



SMEAD
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This Diamond Ring

Gary Lewis and the Playboys had a huge hit record in 1965 with the song, “This Diamond Ring”. We believe that the lyrics are analogous to the most important thing that is currently happening in the stock, bond and commodity markets around the world. The diamond ring we are referring to is the belief in the emerging market secular growth story. In our opinion, how that story plays out will determine who wins and who loses in the stock market as we look out to the year 2012.

Who wants to buy this diamond ring?

She took it off her finger, now it doesn't mean a thing

This diamond ring doesn't shine for me anymore

And this diamond ring doesn't mean what it meant before

So if you've got someone whose love is true

Let it shine for you

In 1999, when US common stocks were the most popular asset class in the world and technology stock interest triggered a huge bubble, most other asset classes were very cheap. Everything from energy, gold, small caps, emerging markets, bonds (both domestic and international) and soft commodities were starved for capital. The diamond ring that people wore was a belief that technology had taken us into a “new era”. The diamond ring needed on their finger in 1999 was the belief that China and other first tier emerging markets would grow in an immense and uninterrupted way for the next 12 years. This ring would have led investors to a serious overweighting in energy, basic materials and heavy industrial companies, which fed off of the massive infrastructure build out which occurs when an emerging market catches fire. The diamond ring shined.

Unfortunately, this diamond ring is being taken off of the finger of worldwide investors.

China's internal stock market, the Shanghai Index, has been in a vicious bear market since late 2007 as it has lost 60% of its peak value. Long after that decline was evident, American and international investors

got sucked into buying US listed shares of Chinese companies via initial public offerings at exorbitant prices. These mostly high tech offerings spent 2011 separating investors from part of their net worth. We specifically mentioned that risk in December of 2010 in a missive called Dang Dang!

Oil prices peaked in 2008 at around \$145 per barrel and commodity market participants have used an unusually large amount of effort to attempt to keep prices up while they still had the diamond ring on. The US appears now to be a net exporter of oil products; is using a great deal less gasoline than we used to and has an amazing number of companies poking holes to crack, frack and pump major amounts of new oil and gas. We believe that when the growing set of middle class drivers in China are disrupted by the fact that “this diamond ring doesn’t shine for me anymore”, oil prices are in a heap of trouble.

Soft commodities, whose most expensive input cost is energy and transportation, have been peaking in the last twelve months as the ring is being “taken off our finger”. When China goes into a recession, we believe they won’t be able to afford to buy as much exported grain or pork or cotton. The visions of secular and uninterrupted growth “won’t mean a thing”.

We have explained for a few decades that a “well known fact” quits shining for you as an investor regardless of whether it is true or not.

The most obvious example is the fact that drove the tech bubble in the late nineties. The diamond ring in the late nineties was the fact that “the

internet is going to change our lives”. Those who wore that diamond ring were doomed to lose as much as 80% of their capital in the 2000-2003 bear market in the US. The sad part of that diamond ring was that it came true. Once everyone knows the “well known fact” and has acted on their belief, the diamond ring becomes a noose around the neck of the believer! We believe we have entered that phase with the current diamond ring.

This stone is genuine like love should be

And if your baby's truer than my baby was to me

This diamond ring can mean something beautiful

And this diamond ring can mean dreams that are coming true

And then your heart won't have to break like mine did

If there's love behind it

There is no rule that says to stay away from diamond rings. When it comes to investing it can be very profitable to be early and have a vision of what the dominant trend of the next ten years could be. With all the computers, information and very smart people out there today, we believe that is it easier to concentrate on what to stay away from and stick to a diamond ring that is much more “genuine” and is “truer” from a historical standpoint. History has proven that the ownership of high- quality large-cap common stocks of a more non-cyclical variety have proven over many decades to produce above average returns as compared to other liquid asset classes.

We feel this is especially true now. While commodities have never done better over ten years than they did the last ten year, large cap non-cyclical stocks have rarely done worse than they have done since 2000.

We are avoiding anything commodity and BRIC-trade related.

Our companies trade at discounts to the average US stock and a huge discount to small cap stocks. The dividend growth is exploding as the executives and board members running large companies realize that stock prices could well be driven by dividend increases the next ten years. Baby boomers in the developed world own most of the money and they want income.

If you own a diverse portfolio of wonderful companies and hold them for 20 years, we believe you don't have to worry about "your heart having to break". A very old and stale "well known fact" like the secular growth story in emerging markets (led by China) is a "diamond ring" that needs to be taken off and moved to investments that will return the affection. "Who wants to buy this diamond ring?" ■

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Smead Capital Management

1420 Fifth Avenue, Suite 2625
Seattle, WA 98101-4149

Direct 206.838.9850

Fax 206.838.9851

Toll Free 877.701.2883

www.smeadcap.com