SAYBROOK CAPITAL

INVESTMENT OUTLOOK

First Quarter 2013

Saybrook portfolios performed strongly in the first quarter, with our stocks advancing 12%. Our portfolio companies are benefitting from a new wave of mergers & acquisitions, most notably for us, the recent announcement that Warren Buffett's Berkshire Hathaway is teaming up with Brazil's 3G Capital to purchase H. J. Heinz Company. Amidst a rising tide of corporate deals, we made a few related adjustments to our fleet in the quarter, as we summarize in this letter. Additionally, we examine current market conditions with a bit of economic history as a guiding perspective.

"Heinz: So Boring It Just Makes Money"

The quotation above is how one news service reported – on Valentine's Day – that Heinz was being acquired. Under the terms of the deal, Berkshire Hathaway and 3G Capital (an investment firm led by Brazilian businessman Jorge Paulo Lemann – a long-time friend of Buffett's) will each contribute about $4 billion for equal share in the new Heinz holding company. Berkshire will also invest $8 billion in preferred shares, collecting a 9% dividend. 3G will be responsible for managing the business, while Berkshire will be a passive investor. To buy Heinz, Berkshire and 3G are paying $72.50 per share in cash, a 20% premium to its pre-deal price. Incidentally, the timing of the deal announcement was helpful to us personally – having neglected to get our wives Valentine's Day gifts, we each returned home with the hope that our spouses would agree that the Heinz news was adequate compensation (they did!).

We started buying Heinz in Saybrook portfolios in 2009 at $40 per share with a dividend yield over 4%. While the dividend had been increasing steadily for many years, the stock price was in a rut, fluctuating within a tight range for nearly a decade. Despite the wonderful business of profitably selling ketchup and other iconic brands in over 200 countries, the company was viewed as uninteresting, and the stock was unloved. But we were impressed with management's strategy for expansion in key emerging markets, as they acquired Foodstar, a Chinese soy-sauce maker, and Quero, a dominant Brazilian tomato-sauce company. We felt the generous and growing dividend was more than enough to wait until the market realized the great potential for Heinz, as it increased sales to a growing middle class around the world. Our timing proved lucky, as the shares rose in almost a straight line to an all-time high of $60 – up 50% from our initial purchases – *before* the current deal was announced. As owners of Berkshire Hathaway, we will continue to have a stake in Heinz's promising future. Additionally, Berkshire stock ended the first quarter at a new all-time high.

A final thought on the Heinz deal: it may serve as a catalyst for consolidation within the food industry as 3G has said it views Heinz as "the first building block" from which to make further acquisitions. The takeover of Heinz, as noted by its CEO William Johnson, represents the "largest acquisition of any company in the history of the food business." It has not gone unnoticed on Wall Street, as many companies within the "boring" food sector have surged. This sentiment is benefitting Saybrook's portfolio, as many of our related holdings – including Mondelez (Nabisco, Cadbury), Kraft, PepsiCo (Frito-Lay, Quaker Oats), and Nestle – are trading at new highs.

Other Deals & Related Portfolio Activity

Along with Heinz, our best-performing stock in the quarter was Norfolk Southern, up 25%. As mentioned in our last letter, we added to our Norfolk Southern position last fall (at favorable prices due to concerns over lower coal shipments) and are pleased to see that dramatic increases in petroleum shipments by rail, amidst a resurgence of U.S. oil production, are making up for the fall-off in coal. More broadly, we are excited about the growth potential for the railroad industry as the economy improves. A recent *Wall Street Journal* cover story stated the following:

> *North America's major freight railroads are in the midst of a building boom unlike anything since the industry's Gilded Age heyday in the 19th century – this year pouring $14 billion into rail yards, refueling stations, additional track. With enhanced speed and efficiency, rail is fast becoming a dominant player in the nation's commercial transportation system and a vital cog in its economic recovery.*

In addition to Norfolk Southern, we have significant rail industry exposure through Berkshire Hathaway's acquisitions of Burlington Northern Santa Fe Railroad and Union Tank Car, which builds and leases oil-transporting tank cars to the rail companies. (Incidentally, like the railroads themselves, Union Tank Car has been around a long time, having been owned by John D. Rockefeller's Standard Oil Trust). We also have exposure through Caterpillar and General Electric which both make locomotives.

While manufacturing remains the core of General Electric's business, the company continues to streamline its operations, announcing in February the $17 billion sale of its remaining 49% interest in NBC-Universal to Comcast. GE will use the cash for share repurchases and continued bolt-on acquisitions, bolstering its growing industrial supply chain and oil & gas businesses. Continuing to simplify its operations, GE will look to further shrink the GE Capital assets (perhaps even exiting real estate and consumer finance businesses). In short, GE's comeback continues. After rising 17% in 2012, the stock was up another 10% in the first quarter.

Early in the year we took a position in Equity Residential (EQR), the largest publicly traded real estate investment trust that owns multi-family properties. We successfully owned EQR early in the last decade, well before the real estate crash, and believe that it is undervalued again today. EQR owns one of the best collections of high-quality rental apartment buildings in high-barrier markets across the country and has an excellent management team. Nevertheless, EQR and apartment REITs, in general, have underperformed the broader real estate sector over the past two years on concerns that the strong demand for rental apartments may soften as the single-family housing market rebounds. While these concerns are valid, we think the market is missing the current underlying value of EQR's portfolio. For example, EQR recently partnered on a big deal to purchase Archstone's top-tier apartment properties from the bankrupt Lehman Brothers estate at a significantly discounted value of $16 billion (Lehman paid $22 billon for Archstone at the top of the market in 2007). We will collect a 3% dividend while we wait to see if the market comes to appreciate EQR's underlying value.

We sold our position in Duke Energy after attending an analyst meeting hosted by CEO Jim Rogers in February. Rogers has generated tremendous value for shareholders: as CEO of Midwest utility Cinergy, he orchestrated the successful merger with Duke which helped the stock *return more than two times the broad utility index and also outperform the S&P 500* between 2009 and 2012. At the meeting, Rogers was surprisingly candid about the growing environmental and regulatory cost pressures facing the utility industry and the low level of growth he sees ahead. Because of the increasing role of renewables (like solar) and greater efficiencies throughout the economy, power demand could be essentially flat in the years to come – even if the economy grows more robustly. Rogers noted that in the 1960s for every 1% increase in total economic output (GDP), electricity demand increased 5%; in the 1990s every 1% GDP increase resulted in a 1% increase for electricity; and today a 1% GDP increase results in just a 0.5% increase in electricity demand. While this is great news for the American economy as a whole and environmental conservation particularly, it does not necessarily portend a great growth story for electric utilities.

We left the meeting feeling that it will be a challenge for Duke to maintain its past rate of earnings growth from regulated price increases. Also, Duke's recently completed merger with Progress Energy has been controversial and resulted in Rogers' agreement with regulators to retire at the end of this year. With the stock having rebounded to near all-time highs and trading at a full valuation, we decided to say good-bye to a profitable investment. Saybrook clients who owned legacy positions from Cinergy days, realized returns well over 50%, not including generous annual dividends. In accounts where we purchased the stock more recently – as a substitute for bonds – clients have enjoyed a good yield in addition to gains of 20%.

We invested proceeds from Duke into Vodafone Group (VOD), the U.K.-based global mobile telecommunications provider. Exposure to European markets has hampered VOD stock in recent years, but the crown jewel is its 45% stake in Verizon's lucrative wireless business (the leading U.S. mobile network operator). And VOD is cheap, especially compared to Verizon (VZ). While VZ is valued at a price-to-earnings multiple of 17x and has a dividend yield of 4.5%, we bought VOD at a P/E of only 10x with a secure 6% dividend yield. It is no secret that for years VZ has been interested in buying back VOD's wireless stake, but the price would be high, estimated at well over $100 billion. Recently, both CEOs have hinted that the timing for a deal may now be right. Indeed, VZ stock is up over 20% the past 12 months, while VOD shares are flat. At the same time, the value of the British pound has declined against the dollar, and low interest rates would enable easier financing for a deal. We were able to buy VOD near its 52-week low on renewed European concerns, and the stock has since climbed 12% on further stories of a potential transaction with VZ.

Economic and Market Commentary: It's Not Different This Time

The first quarter closed with the S&P 500 at a new price high, just surpassing a level last reached in October 2007. However, it is worth remembering that the stock market is essentially flat with the peak first attained 13 years ago in March of 2000. With the unemployment rate still high at 7.6%, those doubting the underlying strength of the recent stock market surge highlight a growing disconnect between high corporate profit margins and stagnant wages. Skeptics are also quick to point out the sub-par level of GDP growth, which has averaged about 2% since the end of the recession in mid-2009 as compared to the 4% average growth of the seven previous U.S. economic recoveries since the Second World War.

Indeed, over the last four years since the near collapse of our financial system, the American economy has been lackluster. The reasons for this are well documented by economists Carmen Reinhart and Kenneth Rogoff in their now famous book, *This Time Is Different*. Their financial history (going back eight centuries!) suggests that recoveries from financial crises are slower than recoveries from most recessions. This is primarily because of difficulties associated with excessive debt levels, as damaged banks limit lending, strapped consumers restrict purchases, businesses are overly cautious about making capital expenditures, and bloated governments are forced to reduce fiscal spending while increasing taxes. In short, we agree with their thesis that the current period is *not* different from other post financial crisis eras and that this period of sluggish economic growth is proof of economic history repeating. As they write, "Our basic message is simple: We have been here before."

Yet, despite the challenges of deleveraging, the American economy is slowly mending, and there are big developments underway that could dramatically fuel capital investment and propel the overall economy in the years ahead. In recent letters we have highlighted transformative changes in domestic energy production (the subject of last spring's Investment Outlook), advances in mobile technology, and a budding resurgence in U.S. manufacturing. To these positives add the potential for major immigration reform now on the horizon in Washington.

While the stock market is reflecting decent corporate profits and may be anticipating the prospect of faster economic growth in the future, why else have stocks been climbing? Interestingly, the Reinhart/Rogoff study shows that although it can take upwards of a decade for economies to fully recover from a financial crash, *stock markets have performed well during these same periods of sub-par growth*. The old Wall Street adage "don't fight the Fed" is certainly proving a predominant factor. Not only has the Federal Reserve doubled the pace of its monthly bond purchases to $85 billion; other central banks, notably in Japan but also in England, Switzerland, and the European Central Bank, are simultaneously pursuing low interest rate policies. Furthermore, relatively stable commodity prices and aforementioned minimal wage pressures are allowing central banks to continue their easy money policies without currently stoking inflation. Stocks are rising now, in part, because they are more attractive than low-yielding bonds (and no-yielding cash or gold).

It is important to underscore that today's historically low interest rates on government bonds, mortgages and other fixed-income securities are fundamentally indicative of an economy that is still well below its full growth potential. And while central banks continue taking extraordinary measures to hold interest rates down, they will inevitably rise when economic growth strengthens and/or when inflation accelerates. As bond markets begin to anticipate higher interest rates, bond prices will decline. In the first quarter the Barclays U.S. Aggregate Bond Index suffered its first decline in years, albeit down only 0.12%. Fixed-income managers that we respect and monitor think that bonds, in general, are at least fully valued and may be overvalued in the more speculative areas. For example, as many bond traders remain focused on chasing yield, last year saw a record new issuance of high-yield (low-rated "junk") bonds of 2.5 times the amount issued pre-financial crisis in 2007.

For the time being, and until interest rates increase meaningfully, a growing number of investors are coming to the realization that stocks are a relatively attractive asset class, particularly when compared to bonds. When the day comes that the Fed begins to reverse its current policy and interest rates jump materially, most investments – *including stocks* – will likely be hurt. A big risk is that investors lose confidence in central bank policies and interest rates begin the rise sharply *before* economic growth becomes more self-sustained. On the other hand, if rates rise as the result of stronger underlying growth, stocks will hold up better than bonds. The latter scenario played out in 1994 when the Greenspan Fed surprised investors by announcing a series of interest rate hikes, leading to a rare down-year for the bond market. Stocks, after initially declining, recovered to new highs, as a strengthening economy outweighed higher interest rates. Despite the uncertainty that looms from the eventual unwinding of the Fed's stimulus, history demonstrates that equity investments in high-quality, undervalued growth companies with pricing power provide a true hedge against higher inflation and ultimately thrive from stronger economic growth.