



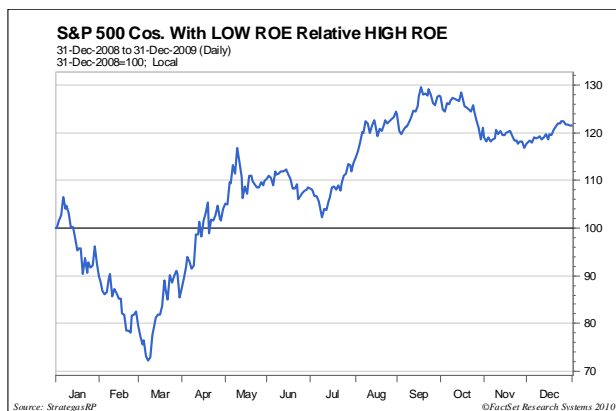
# LATEEF

INVESTMENT  
MANAGEMENT

## Lateef Fourth Quarter 2009 Commentary

In the midst of the financial crisis firestorm during the fourth quarter of 2008, Warren Buffett penned an editorial in the *New York Times* advising that although he could not predict short-term movement of the stock market, “What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over.” The current bull market began a few months later and, since the S&P 500 bottomed on March 9, 2009, the index soared 68% through year-end 2009 to mark the sharpest rally since the Great Depression. The S&P 500 advanced a further 6% during the fourth quarter which extended its gain for the year to 26.5%. Investors continued reacting positively to better than expected earnings reports and signs of healing in major banks that were on solid enough footing to repay \$168 billion of the \$245 billion of borrowed government funded Troubled Asset Relief Program (TARP) money.

Our non-taxable all-cap equity composite performance slightly edged the S&P 500 for the year which marked the 9<sup>th</sup> time in the last 10 years that we outperformed the index. While much has been written about the last ten years as a “lost decade” for stocks with the S&P 500 index returning a negative 1%, our composite has generated a positive 6.6% annual rate of return net of fees. The 26.5% return for the S&P 500 index in 2009 is noteworthy in that it was led by lower quality stocks. While luxury retailers and long-term investors like us advocate that quality never goes out of style, in the short-run this mindset may not be fashionable. Stocks with low ROE, no earnings, high debt and no dividends outperformed their counterparts with high ROE, positive earnings, low debt and dividend payers.



Source: Strategas



We are encouraged by our absolute return of our non-taxable all-cap and growth composite of 26.6% and 27.9% respectively for the year, especially when we compare the make up of our portfolio to the S&P 500. For most of the year, 35% of our portfolio (Berkshire Hathaway, ITT Educational Services, Accenture, Suncor, Affiliated Managers Group and Visa) was not in the



S&P 500 index until Visa was added to the index in December. We currently own 19 companies and we are indifferent whether our companies are in an index. We are simply searching for the most outstanding businesses as measured by a consistently high ROIC, led by successful and transparent managers who have an owner-oriented attitude, at an attractive price.

We achieved our 2009 performance despite two of our largest holdings, ITT Educational Services (ESI) and Berkshire Hathaway (BRK), severely lagging the market as each rose only 2%. ESI reported third quarter year-to-date earnings growth of 53% the best in class for our portfolio. Overshadowing the stellar fundamentals of ITT however, are lingering industry concerns about accreditation, enrollment counselor compensation, tuition levels, gainful employment, and student loan default rates that has prompted the Department of Education to conduct hearings for the entire education industry (both for-profit and non-profit) regarding appropriate oversight. These hearings have lasted the better part of 2009 and will be concluded in January of 2010 with resolution by April. We don't believe ITT will be affected in any structural way by possible new regulation and should benefit from their transparency by showcasing their graduation rates and related salaries. Investors have also been concerned about ITT's willingness to self-fund private student loans to fill a void left behind by some lenders who stopped lending in the midst of the credit crisis. We believe ITT will be successful in increasing their consortium of lenders in the first part of 2010 to buy ITT's receivables and provide a continuing source of student private loan funding. Meanwhile, ESI is cheap with a trailing twelve month free cash yield of 6% and a PE of just 12x expected 2009 earnings and 10x 2010 earnings.

Perhaps there is no better example of enduring quality lagging the market in 2009 than BRK. Berkshire Hathaway is trading at just 1.2x its book value of \$84,000/share compared to its 10 year average of 1.6x. At \$99,200/A share, the stock is priced at only a slight premium to the value of just its investments of cash, bonds and stocks of \$92,400, and effectively ignoring the value of its 70 wholly-owned subsidiaries. We have to speculate to find reasons why BRK has lagged. Concerns remain about Warren Buffett's age (he is 79) and succession plans. Also in 2008, BRK was a victim of forced liquidation by marginal owners who had liquidity needs, including failing hedge funds, and in 2009, speculators returned to the lower quality financial companies that had more speculative appeal. We believe BRK is inherently worth about \$140,000/A share and that quality will be valued appropriately once again.

BRK addressed questions about what it would do with its excess cash during 2008 when the company announced its largest ever acquisition by buying the remaining 77% of Burlington Northern Railroad (BNI) that it didn't already own for \$26 billion, or \$100/share. The terms are 60% cash and 40% stock. In order for BNI investors to swap their \$100/share into a BRK share, BRK will split its B shares 50 for 1. After the split in late January 2010, BRK B shares will trade around \$66/share. BRK expects to benefit in the long-run as rails are a more cost-effective form of shipping than trucks especially at higher oil prices; rails release fewer pollutants than trucks, are vital to the future prosperity of our economy, are geographically well-positioned in the West, and are a bullish bet on our economy rebounding.



The leading contributors to our performance in 2009 were Aflac (AFL) and Scripps Networks Interactive (SNI). AFL more than doubled from our original cost in March 2009, proving we had found a quality gem amidst the financial rubble. AFL's dividend was yielding over 8% and its PE was just 3x even though it does not issue credit like other banks and did not offer income annuity promises like other insurers. The company's supplemental cancer policies are fixed and not open-ended. Also unlike many other banks and insurers, due to AFL's strong cash flow, it has not resorted to reducing its dividend or issued dilutive stock to boost depleted capital. Most important, it has been led by Dan Amos, CEO for 19 years, who was quoted in USA Today on December 28, 2009, "Don't risk a lot for a little. With the duck (ad promotion), I was risking a little for a lot." He added that transparency and communication saw him through the tough times when AFL stock fell from \$67 to less than \$11 in less than one year. He ordered the company to post on its website every bond investment the company owned. He also relinquished his rightfully earned 2008 bonus of \$2.8 million because he felt guilty, knowing his neighbors and shareholders who owned the stock were suffering. We admire Dan's integrity, owner-orientation, transparency and philosophy of not risking a lot for a little and believe AFL is still attractive at just 9x consensus 2010 earnings, with a free cash flow yield of 26% and a ROE of 20%.

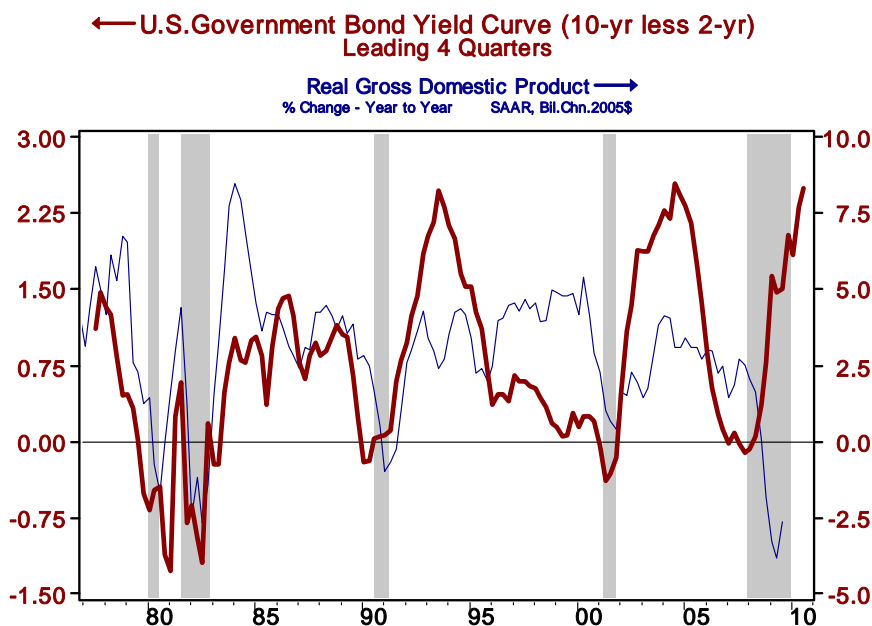
As the advertising market improved, SNI was able to take advantage of their highly rated cable channels (HGTV and Food Network) to generate better than expected revenue growth. Additionally, the market began to anticipate SNI's successful renegotiation of their affiliate contracts which will result in higher cash flows and earnings.

In last year's Fourth Quarter Commentary, we noted that market timing was futile because it is less tax efficient and requires being right about the timing of re-entry into the market. We also mentioned that it was an opportunity to take advantage of others' fear of stocks since valuations were attractive as indicated by the PE ratio of just 13x for the S&P 500 index. Despite the market rally this year, many investors feel comfortable holding cash equivalents and are evidently waiting for the "robins." Money market assets totaling \$3.3 trillion now represents 30% of the U.S. market capitalization compared to its 25 year average of 13%. This year alone, investors have poured over \$315 billion of assets into bond funds while removing \$5 billion from stock mutual funds. While cash won't decline in absolute value, we believe cash and short-term government bonds are risky long-term assets that are likely to depreciate in real value. They yield almost nothing (especially after tax considerations) with 1 year, 2 year and 10 year Treasury yields of just .4%, 1.1% and 3.8%, and are vulnerable to the inflationary pressures accumulating from the government policies used in addressing the financial crisis. Despite the move in equities this year, we believe there is still opportunity in equities, and in particular the equities we own for the following reasons:

- A good portion of the \$3.3 trillion parked in money market funds, earning near-zero percent interest rates, is poised to reenter the market, which is bullish for stocks.
- The prospects for equities are intertwined with the prospects for an economic recovery. The yield curve, which is the difference in yield between the long-term ten year Treasury bond and the short-term two year Treasury bond reached 281 basis points compared to 127 basis



points in December 2008. Historically, an increasing spread has indicated near term economic health.



Source: Strategas

- Corporate deal-making can be a healthy sign of an improving economy and a confident statement for the attractiveness of stock prices. The months of November and December 2009 have seen the most active deal-making since the summer of 2008 and the dollar value of deals in those two months is 4x higher than the prior year. Deals besides BRK acquiring BNI also included Exxon buying XTO Energy, Comcast's purchase of NBC Universal, the merger of Stanley Works and Black & Decker and our own Scripps Network Interactive (SNI) effective acquisition of the Travel Channel. In November 2009 SNI, owner of Food Network and Home and Garden TV, announced it would acquire a 65% controlling interest in a partnership with Cox Communications to buy the Travel Channel. We expect the Travel Channel deal to be additive to SNI's earnings primarily by leveraging SNI's ad sales, affiliate sales and tech services as well as affiliate fee renegotiations in two years.
- Emerging markets are expected to grow at rates faster than the U.S. While most of our portfolio holdings are domiciled in the U.S., collectively they have 43% of their operations sourced outside the U.S. We have the advantage of accessible management and strong corporate governance and still have a strong exposure to overseas growth.
- Global logistics data in late 2009 signal a rebounding economy. Cargo volume on Asian airlines increased 38% year over year in December and 18% year over year in November. The Dubai Airport reported that cargo increased 19.6% in November. Lastly, the ports of Long Beach and Los Angeles reported that loaded container exports increased 11% in November. These trends bode well for Expeditors' International and to a lesser extent, C.H. Robinson.



- Home prices are stabilizing according to the Case Shiller, which reported that home prices across the country have been flat to higher for five consecutive months ending October 2009.
- Finally, our composite portfolio of companies continued to out execute the market in several ways through the third quarter:
  - Our portfolio's earnings grew 2% compared to a 20% decline in the S&P 500. This follows 2008, when our companies grew earnings 13% compared to a decline of 40% for the S&P 500.
  - Our company's ROE of 36% exceeded the S&P 500 of 3%.
  - Our free cash flow yield is nearly 6% with the promise of cash flow growth compared to the ten year treasury yield of 3.8%.

We believe our composite portfolio is still undervalued by slightly more than 30% before reaching fair value and will benefit from the market opportunities mentioned above. While we still haven't actually seen the robins, in our opinion, spring has not yet fully sprung for our stocks.

As usual, our website ([www.lateef.com](http://www.lateef.com)) has been updated with our current ADV Part II and privacy policy. ADV Part II is also available in hardcopy format upon request. Our privacy policy is attached.

For additional insight into your portfolio, our Q409 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,

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