

# SAYBROOK CAPITAL

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## INVESTMENT COUNSEL AND MANAGEMENT

September 19, 2008

Dear Client:

Given the unprecedented events impacting several important financial institutions over the past two weeks, we want to update you on what has occurred (Part I) and, more directly relevant to you, reiterate Saybrook's defensive portfolio position (Part II).

### **I. Recent Events**

#### *Nationalization of the GSEs and the U.S. Housing Market:*

Over the weekend of September 6-7, Treasury Secretary Henry Paulson announced the federal rescue of Fannie Mae and Freddie Mac, the two government-sponsored housing enterprises (GSEs). The GSEs have been put into 'conservatorship,' and regulators have replaced the company boards and CEOs. At taxpayer expense, the government has protected the bondholders, but the common stockholders have been wiped out. The rescue plan prevented a meltdown in the mortgage market, as the GSEs have been securitizing about 80% of U.S. mortgages this year. The plan envisions a reduction in GSE activity beginning in 2010 (we hope the current form of nationalization will be temporary and that a long-term plan will shrink or break up the GSEs in order to better protect taxpayers and instill market-based competition for mortgages).

Importantly, the Treasury's actions have enabled the GSEs to continue financing mortgages and have lowered funding costs and, therefore, mortgage rates. In fact, 30-year fixed mortgage rates have fallen below 6% for the first time since April. While this is by no means a cure-all for the housing market, it coincides with some early signs of stability. For example, the widely followed S&P/Case-Shiller Index of U.S. housing prices recently showed that 9 of the 20 major metropolitan areas have shown modestly improving prices. A related study also notes that the ratio of incomes and home prices has neared a level consistent with the end of past housing slumps.

#### *The Demise of Lehman, Merrill, and AIG and the Question of 'Moral Hazard':*

On Monday, September 15, following another weekend of intense meetings among federal and banking officials, Lehman Brothers filed for bankruptcy and began the process of liquidating assets. Over the same weekend, Bank of America announced the purchase of Merrill Lynch, the nation's biggest brokerage firm. This all-stock deal would allow Merrill to avoid Lehman's fate, which had appeared increasingly likely.

On Tuesday, September 16, the Federal Reserve announced a two-year \$85 billion loan to American International Group (AIG), the giant diversified insurance company. While short of another conservatorship, the deal is secured by all of AIG's assets, the federal government obtains up to 80% ownership, and the CEO has been replaced. When attempts at private-sector funding failed, the Fed determined that AIG's collapse would be "catastrophic." As a major global insurer against corporate debt and mortgage defaults, AIG's disorderly

liquidation would cause an international financial panic. With the stock trading at about \$2 per share, AIG shareholders have suffered a 97% decline this year. While AIG was once a core holding, we sold all of our positions in 2005 at \$65 to \$70 per share.

It is unfortunate to witness the demise of these three storied financial institutions as independent entities. However, the reduction of ‘moral hazard’ – and the restoration of market-based consequences of failure from excessive risk-taking – is crucial to the long-term health of our overall market system. The fact that the government did not ‘bail-out’ the managements or shareholders of these firms has set a very important precedent for future economic behavior.

#### *Government Action – The Next Steps:*

On Thursday evening, September 18, the Treasury Secretary, along with congressional leaders, announced a comprehensive approach to the financial crisis, including: a temporary ban on short-selling of financial stocks; the creation of federal insurance for money-market investors; and, most significantly, the creation of an entity to *proactively* purchase distressed bank assets and liquidate them in an orderly manner when markets stabilize. There is precedent for this action in the successful deployment of the Resolution Trust Corporation during the savings-and-loan crisis nearly twenty years ago. With other troubled commercial and investment banks scrambling for support, we hope the newly emerging government plans are enacted swiftly, but also carefully, as we remain mindful of possible unintended consequences.

#### *Commodities and Inflation:*

While we remain quite concerned about fundamental weakness in the global economy, some positive developments have also emerged since we last wrote to you in July. Commodity prices, including food, energy, metals, and materials, have corrected significantly from recent speculative levels, exemplified by the much-heralded 40% decline in the price of crude oil. This, of course, is partially a reflection of global economic weakness. The dollar has also reversed its decline and strengthened over 10% from its lows. Recent trends in commodities and currencies, in addition to strong worker productivity, are easing concerns on U.S. inflation. In fact, statistics released in mid-September revealed the first month-to-month drop in consumer prices in over two years. Inflation has been one of the core economic challenges we have highlighted, and, while we are certainly not ready to declare victory yet, we are cautiously optimistic that continuing economic weakness will not be accompanied by 1970s-style stagflation.

## **II. Saybrook Capital’s Defensive Position**

The demise of legendary investment houses has been accompanied by the permanent loss of capital, specifically the wealth formerly in the hands of their shareholders and employees. On the other hand, by law, stock and bond investments held “in custody” at firms like Lehman Brothers are safely segregated in the names of the investors. Nevertheless, times like these make us at Saybrook feel fortunate to be operating as an independent advisory firm and not subject to the massive disruptions being felt by our larger peers. Managing portfolios in such a climate is challenging enough without distractions on the corporate level.

The historic credit crisis that will alter forever once-powerful financial institutions will also permanently change ‘Wall Street’ as we now know it. But it is worth reminding our clients that Saybrook Capital invests primarily in ‘Main Street’ - our investment strategy focuses on businesses that manufacture products and provide valuable services to their customers. While we, of course, utilize financial institutions to custody assets and execute transactions, we do not own shares in any of the aforementioned companies. During these tumultuous months our

companies continued to conduct and grow their respective businesses, rather than worrying about their day-to-day survival. In fact, our search for undervalued growth in recent years has increasingly led us to more defensive industries, such as medical devices, food and beverages, infrastructure, and consumer services, which are less exposed to the volatility of economic cycles and financial turmoil.

In addition to our low exposure to the financial sector and our concentration in more defensive shares, we have lowered our overall percent in equities, beginning in late 2007 and as recently as this August. Concurrently, we have felt this year marks a practical time to realize gains on investments since we expect capital gains taxes to rise, possibly as soon as 2009. Our accounts entered September at equity levels that are particularly low relative to our long-term equity orientation.

Finally, at risk of stating the obvious, diversification is imperative in this environment. The financial press never hesitates to portray the personal side of a financial crisis, with stories of massive losses of wealth for current and retired employees of failed institutions. Diversification is one of the guiding principles of prudent investment management. At Saybrook we strive to limit our clients' exposure to any one company or industry regardless of our high opinions of their particular products or management team. Minimizing losses, whether stemming from company-specific actions or sector-wide deterioration, limits the risk of permanent impairment of capital.

Saybrook Capital invests in individual companies and not 'the market,' therefore our portfolio holdings are reacting in different ways to this credit crisis. Some investments, such as Procter & Gamble, have benefited as investors seek safety in defensive stocks; other shares, such as General Electric, have been punished (we believe disproportionately) under the perception that certain divisions are overexposed to financial fallout. However, most of our stocks have performed somewhat independently in the current quarter, rising and falling based on factors that are important to their particular industry. As a whole, our typical portfolio shows relatively small losses versus the S&P 500 at this point in the third quarter. Furthermore, because fundamental valuation is central to our investment philosophy, we recognize that periods of panic create opportunities for those with ample cash reserves.

Events are evolving rapidly on Wall Street and in Washington. While the environment remains fluid, the markets have reversed some of their declines for the week. We hope you have found it helpful to read this commentary two weeks before our normal quarterly update.

Sincerely,



Luke M. Babcock



Bruce M. Babcock



Scott R. Hirsch