

3rd Quarter 2009

Portfolio Insight

A strong rebound in equities over the past two quarters has made up some lost ground in the financial markets and has partially restored investor confidence. While the economy is showing signs of improvement, there are few that expect a robust recovery or a quick return to previous levels. It is always our objective to buy companies that we believe will grow revenues and earnings faster than the market. Ideally we participate for years in the growth phase of a business by buying when the future growth is not yet broadly evident. Our research process is designed to recognize early signs of change and to therefore anticipate prospective growth. Following you will find a review of our research process and some of the ideas that we think will be productive in the next few years.

“Our research process is designed to recognize early signs of change...”

We use ‘top down’ and ‘bottom up’ analysis. The ‘top down’ approach helps us identify inflection points and significant changes in macro-trends. For example, changes in political control in Washington have focused our attention on industries that might benefit or be hurt by the controlling party agenda. The economic crisis is likely to result in regulatory changes which will impact various sectors of the financial services industry. We are also paying attention to the intensity of the housing bust, noting the social, political and economic implications for state governments, banks, and retailers from a strapped and aging consumer. While the political and economic headlines have been bleak, there have been promising scientific discoveries in nanotechnology, biology, chemistry, and physics.

In light of significant changes in the economic, regulatory, scientific, political, and social arenas, we have re-examined our expectations for many industry groups, investigated alternative ideas, and have formulated a new set of expectations. While we are unlikely to get the details exactly correct, we have a pretty good track record for identifying the direction of change, and on acting on shifts in industry dynamics.

For industries that we believe offer compelling revenue prospects, we drill down to see how change

might affect specific company top and bottom lines. We look for companies that have noteworthy competitive advantages such as patents, high value brands, or innovative products. These advantages generally result in companies having pricing power, one key to growing their earnings. We also evaluate the quality of earnings, management integrity and accounting practices. If these factors do not give us confidence in a company or its management, we look elsewhere. And of course we also calculate projected earnings and cash flows, compare valuations, and evaluate competitors. The result is a list of buy candidates in favored industries. The same process is used to evaluate current holdings and to determine if some industries are becoming disadvantaged or if valuations are rich relative to the opportunity. If so, it is time to sell.

Our research process is iterative. An industry review may unveil new companies; a company review may reveal new competitors; new competitors can morph into new industries. Consider the Internet: an entirely new industry that in the early 1990’s was dependent on dial-up access through phone lines. New technologies created ‘always on’ broadband which begat new companies, like on-line search advertising, social networking, and video on demand, that are challenging the competitive structure of old industries: newspaper ads, high school yearbooks and DVD store rentals.

Following are several themes that we believe have merit in the current environment:

Wireless

The wireless industry is driven by mutually reinforcing social and technological change. At the social level, consumers are placing growing emphasis on convenient communication and ease of use. This preference favors wireless devices over landline technologies. Younger consumers are at the vanguard of this trend and many are “cutting the cord” entirely. Multifunctional cell phones appear to be displacing lower-end digital cameras, GPS devices, music players, and even watches.

Smart phones are one of the fastest-growing and most profitable segments of the wireless device market. In the midst of a sharp global recession, wireless data volumes are growing at 20-40%

annual rates around the world. Apple iPhone users, who seem to be at the forefront of the convenience transition, are using the Internet so much they are causing congestion on AT&T's wireless network, even though they represent less than 5% of AT&T subscribers.

It seems that a self-reinforcing cycle is underway. As traffic grows, wireless carriers are being forced to upgrade their network capacity and technology, and in so doing will likely trigger broader smart phone adoption; more smart phones could then drive more traffic and another network upgrade. Most of the major wireless carriers worldwide have announced that they will introduce LTE (Long-Term Evolution) technology on their networks between 2010 and 2012. LTE technology appears to offer a 5-10x faster downlink and a 3-5x faster uplink. Suddenly, a number of functions such as email, video and even direct machine-to-machine communications, will become more attractive and presumably trigger greater user interest.

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Energy Conservation

The rising cost of energy is driven by growing demand in developing economies, the natural decline rate of existing oil fields, the difficulty in obtaining new reliable supplies and higher environmental costs and taxes. The least expensive form of energy is conservation. We are focused on innovative industries and companies that are able to provide cost effective solutions and typically have high barriers to entry, good returns on capital and visible growth opportunities.

One example is the impending modernization of the electricity grid to an intelligent digital grid. A “smart grid” will allow consumers to better manage energy consumption and utilities to pinpoint power outages. “Smart meters” allow two-way communications between utilities and consumers to reduce electricity use, improve power quality and cut the amount of wasted electricity. Energy conservation through grid upgrades can be far more cost effective than building new generation sources.

Conservation also affects the transportation sector since global fuel economy standards are increasing. The 2007 Energy Bill mandates 35 miles per gallon (mpg) in the US by 2020, up from 25 mpg today. Europe, Japan and even China are also requiring higher fuel efficiency to reduce CO₂ emissions. We see two investable areas resulting from this trend: (1) improving the efficiency of traditional engines and (2) increasing the number of hybrid electric vehicles. Adding a turbocharger

and a high pressure direct fuel injection system can result in 15-20% greater fuel economy. Diesel engine adoption is also likely to increase in the US (currently about 5% of new car sales). The fuel-conscious European fleet grew from 22% diesels in 1997 to 51% in 2006. Current diesel engines burn cleaner, run quieter than the previous generation and improve fuel economy by 20-25% compared to a gasoline engine. As to hybrids, such vehicles are expected to be powered by lithium ion batteries. Lithium mining is an oligopolistic industry, and while the current demand for lithium batteries is driven by cell phones and laptop computers, the automotive battery market could substantially increase current lithium usage.

Health Care

Demographic trends are clear: the US and, many developed countries are growing older, needing and consuming more health care. At the same time, there have been exciting scientific discoveries since the Human Genome Project was launched. There is enormous long-term opportunity for medical and other scientific breakthroughs to create novel products and entirely new high growth industries. Leading companies in the field are developing new therapeutic products to treat serious diseases.

Government funding for basic research is also increasing significantly for the National Institutes of Health and National Science Foundation. As much of this funding will be spent on scientific instruments and consumables used by researchers, leading producers of life science tools (such as mass spectrometers, micro arrays, and DNA sequencers) will see exceptional opportunities for growth.

Over the next five years, \$85 billion of branded drugs will lose patent protection, providing meaningful growth for the generic industry. In addition, by the middle of the next decade significant opportunities will arise for a handful of generic drug companies with the know-how, production capabilities and financial strength to produce generic biologics. Also known as bio-similars, these pharmaceuticals are derived from life forms, are highly complex, and are quite sensitive to manufacturing process changes.

Current Outlook

We have noted in several communications that the US and other developed economies are entering a prolonged period of below-trend growth. Companies with low debt levels and/or innovative products that will not require a robust economy for their own growth represent core holdings across all of our clients' portfolios. We continue to believe that businesses that are innovators and market share takers are likely to offer the greatest opportunity for capital appreciation.