SAYBROOK CAPITAL
INVESTMENT OUTLOOK

Year-End 2011

2011 was a tumultuous year. Arab Spring upheavals and Iranian threats in the Persian Gulf roiled oil prices, while natural disasters – first in Japan and then in Thailand – disrupted global supply chains. Governments on both sides of the Atlantic proved themselves dysfunctional as the U.S. suffered the first ever rating downgrade on its Treasury bonds and the euro zone flirted with multiple bank failures and the fracturing of the common currency. Emerging markets from China and India to Brazil faced increased inflation and slower economic growth rates. International stock markets, reflecting this angst, declined throughout the year. The broad U.S. stock market, however, held up better. The S&P 500 Index, after many sharp moves in both directions, ended the year *exactly where it began* (closing at 1,257.60 vs. 1,257.64 at the end of 2010).

U.S. Stocks: "The Best House in a Bad Neighborhood"

In the U.S., early year hopes for sustained economic improvement were dashed as the political and fiscal picture darkened over the summer. The stock market declined significantly in late summer, ending the September quarter nearly 20% down from its April highs, before rebounding late in the year. Given heightened economic risks, treacherous market volatility, and our even more defensive portfolio positioning since the summer, we were reasonably satisfied that Saybrook account values overall remained essentially unchanged for the full year.

Back in our first quarter 2011 letter, we noted that even if underlying fiscal challenges were not met in the near-term, U.S. equities, as "the best house in a bad neighborhood," could outperform other investments. This certainly proved true, as the flat U.S. performance stands out relative to notable declines around the world:

	Price Performance 12/31/10 - 12/31/11
S&P 500 (U.S.)	0.0%
STOXX (Europe)	-11.3%
MSCI Emerging Markets	-20.4%
Hang Seng (Hong Kong)	-20.0%
Nikkei 225 (Japan)	-17.3%
Bovespa (Brazil)	-18.1%
Sensex (India)	-24.6%

Consistently focusing on high-quality, undervalued growth companies served us relatively well in a year when many prominent investors underperformed the market. Domestic equity mutual funds were down an average -3% last year, and iconic money managers, such as Bill Miller, threw in the towel (Miller's Legg Mason value fund declined -4% in 2011, after underperforming significantly over the last five years). Other asset classes also struggled. Hedge funds lost an average of -5% (according to Hedge Fund Research Inc.), and we know of several well-regarded funds that lost more than -20% for the year.

The bond markets similarly stymied prognosticators. For example, PIMCO's bond guru, Bill Gross made large bets against U.S. Treasury bonds last spring, which resulted in sizeable losses as investors flocked to safety and bid up Treasury prices over the second half of the year. And, notwithstanding the much publicized prediction – by famed Wall Street analyst Meredith Whitney – of massive municipal defaults in 2011, municipal bonds rallied broadly. For taxable accounts where we own municipal bonds, our resolve to maintain positions and to selectively buy new bonds in the midst of last year's falling prices paid off, with Saybrook's aggregate municipal bond holdings up +8% for the year.

"Playing Defense" Amidst Ongoing Challenges

While we still face the same underlying challenges outlined in last year's investment letters, the fourth quarter saw two positive developments. First, in the U.S., economic expansion resumed after stalling in the first half of the year. Although GDP growth over the full year was modest, industrial production proved resilient during the fourth quarter and the monthly unemployment rate began to trend down, ending the year at 8.5% (vs. the recession high of 10.1%). Second, in Europe incremental progress was made to contain the sovereign debt crisis as the European Central Bank (ECB) provided $630 billion of three-year loans at 1% to more than 500 European banks. Additionally, the U.S. Federal Reserve is swapping dollars for euros with the ECB at low interest rates. These actions provide much needed liquidity to European banks and may help European governments, particularly Italy, France, and Spain, which must borrow an estimated $1 trillion this year to replace maturing sovereign bonds and cover current budget deficits.

These improvements helped propel a fourth quarter stock market rebound; nevertheless, we remain concerned about the magnitude of debt held by developed country governments and the tenuous strength of global economies. As European leaders attempt to implement long-term fiscal reforms, they face a looming recession exacerbated by austerity measures and bank deleveraging. As German Chancellor Merkel warned in her New Year's Eve address, "next year will no doubt be more difficult than 2011."

Expectations that Europe will have at least a moderate recession this year are widely held and, thus, largely priced in by financial markets. A deep European recession, however, would certainly reverberate around the world. Emerging market economies – which provided two-thirds of global growth over the last five years – would further decelerate. And the U.S. economy, which has, for now, managed to decouple from Europe's problems and continue its slow-paced recovery, would face a higher risk of slipping into recession.

Amid a fragile economic recovery, the U.S. will have to endure another year of bitter gridlock in Washington. The repeated failure to reach a bold, bipartisan fiscal plan along the lines of the Bowles-Simpson Deficit Reduction Commission recommendations was, in our view, the biggest U.S. disappointment last year. Although we believe that such a comprehensive fiscal plan still has a good chance, meaningful progress will certainly wait until after the November elections.

More broadly, 2012 will be a year of political uncertainty, as 28 countries (representing roughly 50% of global GDP) will hold elections or experience a change of government. There will be more turmoil in the aftermath of political upheavals in the Arab world and potential instability with the new regime in North Korea. At the top of a long list of other geopolitical worries are escalating tensions over Iran's nuclear ambitions and recent threats of aggression.

Over the last four years of uncertain economic, political, and geopolitical conditions, Saybrook has maintained a defensive posture. While we have tactically raised cash reserves where appropriate and we always maintain liquidity for buying opportunities that may arise in dislocated markets, we have chosen to "play defense" primarily through shifts in the composition of the equity portfolio favoring enduring, multinational companies with strong balance sheets. Our portfolio companies have been battle-tested through the recent recession and possess the financial strength to survive a future crisis and still pay out a growing stream of dividends.

During this period we have frequently highlighted how our portfolio companies have steadily raised their annual dividend payouts, and we are confident this will continue. Concurrently, we have increased the portfolio's allocation to relatively higher-dividend paying companies. The combined result is a 63% increase in the last four years of the overall dividend payout from Saybrook's equity portfolio. We believe that high-quality dividend paying stocks are now more attractive than corporate bonds. Furthermore, income-seeking investors are now beginning to own dividend stocks as a substitute for low-yielding bonds, a potentially long-lasting trend.

At a recent investor conference, financial writer Michael Lewis discussed the dire fiscal challenges on both sides of the Atlantic – the subject of his new book, *Boomerang*. Towards the end of the talk, the moderator noted that the book ended somewhat abruptly without speculating on the ultimate outcome, and asked the author: "How, in your view, does the story end?" To which Lewis replied: "I don't know…but I'll tell you how I'm invested…I own a lot of large, dividend-paying battleship companies." Leave it to a best-selling author to describe our investment strategy better and more succinctly then we can.