



SMEAD
capital management

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Good to Great

Jim Collins wrote a book which was published in 2001 titled “Good to Great”. His thesis was born through 10 years of research on outstanding companies. He narrowed the research on hundreds of companies down to 11 that had exhibited greatness on a wide variety of parameters including stock price performance. As we look out to 2008 at the investment markets, the key characteristics of these “Great” companies could instruct us and sharpen our vision. It’s a strong standard to examine our approach to the markets and our discipline as we enter the New Year.

His first key point was that “good is the enemy of great”. In other words, sustained and consistently good performance many times fooled good companies into postponing tough choices and not making long-term plans, major changes and improvements. Much like humans (including me), companies rarely reinvent themselves when things are going well. Portfolio managers can be hesitant to pursue the potentially success-rich beaten up sectors of the stock market when things have gone well in the previous four years. Companies are reluctant to exit poor performing subsidiaries when the performance is covered by overall success. We believe the opportunities available in the U.S. stock market in beaten up consumer discretionary and financial companies could be the start of a “Great” period for our portfolios.

Second, he emphasized how crucial Level 5 leadership is to going from “good to great.” Humility was the number one ingredient of superior

(Level 5) management as revealed in their research. Vioxx lawsuits brought tremendous humility to the Pharmaceutical industry in 2004 thru 2006 and in the aftermath some of the Pharmaceutical companies saw remarkable corporate, legal and stock price improvements. Three to four years of the U.S. Federal Reserve Bank raising interest rates and U.S. investors selling large capitalization domestic stocks to send their money to other asset classes has humbled us at Smead Capital Management Inc (SCM). Humility and bargains are a nice combination in portfolio management.

The third critical factor for Collins had to do with filling the company with the right people. His research showed that outstanding people would figure out what to do and where to go and everything else took care of itself. We have outstanding people at Smead Capital Management Inc. and hope to add more over the years. In January, Tony Scherrer will join our team. He comes to us with 14 years

experience in managing money (mutual funds and separately managed accounts) and last oversaw portfolios for U.S. Trust Co. He brings expertise in both the institutional and high-net worth markets to SCM.

We use another team of people to help us manage your money that we don't have to pay. They

are what I like to call the "smart-money crowd". This team is made up of wealthy investors (Warren Buffett), strong money managers (Bill Miller, Mason Hawkins, Wally Weitz, etc.), insider buyers (officers, directors and substantial stockholders of publicly traded companies) and the specialists on the floor of the New York Stock Exchange (NYSE). All segments of the "smart money crowd" are telling us the same thing. They are buying aggressively for the first time in years (Warren Buffett, Mason Hawkins and Insiders), selling the least in 40 years (NYSE Specialists) or trying to stop people from bailing out on their successful long-term discipline because of temporarily below-normal results (Bill Miller and Wally Weitz). Coincidentally, this usually happens close to major market or style bottoms.

Collins' fourth key component of going "good to great" was confronting the brutal facts while never losing faith. He found that on the road to great that you must deal with the current difficulties and not let them interrupt your vision of the ultimate goal. He relayed his interview with Admiral James Stockdale, who spent 8 years (1965-73) in a Vietnamese prison camp. He never once wavered on his belief that they would make it home, but dealt honestly with each temporary difficulty. One time he ripped up his own face so his healthy image wouldn't be used in a television report showing how well prisoners were being treated ("He cut off his nose to spite his face"). When asked by Collins about who didn't make it out, he replied, "the optimists." Collins was as surprised by his response as I was. The

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optimists said, "We'll be out by Christmas." Christmas came and they were still in prison. Then it was Easter they looked forward to and it came and went without rescue. It ultimately led many of the "optimists" to try escaping, which was a form of suicide in these heavily guarded camps.

What a picture of life and investing the Stockdale

example is. Focusing on the ultimate goal and dealing in a brutal and honest way with temporary difficulties is a great prescription for life. We endeavor to earn above-average returns in the stock market and do not waver when the results don't come for us on schedule. The reason that more people don't enjoy the benefit of historical stock market returns (10%) is that the order and time frame are an unknown. We have been as guilty as anybody with our constant optimism. We remain focused on the long-term goal, but we pledge to always communicate when temporary difficulties come to us in the markets. We believe our communications (lectures, newsletters, personal conversations and media appearances) are a differentiator for our business.

The fifth component of becoming "great" is his "Hedgehog Concept". When being attacked, a hedgehog curls up and exposes nothing but its needles to ward off the enemy. Great businesses defend themselves by staying away from non-core businesses that don't play to their strengths. We'd like to think that at SCM we do the same thing. When tech stocks got overheated in 1999, we curled up and stayed away. When the residential real estate mania

took over in 2005 we warned our clients in every available way. And now that multiple-asset class diversification, oil and gold

mania and infatuation with the International Emerging Markets of Brazil, Russia, India and China have set in we are doing the same thing. While everyone worries today about the U.S. economy falling apart, we think

much bigger risks exist in the most popular markets. Maybe the China Olympics in August of 2008 will be to International Emerging Markets what Y2K was to the tech bubble.

Lastly, Collins writes about a culture of discipline. He refers to a world-class athlete name Dave Scott. Scott competes in triathlons and washes his cottage cheese to gain a nutritional edge on the competition. When it comes to investing, Warren Buffett describes it best. He calls it your "Circle of Competency". Collins likes to think of it as creative discipline. We use our eight criteria to pick stocks and currently our criteria produces more good ideas than we have money to buy (see our recent letter). Therefore, you have seen us trim some large holdings and sell some poorer performers to offset the gains and free up capital to pursue bargains created by the two big panic selling binges

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(washing our cottage cheese). We are buying excessive weakness in the consumer discretionary area and financial stocks. I have a strong circle of competency in those areas. I have worked in the financial services world for 28 years and my wife and the mother of our five children (pretty much grown) has worked hard buying items in the other one.

We have never been more excited about the long-term goal of earning above-average returns in the stock market; we never know exactly how it will all play out, but we want to sincerely thank you for your patience, confidence and referrals as we embark on the year 2008. ■



*Tony A. Scherrer, CFA
Senior Vice President & Portfolio Manager*

*Smead Capital Management welcomes
Tony A. Scherrer to our team.*

*Tony brings fourteen years of professional
investment experience in the Financial
Services Industry and will lead our
efforts to manage money for institutions.
He will have responsibility in Portfolio
Management and analysis as well as
Institutional Marketing.*

*Prior to joining Smead Capital
Management, Tony was a Vice President
and Senior Portfolio Manager at U.S. Trust
and Harris Private Bank.*

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