SAYBROOK CAPITAL
INVESTMENT OUTLOOK

June 30, 2008

In our last three *Investment Outlook* reports, we have discussed four matters that threaten the health of our economy and financial markets: the housing and credit crisis; the financial contagion spreading to the broad economy; the weakening U.S. consumer; and commodity-driven inflation. Beginning in September 2007, we highlighted how these issues were inter-related and the actions we had taken to mitigate our portfolio risk. As we approach the one-year anniversary of the credit crisis, it is fair to state that, despite major government intervention, these problems have not been resolved. Although certain areas of the economy have remained surprisingly resilient, much of the crisis has unfolded as many had feared or even worse than expected. And, of course, energy prices have sky-rocketed faster than anyone predicted, with the price of a barrel of oil soaring 40% during the second quarter. In addition to providing an update on these issues, in this letter we discuss how our portfolios remain defensively positioned.

In the months that followed the Bear Stearns collapse in March, a false sense of relief spread, with the financial community believing that Federal Reserve's actions would prevent further failures and possibly become the pivotal event that would lead to recovery in the financial sector. Unfortunately, the developments of late June and early July represent a new leg down in the credit crisis. These events comprise the first notable bank failure of this era (IndyMac Bancorp, a California-based thrift) and the possible bankruptcy and/or bailout of various financial institutions, including 'Government Sponsored Enterprises' (GSEs), most notably Fannie Mae and Freddy Mac. In an attempt to build confidence in response to a massive sell-off of Fannie Mae and Freddy Mac's shares, the U.S. Treasury has proposed several measures just short of nationalizing the companies: access to the Federal Reserves discount window, the ability for the government to inject equity capital, and tighter regulations on the GSEs' excessive leverage.

The GSEs were chartered by Congress decades ago to buy mortgages from banks in bulk, with the intention of making them more available and affordable. Fannie Mae and Freddy Mac now own or guarantee half of all home mortgages in America, with an underlying value of more than

$5 trillion. Long-time critics have argued, correctly it seems, that the GSEs' profits were privatized, while their risks are socialized. The GSE crisis and intervention, while not a surprise to those who have long warned of the hazard of their implicit government backing, are still stunning events. In short, the U.S. Treasury's guarantee will now be viewed as explicit. As of this writing, the government has achieved its stated goal: mortgages remain available for qualified buyers at still-reasonable rates. But this still unfolding episode has a variety of other consequences, including: eroding confidence in our financial system, an even larger fiscal load for the U.S. taxpayer, an increased 'moral hazard' of presumed future bailouts, and a much expanded government role, via the Fed and Treasury, in the private financial system.

The credit crisis has clearly spread beyond sub-prime housing, as some businesses are now finding it harder to receive loans. Beyond finance and real estate, the companies facing the biggest challenges up until now are those with large finance divisions (e.g. some retailers and industrials), a disproportionate sensitivity to energy prices (e.g. airlines and autos), or generally declining fundamentals (e.g. pharmaceuticals and newspapers). While the financial sector has suffered through a year of high-profile credit disruptions, in much of the 'real economy' leading companies in industries including infrastructure, materials, technology, defense, energy, medical devices, and beverages continue to expand and even acquire their competitors. While many of the best businesses appear resilient in the face of a severe credit crisis, we believe some could face more serious challenges ahead, with the potential for a slowdown in their foreign business and a weak U.S. economy into 2009.

The much-predicted slowdown for U.S. consumers is underway, but has not reached the dire level that has been long forecasted. Most consumer recessions are led by massive waves of layoffs. Thus far, unemployment measures, such as weekly initial claims and monthly business and household surveys, remain weaker than recent years, but not near levels associated with past recessions. Instead, consumer caution has been driven by a worrisome combination of high gas and food prices, sluggish wages, tightening credit, and reduced home equity values. Retail sales figures have not tumbled yet, thanks in part to the recent government rebate checks. Retailing stocks, however, have been punished as consumers are expected to shop less frequently (lower revenue) and more carefully (weaker margins). Although we have successfully owned many

retailers over the last 30 years, now is a time for only the highest quality consumer companies. The best businesses have unique offerings, are able to effectively control their costs and gain market share during weak periods, and, over the long run, have the opportunity to fundamentally change their industry.

The biggest negative change in the second quarter was the unprecedented run-up in energy prices, as oil prices surpassed $145 per barrel earlier this summer. Our energy holdings benefit enormously from high oil prices, just as sectors of the overall economy (e.g. petroleum, mining, farming, and alternative energies) thrive on the commodity boom. But like the aforementioned consumer, non-energy businesses are hurt doubly: cost inputs (materials, transportation, etc) are sharply up, while end users have less money to spend. It is often said that high commodity prices are both a "tax" (hurting economic growth) and an "inflator" (raising the cost of all products). Historically, high energy prices are inflationary for a period of time, but can be ultimately deflationary as their sustained, elevated costs lessen demand and weaken overall economic output. This self-correcting mechanism is already underway with many industrial commodities correcting to levels below a year ago. While metals such as zinc, nickel, and lead have fallen over 30% in anticipation of a global slowdown, for a variety of economic, geo-political, and speculative reasons, the price of a barrel of oil remains stubbornly high. The evidence so far is that companies are controlling other costs (e.g. wages), sacrificing margins by not passing through all their higher costs to the end users, and/or innovating their supply-chain operations (e.g. Proctor & Gamble recently announced a comprehensive review of their global distribution system). So far, these types of actions by businesses have helped to prevent a 1970s-style inflation spiral. Nevertheless, broad inflation expectations have reduced stock market valuations, and we do not expect stock multiples to meaningfully expand until we see a sustainable decline in oil prices. Likewise, current high energy costs are another reason for our cautious global economic outlook into 2009.

Nearing the one year anniversary of our current financial crisis, we face weakened domestic and global economies and equity markets that reflect even more pain to come. In fact, broad U.S. stock markets (which have fallen over 20% from their 2007 highs) disguise even more massive losses of capital. Measured by their respective indices through the end of June, banks are down

over -52% from their highs, and home-builders are down -78%. International stocks are no longer a haven with Europe -23%, India -41%, and China -53%. In short, many investors have experienced massive losses of capital.

Saybrook Capital's portfolios continue to perform 'less bad' than broad market indices. We have been able to limit some losses over the past 12 months by holding higher cash balances since late 2007, when we grew more cautious. Our relative performance is also attributable to not owning any banks. While banks continue to write-down losses from sub-prime mortgages, we are also concerned that they are in the early stages of realizing losses from commercial and consumer loans. Some well-run financial institutions will emerge from this downturn as strong companies with increased market share, and a few shrewd investors will succeed in buying at the bottom. However, the last nine months are littered with 'sophisticated investors' (Sovereign Wealth Funds, private equity firms, and well-known value investors) who have been far too 'early' in buying the falling shares of financial companies. At this stage, we see more attractive growth opportunities in other industries and remain cautious about the banking sector.

Regardless of our relative performance, 2008 remains a testing period. While we will always be <u>fundamental</u> investors who seek to <u>own companies</u> for long-term appreciation, during times such as this, we continually re-evaluate our holdings. In late 2007/early 2008 we sold a handful of companies that appeared most at risk in this environment. Disciplined selling is a challenge, but protection of our clients' capital is our overarching objective. While we sold the following stocks for a variety of reasons, their subsequent declines demonstrate that our caution was warranted: United Health Group -54%, Citigroup -48%, and UPS -19% (each measured from our sale price to the end of June). Still today we constantly review all of our portfolio companies to consider their worst-case scenario in terms of exposure to credit, energy, and the consumer. And we must also ask ourselves if there are other high-quality companies that are well-priced and are better able to thrive in a difficult environment. In short, it is not a time to panic, chase trends, or try to time the market. Rather, past experience has shown us that investors can accumulate superior returns out of a difficult period by maintaining a long-term outlook and a strict adherence to one's discipline, while also keeping an open mind for both fundamental changes and new opportunities. This is our goal.