

SAYBROOK CAPITAL INVESTMENT OUTLOOK

December 31, 2009

As we begin a new year and a new decade, we reflect on some lessons learned during the historic, tumultuous period investors have just been through. We thought this would also be an appropriate time to provide an update on positive developments at Saybrook Capital during the last three years - a challenging but rewarding period for our firm.

Like all investors, we are relieved that a deeper and more lasting financial calamity was avoided in 2009. At the same time, we are mindful that there was no certainty in that outcome. In the year-end edition of *The Economist*, the lead editorial titled “The Great Stabilisation [*sic*]” argued that “despite claims to the contrary, the Great Recession could have been a Depression.” In early 2009 “global economic activity, from industrial production to foreign trade, was falling faster than in the early 1930s...2009 was extraordinary not just for how output fell, but for how catastrophe was averted.” The current period of stability “was not inevitable...it was the result of the biggest, broadest and fastest government response in history.”

The editorial goes on to argue – and we agree – “that today’s stability, however welcome, is worryingly fragile.” A successful transition to a sustainable economic recovery is certainly possible, but will depend on how several formidable economic challenges are met in this new decade. These challenges include the weakened banking system, the largest fiscal budget deficits since World War II, over-indebted households, and high unemployment rates. In recent letters, we have discussed these headwinds to a robust recovery.

While any economic forecast is, by definition, marked by uncertainty, the current outlook feels particularly unclear. It is too soon to know the long-term consequences of the global credit crisis. We are reminded of a book published last year called *The Great Depression: A Diary* in which Benjamin Roth, a lawyer during the Depression, wrote his reflections on economic conditions and the changing outlooks of the “experts” throughout the 1930s. At the end of that decade, Roth wrote: “As I re-read some of the predictions made by outstanding economists in past years, I must laugh. They were all wrong. None of them foresaw the 1937-1939 collapse, and many predicted inflation before this.”

Humility and Thoughtful Management of Risk

Last year a pioneer of risk-management, Peter L. Bernstein, died at the age of 90. When asked late in his life the most important lesson he had to *unlearn*, the legendary investor, economist, and author said: “That I knew what the future held, that you can figure this thing out. I’ve become increasingly humble about it over time and comfortable with that. You have to understand that being wrong is part of the [investing] process.” With the benefit of hindsight, we have learned that we made our share of mistakes over these past few years and certainly missed opportunities offered by the market collapse. Some of our judgments, particularly those made amidst the fog of market chaos and extreme uncertainty, will be

proven wrong. But we also realize that so many aspects of investing – from the macroeconomic level down to a single company’s growth plan – require decision making amidst uncertainty.

As we reflect on the lessons learned from our own experiences, the constant need for humility is on the top of our list. Thinking back over the period in which the housing bubble and credit crisis emerged, we are reminded that so many highly revered people who hold positions of great responsibility and influence can act with such over-confidence and hubris. Alan Greenspan is one of many figures, in both the public and private sectors, who come to mind. Witnessing the collapse of so many eminent Wall Street institutions in the fall of 2008 reminded us that nothing guarantees lasting success. The failure of a great firm, or even an entire banking system, can happen quickly.

The experiences of these last years serve to remind us of the dangers of excessive leverage, which was the root cause of the credit crisis. While Saybrook Capital never invests on margin (thus, our investment performance is never enhanced by leverage), we must continue to be vigilant in seeking to own companies that have strong balance sheets with low levels of debt.

Over the past decade we have witnessed the collapse of an extraordinary number of asset-price bubbles: technology stocks, residential housing, and commodities. These experiences, not to mention the long history of financial manias and busts, suggest that we, as investors, should always beware of the emergence of bubbles and their potential impact. Even now, so soon after the recent collapse, a low interest rate climate risks fueling new bubbles, particularly in emerging markets (one well known hedge fund manager is currently arguing that China has become a bubble).

Our own investment experience has taught us to beware of bubbles that can decimate even blue-chip companies. To wit: American International Group (which we were fortunate enough to sell some years ago at high prices) was essentially destroyed by the massive credit-default swap contracts issued by a relatively small division of the company; and General Electric (which we still own) came dangerously close to collapse as a result of their finance division’s extensive loan portfolio.

As investors, we cannot completely avoid the risk of capital loss. We understand that in our business risk-management is more of an art than a science and, thus, is always imperfect. But we also believe that a thoughtful, disciplined, and flexible approach to managing risk is essential to investment success over the long-run.

Throughout our history Saybrook Capital has operated with a consistent Undervalued Growth investment philosophy. At its core, our process seeks to balance safety of principal with superior (unlevered) growth. We view risk as the threat of the permanent impairment of capital (as opposed to fluctuation in asset prices), and we adhere to essential disciplines that help us mitigate that risk. These include investing in what we believe are high-quality, yet undervalued assets, and building diversified portfolios across individual position sizes, industry groups, and asset classes. Diversification protects our capital from overall impairment and allows us the opportunity to recover from declines, even in the event of massive

losses in some holdings. That was not true for others who had a disproportionate share of their capital invested in Bear Stearns or Lehman Brothers (and unfortunately, we know of many who did).

We are committed to owning equities for long-term appreciation, even through such terrible periods as we have just witnessed. But as we have said before, that commitment does not mean simply buying and holding a fully invested portfolio regardless of the economic climate. The diversification and liquidity provided by significant bond and cash positions proved vital during the acute phase of the crisis in late 2008 and early 2009. We believe that it is always prudent to hold some cash in a portfolio, and individual client circumstances will often guide us to the appropriate level. But there is no precise formula for how much cash to hold as a hedge to a potential market crash. Determining sensible cash levels involves assessing the trade-off between safety and higher returns.

This age old dilemma is especially vexing today with money-market rates near zero. As much as we like to make reasonable returns on all our invested capital, we understand that liquidity is the primary reason for allocating a portion of an investment portfolio to cash-equivalents. This was summed up in a very articulate manner by Thomson Hankey, the governor of the Bank of England in the 1850s, who said: "Ready money is a most valuable thing, and cannot from its very essence bear interest; everyone is therefore constantly endeavoring to make it profitable and at the same time to retain its use as ready money, which is simply impossible."

As with all aspects of our investment process, we must adhere to our core disciplines while at the same time remaining flexible and open-minded. Humility is perhaps the key to achieving this balance.

Saybrook Capital – Firm Update

As we exit a challenging decade for the investment business, we are, nevertheless, excited about the progress we have made as a firm, the quality of our longstanding clients, and the prospects for Saybrook Capital in the years to come. We are particularly pleased with the recent growth and strengthening of the company, both in terms of new clients and our staff and back-office systems.

Saybrook Capital is beginning its 35th year of providing investment counsel and management to a select group of families and institutions. Luke Babcock joined nine years ago, and Scott Hirsch merged his investment management business with Saybrook at the beginning of 2007. The investment philosophy and family office services inherent to Scott's business have complimented Saybrook's long-standing investment process, with added areas of expertise including detailed work on estates, trusts, and the allocation and oversight of capital to outside managers in alternative asset classes. With the merger, Luke and Scott became co-managing partners and, with the continuous help of Bruce Babcock (who founded Saybrook Capital in 1976), have guided Saybrook's clients through a challenging investment era.

While Scott and Luke became co-owners of Saybrook in 2007, day-to-day responsibilities have evolved gradually over the last three years, as Scott and Luke assumed full responsibility for all final investment decisions and the operations of the firm. During this same period, Bruce has focused on broad strategy, while still providing analysis on our portfolio companies. Beginning this year, Bruce is taking a further step back from day-to-day operations of the firm in order to pursue broader interests. We are delighted that Bruce is committed to a role of “strategic counsel” at least into 2011, maintaining the office in Winston-Salem and continuing to study economic and business trends and pursue investment ideas. This role will enable Bruce to remain available to clients and to continue his lifelong love of investing. Bruce’s experience and wisdom will continue to be valued and utilized by the rest of the team; he will retain a long-term ownership stake in Saybrook Capital Corp. and, of course, remain a significant client of the firm.

Saybrook’s assets under management have doubled in the last three years, as a result of our merger and subsequent new client growth. Business opportunities are often found in periods of extreme market disruption, and Saybrook has benefited by gaining new clients who are attracted to our customized business model and high ethical standards. While we do not advertise our services, we have always welcomed the opportunity to meet potential new clients that share our investment goals.

During this period of significant growth for our firm, we are particularly proud of the continued hard work of our staff at Saybrook Capital, their loyalty, and attention to detail. In the continued effort to shift the day-to-day operational responsibilities to Luke and Scott, we have expanded our New York staff. Mary Elizabeth (Liz) Grodski joined us last year, after a strong recommendation from a valued client. Her analytical, bookkeeping background has proved indispensable as she learns to operate our sophisticated portfolio management and client statement software. She joins Cindy Rosenfeld who has spent the past decade working closely with Scott and his longstanding clients. And finally, Laureen VanLandingham, as Saybrook’s veteran office manager, has contributed greatly to make Saybrook the efficient and sustainable institution it is today. From our North Carolina office, Laureen is overseeing the transition of our back-office to New York. Not only are our operations in good hands with these outstanding employees, but we are pleased with the direct and helpful relationships they have developed with our clients.

In recent years we have also invested in our technology. We utilize the state-of-the-art Advent software for client-friendly statements and daily reconciliation of all account balances. Our systems are linked across our multiple offices, critical for back-up in case of power-failures or other emergencies. Despite our expanded staff and systems, Saybrook Capital remains a lean organization, and, therefore, we leverage the essential capabilities of the custodian banks where client assets are held. While we have helped to place clients’ securities at banks or brokerage firms that fit their particular needs, we always enable clients to select or remain at the custodian of their choosing. We have recently initiated a relationship with Pershing Advisory Solutions, which was founded in 1939 and is now a subsidiary of the Bank of New York Mellon. Pershing is the world’s largest clearing firm and is structured primarily to service SEC-registered investment advisory firms like Saybrook. Several clients who have elected to use Pershing for custody are pleased with their trading capabilities, low commissions, and efficient service.

Finally, and most importantly, Saybrook is blessed with the caliber and steadfastness of our clients. It means a lot to us that we have not lost any clients during these recent challenging years. The S&P 500 *declined* in value by 10% cumulatively over the last ten years, a decade that was book-ended by two extreme bear-markets. Fortunately Saybrook's results have been better. Our average account returned 30% cumulatively for the decade, which equates to modest but positive annualized gains. The last ten years notwithstanding, our entire 34-year record is a market-beating annualized net gain of 12%.

Extreme apprehension was universal during the darkest moments of late 2008 and early 2009, but due in part to our clients' trust and long-term perspective, we were able to ride through this period better than most. Our clients let us do our job, while many investment firms had to resort to "lock-ups," to prevent withdrawals. Even in difficult times, our investors have not only been a pleasure to work with but have also provided instructive guidance. We thank our clients, from the longest-standing to the most recent, for this overwhelming support.