



Second Quarter 2010

What are the Odds?

A number of years ago we wrote a piece about two very similar State of the Union speeches. Calvin Coolidge gave his last State of the Union address in December of 1928 and President William Clinton gave his last one in early 2000. Here are the opening statements of these speeches:

“No Congress of the United States ever assembled, on surveying the state of the Union, has met with a more pleasing prospect than that which appears at the present time.”

Coolidge, December 1928

“We are fortunate to be alive at this moment in history. Never before has our nation enjoyed, at once, so much prosperity and social progress with so little internal crisis and so few external threats.”

Clinton, January 2000

Our country was at peace, had enjoyed an amazing run of prosperity, sat on booming stock markets and the US government had its financial

house in order in both cases. These speeches represented inflection points of legendary magnitude. These were the worst two times to invest in common stocks in the last 100 years. What were the odds of that happening?

At Smead Capital Management (SCM), we see a great deal of consternation in the marketplace about the opposite circumstances we see today. The US government and many individual states are running huge budget deficits. We are fighting a worldwide war on terrorism and a number of hotspots are flaring up all over the world. The economy has suffered the deepest recession since 1981-82 and the biggest financial panic since the 1930's. Lastly, the US stock market is well below where it was at the time of President Clinton's speech after more than ten years. Which decade had worse stock market performance than the one we just finished? You guessed it, the one following Coolidge's speech in 1928.

What are the odds that this is a good time to invest in the US stock market for the next ten years? At SCM, we think high! Tough times

impose a discipline on consumers, financial institutions, governments, companies and politicians which lay the groundwork for years of future success. It is exactly the opposite of the sloppy, unethical and undisciplined participants who dominated the markets after years of prosperity and booming stock prices.

We believe the S&P 500 Index will hit 2000 and the Dow will hit 20000 in the next ten years.

Most market commentators were talking about stocks rising to the sky and the elimination of business cycles in the late 1920's and the late 1990's. Today, all we hear about is how much hell we have to pay for the sins of the past ten years. Some call it the "New Normal". Any number of respected market pundits will tell you how low we have to go to make things right in stocks. Let SCM make an optimistic prediction for you based on today's negative psychology and seemingly endless list of unsolvable problems. We believe the S&P 500 Index will hit 2000 and the Dow will hit 20000 in the next ten years. What are the odds that the stock market will appreciate 7% per year for the next ten years to accomplish those numbers? We believe way above normal because of how scarce that opinion is.

Price-to-earning (PE) ratios told you quite a bit about what was coming for the stock market in 1929 and 1999. In 1929, the Dow Jones Industrial Average (DJIA) peaked at around 28 PE. This means that the after-tax profits of the business were equal to less than 4% of the company's combined stock market capitalization. High quality bonds were offering around 5% at the time. It was a poor risk reward ratio begging for

uninterrupted growth in the economy and in corporate earnings.

The same thing could be said in 1999. The DJIA peaked at around 27 PE with high quality bonds somewhere around 7%. Each one of these instances saw investors rabidly excited about new technology. In 1929 it was automobiles, airplanes and uses of electricity. In 1999 it was the internet and how it was going to change our lives. The 1999 episode was especially damaging because it caused investors to congregate in the 50 largest tech stocks. Most of those were specifically a US stock market phenomena. The tech stocks were most likely to be owned by large cap growth money managers and in large-cap growth mutual funds. Therefore, large cap growth funds got drowned in billions of dollars of new money. In an effort to reduce portfolio risk, these managers used the money to diversify away from tech into consumer staple and pharmaceutical company shares. Unfortunately, this drove PE multiples to 30 to 50 on those sector share prices dooming them to a decade of dismal stock price performance.

When stocks offer significant upside to bonds, we at SCM are very comfortable owning stocks which meet our eight criteria.

Today the DJIA trades at a trailing PE multiple of 14.5 and 13 times the consensus estimate for 2010. If the consensus estimates are correct this means that 7 to 8% of the stock price will be made in after-tax profits this year. Five year AA-rated Corporate Bonds yield 2.8% and ten-year Treasury bonds yield around 3.15%. When the gap between lower risk bonds has tilted away from stocks, beware. When stocks offer significant upside to bonds, we at SCM are very comfortable

owning stocks which meet our eight criteria.

Based on PE ratios the story for our portfolio is even more compelling than the overall stock market. In the process we are being given better odds. Our companies trade at a dollar-weighted average PE of 13.2x on a trailing basis and 12.1x on a 2010 consensus estimate basis. For 2010 our after-tax earnings yield is close to 8.5%. We think it's in a commandingly attractive position in relation to earning interest in lower risk bonds. Our story is even stronger on a market relative basis when you consider our companies stronger balance sheets, higher average returns on equity, ten-year revenue and profit growth, earnings stability and much higher free cash flow generation.

Here is the great irony of where we are today and how the odds stack up. Our portfolio is dominated by companies which were in favor in 1999. These companies traded at those 30-50 PE multiples that you pay us to stay away from. The list includes MSFT, EBAY, MRK, BMY, JNJ, ABT, WMT and DIS among many others. These companies were priced for perfection back in 1999 and in most cases trade for a lower PE ratio today than the average stock in the DJIA or S&P 500 Index. The most ironic part of all is that they have been beaten down lately by heavy mutual fund liquidation as investors flee large cap money managers and the large cap mutual funds that own these stocks. It seems like the last major punishment for all the misguided affection of the late 1990's. Major sector bottoms come when there is no one else to sell. At SCM, we believe that investors with a three to five-year outlook who are invested with us have the odds stacked quite heavily in their favor. Thank you for your ongoing confidence and patience as these odds play out. ■

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