



LATEEF

INVESTMENT  
MANAGEMENT

### Lateef First Quarter 2010 Commentary

Equity markets began the new year strong as the S&P 500 index extended its recovery to a fourth consecutive quarter by rising 5.4% in the first quarter of 2010. The quarter's performance reflected stronger earnings, stabilization in the labor and housing markets, benign inflation and improving consumer confidence.

The first quarter 2010 performance for the Lateef All-Cap and Growth Equity composites, was in-line with the S&P 500 index. Our first quarter leaders included two stocks that rewarded our patience; Berkshire and ITT Educational Services which gained only 2% in 2009.

- **Berkshire Hathaway** (BRK +24%) split its "B" shares 50:1 allowing Burlington Northern shareholders the option to swap their shares in a tax-free exchange for Berkshire shares to effect the merger. The increased liquidity in Berkshire shares was the tipping point for S&P to finally include Berkshire in its S&P 500 index. The stock bolted higher from demand by index funds, by investors attracted to the lower stock price and by a recognition of its compelling value.
- **ITT Educational Services** (ESI +17%) reported a 59% increase in Q409 EPS growth to \$2.56/share, which followed a strong 34% increase in the prior year, and exceeded consensus estimates by \$.20/share. Student enrollment grew 30% and the company secured a \$300 million student loan package from outside lenders, which will alleviate ITT's funding of student loans that was previously done to accommodate students who were frozen out of the lending market in the recent credit freeze.
- **Aflac** (AFL +18%) reported strong Q409 operating earnings growth of 20% driven by robust premium sales growth of 15% in Japan. Aflac also ended the year with a risk based capital ratio, an indicator of balance sheet strength, of 475% which is well ahead of their minimum goal of 375%.

The first quarter laggards were either due to self-inflicted wounds of conservative guidance or due to temporary reasons for weaker than expected results. In each case, we believe the structural competitive advantages are intact.

- **Qualcomm's** (QCOM -9%) decline of 9% belied its volatile quarter which included a single day drop of 15% in reaction to its Q409 earnings report. QCOM retained its earnings guidance for the year but slightly lowered its revenue guidance due to a higher mix of sales of lower priced cell phones sold in developing countries while developed regions in Japan and Europe had subdued demand. Later in the quarter, QCOM's announced a new \$3 billion stock buyback authorization after just completing a repurchase of \$1.7 billion. Then, in late March QCOM raised its earnings guidance for its next quarter on improving sales of chipsets. Notwithstanding this intra-quarter volatility, we believe QCOM will benefit as consumers migrate to 3G phones (third generation smart phones with higher functions such as internet access, email, cameras and touch screen) as only 20% of the 5 billion worldwide phones today are 3G and penetration is expected to double to 40% by 2012.
- **Teradata** (TDC -8%) shares underperformed despite better than expected Q409 earnings due to management's admittedly conservative guidance for 2010 revenue growth and the impact on profits from catch-up spending from sales training and incentive expenses that were frozen last year. We believe Teradata is executing well and will benefit from new customer growth as they have only penetrated one-third of the Global 3000 market and from the growing complexity of enterprise wide queries that now incorporate geospatial, video and RFID information.
- **Suncor** (SU -8%) shares fell as one of the company's two primary upgraders suffered an unplanned outage due to a February fire, that interrupted production. The upgrader can process 125,000



barrels/day. On April 1<sup>st</sup>, just after the quarter ended, Suncor announced the fire damage was repaired and the upgrader production had returned to full production rates.

During the quarter, where appropriate, we purchased a new position in State Street, sold Fastenal and trimmed Berkshire Hathaway.

State Street operates two lines of business. The first, Investor Services, contributes 85% of revenues, and provides services for institutional investors such as custody, fund accounting, fund administration, foreign exchange and daily pricing. The second, Investment Management, provides asset management in passive index funds and exchange traded funds, and active strategies through their State Street Global Advisors platform. State Street shares a “toll gate” virtue similar to several of our other companies where over 80% of their revenues are recurring. We believe State Street will continue to benefit from the secular growth in pension funding, globalization, and increased sophistication and innovation in asset management. State Street’s competitive advantages include scale and technology. State Street has \$19 trillion in assets under custody and \$1.9 trillion assets under its investment management which offer advantages that deters new competition. The company spends 20-25% of operating expenses on technology and has a unique, proprietary global IT system; for example, State Street prices over 8,000 mutual funds daily which is 4x the size of its next closest competitor.

State Street’s long-term financial goals are to increase revenues 8-12%, EPS 10-15% and generate a ROE of 14-17%. We believe State Street is attractively priced at 13x expected 2010 earnings compared to its historical average of 19x. The depressed price was driven in part by losses at its Investment Management division. Subsequently, State Street replaced its asset management President, Head Lawyer, Chief Risk Officer and Chief Compliance officer, and settled related lawsuits with investors and the SEC. State Street is well capitalized and we believe that as State Street returns to its former track record of generating consistent fee-based income, especially from its core custody business which did not encounter investment related losses, investors will accord a valuation more reflective of its innate predictability.

Our goal is to hold outstanding businesses led by respected, owner-oriented managers whose stock is priced at a discount to our estimate of fair value. Companies such as these will only be profitable holdings if priced appropriately for their future opportunities. If a well-managed company becomes widely admired for its virtues and does not price its risks adequately, we will sell. This is the case with Fastenal where we believe we are selling a “100 cent” dollar and are using the proceeds to buy State Street for a “60 cent” dollar. We sold Fastenal at a price earnings ratio above 30x expected 2010 earnings. Fastenal delayed opening new stores last year until sales at existing stores had stabilized. Their plan last fall was to resume store growth of 7-10% by January. Fastenal has further delayed opening stores until the second half of 2010 despite stabilizing sales. With 2,400 stores in the U.S. compared to management’s estimated 3,500 store opportunity, we think the stock price does not adequately address the eventual slowing unit growth in the U.S.

In March 2009, we increased our portfolio weight in Berkshire Hathaway from 5% to 7.5% when the stock price was a 50% discount to our estimate of intrinsic value. After the recent “B” share stock split and related index buying, the stock price appreciated to a level that was within just 10% of our estimate of intrinsic value. So we trimmed our position back to its original 5% weight.

In the last three months we have personally visited 13 of our 19 invested companies. We value the opinions and feedback of our portfolio of companies for their views on the pulse of the economy. Generally, our companies see a slow but gradual recovery. Warren Buffett now oversees 80 operating companies and reads daily sales reports from Berkshire’s diverse businesses. He said in a March 1<sup>st</sup> CNBC interview that the “economy is getting better but at a very, very slow rate. There are a few businesses that have had a fair amount of bounce, in terms of electronic components which we distribute, and others that have had no bounce at all. Consumer businesses are struggling. The American public is deleveraging to some degree. They can’t refinance anymore...jobs will be



slow to come back.” Echoing Buffett’s comments, Expeditors International said in their March 8-K SEC filing that they “agreed with a shareholder who coined the anticipated recovery as a “Nike Swoosh” effect which is a very sharp decline in 2008 followed by a long and gentle upward slope for several years (as in 3 or 4).”

We are encouraged by signs of a rebounding economy as reflected by recent year-over-year monthly cargo volume and credit card transaction trends mentioned by Expeditors and Visa. Expeditors said that its monthly airfreight cargo volume, which represents high value goods, from August 2009 to January 2010 grew -8%, -4%, +3%, +12%, +36% and +42%. At Visa’s Investor Day in March, the CFO concluded that “The world is traveling (once again)” supported by their cross-border transaction volume which improved from October 2009 of zero growth to January and February 2010 of +7% and +11% growth. Debit card volume has been consistently robust at +20% but credit card volume has improved from 4% growth in October 2009 to +12% growth in February 2010.

Notwithstanding these encouraging sequential cargo volume and transaction volume increases, we are mindful of the stubbornly high unemployment of nearly 10%, the time it will take to digest the overhang of overbuilding in housing, rising foreclosures and the implications of the recently passed health care legislation. The narrowly passed health care bill promises to expand coverage to 32 million uninsured Americans at a cost of almost \$1 trillion. We do not own any public health care companies but we are assessing the implications of this legislation on the sustainable earnings power of health care companies and on the consumer. Years ago Japan moved to a universal health care plan which began with a 0% co-pay for individuals that is now 30%. Aflac is a major beneficiary with its supplemental cancer insurance that has proven popular in Japan. Aflac may similarly benefit in the U.S. if the costs are passed down to consumers in the form of higher deductibles.

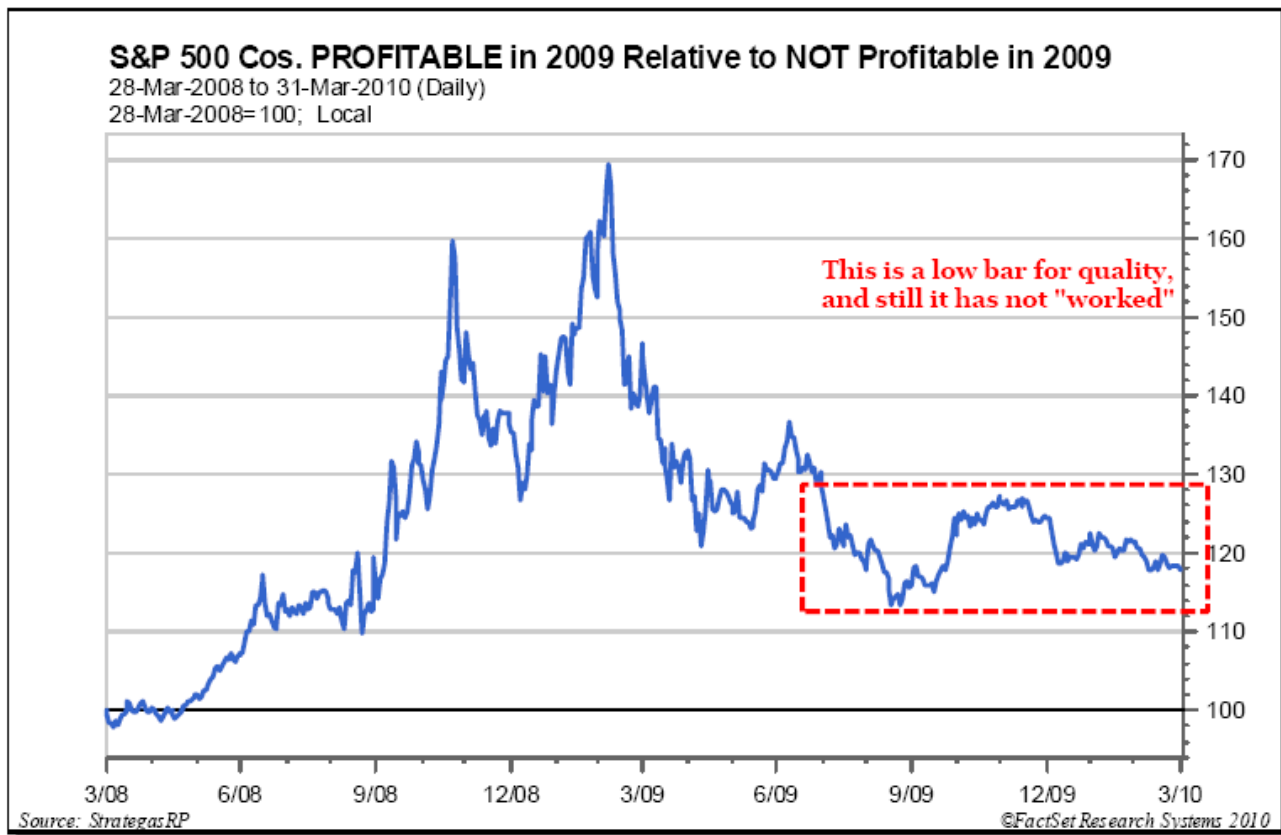
Our focus on owning companies that generate consistent cash flow growth, that can power their way through a challenging economy, was evident in the recent historically chaotic period:

- 70% percent of our portfolio of companies earned more in 2009 than in 2007 during a period when the S&P 500 earnings fell 31%.
- 80% of our companies are expected to earn more in 2010 than in 2007. The S&P 500 is expected to earn 10% less in 2010 than in 2007.

We believe in the old saying, “Be greedy when others are fearful and be fearful when others are greedy.” In the first quarter of last year while the market was still shaking from the aftershocks of the Lehman Brothers’ bankruptcy in late 2008 and its impact on the credit crisis, we saw unusually attractive opportunities to invest in select quality businesses and, for portfolios with cash and where appropriate, we added four new holdings; Aflac, ITT Educational Services, Qualcomm and Suncor, and added to our Berkshire holding. For the one-year ended March 31, 2010, the S&P 500 rose 50% and in aggregate our additions increased 66%.

Despite the market rally in the last year, we believe there is still opportunity in equities, particularly in quality equities for three reasons:

- According to Strategas, the level of nominal GDP is less than 1% off its prior peak in Q308, corporate profits are only off 11% from their prior peak in Q306, and yet the S&P 500 index is off 26% from its prior peak in Q307.
- In 1999, at the height of greed in equity markets, investors plowed \$190 billion into equity mutual funds compared to \$5.5 billion in bond funds. Last year mutual fund investors plowed \$375 billion in bonds funds with historic low yields and invested just \$11.3 billion in equity funds.
- Quality stocks, as measured by S&P 500 companies with earnings have lagged their counterparts without earnings.



Furthermore, we believe our portfolio remains attractively positioned as follows:

- We believe there is at least 35% upside to our estimate of current intrinsic value.
- Our portfolio has a 6% free cash flow yield.
- The ROE of our portfolio of 23.5% is much higher than the S&P 500 of 14.7%.
- The PE of our portfolio is 18x expected 2010 earnings, which is only a slight premium compared to 16x for the S&P 500, but appears deserved given the ability of our companies to power through the economic turmoil with less volatility than the broader market.

The market punished equity investments in 2008 and rewarded many companies with no earnings in 2009. Our investment process and philosophy has remained consistent since the Firm's inception in 1974, and it has been our experience that over the long-term, stock price performance correlates closely with earnings growth. We believe our portfolio of quality companies are poised to be rewarded in 2010 and over the long-term, as company fundamentals drive stock price valuations.

For additional insight into your portfolio, our Q1 2010 webcast is available at [www.lateef.com](http://www.lateef.com). Thank you for your trust and confidence, and as always, please contact us with any questions.

Sincerely,

*Lateef Investment Management*

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