The Smell Test
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Dear Fellow Investors:

In my family we have a busy household with many friends and relatives floating in and out. We stockpile non-refrigerated foods in a large pantry and many times we don't get these items opened before the date listed as safe to eat expires. At that point we open the package and do what we call *the smell test*. If it smells fresh, we taste test and if it passes both tests, we eat it. We at Smead Capital Management would like to consider a certain current stock market circumstance to see if it passes *the smell test*.

I started my career at Drexel Burnham Lambert. It was in the news because it was the target of an SEC investigation and US Attorney's office criminal probe in the late 1980's. I was a young stockbroker and assistant office manager without the life experiences to understand the full implications of the situation. The company had no fans in politics and was hated in the marketplace for hogging almost all of the revenue and profit in the market for trading and underwriting what came to be known as "junk bonds". These were bonds rated less than investment grade and prior to Drexel's trading desk, did not have much of a market. The company fought the government and ultimately was liquidated when their primary market, junk bonds, collapsed in 1989 during the Bank and Savings and Loan crisis of that era. They didn't pass *the smell test*.

Goldman Sachs is the target of an SEC civil suit and the US Attorney's office is doing a preliminary investigation into possible criminal charges. They made markets in synthetic CDO's (Collateralized Debt Obligations) and are being accused of creating a CDO so that it would fail for the benefit of a client, who was betting against these kinds of instruments. Let's open the package and do *the smell test*.

Every investment transaction has a buyer and a seller. Both parties believe they are right and someone is charging a commission for brokering the trade. John Paulson was the Goldman client who wanted to take the short side bet on the CDO in question and he was a relative unknown outside of his segment of the hedge fund world. He wanted to bet against the US mortgage market. The municipal insurance company, ACA, which put the deal together, did so to insure these bonds for a premium. They did not want to absorb the full risk, so they laid some of that risk off on ABN Amro, a large European financial institution which had made many investments just like this one in that time frame. In early 2007, we all knew that there was trouble brewing in US residential real estate, but we didn't know the magnitude or velocity at which this problem would unfold. The media and populist politicians appear to be rewriting history because they were asleep at the wheel in early 2007 and the animals are now "out of the barn". Politicians tapping into populist political anger at banks is much easier than trying to get their constituents to admit their own greed in residential real estate. Telling the American public that they had as much to do with the mortgage meltdown and the deep recession of 2008-09 as the greedy financial institutions seems totally unacceptable when congressional elections are coming up in November.

Warren Buffett got to watch Drexel Burnham up close and when he got into a similar situation with a company called Salomon Brothers in 1992, he reacted swiftly. He took over Chairmanship of the company and immediately went to the government and told them that that the company (Salomon Brothers) would do whatever was required by the US government to make amends. He also pledged to the government that a culture would be put in place going forward so that it wouldn't happen again and allowed ongoing verification by the feds. He was a large shareholder in Salomon through 9% convertible preferred shares he owned and is a large stakeholder in Goldman by virtue of a $5 billion investment he made in the fall of 2008 in a 10% preferred, which has warrants attached to buy Goldman common shares at $115 per share. When he opened the bag over the weekend at his annual meeting and on T.V. this morning (May 3rd, 2010), it didn't smell bad. He is making no effort to takeover any control or leadership of the company and gave CEO Lloyd Blankfein as resounding an endorsement as I have just about ever heard him give! When asked who he'd get to run Goldman if Lloyd was forced out, Buffett said, "If Lloyd had a twin brother, I'd vote for him."

We are going to taste our shares of Goldman Sachs. We believe they have many political friends and many satisfied customers. As fragile as the financial system was in 2008 and early 2009, we don't think the populist politicians are interested in cutting off their nose to spite their face. Crippling Goldman in any permanent way could torpedo confidence in our economic recovery, but damaging them some in the short run might help get a stronger bank regulation bill passed in Congress. And while the government is at it, let's pursue those who lied about their incomes to get loans, real estate agents who encouraged them and mortgage companies which passed those fraudulent loans into large bond pools. Somehow, skipping them to get to the end of the food chain doesn't pass *the smell test*.

Best Wishes,

William Smead

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