SAYBROOK CAPITAL
INVESTMENT OUTLOOK

Second Quarter 2009

Against the backdrop of a dramatically worsening credit crisis over the last two years, we pen this Outlook in a period of relative calm. While the current respite is much welcomed, many economic uncertainties suggest it may not be long-lasting. As we have highlighted in our recent letters, the period between September and March was one of outright fear throughout global markets, and – it is no exaggeration to say – the near collapse of our financial system. While the risk of an economic depression rose in the first quarter of this year, the second quarter was marked, most significantly, by a huge sense of relief that financial calamity may be averted. Though imperfect, most agree that the government actions – taken in the midst of the crisis – have prevented the worst case scenario.

Stabilization

The president of the San Francisco Federal Reserve Bank, Janet Yellen, recently compared the American economy to "a patient in intensive care whose condition has stabilized." Indeed, from the solvency of the banks, to the level of manufacturing around the world, there was a sense in the second quarter that we came back from the brink. Confidence is growing that the banking system is beginning to stabilize. Although tangible progress has been slow in removing troubled assets from bank balance sheets, major U.S. banks survived Treasury Department stress tests in the second quarter and, most importantly, were able to raise private capital, an important step toward addressing their underlying weaknesses. With regard to manufacturing, the rate of decline in durable goods inventories has slowed in recent months, and global factory output has shown signs of rebounding, after plummeting in the first quarter. After nineteen months of recession for the U.S. economy, encompassing sharp declines in GDP and rising levels of unemployment (9.5% as of June), the *rate* of deterioration has slowed. Although we have been encouraged by a range of more positive indicators, we are mindful that *less bad* is not the same as *good*. Some recent figures do suggest the possibility that GDP growth may now be resuming. Given the depths to which the economy recently sank, and the amount of monetary and fiscal stimulus in the system, a *cyclical rebound* can be expected. But the question remains how robust and sustainable a recovery?

Headwinds

Regardless of the expected cyclical improvement, we are concerned that a combination of structural economic factors will act as headwinds, limiting rates of growth in the economy and stock market. These *secular* forces include: the rising federal budget deficit (now 13% of GDP), increasing state and federal tax rates, more stringent federal regulations (banking and market oversight, antitrust enforcement, consumer protection, etc.), and, most immediately, the continued unwinding of personal debt. The ratio of debt-to-personal-income reached 133% in 2007 (up from 55% in 1960), while the personal savings rate fell to almost

zero in recent years, down from 8% twenty years ago. Some of this painful deleveraging is behind us, as households have rapidly reduced expenditures, and the savings rate has averaged nearly 4% in 2009 (adjusted for the impact of the stimulus package). A more sustained shift towards saving and investment would be good for the economy over time, but, with consumer spending accounting for more than two-thirds of current U.S. output, a continuation of these lower consumption rates may lead to a muted economic recovery.

Another challenge is the battle currently underway between the economic forces of deflation versus inflation. The Fed has been rightly concerned that without continued aggressive monetary stimulus, the severe recession could lead to a vicious cycle of deflationary forces in which the lack of real demand leads to increasing unemployment and then to more idle capacity. Yet, there is growing concern that the Fed's current 'easy money' policy, coupled with increased fiscal spending by the government, will cause heightened inflation. While neither outcome is desirable, deflation is the greater evil, as it is harder to contain over the long-term (e.g., the Great Depression and Japan in the 1990s). In the near-term the countervailing forces seem to be offsetting each other, preventing either severe deflation or rapid inflation. In fact, the Fed removed from its June statement some language relating to deflationary concerns; and it is worth noting that consumer prices are more subdued now than they were a year ago, and wages are restrained as unemployment rises. Nevertheless, we remain concerned that inflation could rise over time and become another longer-term headwind.

A prolonged period of slower growth may be the price we must pay to stabilize our economy in the wake of recent excesses. Over the long-run, higher and more sustainable levels of growth may be achievable if the American economy is able to transition from one based on leverage and consumption to one with more emphasis on investment and production, while continuing to improve productivity. In any case, we believe the aftermath of the financial crisis and severe recession will not necessarily mimic the cyclical patterns of recent past recoveries. Our outlook for a period of slower economic growth, combined with the aforementioned headwinds, would suggest that valuation levels (i.e. P/E multiples) on the overall stock market may be constrained for the foreseeable future.

Portfolio Strategy

Despite the extraordinary challenges of the past two years, we have held firm to Saybrook Capital's long-established investment philosophy. In the context of our cautious outlook, there are three particular elements of our portfolio strategy that should be emphasized. First, we will continue to stay the course with our long-term equity investment portfolio and limit market-timing. Second, we will continue to own and buy only the highest-quality companies, despite the recent outperformance of more speculative stocks. Third, we believe the market is offering a rare opportunity to invest in companies that meet both our *Undervalued Growth* discipline and offer *secure and increasing dividend income*.

In January's year-end Outlook, we warned of the risks of market-timing, as periods of panic selling often precede significant market gains. An investor who capitulated in February or March would have missed a

more than 30% rebound that followed those market lows (although the S&P 500 still remains down nearly 40% from its 2007 highs). While we have sought to maintain ample cash reserves and limit our equity exposure in higher-risk sectors of the economy (such as financials), we have not wavered from our discipline of investing in equities for long-term appreciation. At Saybrook Capital we always analyze investment decisions on a fundamental basis – one company at a time. We recognize that many traders attempt to benefit from short-term momentum by buying stocks that declined the most or companies that may narrowly avert bankruptcy. Certainly a lot of money has been made recently in this fashion; however, this is not our investment style. We will continue focusing on our record of generating long-term superior returns by seeking strong and growing companies and looking for opportunities to buy them at attractive prices.

In this challenging era, we believe it is essential to concentrate on owning only the highest-quality companies – those with top-tier financial strength and clear leadership positions within their industries. In a protracted slow-growth environment we foresee clear winners and losers; companies with dominant scale, strong balance sheets, overseas reach, and winning products and services will steal market share from their struggling competitors. We expect this to occur across many industry sectors, allowing the most solid companies to continue or resume their growth as weaker businesses falter.

As we have often stated, we believe that a company's dividend policy is a good indicator of its financial condition and the health of its underlying business. While we have always been attracted to companies with growing dividend streams, we believe the current period offers a wonderful opportunity to buy Undervalued Growth companies with high and growing dividend yields. The recent period of market turmoil and the more speculative nature of the recent market rebound have created a rare occasion where these characteristics have converged. Not only have overall stock market valuations become much more attractive in the past year, but many dominant businesses with relatively high dividend yields have remained at generationally low multiples, even as more volatile stocks have jumped on news of a possible economic recovery. Until underlying earnings growth resumes and is rewarded by higher stock market valuations, we are content to be *paid-to-wait*, as many of these companies boast bond-like yields and are steadily increasing their payouts.

During the first half of 2009, we have found attractive opportunities in high-quality companies that fit this theme of convergence between Undervalued Growth and solid, expanding dividends. With new purchases or increased positions in Procter and Gamble, Automatic Data Processing, and Medtronic, we have gained exposure across the diverse industries of consumer staples, corporate outsourcing technology, and medical devices. These companies have yields ranging from 2½-4% and have raised their dividend payouts 9-14% in the last eight months. Steady, growing yields and reasonable valuation levels create the potential for meaningful total return, and these attributes should provide an 'anchor-to-windward' if the market resumes its decline.