Bull Case Nobody Makes
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Dear Fellow Investors:

In a Gallup Poll last week, 75 percent of Americans said the nation’s biggest problem in their mind was an economic problem. Precious metals and most commodities have hit records in the last six months. At an institutional investor conference we presented to last week, the participants championed risk reduction strategies using either highly illiquid, risky private equity, emerging market equity and debt offerings. Or they bragged about loading up on a commodity index, commodity ETFs and/or gold and silver. Some were puffed up about diversifying away from China by pursuing "Frontier" stock markets in Pakistan, Indonesia and other unsavory places. The pinnacle was my nephew telling me that he had purchased five ounces of silver recently at $50/ounce. He's 19 and it was his first attempt at speculative risk.

We at Smead Capital Management feel compelled to make a US stock market bullish case which feels as good to this writer as avoiding tech stocks did in late 1999. It is so lonely that it is divine. Andy Grove, former Intel CEO, said that the best advice he ever got came from his City College of New York professor. He said, "When everyone knows that something is so, it means that nobody knows nothin'." John Maynard Keynes said, "Investing is the one sphere of life and activity where victory, security and success is always to the minority and never to the majority." We have travelled the country over the last two years, spoken at CFA Societies, presented to numerous institutional, consulting, RIA and financial advisor organizations. We believe the majority has put their assets into investments that will provide defeat, insecurity and failure. Out of this knowledge comes a very optimistic bull case which is available to those who have the courage to look foolish in the short run and avoid today's popular asset allocation.

Large cap growth stocks received the highest PE ratios in US history in the late 1990's as the world crowded into the 25 most popular tech stocks. As large cap fund managers got deluged with money pulled from every other asset class, they attempted to reduce risk by bloating the PE ratios of large-cap growth names like Pfizer, Merck, Colgate and Clorox. At 40-50 times earnings and with the majority piled in for the ride, these mature company stocks were doomed for 10 years. Other asset classes were starved for capital and you could have thrown darts at them back then. Only a small minority had the courage to flee the crowd and widely diversify into other asset classes. Harvard's endowment did, as did Warren Buffett. He stopped buying individual US stocks and sought to protect his capital by buying whole businesses and removing his large capital base from the judgment of public markets.

The investments which were wise in 1999 and were owned only by the small minority of investors, brought victory, security and success. Unfortunately, it is 12 years later, and the same asset allocation that was wise in 1999 is now the majority, and is unwise today. These trades are so crowded that it has reached the deserts of Africa, the jungles of Indonesia and the Westfield Mall near my hometown of Washougal, Washington. To understand the bull case, you need first to believe that today's popular asset classes are doomed to ten years of misery and those companies, sectors and countries which benefit from their misery could produce immense relative and solid absolute performance.

I am very fortunate to have been taught by my Econ professor that economics is a lot like physics. For every action there is an equal and opposite reaction. What will happen to make emerging markets, precious metals, oil, farm commodities, natural resource based countries, and US stocks in the energy, basic materials and heavy industrial areas turn incredibly sour? Lipper reported last week that April 2011 was the 23rd consecutive month of net liquidation of US equity mutual funds. This occurred in one of the biggest up moves in 23 months in US stock market history. What could reverse the direction of these flows?

The linchpin of the bull case is the violent economic contraction about to occur in China. We will not bore you with a rehash of prior missives, but let it be said that they have deceived investors into massively over-capitalizing these popular asset classes. China's growth is behind all the over-confidence in every market I've mentioned. When the fact that China is hitting the wall becomes more clear, wide asset allocators who don't take what I've written seriously will sit for ten years in misery, in our opinion.

Out of this comes the bull case. The US economy has spent four years cleansing itself. We've recapitalized our banking system by recognizing over $1 trillion in losses. We are foreclosing and short selling billions of dollars of real estate. Housing is the most affordable in 60 years. We are learning to live inside our means and US households are close to Household Debt Service Ratios similar to 1982 and 1992. These were the start of five-year prosperity periods where the Gallup Polls showed numbers like they are today. We are in control of the keys to the virtual reality economy and have all the best companies who are helping us to maximize interactions between the virtual and real economy. Think Ebay/PayPal, Apple, Facebook, Linkedin, Groupon, Fedex, UPS, Amazon, etc. We feed the world, keep it secure, invent a large part of the best medical science and share productivity/higher living standards with anyone who wants to interact honestly with us. Our greatest days are ahead of us.

We are all frustrated by how long this cleansing is taking. What will trigger our next great prosperity period is a collapse in commodity prices and a reversal of all the misery which asset allocators are set to profit from, but missed by ten years ago. Less money leaving to pay for oil and the repatriation of emerging market money will set off a bull market in the American dollar, in our opinion. The rising confidence will force short-term interest rates up. Businesses will be rewarded for how they participate in our bright future and how well the business throws off free cash flow. Capital intensive industries and countries will see profit margins plunge as they are in no position to produce free cash flow unless commodities are soaring and China is building projects which have no rental income!

We are playing the bull case by over-weighting consumer discretionary powerhouses like Disney, Nordstrom and Cabela's, domestic financial heavy weights like Franklin Resources, Wells Fargo and Berkshire Hathaway and over-weighting the geniuses of medical science like Merck, Amgen and Mylan Labs. We at SCM can't wait to get to the future because we are in a lonely minority and making the bull case nobody wants to even admit to.

Best Wishes,

William Smead

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