Solving the Common Stock Mystery

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Dear Clients and Prospective Clients:

A series of clues have been provided to long-term investors over the last five months and we at Smead Capital Management believe these clues could solve the mystery.

Clue Number One: The Dow Jones Industrial Average and the S&P 500 Index are below where they were ten years ago.

Clue Number Two: Ben Inker's research for Grantham, Mayo and Van Otterloo (GMO) showed on a theoretical basis that 75% of the present or intrinsic value of a company comes from free cash flows and dividends occurring longer than 11 years from today and long-term economic growth gravitates to the mean. (See *"The Parable of the Stock Market Sower"*)

Clue Number Three: Companies with wide moats (favorable barriers to competition) stay profitable longer than companies with less wide or no moats. In theory, the longer a company maintains high levels of profitability, free cash flow and dividends, the higher its present value is today.

Clue Number Four: Holding periods have dropped precipitously over the last 25 years on the New York Stock Exchange from five years to less than one year--the lowest since the 1920's. (See *"The Correction that Refreshes"*)

Clue Number Five: Consumer Staple and Healthcare stocks are the most over-represented in the S&P 500 Value Index in the last 15 years. We believe this is even more unusual at the end of a recession. (See *"The S&P 500 Value Index Tells the Story"*)

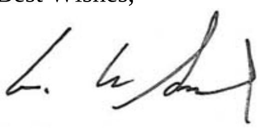
Clue Number Six: Morningstar reports that based on their stock analyst's research that companies with wide moats are 15% undervalued in the market as of August 22nd, 2009, while those with narrow or no moats are either fairly valued or overvalued on average.

Most Popular Conclusion: Trade more often because long-term investing is for losers. Quality doesn't matter, because what matters is what is going to go up in the next three months. Why should we be interested in long-term profitability, because in the long run we are all dead?

Smart Money Conclusion: A terrible decade of stock performance could lay the groundwork for more normal returns (we believe 8-10%) at a minimum. More normal returns are dramatically better than the interest rates on lower risk bond investments. We believe Ben Inker's and Morningstar's research could confirm/foretell that long-duration (aka wide moat) companies are prepared to provide serious out-performance over the next five to seven years. Holding periods could expand when wide-moat companies like McDonalds, WalMart, Merck and Bristol Myers-Squibb regain the upper hand in the NYSE marketplace. The best companies (as measured by balance sheet, brand power, returns on equity, free cash flow, etc.) could trade at their normal/historical premiums to the average stock. Our lives as portfolio managers at SCM could make sense again.

Why do we feel like Columbo?

Best Wishes,



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