Dot-Commodities

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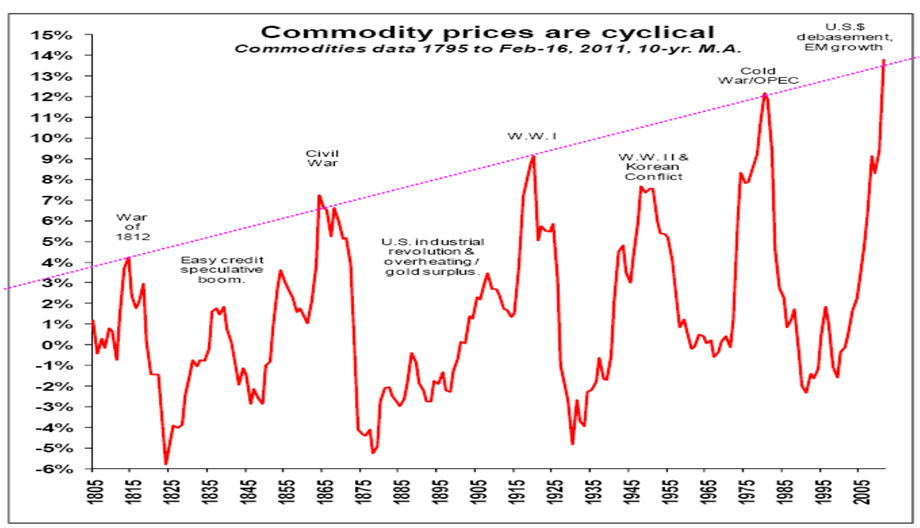
Dear Fellow Investors:

At Smead Capital Management we have decades of investment experience starting as early as 1980, and have read the US economic history which we didn't live through ourselves. In a recent research piece, Brian Bannister, Equity Investment Strategist at Stifel Nicolaus, has exposed the US economic history of speculative episodes in commodities over the last 200 years. Let me be the first one to tell you that we believe that this is a massive bubble and will end as badly for investors as the other speculative excesses have.

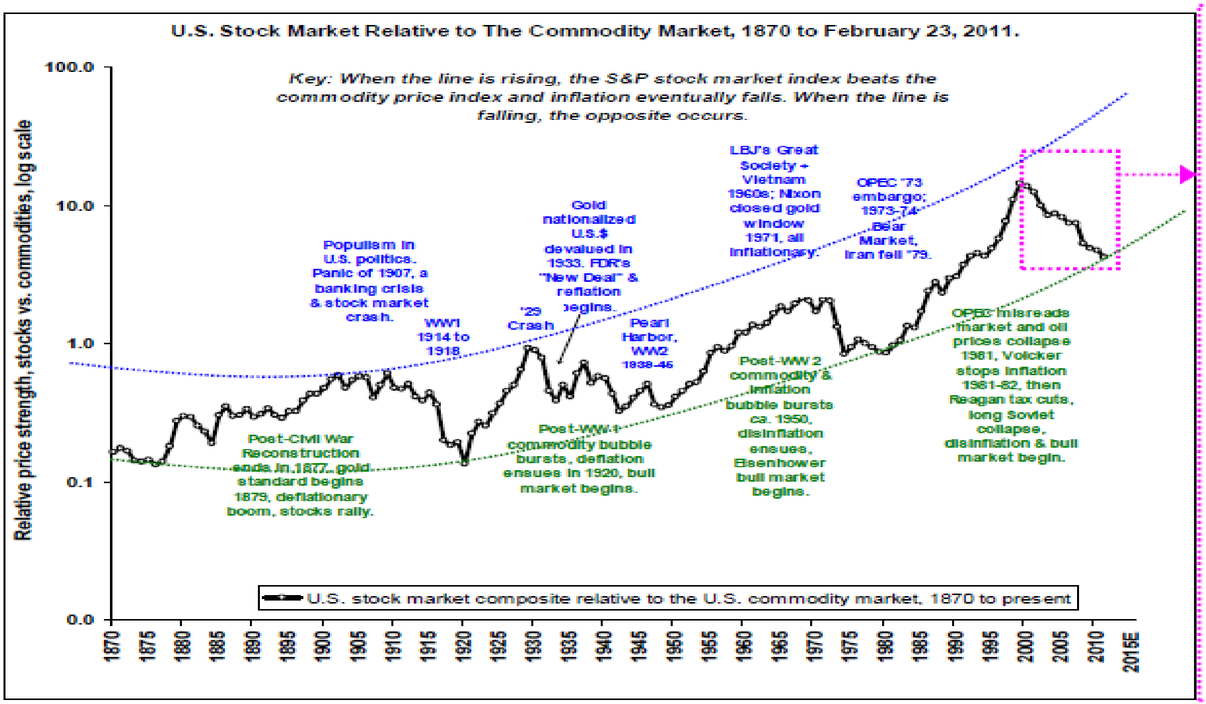
Bannister charted commodity performance by looking at trailing ten-year results. He found that this current episode is the best rolling ten-year performance in the 200-year history of commodity investing in the US. His charts also showed that if it follows history, this boom lays the groundwork for a bust even bigger than the busts that followed extremely high ten-year returns before.



Source: Stifel Nicolaus Macros & Portfolio Strategy, March 9, 2011

Mr. Bannister and his research cohorts were thinking clearly because they looked at long-term equity performance vs. long-term commodity investing performance and noticed that the 240-year trend clearly favors equities (see chart below). The longer the history, the more equities out-perform. This is despite occasional counter-secular trends like our current episode. Bannister shows that this episode is very similar to previous commodity investing infatuations. Here is how Bannister explained it:

“This "Paper Assets vs. Hard Assets" trade looks like it is reaching its outer limits, and may reverse direction in a typical long cycle, with stocks outperforming commodities. Centuries of data support the view that commodity production is a price-taking, high fixed cost, capital-intensive, cyclical industry, and that stocks, in contrast, magnify the intellectual capital of human ingenuity."



Source: Standard & Poor's (S&P composite joined to S&P 500), U.S. PPI for All Commodities joined to the CRB spot then the CRB future

Source: Stifel Nicolaus Macros & Portfolio Strategy, March 9, 2011

Allow us at Smead Capital Management to rephrase this in simpler terms. We believe owning common stocks with long holding periods is a positive sum game where economic growth leads patient investors to a profit well above frictional costs. Commodities at their best are a zero-sum game where a loser is matched evenly with a winner. At worst, and most of the time, high frictional costs make it a highly negative-sum game. At best, commodity investing is a poker game at home. At worst, it is being played at a casino where the rake is substantial. We believe it is not a coincidence that the world's largest commodity trading firm (betting casino), Glencore, is attempting to go public this month.

How did Bannister explain the devotion to commodities which has been established with investors? It is the same explanation at the rabid stage of any speculative episode: the rearview mirror. Investment committees and momentum investors look at what has done well and what it would have meant to have been invested earlier in the hot category. Late in the cycle the feverish urge is met with Wall Street's open arms to provide the adoring masses with simple and direct participation in the hot category. In the late 1990's Tech Bubble it was sector mutual funds and Initial Public Offerings (IPO's) of Dot-Com companies. This time it is IPO's like Glencore, Youku and DangDang. It is also a completely pervasive binge on Exchange-Traded Funds (ETF's) which give you direct exposure to all the hottest momentum trades in commodities and all things BRIC-trade related.

What is the end game to all this? We believe it all dies when there are no bigger fools and there is nobody left to buy. We will be the first to admit that we can't know when this fever breaks, although we believe that it has a great deal to do with the US ending its emergency-oriented monetary policy. At the point when there are no more "bigger fools", things not only stop going up, but there is virtually no bid going forward on the way down. Just check the charts of everything from Cisco and Juniper Networks to Amazon and F5 Networks from March 10, 2000 to the end of 2002 to see what the misery could be like in these commodity markets, in our opinion, when they break.

Therefore, copper, cotton, coffee and gold are no different today, in our eyes, to a dot-com company with a great story surrounding it in 1999. The Internet was going to change our lives and so is uninterrupted growth in China. However, dot-com companies did have some possibility of being a positive sum game, while these "dot-commodities" we feel can only benefit from someone else's misery or by making the receiver of the frictional costs wealthy. You are officially warned!

Best Wishes,

William Smead

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