

# SAYBROOK CAPITAL

## INVESTMENT OUTLOOK

*Year-End 2012*

2012 witnessed a litany of uncertainties, with investors' fortitude challenged by continued European debt woes, decelerating emerging market economies, and a contentious fiscal cliff debate culminating on the last day of the year. While each of these issues could have derailed the fragile economic expansion, the challenges, in aggregate, and their resolutions, however imperfect, turned out to be better than feared. Hence, stock markets have performed well – surprising many. Our stock portfolios, both last year and on average over the past four years, have generated returns approaching our 36-year annualized return of 12%. While we remain dissatisfied, in particular with elected officials' unwillingness to more comprehensively address long-term fiscal problems, we continue to believe that the non-financial U.S. corporate sector is an oasis of fiscal health amidst the ongoing deleveraging among banks, households, and governments. We have been gradually positioning the portfolio to benefit from several constructive trends that could lead to stronger overall economic growth. Furthermore, we are confident that owning shares of companies will outperform other investment alternatives over the long term.

### *Fiscal Cliff Averted but Waiting for Reform*

While now an infamous and familiar expression, it is hard to believe we had to define “fiscal cliff” in our 2012 letters. Unfortunately, due to a Washington culture that refuses to tackle underlying fiscal issues, this is likely not our last discussion on the subject. First, the good news – the agreement signed on January 2, 2013 is probably the best U.S. taxable investors could have hoped for given the circumstances:

- Clarity on federal tax policy, in particular the *parity* between dividends and capital gains tax rates set at 23.8% (for couples earning more than \$450,000).
- The estate and gift tax exclusion is made permanent at \$5 million per person or \$10 million per couple (indexed for inflation) with 40% federal tax on estates above those levels.
- And, of course, a tax cliff averted for 98% of taxpayers, as income tax rates are maintained for couples with incomes under \$450,000. An increase in all income tax rates during a fragile recovery could have ignited a recession and market downturn.

The glaring negative – a rare opportunity for a Simpson-Bowles inspired grand bargain was not achieved. The debt and spending debate has been deferred, the budget sequestration deadline looms, and the chance for true tax reform is shelved yet again. At the Museum of American Finance's annual John Whitehead Award Dinner in early January, we cornered Erskine Bowles. We were struck by the debt commission co-chairman's negative feelings about the recent fiscal cliff deal and Washington's general inability to make the difficult decisions required to reform the tax code and entitlements. It seems the best that can be hoped for now is continued incremental steps.

*Portfolio Positioning and Market Outlook*

Some recent purchases, which we noted in our summer letter, have done well in late 2012 and into January. Shares of Norfolk Southern dipped last fall on the news of even lower coal shipments, and we added to positions at those lower levels. We now have a +10% appreciation from our overall average cost, as the stock has gained on improving economic figures, better than expected fourth quarter earnings, and increasing petroleum shipments by rail as U.S. pipeline capacity strains to meet surging production in the heartland oil-belt. Allergan's cosmetic-pharmaceutical business continues to meet our high growth expectations, helped by recent broadening into migraines and bladder-control. Our average position has appreciated over 20% from last summer's purchases. We have also further concentrated our efforts in energy, which we wrote about in detail last spring. The broad energy sector, including our holdings, underperformed in 2012; nevertheless we continue to add to positions at attractive prices.

We possess an ownership culture and aim to build intimate knowledge of our companies and their management, but also recognize the pitfalls of building a "butterfly collection," whereby old, familiar names gather dust in the portfolio. In the last quarter we sold Staples and Intel. Although these multi-year holdings hurt our performance in 2012, they generated modest gains for most clients since purchase. Both companies pay generous dividends and meet our undervalued criteria; however we believe their growth prospects have diminished, impacted by the disruptive changes brought by mobile technology. Staples' office business has been hurt by lower demand for two of their biggest products, paper and ink/toner cartridges, victimized by the popularity of smartphones and tablets such as Apple's iPad. Intel, too, has suffered as their dominant market share in PCs and laptops has proved less important in an environment where consumer tastes are shifting to portable devices where Intel has had less penetration, despite the company's best efforts over many years.

Other portfolio companies such as Google and Apple, while not without their own risks, are better positioned for this disruptive mobile technology trend. Google's recent landmark settlement with the Federal Trade Commission, absolving the company of U.S. antitrust charges, removes a huge risk for the company. After a two-year investigation, the FTC concluded the obvious – Google's innovations improve the search experience and do not harm consumers. Apple's stock has fallen 35% from its September highs on several concerns, including competition from Samsung's smartphones (which use Google's Android platform) and fears that Apple will sacrifice its margins to gain entry to new markets. We believe that bringing millions of new customers, in China and elsewhere, into Apple's entertainment ecosystem justifies the offering of lower-priced iPhones and iPads, just as the company did successfully with its iPod strategy to dominate the MP3 market in the last decade. We view this as an opportunity to buy shares of a world-class growth company at a below-market valuation, with a dividend yield that exceeds the

payout of a 10-year U.S. Treasury note and a cash cushion of \$137 billion. Alas, it may take time for Apple to demonstrate to skeptical investors that its increased revenues can justify lower margins.

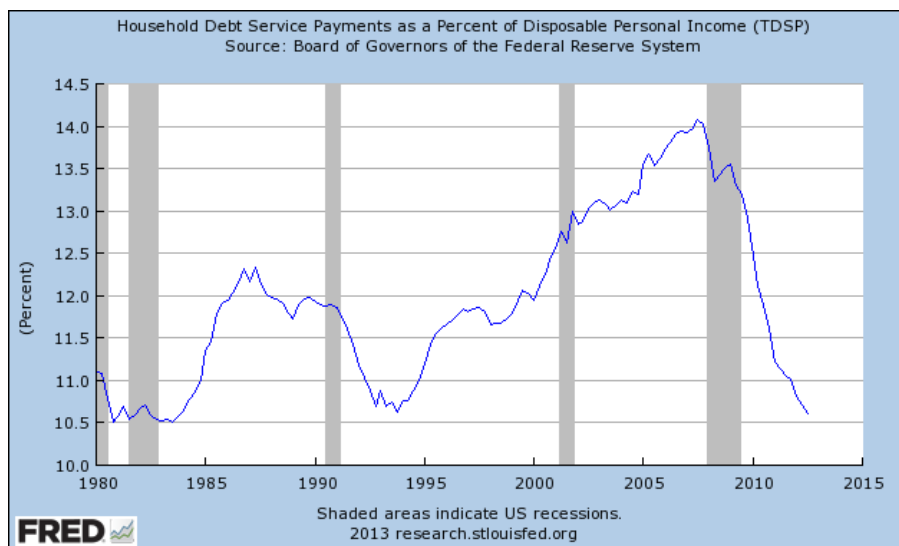
As opposed to the disruptive volatility of the technology industry, consumer products companies boast steady franchises. We have long concentrated on these global businesses as a way to profit from the growing middle class in emerging markets. These high-dividend stocks sometimes lag in strong market advances. The group appreciated in the range of 5 to 10% in 2012. Diageo, however, was a glorious exception. The London-based distiller was our best performing stock in 2012, advancing 36% (on the heels of a 21% gain in 2011) as consumers in China, India, and Brazil spend a little bit of their growing discretionary income on affordable luxuries like Johnnie Walker Black Label Scotch Whiskey.

Over the last four years since the financial crisis, we have managed our portfolios with a generally high exposure to stocks, yet with a heightened focus on quality holdings. This investment posture has helped us to stay the course, stomaching the uncertainty implicit in this deleveraging era and generating double-digit annualized returns over four years, amidst tepid economic growth. While we certainly do not exceed our benchmarks every year (our stock returns trailed the S&P 500 in 2012), our absolute returns have benefitted steadfast clients, particularly in comparison to those who – seeking to invest “safely” – have shunned stocks.

The bond market has enjoyed a 30-year bull market. Despite positive stock returns over the last four years, net mutual fund flows have moved from stocks into bonds nearly every month, and investors have been using low-yielding bond funds as a substitute for no-yielding cash reserves. When the Federal Reserve eventually signals an unwinding of its \$85 billion per month bond-buying campaign, or if the economy proves stronger than expected, the repercussions for interest rates will be severe. Bondholders will learn that they are not protected from losses in a period of rising rates. Equities, particularly ones that pay growing dividends, are a natural beneficiary when these money flows inevitably reverse.

Meanwhile, the average hedge fund has trailed the stock market in each of the last four years. Certainly there are some managers who can consistently add value, net of their high fees, through clever arbitrage or short-term trading tactics. But we are confident that, as it has been throughout most of investment history, owning shares of profitable businesses for the long term will create real wealth that eclipses the returns of hedged products and other investment alternatives. Like bonds, hedge funds have been on the receiving end of asset flows, despite low returns. Many large pension funds and endowments have allocated 50% or more to alternative classes such as hedge funds, while leaving 30% or less in public equities. We are beginning to hear discussion of “great rotation” out of bonds and alternatives and into attractively-valued equities. The evidence is scant so far, but it is possible we are at the infancy of a promising and lucrative trend for stocks.

While 2013 should see an economic assist from pent-up demand for capital expenditures (on the household and municipal side as post-Sandy rebuilding begins and on the corporate side as investments postponed by the fiscal cliff proceed), we are more excited about larger developments that could dramatically fuel capital investment and propel the overall economy in the years ahead. We continue to closely follow the revolutionary advances in domestic energy production and the related resurgence in domestic manufacturing. In real estate, as the glut of properties is gradually worked off, home prices and construction activity are increasing. We recently spoke with a prominent real estate firm which is investing in foreclosed single-family properties to be converted for rental and eventually sold. More broadly, while much has been made of the slow, uneven recovery since the economy bottomed four years ago, a rapid return to growth would not have forced the reduction in financial leverage and a *return to fundamentals* that we may be experiencing. While efforts to decrease debt and financial engineering are evident across the government, private, and financial sectors, perhaps the most powerful example is household debt, where mortgage and credit card debt service, as a percent of disposable income, declined to near record lows in 2012.



- Federal Reserve Economic Data

We see the glass half full, encouraged by both the current mending process and glimmers of growth that may set the stage for the next great period of secular expansion. A more constructive long-term view is far from consensus. The “New Normal” orthodoxy of endless stagnancy and high unemployment is now broadly accepted. Just as 2012’s decent returns occurred as the year’s challenges were overcome, the possibility of a new era of growth surmounting the conventional wisdom of weakness could surprise skeptics and will, at some point, lead to a long period of superior stock returns.