SAYBROOK CAPITAL
INVESTMENT OUTLOOK

Third Quarter 2009

In our June Investment Outlook we noted after nineteen months of recession 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. While until recently few were predicting the end of the Great Recession, economists today are racing to raise their estimates for economic growth (expected to be positive when the backwards-looking GDP figures are released at the end of October). Despite this rapid swing in sentiment, the question that has not changed for us is: how robust and sustainable a recovery? In this Outlook we discuss the conflicting dynamics of near-term cyclical strength and longer-term secular challenges, and we reiterate our investment strategy for addressing this uncertain environment.

Economic Recovery: Cyclical or Secular?

Three powerful forces are leading the current rebound: government stimulus, inventory rebuilding, and demand from developing countries. The first two may just drive a near-term surge of activity, while the latter is the only one of the three economic drivers that currently appears to be sustainable.

Our government's stimulus efforts, both monetary and fiscal, have injected activity into certain parts of the economy. The wildly popular cash-for-clunkers auto purchase offer, temporary tax credits for first-time home buyers, and a spike in refinancing due to low mortgage rates all demonstrate that consumers will respond to generous incentives. Yet statistics measuring the travel and furniture industries (what the consumer actually does with their car or house) indicate continued thrift. Incentivized activity fostered by U.S. and foreign government stimulus, at best, provides a short-term economic lift until underlying private sector demand recovers.

Inventory restocking is beginning to boost the economy after at least a year of cash-hoarding by businesses, and, like a coiled spring, the strength of its recovery is often proportional to the preceding decline. Excess capacity reduction and inventory liquidation likely peaked in the first half of this year, so the next few quarters should benefit as companies restock and reinvest. While corporate conservatism will likely endure, a temporary surge in company expenditures can account for a period of above average growth.

Overseas demand – especially in emerging economies – is one area we expect to be a secular, rather than cyclical, force. Increasing wealth and its impact on consumption and infrastructure spending in the developing world will enable these economies to grow at a far faster, albeit more volatile, rate than the developed world. Economies in countries such as Brazil, India, and China expanded even during the depths of the 2008-2009 recession.

Working against a sustainable recovery are the headwinds that we have discussed in past investment letters: consumer weakness, dearth of credit, and the long-term budgetary legacies of the credit crisis and subsequent policy actions. While some consumer sentiment measures have improved in recent months, employment figures tell a different story. With nearly 10% of the U.S. workforce unemployed and home and portfolio values still much impaired, consumers are hardly euphoric. On recent conference calls with such portfolio companies as Walgreen Drugstores, Johnson & Johnson, and Procter & Gamble, our managers are highlighting a continued shift in consumer behavior, as shoppers buy more carefully, look for sales and generic-brands, and focus on staples instead of discretionary items. A lasting increase in the national rate of savings – it had recently reached zero after a thirty-year decline from savings rates as high as 10% – would do much to repair household balance sheets, but would lead to sub-par growth in the 70% of the U.S. economy that is consumption-based.

Although current demand for investment-grade corporate bonds demonstrates that credit is plentiful for highly-rated corporations, many small businesses and start-ups are literally unable to borrow. As Bob Hope famously said, "banks will only lend to those who can prove they don't need it." Indeed, in many parts of the economy, loans are simply unavailable. Whether it be an unwillingness to extend credit or an aversion to shouldering debt, a return to past growth rates, fueled by leverage, is unlikely. This lack of credit has negative reverberations throughout the economy, especially for employment, as small businesses traditionally create the majority of new jobs in America.

While history will someday judge the effectiveness of the bold policy reactions to the financial crisis, we remain concerned about the long-term fiscal consequences. Estimates of $1.5 trillion for the 2010 federal budget deficit place it in the range of 12% of total GDP, a level not reached since World War II and twice the worst levels of the 1980s. At this magnitude, even a strong economy and a perfect exit from TARP and other stimulus programs would still leave a massive fiscal void that could be filled with a growth-inhibiting mix of higher taxes and climbing inflation. A more immediate symptom of Washington's stimulative policies is the weakening dollar – now at a 14-month low versus the euro. In the near-term, a cheap dollar is helping drive exports and increasing the foreign profits of U.S. multi-national corporations (including many that we own), but eventually it could lead us to a dangerous resurgence of inflation.

All these challenges are long-term in nature and are being set aside at the moment, as the stock market currently celebrates the end of the Great Recession, and investors wonder if we are at the dawn of a new, lasting bull market. The last such era began in 1982, after a long, volatile period when the direction of the Dow Jones Industrial Average was ultimately sideways. The Dow first reached 1,000 in 1966 and did not meaningfully surpass it until 1982, with many sharp downturns and big rebounds in between. Twenty-seven years ago investors were about to benefit from significant fundamental changes as interest rates, inflation, and taxes were all high and headed *down*, and stock market valuations were low and headed *up*. A comparative glance at these two periods reveals that secular shifts may not be so favorable in the future.

Then & Now: August 1982 vs. October 2009

	August '82	**October '09**
Fed Funds Rate	10.12%	0.15%
Prime Rate	14.39%	3.25%
10-Year UST Yield	13.60%	3.40%
Inflation (Core CPI)	7.06%	1.51%
S&P 500 P/E (10-yr trailing EPS)	11.0x	17.3x
S&P 500 Price to Book	1.0x	2.3x
S&P 500 Dividend Yield	6.60%	1.97%
Top Marginal Tax Rate	50%	35%
Capital Gains Tax Rate	20%	15%

Source: Strategas Investment Partners, LLC

Our Focus on Quality Companies

Our portfolio companies are executing well in this environment, and our core stocks are outperforming since July, as the market rally has broadened. While we remain concerned that consensus has quickly moved to an overly bullish sentiment, we are pleased to own companies that are positioned to participate in up markets, yet can still thrive in a slow-growth environment.

During the early stages of this economic recovery, many businesses are reporting surprisingly strong earnings through a combination of job reductions, lower interest and commodity expenses, and favorable year-over-year comparisons. We do not recall a time when an economy was able to ride cost-cutting and easy earnings comps to a new era of prosperity. In fact, many of these short-term boosts are simultaneously damaging to the broader underlying demand side of the economy. While our companies also are enjoying this earnings boost, we continue to seek *sustainable* growth and are particularly focused on metrics of *quality*, specifically: industry leadership, global exposure, consistent and growing dividends, and strong balance sheets. The market collapse, which accelerated one year ago as investors sold indiscriminately in a scramble for liquidity, marked an opportunity to buy superior companies at similar valuations to their weaker counterparts. While higher quality businesses do not necessarily outperform during quick recoveries or bounces off the bottom, we believe they will be the winners in a protracted slow-growth environment for a variety of reasons.

Superior leadership can help organizations build share over weak competitors and successfully adapt to a changing marketplace. A broad global footprint with decades of emerging market experience enables strong multi-national corporations to successfully service the growing middle class in developing regions of the world. A mountain of cash on the balance sheet becomes particularly valuable, as the money can be intelligently deployed for marketing, research, capital expenditures, strategic acquisitions, and/or returned to shareholders in the form of higher dividends. The best companies continue to raise payouts through this difficult cycle, while poorly funded counterparts must cut dividends and dilute their shareholders through additional stock issuance.

We see some early signs that our concentration on high quality stocks is beginning to pay off. Our portfolio companies continue their steady record of raising dividends, increasing payments by an average of over 5% versus a 17% *decline* for S&P 500 companies over the last 12 months. We emphasize the importance of sustainable and growing payouts to shareholders, because historically nearly half of all stock market returns have come from dividends. As our portfolio companies, such as Walgreens, FactSet Research, and Nestle, report their quarterly results, we have been impressed by their productivity improvements, market share gains, new product introductions, and successful implementation of growth plans. Most recently, Google, which we purchased for most accounts at multi-year lows last fall, surpassed expectations with accelerating revenue growth and improved margins, as the company takes share from traditional media and begins to monetize new technological offerings. We are pleased to have significant appreciation in our Google holdings and are enthusiastic about the future for the search engine standard-bearer.

Portfolio Strategy

As with all equity investors, we are delighted and relieved at this year's stock market rally. While the scale of the rebound has surprised most market observers including ourselves, we are reminded of the case we made for long-term investing in stocks in the midst of last year's crash. The powerful 2009 rally underscores the risk of excessive market-timing and validates our statement that to realize the full appreciation potential of stocks, one must remain committed to owning them, as most gains occur in brief, unexpected periods.

A commitment to owning equities, in our view, does not mean simply buying and holding a fully-invested portfolio regardless of the investment climate. During the credit crisis that began in late 2007, Saybrook portfolios declined less than the market in part by avoiding much of the troubled real estate and finance sectors, but also by holding larger amounts of cash and bonds. These asset classes, by providing diversification and liquidity, were vital during the acute phase of the crisis in late 2008 and early 2009. We have raised equity exposure beginning in April and have selectively bought and/or added to stocks over the last two quarters. Despite this increase in equities, any amount of cash or fixed income will create a drag on overall portfolio performance during such a powerful rally. Our investment philosophy, and its underlying focus on capital preservation, compels us to maintain a diversified portfolio, even at the expense of near-term relative performance.