



Lemmings Part 2

July 27, 2010

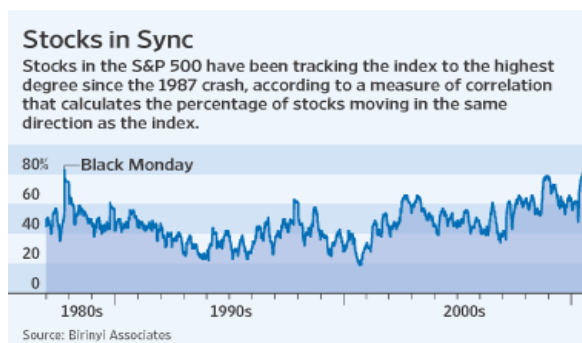


William Smead
Chief Executive Officer
Chief Investment Officer

Dear Fellow Investors:

We at Smead Capital Management (SCM) shared with you recently a comparison between the behavior of lemmings and investors, both individual and professional. Lemmings multiply in a geographic region until the food supply is incapable of providing proper nutrition. Investors congregate in markets, sectors and strategies until there is very little opportunity for profits. Unfortunately investors, both professional and amateur, don't have a built in natural instinct to move to the next area like the lemmings do. We've had quite a few questions asking for clarification on our piece last week and it brought out some salient points which might help all of us interested in common stock appreciation.

In the article by E.S. Browning called "The Herd Instinct Takes Over", we enjoyed research being done at Birinyi and Associates. It was led by Jeffrey Yale Rubin and produced the following chart. The chart shows what percentage of the stocks in the S&P 500 Index are moving in step with the index price movements.



A few things were left a little fuzzy last week that need clarified. First, we got a number of questions asking if today's circumstances are significantly different than in the 1987 Crash, when the correlation was this high. The answer is that program trading and portfolio insurance were dominating the stock market in 1987 in the same kind of creepy way that it has been the last couple of years. **THIS IS NOT THE FIRST TIME THAT PROFESSIONAL INVESTORS CONGREGATED IN A VERY ACTIVE STRATEGY AND SPOOKED INDIVIDUAL INVESTORS!** However, we believe you don't need to worry about it because there are so many people doing it and those lemmings will go somewhere else as the pendulum swings back toward stock picking.

Second, the best time to be stock pickers is to begin with an extended period of high correlations stretching into elongated periods of low correlation. While the mindless program trading and ETF flipping is going on, be one of the smart, instinctual lemmings who can recognize that someone “moved their cheese”. Go where the nutrition is rich. At SCM our capital appreciation portfolio is loaded with companies which fit our eight criteria and trade at 10 times free cash flow or better. If you owned the entire company, you could take ten percent of the current price out in cash and not disturb the ongoing maintenance of your company’s business! Compare that to the average stock in the index (where program traders and ETF investors have squatted) or to the money market funds, CDs, Treasury bills and bonds, high grade and junk bonds, and gold where individual investors have geographically located themselves. The difference in nutritional value is stunning as interest rates on quality securities are miniscule from a historical standpoint. We believe the lemmings are smart enough to have gone somewhere else already.

What is holding everyone back? At SCM we believe fear is holding back individuals, institutions and professional investors. Individuals are afraid of losing money because of the last huge bear market and are completely intimidated by the scare mongering in the media. Institutions make changes in committees and move much slower normally and are afraid of looking presumptuous. Professionals are afraid of losing clients because of whatever time it takes for the new area of nutrition to make itself obvious to non-lemmings. They all need leadership and at SCM we stand ready to do our part. We believe correlations are headed down and probably for an elongated period.

Best Wishes,

William Smead

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