Stomach Reinforcement

William Smead
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Dear Clients and Prospective Clients:

There are two opinions we hold at Smead Capital Management which are very contrary to the conventional wisdom in the marketplace. First, we feel that we are much closer to behavioral changes in the automobile and environmental world than most people think. Second, we believe we are about to enter a long stretch of outperformance among U.S. stocks by large capitalization companies which fit our eight criteria. We think our "gut feelings" on these subjects are correct, but once in a while you need a little encouragement when your opinion is especially contrary. Jeremy Grantham, of Grantham, Mayo, Van Otterloo & Co. (GMO) fame, is probably the most respected institutional asset allocator in the world today. He chose in the last few weeks to forcefully back us on our arguments and reasoning.

For our thoughts on Oil and Oil-oriented investments, see our recent Missive titled "Bull Markets in Oats and Hay". Our thesis assumes that the change to electric and hybrid cars will be much swifter than most investors think (5 to 10 years). This swift transition could destroy the "Peak Oil" mentality which had developed last year as oil reached $147 per barrel. It took 25 years for the U.S. to move from horses to cars (1900 to 1925) and we believe everything changes much faster now than in the past. We are under-weighting Oil and Oil service stocks despite their recent popularity.

Grantham seems to be in agreement on the changes in autos, but his opinion is driven by climate change. In a recent interview with Smart Money he said this: *"The people who move quickly in this market can make money. The people who invest in energy alternatives will make more. Alternative energies and combating climate change are the single most important economic initiatives over the next 10 years-really over the next 50 years. It will be a very exciting next 50 years."* A victory for energy alternatives is a loss for Oil and Oil Service companies in our opinion.

We always like our investment style of seeking out high quality "blue chips" companies which are out of favor, but once every 10 to 15 years they get especially attractive relative to all the other places people can put their money in the U.S. Grantham and his firm run intense mathematical models to try and determine which asset classes should perform the best over the next seven years. They now manage directly over $80 billion in assets. Here is what Grantham said in a series of interviews at Morningstar's recent investor conference and Forbes magazine:

Grantham expects a subset of U.S. stocks -- those he labels "high quality" -- to produce after-inflation annualized returns of 11.5% over the next seven years. Five-and-a-half percentage points on an annualized basis is an enormous difference -- and gives investors plenty of incentive to identify those "high quality" stocks.

Although Grantham doesn't directly define "high quality," he provides some clues in an interview with Forbes *in which he said, "And the best bet, for my money, then and now, a year later, was to buy the great franchise companies, the great quality companies." This suggests that he favors companies that possess a moat -- a sustainable competitive advantage -- and that earn excess returns over their cost of capital.*

At Smead Capital Management we have solved Jeremy Grantham's dilemma and have come up with the eight criteria below to define high quality and use it to create our common stock portfolios.

1) **Strong Balance Sheet –** Preferably more cash than debt, the ability to pay off debt in the next couple years out of free cash flow or companies with debt that have very consistent customer bases

2) **Long History of Profits and Dividends (or stock buybacks)**

3) **History of Shareholder Friendliness** - Making shareholder friendly choices with available capital

4) **Strong Insider Ownership –** Preferably with recent purchases

5) **Easy to Understand –** Business meets a sustainable economic need

6) **High levels of free cash flow**

7) **Wide Moat –** High levels of profitability maintained by barriers to entry

8) **Low Price in relation to the fundamentals of the business (**price-to-earnings/sales/cash flow/book value) in comparison to the last five years

Grantham believes as we do that economic growth could be muted by the debts over-hanging the economy from the last ten years. He thinks that China and India can't grow as fast without the U.S. returning to our prior spending levels and he doesn't foresee that in the next seven years. We believe a huge number of retirement age baby boomers could result in sustained high unemployment figures. This "New Boomer Austerity" or attitude could cause the existing spending "reset" (like what we've seen since September of 2008) to last for as long as a decade. In that environment, competing with financially strong and well entrenched companies like WalMart, Microsoft, Merck and Disney could be difficult at best and impossible in many cases. The ultimate irony of all this is these "quality" companies trade at or below market P/E ratios and pay above average dividends for the most part. Numerous years of under-performance and reversion to the mean is driving GMO's computer models and Jeremy's opinion. Our stomachs are strengthened!

Stay thirsty for investment success my Friends,

William Smead

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This Missive and others are available at www.smeadblog.com.