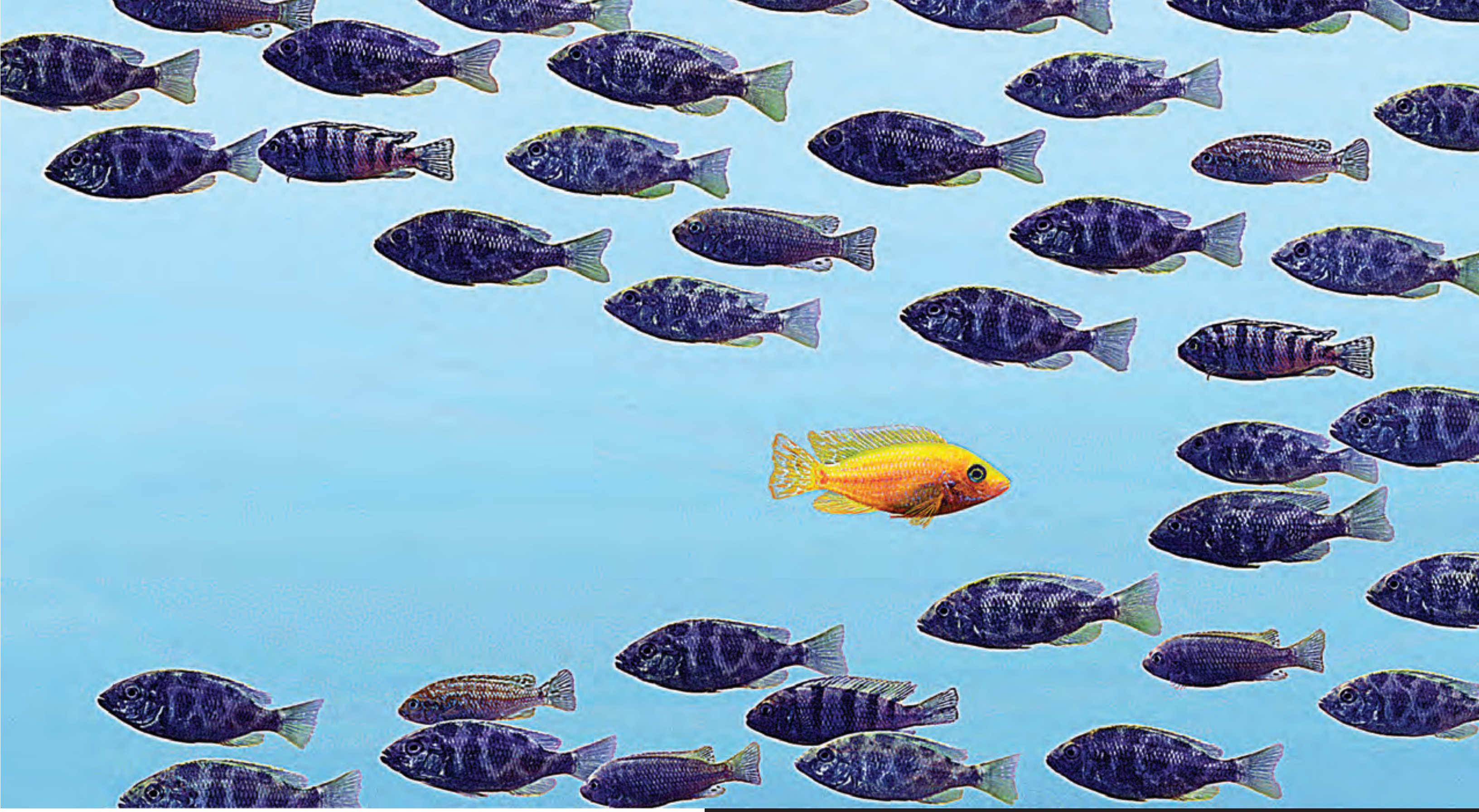

Seeking Investment Intelligence

FOUNDERS CAPITAL MANAGEMENT
2014 ANNUAL REPORT

Investing for the Long Term. Every Day.

FOUNDERS
CAPITAL
MANAGEMENT

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

2014 Annual Report:

"Seeking Investment Intelligence"

Table of Contents

PRINCIPALS' LETTER
From: Founders Capital Management

2014: Seeking Investment Intelligence

2014 ended on another extraordinary note as market participants watched stock prices reach new records (despite a roller-coaster ride at the end of the year). The U.S. stock market has officially dumbfounded negative spectators as most industry segments rose to their highest historical prices. This feat was accomplished despite European financial and political turmoil, shaky financial ground in Japan, and an economic slowdown in China. The U.S. surprised market followers as our economy gained strength during the past 12 months, while most of the developed world experienced a temporary economic setback. All told, the U.S. markets seem to be the best house in a challenging neighborhood.

The Standard & Poor's 500 (S&P 500) increased 13.7% in 2014—another home-run year for investors. The double-digit rise of the S&P 500 during the past 365 days is on top of the 32.4% return in 2013, and 16% return achieved during 2012. As we stated in our midyear letter, who is really keeping track at this point—the S&P 500 has now risen more than 200% from its March 2009 low—quite the comeback.

Despite the convincing market run-up, investors remain tepid and wonder if markets can continue their upward swing in the future. We do not know the answer to this question and, in our view, attempting to prognosticate market prices would be futile. When we step back to evaluate the global economic landscape, we remain wary about circumstances that could lengthen the ongoing worldwide political and economic stalemate. Again this year, 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 governments to contend with large entitlement programs that are unsustainable in their current forms

We mentioned last year that harsh financial penalties would eventually be imparted on many citizens if the above matters continued to fester—and they do. Politically, it is more expedient to "kick the can down the road" and delay finding solutions to these shared global issues than to introduce further angst by contending with them today. Of course, deferring addressing these challenges only worsens economic woes as debts and entitlement obligations continue to mount. In the meantime, in an effort to create market and social stability, governments and central banks are utilizing short-term measures to "prop up" our collective financial and social system. Near-zero short-term interest rates and quantitative easing (purchasing government and government-backed bonds), along with rising government debt, all seem to accommodate global citizens in the short term—but, in our view, this activity over the long term is untenable. Like the ostrich that places its head in the sand to avoid danger, we will eventually have to face our current financial and social problems if we are to set ourselves on a corrected path toward long-term value creation worldwide. The longer we keep our heads in the sand and postpone developing solutions to address these concerns, the greater the probability our economies (and markets) will flounder.

For the time being, with near-zero interest rates, investors have little place to go for returns—and they are turning to the stock market. As 2014 came to a close, financial markets had not only fully recovered but surpassed expectations as a result of financial stimulation by the federal government. Despite the more-than-positive market results over the past five years, our experience tells us to hew closely to caution and prudence in the future. We think most market participants have become "psychologically anchored," believing that past market gains act as a predictor of the future—but this is not usually the case in reality. In other words, we should expect "moderate returns" going forward. Obviously, not everyone thinks this way. We continue to witness investors (both professional and nonprofessional) move ever-higher amounts of money to higher-risk assets to obtain increasing returns in a restrictive, near-zero, short-term, risk-free interest-rate environment. The recent rise in prices for risk-type assets has provided the rationale for putting money into places that have little or no economic value.

We repeat an admonition from last year's letter: It is important to be mindful of how global market participants are stretching for returns—and, in many cases, overspeculating—in the pursuit of increasing gains. Our response has been to become more conservative as we watch the increasing complacency in both the equity and fixed-income markets.

Given the economic recovery we have experienced since the 2008 financial crisis and the corresponding gains in the markets, we should not allow ourselves to be lulled into a false sense of security with a belief that the higher-than-normal annual returns of the past three years are a permanent fixture in our portfolio. We remain alert to the changing conditions characterized throughout our letters and aware of several circumstances that could lead to short-term financial stress. We continue to fight the tendency to become weighed down by the "psychological anchors" of human nature that inflict so many investors. Our ongoing restraint in not following the crowd's thinking is something we would like to explain this year to illuminate why we remain confident with our current position in a more challenged investment environment.

This year, the theme of our letter is "Seeking Investment Intelligence," and our 2014 topics include:

- The Continued Chase for Ever-Greater Returns
- Natural Investment Psychology
- An Unnatural Approach to Investing
- Striving for "True Investment Intelligence"

* * *

The Continued Chase for Ever-Greater Returns

> **"It ain't what you don't know that gets you into trouble.**
> **It's what you know for sure that just ain't so."**
> ***—Mark Twain***

We are astounded watching individuals continually chase assets motivated primarily by rising prices. Many investors appear to be practicing the "Chuck Prince Musical Chairs Principle." In a 2007 interview with the *Financial Times* prior to the financial crisis, the former CEO of Citigroup stated, *"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're (Citigroup) still dancing."*

In 2008, the music (i.e., liquidity) stopped on Wall Street, and Mr. Prince did not escape the ensuing flames that engulfed financial institutions, including Citigroup—the stock is still down more than 90% since the *Financial Times* interview and will likely take more than several decades to recover. How could a smart CEO who was keenly aware of impending issues that would surely plague the financial markets and his company allow (and even endorse) his firm's participation in such risky behavior?

Today, many investors are doing the same—with nowhere to go and a strong desire to obtain returns, individuals are knowingly opting to accept higher risk by placing their money in assets that possess little to no economic value. The sentiment seems to be, "*Before the music stops and the value(less) of these speculative assets fall, we'll have an opportunity to get out at the top."* In short, painful memories are fleeting, and caution has flown the coop since the financial crisis of 2008.

Professional and nonprofessional market participants are actively pursuing stocks that supposedly have a tremendous future, or companies that seem to be chased by others. Investor excitement, as well as disappointment, continues to churn around stocks such as Facebook, Groupon, Zynga, LinkedIn, Pandora, Zillow, Yelp, and Twitter. (Maybe Uber—the ridesharing service founded in 2009 that is wreaking havoc among conventional taxi services, will soon join this crowd—the company is planning an IPO in 2015 with a valuation of more than $40 billion!)

Last year, we reported that the collective value of social media-related companies had risen approximately 150% in 2013, to $225 billion. This year, the collective value has risen 28%, to $289 billion—and we thought they were overvalued a few years ago. Investors are now paying an estimated $289 billion for this group of businesses that will produce around $1.9 billion in reported profits during 2014—that translates to 152 times Generally Accepted Accounting Principles (GAAP) earnings. (Facebook's earnings of $2.9 billion leaves a combined $1 billion loss for the remainder of the group.)

We have updated the following chart that we have presented in our last few letters:

	Market Cap at IPO Price *($ billions)*	**Market Cap 12/31/2014** *($ billions)*	**Gain/(Loss) since IPO**	**Price/Revenue 12/31/2014**	**Price/GAAP Earnings 12/31/2014**
Facebook	82	218.0	166%	17.6x	75x
Groupon	13	5.5	(58%)	1.7x	Loss
Zynga	7	2.4	(66%)	3.5x	Loss
LinkedIn	4.8	28.5	494%	13x	Loss
Pandora Media	2.5	3.7	48%	4x	Loss
Zillow	.66	4.3	552%	13.3x	Loss
Yelp	.95	4.0	321%	10.5x	426x
Twitter	14	22.7	62%	16.5x	Loss

Once again, the concern with these so-called opportunities continues to be valuations that are totally dependent on prospects yet to be realized. 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. So, why are many seasoned professional investors continuing to buy into these stocks?

Falling Victim to a Curse!

Before we fully answer this question, it is instructive to share a few stories of several geniuses who fell victim to a common investor curse.

The Story of Mark Twain

Samuel Clemens (pen name: Mark Twain) was a literary genius. We grew up reading his famous and timeless stories—*The Adventures of Tom Sawyer* and *The Adventures of Huckleberry Finn* (largely written in Hartford, CT, by the way). What many do not know is that Sam's genius extended to inventions, including a patent on the "Improvement in Adjustable and Detachable Straps for Garments"—a strap that allowed for the tightening of shirts at the waist that was supposed to take the place of suspenders. Mr. Clemens also received patents for a self-pasting scrapbook and for a history trivia game. His scrapbook patent alone produced $50,000 in royalties. Clearly, Samuel Clemens was a genius, and he made a fortune from his writing, lecturing, and several inventions—but his gifted intellect failed him when it came to investing, which nearly bankrupted him.

Mark Twain's investment adventures could be likened to rafting down the Mississippi River with the hope of finding riches, only to experience nightmares brought on by speculation thunder (in *The Adventures of Tom Sawyer,* he changed the word "hell" to "thunder," considering that the book's intended audience was children). Sam Clemens had a desire to get "filthy rich." As he received large amounts of royalty income from his books and his patent, he went on the aggressive hunt for stock ideas. He stated to his friend and fellow novelist, William Dean Howells, "I must speculate in something, such being my nature." Speculate he did—gossiping with Wall Street traders for hot tips, he purchased companies such as Denver & Rio Grande Railway, South African diamond mines, and the Independent Watch Company. He was so desperate to sell the stock of Independent Watch after buying it up from promoters that he wrote a mock newspaper ad, "Make me an offer (an exorbitant one not required)."

After these disappointments, he then decided to place $23,000 into the Hartford Accident Insurance Company—which went bust in less than two years. Acting once again on a "tip," Mr. Clemens bought $21,000 of the Oregon & Transcontinental Company on margin. As the O&T Railroad went down in price, he bought more. After losing almost 80% of his money, he instructed his nephew to figure out whether to sell or hold the stock, stating that he "didn't wish to ever look at a stock report again." He sold at $12 per share, losing more than $18,000. (Sam also put money into the New York Vaporizing Company, whose value vaporized almost instantly.)

Samuel Clemens was a genius, but a hapless player in the market. He was incapable of resisting any stock that sounded like a lottery ticket. He ended up calling margin "mud," brokers "stock meddlers," and executives at companies "chartered robbers." He lost a fortune in the stock market, as well as in several business ventures that were intended to make him insanely wealthy. Why did his genius fail him in this pursuit?

The Story of Sir Isaac Newton

Isaac Newton invested his fortune in the South Sea Company. Paradoxically, he made this "all in" investment decision after realizing a rewarding 100% profit on 7,000 pounds he had invested in the same company. On doubling his initial investment, Mr. Newton sensed that the risk in this stock was too high and decided to take his money completely off the table. The ironic part of this genius' assessment of risk is that, shortly thereafter, as he nervously watched the stock price climb from his sideline position, he decided to jump back into the action. Newton went all-in, placing all his money into the South Sea Company, and then watched the stock nosedive—taking most of his fortune (£20,000—the equivalent of more than $6 million today)—with it.

The "South Sea Bubble," as it was eventually named, is worth reviewing, since it is one of history's worst financial debacles. The craze started in 1711, after the War of the Spanish Succession left England in debt to the tune of £10 million. The English government granted an English financial institution—the South Sea Company—a deal whereby England's debt would be financed through the firm in return for 6% interest (a lower interest rate on its debt). The government added another incentive to sweeten the deal: Exclusive trading rights with South America. The South Sea Company readily agreed to the monopoly trade arrangement in the South Seas, believing that Mexico and South America would enthusiastically trade gold and jewels in exchange for wool and fleece clothing made in England.

The South Sea Company management team fed investors' delusions of grandeur and hyped the stock. It was generally believed that the South Sea Company "could never fail," given its implied government backing. By 1718, though, a new picture began to emerge. Britain and Spain were at war again, bringing all chances for trade in the South Seas to a grinding halt. Believe it or not, investors were still not daunted and kept clamoring for South Sea Company stock. Making matters worse, investors from other European countries had started to scramble frantically for South Sea shares, driving the stock up even further. All this despite the fact that throughout the craze's seven-year time frame, the South Sea Company had not generated any profit from its operations.

Management, realizing that the company's shares were substantially overvalued relative to the (lack of) profits, decided to sell at exorbitant prices, while other investors remained unaware that the business was profitless. When word got out that the management team had sold out completely, investors who were left holding the stock panicked and immediately began to sell their worthless shares, causing many to lose their fortunes in a heartbeat—Isaac Newton among them. No one could mention the South Sea Company again in front of Isaac Newton without a backlash. Here was one of history's greatest geniuses, and he had fallen victim to hype, even after knowing that this stock was defying gravity. And Newton's folly could not be attributed to lack of financial acumen—his recognized genius extended to finance as well as mathematics. He is credited with piloting the nation through a recoinage in 1696; initiating tying currency to gold in 1717, which eventually led to the establishment of the "gold standard;" and serving as England's Master of the Royal Mint for 27 years. So, why did Isaac Newton's genius fail him in the South Sea debacle?

Natural Investment Psychology

> **"All through time, people have basically acted and reacted the same way in the market as a result of greed, fear, ignorance, and hope. That is why the numerical formations and patterns recur on a constant basis."**
>
> **—*Jesse Livermore,* How To Trade In Stocks**

Unfortunately, humankind is cursed by human nature. Much has been written about this vexatious problem, and even more has been written about how to overcome it. It seems evident that, no matter how hard we try, no one escapes the vagaries of basic human nature —not even geniuses. Why is it that we succumb to our natural instincts? Is it a primal predisposition based on the survival instinct (i.e., fighting for finite resources while comparing ourselves to others)? Or is it based in greed, whereby humans can never be satisfied with what they have, always seeking more? Although we do not have answers to these questions, we can accept the likelihood that we are forever weighed down with the anchor of human nature.

While we are not experts in human psychology, it is beneficial for us to attempt to understand the factors of human psychology that lead to age-old investor mistakes. We believe that most of human psychology can be categorized into three areas: Emotion, Bias, and Desire.

Emotion

In learning about Isacc Newton, one quickly understands that his contributions to humankind encompass much more than the laws of motion asserted in *Principia*—and his story includes a lesson about human nature and the laws of market e(motion). Emotions drive a lot of our daily behaviors, especially in the investment world. We all know that individuals buy and sell in the market based on both greed and fear. Saying to someone, "You should not be influenced by greed or fear in the market" seems trite, since these emotions are intrinsic to every human being.

To avoid being influenced by emotions in the market, we must first attempt to understand them. Deconstructing basic human emotions, we look first at the destructive emotional families that are rooted in anger and attachment. Anger, in our view, is a strong exaggeration of repulsion. When a stock initially goes down after buying it, most investors we know will automatically say, "I hate this stock. Why did I buy this dog?" Many times, doubt enters the equation, along with the bias to avoid loss, and we decide to sell. On the opposite side, when a stock goes up after a purchase, an individual naturally becomes attached. Quickly, the investor feels enthused and has a craving for more. He will say, "I love this stock—I need to buy and buy!"

Finally, we have to mention the correlated emotions of envy and pride. We often base decisions on envy, believing that someone else has much more than us or is "doing better" than us—leading to a feeling of not wanting to miss out. Envy and pride are the most dangerous emotions in the investing business because they emanate from both anger (at someone else) and attachment (to wealth)—a poisonous combination. Many investors fall victim to these above emotions as they seek to be wealthier and smarter than other market participants.

Bias

In addition to emotions, we all have cognitive bias. An example of cognitive bias is when we see someone with eyeglasses and our brain automatically concludes that this person is blessed with superior intellect. We are afflicted with many cognitive biases, but in the investment business the most prevalent are:

- loss and hurt avoidance
- confirmation bias (where we look for evidence to reinforce that we are right)
- hindsight or recency bias (the belief that a recent pattern of a stock's rise or fall determines its future)
- overconfidence bias (in automobile terms, the belief that we are better drivers than other people on the road)
- complexity bias (the belief that complex things reflect higher thinking and intelligence)—this one explains why many financial advisors tout "diversification strategy," "style boxes," "age and risk tolerance correlation," etc.—such terms lead the uninformed to perceive that a investment process is complex and requires their expert services

Now imagine how our natural bias tendencies interact with our emotions when we face a declining stock price (triggering both contempt and loss avoidance). If an investor wants to hold on to the stock, he rationally seeks confirmation that his decision was right—looking at a chart that displays the stock going up during a certain period of time, and relying on hindsight to support a hold-on or buy-more decision. If an investor is inclined toward a sell-out decision, she concentrates on the portion of the stock chart that displays a downward trend—again leaning on hindsight bias to support this decision. Clearly, our natural cognitive biases combined with emotions can create a schizophrenic state of mind, leading investors to quickly buy and sell based on intrinsic emotions and biases—a lethal combination.

Desire

The last "psychological anchor" that weighs us down is our natural desires. Maslow's hierarchy of needs identifies basic human needs such as our desire for food and shelter, as well as safety and security that motivate our actions. Homing in on desires that impact our investing activity: Human beings live as a homogeneous group, and we all have a desire to belong, or "fit in." This desire for conformity creates an environment conducive to "groupthink" and "following the crowd." If everyone is buying a certain stock, or successfully getting rich flipping real estate, there is a strong pull to participate.

In addition to a desire to conform, we have a strong desire for happiness. All human beings pursue this elusive desire—and, ironically, very few individuals describe themselves as truly happy. We will avoid an ideological debate about what constitutes true happiness and focus on the fact that, for some reason, it is widely believed that wealth is a means to bringing about greater personal happiness. Perhaps the pursuit of happiness through expanded wealth is rooted in a chemical reaction that induces a feeling of temporary pleasure—as a stock goes up, we feel good as our fortune increases. We have a strong desire for a euphoric state of happiness, and this natural yearning pulls us in many directions—including what many may describe as false, or materialistic, happiness. Regardless, much of our investing prowess can be traced to a desire to fulfill this basic need.

Now to a big one—the desire for superior intelligence. We believe this human desire is so strong that it leads to tremendous mistakes. The pull to always be "right" influences our human behavior in ways that often lead to irrational behavior. By nature, we are "answer- and solution-seeking," tending not to believe that we can learn from others and therefore pursuing "self(ish) knowledge"—and getting caught up in minutiae thinking in the process. As the saying goes, we "dig ourselves into a hole." How many times have we witnessed an individual defending his argument even after being proven wrong? The investment world is a magnet for intelligent individuals and, oddly, it is a profession in which most feel they have a particular expertise, along with superior intellect. With this context, we can see why many individuals fall victim to "stock tips" provided by "Young Turk" "Ivy Leaguers" in the investment business—ignoring older or more experienced individuals who may offer old-fashioned and proven rational advice.

Now for the lollapalooza: When we combine our stream of consciousness—the continued, unedited flow of thought—with our inclination to complete a story (or forecast the future) as well as our emotions, biases, and desires, we end up with some crazy combinations. To illustrate: Imagine the father on the occasion of his daughter's first date. She says she is "just going out for some ice cream" with a nice boy she just met, and will "be back home in a few hours." The boy pulls into the driveway in a Porsche. He slickly steps out to greet the daughter, and during introductions the father learns that he is three years older than his daughter. He quickly asks, "So where exactly are you going—ice cream? Will you be home in an hour?" At this point, the daughter delivers the "old-man look," and as she rolls her eyes and gets into the car, the father can see that she is thinking, "Doesn't he trust me?" Of course, the issue is not about trust— a hypothetical story has quickly developed in the father's mind fueled by emotions as well as a mix of biases (perhaps hindsight bias—"seen this before") and a desire to ensure his daughter's safety and happiness.

This story is analogous to the individual who hears about a stock through a knowledgeable friend that appears to be wealthy. He buys the stock, it goes up, he becomes emotionally attached, and he wants to buy more. Watching others flock to the stock confirms superior intellect. Looking at chart patterns (i.e., hindsight bias), he dreams of how he is going to spend the newfound fortune as the stock defies gravity and grows to the stars. This story usually ends in disaster, as Sam and Isaac learned.

An Unnatural Approach to Investing

> **"More money is made in the end by an oversupply of caution than by indiscriminate recklessness."**
>
> **"Railroads and real estate are the things I like. Before deciding on an investment, I seek out every kind of information about it."**
>
> **"Never speculate in Wall Street; eat slowly; don't stay up all night; don't drink ice water; keep out of drafts."**
>
> **—Hetty Green**

Before the Oracle of Omaha Came the Witch of Wall Street

Around the same time as Mark Twain, there was an investor who was active in the market but most people have never heard of. When we think of "value investing," we know that the father of this method was Benjamin Graham, and his famous student—the Oracle of Omaha (Warren Buffett)—took his concept to a new level. All this is true, but the practice of value investing can actually be traced back even further, to the "Witch of Wall Street"—Hetty Green.

Hetty Green built a fortune by taking advantage of stock market extremes and practicing a more conservative approach to investing when market opportunities were not clear and obvious. She didn't trade in and out of the markets on a regular basis and was not interested in making a few percentage points by guessing the short-term direction of a particular stock. Mrs. Green would buy and hold stocks for years—even decades. She referred to herself as an "investor"—a relatively new term in the early 1900s that was rarely used on Wall Street.

Mrs. Green had an encyclopedic knowledge of the market and her own finances. She constantly updated a list of prices at which she would buy into or sell out of investments, keeping it all in her head for fear of lawyers getting their hands on written documents. When the world seemed to be falling apart and panic ran wild on Wall Street, she was a big buyer of stocks. When the party was booming and everyone was buying stocks, and her holdings seemed extremely overvalued, she would reluctantly, but shrewdly, sell certain stocks she had purchased in the last decline for many times her purchase price.

If this sounds "Buffettesque," you can imagine how wildly successful she was. If Ben Graham is the acknowledged "father of value investing," Hetty is its mother. She started with an inheritance of about $5 million, and by the time she died in 1916, Mrs. Green was thought to be the richest woman in the world, having accumulated approximately $150 million in assets (the equivalent of around $3 billion today). What was the difference between Hetty Green, and Mark Twain or Isaac Newton? Certainly it wasn't IQ.

The difference comes down to how Hetty Green managed and controlled the human psychological traits that impact all investors—Emotion, Bias, and Desire. She developed an "investment intelligence" that allowed her to take advantage of others' folly.

Mrs. Green was subject to emotions just like everyone else, but she thwarted their influence by practicing extreme humility and understanding. She wore the same black dress nearly every day, stuffing it with old newspaper scraps during the winter months to keep her coal charges low. (Children ran when she walked down the street because they had seen long black skirts only in pictures of witches—which earned her the nickname, the Witch of Wall Street.) She lived in low-rent apartments and munched on a raw onion all day as if it were an apple, explaining that it staved off hunger and saved on grocery bills. She walked to the grocery store where she bought broken cookies in bulk because they were considerably less expensive. She also returned berry boxes to get her nickel deposit back. Hetty was a student of businesses and stated, "Before deciding on an investment, I seek out every kind of information about it." She wanted to thoroughly understand where she was placing her money.

Her reputed living habits may have been extreme—she was an ardent Quaker—but the concept of focusing on humility and understanding to maintain rationality was a key practice that ensured that she did not indulge emotions in the market.

In addition to cultivating the behaviors of humility and understanding, Hetty Green looked at the world differently to place her natural biases on the back burner. Instead of regarding stocks as a pieces of paper to be traded, like the rest of Wall Street, she looked at them as ownership portions of a business. She viewed the world from the inside-out as opposed to outside-in—practicing “opposite thinking.” She described the secret of her investment success by saying, “There is no great secret in fortune-making. All you do is buy cheap and sell dear, act with thrift and shrewdness, and be persistent.” As we can see, Hetty was extremely diligent and disciplined, practicing a conservative investment philosophy that can be described as pretty simple—even for that time. Once she purchased a company, she would maintain her holdings over the long term. In addition, she absolutely stuck with what she “knew” and did not stray from her well-defined sphere of competence—for example, she stated that she liked *certain* railroads and real estate.

To overcome the natural desires of superior intelligence, conformity, and false happiness, Hetty focused on being a curious and passionate learner who consistently gathered collective knowledge to minimize risk while studying businesses in which to invest. She looked for facts when identifying good companies and was attracted to businesses that were well-managed. Hetty did not seek answers, but sought alternatives to allocate her capital, understanding opportunity costs as well as the business risks associated with her invested funds. She would have laughed at the concept of “beta,” which was theorized decades later. Mrs. Green acted independently and was also a “systems thinker” who would look for interconnections that could benefit her. For example, a story of her interaction with a renowned short-seller, Addison Cammack, illustrates Hetty’s ability to act independently and take advantage of market interconnections (a short-seller borrows shares, then collects money by selling them in the open market with the hope of making a profit by repurchasing the so-called rented shares at a lower price prior to delivering them back to the original owner):

Addison Cammack decided to sell short a large portion of the shares in the Louisville & Nashville Railroad Co., betting that the railroad stock was bound to fall. Hetty Green already owned millions of dollars' worth of the stock, thinking that this railroad was a well-run company. As Mr. Cammack continued to borrow and sell shares short, she watched and waited until no shares were available on the open market. Then she decided to place orders to acquire more shares at the now-lower price (it was extremely undervalued due to Mr. Cammack’s consistent short selling). However, given that few shares were on the market, Mr. Cammack got caught in a "short squeeze:" The stock took a sudden leap upward due to the imbalance of buyers and sellers, and Mr. Cammack began losing his shirt on his short. Mr. Cammack tried calling on Mrs. Green to buy her Louisville & Nashville Railroad shares to cover his short, but she refused to see him, leaving him to squirm. The following day the great short seller begged again to see her, and she relented, handing him a slip of paper showing him what she had paid for each of her 40,000 shares. She told Mr. Cammack that "just to be neighborly," instead of taking every penny he had, she would part with her stock for a mere $10 per share over her recent purchase price. Mr. Cammack handed her a check for approximately $400,000 and pronounced himself lucky to escape with his hide intact. We can also see by this story that Hetty Green, although very shrewd, emphasized fairness and cherished honesty and integrity.

The above description of Hetty Green is not meant to be a “Warren Buffett” broken record—it is meant to display how, since Wall Street’s inception, viewing the market as a conduit in which to buy portions of businesses has led to successful investing. Many individuals over the past century have traveled the pathway to wealth. However, few have been able to stay on this road due to the “curse” of human nature.

We cannot emphasize enough how important it is for investors to focus—and continually *re*focus—on training the mind to seek humility and understanding, look at the world differently, and become a curious and passionate learner who consistently gathers collective knowledge to minimize risk while studying businesses in which to invest. This enables the investor to minimize the inclination to indulge unconstructive “human nature” tendencies that are so prevalent in the market.

Striving for "True Investment Intelligence"

> **"The difference between stupidity and genius is that genius has its limits"**
> ***—Albert Einstein***

Someone once described true intelligence as encompassing two qualities: First, pure objectivity—the ability to control one's state of mind to be rational at all times. Second, pure wisdom—the ability to display complete understanding and humility. Very rarely, a person possesses this "perfect intelligence"—the capacity to be rational and objective at all times, while at the same time having wisdom to understand with unbounded humility. The rare humans that have maximized the ability to display these combined qualities have earned historical significance and admiration—stories are told, books are written, and most of us wish we possessed their intelligence.

In practice, a good investor attempts to bring these same general qualities to bear when seeking securities in which to invest. As with any profession, true investment intelligence is a constant pursuit. It is not something that is eventually reached. This is why, in our view, successful investing should be considered a journey rather than a destination.

Founders Approach and Current Position

As you can deduce, the Founders approach is to follow the investment practices of Hetty Green, Benjamin Graham, and Warren Buffett. We consider ourselves to be on a long journey, consistently striving for greater investment intelligence—maintaining a pure value investing focus.

Our current position can be summed up by a story from our 2008 letter about Jesse Livermore, who was active in the market around the same time as Mark Twain and Hetty Green:

Jesse was considered one of the greatest stock market speculators in history. He was so good at trading market trends that he foresaw the 1907 and 1929 stock market crashes—and leveraged what he recognized as opportunities to reap net gains of $3 million and $100 million during those times, respectively. Then Jesse proceeded to lose these fortunes, both times. Why? His own story about a character called Mr. Partridge, from the book, *Reminiscences of a Stock Operator,* explains his problem.

Mr. Partridge was an investor who was sought after by many stock traders for his wisdom and advice. They referred to him as "Old Turkey." Along with dispensing advice, Old Turkey apparently gathered tips and information on many companies from traders. When a trader knew that Mr. Partridge had purchased a position in a company based on their information, they felt compelled to advise him when to sell. Old Turkey's response was always the same: "You know, it's a bull market." One trader became extremely frustrated with Old Turkey's response and pushed for an explanation. Mr. Partridge stated: "I'd lose my position. And when you are as old as I am and you've been through as many booms and panics as I have, you'll know that to lose your position is something nobody can afford; not even John D. Rockefeller. I paid a high price for it and I don't feel like throwing away a second tuition fee."

Jesse Livermore emphasized what led to his reversals of fortunes. "After spending many years on Wall Street and after making and losing millions of dollars, I want to tell you this: It never was my thinking that made the big money for me. It was always my sitting. Got that? M*y sitting tight!*" In the end, Jesse Livermore concluded that not adhering to Old Turkey's rule was the main reason for his losses. (Jesse had given in to his emotions, biases, and desires.)

1) During these challenging times, Founders first and foremost plans to sit tight on our core holdings, which will allow us to escape the natural emotions circling markets and influencing individuals to trade fast and often in a frenetic pursuit of returns. *This behavior creates an accident waiting to happen.* We humbly acknowledge that we have little to no ability to "call" the right direction of the market, or to trade in-and-out effectively. We can say with conviction, however, that almost all individuals who practice this art eventually end up in ruin.

2) Founders will continue to understand exactly where we are placing our money. We will strive to avoid falling victim to biased thoughts, such as rear view-mirror thinking, where hindsight trends are used to anticipate future prices. This holds especially true for investing in opaque securities that we do not understand. We will "stick to our knitting" and only acquire companies that we know in depth and that are positioned to gain strength in any economic environment. We will focus on what is knowable and important, as opposed to what is unknowable and unimportant —essentially, we are determined to remain focused on what is in front of us.

As you will see in our Management's Discussion and Business Unit Review later in this report, throughout our discussion about the performance of our businesses this year, we point out the inherent business qualities that each of our companies possess that enable them to thrive under any economic condition.

3) Founders will continue pursuing our education—striving to be passionate and curious learners, seeing interconnections within our holdings, and seeking collective knowledge to understand the value of the assets we own. During perplexing times, it is essential that we ignore any inclination to compare ourselves to "market gamblers" or to conform to investment "crowdthink." As such, we will focus on the ability to calculate the approximate long-term value of the assets in our portfolio. Doing so will shore up confidence that the securities we hold possess sustainable competitive advantages and enduring value potential, allowing them to grow far into the future.

At Founders, we care deeply about the money 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 tightly to our value investing philosophy, and we seek to invest where intrinsic value grows over time. And we always act with honesty and integrity—there is no other way.

Although we are unable to provide exact answers to questions about any market's near-term direction, the display of emotional investing around the equity and fixed-income markets compels us to continue 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 remain confident that we possess securities at current 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 favorite Warren Buffett quote:

> **"We will continue to price, rather than time, our purchases. In our view, it is folly to forgo 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: 2014 Highlights

We will start this year's equity holdings review by emphasizing that we remain upbeat with our capital allocations, including the expected returns over the next 10 years—even knowing that there are challenges ahead. Why can we say this? A few points we'd like to reiterate regarding our companies:

- **We are confident in the high character displayed by the leadership of the companies in our portfolio** and think they are managed in a flexible manner that allows these businesses to adapt in changing times.
- **We approach our investments as partners that are focused on increasing long-term profitability,** as opposed to joining 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 truly wake up each morning knowing that the wonderful businesses we own—Coca-Cola, PepsiCo, Procter & Gamble, United Technologies, Lockheed Martin, CSX, Johnson & Johnson, Medtronic, DaVita, Microsoft, Intel, IBM, Berkshire Hathaway, Home Depot, Disney, Chevron, Conoco, and our other holdings—continue to strengthen their enterprises independent of any short-term gyrations in their stock prices.

Following is a summary of business highlights from our portfolio companies during 2014, along with our expectations for 2015. We will start with a review of our major purchases during the past 12 months:

Purchase of DaVita Healthcare Partners

During the 1st quarter, we made a large commitment to DaVita Healthcare Partners, a healthcare service company that administers kidney care and dialysis services throughout the U.S. In addition, the company also manages and operates medical groups, a network of primary care physicians, urgent care centers, and ambulatory surgery centers.

DaVita's kidney dialysis division represents 80% of the company's business and is one of the two largest dialysis providers in the U.S., along with Fresenius Medical Care AG & Co. DaVita's U.S. dialysis and related lab service businesses operate through a network of more than 2,150 outpatient dialysis centers throughout the U.S. that serve approximately 170,000 patients, representing an estimated 34% market share of the U.S.-based dialysis business. The company also is growing internationally, with 87 outpatient dialysis centers located in 10 countries outside of the U.S.

The dialysis business is predictably steady due to a stable patient base, which we believe will continue owing to a growing need for dialysis services. According to the United States Renal Data System, the U.S. dialysis patient population has grown at a rate of approximately 4% annually over the past several years. Given the aging population and increase in prevalence of diagnosed diabetes, DaVita expects the growth rate to continue at 4% per year in the near future. In addition, since DaVita is on the forefront of developing relationships with referring physicians—as well as offering quality clinical care that will lead to reduced patient mortality rates—the company's size and broad patient service capabilities position it to grow further and to consolidate the industry through the acquisition of new dialysis centers.

DaVita also owns HealthCare partners (HCP). HCP is a patient- and physician-focused, integrated health care delivery and management company that has been providing coordinated, outcomes-based medical care in a cost-effective manner for nearly three decades. Through capitation contracts with some of the nation's leading health plans, HCP currently has more than 835,000 members under its care in California, Arizona, Nevada, Florida, and New Mexico.

HCP is a growing business for DaVita, as physician networks are developing due to lower reimbursement rates, as well as administrative complexity. HCP plans to add partnerships and joint ventures to its network, positioning the company to provide high growth as well as high returns. A significant note: HCP has stated that new growth opportunities may actually be higher than projected; the company is seeing more opportunities for growth that come with lower capital requirements compared to typical mergers and acquisitions, as this is not a capital-intensive business. The company envisions opportunities from three- and four-way joint-venture partnerships that help physicians, hospitals, and/or payers overcome hurdles to implementing new value-based reimbursement models. The joint venture structure provides a platform for lower capital requirements and potential for a high return on investment.

In 2014, DaVita expected to finish the year with revenues exceeding $12.5 billion, operating income of $1.8 billion—including $1.5 billion from dialysis and ancillary services—and approximately $300 million from HCP. We think the company is positioned to grow annual earnings over the next 10 years of between 12% and 15% and believe the company's valuation is higher than its current selling price.

In summary, the stability of DaVita's dialysis business due to recurring revenues through ongoing patient visits contributes to strong margin performance and robust cash-flow generation. We expect that DaVita will continue to grow through both investments in new dialysis centers and modest-size acquisitions. The HCP business represents a tremendous growth opportunity for the future of this company as healthcare practices consolidate in the coming decade. HCP is one of the best physician practice platforms in the country, with a model that stands to benefit from the long-term shift that is under way in healthcare reimbursement from traditional fee-for-service to incentives for quality and cost control. Combining the steady growth and cash generation of the company's core dialysis business with the best physician practice management asset in the country, DaVita HealthCare Partners is positioned at the forefront of a potentially long-term shift in healthcare delivery and reimbursement as healthcare reform is implemented.

Our Investment in Communications—AT&T

During the 2nd quarter, we made a commitment to AT&T. Just about everyone is aware of AT&T, the communications juggernaut that has been in operation for more than 135 years.

A brief history: The company that eventually became AT&T started as an arrangement between inventor Alexander Graham Bell, Gardiner Hubbard, and Thomas Sanders (Hubbard and Sanders agreed to finance Bell's work). At the time, Bell was trying to invent a talking telegraph—i.e., the telephone. Of course, he succeeded, and in 1877 the three men formed the Bell Telephone Company. Now for the good part: The first telephone exchange, which operated under a license from Bell Telephone in 1878, opened right here in Connecticut—in New Haven. Within three years, telephone exchanges existed in most major cities and towns in the U.S., operating under licenses from what had now become the American Bell Telephone Company. The American Telephone and Telegraph Company (AT&T) was incorporated on March 3, 1885 as a wholly owned subsidiary of American Bell. Its charter was to build and operate the original long-distance telephone network. Within a short time frame, just about everyone in America adopted the telephone as a major source of communication.

What is interesting to business aficionados is that for much of its history, AT&T functioned as a legally sanctioned, regulated monopoly. The fundamental principle, formulated by AT&T president Theodore Vail in 1907, was that the telephone—by the nature of its technology—would operate most efficiently as a monopoly that provided universal service to all citizens. Vail wrote in that year's AT&T annual report that government regulation, "provided it is independent, intelligent, considerate, thorough, and just," was an appropriate and acceptable substitute for the competitive marketplace. Given the importance of the telephone to the communication infrastructure, the U.S. government accepted this principle through a 1913 agreement known as the Kingsbury Commitment.

For the next 70 or so years, AT&T acted as a regulated utility, providing fair service at a fair price to its customers. As such, investors in AT&T were offered a steady and reliable return. AT&T's stranglehold over the communications network eventually was challenged, however, leading to an antitrust suit by the U.S. government against the company. The suit began in 1974 and was settled in January 1982, when AT&T agreed to divest itself of the wholly owned Bell operating companies that provided local exchange service. The government believed that separating the local exchanges would lead to competition that would lower prices to consumers as well as break up a monopoly that had existed for approximately 100 years.

With the breakup of the conglomerate into regional telephone companies, long-distance telephone service became a fiercely competitive business. Over a 12-year period beginning in 1984, AT&T's market share fell from more than 90% to around 50%. It turned out that the government was right—telecommunication prices plummeted, dropping by an average of 40% by the late 1980s. St. Consequence also resulted, and volume exploded. In 1984, AT&T had carried an average of 37.5 million calls per average business day; by 1989, the equivalent volume was 105.9 million, and 270 million in 1999—a new communications era had been born. With the advent of the Internet, an ever-increasing percentage of the traffic on AT&T's network was data and video rather than voice, and AT&T "2.0" evolved from a long-distance company to an integrated voice and data communications business.

The renewed AT&T has become a global Internet Protocol (IP) networking provider dedicated to delivering powerful networks, applications, and capabilities to business, government and consumers. Today's AT&T provides sophisticated communication services, including wireless technology, broadband, and Voice over Internet Protocol (VoIP) for consumers and businesses.

This background brings us to our current investment opportunity. AT&T continues to expand its communication capabilities, having announced a $48.5 billion acquisition of DirecTV. DirecTV is a leading satellite broadcast provider of digital television entertainment in the U.S. and Latin America. Satellite broadcasting is an alternative to cable service. With a subscriber base of more than 20 million in the U.S. and more than 18 million throughout Latin America, DirecTV is currently a $33 billion business that generates $2.8 billion in annual profits. The company's famous "NFL SUNDAY TICKET" package allows subscribers to view the largest selection of NFL games each Sunday during the regular football season.

We believe that the combination of AT&T and DirecTV enables these companies to leverage their unique capabilities to take advantage of a global communications opportunity (look for even further growth via acquisitions in Latin America). AT&T's expertise and offerings in networking, wireless, broadband, and IP, coupled with DirecTV's satellite broadcasting network, creates a powerful platform for AT&T to expand globally. This acquisition will further magnify AT&T's data and video capabilities, offering consumers unprecedented access to video content on any device. The combination of these two companies is currently undergoing regulatory approval, and we are hopeful that this transaction will be completed by mid 2015.

In the meantime, AT&T represents an enticing investment by itself. The company will produce around $13.2 billion of profits during 2014 and distribute more than $12 billion of earnings to shareholders through dividends and share repurchases. AT&T's 5.6% year-end dividend is among the highest of large companies and can be considered a fixed-income investment. We are excited owners of AT&T and believe that we are being provided fair compensation today, with a global growth opportunity in the future.

CONSUMER GROUP

Our primary consumer holdings—Coca-Cola, PepsiCo, and Procter & Gamble—continued to grow their global franchises during 2014, despite tough economic conditions outside of the U.S. In aggregate, we expect our consumer group to produce ever-increasing results again in 2015 (as well as in 2016, 2017, etc.). We place these companies in the "best-managed businesses" category as we witness each entity strive to balance its business investment program with capital returned to shareholders.

How can our consumer group perform well, even under stressed global economic conditions?

1. There is a consistent purchase pattern among their product categories that creates an efficient long-term revenue and profit stream. You can imagine the daily consumption of Coca-Cola, PepsiCo, and Procter & Gamble products on a worldwide basis. Regardless of the country, every mother is going to wash clothes with some type of detergent, children will continue brushing their teeth, and most men and women will continue shaving—all using Procter & Gamble products, including Tide®, Crest® and Gillette® razors—almost daily. In addition, every day, more than 1.6 billion human beings around the globe consume an estimated 55 billion servings of non-water beverages—Coke® and Pepsi® represent more than two billion (4%) of these "other than water" beverage servings, and their market share is growing. Although the total consumption of Coca-Cola and Pepsi equates to more than 100 servings per person on the planet, there is still a lot more room for grabbing market share!

2. Consistent purchase patterns and high product turnover allow these consumer companies to effectively utilize assets. If a business needs to invest vast sums of money into property, physical plant, and equipment to produce consumer goods, a steady unit sales pattern accompanying these assets leads to consistent production efficiency—maximizing the return on each dollar invested in the business. In other words, these businesses produce a lot of cash for their owners.

3. The art of making Tide, Crest, or concentration syrup for Coca-Cola and Pepsi products has not changed in decades—which means associated property, plant, and equipment last for years. During difficult economic times, these companies can "withhold" large capital expenditures. This is very important, as these businesses can continue to increase their penetration in growing parts of the world with minimal reinvestment, even as economies undergo temporary setbacks. Eventually, when good economic times return, these businesses are ready to invest further to capture the higher consumption rates that accompany an expanding global economy.

Businesses that do not share the above attributes—for example, manufacturers of large appliances, automobiles, or heavy machinery—suffer under difficult economic environments as purchases for their large, expensive items decline precipitously. Because these businesses that are more capital-intensive experience slower and erratic product turnover, they are not usually good long-term investments.

Coca-Cola, PepsiCo, and Procter & Gamble can be placed in the "great business" category—enterprises that stand the test of time (both good and bad). Given their global strength, product diversity, and cultural depth, 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 that 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 superior intrinsic value, underscored by their long-term value-creation potential.

Coca-Cola

The Coca-Cola Company is a large holding in our portfolio, and one that we have held since Founders Capital Management was formed. We have no intention of selling (or cutting back) our position—in fact, we will likely increase our holding over time. With this as background, we encountered an instance this past year that required us to write Coca-Cola's board of directors. Although Founders is a relatively small holder of Coke's overall stock, we are nevertheless among the top 575 shareholders and believed that our (rare) action to send a letter was a necessary step.

Coca-Cola's 2014 Executive Compensation Plan

As we have discussed in the past, in addition to salary and cash bonuses, executives usually have an opportunity to participate with shareholders when gains in business value result from management's contribution. The additional remuneration for creating value on behalf of shareholders is usually provided through stock options and/or stock grants. At the beginning of 2014, a proposed new Coca-Cola executive compensation plan stirred controversy regarding the plan's potential negative impact on its owners.

At the company's annual meeting in April 2014, Coca-Cola put forth a new executive compensation plan that required approval through a shareholder vote. Although Founders voted against the plan after reviewing the proposal, the executive compensation plan passed with flying colors (most shareholders do not vote their shares). Nevertheless, there was disagreement among those who did vote, and it is instructive to review the 2014 Equity Plan, as several stockholders (including Warren Buffett) questioned its financial impact on owners.

The crux of the 2014 compensation plan was the reservation of 500 million shares of Coca-Cola stock, to be available for issuance during the next four years to award executives that met or exceeded performance criteria outlined by the company's board. (To provide perspective: There were about 4.4 billion outstanding Coca-Cola shares at the time of the proposed plan—and so reserving 500 million additional shares for issuance to executives was a lot). In the company's 2014 proxy statement that accompanied the annual report, Coca-Cola provided an illustration of the potential dilution to shareholders in the event that all 500 million shares were issued via a mix of 60% options and 40% full-value stock rewards. In this case, the company explained, an approximately 14% dilution to shareholders would occur. However, this dilution would be mitigated through share repurchases in the open market from executive proceeds exercising their options, as well as with cash flow generated by the company—essentially, through profits.

On reading the 2014 Coca-Cola Proxy Statement, David Winters, fund manager of Wintergreen Advisers, claimed that the 2014 compensation and equity plan was an "outrageous grab" by management that would open a big gap between how much of Coke's profit goes to shareholders and how much goes to Coke's top officers. Wintergreen Advisers, which owns about 2.8 million shares of Coca-Cola, calculated that the plan represented a $24 billion gift to Coke's management and came out vigorously against the 2014 Equity Plan with a letter to Coca-Cola's board, coupled with a campaign to gain fellow shareholder backing. This movement also included a direct attempt to gain support from Warren Buffett (Berkshire Hathaway is Coca-Cola's largest shareholder, with more than 9% ownership). Warren Buffett weighed in, agreeing that the compensation plan was excessive, but disagreeing on the dilution impact, stating that the impact was near 2.5%, not the 14.2% outlined in the 2014 Coca-Cola Proxy Statement or by David Winters.

The first question: What accounts for the disparity between the dilution calculated for the 2014 Equity Plan by the Coca-Cola Co. and David Winters and the dilution calculated by Warren Buffett?

Restricted Stock and Stock Option Rewards

There are several challenging issues when evaluating executive stock compensation at most corporations today. A restricted stock grant is usually an award of company stock whereby the recipient's rights in the stock are restricted until the shares vest. In other words, an executive may be granted 1,500 shares of full-value stock, but it may vest over a three-year "vesting period." Once the vesting requirements are met, an employee owns the shares outright and may treat them as he would any other share of stock in his account. The calculation for valuing restricted stock grants is fairly straightforward—executives are granted a number of shares at an approximate price around each anniversary year of the equity plan. The value of the stock at the time of the grant is equal to the dollar value of the reward.

The valuation for stock options is different from that of restricted stock and is determined by several moving variables that are not used in the calculation to value full-value stock awards. One major difference is the "interest-free loan" provided to executives on the day the stock options are granted. For example, a Coca-Cola executive that is granted an option to purchase 100 shares of Coca-Cola at $40 per share will not have to pay the initial $4,000 to acquire his stock for up to 10 years.

To illustrate the financial impact this stock option-related loan has on owners, we will share one family's experience: When a wife and husband were expecting their first child, the husband's company transferred them to upstate New York. The couple was anxious to "start their family" and proceeded to purchase their first house—a small cape with an unfinished second floor. A few weeks prior to closing, they encountered the usual unexpected costs. The wife's grandmother offered the couple an interest-free loan to be paid back over time. The couple did not fully appreciate the significance of that loan—which, in effect, enabled them to invest unpaid interest to finish other parts of the house—until many years later.

Stock options that are used as part of an executive compensation program are similar to the grandmother's interest-free loan—the strike price of the option remains fixed once it is granted, and the executive delays payment for this fixed portion of the stock for many years—up to a decade. The grandmother may have felt good about her gift to her granddaughter, but we can guarantee that as a stockholder in a company, she would not have been happy to provide that same gift to the CEO.

At the outset, there are several questions shareholders have to ask regarding the value of stock options provided under the plan:

1. *How many options will actually be granted from the proposed equity plan (based on executives achieving the performance objectives outlined by the board of directors)*
2. *What will be the "average strike price" on options granted over the duration of the equity plan?*
3. *Once granted, what length of time are options allowed to be exercisable by executives participating in the equity plan?*
4. *How long will executives hold on to their options (i.e., free loans) prior to exercising?*
5. *What will be the "per-share value" of the company at the time the options are exercised over the life of the plan?*

Providing specific answers to these questions is nearly impossible, which leads to different assumptions that can create a large disparity when forecasting shareholder dilution from an equity plan. In the case of Coca-Cola's 2014 Equity Plan, if one assumes that options granted at $40 per share will be exercised in four years, and the value of Coke's stock will be $60 per share in 48 months, then the executive will make approximately $20 (the difference between the $60 share price and $40 strike price) on each share granted as part of his compensation. Therefore, if an executive is granted an opportunity to purchase 1,000,000 shares of Coke's stock at $40 per share over the next four years and waits 48 months to exercise his option when Coke is selling at $60 per share, he will profit $20,000,000 pre-tax—*not a bad day.* (Of course, our executive will need to come up with $40 million to cover the exercise price at $40 per share—a tall order.)

Now here is where things can get fuzzy: If the executive is allowed to hold on to his options for a total of 10 years, and Coke's per-share value grows at 7.5% per year, then Coca-Cola's stock will likely sell at around $92 per share at the 10-year point. At that price, the executive stands to make $52 per share granted (the difference between the $40 grant price in 2014 and the $92 exercise price in 10 years). Now, I don't know about you, but it would make a lot of sense for executives to hold out as long as possible prior to exercising their options, given that they have a free loan; defer the need to come up with $40 million, and let the company's value increase each year during the allowable exercise period—and most executives do just that. In this scenario, our executive would make an additional $32 million by stretching the right to exercise his options from four to 10 years.

Based on this fact, our calculation for Coca-Cola's dilution to shareholders over the four-year life of the 2014 Equity Plan was 3.5%, or .875% per year. This translates into a nearly 1% dilution per year—in our opinion, this is high executive compensation for the value delivered. After the favorable vote by shareholders, given the negative economics of this plan, we felt it necessary to communicate our dissatisfaction and submitted a letter to Coca-Cola's board in April 2014 (the letter to Coca-Cola's board is provided as an attachment to this annual letter).

As a result of shareholder backlash, in October 2014, Coca-Cola announced a revision to its Equity Plan, stating that the company will now provide employees fewer shares and stock options and shift to more cash-based performance awards beginning in 2015. We are very happy with this result.

Additional Thoughts on Executive Compensation

Executive compensation continues to be a controversial subject that often raises eyebrows among owners of public companies. We sometimes see instances of a CEO who is underpaid, given the wealth created for shareholders during his tenure. More often, however, a CEO is paid handsomely for delivering average or below-average results, or even for leaving a company due to shareholder dissatisfaction.

Many investors, including Warren Buffett's business partner, Charlie Munger, believe that corporate management has become greedy about compensation. In Mr. Munger's view, "About half of American industry has grossly unfair compensation systems where the top executives are paid too much," a situation he attributes to simple envy. Senior managers feel entitled to compensation similar to that granted executives at companies of equivalent size (even if that compensation is inflated), and the compensation of senior managers actually increases with the size of the company. The CEO of a billion-dollar company, for example, usually earns more than the CEO of a half billion-dollar company. Of course, the size of a company's sales has little to do with the size of its profits. Perhaps this explains the desire of many senior management teams to enhance their company's sales through acquisitions, which translates into higher compensation for them.

Management compensation should reflect business performance, not size. If senior management achieves an average growth in sales, but the return on capital remains below average for their industry, it follows that their compensation should be correspondingly below average. Nevertheless, many corporate compensation committees, which hire consulting firms to compare compensation schemes of various companies, approve plans that have little or nothing to do with the effective allocation of capital.

Let's say that the CEO of ABC Company has been able to grow the return on $1,000,000 of invested capital from 15% to 20% over a two-year period. Owners would feel comfortable compensating this CEO for the extra $50,000 of potential owner earnings produced each year. Conversely, let's say that, during this same time frame, the CEO of XYZ Company grew the company's invested capital from $1,000,000 to $1,500,000, but the return on invested capital decreased from 15% to 10%. With no increase in potential owner earnings (assuming a constant cost of capital), this company's owners would not feel any wealthier, with the calculated return for the business remaining stagnant at $150,000. These owners would therefore feel less willing to compensate the CEO. Yet the CEO from XYZ Company will present to its board higher sales growth than that of ABC Company and expect equal—if not more—pay compared to his ABC Company counterpart. Now, watch out for the promise of future returns.

The most common scenario is a compensation scheme that rewards management for producing increased earnings that correspond with the increase in invested capital. Each year, management takes a portion of the retained earnings to support the future growth of the business. In this case, stock options grow in value as executives manage capital in an "average fashion." In fact, the more management takes, the more these give, even if the returns on retained earnings remain stagnant. Owners of companies with this compensation approach should consider increased executive compensation as additional invested capital—such was the case with Coca-Cola's 2014 Equity Plan.

While there are instances in which management has earned stock options and grants, with the resulting compensation being equitable, it is our opinion that stock options and grants do not necessarily place management and owners in a similar circle of ownership. Business owners continuously have a cost associated with their invested capital, as well as a risk of loss. Managers who receive stock options at a fixed price, along with full-value stock, only share in the growing wealth of the company, with no real risk of loss.

We would advocate several changes to the executive compensation programs that exist today. Alterations could be made to orient rewards toward owner value drivers. For example, a management compensation plan could be more heavily weighted toward the positive or negative long-term changes in growth and the return on invested capital. This would encourage management to truly participate in the growth of intrinsic value of the business. Once the compensation is determined, the payment could be in cash, with a portion required to be invested in the business through a purchase of the company's stock in the open market. If a portion of management compensation is stock options, the strike price should initially be set at a company's intrinsic value and should grow at a determined opportunity cost of capital—i.e., there should not be an interest-free loan associated with the granting of stock options. Of course, there are many potential variations to this type of approach; the goal is to place management and owners in a similar sphere when developing management compensation plans. Today, they are hardly in the same boat.

At this point, many may wonder why we did not reduce our position in Coca-Cola on the announcement of the 2014 Equity Plan—not a chance. Coca-Cola is a great business and, as it turned out, with the modification to the 2014 Equity Plan, we experienced a small "bump" in our relationship with Coca-Cola because *the company listened to its shareholders*.

During 2014, The Coca-Cola Company grew its overall volume by approximately 2% (similar to 2013). Growth remained slower than the annual 4%-5% annual volume growth achieved in previous years. Once again, the year's sluggish advance was impacted by several factors, including slower case volume growth in Eurasia and Africa (approximately +5% in 2014, compared to +9% in 2013 and +11% in 2012), and Latin America (+1% in 2014, versus +2% in 2013 and +5% in 2012). Over the past 12 months, North America remained relatively flat, while Europe showed year-over-year volume declines of approximately 2%. In addition to slower international growth, a negative currency exchange impacted sales, leading to another slight increase in year-over-year reported revenue. The bottom line: Coke's continued volume slowdown combined with an unfavorable currency exchange interfered with the company's 2014 earnings growth. The company will likely report $2.00 per share in earnings in 2014, on a par with the past few years.

When we evaluate Coca-Cola's long-term prospects, we are unfazed by the recent slowdown and remain confident in the company's long-term prospects. During this challenging economic time, Coca-Cola is embarking on streamlining its operations and implementing an efficiency program that will result in $3 billion in annual savings by 2019. The company is also evaluating new products that consumers are trending toward— taking a 17% stake in Monster Beverage Corporation, for example. In addition, Coke is being innovative by experimenting with new distribution and home consumption methods for cold beverages via the company's relationship and investment in Keurig Green Mountain. During the next five years, Coca-Cola will also refranchise the company-owned bottling network, freeing up capital to invest in other areas of the business. Finally, Coca-Cola is on track to take advantage of the two billion people around the world who will enter the middle class by 2020, keeping pace with a five-year, $30 billion investment in various markets around the globe. We like the above initiatives and believe that Coke will be positioned in the near future to renew its volume growth, enabling the company to achieve its long-term 5% target.

Coca-Cola still represents a tremendous global growth story for both customers and shareholders. The company will once again produce approximately $8.5 billion of cash for shareholders in 2014, and owner cash production will likely remain static in 2015 as the company reorganizes for the future. Coke currently pays an annual dividend of $1.22 per share, which represents an approximately 2.9% yield, and we think the company will increase its dividend again in 2015—to around $1.32 per share. Coca-Cola will also repurchase approximately $4 billion of stock during the next 12 months. The combined dividend and stock repurchases provides shareholders an approximate 5.2% "pass-through yield" at Coke's year-end price, compared to a 2.17% 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

PepsiCo enjoys business attributes—low capital intensity, with enduring consumer brands that have consistent purchasing patterns—that make it a magnet for investors seeking a value(able) investment opportunity. As Coca-Cola's largest competitor in the beverage space, PepsiCo is duplicating Coke's commitment to invest in key emerging markets such as India, China, etc. On the other hand, it pays to remember that PepsiCo is not a mirror image of our Coca-Cola investment. PepsiCo is much more than a beverage company—it is a dominant snack-food company. Its mainstay global snack business, which represents more than 60% of the company's operating profits, has a *tenfold* relative global market share advantage compared to its closest competitor. Now that is a great business.

Last year, we discussed how PepsiCo's diverse portfolio had become an attraction to alternative investment management firms (activist investing seems to be in vogue right now). As you may recall, one activist investment firm that took a toehold position in PepsiCo—Trian Partners—presented the following strategic recommendations to the PepsiCo board:

1) Merge with Mondelez International, a leading snack-food company spun off from Kraft, and/or

2) Split the company into two parts: The faster-growing snack-food business, and the slower-growth beverage business

We are pleased to report that neither of the above recommendations has been undertaken, and long-term shareholders have been rewarded for their patient investment in PepsiCo during 2014. Although the activist investment involvement created some angst in PepsiCo's management ranks, PepsiCo management has taken several steps that are creating long-term value, including:

1. Renewing the company's investment in both the beverage and snack-food brands
2. Focusing on better capital allocation to core businesses that deliver higher returns

As a result of these actions, PepsiCo's margins and profitability are beginning to increase and will likely return to pre- "poor capital allocation" days.

In 2013, we were rather critical of PepsiCo's past capital allocation program and pointed out how important effective capital allocation was to a CEO's job—especially at a company that has successfully produced 25%+ returns on employed equity capital. (The 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.) In 2014, we would like to recognize PepsiCo's CEO, Indra Nooyi, and her management team for addressing the concerns raised by shareholders—including us.

We firmly believe that PepsiCo's leadership is back on track, and we support the current dual beverage/snack structure as long as capital continues to be effectively allocated within the core businesses and for shareholders. Maybe we should thank Trian for putting PepsiCo's management team under a microscope and "lighting a small fire" under its capital (mis)allocation program. We are very pleased that Trian's proposals to force PepsiCo to overpay for other businesses, and/or to spend an inordinate amount of time "splitting this baby in two," have fallen by the wayside. PepsiCo's value is now being realized by the company "sticking to its knitting" and building its wonderful core snack-food and beverage businesses.

In 2014, PepsiCo continued to increase its return to shareholders, raising the annual dividend by more than 15%, from $2.27 per share to $2.62 per share. We expect PepsiCo to raise its dividend to approximately $2.75 per share in 2015, which implies a yield of 2.9% at the year-end stock price. In addition, we anticipate that the company will repurchase an additional $4 billion of stock in 2015. This action adds another 2.8% return to shareholders, reflecting a 5.7% pass-through yield. In 2015, we expect PepsiCo to grow its per-share earnings at 8%, producing around $4.90 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

Procter & Gamble (P&G)—another of our long-term consumer holdings—sells leading brands that we are all familiar with: Pampers®, Tide®, Ariel®, Always®, Pantene®, Gillette®, Bounty®, Dawn®, Gain®, Charmin®, Downy®, Crest®, Oral-B®, Olay®, Head & Shoulders®, Wella®, Vicks®, and Braun®.

Since 2012, P&G's worldwide net sales volume has remained relatively flat, at approximately $84 billion, with earnings per share rising 4% over this same period—to $4.22 per share in fiscal 2014 (excluding impairment charges). P&G has faced headwinds due to rising commodity and energy costs that impacted its businesses, 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 and profit growth the past few years. However, the current equation of lower energy prices combined with lower business costs should provide a tailwind to P&G in the next year.

Since taking over as CEO about 18 months ago, A.G. Laffley has been executing on a plan to strengthen P&G by reallocating dormant capital in non-core businesses and reigniting growth in core brands. In the past 12 months, P&G has announced the sale of non-core brands, such as the sale of Iams® pet foods to Mars for $2.9 billion; and the sale of Duracell® to Berkshire Hathaway through an exchange of Berkshire-held P&G stock for Duracell stock valued at $3.0 billion, plus $1.7 billion cash. (We will discuss the value of this deal for both sides in our Berkshire Hathaway review later in this report.) Mr. Laffley is also executing on lowering P&G's cost structure and remains committed to the organization's five-year, $10 billion cost-savings initiative announced in 2012.

We believe these necessary actions will create long-term shareholder value and are excited to see a broadening execution of Mr. Laffley's plan. We continue to believe that P&G will remain highly profitable and will continue to renew its growth as the middle-class market develops around the globe. We expect the company's core earnings to be approximately $4.50 per share during calendar 2015, and that all $12 billion in profits will be returned to shareholders in the form of dividends (approximately $7 billion, or $2.57 per share) and share repurchases (approximately $5 billion). The combined dividend and stock repurchases provides shareholders an approximately 5% pass-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 very profitable in 2014, and we expect these businesses to produce even better results in 2015.

Our industrial group is largely represented by infrastructure businesses that 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 Martin are exceptional in that these companies initially contract to sell their products at a low profit margin and then strike high profit-margin contracts to service the products over their lifespan. For example, when UTC installs elevators and air-conditioning units in 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 the 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 due 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, it is likely that 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

As many already know, our interest in railroads has been in place since 2007, when we began purchasing Burlington Northern Santa Fe. Once Burlington Northern Santa Fe railroad was purchased by Warren Buffett of Berkshire Hathaway in February 2010, our railroad investment went a bit off track, but we took some solace in the fact that it was being purchased by Berkshire—our largest holding. Since that time, we have not allocated money to a railroad because the relationship between price and value failed to meet our test. (In short: We wanted a better bargain.) Finally, CSX hit our "strike zone," so we began to purchase it 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. The rail industry has undergone consolidation over the past 185 years, resulting in the 1980 merger of the Chessie System and Seaboard Coast Line Industries, forming what we know today as CSX.

As one of two major north/south railroads, 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 85,000 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 2014, CSX generated $12.5 billion in revenue and served three primary lines of business:

1) The **merchandise business** ships approximately 2.9 million carloads (up 6% year-over-year) and generates 62% of revenue and 43% 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** remained static and ships approximately 1.2 million carloads, accounting for nearly 23% of revenue and 18% of volume. Due to softening demand in this business, a year-over-year 4% increase in coal volume was offset by a 4% decline in coal revenue. Despite the stationary nature of the coal business, it is a strong category as the company continues to transport domestic coal to electricity-generating power plants, steel manufacturers, and industrial plants over a great part of the U.S.

3) The **intermodal business** accounts for approximately 15% of revenue and 39% of volume, and volume increased 6% year-over-year. 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.

While CSX is heavily leveraged to the price of coal, it is becoming less so as other business lines continue to grow. For example, the merchandise business continues to flourish through CSX's reach 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. On one hand, CSX obviously provides outbound transportation to companies producing oil from shale oil wells. On the other hand, what is not as obvious is the inbound transportation of drilling supplies (sand and chemicals) used to drill the hundreds of wells. Given that the average "frac project" (to drill for shale oil) requires one million pounds of sand or other chemicals/commodities, this inbound transportation of goods has become a major source of revenue growth for CSX. We expect this positive development to continue over the long term—although not in a straight line—as America's oil production continues to rise. The current reduction in oil prices may slow drilling in 2015, and this could negatively impact CSX's merchandise shipments in the short term.

CSX also has a tremendous growth opportunity in the intermodal business that should offset much of the anticipated slowdown in the merchandise business. We are particularly excited about CSX's southern and southwest rail network, which is perfectly aligned with the Panama Canal expansion that is now 85% complete. During 2015, the Panama Canal is due to inaugurate a third set of locks, and this added capacity will not only increase the throughput of the canal, but will also accommodate significantly larger vessels. Currently, 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 global freight movement as container ships larger than the Panamex will be able to pass through the canal once the expansion is completed. Previously, these larger ships could not reach the U.S. east coast from Asia without a lengthy diversion around the tip of South America or through the Suez Canal. As a result, west coast ports in the U.S. accept some 75% of Asian traffic, and this 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 import freight to bypass the transcontinental trip on western railroads. Most ports on the U.S. east coast are finalizing a build-out in anticipation of larger ships entering ports such as Houston, Charleston, Hampton Roads, and New York. It is expected 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 the east coast ports.

Tying Together U.S. Energy and the Panama Canal Expansion

The Panama Canal expansion will be significant for the U.S. economy as this development will prepare our country to become one of the world's main exporters of energy. Large ships carrying U.S. gas and oil from the Gulf of Mexico or the east coast will be able to pass through the canal and onto big markets in Asia, such as China, South Korea, and Japan. (Japan will become a very important market for U.S. gas as the country phases out of using nuclear energy following the Fukushima disaster. The journey time for large ships from the U.S. to Japan through the expanded Panama waterway will be cut by up to 20 days.) Besides U.S. gas and oil, the canal could also be used to ship larger volumes of other commodities such as coal and iron ore to destinations throughout Asia. Clearly, a double benefit will materialize for CSX as the growth of imports and exports via expanded east coast ports creates an environment for additional freight revenues and profits.

During 2014, CSX passed $1.15 billion of cash over to shareholders in the form of dividends (around $630 million) and share repurchases (another $520 million). In 2015, we expect CSX to distribute an additional $1.25 billion to shareholders through a combined dividend and stock repurchase program. This provides shareholders an approximate 3.5% pass-through yield at CSX's year-end price, and we believe that this yield will grow as freight traffic increases over CSX's fixed-rail network.

In summary, we think our investment in CSX is an opportunity to participate in the continued growth of the U.S. The growth in CSX's freight volume will endure over the next decade and may increase a lot more than many 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. The projected increase in volume, coupled with lower expenses, will further leverage CSX's income and cash available for shareholders. We will remain long-term 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. Each one 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.

UTC has tremendous global reach in each of its business units. For example, China is now Otis elevator's largest market, representing 20% of this company's revenue. Otis continues to grow as China develops and is providing 225 elevators and escalators for the 117-story Golden Finance Building in Tianjin. In India, Otis secured the country's largest elevator and escalator contract, supplying 670 units for the massive Hyderabad Metro Rail Project.

In addition to building development, UTC is heavily involved in providing commercial and military applications, parts, and services. For example, by the end of this decade, Pratt & Whitney will be producing engines at rates not seen since the early 1980s when the company was a dominant jet engine producer. Pratt & Whitney is delivering the next-generation jet engine that will power the F-35 fighter jet—with more than 3,000 expected jet deliveries in the coming decades.

The above examples serve to demonstrate UTC's business model: Focus on the installation of large infrastructure products, and then derive much of the company's future revenue from servicing agreements. Aftermarket services currently generate more than 40% of the company's $65 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, UTC can also be viewed as a long-term fixed-income investment. The company is expected to produce approximately $7.20 per share in cash in 2015, an increase of 5% over 2014. When comparing the forward cash stream of $7.20 per share to the company's year-end stock price of $115.00 per share, investors are receiving an initial 6.26% yield on their UTC investment—and we expect this per-share cash yield to continue growing over the next decade. We are very enthusiastic owners of UTC 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, $44.5 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.

Prior to 2014, investments in the defense sector were out of favor due to ongoing uncertainty about the U.S. defense budget. This has now changed, as many market participants have recognized the ongoing necessity to invest in defense. Although we believe that the defense industry is likely to face budget reductions over the next 10 years, certain companies hold a strategic advantage in delivering "next-generation" defense products in the coming decades. For example, the U.S. military has contracted with Lockheed Martin to supply the F-35 fighter jet. The F-35 program is the largest defense project in the U.S., aimed at replacing the aging fleet of Air Force F-16, Navy F/A-18, and Marines AV-8B aircraft. This project will 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 pressures on the U.S. defense budget. (It is interesting to note that even though Lockheed Martin and United Technologies are the main contractors for the F-35, approximately 30% of this jet's value is produced overseas—providing crucial employment for many foreign countries during the global economic slowdown.)

Lockheed Martin produced approximately $11.20 per share in earnings during 2014 and distributed approximately $3.7 billion to shareholders through dividends and share buybacks. Lockheed Martin currently pays an annual dividend of $6.00 per share, which represents a 3.1% yield at the company's year-end stock price. Lockheed's dividend, coupled with its ongoing share repurchases, provides shareholders a 6.5% pass-through yield at the company's year-end stock price. Despite another healthy increase in stock price this past year, the company's high pass-through 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 2014, and we expect these medical businesses to continue growing in 2015.

Until the past 24 months, the healthcare industry was uncertain for investors due to "uncertainties about pending" healthcare reform legislation (i.e., the Affordable Care Act), as well as ongoing wrangling between government and industry parties over the management of increasing long-term healthcare costs.

Despite the recovery in healthcare-related stocks, we cannot forget that the U.S.'s large fiscal imbalance is due, in part, to the significant growth in healthcare spending. Healthcare spending is still growing at a faster rate than the U.S. Gross Domestic Product (GDP). Last year, we cited a 2013 report from The Commonwealth Fund that outlined the steady climb in healthcare spending as a share of U.S. GDP. Healthcare spending currently constitutes 18% of GDP, up from 14% in 2000 and 5% in 1960. Based on current projections, it is estimated that healthcare costs may exceed 20% of U.S. GDP by 2023. This situation is unsustainable and requires, among other measures, the long-term control of Medicare and Medicaid expenditures. One way to rein in Medicare and Medicaid's cost growth is through government-controlled pricing, which translates into lower profitability for the healthcare industry. With all the changes of the Affordable Care Act being implemented, along with possible future alterations to healthcare, it has become increasingly difficult to predict the future of companies involved in drug development, medical devices, and other healthcare-related fields. Thus, investors should exercise extra care when selecting companies in this sector.

We believe that the uncertainty about the healthcare sector has provided 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 has consistent purchasing patterns and strong loyalty from a growing global customer base. It is our opinion that both companies are positioned to do well as the world population both increases and ages in the coming decades.

Johnson & Johnson

Johnson & Johnson (J&J) is a large healthcare organization with 275 operating companies located in 60 countries, 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—39% of sales from drugs, 40% from medical devices, and the remaining 21% 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 organizational structure that allows each business to operate as an entrepreneurial company. The strength of a diverse organization can sometimes lead to complex management challenges—but under an entrepreneurial structure, each J&J business puts a heavy emphasis on growth.

Prior to 2013, J&J faced several challenges, including law suits that resulted from numerous product recalls that stemmed from manufacturing mishaps. Since J&J hired a new CEO, Alex Gorsky, this large company is back on track. In 2013 and 2014, Mr. Gorsky stepped back and re-emphasized J&J's purpose. He dusted off and prioritized J&J's 300-word credo established back in 1943 by the son of the company's founder, 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."

Although this seems easy on the surface, this document that describes 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, has renewed J&J's growth. During the past two years, J&J increased sales by more than 11% and profitability by more than 60%—from $10.5 billion to $17.1 billion. This "stick-to-the-knitting" approach led to a turnaround that we applaud.

During 2014, J&J will earn approximately $6.00 per share of adjusted earnings and should grow core earnings at 5% in 2015, to $6.30 per share. The company is expected to generate $17 billion of owner earnings in 2015 and will return much of this cash to stockholders through continual share repurchases (up to $7 billion) and $7.8 billion of dividends (a 2.7% dividend yield at the year-end stock price). We believe that 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 will remain a core 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.

Medtronic's Acquisition of Covidien

In our year-end 2013 letter, we discussed Medtronic's move to a "patient-centric" business model. During the 2nd quarter of 2014, Medtronic further expanded its patient-centric strategy with the announced acquisition of Covidien. The $42.9 billion announced purchase price for Covidien, encompassing $16.2 billion in cash and $26.7 billion in Medtronic stock, should be completed in early 2015. The combination of Medtronic and Covidien creates the largest medical device company, with $30 billion in revenues serving customers in 150 different countries. Following are several benefits that will result from this acquisition:

1. **Covidien greatly expands Medtronic's product offerings.** The acquisition broadens Medtronic's current portfolio of cardiovascular, spine, neuromodulation, and diabetes products to include Covidien's surgical, vascular, respiratory, and patient-monitoring products. There seems to be very little overlap between the Medtronic and Covidien product offerings, so we do not anticipate the Federal Trade Commission interfering with the ultimate deal consummation.

2. **The combination of Medtronic and Covidien is expected to result in at least $850 million of annual pre-tax cost synergies by the end of fiscal year 2018.** These synergies will result from benefits gained through optimizing the combined companies' global back-office, manufacturing, and supply-chain infrastructure, as well as the elimination of redundant public company costs.

3. **The deal will be tax-effective for Medtronic** as it will allow the company greater flexibility in deploying its cash. The deal will be structured as a tax inversion, whereby the "new Medtronic" will redomicile in Ireland and become Medtronic plc. (Covidien was domiciled in Ireland.) Covidien's tax rate is around 17%, while Medtronic's is approximately 19%. In addition to the deal allowing some modest tax-rate reduction, Medtronic will be able to more flexibly use cash to benefit shareholders. Medtronic's future free cash flow will no longer be trapped offshore, which will allow the company to return cash to the U.S. without significant tax penalties. This all leads to greater dividends and stock repurchases for shareholders in the future.

In summary, the Covidien acquisition creates greater product breadth and cost savings for Medtronic, as well as increased flexibility to allocate capital to shareholders. It is our estimation that a combined Medtronic and Covidien will generate $6.5 billion in free cash flow. We are excited about this opportunity and remain enthusiastic owners of Medtronic.

Independent of the Covidien acquisition, Medtronic's core business continued to grow in fiscal 2014. Sales increased an additional 3%, while adjusted earnings grew 5.5%, to $4.03 per share. During 2015/2016, we expect core Medtronic (ex-Covidien) sales and earnings growth of 3.5% and 8%, respectively. The company's approximately $4.3 billion of earnings are largely available for distribution to shareholders, representing a 6.1% look-through yield at the company's year-end price. Medtronic is returning money to shareholders via a $1.22 per-share dividend ($1.2 billion) and will likely continue its stock repurchase plan, acquiring over $2 billion of stock the next 12 months. Given Medtronic's current market strength in devices and future market opportunities via the Covidien acquisition, we will continue to hold this quality healthcare company in our portfolio over the long term.

TECHNOLOGY GROUP

Of all the businesses represented in our portfolio, the information technology (IT) sector is the toughest—business disruption occurs several times each decade, and therefore, industry participants and investors can never rest on the laurels of past success. The technology sector continued to be in a complete state of flux during 2014 as device miniaturization and cloud computing proliferated the marketplace. Given the inherent disorder and warp-speed change of the IT sector, it is very difficult to determine what companies will succeed or fail. Through new iPhone® and iPad® products, Apple has been a primary disrupter in the latest technology cycle, and further miniaturization lies ahead with the anticipated introduction of the Apple Watch® in early 2015. Amazon is aggressively adding technology disruption by offering cloud services to businesses and by selling its Fire TV, tablet, and phone products to consumers.

In essence, the downsizing of computerization enabled the fitting of a powerful computer into the palm of one's hand, and this capability has quickly moved to wearable devices. Computing miniaturization is driving a new generation of products that empower every individual to stay connected to the world at all times. This high-speed connectivity remains a challenge for 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.

Which companies will gain competitive control within the new IT ecosystem is anyone's guess. But we remain committed to the belief that an opportunity exists as investors "toss aside" the traditional/older companies in favor of new emerging companies that are popularized by new technology and the latest social media craze. The difference in price versus value is rather wide (and growing) with selective technology companies that maintain a strong competitive position, even in an evolving technology landscape.

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

Microsoft

Microsoft is a great example of how companies in the fast-paced change technology sector can influence financial results. Eighteen months ago, most technology experts described Microsoft as a "lost company" that remained out of touch with new technology that was overtaking the company's Windows franchise. Many pundits were predicting the eventual demise of Microsoft, labeling it the "last" technology company investors should own. Although we had not lost confidence with Microsoft over the long term and believed the company would adjust to the new technology environment, we became concerned with the growing uncertainty about the company's market position. Thus, we made a decision to reduce our holding in Microsoft as the company's core products seemed less dependable and defendable, as well as less predictable and protected. Well, a lot has changed with Microsoft in the past 12 months. New leadership provided by Satya Nadella, who brought to the company a background in cloud and enterprise computing, is putting Microsoft back at the forefront of technology change. What is shifting at Microsoft?

As a consumer revolution takes place in the technology area through device miniaturization, the portion of Microsoft's business that relies on devices such as PCs and phones is being more than replaced by Microsoft's service offerings to large businesses, such as enterprise applications and cloud services.

We have previously 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 (i.e., 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 in their IT spending budgets.

This is an area of the technology business that is very "sticky," as corporations are not as fickle as consumers who change products at a heartbeat. While Microsoft will likely face ongoing headwinds on the consumer side that will take some time to work through, we believe that there is a strong case for the company to emerge as a dominant player in corporate computing. The "utilitization" of the enterprise and cloud segments of the business is very attractive as well as highly profitable due to their long-term annuity-like attributes. For example, Microsoft's Enterprise segment, which currently accounts for approximately 57% of total revenue, is larger and more profitable (with an 82% gross margin) than the consumer business (a 46% gross margin). In addition, Microsoft's adaptation to cloud services has been rather smooth, and Mr. Nadella has stated that cloud computing will remain a high priority. The company reported that Azure, Office 365, and Dynamics Customer Relationship Management (CRM) Online collectively grew more than 125% compared to the previous year. This represents a $4.4+ billion fast-growing business that has quickly become 5% of the company's revenue. Visibly, the stage is set for Microsoft—with its 100+ datacenters—to be a major beneficiary of the cloud computing trend.

As you can imagine, Microsoft had very good business results in 2014, and we expect even better results in 2015. Microsoft's adjusted earnings were $2.77 per share in its fiscal year-end (June 2014) and are expected to reach $3.16 per share in fiscal 2015—a growth of 14%. In the next 12 months, Microsoft will again generate more than $25 billion of owner earnings and will return approximately $20 billion of cash to stockholders through net share repurchases of $11 billion and around $9 billion of dividends (an approximately 5.2% pass-through yield at the year-end stock price). Given the consistent return of cash to owners of this company, Microsoft will remain a long term technology position in our portfolio.

IBM

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

In the past decade, IBM's 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 municipalities) tailored technology solutions to meet logistical challenges. To summarize: IBM will assist cities in building hardware and software solutions 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 providing consulting and tailored technology solutions to the public and private business segments is unique, worldwide, and slightly different from other technology organizations that offer "mass" computer solutions to similar customers.

Like Microsoft, cloud computing is becoming a larger part of IBM's business—IBM will have more than 40 datacenters by the end of 2015. But, because this business is still nascent, the loss of revenue and profitability from IBM's large mainstay hardware and software businesses have not been fully replaced by new revenue from the growing cloud segment. Due to this challenging transition, IBM remains out of favor with investors, and analysts are questioning the company's ability to successfully shift to a service-based technology company. In addition, many analysts think the service-based technology segment is a "commodity type" business with hundreds of competitors seeking to gain scale in this easy-entry area. We humbly disagree, and think that cloud computing is not a commodity business. From a historic perspective, we can cite similar fragmented, capital-intensive, networked businesses that eventually consolidated to just a few dominant players. For example, the oil-refining business in the early part of the 20th century was an extremely fragmented network with hundreds of participants, only to be consolidated under John D. Rockefeller. Standard Oil became so dominant that the government eventually decided to break up the company—Exxon and Chevron emerged as large parts of this breakup. The utility business is another industry that naturally lends itself to consolidation, since survival in this business relies on large scalability and networking to maximize revenues and profitability. Plus, an abundance of capital is initially required to build facilities prior to taking in any money. Given these business requirements, we can see that very few companies have the networking capability and capital to compete—which is why the utility business is regulated.

Such industries require a strategy of scale and "control of the middle"—and, based on past experience with this business model, we think IBM (and Microsoft) is positioned to emerge as a dominant player in this space. We believe the "utilitization" of computing will necessitate a tremendous network, as well as scale to maximize revenue and profitability—and this correlates with large capital expenditures to build server farms throughout the world. According to Forrester Research, global computing infrastructure is projected to be a $160 billion business by 2017, growing to a $240 billion business by 2020. This sizable infrastructure technology business requires tremendous up-front capital outlays that only a few firms will be able to commit to in the pursuit of building a network to obtain a future revenue and profit annuity stream.

Why IBM? – A Step Beyond Cloud Computing

Cloud computing offers an infrastructure-based company such as IBM a tremendous future, but more important is IBM's leadership in cognitive computing. With the advent of cloud computing, massive amounts of information (i.e., "Big Data") will be housed on interconnected computers all over the world—serving as the backbone of the Internet. Cognitive computing—essentially turning this massive warehouse of information into working 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 coming. IBM is the uncontested leader in developing learning computerization that will play a major role in our future.

We highlighted last year the book, *Smart Machines: IBM's Watson and the Era of Cognitive Computing,* by John Kelly III (Director of IBM's research). This book explains where and how IBM is approaching cognitive computing. In 2011, IBM's Watson computer (named after IBM's first CEO, Thomas Watson) famously beat two former 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. The IBM Watson Group is in full action today and has built a dedicated business unit headquartered in New York City that houses more than 1000 employees devoted to cognitive computing. The IBM Watson Group 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. On the creative front, Watson IBM Research is working with chefs to explore whether a computer can assist in designing flavorful recipe ideas that no cookbook has ever thought of. Watson is worldwide: This past year, IBM announced an initiative to invest $100 million in a 10-year initiative to use Watson to help African countries with development challenges including healthcare, economics, and education. These Watson Group projects will be developed at IBM's Africa Research laboratory, which opened last year in Nairobi.

We think the opportunities in the cognitive computing field are boundless, and IBM has a leading position in learning and executing this innovation. Given this prospect, 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.

Despite questions about IBM's ability to transition seamlessly to a new era in computing, the company still possesses business consistency and earnings predictability. As a result, IBM repurchased approximately 9.5% of its stock in 2014—in addition to providing a dividend that was greater than 2% of the average stock price, representing an 11.5%+ pass-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

With technology disruption reaching a critical high point in 2014, it is instructive to review the history of Intel. Intel Corporation was founded on July 18, 1968, and its very name stems from Integrated Electronics. Today, 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 a dominant market share for microprocessors that are used in desktop and laptop computers as well as computer servers. However, this was not always the case.

At its founding, Intel was distinguished by its ability to make semiconductors. Intel's business grew during the 1970s as it expanded and became adept at high-end, efficient manufacturing processes. Intel's manufacturing excellence allowed the company to produce a wider range of semiconductor products than competitors, giving the company an opportunity to control the market. In the early 1980s, Intel's business was dominated by dynamic random-access memory (DRAM) chips—a device that stores each bit of data in a separate capacitor within an integrated circuit. This is a commodity product focused on memory in the world of computing and is subject to tremendous competition. By 1983, low-cost Japanese semiconductor manufacturers had entered the DRAM business and dramatically reduced the profitability of this market.

At the same time, competition became fierce in the commodity DRAM market, and a tremendous disruption began as personal computing took hold—PC usage was growing exponentially among consumers. The rising success of the IBM personal computer, based on an Intel microprocessor, became the inflection point for Intel. Gordon Moore, Intel's CEO at the time, was convinced that high-end microprocessors were the future, and he "bet the company" on a business model shift, leaving the memory market to gain an unmatched competitive advantage in the new microprocessor space. This business model shift worked, and Intel has enjoyed a dominant position in the PC market over the past few decades. However, technology disruption is here once again, as consumers rapidly move to smaller mobile devices. PC sales have slowed over the past several years, and Intel has faced a challenging period. It is now once again necessary for Intel to adjust its business model to meet the growing demand for mobile and cloud computing products—areas in which Intel previously had a minor presence.

This brings us up to date on Intel. So, why did we go all-in on Intel as the company was going through this disruptive period that created business uncertainty?

It was our opinion that Intel's transition to a mobile segment would take time, but that the company would 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 3,450 co-located datacenters on 246 properties in 20 countries make up what we can call the "global computing platform." These datacenters collectively contain 55+ 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 2021—and Intel is 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 utilization of computing and will obtain a terrific revenue and profit annuity in future years through its multi-product offering in high-end computerization.
- **Intel decided to enter the foundry business to fabricate products for mobile chip makers.** This so-called backdoor entry into the mobile market should assist the company in gaining valuable knowledge in the mobile segment, while also better utilizing its vast manufacturing network, an area of strength for the company.

Intel is managing the current technology disruption well, and the market has recognized this through its rebounded valuation. The company will earn approximately $2.25 per share in 2014 and is projected to grow more than 6% in 2015, to $2.40 per share. We expect the company to continue its growth in 2016 as it gains further penetration in cloud computing and works toward developing a profitable foothold in the mobile space. In the meantime, the company will generate approximately $10.5 billion of owner earnings and will return this cash to shareholders through share repurchases of $5.5 billion, plus $5 billion of dividends—Intel's dividend yield is 2.6% at the year-end stock price, and the pass-through yield is around 6% when including share repurchases. We still consider Intel a good investment given the current return to owners, along with its optimistic future.

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 10% growth in book value during 2014, a slowdown from the 14% annual increase in 2013 and 2014. Since the 2008 financial crisis, Berkshire's annual per-share book value has grown approximately 13% (Book value growth provides an indication of Berkshire's value creation but is not a perfect correlation). This is a great result, and Warren Buffett keeps practicing the Ted Williams batting stroke, knocking the cover off the ball just about every time he decides to swing at an investment pitch. This is beginning to sound repetitive, but in this business it is amazing to watch Mr. Buffett step into the batter's box, and hit one home run after another. And in 2014, we believe Mr. Buffett hit several pitches out of the park that add future intrinsic value that is not currently reflected in Berkshire's book value.

The Exchanges

During 2014, Berkshire agreed to three unique deals that will lead to greater value for Berkshire shareholders. First, after a significant gain, Berkshire exchanged its 19 million shares of stock in the oil refiner, Phillips 66 (worth approximate $1.4 billion), for full ownership of the energy firm's pipeline-services business—Phillips Specialty Products. Second, Berkshire also exchanged its 1.6 million shares (worth $1.1 billion) of Graham Holdings (the successor company to Mr. Buffett's long-time Washington Post Company investment) for a Miami-based television station plus $327 million of cash, as well as Berkshire stock held by Graham Holdings. Finally, Berkshire agreed to exchange its longtime holding of $4.7 billion of Procter & Gamble stock (from the original Gillette investment) for full ownership of the Duracell battery business, which comes with approximately $1.7 billion of cash at closing. Why are these "good deals" for Berkshire?

In each of these investment cases, Berkshire achieved significant gains. For example, in the case of Berkshire's 52.4 million share holding of Procter & Gamble that developed from Warren Buffett's purchase of Gillette's stock in 1989 (P&G acquired Gillette in 2005 for $57 billion), Berkshire's original investment was $336 million. The $4.36 billion difference between Berkshires $336 purchase price and current $4.7 billion value of P&G stock is subject to more than $1.0 billion in taxes in the event of a sale. However, since Berkshire arranged an "exchange of P&G shares" for the Duracell subsidiary, Berkshire will avoid paying these taxes. Each of the exchanges Berkshire arranged in 2014 achieved value-creating objectives for shareholders: Partial ownership to full ownership in good businesses that produce lots of cash, acquired at fair prices, inclusive of tax savings. (This was also a great deal for P&G—through this exchange, the company will retire the 52.4 million shares of stock held by Berkshire, creating greater value for P&G shareholders.)

Berkshire accomplished other billion dollar-plus value-creating transactions this past year. In October 2014, Berkshire Hathaway agreed to acquire the Van Tuyl Group, the nation's largest privately owned auto dealership group, with 78 locations that, in aggregate, sell 240,000 vehicles per year, generating almost $8 billion in revenues in 2013. Van Tuyl Group ranks fifth among all U.S. auto dealership groups, and after becoming a part of the Berkshire Hathaway family of businesses, the company will be known as Berkshire Hathaway Automotive. This multibillion-dollar acquisition gives Berkshire Hathaway an opportunity to create shareholder value through further concentration of the nation's automobile distribution system. Today, there are more than 17,500 new-car dealerships in the U.S. and, given the increasing complexity and capital requirements associated with the automobile distribution business, it is highly likely that consolidation will continue during the next decade. The combination of Berkshire's deep pockets with Van Tuyl's management expertise will create a unique competitive advantage for Berkshire's new automotive group. We can look forward to future announcements of bolt-on acquisitions in this business.

In December, Berkshire also completed an investment in Restaurant Brands International, formed by the $12.5 billion merger of Burger King and Tim Hortons restaurant and coffee chain. This combination of 18,000 restaurant locations with $23 billion in sales created the third-largest operator of fast-food restaurants in the world and involved a tax inversion into Canada, where Tim Hortons is headquartered. The new holding company is majority-owned by 3G Capital, with the remaining shares in the company held by current Burger King and Tim Hortons shareholders. 3G Capital is not new to taking stakes in large companies, having made past investments in AB Inbev and H. J. Heinz, the latter financed with capital from Berkshire Hathaway.

With this as a backdrop, Berkshire Hathaway also played a part in financing Burger King's acquisition of Tim Horton's through an acquisition of $3.0 billion of Cumulative Perpetual Preferred Shares that earn 9%, plus a warrant to purchase approximately 8.4 million common shares at an exercise price of 1¢—yes, one cent. When the warrant portion of this deal was exercised, Berkshire owned $275 million of Restaurant Brands International's outstanding stock for an $84,000 investment—that's a good deal.

We will continue to hold Berkshire Hathaway as long as management stays focused on creating value for shareholders. Berkshire keeps building its financial muscle, producing long-term value from a well-established financial business that consistently generates a low cost of borrowed customer funds (less than zero). The float produced by Berkshire's insurance subsidiaries "sticks" within the company for many years—i.e., Berkshire gets to maintain premiums paid by insurance customers for years prior to paying out claims. 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, and his money management team, clearly demonstrate the art of value(able) investing, picking up $1 of today's value for the price of 65¢. We remain enthusiastic owners of Berkshire, and we look forward to Berkshire's future allocation decisions on the approximately $35+ billion of investable cash currently sitting on Berkshire's balance sheet.

Fairfax Financial Holdings

Our second-largest financial services investment is Fairfax Financial Holdings. Chairman and Chief Executive Officer Prem Watsa is building Fairfax's insurance and reinsurance business in a fashion similar to how Warren Buffett built Berkshire. Fairfax operates on a decentralized basis, with each Fairfax subsidiary insurance company providing a range insurance products. Fairfax also strives to maintain 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.

Since the company's founding in 1985, Fairfax Financial Holdings' per-share book value has grown at a compounded rate of 20+% per year. During 2104, Fairfax's per-share book value grew approximately 21%, more than making up the 10% decline from the previous year. Clearly, Fairfax's annual results can be very "lumpy." This is largely due to embedded returns on investments that are not reflected for several years through the company's income statement and balance sheet. In this case, 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 the successful insurance company stool, and we are excited about its future prospects.

In the past 12 months, Fairfax continued to grow its insurance business organically, as well as through opportunistic acquisitions. In 2014, the company acquired international insurance operations in Indonesia (PT Batavia Mitratama Insurance), Sri Lanka (Union Assurance PLC), Malaysia (MCIS), and Hungry, Slovakia and Czechoslovakia (QBE Insurance). In November 2014, Fairfax also completed the acquisition of Pet Health, North America's 2nd largest provider of medical insurance for cats and dogs.

All these acquisitions fit Fairfax's goal—to gain full control and accumulate low-cost float that will stay within the company for a long period of time. Based on our estimation, the average holding period for Fairfax's funds has lengthened more than 50% in the past 14 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 even greater long-term investment flexibility. We think of Fairfax as a "baby Berkshire."

On the money-generating side of the equation, Fairfax invests its float in understandable assets, including non-insurance companies that Fairfax is purchasing outright. While there are some cases in which Fairfax has made investments that are "not so understandable" to non financially-oriented individuals, 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 primary examples of what we consider to be Fairfax's esoteric investment activity.

Prior to the financial crisis of 2008, Fairfax had taken derivative and swap positions to protect the company's net worth in case of a sudden market downturn—these positions worked out well for the company during the financial debacle. Given the robust market recovery over the past six years, along with the still-fragile global financial system, Mr. Watsa and his team have implemented a similar strategy to protect the company's net worth in case of sudden market turmoil. In addition, Fairfax has executed an 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, U.S., United Kingdom, and France. These contracts specify that, in the event of annual cumulative deflation occurring over a weighted average period of 7+ years, Fairfax would be protected from the adverse financial impact of decreasing pricing levels. This is an important concept to consider, given that the company is experiencing overall underwriting results whereby they are paying policyholders throughout the world 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 terrible equation.

Fairfax has purchased additional protection against deflation this past year, increasing the notional contract value from around $81 billion to approximately $108 billion. 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., U.K., and France experience just 1% of cumulative deflation over the contract period, Fairfax will receive around $1.1 billion on the $108 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 $3.5 billion in the next seven or so years from these derivatives alone. This illustrates the sensitive nature of these contracts—we will forgo a discussion about the outrageous value of these Fairfax contracts if we repeat a U.S. 1930s or Japan 2000s scenario.

We think that Fairfax Financial Holdings remains a good investment during difficult financial times, and we are excited about our long-term opportunities with this company.

RETAIL GROUP

Our major retail holdings—Home Depot and Walgreens—had a terrific year in 2014 as retail purchases grew at both specialty businesses: Year-over-year, same-store sales increases exceeded 5% for both companies. We attribute this better-than-average result to our specialty retailers' understanding of four essential elements to retail success in this tough business:

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.

Clearly, retailing has many moving variables that require tending each and every day. Inattention to any of these details can lead to difficulty—Sears, J.C. Penney, Staples, and Best Buy are all facing challenges in one or more of the above areas, with corresponding sales declines.

Our interest is in large, industry-specific retailers that gain economic value as their industries consolidate over the long term—Home Depot and Walgreens still 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 accelerates 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 continuing to gain ground in the difficult retail space 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 a fantastic year, with same-store sales increasing more than 5% and gross margins reaching 35%— essentially, higher sales along with an increased profit margin in this space lead to greater shareholder value. As housing continues its recovery, Home Depot is thriving as it focuses intensely on combining the best of our "great retailer" four legs.

In previous letters, we have mentioned Home Depot's initiatives such as "Customer First" (to raise customer satisfaction) and "Localization" (to create a product assortment that is tailored to each local market). These two programs, focused on enhancing customer service and providing greater product selection to specific customers, created an environment for Home Depot to thrive in 2014.

In addition, revenue and 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 six 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. The combined revenue and improved productivity initiatives enacted by Home Depot create greater business value, while the effective combination of "bricks and clicks" provide greater customer flexibility.

Home Depot announced this past November that Chairman and CEO Frank Blake will be relinquishing the CEO role to Craig Menear, who was positioned for this succession through his appointment as President of U.S. Retail earlier this past year. Mr. Blake will retain the Chairman spot and maintain an office at Home Depot's Atlanta headquarters. We expect a smooth transition with this leadership change, since Mr. Menear has been with Home Depot since 1997. During his 17 years with the company, Mr. Menear has gained deep familiarity with important initiatives that have brought Home Depot to the forefront of the home improvement retail industry—for example, he led the company's merchandising and supply chain transformation that was the cornerstone to solidifying their four legs of the retail success stool.

We expect Home Depot to earn approximately $4.54 per share in calendar 2014 and to increase its earnings 15% in calendar 2015—to $5.23 per share. As a result of staying focused on the four-legged stool of retail success, we expect Home Depot to continue producing significant amounts of cash that will be distributed to shareholders. The company will generate more than $7 billion of owner earnings and will return this cash to stockholders through share repurchases of approximately $5 billion and $2.5 billion of dividends (a 5.4% pass-through yield at the year-end stock price). We remain pleased with the company's focused approach to customers and shareholders, and we plan to remain long-term owners of this one-of-a-kind retailer.

Walgreens

Walgreens is a dominant retail firm that is focused on the healthcare segment—and is gaining strength as the company emphasizes global expansion. In 2014, Walgreens executed plans to officially become a global entity through the company's second-stage acquisition of Alliance Boots, the leading pharmacy-led health and beauty group in Europe. As you may recall, in 2012, Walgreens exchanged $4 billion in cash and 83.4 million shares of stock for a 45% equity ownership stake in Alliance Boots. In August 2014, Walgreens announced that the company will carry out its option for a full combination by acquiring the remaining stake in Alliance Boots. In preparation for the deal closing, in November 2014, Walgreens–Alliance Boots issued an $8 billion debt offering, whereby on December 31st 2014, Walgreens purchased the remaining 55% of Alliance Boots for approximately $15 billion, encompassing 5.29 billion cash and $10 billion of Walgreens stock.

The combined organization is also taking shape, as Walgreens announced that President and CEO Greg Wasson has informed the board that he will retire from the company shortly after the close of the second step of the Alliance Boots transaction. Walgreens Chairman James Skinner (McDonald's famous CEO who turned around the franchise after its 2003 decline) will become Walgreens–Alliance Boots executive Chairman, while Stefano Pessina, Alliance Boots Executive Chairman, has been named as the temporary successor to Mr. Wasson. He will chair a new strategy committee of the Board and will serve as acting CEO, pending a Board search for a successor.

The Walgreens–Alliance Boots partnership accelerates a strategy to transform the traditional drugstore and creates a company platform for selling and distributing healthcare products to one billion people through 11,000 stores and 370 wholesale distribution centers in 25 countries. What emerges from this healthcare combination is an integrated, global drug distribution platform that is currently unmatched—providing Walgreens the "first mover advantage." The combined company will be the largest purchaser of prescription drugs in the world, giving it more leverage in negotiations with drug suppliers to lower costs on the annual purchase of hundreds of millions of prescriptions.

The Walgreens and Alliance Boots emphasis on providing unmatched customer and patient healthcare services, expanded product selection at affordable prices, and interconnecting the global in-store and online retail experience will create a specialty healthcare business that is different and unmatchable. 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 2014, with same-store sales growing approximately 5.8%, largely driven by an 8.3% increase in prescription drugs. The company earned adjusted earnings of $3.28 per share in its fiscal year-end, August 2013, and should grow earnings at approximately 8% in fiscal 2014, to $3.54 per share. We are excited to be owners of this global franchise, and expect great results in the future.

MEDIA GROUP

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

Walt Disney Company

Disney is a one-of-a-kind media company and a franchise that we place in the "best-of-the-best" category. Under the leadership of Disney's current CEO, Bob Iger, the management team has done a remarkable job creating shareholder value. Mr. Iger 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,* and now *Frozen...*.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 through the company's unmatched creative team—which leads to a story about Bob Iger's leadership. This past year, we were curious to understand how Disney animation was able to regain its luster in animated film, so we picked up the book, *Creativity, Inc.* by Ed Catmult, President of Pixar Animation (and now Disney Animation).

When Steve Jobs was leading Pixar, he approached Ed Catmult and John Lasseter (Pixar's creative genius) about a sale to Disney. After the initial shock, Steve requested that they "Get to know Bob Iger. That's all I ask." When Ed Catmult met Bob Iger, Mr. Iger stated that animation was the lifeblood of Disney and he was determined to see that part of the business rise again. He asked question after question, and was inquisitive as to how something so special was built at Pixar. Mr. Catmult recalls thinking that in all the years Pixar and Disney had worked together, Disney's leadership was now asking what we did at Pixar that made the company different.

The rest is history: Disney did purchase Pixar, and Ed Catmult and John Lasseter were given the freedom to transfer their Pixar creative management success to Disney Animation (which remained separate). Under this duo's leadership, Disney Animation reinvigorated itself, creating blockbuster films such as *The Princess and the Frog, Tangled, Wreck-it Ralph, Frozen,* and *Big Hero 6.*

The movie success is important, but what is more important is how Mr. Iger managed through this acquisition. First, he agreed to Steve Jobs' request to put Ed Catmult and John Lasseter in charge of Disney Animation—essentially giving them control. Second, he embraced Steve Jobs, a forceful personality, to become a member of Disney's board. The humility and understanding Bob Iger displayed in this scenario is rare among "large ego-driven" CEOs. His "soft on the people, but hard on Disney's values" approach released the creative culture inherent in the company, providing an environment for employee passion to once again produce great animation. Mr. Iger continues to repeat (and repeat) this humble approach with the integration of Marvel Entertainment and now Lucasfilms within the Disney family. We are looking forward to Disney's first Star Wars film since its acquisition of Lucasfilm*, Star Wars: Episode VII,* which is set to be released in December, 2015.

The Disney board has requested that Mr. Iger stay in the leadership position at Disney through 2018—we are pleased with his acceptance. 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 in the media and entertainment industry. We think Disney's broad range of content and growing international presence (Shanghai Disney Park is opening in 2016) will allow the company to extend its global reach for many years to come.

Disney earned $4.32 per share in its fiscal year-end September 29, 2014 and should grow earnings at 8% in the next fiscal year, to approximately $4.67 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. We are enthusiastic owners of Disney, as the company exponentially increases value for shareholders through its global expansion.

COMMODITY-BASED HOLDINGS

Our commodity-based holdings include Chevron and ConocoPhillips, as well as smaller positions in several other oil companies. We have held commodity-based positions since 2004, primarily through an investment in integrated oil companies. At the time of our commodity-based purchases, we were concerned that higher oil prices may occur due to 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 collective solution has been to print more money and debase currencies in the process. Even today, there continues to be a tremendous debate (as well as emotion) about volatile commodity-based investments, and their reaction to either a deflationary or inflationary result stemming from increasing government debt and currency debasement.

Despite the inherent price gyrations of commodities investments, our opinion has not changed since 2004: We remain concerned about the global financial system that seems to be encountering ongoing challenges with growing debts and imbalanced currencies—these two are tied. For example, when recently looking at key areas in the world such as Europe, Japan and Russia, we are witnessing whipsawing currencies, largely based on economic challenges that remain from the financial crisis. In other words, the global recovery has been erratic, despite rising markets. As an offset to the disruption in foreign exchanges in 2014, the U.S. dollar has increased 7%+ against emerging market currencies, impacting the price of oil.

A word about oil is warranted, given its precipitous 45% price drop in the last few months of 2014. First, the macro forecast of oil prices: Pundits had predicted that the per-barrel price of oil would be around $100 by year's end—so much for that prediction. Few predicted that oil would trade below $60 per barrel and would have considered prognosticators of this price to be insane. But here we are at year's end with worldwide oil trading around $55 per barrel and the U.S. Energy Information Administration (EIA) now forecasting an average worldwide price per barrel of oil in 2015 at $68. All this forecasting seems silly, since many variables can impact the short-term price of oil, including short-term imbalanced trends in supply and demand, a fluctuating dollar (as oil trades largely in U.S. dollars), shifts of distillate processing from one region to another, as well as so-called punitive measures that are rumored to be taken against rogue oil-producing nations—i.e., sanctions against Russia.

More important than focusing on the oil price decline is the need to evaluate the domino impact that low oil prices can have on the global economy, which has not yet worked its way through the financial system:

- Reduced revenue can greatly impact deficits and currencies for countries that are reliant on oil sales, such as Russia, Saudi Arabia, Venezuela, etc.
- Reduced investment in oil drilling can impact earnings among oil companies as well as employment in the U.S.
- Inexpensive gasoline increases fuel consumption, leading to purchases of larger automobiles and a delay in developing more energy efficient transportation.
- Banks and investors that lend money to oil development businesses, as well as emerging market companies who borrow in U.S. dollars, may encounter loan stress.
- Oil demand picks up, while drilling and production decline—oil companies decide to slow their tapping of oil reserves to sell this commodity at higher future prices.

When rationally looking at the current global supply/demand equation, worldwide oil consumption has slowed to 91.5 million barrels per day—representing only an approximately 1% year-over-year increase—and is expected to grow only another 1% in 2015, to 92.4 million barrels per day (this is hardly a demand crash). Oil production, on the other hand, has increased to 92.8 million barrels per day to meet a slightly higher rise in oil demand. All in all, we are now experiencing a short-term imbalance between oil supply and oil demand that will take around one year to absorb.

Where is Founders on all this? It is our opinion that a long-term imbalance continues to grow between "easy" oil supply and demand, and the recent hasty decline in price is possibly attributable to investor emotion. According to a 2013 World Energy Outlook report issued by the International Energy Agency, daily worldwide oil consumption will rise to approximately 101 million barrels per day by 2035. Although supply and demand is slightly imbalanced today, it is our opinion that "safe" worldwide oil production capabilities are about equal to current demand. We believe that the future oil needed to meet rising demand is going to be "less easy" and more expensive to get out of the ground. The future oil supply to meet growing demand comes from fracking in the U.S., tapping oil sands in Canada, and deep-water drilling in the Gulf of Mexico and Arctic Circle. With the current oil price crash, many projects in these areas are now being reduced and/or mothballed, but the consequences on oil prices due to oil companies placing these projects on hold are yet to be determined—these complex projects take more time than one may think to develop. Since the total marginal cost for the largest oil and gas companies to produce the next barrel of oil to meet demand growth is more than $90 per barrel from difficult drilling sites, mothballing projects to produce the future oil needed to meet energy demand could have a domino impact we may not enjoy—such as a long period of higher oil prices as rising demand eventually becomes more difficult to fill. In summary, we believe that the marginal cost of producing a barrel of oil to meet long-term growing energy demand is the price that should determine a barrel of oil—we just don't know exactly when this price will be realized.

Oil Company Investments

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. Over the past five years, we increased our exposure to integrated oil companies through investments in businesses that we felt traded at discounts to their long-term values such as ConocoPhillips and several other integrated oil companies. We now have a rather large investment in the energy sector and anticipate oil trading at a future price that exceeds $55 per barrel, given that the marginal cost of producing a barrel of oil is much higher.

In the meantime, our combined oil holdings continue to produce cash for shareholders—the average dividend being paid by our integrated oil companies exceeds 4.5%. In this case, we can afford to be patient and wait for higher oil prices brought about by the mix of increasing global demand and oil production from costly-to-produce oil fields.

FIXED-INCOME INVESTMENTS

The Barclay's U.S. Aggregate Bond Index, which represents the broad debt market, experienced a 5.97% gain in 2014. This gain follows a 2.0% *decline* in 2013, along with an average annual bond index gain of approximately 6.1% the previous four years. Since the credit crisis of 2008, investors have literally poured money into bond funds. We have stated several times over the past few years that these individuals were losing business perspective and chasing returns in the credit market, and we feel as strongly today about this viewpoint as we did when we first wrote about it—investor insanity can go on for a longer period of time than one thinks.

When evaluating the current fixed-income market, we believe individuals would still be *far* better off taking a business approach to their investing. We reiterate once again: 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 the 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 the 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.

After reviewing 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 on December 31st at a 2.75% yield, and chose to reinvest the coupon payments into these same bonds at par, it would take more than 25 years to double our money. If we presented our clients with a similar arrangement to invest in a business that produces a 2.75% return on equity and retains all the proceeds to repeat this poor return, our judgment would be severely questioned, regardless of whether the business was assured survival. Unluckily, today's absolute abysmal return of 2.75% on a 30-year Treasury is guaranteed to lose money against inflation that averaged 3%

over the next 30 years (we will stay away from any forecasting). Unfortunately, many financial participants continue to place a greater-than-average portion of their clients' assets in *un*businesslike opportunities. (This does not mean that bond prices will not continue to rise—investor panic and/or deflationary pressures may attract additional money to fixed-income investments, even at low yields)

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 possibility of future rising interest rates and even greater chances of default. We remain concerned about low long-term market interest rates, which will eventually move upward as the Federal Reserve begins to change the direction on maintaining a low interest rate environment—we just don't know when. As the economy continued to improve during 2014, the Federal Reserve put an end to quantitative easing. Although many think that rising interest rates are a ways off, our experience with oil this past year should show that the crowd is many times wrong. Market interest rates could surprisingly move upward in the near future, which would place tremendous pressure on low-yield investments.

In 2015, we have ongoing tranches of municipal and corporate bonds coming 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. Over the past few years we have placed fixed-income capital in "callable bonds" and "convertible securities" that we felt provided safety, with an adequate return.

Callable Bonds

A callable bond (also called a redeemable bond) is a type of debt security that allows an issuer of a bond to retain the privilege of redeeming the bond at a point before the bond reaches its date of maturity. In other words, on the "call date," the issuer has the right, but not the obligation, to buy back the bonds from the bond holders at a defined call price. The call price usually exceeds the par, or issue price.

Basically, a callable bond provides the issuer an option to redeem a bond prior to its maturing—however, it pays for this right by offering a higher coupon rate. If interest rates in the market go down by the time of the call date, the issuer will be able to refinance its debt at a cheaper level and will be incentivized to call the bonds it originally issued.

With a callable bond, investors have the benefit of a higher coupon than they would have had with a non-callable bond. On the other hand, if interest rates fall, the bonds will likely be called and investors will need to find other investment alternatives. In our case, this is what has been occurring—several of our bonds are being called in by issuers as they are able to refinance their debt at lower rates than their currently issued bonds. We continue to look for alternatives as our callable bonds are redeemed. On the positive side, we have enjoyed a higher rate of return through our ownership of callable bonds, despite taking on greater work of finding new bonds once previous issues have been called. Going forward, the opportunities in this area have just about disappeared.

Convertible Bonds

A convertible bond is a type of bond that the holder can convert into a specified number of shares of common stock in the issuing company, or cash of equal value. It is referred to as a hybrid security as it possesses both debt- and equity-like features.

From the issuer's perspective, the key benefit of raising money by selling convertible bonds is a reduced cash interest payment. Another advantage for a company issuing convertible bonds is that, if the bonds are converted to stock, the company's debt vanishes.

To compensate for having additional value through an option to convert the bond to stock, a convertible bond typically has a coupon rate lower than that of similar, non-convertible debt. The investor receives the potential upside of conversion into equity with a convertible bond while protecting downside with cash flow from the coupon payments and the return of principal upon maturity.

Let's review an example of how this works. If we have an opportunity to purchase a 3.5% bond today at par ($100) that matures in 2034, and is convertible at our option to three shares of stock at $33.33 per share, would this equate to a "good deal?" At first blush, a bond that provides 3.5% interest over a 20-year period does not look very enticing. However, if the stock price of our hypothetical company is currently trading at $31 per share, and we ascertain "the value of the company" to currently be $40 per share and growing at 7.5%, we might see things differently. By purchasing a bond at par that possesses a 3.5% coupon payment, and knowing that the true value of this security is 20% higher than our conversion price, we have an opportunity to gain initial interest on our money, along with an option to convert it at a higher price in the near future. In fact, if we hold on to this bond for five years, the underlying value of the conversion will grow at 7.5% per year, from $40 to $57 per share. This equation provides an investor a minimum 3.5% initial return on her money, along with price appreciation potential of 11%+ per year over the next five years—representing a total possible annual return greater than 14.5%. (This is now a very good deal.)

Unfortunately, most investors seem to be speculating in bonds, chasing low-yielding returns and/or buying what we consider junk—many of these securities will likely live up to their name. We are maintaining our stance of finding the best-yielding securities, while understanding the risks we are taking with each individual fixed-income allocation. Although we have found selective special-situation opportunities to reallocate money to fixed-income securities that provide fair returns, good prospects are extremely rare and have all but disappeared. We will keep our eyes open for opportunities, but we are likely to accumulate a large amount of cash during 2015. Although this is not intentional or out of market fear, we will remain disciplined in seeking fair returns for the risks we take. As always, we believe that being patient and watching for better opportunities is much better than doing something unintelligent.

* * *

OUR FINAL THOUGHT

Since we started this letter with a discussion about emotions, it is appropriate that we finish it with our sentiments. One emotion that seems to have escaped writings about our human nature over recent years is gratitude. The neglect of this emotion needs further study, as it is not limited to psychology, but also in human virtues—Aristotle did not include gratitude as an entry on his list of human virtues. Why is this?

Perhaps the reason we do not display gratitude is due to the fact that when we express appreciation, it may remind us that we are not completely in control of our destiny—something human beings have a tendency to desire. If we admit to being indebted or interdependent, then our destiny can be in others' hands—and with that admission, we become vulnerable. Of course, each of us recognizes that we are not completely self-sufficient and cannot exist without the support of others.

With this said, each one of us at Founders Capital Management is grateful for our clients, many of which are close friends and family. Without your dedication and commitment to us, we would not be where we are today. We thank you for the opportunity to serve you and for your continued trust. We look forward to working on your behalf during 2015.

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.

April 28, 2014

Board of Directors
The Coca-Cola Company
One Coca-Cola Plaza
Atlanta, GA 30313

Dear Members of the Board:

We would like to begin this letter by recognizing your stewardship over the "greatest brand" built over the past 128 years, and Coca-Cola's status as an American icon that is representative of our culture, entrepreneurial spirit, and success in capitalism. As you are aware, Coca-Cola is widely studied as a company, and emulated as a business that historically delivers balanced value to its important constituents – customers, employees, shareholders and communities throughout the world. In other words, through the decades, Coca-Cola has stood out as a stellar example of a company that creates ongoing value.

Given the above as background, it is no surprise that over the past few months there has been tremendous controversy surrounding The Coca-Cola Company 2014 Equity Plan. Since the plan has been "rubber stamped" with approval by 83% of the votes cast, and the controversy has now died down, we have had some time to reflect on its impact and would like to share several thoughts.

Compensation and Capital Intensity

We think we would all agree that executive compensation is an important part of the Board's responsibility to effectively allocate capital, and provide incentive to individuals that are assigned to generate greater value for owners of the company. Given the large changes in the structure of corporate compensation over the past few decades that is now weighed heavily toward options and full value stock, it is our opinion that executive compensation should be viewed as a capital investment. The investment in human capital has become equally important to any capital investment in property, plant & equipment, etc. In other words, large, complex global businesses are difficult to manage and build, and the allocation of capital toward compensation today should be measured by a business owner as part of the total capital investment made in any enterprise.

Value Creation

We think we would also agree that value creation is the principal job of any management team and should be measured by several key criteria – in Coke's case what is important is the growth in unit case volume and concentrate sales, profitability, as well as maintaining and growing the return on invested capital (the list in the proxy was exhaustive). By its nature, Coca-Cola is a wonderful business – an organization built from its early days that has mastered the art of segregating and integrating various business components (distribution, marketing, etc.) to maximize its returns. In other words, the capital intensity is low, while brand equity is enduring – allowing the company to obtain a premium price from consumers while enjoying an efficient and low capital structure – in the end, an enviable cash machine that should be protected.

The 2014 Equity Plan Effect

When viewing the capital intensive nature of the recently approved equity plan, a business owner can only conclude that it is value destructive versus value creating. The explanation outlined in the proxy of utilizing ongoing share repurchases to mitigate the potential dilutive effect of the equity plan is philosophically flawed when assessing value. The "take from Peter to pay Paul" argument is something the shareholder should reject due to its nature as a basic wealth transfer.

The true economic impact of the equity plan should be viewed from a business perspective. To start, Coke's total invested capital (adjusted for excess cash, goodwill and intangible assets) in the business has increased around $2 billion the past year, to approximately $32.5 billion. However, net earnings have remained relatively static at approximately $8.6 billion after adjustments are made for foreign currency, pension contributions and other small items. When looking at the numbers, the return on invested capital has actually decreased year over year, from approximately 28.5% to 26.5%, while growth in worldwide unit case volume and concentrate sales slowed from 4% to 2%. In fact, this is a value destructive equation, as capital intensity increased, growth slowed, and profits remained flat from 2012 to 2013. We understand that management tried, but this performance is hardly deserving of a reward.

The approved equity plan only adds fuel to this business deterioration. Under current accounting, the plan embodies a hidden expense that would negatively adjust annual earnings by approximately $1.8 billion, in addition to a hidden increase of invested capital in the business over the life of the plan conservatively estimated to be around $12 billion at today's value. If accounting rules changed whereby the $12 billion equity plan liability was recognized on the balance sheet, along with the share grants expensed each year against earnings, the adjusted return on capital would further deteriorate. Coke's 2013 earnings would be lowered to $6.8 billion, while invested capital would increase to $44.5 billion, depressing The Coca-Cola Company's return on invested capital to approximately 15%. As one can see, by unveiling the true economic impact of this plan on the business, Coca-Cola transforms from a franchise with wonderful economics, to one that is average at best.

Lastly, in reading hundreds of annual reports each year, it is our estimation that Coke's approved equity plan is near twice the average American corporation. In addition, the current "fixed-price" offered to participants receiving a grant in this plan today represents an approximate 20% discount to Coca-Cola's intrinsic business value – serving as a "double whammy" to shareholders.

<u>Summary</u>

We believe that it took 128 years for Coca-Cola to develop its reputation as a company that exemplifies not only America's entrepreneurial spirit and success in capitalism, but reinforces our cultural character represented by strong values and shareowner orientation. Unfortunately, as owners in Coca-Cola it is our responsibility to point out that this plan crosses the line, and tarnishes Coca-Cola's overall reputation, including its brand that the Board is supposed to protect. In essence, the Coca-Cola Board's backing of this plan has destroyed value in several ways – both tangible as well as intangible. Coca-Cola serves as a benchmark for corporations throughout the world, and this poor example of capital allocation has the potential to set a precedent that will likely place us back into the late 1990s, a time when egregious compensation packages significantly impacted business owners, as well as investors' trust in capitalism.

Sincerely,

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Investing for the Long Term. Every Day.