SAYBROOK CAPITAL
INVESTMENT OUTLOOK

Second Quarter 2010

The buoyant stock market rebound of the past year reversed abruptly in the second quarter as investors were besieged by a litany of negative developments around the world. These include the sovereign debt crisis in the Mediterranean region, concerns about the Chinese economy, and tensions on the Korean peninsula. Other events since we last wrote in April were the 1,000 point intra-day decline in the Dow Jones Industrial Average (the May 6 "Flash Crash"), the SEC fraud case against Goldman Sachs, and the congressional passage of contentious and sweeping financial regulations. Dominating the news was the BP oil spill, which has devastated the Gulf of Mexico and negatively impacted the entire energy sector, including companies otherwise uninvolved in the calamity. Additionally, recent reports of decelerating economic activity, along with the heightening international concerns, particularly in Europe and China, have raised doubts about the durability of the global recovery.

In this investment letter we review international challenges and opportunities. Investing in businesses with growing overseas exposure is a key pillar of our strategy to own high quality companies that are undervalued. Despite global uncertainties, we remain especially encouraged by positive secular trends occurring throughout much of the developing world.

International Challenges

When we last dedicated an entire Investment Outlook to *international* issues in early 2007, the investment world was enamored with the so-called "BRIC" nations of Brazil, Russia, India, and China. At that time, many argued that a new *decoupling* paradigm was enabling these and other developing economies to steadily grow regardless of the problems faced in the more industrialized world. Three years later, the success of this theory is mixed. These emerging economies did indeed avoid the worst of the global recession, but their stock markets have been subjected to the same brutal volatility experienced by the rest of the world. Now investors are focused on troubles in the developed world and have adopted a new geographic acronym, "PIIGS", representing the euro-zone

nations of Portugal, Italy, Ireland, Greece, and Spain, where structural budgetary and demographic problems have risen to the forefront.

What began as a concern that Greece was struggling to refinance its sovereign bonds has spread into a European debt crisis roiling global markets over the last three months. The credit ratings of Greece and other struggling Mediterranean countries have been down-graded to near junk status as investors remain understandably skeptical of their emergency austerity measures and ability to issue new debt. A €1 trillion stabilization fund was introduced on May 10 by the European Union and the International Monetary Fund. The announcement was bold but scant on operational details. To a large extent, the success of the fund depends on the willingness of the more stable European nations, such as Germany and France, to rescue their profligate neighbors. In this attempt they must defer much of their monetary authority to an untested European Central Bank. The hope is that these measures, combined with the recently completed stress tests on 91 European banks, are strong enough to stabilize the situation and allow time for the weaker EU members to refinance their sovereign debt and implement fiscal restructuring. If not, the impact of a European market failure – similar to that which U.S. financial institutions experienced in the fall of 2008 – would reverberate around the world and could threaten the viability of the euro as a currency.

China, while still growing at a healthy rate and facing none of Europe's structural headwinds, has nonetheless contributed to recent turbulence. Fearing an overheated economy and ensuing inflation, Beijing is winding down its massive stimulus program that began in 2008 and is trying to rein in real estate speculation and lending. In June, Chinese officials announced they will allow the yuan to rise versus the dollar, which could restrain the country's booming export growth. Policy-makers are now targeting a stated GDP growth rate of 8%, representing a major deceleration from 12% earlier this year. This attempt to centrally engineer a soft-landing in the third largest economy in the world is unprecedented, and the outcome, of course, is uncertain. Such concerns have contributed to notable weakness in the Chinese Stock market, as the Shanghai Composite Index fell 30% in the first half of 2010 and is down 60% from its 2007 highs.

The challenges in Europe and China are quite different, but resolving them depends largely on the success of monetary and fiscal policy. In Europe, calls for budget tightening have ignited tensions between those advocating fiscal austerity versus those who continue to support stimulus as the more appropriate policy in what is now the third year of global economic stagnation. These difficulties

are magnified by Europe's poor demographics (low birth-rates and aging populations). In contrast, China and many developing nations boast secular tailwinds, with more favorable demographics and rising standards of living. China's challenge is to boost domestic consumption and reduce reliance on exports, while simultaneously growing fast enough to satisfy the employment demands of an increasingly urbanized population. Given the gravity of these challenges and the interconnected nature of the world economy, further negative developments in either Europe or China would hobble the still-fragile global recovery.

Investors are struggling to balance these international concerns and recent moderating economic figures, on the one hand, with strong reports from individual companies, on the other. As we listen to our portfolio companies' second quarter conference calls this month, we are paying particular attention to the economically-sensitive industrial sector. Thus far, we are encouraged not only by the solid results for the quarter, but also by rising earnings guidance for the balance of the year, as our companies are citing still strong international demand.

International Opportunities

We believe a sound investment strategy in such an uncertain era is to own high quality companies, including multi-national businesses with long histories of serving customers in the developing world. The majority of our portfolio companies today have a large and growing international footprint. In fact, global exposure is a mainstay of our overall quality company criteria, along with strong balance sheets and the ability to return an increasing amount of cash to shareholders. The focus of our international strategy is to own companies that are well-positioned for industrial export growth and the expanding consumer class in developing countries.

We are still in the early stage of a long, secular period where a significant source of economic growth will be in such developing regions as Asia, South America, and possibly Africa. The rapid expansion of infrastructure in these regions offers tremendous opportunity for U.S. industrial exporters. Factories, transportation systems, hospitals, utility grids, energy, and technology networks are all experiencing massive growth. Businesses such as Emerson Electric, Caterpillar, GE, Intel, and Schlumberger are well-positioned to handle many of these capital-intensive projects, as they tend to involve a level of manufacturing sophistication often un-matched in local markets.

Caterpillar, for example, announced on its second quarter conference call that it will build its fifth Brazilian manufacturing plant to keep up with robust Latin American demand for its backhoes and loaders. Not only is this emblematic of the pace of construction in the region, but new factories create their own demand as local housing, transportation, and telecommunications are upgraded. Caterpillar recently raised their year-end earnings guidance, specifically citing strength in emerging economies. American factory activity has also increased to meet growing overseas demand, and the U.S. government has set an ambitious target to double exports over the next five years. A continuation of this infrastructure build-out, combined with a movement towards more liberalized world trade would help the U.S. meet this goal and further benefit our export-oriented companies.

The rapid emergence of new consumers throughout these developing regions of the world offers a similarly attractive investment opportunity. The emerging middle classes in both China and India, for example, are now *each* near the size the *entire* U.S. population. All emerging markets combined now account for 34% of global consumer spending (compared to 27% for the U.S.). For multi-national companies that produce and distribute consumer staples, such as packaged foods, soft drinks, liquor, adhesives, detergent, and diapers, there is a long period of global growth ahead. But, in order to meet this demand, businesses must contend with many local challenges, such as differing cultural norms, lower incomes, trade restrictions and duties, less sophisticated supply chains, and domestic competitors. We own companies that have been in these regions for decades and in the near-term are willing to sacrifice profits and accept lower margins as they continue to invest for long-term growth. We believe that companies such as Procter & Gamble, Diageo, 3M, Nestle, and PepsiCo have the long-running experience, local facilities, and scale in place to enjoy material growth from their already substantial emerging market presence. Nestle, for example, already the leader in international food brands, is further investing in new region-specific products, as the company operates twenty-nine research and development centers worldwide focusing on local tastes and preferences. This month, Nestle marked thirty years of R&D presence in Singapore by announcing a new Southeast Asian hub for coffee innovation, where they are making significant inroads in a traditionally tea-drinking culture.

While most but not all of our portfolio companies are domiciled in the United States, it is the geographic diversity of their revenue that makes them international businesses. In a recent interview, Schlumberger CEO, Andrew Gould, stated that his company “has not had a nationality for forty to fifty years.” With headquarters in Paris, Houston, and The Hague and with management

spread throughout the world, Schlumberger uniquely benefits from its global structure as it provides energy services in an industry characterized by nationalistic tendencies. In the case of some companies, we understand that business-to-business activity can skew financial data. For example, Honeywell International's foreign sales are understated, as they are a major subcontractor to Chicago-based Boeing, while Intel's emerging market sales are high due in part to large PC assembly plants in Taiwan. While precise country-specific information can be hard to find, our summer intern, Matt Meade, has compiled the following data from some of our globally oriented portfolio companies.

Percent of Revenues – International & Emerging Markets

Company	Overall Non-U.S.	Emerging Markets Only
Schlumberger Ltd	82%	65%
Intel Corp	80%	55%
Caterpillar Inc	69%	39%
Diageo PLC	65%	33%
3M Co	63%	37%
Nestle S.A.	62%	32%
Procter and Gamble Co	61%	32%
Emerson Electric Co	55%	32%
General Electric Co	54%	30%
PepsiCo Inc	48%	32%

Despite the geo-political, economic, and market turmoil of the past decade, and most recently in the second quarter, the rising standard of living among a growing portion of the world population and the improvement in infrastructure in once-poor regions of the world are examples of real progress. Notwithstanding the challenges that lie ahead, we are excited about these long-term opportunities in developing economies and believe we have a portfolio that will benefit tremendously.