



# LATEEF

INVESTMENT  
MANAGEMENT

October 02, 2008

Dear Client,

It has been said that if you don't know jewelry, you had better know the jeweler. If you don't know the four "Cs" of diamonds - carat, cut, color and clarity - then you had better know a jeweler that you can rely on for trust and competence. The same is true for investing in this unprecedented, tumultuous, chaotic, and revealing stock market. This quarter witnessed the sobering demise of stand-alone, formerly well-regarded companies, such as Fannie Mae, Freddie Mac, AIG, Lehman, Washington Mutual and Wachovia. Each company failed the three "Cs" test of viable financial companies: capital, credit, and credibility. They failed to have adequate levels of capital, lost access to daily funding, engaged in unsound lending, and lost control over risk management. The combination of enormous leverage and opaque high risk investments in toxic subprime mortgages concerned us enough to avoid these companies and have proved to be their undoing.

The financial fallout from the mismanagement of risk is unprecedented, massive and far reaching. The initial cost of the government's rescue plan of \$700 billion is as much as the cumulative cost of the Iraq war. Wall Street brokerage firms have scrapped their business models and have had to convert to commercial banks. The government decided to insure money market funds in order to prevent panic redemptions. The virus of over \$500 billion (and counting) in write-offs related to subprime mortgage loans has paralyzed credit markets and increased the cost of lending in a manner where Wall Street has infected Main Street. Consequently, many nonfinancial businesses that rely on credit for ongoing operations are stalled.

We believe the government's rescue plan will relieve banks of illiquid assets in a healthy deleveraging process, and provide liquidity which will propel the economy. It is not a bailout plan. It is essentially an investment in illiquid mortgage pools that have an income stream, and if purchased wisely in a market-based system, should make significant money for the U.S. as it eventually resells the assets once the economy improves.

Still, misperception, pessimism and uncertainty abound. Daily headlines warn of a deepening financial crisis; rumors of another once-heralded company desperately rushing to the arms of a suitor to avert bankruptcy; and, of course, the latest round of the pre-election slugfest. Stock market investors, who typically abhor ambiguity, responded in a predictable fashion with the S&P 500 index declining 8.4% during the third quarter and 19.3% through the third quarter year-to-date. We are gratified that several of our companies' stock prices have sharply rebounded this quarter as investors begin to recognize their earnings power and resiliency, and differentiate them from weaker competitors. As we discussed in our last quarterly letter, our concerns of a speculative bubble in energy prices were validated by the 30% drop in oil for the quarter; in addition, our lack of energy and commodity exposure in our portfolio helped our performance during the quarter.

The legendary dean of worldwide value investing, and gentleman in life, Sir John Templeton, sadly passed away at 95 on July 8<sup>th</sup>. He presciently advocated "buying at the point of maximum



pessimism...knowing in advance you are going to have to live through bear markets and business recessions, you prepare yourself financially...you don't have debt because you might get wiped out at the wrong time...In all my 53 years of investment counsel there's never been a year without problems, but for every problem we have ten blessings. You only hear about the shocking things. So please don't be discouraged by the shocking and horrible things that you are flooded with. Take the time to find out what the underlying facts are." We couldn't agree more. We would like to highlight a few relevant facts.

- Our portfolios generally have between 15-20 stocks and are not "the market." Our investments are carefully researched and selected on a case-by-case basis based on the durability of their competitive advantage, the sustainability of their high return on capital, the quality and track record of management and the attractiveness of their stock price. The portfolio is positioned with leadership companies that we believe can control their economic destiny, have pricing power and are capable of prospering and growing through this economic slowdown. We continue to avoid brokers or banks in our portfolio or any company directly related to the subprime epidemic.
- Our time tested investment discipline is based on understanding what we own and avoiding companies with excessive debt. We have a disciplined process to manage both business risk and price risk to avoid permanent loss of capital. In contrast to the failed companies, our companies have clean balance sheets, generate free cash flow, and don't invest in subprime mortgages.
- **All 20 of our invested companies generate free cash flow** (cash income exceeds all working capital and capital spending needs).
- In fact, **90% of our companies have repurchased their own stock in the last year or are committed to do so imminently.** Only Berkshire Hathaway and Nasdaq OMX Group are not buyers of their stock as they have their hands full with large value creating investments and acquisitions.
- Our experience has taught us that stock prices track earnings/cash flow growth over time. **In the first half of 2008, our composite set of 20 invested companies generated 14% earnings growth compared to a decline of 28% for the S&P 500.**
- Consensus earnings estimates from Wall Street analysts project that **our companies should increase earnings 13% this year and 13% next year compared to an estimated decline of 9% in 2008 and an increase of 4% in 2009 for the S&P 500.**
- The composite **return on equity of our companies is 28% compared to just 12% for the S&P 500.**
- Many of our companies have no debt and most of our companies that do have some debt, generate enough free cash flow to retire their debt in only two years.
- As part of our ongoing due-diligence, we have personally met with senior management of all of our companies in the last six months, many several times, and fully one-half in the month of September alone. We have also met with many of their competitors, distributors or customers to assure ourselves the solidarity of our company's competitive advantages.

In times of market distress, our leadership companies are often able to take advantage of, and ultimately benefit from, economic turmoil. Berkshire Hathaway has opportunistically invested \$28 billion this year in mispriced and capital starved opportunities. Berkshire announced an agreement in September to acquire Constellation Energy Group (CEG) for \$4.7 billion or \$26.50/share. Just 5 days earlier, CEG was trading at \$58/share and in January of 2008, the stock was over \$100/share. Constellation had \$21 billion of sales last year and owns a large fleet of power plants in the eastern U.S. including Baltimore Gas & Electric. It derives 20% of its earnings from a commodities trading business and fears over its liquidity needs hammered its stock. BRK is buying Constellation for 5x consensus earnings for 2008. Berkshire also announced in September an investment of \$5 billion in Goldman Sachs for a perpetual 10% preferred



stock and Berkshire has a 5 year option to buy \$5 billion of common stock, representing 8% of Goldman, at \$115/sh, or 9x 2008 consensus earnings. On October 1, Berkshire announced a \$3 billion investment

in GE for a 10% perpetual preferred stock and a 3 year option to buy \$3 billion of common stock at \$22.25/sh, which is 11x expected 2008 earnings. The Constellation, Goldman and GE investments were uniquely suited to Berkshire's ability to commit capital in a size and timeliness that no one else can. This highlights a key competitive advantage of Berkshire.

Costco will offer branded merchandise this holiday season that had not been previously available at Costco. Soft sales in full priced luxury stores have motivated luxury brands to unload surplus inventory at lower prices to warehouse clubs. Most brands remain with Costco after they experience the high velocity of sales at Costco. New brands include: Schwinn, O'Neill, See's, Sony, Waterford, Callaway, NordicTrack, Herman Miller, Tag Heuer, Yamaha, Godiva, and Tumi.

Colgate raised prices for its toothpaste in the U.S. by 9% this Fall to offset sharp increases in its oil-based raw material costs, and market shares continue to increase, as a testament to its brand power. The company should benefit now that oil prices have retreated 30% from its high.

We have taken advantage of the volatility in the market to add Scripps Networks Interactive (SNI), Visa (V) and EMC Corp. to accounts with available cash. We trimmed a portion of our Apollo investment due to its recent appreciation, in order to make room for a new position. Scripps Networks owns cable TV channels including Food Network and HGTV, and was recently spun-off from E.W. Scripps to allow it to thrive unencumbered by the E.W. Scripps legacy newspaper business. Both Scripps and Visa began trading as separate public companies this year. We believe that as Visa continues its transition from a not-for-profit to a for-profit enterprise, they will realize more operating efficiencies, and earnings growth will be better than expected. EMC is a leader in the industry of data management and storage which is growing at exceptional rates due to the proliferation of video over the internet. When adjusted for its excess cash and a publicly held investment, EMC is priced at just 10x earnings.

In summary, while we have seen the stock prices of our companies drop this year, we believe this has been the result of a dislocation between stock price and intrinsic value, as opposed to a deterioration of the underlying value of our holdings. Our portfolio rallied in the third quarter after the market digested second quarter earnings. We believe this trend will continue as the market identifies companies with enduring value, and subsequently we believe a flight to quality will occur. Like the jeweler, we remain diligent in distinguishing the "cubic zirconia" from precious gems in the marketplace and remain focused on our time-tested process.

Thank you for your confidence and please don't hesitate to contact us if you have questions or comments.

Lateef Investment Management