



July 21, 2010

During the second quarter of 2010, the S&P 500 index (including income) declined 12.85%, after peaking around April 29. The Dow Jones Industrials and NASDAQ were both down, 13.31% and 14.30% respectively.

One of our friends in the business recently said stocks are cheap (which is true) but macro issues are awful. That is what is hurting the stock market, he says. Yes, there are questions about the European economy, the Euro, our economy, the dollar, geopolitical threats quietly growing from Russia and China and not so quietly growing ones from Iran, questions about the open-ended costliness of Obamacare, eventual doctor shortages, the threat of a rise in energy costs if Cap and Trade is passed, what about "card check"—that isn't dead yet (even W. Buffett is against it); our big concern is, "Will BHO repeat FDR's mistakes of 1936 and raise taxes in a fragile economy causing the economy to revert to recession a la 1937." What will his other grand experiments in government lead to, such as the new Financial Regulation bill? How much will it limit credit and slow our economy? What will happen to the cost of oil, and gas at the pump, if the drilling moratorium is not lifted soon? There will always be questions from the pundits and the media to shove their way into the business headlines. That's what they get paid for, to get our attention.

Well! (as Jack Benny used to say.) With all the concerns, why are we so little in cash? The answer is because the values are just so compelling. When there is uncertainty like there is today, it can create amazing values. We have the cheapest stocks on a broad basis since the 1970s when Nixon and Carter wore us down. We are investment managers. Our job, what we get paid for, is to invest when the values are there, and they don't usually show up in this abundance unless the headlines are worrisome. But the values are there in spades now (see Appendix). These are the prices we have been waiting and hoping for. It's time to hang tough. Tough times are the opportunity to upgrade one's portfolio and to buy and/or hold onto the best companies at such bargain prices.

With respect to managing your assets, we like our portfolios to bend in downdrafts like we have just experienced (not that we know for sure that the current downdraft is finished) rather than break. That is why we will tend to make more changes in declining markets, trying to cut losses, to retain assets with which to fight another day, trying to upgrade to take advantage of stock drops in securities we have envied owning but on which we have placed certain buying limits, trying to adjust to the frequent, mercurial and, in some cases, large implications of the rapid changes occurring in D.C.

It will be noted of course that our activity takes place around the edges of the portfolio but does not disturb the larger number of core portfolio holdings, to be discussed in ensuing pages.

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One last general comment before we go onto specifics. Some have asked about putting more money with bonds and/or money market funds. Today, it does not make much sense to put a lot of one's money in cash, beyond the level considered basic and prudent. With such tiny returns from savings accounts and money markets, one is paying a very high price for liquidity. Bond yields are also skinny. The 10 year US Treasury yields are barely 3%, the equivalent of paying a price-earnings ratio of 33 times earnings for bond interest; we do not need to pay 30 times earnings for anything or even close to it with the S&P at 12-13 times this year's estimated earnings of \$80-\$85. Compared to bonds and cash, stocks are definitely where the values are. The upside potential in stocks is large from here if history is any guide. Moreover, bullish sentiment is nowhere to be seen.

Let's talk about some of the more important changes in the quarter.

We have taken profits in the overall position in First American Corporation and its spin-off Corelogic due to our concern about some large lawsuits that may prove to be spurious, but that are large enough to raise the risk profile of both companies a fair amount, we believe.

Some accounts owned General Dynamics because our first choice in aerospace and defense, the stock of Rockwell Collins, was too high to buy. We eliminated the position in General Dynamics in favor of buying Rockwell Collins after the latter dropped into the mid \$50s. As good a company as General Dynamics is, Rockwell Collins is even better, in our judgment. Also, we anticipate a drop in defense spending, as this government seems to think defense is a more expendable function than non-defense expectations even though defense spending is down under 4% of Gross Domestic Product, while non-defense spending is 8.5% of GDP. The 45-year average of defense spending as a % of GDP is 5.5%. General Dynamics is a wonderful company with a very profitable commercial operation, Gulfstream, to go along with its broad representation in areas of defense. We hope to revisit the investment sometime in the future.

Nevertheless, we want to retain a representation in the Defense/Aerospace area as a hedge against external threats to our country. And in any case, we have liked for many years the shares of Rockwell Collins, the leader in aviation electronics (avionics) for the commercial and defense markets. We also like the company's roughly 50/50 balance between defense and commercial segments of the economy, more exposure to commercial markets than General Dynamics. This is one of the best management teams in our portfolios. Rockwell Collins is a growth company with a strong balance sheet, little net debt, operating margins around 20%, little competition and its highest ever percentage of representation in the Boeing cockpit. The Boeing 787 will be in production in a few months; orders for the 787 and other commercial planes are building the backlog at Boeing and other airplane makers as a result of the suddenly prospering global airline industry, and should get earnings up at Rockwell Collins, heading toward first \$4 per share in 2011, then \$5 per share by 2012 or 2013. The September quarter should be the start of a new ramp up in revenues and earnings.

We have been introduced to a growing insurance company, as a result of a recommendation by a fellow money manager and friend, Lansing Davis of Davis Capital. The company, W.R. Berkley, headquartered in Greenwich, CT, is a property and casualty company with \$17 billion in assets and nearly \$4 billion in written premiums that was founded in the early 1970's by none

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other than Mr. W.R. Berkley himself, who continues to own about 20% of the company while many of the employees also own large amounts of stock.

Mr. Berkley, 65 years old is chairman and CEO, and he and his son who is President and COO run the company and give their managers a lot of autonomy at the operating subsidiary level. The company insures quite a broad variety of insurance categories, including many specialty items.

The company has grown in the past decade from \$1.5 billion to \$3.8 billion in net written premiums and from \$.27 to \$2.23 last year in earnings per share, while raising the still modest dividend steadily and reducing the shares outstanding from a peak of 191 million to about 151 million.

The stock is down from a high of \$40 four years ago to the \$27 level which is only \$1 or so over book value per share, which, in an insurance company, is a pretty liquid bunch of assets. We think the low ratio of stock price to book value limits the downside risk in this stock.

Earnings at \$3.73 were higher in 2007 but have fallen as the company has chosen to write less business (and watch its total book of business decline) while it waits for better pricing. When the latter occurs, Berkley has the capacity to write a lot of business in a short period of time and get earnings back at the \$3 1/2-\$4 a share level. Many in the industry expect the "soft pricing" of the past few years to continue well into the future due to still pretty good industry profitability. Management thinks industry claims are about to rise, reducing industry profitability, and discouraging and delimiting capacity of competitors to write business. Since rates follow closely behind claims in this business, the rates should rise. As an example, in the oil drilling markets, insurance rates are up 40% in recent months.

The stock is about 10 times 2010 estimated earnings; the company is mostly a domestic company, and we like the way this shareholder heavy management thinks, like the owners that they are.

One of the most disappointing stocks we own is one of the cheapest. A few months ago we started buying shares in Energizer, (replacement batteries, Schick-Wilkinson shaving business, and Playtex which makes plastic items for babies, suntan lotion and tampons, among other consumer items), in the mid-\$60's (down from \$120 in 2007) at the "elevated" earnings multiple of 12-13 times estimated EPS of \$5.30-\$5.40 for the year to end September 30. This is a well-established household goods company that is in oligopolistic competition with Duracell in batteries and Gillette in shaving; both of those are subsidiaries of Procter and Gamble. You would expect earnings of a household goods company to be stable and recession resistant, and to provide a large amount of free cash flow (depreciation and net profit cash minus capital spending), and behold, Energizer fits that description; so there shouldn't be much risk to earnings even if the economy slows. Operating margins and net margins were at healthy levels of 20% and 8%, respectively, and in 2008-2009 and in 2001-2004 were averaging about 18% and 8%, respectively, so the company has shown relatively well in bad times.

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Since we purchased the stock, it has receded to as low as \$49 and is now only about 10x earnings at \$54. The juicy free cash flow yield is 11%. That is, if you bought the entire company for \$54 a share (x 70 million shares) or \$3.8 billion, you would, even with zero growth, get all your equity money back in 7-8 years, and if growth was 10% per year (it has been growing much faster since 2000), the payback period could be closer to 4-5 years.

The 3rd quarter (June) earnings are supposed to be down modestly due to price cutting by Duracell that Energizer had to meet, but we look for stabilized market shares and prices and for Energizer earnings to jump in fiscal 2011 to over \$6 per share. Did we mention this stock is down from \$120?

Amongst our core stocks that we think can outlast the life of the current writer and go on for decades are some truly outstanding businesses. We have commented on some of these previously, C.H. Robinson and Expeditors International were discussed in our Q3 letter last year which can be found on our website at [www.llenroccap.com](http://www.llenroccap.com). Those two companies are participating in the recovery in domestic and international movement of goods. Air cargo volumes have been extraordinarily strong so far this year up through June on a global basis. Both companies have low to mid single digit market shares in their respective markets in the domestic and international freight forwarding business. Both companies continue to outgrow their competitors and are still totally self-funding with lots of cash. Neither company ever carries debt. 2008-2009 were years of interrupted growth for Expeditors. We expect a new string of growth years starting this year. Second quarter earnings, just pre-announced this week, caused Wall Street to substantially raise estimates.

Another long held favorite, a core holding, we have not discussed is Brown-Forman, a leading global spirits company, headquartered in Louisville. Its flagship brand is Jack Daniels, which we guesstimate represents about 65% of earnings. Brown-Forman is a standout builder of brands it acquires while they are young or that Brown-Forman creates itself.

It purchased Jack Daniels in 1956 (when I was a sophomore at UCLA) and now case sales are approaching 10 million for Jack Daniels Tennessee Whiskey, plus over 300,000 cases of Gentleman Jack and nearly 100,000 cases of Jack Daniel's Single Barrel and the equivalent of over 470,000 case-equivalents of RTDs (ready-to-drink servings) of Jack Daniels line extensions including Jack Daniel's & Cola, Jack & Ginger and Jack Daniel's Country Cocktails. RTDs grew 39% last year versus a still respectable 2% growth of basic Jack in a year of depressed on-premise spirits consumption. Jack Daniels is the 4th largest selling spirits single brand in the world and the #1 selling whiskey. Other brands that the company has nurtured from small beginnings are Finlandia Vodka, Southern Comfort, Woodford Reserve, a smooth premium whiskey, and Sonoma-Cutrer, a popular but nevertheless very good tasting "white table cloth" priced Chardonnay; also recently purchased liquors are Tuaca and Chambord, which are growing from small bases.

A 2007 acquisition was the #1 selling tequila in Mexico, El Jimador, and its premium priced companion brand El Herradura. The two give Brown-Forman 16% of the Mexican tequila market and give Brown Forman a major growth factor brand to develop in the important US

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market for tequila, not yet a mature market. Older brands no longer supported by advertising are Old Forrester and Early Times, which nevertheless provide highly profitable free cash flow.

The spirits business is one of the best businesses we have encountered. Gross margins, even after subtracting excise taxes of about 23%, are 50%. Unlike the beer business where multiple brewery plants are required to keep the product delivered fresh, Brown-Forman can make millions of cases of Jack Daniels a year in one distillery in Lynchburg, Tennessee. Freight per dollar of sales and distribution costs are lower than for beer. For each of its brands, one distillery per brand will do.

Advertising has always been in the forefront of Brown-Forman brand building, and the company tends to spend more than competitors on advertising and promotion, although advertising has declined uncharacteristically for two years running. Advertising spending still represented a robust 11% of sales, far higher than competitors.

Foreign sales are about 1/2 of total sales, which is remarkable since foreign sales were 22% of sales only a decade ago. Brown-Forman claims it has only 1% of global spirits sales, which gives it plenty of runway. In that perspective, it reminds us of several other of our growth companies: Expeditors International in air and ocean freight and C.H. Robinson in domestic truck freight forwarding, each with only a few percent (less than 5%) of the available market; another is Dentsply International in the global dental market. (Now there is a market, 32 teeth times 6 1/2 billion people equals 208 billion teeth!), and Fastenal, our entry in the global industrial supply market. All these we call core holdings. Other holdings we consider core are Rockwell Collins, Graco and Techne. If your portfolio does not include one or more of these, please know that it is only because the stock has not been in a buying range since you became a client.

As this letter goes to press, we are just past the beginning of second quarter earnings releases. As we mentioned in our April letter, we expect very good earnings out of US corporations in general and more specifically out of our portfolio companies. We are hopeful that stock prices will respond to these very good earnings.

These companies mentioned above and the remainder of our companies in your portfolio are performing to plan in this period of turmoil in our economic history, and we continue to think participating in these well managed, leadership type companies, many of which enjoy somewhat limited or weak competition, is among the best low tax, growth strategies for building capital long term in this "brave new world" in the early part of the 21st century.

Let us quote from our letter last July: *"At Llenroc, our perspective is that we only need to find three or four handfuls of outstanding companies that can carry the day through this challenging time in our history. During the 1930s, there were quite a number of then moderate-sized American companies that made it through the decade such as DuPont, IBM, Dow Chemical, General Electric, 3M and Coca-Cola, that were profitable then, sold at moderate earnings multiples for much of that time, and proved to be very profitable companies for decades. Long term stockholders of such outfits had stores of value through those rough times and were amply rewarded for their patience subsequently. A modern version of that collection of great*

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*companies is certainly what we are seeking at Llenroc to find for our clients. Since there is a good deal of creative thinking in our research team, which boasts 85 years of experience in looking for just these kinds of companies, we are confident of our success. We have already identified some of the "evergreen" companies as long-term investments in the past. You own some of them, and it is our intent to add to this list in the years ahead."*

Most cordially,

Roland D. Underhill  
Managing Director

P.S. And now for some good, but off-the-wall, news about the tragic BP well. Our long time friend, Charles Maxwell at Weeden & Co. tells us that, regarding that wee extra bit of oil in the Gulf of Mexico, bacteria love warm water and will eventually devour the oil in the water! The reason this never happened at Valdez is that the water is too cold in Alaska for bacteria to thrive; not the case in the Gulf of Mexico. In 1979, there was an only slightly smaller well gone wild for 10 months prior to being capped in the offshore Mexico part of the Gulf of Mexico. It took a few years but all the oil was eaten by bacteria who actually find nutrition from the leftovers from the dead animals and plants that originally formed the oil. The GOM ocean waters were eventually restored to their original state, much like a forest fire leads to new thriving growth a few years later.

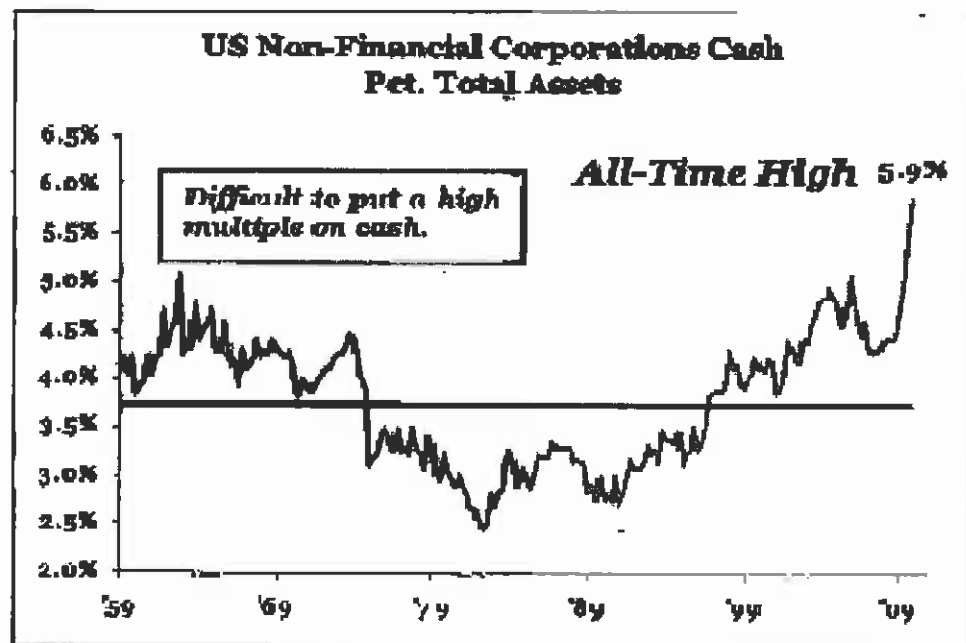
## Appendix 1

"One of the cruel ironies of the recent angst about global economic growth may be that the average American corporation may have never been as healthy as it is now. Data from the Fed's flow of funds accounts reveal that cash as percentage of total assets and undistributed corporate profits are at all-time highs. And yet, as the chart on this page suggests, companies remain loathe to part with their reserves in the form of dividends, M&A, or share repurchases. One could chalk this up as a natural cautiousness in the aftermath of the most perilous financial crisis in three generations, but we believe this phenomenon may be indicative of corporate sclerosis in the face of large and seemingly ever-

changing rule on business. The Roosevelt Administrations faced a similar conundrum in the late 30s and, regrettably, decided to impose an undistributed corporate profits tax and to raise payroll taxes, further dampening animal spirits. If there is any good news in all this it is that any clarity of the rules may provide the basis for a meaningful pick-up in activities that, one would hope, could enhance

shareholder value. Of course, the high levels of cash on corporate balance sheets is no doubt weighing on multiples - opening the coffers may entice investors to pay-up for growth" (Trennert, Bohnsack, Verrone, 2010).

Trennert, Jason. Bohnsack, Nicholas. Verrone, Chris. "Capital on Strike: Cash Levels at All Time Highs, Dividends, M&A, Buybacks All Moribund." *Strategas Investment Strategy Report* (June 7, 2010).

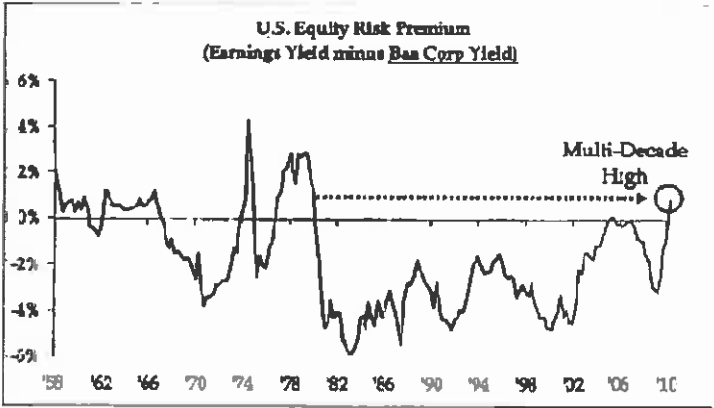
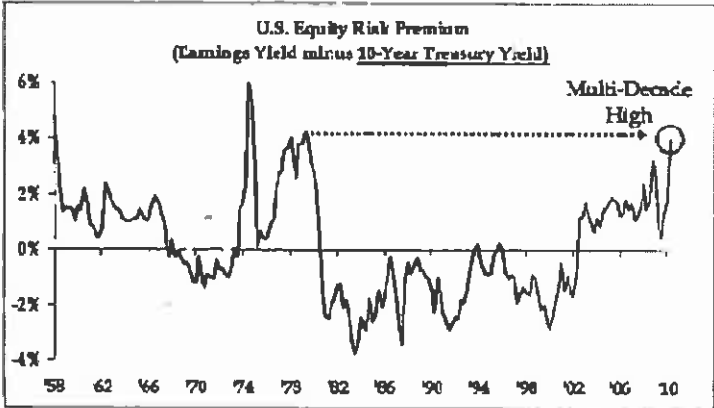


## COMPANIES WITH PERHAPS TOO MUCH CASH

The companies below all have cash as a % of assets greater than their three year-average. We've listed the top 50.

		Cash % Assets	Sector
ALTR	Altera Corp.	65.9	Information Technology
LLTC	Linear Technology Corp.	63.3	Information Technology
VRSN	VeriSign Inc.	62.7	Information Technology
GOOG	Google Inc. (Cl A)	61.8	Information Technology
ADI	Analog Devices Inc.	60.8	Information Technology
NOVL	Novell Inc.	57.4	Information Technology
LO	Lorillard Inc.	57.2	Consumer Staples
HUM	Humana Inc.	56.8	Health Care
PCLN	priceline.com Inc.	56.2	Consumer Discretionary
TLAB	Tellabs Inc.	54.2	Information Technology
A	Agilent Technologies Inc.	54.2	Information Technology
NTAP	NetApp Inc.	54.2	Information Technology
FRX	Forest Laboratories Inc.	53.1	Health Care
CRM	Salesforce.com Inc.	50.5	Information Technology
QLGC	QLogic Corp.	50.0	Information Technology
CSCO	Cisco Systems Inc.	49.3	Information Technology
MCHP	Microchip Technology Inc.	48.3	Information Technology
MSFT	Microsoft Corp.	46.7	Information Technology
NVDA	NVIDIA Corp.	46.4	Information Technology
TDC	Teradata Corp.	45.2	Information Technology
XLNX	Xilinx Inc.	43.5	Information Technology
JDSU	JDS Uniphase Corp.	43.4	Information Technology
EXPD	Expeditors International	43.0	Industrials
MA	MasterCard Inc. (Cl A)	42.6	Information Technology
ADSK	Autodesk Inc.	42.4	Information Technology
NSM	National Semiconductor Corp.	41.3	Information Technology
KLAC	KLA-Tencor Corp.	41.0	Information Technology
CTSH	Cognizant Technology	40.9	Information Technology
WDC	Western Digital Corp.	40.4	Information Technology
WLP	WellPoint Inc.	39.5	Health Care
CF	CF Industries Holdings Inc.	39.3	Materials
CEPH	Cephalon Inc.	39.2	Health Care
QCOM	QUALCOMM Inc.	39.1	Information Technology
SYK	Stryker Corp.	39.0	Health Care
RSH	RadioShack Corp.	37.0	Consumer Discretionary
AMD	Advanced Micro Devices Inc.	36.9	Information Technology
ISRG	Intuitive Surgical Inc.	36.9	Health Care
TER	Teradyne Inc.	36.5	Information Technology
LXX	Lexmark International Inc.	35.5	Information Technology
AMGN	Amgen Inc.	35.0	Health Care
WAT	Waters Corp.	34.9	Health Care
NVLS	Novellus Systems Inc.	34.5	Information Technology
LSI	LSI Corp.	34.4	Information Technology
URBN	Urban Outfitters Inc.	34.1	Consumer Discretionary
ADBE	Adobe Systems Inc.	33.6	Information Technology
DELL	Dell Inc.	33.1	Information Technology
MOT	Motorola Inc.	33.1	Information Technology
GPS	Gap Inc.	32.4	Consumer Discretionary
TSS	Total System Services Inc.	32.0	Information Technology
SNDK	SanDisk Corp.	31.7	Information Technology

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The above charts show the earnings yield (earnings per share divided by price i.e. the inverse of the price-earnings ratio) minus bond yields for the 10-year US Treasury bond and the Baa corporate yield. As we mentioned in the text, stocks are cheaper now both absolutely and compared to bonds more than anytime since the Carter-Reagan transition and before that since the long 1973-74 recession combined with Watergate; before that stocks were cheap in the 1960's. All those points in time lead to above average stock market gains subsequently.

