



## Making Great Business Music

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**William Smead**  
Chief Executive Officer  
Chief Investment Officer

Dear Fellow Investors:

Music played on gigantic church organs has structural and variable components. The church the organ is housed in, the organ, the pipes and the bench you sit on to play the organ are all critical fixed components. The organist and the sheet music are variable. Each church has multiple organists, but some songs are written and used by almost every church which has an organ. Think of "How Great Thou Art" or "Amazing Grace" and imagine how many copies of the sheet music to these old hymns are sold. The fixed or structural components are critical, but not a great business, because once you have an organ, pipes and a bench you won't need a new one for a long time. This is what some people call infrastructure. The organ and organ pipe business is only as good as large church growth. Every church needs sheet music even if it only has a keyboard. The writer of songs and their sheet music publishing house don't have to invest in churches, organs, pipes, benches or pianists to sell their product. Someone else is bearing most of the cost associated with creating the need for your product. And your product wears out faster than the other components of great music.

I'll give you a few historical examples. SLM Holdings (SLM) or Sallie Mae facilitates the student lending process. They don't have to create colleges or students or the favorable economics that a college education provides. Coca Cola (KO) sells syrup for soda drinks. They don't have to create McDonald's (MCD) restaurants or movie theaters or sporting events or homes. Microsoft (MSFT) didn't make computers or semiconductors. They only made the operating systems and the software for utilizing the computer. Computer and semiconductor manufacturers bore a large part of the cost of the industry. Not only did these companies (SLM, KO, MSFT) have repeat business, but someone else covered a large part of the expense associated with the impressive profitability, high returns on equity and long duration of the business. If you are wondering, this is exactly why we don't like Microsoft trying to invent new product lines by bearing the brunt of the structural expenses.

Which brings us to an announcement made by Proctor and Gamble (PG) recently. They are going to begin selling their top brands directly through the Internet. They say it is because they can learn large amounts of information about their customers. We know that WalMart (WMT) has every intention of being the dominant online merchandising company in the world and Amazon has the lead at the moment. Nordstrom (JWN) is growing faster in their online division than in any other aspect of their business. What does this tell us? It tells us that these great companies are going to bear a large part of the structural costs of a company called PayPal, the largest online payment system and a wholly-owned subsidiary of eBay (EBAY). The next time you look at a company to invest,

consider how much of the structural costs of the industry they bear and it might help you figure out if they can make terrific money from making great music.

Best Wishes,

***William Smead***

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