2018 Year-End Investment Review

There was almost nowhere for investors to hide in 2018. Stock markets around the world were down sharply, as were most other asset classes. About two-thirds of our equity holdings were down or flat for the year, with notable weakness in housing-related companies, energy and industrials. Saybrook portfolios ended 2018 down modestly, just the third down year in Saybrook's 42-year history. While all of this decline was recouped in the first three weeks of January, we suspect that high volatility will continue. Investors will need to look beyond the unpredictable day-to-day point swings and instead concentrate on long-term returns.

The following table illustrates how pervasive the damage was in 2018, with only short-term U.S. Treasury bills positive for the year:

2018 Price Changes (indices do not include dividends)

NASDAQ	-4%	U.S. Treasury Bills	2%
S&P 500	-6%	Barclays Aggregate Bond Index	0%
Dow Jones Industrial Average	-6%	Gold	-2%
FTSE 100 (Great Britain)	-12%	S&P Municipal Bond Index	-2%
Nikkei 225 (Japan)	-12%	HFRI Equity Hedge Fund Index	-7%
MSCI Emerging Market	-17%	Dow Jones REIT Index (Real Estate)	-8%
DAX 30 (Germany)	-18%	CRB Commodity Index	-11%
Shanghai Composite (China)	-25%	Nymex Crude Oil	-25%

Following 20%+ gains for stocks in 2017 – a year of calm, steadily rising markets – 2018 was the polar opposite. After a short-lived upswing last summer, the U.S. stock market declined 14% from September to December, its worst quarterly performance since 2008, and in late December the S&P 500 was briefly 20% down from its September highs. Underlying this rout was a growing "wall of worry" including the ramifications of a trade war with China, less synchronized global growth, fears of a U.S. recession, uncertainty over Federal Reserve policy, and concerns about shaky political leadership. Below we review these issues, and then we discuss the year's portfolio adjustments and how, amidst the market turmoil, we remain focused on improving the quality of our holdings.

China and Global Trade

China's slowdown, exacerbated by higher tariffs, has hurt global economic activity. China's exports were down 4.4% year-over-year in December, and its imports fell 7.6% for the same period, suggesting even greater weakness in Chinese consumer demand. Export-oriented economies Japan and Germany both experienced contracting GDP in the third quarter, with slowing exports of autos and other capital goods to China. Weakness in these economies could be a conduit for the Chinese slowdown to spread elsewhere,

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given other trading partners with interlinked supply chains supporting these export behemoths. Multinational companies are starting to feel the impact of this slowdown, with Apple recently citing China as a prime cause of its weaker quarterly iPhone sales. A resolution to the trade war will be critical to prevent further slowing. The stock market is now fixated on the fast-approaching March deadline for a trade deal between the U.S. and China (established at December's G-20 meeting), and while it may be difficult to achieve, economic risks and stock market plunges have a way of focusing the minds of negotiators on both sides. Certainly a trade deal would be well-received if it is viewed as substantive and leads to better protection of intellectual property of multinational companies.

Recent news out of China highlights the country's current efforts to stimulate its economy, including lowering required bank reserves, cutting taxes, and increasing infrastructure investments. China has used such aggressive stimulus methods successfully off and on for over a decade, but piling up debt to do so, and one wonders how long a command economy can continue this process without inflaming further imbalances. The more immediate market-related question is whether these measures and a resolution to the ongoing trade war will be enough to forestall the slide in the Chinese economy?

Will Slowing Global Growth Tip the U.S. Economy into a Recession?

Despite a global slowdown, the U.S. economy remains resilient. Employment surged in December, with new workers entering the job market. Hiring and wage increases, combined with low inflation and falling gasoline prices, all continue to support U.S. consumption, as was evident with holiday sales growing at the highest rate in six years. Railroads, reliable economic bellwethers since they haul goods for a broad range of industries, report a 6.6% increase in railcar loads for early January. While strength in jobs, retail sales, and rail volume are encouraging, they are *current* indicators which can change quickly. Some *leading* indicators, such as the ISM manufacturing survey, have decelerated, and, as the Fed is beginning to acknowledge, our economy is not an island immune from the slowing world economy.

The Federal Reserve reduced monetary stimulus in 2018 by raising interest rates four times and by continuing to unwind its $4 trillion portfolio of Treasury and mortgage bonds. The Fed has been moving gradually toward a more normalized monetary policy during a period of economic strength, but, as "quantitative easing" gives way to "quantitative tightening" a powerful market tailwind has been removed. In his first year as Chairman of the Federal Reserve, Jerome Powell has undoubtedly realized that orchestrating an economic "soft landing" is an extremely difficult job, as worries of an overheating economy in early 2018 gave way to recession fears by the time of the December rate hike. Yields on long-term Treasury bonds notably declined in the fourth quarter and may be signaling a continued global slowdown, but also contained inflation, both of which allow the Fed to be patient with regard to future rate increases. In fact, past Fed Chairwoman, Janet Yellen, speculated recently that the December rate hike may be the last of this cycle.

The late economist Paul Samuelson famously quipped that the stock market had "forecast nine of the last five recessions." To his point, three 20%+ market corrections that we remember well, 1987, 1998 and 2011, were not associated with recessions; in fact, powerful rallies followed those three sell-offs once visibility of the economic expansion in each of these periods returned. The recent stock market decline may have also been premature in predicting a U.S. recession. While any number of the issues discussed above could certainly get worse, the current U.S. economic data we see are more consistent with a deceleration in growth, rather than a recession.

If, over the next year or two, the U.S. were to slip into a technical recession (defined as two consecutive quarters of contracting GDP), we would expect it to be relatively shallow. One reason is the rolling slowdowns that our economy has already experienced in this cycle, including in 2015-16, when commodity prices collapsed and energy and capital goods companies struggled. Additionally, the last twelve months have seen a housing sector slowdown, similar to 1994, also a period of rising interest rates but without an actual recession to follow (see chart #1). While such periods are painful in specific industries, they are ultimately healthy as economic imbalances are wrung out and stock prices consolidate until investors get the confidence that growth will resume.

The Leadership Wildcard

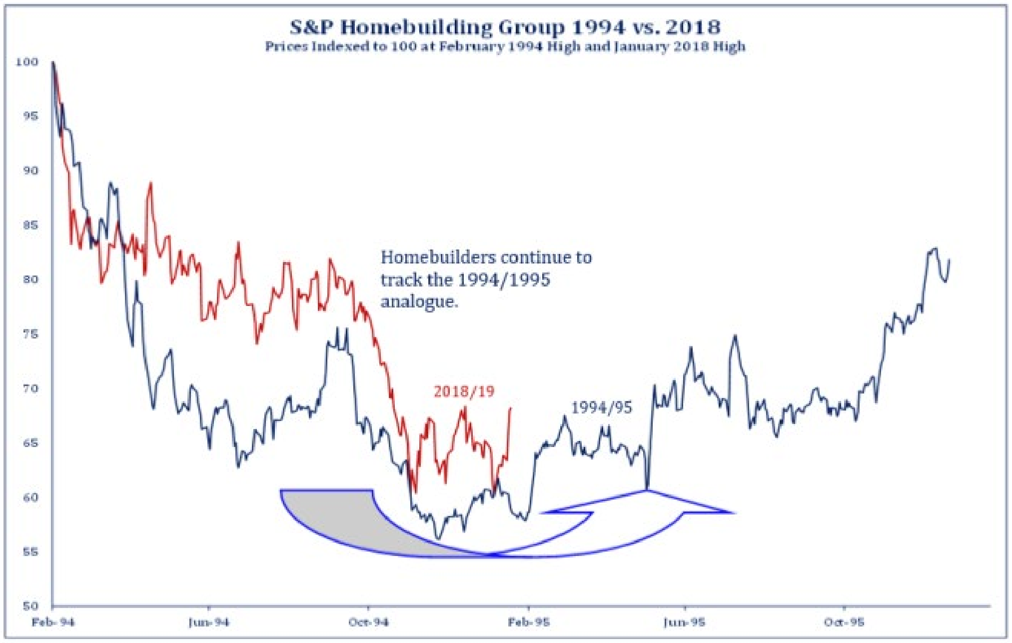
Accompanying December's market swoon was more erratic behavior from the White House, with the sudden resignation of Defense Secretary Mattis and President Trump's threat to fire the Fed Chairman. The now longest-running government shutdown is the latest example of extreme gridlock and could portent future battles over the debt ceiling. We do not know how much more chaotic things will get with the report from Special Counsel Mueller still-pending. In a recent speech, Hank Paulson, who was profoundly tested as Treasury Secretary during the 2008 financial crisis, warns that "dysfunction in government" could compound an otherwise manageable risk into a broader crisis of confidence.

The U.S. has no monopoly on shaky leadership, with protests in the streets of Paris, Italy's budget standoff with the European Commission, and Britain's disorderly attempt to exit the EU. While the March 29 deadline may get extended, a potentially haphazard "hard Brexit" could pose significant business disruption and risk to global financial markets. Students of history know that stable leadership should never be taken for granted. Unpredictable government is a wildcard in today's economic equation.

Portfolio Repositioning in an Era of Disruptive Technology

Amidst economic and market uncertainty, we are focused on continually improving the quality of the portfolio as we seek to own companies that are positioned to benefit from, or at least withstand, the disruptive forces of prevailing technologies. We have been engaged in an unusually active period of portfolio changes over the past year. We have sold some long-held energy, food and consumer products companies that we feel are not adequately adapting to the business landscape in this era of rapid change. We have added to core existing positions with attractive growth prospects and have initiated new positions in Sherwin-Williams and Verizon.

Chart 1



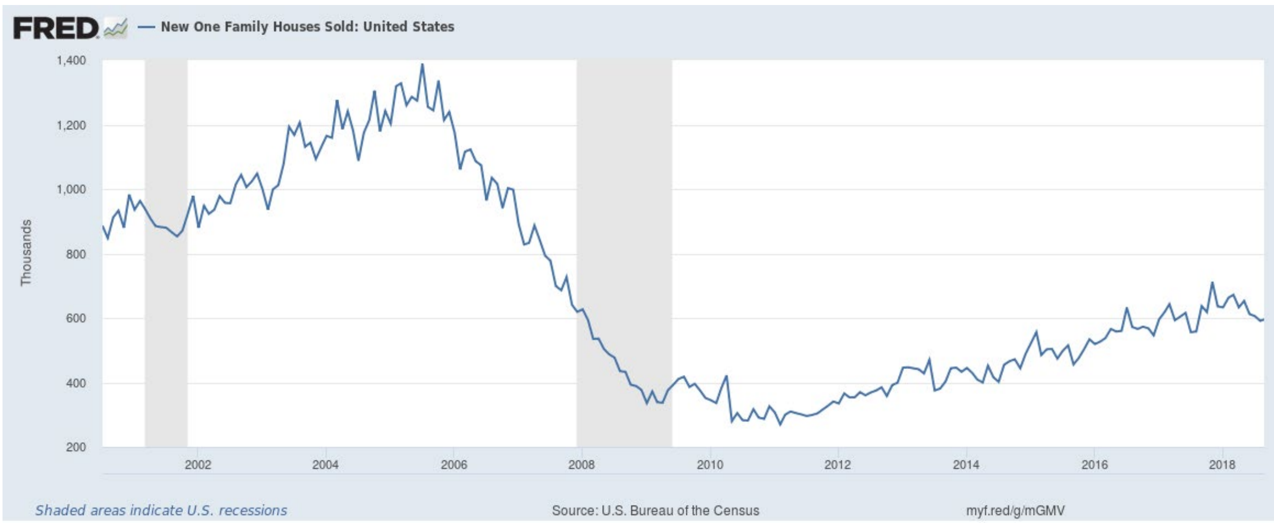
- Strategas Research Partners

Where's the Floor in Flooring…and Paint?

In what has been a terrible year for housing-related stocks, flooring company Mohawk was our worst performing stock in 2018, giving back its strong 2017 gains and then some. Chart 1 illustrates the more than 40% decline in homebuilder stocks in 2018, a similar magnitude to the drop that occurred in 1994 before a subsequent rebound. In addition to general housing market softness, higher mortgage rates, and unusually high cost pressures (commodity inflation, trucking, labor and tariffs), Mohawk is currently working through several internal execution issues relating to its new plants and acquisitions. It also faces capacity constraints as the leading producer of luxury vinyl tile in a period of unprecedented demand for this versus other flooring products. Nevertheless, our faith in Mohawk's potential is underscored by the fact that CEO Jeffrey Lorberbaum owns 14% of the common stock and is willing to aggressively and continuously build the business – despite current headwinds – in order to drive higher future earnings power. Not only are we sticking with Mohawk, which is extremely cheap relative to its cash flow, we have broadened our exposure to the housing sector during this period of softness by initiating a position in Sherwin-Williams.

Founded by Henry Sherwin and Edward Williams in 1866, the company today is a global leader in manufacturing and distributing paint and industrial coatings. With its big 2017 Valspar acquisition, Sherwin-Williams became a major consolidator in this highly fragmented industry. Like Mohawk, Sherwin-Williams currently faces elevated raw material and incremental supply chain costs, along with acquisition integration risks. Indeed, both companies may face earnings pressure for several more quarters, and the road ahead is likely to be bumpy for stocks with housing exposure. But our investments in Mohawk and Sherwin-Williams are intended to be long-term in order to benefit from the wave of household formation still ahead of us by the millennial generation. The supply of U.S. housing remains low, with a modest rate of new residential construction over the last decade following the housing bust (see chart 2). Importantly, these investments are predicated on our belief that flooring and paint businesses are hard to disrupt by new technology. So, while we can't predict where the "floor" is for both stocks we do know that flooring and paint will continue to be essential products.

Chart 2



Finding Value in Wireless

We first became interested in Verizon Communications, the leading U.S. wireless provider, late in 2017 after a bruising price war had driven its stock price down sharply. A low valuation combined with a well-protected over 4% dividend presented a classic case of an unloved "Dog-of-the-Dow" opportunity. Meanwhile, a more positive backdrop was developing for Verizon with subscription prices stabilizing, distracted competitors (AT&T with its big misguided Time Warner acquisition, and Sprint/T-Mobile in merger negotiations), and a multi-year cost-cutting program underway. Since our initial investment, the company has surpassed earnings expectations over the past several quarters, and its stock was a rare notable gainer in 2018, propelled by its expanding base of wireless phone subscribers and its focus on upgrading its core wireless 5G network.

Shifting Away from the Internal Combustion Engine

While best-in-class energy companies such as ExxonMobil and Schlumberger have generated decent returns for us over many years and have been wonderful investments for the greater part of a century, momentum is shifting away from the internal combustion engine. Given the imperative for dramatically reduced emissions and the advancement of battery technology for the electrification of cars, the day will come when we see declining demand for petroleum. In the meantime, energy investing has become increasingly unpredictable with extreme oil price volatility given the excess supply from ever-improving domestic shale drilling technology. We began significantly reducing our energy exposure in the second quarter when geopolitical supply concerns and more robust economic growth temporarily drove oil prices and shares higher.

The Changing Future of Consumer Brands

Like our long-held energy companies, our basket of iconic food, beverage and consumer products investments have generated tremendous returns for decades and continue to deliver steady, bond-like dividends. However, the growth potential and pricing power for many of these staples has been reduced in the face of two broad challenges. First, brand loyalty is dissipating as consumer preferences are rapidly shifting; e.g., away from established, processed food brands toward new, healthier niche products. Second, the marketing capacity and shelf-space dominance long enjoyed by mainstream brands is declining due to intensifying competition from mass discount retailers, the dramatic rise of e-commerce, and the growing appeal of lower-priced, quality offerings, such as the increasingly ubiquitous "365" private label brand from Whole Foods (now owned by Amazon). We have been reducing positions in this sector because we see better returns on investment elsewhere.

Adding to Core Positions

We have reinvested some proceeds into existing portfolio companies, taking advantage of stock market weakness to buy at more attractive valuations. For instance, we added to our positions in Alphabet and Berkshire Hathaway; both stocks declined about 20% from their highs, yet, each is sitting on over $100 billion of cash. Although regulatory scrutiny of Alphabet's Google is likely to intensify, the business continues to generate impressive growth from core search/advertising and is well-positioned for emerging growth from its deep inroads into artificial-intelligence. While the broad market decline has impacted Berkshire's stock portfolio, the overall company trades at an enticing discount to its underlying intrinsic value, and its board of directors in July approved new guidelines allowing Messrs. Buffett and Munger much more flexibility to buy back Berkshire's own stock.

We also used sell-offs to add to our collection of digital payments holdings, PayPal, Visa and Mastercard; each of these stocks managed to finish the year up 15% or more. Interestingly, the one-third of our portfolio that was up for the year was comprised of companies that share a similar business model focused on subscription-like, recurring revenue streams, including long-held positions in Automatic Data Processing and FactSet, in addition to Verizon and payments stocks.

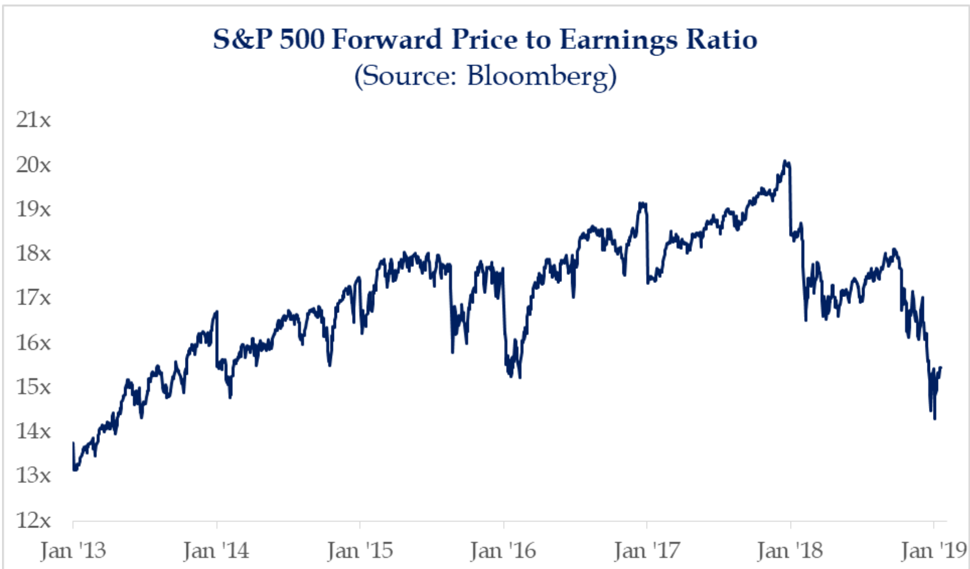
A Tremendous Payments Runway Ahead as the World Digitizes

Across the payments landscape, a recent analysis in *The Wall Street Journal* states: "it is increasingly clear that the ultimate winners are likely to be…Visa and Mastercard" and that "among less traditional players, PayPal looks best positioned, thanks to a strategy that accommodates these giants." To wit: credit and debit cards are likely to account for 70% of total consumer payments by 2022, up from 53% in 2012, as cash and checks continue to disappear as a method of payment. As we have written in past letters, PayPal's 2016 decision to form alliances with Visa and Mastercard was crucial to the company's continued success.

The convenience of PayPal's online checkout button on vendor websites and other "mobile wallet" applications are now married to traditional card networks both in stores and for e-commerce. Looking to the future, PayPal's vision is "to be the world's largest open digital platform for commerce," and its goal is to increase the number of its users from 250 million currently to one billion world-wide.

Reasonable Valuations

2018 was certainly a bad year for investment returns. The good news is that stock prices have become more attractive relative to earnings. The S&P 500 index began 2019 at 15x its total expected earnings for the year ahead versus the more than 18x equivalent valuation a year ago.



We cannot predict the direction share prices will go tomorrow or even a year from now. As Benjamin Graham wrote about the stock market in *The Intelligent Investor* (1949): "Mr. Market lets his enthusiasm or his fears run away with him." 2017 and 2018 indeed personified Mr. Market's tendencies toward opposite extremes. Nevertheless, investors must be willing to endure such uncomfortable volatility and stay invested in order to achieve superior returns to those generated by bonds or cash.