

SAYBROOK CAPITAL

INVESTMENT OUTLOOK

Year-End 2013

We will remember 2013 as a year when everything worked. It was one of Saybrook Capital's best years with our equity-only institutional composite returning 36%. Our investors benefited from the year's two largest corporate acquisitions: Heinz and Vodafone. Our largest overall holding, Google, climbed 59% during the year. Our companies executed exceptionally well, reflected by our stocks generally outperforming the broad indices. And finally, we made some promising new purchases at the end of the fourth quarter. In this year-end Outlook, we examine some of Saybrook's core holdings and how our 2013 returns are a result of our long-term investment strategy and steadfast concentration on key themes that we expect to continue through this cycle and beyond. And in our market outlook section, we take note of some concerns as we enter 2014.

Our Strategy is Working

Overall, it was an outstanding year for our favorite asset class, U.S. stocks, which outperformed nearly all other investments (in notable contrast to gold prices and emerging market stocks, which *fell* 28% and 5%, respectively). Given our constructive view on the U.S. economy in general and our companies in particular, we have been willing to be heavily invested in stocks. In fact, 2013 saw us as fully invested in equities as ever, within the parameters of each client's mandate or target asset allocation. While strong returns in 2013 are, of course, gratifying and directly beneficial to our clients, annual performance is a short-term metric. More meaningful for us is the confirmation of our long-term investment philosophy. After years of hard work and careful portfolio positioning, Saybrook's results objectively confirm that our clients are well-served by a strategy that is working. This includes our overall positive exposure to equities and our concentration on the industries and companies that are thriving in this environment.

For five years, since early in the recovery following the 2007-09 credit crisis, we have been positive on U.S. stocks, calling the asset class "the best house in a bad neighborhood." This was best summed up in our Outlook one year ago when we cited the healthy reduction in debt and leverage in the slowly recovering U.S. economy, contrasted with the imbalances building up in many developing market countries. Characterizing the glass as "half-full" we highlighted the attractiveness of *owning* great businesses as opposed to bonds and alternative asset classes, especially when shares could be acquired in a period of skepticism about the stock market. Over the last five years we have steadily increased our allocation to stocks, with our "hedge" being the high quality and durability of the companies we own. In hindsight, this high-quality discipline has helped us stay the course and remain invested during several market corrections (including the nearly 20% sell-off in the summer of 2011). Bonds have been de-emphasized in our balanced accounts, and, while not fully liquidated, we have been hesitant

to reinvest maturing issues. In a year where U.S. stock indices bested all international counterparts except Japan – posting the highest annual returns since 1997 – and where bonds lost money in a rising interest rate environment – the 10-year U.S. Treasury climbed from 1.75% to 3.01% – our current bias towards U.S. stocks paid off handsomely.

On an individual stock basis, we have been positioning the portfolio to benefit from several emerging trends. First is our focus on the *U.S. as an attractive manufacturing economy*, especially when compared to more stagnant European and stumbling emerging markets. We are struck by recent forecasts that expect the U.S. economy and corporate earnings to grow faster than those of the world's developing regions in 2014 – for the first time since the late 1990s. Driven in part by the shale energy boom and technological innovation, this positive trend for U.S. industry should continue. Norfolk Southern, a core Saybrook holding, is a good example of a direct play on this development. This 170-year-old railroad is growing with exposure to burgeoning industries, such as hauling crude oil and sand for hydraulic-fracturing, as well as resurgent areas like the U.S. automotive sector. Additionally, the company is gaining share from its less efficient trucking competitors. With large fixed costs combined with notable productivity improvements, the railroad is a classic beneficiary of positive operating leverage – in the just-completed fourth quarter Norfolk Southern grew revenues 7% with costs only up 2%, leading to a 25% increase in earnings per share. Such results generated a 54% total return for the stock in 2013.

Closely related to this industrial renaissance is the emergence of the *U.S. as a dominant domestic energy producer*, which is lowering commodity costs and making North America an attractive location for manufacturing. Schlumberger, our long-held oil services leader, is the foremost expert on seismic testing, drill-bit equipment, and unconventional extraction. In a field where advanced technology increasingly matters more, Schlumberger out-invests its competitors while generating industry-leading free-cash-flow. Schlumberger's stock returned 32% in 2013. Companies that own the underlying commodities also rose, but more modestly, as the energy glut has reduced the underlying value of their proven reserves. We remain particularly bullish on natural gas as a versatile fuel and are optimistic on pure-play Southwestern Energy and the now-largest U.S. gas producer, ExxonMobil. Incidentally, we are pleased to see our gas focus affirmed by Berkshire Hathaway's recent announcement of the purchase of \$4 billion in Exxon's shares.

Mobile technology has been another area of concentration since our purchase of Google in late 2008 in the midst of the financial crisis. While widely admired for its dominant and still fast-growing search and advertising platform, the stock had lagged in 2012 due to concerns about the internet's ongoing transition from a PC world to one of mobile alternatives. Nevertheless, we have been confident in Google's credible management team and

their vision that the evolution towards phones, tablets, and other mobile devices poses an exceptional opportunity. In 2013 the company surpassed investors' expectations by successfully targeting mobile advertisers, and the stock appreciated 59% for the year. Furthermore, the company has constructively addressed most of the anti-trust concerns in the U.S. and Europe, avoiding the regulatory battles that haunted Microsoft for years. Now in 2014 the company has offered \$3 billion out of its \$57 billion war chest to acquire Nest Labs, the maker of sophisticated web-connected thermostats and security alarms, which Google's own venture arm helped seed several years ago. Nest's founder, Tony Fadell, will bring to Google his design savvy (in his earlier career at Apple he was the original designer of the iPod). Google's entry into the vast home automation market and its other forays into the broader "internet of things" – e.g., wearable devices (Google Glass) and self-driving cars – demonstrate a desire not to rest on its search-engine laurels.

Our *dividend growth strategy* results from our focus on high-quality companies with pricing power during the 2007-09 credit crisis. Rather than looking for the highest dividend payers, often an indication of declining growth and/or a depressed stock price, we have sought companies with a steady record of *increasing* dividends annually – a sign of commitment to shareholders, balance sheet strength, and confidence in future growth of earnings. We held on to these steady businesses during the lean years, confident that clients would collect a growing stream of income and eventually be rewarded with significant stock appreciation. For example, Automatic Data Processing (ADP), one of the four remaining AAA-rated companies in America, has raised its dividend for 39 consecutive years, increasing its quarterly payout nearly 50% since our purchase in 2009. A provider of payroll processing to companies, ADP's profits accelerate when there are more paychecks issued and when interest rates rise (like an insurance company, the company holds a "float" of billions of dollars of payroll at any given time). A gradually improving employment picture and signs of higher interest rates helped ADP return 45% in 2013.

We have targeted the *growth of the global middle class* by investing in a basket of global consumer products companies. Notwithstanding recent slowdowns in emerging markets, we are confident in the emergence of hundreds of millions of new consumers in the decades ahead. Heinz, with its flagship ketchup brand, was part of our stable of food and beverage businesses. Expanding with clever acquisitions of a salsa brand in Brazil and a soy sauce company in China, Heinz is a classic example of a U.S. company with growing business in emerging markets. Alas, Heinz was purchased in 2013 by Berkshire Hathaway and a Brazilian private equity firm, 3G Capital (at a generous 82% premium from our average purchase price). We continue to believe that owning dominant multinational brands is a proven way to capture growth from developing regions with less risk, and Saybrook maintains positions in select companies with Heinz's potential.

The year was capped off with a second big deal when Verizon announced that it would buy Vodafone's share of Verizon Wireless for \$130 billion. As we have noted previously, after watching the company for years, we bought Vodafone in March betting that the time was right for the sale of its U.S. wireless business. While we expect the deal to close this winter, it generated a total return for Saybrook's Vodafone shareholders of 59% from purchase in March to year-end. *Heinz and Vodafone were the two largest acquisitions of 2013*, and they signify a reemergence of long-dormant optimism in corporate boardrooms. Another aspect in common is that these deals both represent significant premiums being paid for important U.S. assets – more evidence that others see great value in the American economy.

Saybrook's portfolio is always a work in progress, and although we had little to sell in 2013 with companies operating well, we did find room at the end of the year to add two new holdings. Visa International and eBay are familiar to most for their iconic credit cards and dominant web auction platform, respectively. But what attracted us to both companies is their leadership in the rapidly expanding electronic transactions business in an era when consumers are abandoning cash and checks in favor of plastic (credit, debit, and pre-paid), online payments, and transactions with devices such as mobile phones. Both companies operate payment networks; as opposed to banks, they do not make loans or extend credit, instead they merely collect small commissions on billions of transactions worldwide. Visa has made great inroads with its debit and pre-paid cards and overseas acceptance. eBay's PayPal has grown far beyond its auction roots to become a broad leader in web-based payments, and, with revenues growing 19% last year, PayPal is on pace to become the company's largest division. We are excited to be surrounding the burgeoning cashless marketplace with these new investments.

Market Outlook

As value-oriented investors, too much optimism, or at least complacency, about the stock market always concerns us. One reflection of optimism is the price investors are willing to pay per unit of earnings, and, for the first time since the 1990s, such increasing valuation multiples have been a primary driver of the stock market's advance. Rising valuations usually accompany multi-year bull markets, and the U.S. stock market's explosive growth in 2013 does follow a 12-year period of essentially flat returns for the S&P 500. Furthermore, in addition to the themes discussed in the paragraphs above, there are several other structural developments that are propelling the stock market, including steadily low inflation, a surprising decline in the federal deficit, and a promising new team at the top of the Federal Reserve in Janet Yellen and Stanley Fischer.

However, we do have more modest expectations for 2014. Without question, the end-of-the-year stock market surge borrowed some fire-power from 2014, and a correction of 10% or worse would not be surprising after an

uninterrupted two-year rise. While leading indicators hint at U.S. GDP growth climbing toward 3%, to date the recovery has been lackluster, and a continuation of sub-par 2% growth would certainly disappoint investors. A setback could also come from an interest rate spike as in 1987, although the Fed's gradual taper has been well-received thus far. The other risk is the continued deceleration of emerging markets broadly and China specifically. So far this weakness has benefitted western developed economies, with slowing Chinese demand moderating commodity inflation. But a hard-landing in China could reverberate around the region (the Shanghai stock market fell 7% in 2013 and, after further declines this January, is now down 40% from its 2009 high). When amplified by rising interest rates in many parts of the world, we could experience a scenario like the crises that gripped Asia in 1997-98. As we write this Outlook, global financial markets have weakened as capital flees once high-flying emerging economies.

As always we remain vigilant, while also secure in our strategy's continued ability to outperform over the long term. We rely on our own bottom-up analysis of each of our portfolio companies, and, on average, they have grown earnings at a faster rate than the broad market. That said, some of our stocks have approached a near-term level of fair value and are perhaps due for a rest after last year's surge. Other companies in our portfolio remain notably undervalued, and we are buying them for new clients. Most importantly, we remain encouraged by the long-run prospects of all of the companies in the portfolio.