Buy Commodities, Sell Brands

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Dear Fellow Investors:

We saw Warren Buffett quoted the other day saying, “We like companies which buy a commodity and sell a brand”. We thought it would be very helpful to unpack his thought and put it into the context of today’s circumstances. We at Smead Capital Management believe these current circumstances are framed by the historical over-pricing of commodities, the coming economic contraction of China, the successful cleansing of the income statements of US households and the inevitable rebound in housing in the US. We will look at the makeup of our portfolio companies which buy a commodity and sell a brand to consider their upside potential in this interesting environment.

When non-economic investors load up on investments in anything which has had a big run up, please circle the wagons. When commodities were at their low point in 1999, it was hard to find any institutional investor or financial advisor recommending exposure in commodities for investors. As of the end of 2010, institutions are dedicating as much as 52% of their portfolio to alternative investments. This includes commodities, gold and energy. These investments are made today for diversification purposes and are simply bets on rising prices. These bets look good in a rearview mirror as we’ve had a once in a generation move into this asset class. We believe that commodities have never been more over-priced in the US and are entering a decade-long bear market.

We believe the reason commodities have been in a bull market for so long is the uninterrupted economic boom in China. When a country with 1.3 billion people grows at over 10% for a number of years without an occasional recession, it ends up relying on fixed asset investments for growth. When fixed asset investments dominate your GDP numbers, borrowed money prepares to turn sour and ultimately lead to a recession/depression. This is something that “getting rid of cable” can’t cure.

The Federal Reserve came out with their household debt service ratio (HDSR) last week. It shows that by the end of 2011, American households had brought the ratio down below 11% to 10.88%. This matches up with the levels seen in the early 1980’s recession and the “anemic” economic recovery of 1990-93. These earlier readings preceded two of the best modern economic growth periods since World War II. While the doomsayers moan about absolute debt levels, we feel they are missing the story on the health of the income statement of the average household. This has boded well for the economy historically. Also, if we continue to be slow to buy houses and cars, this HDSR could put discretionary spending into its most favorable position in decades.

Lastly, this current "anemic" economic recovery has been severely retarded by the boom commodity prices of the last two years, in our opinion. We've had to work off a huge number of foreclosed and short-sale housing inventories, while the deep recession temporarily crippled household formation (Jeff, Who lives at Home). It is rebounding as 20-somethings get sick of living with the parents and the parents get sick of living with Jeff. As Mr. Buffett said recently, "eventually hormones take over" and as Brett Arends pointed out in Smart Money," renting is more expensive than buying in about 75% of American cities." You add high lumber, copper, iron ore and oil prices to this mix and you get the worst depression in housing and blue-collar employment since the depression. All these headwinds are about to become tailwinds, in our vision, over the next five years.

Therefore, betting on the US economy and the US consumer looks very favorable to us, especially where the rebounds in employment and consumer confidence have an impact. In fairy tales, people are asked to spin straw into gold. We like to own companies which spin milk and coffee (SBUX), cotton (JWN and CAB), internet access (EBAY and ACN), tax returns (HRB) and chemicals (MRK, AMGN, BMY, ABT, PFE and MYL) into gold. Profit margins on commodity-related companies and companies reliant on emerging market growth could plummet in the near future. Just ask the folks at BHP Billiton. They announced March 20th, 2012 that they are seeing in a big drop off in demand from China. In turn, we believe margins could go up for anyone who is positively impacted by lower energy prices and/or commodity prices in general. This is especially true if you "buy commodities and sell brands".

Best Wishes,

William Smead

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