

Founders Capital Management, LLC

2008 Annual Report:

“Seeing Things As They Really Are”

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PRINCIPALS' LETTER

From: Founders Capital Management

2008: Seeing Things As They Really Are

During 2008, the stock and fixed-income markets experienced a tremendous amount of volatility, making 2007's gyrations seem tranquil in comparison. The S&P 500 plunged 37%—marking the greatest annual loss since 1937. As the year unfolded, the housing mortgage meltdown and pressure on securities associated with high-risk loans spawned a full-blown credit crisis, precipitating investor panic. Investors cried, “*SELL*.” We truly experienced a once-in-a-generation financial earthquake—and tremors are likely to follow. Similar to last year, 2008 was a year to “lose less money” by avoiding various types of financial investments that suffered permanent loss.

Although the market was successful in generating a small so-called “Santa Claus rally” during the last few days of the year, any short-term rally is suspect due to lingering risks in the financial arena. We will most likely continue to see random price movements in both the stock and fixed-income markets during 2009—along with a high degree of volatility.

This leads us to our usual statement, which we have *modified* since market conditions have changed:

With today's uncertain environment of low interest rates, opaque financial markets, volatile commodity prices, high amounts of consumer and government debt, a bloated trade deficit, large currency imbalances, and ongoing geopolitical issues—investors (including professional) have panicked. At current prices, we expect our holdings (both stock and fixed-income) to perform fairly well into the future.

This is not a general statement on the short-term direction of the stock and fixed-income markets. We believe, however, that great companies (many of which we own) are literally “on sale” at their current quotations. We also believe that these fantastic businesses will continue to rise in value over the next 10 years, despite short-term gyrations in the markets.

A side note: Many investors look at their current portfolio and state, “*The stock market is a disaster—the value of my portfolio is the same as it was 10 years ago.*” Our response to this: Au contraire! What investors may fail to realize is that 10 years ago, the quoted prices of companies in their portfolios were inflated far beyond the business value of their underlying holdings—by up to 100%, in many cases. Today, the opposite holds true: Many of the companies within an investor's portfolio are being quoted at prices that reflect a 50% discount from their business value. In essence, the actual business value of an investor's portfolio has grown over the past 10 years, despite currently quoted prices remaining flat. As we have stated in the past, investors wishing to grow their wealth should

concentrate on the pace at which their investments grow in intrinsic value. Unfortunately, this is not the norm. Instead, most individuals are only ecstatic with high growth in paper wealth, regardless of whether that wealth is grounded by a commensurate expansion in *business value*.

Founders Capital Management is pleased to report that once again, over the past 12 months, the underlying business value of our aggregate equity holdings grew, although at a slower pace. The companies we own remained profitable and continued to exploit attributes that give them a long-term competitive advantage. In fact, we expect many of our companies to actually grow stronger in this weak business environment as competitors fall by the wayside or go out of business. On the other hand, several of the businesses we invested in through fixed-income securities have deteriorated in value. As a result, we chose to make a number of adjustments in this area. These issues are fully addressed in our fixed-income section.

This brings us to the theme of this year's letter: "Seeing Things As They Really Are."

The above illustrations by artists Thomas Nast and Haddon Sundblom feature timeless American images that are familiar to us today. Nast, the famous caricaturist for *Harper's Weekly* in the late 1800s, is the creator of several iconic American images, including the Democratic party donkey, the Republican party elephant, and the image of Uncle Sam wearing striped pants, a long overcoat, and a top hat. In 1863, Nast began to evolve his own concept of Santa Claus. Nast gave his figure a "flowing set of whiskers" and dressed him "all in fur, from his head to his foot." Nast also drew a series of cartoons of Santa Claus for a book by George P. Webster. Nast's vision had the old boy living at the North Pole with a workshop for building toys and a large book filled with the names of children who had been naughty or nice.

Thomas Nast was once asked to draw caricatures of the guests at a party he was attending. Engaging in the fun, he drew a caricature of everyone at the gathering, and then passed the caricatures around to see how well they could identify the drawings. Each of the partygoers identified every caricature correctly—except for their own.

The point of the story: We are in a period of tremendous economic and political turmoil, and each individual, state, and nation can point to the various problems that led to our current circumstances—all outside of their own sphere of influence. Yet each appears unable to recognize their own actions that contributed to our current state of affairs—in other words, they fail to see things as they really are.

Although we do not normally take a macroeconomic view when investing, today's uncommon financial environment forces us to think in broader terms. Therefore, we will take a "pragmatic view" in this year's letter, reflecting on where we are, how we got here, where we are headed, and what we are going to do. We will discuss:

- **today's transfer of wealth and the weight on property ownership,**
- **capitalism versus socialism, and their respective impacts on wealth creation,**
- **globalization of markets and unified regulation, and**
- **deflationary and inflationary pressure on businesses**

2008 in Perspective

Where are we?

"...This is preeminently the time to speak the truth, the whole truth, frankly and boldly. Nor need we shrink from honestly facing conditions in our country today. This great Nation will endure as it has endured, will revive and will prosper. So, first of all, let me assert my firm belief that the only thing we have to fear is fear itself— nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance...."

....The [bankers] have fled from their high seats in [these hallowed halls] of our civilization. We may now restore [these hallowed halls] to the ancient truths. The measure of the restoration lies in the extent to which we apply social values more noble than mere monetary profit.

Happiness lies not in the mere possession of money; it lies in the joy of achievement, in the thrill of creative effort. The joy and moral stimulation of work no longer must be forgotten in the mad chase of evanescent profits. These dark days will be worth all they cost us if they teach us that our true destiny is not to be ministered unto but to minister to ourselves and to our fellow men.

Recognition of the falsity of material wealth as the standard of success goes hand in hand with the abandonment of the false belief that public office and high political position are to be valued only by the standards of pride of place and personal profit, and there must be an end to a conduct in banking and in business which too often has given to a sacred trust the likeness of callous and selfish wrongdoing....

....in our progress toward a resumption of work we require two safeguards against a return of the evils of the old order; there must be a strict supervision of all banking and credits and investments; there must be an end to speculation with other people's money, and there must be provision for an adequate but sound currency.

These are the lines of attack. I shall presently urge upon a new Congress in special session detailed measures for their fulfillment, and I shall seek the immediate assistance of the several States.

Through this program of action we address ourselves to putting our own national house in order and making income balance outgo....

—Excerpted from Franklin D. Roosevelt's First Inaugural Address
March 4, 1933

"Those who cannot learn from history are doomed to repeat it."

—George Santayana

The financial and economic environment we face today has an eerie familiarity. In many ways, our current situation resembles the infamous depression era of the 1930s. We have a high state of confusion in the financial markets, inconsistent government intervention, and a lack of planning to address various problems—leading to “shoot-from-the-hip” *reactions* to each rising crisis. A lack of liquidity has led to a frozen market—in other words, the markets are virtually closed, and they will stay that way as long as reluctant buyers and panicked sellers are unable to come together. For the most part, the government's short-term solution seems to amount to throwing money at the problem(s).

And this is not just a United States phenomenon. The market collapse has spread throughout the world, magnifying our own financial earthquake. In response, central banks around the globe are following the U.S. lead, printing money to save their financial systems and to ensure that their country's currency does not become too disparate from the U.S. dollar, which would impact their ability to trade.

The cumulative result: Each country is acting independently to address the financial crisis impacting their home market, unwittingly exacerbating the contagion in a world that is now truly interdependent. All players will eventually need to pull together in a coordinated effort to dig their way out of the dilemma. Until coordination becomes the overriding theme of a so-called “plan,” all countries will

most likely experience negative financial and economic consequences as they continue to attempt to move the “economic levers” to their favor. These self-serving acts are likely to enhance imbalanced government budget and trade deficits, volatile commodity prices, and gyrating currency exchange rates—leading to further instability among world markets as we transform into an organized interdependent society.

A few salient points about the U.S. position:

- The low cost of goods produced outside the U.S. and our high consumption of foreign goods has led to imports eclipsing exports, resulting in a U.S. trade deficit that now exceeds \$650 billion (about 5% of GDP).
- The U.S. trade deficit is leading foreign countries such as China, India, Japan, and Saudi Arabia, which have become flooded with U.S. consumers’ dollars from their purchase of imported goods, to purchase U.S. Treasuries.
- The aggressive purchase of U.S. Treasuries by various individuals and countries seeking safety from uncertain markets is leading to lower-than-normal interest rates. At the end of 2008, the purchase of a 10-year U.S. Treasury Bond yielded 2.25%—the lowest level on record.
- Savings by U.S. families is at an all-time low, and total U.S. consumer debt now exceeds \$14 trillion. Consumers having taken advantage of low interest rates, borrowing against the equity of their homes, and maximizing lines of credit through the aggressive use of credit cards—more than \$8,500 per U.S. household.
- The U.S. government is borrowing billions of dollars to stem the current financial crisis and fund an economic recovery. In 2009, the U.S. government budget deficit may top \$1 trillion, as the U.S. Treasury commits \$1.0 trillion+ to backstop the U.S. banking system.
- The world market may begin to question whether the U.S. government and consumers will be able to pay back their massive loans in a timely manner. A potential loss of confidence in the U.S. dollar as a result of our excessive borrowing could lead world markets to stop accumulating dollar-denominated assets. Such a loss of confidence could spur rising interest rates as countries stop purchasing U.S. Treasuries.

The U.S. Treasury and the Federal Reserve are jointly attempting to take a balanced approach during this financial crisis—managing a faltering economic environment while staving off both deflation and inflation. Since investors do not know exactly how government maneuvers will further impact the variables summarized above, they should focus on allocating capital with intelligence. In our view, this means allocating capital with objectivity and wisdom. Investors should remain objective about the markets and their investments, taking a rational view of expected risks and rewards. They should also be mindful of investment wisdom, which dictates that they care for clients’ money as if it were their own. Although investors cannot foretell the future course of an uncertain market, they should seek to position capital in ways that maximize the protection of total principal and achieve fair long-term returns.

One particularly troubled area is the financial sector. Banks, investment banks, and insurance companies are now teetering on the edge of bankruptcy after overleveraging their balance sheets and taking advantage of naïve investors to enhance their personal returns. Today’s Wall Street participants have given new meaning to Franklin Roosevelt’s declaration, “...[bankers] have fled from their high seats in [these hallowed halls] of our civilization. They not only fled the hallowed halls with investor money, but took the seats, furniture, artwork, and drapes with them. Of course, many professional investors are not without blame, having fallen victim to Wall Street’s alluring promise of quick profits. They acted like the single guy living at home with his sickly father and working in the family business: The guy knew there was a fortune to inherit when his father died. So he decided he needed a wife with whom to share his impending fortune. One evening at an investment meeting, he ran into the

most beautiful woman investment banker working on Wall Street. Her natural beauty took his breath away. Without hesitation, he approached the woman and said; “I may look like an ordinary man, but in just a few years, my father will die and I will inherit \$100 million dollars.” Being an investment banker, the woman was very impressed, so she asked for his business card. Three days later, she was his stepmother.

A large transfer of wealth has taken place in the U.S., with Wall Street players putting themselves in front of their clients and fleecing large amounts of money from investor pockets. As unprotected investors watched the equity in their hard-earned property transfer to the Wall Street “helpers,” they wondered: “Where exactly has my money disappeared to?” The explanation lies in the extent of the wealth transfer, which was enhanced through heavy borrowing against investor assets. The availability of inexpensive money allowed “all” participants to leverage their assets, backed by minimal amounts of equity. The end result: As asset prices began to fall precipitously, equity was wiped out, with insufficient assets available to pay back borrowed money. A government bailout is now necessary to staunch hemorrhaging asset prices. The bailout will take many forms and cover all participants—including overleveraged banks that focused on dicey mortgages and credit cards, investment banks that allowed hedge funds to borrow vast amounts of money to invest in speculative assets, auto manufacturers that sold cars at a loss while attempting to make profits via car loans provided through credit firms they owned, and homeowners that borrowed far more money than their capability to pay back assuredly. With a large (and necessary) government intervention, it is now likely that individual property values will be permanently impaired.

We believe that the economic prosperity of a nation correlates strongly with its government’s efforts to protect individual property rights. A primary goal of any successful government is to create an effective environment in which citizens may own and transfer property for various uses, whether for public or private businesses, housing, land, etc. Historically, countries whose governments have interfered with citizens’ property rights through central planning and other methods have experienced stifled economic growth and faltered. For example, we have witnessed tremendous economic development in China over the past decade as the government began to allow citizens to own property instead of keeping it under government control. The standard of living rose markedly, and the Chinese economy took off as farming and manufacturing productivity increased, all due to the potential bestowed by the government on each individual to increase their wealth.

In the U.S., we have created and evolved a system of laws and regulations to protect an individual’s property. Every once in a while, however, a needed adjustment to these regulations hasn’t kept pace with a changing economic and financial landscape. For example, the revolution of banking over the past 20 years has outpaced the evolution of regulation. The result was unprotected investor property, which led to Wall Street abuse. A vast wealth transfer has now taken place as interconnected layers of “helpers” siphoned off property from unsuspecting investors, finally requiring the government to step in. The world is now questioning the concepts of democracy and capitalism, and wondering if a controlling government that oversees socialism might be a better system.

We believe that democracy and capitalism, coupled with the protection of individual property, lies at the heart of U.S. success. Until we further evolve our country’s laws and regulations regarding the protection of investor property, however, we are going to have to undergo a “forced nationalization” of our financial system. This temporary socialization will weigh on investors’ returns for a long time to come—and unfortunately, there is nowhere to hide. As FDR said in his inaugural address: “...*there must be an end to a conduct in banking and in business which too often has given to a sacred trust the likeness of callous and selfish wrongdoing.*”

How did we get here?

We believe the current financial predicament in the U.S. is largely attributable to three fundamental issues:

- 1. Conflicted & perverse incentives:** Generally, excess investment returns throughout the 1990s upped the ante, creating a “need” for more aggressive and complex investment strategies that

would continue generating stellar investment results. Individuals became accustomed to, and even began to feel “entitled” to, annual returns upwards of 15%. The financial advisor that did not meet a 15% “bogey” could expect to be fired. As a result, expert advisors began to proliferate within the investment industry. General advisors hired other expert advisors who had so-called “greater expertise” in certain areas of the increasingly complex financial industry. Basic money managers hired supposedly more sophisticated money managers (hedge funds) to boost returns. Investors also acted like honey bees, jumping from one sweet spot to another (stocks, bonds, real estate, etc.), all in the pursuit of getting rich quick.

Banks and investment banks helped their clients to achieve greater investment results by introducing sophisticated investment contrivances—from special mortgage products to instruments designed to spread and cover risk (derivatives). Supposed unbiased rating agencies were ushered into the act to bless sophisticated investment instruments. Excessive fees charged for these services fed an incentive for the banks to increase investment complexity to justify their own higher fees as they chased higher returns.

Who is to blame for this spiraling dynamic: The investors, for demanding 15%+ returns and firing advisors on a dime for not producing the “expected results?” The advisors, for seeking additional help to meet higher expectations? The banks and investment banks, for supplying ever-more sophisticated investment products to meet customer demands? The mortgage brokers, for pushing people to refinance their houses to enable them to obtain more money to satisfy their increasing consumption habits? Or the rating agencies, who provided high investment ratings as the new investment world figured out a way to “diversify risk” through investment insurance? Most likely, no individual group is to blame—but rather human nature. The everlasting desire to obtain riches easily fed a conflicted and perverse incentive system that enabled everyone to see things the way they wanted them to appear, versus seeing them as they really were.

- 2. Securitization and credit expansion:** Another cause of our current situation is the advent of securitization, which changed both credit extension and the investment landscape.

In last year’s letter, we stated that in the old days, when a bank lent money to a homeowner, the loan was kept at the bank and serviced over the life of the obligation. That landscape is unrecognizable today. Banks now package their extended mortgage loans (along with auto and credit card loans) and sell them to the investment community—then take the money they receive from the sold loans and repeat the process. This circular motion of money is called *securitization*. The process of securitization produces bank fees and supposedly transfers the loans from the bank’s balance sheet to investors, spreading risk throughout the investment world. Securitization also allows for an efficient expansion of credit. Unfortunately, what began as a simple solution for extending credit, managing risk, and producing extra fees quickly became abused by all participants.

Individuals took advantage of easy credit as interest rates declined significantly over the past 25 years. Who in their right mind would deny an offer of “free money”—think 0% credit card financing for six months, with the novel idea of jumping from one bank to the next to indefinitely avoid paying any interest. Others obtained an interest write-off on their taxes by refinancing their house and/or taking out a home equity loan to pay off their maxed out credit card line—only to retrigger their short-term credit availability and repeat the cycle as their house increased in value.

As the demand for free money increased, financial institutions began to aggressively extend loans to individuals who were not creditworthy, knowing that they could make a quick profit and “dump” the higher-risk loans on unsuspecting investors. Investment banks even developed innovative investment products that dealt with the growing speculative pool of loans by slicing the mortgage and other types of loans into various securities called “collateralized mortgage obligations” (CMOs) and “collateralized debt obligations” (CDOs). These debt obligations can have 10 or more slices, with the highest-rated pieces getting first priority in the loan pool, appealing to very conservative investors. The lowest pieces can literally trade like a stock, since

these loans offer a higher interest rate to the investor but have a greater probability of ending up in default. These speculative slices attracted higher-risk investors (think: hedge funds).

Credit increased exponentially, and eventually more than 11,000 investment pools existed, each encompassing thousands of loans and thousands of investors. Many of the loans that were issued to individuals who were not creditworthy received agency ratings that placed them in the highest AAA-rated CMOs and CDOs. As asset prices and their corresponding loans began to collapse, the warts of many CMOs and CDOs came to light, and investors scrambled for the exits. The loan pools are so convoluted that experts can't follow the money to decipher what the pools are worth. Making matters worse, many banks throughout the world decided to engage in "lazy banking" and purchase CMOs and CDOs with customer deposits in lieu of going through the procedure of loaning out money in the traditional way. The global banking system has now virtually collapsed, requiring governments to step in to supply emergency capital that has dissipated from faltering financial institutions.

- 3. Antiquated regulation:** The financial landscape changed rapidly during the past decade as financial "innovation" (securitization and derivatives) spread throughout the world. The Internet, coupled with higher speed broadband transmission, offered a new communication method for investors to quickly move capital throughout the world. The normal evolution of the financial markets went into fast-forward, and a revolution in the global financial markets took place as the markets officially became interconnected. Regulation of financial markets remained independent, however, with each nation enforcing their own particular security laws that were rapidly losing relevance to the fast-changing financial universe.

There is one area in which regulation has not kept pace with financial innovation: The Federal Reserve requires U.S. banks to maintain a certain percentage of equity capital (called tier ratios) to support their lending activity. With the advent of securitization, banks found it difficult to meet the required capital commitments when they purchased many loans from mortgage brokers. Looking for a way to lever up beyond the equity requirements to support their aggressive purchase of mortgages, banks created Special Investment Vehicles (SIVs) that temporarily purchased and "warehoused" these loans with borrowed money in preparation to be resold to investors. The banks were not required to put these investments on their balance sheets as they were considered "contingent liabilities," which the bank would not normally be liable for "except in unusual circumstances." Through SIVs, banks were successful in circumventing the equity requirement regulation by eliminating the need to raise additional equity to support these "temporary" loans. Imagine what happened when the credit markets froze and banks were not able to sell the loans within their warehouse vehicle—the banks became liable. Unusual circumstances occurred and what was off-balance sheet then became on-balance sheet now—creating a big problem.

The hedge fund industry is another area in which a lack of regulation contributed to the current turmoil. As a refresher: Hedge funds have a stated goal of minimizing investment risk while maximizing gains. A simple hedge fund attempts to evade the risk in a portfolio, for example, by selling certain stocks short (i.e., betting that these securities will decrease in value) while purchasing other stocks long (i.e., betting that the value of these securities will rise). The theory is that if the stock market goes down, one will make money on the companies that were predicted to drop in price. It is expected that the money made on the trampled companies will offset or even surpass the money lost from falling stock prices on companies that were predicted to go up. The reverse happens when the stock market goes up—the gains on the stocks that one bet would rise are expected to far exceed the losses from bets on the stocks that were predicted to fall. The endgame of a well-hedged portfolio is that, no matter what occurs in the market, an investor loses little money and actually makes some money. The other tactic that helps a hedge fund maximize investor returns while employing a market-neutral portfolio is leverage. Many hedge funds will borrow \$20 for every \$1 placed within the fund.

Hedge funds were originally designed for very wealthy individuals who fit the label of “sophisticated investor.” Well-heeled and knowledgeable about risk, such investors were attractive candidates for hedge fund operators, who were not required by law to register as investment advisors with the Securities and Exchange Commission. For a long time, the scheme of hedge fund operators hooking up with wealthy investors operated intact.

Eventually, however, hedge funds, with Wall Street’s help, found a way to reach beyond the “well-heeled” investors to offer a similar type of investment approach to the masses through pension and endowment funds. At the beginning of 2008, some 9,000 hedge funds managing more than \$1.8 trillion—a large portion of total invested funds in the U.S.—were in operation. The market-neutral objective of hedge funds increased in popularity over the past five years as institutional investors sought high returns with minimal volatility. As hedge funds grew in competition, they began to pursue similar strategies. Eventually, to continue to meet the goal of a market-neutral portfolio that delivered high returns, most hedge funds ended up with a high percentage of hard-to-value opaque securities, including derivatives. When there are a lot of different hedge funds trading opaque securities with each other, everything is fine. But all trading stops when the price of those securities drops precipitously. When that happens, leveraged hedge funds can thus lose between a lot and a whole lot of money easily—and they did.

The great unwinding

The turbulent market of this past year is the result of the equity and fixed-income markets undergoing an increasingly severe “deleveraging” brought about by financial institutions and investors (primarily hedge funds) that borrowed money to enhance returns. Many investors placed borrowed money into speculative securities—associated with debt—that were made to look investment-grade by the investment banks that sold them and by the agencies that favorably rated them. Opaque securities that were deemed safe were purchased by unsuspecting investors who never really understood the securities they acquired—and a fearsome unwinding commenced as they began to realize that what they owned was “air.” Ironically, the toxic fixed income-related assets that are coming unwound—which no one will buy—were pushed by investment banks who lent large sums of money at rates of up to 30% per year to the hedge funds to make these “leveraged bets.” To meet margin requirements and cover loans as the market tanks, investment banks are forcing hedge funds to sell “any” asset that can be liquidated—impacting the stock prices of iconic American companies such as Coca-Cola, PepsiCo, and Microsoft. It is quite possible that the only thing left on many hedge fund books will be toxic and worthless fixed income-related assets.

Everyone is asking: When will the unwinding end? As we have stated frequently throughout this year, Winston Churchill once stated after Britain’s victory in Africa during World War II: “*Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning.*” Unfortunately, it looks as if we are now at the end of the beginning of the massive unwinding of speculative fixed income-related securities. And this unwinding will most likely continue to impact safe securities as many hedge funds “panic sell” to create liquidity to meet loan (margin) requirements and investor redemptions. Yes, many individuals are just now waking up to the fact that the hedge fund world is a black box that holds securities they have invested in yet know nothing about. Predictably, these individuals are demanding their money back from hedge funds—adding to the so-called “forced liquidation,” and intensifying the great unwinding.

A frozen credit market and schizophrenia

Banks are finding it extremely difficult to “manage” their way out of a frozen credit market that originated from the mortgage meltdown and surrounding pressure on derivatives (bets) associated with these high-risk loans. These obscure mortgage-related securities are at the center of a financial earthquake whose tremors during the past year have led to the domino collapse of major financial institutions including Bear Stearns, Fannie Mae, Freddie Mac, AIG, Lehman Brothers, and Washington Mutual, to name just a few. Large aftershocks are likely to continue in the banking industry throughout 2009 as rumors about the collapse of many more financial institutions continue to spread throughout the market.

The U.S. Treasury and Federal Reserve came to the rescue of some financial institutions—including Bear Stearns, Freddie Mac, Fannie Mae, AIG, and Wachovia—but let others such as Lehman Brothers and Washington Mutual “die on the vine.” The government allocated bailouts to institutions whose demise it deemed too great for the markets to bear. These arbitrary decisions wreaked havoc on the credit market as investors were left to guess which financial institutions would be saved and which would be allowed to fall into bankruptcy.

Fearing insolvency, banks are now hoarding money, creating a more difficult environment for individuals and businesses to obtain credit to refinance their loans as they come due. The U.S. government’s Russian roulette approach to managing the crisis has fed uncertainty to the point that investors are no longer able to evaluate risk. This, we believe, is the core reason the credit markets have literally frozen solid, and this confusion between uncertainty and risk is likely to continue to create random price movement within the stock and fixed-income markets throughout 2009—until a reasoned and coordinated bailout plan is articulated and executed.

In the meantime, all investors are fleeing to the sidelines and purchasing U.S. Treasuries at any price until they can make sense of the credit market. At the same time, the short-term debacle does not alter the underlying credit problems—many banks, hedge funds, and individuals remain overleveraged, and the unwinding of debt still has a long way to go. Our opinion is that the storm is not over, and that market conditions require investors to reevaluate their positions—to weather the storm with eyes wide open.

Where are we headed?

We previously mentioned the wealth transfer that has taken place over the past decade. Individuals who refinanced their property several times against the rising equity in their houses have passed their homeowner equity on to mortgage brokers and banks and consumed the equity they removed from their homes. All Americans participated in the great credit expansion. In the future, individuals seeking bank loans will be required to place “real equity” into their property. The days of 100%+ financing are gone. This will require Americans to save, curtailing superfluous consumption.

Investors seeking to maximize their returns in difficult times transferred their wealth to high-charging hedge funds and investment banks that aggressively borrowed money against investor equity to deliver enhanced returns. With declining asset prices, equity disappears but the liabilities remain. Equity becomes intangible but debt remains real. The equity that has been removed from all assets is so all-encompassing that it has become necessary to re-equitize the entire financial system. The only institution with the ability to produce equity “at will” at this scale is the U. S. government—and thus, we will need continued government intervention.

Whether the intervention is realized by providing friendly loans to individuals who cannot meet their mortgage payments or to financial institutions that overleveraged to enhance returns, the end result is the same: The U.S. Treasury is stuck with having to provide vast amounts of money to replace the equity that was removed from the financial system by all participants. This so-called re-equitization requires the government to borrow trillions of dollars, currently at low rates, to pump into the financial system to keep it afloat. The key question is: Can the government pay back investors and remove borrowed money from the financial system, or will the government be forced to repurchase all the debt and permanently place money into the financial system—in essence, printing money? This action is referred to as “monetizing debt.”

We don’t know the answer to this question. What we do know is that the U.S. government will become an equity partner to homeowners and financial institutions—thereby nationalizing a vast amount of property within the U.S. This nationalization of an estimated 10% or more of the U.S. capital markets creates a dilemma for investors as the government becomes a business partner and serves as the primary owner of a large part of the U.S. financial system. Taxpayers who back U.S. government ownership will demand to be paid first, impacting returns and wealth creation for remaining investors. In the end, our financial system may be teetering on the brink of socialism for a while as credit absorption takes place, perverse incentives are removed from Wall Street, and abused

capitalism seeks to right itself. This may take a decade or more to play out, and for the time being, financial returns may ultimately be dictated by government returns—not a good scenario for most investors.

Continuing globalization of economies and markets will force countries to move toward constructing global regulation and security laws that protect individual investor property in the future. We can expect to see regulations changing for banks, including the requirement that these institutions disclose all investing activity, even temporarily, to ensure they do not circumvent capital ratios designed to maintain a safe financial institution. In addition, we will see regulation of opaque investment firms such as hedge funds. It makes little sense that these investment vehicles—several of which control more than \$30 billion—do not fall under U.S. regulatory purview. No corporation managing \$30 billion of public money could get away with such minimal reporting and oversight, a situation that all but invites fraud and mishap (think: Madoff)!

The U.S. will also have to develop a unified “code of behavior” to be adhered to by all participants in the financial system to ensure that perverse incentives do not rear their ugly heads in the future. We may possibly return to a period in which, to paraphrase Franklin Roosevelt, happiness lies not in the mere possession of money, but in the joy of achievement and the thrill of creative effort. May the “joy and moral stimulation of work” no longer be forgotten in the “mad chase of evanescent profits.”

A considerable aspect of our current financial crisis, in addition to the deterioration in value of financial assets, is a great loss of confidence. This is the keystone of the current credit crisis that has now lasted over one year. To reiterate from last year’s letter: J.P. Morgan summed up our current situation decades ago, when he was asked if commercial credit was based primarily on money or property. Said Morgan: “*No sir, the first thing is character. Before money or anything else. Money can’t buy it.*” Our financial system is built on trust, and when trust wanes, the financial system is vulnerable to collapse. Until we gain faith in the character of individuals that are responsible for managing our wealth, the markets will falter.

And now for the question on everybody’s mind: Recession or Depression?

Our noncommittal answer: We don’t know. But if we do enter a deep recession or even a depression, one needs to ask whether it will be accompanied by deflation or inflation. Neither of these scenarios is desirable, but the answer is important for investors. So far, the consensus seems to fall into the camp of deflation, as asset prices have fallen precipitously during the last half of 2008 and left many individuals and corporations with lower equity and growing liabilities. On the positive side, deflation is also accompanied by falling prices of many goods—just look at the price of oil, which has dropped from a high of approximately \$145 per barrel to less than \$40 per barrel in just six months. On balance, however, deflation is very destructive, with the falling prices of assets, wages, and most goods not accompanied by a commensurate decrease in the amount of what is owed. The core around which capitalism is built is the extension of credit, and a contraction of credit was a major contributor to the deflationary depression of the 1930s.

The U.S. government is working diligently with the Federal Reserve to avoid a deflationary environment, aggressively lowering interest rates and rapidly feeding trillions of dollars into the financial system to enhance liquidity, shore up falling asset prices, and get the credit gears moving again. We believe that the quick response by the U.S. Treasury and Federal Reserve will likely help us avoid a long-term deflationary environment. We are fairly confident that credit will “unfreeze” and continue to be extended by financial institutions. Investors should probably pay heed to Isaac Newton’s third law of motion, however: *For every action, there is an equal and opposite reaction.* If the act of placing vast amounts of money into the financial system is not reversible through the removal of that money in the future, it is highly likely that we will enter into an inflationary period—perhaps one that is quite high. This scenario is no better than a deflationary environment, with wage increases likely failing to keep pace with the rising prices of all goods and services. Just think of how we all felt paying more than \$4 a gallon for gas during the summer of 2008 while our incomes remained static.

In the past, we have stated that inflation has the largest impact on the long-term return of all types of capital. Since inflation is essentially too much money chasing too few goods, and is a man-made phenomenon, many believe it can be man-mastered through the injection or removal of money from the financial system.

The inflation equation is important to understanding the "real earnings" a business produces for owners. "Real earnings" are determined by the extra purchasing power an investor achieves having placed his money at risk. For example, let's say you decide to start saving for your child's college education that will start in 10 years. Suppose you opt to put aside \$20,000 today for the anticipated first year of college. Given that you think tuition will increase 3% per year, you decide to put the \$20,000 in a safe tax-exempt bond that earns approximately 3.5% per year. At the end of 10 years, the \$20,000 will have grown to a little over \$28,000—not great. But how would you feel if, at the 10-year point, you discovered that the first year's tuition bill had inflated annually at more than 7%, to \$40,000? You certainly would not feel very savvy, having produced no "real earnings" from your initial investment after 10 years. Clearly, if inflation reaches a high enough rate, it can make the purchase of various assets unappealing.

At a minimum, to produce "real earnings," a business must achieve a "return on its invested capital" that exceeds its "cost of capital."

Inflation is like a tapeworm on most businesses. First, inflation has a large influence on the cost of capital as passive returns will most likely keep pace with inflation and be benchmarked against corporate returns. For example, during a period of 10% inflation, a passive investment in a 10-year U.S. government bond will offer a yield of at least 10%. This becomes the minimum benchmark for an investor's cost of capital, and he will seek returns that are north of this cost. On the other hand, if a corporation achieving a 12.5% return on its equity capital distributes all this money to owners, they have not produced "real earnings." The problem lies in the fact that the 12.5% return for owners may be taxed at 28% or more, leaving a 9% real return. The 9% return gives the investor only 99% of the purchasing power he originally had at the beginning of the year.

Second, an increasing rate of inflation creates an environment in which a "double tax" is assessed against a company's capital. Let's assume an automobile company faces tremendous global competition and has constant difficulty raising prices without losing some share of the market. This company inhabits a highly capital-intensive industry, in which the development of a new vehicle or the addition or retooling of plants can cost billions of dollars. During a period of high inflation—let's say 10%—this automobile company may be forced to hold back certain capital expenditures due to high interest rates and the corresponding high cost of capital. Competition makes it difficult for this company to raise prices by 10% to keep pace with inflation. If the company decides to wait for better times to make significant capital investments, its current annual earnings and dividends may continue to grow, albeit at a slower pace than 10%. An insidious problem is occurring, however. Capital costs associated with building the same number of units are most likely growing along with inflation at a rate of 10%. This so-called inflation tax will become a significant factor in the future, when the automobile company needs to replace and/or add physical plant and equipment. All earnings produced during the inflationary period, and maybe more, will be needed to ensure the future survival of this automobile company. If we are facing an inflationary environment, one can forecast the return on any tax dollars that are invested in the U.S. auto industry: Less than zero.

What are we going to do?

In these uncertain times, we will continue to stay our course of investing in great businesses that do well in both deflationary as well as inflationary times. Many may wonder: Why not sell out of these positions and wait for better days to buy back into the market? This is a valid question, and a natural one to ask in this exceptionally uncertain investing environment. It reminds us of the story about Jesse Livermore:

Jesse was considered one of the greatest stock market speculators of all time. 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? *My sitting tight!*” In the end, Jesse Livermore concluded that not adhering to Old Turkey’s rule was the main reason for his losses.

The first thing we are going to do during these uncertain times is to sit tight on our core holdings, realizing that their value is ultimately greater (perhaps much greater) than the current selling price. 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 that almost all individuals who practice this art end up in bankruptcy.

The second thing we are going to do is to continue understanding exactly where we are placing our money. We will not be enticed into investing in opaque securities that we do not understand. We will stick to our knitting and only acquire companies that gain strength in any economic environment. In the next section, throughout our discussion about the performance of our businesses this year, we will point out the inherent qualities that each of these companies possesses that provide them the ability to grow under any economic condition.

The third thing we are going to continue to do is to understand the value of the assets we own. During these difficult times, it is essential that we maintain an ability to calculate the long-term value of the assets within our portfolio. Doing so will shore up confidence that these securities will find their intrinsic value once rational investment behavior returns—and it will.

At Founders Capital Management, our activity will remain deeply rooted in the time-tested principles of investment simplicity. We will seek investments in securities that we know and understand, and in assets whose intrinsic value we can fairly estimate. We will also continue to:

- Manage our portfolio in a way that avoids excessive trading
- Strive to identify developing risks—even in areas that have not yet erupted
- Invest for the long term, and concentrate on the distinction between what is knowable and important as opposed to what is either knowable and unimportant, or important and unknowable
- Hold to the conviction that emotional stability and thinking independently from the crowd eventually lead to success, despite random price fluctuations in the market.

Of course, panic in the markets holds opportunity, and we have patiently waited for great companies to sell at fair prices. And so now, on to the good part—opportunities that have surfaced during the past year to purchase great companies at lower prices!

MANAGEMENT'S DISCUSSION & BUSINESS UNIT REVIEW

Equity Holdings: 2008 Highlights

In a nutshell: Founders Capital Management's portfolio is a collection of great businesses trading at better-than-fair prices that continue to gain value every day. Berkshire Hathaway, Coca-Cola, PepsiCo, Procter & Gamble, Microsoft, Burlington Northern, Johnson & Johnson, Medtronic, Disney, Comcast, and our other holdings continue to grow their aggregate earnings (faster-than-current inflation) independent of the short-term gyrations in their stock quotations.

As we stated previously, throughout the discussion on our businesses this year, we will point out the inherent qualities that each company possesses that provide them the ability to gain strength even during difficult economic times (which is not to say that a recession has zero impact on their short-term growth).

Following are business highlights from our portfolio companies during 2008.

Consumer Group

Our primary consumer holdings—Coca-Cola, PepsiCo, and Procter & Gamble—had a very good 2008. (We also hold smaller positions in several other consumer businesses, including Nestlé, a food company; and Diageo, an alcoholic beverage company.) In aggregate, we expect our consumer group to continue producing good results in 2009, despite the current recession.

How can our consumer group perform well during difficult economic times?

1. There is a consistent purchase pattern among their product categories that creates an efficient revenue and profit stream. You can imagine the daily consumption of Coca-Cola, PepsiCo, and Procter & Gamble products on a worldwide basis. Whether in robust or difficult times, every mother is going to wash clothes with Tide[®] detergent, children will continue brushing their teeth with Crest[®], and men and women will continue shaving with Gillette razors—all Procter & Gamble products—almost daily.
2. Consistent purchase patterns and high product turnover allows these 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 leads to consistent production efficiency—maximizing the return on each dollar invested in the business.
3. The art of making Tide[®], Crest[®], or concentration syrup for Coca-Cola 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 increase their penetration in growing parts of the world with minimal reinvestment, as more mature economies are forced to curtail purchases in difficult times. Eventually, when good economic times return, these businesses are ready to invest further to capture the higher consumption rates that accompany an expanding economy.

Businesses that do not share the attributes outlined above—large appliances, automobiles, or heavy tool makers, for example—contract under difficult economic environments and thus are usually not good long-term investments. In contrast, Coca-Cola, PepsiCo, and Procter & Gamble are “dream businesses” that stand the test of time. Let's review each of them.

Coca-Cola

Necessity is the mother of increased sales—and a mythical figure.

How did the modern-day image of “Merry Old Santa Claus” come to be? The German-born American illustrator Thomas Nast initially defined the Jolly Old Elf for us in 1863. During the Great Depression, Coca-Cola was looking for ways to increase product sales during the winter, which was traditionally a slow time of year for the soft drink market. The company turned to a talented commercial illustrator named Haddon Sundblom, who evolved Nast’s original concept through a series of memorable drawings depicting a larger-than-life Santa Claus dressed in red and white enjoying Coca-Cola. From that point on, Coke’s annual advertisements featuring Sundblom Santas enjoying a Coke became embedded in consumer consciousness and a permanent holiday feature, helping to stimulate Coca-Cola sales throughout the winter. It also appealed to children, an important segment of the soft drink market. The result: Coca-Cola more than doubled its earnings during a major part of the Depression, from \$2.56 per share in 1929 to \$5.95 per share in 1938.

In 2008, Coca-Cola grew its worldwide volume at a rate of approximately 5%, and we forecasted Coke’s earnings to be approximately \$3.10 per share for the year. Despite the recession, we are still expecting growth in Coke’s profits over the next few years due to improvements in various parts of the company’s business. International and emerging market opportunities remain a critical driver for the company. The company receives an estimated 40% of concentrate business profits from emerging market economies. Volumes in these markets have been growing strongly on the back of favorable overseas economic conditions. As global economy slips into recession, however, we need to adjust our expectations for continued aggressive volume increases over the next few years. We now think that Coke’s worldwide volume will grow around a rate of 3% versus our previous expectation of 4%. Nonetheless, we expect Coke’s annual earnings per share to grow at a rate of 7% to 8% given the company’s ability to increase their productivity of capital. Coke receives some 80% of its profits from overseas markets, and while a negative currency exchange may weigh down profit growth slightly over the next six to 12 months, over the long term, we believe a possible deterioration of the dollar will add to Coke’s profit growth.

The company continues to make headway in strengthening its bottling system, which will help Coke expand its global market share, even in difficult times. Coke has allowed its bottling system to improve its returns by offering pricing and promotion support. As a result, many bottlers are now earning increased returns on their capital-intensive businesses.

There is now a much better alignment between Coke and its bottling partners, who are working together to find coordinated “win-win” solutions to mutual challenges. This new collaborative approach by Coca-Cola has allowed both organizations to reinvest for the long term.

In the latter half of 2008, Coke announced its intention to purchase China Huiyuan Juice for \$2.4 billion in an all-cash deal. Coke is awaiting Chinese government approval of the acquisition and expects to close on the deal in spring of 2009. What does this mean for shareholders? China represents Coke’s fourth largest market by volume (behind the U.S., Mexico, and Brazil, and just ahead of Japan). Coke currently enjoys double-digit volume growth in China at approximately 17% per year, driven by both sparkling and still beverages.

Coca-Cola continues to focus on diversifying its portfolio away from carbonated beverages to rapidly grow the still beverage categories, acknowledging that water and juice segments are likely to increase in importance for a rising middle class in emerging markets such as China. The Chinese juice market accounts for about 23% of total soft drink (or nonalcoholic ready-to-drink) volumes and is growing at more than 15% annually. The value of the Chinese juice market in 2009 is projected to be about \$2.5 billion. Currently, Huiyuan Juice has the leading 10.3% volume share of the fruit/vegetable category in China, followed by Coca-Cola at 9.7%, and so the Huiyuan Juice deal would catapult Coke to the leading fruit/vegetable juice position in China, with a total 20% market share. This deal would also give Coke an opportunity to leverage Huiyuan Juice’s vast distribution system and “push” all Coca-

Cola products to retailers in key northern areas in China, where Huiyuan has 31 manufacturing plants with excess capacity.

Coca-Cola's ongoing share buyback program will slow down for the remainder of 2008 as the company conserves cash to support the Huiyuan Juice acquisition. The share buyback program was cut back to \$750 million for this year, but we should cheer as the company continues to buy back stock at bargain prices. As fewer shares are outstanding, earnings per share will grow higher than operating income.

For all of 2008, Coca-Cola generated approximately \$5.5 billion in cash, which supported its expansion, as well as a 3%+ shareholder dividend and share buyback program. In 2009, we expect Coke to earn more than \$7.5 billion and to continue returning a large portion of its earnings to shareholders in the form of dividends and share repurchases.

PepsiCo

Given the U.S. economic downturn, PepsiCo experienced slower growth than anticipated in the second half of the year and reduced its earnings estimates slightly for 2008, from \$3.72 to \$3.68 per share. In 2008, worldwide volume increases remained healthy at 4%, with sales growth exceeding 10%. This unprecedented performance is being driven by the company's aggressive international growth in drink and snack products. PepsiCo's global business accounts for more than 50% of the company's sales, and the snacks business holds 60% of the company's global sales and profits—in other words, PepsiCo is a snack juggernaut.

And the future is global!

Toward the end of 2008, PepsiCo announced a plan to invest \$1 billion in China over the next four years. PepsiCo will use the investment to fund large capital programs that expand manufacturing capacity, particularly in interior and western areas of China; to build the company's sales force to expand product distribution; and to expand local research facilities to develop new products that are tailored to Chinese consumers.

PepsiCo stimulates product demand by working with local food experts and master chefs to adapt its products to local tastes. For example, a couple of years ago, the company saw that the potato chip business tended to drop off in the summer months because the Chinese viewed potato chips as a heating food, which upset the yin/yang balance of heating and cooling. In response, the company introduced potato chips featuring cooling flavors such as lemon, cucumber, and yogurt, ensuring balance not only with regard to yin/yang but in its yearlong sales performance. PepsiCo's China business is now as robust during the summer as it is during the winter months. PepsiCo is bestowing its flavor attentions on other international consumers: This year, the company introduced white mushroom-flavored chips in Russia and seaweed-flavored chips in Thailand.

In addition to adapting existing products for specific international markets, PepsiCo seeks to penetrate local snacking habits. For example, teatime is a big snack occasion in India, so the company developed Kurkure, a lentil-based snack with intense spices. This product, foreign to the North American market, has been so successful it almost doubled PepsiCo's snack business in India. In 2008, the company launched Kurkure Extreme, which targets younger Indian consumers looking for extreme flavor and spice intensity.

In 2008, PepsiCo increased its efforts to return more money to shareholders, and the company raised its annual dividend by 13.3%, from \$1.50 per share to \$1.70 per share. Based on PepsiCo's current stock price, the annualized dividend implies a yield of about 3.2%. In addition to the \$2.64 billion in dividends to be distributed to shareholders in 2008, the company will also complete approximately \$4.4 billion in stock buybacks, representing an 8%+ return to shareholders. And the best is yet to come: In 2009, we expect PepsiCo to grow its earnings between 7% and 8%, despite the global recession. We are extremely pleased with PepsiCo's ability to advance in a difficult economic environment.

Procter & Gamble

Last year, we added Procter & Gamble to our consumer products portfolio, and we continued to accumulate more of this company during 2008.

Incorporated in 1905, Procter & Gamble Company is the world's premier consumer products company, with sales in more than 180 countries. The company is organized into three global business units: Beauty and Grooming (a \$250 billion market), Household Care (a \$200 billion market), and Personal Care (a \$240 billion market). To get an idea of this company's worldwide depth: Three billion times a day, P&G brands touch the lives of people around the world. The company has one of the strongest portfolios of trusted leading brands, including Pampers[®], Tide[®], Ariel[®], Always[®], Whisper[®], Pantene, Gillette, Bounty[®], Dawn[®], Gain[®], Charmin[®], Downy[®], Lenor[®], Iams[®], Crest[®], Oral-B[®], Duracell[®], Olay[®], Head & Shoulders[®], Wella[®], Vicks[®], and Braun[®]—to name just a few.

Over the past five years, P&G has transformed itself from a company focused primarily on household products to a diversified consumer products manufacturer. Many ask: Where and how will P&G grow in the future? Although P&G is already a large company, with more than \$80 billion in global sales, we consider its opportunity for growth to be virtually unlimited. P&G competes in markets that represent almost \$700 billion in aggregate sales, and the company's combined share of these markets is approximately 12%. Per capita expenditures for P&G products is \$108 in the U.S., \$86 in the United Kingdom, and \$44 in Germany. In China and India, which represent a combined population base of more than two billion, per capita consumption of P&G products is \$2.60 and \$0.60, respectively. In our view, Procter & Gamble is a relatively small company positioned to capture an increasing share of a more than \$600 billion global sales opportunity.

How can P&G continue to grow its product volume at 4%+ in these challenging economic times? While increasing sales and market share in a competitive environment is difficult, P&G will realize much of its future through the company's continued emphasis on innovation and new product development. Annually, P&G invests more than \$2.2 billion on innovation—equal to the combined total investment in product innovation of its two closest competitors.

Like PepsiCo and Coca-Cola, P&G's global success is attributable to the company's talent for adapting products to suit local tastes and income levels. We previously mentioned P&G's strategy of "tiering" product offerings: The company offers Basic Crest[®] toothpaste for the budget-minded consumer, and Crest Whitening Expressions[®] and Crest Pro Health[®] for less price-sensitive consumers. Gillette[®] razors are also tiered. Only a small segment of the population in a developing country is able to afford the Fusion razor—Gillette[®]'s innovative five-blade shaving system. Budget-minded customers may prefer to purchase the two-bladed Gillette Trac II[®]. But once Gillette[®] has hooked a new customer in a developing country on the Trac II[®] razor, it is only a matter of time before he will be trading up to superior Gillette[®] products.

P&G's product ladder approach allows the company to effectively market its products to consumers in various income segments and sets up increased profits for P&G far into the future as customers "trade up." As a kicker: With so many versions of P&G products in play, retailers are forced to accept "all" lines of P&G products to meet the various customer demands. This maximizes P&G's share of finite retail shelf space, pushing their competitors' products to the side.

We expect P&G to produce approximately \$3.90 per share in earnings during 2009 and to return a large portion of the \$11.5 billion in profits to shareholders in the form of dividends and share repurchases. We remain excited about P&G's tremendous global opportunity and have made a long-term allocation of capital to this company. In other words, any short-term market fluctuation in Procter & Gamble's stock price will not bother us a bit.

Industrial and Transportation Group

Our primary industrial and transportation holdings—Burlington Northern Santa Fe Railroad and United Technologies Corporation—were profitable in 2008, and we expect these businesses to produce good results in 2009.

How can infrastructure businesses such as Burlington Northern and UTC perform well during these tough economic times? One primary reason: Each possesses a cemented infrastructure that is difficult to remove and/or duplicate. For example, it has taken more than a century to build the U.S. railroad infrastructure, and it would take an inordinate amount of time and capital to create a business transportation system that competes with a railroad like Burlington Northern. Although the railroad business is capital-intensive compared with most consumer-product businesses, certain attributes make this type of investment attractive in the current environment. When facing challenging economic times, companies attempt to run more efficiently and lower total operating costs. Moving shipments of goods using rail instead of higher-cost trucking can achieve large productivity increases. Thus, we expect that many companies will seek to curtail shipping costs by significantly increasing their use of rail instead of trucking. Any increase in volume (and revenue) over an established infrastructure that is difficult to duplicate spells higher profits for a company such as Burlington Northern.

United Technologies

Throughout 2008, we added UTC to our portfolio. This Hartford, Connecticut-based company, incorporated in 1934, provides high-technology products and services to the building systems and aerospace industries. UTC conducts its business through six principal segments: Otis, Carrier, UTC Fire & Security (UTC F&S), Pratt & Whitney, Hamilton Sundstrand, and Sikorsky. Otis encompasses elevators, escalators, moving walkways, and services. Carrier addresses residential, commercial, and industrial heating, ventilating, air conditioning (HVAC), and refrigeration systems and equipment. UTC F&S offers fire and special hazard-detection systems, firefighting equipment, electronic security systems, and security personnel services. Pratt & Whitney supplies commercial, general aviation, and military aircraft engines, parts, and services; industrial gas turbines; and space propulsion. Hamilton Sundstrand provides aerospace products and aftermarket services. Sikorsky offers military and commercial helicopters, aftermarket helicopters, and aircraft parts and services.

UTC has a business model that provides them a unique competitive advantage. The company concentrates on infrastructure businesses that have a slow replacement rate—think of how often you need to replace an elevator, air conditioner or airplane engine. Yet these products have a high servicing component. Once UTC has won a contract for supplying elevators or air conditioners for a building, the associated servicing contract can continue for years, providing a predictable and long-term revenue annuity. In addition, once these products are installed, it is highly unlikely that they will be replaced anytime soon, since removing banks of elevators or large air-conditioning systems from buildings takes a lot of time, effort, and money.

Although UTC is an industrial conglomerate encompassing some of the most recognizable global brands, there is some concern about the potential impact a slowdown in commercial construction will have on the company. This concern has merit, but on the other hand, UTC is a global industrial company with more than 60% of sales coming from non-U.S. markets, including approximately 30% from Asia. This is significant, since infrastructure building is much higher in emerging markets such as China and India.

We believe that a slowdown in worldwide construction is reflected in the company's stock price, and that UTC has a long-term sustainable growth rate that is not being viewed favorably by investors who are focused on the short-term challenges. Given the pullback in the company's stock price, we were given an opportunity to purchase this quality company at a fair price.

We expect UTC to produce approximately \$4.85 per share in earnings during 2008 and to maintain a similar profitability level through the 2009 recession. We also expect the company to distribute most of its \$4.6 billion in profits to shareholders through dividends or share buybacks.

Burlington Northern Santa Fe Railroad

Burlington Northern has the second-largest rail network in the U.S. (Union Pacific Railroad is slightly larger). Burlington Northern's 32,000-mile rail network spans the western two-thirds of the U.S. Through marketing agreements with other railroads and its own network, Burlington Northern serves the Midwest, West Coast, Southwest, and Southeastern regions of the U.S. In total, the company operates in 28 states and two Canadian provinces. Of all the major railroad companies, we believe Burlington Northern is in the best position to take advantage of the anticipated growth in rail transportation—especially coal, agricultural, and intermodal (i.e., combining more than one method of transportation, such as railroads to trucks).

Our interest in Burlington Northern was spurred by a long-term increase in worldwide energy demand that is driving businesses to seek more cost-effective ways to ship their goods to end-users. Although energy demand has slowed during 2008, we do not see an end to companies' desire to curtail operating costs and to increase productivity in the upcoming years. According to a recent article in *The Financial Times*, in 2009 Procter & Gamble plans to improve its productivity by doubling (from 15% to 30%) the volume of its U.S. shipments that can be transported by rail.

We also believe that energy prices will remain higher than most expect over the next decade. An analysis of the movement of goods has not changed much in the past year—more than 70% of the transportation of merchandise revenue is accomplished via trucking. Since rail transportation is approximately three to five times more fuel-efficient than truck transportation, we are likely to see the percentage of goods transported via rail vs. truck increase over the next decade—perhaps significantly, if we experience higher inflation. The growing use of rail, along with the expansion of railroad services via “double track” (vs. single track) and “double stacking” of containers, could drive a large expansion in railroad use, revenues, and profits.

In the meantime, the rail business will continue to encounter several short-term negatives in 2009. The housing sector slowdown will be a persistent drag on Burlington Northern's revenue growth as the company's industrial products business, which accounts for 25% of Burlington Northern's revenue, remains sluggish. Furthermore, the decline in oil prices will remain a double-edged sword for Burlington Northern. While diesel fuel costs for locomotives continue to represent a sizeable percentage of operating expenses in the rail industry, a dramatic fall in the price of oil will restore trucking as a competitive alternative. We think this risk is minimal, however, and expect oil prices to remain historically elevated.

Having outlined the short-term negatives, on to the future positives: Indications are strong that the U.S. will soon embark on a massive program to upgrade its infrastructure—improving roads and bridges across the country, while perhaps also moving toward greater energy independence by pursuing alternative energy sources such as wind and solar power. If this comes to pass, as we suspect it will, rail will play an important role in the transportation of large construction equipment, drilling and transmission pipe, wind turbines, etc.

We expect Burlington Northern to earn approximately \$6.30 per share in 2008, and around \$6.50 per share in 2009. We still believe this company will be able to grow annual earnings in the double-digit range over the next five to 10 years. Our objective is to remain long-term investors in this company.

Healthcare Group

Our primary healthcare holdings, Johnson & Johnson and Medtronic, achieved profitable growth during 2008, and we expect these medical businesses to grow their earnings throughout 2009.

How can healthcare businesses such as Johnson & Johnson and Medtronic perform well during difficult economic times?

The pharmaceutical segment of the healthcare business is very unpredictable. Prescription drug pricing is an ongoing political lightning rod, patent expiries and generic competition can quickly erode

drug sales, and R&D continues to be not only costly, but inefficient. (On average, it takes more than 15 years and can cost up to \$1 billion to bring a new drug to market—and only one out of 100 potential new drugs in development makes it all the way through the process to gain FDA market approval.) Nevertheless, we believe that investing—at the right price—in a diversified portfolio of healthcare companies that do not carry many of the typical risks associated with this sector can be rewarding. Johnson & Johnson and Medtronic are two companies that fit our investment criteria: Both occupy product segments that are resilient under any economic condition, and each displays consistent purchasing patterns and strong loyalty from their growing customer bases. Both companies are positioned to do well as the global population increases and ages in the coming decades—and both are currently selling at the “right price.”

Johnson & Johnson

During 2008, we took a significant position in Johnson & Johnson. J&J is dedicated to manufacturing and selling a broad range of products in the healthcare industry and employs 119,000 staff worldwide. The company is extremely decentralized, with more than 250 companies operating in virtually every country in the world. J&J's business activities are segmented into three primary groups: Consumer, Pharmaceutical, and Medical Devices and Diagnostics. The Consumer segment includes a range of products that are familiar to all of us: Aveeno[®], Clean & Clear[®], and Neutrogena[®] skin care products; Band-Aid[®] adhesives; Johnson's[®] baby products; Listerine[®]; Motrin[®]; Tylenol[®], and more. The company's Pharmaceutical segment includes blockbuster products such as Risperdal[®] for treating symptoms of schizophrenia and Remicade[®] for the treatment of Crohn's disease. The Medical Devices and Diagnostics segment features products ranging from DePuy[®] orthopedic joint reconstruction and spinal care products to Vision Care's disposable contact lenses.

Why J&J?

J&J is the most successful healthcare company in the world. This diversified company has delivered an unparalleled performance since its incorporation in 1887, growing annual earnings consistently at 10%+ even during the Great Depression and through many recessions that have occurred over the past century. We believe J&J hasn't even reached the middle of its long-term growth story. Our opinion is that the next century will offer J&J worldwide growth opportunities that parallel those of the past century. Why?

The three segments in which J&J competes constitute approximately 30% of the \$4 trillion global healthcare market. J&J is a very large company, but its sales represent only about 5% of total sales in the three sectors. The other 70% of the healthcare market represents a massive future opportunity for J&J—a \$2.8 trillion slice of the healthcare pie.

J&J also has a unique business model within the healthcare industry. For more than 120 years, the company has created an entrepreneurial culture using a decentralized management style. This approach has enabled the company to thrive in an ever-changing healthcare market by adapting to many different business opportunities. The end result: J&J has been able to deliver an exceptionally consistent performance decade after decade, racking up more than 75 consecutive years of sales increases, 25 consecutive years of earnings increases (adjusted for special items), and more than 45 consecutive years of dividend increases.

J&J will continue to grow its sales during the recession. Much of the company's near-term growth will come from the U.S., which remains the world's leading healthcare market. Approximately 47% of J&J's revenues come from outside the U.S., and we expect growth in emerging markets to propel the company forward during the next decade. The most significant growth opportunity over the next several years, however, will come from the so-called BRIC countries—Brazil, Russia, India, and China.

We expect J&J to earn approximately \$4.50 per share in 2008 and to produce \$4.65 in earnings in 2009. The company generates strong cash flow and is implementing a \$10 billion share repurchase program, which equates to acquiring 6% of the outstanding stock at the current share price. This is on

top of a 3% dividend. Given the potential return to shareholders, J&J remains a very attractive addition to our portfolio.

Medtronic

Throughout 2008, we added to our position in Medtronic, the leader in implantable cardioverter defibrillators (ICDs) and other devices for managing out-of-step hearts. The company is also a growth leader in sales for devices that manage chronic diseases of the spine, pancreas, and brain.

Two features highlight our decision to increase our stake in Medtronic: First, management has a strong commitment to investing more than 9% of sales into R&D, which is the underpinning of future long-term growth. Medtronic has a robust pipeline of products that target many underpenetrated markets. These products include drug eluting stents, artificial discs, neurostimulation, and continuous glucose monitoring devices for patients suffering from diabetes. Medtronic's steady cash flows and strong balance sheet also allow the company to make acquisitions that complement its R&D efforts and broaden an already diverse portfolio of products. Second, we expect Medtronic to increase its emphasis on growing international revenues. In international markets, Medtronic is not consistently the category leader as it is within the U.S. We anticipate the company to increase its share in many product areas as international markets expand. Medtronic expects five-year compounded annual growth of 46% in Russia, 40% in China, 25% in Brazil, 25% in Asia/Korea, 23% in India, 19% in Canada, 15% in Europe, and 15% in Japan. The company is aggressively adding sales representatives to address opportunities within these emerging markets.

We expect Medtronic to earn approximately \$2.90 per share in 2008 and to grow its earnings to \$3.15 per share in 2009. At the current price, we feel a strong economic interest is warranted for a rare global company that can be viewed many years into the future.

Technology Group

Microsoft

Our technology holding, Microsoft, continues to announce positive results. Although a weak global economy will temporarily hobble demand for software, we believe Microsoft is positioned to weather the storm better than most technology firms. Software is not a capital-intensive business, and this sector overall is positioned for consistent growth as world demand for computing continues to increase. Even in this difficult environment, Microsoft is expected to increase its year-over-year revenue at 7%, and its operating profits at 10%+. The company's balance sheet remains a virtual fortress, with cash and short-term investments of \$20.7 billion and long-term investments exceeding \$4.25 billion.

During 2008, Microsoft threw a new twist into its growth strategy by announcing a desire to acquire Yahoo!. Yahoo! successfully rebuffed Microsoft's overture, stating that it is not interested at Microsoft's "low" offer price. Since this rebuff, Yahoo!'s stock has nosedived more than 60%. Our opinion of Microsoft's acquisition plan remains unchanged—we are always skeptical of any acquisition, especially a large one, because organizations have a tendency to become sidetracked from normal business when pursuing a target. In addition, winning can sometimes lead to losing as management combines two organizations with different businesses and, more important, dissimilar cultures. With hesitation, we initially supported this potential transaction with the rationale that Microsoft needs to protect its core Windows® and Office® franchises, especially if an increasing percentage of software products start being sold (or rented) via the Internet and supported through advertising. Although a potential Yahoo! acquisition would give Microsoft the ability to manage the distribution of its products as the Internet business landscape evolves, we believe that Microsoft can achieve this goal without paying such a high price. We are not disappointed that this acquisition fell through at the high price offered. We anticipate, however, that a transaction involving Yahoo!'s search engine is still possible. We will keep you posted as Microsoft's Internet strategy continues to unfold in 2009.

Microsoft is a perfect example of a company with a (perhaps large) disparity between its current market price and its intrinsic business value. We estimate that Microsoft's intrinsic business value has almost doubled over the past five years. During this same time frame, the company's stock price has declined approximately 28%—and we felt that Microsoft was selling at a fair price five years ago! How does this incongruity between market price and intrinsic business value develop? In Microsoft's case, extreme investor pessimism about the company's future—some of it justified—has become prevalent. Many have begun to question the importance of Microsoft's basic operating system in the future Internet-based computing world. Investors are also concerned about Microsoft's ability to build new products that will help the company adapt to the changing Internet-centric computing environment. We believe this pessimism is somewhat exaggerated as we watch Microsoft continue to grow its franchise in a challenging environment.

Microsoft's current market capitalization is a little over \$175 billion, including approximately \$20 billion of cash on the company's balance sheet. Microsoft is currently generating around \$18 billion of cash annually, and this amount is growing at 8% to 10% per year. Under this scenario, Microsoft would be able to buy back most of the company from shareholders within 10 years if the business can continue to grow in the near future as it has during the past five years. (In fact, after the Yahoo! acquisition fell through, Microsoft announced its intention to buy back \$40 billion in stock over the next five years, representing a repurchase of over 20% of the company at its current price.) While we are not exactly sure if growth is guaranteed, we believe it is highly probable that if Microsoft were to be neutralized in the emerging Internet-based computing world, it would most likely take more than 10 years. So the real questions are: How long will it take for Microsoft to be "unseated" in the computing world through a dislocation caused by the Internet? And what intellectual capabilities does the company possess that will enable it to adapt to the changing environment? Our answers to these questions are on the positive side. It has taken Microsoft more than 25 years to place its tentacles throughout the computing world, and it would cost the computing world billions of dollars to change its current IT structure. Considering this, we feel Microsoft has tremendous intellectual talent and most likely has time to continue adapting its products for the changing environment. In the meantime, we will remain patient owners achieving an earnings yield of 10%+ at Microsoft's current market price.

Financial Services Group

Berkshire Hathaway

Our largest financial services holding, Berkshire Hathaway, will most likely report mediocre results for 2008. As we have stated in previous letters, during the past few years, Berkshire's tremendous results were attributed to Warren Buffett's willingness to accept large catastrophic risks when other insurance companies were reluctant due to the high hurricane activity of 2005. Given virtually nonexistent hurricane seasons in 2006 and 2007, Berkshire Hathaway achieved once-in-a-lifetime back-to-back results, with earned insurance premiums virtually falling to the bottom line.

In 2008, as we had anticipated, Mr. Buffett significantly scaled back the company's coverage of catastrophic events such as hurricanes, leading to underwriting results that are not equal to the past two years. We were unconcerned with Mr. Buffett's decision to temporarily pull back on Berkshire's catastrophic insurance coverage throttle. Insurance is a business in which discipline is not only a requirement for profitability, but a necessity for long-term survival.

As Berkshire scaled back catastrophic coverage, other insurance companies jumped in with both feet. The 2008 hurricane season ended up being more active than anticipated, leading to negative results for insurance companies that had aggressively supplied hurricane coverage. Along with nature's storms, the recent market downturn permanently impaired many insurance company franchises as their investments declined precipitously. Given this one-two punch in the industry, we can likely look forward to a "hardening" of insurance prices. As most insurance companies are weakened, Mr. Buffett should begin to press the underwriting throttle forward and provide insurance coverage at higher prices.

Warren Buffett maintains a passionate desire to continue growing Berkshire Hathaway. Even with a pullback in catastrophic insurance underwriting, the company is generating cash and cutting a flurry of large deals in the current market downturn: Goldman Sachs Group, Inc. announced an agreement to sell \$5 billion of perpetual preferred stock to Berkshire Hathaway in a private offering. The preferred stock has a dividend of 10% and is callable at any time at a 10% premium. In conjunction with this offering, Berkshire Hathaway will also receive warrants to purchase \$5 billion of common stock with a strike price of \$115 per share, exercisable at any time for a five-year term. In addition, General Electric announced that it will sell \$3 billion of perpetual preferred stock to Berkshire Hathaway. The preferred stock has a perpetual dividend of 10% and is callable after three years at a 10% premium. Berkshire Hathaway will also receive warrants to purchase \$3 billion of GE common stock with a strike price of \$22.25 per share, exercisable at any time for five years.

Even though Berkshire Hathaway has a tremendous opportunity to effectively allocate excess capital in these uncertain times, there has been some confusion about a series of derivative transactions Mr. Buffett entered into. Although Mr. Buffett will fully explain these transactions in his upcoming letter, we will attempt to provide an overview (based on Mr. Buffett's explanation) of the contracts that are causing controversy—and gyrations—around Berkshire Hathaway's stock price.

Over the past few years, Berkshire Hathaway has entered into several derivative contracts. In the first series of contracts, Mr. Buffett provided insurance protection if the U.S. and various foreign stock indices closed below a certain level in the future. These "put contracts" had original terms of either 15 or 20 years and were struck at the market. For providing this insurance coverage, Berkshire received premiums of \$4.5 billion, which may be invested between now and the expiration dates of the contracts. As Mr. Buffett has explained, it is important to understand that the puts in these contracts are exercisable only at their expiration dates, which occur between 2019 and 2027. Berkshire will then need to make a payment only if the index in question is quoted at a level below that existing on the day the put was written.

In the second series of contracts, Berkshire insured certain bonds that are included in various high-yield indices if they default. According to Mr. Buffett's explanation, these contracts expire at various times from 2009 to 2013. Berkshire collected approximately \$3.2 billion in premiums on these contracts, had paid \$472 million in losses as of 2007, and, in the worst case (though it is extremely unlikely to occur), could be required to pay an additional \$4.7 billion. As with the other contracts described, Berkshire will invest the premiums between now and the time the contracts expire, or until losses meet or exceed the premiums collected.

It is also important to point out that accounting rules for derivative contracts differ from those that apply to Berkshire's investment portfolio. In an investment portfolio, changes in value are applied to the net worth shown on Berkshire's balance sheet but do not affect earnings unless they are sold (or written down). Changes in the value of the Berkshire's derivative contracts, on the other hand, must be applied to earnings each quarter.

Essentially, derivative positions can cause large swings in reported earnings, even though the true value of these positions changes slightly. The volatility of the markets during 2008 has caused Berkshire Hathaway's reported earnings to "jump around" quite a bit.

It is our opinion that it is far too early to judge the outcome of these long-term contracts. The likely scenario is that over the upcoming years, the markets will grow in value and price, allowing most of these contracts to expire without any payment obligation—allowing Berkshire to pocket most of the premiums. In the meantime, Mr. Buffett will invest the premiums at advantageous returns in a depressed market.

We remain enthusiastic holders of Berkshire Hathaway, and we look forward to watching the intrinsic value of this holding continue to grow in the future.

Retail Group

Our major retail holdings, Home Depot and Walgreens, had a tough time in 2007, and both experienced a difficult operating environment in 2008 as consumers cut back on retail purchases. Nevertheless, we remain strongly interested in retailers that can actually benefit in a tough economic environment. Although companies in the retail industry face intense competition, the retail areas in which we are invested involve a couple of two-horse races—between Lowe's and Home Depot in the home improvement market, and between Walgreens and CVS in the retail pharmacy market. In our view, it is nearly impossible for new competitors to gain a foothold in these specialized retail segments that require substantial infrastructure and real estate. For example, a new competitor would find it very difficult to penetrate Home Depot, which owns about 87% of its stores and has listed property and equipment valued at about \$27 billion. (Walgreens owns 19% of its stores.) An additional point: During difficult economic times, consolidation occurs as large retailers put pressure on smaller competitors. Thus, the challenging economic climate may provide opportunities for our retailers to increase their market share and long-term shareholder value.

Home Depot

Home repair and remodeling has slowed significantly during the past two years, and Home Depot's (and Lowe's) business performances are somewhat tied to housing. The good news: Residential investment as a percentage of Gross Domestic Product (GDP) (the way to look at the market) is expected to fall to around 2.8% for 2009—the lowest in more than 50 years. Based on this scenario, total dollars spent on residential investment would decline by around 15% from the current level due to slightly negative GDP growth in 2009. This picture represents a 50+-year low and a peak-to-low decline of approximately 47%, larger than any other peak-to-low decline in contemporary history. Nevertheless, even under this doom-and-gloom situation, housing appears to be close to hitting bottom, and the rate of decline should begin to moderate in the coming year. Our opinion is that residential investment will most likely bottom out toward the end of 2009 and begin to rise slowly from there. On a positive note, existing home sales have started to stabilize. Housing starts are far from their peak, however. We believe this can be taken as a sign that declines in residential investment spending will begin to moderate in the upcoming year. The bad news: There will be continued pressure on housing prices in 2009 as record foreclosures, an inventory glut, and rising delinquencies continue to impact the U.S. economy. In addition, tighter lending standards will slow the extension of consumer credit, and retailers such as Home Depot will be negatively impacted as many individuals focus on paying down high-interest debt.

To summarize: We expect the home repair and remodeling market to remain sluggish through most of 2009. The key question: Why not sell Home Depot today and repurchase this company when the housing and retail environment improves?

You can anticipate that our response will be similar to that of “Old Turkey”—We would lose our position, and to lose one's position is something nobody can afford. We think Home Depot is selling at a (perhaps significant) discount to its intrinsic value, and much of the negative news about the difficult housing and retail environment is reflected in its current market price. Meanwhile, Home Depot is making progress on several fronts and gaining a competitive advantage against smaller competitors in this challenging environment. Home Depot's new merchandising, in-store, and supply-chain initiatives are stemming market share erosion and improving the company's profit margins. In addition, the revamping of Home Depot's supply chain is leading to significant benefits, including an improvement in-stock levels, increased sales, and a lift in the company's gross profit margin.

The turnaround at Home Depot's retail stores will continue in 2009. We expect the company to earn approximately \$1.50 per share under recessionary conditions, and with a solid dividend yield of 3.75%, investors are being paid to wait until the economic cycle turns around. When the recovery does come, Home Depot's consistent focus on improving operating performance and asset productivity should pay rewards. Overall, we remain confident that the company is doing the right things, under the

appropriate circumstances, and we will remain committed owners of Home Depot. Our plans have not changed, and we expect to hold this company for the long term.

Walgreen Company

Walgreen Company (“Walgreens”), based in Deerfield, Illinois, operates a retail drugstore chain that produces \$59 billion in annual sales. The company has more than 6,500 stores located in 48 states and Puerto Rico. On the “front end,” Walgreens sells general merchandise that includes beauty and personal care products, household items, candy, photo finishing, greeting cards, seasonal items, and convenience foods. This segment accounts for 25% of total sales. The company also sells over-the-counter medicines that represent 10% of total sales. The remaining 65% of sales, characterized as “back end,” consists of prescriptions filled at the drugstore counter and via the U.S. mail, telephone, and Internet.

In 2008, Walgreens faced a difficult operating environment, as industry wide sales of prescription drugs grew at the slowest rate in 47 years and a weak economy forced some Americans to reduce doctor visits and leave prescriptions unfilled. In response, the company announced further reductions in its pace of new store openings from 4% to 4.4% growth in 2010 and 2.5% to 3.5% in 2011. Taking into account a difficult economy and the slower store growth, we are adjusting the five-year annual growth prospects for Walgreens downward, from 14% to 12%.

As management reduces the pace of store openings, we expect the company to place greater emphasis on making stores more productive and enticing shoppers to buy one more item during each visit, which is something the company already does well. We also think Walgreens has an opportunity to increase its penetration of private brands above its current 20% of front-end sales.

Competitive pressure is likely to increase during the economic downturn. However, we believe that Walgreens will benefit from growth projected in the prescription drug market as a result of \$75 billion of branded drugs going generic. We also think the company’s earnings will get a boost over the long term from its emphasis on Sunbelt states that are attracting retirees—a group that uses more prescriptions than average. In addition, there is room for internal growth within Walgreens current store base, with 36% of the company's locations less than five years old and 25% of the locations three years old or less. It typically takes about three years for stores to reach breakeven, so as the pace of store growth begins to slow, there could be a few residual years in which the company's profits get a boost as newer stores mature and become profitable.

The retail prescription drug business continues to undergo tremendous change as generic and specialty drug prescriptions, along with mail-order prescription programs, proliferate the market. In addition, as the baby-boom generation matures and the demand for and complexity of prescription drugs rises, prescription drug retailers and wholesalers may evolve into patient data warehouses that become a focal point for managing healthcare across the nation. Our expectation is that Walgreens will remain a leader in the retail drug business and will continue to grow its franchise to 7,000 stores by 2011. In the meantime, we believe Walgreens will earn around \$2.10 for 2008 and increase earnings per share to \$2.15 in 2009.

Media Group

Our media division continues to grow and supply “great content” to customers. We strongly believe that a concentrated investment in quality content providers will pay handsomely in the future. Disney, Comcast, and Gannett are all media companies that supply the news, stories, and shows that America reads and watches every day.

Companies across the media landscape are retrenching to survive tough economic times and Disney, Comcast, and Gannett are no exception. The media business is cyclical in nature due to its heavy reliance on advertising as a source of revenue. The cutbacks on advertising expenditures that occur during recessionary times impact the profitability of media companies. While our media businesses rely on advertising as a source of revenues, in aggregate they are less dependent on this source than

most other media companies. We feel our media businesses will continue to gain competitive strength during the economic downturn due to their solid foundation in either family entertainment or cable and Internet. Disney and Comcast also have annuity-like attributes, selling products that are in demand every day—very few consumers will deny their children a Disney animated film or cancel their cable service during a difficult economy.

Walt Disney Company

During 2008, we added to our stake in The Walt Disney Company, a diversified worldwide entertainment company with operations in four segments: Media Networks, Parks and Resorts, Studio Entertainment, and Consumer Products. We believe Disney has stronger long-term growth prospects than most investors realize, due to the company's highly competitive position within the entertainment industry. Disney has a broad range of content and significant international exposure (Disney is localizing animation and other media content to each individual country). In addition, the company will begin to reap the benefits of years of aggressive investing in key growth areas such as the Internet, wireless communication, video games, and numerous consumer products.

We believe that Disney is well positioned to withstand a negative economic climate in several ways. Disney is less exposed than most media companies to the fallout from declining advertising sales, with just 20% of its revenue coming from advertising. Though the company's Parks and Resorts division is one of the most sensitive to a consumer-spending downturn, Disney has the ability to reduce its variable costs to match attendance, thereby minimizing the impact on profits. To offset a reduction in bookings, for example, the company is beginning a new promotion to help boost attendance at the parks that includes an increase in the number of low- and moderate-priced hotel rooms offered at its resorts. The Studio Entertainment division is also well positioned to cope with a downturn and significantly reduced its overhead and production schedule almost two years ago, while other media companies are just beginning to address these areas. In this recessionary environment, the Media Networks division is resilient; Disney's cable networks are collecting significant revenues from affiliate fees, although this is somewhat offset by a reduction in advertising revenue at Disney's ABC broadcasting network. The company's crown jewel, ESPN (located in Bristol, CT) is performing well, though it is also not immune from an advertising falloff.

We expect Disney to earn \$2.05 per share in 2009, down from \$2.27 per share in 2008. It is our opinion, however, that Disney has the ability to grow its annual earnings at 10% or more in the future. We feel an economic interest is warranted for a rare global company that will be significantly more valuable 10 years from now. We intend to hold Disney for a long time.

Comcast

We hold a major position in Comcast, the largest cable provider in the U.S. Comcast also owns cable networks and sports and programming assets, including E! Entertainment Television, The Golf Channel, the Philadelphia Flyers NHL hockey team, and the Philadelphia 76ers NBA basketball team.

Comcast had a challenging year weathering a weak advertising environment and softening product demand. Nevertheless, the cable business is somewhat recession-resistant, since consumers tend not to cancel their cable services, even in an economic downturn. An economic slowdown can affect certain areas of the cable business, but not others. For example, when housing starts decline, there are fewer opportunities to gain new subscribers. But when existing home sales decline, fewer services are connected and disconnected. This diminished activity saves money as cable assets are more productive. During difficult economic times, however, customers are reluctant to upgrade to high-end services such as Comcast's HD TV. We expect a reduced uptake of higher-end services to impact Comcast's revenue growth in the upcoming year.

Our thoughts have not changed regarding Comcast's long-term growth prospects. We believe the company is positioned to double its earnings over the next five years. This growth plan will rely on the aggressive marketing of Comcast's "triple-play package," which offers a combination of digital cable, high-speed Internet, and digital telephone to customers. It also includes company efforts to broaden its

offerings to price-sensitive consumers by introducing lower-priced video and Internet services. Finally, Comcast will need to continue adding subscribers to its higher-tiered services, including digital video, high-speed Internet, and digital phone.

One other highlight: With much of the infrastructure needed to expand its products and services in place, Comcast's capital expenditures fell approximately 10% in 2008. Compare this to Comcast's telephone company competitors, which would have to make large capital investments to upgrade their infrastructure to offer products and services similar to Comcast's.

Comcast continues to leverage its cable assets and should grow free cash flow at approximately 32% per year over the next five years—from \$2.8 to \$8.1 billion, despite the recession. This has a positive impact on the amount of money Comcast can distribute to shareholders through dividends and/or stock buybacks. In 2008, Comcast initiated its first regular quarterly dividend, at a rate of \$0.0625 per share, or \$0.25 annually. This represents a 1.5% yield at the current stock price. Over the last 15 months, the company has also repurchased approximately \$4.1 billion of its stock, reducing outstanding shares by approximately 7%.

In 2009, we expect Comcast to generate approximately \$1 per share in cash that can be distributed to owners. This equals a 6%+ return at Comcast's current quotation. We anticipate the company to return a majority of this cash to shareholders by repurchasing stock at an accelerated rate. Our view of Comcast's future has not changed, and we plan to keep this company in our portfolio for the long run.

Commodities Group

Our Commodity Holdings include Barrick Gold, Central Funds of Canada, and Chevron. We invested in commodities such as gold, silver, and oil for two core reasons: First, it was our belief that the value of the U.S. dollar would deteriorate over the long term, and unfortunately this assumption proved correct. We have not changed our view about this and believe that our country's current loose monetary policies will result in a continuing deterioration of the U.S. currency. Over a long-term period in which the dollar has continued to lose relative strength against world currencies, gold has risen to more than \$800/oz.

While changes in the dollar's value will continue to be an important factor in determining the price of certain commodities, in the future it will not be the only driving issue. We also have concerns regarding the geopolitical and global financial landscape, as the world money supply increases rapidly—the U.S. is not the only country printing money. This fact further supports an argument for higher long-term commodity prices, as a growing world money supply can ultimately lead to inflation.

Second, there is a long-term growing imbalance between commodity supply and demand. For example, during 2008, daily worldwide oil consumption reached approximately 87 million barrels of oil per day, while production leveled off at 86 million barrels per day. While the current recession has dampened demand, the long-term widening gap between consumption and production will most likely lead to higher oil prices, despite any short-term downturn in oil prices. We continue to believe that the price of oil will "plateau" at a higher level in the future (although we do not have a specific price in mind) than it has in the past, with the rapid growth of economies in countries such as China and India driving increased energy demand.

Barrick Gold Corporation

Barrick is building a new generation of mines around the globe and maintains the lowest total cash costs among the major gold producers. The company is also positioned to take advantage of higher metal prices, since management removed gold hedges in order to be exposed to higher gold prices, and accumulated large gold (and non-gold) mining deposits to allow the company to have sufficient replacement ore bodies in the future.

In 2008, a stable average gold price was offset by the continuation of lower input costs such as oil. As oil prices have declined from a peak of around \$145 per barrel to the current level below \$40 per

barrel, Barrick's energy costs declined. Energy constitutes about 25% of the company's total operating expenditures, and if oil price reductions remain in place, cost pressures will subside into 2009.

Barrick continues to focus on "earnings" and returning cash to shareholders. This strategy is unusual for a mining company, as most competitors attempt to spend profits on finding the next "gold strike." As a result of these actions, it is our opinion that Barrick's value will continue to increase over time.

Central Fund of Canada

In addition to Barrick, we maintain a sizeable investment in gold and silver bullion through our interest in Central Fund of Canada, a specialized investment holding company that purchases gold and silver in the open market and stores the bullion in a bank vault. Central Fund's net assets at market value are approximately \$1.35 billion, represented by 50% gold bullion and certificates, 48% silver bullion and certificates, and 2% cash, marketable securities, and other working capital amounts.

Chevron

Our largest oil investment is in Chevron, a leading international integrated oil and gas company with operations worldwide in a variety of energy segments. Our continued interest in Chevron is based on the expectation that the company will grow volumes at an annualized 3% rate through the end of the decade. Future new production will also change the company's profile, which will become more heavily weighted toward natural gas. If the company Gorgon project in Australia moves ahead, Chevron could add more than 20 trillion cubic feet of natural gas to its proved reserves. Approximately 35% of Chevron's current production is natural gas, and the company expects this figure to reach 45% by 2015. Natural gas prices are currently low, and any future price increase in this energy source will provide a further boost to Chevron's earnings.

Chevron also has promising oil and gas prospects through 40 major capital projects, with a net investment of \$1 billion or more per project. Much of this investment is earmarked for the Gulf of Mexico's deep-water projects, which will climb to a sector-leading 20% by 2011. This portfolio shift of oil production allows Chevron to increase the cash received per barrel of oil since development expenses for the deep-water sites have already been completed. Deep-water oil fetches higher prices on the open market. Although there has been a large drop in oil prices in 2008, we believe the current valuation of Chevron (and other oil companies) still does not reflect higher long-term energy prices.

Fixed-Income Investments

The Morningstar bond index dove 6.8% in 2008 as investors fled mortgage-related and corporate fixed-income securities and traded into government bonds. U.S. Treasuries gained as the Federal Reserve aggressively reduced short-term interest rates and investors ran to government bonds, with the hope of hiding from credit risks that loom in nongovernment securities. The fright has been so horrible that investors are currently "paying" the U.S. government to hold their short-term money—a negative interest rate actually exists.

In 2008, investors also anticipated lower long-term interest rates in the future, with the expectation that the Federal Reserve would begin to monetize outstanding debt by purchasing longer-term government bonds. The government's purchase action can permanently add money to the financial system, but it temporarily reduces long-term interest rates. Lower interest rates help individuals renegotiate their adjustable-rate mortgage loans with banks. Conversely, the mortgage renegotiation process with homeowners helps financial institutions avoid reporting large losses as write-offs from defaulting loans within mortgage pools. In the end, the Federal Reserve's interest rate-lowering actions and added liquidity dealings does not change the reality that there are still hundreds of billions of dollars in loans that individuals will not be able to repay, and financial institutions will continue to write off these bad debts. Most likely, we will need a coordinated long-term plan to unfreeze the debt markets and relieve many individuals and financial institutions from an ongoing credit crunch.

It is our opinion that long-term market interest rates will possibly move upward in the future as the Federal Reserve maintains low interest rates and aggressively creates liquidity in the market, all with the goal of assisting leveraged borrowers to refinance their debts. This short-term action plan of low interest rates, along with the *initial* \$700 billion liquidity package approved by Congress to stem the financial crisis, will most likely have a long-term negative impact on security prices. As incoming data such as a continued housing slowdown and rising mortgage default rates lead to a further loosening of monetary policy, the resulting increased money supply can lead to an increase in long-term interest rates as inflation continues to take off within the economy. Simply put: It is quite possible that the short-term saving of the financial system will have long-term consequences.

We expect that the conflicting circumstances around interest rate movements can cause further instability in fixed-income investments, especially after the liquidity crisis subsides and investment sanity enters the marketplace. Rational investors will take exception to lending money to the U.S. government at rates between zero and 2.25% (on a 10-year bond), only to have the government turn around and earn 10%+ on this borrowed money through their investment of preferred stock and equity warrants in financial institutions. This so-called “spread” of 8+ percentage points is usually reserved for investment banks and hedge funds—not the U.S. government. Investors should begin to expect that the cost of capital, now set at 10% through various government deals with troubled banks, will work its way through the system. Fundamentally, investors who have money to invest are also going to demand higher rates of return on borrowed money—which is another reason the credit market is frozen.

In summary: We remain concerned about the long-term issues related to loose lending practices by major banking institutions over the past five years that have not yet worked through the system, as well as the possibility of higher inflation in the future due to an expanding money supply and long-term rising commodity prices. In this volatile environment, we will stay committed to short- to mid-term fixed-income opportunities that offer a fair risk and reward profile.

A Reflection and a Confession

Over the past 12 months, we had several tranches of treasury, municipal, and corporate bonds come due. We continued with a strategy of avoiding longer-term fixed-income investments, which are more sensitive to rising interest rates, and placed the majority of the proceeds in a mix of short-duration, fixed-income securities (i.e., one to three years) earning approximately 5.5% to 7.5%. These fixed-income securities were, for the most part, corporate bonds of companies that we would not ordinarily own as long-term businesses, but they produced sufficient profitability to meet their payment obligations to bondholders under recessionary conditions. In fact, we were very happy with the increase in returns on these short-term corporate bonds when comparing their returns to equivalent U.S. Treasuries, which offered an approximate yield of 3%.

As economic conditions deteriorated quickly and credit markets froze beyond mortgage bonds to corporate bonds, the long-term survival of several companies began to come into question—if *we encountered a depression*. The corresponding bonds fell in price and significantly impacted our fixed-income performance. Even though we had avoided investing in most of the financial fixed-income securities that eventually will become worthless, we needed to reevaluate the companies that we lent money to, understanding that we may experience *depressionary* conditions.

We reached the conclusion that several of the companies might not survive a once-in-a-hundred-year “depressed” environment and may be forced into bankruptcy, which would leave us having to rely on a restructuring or liquidation to recover our money. We decided to sell several bonds at a loss and to reallocate the funds to positions that would provide very good returns, yet not suffer the same consequences if depressed conditions prevailed.

Our first motto when investing in fixed-income instruments is to protect principal. Clearly, this rule was violated in 2008. We experienced a partial deterioration of capital that will take some time to recover. At this point, we have removed a large portion of the default risk within our fixed-income portfolio. We cannot guarantee that default will not materialize in the future, however. With this said, we do believe the aggregate interest received on our corporate bonds (including any chance of default)

will exceed the yields offered on government securities over the same time period—currently less than 1%. As our fixed-income investments mature, we will continue to reallocate capital to short-term fixed-income securities with the intention of repositioning this capital to higher-yielding securities if we encounter inflation.

WHAT'S CHANGING AT FOUNDERS?

In early 2009, we are going to invest heavily in our business. By the time you read this letter, we will be up and running with Bloomberg. The Bloomberg terminal is a computer system that enables financial professionals to monitor and analyze real-time financial market data. This is particularly important when trading bonds, as bonds are priced (and traded) very differently than stocks. Believe it or not, bonds are more akin to a private transaction that takes place between a buyer and a seller—in other words, a negotiation takes place.

When we are interested in purchasing a bond, we normally call several bond traders to “gain an interest.” Using a Bloomberg terminal, the bond trader then attempts to match a buyer and seller for this bond. Unfortunately, because we do not currently have a full view of which firms own bonds and at what price they are offering to sell them, it can be difficult for us to find the best bonds at the lowest possible price. Until recently, there was little difference in the pricing of bonds among the various owners, and there was a reasonable inventory of bonds that we believed to be appropriate for our clients’ portfolios. However, the recent freeze of the credit markets has created wide disparities in bond quality and pricing. As a result, it has become necessary for us to invest in the same Bloomberg terminal that the bond traders use. We believe this will allow us to purchase better-quality bonds at lower prices for our clients in the future.

2008 was a difficult year for investors, to say the least. We understand that there is a tremendous amount of anxiety. To provide you another view, at the end of this year’s letter, we have attached an op-ed letter written by Warren Buffett that was published in the October 16, 2008 issue of *The New York Times*. Warren Buffett is personally buying stocks in a big way.

Although there were (and will continue to be) challenges, Founders will continue to “see things as they really are.” We want to see where we are placing our money and maintain a view on the intrinsic value of things. In this age of continuing high uncertainty, it is our opinion that to be successful at the investment game, it is important to focus on long-term business and economic considerations rather than short-term trading strategies. We will continue our effort to avoid irrational decisions that are influenced by emotions—including fear of failing to meet desired returns for clients, fear of lacking intelligence and overanalyzing a situation, and being greedy when prudence should prevail.

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

Thank you for the opportunity to serve you and for your continued trust. We look forward to working on your behalf during 2009.

The New York Times

October 16, 2008

Buy American. I Am.

By WARREN E. BUFFETT

The financial world is a mess, both in the United States and abroad. Its problems, moreover, have been leaking into the general economy, and the leaks are now turning into a gusher. In the near term, unemployment will rise, business activity will falter and headlines will continue to be scary.

So ... I've been buying American stocks. This is my personal account I'm talking about, in which I previously owned nothing but United States government bonds. (This description leaves aside my Berkshire Hathaway holdings, which are all committed to philanthropy.) If prices keep looking attractive, my non-Berkshire net worth will soon be 100 percent in United States equities.

Why?

A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors. To be sure, investors are right to be wary of highly leveraged entities or businesses in weak competitive positions. But fears regarding the long-term prosperity of the nation's many sound companies make no sense. These businesses will indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now.

Let me be clear on one point: I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month — or a year — from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over.

A little history here: During the Depression, the Dow hit its low, 41, on July 8, 1932. Economic conditions, though, kept deteriorating until Franklin D. Roosevelt took office in March 1933. By that time, the market had already advanced 30 percent. Or think back to the early days of World War II, when things were going badly for the United States in Europe and the Pacific. The market hit bottom in April 1942, well before Allied fortunes turned. Again, in the early 1980s, the time to buy stocks was when inflation raged and the economy was in the tank. In short, bad news is an investor's best friend. It lets you buy a slice of America's future at a marked-down price.

Over the long term, the stock market news will be good. In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497.

You might think it would have been impossible for an investor to lose money during a century marked by such an extraordinary gain. But some investors did. The hapless ones bought stocks only when they felt comfort in doing so and then proceeded to sell when the headlines made them queasy.

Today people who hold cash equivalents feel comfortable. They shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value. Indeed, the policies that government will follow in its efforts to alleviate the current crisis will probably prove inflationary and therefore accelerate declines in the real value of cash accounts.

Equities will almost certainly outperform cash over the next decade, probably by a substantial degree. Those investors who cling now to cash are betting they can efficiently time their move away from it later. In waiting for the comfort of good news, they are ignoring Wayne Gretzky's advice: "I skate to where the puck is going to be, not to where it has been."

I don't like to opine on the stock market, and again I emphasize that I have no idea what the market will do in the short term. Nevertheless, I'll follow the lead of a restaurant that opened in an empty bank building and then advertised: "Put your mouth where your money was." Today my money and my mouth both say equities.