
FINDLAY PARK PARTNERS LLP

FINDLAY PARK AMERICAN FUND NEWSLETTER 1ST AUGUST 2012

Price of Dollar Shares: \$51.54

Price of Sterling Hedge Shares: £28.12

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

Year-to-date the Fund is up 9.3% which compares to a 5.6% rise in the Russell 2000 and 9.2% in the S&P 500. Despite having averaged cash around 12% this year we still managed to slightly outperform our benchmark indices through good stock picking and largely staying out of trouble. The world has many challenges and we are trying to be a sensible steward of our investors' capital in this environment and navigate through it safely.

Economy and Stock Market

One thing is very clear: over the last several months the world economy has been slowing. Last year US companies were very surprised as they went through the second half of 2011 that their European exposure held in, albeit with little growth. This year almost every company is calling a slow-down in Europe and this is exacerbated by the weakness of the euro year on year against the dollar. In fact foreign exchange comparisons against almost all currencies are very negative for US companies for the next couple of quarters and this has exaggerated the reported sales slowdown. This also erodes the competitiveness of US companies to some extent. We recently met with David Farr, CEO of Emerson Electric, a very high-quality US industrial company. Many of his competitors are European companies and he is having to plan for what he expects to be a 1:1 or 1:1.1 euro:dollar ratio. **One of our main questions for US companies is how many of their competitors are European, as we don't think many US investors are focussing on this particular issue.** Chinese growth has also been very slow this year and most US companies are expecting a modest pick-up in the second half of the year. We listen to the bull and bear cases on China closely as it has been so important to world growth in recent years. The economic data is so opaque to us that China remains another uncertainty. The Shanghai composite is at lowest level since February 2009.

US unemployment statistics looked promising in the first few months of the year amid signs of a bottoming and modest upturn in the housing market. Recent evidence suggests the housing recovery is happening more sharply in some of the more stressed states such as Florida, Arizona, Nevada etc., where the long-term demographics are positive. Inventories of homes have shrunk fairly sharply and the government is implementing new policies to help clear the housing market. It is a slow progress,

but we seem to be moving in the right direction, and with housing having accounted for 6-7% of the economy at the peak and now 2.5%, this should be positive going forwards, particularly as you are able to take out a mortgage at about 3.75% over 30 years fixed. ***The Economist in a recent article suggested US house prices were more undervalued than almost anywhere in the world.*** The improvement in the market will also improve job mobility, which has been a key positive for corporate America in the past. New starts are picking up nicely and an improvement in the housing industry will be positive for employment and a key factor in reducing employment from current levels, as many workers in the construction industry cannot be employed elsewhere. Unfortunately the employment numbers have not looked good over the last few months. House prices are now down 30% on average, roughly, across the country, with many states having seen prices fall further than that. Recent statistics suggest pricing is now rising again and the sentiment of this happening brings more people off the fence to buy with a very low interest rate and what is quite often a big discount to replacement value. An interesting anecdote is that Miami appeared to have at least ten years of supply of newly-built high-rise condominiums in 2008. These have all been absorbed and new blocks are beginning to go up, but much of the absorption is mainly foreign and Latin American investors.

One of the most positive things to happen for the US economy over the last few years, has been the improvement in technology to exploit shale oil and gas. This is resulting in a wide array of new chemical plant investment announcements over the last year, as the US is now more competitive as a result of cheap feedstock than anywhere else in the world. Most existing plants are operating at capacity. Overall this should make the US economy much more competitive over the next few years, particularly as real wages for much of America have not risen a lot over the last ten years. The flexible labour force, cheap energy and increasing world-wide logistics costs, partly driven by higher oil prices, are leading to many companies considering expanding operations in the US again. It is interesting to see what has happened within the fuel sources for electricity generation in a short period of time. Two or three years ago, coal made up 48% of electricity production in the United States, a level which it had averaged for several decades. With the advent of cheap gas, coal has now fallen to 32% of production over the last couple of months and gas has risen from a long-term average of 20% to levels similar to coal at 32%. The environmental protection agency has introduced new legislation that will result in the closure of some uneconomic pollution-producing coal plants over the next couple of years. Drilling for gas at current price levels has dried up significantly, with much of the land rig activity now focussed on oil within the United States. This should result in gas rising from unsustainably low

levels over the next couple of years, but is likely to remain very competitive on a world basis, where it is currently \$3 per MCF against around \$10 in Europe and \$15 plus in the Far East in the LNG market. Many industries, such as steel, fertilisers and other energy-intensive industries are going to be much more competitive on the world stage than they have been for many decades. Even the switch from coal to natural gas at these price levels has resulted in lower utility bills for everyone. There is now so much oil being produced in the United States, relative to recent times, that the infrastructure has lagged behind the rise in production, resulting in very good margins for many refiners as the discount on WTI oil to Brent has widened. Rail companies are moving much of the sand and pipeline fracking equipment etc., and also moving oil from areas such as the Bakken in North Dakota, where there is not currently much pipeline access as this new basin has opened up. It is possible that the US will produce 1 million more barrels of oil a day this year, just from onshore production ramping up. The Gulf of Mexico has now recovered back to pre-Macondo levels and it even looks to have the potential for a mini-boom in the deep-water area over the next couple of years as more rigs are moved back to this very promising basin. Net oil imports into the United States are at the lowest level since 1995, helped by less usage which should fall further under the new fuel consumption legislation for cars introduced last year.

Household debt peaked as a percent of income at 133% in 2007, up from just under 100% in 2000. Through debt pay-down and mortgage charge-offs, it has now fallen to 114% and obviously with very low interest rates the cost of servicing this has fallen very substantially. Unlike Europe, the US banking system recapitalised itself very quickly and is in very good financial shape, even relative to forthcoming Basel III targets. As we highlighted in our March newsletter, the stress test introduced earlier this year was very extreme, with a 50% drop in the equity market, unemployment going to 13%, 30% further drop in property prices and the economy dropping 8% over two quarters. Most banks passed this test of still having to have more than 5% tier one capital. The ones that did not pass it are likely to pass at the end of this year. Commercial and industrial loans have been picking up and banks are keen to lend as their net interest margin is being squeezed as securities roll over at low rates. One of the things that has held back lending for mortgages is the 'put-back' issue where Freddie Mac and Fannie Mae are putting back mortgages they took from banks. This has been a major issue in many banks exiting the mortgage business or significantly downsizing their operations. Wells Fargo has been expanding into this vacuum and now accounts for over 30% of the US mortgage market. The government now realises the put-backs have been a major hindrance to mortgage availability and we are hopeful that over the

next 6-9 months most banks will have much more clarity on where they stand with this issue, which should increase mortgage availability. The consumer continues to refinance at record low rates at a rapid pace.

US trade deficit has fallen from around 6% of GDP to around 4% as consumers have retrenched somewhat from the debt-driven import growth of the last decade and the rapid cost-cutting of US companies during 2009 resulted in many becoming more competitive on the world stage. Exports to China have increased 53% since 2007. Some commentators are forecasting that the US will be energy sufficient by 2020 and energy has been a major component of the trade deficit over the last couple of decades.

The bears on the US stock market highlight record high profit margins that must revert to the mean, and there is no doubt that sales growth has been slowing over recent quarters, but this has been particularly evident in the more international companies, particularly when translating back into dollars. The margin ramp that we saw from the extreme cost-cutting in 2009 is clearly dissipating and profit growth is slowing. There is also the issue of the fiscal cliff at the beginning of 2013. Goldman Sachs estimates a fiscal drag of around 4% of GDP. We recently met with one of their economists and they think this will be watered down to more like 1% as sense prevails in Washington and legislation is put in place to reduce the impact in 2013. The problem is the political gridlock in Washington, where the two parties are more polarised than we can remember. It is also an election year and the debt-ceiling has to be renegotiated upwards at the end of the year, which again will probably be pushed into early 2013. **The timetable in Washington to get something done on all these issues is very tight, and we have already heard from several of our companies that the current weaker economic environment may be being caused by companies uncertain about what will happen next year in the US.**

The bulls highlight the fall in the price of oil, which normally results in the US economy picking up with a 6 month lag and the improving housing market, increasing competitive position and improving household finances. The stock market also looks very reasonable value at 12.8 times earnings estimates for 2012 and 11.9 times 2013. Free cash-flow is gushing out of American companies and balance sheets are in the best shape we can remember. Companies are buying back a record amount of stock and this is reflected in our portfolio, which has traditionally had around 50% of the companies buying back their own stock and now a higher percentage than that. Also many of our companies are

doing very meaningful buybacks. In the last newsletter we highlighted how this can improve the compounded free cash-flow per share over time, even from companies with modest organic growth.

Expectations for profits have fallen over the last few months, and during the recent results season companies with some economic sensitivity that came in in line with expectations and did not change their guidance for the rest of the year, produced some rather favourable stock reactions.

In a very uncertain world the more defensive, bond like predictable sectors have continued to generally outperform this year, especially those producing a yield in a world short of income. The tax on dividends from US corporations for US residents is only 15% and if the Bush tax cuts expire this will jump to 35-40%!

The market seems to respond favourably to bad news at the moment, with the expectation that this will cause the Federal Reserve to introduce new tools to help the economy. The Fed chairman confirmed that these might be:

- Treasury and MBS purchases
- Using the discount window for lending purposes
- Forward guidance regarding rates and the balance sheet
- Cutting the interest rate paid on excess reserves

Expectations of Fed action seem to have buoyed the market recently but we feel some of this is priced in.

Over recent years we have communicated to investors that we expect to keep a cushion of 8% cash at all times given the various uncertainties in the world. Prior to the last newsletter we increased this cash to 15% and it currently remains around 14%.

Portfolio

Earlier in the year we reduced some of the economic cyclicality from the portfolio at the margin. In an environment where overall US corporate margins may be peaking we have focussed on companies that still have good margin potential over the next few years, which restricts us to a much smaller portion of the stock market to look at than normal. In our experience the stronger companies continue to get stronger and this theme resonates throughout the portfolio as it has done over recent years. The quality of the portfolio is as high as it has ever been, especially as we have been creeping up

the market cap spectrum - the current average is approximately \$15.5 billion. **Our focus has always been on companies that if you look out three to five years you have a high degree of certainty where that industry and that company will be, and hence can see with more certainty than for most companies where their earnings and free cash-flow will be.** Many businesses are being turned on their head by developments on the internet or technology. We have re-emphasised our focus on companies run by exceptional management teams who are able to add value in uncertain times. As mentioned earlier, we are looking through all our investments to make sure they do not have too much European competition as it seems likely that the euro will continue to weaken, making that competition much tougher, and if it falls apart it will make that competition even more extreme. We have tried to de-emphasise those companies that require the trigger to be pulled on large multi hundred million dollar projects, as in the current uncertain environment there will be a tendency to put these on hold for the moment. We are trying to focus on companies that have relatively small ticket items, and hence a much better recurring or predictable revenue stream. The whole team are looking hard at companies that benefit from lower commodities prices, after battling with a decade of rising prices. Many of these companies are run significantly more efficiently than they were in the past and this could surprise investors.

Below we briefly highlight one of the stocks Sarah-Jane has been building up over the last six months, another company with a strong competitive position having expanded into new growth markets and now ramping up production, resulting in a significant build in free cash-flow per share.

Crown Holdings designs, manufactures and sells packaging products for consumer goods through plants located in many countries around the world. Primary products include steel and aluminium cans for food, beverage, household and other consumer products. Over the years the company became the dominant provider in this business in the United States through a very low cost lean manufacturing business as it also consolidated the industry using its free cash flow to build market share through acquisitions. More recently it has expanded into faster growing markets where the underlying growth for such consumer products is expanding at a multiple of that of the USA. Capital expenditures on these new plants has held back free cash flow over recent years particularly as these sophisticated plants can take a while to reach peak operating margins. The plants are generally built when they already have contracts to fill the capacity. A large part of the contracts often come from their US customers who are expanding abroad and already have had a good experience with them. The company is now going into harvest mode on some of the capacity that has been put in place and this

will result in rapid free cash flow growth in what appears a rather mundane business. The shares sell for a low multiple of forward free cash flow, especially relative to some of the better known consumer staples stocks despite Crown Holdings displaying many of the same characteristics.

Many investors have sensibly hidden in consumer staples in the last eighteen months, and these stocks have generally performed pretty well. However, valuations have risen at a time when the dollar has strengthened and often volumes have weakened, making comparisons more difficult. With our mid-cap focus we have limited exposure to these stocks, but hope to find other companies like Crown Holdings, which have very predictable outcomes but can be purchased on much lower valuations. The main consumer staple we have is Coca-Cola, which has performed very well and we are considering reducing.

With a team of ten people who are all seasoned and successful investors in their own right, searching for new investment ideas, we seem to be coming up with a lot of stocks we want to add to or initiate new positions in, but we tend to feel more comfortable with companies we know very well in this environment.

Conclusion

The bears on the US stock market focus on unsustainably high margins, driven up by the extreme cost cutting in 2009, and that these must revert towards the mean. We feel American companies moved ahead of much of the competition during this time period. Margins will not stay there for ever, but we feel that margins will remain high for the moment. **We are responding to this by only focusing on companies that have margin potential.** The other issue the bears focus on is the fiscal cliff at the beginning of next year, which, according to many commentators, is 3.5-4% of GDP. There is admittedly a very short period to deal with this, with the election looming, and this should remain a concern at the moment. Messer's Simpson & Bowles seem to be getting a lot of traction despite the election looming, and **we are hopeful that this fiscal cliff can be watered down, but it remains a major uncertainty for the moment.**

On the more positive side, valuations appear reasonable, investors are more cautious, companies are generating substantial free cash-flow and balance sheets are in very good shape. **A decent portion of the return in the Fund will come from companies, which are growing at modest levels in a slower**

world growth environment, buying back a significant amount of their equity at attractive levels with their free cash-flow, driving compounded earnings and free cash-flow per share significantly above the underlying growth of the companies. We highlighted a table in our last newsletter with a company growing its free cash flow at 5% and buying back its stock with all its free cash-flow at 12 times, compounding its underlying free cash-flow growth over 5 years at 14.5%.

Our readers are obviously aware of the issues in Europe and the opaque economic statistics one has to focus on in China, which has been a major driver of world growth over the last decade. The world economy is clearly slowing at the moment, unlike last year when it was much more resilient even while interest rates were being tightened to bring inflation under control, particularly in emerging economies. This year inflation expectations are coming down (although the recent drought in America has negative implications for food price inflation) and hopefully investors will, at some stage, start looking up to better economic growth. However, the environment remains very uncertain. We have said to investors in the last few years that our cash was unlikely to drop below 8% and also communicated it rose to 15% in the last newsletter. It is currently 14%, a level we feel comfortable with for the moment but we will be pragmatic about putting it back to work.

Your team of ten seasoned analysts and managers concentrating on the Fund seem to have more ideas they want to add to than sell at the moment especially if the macro picture clears a little. Having progressed through most of the results season, this is hopefully an encouraging sign.

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	9.33%	5.63%	9.21%
Performance since inception	415.40%	70.66%	31.08%
Compounded Rate of Return from inception to 31 July 2012	12.07%	3.78%	1.90%

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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