

INVESTMENT LETTER

The J.M. Smucker Company (NYSE: SJM)

Our investment letter mission: To write research that offers, in a lively and succinct style, hard-to-find facts about a company, and research that also provides occasional, but not guaranteed, flashes of humor.

October 25, 2011

It was a summer morning in Oklahoma. I had just stumbled out of bed and made my way into the kitchen to turn on the switch of one of civilization's greatest inventions: the grind and brew coffee machine. As I observed this marvelous device do its work, listening to the blades chop up the coffee and watching the filtered coffee drip into the carafe, I could not help but think of **The Folgers Coffee Company**. Procter & Gamble (NYSE: PG), the company known for Tide, Pantene, and Mr. Clean, believed that coffee no longer fit with its emphasis on household cleaning and personal care and sold **Folgers** to **The J.M. Smucker Company** in 2008. **Smucker** believed that coffee belonged, as the company says, in a supermarket's "center aisle," along with **Smucker's** generous offerings of jam, jelly, and ice cream toppings. **Folgers** now comprises approximately forty-four per cent of **Smucker's** revenue.

The coffee was now ready to drink but the desire to respect the counsel and knowledge of the medical experts who watch over me made me think twice about taking a sip of the brew that tasted so good and made you feel so good. I remembered that my internist, Brent Laughlin, M.D., and his P.A., Samara Nichols, had advised me to always have something to eat before I drank coffee in the morning. A compliant patient, I reached for a jar of **Smucker's Natural Peanut Butter (Chunky)** and a jar of **Smucker's Low Sugar Strawberry Reduced Sugar Preserves**. I then took one slice of **Ezekiel 4:9 Bread**¹ from the freezer, toasted it, and now I had the three ingredients necessary for a healthful (not healthy) breakfast, whose preparation complexity did not exceed my limited knowledge of what food goes with another food, and how to put together different foods or ingredients that would look good, taste good, and be good for me.

I do not spend much time in my kitchen, except for making breakfast. I rarely cook and I am well aware that making a peanut butter and jelly sandwich is not cooking. I do have, however, culinary ambitions, and three years ago, when I was in Sears, considering an upgrade to a more advanced stove, my ambition got the best of me and, with of course some push from a commission hungry salesman, I bought a stove with an extra cooking surface so I could better coordinate simultaneous delivery of all dishes to the table. Guess what? I have used the stove less than ten times in a year and a half.

But I have used my toaster several hundred times, to toast the bread that, along with the peanut butter and jelly, makes the sandwich that is a staple of people who want something that is nutritious as well as tasty, have limited culinary skills, and little time for food preparation. This sandwich is the perfect food for a yuppie who drives around Utica Square in a LandRover begging to be noticed, but a yuppie is not likely to make coffee at home. Instead he or she will stop at **Starbucks Corporation (NASDAQ: SBUX)** for a cup of strong coffee that is almost guaranteed to raise one's intelligence quotient immediately. For a suppie, however, particularly one like me who lives a modest lifestyle and respects frugality, making coffee at home and drinking the coffee in a quiet atmosphere, and not having to stand in line for the coffee, makes sense. (A yuppie is a young urban professional, of course, and a suppie is a senior urban professional like myself. A suppie, in addition to Medicare, may have *supplemental* health insurance.)

¹ **Ezekiel 4:9 Bread**, made from sprouted grains, has a high protein content and is claimed to be exceptionally healthful. (Made by Food For Life Baking Co., Inc.) *I get this bread at Whole Foods Market, Inc. (NASDAQ: WFM) on my infrequent shopping expeditions. My diet is probably good but I am always envious of the people who seem to be regulars at the store. They seem to bring a discipline to choosing foods (and supplements where I suspect the margins are the fattest) that makes me jealous. Their ability to postpone pleasure, to have instant gratification under control, is impressive, as is their sacrifice of their taste buds to the greater dietary good. For example, one of my friends would have lunch with me in the Whole Foods delicatessen. After a delicious dessert, she would then order a 'wheatgrass drink', consume it, and make a tremendous grimace. The taste was so awful that she was forced to consume a few more portions of a rich dessert, often chocolate. As she performed the wheatgrass ritual I watched in admiration at her discipline, and I reached out silently to her with compassion for the demands she made on her taste buds.*

My thoughts returned to the task at hand, which was to get something to eat and to get some coffee in my system so I could spend a half hour reading *The Wall Street Journal* and then do some swimming before the New York Stock Exchange opened for business and brought another day in the battle for investment survival.

After a few bites of the sandwich, I took a sip of the coffee, thinking what a wonderful drink (and unfortunately an addictive drink) coffee is. From the great taste of coffee my mind went to the subject of coffee, particularly [The Folgers Coffee Company](#).

My morning routine calls for a half-hour study of *The Wall Street Journal* and the *Tulsa World*, but today, having spent some time earlier in the week talking with the head of investor relations at [Smucker](#), Mike Dillon, and enthused about the prospects for [The J.M. Smucker Co.](#), and aware of the important role that coffee plays in the company's success, I decided to see what a respected source, *Consumer Reports*, had to say about the [Folgers](#) brand. I booted up my computer and let Google take me to the *Consumer Reports* home page. From there I was able to find an August report on [Folgers](#).

Consumer Reports Taste Tests The Best Cups of Joe

Hours of Testing Finds New Champs Among Colombian and Ethiopian Varietals; America's Best-Selling Brands, [Folgers](#) and [Maxwell House](#), Score Only Fair

YONKERS, NY — *Consumer Reports* brewed over 1,000 cups of coffee to deem two new champs among Colombian varietals in the latest issue available on newsstands today. Gloria Jean's Colombian Supremo Medium Roast and Newman's Own Organics Colombian Especial Medium Roast beat the *Consumer Reports* top pick from the March 2009 report, Eight O'Clock Coffee. The former champ delivered less flavor than in past tests even though their slogan claims, "New Look, Same Great Taste," **while America's best-selling brands, [Folgers](#) and [Maxwell House](#), scored only Fair, with far from perfect taste profiles.** *Consumer Reports*, August 2011.

The report was not good but it was a report, I reminded myself, about flavor and taste, and therefore it was subjective, especially since it was based on a small sample of coffee drinkers, that is, the taste testers who work at the *Consumer Reports* headquarters in Yonkers, New York.

I do not discount the importance of taste preferences and, respecting the judgment, rigorous testing, and the clout of *Consumer Reports*, I was puzzled. The magazine's neutral view of [Folgers](#) coffee was at odds with the product's overwhelming market share. What explained the contradiction? I thought for a few moments and then one possibility came to mind. [Folgers](#) spends millions on advertising and marketing, and much of this expenditure is highly effective. If taste can be influenced, and if taste is one dimension of perceived quality, then sophisticated advertising can weigh heavily in favor of a product's acceptance. (This is not to say that I can lay claim to a great discovery. Procter & Gamble and Coca-Cola (NYSE: KO) spend hundreds of millions of dollars each year to enhance their brand, and advertising and marketing are well known to powerfully influence the perception of quality, even taste.)

INVESTMENT THESIS

[The J.M. Smucker Co. \(NYSE: SJM\)](#)

[Smucker](#) makes products that are highly regarded and that have dominant market shares. Consumers buy coffee, jellies and jams, and peanut butter steadily, in bad times and in good times, as these products are not a large percentage of the consumer budget. Consequently, the earnings predictability of the company is high. Also, because of the company's reputation, the company has pricing power and thus enjoys good margins and can look forward to a substantial amount of free cash flow every year, a fact that enables the company to raise its dividend every year, contributing to the total return enjoyed by a shareholder. When you think about it, the [Smucker](#) story is a simple one. And there is a lot to be said for simplicity.

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