Dear Fellow Investors:

At Smead Capital Management, we often get asked if we visit the top management of the companies we research. While we read everything we can and do get exposed to the management of our companies over time, we believe it extends credulity to think that a 15 to 30 minute meeting with a senior executive of one of our firms is going to produce alpha for our clients. And, even if the meetings were useful, is there a single senior manager in the US who would tell us that they have big problems around the bend or that their common stock is immensely over-valued?

Therefore, we don’t care too much about what they say regarding their company because we understand that their job is to be the cheerleader for the organization as well as its leader. What we do care about is the size of ownership in the company among founders, 5% or greater owners and the top executives and board members. We are especially concerned with their buying and selling lately. We care about what they do with their ownership of the company, not what they say.

A little background on our eighth criteria for stock selection is appropriate for our newer readers. Insiders are made up of officers, directors and owners of larger than 5% of the common stock of a publicly traded corporation. They can trade legally in their own stock using a series of guidelines and reporting rules determined by the Security and Exchange Committee (SEC). Most studies we have seen suggest that recent insider purchases, especially ones from the senior executives of a firm and large long-time owners, are an indicator of common stock outperformance in the following two years. Here are the results of one of the most recent studies as reported by Jeff Benjamin of Investment News on July 11th, 2013:

In his own research (David Miller), he looked at the buying activity of the highest-level executives of S&P 500 companies for the period from 2003 through 2010. He found that when at least three top-level executives collectively bought at least 10,000 shares of the company's stock in a given quarter, that stock outperformed the S&P over the next 12 months by an average of 11.5%.

Conversely, if at least three top executives of a given company collectively sold more than 10,000 shares of the company's stock during a quarter, the stock underperformed the S&P over the next 12 months by an average of 4%.

Other studies segment the insider buying based on importance of executives, size of the purchases and the number of participating insiders. These trades are reported within two days of the purchases and are made public everyday.

As a firm, we buy into companies which meet our other seven criteria and have sizable ownership stakes among the founders and the top executives. We like to be side by side with owners who have been made wealthy by their businesses and believe in the future wealth creating ability of their respective companies. Just as a professional athlete doesn’t wake up one day and become great, we look for companies which have made owners wealthy in the past and for evidence that they believe in the future of the business. Our list of companies with large insider ownership includes eBay (EBAY), Cabela’s (CAB), Disney (DIS), Nordstrom (JWN), Comcast (CMCSA), Walgreens (WAG) and one of the most famous of large insider
owners, Warren Buffett, whose company Berkshire Hathaway (BRKB) maintains a large ownership in Wells Fargo (WFC) and Bank of America (BAC).

We like to tell people of the importance of our eighth criteria as a timing mechanism through a hypothetical story. Let’s say you lived next door to Jamie Dimon, the CEO of JP Morgan (JPM). It is the summer of 2012 and he is getting excoriated in the newspaper because his firm’s trading unit in London lost $6 billion on what has been called, “the Whale Trade.” JP Morgan stock is trading at $34.50 per share and has been pummeled in the recent past. You are outside mowing the lawn and you see Jamie in his yard. You exchange pleasantries and you ask him what he has been up to. Since the SEC requires almost immediate filing, he says, “I just bought $16 million worth of JP Morgan stock in the open market.” You are aware that he already owns millions of dollars of the stock, has been made wealthy by it in the past and that $16 million is more than he gets paid in a normal year. We think any normal person would finish the pleasantries and rush back to their computer and either put in an order to buy for Monday morning or would make a note to call their financial advisor first thing to buy some shares.

The great investor, Peter Lynch, valued this hypothetical situation so much that Fidelity Investments, his parent company, pioneered the gathering and use of legal insider trading information. Lynch always said, “Insiders might sell their shares for any number of reasons, but they buy them for only one: they think the price will rise.” Peter Lynch was willing to put himself in the position of being the neighbor of the insider and trust what the insiders did rather than what they said.

When a company meets all eight of our criteria and has seen recent insider buying, we get very motivated to buy or add to our existing positions. We believe that our trust, developed over the last 34 years of stock market participation, in these historically wise market participants, is a leg up on most stock picking organizations. We trust what these insiders do, not what they say.

Warm Regards,

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. Bill Smead, CIO and CEO, wrote this article. 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.smeadcap.com.