



An Abusive Parent



William Smead
Chief Executive Officer
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Dear Clients and Prospective Clients:

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.

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) Buy 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, but the ground work was laid in the enthusiasm of the market bubble ten years ago. 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 watch Jeff Immelt, the CEO of GE, try to defend its AAA rating as the stock falls to the recent \$6 to \$7 level per share. There has been about \$300 billion lost in the last 17 months by owners of this former blue chip. Is that any way to treat people you are supposed to reward?

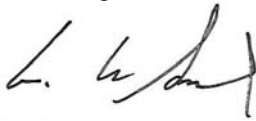
We are probability people here at Smead Capital Management. We feel our job is to stack favorable probabilities into the financial life of our investors. Just look at point number 3. There have been at least four cataclysmic selling waves since October of 2007. Each would have qualified as the “point 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 pulled your pants down, 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 this last week, 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. Beware though, those extreme sentiment readings of 2000 came two weeks apart and we could need verification of this one.

Why do we care? We care because the best ten-year stretches in the stock market have followed the worst abuse in the past and the crowd of those already in the shelter far exceeds those of us trying to execute historically right behaviors.

Warm Regards,



William Smead

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