Yacktman Capital Group

2303 Ranch Road 620 South, Suite 135-174, Austin, Texas 78734

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The S&P 500 continued its upward momentum with a 6.9% increase in the first quarter of 2011. Stocks in general have had the best first quarter in 13 years. Comparatively, YCG returns averaged 4.95% across composites in the first quarter.

However, it has not been an easy ride. The market stumbled at times due to a variety of reasons: political turmoil in North Africa and the Middle East that toppled governments and dictators, new military action in Libya to add to the old wars in Afghanistan and Iraq, a horrible earthquake in Japan followed by a tsunami and nuclear disaster, chronic financial woes that threaten to dismember the European Union, budget issues in Washington, and exploding oil and food prices. This is by no means an exhaustive list of problems that affected the markets. Yet, whatever the events are that threaten to topple over this drunkenly bullish market, they only seem to cause a slight, momentarily stumble backwards and then it resumes sauntering forward again. The real question that remains is what will finally cause the market to come thundering back down to reality.

Drunk on Debt

With the national debt exceeding $14 trillion, we are trapped in uncharted waters in the largest monetary experiment in history. Keynesian economics rules in Washington, where the prescribed drug for our economy's problems is another dose of stimulus. Like Pavlonian dogs, the markets seem to react almost instinctively bullish at even the slightest hint of another injection, and the stimulus is considered to be working. However, it fails to address the underlying problems.

Healthy economic growth stems from savings that are invested, not from debt or by printing money. However, stimulus money is generally being used to finance consumption instead of growth or investment in goods and services the rest of the world wants. In this manner, we are not really growing the economy by creating new jobs and growth. Even with the stimulus, we are not really thriving. We are simply surviving; holding on to our fiscal life raft and hoping the storm will eventually calm.

Sadly, when the stimulus spending putters out, the mirage-like growth we have seen will disappear with it, and so will the promise of a calm economic climate. So what is next when that occurs? Can we really continue to inject euphoria into the economic system, encouraging the use of debt to solve a problem caused by excessive debt? As Einstein famously said, "Insanity [is] doing the same thing over and over again and expecting different results." We know full well that someday we will have to pay the consequences of living beyond our means as a nation.

If we viewed the government as a business, it would certainly not be an attractive stock. Expenses exceed revenues, and the remaining cash flow shortfall is being supported solely by financing activities – not a sustainable path. It seems reasonable to think that the only reason Moody's Investors Service even gives the U.S. an AAA credit rating is because of the currency's reserve status. However, even Moody's has warned the country's top AAA credit rating is at risk.

Clearly, the national debt situation is not getting any better. Eventually, to solve a debt problem you have to start spending less than you earn. This can be accomplished by either spending less or creating something of value to cover your spending habits. Currently, the government's budget plans to spend about $1.70 for each $1 in revenue, and last year it was spending $1.60 per $1 in revenue. So the government seems to be going on a spending spree in the wrong direction. In the long run, this almost certainly leads to extreme debt and inflation. Of course, Keynes never was worried about the long-run…

With the gross debt-to-GDP ratio currently at 93%, we are on pace to exceed 100% debt-to-GDP by the end of this year. Sure, during WWII in 1946 our gross debt-to-GDP rose up to 120%, but our current situation does not resemble 1946 in any way. In 1946, spending was non-mandatory, with almost all of the borrowing coming from the government's needs for war machines and supplies. Once the war ended, government was able to produce a budget with surpluses and quickly pay down the debt. In fact, during Truman's presidency (1945-1953), debt-to-GDP went from 120% to about 70%.

Fast forward to 2011, and our budget is quite different. In the current budget plan, so-called "mandatory spending," things such as Social Security, Medicare, Medicaid, etc. that are not legislated from year to year already soak up all of the annual revenues! Short of a major overhaul of these social programs, we are driving up a mountain of debt. Of course, the other side of the equation is increase tax receipts, but not only can we not raise taxes enough to keep up with the increased spending, but attempting to do so has far greater unintended consequences for the economy. We wish we could exercise some fiscal restraint and live within our means, but we do not plan on any self-control coming anytime soon. We see the Federal Reserve using the wealth effect tactic in providing a false sense of security. It is this feeling of security that has lead people to believe in this recent market recovery, but we cannot keep ignoring the 800-pound gorilla in the room – the national debt. Of course we always wish the day of reckoning could be forgotten or pushed back awhile. However, no amount of pushing it back or kicking the can further down the road will prevent the inevitable: that day must and will come. When it does, the bond markets will indeed rebel. Yet, another reason to be invested in strong multi-national corporations with pricing power and diverse currency revenue streams.

Some new investments during the first quarter would include the following: *Sysco*, *News Corp*., and *Abbott Laboratories*.

Sysco

Houston-based Sysco is the single largest player in the $215 billion North American food-service business, distributing a variety of foods and dining supplies to a broad range of customers, including restaurants, hospitals, schools, and hotels. The company commands a dominant 17% of market share in the industry, so despite being in a low-margin business, Sysco has proved it can make high returns on invested capital without leverage. Their large market share also means Sysco has economies of scale and pricing power, which allow Sysco to have some of the best margins in the industry and an economic moat that puts those margins at low risk to change. In short, Sysco has the competitive advantage.

Some investors fear the future holds a trend toward dining in for decades to come as cash-strapped consumers worry about job security and lost value in their investment portfolios. Even if this trend would continue for such an unlikely length of time (after all, eating out is still one of the cheaper forms of entertainment), Sysco seems well positioned to cope with such a shift in spending due to its diverse customer base (no one customer makes up more than 10% of sales). Furthermore, the company has about 40% of its business outside the restaurant sector and in areas that are less economically sensitive, such as hospitals, military, and schools. Regardless, while the trend toward dining at home may look perilous at first glance, it could also prove to be an opportunity for the company to take more market share from its fragmented rivals. Even if Sysco's upside does not reach full potential back to its historic 20+ P/E ratio, its fat dividend yield of nearly 4% will definitely provide a more satisfying meal than just cash along the way.

News Corp.

The entertainment industry has definitely been seeing a lot of technological disruption in the past few years. In fact, the most predictable aspect of the media industry is that things are going to change. However, this does not mean that picking media stocks is like betting on the next horse to win the Triple Crown.

The media industry can be broken down into essentially three parts: the content business, the distribution business (or conduit that distributes media from the content businesses to the consumer), and the business of producing the endpoint devices (TVs, iPhones, iPads, etc.).

If there is one thing that you can always count on, it is human nature. We as people have always shown a revealed preference for variety. That is why we always want to watch the newest shows on TV. Sure, the occasional rerun of The Dick Van Dyke Show or even CSI may be appealing at times, but ultimately we will always want new content. Since good content will always have some pricing power, content businesses are always going to continue to make money.

However, as technology advances, the way content is distributed and viewed are constantly changing. For Comcast, there are threats to their triple play. Even if you can accurately predict how media will be distributed in the future, there is still much uncertainty about Comcast's pricing power and ability to negotiate fees. As for endpoint devices, companies like Apple have shown that there is no end to the plethora of hot, new devices that can be used to view media. Nonetheless, the quick rise of Apple, just like Microsoft and IBM of the past, also notes that today's winning horse may be tomorrow's glue.

Comcast has definitely recognized the threat to its distribution profit generator, the triple play. That is why they have recently acquired NBC Universal in an attempt to get direct access to a producer of content that will stabilize their revenues. But the core cable distribution pipeline business will still generate about three-quarters of the operating profit. So, as Comcast has now reached a more fair value, we have begun trimming our position and sticking it into a more content oriented business – News Corp.

In contrast to Comcast, more than three-quarters of News Corp. profits are made in the cable network programming in programs such as Fox business, STAR, FX, etc. They also own the 20th Century Fox film studio, some Internet properties such as MySpace, and a print division (global Wall Street Journal & Times of London, regional New York Post, HarperCollins book imprint). At its recent valuation, content-heavy News Corp. has looked like one of the better risk-adjusted values in the marketplace.

Abbott Laboratories

Recently, pharmaceutical companies have been left behind in a roaring market amidst fears of expiring patents and changing regulation. However, the general discounting of an entire group, such as pharmaceuticals, can lead to a few gems hidden in the rough. One such case is Abbott Laboratories (ABT), a company that we believe deserves to trade at a premium amongst the group.

Abbott's stock price took a big hit early in the quarter with worries about the slowing growth rate of its most profitable drug, HUMIRA, which left investors wondering about the company's future. Yet, relative to peers, Abbott has limited patent losses in the near term. Their current mix of major drugs such as HUMIRA, Thicor, and Trilipix all have patents until 2016. Additionally, Abbott's strong pipeline and leading niche in cardiovascular disease drugs suggest that this is a strong company poised for a rebound.

HUMIRA has been Abbott's primary growth prospect in recent years, seeing a 20% growth in 2009 and 15% in 2010. While some investors speculate that a slowing growth rate for HUMIRA will translate into a slowing growth rate for returns, other analysts suggest that HUMIRA's low penetration rate in various diseases will cause its use to grow at double-digit rates for at least the next four years. Furthermore, Abbott seems to be moving away from its dependence in HUMIRA with new drugs and instruments for cardiovascular disease as well as new acquisitions Solvay Pharmaceuticals and Piramal Healthcare Solutions, which allow Abbott a foot in the door in the emerging markets overseas. All of these combined suggest that Abbott is not going to stop growing anytime soon.

In fact, Abbott has shown a lot of growth in the past couple decades. Actually, you can pick up Abbott at the same price level it traded in 1998, except its free cash flow and earnings have more than tripled since then! Abbott's dividend has continued to increase for the past 37 years to a juicy current yield of 3.8% at the time of our purchase.

One could easily find complaint that management has not taken advantage of low stock prices to repurchase Abbott stock. Adding to this lack of share repurchases, a recent layoff of 1,900 employees could spook investors into wondering if Abbott's management knows where it is headed. However, the management team has a proven track record in utilizing its cash flow to grow via value-enhancing acquisitions. The recent acquisitions of Solvay and Piramal suggest that Abbott managers are at it again, planning to expand globally in fast growing markets such as India. We believe they will continue to re-invest intelligently via skilled acquisitions. This makes the lack of share repurchases somewhat forgivable.

Overall, Abbott proves to be a good blue chip, a recession proof stock and a good business relative to other companies in its industry. Despite advantages like a high dividend yield, low P/E, high growth, and a strong set of current and upcoming drugs, Abbott Labs continues to trade in-line with its peers, making it look quite attractive to a patient buy and hold investor.

Concluding Remarks

Given our strong belief that markets are largely overpriced, as we have stated in recent letters and blogs, we have been asked on several occasions, "Why not sell now and buy again when prices return to 'normal' levels?"

The answer is that we do not have a crystal ball that will predict when and how the market will correct itself. Markets can remain overvalued for long periods of time. Therefore we will not get involved in the game of "timing the market." Trying to time the market has never proven to be an effective strategy over the long run. We prefer to keep strict adherence to our time tested method of purchasing companies that are undervalued in absolute terms (meaning an overall high expected forward rate of return regardless of market levels), rather than purchasing stocks that are only cheap relative to an overvalued market.

For example, suppose you go to Nordstrom's and find a product that is 10% off, which you feel good about, until you realize the next day that the same item is selling on Ebay for 50% off. Now that "deal" at the department store doesn't feel so good anymore. Luckily in this scenario, you can still return the relatively cheap item that you bought at Nordstrom's and purchase the absolutely cheap item at Ebay. In the stock market, however, correcting these types of mistakes do not happen without a permanent loss of capital.

It is true that undervalued stocks found in your portfolio can still decline – cheap can always get cheaper. But that is ok as long as those losses are only temporary. The danger is being tricked into purchasing stocks that are only relatively cheap while simultaneously absolutely expensive. This is because a decline in price would mean a permanent loss of capital. Thus, we remain ever vigilant in our efforts to avoid the permanent losses by searching for absolutely undervalued companies. We believe the companies in your portfolios will provide the best future risk-adjusted rate of return, regardless of future macroeconomic conditions or market fluctuations.

Thank you for your continued trust and loyalty.

Sincerely,

Brian A. Yacktman

Manager

William D. Kruger

Manager