SAYBROOK CAPITAL
INVESTMENT OUTLOOK

First Quarter 2010

The Great Recession likely bottomed nearly one year ago, but it remains unclear how strong and sustainable this recovery will be. While we are encouraged by recent data and the prospect of continued economic improvement over the course of this year, we remain concerned about numerous long-term challenges. In addition to a brief review of recent economic developments, in this letter we discuss our case for investing in *high quality* companies and the ways in which we are finding value in outstanding businesses.

Despite angst over issues ranging from Euro-zone debt troubles and tightening Chinese monetary conditions to controversial healthcare legislation and heated debate over financial re-regulation at home, current indicators suggest the U.S. economy is improving at a faster rate than many, including ourselves, expected. Leading the way has been manufacturing, as companies in the U.S. and around the world are reporting a surge in new orders. It appears that new demand is boosting industrial output beyond what would be expected from mere inventory rebuilding. Other data including stronger retail sales and lower weekly jobless claims are also encouraging. Of course, the overall high level of domestic unemployment and the severely impaired housing market remain problematic, yet even these numbers have stabilized, and any improvement in these areas could further augment the recovery.

Given the nature of economic cycles, powerful recoveries often follow severe downturns, as businesses rebuild inventories, increase capital spending to compensate for under-investment, and eventually rehire workers. Likewise, consumers start to satisfy pent-up demand after a period of retrenchment and savings. The current burst of economic activity is particularly pronounced when compared to low recessionary levels of a year ago. Furthermore, one cannot underestimate the massive monetary and fiscal stimulus, along with major government financial sector intervention, that helped to stabilize the system last year and whose impact will continue to benefit the economy this year. However, a big question to be faced later this year and beyond is how well the private sector economy can perform after the government stimulus wears off and the Federal Reserve raises interest rates.

Once the catch-up cycle fueled by unprecedented stimulus runs its course, the sustainability of the economic expansion becomes critical. It is this phase, likely 2011-2012, where long-term headwinds could begin to restrict the levels of growth associated with previous post-World War II expansions. These *secular challenges* (defined as long-term and structural in nature) include rising taxes, increased regulatory costs, high debt levels and savings imbalances, enormous fiscal deficits, and the possibility of higher long-term interest rates and inflation expectations.

In recent speeches, Fed Chairman Ben Bernanke has brought attention to many of the same secular challenges that worry us, particularly highlighting the structural fiscal deficit and demographic challenges, as an aging population places unsustainable pressures upon entitlement spending. Furthermore, Bernanke cites the rate of long-term unemployment, as job skills are eroded with nearly half of today's jobless out of work for over six months. A large block of the population becoming less-employable is an ominous sign. While not insurmountable, these problems stand as obstacles in the path of a durable expansion.

Obviously, we are not the only investors to see near-term cyclical strength ahead of long-term secular challenges, and, in fact, a well-known strategist, perhaps representing the new consensus, recently stated that he is "bullish until the bill comes due." This catchy phrase sums up the dichotomy we have described, yet, as long-term investors, we believe the best strategy amid such secular uncertainty is to seek high quality companies at reasonable prices.

The Case for High-Quality Stocks

While Saybrook Capital's Undervalued Growth philosophy has always emphasized superior businesses, certain company characteristics became paramount in the midst of the 2008-09 crisis. As we evaluated existing holdings and searched for new ideas, two critical factors rose to the forefront of our quest for quality in an investment world turned upside-down: *strong balance sheets* and *the ability to return cash to shareholders*. Holding companies with these attributes, we felt, would allow our portfolios to survive even a potential depression scenario. We disciplined ourselves to sell some stocks that did not pass these more stringent tests, and we bought some excellent companies which met these criteria.

Our basic definition of quality is not new or unique. In fact, in his 1949 classic, *The Intelligent Investor,* Benjamin Graham cites "capital structure" and "dividend record" as two "persuasive tests of high quality." A strong balance sheet does not preclude the use of debt, and some industries benefit from access to the credit markets. Likewise, a business need not pay cash dividends to be deemed high quality (it may choose to reinvest free cash flows back into its business for future growth), but the ability to return a growing stream of income back to the shareholders is key to our measurement of superior companies. We analyze a series of more subjective characteristics that are the means towards achieving these two essential high quality standards for our portfolio companies. These distinctions include: leading market share, barrier to entry for competitors, consistency of a company's revenue stream, a record of deploying cash intelligently for the benefit of shareholders, high investment in research and development, low-cost production and/or pricing power (essential in a possible era of heightened inflation), and management integrity. Increasingly we are attracted to businesses with large international footprints that are well-positioned for industrial export growth and the expanding consumer class in developing countries.

We appreciate the difficulty of identifying superior businesses and are careful not to classify companies as such merely by their size or longevity. Graham called the "matter of choosing the best stocks…a highly controversial one," and he warned of relying too much on the reputation of a firm's management or the wisdom of so-called experts. Philip Fisher, a pioneer of quality stock investing, cautioned against extrapolating a company's superiority based solely on past performance, citing the once blue-chip radio stocks at the dawn of the television era. Popular today are surveys of "most admired" companies; and, while we are pleased that several of our portfolio companies, such as Automatic Data Processing and Johnson & Johnson, top recent lists, we understand the backward-looking nature of such acclaims.

Ten years ago, at the end of the 1990s bull market, the approach of buying high quality market leaders *would not* have led to outperformance over the decade that followed. Just as with the "nifty-fifty" boom of the late 1960s, large dominant companies had become overvalued, and a period of reversion-to-the-mean ensued. In the 2000-2002 downturn, we helped protect and grow principal by finding value in lesser known, smaller companies that had been overlooked during the 1990s boom. Now we are in a period where the pursuit of Undervalued Growth leads us to businesses with the highest quality characteristics, and many, but not all, of these companies happen to be large multi-national organizations.

We expect these companies to grow faster than their competitors in an era of secular challenges because of their vast resources for research and marketing, ability to self-fund in a continued period of credit deleveraging, scale and experience in reaching growing overseas markets, financial clout to outperform or acquire competitors, and free cash flow to continue to reward shareholders with growing dividends and/or stock buybacks. In short, across all industries, we foresee a growing divide between the winners and the losers.

Just as importantly, these types of companies remain reasonably priced by our valuation metrics. This is in part because these stocks, as an asset class, have been out-of-favor for the past decade, as institutional investors sought alternatives in areas such as real estate, private equity, hedge funds, commodities, and emerging markets. This trend away from quality stocks has gone to such an extreme that Yale University's David Swensen, one of the first endowment managers to overweight alternative investments, has indicated a gradual allocation shift back to public equities. Also, during the stock market collapse of 2008-09, many of the best companies' stocks fell along with the worst, as over-leveraged investors became forced sellers of anything liquid. Many of these high quality stocks have lagged during the recent recovery, as traders seek quick profits in more speculative stocks.

Finding Value in Outstanding Businesses

Notwithstanding the powerful rally of the last year, we are still finding compelling values in companies that fit our strict quality criteria. Beginning in October of 2008 and continuing through early 2010, we have been able to purchase or add to positions in wonderful businesses in a variety of industries, such as Google, Procter & Gamble, Honeywell, and Caterpillar. Our most recent purchase, Intel, is an example of a superior growth company bought last month at what we believe to be an attractive price. Intel has over $14 billion in net cash (by our calculation of cash equivalents minus debt), a 3% dividend yield (at our cost), world-class semiconductor manufacturing capability, and dominant global market share. Management just announced that "strong worldwide demand led to the best ever first quarter," and we are particularly excited about the company's prospects as businesses embark on a long-deferred computer and server upgrade cycle (incidentally, Saybrook is doing its part by investing in new server technology this spring).

We believe our portfolio companies are positioned to perform well whether the economy proves to be stronger than expected or more lackluster in the face of serious headwinds. In fact, over the last several months many of our companies have utilized their financial strength to opportunistically acquire businesses that should extend their competitive positions. The following is a list of recent corporate activity impacting our portfolios:

- Emerson Electric expands its data technology business with the addition of Avocent Corp.
- PepsiCo acquires its domestic and foreign bottlers
- Berkshire Hathaway buys 100% of Burlington Northern Santa Fe Railroad
- Kraft Foods completed its hostile acquisition of the iconic British confectioner, Cadbury PLC (paying a 40% premium, benefiting our investors who held Cadbury shares)
- ExxonMobil is finalizing the takeover of long-time Saybrook holding XTO Energy (for a 17% premium and a 230% gain from our original purchase in 2004)
- Schlumberger announces the acquisition of Smith International and its drill-bit technology
- Walgreen expands in the New York City region by purchasing the Duane Reade pharmacy chain at an attractive price from a distressed private equity seller

These acquisitions add to our companies' core operations and should help generate long-term value, in contrast to failed "transformational" mergers of past eras. For many years it has been difficult for companies to make rational strategic acquisitions as they faced high valuations and stiff competition from private equity buyers with access to easy leverage. The credit crisis has crippled the leveraged buy-out market, leaving the playing field open for our high quality companies. Healthy corporations (unlike stretched consumers and indebted governments) possess record amounts of cash from undistributed profits. While announcing the acquisition of Duane Reade, Walgreen's CFO remarked: "We are sitting on a lot of cash and generating a lot as well …we are conservative with our cash, but hoarding it right now isn't probably the best use of it." We expect our portfolio companies to continue to be on both sides of future deals, as the sentiment expressed by Walgreen spreads.