

SAYBROOK CAPITAL

INVESTMENT COUNSEL & MANAGEMENT

2019 Year-End Investment Review

The last year of the decade was a great one. Saybrook stocks were up, on average, 30% for the year. More significantly, we are pleased by how well our longstanding portfolio companies performed from an underlying business perspective in what proved to be a wonderful 10-year period for investors.

The sharp advance in stock prices last year was aided by the stimulative effects of three Federal Reserve rate cuts along with continued strong U.S. job growth and consumer spending. In stark contrast to the dour mood in late 2018 amidst a global manufacturing downturn and recession fears, stock markets cheerfully closed out 2019, encouraged that the “phase one” China-U.S. trade deal and an orderly Brexit would allow stronger global economic growth to resume. Pessimism a year ago, optimism now. No one can accuse Mr. Market of a predictable temperament.

The following table (which we used last year to show that almost everything was *down in 2018*) illustrates that nearly all asset classes were *up in 2019*:

2019 Price Changes (indices do not include dividends)

NASDAQ	+35%	Nymex Crude Oil	+31%
S&P 500	+29%	Dow Jones REIT Index (Real Estate)	+22%
Dow Jones Industrial Average	+22%	Gold Spot \$/oz	+18%
DAX 30 (Germany)	+22%	HFRI Equity Hedge Fund Index	+14%
Shanghai Composite (China)	+22%	CRB Commodity Index	+12%
Nikkei 225 (Japan)	+18%	Barclays Aggregate Bond Index	+9%
MSCI Emerging Market	+18%	S&P Municipal Bond Index	+7%
FTSE 100 (Great Britain)	+12%	U.S. Treasury Bills	+2%

As Saybrook enters its sixth decade, we take a retrospective look at the importance of staying invested even in the face of serious economic and financial market challenges such as those a year ago, a decade ago, and when our firm was established in the 1970s. We review developments at Apple and Google, and what we believe are promising long runways of growth opportunity for both companies, as they continue to transform the global economy and help drive a burgeoning productivity boom. We also provide an overview of the breadth of portfolio holdings that contributed to our full year results and the unique defensive characteristics of our biggest positions.

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Portfolio of Many Contributors

Leading the charge in 2019 was Apple, soaring 86% after a 7% decline the previous year. Our basket of digital payment companies, Visa, Mastercard and PayPal, continued to deliver impressive results, and their stocks rose on average over 40%. With some improvement in housing-sector indicators, our market-leading paint company Sherwin-Williams rallied 49%, while Mohawk advanced a more modest 16% in a still difficult operating environment for flooring. A broad collection of portfolio companies owned for the past decade or longer were up 30% to 40%, including: payroll services processor ADP, global food and snack purveyors Nestle and Mondelez, financial data provider FactSet, industrial conglomerate Honeywell, and digital advertiser Google.

The War Chests

Berkshire Hathaway stock was one of our weakest performers last year, up 11%, but trailing the broader market and hampering our overall results. Berkshire, trading at a discount to its intrinsic value, is an enigma given that its underlying business results remain strong and generate enormous free cash flow, adding \$20 to \$30 billion to its cash stockpile annually.

Interestingly, our two largest portfolio holdings, Berkshire and Google, are sitting on a combined \$250 billion of cash (in almost equal amounts). These war chests add an unusual counter-cyclical element, enabling both companies to potentially benefit from a future market downturn. For example, they could deploy cash meaningfully to make acquisitions while others hunker down. They could buy back significant amounts of their own stock, which both companies have just recently indicated a willingness to do. While other short-sighted CEOs have notoriously squandered cash on bad acquisitions and overpaying for their own stock, Berkshire (for half a century) and Google (for the last decade) have successfully deployed cash to create value. In short, we like cash. We like it even more when held by astute and disciplined capital allocators.

Apple Beyond iPhone

Apple ushered in the mobile age with the introduction of the first iPhone over a decade ago. Intrigued by early product success and the intense brand loyalty of Apple users, we began to follow the company closely, and our confidence grew. First, upon Steve Jobs' death in 2011, Tim Cook (then 50) seamlessly took over as CEO while maintaining the founder's vision. Apple's large cash position and new dividend (initiated in 2012) were another attraction. The company's nascent "ecosystem" of services (at that time primarily music and photos) also suggested to us that it was merely the beginning of a legendary story.

Equally important, Apple's stock satisfied our valuation criteria, trading at a discount to its growth rate and the overall market. This was due to the perception that its growth was tied solely to hardware that could easily become obsolete, as happened with once-iconic products from predecessors such as Nokia and Sony. It took us time, but we came to realize that Apple was our kind of investment – a quintessential *Undervalued Growth* story. Since our first purchases in late 2012 and early 2013, the stock has risen 400%, and its dividend payout has doubled.

Ironically, 2019 was a year of low expectations for Apple's iPhone business given weakness in China and a slower upgrade cycle, with some consumers waiting for next year's 5G models. In fact, handset sales declined 14%, yet the stock surged as it became clear that the company could substantially diversify beyond iPhone.

Apple Net Sales by Category (fiscal year ending September 2019):

iPhone	\$ 142.4	-14%
Mac	25.7	+2%
iPad	21.3	+16%
Wearables, Home and Accessories	24.5	+54%
Services	46.3	+18%
Total Net Sales	\$ 260.2 Billion	-2% (vs 2018)

In fiscal 2020, iPhone is expected to represent less than 50% of overall corporate revenues. Apple's most notable progress has been in the "Wearables, Home and Accessories" and "Services" divisions. The five-year-old wearables business already generates \$25 billion in revenues and is growing at over 50%. The enormously popular (and surprisingly expensive) AirPods and the increasingly ubiquitous Apple Watch were popular holiday gifts this year. Apple's high margin and recurring revenue stream Services group includes iCloud storage, App Store, Apple Music and Apple Pay. Now Apple TV+ is coming to our living rooms, and Apple CarPlay is guiding our dashboards. To put the sheer size of Apple's non-iPhone divisions in perspective, Wearables as an independent company would be in the top 150 U.S. corporations by sales, ahead of McDonald's Corp., and Services, among the top 70, larger than American Express.

Healthcare is perhaps Apple's greatest opportunity ahead. Given that popular wearable devices are already used for fitness tracking, Apple is well-positioned to become a leader in health monitoring. Likewise, Apple's commitment to privacy protection makes it trustworthy contender for the sensitive but essential role of organizing individual medical records.

After nearly doubling in the last 12 months, Apple's stock price may be ahead of near-term earnings growth. However, we remain optimistic on the company's prospects over the next several years, given

its ongoing shift towards recurring services. The groundwork is being laid to evolve into a hardware-as-a-service model, whereby consumers subscribe to the latest Apple device rather than purchasing it. Referencing the popular upgrade plans during October's earnings call, Cook effectively unveiled this bundling strategy, saying: "...to some degree that exists today...this will grow [disproportionately] in the future to larger numbers." Additional services bundled with a hardware plan would bring even greater stability to Apple's revenues and perennially link subscribers with Apple's ecosystem, further separating the company from the traditionally fickle hardware cycle that has depressed its stock valuation for so long.

At Saybrook we love the stickiness of recurring revenue businesses, and investors are willing to pay increasingly generous valuations for such desirable business models. We believe that Apple, with its consumer brand loyalty and network of services, is becoming one of the best subscription businesses in the world.

Google Coming of Age

No company better represents the digitization of the global economy than Alphabet – the parent holding company of Google. Its services – including Search, YouTube, Gmail, Maps, Waze, Play, Android, and Chrome – unbridled the modern internet and are used by over one billion people every month. Over the past decade and in recent quarters, the company has generated 20%+ average annual revenue growth, an incredible achievement considering that revenues topped \$150 billion last year. Given this success, it's easy to forget that Alphabet is still young with a long runway ahead.

We have owned Google for 12 of its just 16 years as a publicly traded company, buying our first shares for Saybrook clients in October 2008 – in the throes of the financial crisis and stock market crash. We had been watching the company grow since its initial public offering in 2004 and waiting for an opportunity to buy it at an attractive valuation.

Our initial attraction to Google centered around the necessity of search and the profitability of advertising. We thought Google's superior search franchise could supplant the television networks and newspapers (which had long been great investments) as a primary medium for advertising. It proved to be a good, early insight. The stock is now up over 800% from our original purchases.

Established while Sergey Brin and Larry Page were still Ph.D. students at Stanford, Google evolved from the initial search engine built in the garage of Susan Wojcicki (who now runs the YouTube division). The founders have been passionate about developing the company from within but have also been adept at externally recruiting talented senior management. In 2001 Eric Schmidt was brought in as CEO to provide "adult supervision" – his previous management experience allowing Page and Brin to focus on products and technology. In 2015 the company was reorganized as Alphabet Inc., with

Ruth Porat recruited from Morgan Stanley as CFO and Sundar Pichai promoted from within to run the legacy Google business, while the founders worked on Alphabet's "Other-Bets" – including new business platforms and moonshot lab projects.

As Alphabet faces inevitable growing pains (with over 100,000 employees) and increased antitrust scrutiny, the company continues to evolve into a more disciplined management structure. Last month Sundar Pichai (age 47) took the helm as CEO of the entire company. The founders relinquished their senior executive roles but will remain actively involved in the company as board members and significant shareholders (together they own 14% of the stock and control 51% of the voting shares). As Brin and Page put it in a recent letter announcing the change and comparing their 21 years at Google to raising a child: "It's time to assume the role of proud parents – offering advice and love, but not daily nagging!"

Much is yet to come as the company enters "adulthood." Google will continue to benefit from the enduring shift of ad budgets from traditional media to digital. With nine out of ten internet searches done using Google, and the company's Android software powering three-quarters of global smartphones, we expect its desktop and mobile ad business will continue to grow substantially over the next several years. It is also the leader in video advertising through YouTube, which is fast replacing television among younger generations. Though YouTube's size and growth rate are not publicly-disclosed, its revenues are likely larger than that of rival Netflix.

Beyond core advertising, Alphabet is expanding market share in cloud computing services for businesses and transforming the landscape of commerce. Already touching one-third of U.S. online sales volume, Alphabet is increasingly becoming an e-commerce powerhouse as it integrates retail and payments functionality on its Search pages, Maps, etc., making it convenient to click and buy on Google. In mobile payments, for instance, the two-year old Google Pay app is already the market leader in India.

Other big initiatives include launching delivery drones, mobilizing self-driving cars, advancing robotics, and digitizing medical records to help shape the future of healthcare. What all these services share is the application of artificial intelligence, and Alphabet's position at the heart of AI engineering and machine learning gives it tremendous potential for new growth. As Sergey Brin has exclaimed: "The new spring in artificial intelligence is the most significant development in computing in my lifetime...we are truly in a technology renaissance, an exciting time where we can see applications across nearly every segment of modern society."

“A Productivity Shock”

As Alphabet’s initiatives and AI applications suggest, we are still in the early stage of a revolution in technology that is perhaps as historically consequential as the Industrial Revolution. As respected investor Stanley Druckenmiller recently remarked “we’re in one of the biggest productivity inflection booms since the late 1800s...a productivity shock [that] can’t be measured.” This phenomenon will continue to impact consumers, companies and the global economy in numerous ways as prices fall, efficiency improves, and industries are transformed.

A glance at a Radio Shack newspaper ad from the early 1990s illustrates technology’s dramatic effect on inflation. The circular advertises 15 separate items (tape recorder, video camera, land-line phone, answering machine, PC, clock radio, calculator, etc.) which today are all embedded in the iPhone. While these gadgets collectively sold at Radio Shack for over \$3,000, all of that functionality is now one-third the price (i.e. the cost of that iPhone). Furthermore, the quality is dramatically better.

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Now extrapolate that kind of cost reduction and quality advancement across the broader economic landscape. For instance, imagine how tech-driven productivity could potentially transform areas of the economy that have remained inflationary, such as education and healthcare. Tim Cook's recent comments on Apple's October quarterly conference call hint at where this may lead: "There will be a day in the future that we look back, and Apple's greatest contribution will be to people's health."

Successful Investing Requires Time, Patience and Perseverance

Two great economic statesmen passed away last month, former Fed Chairman Paul Volcker and investment banker Felix Rohatyn. Reading their obituaries reminded us how dire the economic landscape was in 1976 when Saybrook Capital started – an era marked by Watergate, stagflation, oil embargoes and a national sense of malaise. By 1980 inflation hit nearly 15% and 30-year mortgages rose above 18%. To be an investor at that time required fortitude, patience and a capacity for long-term optimism. Leadership helped turn the tide, but it took time. Rohatyn is credited with guiding the effort to save New York City from bankruptcy during the critical period between 1975-78. In 1979-82 Volcker led the Federal Reserve's crusade against the ravages of inflation, aggressively raising the fed funds rate as high as 20% (it's under 2% today). He vanquished inflation, but only after a severe recession marked by 11% unemployment. Investors who persevered through all this would be rewarded handsomely. The stock market turned in August 1982 and from there would soar to new highs, rising 230% during the 1980s.

Likewise, the just-completed decade began in the wake of the stock market crash and Great Recession, shortly after our current partnership was formed and we assumed ownership of Saybrook. Amid the absolute fear that reigned in 2008-09, our gut-check on the quality of our portfolio companies and strength of their balance sheets gave us the confidence to hold onto our core positions even though a multi-year depression-like scenario was a material possibility. As it turned out, the early years of the decade proved to be a generational opportunity to buy high quality stocks at low prices, even as the economy stabilized and markets surged off of extreme lows. We remained steadfast buyers during those consequential years, as the stock market would go on to increase 190% during the 2010-2019 decade. With the benefit of hindsight, staying invested was as important as picking good stocks, and it was one of the wisest decisions of our careers.

A year ago investors faced a similar, albeit less severe, test. An escalating trade war, Fed rate hikes, and a global manufacturing slowdown led to a 20% drop in the S&P 500 and widespread fears of a possible U.S. recession. In last January's letter we discussed this growing "wall of worry" and explained reasons why the U.S. economy remained resilient and why the stock market decline may have been an overreaction, noting that the "current U.S. economic data we see are more consistent with a deceleration in growth, rather than a recession." More important than what we wrote was that we

remained confident in the quality of our long-term investments and stayed the course. In fact, we used the fourth quarter 2018 sell-off as an opportunity to add to our core portfolio companies, including buying more Apple and Google.

As we begin 2020, investor sentiment is ebullient. In addition to the recent trade truce with China, Congress approved USMCA which is expected to modestly improve the former NAFTA trade pact with Mexico and Canada. Having removed some trade uncertainty, these agreements might lift business confidence and capital spending. However, the stock market now reflects much of this good news as well as higher expectations for the economy and corporate profits, setting up the possibility of a pullback if either of these disappoint. And, of course, November's presidential election likely promises a renewed bout of market volatility.

Nevertheless, looking to the decade ahead, we remain enthusiastic. Profound technological transformations will stimulate growth, further enhance productivity and help address global challenges. These advances will not come without disruption and inevitable regulatory hurdles, particularly for leading technology companies. There will be setbacks, but history argues for optimism. The 2020s promise to be an exciting era...buckle up!