SAYBROOK CAPITAL

INVESTMENT REVIEW & OUTLOOK

Year-End 2017

Saybrook investments performed strongly overall in 2017, with total portfolios up 20-25%, driven by global economic expansion, U.S. corporate tax cuts, and a resurgence of business "animal spirits." Amidst what proved to be an exceptional year for global financial markets, we are pleased that our portfolios performed so well, even with substantial cash reserves. More importantly, our portfolio companies continue to position themselves for long-term growth across several important areas, including payment networks, mobile technology, railroads, industrials and housing.

The Surprise of 2017: Synchronized Global Growth

While many investors over the past year worried that discord in Washington would disrupt financial markets, the real story for stocks, which no one was predicting last January, has been the emergence of synchronized global growth for the first time in more than a decade. 2017 growth rates exceeded expectations in the U.S., Japan, and Europe, as well as China, India, and many other emerging market countries. In what has been a historically long economic cycle, some of these areas, particularly the euro zone, are earlier in their recoveries than the U.S. In 2018 global growth looks to be accelerating, with the IMF forecasting economic expansion in a record 186 out of the 192 countries it monitors. Some data points offer a flavor of this widespread growth: German industrial production at an eight-year high; Japan in its longest expansion since 1990; global annual auto sales surpassing 90 million vehicles for the first time, with more than 25% going to Chinese buyers; and oil prices climbing to three-year highs with increasing worldwide demand. The U.S. economy, meanwhile, continues its upward trajectory. With annual job growth exceeding two million for the seventh straight year, unemployment stands at a 17-year low of 4.1% and GDP growth has increased at a better-than-expected rate near 3% over the last three quarters.

A Resurgence of "Animal Spirits"

Along with global growth, a resurgence of "animal spirits" – the rise in business confidence and investor sentiment – proved to be an important coinciding trend in 2017. This surge in optimism among the business community was sparked by the perception that Republican control of Congress and the White House following the 2016 elections would lead to business-friendly policies. This perception was validated by widespread regulatory rollbacks starting early last year and was bookended by significant tax legislation in December. While part of a larger, complex and controversial bill, the major changes in U.S. corporate taxation taking effect in 2018 will positively impact our portfolio companies, most notably: the reduction in corporate tax rates from 35% to 21%, a "territorial" system whereby foreign subsidiaries are not subject to U.S. taxation going forward, repatriation of past foreign earnings in exchange for a one-time 15.5% tax, and 100% depreciation of capital expenditures for the next five years. These changes provide corporations with greater flexibility for dividends, share buy-backs, debt reduction, and acquisitions.

Beyond a near-term economic boost, the degree to which longer-term growth will be stimulated by these corporate tax cuts remains to be seen. However, the power of confidence in economic behavior and decision-making should not be underestimated. In his 1936 publication, *The General Theory of Employment,* *Interest and Money*, the renowned economist (and investor) John Maynard Keynes originally used the term "animal spirits" to help explain why capital allocation and other economic decisions are made and to describe human emotion that drives consumer confidence.

"A wave of optimism has swept over American business leaders, and it is beginning to translate into the sort of investment in new plants, equipment and factory upgrades that bolsters economic growth, spurs job creation – and may finally raise wages significantly," *The New York Times* reported in a front page story on January 2nd. Many U.S. corporations have already announced plans for pay raises and/or bonuses, including portfolio company, Apple, which will also pay $38 billion in taxes to repatriate much of its $252 billion in profits accumulated overseas. Apple announced it will add more than 20,000 new U.S. jobs and spend $30 billion on advanced U.S. plants and facilities over the next five years, an increase in domestic investment which CEO Tim Cook attributes to the corporate tax overhaul.

Risks and Unintended Consequences

In addition to the more evident geopolitical risks we face in 2018, such as North Korea and NAFTA trade re-negotiations, there could be negative unintended consequences over time from massive changes in the U.S. tax code. Michael Bloomberg, former New York mayor, corporate CEO, and staunch Wall Street supporter, argues that corporate tax cut benefits will be negatively offset by higher long-term deficits and reduced investment in public funding priorities. Major tax alterations can have powerful and unexpected spillover effects. To wit, *The New York Times* reported: "Obscure provisions around depreciation rules in the 1986 tax reform act set off a downturn in the commercial real estate industry that, in turn, was a major factor in the 1990 recession." A more immediate risk is that the additional fiscal stimulus from the tax cuts, at a time of strengthening global growth, could cause a spike in inflation and interest rates from an overheating U.S. economy. Recall that the 22% stock market crash on October 19, 1987 came in the wake of the bipartisan 1986 tax legislation, a period of rising interest rates and somewhat similar financial market exuberance.

The stock market today is not prepared for a sharp interest rate upturn as the consensus view among investors and the Fed is that the "Goldilocks" economy will continue with economic growth strong enough to further reduce unemployment, but not so strong as to engender higher-than-desired inflation. Given the widespread optimism across financial markets, we detect the rise of that always dangerous sentiment that it is now "easy" to make money in the stock market. Investor complacency has been heightened by the fact that there hasn't been a single day in well over a year when the S&P 500 declined more than 2%, a period of market tranquility unseen in decades. An eventual market correction is, of course, inevitable and would be healthy, as it would help reign in speculative excesses.

Stock Valuations:

As we enter 2018, we are mindful that price-to-earnings ratios appear high on an absolute level, and good economic news is already reflected in current share prices. However, relative to still *low interest rates* and given the *substantial impact of corporate tax cuts on future earnings*, valuations look more reasonable. In a recent interview, Warren Buffett called the corporate tax overhaul a "huge factor in valuation." He went on to say, “you had this major change in the silent stock holder [the federal government] in American business who has been content with 35 percent ... and now instead of getting a 35 percent interest in the earnings they get a 21 percent and that makes the remaining stock more valuable." Put another way: $100 of domestic corporate earnings now becomes $79 (after a 21% tax) versus the $65 (at the prior 35% tax), effectively increasing an investor’s share of ownership by nearly 22%.

While we obviously cannot predict interest rates or market fluctuations, we can focus on our portfolio companies’ long-run prospects and the degree to which they will benefit – or be at risk – from emerging global trends. Below we highlight several sectors where we have concentrated much of the portfolio. Not only were our companies in these areas major contributors to our results in 2017, they are investing aggressively to position themselves for continued growth in the future.

Payment Networks:

We have been heightening our focus on the fast-growing area of global payment networks, as consumers are increasingly paying with credit and debit cards while shifting away from cash and checks. We initiated positions in Visa and PayPal (via its former parent company, eBay) in 2013 and have selectively increased both positions and added MasterCard for some accounts. The explosion in e-commerce has hastened the transition to electronic payments, driving more share to these companies, which collect merchant commissions on billions of transactions worldwide without the risk of issuing credit. PayPal, which has grown well beyond its web-auction roots (it was spun off as an independent company in 2015), is particularly well-suited for shopping on mobile devices, and has promising growth in its cross-border remittance and social payments (Venmo) businesses. PayPal recently formed strategic alliances with Visa and MasterCard, both previously viewed as mortal adversaries. These partnerships enhance the collective competitive positions of all three companies versus upstart rivals. Our portfolio companies in this space have invested heavily to bolster their “network effects” – the phenomenon whereby a service becomes more advantageous the more broadly it is used, in this case both consumer preference and merchant acceptance. Another priority has been international expansion. India, for example, is making a significant move away from paper currency. While Visa faces competition in India (from the state-backed Rupay), it recently reported a doubling of transaction volume in this huge market. Reflecting greater than 20% earnings growth and promising new markets, these stocks were our strongest performers in 2017, with PayPal climbing 86% and our other payments stocks up over 45%. We believe this story is still in the early innings, given the global opportunities for payment networks and the strong market positions of our portfolio companies in this space.

Mobile Technology:

We first bought Google (now called Alphabet) in the fall of 2008 in the depths of the financial crisis, having been attracted to the internet search platform which was just starting to dominate advertising the way network TV once did. While the stock occasionally lagged due to concerns about the transition away from a desktop world, we built the position into one of our largest holdings, confident that the evolution towards mobile devices posed an opportunity for the company. In 2017, after initial concerns about ads linked to inappropriate videos on its fast-growing YouTube network, the company again surpassed investor expectations, rising 33% for the year on increased mobile ad utilization and profit margins at the highest levels since 2013. The next technological frontier is artificial intelligence, and Alphabet continues to invest heavily in "AI". For example, its Waymo autonomous auto subsidiary will soon begin to accept Arizona passengers in its driverless cars – a technology that was the butt of jokes a mere five years ago.

Apple appreciated 46% in 2017, benefitting from new product launches and increasing revenue from apps and entertainment. In fact, during 2017, Apple's services ecosystem surpassed $7 billion in quarterly (and mostly recurring) sales, which, as a standalone company, would place "Apple Services" in the Fortune 100. Apple, which we began buying in 2012, is often maligned as a products company only as good as its next launch, explaining its historically low valuation. But perhaps its growing and durable annuity stream is what prompted Warren Buffett, who has famously avoided technology for much of his career, to compile a $20 billion position in Apple over the last 18 months.

Railroads:

Saybrook has assembled a collection of railroad holdings over the past decade, with our ownership in Norfolk Southern, Union Pacific and Burlington Northern (via Berkshire Hathaway's 2009 acquisition). Investment in the U.S. freight railroad system is a long-term play on the strength of our manufacturing sector, the growth in global trade (containers transfer directly from ship to railcar), and the further efficiency of rails versus trucking competitors. With large fixed costs combined with notable productivity improvements, railroads are classic beneficiaries of positive operating leverage – in the first three quarters of 2017, with costs up only 4%, Norfolk Southern grew revenues 7%, translating into a 17% increase in earnings per share. The U.S. corporate tax overhaul is extremely favorable to railroads whose operations are almost entirely domestic (prior to the recent tax law changes, U.S. railroads paid effective tax rates of nearly 40%). Our pure-play rail investments rose over 33% in 2017, and Berkshire Hathaway was up 21%.

Industrials:

Our two industrial holdings, Honeywell and 3M, are performing extremely well and their stock prices were each up more than 30% last year. Industrial producers had an excellent year in 2017, benefiting from domestic and overseas economic acceleration, and we are expecting a further boost for producers of capital goods, as corporations utilize some of their tax cut windfall to take advantage of 100% depreciation on capital investments. Additionally, a tightening labor market encourages companies to invest in productivity-enhancing plants and machinery. Honeywell, with its concentration on commercial and factory automation is particularly well-suited to benefit from increased capital expenditures. Importantly, our industrial businesses have significant exposure to overseas markets, both rapidly expanding regions such as China and India, but also large developed markets, like Europe and Japan, which have resumed growth. As the value of most foreign currencies have increased with their resurgent economies, overseas profits become further augmented when translated back into dollars. Honeywell and 3M have invested heavily across the world over decades and are well-positioned for continued global expansion. At a recent meeting with 3M, CEO Inge Thulin expressed to us his confidence that sales in China (currently 12% of the company's overall revenues) could more than double in the next five years, with products ranging from air safety filters to electric car components. In contrast to the well-publicized debacle at industrial rival GE, which lost a third of its value in 2017, the management teams at Honeywell and 3M have proven themselves with smart capital allocation decisions and better transparency with shareholders.

Housing-Related:

Our most recent significant purchase is Mohawk Industries – the world's largest flooring manufacturer with leading positions in ceramic, carpet, laminate, wood, vinyl, tile and stone flooring. The stock rose 38% in 2017 as the company expanded its plants and products amid improving housing markets in the U.S. and around the world. We first considered buying Mohawk in 2006, but passed due to concerns about the deteriorating housing market at the time. We continued to watch the company and became more impressed by its increasing global market-share and comprehensive product offerings. Management successfully expanded into new regions, including recent factory openings in Tennessee, Mexico and Russia. Mohawk has also been aggressive in buying and integrating U.S. and foreign flooring businesses. Having acquired nearly 40 companies since 1992, Mohawk just announced the purchase of Godfrey Hirst Group, the largest flooring manufacturer in Australia and New Zealand.

We began building a position in 2016, attracted not only to Mohawk's valuation relative to greatly enhanced earnings power, but also to several underlying qualities the company has demonstrated. These include: dominant market-share, durable competitive advantages from its distribution networks, tremendous global growth opportunities, strong cash flow and profitability metrics, balance sheet prudence, proactive sustainability initiatives and a family-run management culture with significant family ownership. Mohawk is a company which embodies many of the key criteria we seek when making new investments.