

## Saybrook Capital Year-End 2016 Review & Outlook

### Saybrook Capital at 40 Years: A Look Back as We Move Ahead

*“The stock market will be higher ten, twenty and thirty years from now, and it would have been with Hillary and it will be with Trump.”* Warren Buffett, November 11, 2016

There was no shortage of surprises in 2016, a turbulent year in politics and financial markets. The year began with a China-led rout which sent global stock markets plunging and the S&P 500 down -12% during the first six weeks. The rise of populism on both sides of the Atlantic fueled the unexpected Brexit vote and the election of Donald Trump. Then, confounding the consensus view among investors that a Trump victory would cause a market collapse, the broad stock indices began a surge the day after the election which drove stocks up +12% by year-end.

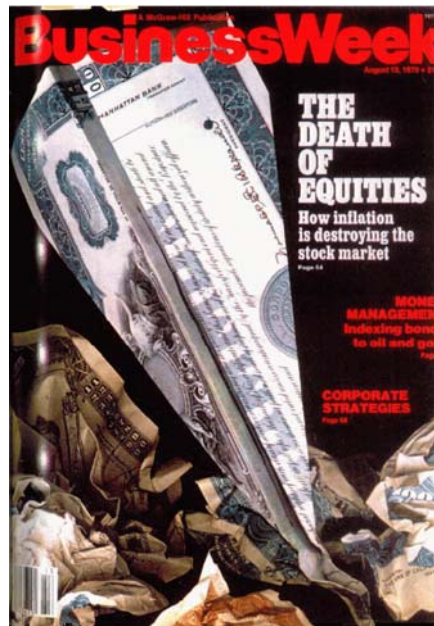
Despite a period of increased volatility, the U.S. stock market was essentially flat for the year-and-a-half leading up to the election, with most of last year’s gains accruing after November 8<sup>th</sup>. This sharp run-up is based largely on the hope that the new president and the Republican-controlled Congress will quickly enact business-friendly policies, including tax reform with favorable repatriation of corporate cash held overseas, lighter regulations and other fiscal stimulus which could lead to significantly higher U.S. economic growth. In short, the incoming administration has set high economic expectations. The risk, of course, is that stock market optimism has gotten ahead of reality given that the political process will be inevitably messy. Other economic risks remain, including a potential movement toward protectionist trade policies and a resulting backlash against U.S. multinational companies. Furthermore, since the election, bonds have sold-off substantially as interest rates have increased and the value of the dollar has risen sharply. A further spike in either could lead to financial market dislocations.

We like the above quote from the Oracle of Omaha because it highlights the importance of a *long-term perspective* when investing and reminds us of the always-present nature of *uncertainty*. In this letter, as we commemorate the completion of Saybrook’s 40<sup>th</sup> year of providing investment counsel and management for families and related institutions, we take a look back at the vagaries of the markets – including many dire periods – during the life of our firm. And as we move ahead, we highlight some insights we have learned during our journey and the central importance of staying true to our guiding principles. Over four decades Saybrook investors with the fortitude to ride-out the tough times have been rewarded with substantial wealth accumulation, as we have generated an average annual return of 12% after fees, outperforming the S&P 500’s 11% annualized return.

2016 exemplified “uncertainty,” a term we use frequently in our letters. In his influential text *Risk, Uncertainty and Profit* (1921), Frank Knight distinguished between risk, which he defined as having

“measurable” probabilities, versus “true uncertainty,” which is unquantifiable. We use the term to describe the unknown risks to the portfolio. Looking back over Saybrook’s 40-year history we recognize that, while some periods of uncertainty are more pronounced than others, uncertainty is a constant.

Saybrook Capital was established in 1976, in the aftermath of the debacle of the Vietnam War, the 1973-74 bear market in which stocks sank by 50%, and the malaise that followed the constitutional crisis surrounding Nixon’s impeachment hearings and resignation. It hardly seemed an ideal time to start an investment management firm with a focus on U.S. equities. It was a brutal investment climate amidst the decline of America’s industrial base and global competitiveness, along with a severe energy crisis and long period of stagflation, marked by both high unemployment and inflation. The decade ended with blows to the U.S. geopolitical position from the hostage-taking in Iran and the Soviet invasion of Afghanistan. In 1979 *BusinessWeek* pronounced “The Death of Equities” in its infamous (and ultimately ill-timed) cover story.



The 1980s dawned not with the optimism for which the decade is remembered, but instead with a severe double-dip recession in 1981-82, marked by 11% unemployment and accompanied by a spike in interest rates to 20% as Fed Chairman Paul Volker moved to combat double-digit inflation. While stocks turned positive beginning in 1983, in the wake of the Latin American debt crisis, the years that followed offered skittish investors many opportunities to panic and sell – most notably the historic stock market crash in October of 1987.



The 1990s are remembered as an era of general peace and prosperity, the unveiling of the internet and the technology boom that followed. Yet, the decade began in recession on the heels of the savings and loan scandal, and was marked by a series of debt, currency, and emerging markets crises causing global market disruptions, most notably Mexico and Orange County, CA (1994), Asia (1997), and Russia (1998). Also in 1998, the Federal Reserve intervened after the collapse of Long-Term Capital Management, a global hedge fund managed by Nobel-prize winning economists! Nevertheless, stock markets soared through the second half of the decade. But despite new highs for the broad U.S. stock indices, the late '90s were frustrating for many value-oriented investors, as a handful of “new-economy” tech stocks seemed to double every several months, while the stocks of many high quality companies that were perceived to be “old economy” has-beens lagged. This, of course, ended badly with the dot-com bubble bursting in 2000 and the technology-heavy NASDAQ index falling by 80%. It would take the next fifteen years for the NASDAQ to recover those losses.

After the euphoria of the 1990s, the first decade of the new century saw years of extreme uncertainty. At the outset, of course, was the 9/11 terrorist attack, another historic date which will “live in infamy” as we suffered the worst blow to the U.S. homeland since Pearl Harbor. A severe recession and bear market followed as the S&P 500 declined by 50% before bottoming after the U.S. invasion of Iraq in the spring of 2003. Then in 2007, the housing meltdown began as U.S. mortgage defaults rose and a global credit crisis ensued with the 2008 failures of Bear Stearns, Lehman Brothers, and AIG. Eight years ago we were in the midst of a Great Recession as U.S. unemployment climbed over 10% and the S&P 500 declined by 60%, reflecting the real possibility of another Great Depression.

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DAI 1091.751 ▼ 50.48 -4.4% NAZDAQ 2179.91 ▼ 1.6% NYSE Comp (1224.76) DJ STOXX 90 2746.81 ▼ 4.0% 30-YR TREAS 4.2 3/31 yield 3.42% OIL \$95.73 ▼ \$5.47 GOLD \$783.10 ▲ \$2.00 EURO \$1.4110 ▼ \$0.08

## AIG, Lehman Shock Hits World Markets

Focus Moves to Fate of Giant Insurer After U.S. Allows Investment Bank to Fail; Barclays in Talks to Buy Core Lehman Unit

The convulsions in the U.S. financial system sent markets across the globe tumbling, as two of Wall Street's biggest firms looked to exit the scene and insurance titan American International Group Inc. turned to the Federal Reserve and the state of New York for assistance.

The U.S. stock market suffered its worst daily point plunge since the first day of trading after the Sept. 11, 2001, terrorist attacks. Financial markets were riveted by the rash of sales Sunday of Merrill Lynch & Co. and the bankruptcy cover filing of Lehman Brothers Holdings Inc., which screamed Monday to sell its most prized businesses before too many employees and customers walk out the door. (Please see related article on Page C1.)

All day Monday, top Lehman officials were holed up in Manhattan at their Seventh Avenue

ing. For much of the day, the major U.S. market indexes were down 2%, which, while a good-sized decline, was smaller than many had thought would be the case. But in the final hour of trading, a wave of selling hit, driven by concern about the fate of AIG. The Dow Jones Industrial Average ended down 504.48 points on Monday, or 4.9%, at its daily low of 10057.51, down 28% on the year. Of the Dow industry's 30 components, all but one—Coca-Cola Co.—fell, led by a 60.8% plunge to AIG.

In Europe, London's FTSE 100 index dropped 3.9%. Several Asian markets, including Japan and China, were closed Monday due to holiday. By Tuesday, Tokyo shares were down 5.1% in early trading, and Hong Kong's Hang Seng index was down 6.1%.

Monday's action was the latest falter in a widening financial crisis that began a year ago with the fall of American housing prices and is now redefining the U.S. financial system. Steps unveiled by the Federal Reserve to avert its emergency bond



### AIG Faces Cash Crisis As Stock Dives 61%

BY MATTHEW KRANTZSCHNO, LIAM FLYNN AND KENNETH NO

American International Group Inc. was facing a severe cash crunch last night as ratings agencies cut the firm's credit ratings. Soaring the giant insurer to raise \$10 billion to cover its obligations.

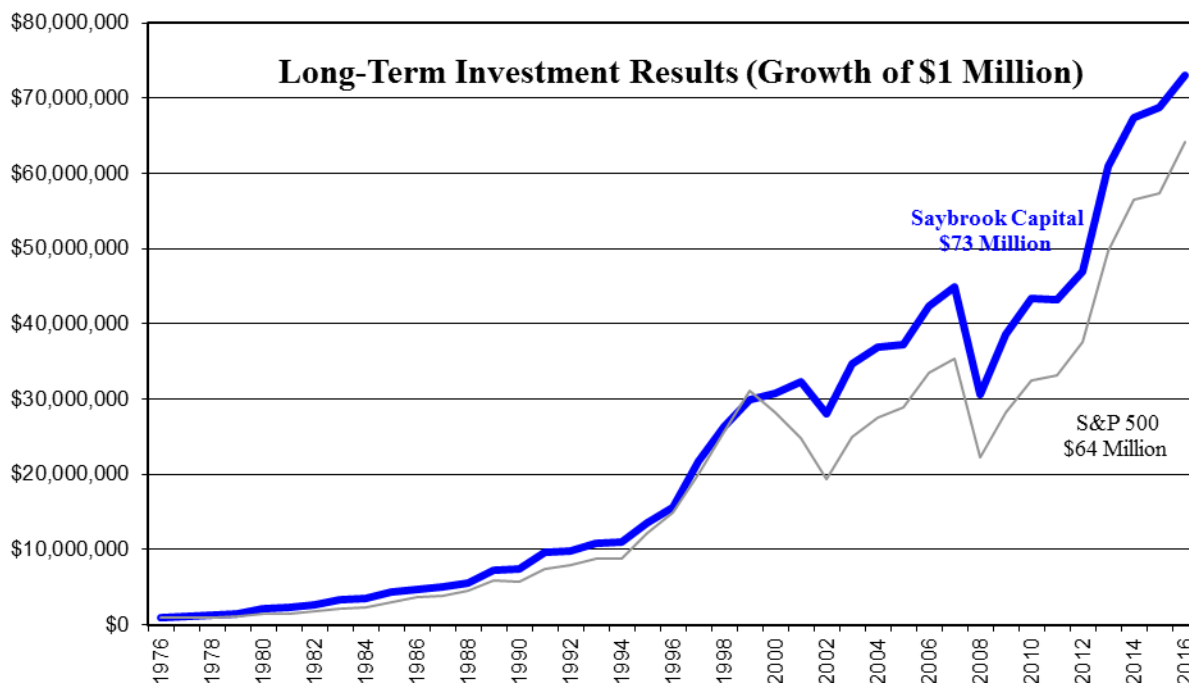
Wall Street now teetering a crisis that began with falling home prices and a decision to equip Wall Street has reached one of the worst in the nation's economic history. One warning to intensify the financial storm and greatly complicate the government's efforts

During the uneasy recovery that has followed, investors have experienced U.S. government shutdowns, the first downgrade of U.S. Treasury debt coinciding with a 20% U.S. stock market sell-off in the summer of 2011, a severe sovereign debt crisis in Europe, unprecedented zero-to-negative interest rates, and now the rise of populism and the most divisive U.S. election in memory.

The reason for this breathless account of 40 years of investment history is to demonstrate that there has always been – and will always be – uncertainty. The rare moments when it feels like there is no uncertainty, say, 1999, are periods of complacency and are often the most dangerous of all environments for investors. All the events listed above were of real concern. As these events unfolded, they provided plenty of reasons for short-sighted investors to throw in the towel and liquidate their holdings. And at each of these moments of time, many did just that. The age-old problem is getting back in, as markets recover inexplicably fast and move to new highs (see 1975, 1983, 1987, 1995, 2003, 2013, November 2016). Furthermore, individuals must pay substantial capital gains taxes if they want to “get out” of the market. Market timing is a loser’s game, one that we choose not to play.

The other reason to remain invested long-term is that stocks go up more often than they go down. If you were to breakout each of the last 40 years you would notice that in approximately 75% of those years, stocks recorded gains (Warren Buffett made this same point in his 2008 annual report, following a 37% decline in the S&P 500). The simple reason that stocks go up most of the time is that just as humans seek progress in the face of adversity, it is the basic mission of corporations to seek profit for shareholders.

Our superior investment results over the last 40 years have been forged holding firm to our investment philosophy and by staying the course in the face of uncertainty.



Our investment careers have encompassed more than half of this period. And over the last decade working together in partnership to manage Saybrook portfolios, we are especially proud to have guided our clients safely and successfully through the great panic of 2007-09. We worked hard to protect principal during that calamitous period and to grow it substantially in the years since. Along the way, we have managed to gain some measure of wisdom, especially during the most challenging periods. The following are some critical insights gleaned over our years in the investment business.

**Learn from history and maintain a curious, open mind** – Life-long fascination with the confluence of events that impact investment decisions is why we were originally drawn to investing and why we have chosen to build our careers in this field over the past quarter century. We relish the intellectual stimulation of constantly being challenged as students of *political economy*: the interplay of philosophy, politics, economics, international relations, trade, psychology, markets, business and management.

**Embrace that which we have the capacity and ability to control** – The confluence of events that often drive markets to extremes cannot be controlled, but market fluctuations can be either sensibly ignored or prudently acted on. 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... [But] the true investor scarcely ever *is forced to sell* his shares, and at all other times he is free to disregard the current price quotation... He [is] entitled then to disregard the market decline as a temporary vagary of finance, unless he [has] the funds and the courage to take advantage of it by buying more [shares] on the bargain basis offered.”

**Think like an owner-investor not a speculator** – The former is characterized by seeking to own shares of sound businesses which we have the competence to understand and assess and which we believe can generate good returns over time, whereas the latter is essentially trading or gambling. As Graham wrote in his first classic book, *Security Analysis* (1934): “An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.”

**Adhere to a disciplined yet flexible investment philosophy** – At its core, our philosophy is to invest alongside our clients and *balance safety of principal and growth of capital*. Through our *Undervalued Growth* approach, we seek to only invest in growing businesses that can be acquired at reasonable valuations. This discipline in making each individual investment decision helps us avoid trouble. For example, during the late ‘90s we didn’t buy tech stocks that offered much potential growth but were trading at unreasonably high valuations. The reverse proved true in 2006-07, when we avoided bank stocks that appeared undervalued but didn’t offer sufficient growth prospects. We maintain *concentrated diversification* with portfolio positions in *high-quality* companies with enduring business characteristics. In this way our portfolios overall have avoided permanent impairment of capital (how we define risk) in challenging times. All of these investing principles encourage long-term ownership of sound businesses to build wealth over time from steadily rising dividend payments and the *compounding effects* of tax-deferred share price appreciation. As Albert Einstein quipped, “compound interest is the eighth wonder of the world.”

**Balance humility and fortitude** – We have made countless investment mistakes over our careers thus far, and we are sure to make many more in the future. More often than not (we hate to admit) our mistakes come from simply failing to adhere to our basic disciplines listed above. Examples include: buying a newer company that does not have sufficiently demonstrated returns; continuing to hold a company that has taken on too much debt or made a significant acquisition that ends up eroding the underlying franchise; or not recognizing quickly enough a fundamentally negative change to a once great company or industry. When we make such mistakes we take some solace remembering the wise perspective of a late mentor and client of ours who often told us: “If you don’t make mistakes, you aren’t doing anything.” The good news is that we try hard to learn from our mistakes, and we do become better investors through the (painful) process. Ultimately, when we get it wrong we take our lumps and move on. Prudent portfolio diversification helps us to mitigate such losses. While we are not always good sellers, we do cut our losses and let our winners run. As the great Fidelity investor Peter Lynch said, “Pick your weeds and water your flowers.”

As we look to the future, we remain completely committed to our guiding business principles:

- Serving our clients with integrity
- Focusing on families and related institutions
- Providing customized investment counsel & management
- Adhering to our time-tested investment philosophy
- Delivering excellent results

Finally and most importantly, in a year marking the 40<sup>th</sup> anniversary of Saybrook Capital and the 10<sup>th</sup> year of our partnership working together, we deeply appreciate our relationship with you and we thank you for your business.

Sincerely,



Scott R. Hirsch



Luke M. Babcock

Saybrook Capital performance is based on the results of a composite of fully discretionary accounts, containing stocks, bonds, and cash. Results are calculated as a dollar-weighted average of the performance of each of these representative accounts, and reflect the payment of management fees (performance is 'net' of fees). Saybrook's long-term record is compared to the S&P 500 (total return including dividends), the most accepted broad index of U.S. equities. Since this index is 100% invested in a cap-weighted portfolio of stocks, while Saybrook's portfolios are usually not fully invested, our portfolios tend to be less volatile than the index, meaning they often rise less in ascending markets and often decline less in falling markets. While Saybrook's performance has been positive during this period, there is no assurance that a portfolio will not decline in the future. In a sharply down stock market, our accounts will probably lose some value. Source: Standard & Poor's.