Anticipating a Haircut

FOUNDERS CAPITAL MANAGEMENT
2013 ANNUAL REPORT

Investing for the Long Term. Every Day.

An innovative money management firm investing in publicly traded equities and fixed-income securities. A deep base in business management with a truly global perspective. A drive to identify true fundamental value. A commitment to buy carefully and hold for the long term. A passion to provide customized investment solutions tailored to each client's financial goals and risk tolerance.

This is Founders.

Founders Capital Management, LLC

2013 Annual Report:

"Anticipating a Haircut"

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PRINCIPALS' LETTER
From: Founders Capital Management

2013: Anticipating a Haircut

2013 will be a year to remember, as wary market participants watched stock prices hit new highs. The U.S. stock market continued to astonish bystanders as it marched forward in the face of a U.S. government financial disturbance, ongoing European financial and political turmoil, conflict in Syria, and a shaky economic and financial foundation in China.

The Standard & Poor's 500 (S&P 500) closed the year with a healthy gain of 32.4%, delivering a home-run year for giddy investors. Impressively, the S&P 500 has risen more than 177% from the March 2009 low—an exceptional climb in a relatively short investment period.

Despite the market run-up, various questions linger:

- Will we be able to get our economic growth back on a "normal footing" and get back to historically lower unemployment rates?
- What will happen if the U.S. government is unable to reach consensus on how to manage long-term budget and debt issues?
- What will be the market reaction once the Federal Reserve further reduces support for quantitative easing (the ongoing monthly purchase of U.S. Treasuries and mortgage-backed securities)?
- Can Europe re-invigorate economic growth as more affluent regions are required to subsidize the less affluent?
- How fast can China develop a self-sufficient economy, and what impact will this have on global trade?

We do not know the answers to these questions. When we step back to evaluate the global economic landscape, however, we remain concerned about circumstances that could lengthen the ongoing worldwide political and economic stalemate. We see common global problems that will become more unmanageable over time unless they are addressed. These include:

1) The inability of the world's major economic powers to collaboratively deal with growing deficits and debts
2) An unwillingness of U.S. elected officials to contend with large government entitlement programs that are unsustainable in their current form

Due to the harsh financial penalties to citizens that would result, countries continue to delay developing solutions to these shared global challenges. Of course, this inaction only worsens our economic woes as debts continue to mount. In the meantime, in an effort to create market and social stability, governments and central banks are implementing short-term "band-aid" measures to address our common financial and social challenges. Near-zero short-term interest rates, ongoing quantitative easing (purchasing government and government-backed bonds), along with rising government debt all seem to accommodate global citizens in the near term, but over the long term these solutions are not sustainable. We will eventually have to stop "kicking the can down the road" and deal with our financial and social challenges if we are to set ourselves on the path

of creating long-term value for all global inhabitants. In our opinion, the longer we procrastinate developing solutions to address these concerns, the greater the probability that the type of market fluctuations that have characterized the past 10 years will continue.

For the time being, financial markets have recovered due to government financial stimulation. Despite the positive market results over the past five years, however, our experience tells us that caution and prudence should prevail going forward. Why?

We recently read a book, *Antifragile,* by Nassim Taleb. The author presents a basic premise: In a desire to create a stable environment in any endeavor, we often create fragility, ultimately leading to unintended instability. In other words, an attempt to *over-control* the environment in any area, such as education, healthcare, economies, etc., often leads to a situation that gets out of control. For example, we can compare the government's desire to control the current economy to an overprotective parent intervening in the life of an out-of-control high school teenager. When the high school teenager is facing many restrictions, along with the threat of severe grounding for each small infraction, we all know what usually happens when this teenager experiences the complete freedom of being away at college. Similarly, over-control and interference today can lead to a destabilized situation in the future.

In many respects, the health and well-being of our market-based society needs to be allowed to self-stabilize—including undergoing periods of short-term difficulty that will make us stronger in the long term.

While governments may be well intentioned in providing *necessary* interference and support, many investors feel permitted to act like the college-bound teenager who is experiencing freedom for the first time. As a result, St. Consequence is beginning to rear its ugly head during this period of government economic over-control. We are witnessing individuals (professional and amateur) move higher amounts of money to increasingly higher-risk assets to obtain returns in a restricted, zero-return environment. The current rise in prices surrounding risk-type assets is providing these investors a rationale to put money into places that have little or no economic value.

We think it is important to be mindful of how global market participants are stretching for returns and, in many cases, over-speculating to seek gains. We are becoming anxious due to complacency that has increasingly entered both the equity and fixed-income markets, and we believe it is worthwhile to repeat the phrase cited in our 2005 letter that was penned by George Eliot in her 1861 novel, *Silas Marner:*

> *"The sense of security more frequently springs from habit than from conviction, and for this reason it often subsists after such a change in the conditions as might have been expected to suggest alarm. The lapse of time during which a given event has not happened, is, in this logic of habit, constantly alleged as a reason why the event should never happen, even when the lapse of time is precisely the added condition which makes the event imminent."*

In other words, the lapse of time between financially stressful situations is not a reason to believe financial stress will not happen again—in fact, the lapse of time is precisely the added condition that could make a financially stressful condition resurface. Many investors have all but forgotten the market fall of 2008/2009, shrugging it off as a "one-time" event that will not happen again. Professional and unprofessional market participants seem convinced that the global central banks will use every means at their disposal to keep markets afloat at high tide and view market collapse as a virtual impossibility.

In considering the economic recovery we have experienced over the past five years since the advent of the financial crisis, and the corresponding gains in the markets, we should not allow ourselves to be lulled into a false sense of security with the hopeful notion that the high annual returns established during the 1990s are here once again. Instead, we remain alert to the changing conditions characterized throughout our letters, and aware of several circumstances that could lead to short-term financial stress today.

The theme of our letter this year is "Anticipating a Haircut," and our 2013 topics include:

- The Wild Chase for Higher Returns
- Anticipating a Haircut
- Disruptors, Runways, and Alpha
- Value Creation and Sustainability

* * *

The Wild Chase for Higher Returns

When investing, you can either soar with the eagles or run with the turkeys

Consider the following tweets about investment activity that is taking place in global markets that are at all-time highs:

IPO @Frenzied – 2013 most IPOs in U.S. since 2000, 222 Initial Public Offerings, $55 billion raised

TWTR @bigipo – Twitter plans 70 million share sale @ $17 to $20 per share, raises offering price to $26 per share at IPO; shares close first day @ $44.70 per share, up 73%!

Junkiest @CCC – Junkiest junk bonds rise 11%+ in 2013 vs. jump in regular junk bonds of 6%+; (higher quality bonds down over 2% the past twelve months)

Subprime @isback – Subprime loans double in 2013; primarily from automobile buyers!

CLO @banks – Collateralized Loan Obligations (slice'em, dice'em and sell'em) are back in vogue as banks and investors strive for yield!

ETF @Bitcoin(s) – ETF's multiply and grow in complexity, making way for new ETF's like Bitcoin. Bitcoin rises from $13 in January, and reaches $1,000+ by December – the new currency!

Sizzle @Hotstock – Social media stocks up 150% in 2013; get on this new investment highway!

These are the sentiments of investors who are opting to accept higher risk by placing their money in assets that possess little to no economic value. How quickly the concept of caution has dissipated since the financial crisis five years ago. Others are taking the "Goldilocks position"—that market values are neither "too hot," nor "too cold." In fact, they are just about right! In many respects, we agree with the position that, on the whole, markets are in the "fair value range." A closer look, however, reveals several alarming realities:

1) The investment community is heavily discounting the fact that much of the risk spawned by the financial crisis has, in principle, been transferred to the government. To avoid economic and social disorder, the U.S. Treasury has issued enormous amounts of debt, while the Federal Reserve has rightly lowered interest rates to near zero while agreeing to purchase large quantities of debt through quantitative easing. In the process, the Federal Reserve balance sheet has swelled into unchartered territory, as it now carries the majority of investor risk.

2) Due to the so-called government backstop, investors have felt comfortable retriggering risk, acquiring lower-quality securities to obtain higher returns in a returnless setting. It is quite possible that the government's desire to do good for society by controlling a financial and economic crisis may be inviting unintended consequences as investors steadily increase their appetite for risk.

Investors seeking higher-than-average returns are chasing assets where rising prices have become the reason to gobble them up, including art, wine, real estate, and speculative securities. This trend is beginning to remind us of another scenario outlined in the book, *Antifragile*—the "turkey conundrum." Briefly summarized: Turkeys betting on their growing population project a steady increase as they fall in love with the farmer who continues to develop their flock. When charting the growth of the turkey population, these smart birds plot exponential growth as the turkeys are routinely fed, carefully maintained in well-kept quarters, and continue to multiply. In fact, the smartest birds boldly increase their investment view and become euphoric in October when forecasting the future turkey population—until November, when the butcher arrives. Suddenly, their statistical confidence in projecting a constant upward slope in turkey population is immediately broken, and the birds run for safety that does not exist.

Today, there are a lot of investment turkeys plotting an ever-increasing price for risky assets, many of which are newly created by Wall Street. For example, there are now more than 1,500 U.S.-listed Exchange-Traded Funds (ETFs), with hundreds waiting in the wings to be approved by the U.S. Securities and Exchange Commission (SEC). To date, investors have placed more than $1.5 trillion in ETFs, many which are loaded with complex derivatives. The "feeding frenzy" for this type of investment is reaching an extreme, as one ETF

seeking approval tracks the value of Bitcoin, a crypto-currency that can be used to make peer-to-peer purchases. The concept of Bitcoin pivots on the idea of a new form of global money that uses cryptography to control its creation and transactions, rather than relying on central authorities. To us, the notion of crypto-currency seems like "air," since you have to use "real money" in exchange for Bitcoin. Nonetheless, Bitcoin increased in price more than fiftyfold in 2013, inviting copycats such as Litecoin and Alphacoin to the market. In the near future, individuals may be able to trade ETFs based on the value of air!

In addition, professional and nonprofessional market participants are chasing certain stocks that supposedly have a tremendous future, or companies that seem to be chased by others. Investor excitement continues to swirl around stocks such as Facebook, Groupon, Zynga, LinkedIn, Pandora, Zillow, Yelp, and Twitter. The collective value of these social media-related companies has risen approximately 150% this past year (and we thought they were overvalued last year). Investors are now paying an estimated $225 billion for this collection of businesses that will produce around $835 million in reported profits during 2013—that is 269 times Generally Accepted Accounting Principles (GAAP) earnings.

We have updated the following chart that we presented in last year's letter:

	Market Cap at IPO Price *($ billions)*	Market Cap 12/31/2013 *($ billions)*	Gain/(Loss) since IPO	Price/Revenue 12/31/2013	Price/GAAP Earnings 12/31/2013
Facebook	82	138.8	69%	18.2x	119x
Groupon	13	7.8	(44%)	3.1x	Loss
Zynga	7	3.1	(55%)	3.5x	Loss
LinkedIn	4.8	25.9	439%	17.1x	528x
Pandora Media	2.5	5.2	108%	8x	Loss
Zillow	.66	3.2	384%	16.5x	Loss
Yelp	.95	4.8	405%	21.2x	Loss
Twitter	14	36	157%	56.3x	Loss

Our concern with these so-called opportunities continues to be valuations that are totally dependent on the future. To us, it still makes little economic or business sense to purchase a portion of a company that does not have a *predictable* earnings stream (let alone losses), along with a *sustainable competitive advantage*. It is our opinion that many of the companies that are currently attracting investors lack both of these critical investment attributes.

A final consideration: Investors are taking large risks with fixed-income securities that possess a weak financial structure, and have risen considerably over the past few years. While the Barclay's U.S. Aggregate Bond Index, which represents the broad debt market, experienced a decline of 2.0% during the past 12 months, the lowest-quality fixed-income securities that we would consider to be junk(iest) —i.e., teetering on bankruptcy—have increased around 11%.

On top of the overall increase in investment complexity, we are witnessing a high amount of short-term funding on Wall Street that creates a perilously coupled situation: Overnight borrowing from money-market funds, insurance companies, pension funds, etc. lubricates Wall Street participants such as hedge funds, which turn around and invest this "rented" money in stocks and bonds, some of which is placed in the assets we previously described. This scenario is all well and good until lenders decide that the risk is too great to provide short-term money to market participants who are putting their money at great risk. If the lenders decide to "pull the credit plug," it may precipitate a mass exodus from high-risk securities by leveraged hedge funds scrambling to pay back overnight lenders.

We are not predicting another liquidity crisis or "market freeze." Nevertheless, we believe that many smaller capitalized and speculative equities, as well as low quality fixed-income investments, are trading at exceedingly high valuations compared to more conservative issues. The considerable rise in price of

speculative securities indicates an imbalance (approaching extreme) between risk and return in these areas. Although we may agree with pundits who state that, in aggregate, the stock market is in the range of being fairly valued, there seems to be a complex bifurcation in security valuations and perilously coupled investment atmosphere that causes us to be cautious.

Given the circumstances, our market view can be summed up as follows:

> **Despite today's uncertain environment of prolonged low interest rates, opaque financial markets, volatile commodity prices, high amounts of consumer and government debt, ballooning trade deficit, large currency imbalances, bloated liquidity, and ongoing geopolitical issues, investors (including professionals) are becoming more lax. At current prices, we believe selective, larger-capitalized equity securities to be fairly valued, while smaller-capitalized equities, speculative equities, and long-term fixed-income securities seem overvalued—approaching an extreme.**

At this point, it needs to be emphasized that we do not have a general view on the future direction of the stock and fixed-income markets—***we are not in the gloom and doom mode, but the yellow caution light is flashing.***

Anticipating a Haircut

The preceding discussion and headline may lead many readers to believe that we are about to retract our "caution light" statement and discuss an imminent market fall. But the haircut we are focused on is the current and anticipated tax increases that we will likely face during the long-term economic recovery. Yes, we are going to attempt to discuss the "undiscussable."

We will skip the obvious discussion about altering (increasing) the tax base to support the growing deficits our economic system faces—in other words, raising taxes on the wealthy. We would like to go beyond the obvious to talk about *hidden taxes* looming in the future that will impact all citizens.

***Inflation tax*es**

Since the credit crisis of 2008/2009, the U.S. government has worked diligently with the Federal Reserve to avoid a deflationary environment, aggressively lowering interest rates and rapidly feeding trillions of dollars into the financial system to enhance liquidity, shore up falling asset prices, and keep America's credit gears moving. The response by the U.S. Treasury and Federal Reserve should be commended—their actions avoided the catastrophe associated with a long-term deflationary environment (think "1930s"). Unfortunately, the financial crisis was very deep, and five years later, interest rates remain at historic lows, and money continues to be aggressively injected into the financial system to allow banks to heal, enable individuals and corporations to restructure their debt at lower rates, and ensure that our financial plumbing keeps things flowing.

Given the longevity of the central bank's actions, investors should probably pay heed to Isaac Newton's third law of motion: ***For every action, there is an equal and opposite reaction.*** If the act of maintaining historical low interest rates and placing large amounts of money into the financial system are not reversible, through both raising interest rates and removing money from the system in the future, it is highly likely that we will enter an inflationary period—one that may be quite high. This scenario is not much better than a deflationary environment, as wage increases would likely fail to keep pace with the rising prices of all goods and services. In addition, inflation has the largest impact on the long-term return of all types of capital, for both investors and businesses.

The inflation equation is important to understanding the "real earnings" that are produced for an individual or business owner. "Real earnings" are determined by the extra purchasing power an investor achieves having placed his money at risk. We have used the following example before, but it is worth repeating:

Let's say you decide to start saving for your child's college education that will start in 10 years. Suppose you opt to put aside $20,000 today for the anticipated first year of college. Given that you think tuition will increase 3% per year, you place the $20,000 in a safe 10-year Treasury bond that earns approximately 3% per year. At the end of 10 years, the $20,000 will have grown to around $26,875, including reinvested coupons —

not great. But how would you feel if, at the 10-year point, you discovered that the first year's tuition bill had inflated annually at more than 7%, to $39,340? You certainly would not feel very savvy, having produced no "real earnings" from your initial investment after 10 years. In fact, you can begin to think of the difference between rising costs and low returns as an "inflation tax." This tax would impact both individuals and businesses and could take a tremendous toll on all citizens.

Investment taxes

Of the roughly $225 trillion invested in the global stock and bond markets, about 70% is invested in bonds, and 30% is invested in stocks. Much of this money is managed on behalf of investors who entrust their wealth to professional money managers to obtain a fair inflation-adjusted return over time. Naturally, to accomplish this feat, professional money management organizations charge fees for their services. Let's look at the economics of this relationship:

If the average annual fees charged by bond funds equates to 1% of assets under management, and we assume that fixed-income returns over the next 10 years will be slightly higher than the 3% risk-free 10-year government bonds offered in credit-worthy sovereign nations around the globe, we can assume that a 30% tax will be placed on investors' fixed-income returns. In the case of managed stock funds, if the average annual fees equals 1.4% of assets under management, and we forecast an annual return of 7% over the next 10 years, we can expect that a 20% tax will be levied on investors' stock market returns. Unfortunately, most of investors' funds currently reside in the bond market, so the so-called investment tax will be closer to 30%, as opposed to 20%. This seems like a high price to pay for investment services in a low-return environment. So much so, that we can refer to these excessive fees as a tax.

You would hope that this would be the end of this story but, regrettably, it is just the beginning. There is an additional hidden tax that investors do not see: An average stock and bond fund will hold a security for around 10 to 12 months. With every trade, a fee is charged for the sale of one security and the purchase of another. It is our estimation that the average trade fee is around 0.15% for stocks and 0.25% for bonds. This means that investors bear an approximate 0.4% tax on each transaction that involves a sale of one security and a purchase of another. Put this all together, and the total annual investment levy can equal 1.5% of assets under management, which represents an approximate 34% tax on a blended stock and bond portfolio that is expecting a 4.4% annual return. Unfortunately, this tax is not going away.

Shareholder taxes

One of the areas we carefully review when reading annual reports is executive compensation—especially the section of the report that outlines stock options and grants. We are particularly interested in evaluating this segment of the annual report to obtain a fair judgment regarding executive pay compared to the value being produced. We would like to say that we have positive comments in this area, but we cannot. We think the compensation provided to most executives today far exceeds the value they create for shareholders. In fact, we can say that, in many cases, it borders on the egregious side—so much that we can state that excessive executive compensation has now become a tax on shareholders. But, before we get into the numbers that will help explain this tax, we should say that many executives earn their high compensation, and we applaud the value created for shareholders. We have no problem paying a lot when we receive a lot more— but this is the exception rather than the rule.

It is our assessment that the average company puts aside approximately 6% of its outstanding stock as options and grants to be issued to its top executives. Now, there are several facets to consider with stock options and grants, including the price at which these are provided, as well as the length of time in which they may be exercised. Nevertheless, based on a conservative back-of-the-envelope calculation, annual stock options and grants issued to executives can hover somewhere around .85% of a company's intrinsic value. Taking into consideration that executives must pay an exercise price for their stock options, if a company produces $100 million in profits and is fairly valued at $1.5 billion, executives would receive around $6.5 million in equity compensation, or approximately 6.5% of yearly profits. If the average company increases intrinsic value at 7% per year, and the executive management fee remains static at 6.5% of profits, then the expected shareholder return should be adjusted downward by .45%, bringing the annual investor return to slightly higher than 6.5%.

Disruptors, Runways, and Alpha

Beware of new terms for recycled Wall Street ideas.

Given the high taxes being placed on average, lower-return investments, most individuals and money managers are logically seeking what they think are "better-than-average" opportunities in which to place their money. Yet most of the business prospects that are associated with higher returns come with less certainty and little to no economic value. The sales pitch from sophisticated brokers and money management firms selling these "high return investments" usually starts like this: ***To obtain higher returns, we need to invest in disruptive companies that have a long runway to serve as the portfolio "alpha."*** In other words, you need to get on the bandwagon chasing the rising stocks that are showing the highest increase in price.

Based on the advice of these expert stock-pickers, it seems that many of them believe that achieving gains in today's market requires figuring out how much disruption a business can create, along with the length of time the entity can produce industry instability. Let's consider the logic of this assumption: Imagine if we had the opportunity to make a lifetime investment in a group of graduate business students in exchange for a portion of their future earnings. To evaluate our most promising prospects, we likely would not seek the most disruptive students in the class, nor the ones that are most adept at sustaining havoc. We would probably look for the smartest students that were honest, hard-working, critical thinkers that acted with integrity and brought out the best in others. The overzealous, "disruptive" students may be good at providing a "long runway" of mayhem as they kick up excitement and get our immediate attention, but they would end up being graduate "business imposters."

Nonetheless, many individuals placing money into businesses today focus on extrinsic qualities such as the level of disruption and the length of time the industry interference can be sustained, disregarding whether these businesses possess attributes that create intrinsic value. These businesses tend to have questionable customer loyalty, ever-changing strategies and products, little to no profitability, and are managed to entice impulsive investors. Because these companies produce little to no money, the measures to value them include nothing new, focusing on quantifying numbers of clicks, eyeballs, and users—while all-important intrinsic value measurements are thrown out the window. In our view, ***you can't measure the distance someone walks by counting the number of times they tap their feet.***

Let's take a look at another example where questionable investment attention has gathered, outside of the contemporary social media craze—the Business Development Company (BDC). Most BDCs are set up much like closed-end investment funds and are public companies that are listed on the stock exchange. They are created to help grow small companies in the initial stages of their development. BDCs are similar to venture capital funds, as they invest in fledgling start-ups with high-interest loans that are convertible into common stock at low prices. The businesses in which BDCs seek to invest shareholder funds can be described as ***disruptive, with a long runway that will deliver tremendous alpha***—i.e., better than average returns. Of course, the investment allure to a BDC is a "cake-and-eat-it-too" outlook—a chance to obtain a high initial dividend rate via a pass-through of high-interest loan payments, along with participation in significant upside potential if several developing businesses in the portfolio take off.

The essential problem is that many small companies in which a BDC invests fail, and to cover a dividend rate that is in the 8% to 9% range, new stock is issued each year that exceeds the payment to shareholders. This activity is more akin to a modern Ponzi scheme, as the money raised from freshly issued stock is essentially used to pay dividends to current shareholders. Nonetheless, BDCs are being chased by naïve investors who believe they are obtaining high yields in a low-yield environment, along with a "kicker" in the future that will support an increase in the BDC's stock price. Given this description, we would place many BDCs in the "business imposter" category. In fact, many of the companies that are disrupting markets in various industries and generating a lot of activity today will likely end up being business imposters. Investors in these cases should beware.

We believe that a collection of businesses should be evaluated using similar criteria to judging successful future business graduate students: One should seek businesses that possess qualities of intrinsic value that are measurable today and have a high degree of probability of strengthening over time.

Value Creation and Sustainability

A good gambler may know how to count, but a respectable investor knows what counts.

A respectable investor does not act like a dice-counting gambler who makes uninformed guesses about the next anticipated roll of a stock, but truly understands what counts when seeking companies in which to place funds. In past letters, we identified what we believe counts when determining the difference between "what value is" and "what is valuable." We consider valuable businesses to possess the "four ables":

- **defend*able*** businesses that are difficult for competitors to penetrate
- s**ustain*able*** businesses that can be viewed many years out
- **predict*able*** businesses that have a high market share of consistently needed products that are integral to daily activity—leading to steady returns on capital and profitability
- **afford*able*** businesses that are selling at a desirable price that provide an investor a fair return over time

Review of Economic Value Creation & Business Models

Businesses that possess the "ables" create economic value by producing distributable owner earnings over time, and allocating these earnings effectively. We have stated previously that corporate earnings should not be viewed on an apples-to-apples basis due to variations in the capital-intensity of one business compared to another. For example: An automobile manufacturer participating in an industry that frequently exhibits self-destructive competitive behavior may achieve an average return of 10% on its employed equity capital, but little of this money can make its way to owners. For every $3 per share of earnings reported, the carmaker *must* retain $2 of this shareholders' money to enable the company to stay on the competitive treadmill. As hard as management may try to generate cash for shareholders, the manufacturer has to retool and/or build factories to produce new autos for future delivery. This type of business thus places a heavy burden on its retained shareholder earnings, requiring management to achieve an equal or better return on freshly invested capital compared to prior returns on retained equity. If management fails to obtain a return on this reallocated shareholder capital that is equal to or better than what was achieved before, then economic value is destroyed over time.

On the opposite side of the coin, a well-entrenched, non capital-intensive business has a tendency to gush cash (for example, Coke's manufacturing of syrup does not materially change). A beverage manufacturer that is able to achieve a consistent 25% return on employed equity capital has difficulty reinvesting 100% of its earnings, since doubling this global business every three years would be difficult—every $1 of shareholder funds retained would turn into more than $9 in 10 years. If this investment dream could come true, however, owners would request that management maintain all capital possible to cumulatively and exponentially increase returns. Understandably, most businesses that generate returns of 25 cents on every $1 of employed equity capital would find it very difficult to reinvest undistributed capital on a continual basis to achieve a return of 25% per annum. Thus, these excellent businesses generate a large amount of unrestricted earnings that, in principle, should be distributed to shareholders through dividends and/or prudent share repurchases. By the way, *we like this category of businesses a lot.*

In our 2011 annual letter, we further defined the "ables" by describing the types of business models a company might employ to make money. We organized well-defined business models and strategies into four broad categories:

1. **Controlling the Middle:** Managing to the center of the "business chessboard," in the style of John D. Rockefeller and Standard Oil's monopoly of the oil industry
2. **Segregation and Integration:** A business structure that uses both vertical and horizontal integration—for example, Coca-Cola and its distribution network
3. **Organic and Mechanistic:** Centralizing and outsourcing various business components such as marketing and operations to gain flexibility and control the production and delivery of a product—Nike is a perfect illustration
4. **Purpose and Focus:** Businesses that continually stress operational excellence, product/service differentiation and innovation, employee development, and customer and supplier intimacy—McDonald's can serve as an example in this category

The Secret Sauce

Underlying the above concepts that explain how current value can be measured in a business is the science part of value creation that is taught at excellent schools offering a masters degree in business administration (MBA). But this advanced education in measuring business ability does not necessarily help someone determine whether or not an entity can create sustainable value over many decades. To evaluate this part of the equation, a special relationship needs to exist where both intrinsic and extrinsic value qualities are present.

In many respects, we review a business similar to determining the perfect spouse for marriage—more often than not, it is much better to focus on the person's innate qualities rather than outward appearance. Of course, appearance may matter in initial attraction, but a heavy emphasis should probably be placed on the heart and character of an individual, since appearance tends to go by the wayside as one gets older (or so we've been told).

When initially evaluating a business, we may ask what makes it attractive. A business that is focused exclusively on creating extrinsic value may incentivize its constituents to pursue superficial attention. For example, if employees are only compensated through stock options, they would likely be incentivized to do everything possible to create an outward appearance of business success to drive up the stock price. In this event, they may not care much about the "real value" created inside the business, as long as the perception of the business is good and keeps the stock price rising.

On the other hand, outward appearances in a business can become important if they provide feedback and support to inner qualities. When a competitive business can strike a long-term balance of using extrinsic appearances to support intrinsic qualities, an emotional connection is made with customers. This connection engenders tremendous ingrained support and longevity. For instance, in the case of Coca-Cola, a consumer may be attracted to the "skirt bottle"—an extrinsic quality that has come to be associated with the intrinsic character of the company over time. In other words, extrinsic qualities can become part of a feedback loop that supports intrinsic traits. Unless they are protected by monopoly or patent, businesses that lack this "one-two punch" will find it more difficult to create permanent value over time.

The big question is: What should an investor look for within a company that would give an indication that the business has a special balance between extrinsic and intrinsic qualities?

Many innovative MBA programs today are attempting to answer this question by developing coursework around the broad subject of "environmental sustainability." Unfortunately, much of the curriculum subject matter seems to be extrinsic—i.e., minimizing greenhouse gas emissions, creating supply-chain efficiency, concentrating on effective water management, etc. These criteria are all well and good, as integrating environmental management and protection with good business does create an enduring entity. However, we think a course focusing on intrinsic values would make more sense. The commonsense course we are referring to is not taught in any MBA program that we are aware of, due to the fact that it was imparted to most of us when were children: It's called character development. For some unforeseen reason, the more intelligent and educated we become, the more this basic component of human nature seems to be working its way to the back burner.

The "special sauce" ingredients that we look for in a business are inherently character-based:

- **What is the nature of the company's culture?** How well respected are the organization's employees? Is failure and experimentation seen as a learning experience and opportunity for future success? How are employees encouraged to think (strategically/differently) and act (with honesty and integrity)? How well does the organization work together to execute its plans?
- **How is leadership viewed in the company?** Would employees describe their leaders as integrated (working on behalf of them), or segregated (working for their own self-interest)?
- **Is the company a "learning organization" or complacent and set in its ways?** How curious and passionate are employees? Do managers and employees seek questions or answers when faced with challenges? Is there an emphasis on training and developing people?
- **Where is the customer in the organization's mind—at the center or at the periphery?** How well does the organization listen to the customer? Does the organization display empathy and act to please customers? How well does the company recognize and adapt to changing customer needs?

- **Does the company view itself as interdependent (developing partnerships) or independent from those with which it interacts—suppliers, community, etc.?** Do employees care deeply for suppliers and the community that interface with the organization? How respectful is the organization to cultural differences? How sensitive are employees and management to changing societal values and needs?

These issues regarding the "artistic" side of business are relatively simple and, in most cases, taken for granted. Moreover, simplicity does not automatically translate into results, as very few organizations can boast of possessing the above intrinsic qualities. Although instilling intrinsic qualities is ordinary in concept, it is difficult to teach as well as implement. Why? Because it is actually a behavioral choice—one that managers and employees individually and collectively make each and every day. A series of "right choices" has to be ingrained or inherent in the corporate culture to create long-term intrinsic value within a business. If a company is able to etch these character traits into its DNA, it becomes a responsible citizen and creates ongoing value for all constituents—employees, suppliers, communities, and shareholders. If not, society eventually casts it out, and the company goes the way of the dinosaur. Building great character is the essential ingredient for businesses to create long-term partnerships, become flexible, and adapt to an ever-changing competitive landscape. ***This is the true disruptor that provides the business a long runway with tremendous alpha!***

Founders Position

At Founders, we care deeply about the money that individuals have entrusted to our stewardship. We view our clients as partners and our investment activity is interdependent—in other words, we eat our own cooking. We hold on tightly to our value investing philosophy, and we seek to invest where intrinsic value strengthens over time. And we always act with honesty and integrity—there is no other way.

Although we are unable to provide an exact answer to questions regarding any market's near-term direction, the mixed emotional display surrounding the equity and fixed-income markets continues to compel us to remain agnostic to any market's short-term movements, and instead keep our eyes open for opportunities that emerge in a volatile environment—and thus, we will remain patient. Given the more speculative behavior taking place in markets, however, we are adhering to one of our favorite Warren Buffett quotes: ***"The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs."***

We are also mindful of future tax implications on our portfolio (the haircut), and investing with our eyes wide open. We place continued emphasis on our confidence that we have acquired securities at prices that will provide a fair return over time (despite gyrating markets and higher-than-normal speculation). This includes our investments in *selected* fixed-income instruments that offer a commensurate risk/reward relationship, as well as acquiring interests in strong individual companies through the equity market that are very profitable and possess a wide competitive moat. Our investment activity in all market conditions reminds us of another Warren Buffett quote: **"*We will continue to price, rather than time, our purchases. In our view, it is folly to forego buying shares in an outstanding business whose long-term future is predictable, because of short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?***

MANAGEMENT'S DISCUSSION & BUSINESS UNIT REVIEW

Equity Holdings: 2013 Highlights

We start this year's equity holdings review by emphasizing that we remain sanguine with our allocations in this area, including the expected returns over the next 10 years. Why can we say this? A few points:

- We are confident in the high character displayed by the companies in our portfolio and think they are managed in a flexible manner that allows these businesses to adapt in changing times.
- We feel we are treated as partners in various business enterprises that are focused on increasing long-term profitability, as opposed to being viewed as part of a group of shareholders that are interested only in a rising stock price that is divorced from a commensurate movement in value.

As long-term investors, we wake up each morning knowing that the terrific businesses we own—Coca-Cola, PepsiCo, Procter & Gamble, United Technologies, Lockheed Martin, CSX, Johnson & Johnson, Medtronic, Microsoft, Intel, IBM, Berkshire Hathaway, Home Depot, Disney, Chevron, and our other holdings—continue to strengthen their enterprises independent of any short-term gyrations in stock prices.

The following is a summary of business highlights from our portfolio companies during 2013, along with our expectations for 2014.

CONSUMER GROUP

Our primary consumer holdings—Coca-Cola, PepsiCo, and Procter & Gamble—once again grew their global franchises during the past 12 months despite continued challenges in several large economies throughout the globe. We expect our consumer group to produce positive results again in 2014 and for many years to come. We place these companies in the "highest character" category as we watch each strive to balance consumer and social development as they increase in size.

In past letters, we have pointed to the superior business model that characterizes our consumer companies. Coca-Cola, PepsiCo, and Procter & Gamble all market products that demonstrate a consistent purchase pattern that provides an efficient revenue and profit stream. The daily worldwide consumption of Coca-Cola, PepsiCo, and Procter & Gamble products enables these entities to perform better than average in both good and bad economic times. These businesses create marvelous economic value—compared to the average business, they are not as capital-intensive, and they all sell products that cater to consumer preferences that are difficult for competitors to duplicate. Each of these companies' brands—for example, Coke, Frito-Lay, Tide, and Gillette—carries a special attribute that attracts large consumer mindshare, along with the security of knowing that the product will be consistent and of a certain quality. The emotional comfort that consumers *worldwide* associate with these brands is generated through a repetitive process of advertising, promotion, and purchases over many decades.

Each of these companies promotes a culture that encourages the individual employee to think differently and to act with honesty and integrity. The corporate leaders are integrated with the organization and think of themselves as cultural stewards of these great franchises. These companies are constantly learning as well as cultivating individuals to meet the future challenges their businesses will confront as they grow in a global marketplace. And finally, these companies take a "worldwide view" and understand that they deal in an interconnected global community in which business and social development go hand-in-hand.

Given the global strength and cultural depth of these business franchises, we can forecast with a high degree of probability that Coke, PepsiCo, and Procter & Gamble will continue to demonstrate the same characteristics in the future as they do today. It is highly likely that each business will substantially penetrate developing markets over the next 10 to 20 years, and the accumulated potential growth of these businesses cannot be fully identified using traditional financial models—in other words, each of these businesses possesses unquantifiable intrinsic value that underscores their hidden value-creation potential. Global franchise businesses with these high character qualities fall into the "disruptive, with a long runway" category because they possess inherent values that are difficult to calculate.

Coca-Cola

During 2013, The Coca-Cola Company grew its overall volume approximately 2%, slower than the annual 4%-5% annual volume growth achieved the previous two years. This year's sluggish advance was impacted by several factors, including slower case volume growth in Eurasia and Africa (+9% in 2013 vs. +11% in 2012), Latin America (+2% in 2013 vs. +5% in 2012) and the Pacific region (+3% in 2013 vs. +5% in 2012). In addition to slower international growth, a negative currency exchange impacted sales, leading to a slight increase in year-over-year reported revenue (excluding a structural change in bottling investments). The bottom line: Coke's volume slowdown combined with an unfavorable currency exchange interfered with the company's 2013 earnings growth. The company will likely report $2.00 per share in earnings in 2013, equal to 2012.

What is our opinion on this short-term blip? Just that: It is a short-term blip. When we evaluate Coca-Cola's long-term prospects, we take into consideration a few themes:

1) As we have previously stated, Coke is more than a "carbonated soft-drink company." The core Coca-Cola soft drink is just the tip of the iceberg for this beverage juggernaut, and comprehending the scope and breadth of this company's stable of brands is very important for long-term investors. The Coca-Cola Company is represented by 500 broad-based brands that are sold in more than 200 countries worldwide, accounting for 1.8 billion servings each and every day. The Coke organization is laser-focused on introducing and adapting new products and brands that meet local customer tastes all over the globe. Despite the company's temporary slowdown, Coca-Cola actually increased its global share of beverage consumption this past year—and we expect this positive momentum to continue.

2) Coca-Cola's "mindshare" is so entrenched among global consumers that is difficult for a new beverage business to build scale to compete with Coke. If a new beverage company is able to grow, Coke is likely to purchase this company and place its product offering through its vast distribution system to gain incremental sales—Glaceau Vitamin Water is a case in point.

3) Coca-Cola has one of the most intricate distribution systems in the world—encompassing 275 bottlers that manufacture and distribute products to within an arm's reach of every global consumer. This unmatched business system is very difficult—if not nearly impossible—to duplicate and allows Coca-Cola to maintain a sustainable competitive advantage. This wide network also positions the company to extend its tentacles into markets that have not yet been fully penetrated.

4) Coke has "strong character" traits as well as resources to further develop our interdependent society. Coke recognizes that the health and well-being of its company is directly tied to the health and well-being of consumers. As concerns about obesity and diabetes mount, the company now offers more than 800 low- and no-calorie brands. Coke also has a robust water resources stewardship and management program and is constantly striving to improve water efficiency, working with communities around the world to address local water treatment and sanitation needs.

It is still estimated that by 2020, more than two billion people around the world will join the "middle class," and this represents a large market opportunity. Coca-Cola is preparing to take advantage of this opening with a continued $30 billion investment in markets around the globe during the next five years—including $2 billion in India and more than $4 billion in China. The Coca-Cola Company has not altered its goal to reach $200 billion in annual revenue by 2020—a growth rate of approximately 7% per year.

Coca-Cola represents a tremendous global growth story for both customers and shareholders. The company will produce approximately $8.5 billion of cash for shareholders in 2013, and approximately $9.0 billion in 2014. Coke currently pays an annual dividend of $1.12 per share, which represents an approximately 2.7% yield, and we think the company will increase its dividend again in 2014—to around $1.20 per share. Coca-Cola will also repurchase $5 billion of stock during the next 12 months. The combined dividend and stock repurchases provides shareholders a 5.5% "look-through" yield at Coke's year-end price, as compared to a 3% yield on a 10-year U.S. Treasury bond. Given the higher yield offered by Coca-Cola, as well as future growth projections, this company will remain a long-term holding in our portfolio.

PepsiCo

As one might expect, PepsiCo's beverage business has many similar elements to Coke's. These two companies are each vying for a greater share of the global beverage business, and rather than take share from each other, they are taking share from competitors. The global beverage business is essentially a two-horse race between Coke and Pepsi. As Coca-Cola's largest competitor, PepsiCo is also making a commitment to invest in key emerging markets such as India, China, etc. On the other hand, PepsiCo is much more than a beverage company—in fact, it is more of a snack food company.

Although PepsiCo commands a large "number two" share of the global beverage market, its mainstay is its global snack business, which represents more than 60% of the company's operating profits. PepsiCo's dominance in the snack food segment is unprecedented—we can say with confidence that PepsiCo has achieved global supremacy in the snack food business. (PepsiCo's snack business has obtained an 80%+ market share in Argentina, 70%+ in Mexico and Turkey, 65% in the U.S. and Canada, and 50%+ in emerging markets such as Brazil. PepsiCo's snack business has a *tenfold* relative global market share advantage compared to its closest competitor.)

A story of value recognition vs. value creation: Given the diversity of PepsiCo's portfolio, some investors believe that the beverage and snack food businesses would be better off on their own—that the company should create two separate entities from PepsiCo. In fact, Trian Partners, an "alternative investment management firm," has presented the following strategic recommendations to the PepsiCo board:

1) Merge with Mondelez, a leading snack-food company spun off from Kraft, and
2) Split the company into two parts: The faster-growing snack-foods business, and the slower-growth beverage business

The rationale is that there is a dichotomy in managing the two different entities and that an exclusive focus on each will create economies of scale as well as greater shareholder value.

The specifics of this proposal would be for PepsiCo to pay $35 per share for Mondelez, or $61 billion (at year-end Mondelez is trading at $35.30, so this initial offer will not be enough). The proposed currency to pay for this acquisition would be PepsiCo stock—which, according to Trian, is undervalued.

So, first-off, PepsiCo shareholders would be expected to "overpay" for Mondelez with "undervalued currency." We believe most intelligent individuals would think it is foolish to pay $1.25 for something that is worth $1.00, and use a currency that is trading for 85% of its value to complete the transaction. This "double-whammy" makes little economic sense. Nevertheless, this is the basic proposal.

You can guess that Trian is one of the top 10 shareholders of Mondelez, with 2.3% ($1.45 billion) of the outstanding stock, while owning .8% ($1 billion) of PepsiCo. Net-net, "overpayment" for Mondelez benefits Trian's wallet.

So where do we stand on this proposal to split PepsiCo in two? The answer lies in an assessment of why PepsiCo is currently undervalued. According to the white paper Trian produced to obtain support for dividing the company into two entities, PepsiCo has recently lagged the market due to three main issues:

1. An underinvestment in the growing snack division to support the slow-growth beverage business
2. Difficulty in retaining management talent, especially in the beverage division
3. Poor allocation of some $24 billion of capital over the past five years to acquire low-return businesses that are more capital-intensive than PepsiCo's core snack and beverage businesses.

As a result of the above actions and inactions, PepsiCo's margins and profitability have suffered. We agree with this analysis, but we do not agree with the proposed King Solomon solution of splitting the baby in two. PepsiCo has been a combined beverage and snack-food company since its acquisition of Frito-Lay in the mid 1960s. Over the past five decades, the company has done a fine job managing and growing these two franchises. In the past five years, PepsiCo has faced challenges, and ultimately we believe this is due to a temporary leadership setback and not an inherent challenge to managing PepsiCo's two main businesses.

The sole job of a CEO is to allocate capital (both monetary and human) effectively. This is a difficult task, especially when the businesses one oversees have enjoyed success and produce 25%+ returns on employed equity capital. The challenge that a CEO encounters in this scenario is an expansion of a company's business

domain while maintaining high returns on capital. To appreciate the magnitude of this task, consider that a CEO who manages a company with a 25% return on shareholder equity and decides to retain all earnings would essentially oversee the reallocation of 100% of the company's original equity in approximately three years.

When a core business produces juicy returns of 25%+, managers of these companies often instinctively pursue growth, and many find a way to allocate unrestricted earnings to projects and ventures with inferior returns (less than 25%). When excess capital builds on a company's balance sheet, many managers just can't seem to help themselves. They eventually spend money on business opportunities that lie outside of their core competencies or—worse yet—overpay for acquisitions, convincing shareholders that diversifying capital among various enterprises will reduce reliance on a few businesses and concurrently lead to increased earnings. For example, PepsiCo's $5+ billion (over)payment to purchase a Russian dairy operation (Wimm-Bill-Dann) falls into the category of taking good return money and throwing it at a business that possesses not-so-good results. The rationale always sounds great—i.e., we have taken advantage of an opportunity to expand international beverage distribution and, in the process, we have added to our good-for-you product line: Drinkable yogurt. These acquisitions most times do not turn out as expected, and ultimately the return on the low-margin, capital-intensive business becomes a costly distraction, consuming too much management attention at the expense of the higher-return businesses.

The CEOs of these companies respond with frustration to business analysts and shareholders who question their strategies and slow-rising stock prices, countering that their moves are necessary to meet growth targets, along with increased earnings projections. These CEOs also point to the sustained high returns on employed equity capital produced by their "conglomerate." The sustained high return comeback may be valid, but savvy investors recognize how the higher returns generated from wonderful businesses temporarily mask the poor capital allocation decision to low-return businesses. These alert investors understand that continuous poor capital allocation decisions will lead to a loss of economic value for the conglomerate, and the high return on overall invested equity capital may not be sustainable. Regrettably, these CEOs fail to comprehend that they are consistently taking profits produced from spectacular businesses and reallocating this capital to low-return, commodity-type businesses, with potentially devastating results.

Our questions about PepsiCo's future performance in creating value fall into two categories:

1) What is the company doing to expand product demand and adapt to local markets, either by continuing to introduce new snack and beverage brands or by tailoring the core PepsiCo brands to local tastes?
2) What is PepsiCo doing to further develop its strong distribution and plant network, especially in developing markets?

The answers to these two questions are found in the company's recent actions. PepsiCo's leadership this past year has "found religion" and reversed the poor capital allocation decisions of the past by increasing the company's investment in its core snack and beverage businesses, and by eliminating questionable acquisitions that do not meet a higher return-on-capital hurdle that contributes to increasing shareholder wealth. This was likely due to investor dissatisfaction displayed by activists such as Trian. We believe the company is back on track and support the current structure as long as capital is allocated effectively within the core businesses and for shareholders. In our opinion, Trian's proposal seems all too familiar—exacerbating PepsiCo's challenges by overpaying for Mondelez and attempting to turn this lower-than-average-margin snack business into higher Frito-Lay returns. We think PepsiCo's value will be recognized as the company "sticks to its knitting" and builds its core (wonderful) snack-food and beverage businesses.

In 2013, PepsiCo continued to increase its return to shareholders, raising the annual dividend by more than 5.6%, from $2.15 per share to $2.27 per share. We expect PepsiCo to raise its dividend to approximately $2.38 per share in 2014, which implies a yield of about 3% at the year-end stock price. In addition, we anticipate the company will repurchase an additional $3.5 billion of stock in 2014. This action adds another 2.75% return to shareholders, reflecting a 5.75% "look-through" yield. In 2014, we expect PepsiCo to grow its core per-share earnings at 8%, producing around $4.70 per share.

In summary, we like the long-term potential and economics of the beverage and snacks businesses and think there is a multi-decade growth opportunity for the dominant companies in these segments. PepsiCo has a large position in these growing areas and will remain a long-term holding in our portfolio.

Procter & Gamble

We maintain a long-term investment in one of the largest consumer companies in the world—Procter & Gamble (P&G). P&G sells leading brands that we are all familiar with—Pampers, Tide, Ariel, Always, Pantene, Gillette, Bounty, Dawn, Gain, Charmin, Downy, Iams, Crest, Oral-B, Duracell, Olay, Head & Shoulders, Wella, Vicks, and Braun.

Over the past two years, P&G's worldwide net sales volume has remained relatively flat at approximately $84 billion, with earnings per share rising 5% over this same period—to $4.04 per share in fiscal 2013 (excluding impairment charges). P&G's slowing performance has been due to rising commodity and energy costs that impact P&G more than most consumer companies, as well as customers trading down to lower-priced product alternatives as the company selectively increased prices to offset its higher input costs. This combination has negatively impacted sales growth as well as profits.

In response to the business challenges it is facing, P&G announced a plan to strengthen its core business and aggressively reduce costs within the company. P&G also changed leadership in 2013, bringing back its famous CEO, A.G. Laffley.

Mr. Laffley has quickly focused P&G on top brands to reignite growth, and the company is gaining traction—P&G doubled its organic sales growth to 4% in their last two quarters. In addition, the company continues to concentrate on developing markets, since accelerating growth in these areas is critical to creating long-term value for shareholders. By 2020, the world's population will grow by 500 million people, and 95% of this population growth will be in developing markets. As we stated earlier, the world's middle class will increase by up to two billion people in this same time frame. Population and household income growth are primary drivers of any multinational company's business growth, and these factors will provide P&G fuel for increasing its business over time.

Mr. Laffley has also placed an increased focus on lowering P&G's cost structure and remains committed to the organization's five-year, $10 billion cost-savings initiative announced in 2012. The cost-savings program pivots on:

- A reduction of approximately 5,700 non-manufacturing overhead positions that was completed by the end of fiscal year 2013
- Achieving $1.2+ billion in annual cost-of-goods savings across raw materials, manufacturing, and transportation and warehousing expenses
- Generating efficiencies in marketing costs, saving approximately $1 billion over a five-year period

Under the renewed leadership of A.G. Laffley, P&G is attacking the difficult challenges the company has been facing in a stressful economic environment. Our belief is that P&G will remain highly profitable and will renew its growth as the middle class market continues to develop across the globe. We expect the company's core earnings to be approximately $4.35 per share during calendar 2014, with all of its $11.8 billion in profits to be returned to shareholders in the form of dividends (approximately $6.5 billion, or $2.41 per share) and share repurchases (approximately $5.5 billion). The combined dividend and stock repurchases provides shareholders a 5.4% "look-through" yield at P&G's year-end price. We remain excited about P&G's global opportunities and will continue to commit capital to this great company.

INDUSTRIAL GROUP

Our primary industrial and transportation holdings—CSX, United Technologies Corporation (UTC), and Lockheed Martin—were profitable in 2013, and we expect these businesses to produce favorable results in 2014.

We have stated previously that our industrial group presents us with a long-term investment opportunity due to a unique business model that provides each company a substantial competitive advantage. These infrastructure businesses are focused on product innovation and offer high-end products and services that are extremely expensive to produce and have a slow replacement rate—attributes that normally would be detrimental to a business's profitability. UTC and Lockheed are exceptional in that they initially contract to sell their products at a low profit margin and then strike high profit-margin contracts to service these products over their lifespan.

For example, when UTC installs the building automation system that controls and monitors heating, cooling, and fire protection equipment for skyscrapers around the world, a long-term contract to service the equipment post-installation is also executed. Similarly, as Lockheed Martin constructs and delivers the F-35 fighter jet to militaries around the globe, the sale of spare parts as well as high profit-margin servicing contracts associated with this delivery can continue for years. In both cases, it is highly unlikely that these costly items will be replaced any time soon, providing a predictable, long-term revenue annuity.

Our railroad investments have comparable advantages. It has taken more than a century to build the U.S. railroad infrastructure, and it would take an extraordinary amount of time and capital to create a business transportation system that competes with railroads such as CSX or Burlington Northern (owned by Berkshire Hathaway). Although the railroad business is capital-intensive, certain attributes make this type of investment attractive in either an inflationary or deflationary environment. In challenging economic conditions—due to either lower sales and decreasing prices in deflationary circumstances, or to exponentially increasing costs in an inflationary environment—companies seek to run more efficiently. Moving greater amounts of goods over a fixed-rail infrastructure instead of via higher-cost trucking enables companies to lower costs and achieve large gains in productivity. Since rail transportation is approximately three to five times more fuel-efficient than truck transportation, we believe railroads will play an increasingly larger role in the transportation of goods throughout the U.S. The growing use of rail, along with the expansion of railroad services via "double track" (vs. single track) and "double stacking" of containers, will continue to drive a large increase in railroad use, revenues, and profits.

CSX Railroad

Our interest in railroads has been in place since 2007, when we began purchasing Burlington Northern Santa Fe, and our newest investment in this sector in 2013 is in CSX. As you may recall, Burlington Northern Santa Fe railroad was purchased by Berkshire Hathaway in February 2010. (We cried a bit when it was sold, but we took some solace in the fact that it was being purchased by Berkshire—our largest holding). Since that time, we have not been able to allocate money to a railroad, as the relationship between price and value did not meet our test. (Basically: We wanted a better bargain.) Finally, CSX hit our "strike zone," so we backed up the train and purchased a lot very early in 2013.

CSX is one of the nation's oldest railroads and traces its roots back to the Baltimore & Ohio Railroad, which—when chartered in 1827—was the nation's first common carrier. Consolidation has taken place in the rail industry over the past 185 years, resulting in the eventual merger of the Chessie System and Seaboard Coast Line Industries in 1980, forming what we know today as CSX.

CSX provides an important link to the transportation supply chain through its approximately 21,000 route miles of track that serves major population centers in 23 states east of the Mississippi River, the District of Columbia, and the Canadian provinces of Ontario and Quebec. The company is large, with more than 4,000 locomotives and 87,000 freight and container cars providing access to more than 70 ocean, river, and lake port terminals along the Atlantic and Gulf coasts, the Mississippi River, the Great Lakes, and the St. Lawrence Seaway. CSX also has an intermodal business that links customers to railroads via trucks and terminals.

During 2013, CSX generated almost $12 billion of revenue and served three primary lines of business:

1) The **merchandise business** ships approximately 2.7 million carloads and generates 58% of revenue and 42% of volume. The company's merchandise business is the most diverse and transports aggregates (which includes crushed stone, sand, and gravel), metal, phosphate, fertilizer, food, consumer (manufactured goods and appliances), agricultural, automotive, paper, and chemical products.
2) The **coal business** ships approximately 1.2 million carloads and accounts for nearly 25% of revenue and 20% of volume. The company transports domestic coal to electricity-generating power plants, steel manufacturers, and industrial plants and also exports coal to deep-water port facilities. Half of export coal and nearly all of the domestic coal that the company transports is used for generating electricity.
3) The **intermodal business** accounts for approximately 14% of revenue and 39% of volume. The intermodal line of business combines the superior economics of rail transportation with the short-haul flexibility of trucks and offers a competitive cost advantage over long-haul trucking. Through a

network of more than 50 terminals, the intermodal business serves all major markets east of the Mississippi and transports mainly manufactured consumer goods in containers, providing customers with truck-like service for longer shipments.

Clearly, CSX is heavily leveraged to the price of coal, other commodities, and international freight (both import and export). Coal transportation is a large source of the company's revenue and, due to the recent surge in oil and gas production within the U.S., the railroads' coal volume and revenue have experienced declines of approximately 9% this past year. The weakened demand for coal is the primary reason CSX's stock price was down in 2012. Growth in other areas such as construction and industrial goods, however, has offset the deterioration in coal freight.

The big question: Will this growth in other areas continue? We believe the answer is yes. The company's rail network extends into key shale oil areas, where thousands of wells are being drilled in places ranging from Pennsylvania and Ohio in the northeast to Mississippi and Louisiana in the south—all "CSX country." Oil is not the only thing that is transported from these shale oil wells—for example, each of the hundreds of wells to be drilled in the Bakken Shale (located in the western U.S.) requires approximately 23 inbound carloads of supplies and materials. Sand, in particular, is a transportation growth driver because of the tremendous volumes needed and the weight of the commodity involved. The average "frac project" (to drill for shale oil) requires one million pounds of sand or other chemicals/commodities. The frac sand market increased around 30% in 2012, and CSX's frac sand business has more than doubled in the last three years. The company is also well positioned to compete for opportunities presented by eastern refineries interested in receiving crude oil from the Bakken Shale region. Historically, crude oil en route to eastern refineries has moved through pipelines or been imported by vessel. With the abundance of low-cost oil in the Bakken region, that supply model is changing.

CSX also has a tremendous growth opportunity in the intermodal business, especially considering that its southern and southwest rail network is perfectly aligned with the Panama Canal expansion. The Panama Canal is due to inaugurate a third set of locks in 2015. This added capacity will not only increase the throughput of the canal but will also accommodate significantly larger vessels. Today, the Panama Canal is one of the most notorious bottlenecks in global trade, with a particular class of ship—the Panamax—designed specifically to be the largest vessel that can fit through the canal's narrow locks. The elimination of these constraints will change the global freight movement.

While Panamax ships have an advantage in accessing more ports, they're not as cost-effective as larger vessels. The biggest container ships can move freight for as much as 50% less per container than Panamax ships. Because the largest ships can't reach the U.S. East Coast from Asia without a lengthy diversion around the tip of South America or through the Suez Canal, West Coast ports accept some 75% of Asian traffic, and freight is sent on Class I railroads such as Union Pacific and Burlington Northern to reach the U.S. Midwest. The Panama expansion will nearly triple the Panama Canal's capacity, increasing the maximum vessel size from 4,400 TEUs to 12,600 TEUs (a TEU, or twenty-foot equivalent unit, is about the size of one intermodal container). This means that larger, more cost-effective vessels will be able to call on East Coast ports, allowing freight to bypass the transcontinental trip on western railroads. Most ports on the U.S. East Coast are building out new capacity in anticipation of larger ships, and ports such as Houston, Charleston, Hampton Roads, and New York expect dramatically greater volumes after the canal expansion. A report from MIT academics estimates that East Coast ports will capture 20%–35% of current West Coast volumes after the expansion. All of this bodes well for CSX, as its rail network is directly connected to these East Coast ports.

What is most important for shareholders is that during 2014, CSX will pass $1.2 billion of cash to shareholders in the form of dividends (around $600 million) and share repurchases (another $600 million). The combined dividend and stock repurchases provides shareholders a 4.1% "look-through" yield at CXS's year-end price, and we anticipate that this yield can potentially grow at 12% per year as freight traffic increases over CSX's fixed-rail network.

In summary, we think our investment in CSX represents an opportunity to participate in the continued growth of the United States. The growth in CSX's freight volume will endure over the next decade and may increase a lot more than analysts expect. Furthermore, CSX has a goal to increase its operating efficiency (through lower expenses) an additional 5 percentage points within the next five years. This is on top of the approximate 5.5 percentage point increase in efficiency gained in the past five years. The projected increase in volume, coupled

with lower expenses, will more than offset any short-term decline in coal shipments. And if coal shipments come back to previous levels, CSX will just make that much more money. We are happy to be owners of CSX.

United Technologies

United Technologies Corporation (UTC) owns firms such as Otis elevators, Carrier air conditioners, Pratt & Whitney jet engines, Hamilton Sundstrand aerospace systems, and Sikorsky helicopters. UTC continues to build on its extensive product portfolio in the commercial and defense market segments. Each of the UTC subsidiary companies has achieved leadership and powerful market entrenchment in its respective area of expertise. UTC's balanced exposure in aerospace and defense reduces revenue uncertainty and helps the firm ride out the challenges of difficult economic times.

To provide a sense of the scope of UTC's global reach, we can highlight UTC's Otis elevator company. During 2013, Otis elevators began a 30-year contract to install, maintain, and modernize 107 elevator units for the London Crossrail, a new high-frequency rail system and Europe's largest construction project. Under a similar agreement, Otis will also supply 299 escalators and 50 elevators to the Hangzhou Metro Line, one of China's newest high-speed rail systems. These examples demonstrate UTC's business model: Install large infrastructure products, and then derive much of the company's future revenue from servicing agreements—aftermarket services generate more than 40% of the company's $63 billion in revenues. In addition, these services are always in high demand because UTC's products are extremely expensive and are used in critical, heavy-wear applications (one cannot have elevators, security systems, building air conditioning units, or jet engines failing).

Given the cash annuity stream associated with the long-term servicing agreements, in many ways UTC can also be viewed as a long-term fixed-income investment. The company is expected to produce approximately $6.85 per share in cash in 2014, an increase of 9% over 2013. When comparing the forward cash stream of $6.85 per share to the company's year-end stock price of $113.80 per share, investors are receiving an initial 6% yield on their UTC investment—and this cash yield is expected to continue growing at approximately 10% each year over the next decade. We are enthusiastic owners of United Technologies and believe we are receiving a very good return on our ongoing investment in this company.

Lockheed Martin

Lockheed Martin is a 100-year-old, $46 billion global security and information technology (IT) company. The majority of Lockheed Martin's business is with the U.S. Department of Defense as well as U.S. federal government agencies. The company is the largest provider of IT services, systems integration, and training to the U.S. government and sells products and services to the governments of other countries as well.

Investments in the defense sector have in recent years been out of favor due to ongoing uncertainty about the defense budget. We believe the defense industry is likely to face reductions in the U.S. defense budget over the next 10 years. Despite the automatic U.S. government spending cuts imposed by the 2013 budget sequestration measures that will impact the defense industry, the companies we hold nevertheless have significant projects that we believe will be delivered in the upcoming years. In Lockheed's case, the company remains on schedule to supply the F-35 fighter jet to the U.S. military. The F-35 program is the largest defense project, aimed at replacing the aging fleet of Air Force F-16, Navy F/A-18, and Marines AV-8B aircraft. This project is expected to deliver more than 3,000 aircraft to eight countries around the world over the coming decades and is worth up to $1 trillion—encompassing $300 billion in new equipment and $700 billion in maintenance contracts. Large aftermarket sales should provide predictable ongoing earnings for Lockheed Martin, despite pressure on the U.S. defense budget.

Lockheed Martin produced approximately $9.70 per share in earnings during 2013 and distributed approximately $3.3 billion to shareholders through dividends and share buybacks. Lockheed Martin currently pays an annual dividend of $5.32 per share, which represents an approximately 3.6% yield at the company's year-end stock price. Lockheed's high dividend coupled with its ongoing share repurchases provides shareholders a 7.1% look-through yield at the company's year-end stock price. Despite a healthy increase in stock price this past year, the company's high yield still represents a better-than-fair return in today's low interest-rate environment. Until this equation changes, our plan is to remain invested in Lockheed Martin.

HEALTHCARE GROUP

Our primary healthcare holdings—Johnson & Johnson and Medtronic—achieved profitable growth during 2013, and we expect these medical businesses to continue growing in 2014.

The healthcare industry remains another area of uncertainty for investors due to the recent healthcare reform legislation (the Affordable Care Act) and wrangling over the management of increasing long-term healthcare costs. One of the fundamental causes of the U.S.'s large fiscal imbalance is the significant growth in healthcare spending, which has been growing at a faster rate than the U.S. Gross Domestic Product (GDP). According to a 2013 report from The Commonwealth Fund, health spending as a share of U.S. GDP has climbed steadily over the past half-century. It now constitutes 18% of GDP, up from 14% in 2000 and 5% in 1960. Based on current projections, we are well on our way to 21% by 2023. This situation is unsustainable and requires, among other measures, the long-term control of Medicare and Medicaid expenditures. One solution to reign in Medicare and Medicaid's cost growth is government-controlled pricing, which means lower profitability for healthcare industry participants. With all the slated changes in the law, and possible future alterations to healthcare, it has become increasingly difficult to predict the future of drug development, medical device, and other healthcare-related companies, and investors should remain leery of this sector until a clearer picture emerges.

We believe that the uncertainty surrounding the healthcare sector provides us an opportunity to own the "right" healthcare companies that do not carry many of the typical risks associated with this group. Johnson & Johnson and Medtronic are two companies that continue to fit our long-term investment criteria: Each company occupies market niches that are resilient under any economic condition or social reform, and each displays consistent purchasing patterns and strong loyalty from a growing customer base. It is our opinion that both companies are positioned to do well as the global population increases and ages in the coming decades.

Johnson & Johnson

Johnson & Johnson (J&J) is a large healthcare organization with 275 operating companies, 450 distribution centers, more than 120 manufacturing sites, 500 outside manufacturers, and 60 enterprise resource-planning systems. It is also diverse, with sales generated by various healthcare segments—40% of sales comes from drugs, 40% from medical devices, and the remainder from consumer brands that we are all familiar with: BAND-AID, Tylenol, Neutrogena, Listerine, and Johnson's Baby Shampoo, to name a few. Despite its large size, J&J maintains a decentralized organization structure that allows each business to operate as an entrepreneurial company. The strength of a diverse organization can sometimes lead to complex management challenges, however, as each entrepreneurial business puts a heavy emphasis on growth.

Over the past few years, J&J has faced several challenges: Its McNeil Consumer Healthcare unit, which produces Tylenol and Johnson's baby products, had 25 product recalls that resulted in a complete shutdown of one of its three North American plants. In addition, J&J's medical devices and diagnostics division, which manufactures products such as artificial hips and knees as well as surgical supplies, announced an approximately $3 billion charge to put money aside for lawsuits resulting from artificial hip product recalls from J&J's DePuy Orthopaedics subsidiary. The bottom line: J&J's decentralized organization had become too loose, and attention to quality suffered.

A true story of leadership and intrinsic value: In 2012, J&J hired a new CEO, Alex Gorsky, to tackle the company's challenges and carry out its plan for continued global growth. Mr. Gorsky has been successful—and the way he turned this large ship around in a short time frame is instructive. He did something simple that permeated every J&J business—he re-emphasized and prioritized J&J's 300-word credo established 70 years ago by one of the company's founders, General Robert Wood Johnson: "We believe our first responsibility is to the doctors, nurses, and patients, to mothers and fathers and all others who use our products and services." The document goes on to describe the importance of maintaining reasonable prices, supplying prompt service, allowing distributors and suppliers to make a fair profit, respecting the dignity of employees, and managing ethically: "When we operate according to these principles, the stockholders should realize a fair return." Enough said—J&J possesses deep intrinsic value that is difficult for anyone to match.

J&J will earn approximately $5.50 per share of adjusted earnings during 2013 and should grow core earnings at 7% in 2014, to $5.87 per share. The company is expected to generate $14 billion of owner earnings in 2014 and will return cash to stockholders through continual share repurchases and $7.4 billion of dividends (a 2.9%

dividend yield at the year-end stock price). We think J&J has a tremendous long-term future as the aging population in the developed world will require new cures, and an expanding middle class in developing areas of the world will need additional healthcare products and services. J&J remains a very attractive position in our portfolio.

Medtronic

We also have a position in Medtronic, the world's largest medical technology company with a global reach that extends to 120 countries. Medtronic produces implantable cardioverter defibrillators (ICDs) and other devices for managing out-of-step hearts. In addition, the company is a leader in devices that manage chronic diseases of the spine, pancreas, and brain. Medtronic continues to develop its patient management business model and expand its position in devices that manage chronic diseases. The company's emphasis on disease prevention and management lowers healthcare costs by minimizing hospitalization, which is one of the largest contributors to rising healthcare costs.

To support its "patient centric" business model, in 2013 Medtronic committed $200 million to acquire Cardiocom, a firm that provides monitoring services to patients with chronic diseases. Cardiocom's products include home glucose monitors for diabetics and weight scales that help doctors detect early signs of worsening heart-health condition. This acquisition puts Medtronic in the business of working with hospitals and insurers to limit the costs of treating patients with chronic diseases such as heart failure and diabetes. It also gives the company an opportunity to provide initial care to patients who are not ready for the company's more costly, high-tech implantable devices. Eventually, when these patients need implantable devices, they will likely be Medtronic products based on the patient's preexisting relationship with the company.

As the evolution of Medtronic's business continues, sales rose an additional 2.5% and earnings increased 10% in 2013—to $3.75 per share. We expect the company to grow sales and earnings at 3% and 8%, respectively in 2014. The company's approximate $4 billion of earnings are largely available for distribution to shareholders, representing a 7% yield at the company's year-end price. Medtronic is returning money to shareholders via a $1.12 per share dividend ($1.1 billion) and is on track to repurchase $3 billion of stock this next year. Given Medtronic's current market strength in devices and future market opportunities in servicing patients with chronic diseases, we plan to hold this quality healthcare company in our portfolio over the long term.

TECHNOLOGY GROUP

The information technology (IT) sector—in which true business disruption occurs several times each decade—remains a tough business for both industry participants and investors. Technology is once again in a complete state of flux as device miniaturization and cloud computing proliferate. Given these circumstances, it is very difficult to determine what companies will succeed or fail in an industry that is characterized by warp-speed change. Apple has been the primary disrupter in the latest technology cycle through its iPhone and iPad products. The downsizing of computerization has provided the opportunity to fit a powerful computer device into the palm of one's hand, driving a new generation of products that empower every individual to stay connected to the world at all times. This speed of connectivity has shaken the old-fashioned computer device makers such as Dell and Hewlett-Packard. The so-called "new space" competitors are the ones that manufacture small, flexible devices and create an environment that enables individuals to stay interconnected via cloud computing. Companies such as Apple, Samsung, Facebook, Twitter, Amazon.com, Salesforce.com, IBM, Google, Cisco, Oracle and Microsoft are all competing in this area.

Who will win in the IT ecosystem is anyone's guess. But we do believe an opportunity exists as investors "throw out" the traditional/older companies in favor of the new emerging companies that are popularized by the latest social media craze. The difference in price versus value is rather wide with selective technology companies that maintain a strong competitive position in an evolving technology landscape.

Companies that provide the backbone of new technology infrastructure to support these new technologies could emerge with a competitive advantage. Players in this space may not be as "consumer oriented" but will nonetheless play an increasingly important role in this rapidly changing industry. With this in mind, we are seeking to invest in undervalued technology companies that are in the "center" of providing technology infrastructure that all participants will need. Our largest technology companies—IBM, Intel, and Microsoft—are positioned to play a major role in the new technology environment.

Microsoft

As you are aware, we reduced our ownership in Microsoft during this past year. We want to begin by stating that we have not lost confidence in Microsoft as a company to own in our portfolio. Nevertheless, several issues that we weigh heavily when investing—allocating capital to a company that is *dependable and defendable*, as well as *predictable and protected*—have become less clear with Microsoft. We mentioned these four words in previous letters and consider them to be the cornerstone to successful investing.

Over the past 10 years, Microsoft fit our criteria by displaying a dependable business model that was defended by the company in an extremely competitive industry. We believed that the company's business returns were fairly predictable and protected by its dominance in the corporate segment. Although many people believe that Microsoft's position and profitability have eroded over the past decade as entrants such as Apple and Google gained consumer support, a closer look is warranted. From 2003 to 2013, Microsoft grew its annual revenues at 9.2% per year, from $32.2 billion to $77.8 billion. Over the same time period, the company increased its adjusted earnings per share 9.7% per year, from $1.04 to $2.62. Of course, stock price and business movement do not always increase in tandem, and Microsoft's stock price increased 3.1% per year over this same time frame—revealing a large disparity between growth in business value and price. Today, we still believe Microsoft remains undervalued, and we maintain a large position. But we decided to reduce our position as we became increasingly uncomfortable with the quick movement consumers are making away from the PC market. Based on our analysis, we anticipated a merger between tablet devices and traditional PCs, but the transition has happened at a more rapid pace than we originally thought. In addition, there is increasing competition from Android, Apple, and other device companies striving for market share in the consumer space—making the industry less defendable, and Microsoft's position less protected. To better compete in this area, Microsoft is in the process of completing an acquisition of Nokia's Devices and Services business. With this transaction, Microsoft will officially become a mixed hardware & software company—which we believe is the ultra-competitive segment of the IT industry.

As a consumer revolution takes place in the technology area, a portion of Microsoft's business is now less certain, making the investment less predictable. With this said, a very large portion of Microsoft's business continues to blossom on the corporate side through its cloud services—and we believe this part of its business is more certain. On balance, Microsoft is undergoing a challenge on the consumer side that will take some time to work through. (As a side note, we believe the challenges around the consumer segment also hold true for Dell, Hewlett-Packard, Apple, and other large consumer technology suppliers—again, we can't predict a winner). Given our confidence that Microsoft's overall business has not eroded, we decided to retain a position in this company. At this point, we believe Microsoft does have a tremendous future in the business segment, but we are somewhat wary of the company's consumer segment.

In the meantime, Microsoft had very good business results in 2013, and we expect the company's success to continue in 2014. Microsoft will earn approximately $2.70 per share in its fiscal year-end (June 2014). The company will generate more than $25 billion of owner earnings and will return approximately $17 billion of cash to stockholders through net share repurchases of $8 billion and around $9 billion of dividends (an approximate 5.4% look-through yield at the year-end stock price). Given the current return to owners of this company, Microsoft will remain a technology position in our portfolio.

IBM

IBM is one of the largest—and perhaps one of the oldest—technology companies on earth. "Big Blue" has evolved through (and survived) many technology disruptions over the past century.

IBM's current business model has moved nearly 100% away from the consumer segment. The company is in the business of supplying large, complex organizations (such as corporations, governments, and cities) tailored technology solutions to meet logistical challenges. For example, IBM will assist a city in building a hardware and software solution to manage energy usage, as well as public and private transportation logistics to efficiently manage traffic (including buses, subways, traffic lights, etc.). IBM's dominance in consulting and tailored technology solutions in the business segment is unique, worldwide, and slightly different from other technology organizations that offer "mass" computer solutions to similar customers.

In the past few letters, we have discussed the emergence of cloud computing—the delivery of computing as a service instead of as a product. Using cloud computing, customers share resources, software, and information

that are provided to personal computers and other devices as a metered service over the Internet. Cloud computing is analogous to an electric utility, whereby the power station delivers power to the electrical grid, and consumers draw down on that power as they need it—and are charged based on their usage. The infrastructure that supports cloud computing comprises large data centers (server farms) that are owned and operated by companies such as Microsoft, Google, IBM, Rackspace, and Amazon.com. Obviously, cloud computing offers businesses an opportunity to reorganize their IT infrastructure and decrease their reliance on corporate servers—resulting in overall savings to their IT spending budgets.

Cloud computing is becoming a large part of the global computing infrastructure, representing a nearly $50 billion business and, according to Forrester research, a potential $240 billion business by 2020. It is our opinion that decisions by companies to "move to the cloud" will not be "all or nothing." Cloud computing is a complement to normal computing that offers increased flexibility, scalability, and affordability to companies—especially small- and medium-size businesses—that seek to improve computing efficiency and productivity.

Many think that cloud computing is a "commodity" business, with hundreds of competitors seeking to gain scale in this easy-entry business. We somewhat disagree—just look at the oil-refining business in the early part of the 20th century, or the utility business. These are industries in which scale and "control of the middle" has been important—and based on past experience with this business model, we believe IBM (and Microsoft) is positioned to emerge as a dominant player in this space. We believe the "utilitization" of computing will offer a tremendous revenue and profit annuity for companies such as IBM and Microsoft.

Why IBM? – A step beyond cloud computing

Cloud computing by itself offers an infrastructure-based company such as IBM a tremendous future, but what is more important is IBM's leadership in cognitive computing. With the advent of cloud computing, massive amounts of information will be housed on interconnected computers all over the world—serving as the backbone of the Internet. Cognitive computing, which is basically turning this massive warehouse of information into knowledge, will create an environment in which computers actually learn. Yes, we are in the early stages of artificial intelligence, and HAL—the fictional computer character in the movie, *2001: A Space Odyssey*—is virtually here. IBM is the uncontested leader in developing learning computerization that will play a major role in our very near future.

The recently published book, *Smart Machines: IBM's Watson and the Era of Cognitive Computing* by John Kelly III (Director of IBM's research) explains where this company is with cognitive computing. A few years ago, IBM's Watson computer famously beat two past grand champions on the TV game show, "Jeopardy." This was no small feat, as it took a team of about 20 IBM scientists five years of intense research to create a computer that could beat the smartest humans in a complex question-and-answer competition. IBM's Watson is going into full action today, as IBM is working with physicians at Cleveland Clinic and Memorial Sloan-Kettering Cancer Center to train Watson to "think" and help doctors diagnose diseases and assess the best treatments for individual patients. The opportunities in this field in which IBM has a leading position are boundless. Given this opening, IBM now places 60% of the company's research focus on developing business analytics tools in various areas that include energy efficiency, healthcare diagnostics, and climate forecasting. (Consider that 20 years ago, more than two-thirds of IBM's research was dedicated to areas such as hardware and materials science.) IBM currently spends more than $9 billion per year on R&D, and in 2012 earned a record 6,478 patents—the most U.S. patents for the 20th straight year.

IBM possesses business consistency and earnings predictability. As a result, IBM repurchases approximately 6% of its stock each year—in addition to providing a dividend that equals approximately 2% of the stock price, representing an 8% look-through yield at the year-end stock price. We are excited about the long-term prospects for IBM and look forward to holding this company for many years.

Intel

Intel is a large technology company that designs, manufactures, and sells computer components and related products. The company's major lines include microprocessors, chipsets, flash memory and graphics products, and network and communications products. Intel holds about 80% of market share for microprocessors that are used in desktop and laptop computers as well as computer servers.

In looking at the company's description, we can surmise that Intel has enjoyed a dominant position in the PC market over the past few decades. However, with consumers rapidly moving to smaller mobile devices, PC

sales have slowed over the past several years, and Intel has faced a challenging period. It is now necessary for Intel to adjust its business model to meet the growing demand for mobile products, an area where Intel has a minor presence compared to other companies. So, why invest in Intel?

It remains our opinion that Intel's setback in the mobile segment will be a temporary phenomenon and that the company will continue its infiltration of the overall computing market in the future based on a number of considerations:

- Intel's microprocessors form the backbone of the Internet and cloud-based computing. According to Data Center Map, approximately 3000 co-located data centers in 95 countries make up what we can call the "global computing platform." These data centers collectively contain 50+ million computer servers, most of which are running on Intel products. Although this is a large number, the amount of computer servers needed to manage the growth of global computing will likely double by 2020—and we expect Intel to be at the forefront of providing technology to help operate this network efficiently.
- Intel is transforming and broadening its scope from a primary focus on designing and manufacturing microprocessors for PCs and servers to include delivery of multiple hardware and software platform solutions. As the number and variety of devices connected to the Internet grows, and computing becomes an even more interactive experience, customers will increasingly want their devices to connect seamlessly and effortlessly to the Internet and to each other. We believe Intel will play an important role in the utilitization of computing and will obtain a terrific revenue and profit annuity in future years through its multi-product offering in high-end computerization.
- Intel has recently decided to enter the foundry business to fabricate products for mobile chip makers. This so-called backdoor entry into the mobile market will assist the company in gaining valuable knowledge in the mobile segment, while also better utilizing its vast manufacturing network.

Intel will earn approximately $1.90 per share in 2013 and 2014. We expect the company to resume earnings growth in 2015 as it gains further penetration in cloud computing and establishes a foothold in the mobile space. We are willing to be patient with Intel, as its stagnant earnings growth is reflected in the current stock price. In the meantime, the company will generate approximately $10 billion of owner earnings and will return this cash to shareholders through share repurchases of $5 billion, plus $5 billion of dividends—Intel's dividend yield is 3.5% at the year-end stock price, and the look-through yield is around 7% when including share repurchases. This is a good investment given the current return to owners of this company, along with its optimistic future. We remain pleased to have Intel as part of our technology portfolio.

FINANCIAL SERVICES GROUP

Berkshire Hathaway

Berkshire Hathaway is our largest financial services holding as well as our largest overall position. Berkshire Hathaway experienced an approximate 14% growth in book value during 2013, on top of the 14% increase in 2012. Berkshire's annual per-share book value has now grown approximately 13% since the end of 2008. This is a fantastic result, and Berkshire's stock price reflects this increase, moving in near-lockstep at approximately 13% annually during the same time frame. You may recall that in the past few years, we have mentioned that Berkshire's stock price had not kept pace with its increase in business value. This divergence has now been corrected with Berkshire's recent rise in stock price. The key "take home message" for investors is that long-term gains in a company's stock price correlate over time to an increase in business value.

Some individuals are pointing to Berkshire and stating that, once again, Mr. Buffett is falling behind the investment times, as Berkshire's 84% increase in per-share book value over the past five years has lagged the S&P 500's 105% rise (Berkshire's 13% annual return in per-share book value has trailed the S&P 500's annual total return of 17.95% over the past 60 months). Berkshire's nearly 25 percentage point lag accumulated over a five-year period does not bother us a bit, and we strongly believe that Mr. Buffett has not lost his investment prowess. We have seen similar circumstances of Mr. Buffett falling behind the market by 20+ percentage points—in 1999. We all remember what happened in 2000 after the tide rolled out on investors chasing Internet stocks—the market fell by more than 40% in the subsequent three years, and Mr. Buffett left the S&P 500 in the dust.

Where are we today with Berkshire? We don't benchmark Berkshire by evaluating Mr. Buffett's portfolio returns compared to the fickle S&P 500. We are most interested in measuring Berkshire's overall growth in intrinsic value. Using this yardstick, Berkshire, in our opinion, is knocking the cover off the ball. It is extremely difficult for any company to increase its business value at 10% to 15% per year, especially in a difficult economic environment. But, Berkshire has been doing just that. It is our opinion that Berkshire is worth slightly more than its current stock price, despite its run-up in 2013.

As such, we will continue to hold this company as long as management is focused on creating value for shareholders. Berkshire's ability to create long-term value stems from a well-established financial business that has consistently produced a low cost of borrowed customer funds over the decades (less than zero). The float produced by Berkshire's insurance subsidiaries "sticks" within the company for many years—i.e., Berkshire gets to maintain this money for a long time. Berkshire primarily generates its float by providing insurance directly to individuals (GEICO), as well as by providing other insurance companies coverage against very large catastrophic-loss events such as hurricanes and earthquakes (this is called "reinsurance").

With the long length of time Berkshire holds customer funds, the company receives the benefit of investing float with a long-term horizon—to obtain a highly probable rate of return on this money. The funds are invested in understandable assets, and in many cases in wholly owned businesses that will remain a part of Berkshire indefinitely. We do not expect this equation to change in the future.

In summary, Berkshire's business model pivots on making investments in and/or buying good companies at attractive valuations with low-cost insurance funding. Mr. Buffett has been successful at buying businesses that generate very high levels of cash flow that accumulates over time—and then effectively reallocating this cash to ever-increasing opportunities. Mr. Buffett is clearly a very good investor, picking up $1 of today's value for the price of 65¢. We remain enthusiastic owners of Berkshire, and we look forward to Mr. Buffett's decisions regarding the approximately $25+ billion of investable cash currently sitting on Berkshire's balance sheet. Stay tuned in 2014!

Fairfax Financial Holdings

Our second-largest financial services investment is Fairfax Financial Holdings. We have previously discussed how Chairman and Chief Executive Officer Prem Watsa is building Fairfax's insurance and reinsurance business. Like Berkshire Hathaway, Fairfax operates on a decentralized basis. Each Fairfax subsidiary insurance company provides a range of property and casualty products, maintaining a diversified portfolio of risk across all classes of business, geographic regions, and types of insureds. Most important, autonomous management teams are focused on underwriting profitably in their respective markets.

A study of Fairfax and Prem Watsa—who many consider to be the Warren Buffett of Canada—is very instructive for anyone interested in building a valuable insurance business. Fairfax Financial Holdings' per-share book value has grown at a compounded rate of 20+% per year since the company's founding in 1985. The annual results can be very lumpy, however, with embedded returns on investments not reflected for several years through the company's income statement and balance sheet. We are more than happy to be patient as long as we understand the activity taking place at Fairfax through the company's disciplined accumulation of low-cost float, the ability to have float stick within the company for a long period of time, and management's ability to allocate capital in a favorable manner for shareholders. Fairfax currently has all three legs of this insurance investment stool, and we are excited about its future prospects.

Fairfax has been growing its insurance business organically, but over time has grown mostly through opportunistic acquisitions. In 2013, the company acquired American Safety Insurance Holdings, an insurance company that focused on the alternative insurance market for environmental risks and specialty risks—i.e., longer-tail insurance. This is a typical acquisition for Fairfax, as American Safety mispriced past insurance policies and subsequently under-reserved for insurance claims that are now coming due. As part of this acquisition, Fairfax has gained full control of this poorly performing insurance company's float and will manage the wind-down of this entity as insurance liabilities are paid over many years. In the meantime, Fairfax has an opportunity to invest this float at a low cost, since it paid less than American Safety's liquidation value.

Fairfax is accumulating low-cost float that is sticking within the company for a longer period of time. In our estimation, the average holding period for Fairfax's funds has doubled in the past 13 years. The longer "tail" (in insurance parlance) that results from Fairfax holding customer premiums for a greater length of time allows

Mr. Watsa and his team the opportunity to invest low-cost borrowed funds over a lengthier time horizon. In layman's terms, Fairfax is now borrowing $16+ billion of customer funds at a low cost and holding these funds for a greater length of time—providing the company greater investment flexibility. We think of Fairfax as a "baby Berkshire."

On the money-generating side of the equation, Fairfax invest its float in understandable assets, including non-insurance companies that Fairfax is purchasing outright. While there are some cases where Fairfax has made investments that are "not so understandable" to the average individual, we believe we understand these more esoteric investments and are comfortable with the capital allocation by Mr. Watsa and his team. To give you comfort, we would like to cite examples of what we consider to be Fairfax's esoteric investment activity:

In the past, Fairfax has made counterintuitive investment wagers that many would consider "gambles." For example, for several years leading up to 2008, Fairfax aggressively utilized derivatives and swaps to insure the company's net worth in case of a severe stock market decline. To the average individual, this looked like outright gambling, but to an insurance aficionado, this wager could be viewed as "cheap insurance," whereby Fairfax paid a low price to protect its portfolio from a catastrophic market event. The counterparties to this transaction were complacent and sold portfolio protection inexpensively, thinking that a negative stock market event would not occur. Mr. Watsa and his team were not 100% sure that a negative stock market event would take place; however, the lack of market volatility at the time created an environment where the "price" for insuring against a market catastrophe became too low—thus Fairfax decided to purchase a lot of insurance. Of course, the financial earthquake erupted in 2008/2009, and Fairfax Financial Holdings made a lot of money. In a single year, Fairfax's common shareholders' equity increased from $4.9 billion at December 31, 2008 to $7.4 billion at December 31, 2009—an increase of $2.5 billion.

Fairfax has again taken similar derivative and swap positions to protect the company's net worth in case of market turmoil, but has added one more inexpensive insurance transaction that provides a good example of the company's investment prowess. In the past few years, Mr. Watsa and his team purchased something called "CPI-linked derivatives," whereby Fairfax purchased derivative contracts that protect the company from deflation that may possibly occur in the European Union, United States, and United Kingdom. These contracts specify that in the event of annual cumulative deflation occurring over a weighted average period of the next 7.7 years, Fairfax would be protected from the adverse financial impact of decreasing pricing levels. Conceptually, this is important today given that the company is experiencing overall underwriting results whereby they are paying policyholders approximately the same as the premiums received. In a deflationary environment, you also do not want a scenario in which your liabilities stay the same or increase while the value of your assets deteriorates significantly—this is a very bad equation.

Fairfax has purchased additional protection against deflation this past year, increasing the notional contract value from $48.4 billion to $81+ billion, with a remaining life of 7.7 years. These CPI-linked derivative contracts are extremely sensitive and are valued via "cumulative deflation"—meaning that for every 1% in cumulative deflation, Fairfax will receive 1% of the notional amount of the derivative contracts. For example: If, on average, the EU, U.S., and U.K. experience just 1% of cumulative deflation over the contract period, Fairfax will receive around $813 million on the $81.3 billion of notional contract value.

The U.S. in the 1930s and Japan in the 2000s experienced cumulative deflation of 14%. If we experienced just one quarter of this amount, Fairfax will gain more than $2.5 billion in the next 7.7 years from these derivatives alone. This displays the sensitive nature of these contracts—we won't point out the tremendous value of these contracts to Fairfax if we repeat a U.S. 1930s or Japan 2000s scenario.

It is our opinion that Fairfax Financial Holdings is currently trading slightly above the company's liquidation value, but far below its intrinsic value. Fairfax Financial Holdings is worth more than its current stock price, and we are excited about our long-term investment in Fairfax.

RETAIL GROUP

Our major retail holdings—Home Depot and Walgreens—each had a banner year in 2013 as retail purchases have fully recovered after the recession. We have emphasized in the past that retailing is a tough business that requires understanding four essential elements to success:

1. **Excellent customer service:** If individuals walk into your store and get a whiff of poor customer service, they will likely choose to turn around and shop elsewhere. Customer service is paramount in this business, and not something a retailer can compromise on.
2. **Product selection and superiority:** A retailer must constantly ensure that it is offering the right selection of products at the best possible price. You can provide a great service to your customer with attentive associates and a wonderful retail atmosphere, and then deliver a disservice by stocking the right products at the wrong price, the wrong products at the right price, or, worse yet—the wrong products at the wrong price.
3. **Value creation:** It is tough to make money in retail—product turnover, day-to-day revenue and expense management, and long-term capital allocation decisions all play into value creation.
4. **How to blend one's so-called "bricks and mortar" offering with the new "online channel:"** Interconnected retail has added a new dimension to this industry.

Retailing has many moving variables that require tending each and every day. Inattention to any of these details can lead to disaster—just ask J.C. Penney and Sears this past year.

Our interest is in large, industry-specific retailers that gain economic value as their industries consolidate over the long term—Home Depot and Walgreens definitely fit this description. These retailers are adding value as their specialty segments continue to undergo consolidation and small competitors fall by the wayside, a dynamic that continues to accelerate during challenging economic times. The retail areas in which we are invested focus on a couple of two-horse races—between Home Depot and Lowe's in the home improvement market, and between Walgreens and CVS in the retail pharmacy market. All four are gaining ground in this difficult economic era and will likely gain further ground in upcoming years. We have not changed our view: It is virtually impossible for new competitors to gain a foothold in these specialized retail segments that require substantial infrastructure and real estate development.

Home Depot

Home Depot had another successful year of growing its business in 2013 and continues to "build" shareholder value. Most consumers are still feeling the pinch due to ongoing economic challenges, but Home Depot is thriving as it focuses intensely on combining the best of our "great retailer" four legs.

We have mentioned in the past that when the economic crisis took hold in 2008, Home Depot took an unprecedented step to introduce and train all U.S. associates on new customer service expectations. The "Customers First" initiative was very detailed and was designed to clarify customer service expectation according to each specific associate position—such as Hardware, Paint, Garden, or Plumbing. At that time, Home Depot was also in the midst of launching its Rapid Deployment Centers (RDCs), which were at the epicenter of the company's plan to reduce its cost structure and improve sales. The RDCs provided Home Depot a more flexible flow of inventory throughout its extensive store network, along with better insight into inventory levels at the stores to meet customer needs.

The company is now taking customer service to a new level by combining customer service and product/price selection. "Localization" is the newest concept that has emerged this year in Home Depot's ongoing determination to drive sales. The company is leveraging its newfound strength in customer service and inventory management to create an assortment of merchandise that is tailored to local customers' tastes. This will help Home Depot drive more repeat sales and customer traffic as increased product relevance will meet local customers' needs.

In addition, revenue & expense management, effective capital allocation, and interconnected retail go hand-in-hand at Home Depot. The supply chain and technology improvements that Home Depot has made over the past five years have become critical to providing customers an interconnected retail experience and have developed into the cornerstone of Home Depot's competitive advantage. Home Depot's supply chain transformation has also enabled the company to interconnect retail fulfillment capabilities as its online model has evolved—from "buy online, return to store," to "buy online, pick up in store," to "buy online, ship to store" in 2013; to "buy online, deliver from store" in 2014. Given the success of the company's interconnected store/online efforts, Home Depot is moving forward with the construction of three additional fulfillment centers and will be implementing a new central order management system (COM) to drive flexible fulfillment capabilities. These actions will provide Home Depot with a central view of inventory in each supply chain

channel, further enable better in-stocks, and allow fulfillment from the optimal point of distribution—all improving the professional and non-professional customer experience at Home Depot.

We expect Home Depot to earn approximately $3.75 per share in calendar 2013 and to increase its earnings 18% in calendar 2014—to $4.42 per share. As a result of the actions described above, we expect Home Depot to continue to produce significant amounts of cash that will be distributed to shareholders. The company will generate more than $6 billion of owner earnings and will return this cash to stockholders through share repurchases of $4 billion and around $2.2 billion of dividends (a 5.35% look-through yield at the year-end stock price). We are pleased with the company's focused approach to customers and shareholders, and we plan to remain long-term owners of this great retailer.

Walgreens

Walgreens, like Home Depot, is an equally dominant retail firm that is focused on the healthcare segment—and gaining ground amid changes in global healthcare. As cited in the company's 2013 annual report, a recent study from IMS, a healthcare analytics company, found that improper and unnecessary use of medicines increased healthcare costs by more than $200 billion in 2012—representing 8% of the nation's total healthcare spend that year. The study singled out pharmacists as "particularly well positioned" to address this crisis by helping patients "through frequent and direct communication" regarding responsible use of medicines. Walgreens' large, expanding store base offers consumers unmatched convenience and pharmacist consultation services.

Walgreens is also intensifying its growth plans with a two-stage acquisition of Alliance Boots, the leading pharmacy-led health and beauty group in Europe. As you may recall, Walgreens exchanged $4 billion in cash and 83.4 million shares of stock for a 45% equity ownership stake in this company last year. Alliance Boots contributed 16 cents per diluted share to Walgreens for the year, as the combination achieved more than the $150 million target of synergies during its first year. Walgreens will likely carry out its option to proceed with a full combination by acquiring the remaining 55% of Alliance Boots beginning February, 2015. The Walgreens–Alliance Boots partnership accelerates a strategy to transform the traditional drugstore and creates a company platform for selling and distributing products to one billion people through 11,000 stores and 370 wholesale distribution centers in 25 countries.

Walgreens' emphasis on providing unmatched customer and patient healthcare services, expanded product selection at affordable prices, and interconnecting the in-store and online retail experience will create a specialty healthcare business that is difficult to duplicate. We believe that the Walgreens of the future is shaping up to be much more than a typical retail pharmacy. The company's planned evolution to offer global consumers a more integrated package of healthcare services will create significant value for shareholders.

In the meantime, Walgreens produced positive results in 2013. The company earned approximately $2.59 per share in its fiscal year-end, August 2013, and should grow earnings at approximately 17% in fiscal 2014, to $3.03 per share. Walgreens will generate around $2.8 billion of owner earnings in the upcoming year and is expected to return approximately $2.0 billion of cash to stockholders through share repurchases and dividends.

MEDIA GROUP

We continue to believe that the media and communications industry is an extremely competitive and dynamic business due to its reliance on changing technology infrastructure (internet, cable, etc.). Due to the vast channels of content distribution, and the multiple mediums in which consumers can access entertainment, it is paramount that media companies create and distribute "great content" to attract customers and advertisers. In no other business can a customer or advertiser switch loyalty as quickly as in the media business. For this sole reason, it is important to choose media companies that have a special toehold in the marketplace. In this category, we have chosen the best media business in the industry—Disney.

Walt Disney Company

We have highlighted before that Disney is a one-of-a-kind media company, and that we place this business in the "best-of-the-best franchise" category. We cannot say enough about the leadership of Bob Iger, Disney's current CEO, who has done a remarkable job creating shareholder value during his tenure. He has maintained

the company's culture and focus while expanding Disney's invaluable library of content, broadening its distribution network, and embracing new technologies that complement and enhance the Disney experience.

In the past, we have described Disney's unmatched content (films, characters, etc.) as an oil well that keeps replenishing itself as it is being pumped. Each time the company develops an animated or iconic film, much of the film development is expensed at the time of its introduction. In future years, when the company re-launches these classic films in updated formats (DVD, 3D, etc.), Disney attains additional revenues and profits without incurring the expense of developing an animated film. We refer to these re-launches from the company's film library as "accessing the Disney vault." Understanding that the content of this vault consists of gooses rather than golden eggs is an important point investors should focus on—these magic gooses keep laying golden eggs. *Snow White and the Seven Dwarfs, Pinocchio, Bambi, Cinderella, Alice in Wonderland, Peter Pan, The Little Mermaid, Beauty and the Beast, The Lion King, Aladdin, 101 Dalmatians*....Our grandchildren's grandchildren will most likely be watching these famous Disney films in the new millennium, no matter what medium the content is delivered on—movie theater, computer, 3D television, etc. The value of the Disney vault is incalculable because of the 100-year annuity associated with reissuing many Disney films as new delivery mediums emerge.

Disney keeps adding new animated films (golden gooses) to its vault—it's latest movie, *Frozen,* was released over the recent holiday season. In the next few years, we anticipate additional movie releases, including *Captain America: The Winter Soldier, The Hundred Foot Journey, Cinderella,* and *The Good Dinosaur*. Disney is also set to release *Star Wars: Episode VII* in December, 2015—Disney's first Star Wars film since its acquisition of Lucasfilm—a purchase that many think Disney paid dearly for.

A short lesson on value created through acquisition: ESPN is a hidden asset in Disney's portfolio that we should highlight. This cable sports network came as a so-called small part of Disney's $19 billion acquisition of Cap Cities/ABC in 1996. At the time, we thought that Disney paid too high a price for Cap Cities/ABC. But 17 years has uncovered a lot of gems. ESPN will contribute approximately $4 billion of operating income to Disney this upcoming year—one year's operating profits for ESPN now represents more than 20% of the original acquisition price. This fact gives us great confidence in Disney's capital allocation capabilities, and we stand behind the company's recent acquisitions of Marvel Entertainment and Lucasfilm.

We are very confident in Disney's management team and believe that Disney has stronger long-term growth prospects than most investors realize due to the company's highly competitive position within the media and entertainment industry. Disney's broad range of content and growing international presence will allow the company to extend its global reach for many years to come.

Disney earned $3.42 per share in its fiscal year-end, September 29, 2013, and should grow earnings at 15% in the next fiscal year, to approximately $3.95 per share. The company will generate more than $8 billion of owner earnings and is expected to return a large portion of this cash to stockholders through share repurchases of approximately $7 billion and dividends of $1.5 billion. Given the ever-increasing value this franchise is creating, we will remain long-term holders of Disney.

COMMODITIES GROUP & INSURANCE

Our Commodity Holdings include Central Fund of Canada, Chevron, ConocoPhillips, and Royal Dutch Shell, along with smaller positions in several other oil companies. We have held commodities and commodity-based positions since 2004, primarily investing in oil, with smaller positions in gold and silver. At the time of our commodity purchases, we were concerned about the possible deterioration of worldwide currencies, given governments' historical propensity to print money to stem the impact of any financial crisis in their countries. Of course, a financial crisis did occur in 2008/2009, and since then we have been facing an ongoing financial predicament as governments figure how to work out of the global financial quagmire—so far, the solution has been to print money and debase currencies. There is now tremendous debate (as well as emotion) about commodities as an investment and their reaction to currency debasement.

Our opinion has not changed: We remain concerned about the global financial system that seems to be encountering ongoing challenges. Our original concerns in 2004 stemmed from a few areas, and this anxiety remains today:

- Given the growing U.S. debt, in 2004 we believed that the value of the U.S. dollar would deteriorate over the long term, and that the country would have no choice but to eventually inflate away its rising debt. This assumption continues to prove correct. Despite the recent announcement to "taper" the $85 billion monthly purchase of U.S. Treasuries and mortgage-backed securities, the Federal Reserve is still planning to pump a lot of money into the financial system, and thus we have not changed our view. We believe our country's ongoing lax monetary policies will likely result in a continuing deterioration of the U.S. currency.

  We have stated before that changes in the dollar's value will not be the only factor determining the price of certain commodities. The U.S. is not the only country printing money to bail out its financial system—the European Union is still encountering a slow-motion train wreck that is way off track as countries such as Portugal, Italy, Greece, and Spain face mounting debt problems. It is our opinion that the European Central Bank will have no choice but to lend and print money to bail out these sovereign nations. This fact further supports the argument for higher long-term commodity prices, since a growing world money supply can ultimately lead to global inflation and a deterioration of all fiat currencies.

- A long-term imbalance continues to grow between oil supply and demand. According to a 2013 World Energy Outlook report issued by the International Energy Agency, daily worldwide oil consumption of 89 million barrels of oil per day in 2012 will rise to approximately 101 million barrels per day by 2035. (In 2013, world oil demand is slightly higher than the 90 million barrels per day produced and is expected to rise another 1.1 million barrels per day in 2014.) Although supply and demand is now in balance, it is our opinion that "safe" worldwide oil production capabilities are about equal to current demand. Yet, according to another 2013 report from Bernstein research, the total marginal cost for the largest oil and gas companies to produce the next barrel of oil to meet growing demand increased 13% the past year, from approximately $92 to $104 per barrel. This includes the abundant shale oil that is being extracted from the U.S., which is likely to become the largest world oil producer through 2035. In summary, the marginal cost of producing a barrel of oil to meet growing demand is the price for which a barrel of oil is currently determined. As demand for energy increases due to emerging economies growing at a rapid pace, pressure may be placed on global oil prices that continue to dally around $100 per barrel.

Oil

We made our initial oil investment in Chevron—a leading international integrated oil and gas company with operations worldwide—in early 2005. At that time, we felt rather confident that an imbalance in worldwide oil supply and demand would push long-term oil prices higher, increasing profits of integrated oil companies. Since our initial allocation of capital to this sector, our confidence has been further emboldened by the lax monetary policies of global central banks. Therefore, over the past five years we increased our exposure to integrated oil companies through investments in businesses that we felt traded at significant discounts to their long-term values such as ConocoPhillips, Royal Dutch, and several other integrated oil companies. We now have a rather large investment in the energy sector and anticipate oil trading at a price exceeding $90 a barrel, given that the marginal cost of producing a barrel of oil is in this range.

In the meantime, our combined oil holdings are gushing cash. The average dividend being paid by our integrated oil companies is around 4%— in this case, we are essentially being "paid" for our insurance against any future inflation.

Gold & Silver

In early 2005, we began purchasing Barrick Gold as a so-called productive hedge against an ongoing descent in the U.S. dollar. However, in early 2013 we decided to sell our position in Barrick and reallocate this capital to an investment in CSX railroad. Why? Between our initial purchase and eventual sale, gold had risen almost fourfold, while Barrick Gold's profits increased sevenfold—but the stock price of Barrick did not increase commensurately with the rise in the price of gold or its profits. The disparity between the increase in Barrick's profitability versus the stock price was the result of management's inability to effectively allocate profits to shareholders. Barrick may have grown its earnings exponentially as the price of gold increased, but it shared very little with owners of the company.

It is logical to ask: What did management do with the more than $6 billion of profits produced during the time of our ownership?

Barrick practiced the Con Edison motto, *"Dig we must."* The management team decided to keep most of the company's profits and dig (over-dig and over-invest is probably more appropriate) for new gold to support future production—in anticipation of ever-rising gold prices.

As business owners, we became increasingly frustrated with this ongoing action. We attempted to communicate with management, but predictably, our thoughts regarding questionable capital allocation decisions fell on deaf ears. In the end, when a good business opportunity is squandered, and you find yourself hoping for a behavior change that does not occur, it is best to move on. In Barrick's case, management ignored shareholders and continued its program of misallocating capital, so we decided to vote with our feet and sell our holdings. We wanted to be associated with a shareholder-friendly company that allocates capital effectively to the owners of the business.

In the meantime, we have maintained a smaller investment in gold and silver bullion through our interest in Central Fund of Canada, a specialized investment holding company that purchases gold and silver in the open market and stores the bullion in a bank vault. Central Fund's net assets at market value are approximately $3.4 billion, represented by an approximately 50/50 split between gold bullion and certificates, and silver bullion and certificates.

Insurance and the Purchase of Puts

In the 1st quarter of 2013, we acquired a new security: IShares Russell 2000 1/17/2015 Puts. These securities are put options on the Russell 2000 Index Fund, which represents 2000 small-cap U.S. stocks. We believe it is important that you understand these put option securities, so we want to thoroughly explain why we purchased them for our accounts. (This can get confusing, so please be patient with this rather lengthy description.)

Definitions: A *put option* represents a contract between two parties to exchange an *asset* (in our case, the underlying asset is the Russell 2000 Index Fund), at a specified price (the *strike price*), by a *predetermined date* (January 17th, 2015). With a put option, the buyer of this contract pays a premium to the seller that he will not get back, unless the option is sold before it expires. In essence, the buyer of a put option retains a right to sell the stock at the pre-determined strike price over an agreed period of time. On the other side, the seller of a put option (called the writer of a put contract) receives a payment (or premium) from the buyer. During the contract period, if the buyer exercises his option, the writer must buy the stock at the pre-determined strike price. If the buyer does not exercise his option, the writer's profit is the premium he received when the contract was entered.

In our case, Founders Capital Management is the buyer of the put option contract, and we retain the right, but not an obligation, to re-sell the security at the strike price by the future date. The seller of the put option contract to Founders has the obligation to repurchase the security at the strike price if we exercise our option. In essence, from our side of the equation, purchasing a put on the Russell 2000 Index Fund gives us the right to literally "put" this security, or make a counterparty buy back this security from us at our discretion over the remaining 12 months on this contract.

To further clarify, let's go through an example of a general put option transaction. Let's say XYZ Company is selling at $100 per share today. If we decide to purchase a two-year put contract on XYZ Company at a strike price of $65 per share, we would retain the right to sell (or put) 100 shares of XYZ Company at this price over the next 24 months. If we paid $5 per share for this right, the so-called writer of this contract collected our money and insured us against any losses that occurred below the strike price of $65 per share. To continue this example, if the stock price of XYZ Company falls 50%, to $50 per share, then it would be to our benefit to exercise our right and make" the contract writer" purchase this security from us at the higher price of $65 per share—basically, our put option contract would have increased $10 in value, from $5 to $15. In essence, the put on XYZ security increases in value as the stock price of XYZ Company falls—in fact, it exponentially increases in value as it gets closer, or below the $65 strike price. Summing up our theoretical case, if we initially paid $5 per share for the right to make someone buy this security from us at $65 per share, we would make a $10 per share profit if we exercised our option and required the counterparty to buy XYZ Company for $65 per share, assuming that XYX Company was trading at $50 per share.

Believe it or not, now comes the hard part—valuing an option: The common way to value an option is to use a model called Black-Scholes. This model to price derivatives (such as options) was first introduced in a series of papers in the early 1970s by Fisher Black, Myron Scholes and Robert Merton. Actually, Scholes and Merton

received the 1997 Nobel Prize in Economics for their work on this model (Fisher Black was ineligible for the prize because of his death in 1995).

The reason we go through this bit of history is due to the fact that Long-Term Capital Management, a famous hedge fund founded in 1993 by John Meriwether, was set up to generate profits for its investors by using the famous Black-Scholes model. We can't help but mention that the future Nobel laureates Myron Scholes and Robert Merton were recruited by John Meriwether to help develop the strategy for this hedge fund—they were also on the fund's board of directors. Initially, the hedge fund was extremely successful, producing annual returns exceeding 40% (after fees) in its first years. In 1998, however, Long-Term Capital Management lost $4.6 billion in less than four months following the Russian financial crisis, leading to the hedge fund's quick collapse. The fund's downfall was so great that it required intervention by the Federal Reserve to coordinate and supervise a $3.6 billion bailout of Long-Term Capital Management among 14 financial institutions. This bailout was deemed necessary to avoid a potential global market meltdown. In early 2000, Long-Term Capital Management was eventually dissolved with the help of Wall Street—so much for quantitative theory meeting practice. Why did Long-Term Capital Management collapse while relying on the "perfect" Black-Scholes model to value derivatives? We will skip the complex math—but it is instructive to review the concept of this model that is still used today to value options.

It's a mouthful, but important background: The primary inputs to valuing an option using the Black-Scholes model include the current price of the underlying security, its dividend yield, the time period left on the option contract, the option strike price, the risk-free rate that is associated with the time period left on the option, and the volatility of the underlying security. In our view, the major flaw in this model is not the mathematical equation that goes into valuing the option (although pricing something using past volatility seems a bit vague to us), but lies in the concept that one weighs heavily on using the *price* of an *underlying* security versus its *value* to figure the worth of an option. Like any investment decision, the correlation between the *price* one pays for an asset, versus its *intrinsic value,* determines an investor's eventual return. In summary, ignoring the *value* of the *underlying* security, while focusing on its *price* to determine the worth of an option, can lead to investor peril. *We believe this is an important point to differentiate.*

In the end, purchasing a put option can be viewed several ways. First, an option such as this can be seen as speculation, where an investor "bets" on an eventual fall of a security within the specified contract period. This is guesswork, and difficult to profit from (as you know, we refrain from any speculative behavior). A second reason to purchase a put option is for protection, as a type of insurance. With a so-called *protective put strategy*, the investor buys enough puts to cover a portion of his holdings of an underlying asset so that if a drastic downward movement of the underlying's asset price occurs, he has the option to sell the asset at the insured strike price. This is what we have accomplished.

Our put options on the Russell 2000 Small-Cap Index insures a portion of our equity portfolio in the event of a significant market downturn between the time of our purchase through January 17th, 2015. We view this as an insurance contract, and our evaluation of insurance is not unlike our evaluation of any other business arrangement. When purchasing insurance, it is important to keep four things in mind:

1) The intrinsic value of the asset you are covering
2) The amount of coverage that you desire against any deterioration of this asset
3) The price you are willing to pay for the insurance coverage
4) The estimated value of the underlying insurance contract you are purchasing

In summary: An investor has to be patient to confirm he understands the value of his portfolio, obtains the right coverage at the right price, and chooses an insurance contract that meets the coverage test in the event that a catastrophe occurs.

At Founders, we have a fair idea of the intrinsic value of our equities, and they are not trading at levels that seem overvalued—in other words, it is our assessment that the collective equity holdings are trading in a "fair value range." Conversely, we also understand that our portfolio has a tendency to fluctuate with the market, despite being favorably valued compared to peer securities. Given this circumstance, we have a general idea of the amount of coverage, along with the price we are willing to pay, in the event of a temporary but significant decline in our equity portfolio. We chose an insurance contract—the IShares Russell 2000—that meets our coverage test if a severe market fall takes place. Why this particular contract? The broad market rally that we have experienced the past several years has been driven by both speculative and smaller-cap stocks—which we

believe are now overvalued. The Russell 2000 contains many of these overvalued securities and has more than tripled from its March 2009 low. Currently, the gap between the *fairly valued* large companies we own and the *overvalued* smaller companies within this index fund seems outsized, and this is why we decided to use the small-cap index fund to construct our insurance contract.

Here are the approximate numbers for our put option contracts at the time of their purchase: If we had a $100,000 equity portfolio, and it was subject to a 35% potential downturn ($35,000), we were willing to insure approximately $11,000 of this downturn over a 21-month period for a one-time payment of approximately $2,200.

Now, to one other important point: *The payment for this insurance contract is coming from a portion of the dividends we receive on our equity portfolio.* At the time of our purchase of the puts, we were receiving *quarterly* dividends of approximately $625 on our hypothetical $100,000 equity portfolio, and utilizing about 50% of these dividends toward the payment of the 21-month insurance contract.

One other point is warranted: *Thus far, the dividends received along with the gains in our portfolios have more than compensated for any temporary loss in price on our insurance contract.* Basically, we are receiving the benefit of higher prices reflected in our portfolio as the market has increased—while being insured against a downturn.

One last point: It is important for us to clarify that we are *not* predicting a market downturn, and in fact have no idea what will happen in the market during 2014. We do know that the price for market insurance became attractive based on our valuation of the IShares Russell 2000 1/17/2015 Puts. Therefore, we decided to purchase coverage on a portion of our equity portfolio. *Price is what drove our decision, not market fear—for there seems to be little right now.*

FIXED-INCOME INVESTMENTS

The Barclay's U.S. Aggregate Bond Index, which represents the broad debt market, experienced a 2.0% *decline* in 2013. This deterioration follows an average annual bond index gain of approximately 6.1% the previous four years. Since the credit crisis of 2008, investors have poured money into bond funds. We have reiterated over the past few years that investors have lost a business perspective in the credit market. Despite the recent setback, we can say with confidence that the current fixed-income market still seems overvalued, and investors would be *far* better off taking a business approach to their investing activity in this area.

If individuals stepped back and looked at their fixed-income investments in a similar manner to an investment in a business, they would become skeptical about their future returns. Let's say that a business with zero debt is able to produce a steady 10% return on equity. If management elects to retain the annual earnings of this business and plow these funds back into the company, investors can expect to see their so-called equity bond double in a little more than seven years.

Now let's look at a bond in a similar business light. If you purchase a bond that produces a 10% coupon and choose to retain the annual earnings from this bond and reinvest this money into the same bond at par, you will also double your money in a little more than seven years—producing a similar result to our business example.

Considering this example, it is our opinion that individuals purchasing bonds today are not taking a business perspective. For example, if we purchased a 30-year U.S. Treasury bond at the year-end 3.97% yield, and chose to reinvest the coupon payments into these same bonds at par, it would take around 18 years to double our money. If we presented you with a similar arrangement to invest in a business that produces a 3.97% return on equity and retains all the proceeds to repeat this poor return, our judgment would be questioned, regardless of whether the business was guaranteed to survive. Ironically, today's *terrible* return of 3.97% on a 30-year Treasury bond is significantly better than the 2.95% offered on this same investment at the end of 2012. (*Fixed-income investors are slowly losing money to obtain better returns.)* Unfortunately, we still see many financial participants placing a greater-than-average portion of their clients' assets in *un*businesslike opportunities.

At Founders, we continue to emphasize several points that concern us about fixed-income instruments. Besides the ongoing poor returns being offered in this area, looming risks associated with this "secure investment vehicle" include the future possibility of rising interest rates and even greater chances of default—especially in popular high-yielding, triple tax-exempt municipal bonds issued by Puerto Rico. We remain concerned about

the low long-term market interest rates, which may continue moving upward as the Federal Reserve begins to taper its purchase of U.S. Treasuries and mortgage-backed securities in 2014.

During 2013, we have had ongoing tranches of municipal and corporate bonds come due. We have maintained a businesslike attitude toward our fixed-income investments, *carefully* allocating money to securities that offer a fair risk and return over the duration of their holding. We are avoiding speculative investment activity such as chasing returns and/or buying what we consider junk, as these issues will likely live up to their name. We are maintaining our attitude of finding the best-yielding securities, while understanding the risks we are taking with each individual fixed-income allocation. Although we have been successful in finding selective opportunities to reallocate money to fixed-income securities that provide fair returns, good prospects continue to be rare. As a result, we are likely to accumulate a large amount of cash in 2014. Although this is not intentional or out of market fear, we will remain disciplined in seeking fair returns for the risks we take. *Being patient, and watching for better opportunities, is much better than doing something unintelligent.*

* * *

OUR FINAL THOUGHT

At Founders Capital Management, our focus will always be on approaching investments with a businesslike view. Although there were (and will continue to be) challenges, we will keep our attention on what's in front of us—adhering to our value-based investment principles. We will fully understand what we are investing in and why, and we will maintain a view on the intrinsic value of our holdings.

In this age of ongoing high uncertainty, it is our opinion that to be successful at investing, it is important to focus on long-term business and economic considerations rather than short-term trading strategies. We will continue our effort to avoid making irrational decisions based on emotions—including fear of failing to meet desired returns for clients and being greedy when prudence should prevail.

We remain comfortable with our current businesses and the future worldwide prospects for each of our operating companies. We are also comfortable with our fixed-income investments and believe the returns are fair for the risks we are taking. We want to assure you that we are mindful of the risks in today's markets and will strive to allocate capital in a way that minimizes any long-term effects on the value of our holdings.

Thank you for the opportunity to serve you and for your continued trust. We look forward to working on your behalf during 2014.

* * *

The examples and descriptions of investments in this client letter do not represent all of the investments purchased, sold, or recommended by Founders and instead represent:

(1) the 10 largest equity positions held by Founders' clients;
(2) the two largest equity positions in each industry group to which Founders has allocated capital; and
(3) all equity positions that account for 3% or more of the total funds allocated by Founders to equity holdings.

The performance of these investments was not a criterion in determining the representative list. It should not be assumed that the investments identified and discussed were or will be profitable.

The views expressed in this report represent the opinion and analysis of Founders Capital Management based on data available from public sources at the time of writing. This report is not intended to provide any recommendations with respect to the purchase and/or sale of any specific security. It is recommended that individuals conduct their own research or consult with an investment advisor prior to making any investment decisions.

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