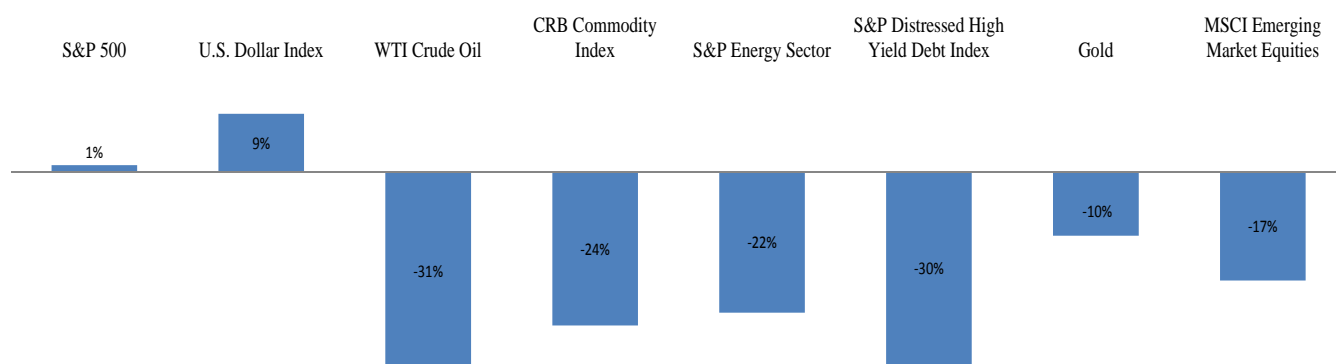


Saybrook Capital

Year-End 2015 Review & Outlook

The broad U.S. stock market ended 2015 essentially where it began. The S&P 500 Index started the year at 2,058 and finished down at 2,044, although it eked out a positive total return of 1% with dividends included. Beneath the surface, financial markets were anything but calm with the S&P down over 10% during the August China-led global market plunge. Even after recovering in the fall, only a narrow sector of the S&P performed well (notably a few large technology stocks), while the average stock in the index was down 4% for the year. As the following chart illustrates, 2015 losses were significant in many areas ranging from oil and commodities to distressed debt and emerging market stocks.



Against such a dire backdrop, our 2015 investment results at Saybrook were decent, although modest, and our average composite equity portfolio outperformed the market. Looking back with a longer-term perspective, one could view last year's flat stock market as a phase of digesting strong gains for equities over the past three years, a period in which our clients' equity portfolios have appreciated more than 50%.

As we begin the New Year, China's convulsions and plummeting oil prices have again driven global markets lower. In our outlook for the year ahead, we discuss a "lower-for-longer" theme that links several current financial market trends.

Portfolio Review 2015: What Worked

In a low growth environment where earnings and valuations stood essentially unchanged for stock market in aggregate, companies with superior growth rates or notable improvements in their underlying businesses were rewarded. Several of our portfolio companies fit this description and outperformed in 2015: Visa (+19% return, as global consumers shift towards electronic payments), Mondelez (+25%, as the candy and snack company pursues a better cost structure), FactSet (+17%, as the financial software company continues to gain market share), and General Electric (+27%, as the conglomerate refocuses on industrial infrastructure with a well-timed exit from financial services).

The company that contributed the most to Saybrook's returns in 2015 and deserves further mention was Google (now known as Alphabet), which increased 46%. We first purchased Google during the darkest days of 2008, using the market crash as an opportunity to own one of the great growth stories of the Internet era. During the

seven years that have followed, Saybrook's investors have enjoyed a quadrupling from our initial purchases, as the search company has come to dominate online advertising, mobile communication, and video distribution. In 2015 the successful transition of advertising from desktop to mobile continued, with key growth metrics in the number of clicks more than enough to compensate for the lower cost per click on mobile devices. Its YouTube franchise (which Google purchased for \$1.65 billion in 2006) is better monetizing its billions of viewers, and is even offering an ad-free subscription model similar to Netflix. But the move that most cheered investors in 2015 was the hiring of CFO, Ruth Porat, from Morgan Stanley. Under her financial leadership, the new holding company, Alphabet, is now divided between its core "Alpha" businesses (Search, YouTube, Android mobile devices) and its more speculative "Bet" concepts (driverless cars, Nest home monitoring, Fiber ultra-high-speed Internet networks, etc), providing more operational clarity and financial transparency for investors.

Portfolio Review 2015: Another Year of Deals

2015 marked the biggest year ever for mergers and acquisitions (M&A), with approximately \$5 trillion in deals announced. Our value-oriented strategy of owning great businesses has served us well during this M&A boom. In July, Kraft Foods was acquired by Warren Buffett's Berkshire Hathaway and Brazilian private equity firm, 3G Capital, for a generous stock price premium and large special dividend. Kraft has now been merged with ketchup king, H.J. Heinz. The new publicly-traded entity, Kraft Heinz Company, is 27% owned by Berkshire Hathaway and managed by 3G Capital, which is deploying its proven zero-cost budgeting and international marketing expertise to grow the bottom line. If this story sounds familiar, it is because Saybrook clients enjoyed a similar occurrence in 2013 when the same investment team acquired Heinz (a core Saybrook holding since 2009), taking it private at a significant premium. We are delighted to have the Berkshire/3G team buy *two* of our portfolio companies; we feel even more fortunate that the Kraft Heinz structure enables Saybrook clients to participate alongside Berkshire and 3G as they improve the newly-merged company and possibly pursue future acquisitions.

In the healthcare sector, news late last year of Pfizer's lucrative offer to merge with Allergan sets Saybrook up for another potential M&A "twofer"! As we updated last year, Allergan, the maker of eye-care products, Botox, and other bio-pharmaceuticals was purchased by Irish-domiciled Actavis in March for a gain of 175% above our average cost (we began to buy Allergan in 2012). We were pleased that our investors received approximately half of the deal proceeds in cash, a valuable currency in an increasingly volatile market. The other half was paid in shares of Actavis, which we have retained, with the whole deal structured as a long-term taxable gain. The Dublin firm subsequently changed its corporate name to "Allergan" and agreed to sell its generic drug business to Teva for \$41 billion; both moves emphasize the company's core research-and-development legacy. In November, Pfizer made a \$160 billion offer for the company, a deal which, *if completed*, would represent a second large windfall paid for Saybrook's Allergan holding in as many years. While agreed upon by both companies, the merger faces much scrutiny, not least because it would mark the largest corporate inversion ever, as Pfizer seeks to reincorporate overseas to reduce its effective tax rate. No American is happy to see U.S. companies move across the Atlantic, and the issue promises to be much debated during the 2016 presidential campaign. Nevertheless, it highlights to us the critical need for sensible and bipartisan corporate tax reform. The difference (or "spread") between Allergan's current price and the value of the merger is unusually large,

reflecting the political uncertainty surrounding this deal. If culminated, we expect a significant gain from today's levels.

In other healthcare news, another chapter in our much discussed Perrigo saga ended last fall with the rejection of Mylan Pharmaceutical's hostile tender offer. Only 40% of Perrigo shareholders voted for the deal, and we joined the majority against the tender. As we outlined in our October letter, the offer significantly undervalued the leading producer of store brand over-the-counter medications, and we considered Mylan's management to be the wrong team to lead Perrigo. Despite the recent price decline resulting from the failed tender offer, we believe that Perrigo has significant growth potential as an independent company or with a more desirable partner.

One of the biggest M&A stories of recent years is one that we *avoided*: Valeant Pharmaceuticals. The company grew from obscurity to an industry juggernaut in a few short years by gobbling up drug and biotech firms, slashing research & development budgets, and sharply raising drug prices. We first encountered Valeant when they made a hostile offer to buy Allergan in 2014 (thankfully Actavis emerged as the "white knight" and topped Valeant's offer). Despite the fact that Valeant was heavily owned and touted for its exponential growth rate by many prominent hedge funds and long-term investors that we know, we were skeptical of their management and the sustainability of their business model. When we attended the annual meeting last spring of Ruane, Cunniff & Goldfarb (the respected, value-oriented investment firm that manages individual accounts and the \$9 billion Sequoia Fund), we were shocked to learn that Valeant made up about 30% of its holdings – by far the biggest position in an otherwise diversified portfolio. By late last year, Valeant's stock price collapsed (down 75% from its August high to its November low) as the company came under siege for its aggressive drug-pricing policies, ties to a sketchy pharmacy partner, and high debt levels.

So why spend so much space discussing a company we have never owned? The story, we think, highlights the importance of sticking to our discipline of seeking to own enduring undervalued growth businesses, even in the face of peer pressure to buy the hot company "du jour". Also, it reminds us to trust our gut instincts (in this case, our first impression was the correct impression). In short, qualitative judgments matter.

Portfolio Review 2015: What Didn't Work

The collapse in commodity prices continued to be a dominant story in 2015 and into 2016. The current price of oil is hovering at 15-year lows, around \$30 per barrel, with prices declining 31% in 2015, on the heels of a 47% drop 2014. The fall in energy prices reflects continued high U.S. production driven by advanced drilling technology, as well as the Saudis' response in keeping output high to protect their market share. The resulting supply glut has coincided with weaker global demand for oil.

This two-year crash in oil and natural gas has clobbered stock prices in the energy sector. Our portfolio companies were not spared, with ExxonMobil and Schlumberger, declining 13% and 16% respectively in 2015. Southwestern Energy, which we no longer own, was a greater disappointment. In retrospect, our first mistake was to underestimate the potential risk from increased debt that Southwestern took on last year to purchase assets in the Marcellus Shale (we had been enthusiastic about the acquisition's long-term potential). We further miscalculated the extent of the domestic natural gas glut and how it was exacerbated by heavily-indebted producers that were forced to continue drilling to meet interest payments on loans, despite market prices that

guaranteed losses. Earlier in the year we traded around this position to harvest losses against substantial realized gains in other investments; however, in the fall, concerned about the durability of Southwestern's balance sheet in this more dire environment, we sold the remaining small positions for a further loss (but, at a price 30% higher than where the stock finished the year). Like all commodities, oil and gas markets will ultimately self-correct, as supply eventually contracts to meet demand. However, to paraphrase John Maynard Keynes, prices can stay irrational longer than highly-indebted producers can remain solvent. Indeed, many now expect over 30% of U.S. oil and gas producers to declare bankruptcy by the end of this cycle, a painful restructuring process – but one that will ultimately reverse the decline in oil and gas prices.

Railroad stocks were another area of weakness, falling 32% on average as the inter-related declines of coal, natural gas, and oil all took a toll on rail shipments. These declines in commodity and energy-related cargo outweighed strengths in building-supply and auto shipments. Saddled with vast fixed costs, these companies were particularly impacted on the bottom line by the 2.5% drop in 2015 carloads. The industry will face a challenging environment again this year. Norfolk Southern's stock price declined 20% last year, even while the company twice rebuffed merger offers from cross-border competitor, Canadian Pacific. While the Calgary-based railroad may attempt a hostile takeover, we place low odds on the deal being completed, as it would likely undervalue Norfolk Southern and would face great regulatory scrutiny from the Federal Surface Transportation Board. However, it is heartening that in a difficult period for rails we are not alone in seeing long-term value in these enduring businesses that are crucial arteries of the North American economy.

We have a further investment in railroads through Berkshire Hathaway, which acquired Burlington Northern in 2010. This rail exposure contributed to Berkshire's 12% stock price decline in 2015. Given that Berkshire is one of our largest holdings, the stock's weakness reduced our overall returns last year. At current levels, however, Berkshire's price relative to its underlying book value is attractive and close to the threshold where the company has pledged to buy back its own stock.

A China-led Global Market Sell-off Continues

While stock markets ended 2015 with a whimper, they started 2016 with a thunderous rout. During January we are witnessing another China-led plunge as the Shanghai stock exchange has declined over 20% (after suspending trading *twice* in the first four days of the year), and global stock markets have fallen 10% on average. As was the case last summer (and discussed in our third quarter investment letter), the global sell-off is the result of continuing concerns over China's slowing economy, the erratic devaluation of its currency, and the aforementioned commodity bust. Although China has huge reserves which it can deploy as it transitions from export dependency to a more consumption-based economy, a near-term risk is that a further slowdown in China leads to devaluations in other emerging market countries, many of which depend on commodity exports.

If the yuan depreciates too suddenly, countries like Indonesia or South Korea might, in response, significantly weaken their currencies to keep exports competitive with China. However, they would face a dilemma in doing so, as such beggar-thy-neighbor devaluations would make it more difficult to repay sovereign and corporate loans denominated in U.S. dollars. And while a currency war is certainly not in China's best interest, it would be hard to contain once started. The Bank of England's chief economist, Andrew Haldane, has characterized these growing economic challenges in China and other major emerging market countries as the "third wave" of the

series of financial crises that began with U.S. subprime mortgages in 2007-08 and continued with European sovereign debt in 2010-12. Many emerging market countries are indeed facing tremendous economic pressures. To wit: *The Economist* proclaimed in a recent cover story on Brazil that “Disaster looms for Latin America’s biggest economy.”

A Lower-for-Longer Perspective

Economic and market trends around the world suggest a lower-for-longer theme, whether it’s continued slow global growth and consequently weaker demand contributing to an extended period of low commodity prices, low levels of inflation restraining a return to more conventional monetary policies, or weaker financial market returns as asset prices continue to consolidate. From the U.S. perspective, recent global convulsions come at an inopportune time. The Federal Reserve raised its benchmark Fed funds rate by 0.25% in December, after having kept its interest rates at zero for seven years. Now, facing heightened global market challenges, deflationary commodity pressures, strong dollar trading headwinds, and continued quantitative easing by Europe’s central bank, the Fed will be forced to go slow in normalizing U.S. monetary policy. And after years of gains for U.S. stocks – in part driven by unprecedented levels of monetary stimulus – stock market valuations appear stretched by some measures, albeit more reasonable after recent market declines. Regarding the outlook, our view is that financial markets are continuing to digest the advances of the past several years and that U.S. stock market returns will be moderate again in 2016. As is always the case in financial cycles, market corrections, such as the one we are currently experiencing, cleanse speculative excesses and are necessary to allow growing company earnings to become more aligned with underlying valuations.

Since emerging from the dark days of the Great Recession, the U.S. economy has proven remarkably resilient. December’s employment report surpassed all expectations and is indicative of an economy that has created 14 million private sector jobs since 2010 (a period in which unemployment dropped from 10% to 5%). Americans are benefitting from a stronger jobs market, long overdue wage increases, and a *tailwind* from lower energy prices which allows consumers to continue shoring up personal balance sheets. Furthermore, U.S. exports to China represent less than 1% of our GDP, so Chinese deceleration does not impact our economy as much as some fear.

Amidst a period of financial turbulence, we find it helpful to recall the old adage: “it’s not a stock market; it is a market of stocks.” It reminds us that we are owners of good businesses that will continue to grow. While some of our holdings may have gotten ahead of themselves in terms of valuation on near-term earnings, others appear attractive at current levels. Looking beyond the current period of volatility, the prospects for our portfolio are bright, especially if one is a patient owner and able to look out three to five years.

In closing, we thought we’d make a pitch for *The Big Short*, the movie based on Michael Lewis’s bestseller about the 2007-08 U.S. housing bubble. In addition to being informative like the book, the movie is immensely entertaining. And for us, it emphasizes the importance of maintaining a healthy sense of skepticism balanced with long-term conviction.