SAYBROOK CAPITAL

INVESTMENT OUTLOOK

Third Quarter 2013

After the challenging "risk-on, risk-off" period during and following the global financial crisis, today's relatively stable climate marks a return to what some call a "stock-picker's market," with the best and most innovative companies rewarded and the laggards punished. Fortunately, we have worked hard over the last couple years to add new growth-oriented names to the portfolio and sell businesses that have failed to adapt to the changing marketplace. Additionally, we have seen a resurgence in merger activity with the two biggest deals of 2013 directly benefiting our portfolio. This letter addresses these dynamics that have helped Saybrook's stock portfolio perform well in 2013, but also concludes with a more sobering look back five years after the fall of Lehman Brothers and how the lessons learned from that crisis impact our current outlook.

This year has been characterized by a series of headwinds, with the third quarter alone including hostilities in Egypt and Syria, ongoing weakness in key developing markets, uncertainty over Federal Reserve Chairman Bernanke's successor, and concerns about the end of the Fed's bond-buying program. How have stocks generated double-digit returns this year despite this litany of problems? One-by-one these issues have been either resolved or postponed, each enabling the stock market to grind higher. In recent weeks the Fed has made headlines twice. First, despite the positive reaction by stocks, we were disappointed in the Fed's postponement of its previously signaled tapering plan, continuing the full $85 billion monthly bond-buying program. Not only does it weaken the Fed's credibility, but it also reminds us of the artificially low interest rates ten years ago at the emergence of the housing bubble. Secondly, the stock market cheered the President's nomination of Janet Yellen as the next Fed Chairman. Yellen, while an early voice of warning before the housing market overheated, is expected to share Bernanke's goal of spurring economic growth.

Early in the fourth quarter we are in the midst of the latest crisis, as the government shutdown and debt-ceiling debate provide the latest concerns for equity markets. It appears there will not be a default on U.S. bonds nor long-term damage to the U.S. economy, but what disappoints us is the inability of our polarized elected officials to compromise. While today's debates are solvable or will at least be deferred with short-term patches and diffused with an improved near-term deficit, we face greater challenges ahead with an aging population and entitlement promises that will be impossible to keep. While political "sausage-making" is rarely pretty to watch, the most recent episode has us particularly worried that Washington lacks the kind of adult leadership required to set the nation's long-term economic health on a sustainable path.

Corporations Are Also Buying Undervalued Businesses

In our April investment letter, we highlighted the Valentine's Day announcement that Berkshire Hathaway and 3G Capital would be purchasing Heinz for a significant premium. The acquisition of this core Saybrook holding was completed this summer with investors receiving $72.50 in cash for each share of Heinz, an 82% gain from our original 2009 purchase.

In that same letter we introduced a new Saybrook holding, Vodafone, the U.K.-based global mobile telecommunications provider. While we owned Heinz as a potential long-term holding with the side benefit of being an attractive takeover candidate, we specifically bought Vodafone because of its potential as an acquisition target. While Vodafone owns mobile businesses throughout Europe, India, Africa, and the Middle East, its crown jewel is its 45% stake in the leading U.S. mobile operator, Verizon Wireless (Verizon owns the remaining 55%). Viewing the Verizon Wireless stake as an attractive asset to Verizon, we purchased Vodafone this March for around $25 per share while European stocks were suffering during the Cyprus bank crisis. In our first quarter letter we explained our rationale:

> *Vodafone (VOD) is cheap, especially compared to Verizon (VZ). While VZ is valued at a price-to-earnings multiple of 17x and has a dividend yield of 4.5%, we bought VOD at a P/E of only 10x with a secure 6% dividend yield. It is no secret that for years VZ has been interested in buying back VOD's wireless stake, but the price would be high, estimated at well over $100 billion. Recently, both CEOs have hinted that the timing for a deal may now be right. Indeed, VZ stock is up over 20% the past 12 months, while VOD shares are flat. At the same time, the value of the British pound has declined against the dollar, and low interest rates would enable easier financing for a deal. We were able to buy VOD near its 52-week low on renewed European concerns…*

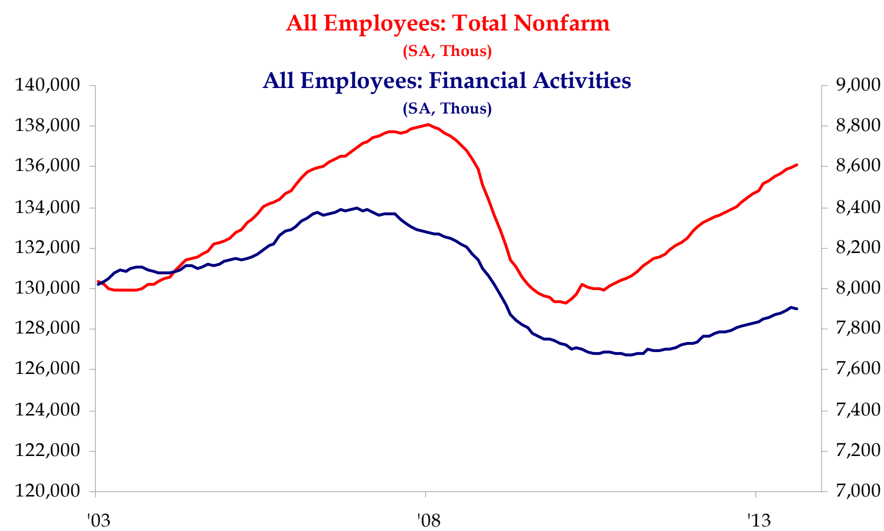
Our recent Labor Day weekend was interrupted by the pleasant news that Verizon and Vodafone formally agreed to a deal valuing the 45% of Verizon Wireless at *$130 billion*, a level beyond our most optimistic predictions and a price higher than the entire value of Vodafone on the day we bought it. $130 billion comes out to $26 for each share of Vodafone. Verizon will pay Vodafone shareholders a combination of cash and stock, with Vodafone returning $84 billion to its shareholders and retaining the rest to pay taxes and expand its international business. By our calculations, for each Vodafone share in the portfolio, a Saybrook investor will receive approximately $12 in Verizon stock, $5 in a one-time cash dividend, an 8% increase in annual dividends, reduced debt liabilities, and, of course, the retained original position in the international mobile business. The deal is expected to close in early 2014.

In the weeks following this announcement, other telecommunication giants have shown interest in the remaining Vodafone business, further driving up the stock price. At over $35 per share Saybrook's Vodafone shares have appreciated 40% since our purchase six months ago. A broad increase in merger activity marks a positive sign as companies are finally deploying their long-held cash, and we are fortunate to be on the receiving end of 2013's two biggest acquisitions. However, we believe it is more than serendipity, as corporate suitors begin to seek the same undervalued growth qualities that have attracted us.

Market Outlook Five Years after the Financial Crisis

Five years after the collapse of Lehman Brothers and the nadir of the global financial crisis, much has been written about the mistakes that were made, the winners and losers, and the likelihood of a repeat. A recent, candid Bloomberg article by then-Treasury Secretary, Henry Paulson, reminds us of two realities of that volatile period in the fall of 2008. One, our financial system was on the brink of a collapse that could have led to an economic depression, and, two, the Troubled Asset Relief Program, more familiarly known as "TARP" or "the bank bailout," was (and still is) extremely unpopular. The idea of banks profiting in the good times, yet being rescued when things go wrong, is morally repugnant to all. However, the alternative scenario was far worse. While mistakes were inevitable under duress, officials (from the Fed, the Bush and Obama administrations, and even Congress – TARP was passed by a bipartisan vote) did the unpopular but correct thing to stem a financial disaster in those darkest days of the financial crisis.

The conventional wisdom is that Wall Street has made out well, represented by the stock market at record levels, while Main Street has suffered, symbolized by a stubbornly high unemployment rate. From our perspective, we see a more nuanced outcome. Formerly prestigious banks and brokerage firms have disappeared, and many that remain are saddled with legal liability from the mortgage debacle, while operating in an environment of compressed net interest margins and heightened regulations. Certain niches like mergers and acquisitions are heating up, but Wall Street employment actually lags overall U.S. jobs figures, leading today's business school graduates to seek better opportunities in technology, energy, and entrepreneurship. In short, Wall Street is unrecognizable from earlier days – likely a positive in the long-term as our economy finds ways to grow outside of financial speculation.



– *U.S. Bureau of Labor Statistics*

Main Street, as a proxy for jobs and consumer spending, has also suffered. We have frequently cited economists Carmen Reinhart and Kenneth Rogoff and their thorough study of 800 years of financial crises. The current malaise closely fits their pattern of slow, uncertain recoveries as excess debt is reduced, marked by cautious spending from all sectors: corporate, consumer, and government. While caution by any given company, individual, or municipality is indeed prudent, the combined unintended consequences of everyone deleveraging at once have been damaging as a whole in the form of reduced hiring, increased savings, and careful spending. So while the sluggish recovery since 2009 has not been short on human tragedy, history demonstrates that it is not unprecedented.

Owners of financial assets, on the other hand, have gained in the last five years. Investors who have steadfastly held equities and other securities have profited from the recovery that began in 2009 and has been fueled by the monetary stimulus of central banks. The other winner over this period has been *non-financial* corporations. Conservative cash management during the financial crisis, combined with prudent cost controls in the recovery, has led to stability and record profits for the corporate sector with shareholders being the prime beneficiary. Clients of Saybrook Capital are not invested in Wall Street per se, but instead are owners of the financial assets of well-managed companies and thus have benefited disproportionately during this recovery.

As far as the likelihood of a repeat financial crisis, Secretary Paulson calls it "a certainty…as long as we have markets, as long as we have banks, no matter what the regulatory system is…bubbles will manifest themselves in a financial system no matter how it's structured and how it's regulated." He feels some of the recent structural changes have been for the better and others for the worse, but that the financial system is better capitalized, and "at the end of the day, more capital is the best defense against bank failure."

S&P 500 Trailing Twelve Months P/E
with Long-Term Average

– *Strategas Research Partners*

With the stock market having more than doubled from five years ago, we are on the constant lookout for signs of complacency and excesses that may lead to another crash. Price/earnings multiples (see chart) have risen just modestly from recent lows, with equities still fairly valued, particularly in an environment of mild inflation. We do not see the classic indicators like exuberant valuations and euphoric investor sentiment experienced in 1986-87 and 1999-2000; instead there remains a healthy level of investor skepticism. There also is no obvious evidence of inflated earnings, driven by financial engineering and debt speculation, conditions that fueled the 2008-09 crisis. Nevertheless, we consider protection of principal our most serious responsibility, and we therefore remain vigilant in our watch for warning signals. While many investors have been on the sidelines missing the outsized gains of last five years, we still believe there are positive returns ahead for stock investors, particularly in contrast with bonds and other alternatives.