January 10, 2014

Dear Clients and Friends,

We are pleased to offer our year-end perspective on the financial markets and, for our clients, your account statements for the year ended December 31, 2013. As we often do this time of year, we enclose comments on several planning matters that may be of interest to our individual and trust clients. Our form ADV Part 2 and privacy statement are available upon request.

The S&P 500 returned 32.4% including dividends in 2013, its highest annual result since 1997. The market's rise was fueled by a dovish Fed determined to keep interest rates near zero, and by stronger than expected corporate earnings which, for now, are unburdened by inflationary pressure, rising labor costs or high depreciation expense. Whether out of uncertainty or lack of reinvestment opportunities, many companies opted to repurchase shares and pay dividends instead of making capital expenditures, thus boosting reported EPS at the possible expense of future growth. Seeing few good alternatives, investors poured money into stocks, driving the S&P 500 to a record high and price/earnings ratios above levels prevailing since the 2008 recession. Indeed, higher valuations were a far weightier factor in the market's rise than earnings, as illustrated by the exceptional performance of IPOs, small cap stocks and barely profitable growth companies. Consider that Snapchat, less than two years old with no revenue and a wildly popular photo sharing application, spurned a $3.0 billion cash offer from Facebook. Optimism abounded.

Investors should not expect a repeat of last year's results in 2014. Bulls point out that valuations are now in line with historic averages. We are somewhat more cautious, given that earnings are abnormally high and p/e ratios are elevated vs. 10-year average earnings (i.e., the market trades at a high multiple of high earnings). The main risks are that profit growth will stall or that the Fed will tighten monetary policy more quickly than expected as the economy strengthens. It is worth noting too that fiscal policy remains unpredictable, and the drumbeat of punitive taxes or regulatory measures to remedy income inequality grows ever louder. A generally sunny mood among investors, full valuations in the stock and bond markets and unpredictable policy initiatives suggest that returns from here – in both stocks and bonds – are likely to be muted in the aggregate.

The allure of the new thing

We live in a uniquely fascinating age, brimming with promise for people in developing countries and mature economies alike. A consumer class is rising in the emerging markets, especially in Africa, where governments are adopting free market policies, and innovations such as cheap cell phones, mobile computing and social media are empowering individuals everywhere in commercial and political life. The disruptive power of technology can be seen in energy too, as new drilling techniques are making the U.S. a major energy producer with far reaching implications for foreign policy and the ability of American businesses to compete globally. We are committing our clients' capital to companies poised to benefit directly from a global middle class, an information based economy and a more competitive American manufacturing sector.

Even as we imagine a more affluent, productive and innovative future, investors should consider various longer term challenges. Among them: adapting to China's emergence as a world economic and military power; reforming tax codes and entitlement programs in mature economies to sustain conditions for future prosperity; and managing environmental threats, especially water scarcity, deforestation and competition for scarce resources. Tension between opportunity and risk is a central variable in careful investing. Fortunes have been lost equally by those chasing the exciting new thing as by those clinging to defunct methodologies. The trick is to assess correctly whether an existing solution can endure or be displaced by something new. Rigorous analysis, a contrarian impulse and an open mind are paramount.

Among the best performing stocks in the market in 2013 were Netflix, Best Buy, Tesla Motors and Micron Technology – all fine companies but each operating in competitive or immature industries with variable profits and uncertain long term barriers to entry, which are reasons we do not own their stocks. While these companies may have bright futures, it is worth bearing in mind the arc of past high fliers, whether internet stocks in the late 1990s, financial companies six years ago or rare earth and commodity stocks more recently. Consider by contrast the investment case for owning steady if less glamorous businesses with the potential to compound earnings for decades. Berkshire Hathaway's $28 billion purchase of H.J. Heinz in partnership with 3G Capital exemplifies the concept of reinvestment. While Heinz is a time honored brand, Berkshire believes the brand is durable and able to grow, especially in developing markets, with minimal capital investment. Considering the shifting sands of the investment landscape here and overseas, where are the most promising opportunities, what will endure, where is risk misunderstood?

Slow money

We seek to own companies with wide moats against potential competitive threats, which are run for the benefit of stockholders and have fortress balance sheets. We aim to own businesses for years, so they must have ample opportunity to reinvest operating cash flow. In this regard we depart slightly from classic value investors for whom valuation is the driving variable in security selection. The wisdom of this simple approach is challenged in the popular press daily, as legions of experts explain the folly of "buy and hold," offer dire warnings of the stock market's impending collapse or tout the latest vehicle (often a fund) geared to benefit from a future beset by complex economic forces. Bearish strategists seem to sound smarter than those stubborn few who make long term, largely unhedged investments in quality businesses, trading infrequently and measuring success over years, not quarters. And yet, putting aside the illiquidity, tax inefficiency, lack of transparency, reporting burdens and cost of most alternative strategies – their main drawback is simply performance. It's hard to do better in the long run than owning great companies if you are willing to tolerate the inevitable short term ups and downs of the stock market.

We and our clients are long term partners with the managements of companies such as Nestle, Praxair, Berkshire Hathaway, Deere, Markel, DirecTV, MasterCard, Brown-Forman, Loews and others. The appeal of such investments isn't always apparent in robust bull markets but over time market prices converge with intrinsic value. Our challenge and passion is to balance investments in these stalwarts with the occasional deeply misunderstood idea that can multiply in value quickly. As always, we are highly sensitive to the risk of permanent capital loss and are unwilling to sacrifice quality for short term results.

Finding value in a lower return world

Michael Porter, a professor at Harvard Business School, was interviewed recently on the role of investment management in allocating capital to businesses that can use it most productively. He lamented that the industry has moved away from this central economic purpose, becoming more about indexing, momentum, gaining short term trading advantages. "As more investors walk away from fundamental investing," he noted, "the need and opportunity grows for value investors."

We approach our profession with precisely this mindset and feel the road ahead is well suited to our strategy of careful, research based portfolio management. We envision a more challenging environment as valuations become stretched, corporate profitability returns to trend and long-term interest rates rise. Even so, there are always opportunities and we are diligent in pursuing them, guided by our best judgment and care for the assets under our management.

Thank you for your confidence in our firm, and best wishes for a safe and peaceful New Year. We hope to see you early in 2014.

Sincerely,

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

Charles T. Howard
Josh Huffard
Bryce O'Brien
Grant F. Winthrop