SAYBROOK CAPITAL

INVESTMENT OUTLOOK

Third Quarter 2014

We are pleased with the solid performance of our investments through the third quarter, particularly on the heels of strong returns last year. More importantly, we are delighted with the fundamental progress being made by our portfolio companies, many of which are trading at new all-time highs. One of our largest positions, Allergan, is in the midst of a complex takeover battle which has significantly increased its stock price and helped reveal the underlying strength of its assets and earnings power.

The U.S. stock market continued to advance through September, notwithstanding a growing litany of geopolitical concerns and economic weakness overseas. Year-to-date gains in the S&P 500, although modest versus last year, reflect glimmers of a stronger domestic economy. In this letter, we provide an update on positive dynamics driving our portfolio results in particular and U.S. economic growth more generally; we also review some signs of risky complacency in the financial markets amidst a prolonged period of low interest rates.

Allergan Update

This year's surge in corporate merger-and-acquisition activity continues to directly benefit Saybrook portfolios. As discussed in our last letter, Allergan (AGN) has been fending off an unsolicited takeover bid made in April by pharmaceutical company Valeant in partnership with hedge fund Pershing Square Capital. At quarter-end, Valeant's cash and stock offer was worth approximately $180 per AGN share, and our Allergan stake has risen over 100%. We initially bought AGN shares in 2012, attracted to its underappreciated Botox and eye-care franchises; we added to our position on price weakness caused by a near-term FDA drug approval set-back in 2013.

Pershing Square, which owns 10% of AGN's stock, has forced a special December 18th shareholders meeting with the hope of changing the composition of AGN's board of directors, thereby clearing a path for the acquisition. In the meantime, the AGN board has been publicly reiterating their "unanimous perspective…that Valeant's offer is grossly inadequate and substantially undervalues Allergan." We agree and have voted our clients' proxies accordingly. AGN is currently in talks with other potential partners. Several outcomes are possible including an alternative AGN merger with Actavis and/or acquisition of Salix (both pharmaceutical companies in complementary markets); or a further increased offer by Valeant. We will not attempt to guess the outcome of any potential deals, but we do believe that the risk-reward of continuing to hold AGN at the current price is favorable. While AGN's stock price could certainly decline if no deal is consummated over the near-term, we believe AGN is ultimately worth more than its current price, even as a standalone company. Indeed, in its attempt to fend off Valeant, AGN has twice raised its long-term guidance, underscoring its ability to grow sales by double digits and annualized earnings over 20% during the next five years. With AGN's clear growth trajectory and extremely strong balance sheet, we are content to patiently watch the deal saga continue to unfold.

Strong Portfolio Performance & Signs of a Strengthening U.S. Economy

More broadly, our results are being driven by an abundance of positive fundamental news from our companies. A brief survey of our stocks which have recently traded at or near all-time highs begins with **Johnson & Johnson**, which – like Allergan – is generating double-digit sales growth in pharmaceuticals and has a strong pipeline of new treatment indications in the works. Shifting from healthcare to technology, **Apple** released the much anticipated iPhone 6 to great fan-fare in September – selling more than 10 million new phones in the first weekend alone. Apple also unveiled plans for its forthcoming Apple Watch next year and the fall roll out of the new Apple Pay technology that will enable consumers to pay at checkout using the new iPhone fingerprint sensor.

On the last day of the quarter (and motivated, at least in part, by potential competition from Apple Pay), **eBay** announced its intention to separate its web-based payments division, PayPal, into an independent public company in a tax-free spin-off to shareholders in 2015. In making the surprise announcement, eBay's CEO declared: "The era of digital payments is upon us." As mentioned in our year-end letter, we purchased eBay late last year primarily to gain exposure to the rapid growth of its crown jewel, PayPal. Subsequently, activist investor Carl Icahn, recognizing the same underlying value potential for PayPal, earlier this year pressured eBay's management to separate it from the legacy marketplace business. With the split now in motion, we would not be surprised to see the emergence of outside bidders for the respective businesses; tech titans Google and Alibaba (now publically traded), along with Visa and the other credit card companies, are rumored to be interested. As with Allergan, stay tuned.

Our railroad holdings, including **Norfolk Southern** and **Berkshire Hathaway** (which owns Burlington Northern Santa Fe), are also trading at new all time highs driven by strong profitability. Norfolk Southern has significantly exceeded its own earnings guidance in recent quarters amid robust rail-carload growth across multiple sectors of the economy; while Berkshire delivered very good second quarter earnings across all of its subsidiaries (and increased its cash war chest to $50 billion). Given that railroad growth is so directly tied to U.S. economic health, and that the vast majority of Berkshire's businesses are domestically oriented, we view recent results from these two companies as an indication of a strengthening American economy.

Despite the prevailing view that our economy is mired in an era in which gross domestic product (GDP) will only grow at about 2%, as it has over the past several years, we are more optimistic. As we have written in detail over the past three years, we believe the current transformation in American energy production and manufacturing will have extremely positive effects on the broad U.S. economy. We certainly think the U.S. has the potential to grow GDP at 3% to 4%, and this higher level of growth could possibly become evident sooner than most economists and investors expect. Our view was well summarized in a recent interview with Stephen Auth, Chief Investment Officer at Federated Investors, who agreed that the energy sector is becoming a major driver of our economy and is creating a manufacturing renaissance due to lower costs. Furthermore, he noted that corporate decision makers – in increasing numbers – are simultaneously saying "maybe I should build that factory down the street, maybe I should do that mergers-and-acquisitions deal, or maybe I should loan to that company."

A stronger economy would, of course, lead to stronger corporate revenue and earnings growth, and would enhance the attractiveness of long-term stock valuations. However, unexpected economic

strength could cause interest rates to rise more quickly than currently anticipated, prompting sudden declines across financial markets. Thus ironically, better news on the economy could lead to a stock market correction – a scenario we would likely view as a good buying opportunity.

Low Interest Rates and Complacency

Notwithstanding the Federal Reserve's commitment to wind down its current stimulus measures in November and expectations of fed funds rate increases next year, interest rates have remained stubbornly low. One reason for this is the continuing economic trouble in Europe. As the European Central Bank initiates additional monetary stimulus, European 10-year government bond yields have sunk (to 2.4% in Italy, 2.2% in Spain, 1.3% in France, and *less* than 1% in Germany). At such low yields, either European sovereign debt is significantly overvalued, or these rates are signaling a prolonged period of deflationary stagnation across the euro-zone akin to what has occurred in Japan for over two decades. In any case, even at a yield of only 2.5%, the 10-year U.S. Treasury bond looks relatively attractive to European investors today, thus prompting money flows out of the euro into the dollar.

As investors grow accustomed to low interest rates and easy access to credit, many "stretch for yield" buying lower quality securities and often doing so with leverage (using borrowed money to generate higher returns), thereby making the investments inherently more risky and distorting financial markets. To wit, low-rated corporate "junk" bond prices have been bid up over the last few years to levels that look particularly overvalued. While stocks are certainly much more attractive to own than bonds, signs of speculative froth have emerged in both areas. As Fed Chair Janet Yellen stated in her semi-annual report to Congress in July: "valuation metrics in some sectors do appear substantially stretched – particularly those for [low-rated corporate bonds and] smaller firms in the social media and biotechnology industries."

Some of these more speculative markets have begun to decline; for instance, the Russell 2000 index of small companies has been notably weak in recent months. While Saybrook is not invested in overvalued junk bonds or speculative biotech and social media stocks, we know from past experience that extended periods of complacency can lead to broad-based financial market declines in which even high quality stocks will sell off as investors rush to seek liquidity. After more than two years without a significant correction in the S&P 500, the probability of such a drop remains elevated, but the timing and magnitude are always impossible to know. As suggested above, we could experience a market decline even as our economy continues to improve. Recall that the sudden 20% stock market declines that occurred in the summer of 2011 and the fall of 1987 did not lead to economic recessions, and in both cases stock markets recovered much more quickly than many had feared.

We know that we cannot predict what the stock market will do next month or next year, but we do know that the values of the overall economy and good companies trend upwards over time. Having the resolve to maintain long-term ownership stakes in a cross section of excellent businesses, even through periods of sharp market turbulence, has proven wise. As undervalued growth investors, time provides an essential alliance. It has been said that "the smartest investors may not be the most prescient, but the most patient."