SAYBROOK CAPITAL

INVESTMENT OUTLOOK

Second Quarter 2014

Saybrook Capital's stock portfolio completed the first half of 2014 up 9%. Stocks in general benefited in the second quarter from a surge in corporate deal-making, most notably for Saybrook a premium bid for core holding, Allergan. Returns also reflect the expectation of better economic growth in the second half, after a shockingly weak U.S. gross domestic product (GDP) report accompanied by unexpectedly low Treasury yields. While mindful that a 10% or more correction and higher volatility should be anticipated, we remain positive on the long-term prospects for our portfolio companies.

Growth in global merger activity is the top financial story of 2014. ISI Group, an independent economic research firm, cites 322 deal announcements since February with an aggregate value of $2.2 trillion. Companies are paying up for growth in an era of slow organic revenue expansion, with the trend facilitated by low interest rates (for buyers deploying debt) and high share prices and healthy balance sheets (for acquirers using stock and cash). Buyouts continue to positively impact Saybrook's portfolio; following our recent Vodafone and Heinz windfalls, Allergan has become the subject of a hostile takeover by rival pharmaceutical company, Valeant. We initially invested in Allergan two years ago, impressed by the outsized growth of its Botox product for both aesthetic and therapeutic uses, as well as the dominance of its eye-care business. After a short-term FDA set-back in 2013, we used the subsequent share price drop to increase our holdings, making Allergan one of Saybrook's largest positions.

Valeant's partner in this deal is activist investor, William Ackman, whose firm accumulated 10% of Allergan's shares in recent months. Our experience with activist investors, most notably Carl Icahn's recent investment in Apple, is that despite the aggravation their "active" involvement can cause in the board room, in one way or another they ultimately do serve as a catalyst for increased shareholder value. Indeed, this proposal has already helped shares to nearly double from our average purchase price. However, we agree with Allergan management that the offering is below the company's true value, considering Allergan has significantly increased its multi-year growth guidance to an annualized rate of +20% or more. Moreover, Valeant's model of slashing R&D spending is inconsistent with the long-term strategy that has made Allergan a pioneer in the pharmaceutical industry. We appreciate the heightened investor attention to this superb healthcare franchise, but we would prefer an alternative merger that better leverages Allergan's R&D prowess, or, at the very least, a further sweetened deal by Valeant.

A further complication is that the proposed merger would move Allergan's domicile from California, where it paid an effective tax rate of 26% in 2013, to Canada, where Valeant is headquartered. A combined entity would likely be taxed near Valeant's recent rate of around 4%, since Canada's generous tax laws not only provides lower rates but also permits profits to be booked "territorially" through the relocation of intellectual property to domiciles such as Ireland and Bermuda. This is one of many recent

merger bids impacted by America's ineffective corporate tax regime. Others just within the healthcare space include Pfizer's failed deal with Britain's Astra-Zeneca, Medtronic's recent announcement with Ireland's Covidien, and Saybrook's holding, Perrigo, which reincorporated in Ireland after purchasing Elan Pharmaceuticals last year. As this tax arbitrage trend can significantly enhance profits, it will continue to be utilized by increasingly larger companies. However, it is disheartening to see the unintended consequences of U.S. tax policy driving businesses and jobs offshore, highlighting the vital need for corporate tax reform.

The first half of 2014 has also been notable in confounding the experts on economic growth and interest rates. Following a winter of extreme weather, first quarter GDP has been revised to an astonishingly weak -2.9% economic contraction. Some of this shortfall will be made up in the following quarters, but the post-crisis expansion clearly remains vulnerable to extraneous shocks. While concerning, the winter contraction is inconsistent with the more granular data we see both in the overall economy and from our companies. High frequency reports measuring jobs, manufacturing, and bank loans all demonstrate modest growth in early 2014 and *acceleration* in recent months. Recently, the June payroll report represented a new high for U.S. employment, finally surpassing the pre-recession levels of 2008. Most of our portfolio companies report solid earnings growth, and some have increased their 2014 guidance. Importantly, our companies have raised their dividend payments an average of 13% over the past year. An old Wall Street adage is that "earnings are opinion, dividends are fact" – quarterly cash payments to investors provide a unique view into managements' confidence and the health of underlying businesses.

Another truism is that markets strive to prove the consensus wrong. The popular view going into 2014 was for interest rates to increase as the economy returns to a more normalized rate of growth. Interest rates, as measured by 10-year U.S. Treasuries, have instead *fallen* from 3.0% to 2.5% over the first half of 2014, despite the ongoing efforts of the Federal Reserve to reverse its unprecedented level of monetary stimulus. This decline reflects a combination of the aforementioned GDP disappointment, weaker overseas economies, increased stimulus from the European Central Bank, and a shrinking federal deficit which has reduced supply of new bonds coming to market. While we have been early in our forecast, we still expect a 3-4% interest rate environment in the next 12-24 months, with the possibility of an inflation-fueled scare on the upside.

The near-term investment environment will continue to be impacted by heightened merger activity, which has raised stock prices and spooked short-sellers. A few other core Saybrook stocks could be prime takeover candidates as corporate and financial buyers begin to recognize the same growth and valuation attributes that have attracted us as investors. The ongoing strength and duration of the current bull market do concern us – two years have passed since we last experienced a broad stock market correction, defined as a fall of 10% or more – and complacency is a risk. Disappointment could come from a spike in interest rates or inflation. Alternatively, economic growth could continue to frustrate on the downside. Longer-term we remain optimistic, particularly given positive secular trends (See our April Outlook "America's Manufacturing Transformation") and the superior positioning of our portfolio companies.