Saybrook Capital
Investment Review

September 30, 2003

Most money managers, ourselves included, have one opportunity each quarter to communicate with all of their respective investors. More often than not, the bulk of these efforts focus on so-called “macro” events, occurrences that impact the market as a whole, rather than particular stocks. Wars, politics, and scandals make for more exciting reading than multiples, margins, and market share; and macro economic and global trends, such as the GDP, consumer spending, and crude oil prices, do indeed filter down to the individual company level. Attention to such broad themes is both significant in the investment process and, we believe, important to discuss with clients.

Periodically, however, we find it constructive in our Investment Reviews to turn away from economic trends and current events and focus instead on the key components of our investment strategy and the methodology used to implement it. In this report, we want to review the strategy and provide examples to demonstrate how it has generated solid long-term performance. World events, booms, and shocks certainly impact the equity markets, particularly over the short term, but it is the less exciting investment disciplines that produce long-term superior results.

Saybrook Capital’s Investment Philosophy Pyramid

We frequently discuss in our Investment Reviews our dual goals, "expansion of capital, preservation of principal", and demonstrate how these expectations have been met. Using the metaphor of a pyramid to describe our investment philosophy, we place these over-arching goals at the pinnacle. Underneath them lies the equally important **investment strategy**. Asset allocation and prudent cash and bond management all contribute to our investment strategy, but our "Undervalued Growth" equity approach is the primary means towards achieving our above-stated goal. Since we spend the majority of our time implementing this undervalued growth strategy and its particular methodologies (buy and sell discipline, fundamental research, etc.), we think it is important to explain it to our investors.

By definition, the undervalued growth strategy consists of two specific elements: growth and valuation. First we seek companies with a steady stream of real earnings growth that can be sustained at an above-average rate for at least the next three to five years. This necessitates distinguishing between "secular" growth and a mere cyclical upturn. Real secular earnings expansion is the result of such characteristics as dominant products, superior marketing, forward-thinking management, margin growth, and a strong balance sheet. Of course, above-average growth can be quantitatively screened with a spreadsheet and consensus estimates, but a mechanical filter fails to uncover many of the intangible qualities that the best companies share. Fundamental research is the only methodology that accounts for these distinctions; this includes original research, analyst conferences, and direct communication with management.

Once a company's growth prospects have been determined, our next step is to employ stringent value criteria. Valuation itself is a two-part process – a buy and a sell decision – and a value perspective is most effective when distortions exist in market pricing. A strict valuation discipline enables investors to buy stocks at the low end of their price range and sell them when their potential is realized. Such a strategy is often called "contrarian", but rather than consciously fight consensus, our model merely lessens the emotional aspect of the buy and sell decision. This helps us to avoid the trap of "growth at any cost", lowering the probability of absolute dollar losses. Our valuation style not only gives us the vision to recognize overly optimistic momentum, but also allows us to capitalize on negative psychology when we feel confident of a company's fundamentals. While equally as important as growth, value follows chronologically in our process, since a stock with no growth potential often deserves its low price.

A past example of the success of this undervalued growth strategy is our long-term investment in successful retail chains such as Wal-Mart, Staples and Walgreen's. There were various periods in the late 1980s and again in the mid 1990s when these stocks traded at about the same valuation as the overall market, despite superior growth rates, exceptional management, and dominance in their respective industries. Convinced that these companies represented secular growth stories that come along quite rarely, we determined price levels where the stocks were attractive to buy. We have been fortunate to accumulate these stocks at very favorable prices in most accounts.

The "sell decision" is more complicated, driven by three possible catalysts: deteriorating company fundamentals (sell), overweighting due to appreciation (reduce), and overvaluation due to appreciation (sell). To date none of these retailers has fallen victim to the first and most dangerous pitfall. As for overweighting, each of these stocks, like all successful holdings, may periodically be "trimmed back" to minimize excessive portfolio exposure to any one company. It is the third catalyst, overvaluation, which is the most challenging to monitor; a growth stock's "target price" can rise considerably over a long-term holding period before it reaches an "overvalued" level. Our disciplined model accounts for stock appreciation due to earnings growth and deserved multiple expansions.

The increase in a stock's target price best highlights the powerful appreciation potential of a growing company. Early in a stock's holding period, we would expect its earnings multiple to increase as the negativity that created its initial undervaluation disappears. Next, over the intermediate to longer term, if the company's earnings growth rate meets or exceeds our expectations without any further change in its valuation, the stock price can rise considerably, fueled by the power of annual compounding. The final leg of this mathematical phenomenon is that the company is recognized as a premier growth story and awarded a price/earnings multiple that exceeds the market. The true reward of successful investing in undervalued growth companies comes from the combination of compounded earnings growth and a meaningful increase in price/earnings ratio.

We should address how the portfolio is now positioned in order to take advantage of both growth and valuation expansion. An area that has shown success already this year is "economically sensitive" growth companies. Instead of investing in cyclical stocks that merely gain from an upturn in the economy, we seek companies with secular growth prospects but that are also influenced by improving economic trends. Media companies such as Gannett and Belo, as well as industrials like Sealed Air and Illinois Tool Works, have secular, long-term growth prospects, but they also are beginning to benefit from an improving global economy. Companies with a fair portion of fixed costs are able to use this operating leverage to increase earnings at a faster rate than revenues, and the market responds to this by awarding a higher valuation. In the third quarter our portfolio benefited from this occurrence, and we expect it to continue as more investors seek out quality growth companies.

Healthcare is another example of undervalued growth, but so far this year it has been lagging. The positive demographics of the pharmaceutical business are indisputable: an aging population, the marvels of modern science, and an increasingly global focus have and will generate greater utilization and positive pricing. However, myriad concerns, including Medicare reform, drug re-importation, and pipeline uncertainties, have driven premier drug companies to below-market multiples for the first time since the Clinton Healthcare plan was introduced ten years ago. After that plan was rejected in 1994, valuations of the best drug stocks surged while the companies achieved 15-20% earnings growth. The result was exceptional returns for investors who bought these stocks when they were out of favor. Just like past difficult periods, we expect the current problems to be mostly overcome, and we believe now is an excellent opportunity to own the elite drug manufacturers and distributors.

Retail, healthcare, and economically sensitive companies are just three sectors within a well-diversified portfolio, but they are good examples of our investment strategy. The influence of politics on drugs and the economy on industrials and media demonstrates that a "macro" perspective is important as well. We continue to be optimistic about economic growth, which, combined with unprecedented levels of productivity, should drive corporate profits to record levels. While following geo-political trends and economic indicators is an important step in the overall investment process, the ultimate test is selecting individual companies. At Saybrook Capital, we do this by searching for superior growth companies that are truly undervalued.