ADVISOR PERSPECTIVES

U.S. Stock Market on the “Edge of Tomorrow”

July 23, 2014

by William Smead

of Smead Capital Management

Dear Fellow Investors,

Recently we heard a market prognosticator declare that we could have a 30 percent decline in stock prices in the next 12 months. Presumably because investors fear starting over again, like many did at the market bottom in 2009, the talking head had ample emotion on which to make such a grandiose assertion. This fear of starting over reminded me of the recent Tom Cruise movie, â€œEdge of Tomorrow,â€Â where Tom Cruise plays Lt. Col. Bill Cage, a soldier forced to live the same day again and again in efforts to develop answers on how to defeat a force which would end the world. Hence, living on the â€œEdge of Tomorrow.â€

Why would a forecaster throw out a decline of that magnitude? What would it mean to us if this market pundit is correct? First, pundits are going to get attention by being edgy. Second, this particular bull market run is over 5-years-old and hasnâ€™t had a major correction since summer 2012. Third, many metrics show that we have reached stock prices in relation to earnings or dividends which have precluded market corrections and/or declines. It seems thereâ€™s a pervasive fear of resetting over and over again among investors.

Unlike Cage, investors forget what it is they are trying to accomplish. Here is how Warren Buffett defines investing:

Investing is often described as the process of laying out money now in the expectation of receiving more money in the future. At Berkshire we take a more demanding approach, defining investing as the transfer to others of purchasing power now with the reasoned expectation of receiving more purchasing power â€“ after taxes have been paid on nominal gains â€“ in the future.

For fun, letâ€™s look at the forecasterâ€™s worst case scenario and see what it would mean to the long-duration common stock owner who seeks greater purchasing power later. If stocks drop 30 percent across the board, many of the key metrics which spook traders would become an argument for above-average returns over the following 10 years. Price-to-earnings ratios would fall to around 11-times earnings. The dividend yield would be 30 percent higher before the next yearâ€™s dividend increases. Stocks as a percentage of U.S. GDP would be in the 75 percent area where past bull markets have begun.

I hope this makes clear why we enjoy owning wonderful companies and spend very little time practicing market timing. If you have to live on the â€œedge of tomorrow,â€ why not live on the edge related to the quality of the companies and our other eight criteria.

Because major institutional investors seem averse to U.S. large-cap stocks, we donâ€™t anticipate a correction of the 30 percent variety in the next year. However, we know that stock market returns are higher in the long run than other liquid assets for this very reason. The owners must retrace lost ground from occasional stock market setbacks because we always operate on the â€œedge of tomorrow.â€

The goals are long-term.

Warm Regards,

William Smead

The information contained in this missive represents SCM's opinions, and should not be construed as personalized or individualized investment advice. Past performance is no guarantee of future results. Bill Smead, CIO and CEO, wrote this article. It should not be assumed that investing in any securities mentioned above will or will not be profitable. A list of all recommendations made by Smead Capital Management within the past twelve month period is available upon request.

Â©Â Smead Capital Management