SAYBROOK CAPITAL
INVESTMENT OUTLOOK

Third Quarter 2011

At the beginning of 2011 and even in our July letter, we were cautiously hopeful that economic growth – though slow – would begin to become self-sustaining and that leaders in the U.S. and Europe would finally start the process of real fiscal reform. These hopes were dashed in August, as it became clear that policymakers were unable to adequately address mounting debt challenges on both sides of the Atlantic, while concurrently developed economies, including the U.S., decelerated. In the wake of these developments, confidence declined sharply, with the S&P 500 falling 17% in 11 trading days through August 8. Because systemic and economic risks have increased, we have utilized brief market rebounds since August to tactically rebalance the portfolio, reducing exposure to economically-sensitive holdings, concentrating even more on defensive and dividend-paying companies, and, where appropriate, increasing our cash reserves.

What Has Changed?

1. Washington proved itself dysfunctional. This incompetence was symbolized by the first ever rating downgrade of U.S. Treasury Bonds by Standard and Poors in early August after the ugly partisan debt-ceiling battle. Despite the fact that the Bowles-Simpson Deficit Reduction Commission recommendations had the potential to bridge wide divides and a grand bargain was nearly reached in July, politicians allowed the compromise towards structural reform to collapse. Although a short-term agreement was reached to avoid default, it was viewed as another case of "kicking the can down the road." Yet another Congressional commission has been created and must find $1.2 trillion in budget cuts before a November 23 deadline. If Washington fails again, automatic, and some say draconian, cuts to the Pentagon and Medicare will be implemented. An agreement such as the one almost reached this summer could still happen, but we are now more pessimistic about the odds of real reform occurring before the 2012 election. The timetable and rancor surrounding this year's budget debate make us skeptical of the prospects of any near-term plans to stimulate the economy, including the White House's recently announced jobs proposal. After four years of markets relying on government bailouts and stimulus, the consensus has quickly become that policymakers are incapable of tackling our serious economic and fiscal challenges and may even exacerbate the problems. At a recent lunch with a political scientist (and client) who has studied partisanship in America over the last two centuries, he remarked how politicians have always been polarized and often lacked civility, but that what is unprecedented today is the *unwillingness to compromise* to help solve the nation's problems.

2. The debt crisis in Europe has become acute. European bank stocks have declined dramatically as Greece continues to falter and the threat of wider contagion spreads. Europe's officials are waking up to the fact that the measures put in place since the spring of 2010 and most recently this July have been

woefully inadequate. European leaders are now faced with several unenviable tasks. First, they must restructure (i.e. write-off) much of the debt of insolvent nations like Greece and possibly others, such as Portugal and Ireland. Second, they must support the bonds of presumably solvent states, such as Italy and Spain, which, at the very least, suffer from a lack of liquidity. Simultaneously, policymakers must encourage or provide new capital to banks throughout the continent that will face losses from devalued sovereign debt held on their books. While the European Financial Stability Facility (EFSF) was agreed to in July, it has not yet been approved or funded by the 17 independent member states, which all answer to bail-out fatigued voters. To fill the vacuum, the European Central Bank is reluctantly acting as the lender of last resort, extending liquidity to banks and purchasing €150 billion of troubled sovereign bonds. After months without any clear progress, global markets are increasingly spooked by this crisis, which could drive much of Europe into another recession, slow global trade and economic growth, and, in a worst-case scenario, precipitate a Lehman-like banking contagion resulting in a systemic collapse. Although it may not be reasonable to expect that any single big plan can shore up the euro zone, a series of strong, coordinated interventions will be required to quell the crisis and reassure investors.

3. Economic growth is not self-sustaining. U.S. Gross Domestic Product (GDP), the broadest measure of overall economic output, grew at only 0.9% for the first half of 2011. Other indicators such as falling commodities prices and poor job growth corroborate this weakening trend. The Federal Reserve has responded to this data with additional aggressive monetary policy. First, in August the Fed stated its intention to leave short-term rates near zero for *another two years*. More recently the Fed announced its plan to sell $400 billion of Treasury bonds maturing in the next three years and use the proceeds to purchase Treasury and mortgage-backed bonds that mature in six to thirty years. This move - dubbed "Operation Twist" when it was last implemented in the early 1960s (with limited success) - seeks to further lower interest rates, encourage mortgage refinancing, and prompt investors to take more risk with their capital. Both of these monetary maneuvers were accompanied by gloomier prognoses on the economy and negative reactions from investors who feel that the Fed is running out of monetary stimulus tools. Whether or not we are in or are heading into a recession, we are certainly in a period that *feels* stagnant with weak job-growth and a reluctance to deploy capital. In a slowly growing economy saddled by debt-deleveraging, negative shocks can more easily disrupt the fragile recovery. The results of ineptitude in Washington and Europe may constitute such a shock.

4. Confidence is sinking. The last two months have witnessed significant declines in many sentiment indicators that we watch. Polls show record-low confidence in our political leaders; consumers express cautious views on the direction of the economy; and corporate surveys lower the expectations for sales and purchases. Surveys are different than measurable activity, and opinions can also reverse quickly, yet these views concern us because negative sentiment can become self-fulfilling reality. The stock market remains the broadest indicator of sentiment, and it has deteriorated rapidly. As the economic and political picture darkened since we last wrote in July, markets have rapidly re-priced to reflect the higher chance of a recession. After nearly doubling from its March 2009 lows, the S&P 500 finished the third

quarter nearly 20% below its April highs. Yields on U.S. Treasuries (notwithstanding the S&P downgrade) and high-quality corporate and municipal bonds have decreased as investors flee to safety and bid up prices.

What Actions Are We Taking?

Through the credit crisis and nascent recovery, we have pursued our undervalued growth philosophy through a strategy of primarily buying the highest quality companies that can endure and grow through this challenging period. Generally, this involves focusing on companies with conservative balance sheets, excess cash flow to return to investors in the form of dividends and/or share buybacks, and an international footprint with access to expanding markets. Often this has meant overweighting defensive companies and industries, such as food and beverages, with dividend yields of 3-4% that are increasing each year regardless of market volatility. Throughout this recent turmoil, we are heartened that the non-banking corporate sector remains a solitary area of strength in the U.S. economy.

In this difficult investment environment, portfolio managers are also defined by what they do *not* own. Since early 2008, we have avoided the banking sector, and we are glad we have with the KBW Bank Index down 42% from earlier this year. Given the regulatory and solvency risks, not to mention yield compression, we do not expect to be buying any banks in the foreseeable future. Beginning last year, we have made a concerted effort to avoid companies with exposure to what we call "austerity risk." We sold stocks in industries such as defense and medical devices that are particularly at risk given the inevitable reductions in government spending in the U.S. and Europe.

As the economy began to recover in 2009, we made several successful investments in industrial businesses with exposure to growth in emerging markets. We selected these more economically-sensitive businesses within our overall framework of seeking quality. These companies all reported strong profits through the June quarter, and Honeywell International, for example, recently reaffirmed earnings guidance for the year. Corporate managers in economically-sensitive industries speak to customers and suppliers on a daily basis and can be a good indicator of the real-time health of their sector, so we listen to their reports closely. However, there have been times, most notably in 2008, when even the most seasoned CEOs missed the Great Recession happening right before them. A challenge for equity investors is to make wise investment decisions when company fundamentals say one thing and the stock price says another.

While we are pleased that our companies' operations remain sound thus far despite the economic and political challenges that abound, we are disappointed that, once again, political and global uncertainties have become the predominant factor in stock prices. Companies will likely report solid third quarter and even year-end 2011 results, but we remain wary of 2012 when the risk of reduced earnings increases.

Recent weak markets are already discounting some likelihood of a recession and therefore lower earnings, but stocks would certainly fall further if that outcome becomes reality. In short, when the financial markets are primarily driven by unpredictable policy decisions rather than corporate results, the risk of significant downside is higher.

Consequently, over the last few months we have made a tactical effort to de-emphasize cyclical areas, looking for opportunities to trim stocks, such as Caterpillar, that have excelled over the last two years even though they have suffered in recent months. We have used short-term rebounds to take some profits and, sometimes, off-setting losses in areas most exposed to the global economy, in case the U.S. sinks into a recession. We have used the sale proceeds to invest in more defensive stocks or, where appropriate, increase cash reserves. In our effort to protect principal, we acknowledge the chance of underperforming the market if stocks follow 2010's pattern with a strong comeback in the fourth quarter - an event we, like all equity investors, would be happy to see.

As long-term investors, we remain resolutely committed to common stocks as a primary investment vehicle. Compared to alternatives, such as Treasury bonds, real estate, or commodities, the fundamentals of U.S. companies remain strong and the valuations reasonable. In our first quarter investment letter we noted how U.S. equities could be seen as "the best house in a bad neighborhood." Unfortunately, it has taken the European debt crisis and worries about a slowdown in emerging economies for the relative performance of U.S. stocks to truly stand out.

	Price Performance 12/31/10 - 9/30/11
S&P 500 (U.S.)	-10.0%
STOXX (Europe)	-21.7%
MSCI Emerging Markets	-18.5%
Hang Seng (Hong Kong)	-23.6%
Nikkei 225 (Japan)	-14.9%
Bovespa (Brazil)	-24.5%
Sensex (India)	-19.8%

As we have argued over the last four years, the best-run and best-capitalized U.S. and multinational companies remain an attractive store of value in a world of turmoil. As more questions arise about the stability of developed nations' fiscal and monetary conditions, perhaps high-rated multinational corporations will increasingly be viewed as the "new sovereigns" by institutional investors, substituting for government bonds as safe, income-paying assets. For investors who can handle near-term volatility, as investors in publicly-traded stocks by definition must, a meaningful allocation to companies that can generate growing dividend income in any economic climate is a sensible investment strategy and will, in due course, lead to significant capital appreciation.