God of Carnage
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Dear Fellow Investors:

As a reward for executing a hectic east coast business trip, we went to a play called "God of Carnage". Jeff Daniels and Lucy Liu starred in this four-actor, one-act play about two couples seeking to deal with a fight between their two 11-year old sons. The 90 minutes of conversation originally centered around how to deal with Lucy's son punching the other boy and breaking two teeth. It was amicable at first, but then ultimately descended into arguments. The conversation exposed most of the individual flaws of all four parents and definitely exposed all the cracks in each marriage. It was very humorous.

Lucy's husband played the part of an attorney who represented a drug company. He was on the cell phone constantly dealing with a crisis related to the side effects of one pharmaceutical product. His dishonest attitude and lack of ethics were on display as he interrupted the discussion on how to deal with the consequences of the fight between the two boys. Since art is a reflection of the culture of the day, the inherent evil of this man and the company which he represented were one of the main centerpieces of the play.

At Smead Capital Management (SCM), we are especially interested in what John Templeton called "the point of maximum pessimism". To understand pessimism you have to look to the media, to the arts and to what we call "the well-known fact". This is a body of economic information which is known to all participants and has been pretty much acted on by anyone who would care to act. As the City College of New York professor told former Intel CEO Andy Grove, "When everybody knows that something is so, it means nobody knows nothing." Our politicians, media and artists know that "Drug" companies are evil. Investors know to stay away from them. The major pharmaceutical companies all trade in the lowest Price/Earning (PE) ratio quintile in the S&P 500 Index, and are the cheapest compared to the other sectors of the US stock market as we have seen in 20 years. Drug stocks haven't been this small a part of the S&P 500 Index since 1984.

This reminds us of the documentary in 2003 about McDonald's called "Supersize Me". A young man ate three meals a day at McDonald's for six weeks and agreed that he would supersize his meal every time an employee asked him if he would like to. He gained a great deal of weight, saw his cholesterol shoot through the sky and was well on his way to killing himself through food over the longer haul. The "well-known fact" in 2003 was that McDonald's sells unhealthy, high fat foods and doesn't care whether they are going to kill you in the process. Investors were sure that there would be a big backlash and McDonald's business would be damaged for years. The stock bottomed out around $15 per share, way down from prices above $30 per share just a few years before.

Pharmaceutical companies make vaccines, treatments and cures by manufacturing medicine. They seek to profit from improving the health of human beings and extending the quality and duration of life. The barriers to entry in their industry are very high because it costs about $1 billion to produce a blockbuster drug. They receive patent protection because many of the medicines they attempt to create never make it to the market and only end up creating expenses. These companies maintain fortress-like balance sheets and earn very high returns on unleveraged capital. In the process, they generate massive levels of free cash flow and pay generous dividends.

The point of maximum pessimism associated with the makers of medicine is tied to four main beliefs. First, they are an easy punching bag for politicians (including the President of the US). Most studies put pharmaceutical sales at around 10% of what we spend on healthcare in the US. Second, they've been feasted on by litigators. The Vioxx settlement shows that whatever downside risk there is associated with a medicine will get exploited to the maximum until we get tort reform. Third, the FDA is scared to approve new medicines at the expense of thousands of people who lives might be hugely impacted by use of a drug not yet approved for sale. Lastly, a number of major existing blockbusters are losing their patent in the next four years and investors can't visualize where these once admired companies will get future revenue growth.

Today, McDonald's is around $70 per share and has been one of the best large cap performers in the S&P 500 Index since the documentary was released nationwide in theatres. They have added healthier choices to their menu, but they still make most of their money selling clean, inexpensive, high-fat content food all over the world.

At SCM, we believe the makers of medicine have very little downside risk as the result of the attitudes exhibited by the play "God of Carnage". As we drive up to the New York Stock Exchange window to order our common stocks, we ask for pharmaceutical manufacturers and say, "Supersize Me".

Best Wishes,

William Smead

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