

# SAYBROOK CAPITAL

INVESTMENT COUNSEL & MANAGEMENT

## 2020 Year-End Investment Review

After a year of historic challenges, we are delighted to report that Saybrook stocks were up, on average, 27% in 2020. On the heels of strong 2019 performance, Saybrook's average equity portfolio appreciated 65% over the past two years, even surpassing our similarly dramatic back-to-back gains in 2013-14. These results underscore the value of staying invested in good companies, even amidst a once-in-a-century pandemic, the sharpest recession and job loss since the 1930s, and a level of domestic discord and violence not seen since the 1960s.

As citizens, we are appalled by the seditious January 6th attack on the Capitol Building. This assault strikes at the heart of our most essential values, among these, as written in the preamble to our Constitution, is the assurance of "domestic Tranquility." Third-ranking House Republican Liz Cheney stated: "There has never been a greater betrayal by a president of the United States of his office and his oath to the Constitution." As long-term investors, we have deep faith in the resilience of our constitutional system and trust that those responsible for the insurrection will be held accountable. With the inauguration of a new president, we are hopeful that a spirit of national unity may emerge, supported by a White House with people of good character and competence. Perhaps with a closely-divided Congress, we may even begin to see signs of bipartisanship.

In this letter we continue our burgeoning digital productivity theme, examining the investment we initiated years ago in PayPal – our best performing 2020 stock, up 117%. We also reflect on our actions during the stock market crash last winter and the importance of remaining invested, while maintaining a balanced portfolio.

### *Covid-19: A Great Accelerator of Digital Transformation*

A year ago we wrote about the coming decade of technological advancement, driven, in part, by our long-held portfolio companies Google and Apple. Amidst a tech-driven productivity boom that could be as historically consequential as the Industrial Revolution, we stated that profound technological advances would stimulate growth, further enhance productivity, and help address big challenges. Little did we know as we wrote those words that such a monumental *challenge* as the coronavirus was already spreading around the globe and that, in response, the rate of technological adoption in 2020 would be so astounding. Looking back a year later, Apple and Google proved themselves vital during the pandemic, as consumers, students and businesses turned to these trusted platforms to meet stay-at-home needs.

**Labor Productivity, Nonfarm Business 2015-2020**  
(Percent change from same quarter a year ago)



Source: U.S. Bureau of Labor Statistics

When the world locked down in March, a sudden and real-life experiment in work-from-home and remote-learning commenced. The way we lived and worked changed fundamentally, and *productivity-enhancing* technologies, such as mobile communication, eCommerce, cashless payments, cloud storage, video-conferencing, and tele-medicine, enabled the economy to function amidst social distancing. The chart above illustrates how U.S. productivity, which increased for years at an annualized rate of between one and two percent, doubled in 2020 as these technologies were more broadly utilized. Productivity may remain elevated even after the pandemic recedes, as methods that save time and money will not likely reverse.

### *PayPal: A Compelling Long-Term Growth Story*

While many of Saybrook's core portfolio companies were well-positioned for the accelerated digital transformation brought on by the pandemic, PayPal Holdings stands out as a quintessential story. We began investing in PayPal indirectly seven years ago when it was still part of eBay. We were primarily interested in the fast-growing PayPal digital payments division which was expanding beyond just servicing eBay's online auction business. The fact that the legacy auction growth rate was slowing enabled us to buy eBay shares in 2013 at an inexpensive 16x earnings. We were delighted when PayPal was spun off to shareholders as a standalone company in July 2015 with no debt and \$5 billion cash. We subsequently sold the original eBay shares to focus on the PayPal story. The company's core payments platform serves essentially as a "digital wallet" positioned to capitalize on two huge (and related) trends: the dramatic shift towards cashless payments and the rapid growth of eCommerce.

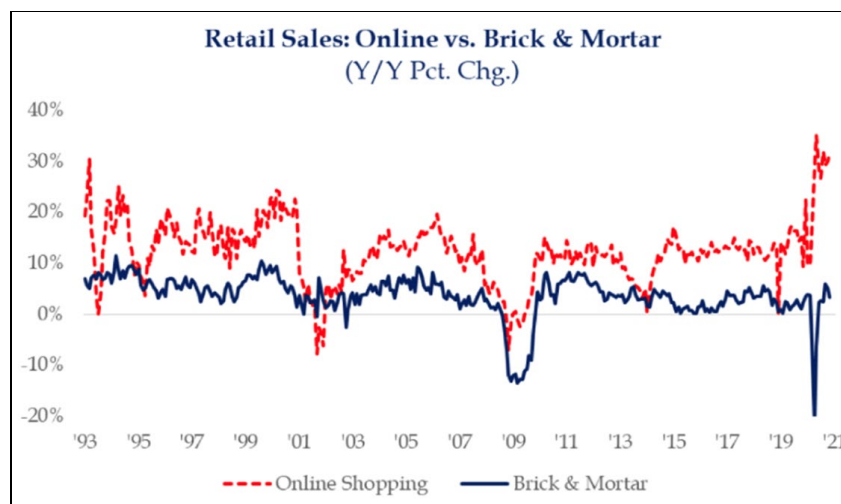
Soon after PayPal became a pure-play, our attention turned to concerns about fierce and fast-moving competition in the digital payments space. Investors worried that PayPal's market position could be eroded by the traditional card behemoths, Visa and Mastercard, and also by well-funded initiatives such as Apple Pay and Google Pay (incidentally, all Saybrook holdings).

Our fears about growing competitive threats were allayed by PayPal’s excellent CEO Dan Schulman and his team. In a bold and consequential strategic shift, PayPal decided to pursue fee-sharing alliances with these would-be competitors. In 2016, PayPal announced agreements with Visa, Mastercard, American Express, Google, Apple, and several major banks, all of which now settle transactions after consumers pay with PayPal.

As these partnerships were forged, PayPal delivered revenue and earnings growth above 20%, and its stock price climbed. While its valuation relative to near-term earnings appeared expensive, PayPal’s long growth runway became even more compelling when the company presented its future objectives at its May 2018 investor meeting. Management highlighted its audacious long-term goal of reaching *one billion active users* worldwide, versus the 218 million users it had at the time. Active users have already risen to 361 million, and payment volumes are up 87% in the two-and-a-half years since that milestone was established. Underlying this growth is the mission of PayPal (and its Venmo subsidiary) to “democratize financial services” by providing financial solutions at a low cost to their customers. CEO Schulman has articulated how it is “expensive to be poor” – traditional banks often gouge for routine services such as money transfers, ATM withdrawals, and overseas remittances.

### *PayPal 2020: A Breakout Year*

With the world sheltered at home last spring, eCommerce exploded, and no one needed (or wanted!) to physically touch cash. The massive growth in online shopping versus traditional retail, shown in the chart below, vastly benefits PayPal given its ubiquitous web presence. PayPal is experiencing its largest ever transaction growth and has gained 56 million new users over the first nine months of 2020 (versus 37 million users in all of 2019). After more than doubling in 2020, PayPal’s stock has now appreciated over 500% since becoming an independent company in 2015.



Source: Strategas Research Partners

PayPal is helping small merchants during a trying period, enabling them to easily move their businesses onto the flexible PayPal network. Anecdotally in our eastern Long Island community,

commercial fishermen, who had lost restaurant accounts, and farmers, whose produce stands had been cash-based, quickly adapted using PayPal/Venmo. We believe that the millions of new users, both customers and merchants now accustomed to the convenience of electronic payments, will continue to use these services after the economy fully reopens.

Great companies are not static. PayPal is positioning itself for an even more promising future. PayPal has fostered the user growth and now early-stage profitability of its Venmo division (acquired along with payments processor Braintree for only \$26 million in 2012). Venmo is distinct from PayPal in that its primary objective is facilitating electronic payments between individuals who “Venmo” each other for shared rent, meals, or other incidentals – we love when one of our company’s services becomes a commonly used verb! The company is now expanding Venmo’s offerings to include check-cashing services, a Venmo credit card, and the ability for groups of friends not just to settle up with each other but also to pay providers *directly* for a shared restaurant meal or Uber ride – something to look forward to when we are all vaccinated. The company recently announced that PayPal and Venmo will enable merchants and users to transact with Bitcoin (without PayPal absorbing any of the extreme cryptocurrency volatility). We are excited to hear more about PayPal’s long-term plans when we “attend” the company’s 2021 investor meeting next month...this time on Zoom.

### *Staying the Course*

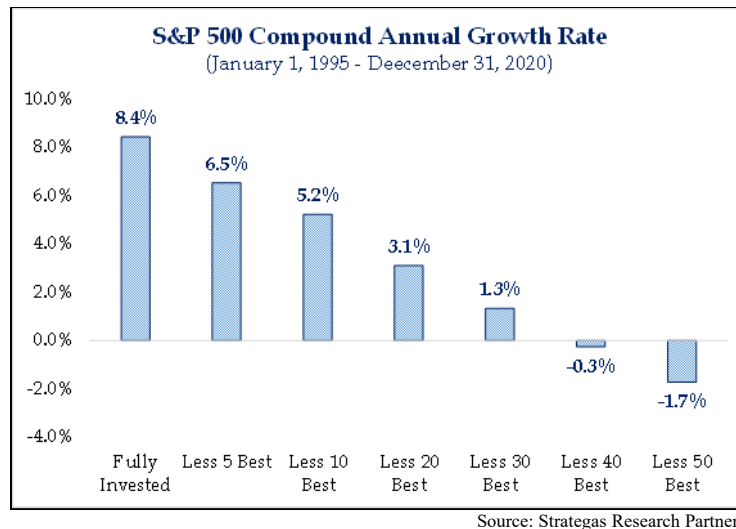
At the beginning of 2020 we had no idea which of our stocks would perform best or that PayPal or Apple would surge as much as they did. In fact, as we noted a year ago, we actually thought Apple shares may have been due for a breather having nearly doubled in 2019, yet the stock advanced another 83% with more positive news from the company in 2020. Indeed, there is no telling how individual stocks will perform in the near-term. It is impossible to predict when outsized returns will occur. The same is true for the stock market. If there ever was an *annus horribilis* that demonstrated the value of remaining invested, it was 2020.

Looking back to the period of extreme fear in March when the stock market plunged 35%, *The Economist* observed: “Many investors panicked...surely, the thinking went, public markets would freeze in the frigid fog of Covid-19 uncertainty – and then stay frozen.” We were resolute, confident in the quality and long-term growth potential of our cash-rich portfolio companies. We were fortunate not to have direct exposure to pandemic-impaired areas such as travel and hospitality. The resiliency of our portfolio was also enhanced by earlier proactive decisions to avoid owning banks and exit energy holdings – sectors that were hard-hit in 2020. Furthermore, we hold cash where appropriate and were not forced sellers. In fact, in March we took advantage of dramatically lower share prices to buy initial positions in Amazon and add to core portfolio companies at attractive valuations.

While we understood the risk of a prolonged recession or worse, we were also quick to recognize the unparalleled scale and speed of stimulus initiatives by the Federal Reserve and Congress in late March and felt these actions would help stabilize markets. Along with massive fiscal spending appropriated under the CARES Act, the Fed (which is estimated to have purchased \$1 trillion in government debt within three weeks in March) ushered interest rates to historic lows.

As Warren Buffett recently stated, “The Fed did a terrific job, they saved us from something that would have been a lot worse than 2008-09 when they acted in March.”

The stock market crash halted on March 23<sup>rd</sup> and, in a surprise reversal, bounced back nearly 20% in just three days. Over the next five months stocks rebounded another 36%. Then, after a brief 10% pullback on no particular news in the fall, the stock market rose another 15% to new all-time highs in the last two months of the year. Most of that surge occurred over a few days in November after it was reported that a highly effective vaccine would be approved much faster than anticipated. Who could have foreseen any of this? Nobody.



Studies actually show that significant portions of long-term returns come from unexpected bursts occurring in just days. The chart above illustrates the severe risk of market timing, as the best five days of the last 25 years accounted for about two percentage points of annualized price appreciation (not including dividends). And taking away the best 40 days results in a slight loss over 25 years!

### *A Balanced Portfolio*

Undervalued Growth is an essential discipline for Saybrook. Seeking specific Undervalued Growth characteristics is not only inherent in our initial stock selection process but is also a crucial factor in maintaining a balanced portfolio. For instance, a portion of Saybrook holdings is comprised of fast-growing companies, which benefit from significant reinvestment opportunities, and which trade at higher absolute valuations (although not necessarily higher valuations *relative* to their earnings growth). Another segment of the portfolio is weighted towards steady, but slower growing, companies that distribute excess cash flow to shareholders and trade at generally lower valuations.

Over the past two years several stocks of the former group have generated significant price appreciation. In addition to PayPal and Apple, other top performers include paint-maker Sherwin-Williams and financial data-provider FactSet Research Systems. These four stocks, on

average, advanced nearly 150%, (vs. 50% for the S&P 500) since the beginning of 2019. On the other hand, several stocks from the latter group lagged, with Johnson & Johnson, Berkshire Hathaway, Diageo, and Verizon rising only 13% on average for the same period. We have been opportunistically adding to these positions and believe that they may be poised for a period of outperformance.

### *The Great Comeback*

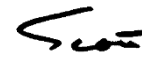
Today's ebullient stock market reflects an economy that has already recovered faster than projected and is likely to see better times ahead. The prospect of a return to normalcy in 2021 was certainly a big driver of the stock market in the fourth quarter. Nevertheless, we are now enduring a hard winter amidst the surging virus. Employment growth has stalled, and, while we have avoided the complete lockdown of last spring, business activity remains constrained. The ultimate recovery depends on the herculean task of getting shots in the arms of hundreds of millions of people as quickly as possible. Widespread vaccinations will unleash huge pent-up demand, especially in conjunction with additional stimulus spending and the eventual deployment of today's surprisingly high personal savings rate (reflecting curbed consumer spending combined with federal stimulus checks, which, based on aggregate economic statistics, more than offset reduced income from job losses). As business confidence resumes, employment and capital expenditures accelerate, and travel and entertainment ramp back up, U.S. and global economies could grow at a faster rate than many expect.

We wish you a happy, healthy and tranquil New Year.

Sincerely,



Luke M. Babcock



Scott R. Hirsch

*Given the extraordinary events of 2020, we have decided to include in this year-end review our previous quarterly client updates chronologically from the outset of the pandemic:*

### **First Quarter Update – April 2020**

First and foremost, we hope you and your family are safe and healthy in these challenging times, and our hearts go out to those on the frontlines of the global fight against Covid-19. We remain as dedicated as ever in our responsibility to protect and grow our clients' capital. As indicated in our March 17 email update, this letter provides more detailed information on your portfolio for the first quarter. For reference, we have included that intra-quarter update below.

It was the worst quarter for stocks since 2008. In just twenty-three trading days, the stock market declined 35% from a record high on February 19 to a low on March 23. Strikingly, March saw a record 5% average daily move in stock market prices (primarily downward). During the worst days of the panic, when traders were forced to cover margin calls or offset other losses, even safe-haven assets, such as Treasury and municipal bonds and gold, were sold. Confident in the quality of our portfolio holdings, we did *not* sell amidst this indiscriminate liquidation.

All 11 sectors of the S&P 500 finished the first quarter down double-digits, even the more defensive areas such as healthcare and consumer staples. The hardest hit industries were down 50% or more, including airlines, hotels and the energy sector (further hurt by an ill-timed price war between Russia and Saudi Arabia). Banks were down over 30%. We have no core holdings in these hard-hit areas, although Berkshire Hathaway is indirectly exposed through its own investment portfolio.

While nearly all of our stocks fell sharply in the first quarter, we are heartened that the portfolio held up somewhat better than the overall market. We benefit from our discipline of owning high-quality companies with strong balance sheets that enable them to withstand painful economic downturns. Nevertheless, a few of our stocks were down more than the market, most notably flooring manufacturer Mohawk, our weakest performer (given the near-total shutdown of the construction industry), and industrial conglomerate Honeywell (with the growing challenges to its aviation customers). Our concentration in growth industries helped the portfolio outperform. With much of global commerce, education and entertainment abruptly moved online in recent weeks, companies like Apple, Google, Visa, Mastercard and PayPal have proven themselves vital. We expect this crisis to accelerate pre-existing trends towards e-commerce, mobile technology, and cashless payments, and our portfolio companies are well-positioned when the economy rebounds.

During the March crash we did some selective buying where appropriate in client accounts. While nearly all of our companies will experience weaker earnings in the coming quarters, we are optimistic about their long-term prospects and thus took advantage of dramatically falling share prices to add to core holdings at what we believe are attractive valuations. We also used this opportunity to take an initial position in a transformative company we have admired for years: Amazon. Although it never trades inexpensively on near-term earnings, Amazon's stock was down over 20% when we made our purchase. As long-term investors, we are enthusiastic about enduring behavioral changes driving substantially higher revenues to e-commerce and cloud-computing – both areas where Amazon is the clear market leader. Near term, we are also pleased to see that Amazon is currently hiring 175,000 new employees to handle increased demand in this time of social-distancing and pantry-stocking.

As we look ahead, it is increasingly clear that the economic damage from the public health crisis will be severe. Former Fed Chairs Yellen and Bernanke have forecast that the U.S. economy could contract at a 30% annualized rate or more in the second quarter, with the unemployment rate surging above 10%. Many small and medium-sized companies will likely file for bankruptcy, especially those that went into this crisis with too much debt. As lesser-developed countries suffer through the pandemic, they also face grave economic challenges as their dollar-denominated debts rise versus their weakening currencies, and their commodity and tourism-based revenues plummet.

The good news, under the circumstances, is that the Federal Reserve has quickly taken the biggest and boldest actions in its history. Massive liquidity has been injected to stabilize nearly all credit markets (including Treasury, agency-mortgage, municipal, collateralized loan obligations, etc.), money market funds, and foreign currency markets. For the first time the Fed will act as a lender of last resort to non-financial businesses, as part of the \$2 trillion C.A.R.E.S. legislation enacted by Congress. Global central banks and the I.M.F. are also taking strong actions to stabilize international markets. There will undoubtedly be more stimulus programs to come. In short, global monetary authorities are going all in.

The remarkable speed and scope of these relief efforts helped spark a sharp stock market bounce in the last week of March. The successful implementation of these complex new programs is now crucial. Plenty of market turmoil still lies ahead, as the duration of the forced shutdown of much of the economy is still unknown. Ultimately, investors will focus on how soon a recovery can gain footing and when stocks return to being valued on normalized earnings.

*March 17 Update:*

Given this unprecedented health crisis and its impact on the economy and financial markets, we want to update you on our operations. This is in advance of our forthcoming first quarter report, which will include more detailed portfolio information. Saybrook Capital remains fully operational, with redundant offices equipped and staffed in New York, Long Island and North Carolina. Despite extreme market volatility, our trading and daily account reconciliation systems have functioned flawlessly.

Amid the uncertainty of the coronavirus pandemic, with travel restricted, schools closing, and public gatherings limited indefinitely, a global economic downturn is underway. Paradoxically, the more completely economic activity shuts down now because of mitigation measures, the more manageable the health crisis will be and the sooner we will return to our normal daily lives.

We are resolute in the underlying strength of our portfolio companies. Your portfolio has minimal direct exposure to industries, such as travel, energy and banking, which have been hurt most in this market panic. Our companies have fortress balance sheets and will endure a recession without permanent damage to their underlying businesses. After +30% stock returns in 2019 and a strong start to this year through mid-February, equities have plunged 25-30%. Because global markets are rapidly pricing in a significant economic contraction, much of



the damage to stock prices has already been done. This crash has been exacerbated by forced selling across asset classes. We, however, are not forced sellers, given our confidence in the long-term earnings power of our companies, the fact that we never buy using margin leverage, and because we hold cash for clients, where appropriate to meet expenditures. We have begun to deploy cash reserves at attractive valuations. We are focused on adding to existing core holdings and companies we have been watching which we believe will emerge stronger after this economic shock subsides.

Through our long careers we have navigated many tough markets before, and we will successfully get through this one too. As this market turbulence continues and headlines remain unsettling, try not to worry too much about the stock market's daily fluctuations – that's our job. We understand the stress that everyone is going through, and we encourage you to take this time to focus on your health and your family. Be assured that we are here working for you, and please do not hesitate to reach out to us with your thoughts and concerns.

### **Second Quarter Update – July 2020**

Although the stock market has recouped much of its pandemic-related losses, economic damages from worldwide business shutdowns linger, and global health uncertainties remain.

Our portfolio companies are doing their part in response to the immense challenges of the coronavirus crisis, demonstrating that they can continue to do well by also doing “good.” The most obvious examples include Johnson & Johnson, one of a handful of global pharmaceutical companies racing to develop a Covid-19 vaccine, which, if successful, would be distributed on a not-for-profit basis. Google and Apple are creating apps and providing free devices for schools to rapidly facilitate today's unprecedented experiment in remote learning. PayPal is using its tech prowess and broad merchant relationships to step in as the largest non-bank institution to help process assistance loans through the Small Business Association's Paycheck Protection Plan.

Notwithstanding wide-ranging business dislocations across many industries, a number of companies (many of which we have long owned) are benefitting from remarkable growth in areas such as mobile communication, eCommerce, and cashless payments. With potentially years of user adaptation occurring in just months, Covid-19 has been the great accelerator of a fundamental transformation towards digitization. We do not expect this trend to reverse. For instance, PayPal and its Venmo division are on track to report the company's *largest ever growth* in new users during the second quarter – with a surge in online shopping and contactless payments (no one wants to touch cash if they can avoid it). This helps explain why shares of PayPal, one of Saybrook's largest holdings, are up over 60% year-to-date and have more than doubled off their March low.

While some stocks are gaining from this dramatic increase in technological utilization, many investors are questioning the perceived disconnect between the overall stock market's fast recovery and the still bleak state of the economy. The initial market resurgence was prompted by an unparalleled amount of stimulus that Congress and the Federal Reserve rapidly injected into the financial system. The Fed expanded financial market liquidity ("money supply") by 25% in just two months starting in late March, while it took the Fed 12 months to do the same after Lehman Brothers failed in 2008. More recently, the Fed initiated direct purchases of corporate bonds to help reduce borrowing costs and forestall a wave of bankruptcies. These and many other measures have boosted confidence that necessary steps will be taken to support the economy during the pandemic.

The collapse of interest rates is another important factor driving the stock market. The yield on the 10-year U.S. Treasury bond has fallen to 0.6%, while Treasury bills and cash now yield next to nothing. The Fed has signaled that it will keep rates at these low levels for at least the next couple of years. In a lower-for-longer interest-rate environment, stocks become more attractive relative to bonds.

Furthermore, the stock market now seems to be anticipating that the economy will continue to recover after nearly halting in the spring. U.S. jobs have come back faster than feared, with May and June reports indicating that over one-third of employees laid off during the shutdown have returned to work. Also, as reopening begins to take hold, some predict that further coronavirus flareups, as witnessed in southern and western states, and even a second wave in the fall and winter may be met with better preparation and targeted quarantines, rather than repeating a complete lockdown of the economy.

Several unknowns remain. First, of course, is how quickly a safe Covid-19 vaccine can be developed and widely administered. Another issue with many ramifications is how tentative school reopenings will be in the fall. Regarding unemployment, while the rate has come down from nearly 15% in April to 11% in June, the current level of joblessness remains higher than any other time since the 1930s. With many small businesses closing permanently and larger companies running with lower staffing levels, it is unclear how long these high unemployment levels will persist and, closely related, when normal (stimulus-free) consumption patterns return. Is it several quarters or several years?

We are still sailing in the fog on corporate earnings overall, as the visibility of estimates for this year and next has been significantly diminished, even for many of our closely-monitored portfolio companies. As our friends at Strategas Research recently shared with us: "In the best of times, estimating earnings is some combination of art and science. With so many companies suspending earnings guidance, however, forecasting earnings has taken on a character of not just art, but modern art or abstract art at that."

We recognize that we cannot predict how the recovery will play out, how long it will take, or for that matter, how financial markets will react. We are certainly glad to have been buying stocks at attractive valuations in March. As a defensive measure, we took advantage of the incredibly strong spring stock market rebound by reducing our industrial exposure. This included the sale of flooring company Mohawk which had been a disappointment and now faces diminished earnings growth potential. In accounts where appropriate, some sale proceeds have been reinvested in more defensive core holdings that remain undervalued, such as Berkshire Hathaway and Verizon. However, because of the much higher degree of uncertainty, we are comfortable patiently holding cash reserves that are higher than usual. These adjustments should make our strong portfolio even more resilient.

### **Third Quarter Update – October 2020**

Amidst ongoing challenges, we are struck by the adaptability of the U.S. economy. Many of our portfolio companies are benefiting from accelerated growth as the pandemic economy hastens technological transformation, while others are proving surprisingly flexible and resilient even in the face of business disruptions.

Despite the tragic spread of Covid-19 and the lasting damage to particular industries and many small businesses, the stock market, overall, is taking its cues from the nascent recovery in economic activity. The economic scars from the pandemic and worldwide business shutdowns appear to be less severe than originally feared. Measures we monitor from home sales to rail carloads are actually above pre-pandemic levels. Eleven million U.S. jobs have been added since May – half of the 22 million jobs lost in March and April. With some notable exceptions, protocols of distancing and mask-wearing have enabled businesses to operate and schools to tentatively reopen, both of which help instill consumer confidence. And monetary policy remains supportive, with the Federal Reserve announcing that Fed Fund rates will remain near zero through at least 2023. In short, the recovery has proceeded faster than expected.

Reflecting this optimism, the stock market continued its strong resurgence through August – capping off five-months of uninterrupted advances. Entering the fall season, market volatility has returned with the S&P 500 at one point in late September down 10% from its high earlier in the month. We view this selloff as an overdue and healthy correction, weeding out some recent speculative excess. On a near-term earnings basis, valuations for many stocks appeared stretched and a pullback was certainly warranted. However, the lack of clear earnings visibility for this year and next, along with extremely low interest rates, makes it hard to calculate appropriate valuations. Nevertheless, risks remain. A further stock market drop may occur in the event of a worse-than-expected second coronavirus wave or a substantial setback in vaccine

developments. A contested U.S. presidential election, of course, is another real concern. But we would note that the threshold for electoral turmoil is already elevated, with traders placing sizeable bearish bets on a hung election (as indicated in the futures market). On the other hand, recent market moves suggest investors believe a Democratic sweep could bring more fiscal clarity.

Notwithstanding uncertainty about the outcome of next month's elections and the length of the pandemic, as investors we are mindful of the longer-term horizon. We often find attractive investment opportunities when good companies are being penalized by the market's near-term concerns. We recently added to our holdings of spirits producer Diageo, the maker of Johnny Walker Scotch, Casamigos Tequila, and other global brands. Its shares were down more than 25% as its volumes have been hurt by the global shutdown of bars and restaurants (although record sales for at-home consumption have softened the blow). While the shares could be range-bound until a successful vaccine is approved, the company will benefit from the post-Covid recovery as we all return to local establishments and begin to travel again. By owning excellent businesses, which we add to at attractive valuations, plus holding increased cash reserves where appropriate, our portfolio is well-positioned for both the difficulties and opportunities that lay ahead.