WalMart don't make it, you need a one-acre garden, a nearby water supply and a set of big guns and lots of ammo. At that point it won't be just the stock market which is abusing us.

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As bad as this decline has abused our stocks in the short-run, you would think that we wouldn't love this "Well Known Fact" as much as the prior ones. You would be wrong. This one is possibly setting up faithful and persevering blue-chip stock investors for the positive ride of their lifetime. First, the March 9th Wall Street Journal was talking about an additional decline of more than 20% off a stock market which has been pummeled more than any market other than the 1929-32 "Great Depression" decline (It should go to jail for this kind of abuse). Second, see above what the sentiment polls are telling us about the attitude of abused investors. Third, our wonderful and well-trained clients have called me more times in the first 10 days of March to tell me that the market is going down more and is going down for another one to two years. All these prognostications coming from folks we've been serving for years and they have never had a personal opinion about the short-term stock market direction prior to this year. Fourth, there is more cash on the sidelines in money-markets relative to total U.S. stock market capitalization than any time in the last 60 years.

We could go on all day with additional evidence, but we think you get the picture. We believe there has probably never been a better time to buy and own quality U.S. stocks (for a two to three-year holding period) in our lifetime than now. We believe the abuse is about to end. The reason is that everyone knows that the opposite is so and, therefore, "nobody knows nothin'". ■

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