Saybrook Capital

Second Quarter 2016 Review & Outlook

Financial markets were stunned by the United Kingdom's June 23rd referendum to leave the European Union, as modest year-to-date gains for U.S. stocks were erased during a brief, but sharp, global equity selloff. Many international markets, particularly in Europe, China, and Japan, are now down double digits. In a flight to safety that has followed, money has flowed into U.S. dollars, Treasury bonds, and stocks, which rebounded at the end of the quarter. Our portfolio companies also recouped their recent declines.

The unexpected outcome of the British exit vote ("Brexit") threatens a fragile global expansion, especially in the U.K. and Europe. Despite the pound sterling falling over 10% (to a 30-year low versus the dollar) and a significant selloff in European bank stocks, financial markets appear to be functioning smoothly and absorbing the Brexit shock. Nevertheless, there are at least four potential negative economic implications of this historic decision. First, the U.K. and EU nations would likely experience disruptions as CEOs delay projects, supply chains are impacted, and dealmakers re-evaluate contracts during a period in which Britain negotiates its exit from the EU. Second, an already weak European banking system may become further stressed. Third, weakness in Europe could exacerbate strains in China and other emerging markets that we have outlined in recent letters. Fourth, if British and European leaders cannot agree to new mutually beneficial trading terms, restrictions on the free movement of goods, services, and capital between the U.K. and the continent could fundamentally harm the region's economy.

Beyond economics, Brexit is indicative of a wider festering political crisis. A wave of discontent in the western world reflects frustration from years of slow growth, stagnant wages, and a general sense of economic anxiety, all of which manifest as fear and resentment toward immigration and free trade. Rising populism against the so-called political "establishment" is being magnified by the demagoguery of politicians of various ideologies on both sides of the Atlantic. Dangerous impulses could lead to a break-up of the venerable United Kingdom itself (Scotland and Northern Ireland have strong ties to the EU and overwhelmingly voted to remain) or future disengagement from the EU by other member states. More broadly, the risk of a sustained turn toward xenophobia and isolationism is of grave concern. A new era of statesmanship is needed to reinvigorate the positive multilateral approach that America did so much to foster in the years following World War II. For the past 70 years, global living standards have increased dramatically because of international engagement and freer movement of goods, services, capital, and people.

For our portfolio companies, the year has so far proven a mixed bag. While many of our dividend-paying consumer and industrial holdings have performed particularly well, our technology and healthcare stocks have, for the most part, been a drag on our year-to-date returns. Tech stocks overall have been weak (reflected by the NASDAQ Index down over 3% at quarter-end). In our portfolio, Google and Apple have taken a breather thus far in 2016 after recent years of strength. Alphabet, the parent company of Google and one of our largest holdings, continues its incredible 20%+ revenue growth rate, so we view the recent weakness in its shares as enabling the company's earnings to catch up to last year's +46% stock price appreciation. Apple has been punished for being in the trough of the iPhone upgrade cycle with its fast-growing services business not large enough to compensate. While there is, of course, no guarantee that the company can resume its high growth rate, we are encouraged by the loyalty of Apple users and the broad ecosystem of its products and services (plus the recently announced initial investment from Berkshire Hathaway).

Our worst performing stock over the last six months was Perrigo. After persuading a majority of shareholders (including us) to reject Mylan's 2015 tender offer, Perrigo's CEO has left the company after unveiling disappointing results, particularly for its poorly-integrated European operations. While we have taken our lumps and the position has been reduced, we are watching to see if new leadership is capable of accelerating its core business of store brand over-the-counter medicines. On a brighter note in the healthcare sector, our large position in Johnson & Johnson is up significantly for the first half of the year. Thanks to its reputation as a diversified, consistent grower, this longtime core holding has thrived in an essentially flat market. J&J is representative of many Saybrook portfolio companies, characterized by strong management teams in favorable industries, continuing to successfully navigate a challenging slow-growth environment. Another stalwart is Mondelez, the world's second largest candy company (behind privately held Mars), which has appreciated over 65% since its spin-off from Kraft foods in 2012. At the end of June Mondelez made an unsolicited offer to buy chocolate company, Hershey. While the initial offer was rebuffed, it highlights the attractiveness of iconic consumer brands.

Over the past two years of increased market volatility from decelerating growth and currency devaluation in China and other emerging markets, low and even negative interest rates, and now Brexit, U.S. businesses with strong balance sheets, rising dividends, and long-term growth characteristics are increasingly seen as safe havens. This perspective has helped propel ten of our portfolio holdings across various sectors to new all-time highs. Not coincidentally, these ten companies boast an average dividend yield of nearly 3%; double the 1.5% yield of 10-year U.S. Treasury bonds at quarter-end. We expect this flight to high-quality, dividend-paying equities to continue despite, or perhaps because of, continued economic and political turbulence.