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The Milken Rule and Wide/Sustainable Moats

December 17, 2013

Dear Fellow Investors:

This is my 34th year in the investment business. You might not be aware that I trained and worked at Drexel Burnham my first nine years in the business. Michael Milken was the driving force behind the success and profitability of my original firm. What happened to Drexel and Mike Milken in the late 1980s is a study in how to have a brilliant vision and how to handle a business with a very wide moat. Its demise has created what I call the Michael Milken rule and we believe it should be used in present day analysis, in particular when it comes to evaluating moats.

Mike Milken's thesis in business school at Wharton was this: below investment-grade rated bonds pay interest rates that are high enough to more than cover the risk of default. He developed the first major trading operation surrounding what were first called "fallen angels." These were formerly investment-grade rated public companies who had lost the investment grade rating via poor business performance or lousy balance sheet management. Later on, Milken developed a huge investment banking operation surrounding the issuance of new debt for less than investment grade companies. These markets became known as the "junk bond" or high-yield debt markets.

Thanks to Milken's trading and investment banking prowess, Drexel became one of the most profitable private companies in the US in 1986. As I remember, we had 95% market share in junk-bond trading and nearly that high a share of the debt issuance of junk bonds. Any effort by firms like Merrill Lynch or Lehman Brothers to develop significant market share were shut down by Milken's group immediately. They barely left crumbs to the rest of the industry. They made no friends and had no viable number two competitor.

Many of you know the rest of the story: equity arbitragers, traders, activist investors and takeover artists jumped on the band-wagon and Drexel got caught up in business with insider traders like Ivan Boesky and other parties which drew the attention of a young, aspiring New York prosecutor named Rudy Guiliani. Milken and Drexel were charged with numerous counts of violating securities laws, resisted a quick clean up, and then were allowed to go into liquidation in the middle of the Savings and Loan debacle in the late 1980s and early 1990s. Drexel was systematically important to the success of the US financial markets, but they had no friends. Nobody had a big enough piece of their industry for politicians to save Drexel and/or the junk bond market. It is my opinion that the lack of liquidity from 1988-92 is a big part of the "jobless" recovery which torpedoed President Bush number one's possible second term ("It's the economy, stupid.")

The Michael Milken rule is to leave your competitors enough business to be significant and successful. Defend your moat politically as well as economically. A second Milken rule is to throw yourself on the mercy of the US government when they decide you've done wrong and ask them exactly what to do to prevent repeating the mistake (see Warren Buffett and Salomon Brothers 1992).

What does history show you about protecting your moat? Coke has always had Pepsi and they are smart enough to act like they are mortal enemies. When folks attack sugar drinks and unhealthy snacks, you pick on two popular companies, not one. McDonald's has Burger King and Wendy's. Merrill Lynch has Morgan Stanley. Bank of America has Wells Fargo and JP Morgan. The list goes on and on. You want a wide moat, but you want other major profitable entities around as well. This is at the heart of understanding the sustainability of a moat. Phillip Morris, RJ Reynolds and a few others shared the US cigarette business for years and shared the legal expensive of defending it.

Who do we think is breaking the Milken rule today? Amazon seems to be attempting to create a platform to drive most everyone else out of business. They appear to us—at least—not happy with just a huge online retail market share. Now they seem to want to attempt to ruin Fedex and UPS by delivering with drones. They want to deliver groceries and attack Costco and Kroger. And they want to provide an online platform for others so that they can identify the most profitable product lines and squash their former partners.

Based on our thesis and the Milken Rule, eBay's success is critical to Amazon. There must be a Pepsi/Morgan Stanley/Burger King for Amazon. Otherwise, when the inevitable business and/or political problem of the future drops at Jeff Bezo's door, there will be a reason for the government to not put him and Amazon out of business. WalMart has struggled with the Milken rule as they got attacked politically. Bezos and Amazon are the darling now, but the attack is not a question of whether, but rather a question of when.

We contend that eBay is not only the New York Stock Exchange of online retail, it also owns the most successful payment system online. They are a toll bridge and are company agnostic. They make money with their partners and seek to enhance their platform seller businesses, while having no interest in warehousing or being all things to all people. EBay simply facilitates commerce and is not a threat to Fedex, Kroger or anyone else. They are in a great position from a moat perspective both economically and politically. Amazon needs them and their success longer term to avoid the Milken rule.

Will Amazon follow the Milken rule and leave enough success for everyone else? Or will they attack PayPal, Costco, Best Buy and all the companies who they'll need to be successful to maintain a healthy and defendable moat. The jury is out!

Warm Regards,

William Smead

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