The Correction that Refreshes

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Dear Clients and Prospective Clients:

Last week I was on a road trip through the states of New Mexico, Arizona, Nevada, California, Oregon, Idaho, Utah and our home state of Washington. During this trip, I took a break from my normal work routine. I feel refreshed. Let me share a few thoughts on what we have seen and noticed in the market in the last few months. Though we don't usually write missives in this fashion, I think it will serve to give investors a good overview of what has been transpiring.

The stock market has had an amazing run from the lows of March which may not come as a surprise to regular readers of our missives. However, the market appears to be taking a break to also refresh itself, especially in the areas of the market that have had the largest gains since the bottom in March. Here is a list of reasons why we think that break started about ten days ago and might last for a few weeks or months:

1) **The oil trade is too crowded and the summer driving season is over**

   As we drove through each state, we observed that most of the new cars on the road with us were more fuel efficient vehicles. At Smead Capital Management (SCM), we believe that the markets are dramatically underestimating the quickness of the transition being made by American automobile purchasers. Ford is ramping up production of its highest mileage SUV (Escape) and its highest mileage sedan (Focus) to replenish inventory purchased in the cash for clunkers program. Demand for gasoline in the U.S. has been permanently damaged by the $4 per gallon gas of the summer of 2008.

2) **Low quality stocks have outperformed high quality**

   The stocks which went down the most in the final stages of the September 2008 to March of 2009 liquidation went up the most in the first four months of rebound. Going forward these stocks will have to stand on the merits of their future cash flows and dividends and many of them don't currently pay dividends.

3) **Holding periods for stocks have hit 60-year lows and most money managers and individual investors only "rent" stocks today**

Holding periods for U.S. stock investors dropped below one year for the first time since the 1920's. Common stock holding periods have declined from ten-year average holding periods in 1941 to five years in 1975 to below one year today. We have argued that there are a great number of professional money managers and remaining individual investors who are considered bullish, but have one foot out the door at all times. With each correction during this bull market, these investors will flee. In 1975, discounted commissions started and John Templeton was the favored guest on "Wall Street Week" with Louis Rukeyser. Today people watch "Mad Money" and trade for $9 dollars per trade. We have argued that higher commission rates and higher capital gain taxes could cause people to get wealthier over the long run due to the unwillingness on the part of investors to flip in and out of common stock.

4) **The consumer reset which began in September and October of 2008 hasn't reached its one-year anniversary**

The economy entered a coma in September of 2008 which lasted for six months. This produced a "reset" in attitudes among consumers across the board. We are six weeks away from year to year comparisons including that consumer "reset". Impatient investors want the fourth quarter comparisons right now and will bale if they don't get them.

5) **The public hasn't come back into the market yet**

Merrill Lynch reported that in aggregate their clients came into the year 2009 with 25% in stocks, 50% in bonds and 25% in cash. They reported that as of June 30th of 2009 the allocation was the same. The correction will be among professionals because the public hasn't even begun to come back in any meaningful way.

6) **The value side of the S&P 500 Index is dominated by Consumer Staples and Healthcare**

Lastly, the S&P 500 Index is broken up by value and growth components. Energy is the most under-represented in the value index in 15 years and consumer staples and healthcare are the most over-represented in 15 years. Consumer staples and drug stocks do well in market corrections and over long periods of time as well due to their dependability.

None of these reasons are a trigger for us at SCM to make changes in our portfolios. We believe that we will do very well over the next few years whether we have a short-term correction or not. In fact, a little scare in the market might just help the companies we like to own.

Best Wishes,

William Smead

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