

SAYBROOK CAPITAL INVESTMENT UPDATE

June 30, 2011

Over the last six months the S&P 500 has fluctuated in a narrow range between about 1,250 and 1,350. Another soft patch for the U.S. economy caused the index to give up all its early year gains, before rebounding sharply in the last week of June and ending the second quarter up 6%.

The recent economic slowdown is partly attributed to a series of natural disasters, most notably the earthquake and tsunami in Japan and tornados and floods in the U.S, along with the oil-price spike following the Arab Spring upheavals. While these shocks have been largely absorbed thus far, and oil prices have begun to come down, consumer demand remains lackluster amid weak private sector job creation. In Europe the Greek debt crisis continues to pose systemic risks. Euro-zone members and the IMF hope to buy time by extending short-term bailout funds tied to Greece's recently announced austerity measures, but the plan looks doomed to fail without a more fundamental approach to the outstanding debt. At issue, ultimately, is the ability of European banks to withstand the inevitable "restructuring" (read default) of some portion of Greece's sovereign debt and the possibility of contagion spreading beyond Europe's periphery to larger countries such as Spain and Italy.

Meanwhile in Washington, efforts are underway to avert a U.S. debt crisis. In conjunction with the mid-summer deadline for a Congressional vote to raise the national debt ceiling, political leaders from both parties are attempting to negotiate a deficit-reduction deal. While it may not occur before the 2012 election, we still believe a grand bargain will be struck that is reminiscent of the bold recommendations of the bipartisan Simpson-Bowles commission, reducing the deficit by between \$2 and \$4 trillion over 10 years. Notwithstanding the current political gamesmanship over the inevitable raising of the debt ceiling, the biggest news is that entitlement spending, tax loopholes, and other such sacred cows are on the table for the first time in more than a generation. The essential - yet painful - process of reducing government debt is finally beginning and will continue to gain momentum throughout this decade.

The high levels of debt, by governments and individuals throughout the developed world, are weighing on the global economy in this post-financial

crisis era. In fact, history suggests that economic recoveries in output and employment tend to be subpar and erratic following a period of major financial stress. Because the process of unwinding debt takes a long time, the repercussions are likely to continue to play out for years to come. Consumers are still burdened by near-record levels of mortgage and credit-card debt, and the availability of credit – which normally provides an economic cushion – has been severely curtailed since 2007. As the Federal Reserve ends its latest round of monetary stimulus, dubbed “QE2”, they are certainly pondering this dilemma as they try to determine if further stimulus is needed or if the expansion is self-sustaining.

While we expect the economic recovery to continue, the overall slow rate of GDP growth and job creation, along with the moribund housing sector, will continue to disappoint those accustomed to the faster (“V-shaped”) rebounds of recent decades. Furthermore, a higher vulnerability to future external shocks amidst a slow recovery certainly raise the risk that the U.S. could fall back into recession.

Given the economic challenges we face in this era, our investment strategy remains focused on owning high-quality companies. While governments and consumers suffer through a long period of deleveraging, multinational corporations with stronger balance sheets are a rare, bright area in the current economic landscape. Many of these companies, including those in the portfolio, benefit from superior cost management, surplus cash flow, and exposure to emerging markets. As we have seen over the last two years, these businesses can still profit handsomely, even in a slow growth environment.

Mindful that our investment letters in recent years have been quite long and that you may enjoy a respite from business reading in the summer, we have incorporated our somewhat more succinct thoughts into this letter, rather than a separate Investment Outlook. However, we must forewarn you that we are currently working on a longer “thought-piece” which seeks to distill many of our recent writings on this unusual era and how we are addressing current challenges through our investment strategy. We look forward to spending some of the remaining summer weeks reflecting on these broader issues, synthesizing our thoughts and ideas about the Saybrook portfolio, and sharing them with you in the fall.