



A Bird in the Hand

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Dear Fellow Investors:

You have to love the GEICO commercials that run on television. Whether it is the little piggy going “wee, wee all the way home” or Randy Johnson throwing snowballs, they seem to strike our funny bone. A recent one is a spoof of the popular antique show from PBS where folks bring collectibles and have them valued. A lady brings a ceramic hand with a bird in it. The gentleman looks at her in all seriousness and announces that it is worth “two in the bush”. The lady that owns it is very happy to get that premium valuation.

The US stock market has been handing out some very tough lessons to investors over the last ten years and, in our opinion, most participants are missing one of the more important of these lessons. Are you ready? A bird in the hand is worth two in the bush. For the owners of a business or partial ownership through publicly traded common stock, it is better to receive cash each year from the company over and above the cash flow that is reinvested into future company growth. In an article titled, “A Reality Check”, Marketwatch columnist Mark Hulbert draws on research which proves this point very accurately. His article refuted a popular theory which states that low dividend payout ratios should contribute to higher corporate growth rates.

“In fact, as I mentioned in my column earlier this week when discussing Cisco’s decision to initiate a dividend, there is some evidence that companies with higher payout ratios also have higher earnings growth rates. One of the first studies in this regard appeared in the January/February 2003 issue of Financial Analysts Journal: “Surprise! Higher Dividends = Higher Earnings Growth,” by Cliff Asness of AQR Capital Management, and Robert Arnott of Research Affiliates.

This finding ran directly counter to the long-standing theory, and has subsequently been subjected to additional scrutiny. Yet the result has been replicated. Another study, for example, which appeared in the January/February 2006 issue of Financial Analysts Journal, looked at 11 foreign countries’ stock markets and found that, just as had been found to be the case in the U.S., “higher payout ratios do indeed lead to higher real earnings growth.”

At Smead Capital Management (SCM), we have many reasons for believing that stacking up cash on the balance sheet of companies is not a contributor to faster growth or intelligent acquisitions. The first reason is obvious to us. How many executives of major corporations would be hired for their skills at common stock analysis or as economists? We would like to think that they are great leaders and quite possibly most have the gifts of administration. However, it is unlikely that they have asset allocation skills like Warren Buffett or Jack Welch. Secondly, consider basic human motivation. When a company is fat and happy are they more or less likely to make

good capital allocation decisions. Lastly, when resources are scarce, folks have a tendency to be way more motivated. I trained young stockbrokers in the 1980's at Drexel Burnham Lambert and we were glad when the young brokers took out a mortgage. Remember, necessity is the mother of invention.

In his prior column on the Cisco Systems dividend announcement, Hulbert wrote the following:

"I base this counter-intuitive claim on a famous 1986 article by Michael Jensen, who now is an emeritus professor of business administration at Harvard Business School. Writing in the May 1986 issue of the prestigious American Economic Review, Jensen predicted that companies would be less efficient to the degree they hoarded cash above and beyond what was needed for current operations.

The reason? That cash too often burns a hole in managers' pockets, and they end up doing a poor job of investing that cash -- engaging instead in foolish pursuits like empire building. These perverse incentives exist, according to Jensen, because "growth increases managers' power by increasing the resources under their control."

With the thought in mind that dividends have made up as much as 46% of very long-term returns in US common stock investing, let's put our view of current circumstances together.

1. The balance sheets of US public corporations are loaded with cash
2. As the economy slowly recovers over the next five years, free cash flow will grow
3. Dividend payout ratios have room to rise
4. As demonstrated in the bond market, investors are hungry for income
5. Aging developed country populations need income

We believe companies which grow their dividends the most could very well attract a great deal of capital. To grow your dividends you need growing levels of free cash flow and plenty of room to raise your payout ratio. You also need the humility at the top and in the corporate boardroom to realize that the other shareholders of your business are better at figuring out what to do with their "bird in the hand" than you are. It is likely significantly better than the "two in the bush" expected from earning paltry interest or paying ridiculous premiums for acquisitions. At SCM, free-cash flow is one of our main criteria and we think you will rarely see our portfolio with a lower current payout ratio than now.

Best Wishes,

William Smead

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