SAYBROOK CAPITAL

INVESTMENT OUTLOOK

Third Quarter 2010

In our January letter we noted that while any economic forecast is, by definition, marked by uncertainty, the current outlook feels *particularly unclear*. Over the last nine months the level of economic uncertainty has only increased with the European sovereign debt crisis and the threat of slowing growth in China, along with domestic worries about persistently high unemployment and the possibility of lasting deflation. The range of serious economic concerns led Federal Reserve Chairman Ben Bernanke to characterize today's environment as "unusually uncertain."

This uncertain climate reinforces the importance of our high-quality investment strategy. We have maintained a large allocation to undervalued growth businesses with the following attributes: financial strength, leading market share, deep international exposure, and growing free cash flow from profits. In a period of very low interest rates, we particularly favor the relative certainty of owning companies with the ability to pay dividends.

The Impact of Economic Uncertainty

Despite the muted sense of recovery, the National Bureau of Economic Research (NBER) recently stated that the Great Recession, which began in December 2007, ended 15 months ago. It was the longest recession since the 1930s, outlasting the severe downturns of 1973-75 and 1981-82. While officially declaring its end, the NBER, however, noted that its definition of a recession is only the period until the economy reaches its low point – not a return to its previous level. Indeed, our economic output (real GDP) is still below its late 2007 peak, and the current recovery is notable for its lack of vigor.

With unemployment too high and inflation too low, the Federal Reserve is considering another round of interest rate-reducing bond purchases on the open market - known as "quantitative easing" (or in this case "QE2"). The first round was initiated at the height of the financial crisis. While the anticipation of QE2 has already led to a further decline in interest rates and fueled the recent stock market rally, we find it disconcerting that the Fed feels it necessary to use one of the few remaining arrows in its quiver. We are also wary of potential unintended consequences of this program; for example, it further weakens the dollar and strains international trade, as countries competitively devalue their own exchange rates.

Rising currency and trade tensions, growing fiscal deficits, changing government regulations, and the complete lack of clarity on tax policy, all contribute to a heightened degree of uncertainty. For example, with current tax rates on income, dividends, capital gains and estates set to expire on December 31, tax policy still remains in limbo; mired in partisan bickering, Congress again delayed action until after the November elections. All of this uncertainty, of course, impacts the economy as businesses hold back on capital investments and hiring, hording their cash instead. Non-financial companies in the S&P 500 are sitting on record cash of well over $1 trillion, according to data from FactSet Research (one of our portfolio holdings, incidentally).

Just as corporations are forestalling investments, so too are individuals. 2010 is the third straight year that individual investors have taken net withdrawals from their U.S. equity mutual funds. In response to investment uncertainty, these funds have poured into government and corporate bonds. In their search for a safe-haven, individual investors may be making a classic mistake: selling stocks which have performed so badly over the past decade, only to chase bonds which have performed so well.

Nevertheless, investor willingness to buy very low-yielding corporate bonds is allowing large companies to borrow cheap. In recent months Johnson & Johnson issued a ten-year bond yielding 2.95% and PepsiCo a three-year bond at 0.875% – rates considerably lower than each company's respective dividend yield. The average dividend yield on the S&P 500 Index, at about 2% is not far from the 2.39% recent yield on the 10-year U.S. Treasury Bond. Similar spreads exist in many developed countries; German stocks, for example, yield about 2.9%, while their 10-year government bonds yield about 2.1%. It has been generations since bonds have yielded so little relative to stocks.

In addition to the higher yields that are currently available from stocks versus bonds, there are <u>many reasons why we like dividends</u>:

Stable Returns

The ability of corporations to pay dividends is a fundamental reason to invest in common stocks. As Benjamin Graham and David Dodd said: "The prime purpose of a business corporation is to pay dividends to its owners; [a] successful company is one that can pay its dividends regularly and presumably increase the rate as time goes on." Graham and Dodd wrote this in their classic book, *Security Analysis*, first published in 1934 – in the midst of the Great Depression. Just as the good companies continued to pay dividends throughout the 1930s, so too have our portfolio companies today.

During a period of record dividend cuts in the S&P 500, as numerous companies were forced to reduce or eliminate their payouts during the recent financial crisis, our portfolio has experienced a cumulative average increase in dividend payments of +16% over the last two years. Aside from a few outliers, mostly lower-yielding stocks that significantly hiked their payouts, the majority of our portfolio companies continued their usual pattern of regular annual dividend increases, resulting in payments that are 5% to 20% higher than in 2008. These stable and growing dividends are an important source of income for some of our clients. But even for those who do not depend on current income from their investment portfolios, growing dividends represent a very important component of the total return from owning stocks.

Dividends make up *more than 50%* of a stock's total return, on average, with the remainder coming from price appreciation, according to historical studies by Ibbotson and Associates going back to 1926. Additionally, companies with a record of regularly increasing their dividends have outperformed the overall stock market over the last 20 years, with lower volatility. As portfolio managers we hope to improve on these averages by reinvesting our dividend streams into new holdings and existing positions at attractive valuations.

Growing Streams of Cash Flow

An important element of our investment strategy is to own companies that have the capacity for sustainable dividend growth, not necessarily those that pay the highest current dividends. As long-term investors we want to own companies that have the ability to pay dividends *and* to reinvest significant cash flows back into their businesses for future growth. Mature, non-growing companies, by contrast, lack opportunities for reinvestment and, thus, distribute most of their profits. In other cases, an abnormally high yield is the result of a severely depressed stock price, and a cut or elimination of the dividend often follows. All of our portfolio companies, even those with lower yields, have the ability to pay higher dividends. Instead, they reinvest substantial profits back into our businesses in order to generate the growth necessary to drive future dividend increases.

Proctor & Gamble and ExxonMobil are two excellent examples of enduring dividend growth companies. In April, P&G increased its dividend for the 54th consecutive year, raising its quarterly payout by 9.5%. P&G, the world's biggest consumer products manufacturer, has been disbursing dividends continuously since incorporation in 1890. ExxonMobil also increased its dividend this May for the 28th consecutive annual boost. Over the last five years Exxon has increased its dividend by an average annual rate of 9.4%. At the same time, Exxon used strong cash flow to buy back its own stock, significantly shrinking its shares outstanding and consequently increasing its earnings for the stockholders by 35% more than they would have without the buybacks.

In tracking dividends it is helpful for investors to calculate their *underlying dividend yield*, which we define as the annual payment relative to original cost-basis. The commonly cited "current yield" is the dividend relative to the current stock price (current yield mathematically declines as a stock price increases). An investor's underlying yield increases over time as dividend payments rise. For example, Procter & Gamble currently yields 3%, based on a current annual per-share payout of $1.93 divided by the recent stock price of $63. We purchased or added to P&G for most accounts in early

2009 at about $48, therefore our underlying yield is 4%. An investor who purchased P&G ten years ago would have an underlying yield of 7%, twenty years ago 22%, thirty years ago 84%, and forty years ago 106%. In fact, some of our clients who have held very long-term positions in companies including P&G are now collecting annual dividends in excess of what they paid for the underlying shares! We are pleased with the growing underlying yields on several stocks we have purchased in the last two years. For example, through a combination of low purchase prices and rising dividend payouts, Johnson & Johnson, Automatic Data Processing, and Caterpillar are all companies where our clients receive underlying yields now near 4%.

Two of our companies, Google and Berkshire Hathaway, have the net cash to pay large dividends, but currently reinvest all of their cash flows for future growth. In the case of Berkshire Hathaway, which has never paid dividends, CEO Warren Buffett has chosen instead to reinvest in new businesses and, more recently, to allocate surplus cash back into Berkshire's more capital-intensive utility and railroad holdings. Over past decades this strategy has dramatically increased Berkshire's book value. Nevertheless, as the company grows larger and as the inevitable management succession nears, we have long believed that Berkshire will one day begin making meaningful distributions to shareholders. In fact, at this year's shareholder meeting in Omaha, Buffett gave one of his first public hints supporting our theory. "There will come a time," he said, "when we cannot intelligently use 100% of the capital we've developed internally, [w]hatever is in the best interests of the shareholders will be done at this point."

Strong Corporate Governance

A policy of paying out regular and increasing dividends tends to engender a culture of good corporate governance. Maintaining the ability to pay dividends, even in difficult times, encourages a degree of conservativeness and reduces management temptation to pursue growth at any cost. A company's dividend policy is, perhaps, the most transparent indicator of the underlying strength of its business, particularly in a recession when only the best positioned companies can increase their dividends. Share repurchases are also a popular use of companies' free cash flow, helping boost earnings per share (as we cited with Exxon earlier). Buybacks, however, are not a reliable gauge of a company's fundamentals, as they carry little expectation of being sustained; whereas dividend increases are dispensed with utmost care, as companies are loath to ever cut payouts.

Additionally, when companies pay a consistently growing dividend, corporate managers have the incentive to hold more common stock, further aligning their interest with shareholders. Conversely, executives that possess only stock-options do not receive dividends and often employ short-term measures to improve the stock price (as an option's value is tied to the stock reaching a certain price by a certain date). The 2003 tax code changes helped to address these corporate governance concerns by aligning dividends and capital gains taxes at the same level. We strongly feel these rates should remain at parity. A return to higher taxes on dividends would lead to perverse corporate incentives with capital gains favored over dividends, and both disadvantaged relative to corporate debt (interest on which is tax-deductible at the company level). De-linking dividends and capital-gains tax rates would reestablish the disincentives that weakened corporate governance and reduced the relevance of dividends during the 1980s and 1990s.

Some Protection from Deflation or Inflation

Perhaps, the greatest investment uncertainty is whether our economy will face a continuing period of deflation (slow growth, weak underlying demand and falling prices) or a renewed surge of inflation down the road (fueled by the monetary and fiscal stimulus we have poured into our system). There is no perfect hedge that works against both the possibility of deflation or inflation, and certainly none for an extended period of the former followed by the latter. However, in either scenario, we firmly believe that owning the highest quality dividend-paying stocks makes sense. In a deflationary period, a steady stream of cash dividends from companies with the balance-sheet strength to maintain them becomes increasingly valuable. In a period of rising inflation, market-share leading companies have the ability to raise the prices of their products and services and return that growing cash stream to shareholders.

In today's uncertain environment, dependable dividends are increasingly important. Many of our letters in recent years have focused on our economy's structural and monetary challenges, which, for a time, could limit expansion of earnings multiples and may restrain overall stock market appreciation. We believe that owning high-quality companies with growing dividends may be the most effective antidote in a period where the stock market remains lackluster and bond yields are generally unattractive. Until the underlying rate of sustainable economic growth improves and is rewarded by meaningfully higher stock market valuations, we are content to be *paid-to-wait*, as our portfolio companies steadily increase their capacity to pay dividends.