Shareholder Friendliness
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William Smead
Chief Executive Officer
Chief Investment Officer

Dear Fellow Investors:

At Smead Capital Management (SCM) we have eight criteria for selecting common stocks. Our first five criteria must be met at all times, while one of the remaining three may be temporarily overlooked. We only ignore weakness in one criteria if we believe the strength of the remaining criteria gives the company the time needed to qualify across the board. At SCM, we give grace in these instances because they typically coincide with a price discount which gives us an attractive entry point for initiating a position in our portfolio.

Shareholder friendliness is one of our criteria and can be waved temporarily. We prefer to have leadership with a great vision of the future, a willingness to keep costs down and the wisdom to allocate free cash flow well. One of our top ten holdings is Microsoft (MSFT). We believe Microsoft trades at a significant discount to fair market value because stock market participants view the company as shareholder unfriendly. Below, we have outlined SCM's quick take on Microsoft shares regarding what we think is the inherent discount due to shareholder unfriendliness. Additionally, we've given a few approaches that could be taken by Microsoft to unlock value going forward.

Thomson-Reuters estimates that the S&P 500 Index trades at 15.1 times trailing earnings. For the sake of our discussion let's assume that a 15 P/E ratio is pretty normal in this environment. This means that if you are perceived to have above average future prospects you trade above 15 times earnings. Your stock would trade below 15 times earnings if your future isn't as bright as the average large public company.

First, we'll take a cold hard look and examine Microsoft. Microsoft had nearly $36 billion in cash and near cash net of debt at the end of its last quarter (over $4 per share). Cash earns almost nothing after taxes for Mr. Softie. Therefore, almost the entire $2.05 per share consensus estimate analysts have for this year is created by operational profits and not interest. If you put a 15 multiple on $2 per share and add back the cash you get a $34 share price. With the stock trading at $26 per share, it means that MSFT trades at about a 25% discount to the average stock. The discount is even heavier if you would be so outlandish as to say that Microsoft has many of the characteristics of an above-average company and deserves a 20 multiple. In that instance, the current price of $26 per share sets up a huge discount to the $44 value per share.

We believe Microsoft is a superior company in a variety of ways. They write great software that is needed. They have been enormously profitable on a consistent basis and have such a good moat that the government sued them for it. Their profit margins are to die for and their balance sheet is impeccable. Thanks to the upcoming refresh cycle in business technology, most analysts look for them to have very strong earnings growth over the next 2 to 4 years. US Corporations have very high levels of cash on their balance sheets and as the economy recovers will use some of it to become more competitive through technology upgrades. So where does the intense dislike of once proud Microsoft and its market multiple discount originate?

Many investors hate MSFT because its stock has fallen over 50% from its tech bubble peak in the last ten years. Some dislike the corporate arrogance and others dislike the fact that they didn't create the "New, New Thing". We at SCM believe the core of the discount has to do with shareholder friendliness. Microsoft tries to act like the puny dividend and the $2 billion of stock they bought back in the first quarter defines them as shareholder friendly. When you sit on $40 billion of cash and near cash, generate $17 billion of free cash flow and pay a stingy $.50 of annual dividend, you anger investors like us who prefer to champion the company.

We've watched the current management squander billions of dollars on the weakest areas of the company (Media and Entertainment Division/Online Division) like a drunken sailor on leave. The problem is that the drunken sailor has been on leave for ten years! We saw a chart last week that showed that Microsoft spends about 14% of revenues in Research and Development, while Apple (AAPL) spends about 2%. In the most recent quarter, MSFT lost $713 million in the online division. If it were a stand-alone company, that would be one of the worst corporate performances in the S&P 500 Index. Hasn't anyone at Microsoft or on the board of directors read Jim Collins book, "Good to Great"? The book says that great companies build themselves around their strengths. There is zero evidence that there exists any venture capital or private equity talent at Microsoft.

Thank God that time is the ally of the patient investor. We believe there are two scenarios for MSFT. The first goes back to the $34 fair value estimate. If the current management stays in place, Microsoft has $8 upside in the next year and upside going forward equal to growth in earnings/free cash flow at the average stock multiples. Nobody wants to pay up for a company squandering it's free cash flow. The second scenario would occur if management closed or spun off all non-core divisions and dramatically increased the stock buyback and annual dividends. Since that is a very low probability event, the only way we get the second scenario is to change management. I'm glad there is upside without it, but it could be a huge stock if someone near the top would speak up.

Best Wishes,

William Smead

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