

SAYBROOK CAPITAL INVESTMENT OUTLOOK

Year-End 2010

Despite an economic recovery that many feel is lackluster, stocks accelerated into the year's end, and Saybrook Capital is pleased that in 2010 our average equity results exceeded our 35-year annualized return of 12%. The year was volatile, with the S&P down 7% in the first half and then subsequently rising 20% in the final four months. After the financial crisis of 2008-09 left significant losses across a wide spectrum of investments and threatened the global banking system, we are delighted to have completed two consecutive years of double-digit equity returns. In a low interest rate, liquidity-driven market where recent leadership has been dominated by smaller and more speculative companies, our high-quality portfolio served us well, by limiting declines during the first half of 2010 and participating meaningfully in the second half rally.

Overcoming Challenges?

In recent letters we have been reminding our investors of the distressingly long list of intermediate and long-term economic and investment challenges. In the summer of 2010, stock prices reflected concerns about another economic downturn and a protracted period of deflation, the perception of anti-business sentiments in Washington accompanied by intractable partisanship, a festering sovereign debt crisis in Europe, and a rapidly expanding U.S. deficit. So what has changed since the summer?

First, Federal Reserve Chairman Ben Bernanke has moved deflation lower on investors' worry list with his controversial, but nonetheless bold, implementation of a second round of Quantitative Easing ("QE2") - effectively saying the Fed will print money and risk inflation to avoid the deflationary mistakes of the 1930s. Although depressed housing prices and slow employment growth remind us that the recovery remains fragile, the fourth quarter rally clearly coincides with reduced fears of an economic double-dip. Additionally, near-term uncertainty over tax rates was resolved after the midterm elections, as President Obama's move to the political center led to an investor and business-friendly tax compromise in December. While the longer-term fiscal and deficit picture remains daunting, we are encouraged by the dialogue that has begun with the release of the bipartisan report from the National Commission on Fiscal Responsibility and Reform. While Chairmen Erskine Bowles and Alan Simpson outraged many with proposals to reduce entitlements and broaden the tax base by eliminating deductions, the recommendations are a positive step in beginning the necessary national discourse about the need for shared sacrifices and bipartisan compromises. The implementation of an effective deficit reduction plan should be top priority in the years ahead.

On the negative side of the ledger, we are more concerned than before about the global risks of rising inflation. Skyrocketing fuel, food, and raw material prices generated by outsized emerging market demand remind us of the 2006-07 period. This time around, however, there is a lack of global policy coordination, as developed countries combat deflation, while the emerging world prepares for rising prices. In Europe, debt woes continue. Credit risks have heightened in Ireland and Portugal, and there are growing concerns that Spain could be the first large economy embroiled in the crisis.

European debt problems are echoed domestically as certain profligate states and municipalities buckle under the weight of revenue shortfalls, under-funded pensions, and dwindling federal support. These concerns, along with a notable increase in bond issuance, have led to a broad sell-off in municipal bonds. As municipalities attempt to significantly restructure their finances, we expect there will be plenty of pain to spread around, including tax hikes (like the dramatic increase in Illinois), mass layoffs, and service cuts; moreover, there is even talk of a streamlined bankruptcy-like procedure for distressed states. While serious, this dislocation in the municipal bond market does create investment opportunities for clients seeking tax-free income. In recent weeks, we have done some selective buying for clients with municipal bond allocations.

Equity markets for the last three years have been dominated by economy-wide macro events. In other words, in an era of housing busts, bank bailouts, a Great Recession, and the subsequent recovery, investment success has been determined by whether or not one holds stocks at all at a particular time, as opposed to which companies one selects for investment. After a sustained period where individual equity returns have been closely correlated to the overall direction of the market, we are beginning to see signs of a return to more normal market dispersions. In fact, in 2010 there was an 88 percentage point spread between the *best* and *worst* returning stocks in the Saybrook portfolio (fortunately most of the spread was on the positive end!). Pundits and strategists call for a “stock-pickers market” whenever they cannot predict the stock market’s overall direction, which, of course, is most of the time. However, we look forward to a market where superior company fundamentals and diligent stock selection are rewarded, and we hope 2011 will be such a year. In this spirit, we will focus the remainder of this letter on changes to the Saybrook portfolio over the past year, explaining our sales in 2010, and introducing some new holdings.

Equity Portfolio Changes

For a good part of the last decade, **XTO Energy** was a Saybrook success. We were originally attracted to the company in 2004 because of its exposure to domestic and land-based energy exploration, its focus on new natural gas extraction technologies, and its successful record of acquiring wells and improving productivity. Seeing these same qualities, **ExxonMobil** acquired XTO in a stock purchase, finalized in June 2010, which reflected a 16% premium from XTO’s pre-takeover price and a 230% gain from our initial purchases. Alas,

while it was hard letting go of our XTO investment, for most clients we have retained the ExxonMobil shares as they reflect XTO's original low cost basis, are quite undervalued relative to Exxon's history, and stand to benefit from the combination of XTO's gas properties and technology with Exxon's legendary expertise and economies of scale. Furthermore, Exxon has a stellar record of rewarding shareholders with an unusually good combination of growth, buybacks, and dividend increases. Although deal skepticism had driven down Exxon's shares leading up to the closing, the stock has rebounded over 30% in the six months since the merger was completed.

The difficult decisions to sell both **Stryker** (last spring) and **Medtronic** (late in the year) were made at separate times but for similar reasons. Formerly, both of these companies were fast-growing leaders in the innovative medical technology industry, with Stryker specializing in replacement joints and Medtronic the leader in cardiovascular devices. After earlier stumbles, we became attracted to their low valuations relative to their historic multiples and growth rates, as moderate but stable growth companies can be quite profitable to investors if bought at the right price. While all companies face challenges, this segment of healthcare has become increasingly problematic. In recent years, companies have sustained countless safety issues and recalls and benefited from only marginal technological advances. Furthermore, profit margins are threatened by major changes to the U.S. healthcare system. Most concerning are further reduced rates of growth as it becomes more difficult to expand sales in an era of tightening fiscal budgets and a changing global healthcare landscape. As austerity sweeps Europe there are literally less euros available for expensive procedures in that continent's government-funded health systems. In the U.S., policy-makers have not yet faced up to challenging Medicare budgetary decisions, but, as Stryker executives described to us at last year's investor meeting, critical medical decisions are increasingly being made "on the carpet" (by administrators) rather than "on the floor" (by doctors), a telling admission from a company noted for its close ties with physicians. Finally, we have grown frustrated by the companies' denial of this slower-growth environment. While they would likely be rewarded by investors if they increased their relatively stingy dividend yields (especially Stryker), instead they try to buy growth with a series of underwhelming acquisitions (especially Medtronic). While we are glad to have sold both of these companies near their recent highs, we are disappointed that our foray in medical devices has left us with anywhere from modest gains to moderate losses for our investors. We are confident that we have found better investment opportunities in other businesses and industries.

Our first move in early 2010 was to buy positions in **Caterpillar Inc.** after gaining comfort with the company's balance sheet and conducting analysis of its earnings potential. Shares of the iconic manufacturer of yellow construction and power-generation equipment were added to nearly every account to round out our basket of exceptional capital good companies (accompanied by our long-time Emerson Electric and General Electric holdings and the late 2009 purchase of Honeywell International). These companies are each

benefiting from global growth, particularly construction and infrastructure building in emerging markets. Capital goods companies operate with a high level of fixed factory investments giving them substantial *operating leverage* when expanding orders drive up capacity utilization rates (i.e., when the world economy grows, these companies grow much faster). Caterpillar especially benefited in 2010 because of its exposure to the lucrative mining industry during a period of rapidly rising raw material demand and prices. Caterpillar's position is further enhanced by its proposed acquisition of Bucyrus International, a leader in advanced mining equipment. Our capital goods companies led the performance of Saybrook's portfolio in 2010, with Emerson and Honeywell both gaining approximately 35%. Caterpillar was the top-performing stock for 2010 in the Dow Jones Industrial Average, up 70%, outperforming nearly everyone's expectations (except for possibly the CEO, Doug Oberhelman, who has been defiantly optimistic during the last two August investor conferences we attended). While pleased with our short-term returns in the company, experience has taught us to remain wary as expectations are now higher and the industry will always be cyclical, regardless of expanding markets in China, India, and Brazil.

Over the course of 2010, we also purchased and added to positions in leading chip-maker **Intel**, whose microprocessors are the brains of most PCs, laptops, and servers. A laggard in the nascent stock market recovery, the technology bellwether has suffered in an era where businesses are hesitant to make capital investments and consumers are more interested in hand-held devices. We are attracted to Intel's extremely cheap valuation, 3½% dividend yield, fortress balance sheet, and, most importantly, the company's record of technological and operating excellence. To date, our gains in this holding are negligible, and, despite record quarterly results, Intel continues to be penalized for not participating in the popular iPhone and iPad platform (Apple uses ARM-licensed chips, which are outsourced through several inexpensive overseas foundries). While we understand the risk posed by non-Intel chips in handheld devices, we are encouraged by Intel's energy-saving Atom processor which is winning inroads into the new generation of Google/Android-based tablets. CEO, Paul Otellini, spoke candidly about these challenges and opportunities on the company's third quarter call:

Tablets are exciting and we fully welcome their arrival...Will they impact PC sales? Sure...we saw the same thing happen when net-books were introduced, but three years later, both the PC and the net-book market segments have grown substantially. We take a longer-term view to the tablet opportunity, and the overarching benefit to Intel...is to have a new, growing computing segment where we can participate...We are going to utilize all of the assets at our disposal to win this segment: the world's best silicon process technology, the best computer architecture, and our global scale...Our 'design-win' momentum is very strong, and...you will see Intel solutions across a variety of form factors and price points. We fully expect to participate broadly and profitably in this category, and that in the end, the tablet category will be additive to our bottom line.

Not to be overlooked, of course, is Intel's position in enterprise servers, the workhorse computers behind websites, e-commerce, and corporate systems. We expect that as computers become more mobile and their uses become more data-intensive, data storage will continue to migrate from the local hard-drive to "the cloud" (remote server fields). On the fourth quarter call just recently, Otellini pointed out that volume of global internet data in 2010 was "greater than all the previous years combined." This astonishing point helped drive Intel's 35% growth in server revenue for 2010. Bearish sentiment on Intel has allowed us to buy the stock at as little as nine times earnings. The company deserves more recognition for its PC franchise (especially as computers become increasingly accessible in emerging markets), dominance in the vital server business, and prospects in the growing handheld market.

At the end of 2010 we initiated modest-sized positions in **BYD Co.** Founded in 1995, this Chinese car and battery manufacturer is an undervalued growth story with the possibility of venture-like upside if its initiatives succeed. Berkshire Hathaway owns a ten percent stake, with Warren Buffett's lieutenant, David Sokol, sitting on the Board of Directors. The company's low-cost, technologically innovative, and vertically integrated auto manufacturing proficiency places it in an enviable position to benefit from both China's growing domestic consumption (China is now the largest automobile market in the world) and its export prowess. And BYD's distinct lithium battery business is making inroads toward solving green technology problems such as time-shift power storage and inexpensive solar generation. We believe the auto and the battery businesses, especially in Asia's growing economies, are attractive on their own. The real excitement, however, comes as BYD combines these technologies to begin mass-producing affordable electric autos, via its own branded cars as well as through joint ventures, most notably a high-profile agreement with Mercedes. BYD's first plug-in hybrid was sold in 2008, and last year the company sold over half a million conventional and electric cars in markets around the world. We expect BYD's products to become more widely known, as company officials announced that their affordable E6 plug-in electric compact car will be introduced in the U.S. in the beginning of 2012. "BYD is going to be a *new energy* car brand," Chairman and founder Wang Chuanfu said in an interview at this month's Detroit Auto Show, "that's because in the U.S. there is fierce competition for gasoline cars; I don't think we have an advantage, but with electric cars it's a different story."

BYD is not a household name to U.S. investors, as it is listed on the Hong Kong Stock Exchange and is headquartered in the neighboring mainland city of Shenzhen. While Saybrook's portfolio consists of mostly U.S. domiciled businesses, we do have a history of owning foreign-based companies with growing global footprints. What matters most to us is exposure to growing end-markets, not the address of corporate headquarters. We are conscious, however, of concerns that the Chinese economy is overheating and that its stock market is rife with speculation, and we acknowledged these concerns when we discussed "International Challenges" in our mid-year 2010 Outlook. More critical, BYD faces a competitive industry, and the

company had its own fundamental struggles in 2010, falling well short of their aggressive sales targets of 800,000 cars. Furthermore, the Chinese government is limiting car ownership in certain urban areas in an attempt to curb air pollution. While none of these issues can be ignored, they enabled us to buy shares in BYD at near 52-week lows (half the price of a year ago). We expect the stock to remain volatile, as the emergence of its technology is uncertain, but we are optimistic about the company's prospects.

Given Saybrook's low-turnover, long-term investing style, 2010 could be considered a relatively high transaction year. The portfolio changes we have made better prepare us for 2011 and beyond, with our new businesses boasting high exposure to expanding markets and leadership in technological and manufacturing innovation. These new economically-sensitive holdings are complementary additions to our diversified portfolio of high-quality companies that helped mitigate losses during the financial crisis and produced solid returns in 2009 and 2010.