Unbroken
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Chief Executive Officer
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Dear Fellow Investors:

Louis Zamperini was an Olympic distance runner who finished eighth in the 5000 meter race at the 1936 Olympics. His story is chronicled by Lauren Hillenbrand in her book, *Unbroken-A Story of WWII Survival, Resilience and Redemption*. Zamperini's promising athletic career was interrupted by the Japanese attack on Pearl Harbor on the seventh day of December in 1941. What happened to Louis can give us some perspective on the endurance and perseverance needed to succeed in what have been very difficult investment markets.

Louis was a B-24 bombardier. In 1943 his plane was shot down on a mission south of Hawaii. He and two other crew members survived against long odds floating on a life raft for 47 days. When they drifted 2000 miles west, they were captured by the Japanese Navy and shipped to a prison camp on the Island of Kwajalein. It was the beginning of a 30-month ordeal in numerous prison camps where he and his mates withstood horrendous torture. The most outlandish punishment came from an officer named Watanabe who the prisoners called, "The Bird".

The Bird knew that Louis was a famous athlete and that he was very disciplined and well trained. He singled him out for especially egregious beatings in hope that it would affect the entire group of prisoners. By the time the war was over, Louis was emaciated, deeply wounded and suffering from post traumatic stress disorder. He woke up every night dreaming about being hit with the belt buckle or bat held by Watanabe. Zamperini was miserable.

At Smead Capital Management (SCM), we feel like we've been in an investment prison camp. First, we were shot down by the 2007-2009 Bear Market and held on to our companies like they were a life raft. We survived, but our portfolios were in pretty rough shape when the bottom came in March of 2009. Since then our portfolios have recovered. Unfortunately, few investors, either individual, professional or institutional, can find the courage to buy these wonderful companies when there could be the most to gain longer-term from employing our eight proprietary criteria for stock selection.

It is not unusual for our contrarian stance to be shunned, we've been in this position many times. However, in the spring of 2010 and the summer of 2011, we have been beaten indiscriminately and unmercifully by the Flash Crash and Sovereign Debt Crisis, respectively. About the tenth time you've been punched in the face by the "risk on, risk off" trade or beaten with an algorithm bat through "high frequency" trading you begin to lose some of your dignity like Louis Zamperini did in the prison camps.

As a 31-year veteran of Wall Street, I am well adjusted to regular temporary stock market corrections and occasional bear markets. History shows that most years include at least one decline of 10 percent or greater and that a 20 percent or greater decline happens about one out of every five years. What frustrates us as long-term holders of businesses like Disney, EBay, Merck and Franklin Resources is that there is virtually no respect shown to their superior attributes in these declines of the last two years. The result is that our companies are exceedingly cheap, in our opinion, compared to other stocks and other asset classes.

As if being punished in the investment prison camp isn't enough torture, we have to stand by and watch the love affair investors are having with Treasury bonds and gold. It is as if a group of war prisoners are being put up at the Ritz Carlton while we join Louis eating seaweed and bug-infested rice. If two percent interest on Ten-Year Treasury Bonds and $1900 ounce gold succeed as investments these next ten years, we believe we'll have much bigger problems than stock market performance. Grab your guns, ammo, rations and water.

Our wonderful companies already average a higher dividend percentage than the rate of interest on the Ten-Year Treasury did at the close of trading on September 6th, 2011. They trade at very low multiples of earnings and free cash flow. The dividend growth over the next ten years could provide adequate comparative returns to other asset classes without much capital appreciation. In today's investment prison camp the dividend payout ratio on the S&P 500 Index is the lowest since 1936 at around 29 percent. As people and companies get out of the investment prison over time, we believe those payout ratios will gravitate toward historical norms around 50 percent. This means that a portfolio trading at ten times after-tax profits could easily pay a five percent dividend in the not very distant future.

By now you are probably wondering what happened to Louis. After three years of struggling with alcoholism and PTSD, Louis was dragged to a Billy Graham Revival in 1949 by his wife, Cynthia. He remembered that he’d promised God on the life raft that if He saved them he would devote his life to God. Louis started a major ministry to wayward teens and spoke all over the world about endurance and perseverance. He also forgave The Bird and his other tormentors. The PTSD miraculously went away.

We at SCM are prepared to forgive the hedge fund whiz kids, ETF flippers, algorithm traders and doomsday gold bugs who are making our investment life temporarily miserable. We expect to lead a large group of wayward investors over the next ten years to enjoy long-term ownership of high quality common stocks. All this is possible if we remain "unbroken".

Best Wishes,

William Smead

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