



**SMEAD**
capital management

1.877.701.2883
info@smeadcap.com

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Surprise! Surprise! Surprise!

The biggest risk associated with writing to you quarterly is the way I date myself by including stories from years gone by. I do this because I know it helps me to understand what is going on and I hope it helps you. With that in mind, I'm going to ask that great philosopher, theologian and intellectual leader, Gomer Pyle, to remind us about what matters in the stock and bond markets as we head into the fourth quarter of 2007.

Gomer Pyle was stationed at Camp Henderson in California in the mythical T.V. Series, Gomer Pyle, U.S.M.C. Gomer's favorite line or saying in the show was "Surprise! Surprise! Surprise!" He said this to indicate affection to a friend in his semi-goofy, down-home manner.

Surprise number one

All I can say about the investment markets right now is surprise, surprise, surprise. Most people who are participating in the investment markets were hit by surprise number one this summer with the collapse of the sub-prime lending market here and around the world. As I have argued vociferously for two years, it is not healthy to have a spat of "safe speculation" even in markets which have had a consistent long-term positive bias. This spat of "safe speculation" was in residential real estate and lenders got caught up in the "New Era" thinking by lending money to people who couldn't pay it back. They made the loans because they believed the underlying asset would appreciate and bail the lenders out.

The panic and stress associated with this "safe speculation" is heightened by the world-wide distribution of ownership of these debts, many of which are unlikely to be repaid. In the old days, a bank or savings and loan made a home loan and if you defaulted, the bank repossessed the home and sold it to someone else as soon as was reasonable. If the bank lost money on a bunch of these bad loans the regulators were quick to jump on them to tighten their lending standards. The market corrected quickly and had some built in discipline.

Not so this time. Aggressive mortgage lenders pushed the envelope and created loans which were

grouped into large pools of mortgages. The pools were heavily divided and repackaged, with other less risky debts into collateralized debt obligations (CDO's) and were sold all over the world. Many of the loans are nearly worthless and their owners are now sitting with billions of losses in the bond portfolios. The most exciting mini-panic circumstances always surround an open-ended problem, because the extent of the problem and the time needed to solve them are hard to wrap your mind around.

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Surprise number two

The second surprise is the group think or "well known fact" currently on Wall Street and among the major investment houses. It's the idea that asset allocation and wide diversification among asset classes and regions of the world is the key to long-term success in investing. Their thesis says by adding riskier asset classes to your mix you actually could reduce risk and enhance return. They could look backward into the rear-view mirror and see that over the last 5 years it was true. When international emerging markets rose while tech stocks dropped, it was a great diversification. If oil, gold and your second home in Florida or Arizona appreciated while your telephone stocks were in the dumper, diversification triumphed. And if small cap stocks made good money while large caps struggled, your diversification had great success.

There are two big problems with the current asset allocation group think. First, it was spawned in 2000-2001 as the stock market began to suffer at the hands of the bursting of the Technology Bubble. At the height of that bubble, U.S. institutions held 77% of their assets in U.S. stocks and the vast majority was in large capitalization stocks. Therefore, any diversification away from large

cap U.S. into other sectors or classes was likely to benefit portfolio returns. Secondly, as the format got more and more popular the money that was being allocated to relatively illiquid, riskier areas like small cap and International Emerging markets drove up their price in an unsustainable manner. The bigger fool theory then kicked in (Hello, Gomer).

Let me give this to you straight like we were Marines at Camp Henderson. Almost everyone owned large cap growth stocks at the start of 2000 and hardly anyone was invested in anything else. Anything else did great and large cap did lousy. Therefore, the experts at the investment houses and wealth management

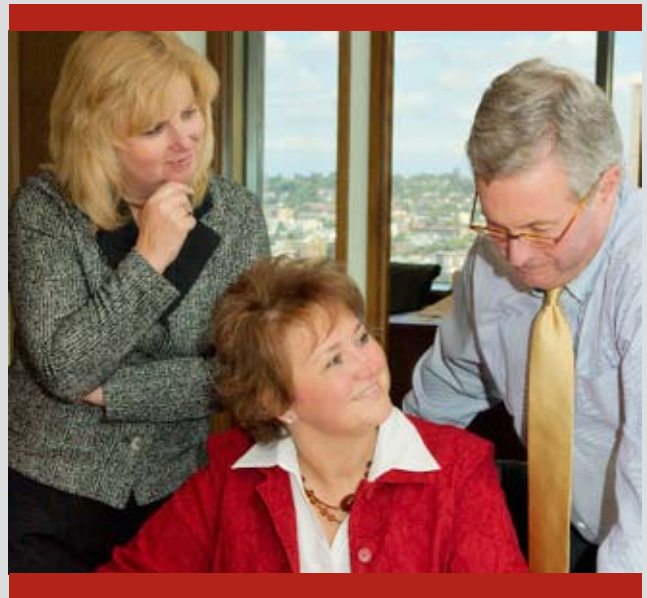
departments have concluded that what worked the last five years could always work. Their thesis plays well with investors who have a hard time sticking to a discipline and are the kind of people who leave the freeway in traffic to take side roads that end up being slower. The side roads make them feel good because they get to keep moving and asset allocation might always keep you in a sector worth bragging about at the cocktail parties. They have a big problem now which is that most everyone has followed them and there is very little dissent besides people like us.

To understand why we dissent, you just have to look at the Forbes 400 list of wealthiest Americans. The most consistent way to get on the list is to have a large piece of your net worth in a business that succeeds for a long time. Large cap stock participation allows individuals like us to participate in worldwide wealth creation without having to worry about our companies going out of business or a military dictator in Thailand or Venezuela. We don't have to paint them or carpet them or pay property taxes while we own them. We only have to provide the capital and the patience. The lack of patience is what the asset allocation people play on. U.S. investors have invested a great deal of money each of the last two years into equities even as they were net liquidators of large cap growth stocks.

Surprise number three

Surprise number three is prophetic in nature and you might need Sergeant Carter yelling it into your ear. It is estimated that U.S. institutions now hold 45% in domestic stocks with a much smaller percentage in large cap than 7.5 years ago. So think about it for a minute. In 2000 U.S. investors had almost all of their risk money in large cap growth stocks at an average of 37 times earnings and almost no diversification. Today there is historically low ownership of U.S. stocks and much of that smaller allocation is in small-cap to mid-cap stocks. Investors are trained to widely diversify into everything from hedge funds and international stocks to homes in Suncadia (a trendy vacation home community near Cle Elum, Washington). Large cap stocks trade at about 15 times earnings, have bright futures and no fan club. Many of the most popular investment gurus are asset allocation enthusiasts and they are treated like Moses coming down off of Mount Sinai by financial professionals and wealthy investors alike. Instead of the Ten Commandments, they provide the ten asset classes or sectors that everyone should be in.

A new fan club is forming. It includes company insiders, who are buying stocks at their highest level since the market bottom of 2002-03 and the specialists on the floor of the New York Stock Exchange who are selling short the least amount of stock in the last 40 years. The old fan club is led by the historically foolish public which has been selling U.S. stocks short at record levels. These facts all point to the same potential conclusion. Smead Capital Management believes that U.S. large cap growth stocks could dramatically outperform most other asset classes, market sectors and countries of the world in the next five years! If we are wrong about the third surprise, you can call me Gomer. ■



This summer, Smead Capital Management took a leap of faith. We left Wachovia Securities to create a truly independent firm that is free to give our clients what they really want: straight talk and extraordinary service.

We are extremely excited to welcome clients and visitors to our new office and website, which we feel fully reflect the alignment of our values and vision.

Though there have been great changes, we are still the same passionate team committed to being there for our clients, through personal contact and the motivational insights presented in our seminars, newsletters and website. If you'd like to find out more, or see our new space, we welcome your call or visit.

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