

October 22, 2009

In the third quarter, both U.S. stock and bond markets rose nicely: the S&P 500, including dividends, rose 15.6%; the Dow Jones Industrials, without dividends, rose 15.0%, and NASDAQ, without dividends, was up 15.6%. Bonds were strong and remain overdone, in our opinion, a judgment we do not hold for stocks.

In our country, the recession (generally defined as two or more quarters of negative GDP) technically is behind us in spite of the large number of still unemployed. (Unemployment is always a lagging indicator and falls back to a more normal 5%-6% range usually quite a bit after the economy is humming again). GDP is expected to be up 3% or so in the third quarter just ended; GDP was down 5.4%, 4.6% and 0.8% in Q4 2008, Q1 and Q2 2009, respectively. Productivity continues to provide stunning buoyancy to national output. As opposed to the 2001-2002 economic pause, which was shallow, this recession has been very deep (and painful).

So, why are the markets so strong. The robust American market has actually been accompanied, if not preceded by strength in the markets of other countries worldwide, as a synchronized global economic recovery has begun, and continues, to develop. Leading indicators here and abroad point to further global economic progress. The scope of the global economic recovery, including gains in employment in quite a number of countries, falling new unemployment claims here, increasing purchasing managers indexes, better consumer confidence and business confidence in quite a few countries, better housing numbers and declining average unit labor costs are just a few of the more important reasons. Throw in the mountains of cash on the sidelines, drawing absurdly low interest, worldwide fear of further declines in the value of the dollar, and still underpriced equities and you have a myriad of reasons to convert cash into equities.

Of course, there remain many reasons to be cautious, such as all the derivatives and default swaps still being created by the remaining investment bankers, the pushing of the mortgage problems down the road under the loan modification programs, and the continuing existence of quantities of toxic assets on the balance sheets of banks and other financial institutions, to name just a few.

We also note the bond market has been the repository of some of this money fleeing cash and to such a degree that bond prices are extended, and we at Llenroc are having a tough time finding acceptable prices for bond purchases.

In the stock market, where prices are up 50% since March, we are finding that the damage that was done to the economy and to confidence last year has still left a fair number of wonderful companies' stocks trading at compelling prices. In our July client letter, our first since being back in the business, we said "This may be one of the most juicy investment opportunities in

history." Is this still true three months later? To a lesser extent, we think the answer is "yes". The problems of the dollar, the state and Federal deficits, the unemployment, the anti-growth and anti-business policies of the government (actually at odds with what the Fed is trying to accomplish) and the rogue states' nuclear threats all still frame the context in which we are all living, but in terms of the everyday problems of what to do with one's money, there are still some terrific values in some fine companies that meet our investment criteria, companies that we think can grow for years to come. Also there are still large amounts of cash on the sidelines that can come back into the market.

This may be an appropriate place to remind our clients of our investment criteria. We are not just putting your monies into pieces of paper that fluctuate, but into small portions of real companies that we think can be very good stores of value for the future. In olden times, the store of value concept referred to people putting their cash into gold, silver or gold and silver coins, Persian rugs, that sort of thing. Companies can be long-term stores of value too, as earnings outgrow the rate of currency debasement.

Here are the criteria listed in our brochure, copies of which are available upon request:

1. High barriers to entry
2. Durable competitive advantages
3. Open-ended growing markets (the easiest place to find true growth companies)
4. A leadership brand franchise, like Heinz in catsup, Coca Cola in soft drinks, or Frito-Lay in snack foods.
5. Being first into a market, like Federal Express
6. A long time-proven track record.
7. Cash flow well in excess of capital spending
8. The ability to self-finance growth
9. Management that allocates capital well and that owns goodly amounts of the stock, or whose compensation is highly dependent on growing earnings.
10. Consistently above-average returns on invested capital and high operating margins
11. Pricing power of the company's products or services
12. Little or no debt
13. A rising dividend

Items #1 and #2 are, in our opinion, the most important. Usually you do not get high barriers to entry without long held and substantial competitive advantages. #10, consistently high returns on invested capital and on sales generally do not last long without #1 and #2. A competitive leg up may come in many forms, from proprietary one-of-a kind products to a superior distribution set up, to low cost producer status, high costs to a customer of switching from one supplier to another (think of Oracle or Intuit in their respective fields; also how long has it been since you went through the hassle of switching bank accounts?); a competitive leg up if accompanied by high barriers to entry, can lead to the ideal of most businesses—limited competition. Such a situation will not last long if the barriers to entry fall and competitive advantages erode.

Any one company in your portfolio is not likely to qualify for all these criteria but unless companies fit a majority of these standards, perhaps we should pass and go to the next candidate.

To those criteria published in our brochure and listed above, we would add three more criteria that are very potent if possessed by a company: 14. Size or scalability, 15. the just previously mentioned high cost to a customer to switch his account, and 16. the cumulative advantages of networking or linking large numbers of nodes, as in a computer network, for example.

Item#5, being first into a market does little good if barriers to entry are low and it is easy for new competitors to swarm. Achieving size or scale is important, but as can be seen in the cases of General Motors, Sears Roebuck or U.S. Steel, size is no guarantee. If you can combine scalability with first mover advantage and a growing network of locations or ways of contacting the customer, then you can come up with a blockbuster company, two of which are in your portfolios. We will discuss them below.

How do our portfolio companies rate in terms of investment criteria? We think it may be both instructive, and conducive to your peace of mind if an understanding of the businesses in which you are invested can be gained by specific example.

C.H. Robinson is one of the companies to which we referred in the paragraph before last. Let's see why this is such a terrific company and how many of our criteria it meets. C.H. Robinson Worldwide is a so-called 3rd party logistics company that acts as a broker between shippers (customers) and truckers or carriers. C.H. owns no vehicles, but puts shippers together with truckers in North America who are looking for freight to haul. C.H. essentially buys cubic feet of space at wholesale and sells the space to shippers at retail, i.e., at a marked up price, usually of around 25%. C.H. has over 200 branches in the U.S., Canada and Mexico, vastly more than any of its competitors and so it can offer carriers a greater supply of freight opportunities than anyone else. Correspondingly, with 50,000 independent truckers (up from 15,000 in 1997) coming to C.H. for freight, C.H. can offer the shipper orders of magnitude more opportunities for quick movement of its goods, without the shipper having to maintain its own fleet of trucks.

The network of over 200 branches combined with sophisticated systems that can track each and every shipment a la FedEx and UPS, plus the availability of 50,000 independent truckers gives C.H. a combined first mover advantage and Himalayan-sized barriers to competition.

The barriers actually are not to entry per se because there today exists a very large, fragmented industry of much smaller truck brokers out there doing the same thing, as well as private fleets galore. (C.H. estimates it has only 3%-4% of the market, thereby implying potential growth for decades available just in North America. C.H. is also trying to duplicate its U.S. success in Europe). For competitors, it is not a problem of entry, but one of scale or scalability, as anyone can put branches in a few major cities and be in business. However, the value to a shipper is to be able to go to one provider like C.H. that it can rely upon for all the geometrically possible lane combinations offered by 200 plus stations in North America. It took C.H. three decades to put this network together and it would take about that long for a competitor to do the same, we believe. Thus, there are a huge barriers to scale that continue to grow higher as more stations are added to the network by C.H. and as more truckers seek business from C.H. each year.

Expeditors International has the same wonderful business model only its thrust is in international air and ocean freight. It has branches all over the globe, over 200 of them. Again, a very fragmented transportation industry, since anyone can open a few locations, but like C.H., Expeditors has been building out its network for nearly 30 years, and it would take just as long as

in our previous example for the Expeditors network to be duplicated. Here too, there is a sophisticated tracking system at work that would be costly and time consuming to duplicate. The business model of these two companies is one of the best we have ever seen. When business is poor, margins expand because carriers which have a harder time filling up their vehicles lower their pricing. When business is good then the top line expands historically at double digit growth rates, even though margins contract somewhat.

An additional competitive advantage for both of these debt-free companies (see item #10) is the incentive compensation system for operating its branches and incenting its employees. Each year, in the case of C.H., and monthly, in Expeditors' case, a significant portion of each branch's operating income is doled out to deserving employees based upon that branch's profits and the perceived employee contribution. The decentralization of this arrangement pushes hiring and firing to the branches, which have a better idea of business conditions locally than does headquarters; the incentive system is a check on excessive expansion or excessive caution about expansion. Headquarter staffs are limited for both companies.

The combination of extensive branch networks, sophisticated computer tracking systems and employee incentive compensation systems together with long-established reputations for superior service make C.H. and Expeditors hard-to-beat competitors for many years to come.

Yet, these two companies compete very little with each other as C.H. is mainly dealing with truckers and in the U.S. primarily, while Expeditors' business is mostly international and mostly with airlines and shipping companies.

What other attributes that we are seeking do C.H. and Expeditors possess? Well, they certainly serve open-ended markets. (item #1) Each has less than 5% of their respective available markets. These are companies that can grow not just for years but for decades. They have long-term proven records of growth and are powerful cash flow machines in which free cash flow (cash flow minus capital expenditures) (item #7) approximates net income after tax. This means they can self-finance their growth (item #8), and do not need to have dilutive equity offerings. Both managements take modest salaries and make most of their annual compensation via incentive compensation or stock options. (item #9) Both also have consistently above average operating margins, return on sales, and both raise their dividends annually. (#10 and #13)

Switching costs aren't particularly high in this industry, and pricing power (item #11) is not anything special except that surcharges by airlines, trucking companies and shipping concerns when oil prices rise are readily passed on to the customer. Neither company relies on brand names in the same sense as a consumer goods company, but obviously, each has gained a very good reputation for service over the years or they would not have a history of growing 15%-20% per year in a transportation industry that grows at mid-single digits.

Thus, we conclude this discussion on how two of our companies meet our criteria. These standards or benchmarks are not foolproof, but they help us get the ball in the end zone most of the time. We are convinced through long experience that sticking to leadership companies in a niche or industry is a lot better than buying into a secondary or tertiary company.

Being able to stay with a leading company for years has several advantages, beside the obvious saving of taxes and commissions. Compounding growth yearly, the 8th wonder of this world

according to Nathan Rothschild, can do wonders for building capital. The managements get to know us over time and to trust us, and when that goes both ways, a mutually beneficial relationship often results. We have been investors in Expeditors since 1995 and in C.H. Robinson since 1998.

Our one casualty in the third quarter was a very good construction company, with important quarry assets, called Granite Construction. We have monitored the company for years, and we think a lot of the management. We cut our losses, however, in the stock because of falling backlogs, but more specifically because we found better values elsewhere. Losses were about 10%. We hope to be quick, but not too quick, in recognizing a mistake. Granite is a fine company, and we may own the stock again someday, but we realize it is not one of our best 15-18 stocks currently.

We believe the rest of the horses in our stable of wonderful companies are running fine considering that the track (the economy) is still muddy. But the best companies usually gain market share in bad times and that is the case with the leadership companies in your list. We cannot reliably predict what the stock or bond markets will do anymore than the next guy, (and we do not know anyone who can), but we have never thought you have to forecast the market to make money in stocks or bonds. Our job is not easy but it is simply described: to identify good businesses with good game plans and the managements to execute those plans, to buy the stocks right and then to be patient. We believe that the ultimate goal of investing is peace of mind, and the management team at Llenroc feels good about the individual stores of value that comprise your portfolio and the prices we have paid for them.

As always, we are accessible, and we invite your questions.

Most cordially,

Roland D. Underhill
Managing Director