First Quarter 2010

Duration as a Prescription for Success

Starbuck's announced their first dividend at a whopping 10 cents a quarter. They pride themselves on unselfish corporate choices and operating on the cutting edge of society and technology and this move appears powerful on their part. Many US corporations sit on huge amounts of cash earning little or no interest and are generating huge levels of free-cash flow after cutting expenses in the recession. Many of our companies (EBay, Amgen, Microsoft, etc.) are in this position and should feel a great deal of pressure from shareholders. In the next couple of years, we feel stock performance could be driven by dividend increases.

To get you an important look at the long-term perspective we turn to Morningstar, which did some neat fund flow analysis recently. It was picked up by a column written by Mark Hulbert on MarketWatch called, "Active vs. Passive". In it he described how fund flows had moved toward passive or index investing among US equity funds and away from active managers in the last ten years. The amount of US equity assets which are indexed grew from 12% to 22% of the total pie. Theoretically the more that investors or their advisors index, the more likely active managers would be to gain the upper hand over passive investments in the S&P 500 Index (scarcity creates value). Unfortunately for the active managers, this was not the case as only 20% of active managers beat the market over the ten years. In the article, Hulbert concluded that all the added advantage that active managers might have received from greater passive participation was dissipated or offset by the increased portfolio activity (turnover) of stock money managers. At Smead Capital Management, we think these results and information are important to contemplate because it sheds light on what it means to be a wise contrarian investor in early 2010 and in the future.

In the next couple of years, we feel stock performance could be driven by dividend increases.

The S&P 500 Index has obvious built in advantages over active funds. As a benchmark it has no management fee. Therefore, throughout the

year the index will gain the advantage of not paying a management fee of .50%-1.00%. The active managers automatically have to overcome this difference through better performance. Second, there are no operational costs associated with the index. In the actively managed US equity fund universe this adds up to an average of 1.31% per year including the management fee. Third, the index has very low turnover historically. This means that trading costs and bid and asked spreads do little to reduce the returns of the index. Lastly, the S&P 500 Index is a market-capitalization weighted index. It means that the S&P 500 Index holds its winners to a fault while allowing the duds (like General Motors) to run their stock price into the ground. At SCM, we believe this is one of the index's biggest built in advantages over active managers. The math is that you can make 10 times your money on a big winner, but you can never lose more than 100% of your money on a stock going bankrupt.

At Smead Capital Management, we think these results and information are important to contemplate because it sheds light on what it means to be a wise contrarian investor in early 2010 and in the future.

Academic research has shown repeatedly that long time periods allow value to get recognized in the marketplace. Eugene Fama's work on efficient markets at the University of Chicago focused on low price to book value. Others like Bauman, Conover and Miller as well as David Dreman have shown clearly that buying the lowest P/E ratio stocks has soundly beaten the market averages if measured over a ten year or longer time frame. This shows that long durations produce better results for both passive and active investors.

On top of all this is the fact that dividends and dividend increases make up a substantial part of long-term returns produced by participating in US equity investments.

Ben Inker, research director at Grantham, Mayo and Van Otterloo (GMO), exposed what is wrong with the high level of activity and portfolio turnover at the average actively managed fund. His work shows that 75 per cent of the current intrinsic value of a stock comes from cash flows earned more than 11 years from now. Why are short term business prospects receiving most of the professional investor attention when company durational success should be their focus? Ironically, in 2009 the average holding period for a stock on the New York Stock Exchange dropped below a year for the first time in 70 plus years. Not only have money managers been more impatient, but individual and institutional investors have been as well! On top of all this is the fact that dividends and dividend increases make up a substantial part of long-term returns produced by participating in US equity investments. The average investor doesn't stay around long enough to collect an entire year of dividend payments.

When we put this wonderful band of players together, we at Smead Capital Management come to this conclusion. When stocks do poorly for a decade, investors are motivated to try to compact duration or holdings periods on stocks to gain an advantage. In the process they

cede success to the S&P 500 Index. And by being impatient and too active they fail to take advantage of the kinds of under valuations provided by cheap stocks. We believe these advantages include dividends, dividend growth and companies with long duration business characteristics (wide moats and strong balance sheets).

It appears that good stock selection, with an eye on low PE's and long duration business characteristics could be very successful for the patient US equity fund manager. It also appears to be quite contrary to the popular view and methodology of active managers in 2010. ■

Smead Capital Management, Inc.("SCM") is an SEC registered investment adviser with its principal place of business in the State of Washington. SCM and its representatives are in compliance with the current registration and notice filing requirements imposed upon registered investment advisers by those states in which SCM maintains clients. SCM may only transact business in those states in which it is notice filed or qualifies for an exemption or exclusion from notice filing requirements.

This newsletter contains general information that is not suitable for everyone. Any information contained in this newsletter represents SCM's opinions, and should not be construed as personalized or individualized investment advice. Past performance is no guarantee of future results. There is no guarantee that the views and opinions expressed in this newsletter will come to pass. Investing in the stock market involves gains and losses and may not be suitable for all investors. Information presented herein is subject to change without notice and should not be considered as a solicitation to buy or sell any security. SCM cannot assess, verify or guarantee the suitability of any particular investment to any particular situation and the reader of this newsletter bears complete responsibility for its own investment research and should seek the advice of a qualified investment professional that provides individualized advice prior to making any investment decisions. All opinions expressed and information and data provided therein are subject to change without notice. SCM, its officers, directors, employees and/or affiliates, may have positions in, and may, from time-to-time make purchases or sales of the securities discussed or mentioned in the Publications.

For additional information about SCM, including fees and services, send for our disclosure statement as set forth on Form ADV from SCM using the contact information herein. Please read the disclosure statement carefully before you invest or send money.

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