

# SAYBROOK CAPITAL

INVESTMENT COUNSEL & MANAGEMENT

## 2021 Year-End Investment Review

Saybrook investments had another great year with equities up, on average, 24% in 2021. Moreover, we have had a remarkable run over the past three years: Saybrook's average stock portfolio appreciated more than 100%. These results again highlight the value of long-term investing in high-quality companies, despite the uncertainty of a lingering pandemic.

The following table, which we have used in previous years, illustrates the range of positive returns for stocks vs. bonds, and the rise of commodity prices and real estate in 2021:

### 2021 Price Changes (not including dividends)

S&P 500	+27%	Nymex Crude Oil	+57%
NASDAQ Composite	+21%	Dow Jones REIT Index (Real Estate)	+46%
Dow Jones Industrial Average	+19%	GSCI (Commodities)	+40%
FTSE 100 (Great Britain)	+14%	HFRI Equity Hedge Fund Index	+12%
DAX 30 (Germany)	+13%	S&P Municipal Bond Index	+2%
Shenzhen A Shares (China)	+9%	U.S. Treasury Bills	+0%
Nikkei 225 (Japan)	+5%	Barclays Aggregate Bond Index	-2%
MSCI Emerging Market	-3%	Gold Spot \$/oz	-4%

In our two previous year-end investment reviews we went in depth on the stories behind our large investments in Google, Apple, and PayPal, which we began buying in 2008, 2012 and 2013, respectively; in this letter we provide brief updates on these companies. Also, we feature several other long-held portfolio companies that have once again performed well, and we assess our basket of payments stocks, which stalled last year. Against the backdrop of a resilient U.S. economy, we review the big surprise of 2021: the persistence of widespread inflation.

Our top performing stocks were Google, FactSet, Sherwin-Williams, ADP, Diageo, Apple, and Berkshire; this group advanced over 40%, on average, in 2021. Each of these high-quality portfolio companies share two distinguishing characteristics: management that understands the importance of reinvesting current profits for future growth and businesses that enjoy significant pricing power.

Another commonality is that six of these seven companies have been owned for over a decade, while Sherwin-Williams was added four years ago. Long-standing clients understand that owning enduring businesses is a hallmark of Saybrook's success. Our consistent focus on the long-term is demonstrated by our low stock turnover and is illustrated in our update letters, where we return again and again to the evolving progress of our select portfolio companies. For example, in our 2013 year-end letter we reviewed our investment in Automatic Data Processing (ADP), the nation's largest provider of business payroll and administrative outsourcing solutions; we wrote: "A gradually improving employment picture and signs of higher interest rates helped ADP return 45% in 2013."

### *ADP and FactSet*

The same can be said of ADP today, and its stock was up 40% last year. At its recent investor day presentation, ADP stated that wage inflation “is good for us” – emphasizing that client funds are billed as a percentage of wages and that higher interest rates yield a higher return on those funds. Because ADP continues to innovate, harness technological opportunities of each era, and enter new adjacent markets (e.g., HR-related outsourcing to smaller companies), it has been successful for six decades. The 20% compounded annual gain of ADP’s stock over the last 60 years is the same return as Berkshire Hathaway, established three years later. More importantly for Saybrook clients, ADP has maintained this impressive average annual return over the 12 years that we have owned it.

FactSet Research Systems, a provider of global financial data, has continuously enhanced the integration of its content offerings and client analytics, gaining market share from competitors like Bloomberg LP and Thomson Reuters. Through the successful integration of many niche acquisitions, FactSet is expanding its client base beyond traditional banking and investment management; for example, the recent addition of Truevalue Labs has grown FactSet’s environmental, social, and governance offering. FactSet continues to expand in the fast-growing Asia Pacific region and across other international markets. When we initially invested in FactSet, it was a little known, but highly profitable, company valued at \$1 billion. Since 2004, FactSet’s market capitalization has grown to approximately \$14 billion. While it is still small relative to our average portfolio companies, we were delighted that FactSet was added to the S&P 500 in December.

Both ADP and FactSet have successfully implemented multiyear investment initiatives to digitally transform their respective services and overhaul their client platforms onto the cloud (using Amazon Web Services). In doing so, each has demonstrated the willingness to endure reduced near-term profitability in order to reinvest for higher future growth. These R&D spending initiatives further enhanced each company’s recurring revenue model and have already resulted in even higher rates of client satisfaction and retention, which enable price increases without crimping demand.

### *Alphabet and Apple*

In that same 2013 letter, we also highlighted Google; we wrote: “Our largest overall holding, Google, climbed 59% during the year.” Today, Google is still our largest holding, and its stock was up 65% in 2021. Google’s parent holding company, Alphabet, has reported extraordinary results in recent quarters, with revenues in key segments Search, YouTube, and Cloud up between 30% and 50% and overall company sales up more than 40%. A Wall Street Journal story after the third quarter release underscored important factors driving Google’s underlying growth from ecommerce, and its market share gains in advertising versus Facebook:

*Much of the company's growth has come from ecommerce advertisers eager to reach customers whose product searches begin online. The company joined with Shopify Inc. this year to simplify search listings and ad purchases for 1.7 million merchants. The effort, which aimed to enliven its ecommerce segment, has helped turn retail ads into Google's largest growth contributor. In recent months, the search giant's retail-ad segment has benefited from the new privacy policy Apple Inc. rolled out. Since April, the iPhone maker has required apps to ask users whether they want to be tracked. The changes have weakened the performance of ads on Facebook Inc. and Snap Inc., according to ad buyers and smaller businesses. Many brands have shifted spending to Google as a result.*

Google's dominant market position and the vigorous advertising recovery have enabled ad pricing to rise with inflation. Its valuation remains attractive, as Google's year-over-year third quarter earnings grew 70%, up even more than its share price for the year.

In contrast to Google, Apple shares have risen not just along with earnings growth, but also from multiple expansion. Earnings growth has been broad-based across every one of Apple's product categories and geographic regions. In the fiscal year ending September 2021, iPhone sales increased nearly 40% with the rollout of the iPhone 13 lineup of premium priced phones. Demand for other devices, including Mac laptops, iPads and AirPods, have also surged in the wake of pandemic lockdowns. Paid subscriptions for its cloud storage, entertainment, gaming, and other services reached 745 million users, up nearly fivefold since 2017. Furthermore, after reinvesting in R&D and paying growing quarterly dividends, Apple bought back nearly \$500 billion of its own stock over the past decade, significantly more than any other company. In the words of NYU finance professor Aswath Damodaran, "they've created the greatest cash machine in history."

Apple's valuation has increased dramatically as our initial thesis about the company's transformation from primarily a hardware manufacturer to an integrated device-and-services ecosystem has become widely recognized. Investors now look ahead to new categories of products and services that Apple could potentially dominate, such as healthcare monitoring, electric-vehicle systems, and the nascent world of virtual and augmented reality (the "metaverse"). Underlying Apple's intense consumer loyalty is its elegant and intuitive product design, embedded services, and reputation for building trust by safeguarding privacy. We gather it is for these reasons that Apple has become Warren Buffett's largest stock holding.

*Berkshire Hathaway, Diageo, and Sherwin-Williams*

Berkshire Hathaway's many portfolio holdings and wholly-owned subsidiaries are performing well, and its stock appreciated 29% in 2021. After underperforming the stock market for quite some time, Berkshire shares have been playing catch-up. The stock began the new year hitting all-time highs and has held up well during the January stock market decline, as investors anticipate that its insurance and financial holdings will benefit from higher interest rates. Berkshire has increased the pace of its buybacks (which Warren Buffett prefers over dividends), repurchasing \$8 billion of stock in the third-quarter alone.

Notwithstanding quarterly buybacks of this magnitude, Berkshire's war chest continues to grow with cash reserves of approximately \$145 billion. This adds countercyclical optionality to deploy cash for additional buybacks or acquisitions during market downturns. We are glad to have added meaningfully to our clients' Berkshire positions in 2020.

Spirits maker Diageo is another long-held portfolio company we added to in 2020, as its recovery, like Berkshire's, lagged the broader market. The producer of top brands, such as Johnnie Walker Scotch, Tanqueray gin, and Casamigos tequila, had been hurt by the global shutdown of bars and restaurants. As on-premises consumption recovered in 2021, Diageo shares rose 38%. The company's increased focus on super-premium labels provides the ability to raise prices. Its long-term growth plans also include marketing more affordable brands such as Guinness and Johnnie Walker Red Label to expanding middle-class populations in emerging markets regions. Additionally, the company is growing ecommerce liquor sales (Diageo is the number one liquor distributor on Amazon in Europe). At its November capital markets meeting for investors, Diageo highlighted these initiatives as central to its goal of increasing market share 50% by 2030.

Paint and coatings manufacturer Sherwin-Williams has performed extremely well throughout the pandemic. Do-it-yourself paint sales jumped during the early lockdown period, while sales to professional contractors and industrial coatings have rebounded more recently. The stock was up 44% last year, also helped by a booming residential housing market. While Sherwin-Williams has the ability to raise its prices to compensate for rising material costs (for solvents, pigments, containers, etc.), there is a lag-time before higher input expenses are offset.

### *PayPal, Visa, and Mastercard*

In contrast to the strong performers above, our payments stocks dented overall 2021 results. This follows a nearly seven-year period in which these portfolio companies steadily outperformed the market as consumers shifted to digital transactions and away from cash and checks. PayPal was our worst performer in 2021, down 19%, after rising 117% in 2020. In last January's letter, we highlighted the company's enviable position at the epicenter of ecommerce, with user adaptation accelerating during the pandemic. During last February's investor day presentation, management introduced its ambitious five-year plan with higher targets for revenue and user growth. Momentum traders, fueled by this optimism, bid up the stock valuation to levels well-above what could be justified by near-term earnings.

Sentiment on the stock began to change at the end of the third quarter. While the company exceeded the high bar set for payment volume and profit growth, management issued more conservative guidance, citing ecommerce supply chain disruptions and a near-term hit to margins from long-term focused technology investments. Additionally, PayPal's stock price, along with many other so-called fin-tech stocks that had

become darlings of the stay-at-home trade, has suffered as traders swapped into bank stocks and other cyclical sectors.

While we knew that PayPal's stock price had gotten ahead of itself, we remained focused on the company's healthy underlying fundamentals. Third quarter results included an increase of 26% in total payment volume and 15% in new accounts, getting to 416 million active users and building towards its audacious goal of reaching one billion worldwide. Its money transfer service, Venmo, is now accepted by Amazon. PayPal completed a major acquisition in Japan, the third largest ecommerce market in the world. And the company rolled out the ability to buy, hold, and sell cryptocurrencies within its digital wallet. In short, we believe PayPal is leading the race to become a dominant financial "super-app" on mobile phones.

In February 2020 we attended Visa's investor day at its corporate headquarters in San Francisco, not knowing that it would be our last in-person analyst conference before the pandemic. The two dominant payment networks, Visa and Mastercard, were thriving in a buoyant economy. But their stocks, having increased fourfold over five years, had reached valuations that were rich compared to projected year-ahead earnings. The lockdowns and sharp recession in 2020 immediately reduced spending on dining, entertainment, and particularly travel, all important segments for the card networks. While domestic in-person transactions recovered in 2021, this fall both companies announced that their highly-profitable cross-border travel volumes were still only 75% of prepandemic levels and would not fully recover until at least the middle 2022. The emergence of the Omicron variant likely further delays that recovery.

Shares of Visa and Mastercard were essentially flat in 2021, further weighed upon by uncertainty regarding regulatory scrutiny and increased competition. A more restrictive environment may make it harder to grow by acquisition, as evidenced when Visa abandoned its \$5 billion bid for start-up Plaid following an antitrust lawsuit by the Justice Department. The financial landscape is also changing, including burgeoning blockchain technology. Potential competitors continue to emerge, well-funded by venture capitalists.

Recent stock price declines provide opportunities to add to these investments at more attractive valuations, particularly given solid underlying fundamentals. Mastercard and Visa delivered over 20% revenue growth in 2021, driven by 12% growth in consumer spending and a favorable mix shift towards online shopping. The payment networks also enjoy a natural hedge against inflation, since they charge as a percentage of a transaction. Furthermore, we are encouraged by exciting new initiatives from these companies. A Mastercard analyst day in late 2021 unveiled improved fraud protection offerings, an essential and revenue-producing service in an increasingly virtual world. Additionally, Mastercard (like Visa and PayPal) is leveraging its existing consumer loyalty and vast vendor networks to offer "Buy Now, Pay Later," where consumers can make an online purchase in four interest-free installments. We believe our three payments companies – with their adaptive cultures – will continue to be the ultimate fin-tech innovators.

### *A Resilient Economy*

Despite Covid's surge last winter, the emergence of the Delta variant in the summer, and Omicron's sudden outbreak after Thanksgiving, the U.S. economy grew at the fastest pace since the 1980s. Domestic output surpassed prepandemic levels by last spring and accelerated to a nearly 7% annualized rate in the fourth quarter, as businesses rebuilt inventories to meet continued pent-up demand. Employment has recovered faster than anyone predicted. The December payroll report revealed a 3.9% unemployment rate, near the 50-year lows. In fact, worker shortages are holding back many businesses, even as companies offer raises and signing bonuses. Emblematic of today's vibrant labor market, a record 4.5 million workers quit their jobs in November, many seeking better opportunities.

### *Inflation: The Biggest Surprise of 2021*

A year ago, with a nascent economic recovery underway, financial markets were not worried about inflation. In fact, in the wake of the pandemic, most economists considered *deflation* a greater concern. Sharp price increases across most sectors in the spring began to attract broader attention, and in our Q1 and Q2 updates we cited concerns that inflation could be more extensive and longer lasting. Even into the fall, the Federal Reserve continued to characterize inflation as transitory, and economists still expected an accommodative monetary policy with no Fed rate increases in 2022. In November Chairman Powell shifted the Fed's outlook, acknowledging that current policy had become untenable. Indeed, the year-over-year Consumer Price Index in December rose 7%, a 40-year high, while the Fed's preferred measure, the core Personal Consumption Expenditures price index, climbed 4.9%.

The current bout of inflation stems from unprecedented levels of government spending and Federal Reserve stimulus in response to the Covid crisis, as well as supply-demand imbalances that have occurred throughout the pandemic, with consumers disproportionately spending on goods versus services. The shortage of workers has contributed to supply constraints and wage inflation. Early retirements, health concerns, children at home, and other factors have combined to depress the labor-force participation rate relative to prepandemic levels. Some companies are raising prices to fund the wage increases necessary to attract workers.

The Fed's December meeting minutes (released January 5) indicated a clear pivot towards a more restrictive monetary policy to combat inflation, with an accelerated wind-down of the Fed's bond-buying program by March. Financial markets now expect up to four 25-basis-point hikes in the Fed funds rate this year, from near-zero today, and a gradual reduction in the Fed's balance sheet. The hope is that inflation moderates with continued improvements in supply chain bottlenecks, allowing the Fed room to move steadily away from its accommodative policy without hindering growth in jobs and the economy. As former Fed Chairman William McChesney Martin famously quipped in 1955, it is now the unpleasant job of the Federal Reserve to take away the "punch bowl" just as the party gets going.

### *Shifting Market Winds*

As we write this letter, the stock market has become much more volatile. Many feel that the Fed is already late in removing the proverbial punch bowl and that inflation will prove intractable. Global supply chains could be further restricted, for example, by factory shutdowns due to China's zero-Covid policy. If stubbornly high inflation remains, the Fed would be forced to raise short-term interest rates at an accelerated pace that could impair the economic expansion.

These concerns, along with expectations for higher long-term interest rates, have severely impacted many previously high-flying stocks. Companies with little or no current free cash flows have suffered the most, shunned by traders who expect future profits to be diminished when discounted for inflation. With nearly half of Nasdaq stocks down over 50% in late January, a lot of damage has already been done in the more speculative areas. But, of course, in market drawdowns all stocks get hit, and we should not be surprised to see a broad correction after a spectacular three-year stock market advance.

Amidst a robust economy, falling unemployment and solid earnings growth, a measured return to normalized monetary policy is both desirable and achievable. However, it will take time before markets are confident that the Fed can orchestrate a soft landing. Given this period of uncertainty, we expect more market volatility, especially compared to 2021, when the S&P 500 chart rose steadily north-by-northeast, with only a few brief sub-5% pullbacks.

### *High-Quality Businesses: The Best Long-Term Hedge Against Inflation*

The Saybrook portfolio is relatively well-positioned for a period of rising prices. Our high-margin portfolio companies provide products and services that are essential or desirable to their customers. The underlying strengths of their businesses have demonstrated their capacity to raise prices without diminishing demand. In short, our portfolio companies enjoy pricing power. These attributes have always been central to how we define quality. Our equities also generate reliable free cash flow to fund a *growing* stream of dividends and/or share repurchases. This is a key advantage for high-quality stocks versus bonds, which generate *fixed income*, or cash, which has its purchasing power eroded over time by inflation.