

SAYBROOK CAPITAL INVESTMENT OUTLOOK

First Quarter 2009

The winter of 2009 will be remembered for jarring headlines of deepening unemployment (the 8.5% jobless rate for March is the worst since 1983), plummeting GDP (-6.2% for the final quarter of 2008, also a generational low), collapsing corporate profits (expected to be down over 50% from the high in 2007), and ever-sinking home prices (now down 29% nationally from the peak, as measured by the Case-Shiller House Price Index). As horrible as these figures are, they were not too different from what we forecast in our last letter, and the data was arguably discounted by the October-November stock market decline. What concerns us, and shocked the market this winter (the S&P 500 was down as much as 26% at one point this year), were the handful of developments that were worse than expected:

Banking: The realization that major banks are still significantly undercapitalized led to widespread concerns this winter that the government will be forced to nationalize much of our banking system – a fear that still lingers. Versus our expectations in December, we have been disappointed in the lack of urgency and specificity in putting forth a comprehensive plan to rid the banks of ‘toxic’ mortgage-backed assets. Six months after the ‘Troubled Assets Relief Program’ was announced, Treasury officials are still trying to establish a workable plan. When revisions were first announced in February, the lack of substance damaged investor confidence. Some progress was made in March as the Treasury Secretary announced details of a ‘Public-Private Investment Program’ to coax potential buyers of distressed bank assets. Despite the initially positive stock market reception, it is unclear if this plan will be the one that “gets it right,” after past costly attempts. Early criticism of the plan cites the asymmetric risk distribution, where the taxpayers contribute most of the capital in the form of government-backed loans, yet a chosen group of asset managers have the potential to reap most of the upside. Likewise, even with government financing, we are skeptical that buyers and sellers will agree on prices for these assets (we have heard that banks would expect 70-80 cents on the dollar, whereas private investors would be likely to bid closer to 20-30 cents). Also, the current plan does not appear to provide enough funding to cleanse bank balance sheets so that financial institutions can increase lending. Congress will likely be asked to appropriate significantly more money (no easy task).

Global Manufacturing: The depth and speed of the synchronized collapse in global manufacturing output has caught nearly everyone by surprise. The worldwide recession has revealed the interdependence of manufacturing markets, with industrial production in many countries falling between 15% and 45%. While its growth is still slightly positive, China has experienced a major deceleration in manufacturing (the largest sector of its economy) and is suffering a 25% decline in exports. Paul Volcker, former Federal Reserve Chairman, said recently that he could not remember a time “maybe even in the Great Depression, when things went down quite so fast, quite so

uniformly around the world.” Industrial production normally declines more than the overall economy as businesses scale back their inventories, but the speed of the decline (some companies we follow reported plummeting orders in February) and the downward spiral it can create are what concern us the most. Accelerating unemployment in the labor-intensive manufacturing sector could lead to a self-reinforcing cycle of lower consumption and demand, leading to further production cuts and layoffs. Equally damaging is the risk of economic nationalism (e.g., tariffs and quotas) as governments attempt to protect domestic industries to the detriment of world trade. We are eerily reminded that similar ‘beggar-thy-neighbor’ protectionism contributed to the severity of the Great Depression.

Policy Consequences: The recent tsunami of populist outrage could weaken or even derail essential economic recovery programs. Railing against excessive Wall Street bonuses and corporate jets plays well on TV talk shows and has acted as a release valve for pent-up bailout fatigue, but this focus may limit the government’s abilities and actions in the face of an historic recession. The extent of this backlash may be tested when Treasury seeks additional bank bailout funds from Congress. Additionally, we face the aforementioned backlash against free trade. Just like Senator Smoot and Representative Hawley in 1930, politicians in the US and overseas can score populist points with local voters by enacting protectionist policies, but world trade and economic recovery can suffer dearly. In the longer-term, the ballooning budget deficit, magnified by recent fiscal and monetary actions, will be paid for with higher taxes and is likely to cause inflation. The attempted stimulation and reflation of our economy may be necessary to avoid a depression, but history suggests that the proverbial “punchbowl” is nearly impossible to take away.

Like eager gardeners awaiting early signs of spring, investors are looking for any ‘green shoots’ to indicate that better times are ahead. While we do not think the economy is bottoming yet, we are mildly encouraged by a wide range of ‘less bad’ indicators in recent weeks, including slight improvements in the volume (not price!) of housing sales and starts, durable goods orders, surveys from the Institute for Supply Management (ISM), and an up-tick in general confidence levels. A few data points surely do not make a trend; however, some economic improvement should be expected given extraordinarily low inventories, unprecedented levels of monetary stimulus, mortgage rates at 4.6% (vs. over 6% a year ago), lower gasoline prices, tax refunds and rebates, and other aggressive policy measures. The stronger stock market of the last few weeks is partly a response to these developments, but we are still mindful of the monumental challenges that remain. Consumer spending, representing more than two-thirds of the US economy, seems likely to be subdued for the foreseeable future. As Americans attempt to recover from declines in the values of their homes and other investments – while at the same time enduring a period of stagnant or declining income – a new era of thrift is emerging. While prudent on an individual and family level, such frugality can lead to a muted recovery. An extended retrenchment in consumer spending and the other previously mentioned negative developments are the reasons for our continued caution.

Some Encouraging Developments for Our Companies:

Despite recent dividend cuts announced by companies in such diverse industries as banking, pharmaceuticals, basic materials, and utilities, our portfolio has continued to benefit from an *increase* in dividends. Saybrook Capital concentrates on growth of ‘total return’ - as measured by stock-price appreciation and cash dividends. However, when stock prices are down, there is an increased value in receiving a steady dividend income (i.e. “being paid to wait”). Furthermore, during periods of high uncertainty, dividend policy can be a useful tool to analyze corporate managers’ internal views of their businesses. We have been spending considerable time recently examining our stock holdings in the context of high-profile negative dividend announcements from companies previously known for providing consistent income. In fact, according to Standard and Poor’s, its S&P 500 Index of large capitalization companies experienced an aggregate dividend cut of nearly 20% in the first quarter, the largest decline on record.

We suffered our own disappointment in February with General Electric’s significant dividend cut, its first since 1938. Needless to say, we underestimated (make that grossly underestimated) the impact of GE Capital’s loan portfolios on the financial structure of the overall company. However, GE is our only holding (to date) to announce a dividend cut. Our typical stock portfolio has experienced a meaningful net dividend increase over the last twelve months: *fourteen of our portfolio companies have raised their payouts* and two are maintaining the same levels (a couple of our companies have never paid dividends, choosing instead to reinvest all profits). Seven of our core holdings are part of an increasingly elite group of companies that have consistently raised their dividends for over 25 years. In today’s environment, we cannot guarantee that all of our businesses will continue their record of annual dividend payments and increases, but the high-quality characteristics that we seek, such as strong balance sheets and expanding free cash flow, should enable most of our portfolio companies to do so. You can be sure that we will be carefully scrutinizing dividend announcements in the quarters to come.

Aside from the increased stream of dividend income, we are also encouraged by many of our companies’ operating improvements. Very few businesses are truly recession-proof, but many of our companies have been able to maintain modest earnings and sales growth in the face of extraordinary economic pressure. Opportunistic managers have also used this downturn to streamline their cost structures and make selective acquisitions. Most importantly, the best companies always gain share during recessions, as weak competitors downsize or are forced out of business. In fact, just within the last month, two of our companies announced notable market-share gains. The relative strength we have observed in our portfolio reinforces our firm belief, as discussed in our previous Investment Outlook, that high quality stocks are still a superior investment for those willing to be patient.