Available at a Low Price in Relation to Intrinsic Value

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by William Smead

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Dear Fellow Investors:

At Smead Capital Management, valuation matters dearly. We believe all the academic studies from Fama-French, Bauman-Conover-Miller and Francis Nicholson, show that cheap stocks as measured by price-to-book value (P/B), price-to-earnings (P/E) or price-to-dividends outperform more expensive stocks. We especially love Nicholson's 25-year study because it shows that the 100 cheapest stocks that make up the lowest P/E quintile see their outperformance expand the longer you hold them. Cheapness is the gift that keeps on giving.

Naturally then, our fifth criteria for stock selection is that a stock must be available at a low price in relation to intrinsic value when we originate a position. One of our intrinsic value calculations comes from Ben Graham's revised intrinsic value calculation shown below.

V: Intrinsic Value

EPS: the company's last 12-month earnings per share

8.5: the constant represents the appropriate P-E ratio for a no-growth company as proposed by Graham

g: the company's long-term (five years) earnings growth estimate

4.4: the average yield of high-grade corporate bonds in 1962, when this model was introduced

Y: the current yield on AAA corporate bonds

We like to buy stocks at a steep discount to their intrinsic value and create an additional margin of safety by being very conservative about the estimated 7 to 10-year earnings growth and by using a 10-year AAA bond rate higher than the one that currently exists. The best way to teach folks how we use intrinsic value is to use a few examples from our portfolio.

Aflac (AFL) is the largest supplemental health insurance company in the US. They are a powerhouse life and health insurance company in Japan. They get 75% of their profits in Japan and investors fear the negative effect of forward yen weakness on the conversion of their profits back into dollars. The company is based in Columbus, Georgia. We believe that the Affordable Care Act and the huge cost increases of corporate health insurance plans will cause deductibles to go up dramatically and feed demand for supplemental policies offered by Aflac. This demand comes voluntarily via the benefits departments at companies. We are using 2014 earnings estimates and earnings growth rates 20% below the consensus of analysts covering the stocks as reported by Bloomberg. If Aflac grows at an 8.1% ten-year average rate and we use 5.5% interest rate for the AAA corporate bond, we get an intrinsic value of $122 per share versus the closing price on March 28, 2014 of $62.66 per share. It is trading at a nearly 50% discount to our extra conservative estimate. If it were to reach our intrinsic value estimation it would appreciate over 95% from today's quote.

Franklin Resources (BEN) is one of the largest money management firms in the US with $879 billion under management primarily through the Franklin-Templeton family of mutual funds. The furthest back we could find a quote on BEN was September of 1983. Back then the stock traded at $.0061 per share and recently traded at $53.67 per share on March 28th of 2014. To say this has been a wealth creator is an understatement. We used earnings of $3.76 per share in 2014 and a 12.5% earnings growth rate versus the street estimate of 15.7%. Our intrinsic value calculation is $90.42 per share, a 68% premium over the recent closing price. Franklin has a widely diversified group of funds and money management approaches which have caused them to prosper in a variety of market circumstances over the last forty years.

These companies fit our other seven criteria as well, but they look especially attractive under our intrinsic value calculation and fifth criteria for stock selection.

Warm Regards,

William Smead

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