# SAYBROOK CAPITAL
# INVESTMENT OUTLOOK

January 31, 2008

In our September investment letter, amid near record levels for the broad stock indices, we underscored our growing concern with specific areas of the economy and how they might jeopardize the five-year run of strong US and global financial markets, citing *"the higher probability of a US recession stemming from a weaker than expected housing market and increased corporate risk-aversion."* We highlighted specific concerns, including declining real estate values, rising mortgage defaults, disruptions in corporate credit markets, and the unintended consequences of collateralizing risk. In this letter we discuss where we are now, the challenges we face, and, most importantly, the steps we are taking to mitigate risk for our investors in this environment.

## Economic and Market Perspective

Over the past four months, we have seen continued declines in housing markets across the nation along with rising home-loan defaults. While these negative trends may have set the stage, the current 'credit crisis' has been exacerbated by aggressive leverage and hubristic financial engineering, as investment banks and other financial institutions used untested derivatives with underestimated levels of risk. In the most egregious example, pools of risky 'sub prime' mortgages were combined to form derivatives called CDOs (Collateralized Debt Obligations), which were heralded as a way to spread risk among different investors. The values of these new securities were based on the boom-cycle notion that housing prices would never meaningfully fall. However, real estate declines and rising delinquencies led rating-agencies to downgrade the instruments, which in turn caused huge price declines, as investors scrambled to sell the unwanted paper. In fact, the same US and global investment banks that structured these types of derivatives turned out to be the biggest losers, suffering over *two-hundred billion dollars* in write-offs to-date. These massive losses have led to severe stock declines, dividend cuts, and need for capital infusions from 'Sovereign Wealth Funds' controlled by foreign governments. A collapse of confidence in the financial services sector carries large significance due to its scale (in terms of profits and market capitalization) and its integral role to non-financial businesses in our market-driven economy. Because of these dislocations in the financial sector and the broader economic implications, the Federal Reserve has been forced since September to aggressively cut its target Fed Funds Rate from 5.25% to 3.00%.

In addition to the Federal Reserve's strong actions, Congress has recently proposed a 'stimulus package' equal to upwards of 1% of GDP (Gross Domestic Product). The Federal Reserve and the

US Government seem determined to inject enough liquidity to keep the economy moving forward. Additionally, several positives could lessen or shorten the current economic slowdown: lean inventories, expanding exports, and moderate wage inflation. These are three trends not normally seen at the beginning of a downturn. Also significant, just as leveraged buyouts have all but disappeared after dominating headlines a year ago, Sovereign Wealth Funds have emerged as the massive, trillion-dollar buyer of debt and equity, both healthy and broken. When the Abu Dhabi Investment Authority wagers $7.5 billion on the future of Citigroup, the biggest issue is not their timing or their terms, but rather the existence of these funds on the world's stage and their willingness to serve as buyer of last resort.

Several challenges remain ahead:

1. Will the credit crunch continue to spread?

Companies outside of housing, finance, and retail have continued to enjoy strong growth (especially from overseas sales), high margins, and continued access to the credit markets. There are few signs of malaise among blue chip non-financial companies, but we are watching closely for signs of reduced liquidity or self-imposed risk aversion. Although the 2007 rate of high-yield debt defaults was a decades-low 0.51%, problems will undoubtedly arise in this area as an increasing number of lower-quality businesses become insolvent. 'Contagion' is the term used for a spreading financial crisis; its impact can appear in unlikely places. Recent headlines, for instance, are dominated by developments in the bond insurance business. Companies that had previously insured only municipal bonds expanded their businesses in recent years by guaranteeing now-troubled structured debt entities (e.g. CDOs). Municipalities that hold AAA-ratings based only on the underlying credit-ratings of their insurers, face disruptions in their access to credit and declines in their bonds as these insurers face downgrades and even insolvency.

2. What happens when banks tighten credit?

After losing billions from bad loans, large banks are belatedly lowering their risk exposures. The consequences are reaching beyond home mortgages to impact auto and credit card debt for credit-worthy individuals and commercial and industrial loans for businesses. While this phenomenon is well-understood and accompanies all economic slowdowns, the severity of this credit crisis could cause a greater than usual pullback in loans. This could more than offset any monetary or fiscal response, and render the central bank and federal government powerless to avert a more severe recession.

3. Will Inflation Moderate or Accelerate?

This economic slowdown is complicated by the accompaniment of stubbornly elevated inflation readings. Are we experiencing merely the lagging effects of inflation left over from

recent global economic growth, or is this the type of 'stagflation' that decimated financial markets during the 1970s? While inflation is generally a 'lagging indicator,' and more timely measures like inflation-adjusted treasury bonds and employment costs show few signs of a detrimental wage-price spiral, a weak dollar and soaring commodity prices are serious concerns. Inflation has been a worry over the last three years, particularly as oil prices tripled, reaching $100 per barrel in December, and food prices soared. The problem is more acute today, as it may limit the ability of US and international central banks to stimulate growth with further rate reductions due to fear of accelerating inflation.

4. Is the long-predicated consumer retrenchment imminent?

US consumers have persisted through recent years on the strength of three powerful forces: appreciating real estate values, easy access to credit, and income from strong job creation. Clearly the first two 'legs' have fallen off, and consumer-spending is balancing on the heretofore resiliency of US employment. Poor holiday sales and January's employment data (the weakest job report since 2003) are troubling indicators.

Obviously, these four broad questions are impossible to answer with any certainty, as is the question of whether the current slowdown will technically be defined as a recession. Conventional wisdom defines a recession as two consecutive quarters of negative gross domestic output. In fact, the National Bureau of Economic Research, which has the dubious distinction of officially designating recessions, states that *"a recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales."* In other words, the downturn must be broad and sustained in order to earn the 'recession' title.

What we do know for certain is that we are in a midst of an economic slowdown (preliminary fourth quarter GDP figures, released in January, show the economy growing at just a 0.6% annualized rate). The relevant question going forward remains the severity and duration of the downturn. The broad stock market is now anticipating the likelihood of a continued economic slowdown, as reflected by the S&P 500's recent 20% declines (from October highs to intra-day lows on January 22nd). A study of the last nine US recessions going back to 1953 finds a wide range of stock market declines, with the average loss of -26%. *Interestingly, much of the market losses come before the recession actually begins, and usually a powerful rally precedes or accompanies the economy's post-recession resurgence.*

## Saybrook Capital's Actions

In Saybrook Capital's 31 years we have persevered through five actual recessions and many other difficult periods. In fact, our proudest moments have been our ability to preserve our clients' principal during those volatile times. So what are we doing this time?

First, in most accounts, we increased cash and decreased equities. As long-term investors we avoid trading on near-term market speculation. However, our companies do not exist in a vacuum, and we are proactive when we observe economic trends that could negatively impact the fundamentals of our investments. Fortunately, our cautious outlook and valuation discipline helped us to sell certain stocks and lower our equity exposure in the second half of 2007. In some cases, such as UPS, the companies' underlying businesses appeared particularly vulnerable in the event of a severe domestic slowdown. We also trimmed a few positions in sectors such as retail, energy, and capital goods because the prices and valuations had moved above what we believe the companies' underlying fundamentals merit.

Second, we continue to evaluate our investments one stock at a time. UnitedHealth Group, which we sold on the first day of this year, is a good example. After analyzing the company for many months, we purchased the stock in the fall of 2006 in the wake of the much-publicized options scandal and management change. The stock was significantly undervalued, while the company's growth potential (we thought) remained intact. In early December 2007, after attending a meeting with the company's senior management, we became increasingly concerned with several distinct fundamental issues. These included: deteriorating customer service, overly aggressive balance sheet management, increased commercial price competition, and growing political risk (particularly for their important Medicare Advantage business). In short, while the sentiment on the stock improved substantially over our holding period, we had become much less confident in the company's long-term growth. We were happy to sell the stock for a gain of more than 20% (the stock has fallen nearly 15% since our sale).

Third, amidst the market turmoil, we continue to find excellent long-term investments. Some of the proceeds from our 2007 sales were added to more defensive positions, such as Nestle and Berkshire Hathaway. While we begin 2008 with continued caution, we are mindful that there are always great businesses that we would love to own *at the right price*. During the recent sharp market drop we did make some purchases, taking advantage of a chance to own high-quality companies at deep discounts to what we think they are worth. Their stock prices could, of course, fall further, but we believe they will be successful over the long-term. In short, our increased cash positions in 2007 have not only helped preserve principal through near-term volatility, but also provide an opportunity to invest capital in increasingly attractive areas. We look forward to discussing these new holdings in future investment letters.

Furthermore, our recently expanded partnership, announced a year ago, has served our clients well during this challenging period. We have benefited from broader company coverage, deeper industry knowledge, and additional years of investment experience. When buying opportunities arise, as they have recently, we are able to use these attributes to carefully add new positions to the portfolio.