



Swallowing the Myth

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Dear Fellow Investors:

When I was in college we had an “Around the World” party at my fraternity. Each of us decorated our bedrooms as a place around the world and served an alcoholic beverage from that region. One of my friends set up Tokyo, Japan and served Sake. Others created Mexico City and served Margaritas or Cheyenne, Wyoming, where Jack Daniels was the preferred beverage. Unfortunately, there was a replication of a place in Guyana called Jonestown. Like a typical sarcastic young male, one of our brothers served “killer” punch in his Jonestown room.

Jim Jones was a false prophet headquartered in San Francisco. He convinced his followers to join him in a socialist revolution and ultimately moved their commune into the tropical country of Guyana. On a very ugly day in 1978, he served cyanide-poisoned Kool Aid to his followers and almost all the cult members drank it voluntarily and died. Their mindless following of the false prophet and utter devotion to the myth that he created led them to destruction.

A recent Wall Street Journal headline story (November 15, 2010) explained that Caterpillar (CAT) is offering a price of \$92/share to buy Bucyrus International. Bucyrus is one of the largest manufacturers of mining equipment in the world. The CEO of Caterpillar, Mr. Oberhelman said, “Our customers have told us they want fewer suppliers of mining equipment.”

Caterpillar is paying 23 times this year’s consensus estimate of earnings for a business that has just had as good a five-year run in its industry as any time in history. The stock has traded in a range of \$6.70 to \$79.50 per share over the last six years and spent the vast majority of that time below \$40/share. Why is Caterpillar over-paying for a cyclical business which has had everything go its way the last six years? Why didn’t he listen to the customers five years ago when the company could have been purchased for far less?

We believe the answer is simple. Mr. Oberhelman has officially swallowed the myth. He believes in uninterrupted growth in China and said so at the press conference. According to the Wall Street Journal:

“Rapid growth from China, India, Brazil and other emerging markets will "push demand" for coal, other minerals and "everything that comes out of the ground," Doug Oberhelman, Caterpillar's chief executive, said during an interview Monday after announcing the company's largest acquisition to date. “The planned purchase, subject to regulatory approvals, would make Caterpillar the world's "broadest supplier" of mining equipment”, Mr. Oberhelman said.

Caterpillar could have purchased this company for nearly half this price many times over the last six years. We believe CAT realized that you only need so many earth movers in China. In our opinion, the Central Government is beginning to understand that it has massively over-built infrastructure (see David Barboza, Oct. 19th, 2010, New York Times “Ghost Cities in China”). How often does your earth mover wear out?

We at Smead Capital Management could site numerous examples of companies getting caught up in their own sales pitch and over-paying to get a bigger part of the red hot section of their industry. Look no further than the May, 2007 purchase of Golden West Financial by Wachovia Bank. The mortgage business was red hot, just like the mining business is today and Wachovia paid a premium price at the top for entry into the business. We all know now that Golden West would have bankrupted Wachovia if Citigroup and Wells Fargo hadn't stepped in to fight over the carcass backed by government guarantees.

The all-time Kool Aid drinker was the Time Warner Corporation. They let themselves be merged together with the “white hot” American Online (AOL) company at the height of the tech bubble. Remember, the internet was going to change our lives. I will never forget how pitiful it was to watch Ted Turner, who knew in his gut what a bad idea this merger was, do a press conference to support the deal. All he could come up with to fill his obligation of support was this embarrassing quote, "When I cast my vote for 100 million shares, I did it with as much excitement as I felt the first time I made love some 42 years ago," Turner said. "I voted for it because we will have a stronger company that will create value. It's not so easy to go out and recreate AOL. No one has been able to do it so far."

At the height of popularity for an industry, many highly thought of CEOs have swallowed the myth. We believe you should avoid all asset classes and sectors tied to this particular flavor of Kool Aid. It is called the BRIC Trade and on the downside it could be destructive to your capital.

Best Wishes,

William Smead

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