William Smead
Chief Executive Officer
Chief Investment Officer

The Road to Omaha: Own High Quality Businesses

April 16, 2013

Dear Fellow Investors:

We are spending the five weeks leading up to the Berkshire Hathaway Annual Meeting focusing on investment keys which are important to both Warren Buffett and Smead Capital Management. This week our focus is on owning "high quality" businesses.

Warren Buffett has said many times that Charlie Munger rearranged his thinking by convincing him that "it is better to buy a wonderful company at a fair price, than a fair company at a wonderful price". Whether a business is wonderful in the eyes of Mr. Buffett is determined by qualitative and quantitative factors. In other words, it is both art and science.

Qualitative Attributes

A couple of fast tests about how good a business is. First question is "how long does the management have to think before they decide to raise prices?" You're looking at marvelous business when you look in the mirror and say "mirror, mirror on the wall, how much should I charge for Coke this fall?" [And the mirror replies, "More."] That's a great business.

When you say, like we used to in the textile business, when you get down on your knees, call in all the priests, rabbis, and everyone else, [and say] "just another half cent a yard." Then you get up and they say "We won't pay it." It's just night and day.

I mean, if you walk into a drugstore, and you say "I'd like a Hershey bar" and the man says "I don't have any Hershey bars, but I've got this unmarked chocolate bar, and it's a nickel cheaper than a Hershey bar" you just go across the street and buy a Hershey bar. That is a good business.

Buffett to the Notre Dame Faculty 1990
Source: Warren Buffett – Full Transcripts, Lecture to Faculty, Notre Dame (page 22 of source)

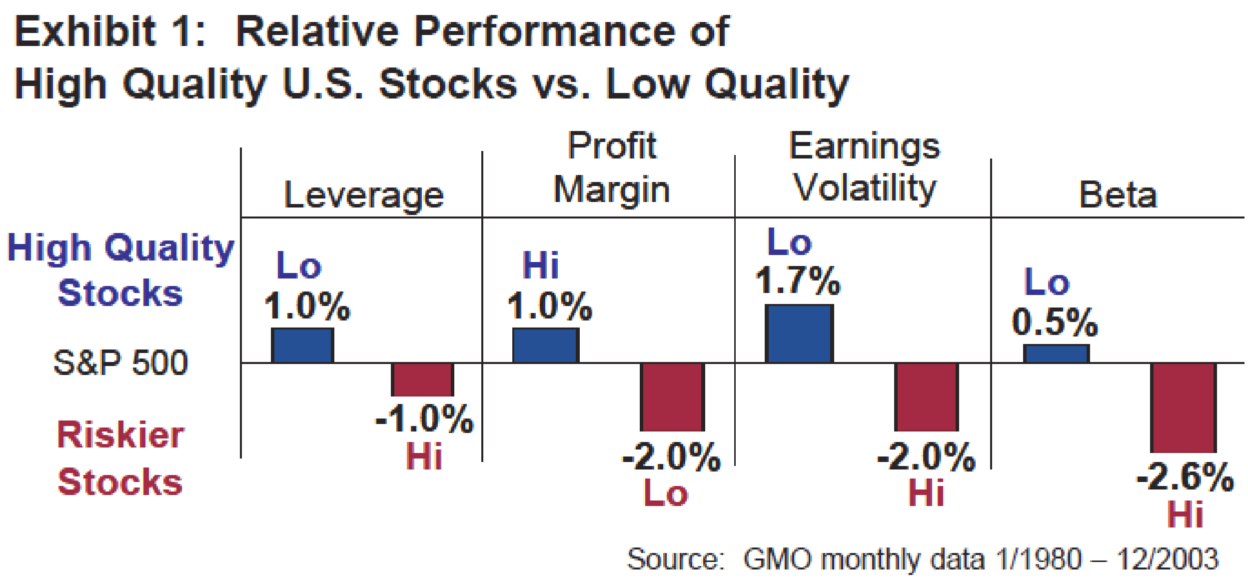
We agree with Warren Buffett because we like to own businesses with "addicted" customer bases. The pricing power of an addicted customer base business is described above. What are folks addicted to in the US? Tobacco is the most addictive legal product in our society, followed by alcohol, coffee/caffeine, women's shoes and a variety of food products, in our opinion. Folks can become addicted to a company's service or delivery system or its branding. Think American Express (AXP) for Buffett and think Ebay (EBAY) for us. The "rabbis and priests" don't need to be called.

Three to four years ago, most investment professionals concerned themselves with macroeconomic arguments to determine whether to own stocks and what to own in their portfolios. If the customers are addicted to your products and/or services, you really don't care what the economic environment is going to be. If they can't get it at one location, "they'll buy it across the street".

We went to the investor day for Cabela's (CAB) recently and in five hours of executive presentations, we didn't see a single slide or hear any discussion about attempting to predict the US economy or its affect on their plans for the future. We wonder if there is a more addicted customer base in America than Cabela's. If inflation shows up, the addicted customer base company gets to raise prices as needed. When coffee sky-rocketed in price between 2009 and 2012, Starbucks (SBUX) just raised prices. When deflation hits, the addicted customer base company maintains prices at levels exceeding the decline in their input prices.

Quantitative Attributes

Thanks to research from Ben Inker of Grantham, Mayo, Van Otterloo, we can see four attributes or factors which demonstrate significant added return (alpha). These attributes are low leverage (strong balance sheet), high sustainable profit margins, low earnings volatility and low share-price volatility. The chart below shows Inker's finding:



Buffett's portfolio at Berkshire Hathaway is loaded with companies which fit Inker's four factors, as does our portfolio. Notice the 24-year time period in Inker's quantitative study. What is Warren Buffett's favorite holding period? The answer is forever and the vast majority of active managers never delve into holding periods long enough to gain the advantages recognized by these factors. Over the last five years, the average holding period on the New York Stock Exchange averaged less than a year. Dalbar recently showed that mutual fund investors were substantially damaging their returns with impatience and Buffett would argue that their active managers are impatient as well. It is a bad parlay, impatience upon impatience. It is hard to be patient without high quality, in our view.

How do these qualitative and quantitative factors play out in Omaha? We will use Coke (KO) as a representative of one of Buffett's largest holdings in Berkshire's portfolio. Coke has a stellar balance sheet (low leverage), sustainably high profit margins, low earnings volatility and is a relatively non-volatile (low beta) stock. He has owned it since 1988. The dividend has risen from $.075 per share annually to $1.12 per share today equating to growth of 11.1% growth rate. Earnings have grown from $.18 per share to $2.02 by 2012. The stock has risen from around $2.37 per share in 1988 to around $40 per share today. A 12% compounded gain without dividends. For Buffett, it defines "high quality".

In the last three weeks we have covered the idea that on “The Road to Omaha” that valuation matters dearly, you want to be a business owner for a long time, and this week we argued that long-duration participation is driven by the need for “high quality” businesses.

Next week: Elephant Hunting With Mr. Buffett

Best Wishes,

William Smead

The information contained in this missive represents SCM's opinions, and should not be construed as personalized or individualized investment advice. Past performance is no guarantee of future results. It should not be assumed that investing in any securities mentioned above will or will not be profitable. A list of all recommendations made by Smead Capital Management within the past twelve month period is available upon request.

This Missive and others are available at www.smeadblog.com.