Financial AIDS
August 31, 2010

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Dear Fellow Investors:

At Smead Capital Management (SCM), we have made it part of our work to take the psychological pulse of the stock and bond markets. When we can identify behavior and sentiment statistics which indicate an extreme crowd has been formed, we choose to be the contrarians and invest appropriately. We call these crowd extremes a "Well-Known Fact". A "Well-Known Fact" is a body of economic information which is known to all market participants and has been acted upon by almost anyone who could care to do so. As we have watched, read and participated in the debate about the economy recently, it struck us that today's psychology surrounding investing is similar to the psychology associated with the AIDS disease (Acquired Immune Deficiency Syndrome) back in the late 1980's and early 1990's.

In the early 1980's, young men in Metropolitan areas like New York City were beginning to get hit by a deadly disease. It ultimately was understood to be a virus which was passed through body fluids. The most common way these fluids were passed from person to person was either sexual contact or the sharing of hypodermic needles in drug use. The public became very aware of the disease in 1987 when actor Rock Hudson declared publicly that he suffered from the disease. The awareness reached a very high level when basketball great, Magic Johnson, announced in 1991 that he was HIV positive stemming from heterosexual contact he had with numerous women. Suddenly, you were worried about whether you had been exposed to AIDS, how you get exposed and a huge number of other unknowable issues. The psychology of the subject was incredibly creepy as projections and anecdotal evidence around us was horrific. A fraternity brother of mine and another good friend from college died because of contracting AIDS. Waiting to find out from a blood test whether you were HIV positive was scary for everyone regardless if you were an altar boy or an atheist.

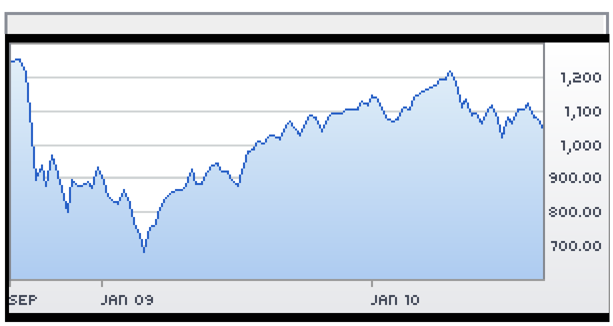
I was very fortunate during that time. While others, out of rational fears, were avoiding interaction with folks who were HIV positive, I had a conversation with another fraternity brother. He had worked in the emergency room at the University of Connecticut Hospital during his residency and was well informed about AIDS. He explained to me that the disease is highly unusual. It needs almost perfect circumstances to be transmitted, but if it gets the perfect setting and body fluid exchange, it is also successful almost 100% of the time. Therefore, you were free to be interactive with other human beings who potentially carried the virus as long as contact with them fell short of providing the perfect circumstances my doctor friend described. By the early 1990's, Americans had modified their behavior and incorporated the risk they would run in this part of their life. Safe Sex (quite an oxymoron) became the nation's most popular mantra. In the late 1980's, we were all afraid of whether we had AIDS or whether our kids would someday get exposed to the virus.

Fast forward to today. The US economy became infected with a disease between 1995 and 2005. We will call it Financial AIDS. Bankers became comfortable having customers borrow against their homes to buy boats and cars so that they could tax deduct the interest. Homes appreciated and everyone involved began to believe that homes never fell in value or if they did that the decline and length of time would be short. It all cascaded into a bubble in the early 2000's in the aftermath of the attacks on September 11th of 2001. Our government felt that the recession triggered by the Tech bubble bursting would be exacerbated by the attacks and used monetary and fiscal policy to pull us out of the recession. Most of the stimulus was translated into the residential real estate markets and a bubble in prices with correspondingly higher and higher loan balances occurred. The perfect circumstances for a financial comeuppance were in place and it was 100% successful. It all ended up in the sub-prime lending fiasco, the derivatives debacle, the deep recession of 2008-09 and the stock market meltdown of 2007-09.

We have all learned a great deal about the causes and the side effects of Financial AIDS. We pretty much know what caused it and who carries the disease. We know that millions of Americans have changed their behavior voluntarily through budgeting and better choices. Others have had their behavior changed involuntarily through foreclosure, short sales and bankruptcy. What we don't know is how long the economy will take to cleanse itself. Is this episode of the disease as bad as the one Japan caught in the late 1980's or as bad as the whole world got it in the Great Depression? The psychology of economists, business owner/leaders and government policy makers is completely dominated by trying to figure the timing of this disease out. THE EXTREMELY NEGATIVE PSYCHOLOGY BORN BY NOT KNOWING HOW LONG THE EFFECTS OF FINANCIAL AIDS WILL LAST APPEARS TO US AT SCM TO BE VERY SIMILAR TO THE PSYCHOLOGY WHICH SURROUNDED HIV/AIDS DISEASE BACK IN 1991!

At the height of concern in the US about AIDS and being HIV positive, Magic Johnson made a comeback and returned to playing for the Los Angeles Lakers. One of the most outstanding players in the league, Karl Malone, refused to take the risk of playing against Magic. It forced him (Magic) to re-retire. Our economic future is almost completely tied up in the extreme psychology tied to Financial AIDS and the media spends most of its time analyzing the opinions of the Karl Malone-like economists, money managers and investors. Everyone from individual investors to the biggest institutional investors approach their investment choices and asset allocation like Karl did back in the early 1990's. If there is any chance of getting Financial AIDS disease, they don't want to participate. To be sure to avoid the disease, avoid risk. Massive amounts of money are being poured into bonds and bond funds under the assumption it somehow "protects" folks like some financial prophylactic. The public is a large net liquidator of common stocks and US equity mutual funds. Here is what the American Association of Individual Investors reported on the sentiment of their dues-paying members:

"The number of individual investors who have a bullish outlook on the stock market for the next six months plunged to 21 percent, from 30 percent last week, according to a widely followed sentiment survey. What's more, this is the lowest weekly reading from the American Association of Individual Investors since a March 2009 level of 19 percent, which occurred just before the S&P 500 collapsed to a 12-year low of 676.



Source: CNBC

So effectively, individual investors feel as good about stocks as they did at the very depths of the credit crisis, even though the S&P 500 is still more than 50 percent higher than that low."

We believe there are few humans and investors that aren't aware of Financial AIDS. Financial AIDS is incorporated into gold prices, Treasury bond prices and common stock share prices. It has caused depressed PE multiples among the kinds of companies which fit our eight criteria for stock selection. It looks to us like a "well known fact" and that means we must avoid what the crowd is doing and invest under the belief that the best money will be made betting against the crowd. We are a nation of Karl Malones at the moment, but we believe that if you embrace some of

America's finest companies and/or take some financial risks in your business you will get well rewarded no matter how long it takes our economy to recover.

Best Wishes,

William Smead

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