OCTOBER 24, 2017

William Smead
Chief Executive Officer
Chief Investment Officer

Rise of the Rest

Dear fellow investors,

The first time I read magazine was in 1980 as a brokerage trainee in New York City. I was fascinated by the company stories and the way the top investment disciplines were analyzed. In the 100th Anniversary Issue—published in September 2017—over 100 successful business and investment people wrote a short essay.[1] We would like to zero in on one of these essays from Steve Case, the former Chairman/CEO/Co-Founder of America Online, Inc. (AOL).

Steve Case led one of the first major businesses which succeeded via the internet: AOL. People used email ("You've Got Mail") and visited chat rooms on subjects of their own interest. AOL became extremely popular in the late 1990s "DotCom bubble" and Case wisely used his hyper-expensive stock to buy the Time Warner Corporation. This allowed him and his cohorts time to sell shares underpinned by a non-internet business (media) while internet-based stocks crumbled in the bear market of 2000-2003.

In the *Forbes* 100th Anniversary Issue, Case gave us an economic history lesson. He reminded everyone that during the industrial revolution, Pittsburgh boomed on steel production and Detroit boomed making automobiles. At that time, Silicon Valley was nothing but fruit orchards. He went on to explain where we are now:

> *"As the industrial revolution peaked and the technology revolution accelerated, the role of those places changed. Today 75% of venture capital still goes to three states (California, New York and Massachusetts); half goes to California alone."*

What Case (the man with brilliant timing in 2000) then said, got us at Smead Capital Management very excited:

> *"Startups will increasingly move to cities where industry expertise exists. The opportunity to grow companies that spur job creation and economic growth holds great promise for what I call these "Rise of the Rest" cities."*

Case is making an argument for long duration common stock owners that has important economic and investment ramifications. We have argued that the largest population group (Millennials) won't stay single and continue to rent in the most expensive cities in the U.S. much longer. We estimate that 80% of the geographic areas of the country offer massively lower expenses to up-and-coming companies, and a significantly lower cost of housing and living for employees.

We believe the economic ramifications of this shift would include the following:

1. Companies would cut overhead by locating large groups of employees in relatively inexpensive office space.

2. Employees would expand their purchasing power for homes, cars and services due to a lower cost of living.

[1]Source: *Forbes* 100th Anniversary Issue, essay by Steve Case (https://www.forbes.com/100-greatest-business-minds/person/steve-case)

3. Americans who make their living in service industries or serving others (e.g. teachers) would make wages leading to a higher standard of living than those who serve in expensive coastal cities.

4. Intra-country migration would improve the livability of already over-crowded cities like Boston, New York and Miami in the east, as well as Los Angeles, San Francisco and Seattle in the west. As a side effect, children might discover the outdoors more easily.

Furthermore, we believe the "Rise of the Rest" would raise the following questions for long-duration investors:

1. Would homebuilding flourish via less expensive land and less expensive labor?

2. The emphasis on free grocery delivery really caters to crowded cities. Is the whole delivery idea going to peak if migration causes a simpler life? Also, if folks interacted with neighbors in their own less expensive and unhurried town, would they be as dependent on social media for community? In essence, would the "Rise of the Rest" break the infatuation investors have with the FAANG companies?[2]

3. Would locally-produced news and movie/TV programming, which caters to the "Rest" of the country, become more valuable in cities away from the expensive coast lines?

4. Would expenses related to healthcare be reduced by delivering away from the most expensive areas of the country?

5. Would an aging baby-boomer group connect better with children and grandchildren in more affordable and less hectic towns?

How does the "Rise of the Rest" influence stock picking at Smead Capital Management?

We always let our stock picks come from our eight criteria for common stock selection. Simultaneously, we have a vision of the next five years which is influenced by demographics and economics. The "Rise of the Rest" can influence holding periods on winning positions which would have the geographic winds at their back. Lastly, the aging of millennials being spread across the country would drive Main Street success and could be a big change from the last nine years. In that environment, value investing could outperform growth and turn the investing world upside down.

In conclusion, we think Steve Case said it best in his essay:

> *"This (Rise of the Rest) will lead to a more dispersed innovating economy, where jobs and wealth are created all across the country, not just on the coasts. We need to level the playing field so that everyone, everywhere, has a shot at the American dream."*

.Warm regards,

William Smead

[2]FAANG companies include Facebook (FB), Amazon (AMZN), Apple (AAPL), Netflix (NFLX), Alphabet (GOOGL).