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Client Letter - March 31, 2013

This year, the S&P 500 Index has come out of the starting blocks with gusto, returning 10.61% in the first quarter. Normally, we would anticipate lagging the broader market in such a frothy environment; however, much to our pleasant surprise, our strategies have virtually kept pace. The Concentrated with Option Enhancement separate account strategy returned 9.68%.

As we've discussed in times past, it seems clear to us that monetary stimulus has been the major driving force behind market prices, and not necessarily sustainable, real economic growth. As we take a step back to reflect on where returns have been generated over the past couple of years, it seems apparent that investors have largely been seeking security in a manner consistent with how academia would define safety amongst asset classes. So, much like wringing out a sponge, money first flowed into U.S. Treasuries, driving up prices and squeezing out every last drop of yield. In search of yield, investors next turned to what they considered safe – corporate bonds – and squeezed out the yield there. Then, money flowed into riskier high-yield bonds, then into utility and telecommunication equities, and now it appears to be flowing into stable, dividend yielding businesses such as health care and consumer staples.

We personally do not invest in search of dividend yields, per se, because dividends are only a derivative of free cash flows. Instead, we focus on buying streams of free cash flows that are or will be delivered to shareholders, if they are available at the right price. As luck would have it, we have found the best risk-adjusted returns to be found amongst high quality businesses, many which are found in consumer staples and health care. The flow of funds up the risk curve and into high quality businesses largely explains why we have kept pace this past quarter in a hyped-up market. Although, we should mention that while this move is recognized by many as traveling up the risk curve, we believe the businesses we own actually carry far less risk than the assets labeled as "risk-free" and low risk. In fact, over the long-term, we believe the "risk-free" asset class is priced to be "return-free" and very high risk.

As the wave of monetary stimulus continues, we believe it's quite possible the markets will rhyme with the "Nifty-Fifty" era when investors drove the P/E's of the largest, most popular 50 stocks to extreme highs in the 60's and 70's. We anticipate this behavior will be found amongst what are *perceived* to be stable, high dividend yielding businesses. We are quick to note, however, that this notion is not what drives our investment strategy. We simply continue to focus on owning securities that are trading at prices that we believe will produce attractive long-term compound annualized returns with reasonable investment risk, generally gravitating towards high quality businesses that are low in capital intensity and cyclicality and that are managed with shareholders in mind.

**A Message of Hope**

In these letters, we often mention our concerns so that you are aware that we are not blinded by the "animal spirits" in this upward trending market. We voice these concerns so that you know we are indeed watching, observing, and being vigilant as we construct and manage your portfolio. However, you likely have noticed we are always quick to mention that we are long-term optimists about our portfolio holdings. This contrast may seem counterintuitive, and so, rather than discussing our concerns as in times past, we felt strongly we should spend some time explaining some reasons as to why we are optimistic about the future.

The long trends of history are decidedly positive, as we can very clearly see from studying...well, pretty much anything. Trends in violence, death tolls from natural disasters, health, poverty, energy, civil rights, labor productivity, GDP per capita, and stock market returns show amazing progress on all fronts of the world's efforts to improve the human condition.

Given the media's focus on the still-far-too-much violence in the world today, you may be surprised to learn (we certainly were) that rates of violence are actually almost universally in long-term decline, most likely due to both the increasing interdependence of the world created by positive-sum trade and commerce and the improvements of governments over time at making violence and theft negative-sum activities for the perpetrators of these crimes. Overall, only 1% to 2% of people now die from violent deaths vs. roughly 15% of people in pre-state societies. Homicide rate declines are even more impressive, particularly in the Western world. As an example, rates of death from homicide in Western Europe are down from between 40 and 90 deaths per 100,000 per year in the year 1250 to just 1 in 100,000 now, and the world's overall homicide rate stands at only about 7 per 100,000 people, with 8 of 10 regions of the world studied by the United Nations Office on Drugs and Crime continuing to experience declines even during the recent period from 1995 to 2010. Deaths in war have plunged from 17 per 100,000 per year in the 10 years after WWII to less than 1 per 100,000 in the last 10 years, making ours arguably the most peaceful era of history. We want to be clear that we recognize that there are still many casualties in war. We are deeply grateful for the men and women (and their families) that serve our country, and we view these statistics as a hopeful sign that perhaps fewer will have to make such tremendous sacrifices in the future.

Death tolls from natural disasters show a similar trend. While we can't control the weather, we can certainly take steps to minimize its human cost. Between 1980 and 2002, the average earthquake killed 2,300 people in India and only 8 in the United States. As poor countries get richer, they should rapidly trend toward developed country levels.

In the arena of health, the situation is similarly optimistic. The average worldwide life expectancy has risen from 53 in 1960 to 70 in 2010. Encouragingly, these increases are fueled by improvements in countries on the high and low end of this bell curve. The average life expectancy of both Sub-Saharan Africa and the U.S. have increased over this time period, with Africa up from 40 to 54 and the U.S. improving from 70 to 78. Some of the most important achievements in improving life expectancy are occurring in the area of child mortality. Despite the world population having increased over the last twenty years, remarkably, the number of under-five deaths worldwide has decreased, falling from 12 million in 1990 to 7.6 million in 2010. Even more encouraging, the rate of reduction in the worst regions of the world for under-five mortality has actually been speeding up. Sub-Saharan Africa, which has the dubious distinction of topping the list, has doubled its average rate of reduction, from 1.2% a year over 1990-2000 to 2.4% during 2000-2010. Breathtaking medical and technological innovations and vast improvements in measurement practices are major causes of these health improvements, in no small part because they have led to dramatic declines in deaths from some of the world's most pernicious diseases. Deaths from malaria are 20% lower than only five years ago, death rates for both lung and breast cancer have fallen by more than a third over the last 40 years, and even Aids deaths have been on the decline in recent years. Polio, which hundreds of thousands of people contracted each year as recently as the 1980s, is on the verge of eradication, and, if the worldwide effort is successful, will be only the third disease to be completely eradicated (smallpox and rinderpest were the first two). Such an astounding accomplishment will very likely galvanize already tremendous efforts on other diseases, speeding up future progress.

Poverty is also on the decline. While poverty in the U.S. (which is defined as a lack of those goods and services commonly taken for granted by members of mainstream society and is equivalent to a yearly income of $23,050 for a household of four) has increased over the last couple of years from a low of 10-11% in the late 90s to 16% in 2012, poverty rates are still lower than they were during the boom times of the late 1950s (when they were 21-22%). More importantly, even in today's tough economic times, extreme poverty, in which households are living on less than $2 a day before government benefits, is fairly minimal at only about 1% in 2011. The real story is the worldwide one, however, and it's overwhelmingly positive. Worldwide, the proportion of people living on $1.25 a day fell from 47% in 1990 to 24% in 2008. Additionally, the proportion of people with sustainable access to safe drinking water has gone from 76% in 1990 to 89% in 2010. It's no exaggeration to state that there has never been a time in which a higher percentage of the world population has had access to the basic subsistence needs that we in the U.S. take for granted.

Commodity and energy costs are, inflation-adjusted, lower than they were 100 years ago, and the recent shale gas boom could very well provide energy abundance for the foreseeable future. This scenario is not even factoring in the holy grail of cheap batteries that could store intermittent energy sources like solar and wind or some other technology that accelerates the not-often-reported move that developed countries have already begun to make away from fossil fuels. While the rich world's economies grew by 6 per cent over the last seven years, fossil fuel consumption in those countries fell by 4%, suggesting that many countries are already preparing for inevitable (though likely very far in the future) decline in non-renewable energy sources.

Since the late 19th century, equal rights and opportunities for women, children, and minorities have been dramatically on the rise, with one incredibly important statistic being that the world has achieved parity in primary education between boys and girls, going from a ratio of 91 girls to 100 boys in 1999 to parity in 2010. Additionally, we're all well aware of, but frequently forget to marvel at, the worldwide declines in slavery, increases in voting rights, and improvements in child protections such as labor laws.

Labor productivity has increased in the vast majority of the world over the last 10 years, but the developing countries still have a long way to go, with one-tenth to one-third of the productivity of the Western world, which should lead to growth and improved living for years to come. Even in the developed world, productivity is 33% higher than it was 20 years ago.

And these trends are even more impressive when you focus in on the long term impact this productivity has on GDP per capita, *even in the face of many scary events* like world wars, oil embargos, depressions, iron curtains, etc. On an inflation-adjusted basis, U.S. GDP per capita is up 2.5x over the last 50 years and more than 7.5x since 1900. Importantly, even if GDP per capita growth rates slow, a little recognized fact is that, since we're starting from a bigger base, the actual improvements will be much larger per year than most of the years during which this economic miracle occurred.

As long as humanity continues the dual trends of 1) capitalism and 2) governments that effectively protect individual rights/property and fairly mete out justice, mankind is likely to flourish and the companies in which we are invested will likely ride these positive trends towards more profits and higher stock market prices, just like great businesses did over the period from 1900 to March 31st, 2013, during which the Dow Jones Industrials advanced from $66 to $14,579, a staggering 22,089% return not including dividends. If the future is anything like the past (and the above rationale suggests it very well might be better), then you don't want to miss out!

**DirecTV: Changing the Channel to Latin America**

Speaking of growth stemming from developing areas, over the past three months, we've built a position in DirecTV (DTV), the largest satellite cable television provider with 20 million subscribers in the U.S. and 15 million in Latin America. While most of the cable and media companies have rocketed upward over the past couple of years, DirecTV has put in a relatively quotidian performance, leaving it valued at a very significant discount to its cable peers, which trade at about 16x 2013 EPS estimates versus DirecTV at a mere 12×. There are a couple of reasons for the underperformance. The first is investors' concern that cable competitors such as Comcast and Cablevision will use their control of both the television and internet markets to ratchet up rates charged on internet subscriptions and lower rates on cable television, protecting their profitability but squeezing DirecTV in the process. The second is the concern that content providers like News Corp, ESPN, and others are gaining bargaining power through the continued proliferation of modes of distribution such as their own online websites, Netflix, iTunes, and Hulu, all of which compete with DirecTV and other cable providers.

In our view, these concerns are overblown. While we believe that the problems in the U.S. are real and should pressure growth over time, we also believe they are unlikely to lead to sudden declines in cash flow. Cable television providers have offered both internet and cable TV for many years and yet DirecTV has grown subscribers in the U.S. every year of its existence, most recently growing them at 1% during 2012. Additionally, DirecTV has consistently raised its average revenue per subscriber, enabling it to successfully offset programming cost increases. It's been able to accomplish this feat as a result of the peculiar nature of its customer base. Its subscribers tend to be either wealthier than average or more rural than average. Both of these customer categories are fairly sticky. Wealthy customers care less about price and more about customer service and programming offerings (both of which are competitive strengths of DirecTV) and rural customers have few alternatives since it's hard for cable companies to justify the cost of expensive build-outs to areas with low population density. Furthermore, the history of technological advancement suggests that consumers value proliferation of choice, leading to older technologies existing for many years alongside newer ones. Just look at banking. The consumer can now deposit or withdraw money through a bank teller, on her mobile phone, at an ATM, or in a retailer's check-out line. Similarly, we believe it's most likely that customers, particularly wealthier ones, will use Netflix, Hulu, and iTunes in addition to, not to the exclusion of, cable or satellite TV.

Though investors' excessive negativity about DirecTV's U.S. prospects is certainly good, in and of itself, for buyers of the stock, the best outcome of this myopic focus on problems at DirecTV U.S. is that it has caused investors to underappreciate DirecTV Latin America's value to the company as a whole. This phenomenon—the tendency to pay attention to the dominant stimuli in one's immediate environment and neglect other equally relevant but less visible data – is called "attentional bias," and it consistently plagues attempts at rational decision making. Let's not make this mistake and instead properly evaluate the less-discussed-but-no-less-important other division of the company, DirecTV Latin America.

DirecTV Latin America is the dominant pay TV provider in Latin America, where the cable plant is much less developed and will take many years to develop a comparable geographic coverage to DirecTV. This fact, combined with rapid growth of the middle class in Latin America and the massive under-penetration of cable-TV in Latin America versus the U.S., explains why cumulative DirecTV Latin America subscribers are growing 30% per year and should be able to grow rapidly for the foreseeable future. Even if this torrid growth rate slows over the next ten years, DirecTV will likely make well over 50% of its profits in Latin America instead of the current 20% by the end of this time period.

We believe this transformation will result in a major perception change among investors, just like it has in the past with similar situations such as eBay and YUM Brands. In eBay's case, the growth of the PayPal division has transformed eBay in investors' minds from a boring and mature auction business that has been out-competed by Amazon to an exciting and fast growing payments stock. In the case of YUM Brands, the rapidly growing Asian KFC division has slowly eclipsed in prominence the underperforming US divisions of KFC, Taco Bell, and Pizza Hut. And just like for eBay and YUM Brands, we believe the transformation in investor perception from a mature U.S. business to a dominant and fast-growing Latin American one will expand DirecTV's P/E multiple from the aforementioned discount to parity or even to a premium versus other media companies. In the meantime, the excellent capital allocators at DirecTV continue to buy back stock at a truly mind-blowing pace (having shrunk the share base by 46% over the last five years), ensuring that we will own an even bigger share of the business when this valuation expansion occurs.

Only time will tell, but, if this investment plays out as we anticipate, we'll be very glad we tuned in.

## **Concluding Remarks**

As always, we are invested right alongside you. We encourage you to remain focused on a long investment horizon. While many global challenges still remain, there is much to be optimistic about when one takes a long-term view. We will continue to be patient and objective as we diligently seek out the best risk-adjusted expected returns.

Sincerely,

The YCG Team

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