



The Exodus

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Dear Fellow Investors:

A number of media outlets wrote recently about the explosion in prices of residential real estate in Vancouver, British Columbia. These articles concluded that over 70% of these purchases were from Chinese Nationals and had driven prices high. Compared to average household income, Vancouver is now nearly twice as expensive as New York City. The articles described numerous transactions of one million Canadian dollars or more for tear-down homes on Vancouver's West Side. At first glance, it appears that folks are massively over-paying for these properties and whenever this kind of behavior pops up, we always want to know why.

Thankfully, a few days later, Gordon Chang of Forbes wrote an article titled "Chinese Entrepreneurs Are Leaving China". Here is how Gordon began to explain the phenomena:

"China's rich, primarily driven by a sense of insecurity, are taking money out of their country. Many are actually preparing to move elsewhere."

According to a new study, almost 60% of China's "high net worth individuals," defined as those possessing more than 10 million yuan in investable assets, are either considering emigration through investment programs or are completing the emigration process. The survey, conducted by China Merchants Bank and Bain & Co., also reports that 27% of those with more than 100 million yuan in investable assets have already emigrated and 47% of them are thinking about leaving the Motherland."

There is an exodus of the best and brightest business people coming out of the country of China. This country, China, is supposed to be the most successful economy in the world over the next 20 years. It is reportedly going to surpass the US as the most important economy in the world. It is using a disproportionately large part of the world's commodity production and had been enjoying a building boom that appears to rival other historical building booms. In fact, one of the few building booms in history which comes close to China's occurred in Egypt when they built the pyramids to honor Pharaoh. Here is how Gordon backed up these statistics:

"The stunning results correspond to reports that the U.S. Treasury unit monitoring illegal money flows has, since the beginning of last summer, detected a surge in hidden cash transfers out of China."

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Almost all of the funds supporting emigration applications were spirited out of China in violation of Beijing's strict rules. The country leads the world in illicit fund transfers, according to Global Financial Integrity, a nonprofit. The estimated total of China's outbound flows from 2000 to 2008 was a staggering \$2.18 trillion."

Since the uninterrupted growth in China has been so integral to success in asset allocation decision making, we at Smead Capital Management will share our opinion. We pay very close attention to insider buying and selling for the same reason that Gordon Chang is paying attention to these illegal fund transfers. We want to own companies where the insiders have confidence and avoid an exodus out of the stocks from those same insiders.

Chinese Nationals have been getting their money out of China in a variety of ways. First, they've taken advantage of foolish US investors by dumping billions of dollars of Initial Public Offerings (IPOs) onto the New York Stock Exchange and the NASDAQ. I was a guest on the floor of the NYSE last fall and a Chinese IPO rang the bell on both exchanges that day. Please refer to our Dec. 13, 2010 missive titled "Dang, Dang". We described how unhappy folks would be when they realize that they got taken by Chinese insider sellers.

Second, investing in common stock inside China is problematic at best. Interest rates are well below inflation in China and for those reasons residential real estate and gold have been favored investments of the newly wealthy. We don't believe it's a coincidence that gold has moved up dramatically during China's uninterrupted boom. It is very hard for the Chinese government to keep track of physical gold owned by Chinese Nationals. Lastly, these Chinese Nationals have been buying residential real estate in Vancouver, BC, London and in the US. All of these countries have large Chinese National populations and cities where new immigrants can form large Chinese communities (little Hong Kong's)!

To understand this exodus of people and money let's examine one of the biggest people movements in history. The people of Israel had come to Egypt to buy grain during a great famine in the Middle East. The Prime Minister of Egypt, Joseph (a Hebrew), wisely had Egypt store huge amounts of grain while the prior prosperity existed. One thing led to another and the people of Israel stayed in Egypt for hundreds of years. Unfortunately, the Hebrew people became enslaved by the nation of Egypt and ultimately were the primary workforce and engineering brains behind the building of the Pyramids and infrastructure of Egypt.

Whether you are well versed in the Old Testament or are just a fan of the movie "The Ten Commandments", you know that the Hebrew people lost a great deal of their personal, spiritual and community freedoms and pleaded with God for a way out. A man raised in Pharaoh's household, Moses, was chosen by God to move back to Egypt from the Deserts of Sinai to lead his people out of Egypt. Through Moses, God brought a series of plagues on Egypt to convince Ramses to let his people go. His heart was hardened and he didn't relent until the final plague came.

The final plague was the death of every first-born male in every household and stock yard in Egypt. God sent the "Angel of Death" into Egypt and the only way to avoid losing your first-born son was to have sacrificed a spotless lamb and smeared its blood over the top of the door to your house. In this way, God's wrath would "Passover" your home. When Pharaoh was awakened to find his first-born son dead, he relented and allowed the Hebrew people to flee Egypt. They fled the most prosperous country in the world to have their personal, spiritual and community freedoms.

Gordon Chang writes that the exodus of these successful entrepreneurs has accelerated since the Chinese government renationalized in late 2008 and put its massive stimulus plan into place to avoid the downside of the worldwide economic contraction of 2007-2009. This was done, almost exclusively, by force-feeding loans from government-owned banks to special purpose vehicles. In this way, developers could build expensive buildings and infrastructure whether it was needed or not. It sounds very much like the Pyramids to us at SCM. Chang thinks more government control and a more "rapaciously" negative environment for entrepreneurs is on the way:

“And the situation is bound to get even worse if Xi Jinping becomes the next Party general secretary at the end of next year, as just about everyone expects. Xi will undoubtedly bring his fellow ‘princelings’ into positions of political power.

The princelings, descendents of former leaders of the People’s Republic, will surely use their new political clout to consolidate their grip on the economy. This means, among other things, that others, especially owners of private domestic enterprises, will have even fewer opportunities than they do today.

‘We can only hope the rich people stay out of patriotism,’ says Xia Xueluan of Peking University. Patriotism, these days, may be the only thing keeping Chinese entrepreneurs in China.

And, from the look of things, it is not enough. The country’s wealthy are going on shopping tours for U.S. real estate and, if they have not done so already, are moving their families abroad. There has, in the last five years, been a 73% increase in Chinese investment immigrants to the United States. Countries, like Canada, are raising their minimum investment requirements for investment-immigrant candidates due to the sheer size of the tide of Chinese cash.”

Whether this is analogous to Egypt or not, it is a picture of what seems to be happening in China. The people who know what is going on and have the financial wherewithal to do something about it are getting their money and, in many cases their family, out of China. They are doing this while US investors plow money into China and other BRIC- trade related sectors of asset allocation. As always is the case, the only way to avoid the downside of what comes after a boom (the bust) requires a sacrifice on the part of the people involved. Lastly, it is a good idea to be part of those who make their exodus before the need to get out is obvious to the masses.

Best Wishes,

William Smead

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