More People

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Dear Fellow Investors:

As value managers, we at Smead Capital Management are as interested as anyone in secular trends. We seek company characteristics which lead us to non-cyclical businesses which are not capital or labor intensive. For this reason, we love businesses which need more people (as customers) to become more profitable. Unfortunately, from time to time, markets massively over-capitalize industries and sectors which they believe will benefit the most from having more people.

A few historical examples are in order. The 1929 stock market peak in the US was built around the idea that there would be more people to listen to radio, drive cars and fly on planes. They were correct that there ended up being more people using all of these relatively new technologies. This didn’t stop them from losing most of their money by 1932. The concept was over-capitalized.

The 1999 US stock market peak was predicated on more people using the internet as it “changed our lives”. Huge national fiber optic infrastructure was built and tech stocks in the US became the darling of the world of investments. Were they right about more people using the internet and the internet “changing our lives”? Yes, they were right and they lost about the same percentage of their assets that the folks did back in the early 1930’s.

The residential real estate bubble in Las Vegas, Phoenix and Miami relied on the idea that more people, especially retiring baby boomers, would move to the Sun Belt states. Prices doubled from 2000-2005 and the sky appeared to be the limit. I have a vacation home in Scottsdale and have had a front row seat on both the boom and the bust down there. After a cold, wet spring in Seattle, I can tell you that more people do want to go down there. The over-capitalization of residential realty destroyed the finances of many investors/owners from then to today.

Where is the “more people” argument being used now to over-capitalize investment markets? We believe it’s in China and other Emerging Markets. Uninterrupted GDP growth in countries with a large part of the world’s population has everyone drooling. They are drooling over what more people means for food and industrial commodities, energy, automobiles, transportation infrastructure, housing and virtual technologies. Residential real estate in China has been so hot the last three years that it has even greatly affected prices for residences in any city with a large population of Chinese Nationals (Vancouver, B.C., London, Hong Kong, etc.) The concept is that more people will move from rural areas of China to industrial centers and that residential real estate is one of the few investments that newly prosperous Chinese citizens can invest their money. This argument is used to justify such gargantuan over-building that it could easily end up making Las Vegas and Miami's real estate bubbles look like a common cold compared to China's life- threatening pneumonia.

China has been dumping billions of dollars worth of low quality initial public offerings (IPOs) of common stock into US stock markets. Most of them are attached to virtual technology and the other drooling categories previously listed. Some of them are even legitimate businesses! I was a guest on CNBC a few months back and Chinese IPOs were ringing the bell on both the New York Stock Exchange and the NASDAQ Market site. We noted in a prior missive the danger in these high risk Chinese IPOs.

Where can you make money by finding value in an industry or sector which could be a beneficiary of more people? We see this in the makers of medicine. Aging baby boomer populations around the world could cause demand for pharmaceutical products to soar at the same time that emerging market countries put in their first meaningful social welfare networks and health systems. In 2005, China and India bought 4% of the world's prescription pharmaceuticals despite making up nearly 40% of the world's population. IMS Health, a leading research organization, calculates that China will be the third largest market for medicine in 2011 and believes that prescription pharmaceutical use could double from 2011 to 2013.

Companies like Merck, Pfizer, Bristol Myers, Amgen, Abbott Labs and Mylan might see a huge ramp up in demand. The beauty of their business is that the manufacturing and sale of their products has very high profit margins and the patent protection would drop off at different times and in different countries over the years. Add in the fact that the total number of major medicine makers/distributors has shrunk through mergers in the last three years and you could have a bonanza. The beauty of all this is that most of them trade in the lowest PE quintile in the S&P 500 Index and are hugely under-owned by institutional, international and individual investors. They make up close to 3% of the index, one of the lowest figures in the last 30 years. They've been neglected while investors over-capitalized companies whose stock prices are already inflated by sales and profits increases from meeting the other needs of the same set of more people!

In a recent expose' called "China Ghost Cities", SBS Dateline shared the truth about what is going on in China. They show how over-built and over-capitalized the country is right now. They tell the story of a toy shop keeper at the (Not So) Great Mall of China. He explains that there are seldom customers and as he speaks you can see how much work needs to be done to repair his teeth. To me it tells you everything you need to know about the emerging market countries of the world. They have more people in need of healthcare and medicine and most of them can't afford the empty homes that have been built there. Those empty condo buildings are built to maintain the façade that GDP growth is uninterrupted so that investors in the maniacal sectors and industries will keep drooling about more people. We look forward to providing the toy-shop keeper and many more people an anesthetic and other medicines for years to come.

Best Wishes,

William Smead

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