



The Seller at the Bottom

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Dear Fellow Investors:

A number of naïve investors have a mental picture of some great buying interest entering the stock market at major low points. The same folks also think a massive number of shares controlled by smart people are sold in huge quantities at the top of the market. In the view of Smead Capital Management (SCM) nothing could be further from the truth. Thanks to a recent article in Investment News and some simple research at the Wall Street Journal's website, you can see at major market low points the seller is someone who prefers to buy, but is forced to sell.

In the article entitled, "American Funds Losing Luster in Eyes of Reps", writer Jessica Toonkel shared the statistics provided to her by Morningstar on which equity mutual funds had seen the biggest outflows since the beginning of the year 2010. The second largest fund family, American Funds, had seven of the top ten funds on the outflow list. Toonkel theorized that the American Funds family, which had been incredibly popular over the last ten years among registered reps and financial advisors, were "losing their luster". We have observed the American Funds over the years and after a ten-year stretch of poor performance in the S&P 500 index and an orgy of bond fund buying the last two years, we are not surprised by their large equity funds getting hit by net redemptions.

A natural outcropping of the liquidation of these popular large cap funds is the making of an especially large seller of the top ten holdings in each of these funds. Therefore, the portfolio manager is forced to sell a large number of shares of the companies which they are the most enthusiastic to buy. The seller is someone who prefers to buy, but their behavior is being dictated to them by the necessity of meeting the mutual fund redemptions. We believe this is true at all major market low points including the May-June 2010 swoon in the US stock market.

The Wall Street Journal website gives you a picture of the top ten institutional holders and top ten mutual fund holders of a stock. We own shares of Merck (MRK) in our portfolios. Seven of the top ten mutual fund holders of MRK as of March 31, 2010 were large funds managed by American Funds and was nearly the same list as the top ten liquidation list that Morningstar and Investment News highlighted. Merck was heavily liquidated in the first half of the year because someone who thinks very positively about the future of the company is selling to meet redemptions. We believe these redemptions are most likely being forced upon the registered reps and financial advisors by the will of clients who prefer to own bonds.

A number of highly respected portfolio managers and asset allocators have pointed out how undervalued large cap US quality is currently compared to other asset classes. The bottom usually comes right after someone who prefers

to buy them is forced to sell. At SCM, we think the exodus out of stocks into bonds hasn't ended yet, but since the seller is someone who prefers to buy, maybe the turn is not too far off.

Best Wishes,

William Smead

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