



## Darkest Before the Dawn

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Dear Fellow Investors:

We have now seen the S&P 500 Index drop below 1150 five times since the first of August. The overriding reasons, listed in no particular order, are fears of another contraction in the US economy, European sovereign debt and bank problems, a lack of political leadership in Washington D.C. and persistent unemployment data. These problems have caused an 18% decline in the index from peak to trough and have given those of us who stay fully invested in high quality stocks another opportunity to examine our thesis.

Our thesis is that by owning the companies which fit our proprietary eight criteria and making changes very sparingly, we can garner the historically superior returns which come from equity ownership and exceed the return of the index over long-term time periods. This comes from a combination of dividends, dividend increases and capital appreciation.

Even though we are not traders or short-term oriented, we at Smead Capital Management would like to throw out a few opinions which cause us to be very positive about the stock market over the next one to two years.

- 1) While market participants look to the US government and the Federal Reserve Board for answers, US Households are doing remarkable and historical work of getting their finances in order. The Household Debt Service Ratio dropped to 11.09% at the end of June after being as high as 14% in late 2007. This is the ratio of how much of the average family's gross income is dedicated to debt service. The statistics are reported on a 90-day lag, which means that the ratio is probably below 11% by now. At the pace that households are improving their income statements, we could see a ratio of 10.6% in the next year. Numbers below 11% existed in 1982 and 1992 at the beginning of extended periods of prosperity. What this means is that households could take on monthly payments comfortably and that bodes well for the employment rich automobile and housing industries.
- 2) Usually bearish firm, Grantham, Mayo, Van Otterloo (GMO), recently put out an extensive research piece indicating that US housing participants are making the "Error of Pessimism". They are arguing that US housing is in position to become a bright spot in the US economy.

- 3) Commodity prices are plunging. In the same piece, GMO argued that China is making the “Error of Optimism” in residential real estate. If real estate activity falls off in China, commodities will continue to decline. No politician could duplicate the incredibly simulative effect of lower gasoline prices, not to mention the enormous psychological benefits in a mobile society like ours.
- 4) Pretty much all stock market participants are bearish. Mutual funds specializing in US Large-Cap equities have suffered huge net liquidations for months. Sentiment polls look similar to the spring of 2009, right before a huge gain in the following two years. Stock correlations are running at highs only seen in the 1987 crash period. This means that the professional traders are selling baskets of stocks simultaneously without regard to their quality. When low correlations come back in the future there is a lot of wheat to separate from the chaff.
- 5) We believe our companies have performed well in a less than stellar environment. The dividend growth the next five to ten years could set records as these lean powerhouses gush free cash flow. Howard Schultz pointed out, as an example, that Starbucks has \$2 billion in cash on their balance sheet and might be interested in strategic acquisitions.
- 6) Insiders (officers and directors of public companies) have been as aggressive in their purchases of their own company’s stock as they were in early in 2009.

We believe many of our stocks have held up quite well in this environment, but some of them look especially attractive at this point. Financial stocks seem to be in a capitulation phase and Wells Fargo (WFC) and Aflac (AFL) look particularly attractive. The household debt ratio inspires us about Disney (DIS), Cabela’s (CAB) and H&R Block (HRB) in what we call our “staple” consumer discretionary category. In healthcare, Mylan Labs (MYL) is retesting its August low and saw significant insider buying at these price levels last month. We would be remiss to not mention that PayPal/ Ebay (EBAY) is preparing to become a major payment force in stores for the first time. It is nice to start a business with 100 million existing customers.

In conclusion, we have reasons for being the optimistic contrarians, even over the next one to two years.

Best Wishes,

***William Smead***

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