

Saybrook Capital

Year-End 2014 Review & Outlook

“Buying Before Buffett”

2014 marked another good year for our clients as equity portfolios were up approximately 12%, in line with Saybrook’s average annualized return since inception. These results come on the heels of one of our best years in 2013, when our average equity account rose 34%. Amid increasing global financial market volatility in the fourth quarter, the U.S. stock market continued its upward trend in 2014, significantly outperforming international stocks, bonds, hedge funds, and, especially, commodity-related investments which tumbled (see charts below). Heading into the New Year, the most significant economic development is the plunge in oil prices – with crude down over 55% since June. The speed of this decline threatens financial contagion among overly indebted energy companies and oil exporting countries. However, lower oil prices are positive for the U.S. economy overall and will help sustain our recent economic momentum, even against a backdrop of weaker overseas growth.

Last year’s strong performance from a broad selection of portfolio companies more than offset declines in our energy-related stocks. Most dramatically, the announced takeover of Allergan – one of our largest positions – propelled the stock to new highs. As we review in this letter, our value discipline and search for excellent businesses have often led us to invest in companies that subsequently get acquired by larger corporations or private equity investors. When you own good companies, good things happen.

Allergan + Actavis: A Friendly Deal

Mergers and acquisitions (M&A) surged in 2014 with global deals topping \$3 trillion. In the biggest deal of the year, Allergan agreed in November to sell itself to Actavis for \$66 billion, trumping a \$53 billion hostile bid from Valeant Pharmaceuticals and hedge fund Pershing Square. This ends the seven month takeover saga we detailed in our third quarter letter, in which we mentioned the possibility of a friendly deal with Actavis. At that time, we stated our belief that Allergan was worth more than its \$180 share price and that we were content to own Allergan for the long term (even on a standalone basis) given the strength of its Botox and eye-care franchises and the quality of its management team. The Actavis deal values Allergan at over \$220 per share and is expected to close this spring, at which time Allergan stockholders will receive \$129 in cash for each of their shares and the remainder in Actavis stock.

For Saybrook investors, this represents a more than 150% gain from average cost. We are delighted with these profits and are pleased to have built our position in 2012 and 2013, well before Allergan became an acquisition target (and hedge fund traders piled in). Combined, the new entity is projected to have sales of \$23 billion, making it a top-10 global pharmaceutical company. We are evaluating Actavis as we consider retaining an investment in the stock.

Value Investing as a Harbinger of Good News

As we have highlighted in recent letters, the M&A boom has been lucrative for Saybrook clients. Last year, prior to the Allergan deal, Vodafone completed the sale of its 45% Verizon Wireless stake to Verizon in a complex but tax-efficient deal generating a 60% gain for our investors. In 2013, H.J. Heinz Co. was acquired by Warren Buffett's Berkshire Hathaway and Brazilian private equity firm, 3G Capital, for an 80% premium to our average purchase price.

Our Heinz investment is instructive (with apologies in advance to those of you who have already endured our telling of this story). When we first bought shares in 2009, Heinz, despite selling ketchup and other iconic brands around the world, was perceived as a boring company operating in mature, slow-growing markets. But we were impressed with their strategy for growth, as they acquired leading Chinese soy-sauce and Brazilian salsa producers as platforms for expanding their distribution into key emerging markets. Furthermore, we bought the stock at a good price, with a dividend yield over 4%. Heinz therefore provides an example of our value discipline, and our low-risk approach to investing in emerging market countries (i.e., owning established companies willing to forgo near-term profits in order to reinvest developed market cash flows into emerging regions).

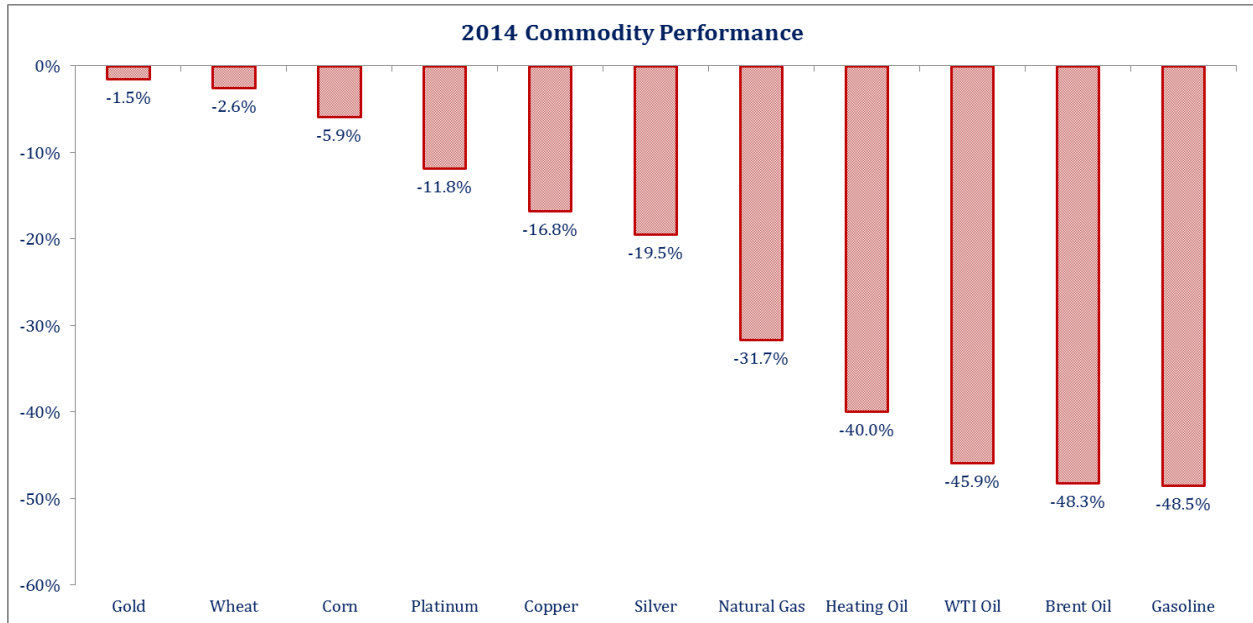
Heinz is also, of course, the inspiration for our admittedly cheeky title, as every value investor hopes to be *buying before Buffett*. As owners of Berkshire Hathaway, we will continue to enjoy a stake in Heinz, and Warren Buffett along with his team have many more years of investing ahead. He has said he would like to team up with 3G Capital again on another friendly takeover, and, with Berkshire's ever replenishing cash war chest now approaching \$60 billion, maybe we will get lucky and buy before Buffett again. Who knows, perhaps we already have.

During the last M&A cycle in 2005-2007, investors profited handsomely when several companies we owned were taken private or acquired, including: Fairmont (hotels), Univision (Spanish TV network), Crescent (real estate), Biomet (medical devices), and Pogo Producing (oil & gas). Back in 2004 when we first bought XTO Energy, we were attracted by its leading domestic natural gas reserves and technological drilling expertise. These were the exact same attributes that enticed ExxonMobil to buy the company in 2010 (generating a 230% gain for Saybrook investors). Incidentally, as XTO was acquired using Exxon stock, and we elected to retain the shares for most accounts, we were pleased to learn in 2013 that Warren Buffett purchased \$4 billion of Exxon shares for Berkshire's portfolio.

While we can now be justly chastised for boasting about our past takeovers, it is important to emphasize that we are *not* in the business of buying stocks simply because we think they may be acquired. Rather, as longstanding Saybrook clients know, we seek to concentrate our investments in a collection of wonderful businesses whose *undervalued growth* characteristics we understand and can analyze. And we hope to own them for the long run. When we bought each of the aforementioned companies, our own analysis determined the shares to be undervalued relative to demonstrated past results and potential growth prospects. Because the underlying values of these businesses were not fully reflected in their stock prices, we were able to buy them cheaply enough to provide ourselves with an adequate comfort level if economic or market conditions subsequently proved challenging, what famed value investor Benjamin Graham called "Margin of Safety".

Oil's Plunge and Ramifications

Meanwhile as we write today, financial markets have become more volatile, fixated on the precipitous drop in commodity prices, especially oil. One day the stock market is up, anticipating the economic benefits of low commodity prices; the next day it's down, fearing financial contagion and deflation. While generally rational over long periods, "Mr. Market" (to use another of Graham's brilliant metaphors) has again slipped into his erratic disposition.



Indeed, the plunge in West Texas Intermediate crude from over \$100 per barrel last summer to under \$50 has surprised investors, energy companies, and oligarchs alike. America's energy transformation, through the utilization of high-tech horizontal drilling and hydraulic fracturing, has unlocked massive supplies of oil and natural gas from shale formations. This increased oil supply from the U.S. and around the world is overwhelming demand as China's economic growth rate slows while Europe and Japan stagnate. The industry, at least in the near term, has become a victim of its own success.

Our energy-related companies will post lower quarterly profits as projects are delayed or scaled back. But they will now press harder to further lower their cost structures, and use this period of industry consolidation to their long-term advantage, acquiring assets at attractive prices and extending their franchises. Over time, of course, supply and demand will adjust, and commodity prices will firm. This could happen more quickly if, for example, North American energy producers rationalize faster than markets expect, if the Saudis reversed their stance and cut OPEC production, or if global economic growth accelerates.

Yet, there are several reasons why the industry adjustment could take time. Many U.S. oil and gas firms have gone heavily into debt, increasing borrowings by over 50% since 2010. Approximately \$100 billion of this debt was issued by speculative companies and is now the largest component of the risky high yield

(“junk”) bond market. Defaults on this debt may cause the mini energy credit bubble to implode, sending shock waves through financial markets, as distressed investors are forced to liquidate holdings. Furthermore, overly indebted enterprises with sunk well costs are forced to continue unprofitable production in order to service their interest payments. Likewise, developing countries whose budgets disproportionately rely on oil exports are exacerbating the supply glut even as their currencies face massive devaluations (oil is 40% of Russia’s budget, which helps explain the ruble’s recent 50% collapse against the dollar).

In the developed world, falling commodity prices, while beneficial to consumers, have stoked fears of deflation. European Central Bank (ECB) President Mario Draghi recently stated that although the risk of persistent price deflation is limited, “if inflation remains low for a long time, people might expect prices to fall even further and postpone their spending.” Reflecting the continent’s ongoing economic struggle and anticipating more aggressive bond buying by the ECB, the euro has fallen below \$1.13 against the dollar, an 11-year low, and Germany’s 10-year bond yield has sunk below 0.50%.

These growing concerns are pressuring credit and currency markets, respectively, and the fear of greater contagion may lead to more turbulent stock price fluctuations (remember, the S&P 500 hasn’t had more than a 10% correction in nearly three years). Amidst all the anxiety, it’s easy to forget the significant economic benefits of lower oil prices, especially for the United States.

We are Long the U.S. Economy

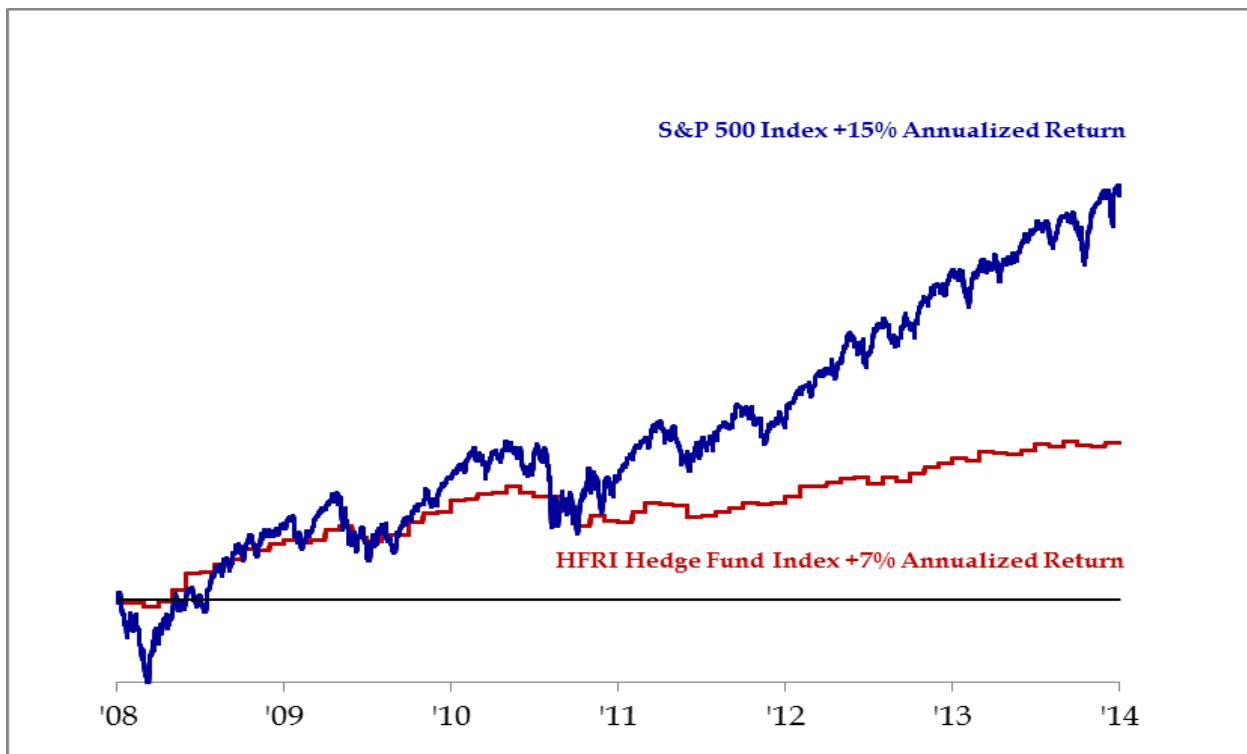
Lower commodity prices are beneficial for America’s overall economy, for consumers and manufacturers alike. With average gasoline prices at the pump nearing \$2 a gallon, down from almost \$4 as recently as June, the average consumer will likely save \$1,000 this year. The extra cash in consumer pockets will encourage them to spend more. In addition, lower energy prices are boosting confidence among businesses managers, likely further stimulating capital spending plans. More broadly, as we have been emphasizing, lower energy costs are helping drive America’s manufacturing transformation for companies of all sizes.

After filling up his old truck at the gas station for \$40 less, a hard-working contractor might also purchase a bag of chips and a Gatorade. At the end of the month when he sees his lower credit card statement, he might even contemplate upgrading to a new truck or finally hiring that additional worker. Producers of snacks and beverages, such as PepsiCo (products noted above), will benefit from increased demand and lower commodity input costs. Savings include, for example, the agricultural ingredients in the product, the diesel in the farmer’s tractor, the raw materials in the packaging, the utilities to run the plant, the fuel in the delivery truck, etc. These lower costs benefit not just food companies, but any manufacturer with significant commodity inputs in its cost structure.

Economists are busy trying to quantify the costs and benefits to the U.S. economy from lower energy prices. While wide ranging, some estimates suggest that at current oil prices capital spending among oil companies will decline by over \$100 billion (down from a level of approximately \$700 billion in 2014).

At the same time, we expect \$200 billion of measurable annual savings at the gas pump alone, not including benefits from lower diesel, jet fuel, home heating oil, and other petroleum-related products. In any case, a net boon from lower energy prices adds to the momentum we saw in 2014, with strong job creation driving down the unemployment rate to 5.6% (last year saw the most jobs added since the late 1990s) and could enable the U.S. economy to breakout and grow 3% or more.

At Saybrook, we believe that the best way to profit from the resurgence and long-term growth of the U.S. economy is to be invested in a collection of excellent businesses with wide economic exposure, even if it means enduring heightened market volatility. Many hedge funds, by contrast, perpetually trade in and out of stocks (thus creating much of that volatility). Certainly there are hedge fund managers that have delivered superior long-term performance while truly managing risk, some of which we hold in high esteem, but results overall have been lackluster. As the chart below illustrates, the average hedge fund has significantly underperformed broad stock indices since 2008.



With such mediocre results, one wonders why so many investors are willing to pay such high fees to hedge fund managers (usually 2% plus 20% of profits per year). At a recent gathering of the Bowdoin College Investment Committee, Stanley Druckenmiller – one of the great hedge fund managers of the past 35 years – quipped that when he started his fund in 1981 there were about eight or nine hedge funds; now there are over 10,000 of them...but still only about eight or nine good ones. As long-term oriented investors, Saybrook's philosophy has always been to invest in good companies, not as traders, but as owners.