SAYBROOK CAPITAL

INVESTMENT OUTLOOK

March 31, 2008

"In times like these, it is important to remember that there have always been times like these."

As discussed in our recent letters, we are in the midst of both a serious credit crisis and a broad economic slowdown. In such times pessimism abounds. Pundits have alternatively compared the current period to the era of stagflation in the 1970s and Japan's 'lost decade' in the 1990s. "The worst financial crisis ever" is a term heard frequently on Wall Street in recent months. But a thoughtful and respected investor recently put events in perspective for us with his insightful quotation stated above.

This instructive viewpoint reminds us that our country has been in difficult financial periods before, and we have also come through them and moved ahead. While the circumstances of each financial crisis are unique, there are certain underlying patterns common to all. These include speculative excess, which lead to severe corrections. Then come calls for regulatory reform, and finally renewed investing in re-priced assets. This difficult cycle is upon us, and it will take time to work through. But for prudent long-term investors, these challenging periods also offer attractive opportunities.

We outlined four fundamental economic challenges in last quarter's report, and in this letter we update developments in each area. Then we review how we have performed and actions we have taken in this environment.

Market and Economic Conditions

The first challenge we discussed in our last letter was the continued spread of the credit crisis. The mid-March collapse of Bear Stearns was a watershed event, as it engendered extraordinary government actions to prevent a wider contagion. Bear Stearns (previously the fifth largest US investment bank) suffered the modern day equivalent of a 'run on the bank' as customers, investors, and counter-parties lost confidence in the firm and rapidly withdrew their money, to the point where Bear Stearns was effectively insolvent and on the brink of bankruptcy. In past downturns, firms such as Drexel Burnham Lambert were forced to simply go out of business, but the complex and interwoven securitization of modern-day finance led to unprecedented measures.

The Treasury and Federal Reserve facilitated the sale of Bear Stearns to JP Morgan Chase, with the Fed (i.e. US Taxpayer) assuming the risk of up to $29 billion of Bear Stearns' assets. Officials were justifiably concerned that a failure of Bear Stearns to honor commitments (e.g. 'credit default swaps' designed to insure against losses) to counter-party banks would ignite a chain-reaction causing other major institutions to fail as well. To prevent further 'bank runs' the Fed now offers liquidity to investment banks previously available only to regulated commercial depositories. This bold move will likely lead to increased financial regulation.

These actions raise understandable concern about the risk of 'moral hazard' - the notion that the Government's bail-out of a firm that mismanaged its own risk encourages excessive speculation; although, surely no other firm would wish for Bear Stearns' fate. Our own view is that the Fed basically did the right thing in the midst of a grave challenge. Regardless, this episode serves as a sign that the Fed is willing to take creative and bold action as needed.

We also raised concerns that contagion would spread to other industries, particularly in the form of tightening bank credit. While losses multiply through the financial sector, total write-offs are now forecast to be as much as $1 Trillion and are about $300 billion to date; the evidence is more muted in the broader economy. Troubled industries, such as builders, airlines, autos, and certain retailers, have had their lines of credit severed (as measured by the spike in high-yield bond spreads). Weak businesses that cannot meet their daily commitments, let alone borrow money to finance expansion, will be forced into bankruptcy, and evidence of this is beginning to emerge. On the other hand, overall corporate balance sheets entered this downturn in exceptional shape. The strongest blue-chip companies are not only better able to weather a difficult economy, but are also in a position to buy assets at fire-sale prices and make strategic acquisitions without competition from leveraged buyout firms.

The recent first quarter earnings shortfall by General Electric struck many as a sign of spreading economic weakness, as GE has long been seen as a harbinger of the broad US economy. GE is a long-time Saybrook holding, and its results were a disappointment to us. Having now heard from management, as well as their industry peers, we feel GE's greatest error was in poorly managing investors' expectations during a slowing economic period. The story is more complex, however, as the bulk of the downside came in the commercial finance, healthcare, and media divisions. On the other hand, revenues from their much-touted global infrastructure business remain intact. We are watching the company closely, but we feel that it presents a great value with its global footprint, the potential to shed underperforming businesses, and a nearly 4% dividend.

As for the ailing US consumer, we mentioned previously that former sources of income (such as credit and home equity) were drying up, with the remaining leg of the stool being relatively high employment levels. However, recent job reports have turned negative and, while not at recessionary levels yet, are trending worse. This pessimism is reflected in low consumer confidence levels and reduced profits for companies selling to American consumers.

In January we cited inflation as another potential negative. Unlike past periods that suffered spiraling wage inflation, the current imbroglio is driven by the skyrocketing costs of commodities, marked by oil climbing toward $120 per barrel and food riots in the developing world. While increased demand for these resources from China, India, and other rapidly growing countries is pushing up commodity prices, other factors, including low US interest rates, a weak dollar, and the diversion of crops to ethanol production, are also contributing to the problem. A slowdown in developing countries should reduce demand for commodities and ease pricing pressures, but we remain concerned that increased prices lower consumers' purchasing power and limit central banks' abilities to keep interest rates low. This environment has understandably led to fears of 1970s-style 'stagflation' (high inflation with negligible real growth). We are watching with concern, as that combination is detrimental to stocks. This climate should be put in some perspective, however, as the 1970s saw extended periods of *double-digit* inflation and unemployment. Thus far, the powerful forces of trade, productivity, and global liquidity have starkly differentiated our current period.

Do developments in these areas reflect the hyperbole we cited in our opening paragraph? It is a stretch to predict "the worst financial crisis ever," a distinction normally reserved for Great Depression, when we have yet to even see conditions normally associated with a typical cyclical recession (although two negative quarters of domestic output are very possible). It has been said that the "American way is to take the pain and move on." The multi-billion dollar write-downs of bad debt (i.e. "the pain") being taken by the financial sector suggests that the US will not follow the path of Japan, where "zombie-companies" were protected from failure and extended their 1990s malaise.

We find it instructional to contrast the attention-grabbing *statements* seen daily in the financial media with the *actions* that are materializing from some intrepid investors. Probably the most important development in the last quarter is the emergence of buyers for troubled assets. When investors such as Wilbur Ross, and other noted private equity firms, not to mention JP Morgan Chase, begin to bid on distressed banks, mortgage operators, and other damaged companies and securities, they are not only putting a value on assets that no one has been able to price, but they are also, possibly, signaling that a bottom is in sight. On the other hand, these financiers may be early, following the Sovereign Wealth Funds of cash-rich nations, which poured billions into falling financial assets in 2007. But the risk-taking by those with 'skin in the game' should carry at least as much weight as the hysteria of current headlines. Yes, risks to the real economy remain, but possibly in the duration rather than the severity of the slowdown. In short, this is no time to liquidate assets and hoard canned goods, but we believe there is enough broad economic risk ahead to maintain our relatively defensive position. Protecting principal remains our guiding objective.

Saybrook Capital's Investment Position

During the first quarter of 2008, the US stock market, as measured by the S&P 500 index, fell nearly 10%, had its fifth consecutive month of negative returns, and on two occasions (late-January and mid-March) reached levels of nearly 20% below last year's record highs. In contrast, Saybrook portfolios had relatively modest declines in the first quarter. While we are never pleased to report a negative period of performance, there are four reasons we performed notably better than the market during this period.

First, our portfolio has been defensively positioned. This has reduced losses due to both the more stable industries in which we have concentrated and the levels of cash that we hold (for clients that do not mandate full investment in equities). We are aware of the "opportunity risk" of our cautious posture. We recognize few can predict the end of a bear market, and that our more defensive portfolio will likely under-perform in the event of an unexpected surge in stocks.

Second, our undervalued growth philosophy helps to prevent impairment of capital during volatile periods. We have always been careful to only buy stocks when they are reasonably priced versus their historic valuation and future growth prospects. This does not guarantee greater results, but a lower purchase price has the effect of cushioning losses relative to original cost – in other words our valuation discipline provides a 'margin of safety.'

Third, we have held disproportionately small positions in the financial sector. As we discussed earlier, much of the market's losses have been concentrated in this area. We remain wary of the banking sector, although constructive on the financial investments in our portfolio, as our companies have largely avoided large write-offs to date.

Finally, we have benefited from some selective buying during the January and March market sell-offs. We have taken advantage of a historic sell-off in areas related to banking and financial services. In January we seized an opportunity to purchase shares of American Express, the iconic charge card company. Likewise, we have bought stock in FactSet Research Systems, an essential provider of financial data to asset management firms and investment banks (we were pleased when management told us on a recent conference call that Bear Stearns represents less than 1% of their client-base). While there is a risk that we are early, as the financial sector has certainly not seen the last of the bad news, we initiated both of these investments at prices 30% below their recent highs. Indiscriminate corrections, when all stocks fall regardless of underlying fundamentals, also provide the chance to buy enduring companies in defensive industries at attractive values. We took advantage of such an opportunity to make investments in Diageo PLC (the largest global liquor producer with premium brands such as Johnny Walker, Smirnoff, and Guinness) and Stryker Corporation (the leading provider of hip and knee replacements and other fast-growing medical technology). We believe this focus on growth at a reasonable price can generate superior long-term returns for our clients.