

October 5, 2011

Dear Friends,

Enclosed please find our September 30, 2011 investment commentary and, for our clients, your portfolio appraisal, performance history and a schedule of realized gains and losses.

Before commenting on the quarter, we would like to welcome Grant Winthrop to our firm. Grant joined us on October 1st after a distinguished career at Milbank Winthrop, where he was a partner for the past 23 years. Grant brings a wealth of experience to our firm and will complement our Investment Committee with his insights. We extend a warm welcome to Grant's clients who have become valued clients of Douglass Winthrop.

The following table summarizes performance for Douglass Winthrop's Composite.<sup>1</sup> The stock market struggled in the third quarter, battered by a steady stream of downbeat economic news and political brinksmanship. Business activity ground to a virtual halt when the partisan tug-of-war over raising our nation's debt ceiling brought us within hours of an historic default on Federal obligations. Ironically, the bond market soared in the weeks following the compromise that resolved the debate (for the moment, at least), despite the first-ever ratings downgrade of U.S. Treasury securities by Standard & Poor's. Faced with deteriorating conditions in Europe as well as deceleration in China and other emerging economies, investors saw U.S. bonds as the best of a bad lot and bid prices up aggressively. As a result, rates on 10-year Treasury bonds fell to an all-time low of 1.72% in late September. To paraphrase our friend Jason Trennert, one of Wall Street's most respected observers, investors seem content to suffer the potential of negative real returns from bonds rather than bear the risk of large absolute losses in stocks. The question is, how long will this go on?

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<sup>1</sup> As of January 1, 2009, the Douglass Winthrop Advisors Composite (DWA Composite) includes all fee-paying accounts open for at least one quarter that provide data to Douglass Winthrop's Advent system. Prior to January 1, 2009 DWA Composite included all fee-paying, discretionary accounts that provided data to Douglass Winthrop's Advent system with an equity weighting of 65% or greater and a total value of \$100,000 or greater on the last day of the prior quarter. Equity Composite and Fixed Income Composite represent the equity portion and fixed income portion, respectively, of all accounts in the DWA Composite. Results are calculated using a "Time Weighted Rate of Return" methodology, are gross of fees except where indicated, and include the reinvestment of dividends. Prior to January 1, 2009, DWA Composite excluded accounts that maintained legacy positions not initiated by Douglass Winthrop where these positions comprised more than 25% of account's value, and accounts open for less than one quarter. Past performance is no guarantee of future performance, and any investment could lose value. Results are unaudited.

Period Ending September 30, 2011	Douglas Winthrop (DWA) Equities	S&P 500 Total Return	DWA Fixed Income	Lehman Index	DWA Composite (Gross)	DWA Composite (Net)
<b>Year-to-date</b>	-3.4%	-8.7%	3.2%	7.5%	-2.8%	-3.3%
<b>Year 1</b>	4.4	1.1	2.7	5.1	3.8	3.1
<b>Year 3 (a)</b>	1.9	1.2	5.5	8.4	2.3	1.6
<b>Year 5 (a)</b>	1.8	-1.2	4.2	6.5	2.1	1.6
<b>Since Inception (a)</b>	6.4	5.0	4.6	5.3	5.9	5.1

(a) Annualized

## The Fine Line Between Confidence and Anxiety

Public markets for stocks and bonds are one of the greatest innovations of modern capitalism. With little more than pocket change, nearly anyone can own a small piece of a business and profit from its success, or lend money to an entity and receive compensation for the risk.

The global securities markets of the 21st century are marvels of technology and regulation, designed to execute orders swiftly and provide fair treatment for all investors, big or small. At their core, however, their smooth functioning requires the same ingredient as the first trades executed under the Buttonwood Tree so many centuries ago: confidence. Investing in publicly traded securities requires an enormous amount of it—confidence that the price reported is accurate; confidence that the trade will settle properly; and confidence that one’s holdings are safe and one’s money is accessible. Perhaps most important, buying a stock requires confidence that the underlying enterprise will increase in value over time, and buying bonds requires confidence that the issuer will be able to repay the obligation with interest when it comes due.

Confidence also plays a leading role in economic activity. Consumers consume more when they are confident that their jobs are secure and their income will support their purchases. Businesses add to their payrolls and spend money on new plant and equipment when they are confident that their order books will justify the extra investment in new capacity. Hence anything that erodes confidence impedes economic activity and impacts the financial markets, both directly (compressing valuation multiples as risk tolerance diminishes) and derivatively (as corporate profits sag).

Events of the past three years have extracted a huge toll on consumer and business confidence. The implosion of the mortgage market not only led to the demise of Lehman Brothers and shotgun marriages for some of Wall Street's most venerable firms, it laid bare the extraordinary amount of risk that banks held on their balance sheets. The near-collapse of our nation's financial system reverberated around the world, catalyzing the events that presaged the European financial crisis that has dominated headlines in recent months. Even those who might be unable to find Greece on a map now know that the country is knocking on bankruptcy's door, and that the Continent's common currency, the euro, is on life support. It takes little imagination to connect these dots to the stubbornly high unemployment rate in the United States. Even as companies sit on a cash hoard that numbers in the trillions of dollars, their managers are reluctant to hire for fear that the next crisis (or burdensome regulation intended to prevent it) is lurking nearby.

Our elected officials have done little to bolster confidence. Regardless of which side of the aisle one favors, one could not help but be depressed by the circus that unfolded this summer in Washington. Members of both parties put their personal political agendas ahead of our nation's economic well-being, a spectacle that may intensify over the fourteen months leading to the next Presidential election.

To be fair, this mess was decades in the making, and no single event, regulation, greedy executive or market excess is to blame. As such, it is unrealistic to think that any one leader, policy or technological innovation will magically restore confidence to its pre-Lehman levels, let alone the giddiness of the late 1990s. Fiscal austerity, both here and in Europe, promises to make its presence felt for years to come. Job creation is likely to be muted until the rules of the game are settled and managers are confident that the goal line won't be moved again. Banks will be stuck between politicians calling for more loans to be made and regulations that constrain the extension of credit to even the most worthy of borrowers. In short, we think we are in for a long, tough economic slog, characterized by several years of muted growth and heightened risk of recession.

### **Keep Calm and Carry On**

There is a silver lining to this cloudy story. The sooner that past excesses are acknowledged and addressed, the sooner the decks will be cleared for our nation's extraordinary resourcefulness and tradition of innovation and entrepreneurship to re-assert itself. Moreover, we believe that the stock market, being the efficient consumer and analyzer of data that it is, already largely reflects the less-than-rosy scenario portrayed in the preceding paragraph.

Consider the following math. We estimate that the companies of the Standard & Poor's 500 Index are likely to earn roughly \$90 per share in 2011, including non-recurring items (which have a habit of recurring with alarming regularity). If one assumes that the economy slips into a recession in 2012 (not our base case, by the way), earnings could decline to \$80 or so. At its recent level of 1120, the S&P is trading at 14 times estimated recession-level earnings. Not only is that multiple below the long-term average, it is a fraction of what one might expect with interest rates as low as they are today. If, as we expect, earnings actually rise next year, the market multiple appears even more attractive.

Of course, we don't buy "the market" and we waste no time trying to predict where a given benchmark might be at any particular point in the future. History also tells us that the greatest bull markets begin when stocks trade for ten times earnings or less, and we are a long way from that level. That said, we believe that over the next decade stocks will deliver total returns, including dividends, far in excess of those offered by bonds or cash. Comparing the earnings yield on stocks (equal to the inverse of the price/earnings ratio) to the yield on long-term Treasury bonds suggests that the former are exceedingly cheap and the latter are exceedingly dear. If one believes in reversion to the mean (as we do), one ought to be selling bonds and buying stocks, assuming one's time horizon is long enough to accommodate short-term uncertainty and volatility. Accordingly, we recommend that our clients' portfolios have as full an allocation to equities as their tolerance for risk or investment policy allows.

One company that exemplifies the value we see in specific stocks is Berkshire Hathaway. As one of our firm's largest and longest-held positions, we've written about these shares before. Berkshire's list of subsidiaries grew yet again in the third quarter with the acquisition of specialty chemical manufacturer Lubrizol, a deal that further increases the company's sensitivity to economic activity (which could help explain the stock's recent underperformance). Rarely has the stock traded at such a wide discount to our estimate of its intrinsic value—that is, the sum of what each of Berkshire's wholly-owned businesses and minority investments in other publicly traded securities is worth. Apparently Warren Buffett agrees with our opinion, judging by the late September announcement that the company intends to buy back its shares in the open market. We are well aware of the arguments that Mr. Buffett's age (81) is a liability. He has answered by naming two much younger men with stellar track records to help him oversee the company's investment portfolio, providing the clearest succession plan to date. As for the operating subsidiaries, Mr. Buffett has always leaned on each company's managers to run their businesses day to day, a practice that is unlikely to change when the moment comes that he no longer serves as Berkshire's CEO. In short, we think the stock offers a very favorable ratio of potential appreciation to downside risk at its current price.

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**Douglass Winthrop**

As long-term investors, we are excited about the future despite the numerous issues described above. Challenges always breed opportunities for those who are willing to roll up their sleeves, dig into the numbers and go against the prevailing wisdom of the crowds. At Douglass Winthrop Advisors, we have a team of investment professionals whose experience averages more than 20 years but whose average age is only 48, suggesting a long and dynamic runway ahead of us. We are grateful for the opportunity to serve our wonderful clients, and as always we welcome your questions and comments.

Sincerely,

Charles G. Crane  
Robert R. Douglass, Jr.  
John Winthrop, Jr.  
Lea Paine Highet

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