

January 12, 2015

Dear Clients and Friends,

We are pleased to enclose our year end commentary and, for our clients, your December 31, 2014 portfolio appraisal, performance history and realized gains and losses reports. Our privacy statement and Form ADV/Part 2 are available upon request.

Our clients' results last year were achieved in an eventful year for the global capital markets. The S&P 500 rose 11.4% (13.7% including dividends) for the year and crude oil plunged 50% between July and December. Europe remained stagnant, divided between a more prosperous northern tier and its southern edge, notably Greece, posing a threat to the European model of monetary union. Interest rates in the U.S. stalled at historically low levels despite widespread forecasts of carnage in the bond market. Hedge funds lost their luster as the allure of paying "2 and 20" for uneven performance, illiquidity and lack of transparency wore thin with investors, most notably CALPERs, which abandoned the asset class altogether. Chinese e-commerce giant Alibaba went public on the NYSE in the largest IPO in history. One has the sense that risk assets, from equities to fine art to apartments in London, are floating on a tide of easy money and the lack of attractive alternatives.

Stocks, as measured by the S&P 500, have tripled in the past six years. The economy too is strengthening, with 2.9 million jobs added in 2014 and hourly wages rising without sparking wider inflation. The fall in oil prices, while not universally good news, is a direct benefit to U.S. consumers, who stand to save on average \$600/household in annual gasoline costs. Trade deals with Asia and Europe seem more likely in the new Congress than they did last year. Inflation is subdued at less than 2.0%. Responding to benign economic data, the Fed has indicated that monetary policy will begin to normalize this year. Even knowing that every Fed tightening since 1955 has produced a contraction in equity multiples, stock markets seem receptive to higher interest rates and untroubled by a steady rise in the dollar. At the start of a new year, investors have reason to be pleased with past results and optimistic for the road ahead. Indeed, the main risks to continued gains in stocks seem to be the unlikely possibility of sharp interest rate increases or a sudden slowdown in U.S. economic growth.

That said, wealth is built from advances in productivity and broad based economic growth, not from the whims of monetary policy or speculation in financial markets. In our quest for investment returns, we start with the goal of not losing money. A contrarian streak runs through our firm. With good news ascendant, now is a time to preserve capital and consider what shoals may lie ahead.

Think differently

A story appeared in newspapers last month that caught our attention. The rate of deforestation in the world's most important tropical rain forests has slowed dramatically, especially in Brazil, where forest loss has declined by more than 80% in the past decade. This achievement alone makes Brazil the country that is doing more than any other to limit net carbon emissions. Putting aside the debate over the causes of climate change, this is unqualified good news and largely outside consensus forecasts a decade ago. A similar non consensus event is happening in the oil market, where excess supply driven by U.S. shale discoveries, anemic global growth and reluctance by OPEC producers to cut output, has halved the price of oil from \$100/barrel six months ago to less than \$50 today. While the supply imbalance is small, the price is adjusting downward until marginal producers are driven out of the market. The collapse in oil prices and unexpected improvement in the rate of deforestation are but two examples of how wrong the experts frequently are, and how useful it can be to think differently.

Looking ahead, a tangle of international crises, from the Middle East to Russia, may unfold in unexpected ways with direct effects on financial markets. Four major Arab countries are in the grip of civil war and, while some may view these as sad but contained chapters in the saga of violence and retribution afflicting the region for decades, they could pose a wider threat of instability. What lies ahead for a generation reared in nihilism and barely acquainted with the educational and economic opportunities many in the West take for granted? Similarly, the crisis in Ukraine may reflect inherent weakness in

Russia that is not fully discounted by investors. Consider that of its 140 million inhabitants, roughly 100 people own one-third of Russia's wealth, according to *The Economist*. Encompassing nearly one-eighth of all land on Earth and sharing a 3,000 mile border with 1.4 billion resource-hungry Chinese, Putin's government has a full agenda merely managing the assets it already has. Yet, beset by a vigorous sanctions regime, a crash in oil prices, pervasive corruption and soaring interest rates to defend the ruble, Russia seems bent on expansion. Thoughtful investors will pay attention to how these crises evolve in the months ahead.

The inherent unpredictability of events humbles even the most experienced investors. As we have written in previous letters, it is hard to accurately forecast what will happen in macro-economic affairs, and then to express such a forecast profitably in a portfolio of financial securities. It is more advisable, in our judgment, to concentrate effort in what we can control, from the people we work with to the companies we own. Our approach is informed by our assessment of macro risks but at the core is grounded in what we can reasonably understand and value. Defensible business models, wide economic moats, recurring revenue, free cash flow, fortress balance sheets: these are our north stars.

Finding value from the ground up

We have found profitable investments in industries including railways, cable networks, aerospace supplies, healthcare, branded consumer products and insurance. Many of our portfolio companies enjoy recurring, subscription revenue and relatively fixed cost structures, enabling management to allocate capital to opportunities with the highest potential return. In the yield starved environment we face today, many investors seek higher dividend yields alone without considering the merits of alternative ways to allocate capital. We feel acquisitions and share repurchases, when executed by informed and disciplined managers, are frequently better strategies for unlocking intrinsic value.

The Liberty companies are a case in point. Backed by the cable pioneer, John Malone, Liberty Global, DIRECTV and Liberty Media operate in the cable, satellite and related businesses in the U.S. and Europe. Liberty Global is consolidating the cable industry in northern Europe, where numerous smaller cable systems still operate. DIRECTV, which is being acquired by AT&T, is one of two major satellite TV providers in the U.S. and has a substantial footprint in Latin America. Liberty Media and its spin-off, Liberty Broadband, are holding companies with investments in media assets. The unifying attributes of the Liberty companies include recurring subscription revenue, Malone's insight into the unique advantages of scale in media distribution and his aggressive use of debt to finance capital investments and share repurchases. Shares outstanding at DIRECTV, for example, have declined from 1.4 billion ten years ago to fewer than 500 million currently. While the underlying business is not growing rapidly, it generates considerable free cash flow, and management has been disciplined in returning that cash to shareholders via share repurchases. None of the Liberty companies pay dividends.

Observant clients will note an expanding list of Liberty positions on their appraisals, including Liberty Global, Liberty Media, Liberty Broadband and subscription rights to purchase additional shares of Liberty Broadband. The Liberty Broadband shares and subscription rights represent the cable interests of Liberty Media (principally 26% of Charter Communications Inc. and a minority interest in Time Warner Cable). Rights offerings are commonly used in Europe as a way for companies to raise capital from existing shareholders, thereby enabling participating shareholders to avoid dilution. We believe exercising the Liberty Broadband rights is advisable and are doing so on behalf of our clients. Following these conversions, the rights will disappear from our clients' statements.

A word of thanks to our clients and partners

We congratulate Bowdy Train, Josh Huffard and Oak Strawbridge on becoming partners in our firm. Our Washington, DC office is off to a great start and we will announce a new member of our team in New York in the months ahead. As our firm has grown, we have endeavored to preserve what we feel is unique about Douglass Winthrop Advisors in an era of financial conglomerates and opaque investment products: an unwavering dedication to our clients, grounded in sensible portfolio management and unbiased wealth management advice. We are grateful to our clients for enabling us to do work we find meaningful and intellectually challenging. You are the lifeblood of our firm, and you have our commitment to earn and keep your trust as your financial advisors.



Sincerely,

Jay Winthrop
Charles G. Crane
Robert R. Douglass, Jr.
Lea P. Highet
Charles T. Howard

Josh Huffard
Bryce O'Brien
Oak Strawbridge
Bowdy Train
Grant F. Winthrop