
FINDLAY PARK PARTNERS LLP

FINDLAY PARK AMERICAN FUND NEWSLETTER 26TH JANUARY 2012

Price of Dollar Shares: \$49.77

Price of Sterling Hedge Shares: £27.07

Please note that the Net Asset Value of the Fund may fluctuate and that investors are exposed to foreign exchange risk if they are invested in the Dollar-class of share.

The above prices are based upon a 9.00am valuation on the above date.

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Performance

Last year we marginally beat our benchmark but we were disappointed not to add a lot of value as we have done over the years. The S&P was essentially flat, the Russell 2000 was down 5.7% and the Fund was down 2.5%. Our Latin American weighting added a lot of value in 2009/2010 but with the Brazilian market down 27% in dollars in 2011 and the Mexican market also down sharply, this was the biggest detractor in overall performance last year.

We feel that we are in very uncertain times and we raised a reasonable amount of cash in the summer of 2011 when we felt the market was not discounting some of the potential problems. After a very sharp fall in the third quarter, the market has since recovered most of its losses while we have maintained our cash position between 12 and 15%. At the back end of the year this held us back somewhat. We have also had a strong get stronger theme within the portfolio for the last several years, and although we are very conscious to reduce any stocks which people view as quality defensive when they relatively get very expensive to the rest of the market, we have still been reluctant to add to some of the more cyclical stocks, as we still think structurally growth is going to be below par for a while. This also held back the performance towards the end of last year.

In such an uncertain world we stress-tested all our companies in the late summer of last year to see how they would perform with a major slow-down in economic growth. Our aim was to hold a list of companies that we could live with in such an environment which would also perform reasonably well in a world which muddled through its current problems with lower inflation and less subdued growth than expected earlier in the year. This strategy means one is unlikely to shoot the lights out against the Index in the short run in a rising market, but we are very aware that we are stewards of your capital, and are really trying to play the odds as best we can in the short run with a rather more defensive bias than normal. The Fund seems to outperform quite nicely on down days but struggles to keep up on up days at the moment, but we always have one eye on absolute return and one eye on relative return and the most important thing to us is the compounded rate of return over the years which is 12.3% as at 25th January since inception. We do not feel it is a time for taking undue risk, but at the same time we are finding individual stocks where we think the return potential over the next two or three years is very attractive and only a very small part of the portfolio is focussed on defensive, high-yield, steady low growth stocks, many of which, in our view, look a little overvalued at current levels.

The bottom line is if we go through a really robust recovery, with a big recovery in cyclical and lower-quality stocks, we are likely to underperform on a relative basis a little and conversely outperform in a difficult environment. We continue to have around 12% cash which is down over the last few months as between us all we continue to find existing holdings to add to and a few old friends we have come back to.

We added to our Brazilian weighting following James and Rupert's trip there in November, as the fundamentals over the next couple of years look very positive. The Brazilian economy is emerging as a top five global economy and we would encourage investors to read the discussions about Brazilian equities in the American and Latin American Fund's December newsletters. The stocks are down whilst their earnings and cash flow have continued to grow robustly which has resulted in many stock price multiples becoming very attractive. The region's currencies were also hit hard in last year's risk off trade and could do better again once risk aversion starts to recede. Many of these investments could rebound sharply on the back of continued earnings growth combined with some upside in multiples from current levels which look rather modest to us. In an environment when investors are willing to take on a little more risk, this portion of the portfolio should help the beta on the upside, but after the multiple de-rating last year, the downside seemed fairly limited. We now have about 11% in Latin America. Whilst we believe that Brazil's fundamentals are very attractive and in our opinion it remains the most promising stock market in the region for now, we want to emphasise that the region is more than just a Brazil story. Mexico is also starting to look increasingly interesting on the back of renewed strength in US/ North American manufacturing, political optionality in July 2012's presidential election which might unlock a new reform program and the undervalued levels that the Mexican peso appears to be trading on. Mexico is also a beneficiary of rising Chinese labour costs and high oil prices. The main issues holding back the attractiveness of this stock market are the Mexican economy's current reliance on a healthy US economy and stock price multiples which are at average rather than bargain basement levels (compared to Mexico's historic trading range over the last decade).

Economy, stock market and other thoughts

The economic news out of America over the last few months has generally been favourable, with a reacceleration in the economy after the weak patch in the middle of last year, after the oil price ran up so sharply in the first half of the year. **Unfortunately the oil price has not fallen much and that**

will continue to hold back consumer spending. Corporate spending picked up in 2011 but may come back a little in 2012 as a result of bonus depreciation coming down. The employment picture has improved more than even the optimists had been hoping, with unemployment now dropping to 8.5%. There are also signs that the housing market may be bottoming following a roughly 30% drop in prices throughout the country. Housing affordability is as cheap as it has been since the very early 1970s, reflecting the fall in prices and very low interest rates. Many people have moved towards renting, waiting for a bottom in the housing market, which has caused rents to spike up in a lot of cities around the States, making it cheaper to buy rather than rent. Unfortunately it remains rather difficult to take out a mortgage on anything like the terms offered in the last 10 or 15 years. Banks require more to be put down in equity and are reluctant to lend longer term at current interest rates. We cannot believe that, with sentiment beginning to turn on housing, the administration in an election year will not put in a new initiative to further improve this very important part of the US economy. There continues to be litigation surrounding many of the banks relating to previous mortgage origination excesses but hopefully this will be resolved in the fairly near future which will also increase mortgage availability. It is reckoned that the housing market collapse contributed about 2% to unemployment and if this can begin to recover it will be very helpful to the employment statistics and also mobility within the US economy, which has always been one of its strengths. After several sub-par years of new car sales and a rapidly aging fleet, investors are becoming more optimistic about this market improving in 2012. Peak shipments were around 17 million, dropped to around 10 million and were around 12 million last year. A more normalised level is thought to be 15 million and this was also a big contributor to economic activity and employment.

The bank sector has performed very well over the last few months, although the ones with the largest exposure to Wall Street have generally been the less good performers. Capital ratios have rebuilt very rapidly since 2009 with many banks having very low pay-out ratios and not buying back stock. We were beginning to see reports that loan growth is accelerating, particularly in the commercial and industrial loan area, and there are tentative signs that both commercial and residential lending are beginning to pick up. Banks are obviously suffering from rather onerous new legislation which structurally reduces return on assets and equity, so valuations are never going to move back to where they were before the downturn, but there should be no shortage of capital available for growth in the US economy as we progress throughout this year. As older loans have been rolling off, banks have been rolling over some of their excess lending capacity into securities

with a much lower yield. So loan growth is key to their earnings power over the next couple of years. Within the sector, the strong seem to be getting stronger and we have added a little to our positions in the sector although our main weighting continues to be Latin American banks, where we see much better upside potential over the next two to three years.

One of the main arguments of the bears on the US is that margins are as high as they have ever been, having seen a steep recovery from the setback in 2009. Productivity growth this cycle has been very strong in America with companies cutting costs two or three times more than normal in the downturn as they stared into the potential of the next depression, and from our experience in meeting companies, they are learning to live with a much leaner cost structure, resulting in higher margins. The negative side of this is that real wages in America have not been rising much for the last 10 or 15 years, putting pressure on the great American middle class. This continues to be an issue with so much of the economy dependent on the consumer. Bain and Company (Mitt Romney's old firm) recently put out a survey showing that the US would be competitive with China by 2015, which is not really very far away. Chinese wages have been going up at around 15% in recent years while there has been no real growth in US wages. Transportation costs have been going up with higher energy prices and many of the companies that we invest in that have moved a lot of the labour and manufacturing facilities to China over the years, are now beginning to move some of that out of China to cheaper places in the Far East, and some are moving it back to the US and Mexico. For the first time since the 1960s there seems to be something of a manufacturing renaissance going on in the US, which is very encouraging although it should be remembered that this is only about 12% of the US economy. It is a much larger portion of the stock market. The renaissance in this sector of the economy has also been helped by what is going on in the oil shale sector, which we have discussed in past newsletters. The US seems to have an abundance of very cheap natural gas as a result of technology improving to extract this from shale formations. With the drop in the price of natural gas from \$12 at its peak last decade to around \$2.50, the US has the lowest-cost gas in the world by some way and is on a path towards energy self-sufficiency over time, which will surprise many people. These shales also produce oil and most companies are focussing on increasing production, and we highlighted some of these figures in the last newsletter. This is, however, very positive for the refining and chemical industries, who are more competitive in America than anywhere else in the world, which is a very different position than two years ago. Other beneficiaries are the fertiliser companies, railways and really any company that can use gas or gas derivatives as a raw material.

There are now projects where the US and Canada are focussing on exporting LNG to the rest of the world and indeed some LNG projects in the Far East are being delayed a little as people look at the implications of this abundance of cheap gas from North America. Not only does it create jobs extracting this gas, but it has a knock-on effect throughout many sectors of the US economy and many of our companies are roundabout beneficiaries of this trend.

Back to margins, they are structurally higher than they have been in the past. They do tend to revert towards a mean over time but they have also been helped by US companies embracing technology, perhaps ahead of most of their competitors world-wide. **We think margins are likely to stay high in the short run and within our portfolio we have a strong focus on only investing in companies that have margin potential for their current levels, to try to mitigate this bear argument for the US stock market.**

America remains the best positioned G7 country for demographics structurally to contribute to growth.

Politics remains something of an issue in the US. In the past there was not too big a difference between Democrats and Republicans and they generally tended to be able to pass legislation to keep America pointing in the right direction. Unfortunately the influence of the Tea Party in the Republican Party has made policy much more polar than it has been in the past, and this is proving a hindrance to dealing with some of the fiscal issues. There continues to be debate as to whether a steep cutback in fiscal policy is needed to balance the budget or for this to be more subdued over the next couple of years, allowing the economy to heal and begin to prosper again without too many anchors. What people perhaps have not been focussing on is that state and local governments structurally are not allowed to have deficits although they seem to produce quite elaborate accounting to get round this. State and local governments get a lot of funding from property taxes and when property was rising they over expanded. Cutbacks have been very severe and *The Economist* had a very good article on this a couple of weeks ago. These entities have laid off about 750,000 people since the end of 2008, which has been a big drag on the overall employment statistics. After 3 plus years of budget cuts and trying to run services more efficiently, the last few months have shown that State and Local governments have not been a drag on employment growth for the first time in several years. They employ about 19 million people compared to the Federal government employment of about 2 million, and this may be a surprise.

There is no doubt that the outlook for the US economy has improved over the last few months and we still remain hopeful that the oil price can come down further, which would be very helpful. This is offset to some extent by very cheap gas, helping many individual industries and employment. However, over 20% of the S&P 500's profits come from Europe and the recent strengthening of the dollar and weakening of many economies around the world will be a drag on reported corporate earnings this year. The market sells on about 12 or 13 times this year's earnings. Companies are generating record amounts of free cash flow and balance sheets are in the best position we can remember. We continue to follow the events in Europe carefully as this could cause major disruption to the world economy. We read a lot about China but, we think, at the margin they are becoming more comfortable that although they have problems in certain parts of the real estate industry, the overall economy should be able to grow at 7 or 8% this year. Thirty eight central banks around the world have cut interest rates over the last few months as inflation seems to be coming under control in most parts of the world, and this is a much more favourable environment than tightening which was happening throughout much of the middle of last year, partly in response to the much higher oil price and food prices, while there was heightened awareness of the problems in Europe every week.

The combination of all these events has meant that the Fund's cash position has moved down modestly to about 12% and if we find attractive new investments from a risk/reward perspective, we are not holding back from investing. However the market has had over a 20% recovery from its low in early October, and we have many investments we would like to buy a little cheaper on any dips in the market. The whole team seems to be on the buy tack rather than the sell tack, which tends to be a good sign.

Portfolio

The overall themes in the portfolio continue to focus on the strong get stronger, with secular growth companies in a period when structurally the growth in the US economy is likely to be more subdued than it has been in the past. Corporate America is generating huge amounts of free cash flow and also using this to buy back large amounts of stock or make very accretive acquisitions as within the US economy there is not the same structural need for this cash as there has been in the past. A record amount of our companies are buying back their own stock with their free cash flow. We try to invest in companies where we think the business model will be similar or better 3-5 years down the road, not impacted negatively by low Chinese wages, technology etc. In a slower growth

environment many of these companies are not growing quite as fast as they were in the last decade, but because of the free cash flow generation they are able to buy back 5-10% of their stock per annum at a time when equities are very cheap by historical standards; **the maths works well for the return on these stocks over the next 2-3 years**. They can also use their free cash flow to make acquisitions which are extremely accretive given the low level of interest rates. One of the things we have tried to focus on in recent years is only investing in companies where we believe the management team are extremely savvy and smart. In a rising economic tide, it tends to even out the differences between corporate management, but in tough times exceptional people tend to excel. Most of our companies generate excess cash and are able to self-fund growth well in excess of low double-digits, but in a more sluggish environment of say 10% bottom-line growth. If you can buy back 5-10% of your stock per annum without putting any more leverage on the company, the underlying value of the shares can compound in the high teens over time. About 60-70% of the companies in the portfolio have recently been actively repurchasing their own shares on some of the lowest valuations they have ever been at. There are also a group of companies where management have been very astute acquirers of other companies and in the current environment they are able to do this whilst significantly enhancing earnings per share. When you have this many companies buying back their own equity and you get a weak patch in the stock market, it is very comforting to know that companies are buying back stock and adding significantly to future value over time. We have always invested in such companies but an even larger portion of the portfolio than normal fits this mould.

Just to give investors a flavour, in practical terms, of what we are talking about, we would like to briefly highlight a few companies within the portfolio. Last week James visited Liberty Interactive in Denver. This holding company owns QVC which operates shopping channels in the US, Germany, UK and Japan and is able to move into new countries with very limited capital investment. It is a difficult business for most male fund managers to get to grips with! But the business model is very attractive with a very high return on invested capital, very stable business, ability to change the assortment of products to what people want to buy, while an increasing portion of sales is moving onto the internet with much better margins. 75% of what they sell is exclusive to QVC, somewhat insulating it from the more competitive online retailers such as Amazon. It took us some time to get comfortable with QVC as a business, as it is somewhat mature in the US and UK, but the advent of tablets and smartphones at a time when the company has significantly upgraded its technology infrastructure

over the last two years, should bode well for mid-single-digit revenue growth and a little margin expansion going forward. On top of this they are looking at moving into new countries such as Brazil, France or China. The company has a market capitalisation of about \$10 billion and about \$3 billion of investments. It also owns some ecommerce companies with very attractive business models which are growing revenues in the high teens. It is somewhat complicated and falls between cracks from a Wall Street analytical point of view. The leverage is relatively low and given the stability of the business, which we could see in 2008/2009 when operating income only dropped modestly and then recovered very quickly, the company can use more leverage. By moving leverage up modestly to around two times debt to EBITDA and keeping it there, **the company can use its free cash flow and growth in operating income to buy back 40-50% of its shares over the next three years.** They could do this while delevering if they could monetise some of their non-strategic investments tax-efficiently and it is always better to shrink equity with cash rather than debt. If you back out the investments, the company sells at below 10 times its free cash flow for this year and will jump sharply in 2013. Fortunately the UK is only about 5% of their operating income and the stock is discounting no improvement here! The internet companies could be spun out, highlighting their value, which no one really focuses on, and this could be worth well over 10% of the value of the overall company. The investments held seem to have good prospects and there is no need for them to monetise these but if they can do it tax-efficiently. The bottom line is you have a mature business in the UK and US but it is growing quite nicely in Japan and Germany as it is underpenetrated and optionality in getting into new markets could create some growth sizzle longer-term. In the meantime, they can aggressively buy back their stock with a very high free cash flow yield. If you do the maths it's hard for this not to be a reasonable investment in the next two or three years. At the same time, one of the smartest investors over the last 20 or 30 years in the US stock market, John Malone, is chairman of the company.

On the same trip, James visited Discovery, which we were adding to our long-term position in in November and December. The company operates 13 cable television channels in the United States and an average of 6 in 200 different countries around the world. They get a dual income stream where the cable television operator pays them an affiliate fee which tends to escalate every year at 3-5% domestically, whereas growth in the international markets is driven more by increasing penetration of pay television. About 40-odd per cent of their revenues also come from advertising, where the international pay television markets are in a position similar to the US 15 or 20 years ago.

Most of the viewing is still done on broadcast networks, but as more interesting cable channels get introduced they gain market share and attract advertisers' attention. As advertising penetration goes up it gives you a tailwind for many years and it looks as though Discovery's international advertising can grow double digits for the next few years in a modestly growing world economy. Affiliate fees internationally should grow in double digits as well, in line with pay TV penetration growing. Domestically the business is more mature but this company spent 20 or 30 years getting carriage on networks in the US and all round the world for channels that often did not have a huge amount of content. They own most of their own content and this is one of the few companies where all their content travels across borders very easily, allowing them a very high margin and very attractive business model. The shares got somewhat overvalued 18 months ago and we reduced our position significantly. We stress-tested this company for a down market in 2012, during the late summer, and this showed the business model to be very resilient in an adverse environment. The company has never had a down year and we purchased the stock at 12 times forward free cash flow. The company again is under-levered, generating about \$1.2 billion of free cash flow this year, which alone will allow you to buy back around 7% of the shares while delevering as the operating income grows. **If you just keep leverage the same they could buy back about 10% plus of their shares.** Debt to EBITDA is about 1.5 times and they think the correct level for such a company with a very stable income stream is about 2.5 times, allowing them to buy back a significant amount more equity in a weak stock market, giving more value longer term. It is really a great distribution company and it is only in its third, fourth, fifth innings of improving content. With more demand for content they say it is a great time to be in the content business which is reflected in our eps growth assumptions over the next few years of around 15%!

Comcast (a leading cable company) is another stock we have been adding to recently. Here is an example of a company that is in a very good position to up its share repurchase. Business is stable, leverage is low and the pay-out ratio could be higher. Comcast has shown 80 quarters of increasing cash flow and yet the stock trades on around 11x free cash flow. The reason for this is the perceived threat to its infrastructure platform. Last year this came from telephone competition and the likes of Netflix and 2012 looks like the era of Apple TV competition. Longer term there was a risk that a wireless company may overlay their expensive fibre networks but at the end of last year Comcast and Verizon signed a deal which we think suggests otherwise. In this deal Comcast sold some spectrum to Verizon (freeing up some cash) but more importantly it signalled that Verizon no

longer wishes to use up its valuable spectrum on video clips. It will instead sell cable services to its huge customer base. We think this alleviates the threat of wireless down the road. Comcast is growing its operating earnings at roughly 5 to 6% but because Capex is staying flat in absolute terms and has declined from 18% to about 12% of sales over the last 5 years and interest costs are coming down, the free cash flow per share is growing at a double digit pace. We think the company is currently under leveraged at currently 2 times debt to EBITDA. It is generating over \$4billion of free cash flow after a \$1billion dividend payment and this is just from the cable side. Comcast is shrinking the share count by about 3% or spending \$2 billion. With the bulk of the Capex spend behind it and no good use of the cash going forward, we think the company should announce a much more significant share repurchase and could easily shrink the share count by 6% without changing the leverage. If they wanted to go down the more aggressive route that their rival, Time Warner Cable, has adopted, they could add another turn to the leverage and boost their fire power by \$15bn but given the cautious nature of the management this is unlikely. The dividend is likely to be increased significantly over the next few years.

Conclusion

Economic statistics within the United States over recent months have been encouraging with the economy rebounding from the soft patch in the middle of last year. Unemployment, at last, seems to be moving in the right direction, having dropped to 8.5%, and there are tentative signs that the housing market is bottoming and even beginning to recover. Banks generally have rebuilt their balance sheets as they have retained capital rather than pay dividends or buy back shares in recent years. Credit quality has stabilised and is improving while bank loans in commercial and industrial have been improving smartly and even real estate loans are showing signs of picking up. We have added a little to the US banks but are generally underweight in the cyclical groups as we think growth will continue to be muted. **We are focussing on companies which have good margin potential from their current levels, to help the portfolio mitigate the risks of a reversion to the mean in US corporate margins.**

There continue to be many macro concerns with all attention on Europe and also China, although we are becoming more comfortable that China will continue to show good growth over the next couple of years. Thirty-eight central banks have now dropped interest rates over the last few months in response to inflation peaking in most areas of the world. This is a much better position than the

middle of last year when everyone was tightening in response to much higher food and oil prices, and investors were increasingly aware of the problems in Europe.

We still think it is a very uncertain world with slower growth prospects in the short run. However, falling interest rates, particularly in emerging economies, will lead to stronger growth later this year and into 2013 and the market will begin to discount that.

Our cash position has fallen from the mid-teens to around 12%, as all your managers seem to be in the buying mood, having stress tested most of our companies last summer, and we are not inclined to sell an awful lot. This has tended to be a good sign in the past.

We continue to focus on the strong get stronger, very high quality management teams who can excel in difficult periods and a focus on secular growth companies as opposed to those benefiting from a strong cyclical rebound. A record amount of our companies are using their significant excess cash flow to buy back stock in what we think are very predictable businesses over the next few years, and this should add significant value per share over time.

Since James and Rupert's visit to Brazil we have added to our Brazilian weighting following the 27% drop in dollars terms that the market had last year. Valuations here appear very cheap following this drop combined with robust earnings growth. The currency has corrected and if investors keep moving more towards risk rather than away, this should benefit the beta of the portfolio on the upside. Brazil feels like a strong link in the global economy and we are very pleased with the quality of our stock holdings in this market and we hope that these positions can perform strongly over the long term.

We are aware that we are stewards of people's capital in a very uncertain world environment and feel it prudent to keep a cash buffer and try and have a portfolio that should do well in most environments. However, if we get a very sharp recovery in world growth and investors moving to more cyclical companies, we will underperform a bit.

| Annual Performance | Findlay Park \$ change | Russell 2000 change | S&P 500 change |
|--|-----------------------------------|--------------------------------|-------------------------------|
| Inception to Year end 1998 | -0.40% | -8.49% | 16.81% |
| 1999 | 49.10% | 19.62% | 19.53% |
| 2000 | 1.28% | -4.20% | -10.14% |
| 2001 | 9.31% | 1.03% | -13.04% |
| 2002 | -11.25% | -21.58% | -23.37% |
| 2003 | 39.48% | 45.37% | 26.38% |
| 2004 | 24.82% | 17.26% | 9.14% |
| 2005 | 15.67% | 3.09% | 2.86% |
| 2006 | 24.06% | 17.00% | 13.62% |
| 2007 | 16.24% | -2.75% | 3.53% |
| 2008 | -30.87% | -34.80% | -38.49% |
| 2009 | 33.25% | 25.22% | 23.45% |
| 2010 | 23.93% | 26.28% | 12.80% |
| 2011 | -2.54% | -5.67% | 0.41% |
| YTD | 5.58% | 6.80% | 4.99% |
| Performance since inception | 397.70% | 72.55% | 26.01% |
| Compounded Rate of Return from inception to 25 Jan 2012 | 12.26% | 4.01% | 1.68% |

Past performance for the Fund and indices is quoted exclusive of dividends and in respect of the Fund is representative of the USD share class on a NAV to NAV basis.

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