EAST COAST
ASSET MANAGEMENT

To: East Coast Asset Management Clients and Interested Parties

From: Christopher Begg, CFA and Benjamin Favazza, CFP®

Date: July 20, 2009

Re: Second Quarter 2009 Update

Market Summary:

Since the lows of March 7th, the S&P 500 has recovered 35.89% through June 30, 2009. Year-to-date, the S&P 500 has had a total return of 3.16% with the second quarter registering a 15.93% total return. The price of crude oil has doubled from the February lows of $34 closing the quarter at $69.89. The price of a troy ounce of gold has rallied 34% to $953 from the October 08 lows of $715. The 30 year US Treasury bond began 2009 at 2.67% and is now yielding 4.55%.

So what's going on?

Judging by these indicators, one might think that the economy is not just recovering but flourishing. Our view, however, is quite the opposite. End demand for goods and services (GDP) continues to wane with -3% year-over-year readings and the US employment situation is the worst it has been in 27 years with unemployment recently registering 9.6% and expected to rise. The housing situation is horrible and we expect it to get worse. The key data point we follow to inform our views on the stabilization of housing prices is months-supply of inventory. This indicator has a flat-line trend at about 5.5 months going back 20 years and it is currently at 11 months (we believe that number could be as much as 20 months if you count shadow inventory-levels). We feel housing prices will continue to move in their downward trajectory until inventory levels normalize, which will take time. With regard to regional/national banks, the state of the housing and commercial real estate market will prove to be an on-going challenge as we fully expect additional rounds of dilutive capital raises to continue in order to bring their mandated coverage ratios in line.

We wrote in last quarter's update that there would be an inflection point from a period of deflationary pressures toward inflationary pressures that would be important to get right. From our last letter "In a deflationary cycle, cash is king. In an inflationary cycle, cash earns a negative real rate of return. The higher the rate of inflation, the greater the harm to the purchasing power of your accumulated wealth." Our view was that the inflationary forces being driven by a global policy response favoring reflationary strategies would eventually win that tug of war. As you can see from some of the numbers noted above, the effects of this response are showing up in asset prices and bond yields.

How are we looking to invest in this environment?

As always, we are relying on a good dose of common sense and a keen eye on the expected return of our investments to navigate through these fluid times. Warren Buffett's words "price is what you pay and value is what you get" couldn't ring more true in this environment. A primary theme with our equity investment strategy is to own the beneficiaries of the current reflationary policy and we have been favoring businesses, industry sectors and countries that have pricing power and/or control natural resources where the bar will be reset at a higher value. We continue to see strong tail-winds in the global sectors of Basic Materials and Energy. With regard to our international allocations, we are favoring those countries that are endowed with natural resources coupled with political/economic stability. The flip side is deselecting investments where there exists an intrinsically impaired ability to raise prices as input costs rise. We are wary of companies and industries with leveraged balance sheets that force them to rely on the "kindness of strangers" when they need to roll over long-term debt commitments. We are avoiding companies with large pension obligations at the same time as their pension assets have been cut in half by market performance. Finally, we foresee a long-term negative shift in demand for the US dollar as a store of value and perhaps as the world's reserve currency. When appropriate, we favor investments where non-dollar revenues repatriated may provide a couple additional percentage points of total return.

For our fixed-income allocation, we have chosen to keep some of our maturing bonds and our allocation that is ear-marked for bonds in very short-term maturities or money market investments. We fully expect yields to continue to climb and believe anything that looks interesting from a spread perspective today, with the quality attributes we require, will look like a relatively poor decision tomorrow once yields climb and better opportunities become available.

What do we expect for the remainder of the year?

Although our strategy is not dependent upon our ability to forecast the short-term zigs and zags of the market, we appreciate the fact that our clients often ask this of us so we offer the following musings. Our analysis suggests that the "elephant in the room" for global equity markets is a prolonged period of heightened inflation/asset-reflation that will continue to favor above-average returns over a secular period for many investments that are fundamentally sound and where valuations are attractive. We temper this bullish forecast with the caveat that some of this positive price move might be illusory in terms of real-return as underlying purchasing power is eroding at an above normal clip. Protection against inflation risk is critical. In the near-term, we fully expect that those looking for "green shoots" and a "v-shaped" economic recovery will be disappointed. We expect this disappointment to give us another opportunity to tactically increase positions at advantageous levels. We will continue to make sound investments that offer very attractive asymmetric characteristics: low probability of downside and a high expected compound rate of return from current prices. We do not make a habit of consulting the vagaries of the manic/depressive Mr. Market for inputs into how we should act. Mr. Market plays a critical role in providing us with a price to transact – otherwise the merits of the individual investment will trump the noise of the marketplace.

Organizational Update:

- New Hire**:** Beginning June 1st, Jack McManus joined East Coast as an Associate Portfolio Manager and Research Analyst. Jack has proven to be an invaluable member of our team and has been with us since day one of our launch in the part-time role of Research Analyst. Jack graduated in May with an MBA from Boston College with a concentration in Asset Management, and was inducted into the Beta Gamma Sigma National Honor Society. Jack is a Chartered Financial Analyst (CFA) and came to East Coast with five years of previous investment experience. The decision to bring Jack on board full-time after graduation was the easiest pivotal firm decision we have made as he has been a vital part of our success to date. He is truly a team player and among his many talents is his ability to wear many hats, which we often ask him to do. Jack and his wife, who currently is a pediatric resident at MGH, live in Melrose and are expecting their first child in September.

- Essex Office: For those of you who have not recently visited our office in Essex, we are pleased to report that we have expanded. We doubled our space as of June 1st, which gave us the opportunity to build out a new conference room with full network/projection capability. While this serves as an important place to meet our clients, it also became mission critical as squeezing the 7+ members of our investment team into an office for our Monday investment meetings became increasingly difficult. We look forward to your next visit.

- Summer Research Analysts: As many of you know, we closely affiliate ourselves with local MBA programs in Boston. We typically offer full-time summer opportunities to candidates who have graduated or have just finished their first year. During the school term, we also offer part-time opportunities (25 hours a week) to candidates that are in their second year. Chris has now worked with over 20 MBA's in this capacity over the last 10 years which led to three strategic full-time hires. We have organized our research process to allow for four positions this summer. We work closely with the executive directors of the Investment Management curriculums at these schools (for example: Center of Investment Research and Management at Boston College and Hughey Center for Financial Services at Bentley College) as well as the recruiting offices to guide us in drafting the "best athletes." We could not be more pleased with the individuals we have working with us this summer. Their past career experience, work ethic, desire to add value, and teamwork have already made their mark on our research effort. Included are the bios for Anya, Scott, Greg and John for your interest and we hope that you have a chance to meet them in person.

- Strategic Growth: The opening line of Charles Dickens's novel A Tale of Two Cities begins: "It was the best of times, it was the worst of times." This could not be more appropriate to summarize the feeling we have had with regard to the timing of our launch. For the most part, we manage the majority of our client's accumulated wealth. Therefore, when we experience any period of dislocation like we had in 2008, where asset values are impaired and fear is rampant, we also feel that pain and can empathize with the perceived uncertainty it creates. Fortunately, we were able to bring in our largest grouping of client assets in the very early months and we were able to make shifts that helped mitigate some of the downside given our views of the true depth of the credit crisis. The silver lining in the timing of our launch is that we have had an abundance of opportunities created when the whole world essentially went "on sale" for 50% off. While some of those corrections were warranted, we believe that many were exaggerated.

Another positive opportunity for East Coast generated by this crisis is that we have been approached by many talented investment professionals who are interested in joining our team as principals. Some of these individuals have been most recently employed at leading bank trust departments and brokerage firms. They have long-standing relationships with their clients and are looking for a more transparent structure that is free from conflicts and bureaucracy. The critical element as we started these discussions with potential partners is that they completely buy into our vision of the firm we have built and continue to build. They have to be like-minded with regard to our investment philosophy, be a good match for our culture, possess strong character attributes, and be willing to implement our process as we want team players, not solo practitioners. We have engaged an executive recruiter to help with the initial phases of this process (initial interviews, background checks, reference checks, etc.) so as to minimize any distraction from our day-to-day focus. We have seen many quality candidates and we feel the environment has afforded us our pick of a champion litter.

As we build our firm, we are aware that it is sustained growth that will allow us to expand both our human and investment management resources, to the benefit of our clients. We have thought a lot about the quality and nature of that growth. We have structured our firm so that the right professional is positioned to maximize our client's satisfaction, which boils down to performance and service. You may have noticed that from the top of our structure we have differentiated Wealth Management and Investment Management. We have done this because we believe the two tasks are very different yet equally important. Cultivating best practices in both is our foremost objective. With full humility as to the task at hand, we expect to build the premiere investment-focused wealth management company for our target client demographic.

The majority of our clients are introduced to us from our existing clients and from our trusted referral sources. While we welcome any referrals our clients make, we also appreciate that we are providing a service that is private and many of you prefer to keep your financial affairs that way. We take this opportunity to thank those that have spoken of our firm in a positive light.

We continue to manage your capital with the utmost prudence and look forward to meeting or talking with you soon. We value greatly your support and trust.

"It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most adaptable to change."

\- Charles Darwin

Sincerely,

Christopher M. Begg, CFA
Chief Investment Officer

Benjamin S. Favazza, CFP®
Chief Wealth Management Officer

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Research Analyst Biographies

Greg Harrison
Greg is a Research Analyst at East Coast. He is currently enrolled in the Master of Business Administration and Master of Science in Finance dual degree program at the Boston College Carroll School of Management. Greg earned a B.S. in Cell and Molecular Biology from the University of Washington and a B.S. in Finance from the University of Maryland University College. Prior to graduate school, he worked in the biotechnology industry as a validation engineering consultant. He is currently a CFA Level 2 Candidate. Greg speaks conversational German.

Scott Mensi
Scott is a Research Analyst and Marketing Officer at East Coast. He is currently enrolled in the Master of Business Administration and Master of Finance dual degree program at the Boston College Carroll School of Management. Scott earned his B.A. in Economics from Hamilton College. Prior to graduate school, Scott worked in the Client Management Group at State Street and more recently as a Marketing Associate at Numeric Investors.

John Rogers
John is a Research Analyst at East Coast. John graduated cum laude from Deerfield Academy in 2006, and is currently an honors student at the University of Pennsylvania. At Penn, John is a member of Wharton's undergraduate real estate club, volunteers for the NGO Power Up Gambia, and is the vice president of St Anthony Hall fraternity. He has prior experience as an analyst at both an investment bank and an asset management firm. John speaks conversational Spanish.

Anya Suvorov, MSF
Anya is a Research Analyst at East Coast. Anya received a Master of Science in Finance degree with high distinction from the McCallum Graduate School of Business at Bentley University. She attained her Bachelors in Finance from Northeastern University. Prior to joining East Coast, Anya interned at Aspen Technology as a Treasury Analyst, where she assisted the Treasurer with financial analysis, modeling and project management. Before graduate school, Anya worked at Brown Brothers Harriman as an Operations Specialist within Corporate Actions department. Anya is a native speaker of Russian.

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To: East Coast Asset Management Clients and Interested Parties

From: Christopher Begg, CFA and Benjamin Favazza, CFP®

Date: October 29, 2009

Re: Third Quarter 2009 Update

Market Summary[1]:

	S&P 500	**MSCI AC World Index**	**MSCI Emerging Markets**	**Barclays Aggregate Bond Index**	**Gold – $/Troy Oz.**	**Crude Oil**
Price 09-30-09	1,057.08	287.23	338.67	1537.21	$1,007.70	$70.61
3rd Quarter	15.61%	18.00%	20.73%	4.01%	8.75%	1.03%
Year-to-date	19.26%	29.04%	57.09%	6.14%	14.25%	58.32%
From March 6th Lows	56.68%	67.31%	85.90%	7.19%	7.28%	55.12%

All asset classes registered strong total returns in the third quarter. A tactical decision to increase equity exposure throughout the year, coupled with satisfactory excess returns attributed to security selection, have produced favorable total returns for our model portfolios. In this update, we will delve into the rationale for our portfolio positioning over the preceding six months and discuss some broad views that continue to shape many of our portfolio construction decisions.

Organizational Updates – Part 1:

We normally conclude with a section on East Coast organizational updates in our quarterly letter. However, given the fact that some of you might find our discussion of inflation a bit tedious, we wanted to make sure you were still awake to read a very exciting company announcement.

- *Two New Partners:* As we highlighted in our second quarter letter, we have been actively engaged in a search for quality investment professionals to join our team. Over the last six months we have worked with an executive recruiter as well as networking with professionals we have worked with throughout our careers. We have had the good fortune of meeting many quality candidates. That being said, a decision to bring on a partner is pivotal, and all the stars have to align for us to be comfortable extending an invitation. We feel quite fortunate to announce two new partners who could not be more complementary to our culture and who round out the professional needs of our organization. We are pleased to announce the addition of Gina Koprowski, CFP® and Robert Murphy, CPA to East Coast Asset Management, Inc.

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. No East Coast strategy will seek to replicate the performance of these or any other indices.

- Gina Koprowski, CFP®: Gina joins us as a Managing Director and Principal of East Coast Asset Management. Her primary responsibilities are managing client relationships and overseeing the firm's operations and compliance. Gina brings 20 years of financial services experience to the firm. Her most recent position was with Fidelity Investments Private Client Group as a Vice President/Senior Account Executive where she worked with her clients to develop customized investment and financial planning solutions. In addition to client management, Gina has also held roles in operations, systems and marketing at Fidelity in Boston, Fidelity Brokerage Services in the UK, Chase Manhattan Bank's Global Private Bank and Rockefeller Financial Services in New York. She earned her BA from McGill University in Montreal, her MBA in Logistics and Finance from the University of Maryland, College Park, and holds a Certified Financial Planner (CFP**®)** designation. Gina is a member of the Financial Planning Association where she is a volunteer in the pro bono Military Outreach Program. Additionally, she is a member of the Boston Estate Planning Council and serves as Chairman of the Board of the 501-3(c) organization, Outdoor Explorations. Gina and her husband were married this past summer and live in Charlestown, MA.

- Robert Murphy, CPA, MST: Bob joins us as a Managing Director and Principal of East Coast Asset Management. Bob brings 23 years of wealth management experience and an expertise in estate and income tax planning to the firm. Before joining East Coast Bob was with Eastern Wealth Management as Senior Vice President/Relationship Manager providing wealth management solutions for clients. Previously, he was a Vice President with Atlantic Trust Pell Rudman. Prior to that, Bob spent 10 years at Cambridge Trust Company as Tax Officer. Bob is a CPA and holds a Bachelor of Science degree in Accounting from Merrimack College and a Master of Science degree in Taxation from Northeastern University. He is a graduate of the National Graduate Trust School at Northwestern University. He has received a Certificate in Financial Planning from Boston University's Center for Professional Education. Bob is a member of the AICPA and the Mass Society of CPAs. Bob lives with his wife and four children in Woburn, MA.

The Deflation-Reflation Continuum:

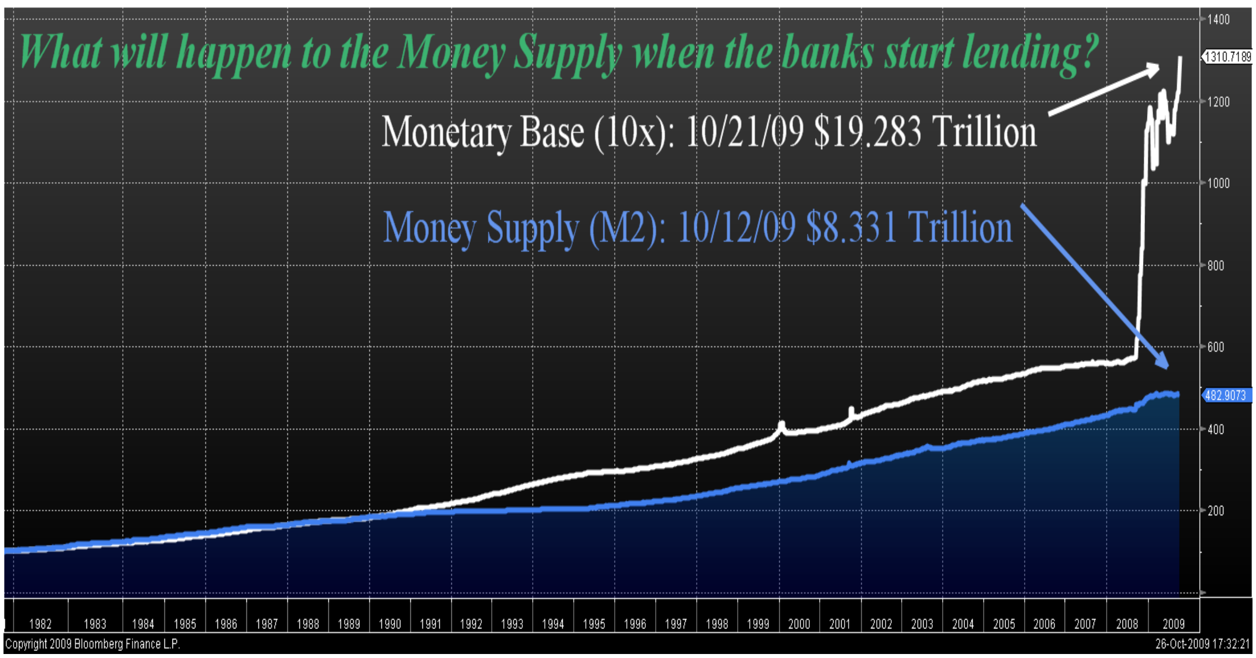
Over the last year we have devoted a good deal of space in our quarterly letters and time in our investment/client meetings to discussions of deflation and subsequent reflation. While we consider our investment philosophy firmly rooted in the value investing school, where we look for mispriced investments on an individual basis, we feel it is critical to have a "global macro" perspective. With this objective in mind we organize our investment process to look at *themes*, *asset class* expected returns, and *global sector* expected returns to complement and inform our bottom up investment analysis.

Our themes, often times, present the team with a list of major headwinds and tailwinds for industries and companies that can be a source of idea flow. This work is also an overlay on the due-diligence work we do on our portfolio companies and the investment universe. From time to time, this aspect of our core research process produces what we call an "elephant in the room" theme. That is, a theme that is relevant to many of our investments. Investment bubbles fall into this category. Since historically all bubbles have reverted, at least to their normalized trends, they can be looked at as near certainties. Over the last decade we have had a couple memorable "mean reversions"; the Tech Bubble of 2000, the US Housing Bubble of 2006, and the corresponding Global Credit Bubble of 2007.

For over a year the "elephant in the room" has been the "continuum" from deflation to reflation. When the credit bubble burst in the fall of 2007, the world went into a painful negative-feedback loop of asset price deflation. Credit markets froze as participants lost trust in both borrowers and lenders. This brought on a vicious deleveraging process as investors were forced, by creditors, government regulation (short-sale rules changed) and by their own emotions of fear and uncertainty to seek liquidity. As selling begat selling and debt coverage ratios plummeted, uncertainty rose and asset prices declined. During a deflationary spiral, the best place to take cover is in the safest and most liquid investment which at that time was US Treasuries. The crisis hit a tipping point in the first quarter of this year when it became clear that policy makers (Fed Chair Bernanke, Treasury Secretaries Paulson–Geithner), would err on the side of bailing out too much rather than too little. In March of this year, we finally began to see the reflationary response to the extraordinary stimulus and bailouts that had been administered to the flailing economy. It was at that point that asset prices started to rise and they have since continued on their upward trajectory.

Jeremy Grantham of GMO, in his May 2009 letter, quantified the situation that the deflationary spiral presented policy makers here in the US. He calculated that the total US market value of housing, commercial real estate, and stocks was about $50 trillion at the peak and fell below $30 trillion at the low. Grantham believed that this drop in perceived wealth would not only have a sustained effect on consumer behavior, but more importantly these assets supported $25 trillion of debt. Late in the first quarter of this year, we at East Coast believed we would have a combination of three outcomes. 1) We would expect to see a systemic write down of debts (debt forgiveness, bankruptcies, foreclosures, etc). 2) We would have several years of accelerated inflation to erode the value of debt. 3) We thought policy makers would attempt to "reflate" assets by increasing the supply of money. We believed that the latter of all outcomes was not only the easiest one for our modern "fiat money" governments to employ but it also has the benefit of having the most immediate effect. Fast forward to today, all three outcomes have materialized with the third remaining our greatest concern.

A useful analogy is the Free Parking jackpot in the game of Monopoly. A popular Monopoly "house rule" adaptation is to put $500 in the middle of the board and the player that lands on Free Parking is awarded these funds. This has the effect of increasing the money supply that is available to players. This is the Federal Reserve equivalent of starting up the printing presses. The net result is there are more funds in circulation to bid for property, build houses, upgrade to hotels, or negotiate direct purchases of property from players, often above market value, to create a monopoly. It also has the effect of indirectly bailing out the player on the verge of bankruptcy, who overbuilt too quickly and has not had the good fortune of anyone landing on his newly constructed property (perhaps the equivalent of the developer who built the n^{th} Miami high rise that now sits vacant). The marginal player now has new funds available to keep him in the game with no consequences for his poor economic behavior. It is ironic that the purportedly capitalist game of Monopoly in fact teaches lessons of socialism.



Milton Friedman put it very succinctly: "Inflation is always and everywhere a monetary phenomenon." The chart above highlights a couple of observations that concern us. Money Supply, often referred to as M2, is the total amount of money available for spending (currency in circulation plus bank deposits). The Monetary Base is a combination of currency and the Reserves available for banks to lend. The normal relationship between the growth of M2 and Monetary Base has been on the order of one to one. You can see from the beginning of the credit crisis there has been a frightening increase in the Monetary Base but it has not yet materialized in a growth of the Money Supply. The Money Supply has not increased because banks have been wary of lending as they continue to incur and fear further losses. We believe as the economy picks up the banks will feel better about lending and we will see an increase in the *velocity* of money which will be a key catalyst for fueling inflation. Our sources tell us that banks are getting more comfortable with lending and there is a healthy appetite for credit. We remain En Garde!

Investors who are keen to the risks of inflation have been voicing their concerns. Warren Buffett penned an op-ed piece in the New York Times on August 19th titled "Slow Growth and the Greenback Effect." Below we have quoted a paragraph from this article which highlights how unlikely it would be for an elected government official to heed these warnings.

> *"Legislators will correctly perceive that either raising taxes or cutting expenditures will threaten their re-election. To avoid this fate, they can opt for high rates of inflation, which never require a recorded vote and cannot be attributed to a specific action that any elected official takes. In fact, John Maynard Keynes long ago laid out a road map for political survival amid an economic disaster of just this sort: "By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens.... The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."*
>
> And a quote on CNBC on June 24, 2009:
> ***"Well, I don't worry about deflation at all.*** *We won't see deflation in any significant amount in your lifetime, which is more relevant than my lifetime. . . We have done things that raise the probability of really high rates of inflation at some point."*

We are hopeful that enough warnings from informed citizens such as Warren Buffett and Paul Volker will help build an appropriate exit strategy for the extraordinary intervention we have seen. However, we never make investments on hope and are rightly skeptical, so we have a heightened focus on protecting not only the principal but the purchasing power of our clients' accumulated net worth. Even if the government heeds these warnings, we conclude that they will be late in removing the excess money from the system. Policy makers will be taking their cues from the economy in the form of the unemployment rate, GDP growth, housing prices, retail sales and how much our factories are being utilized. All of these numbers will be anemic for a prolonged period of time. Their constituents and voters will be feeling the pain, and with re-election a necessary objective, they will be loathe to pull money out of the system or raise interest rates. We believe the white knight will arrive too late and after inflation consequences are in the system. Paul Volker was a very unpopular Fed Chairman when he had to reign in the ravages of the stagflation crisis of the 1970's.

Portfolio Positioning – Then and Now – Our Broad Views:

The inflation situation we describe above is a risk that we need to position against. Our clients that are in retirement or approaching retirement have accumulated assets to last them a lifetime. We are not pessimists or doom and gloom investors - but we are realists. Given the heightened risk of purchasing power erosion, we have been implementing a decisive, prudent, and disciplined strategy to protect against it.

- *Then and Now:* As we mentioned earlier in the letter, the first quarter marked an inflection point where we moved from the low-end of our asset allocation ranges in Equities and have gravitated toward the higher-end of our clients' customized ranges. We will always first and foremost allocate capital based on valuation. As value investors, our view of the quality of the investment drills right down to what we expect to extract from that opportunity in cash – all income plus return of our principal. We compare this expectation of return (IRR) to all investment alternatives across all asset classes. This said, high quality global equities have represented the best expected total return from a valuation perspective. They also share the important attribute of being an effective inflation hedge for those companies that have the ability to raise prices with inflation or have tangible assets that are being reflated. We had been making investments during the periods of dislocation in the 4th quarter of 2008 and 1st quarter of 2009 that have paid off handsomely to date. Below we will highlight some broad views that continue to shape the composition of our portfolio.

- *Broad Views:*

  - Equities – "the "Q" component: We perceive a valuation anomaly globally between companies that we define as high quality (Q) when compared to many lower quality cyclical companies. Since the lows in March, when "Armageddon" was taken off the table, there has been a strong outperformance of lesser quality businesses that appear to be priced for a return to bubble-era profitability. Conversely, companies we always tend to favor that have a durable global franchise (example; Nestle, Colgate, Coca Cola, Novartis, Pepsi) trade at the low-end of their 20 year range of valuation multiples and pay well above-market dividend yields. Businesses that have scale advantages, and who are the price-setter in the industry, have the very important characteristic of being an inflation hedge for us. Many of our portfolio positions fit into this category and we have been doing further due diligence on new potential holdings. We fully expect this area to be a relative and absolute bright spot in our portfolio for the foreseeable future.

  - Tangible Assets and Natural Resources: As discussed above, we have a global reflationary environment where central banks are increasing the money supply to levels we have not seen. At the same time, we are in a period of contracted global growth as the world deleverages from the credit bubble. Thus, we have a lot of capacity that will remain underutilized. Where will all the excess money flow? It will flow into assets and more specifically into real assets. While we do not view real-estate as an attractive asset class as it works off its own excesses, we are favoring countries that are resource rich and companies that have tangible assets. Investments we have made with this view in mind are; country/sector specific ETFs such as Australia, Canada, Brazil, and the Global Materials Sector, and company specific investments such as Petrobras.

  - Gold: With cash and near-cash investments earning very low interest rates, our opportunity cost is low to shield some of our fixed-income allocation from inflation. We have and will continue to look at gold in this way. We do not like many of its characteristics as it pays us nothing in income, it indirectly costs us to store it, and very little gold has ever been used up. John Paulson summed up two reasons an investor would want to own gold when he spoke at the Grant's conference in New York a few weeks ago. He said one was the "fear factor" which is a hedge against Armageddon. The second factor and principal source of gold demand is that for a protection against currency debasement. Paulson explains: "Demand for gold as an inflation hedge is, for me, 100 – 1000 times more than the demand for the 'fear factor.'" There are many people, institutions, and countries that are holding major reserves in "fiat" paper currencies that are being debased. We expect a sustained rally in the price of gold and we find it an effective parking spot for money we have that is not earning an adequate interest rate and that is not shielded from inflation risk. We look forward to the day that we will not have a gold allocation in our portfolio again.

- Emerging Markets: We feel the countries of Brazil, China and India represent a vast opportunity for investment over the coming decades. While many of these countries face serious headwinds as their export markets may be weak for the foreseeable future, there exists an emerging consumer economy which will reward many of our investments that may be domiciled in these countries or are global franchises that sell their goods and services into these countries. We will not overpay for growth, but we will challenge ourselves to devote resources to uncover great opportunities, based upon sound investment principles, in these markets for our clients.

- Fixed-Income: We have been telling you that interest rates will rise to reflect the risk to a bond holder of getting dollars back that are worth less. An interest rate of 3.52% for a 10 year Treasury bond and 4.35% for a 30 year Treasury bond is not nearly a sufficient return for a bond holder. Rates are being kept artificially low as the Fed has been buying Treasuries. They have, in fact, made up 100%+ of the demand for the net-new issuance of Treasuries. This is not sustainable. Spreads have narrowed over the last six months and interest rates on corporate bonds of the quality we seek are not nearly interesting enough for us to allocate capital to that space in a meaningful way. We have been buying some short-duration Treasury Inflation Protected Securities (TIPS) and looking at some very safe floating rate options. Muni bonds will get more interesting as interest rates along the curve rise (as taxes increase, Municipals will also be an important after –tax investment for taxable clients) but we feel patience in this space will reward us.

- Environmental Revolution: One of the greatest tailwinds present in our global economy will be the allocation of resources to deal with climate change. The investment implications are exciting and there will opportunities to separate the speculation of start-up risks and make investments where we have a large margin of safety. Buffett and Munger’s early investment in BYD Co Ltd – a car battery manufacturer for electric vehicles was such an investment.

- On the Lookout for Tail Risks: We have a heightened awareness of “tail risks” (e.g., high-impact, hard-to-predict, and rare events beyond the realm of normal expectations– think black swans) after what we have all lived through over the last two years with regard to the global credit bubble. For example, the enormous trade and fiscal imbalance between China and the U.S. is a risk we are looking at closely. Our process looks to uncover what some of these might be and determine if there are any effective hedges we can employ to mitigate the potential for downside should that particular tail risk occur. We believe a process that continually attempts to answer the question “what could go wrong?” can be effective.

Organizational Updates – Part 2:

- *Research Analysts:* We will continue to make a point of introducing the research analysts that join us from the various MBA programs we work with. The responsibility of the research analyst is split on a 70/30 basis between two critical research objectives. The majority of time is spent compiling qualitative and quantitative data to produce an East Coast defined thesis write-up on an assigned prospective investment for the team to review. The secondary task is stewarding assigned "global macro" themes as well as sourcing categories to present new information and data for the team to evaluate.

  We have two hiring periods throughout the year. We offer full-time summer positions that last from May through the end of August and we offer part-time (mostly 2nd year MBAs) positions to candidates from September to May. We have expanded our reach beyond Boston for the first time and we have engaged the Value Investing Programs at Columbia University in New York (where both Benjamin Graham and Warren Buffett taught) and the Ivey School of Business at the University of Western Ontario in Canada. Our remote analysts will connect to our bi-weekly investment meetings by web conferencing technology and have remote access to collaborate on research through our proprietary research database. Matt Lowenstein from Columbia University is our first remote research analyst. We are pleased to announce four research analysts that will be joining us through May; Greg Harrison (we must not have scared him off as he is returning after being here full-time this summer), Matt Lowenstein, Amit Shah, and Onur Sergici. Included are the bios for Greg, Matt, Onur, and Amit for your interest and we hope that you have a chance to meet them in person.

- *Farm Team Update:* Last quarter we were excited to formally announce that Jack McManus, CFA had joined us full-time as an Associate Portfolio Manager and this quarter we get to make a more collegial announcement. On October 6th, a healthy baby boy, Rohan McManus appeared on the scene at 8 pounds, 3 ounces. We are thrilled for first time parents Jack and Shilpa.

We continue to manage your capital with the utmost prudence and look forward to meeting and talking with you soon. We value greatly your support and trust.

"One must pass through knowledge and arrive at simplicity."
Shibumi – Trevanian (1979)

Sincerely,

Chris

Christopher M. Begg, CFA
Chief Investment Officer

Benjamin S. Favazza, CFP®
Chief Wealth Management Officer

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Research Analyst Biographies

Greg Harrison
Greg is a Research Analyst at East Coast. He is currently enrolled in the Master of Business Administration and Master of Science in Finance dual degree program at the Boston College Carroll School of Management. Greg earned a B.S. in Cell and Molecular Biology from the University of Washington and a B.S. in Finance from the University of Maryland University College. Prior to graduate school, he worked in the biotechnology industry as a validation engineering consultant. He is currently a CFA Level 2 Candidate. Greg speaks conversational German.

Matthew Lowenstein
Matt is a Research Analyst at East Coast. He is a full time student at Columbia Business School's MBA program and graduated with a B.A. in History from Cornell University. Prior to working at East Coast, Matthew worked as an analyst at JP Morgan Chase. He then went to Beijing where he studied Mandarin Chinese, worked as a consultant at Beijing Grand Consulting, and an equity researcher at Wedge-MKI. He speaks Mandarin, Spanish, and French.

Asri Onur Sergici
Onur is a Research Analyst at East Coast. Onur received a Master of Science in Mechanical Engineering degree from Northeastern University and Master of Business Administration and Master of Finance degrees from Carroll School of Management at Boston College. Prior to joining East Coast, Onur was a research associate at State Street Associates, where he worked with institutional investors on issues related to portfolio and risk management covering a range of topics such as currency hedging, share class hedging, optimal portfolio and manager reallocation, value-at-risk calculations. He sits on the board of directors of The Eliot School, a non-profit organization for crafts and fine arts education. Onur is a candidate for Financial Risk Manager designation. He speaks German and Turkish.

Amit Shah
Amit is a Research Analyst at East Coast. He is currently enrolled in the Master of Science in Finance degree program at Boston College Carroll School of Management. Amit earned a B.S. and M.S. degree in Decision and Information Sciences from the University of Florida. Prior to graduate school, he worked as an IT Security consultant. He is currently a CFA Level 2 Candidate.

To: East Coast Asset Management Clients and Interested Parties

From: Christopher Begg, CFA and Benjamin Favazza, CFP®

Date: January 27, 2010

Re: Fourth Quarter 2009 Update

Happy New Year! We begin the new decade focused and energized toward our dual objective of delivering superior wealth and investment management services to our clients.

Market Summary[1]:

	East Coast Equity Composite[2]	S&P 500	MSCI AC World Index	MSCI Emerging Markets	Barclays Aggregate Bond Index	Gold – $/Troy Oz.	Crude Oil
Price 12-31-09	n/a	1,115.18	299.44	363.48	1540.34	$1,096.95	$79.36
4th Quarter	5.77%	6.04%	4.74%	7.54%	0.22%	8.86%	12.39%
2009	30.54%	26.47%	35.17%	68.93%	6.37%	24.36%	77.94%
From March 6th Lows	51.60%	66.14%	75.24%	99.92%	6.91%	16.78%	74.34%

All equity and commodity asset classes registered strong total returns for 2009 and robust returns for the 4th quarter. Bonds did modestly well as spreads narrowed throughout the year and leveled off near the beginning of the fourth quarter. A tactical decision to increase equity exposure throughout the year coupled with satisfactory excess returns attributed to security selection have produced favorable total returns for our managed portfolios.

We launched in the midst of a perfect storm – a US housing bubble of historic proportion which in its macro form was in fact a global credit bubble. A loyal client/referral base, coupled with a proven philosophy and battle tested process allowed our firm to exit this crisis stronger than when we entered. With regard to portfolio positioning, in 2008 we were rightfully fearful when others were greedy (complacent) and in early 2009 we acted appropriately on our research insights thus allowing us to opportunistically pick through the rubble. Both endeavors added meaningfully to our total return: the former helped mitigate downside and the latter positioned us for appreciation when equity markets improved in March. We thank you again for your trust and support in allowing us to make those key decisions that were often contrary to the emotion of the moment.

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. No East Coast strategy will seek to replicate the performance of these or any other indices.

[2] The East Coast Equity Composite comprises the equity component of all accounts under management and is computed gross of management fees and net of all trading fees and expenses.

A Decade to Be Forgotten? – Beware of Recency-Bias:

The first decade of the new millennium will not be fondly remembered by the buy and hold investor, particularly for the investor who bought on day 1 and sold on day 3,652. An investor who bought on 12/31/99 and sold on 12/31/09 would have earned a cumulative return of -10% in the S&P 500 (including reinvested dividends) and would have incurred a 41% loss if they had invested in the NASDAQ. Equities have historically paved a path littered with periods of greed and fear as capital markets move upward and onward. The decade began with the greed and euphoria of the technology bubble and concluded with the paralyzing fear paramount after the popping of the credit bubble. From the chart below, you can see just how wild a ride the last ten years have been.

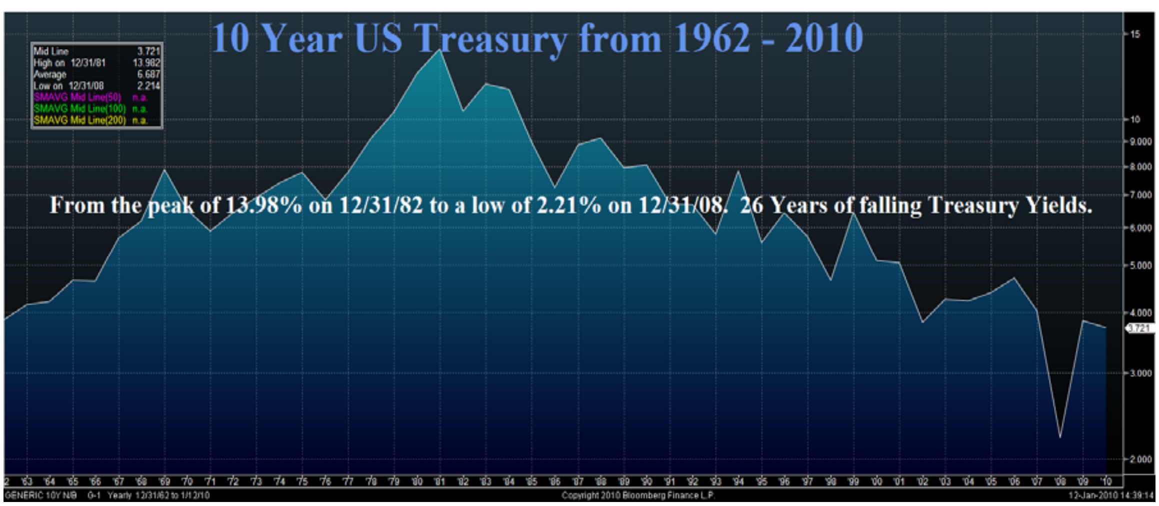
This view is a misleading illustration of how an astute investor might have fared. Mr. Market gave the keen-eyed observer plenty of clues on when, where, and how one should or should not allocate capital. An investor not equipped to identify bubbles, peak or trough valuations, or to estimate expected returns based on price, is probably past the point of frustration and waving a white flag.

The human psyche suffers from the "recency-effect" which is a cognitive bias that results from a disproportionate salience of recent observations. An observer of the last decade/last year would deduce that equities are too volatile, represent great risk, return nothing to shareholders and should be avoided at all cost. If we looked at the PIMCO Total Return Bond Fund (PTTRX), the largest US taxable bond fund at $201bl of assets, and Fidelity Cash Reserves (FDRXX) as proxies for bonds and cash, the annualized returns were 7.65% for bonds and 2.94% for cash over the last decade. Thus, fully loaded with recency-bias, an investor would interpret equities (S&P 500 -0.95% annualized) to be an inferior asset class to bonds and cash.

If we take the perspective that the last 10 years were the trees and we step back to truly see the forest, a different story unfolds. We have used a logarithmic chart to show the true visual proportion of these moves over a prolonged period of time. The compound annual return from 12/31/39 to 12/31/09 was 10.63% for the S&P 500. If we exclude the decade leading up to the technology bubble and this last decade, one can see returns are even more robust at 11.63%. Perspective and fact are everything in the business of investing. Compare those returns to bonds at 6.23% annualized and cash returning 3.1% annualized over the full 70 year period.

The Deflation-Reflation Continuum – Update:

The two critical risks to accumulated wealth are principal risk and purchasing power risk. Risk of losing the purchasing power of your assets has not been a factor since the cyclical inflation of the 70's. During that time, inflation spiked and ten year Treasury yields subsequently peaked at 14% in the early 80's. Through the 4th quarter of 2008 we lived through 26 years of falling Treasury yields. Again, fully loaded with our recency-biases, we are emotionally inclined to not worry about inflation risk and rightfully have been more focused on principal risk after having lived through the "double-bubble" roller coaster of the last decade.



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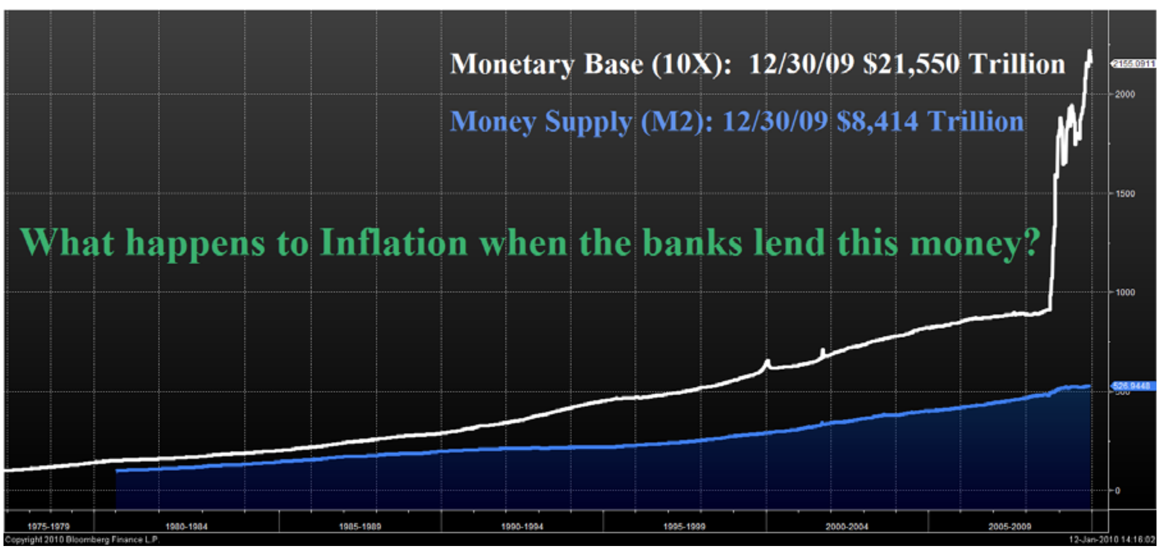
We now conclude that the weight of the evidence suggests the need to be concerned about potential inflation. We do not pretend to understand every nuance of this subject as it's extremely complex coupled with a dizzying array of "what if" scenarios. In these instances we seek outside counsel for guidance. We have talked at length with numerous inflation/deflation experts on this subject, many with varying views. In turn, we have observed that one's viewpoint is directly related to the outcome that best suits the "expert". If you ask a bond investor like Bill Gross, who is directly and indirectly responsible for managing $500bl of bonds, he will tell you deflation is the concern. If he said inflation, he should be selling every bond, a decision which would have grave career risk. Our research has produced a good amount of data to sort through and as such we continue to favor inflation protection strategies.

The most sage advice on this subject comes from those that have accumulated wealth, who like our clients, are at risk of losing the purchasing power of those dollars not invested appropriately. We made mention in last quarter's letter that Warren Buffett is rightfully concerned. He penned an op-ed piece in the New York Times on August 19th titled "Slow Growth and the Greenback Effect." More recently, in the fourth quarter of 2009, Buffett spent the remainder of his investable cash hoard (actually using some debt) to purchase Burlington Northern for $35bl. This ranks as the largest transaction of his career. While the investment has a lot of merit in an industry that is transforming, we see this as more of a statement of wanting to own businesses versus the eroding value of cash. We want to quote again from his NYT piece as it summarizes succinctly our views on inflation risk.

> *"Legislators will correctly perceive that either raising taxes or cutting expenditures will threaten their re-election. To avoid this fate, they can opt for high rates of inflation, which never require a recorded vote and cannot be attributed to a specific action that any elected official takes. In fact, John Maynard Keynes long ago laid out a road map for political survival amid an economic disaster of just this sort: "By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens.... The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."*



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We first showed this chart in last quarter's letter. It is important to revisit this chart with current data as it highlights a few observations of concern. The change from our previous letter is a continued upward move in the monetary base. As a refresher, Money Supply, often referred to as M2, is the total amount of money available for spending (currency in circulation plus bank deposits). The Monetary Base is a combination of currency and the Reserves available for banks to lend. The normal relationship between the growth of M2 and Monetary Base has been on the order of one to one. You can see from the beginning of the credit crisis there has been a frightening increase in the Monetary Base but it has not yet materialized in growth of the Money Supply. The Money Supply has not increased due to banks reduced lending as they continue to incur and fear further losses. We believe as the economy improves banks will feel better about lending and we will consequently see an increase in the *velocity* of money - a key catalyst for fueling inflation. We continue to talk to banking executives and lenders on Main Street who tell us there is an appetite for credit and lenders are beginning to respond.

The recent release of *Sherlock Holmes* gave us the impetus to read some of Sir Arthur Conan Doyle's short stories and excerpts from his original four novels. The famous quote from the "Adventures of the Beryl Coronet" sums up our view of the options available to the Fed. "It is an old maxim of mine that when you have excluded the impossible, whatever remains, however improbable, must be the truth." As Buffett said above, the politically/economically impossible decision to increase taxes and/or reduce spending are two of the three options to deal with the newly found leverage on the government balance sheet. The third option is to fire up the printing press in the name of "quantitative easing" and pay/finance those debts with newly minted dollars. In reviewing the newly released FOMC minutes, we observe the Fed leadership to be far from hawkish on inflation. As Professor Moriarty was the nemesis to Sherlock Holmes, a dovish Bernanke might be the arch enemy to accumulated wealth not positioned to deal with inflation.

Portfolio Positioning – Then and Now – Our Broad Views:

We have been implementing a decisive, prudent, and disciplined strategy to protect against the heightened risk of purchasing power erosion. As many of our portfolio construction decisions and broad views remain intact from the last quarter's letter, we felt it was important to restate those views and include additional information where appropriate.

- *Then and Now:* The first quarter of 2009 marked an inflection point where we moved from the low-end of our asset allocation ranges in equities and gravitated toward the higher-end of our clients' customized ranges. We will always allocate capital based on valuation. As value investors, our view of the quality of the investment drills down to what we expect to extract from that opportunity in cash – all income plus return of our principal. We compare this expectation of return (IRR) to all investment alternatives across all asset classes. This said, high quality global equities have represented the best expected total return from a valuation perspective. They also share the important attribute of being an effective inflation hedge for those companies that have the ability to raise prices with inflation or have tangible assets that are being reflated. We made investments during the periods of dislocation in the 4th quarter of 2008 and 1st quarter of 2009 that have paid off handsomely to date. These views continue to shape the composition of our portfolio.

- *Broad Views:*

  - The "Q" Component - Quality: Just as we saw a low quality rally after the lows in 2003, we have seen a rally in lower quality companies versus higher quality since the lows in March of 2009. Higher quality businesses are not only poised for deferred outperformance but have in fact been leading since October of 2009. Examples of high quality names are the following: Nestle, Waste Management, Colgate, Coca Cola, Novartis, and Express Scripts. These companies trade near the low-end of their 20 year range of valuation multiples. Businesses that have scale advantages, and who are the price-setter in the industry, have the very important characteristic of being an inflation hedge for us.

  - Tangible Assets and Natural Resources: As discussed above, we have a global reflationary environment where central banks are increasing the money supply to levels not previously seen. At the same time, we are in a period of contracted global growth as the world deleverages from the credit bubble. Therefore, we have a lot of capacity that will remain underutilized. Where will all the excess money flow? It will flow into assets and more specifically into real assets. While we do not view real-estate as an attractive asset class as it works off its own excesses, we are favoring resource rich countries and companies that have tangible assets.

  - Gold: With cash and near-cash investments earning very low interest rates, our opportunity cost is low to shield some of our fixed-income allocation from inflation. We have and will continue to look at gold in this way. We do not like many of its characteristics as it pays nothing in income, it incurs indirect storage costs, and very little gold has been used up. John Paulson summed up two reasons an investor would want to own gold when he spoke at the Grant's conference in New York in the Fall of 2009. He said one was the "fear factor" which is a hedge against Armageddon. The second factor and principal source of gold demand is that of a protection against currency debasement. Paulson explains: "Demand for gold as an inflation hedge is, for me, 100 – 1000 times more than the demand for the 'fear factor.'" There are many people, institutions, and countries that are holding major reserves in "fiat" paper currencies that are being debased. We expect a sustained rally in the price of gold and we find it an effective parking spot for money that is not earning an adequate interest rate and that is not shielded from inflation risk. We look forward to the day that we will remove the gold allocation from our portfolio.

  - Emerging Market Consumer: We feel the countries of Brazil, China and India represent a vast opportunity for investment over the coming decades. While many of these countries face serious headwinds as their export markets may be weak for the foreseeable future, there exists an emerging consumer economy which will reward many of our investments that may be domiciled in these countries or are global franchises that sell their goods and services into these countries. We will not overpay for growth, but we will challenge ourselves to devote resources to uncover great opportunities, based upon sound investment principles, in these markets.

  - Fixed-Income: Interest rates continue to rise. The 30 year US Treasury Bond has increased 2% since 12/31/08 and 0.57 % since the end of the third quarter. We have been telling you that interest rates will rise to reflect the risk to a bond holder of getting dollars back that are worth less. An interest rate of 3.83% for a 10 year Treasury bond and 4.65% for a 30 year Treasury bond is not a sufficient return for a bond holder. Rates are being kept artificially low as the Fed has been buying Treasuries. They have, in fact, made up 100%+ of the demand for the net-new issuance of Treasuries. This is not sustainable. Spreads have narrowed over the last several months and interest rates on corporate bonds of the quality we seek are not interesting enough for us to allocate capital to that space in a meaningful way. We have been buying some short-duration Treasury Inflation Protected Securities (TIPS) and looking at some safe floating rate options. Muni bonds will get more attractive as interest rates along the curve rise (as taxes increase, Municipals will also be an important after–tax investment for taxable clients) however we feel patience in this space will reward us.

- Environmental Policies: We expect a lot of discussions from all major businesses regarding Sustainability Policies including hiring Sustainability officers to steward this effort. We have incorporated ESG (Environmental, Social, and Governance) overlays into our process. We feel businesses that do not embrace ESG initiatives will face severe headwinds and in aggregate will underperform in this new paradigm. One of the greatest secular themes present in our global economy will be the allocation of resources to deal with climate change. The investment implications are exciting and there will be opportunities to separate the speculation of start-up risks and make investments where we have a large margin of safety.

Organizational Updates:

- *East Coast Website/Client Vault:* We recently launched our new web site for East Coast. We see our web site as having three primary objectives;

    1. General Firm Overview: provide basic information about our wealth management company for the benefit of interested parties; clients, prospects, strategic partners, referral sources, and friends. While we would prefer to include additional schematics and details regarding our investment management services, we have not included those materials for competitive reasons. However, additional information is readily available for qualified parties.

    2. Content: All principles of our firm are assigned areas of expertise within the investment management and wealth management disciplines. You should expect periodic updates in our News and Updates Section which will include the headings of: Investment Management, Financial Planning, Estate Planning, Charitable Giving, Tax Planning, and ESG (Environmental, Social, and Governance). These updates will be emailed as well.

    3. Client Portal: During the 1st quarter we will be contacting all clients to provide encrypted login credentials. The client portal will include a client specific "vault" where all pertinent materials will be stored; Quarterly Reports, Investment Policy Statement (IPS), Financial Plan, Wills and Trusts, and any other client specific information. We have partnered with a firm that has been selected by Fidelity, Schwab and other leading custodians and is a leader in

protecting client information. This portal will also include reports that are updated daily. The reports should provide greater reporting capability than available through our custodial web sites. We want our clients to have access to both.

- *Research Analysts/Interns:* We are pleased to announce a new research analyst/intern that has joined our team: Rob Hales, CFA.

    - Rob Hales, CFA just graduated from the Richard Ivey School of Business at the University of Western Ontario. Rob was enrolled in the Value Investing Program directed by Professor George Athanassakos. Rob was a member of the team that won the Fairfax Award which was founded by one of our most respected value practitioners, Prem Watsa of Fairfax Financial. Rob lives and works from Ontario, Canada.

- *Principal/Managing Director Search:* We have engaged two recruiters in an ongoing search to find an additional Manager Director/Principal to join East Coast. The cultural fit has to be perfect, as such we expect this search to take time and we will proceed with patience. We will most likely find the right candidate through our network so if you know of anyone who is a seasoned professional with existing client relationships, we would welcome an introduction. Every existing member of our team brings a complimentary skill set and adds layers of depth to our organization. We look forward to updating you on our progress in our next letter.

Immediately following this update, we have included an appendix which provides some commentary on our investment process. We continue to manage your capital with the utmost prudence and look forward to meeting and talking with you soon. We greatly value your support and trust.

"It is a capital mistake to theorize before one has data. Insensibly one begins to twist facts to suit theories, instead of theories to suit facts."

Sherlock Holmes, Scandal in Bohemia (1888)
Sir Arthur Conan Doyle

Sincerely,

Chris

Christopher M. Begg, CFA
Chief Investment Officer

Benjamin S. Favazza, CFP®
Chief Wealth Management Officer

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APPENDIX A:

East Coast Research Process – Scientific Method and "Ariadne's Thread"

A good dose of curiosity and a passion for solving complex puzzles seem to be two common traits of successful value investors. These professional investors look for an edge in the way they think, source ideas, recognize patterns, and apply due diligence to a prospective investment. From time to time, they feel inspired to write something substantive about their process that may prove how they have a differentiated view. We recognize that the truly great long term records of protecting and growing capital have been achieved by those with a great deal of humility and no ego. It is not our objective to find the "holy grail" or the "edge" but to have an ever improving process to gather, analyze, and make decisions. With this objective in mind, we wanted to give you a conceptual view of how we think about the decision making process.

The objective of our investing efforts is to compound capital at superior annual rates of return while minimizing - downside volatility, fees, and taxes. The secret of sound investing that Benjamin Graham ventured in the opening pages of the Intelligent Investor (1972), could not be a more perfect motto: *Margin of Safety!*

We think it is constructive to consider the investing process as a scientific exercise. One that is definable, measurable, governed by laws and most importantly repeatable. We grimace when we hear people refer to investing as an art, as we view art as discovery of the complex through intuition where science allows process to create simplicity out of complexity. Order from Chaos. One of the key architects of the Scientific Revolution of the 17th century, often referred to as the age of the Enlightenment, was Rene Descartes. Descartes overarching vision was one of knowledge as a system of interconnected truths that can be ultimately abstracted into mathematics. The beliefs that drive our research behaviors are principles that we feel are empirically self evident and which can aid us in deducing each potential investment to mathematical ranges of expected return. If we are in possession of reasonable estimates of return (Internal Rate of Return - IRR estimates) for potential investments, we can allocate capital towards deserving investments and away from those less deserving. A "Newtonian" "apples-to-apples" comparison!

The story of the Cretan labyrinth[3] can help serve as a metaphor to describe how we manage the research process by which we construct our managed portfolios. The thread that Ariadne gave to

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[3] Ariadne was the daughter of King Minos of Crete, who conquered the Athenian nation. An unfortunate intimacy between Ariadne's mother and a bull resulted in the birth of the monster − half-bull, half-man − called the Minotaur, who was banished to spend his days in the Labyrinth. King Minos, being something of a tyrant, called for tribute from Athens in the form of young men and women to be sacrificed to the Minotaur.

The young Athenian hero, Theseus, offered to accompany a group of the young unfortunates into the Labyrinth so that he could kill the Minotaur and save Athens from the cruel tribute. Ariadne fell in love with Theseus and, not wishing to see him at the mercy of her cannibal half-brother, she provided him with a means of escape from the Labyrinth− a silken thread. Theseus simply had to unwind the thread while he went through the Labyrinth; should he come to a dead end he could rewind it to the point where he had made a choice of paths and continue his search using the alternative route. The scheme worked out beautifully, the Minotaur was slain, and Theseus found his way back out of the Labyrinth.

Theseus to provide him a mechanism to find his way out of the Labyrinth after slaying the Minataur is an effective way to describe how we work our way to an actionable investable idea.

The labyrinth in the real world is the Borgesian maze of infinite investment choices and the Minotaur represents our irrational thought. We believe we have fight or flight survival instincts embedded in our DNA which drives irrational thought and behavior based on emotions such as pain, fear, greed, euphoria, and apathy. Thus, in the world of investing the typical investor finds himself searching through the labyrinth like the imprisoned Minotaur, often lost in the depth of decisions that lead nowhere. Enlightenment visionary Sir Francis Bacon wrote extensively on the subject of irrational thought, he said "the mind, hastily and without choice, imbibes and treasures up the first notices of things, from whence all the rest proceed, errors must forever prevail, and remain uncorrected." Thus knowledge is not well constructed but "resembles a magnificent structure that has no foundation."

The metaphor of Ariadne's thread is an effective way to describe how we think of the due diligence process for any prospective investment. The idea starts at a point along the continuum of the process – at a point along the thread. The starting point for us is generally a sourcing category that we have already deduced as explanatory and might be instructive in producing a mis-priced idea (ex. Spin Offs, Industry Transformation). We then follow the thread up through the hierarchy of our decision making process. Guided on a path that takes us through our phase 1 thesis, phase 2 thesis, ESG Overlay, comparative asset class and sector expected returns, and consideration of our primary and secondary themes. With each level the idea passes, the investment theory (thesis) becomes clearer. At the end, if the thesis truly has merit, it finds the exit to the labyrinth – simplicity, the source of its mispricing, and its expected return.

Bottom up investing is one of the more popular value investor claims. While we agree that "deep dive" research based on the fundamentals of a business is essential, we also feel practitioners wielding only this tool can miss critical information. This shortcoming has never been more apparent than after the credit bubble we just lived through. We feel our approach is different in how we get there. We prefer the process a natural scientist would employ; a reductionist method from the top down across levels of organization by analysis, then bottom up across the same levels by synthesis. To be clear, we may start at any end point in the labyrinth; top, center or bottom. We might start at a primary theme and work our way down the thread and then back up by synthesis or begin with a sourcing category which produces an idea where we work our way up the thread through the higher levels of organization.

As the idea matures, the theory/thesis becomes more parsimonious as we shave away that which is superfluous. We are constantly searching for the key data point(s) if possible. If the theory has merit, after thorough investigation, we now have knowledge of the critical elements needed for success. Our sell discipline is the continued effort around confirming or refuting the hypothesis. This scientific method of parsimony helps us to avoid the psychological tendency to stay with investments where information changes or where the theory is wrong. If we list many attributes of an investment in some form of collective mosaic without hierarchy then it is much harder to sell because at any time you can justify staying in the investment if one of the variables continues to be valid.

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To: East Coast Asset Management Clients and Interested Parties

From: Christopher Begg, CFA and Benjamin Favazza, CFP®

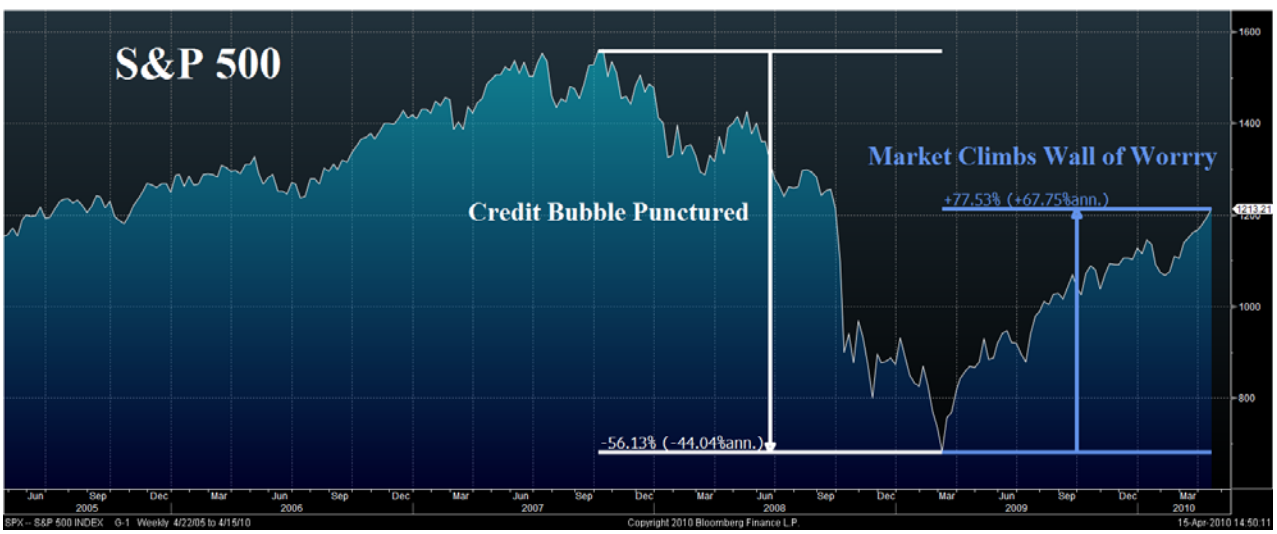
Date: April 30, 2010

Re: First Quarter 2010 Update

Market Summary[1]:

	S&P 500	MSCI AC World Index	MSCI Emerging Markets	Barclays Aggregate Bond Index	Gold – $/Troy Oz.	Crude Oil
Price 03-31-10	1,169.43	307.40	368.93	1567.78	$1,113.25	$83.76
1st Quarter	5.39%	3.24%	1.50%	1.91%	1.49%	5.54%
2009	26.47%	35.17%	68.93%	6.37%	24.36%	77.94%
From March 6th Lows	75.09%	81.24%	102.92%	8.81%	18.51%	84.01%

Equities continued to climb a wall of worry registering strong total returns for the first quarter of 2010. US equity markets were the brightest spot with a S&P 500 total return of 5.39% compared to 3.24% for the MSCI All Country World Index and 1.5% for the MSCI Emerging Market Index. The S&P 500's satisfactory result was not without volatility as the index experienced a drawdown of 8.15% between January 20th and February 8th.

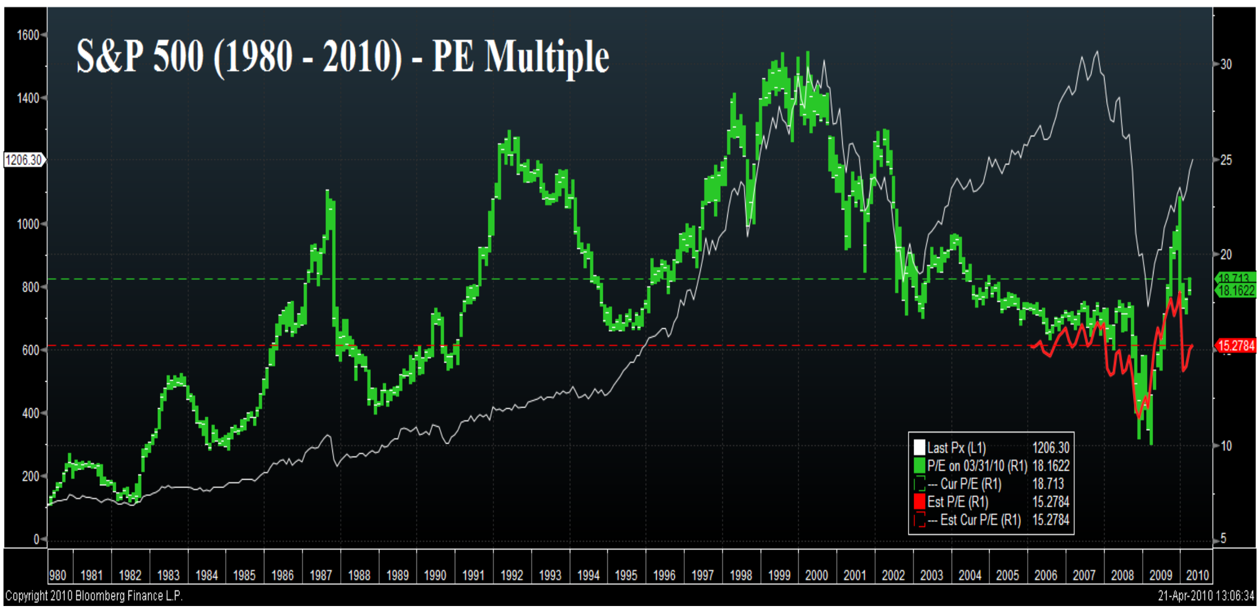


[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. No East Coast strategy will seek to replicate the performance of these or any other indices.

As the market advances investors are continuing to question the upturn - Is this rally for real? How can the market do well in the face of so much excess capacity? What about the potential for a double dip? Could we be in a deflationary spiral similar to what happened in Japan and during the Great Depression? Questions aside, the market continues to move higher; as of the writing of this letter the S&P 500 has appreciated 77% from the lows of March 6th 2009.

We have and continue to be nearly fully invested on the equity side of the ledger. Clients were moved to the high end of their tactical asset allocation ranges in early 2009 and we continue to view our portfolio of equities as the most attractive place to allocate capital. Our actions are driven by the objectives of preserving principal, protecting purchasing power, producing a growing stream of income, and compounding capital.

Although we view our portfolio holdings as attractive, we observe the overall US equity market as being fairly priced. Based on reasonable estimates of 2010 earnings per share (EPS), the S&P 500 trades at 15 times earnings, which we perceive as the long term norm.



As discussed in previous letters, a valuation anomaly exists in the market between businesses we deem of high quality (competitive position, earnings stability, and unlevered balance sheet) and lower quality (sell an undifferentiated product or service, volatile earnings stream, and levered balance sheet). Speculative companies that were priced for bankruptcy during the “great recession” have since had extraordinary rallies as liquidity came back into the markets. When evaluating the higher quality businesses we have been buying, we are still seeing double digit nominal expected total returns from today’s prices. We are also recognizing a healthy portion of that return from a growing stream of dividends.

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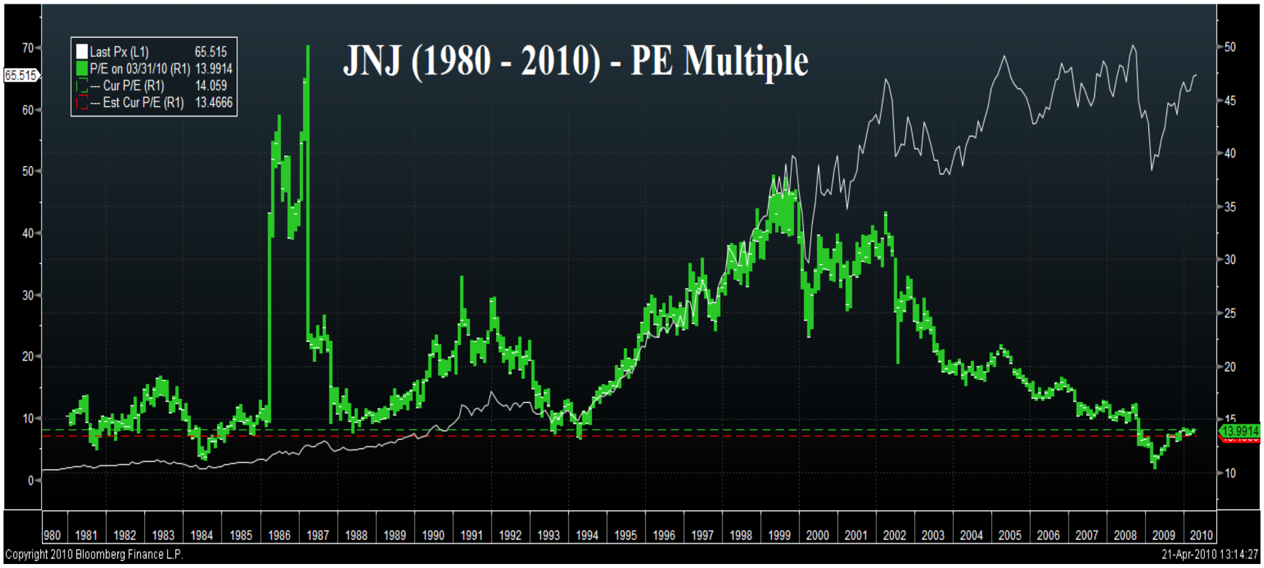
The chart on the preceding page is of the S&P 500's PE multiple (PE multiple in green and price indicated in white). Compare that chart to the chart below of the PE Multiple of Johnson & Johnson (JNJ) over the same 30 year time period.



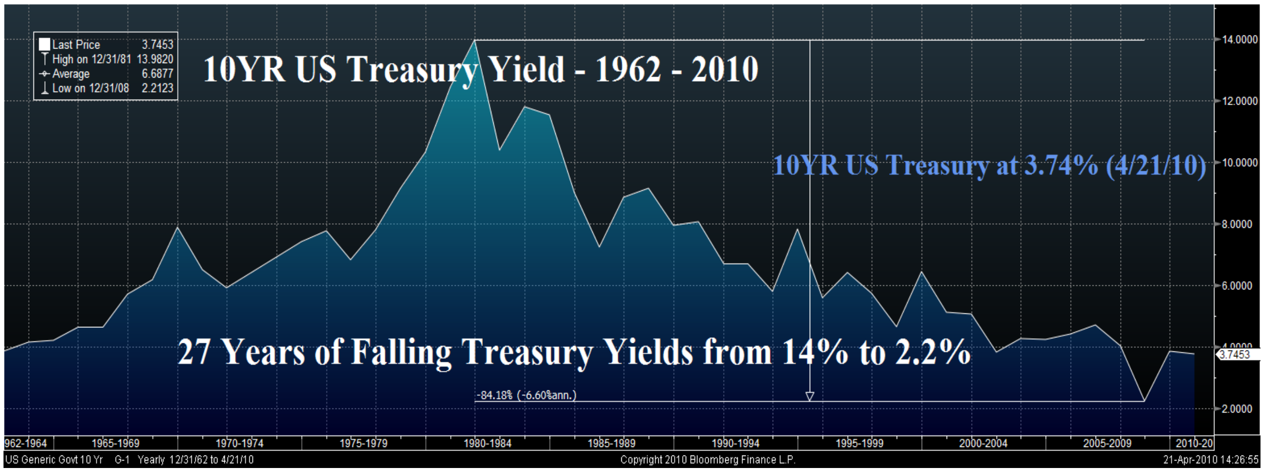
While we don't make a point to talk about our portfolio holdings in our quarterly communications, we think JNJ is a representative example of a high quality business. JNJ trades at 13.4x 2010 EPS and pays a 3.3% dividend yield. JNJ is the leader in the majority of their markets and has scale advantages over their competition giving them the critical attribute of pricing power as inflation percolates throughout the economy.

While we enjoy the healthy expected return attributes in our portfolio of equities, we are also getting inflation protection coverage for no additional cost. The greatest amount of uncertainty will come from the effects of global government policy in dealing with the inherited debt of the credit bubble. Thus, we are concerned about purchasing power erosion. Owning a stake in a competitively entrenched business that sells something the world needs/desires is the best way to protect accumulated wealth. Fixed-income for the most part does not have the same inflation protections and therefore we are operating with caution in this asset class, particularly given the paltry yields being offered to investors. Below we will discuss our views on bonds from this perspective.

<u>The Deflation Illusion – A Bond Bubble?:</u>

We are witnessing the formation of a potentially painful near-term bubble that will hurt some investors who have accepted miniscule yields and are unknowingly taking great risks. The Fed has adopted a policy of zero interest rates and massive monetary stimulus and will continue to err on the side of too much versus too little. Bernanke, who is better schooled than any other economist on the mistakes of the Great Depression, has adopted the mantra "Never Again" with regard to removing stimulus too soon. However, interest rates at zero percent have forced income-oriented investors to move out on the maturity and/or credit risk scale with regards to bonds in order to capture yield.

Below is the 10 year US Treasury Yield chart. We have lived through 27 years of falling yields and a remarkable performance period for bonds. Bond investors have had this major tailwind at their backs. The future will be about headwinds as interest rates properly calibrate to compensate for a greater risk of inflation due to money supply machinations.



Investors, driven by their recency-bias, are not prepared to deal with a paradigm which involves the reality of steadily increasing interest rates. This is indicative of the net mutual fund flows since March of 2009. We have seen 98% of all mutual fund net flows go into bond funds with less than 2% directed toward equity funds. This amount equates to close to $440bl of net fund flows toward fixed-income, which dwarfs any previous record. These numbers were also registered in the time frame when equity markets have been marching ahead at a steady clip with a cumulative return of 77%.

Credit spreads are now the lowest they have been since before the crisis began. The spread on the Barclays Aggregate Corporate Index over US Treasuries is now 142 basis points after spiking to almost 900 basis points in January of 2009. Investors are being paid very little above treasuries to take credit risks. See chart below.

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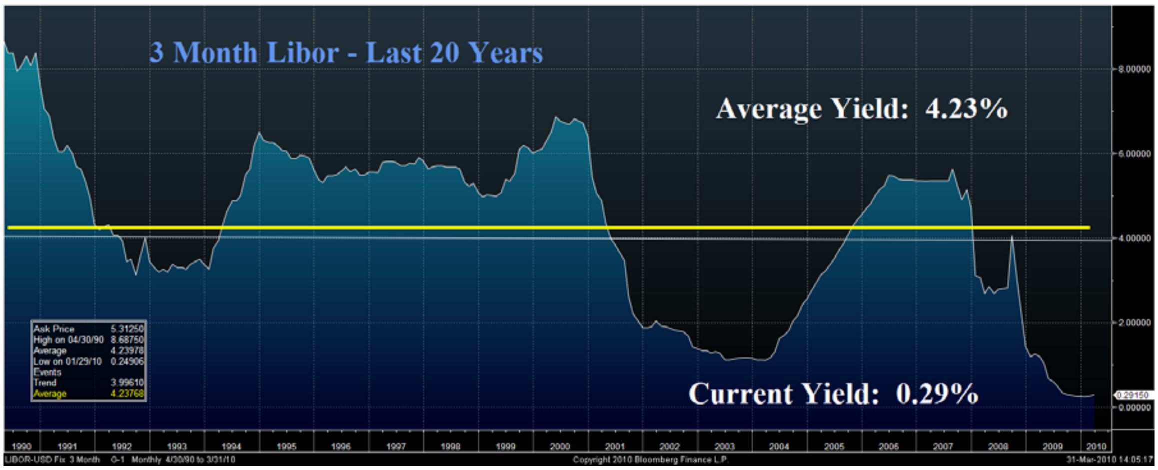
The other interesting trend we have observed is the rush into products which have a perceived hedge against rising rates. The most popular, based on the number of emails and calls we are getting from fund companies, is floating rate bonds. When we talk to bond managers or strategists that are interested in selling this “holy grail” for rising rates, we are shocked how little is mentioned about the credit quality of the underlying issuers. What makes up most of these floating rate funds are below investment grade borrowers that are paying Libor plus 300 – 600 basis points. If Libor goes back to 5% , its level 2 years ago, what is the chance that defaults go up significantly for these indebted companies? The more due diligence we performed in this space the more concerned we became about the risks.



With regard to our fixed-income allocations, we will patiently earn lower immediate yields to protect capital until common sense opportunities present themselves. The investor folly taking place in the world of fixed-income strikes us as the equivalent of buying “tech stocks” in 1999. Caveat emptor!

<u>Pricing Power – Safety and Opportunity:</u>

Pricing power is a remarkable attribute brought forward when a business has a competitive advantage. This can come from brand awareness, scale advantages of being the low cost producer, or from regulatory protection.

There is safety in pricing power. In an inflationary environment it can be the difference between a profit and a loss. Our goal is to own businesses that can pass on increases in their cost of goods sold.

Pricing can also create exponential earnings leverage and consequently opportunity. We are particularly fond of owning businesses where an industry transformation has occurred, such as an industry consolidation, which can lead to beneficial pricing dynamics to the remaining players (usually resulting in an oligopolistic position). Over the years, some of our most rewarding investments have come after industry consolidation. Today, one of our greatest opportunities exists in an industry where consolidation has occurred and where the remaining two players have a runway of price increases which will prove to be exponential in free cash flow growth to shareholders. Below we have included the income statement of one of these businesses to show you how pricing power translates into compounded earnings per share growth.

Industry Transformation - Pricing Power Example

Assumptions		**2008A**	**2009E**	**2010E**	**2011E**	**2012E**	**2013E**
Price		100	104	108	112	117	122
Growth	*4%*		*4%*	*4%*	*4%*	*4%*	*4%*
Units		134	134	134	134	134	134
Growth	*0%*		*0%*	*0%*	*0%*	*0%*	*0%*
Unit Cost		63	63	63	63	63	63
Growth	*0%*		*0%*	*0%*	*0%*	*0%*	*0%*

Income Statement		**2008A**	**2009E**	**2010E**	**2011E**	**2012E**	**2013E**
Revenues		$ 13,388	$ 13,924	$ 14,480	$ 15,060	$ 15,662	$ 16,289
Operating expenses		8,466	8,466	8,466	8,466	8,466	8,466
SG&A		1,477	1,477	1,477	1,477	1,477	1,477
D&A		1,238	1,238	1,238	1,238	1,238	1,238
Other		(27)	(27)	(27)	(27)	(27)	(27)
		11,154	11,154	11,154	11,154	11,154	11,154
Income from Operatio		2,234	2,770	3,326	3,906	4,508	5,135
Other expense (net)		(478)	(478)	(478)	(478)	(478)	(478)
EBT		1,756	2,292	2,848	3,428	4,030	4,657
Taxes	38%	669	873	1,085	1,306	1,535	1,774
Net Income		$ 1,087	$ 1,418	$ 1,763	$ 2,122	$ 2,495	$ 2,882
Shares		492	492	492	492	492	492
EPS		$ 2.21	$ 2.88	$ 3.59	$ 4.31	$ 5.07	$ 5.86
EPS Growth		**n/a**	**30%**	**24%**	**20%**	**18%**	**16%**
EPS 5 year CAGR		**22%**					

You can see on the top line we have modeled 4% price increases and have made no adjustments to volume increases (although this business could see strong volume increases as we emerge from the recession). The price increases drive revenue growth over the same level of fixed expenses. The box on the bottom of the model shows the corresponding EPS growth. Four percent compounded price increases over the next five years corresponds to 22% compounded EPS growth. The fact that we are presently buying this business at an 8% free cash flow yield equates to a range of expected returns between 15% and 30%+ compounded over the next 5 years. Long-term investors are keen to the EPS leverage that pricing power bestows.

Organizational Updates:

- *Director of Operations:* We will be formally announcing our new Director of Operations in the middle of May. Although every hire we make is critical, we spent additional time and effort with this particular search, as this role has so much interaction on the service side with our clients. We wanted to ensure we made the right choice and found someone that can be with us for a long period of time for the benefit of our clients. We could not be more pleased with how this individual fits into our firm culture and look forward to making the formal announcement shortly.

- *Principal/Managing Director Search:* We are actively engaged in prospective partner discussions toward our goal of adding one to two additional Manager Director/Principals in 2010. As we have written to you in the past, the cultural fit has to be perfect. We will most likely find the right candidates through our network so if you know of anyone who is a seasoned professional with existing client relationships, we would welcome an introduction. Every existing member of our team brings a complimentary skill set and adds layers of depth to our organization. We will continue to update you on our progress.

We continue to manage your capital with the utmost prudence and look forward to meeting and talking with you soon. We greatly value your support and trust.

Immediately following this update, we have included our portfolio positioning which reviews where we have been allocating capital over this cycle and highlights the broad views that continue to shape the portfolio today.

"1. Curiosity - it is the most powerful thing you own. 2. Imagination - is a force that can actually manifest a reality. 3. The respect of your team is more important than all the laurels in the world"

James Cameron on "Lessons Learned" at TED2010

Sincerely,

Chris

Christopher M. Begg, CFA
Chief Investment Officer

Benjamin S. Favazza, CFP®
Chief Wealth Management Officer

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APPENDIX A:

Portfolio Positioning – Then and Now – Our Broad Views:

As discussed above, we have been implementing a decisive, prudent, and disciplined strategy to protect against the heightened risk of purchasing power erosion. As many of our portfolio construction decisions and broad views remain intact from the last quarter's letter, we felt it was important to restate those views and include additional information where appropriate.

- *Then and Now:* The first quarter of 2009 marked an inflection point where we moved from the low-end of our asset allocation ranges in equities and gravitated toward the higher-end of our clients' customized ranges. We will always allocate capital based on valuation. As value investors, our view of the quality of the investment drills down to what we expect to extract from that opportunity in cash – all income plus return of our principal. We compare this expectation of return (IRR) to all investment alternatives across all asset classes. This said, high quality global equities have represented the best expected total return from a valuation perspective. They also share the important attribute of being an effective inflation hedge for those companies that have the ability to raise prices with inflation or have tangible assets that are being reflated. We made investments during the periods of dislocation in the 4th quarter of 2008 and 1st quarter of 2009 that have paid off handsomely to date. These views continue to shape the composition of our portfolio.

- *Broad Views:*

  - The "Q" Component - Quality: Just as we saw a low quality rally after the lows in 2003, we have seen a rally in lower quality companies versus higher quality since the lows in March of 2009. Higher quality businesses are poised for deferred outperformance. Examples of high quality names are: Nestle, Waste Management, Colgate, Coca Cola, Novartis, and Express Scripts. These companies trade near the low-end of their 20 year range of valuation multiples. Businesses that have scale advantages, and who are the price-setter in the industry, have the very important characteristic of being an inflation hedge for us.

    Jeremy Grantham echoed our views on this anomaly in his April 2010 quarterly newsletter. Take our word for it - this is as glowing a recommendation as you will get from Jeremy.

    > *"Surprisingly, within the U.S. the large high quality companies are still a little cheap, having been left behind in the rally. They are unlikely to do very well in a bubbly environment, however long it lasts, but should be great in declines and in the end should win. A potential plus for quality franchise stocks in the next few years is that they are far more exposed to emerging countries and , as investors fall in love with all things emerging, this should be seen as an increasing advantage. A mix of global stocks, titled to U.S. high quality, has a 7-year asset class forecast of about 5% excluding inflation compared with a long-term normal of about 6%. Not so bad."*

- Tangible Assets and Natural Resources: We have a global reflationary environment where central banks are increasing the money supply to levels not previously seen. At the same time, we are in a period of contracted global growth as the world deleverages from the credit bubble. Therefore, we have a lot of capacity that will remain underutilized. Where will all the excess money flow? It will flow into assets and more specifically into real assets. While we do not view real-estate as an attractive asset class as it works off its own excesses, we are favoring resource rich countries and companies that have tangible assets.

- Gold: With cash and near-cash investments earning very low interest rates, our opportunity cost is low to shield some of our fixed-income allocation from inflation. We have and will continue to look at gold in this way. We do not like many of its characteristics as it pays nothing in income, it incurs indirect storage costs, and very little gold has been used up. John Paulson summed up two reasons an investor would want to own gold when he spoke at the Grant's conference in New York in the Fall of 2009. He said one was the "fear factor" which is a hedge against Armageddon. The second factor and principal source of gold demand is that of a protection against currency debasement. Paulson explains: "Demand for gold as an inflation hedge is, for me, 100 – 1000 times more than the demand for the 'fear factor.'" There are many people, institutions, and countries that are holding major reserves in "fiat" paper currencies that are being debased. We expect a sustained rally in the price of gold and we find it an effective parking spot for money that is not earning an adequate interest rate and that is not shielded from inflation risk. We look forward to the day that we will remove the gold allocation from our portfolio.

- Emerging Market Consumer: We feel the countries of Brazil, China and India represent a vast opportunity for investment over the coming decades. While many of these countries face serious headwinds as their export markets may be weak for the foreseeable future, there exists an emerging consumer economy which will reward many of our investments that may be domiciled in these countries or are global franchises that sell their goods and services into these countries. We will not overpay for growth, but we will challenge ourselves to devote resources to uncover great opportunities, based upon sound investment principles, in these markets.

- Fixed-Income: Interest rates are poised for significant and prolonged upward move. The 30 year US Treasury Bond has increased 2.03% since 12/31/08 and 0.66 % since the end of the third quarter. We have been telling you that interest rates will rise to reflect the risk to a bond holder of getting dollars back that are worth less. An interest rate of 3.66% for a 10 year Treasury bond and 4.53% for a 30 year Treasury bond is not a sufficient return for a bond holder. Rates are being kept artificially low as the Fed has been buying Treasuries. They have, in fact, made up 100%+ of the demand for the net-new issuance of Treasuries. This is not sustainable. Spreads have narrowed over the last several months and interest rates on corporate bonds of the quality we seek are not interesting enough for us to allocate capital to that space in a meaningful way.

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To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – Chief Investment Officer

Date: July 7, 2010

Re: Second Quarter 2010 Update

Market Summary[1]:

	S&P 500	MSCI AC World Index	MSCI Emerging Markets	MSCI EAFE Index	Barclays Aggregate Bond Index	Gold – $/Troy Oz.	Crude Oil
Price 06-30-10	1030.71	268.26	344.96	1348.11	1622.48	$1,242.25	$75.63
YTD	-6.64%	-9.06%	-6.17%	-12.81%	5.33%	13.25%	-4.70%
2nd Quarter	-11.41%	-11.91%	-8.37%	-13.65%	3.49%	11.59%	-9.71%
2009	26.47%	35.17%	78.51%	32.36%	6.37%	24.36%	77.94%
From March 6th, 2009 Lows	55.09%	59.61%	93.96%	53.48%	10.64%	32.25%	66.15%

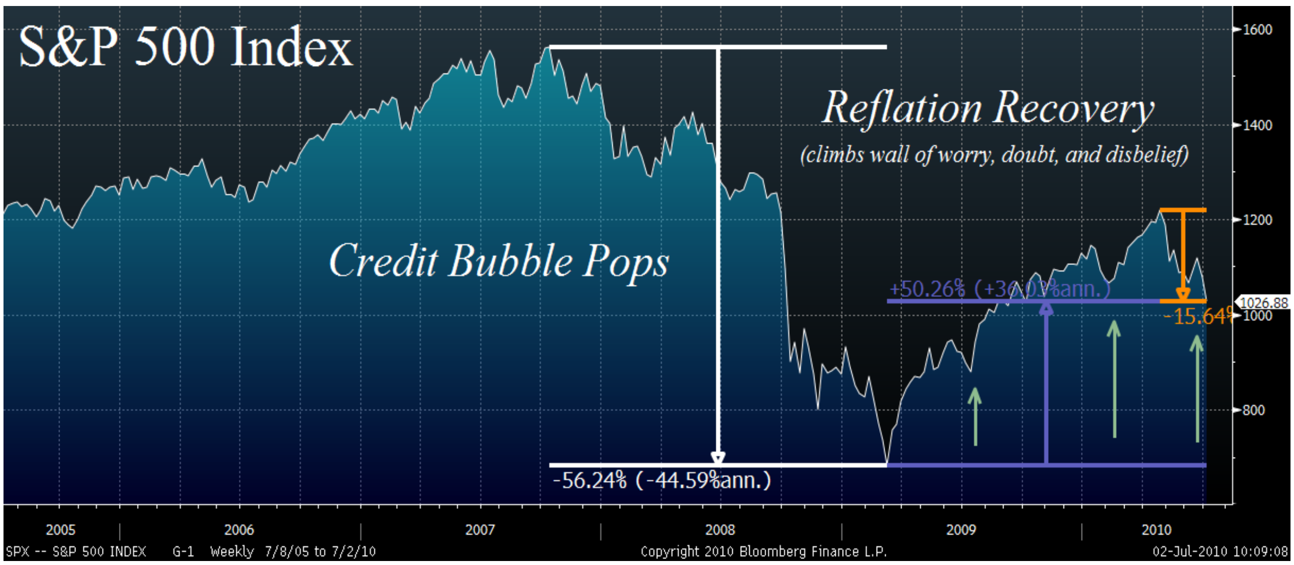
Across the board equities registered double digit negative returns for the second quarter of 2010 with a -11.4% return for the S&P 500 and weaker returns in developed international equity markets such as Europe, with negative returns in the mid teens. One of the few lustrous spots among asset classes was precious metals, with the "barbaric relic"- gold appreciating 11.59% in the second quarter, with a year-to-date return of 13.25%. Interest rates and credit spreads fell resulting in positive bond returns for the second quarter and overall year-to-date positive returns.

As discussed in past letters, a significant portion of the debt created during the period leading up to the popping of the credit bubble has not disappeared but has been and continues to be transferred from the private sector to the public sector. The fall out from high levels of sovereign debt, which first manifested itself in Europe and more specifically Greece, was the primary culprit for the correction we have been experiencing since April 23rd. Equity markets, spooked by the uncertainty about how broadly the contagion will be felt, have corrected 15% in the US and over 20% in international markets.

We took proactive measures in the first quarter to reduce exposures to Global Materials[2] due to the current level of deflationary bias. However, we continue to favor the expected compounded

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. No East Coast strategy will seek to replicate the performance of these or any other indices.
[2] Holdings in the sector reflected our broad view of bullishness on "Tangible Assets and Natural Resources" articulated in Appendix A.

returns of the businesses we own at these price levels. While we expect a prolonged period of heightened volatility, the greater risk to accumulated wealth is the erosion of purchasing power versus permanent principal impairment. We will explain below why we believe the deflation argument over the mid-long term is a fool's errand in a world where fiat currency central banks have WMD – weapons of mass debasing – printing presses. The greatest opportunities to compound capital come from periods where dislocations are being driven more by "what ifs" than the "what is." Fundamentals trump hypotheticals and facts weigh heavier than emotions. Our portfolio is not only well positioned for healthy compounded returns, but also exhibits a margin of safety as we're positioned to mitigate the effects of and to take advantage of tail risk events should they occur: hyper-inflation, a bond bubble, paper currency debasement, a significant spike in interest rates and financing costs, a credit and liquidity shock, and a double dip recession.



Where is the Crowd - where is the Edge?

The concluding agenda item of our weekly investment meetings is to re-visit a list we maintain called "where is the crowd - where is the edge?"[3] This is where we elevate our thought process to the 30,000 foot level and take view of where we believe the greatest amount of consensus thought (think concentric circle) is taking place and conversely identify what resides on the edge of that consensus thinking. Over time an investor following the crowd will be at best destined to mediocre returns and at the worst of times will, in lemming-like fashion, take the leap off the cliff and register a permanent loss of capital. The path toward generating truly exceptional long-term compounded returns is to have a differentiated view built on business sense and harnessed through a repeatable process. The table below highlights our most recent list.

[3] We cannot take full credit for this term, as we heard this exercise expressed by Seth Klarmen of Baupost during a speech he delivered to one of our partner value investing MBA programs at the Ivey School at the University of Western Ontario.

	Where is the Crowd?	Where is the Edge?
1	Everyone is a macro economist.	Fundamental/value investing and micro themes
2	Binary extreme outcomes of inflation/deflation.	Individual investment merits based on expected return. Inflation negates deflation.
3	Flood to fixed-income – individual investor – walking out on the yield and risk curve to escape 0% cash rates and equity volatility.	Bond bubble. Attractive equity total return expectations.
4	Inflation protection through TIPS and floating rate bonds.	Inflation protection through owning a fractional interest in a business with pricing power.
5	Gold – speculators are weak holders – non-believers. Reluctantly adding to gold as inflation hedge (<5% portfolio allocation). New highs – misperception that a bubble is forming.	Own gold for mid-long term because sovereigns will be forced to secularly debase fiat/paper currencies and due to low opportunity cost (<1% cash yields).
6	Overly bearish and emotional conclusions based on macro concerns (extreme volatility).	Bullish and steadfast on fundamentals and business going concerns.
7	Short time horizons.	Mid-long time horizons.
8	Leverage is no longer a corporate noose, low rates and record low credit spreads will be the norm for a prolonged period of time.	Leverage is not a double edge sword but a guillotine. Interest rates will rise dramatically across curve and spreads will widen substantially.
9	Inferior companies can thrive in this new world where the impaired are bailed out.	High quality companies have a competitive advantage and will garner meaningful market share gains against weaker players.
10	Complexity	Simplicity

We will review each of the 10 areas listed above and explain why we have taken steps toward mitigating risk away from the consensus and where we are seeing a variant opportunity.

Consensus Views and Where we believe a Variant Perception Exists:

1. Everyone is a macro-economist: The current focus on the macro view is unprecedented – at no time during our respective careers have we ever seen this view so skewed. We have incorporated a global macro overlay to our bottom up approach of looking at the expected return of each investment; however, we believe future returns will be less directional on macro stimuli and more influenced by the merit of the investment. We find it more constructive to look at micro themes that create sector tailwinds supporting certain industries and company fundamentals. Each week we rank the expected return and the quality attributes of our universe of businesses and maintain a list of our top five micro themes, where each is stewarded by an analyst for data point updates. Compelling

opportunities continue to percolate from both areas while the world wrestles with the noise of the macro. We expect to be rewarded handsomely from these areas of focus over the cycle.

2. Binary extreme conclusions of inflation/deflation: In the same vein as an overly macro consensus, we also observe that investors are paralyzed by the belief they need to correctly assess whether we are in a period of prolonged inflation or deflation. The arguments towards deflation are ones that have merit over the short-term based on excess capacity; however, they have zero weight over the mid-long term. With Ben Bernanke leading the charge to fight deflationary forces we conclude the mantra at the Fed is "Never again." Never again will this Fed prematurely remove stimulus given the lessons learned in the Great Depression and more recently in Japan. A very instructive summary of Bernanke's thoughts in this regard can be found in a March 2003 speech he made to the Japan Society of Monetary Economics in Tokyo, Japan[4]. We quote directly from the conclusion of the speech "With protracted deflation, however, excessive money creation is unlikely to be the problem." We were also very interested in reviewing the transcripts of the European Union's response the Greece bailout. The net effect was a decision to use quantitative easing to deal with the bailout needs of the less fiscally sound members of the union. Milton Friedman's words echo in infinity-"inflation is always and everywhere a monetary phenomenon."

   Buffett's recent New York Times Op-Ed[5] comments are timeless, "Legislators will correctly perceive that either raising taxes or cutting expenditures will threaten their re-election. To avoid this fate, they can opt for high rates of inflation, which never require a recorded vote and cannot be attributed to a specific action that any elected official takes." We believe we know the end game without joining in the consensus guessing short-term moves, and are positioned to protect not only principal but purchasing power. The short-term money supply moves could offset deflation but at some point stimulus will not be able to be pulled back quick enough and inflation will leak out – to what degree remains unknown - thus we seek to protect against this mid-long term inflation risk to the best degree possible.

3. Flood to fixed-income: We have seen an unprecedented flood of new money into fixed-income investments as investors are forced out of what they perceive to be a foolish decision to earn Bernanke's zero percent interest rates. Investors have inadvertently put themselves into a position of significant risk. We foresee the cost of money rising to reflect the true effects of what quantitative easing does to the value of money. It strikes us as absurd to agree to receive 3% plus a record low corporate spread (145bps) to loan money only to receive your depreciated fixed principal back in the future. Yet, investors have moved over $450Bl of net new funds to this asset class over the last 16 months. If yields move from 3% to 7% which we believe they will (at the very least) and corporate spreads widen to 350bps from 145 bps, we expect the Barclays Aggregate Index with an average maturity of 7 years to correct between 25 – 40%. This will be a catastrophic shock to the unknowing individual investor who has allocated out of "risky" equities and into "safe" bonds.

[4] The transcript of this speech can be found at the Federal Reserve website under this link.
[5] The Greenback Effect by Warren E. Buffett published August 9, 2009 – under this link.

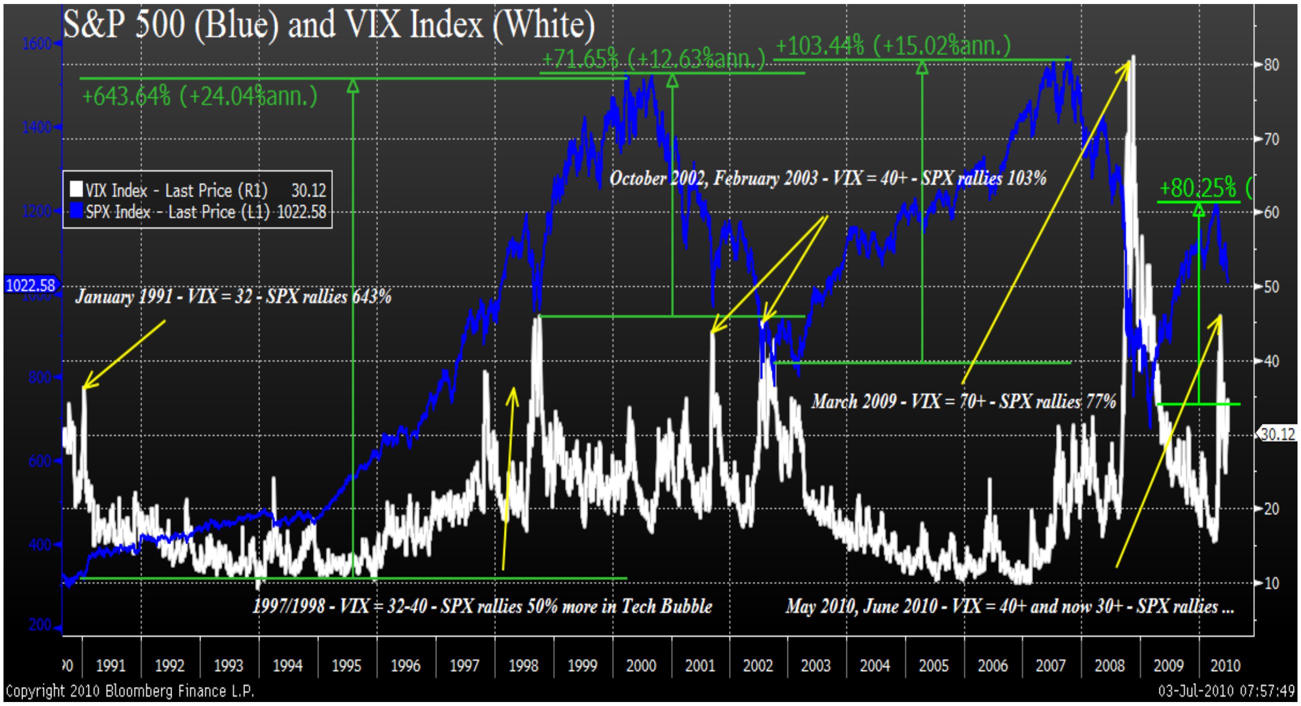
4. Inflation protection through TIPS and floating rate bonds: An underlying TIP is equivalent to owning a ten year treasury with an adjustment for CPI. The government keeps the scorecard on CPI and has changed its definition for calculating this metric for its own benefit countless times. We expect the ten year to rise dramatically and believe that CPI will be a lagging and manipulated indicator of real inflation. To that point we gain no real satisfaction in owning this protection. The shorter duration TIPS (which are now 5 years) have some merit but they are by no means an ideal hedge. We continue to monitor floating rate bonds as the most interesting investment du jour. The investor believes as interest rates climb they in turn will be protected as their income will climb with Libor rates which currently hover around 0.30%. As we looked at the underlying issuers we found areas for concern. Investors do not realize the risky credit profiles of these businesses that have no fixed-rate refinance options, even in an environment where liquidity is being provided hand over fist. We wrote about this in our last letter and during this period of dislocation some of these floating rate bond funds dropped nearly 20% during a phase when Libor was climbing. Caveat Emptor!

5. Gold – weak holders: Gold is reaching new highs and thus there is speculative fervor to increase gold allocations. However, speculators appear skittish with one foot through the door and their hand on the exit. We increased our allocation to gold early in the second quarter and have recently been building a position in silver. Our views differ from the consensus; we believe gold and silver are only an effective store of value when the world's reserve currencies are being debased. Gold will do materially better relative to developed world currencies. We have seen this occur in 2010 with gold +13% year-to-date. We also have this view in light of a very small opportunity cost of owning gold as we are using cash that we have tactically allocated away from credit investments. We make investments with a mid-long term horizon and expect to own gold through periods of volatility as long as the underlying thesis remains in-tact.

   Recently we met with Greenlight Capital in New York, where we gained additional insight on the reasoning behind David Einhorn's decision to create a fund that is completely backed by gold[6]. We were interested to hear that their conviction in currency debasement and hence a large gold position was so strong they wanted to express this view in a degree greater than their existing funds mandate. Intelligent capital and sovereigns are materially changing their views on the efficacy of precious metals for positive absolute returns versus fiat currency depreciation. Even modest supply-demand shifts would move prices materially higher. We will continue to assess the proper weight of this investment in light of central bank money supply activity.

6. Overly bearish and emotional conclusions – extreme volatility: We have and will continue to see extreme volatility as the world draws macro conclusions. These periods of volatility have historically generated unprecedented buying opportunities. Below we have highlighted the VIX index which is a good representation of the emotion of the markets. Periods of heightened volatility, as we have today with a reading near 40, have been inflection points where we have seen the beginning of major bull moves in compounded rates of return in equities. While we do not put too much weight on these technical indicators, it is hard to ignore these readings and how they correlate with the current overly bearish sentiment. We feel this is a very bullish sign for things to come.

[6] John Paulson of Paulson and Co. has also created a similar fund for like reasons in 2009.



7. Short time horizons: Time horizons have shortened dramatically as seen during the depths of the credit bubble where an economic Pearl Harbor was taking place. Investors are putting very little value on the long-term implications of a business's competitive advantage, absolute valuation attractiveness, and bond yields versus long-term inflation rates. The focus is on the here and now. Investors with a differentiated view on time horizon (mid-long) will be rewarded extensively; this is one of the great free lunches available today.

8. Leverage is no longer a corporate noose: Interest rates will climb dramatically, credit spreads will normalize to the true risk of these indebted companies. We are avoiding equity with large debt loads and have unwound much of our corporate bonds as credit spreads have come in to pre-crisis levels.

9. Inferior companies can thrive in this new world of bailouts: Markets have rewarded inferior businesses with full valuations while their indebtedness remains since the Fed stepped in to support financial and corporate balance sheets. The true funding costs of these liabilities will expose themselves through the cycle and many of these businesses will be significantly constrained. This is when the strong, competitively advantaged businesses will have an opportunity to gain share. The true merit of quality versus lower quality will be clear. Investors will look back at this moment in time and see this period as one of the best opportunities to own great businesses at reasonable prices. Pricing power opportunities will serve as a tailwind as inflation exposes itself to the light of day.

10. Complexity: Yield chasers learned the hard lessons of the dangers of a prolonged period of low interest rates. Investors seeking greater returns than cash will seek out alternatives

and will look to more complex securities to arrive at moderate yield advantages. This equates to taking on unforeseen risks as we saw in the mortgage backed security market. Today it might be showing up in owning floating rate bonds, guaranteed investment contracts, and fixed-income mutual funds that have lengthened durations in front of a bond bubble to site a few examples. We believe the variant perception and the edge of this thinking is simplicity. Owning a fractional interest in a business that commands global advantages and has pricing power is a reasonable idea. Owning these businesses at valuation troughs in PE Multiples, attractive free cash flow yields, robust dividend yields, with no debt constraints, and with market share growth opportunities is a spectacularly simple and prudent decision.

Investing Deliberately:

One of the benefits of the iPad is being able to carry a virtual library on a 13mm wide device. Apple imported the entire Project Gutenberg library of over 30,000 out-of-copyright books into iTunes and has made most of those available for free. While there may be no free lunches on Wall Street, I liked this value proposition and took the opportunity to put a number of books at an index fingers' reach. Returning on the Acela from investment meetings in New York I decided to skim through a few classics and settled into Thoreau's Walden.

One of Thoreau's most frequently quoted passages comes in Chapter 2 – "Where I lived, and What I lived for", paragraph 16 where he tells the reader he has gone to the woods to live deliberately[7]. As the paragraph continues, I was particularly drawn to a part that is not frequently quoted. As is the case with investment research, so much truth and clarity is exposed when you check the source. Thoreau exclaims that he wanted to "drive life into a corner, and reduce its to its lowest terms, and if it proved to be mean, why then to get the whole genuine meanness of it, and publish its meanness to the world; or if it were sublime, to know it by experience, and be able to give a true account of it in my next excursion."

Eureka! I realized that sums up perfectly the plight of most investors, particularly in light of the volatility of the past two years. The investor rides a rollercoaster of emotion that is often described as fear and greed. I much prefer Thoreau's terms in stating that the investor feels the market is either being mean or sublime. Over the past two years, the markets' meanness was displayed as the credit bubble was exposed and market prices fell nearly 60%. From those lows through May of this year, investors felt sublime as market prices recovered 70%. Neither of these emotions exhibits any sense of truth.

So if we drive investing into a corner and reduce it to its lowest terms, what do we end up with? The essential fact is calculating an investment's expected rate of return (IRR) from the current price. These estimates are based on the future cash flows that either a business will generate discounted to the present or the cash flows (coupons and principal) a bond will pay. We are

[7] "I went to the woods because I wished to live deliberately, to front only the essential facts of life, and see if I could not learn what it had to teach, and not, when I came to die, discover that I had not lived. I did not wish to live what was not life, living is so dear; nor did I wish to practise resignation, unless it was quite necessary. I wanted to live deep and suck out all the marrow of life, to live so sturdily and Spartan-like as to put to rout all that was not life, to cut a broad swath and shave close, to drive life into a corner, and reduce it to its lowest terms, and, if it proved to be mean, why then to get the whole and genuine meanness of it, and publish its meanness to the world; or if it were sublime, to know it by experience, and be able to give a true account of it in my next excursion." Walden – Henry David Thoreau (1854)

either a fractional owner of a business, a fractional owner of a collection of assets or have a contractual agreement with an entity to receive a stream of income and principal at set calendar dates. While there are many other nuances to consider, those are the primary considerations that have and will continue to determine an investor's return. The concept that in the short-term the market is a voting machine and in the long-run a weighing machine rings as true as it did in 1934 when Benjamin Graham articulated it in this way.

As Thoreau went to the woods to live deliberately, to front only the essential facts of life, we challenge ourselves as investors to invest deliberately by fronting the essential facts. Thus our sense of "meanness" or "sublime" will be in regards to the opportunity set (attractive or unattractive IRR's estimates) versus the prices that are being quoted on the exchange.

Organizational Updates:

- *Director of Operations:* We could not be more pleased to introduce you to our new Director of Operations, Tara MK Connelly. Tara will lead the charge on operations activities for the firm, including the sensitive area of client service requests and reporting. We look forward to introducing you to Tara over the next several weeks by phone and hopefully in person when the opportunity presents itself. Tara joins us from the Quayside Publishing Group where for the past seven years she directed Operations and Human Resources, as well as assisted the CEO in all aspects of the business. Previous to that she worked for three years with the macro analysis group at Wellington Management handling research for the US, European, and Emerging Markets. Tara has a BA from the University of Massachusetts, Amherst with a duel major in Journalism/Anthropology and a minor in History. She has earned a certificate in Human Resources Management from Northeastern University where she is currently working on completing her MBA. Tara resides in Rockport with her husband, Chris and two daughters, Veronica and Eliana.

- *Associate Research Analysts:* Our summer Associate Research Analysts have been hard at work since late May. We are fortunate to have 5 individuals with us for the summer. Our partner MBA Programs consist of Columbia University, the Ivey School at the University of Western Ontario, and our long standing relationship with Boston College. We have worked closely with the Executive Directors of these schools, particularly those engaged in Investing Curriculums and if applicable their Value Investing Programs. We had an impressive number of applicants for our openings this summer and we are very pleased with the quality, experience, and intelligence of those invited to join our team. We have included their bios in the appendix for your perusal. We hope you may have a chance to meet Kyle D'Silva, CFA, Anant Ahuja, MD, Denislav Ivanov, Eric Jung, and Brett Paulsrud during a visit to our Essex or Boston office.

- *Principal/Managing Director Search:* We are actively engaged in prospective partner discussions toward our goal of adding one to two additional Manager Director/Principals in 2010. As we have written to you in the past, the cultural fit has to be perfect. We will most likely find the right candidates through our network so if you know of anyone who is a seasoned professional with existing client relationships, we would welcome an introduction. Every existing member of our team brings a complimentary skill set and adds layers of depth to our organization. We are pleased to announce that we have invited a fifth partner to join East Coast and look forward to a formal announcement in August.

We continue to manage your capital with the utmost prudence and look forward to meeting and talking with you soon. We greatly value your support and trust.

Immediately following this update, we have included our portfolio positioning which reviews where we have been allocating capital over this cycle and highlights the broad views that continue to shape the portfolio today.

"Any fool can make things bigger, more complex, and more violent. It takes a touch of genius -- and a lot of courage -- to move in the opposite direction."

Albert Einstein (1879 – 1955)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
Chief Investment Officer

Founding Partners:
Christopher M. Begg, CFA
Benjamin S. Favazza, CFP®

Partners:
Gina Koprowski, CFP®
Robert Murphy, CPA

EAST COAST
ASSET MANAGEMENT

APPENDIX A:

Portfolio Positioning – Then and Now – Our Broad Views:

We have been implementing a decisive, prudent, and disciplined strategy to protect against the heightened risk of purchasing power erosion. As many of our portfolio construction decisions and broad views remain intact from the last quarter's letter, we felt it was important to restate those views and include additional information where appropriate.

- *Then and Now:* The first quarter of 2009 marked an inflection point where we moved from the low-end of our asset allocation ranges in equities and gravitated toward the higher-end of our clients' customized ranges. We will always allocate capital based on valuation. As value investors, our view of the quality of the investment drills down to what we expect to extract from that opportunity in cash – all income plus return of our principal. We compare this expectation of return (IRR) to all investment alternatives across all asset classes. This said, high quality global equities have represented the best expected total return from a valuation perspective. They also share the important attribute of being an effective inflation hedge for those companies that have the ability to raise prices with inflation or have tangible assets that are being reflated. We made investments during the periods of dislocation in the 4th quarter of 2008 and 1st quarter of 2009 that have paid off handsomely to date. These views continue to shape the composition of our portfolio.

- *Broad Views:*

  - The "Q" Component - Quality: Just as we saw a low quality rally after the lows in 2003, we have seen a rally in lower quality companies versus higher quality since the lows in March of 2009. Higher quality businesses are poised for deferred outperformance. Examples of high quality names are: Nestle, Waste Management, Colgate, Coca Cola, Novartis, and Express Scripts. These companies trade near the low-end of their 20 year range of valuation multiples. Businesses that have scale advantages, and who are industry price-setters, have the very important characteristic of being an inflation hedge.

    Jeremy Grantham echoed our views on this anomaly in his April 2010 quarterly newsletter. Take our word for it - this is as glowing a recommendation as you will get from Jeremy.

    > *"Surprisingly, within the U.S. the large high quality companies are still a little cheap, having been left behind in the rally. They are unlikely to do very well in a bubbly environment, however long it lasts, but should be great in declines and in the end should win. A potential plus for quality franchise stocks in the next few years is that they are far more exposed to emerging countries and , as investors fall in love with all things emerging, this should be seen as an increasing advantage. A mix of global stocks, titled to U.S. high quality, has a 7-year asset class forecast of about 5% excluding inflation compared with a long-term normal of about 6%. Not so bad."*

- Tangible Assets and Natural Resources: We have a global reflationary environment where central banks are increasing the money supply to levels not previously seen. At the same time, we are in a period of contracted global growth as the world deleverages from the credit bubble. Therefore, we have a lot of capacity that will remain underutilized. Where will all the excess money flow? It will flow into assets and more specifically into real assets. While we do not view real-estate as an attractive asset class as it works off its own excesses, we are favoring resource rich countries and companies that have tangible assets.

- Gold: With cash and near-cash investments earning very low interest rates, our opportunity cost is low to shield some of our fixed-income allocation from inflation. We have and will continue to look at gold in this way. We do not like many of its characteristics as it pays nothing in income, it incurs indirect storage costs, and very little gold has been used up. John Paulson summed up two reasons an investor would want to own gold when he spoke at the Grant's conference in New York in the Fall of 2009. One was the "fear factor" which is a hedge against Armageddon; the second factor, and principal source of gold demand, is that of a protection against currency debasement. Paulson explains: "Demand for gold as an inflation hedge is, for me, 100 – 1000 times more than the demand for the 'fear factor.'" There are many people, institutions, and countries that are holding major reserves in "fiat" paper currencies that are being debased. We expect a sustained rally in the price of gold and we find it an effective parking spot for money that is not earning an adequate interest rate and that is not shielded from inflation risk. We look forward to the day that we will remove the gold allocation from our portfolio.

- Emerging Market Consumer: the countries of Brazil, China and India represent a vast opportunity for investment over the coming decades. While these countries face serious headwinds given their weak export markets, there exists an emerging consumer economy which will reward investments that may be domiciled in these countries or that are global franchises that sell their goods and services into these countries. We will not overpay for growth, but will challenge ourselves to devote resources to uncover great opportunities in these markets based upon sound investment principles.

- Fixed-Income: Interest rates are poised for significant and prolonged upward move. We have been telling you that interest rates will rise to reflect the risk to a bond holder of getting dollars back that are worth less. An interest rate of 3.66% for a 10 year Treasury bond and 4.53% for a 30 year Treasury bond is not a sufficient return for a bond holder. Rates are being kept artificially low as the Fed has been buying Treasuries. They have, in fact, made up 100%+ of the demand for the net-new issuance of Treasuries. This is not sustainable. Spreads have narrowed over the last several months and interest rates on quality corporate bonds are not interesting enough for us to allocate capital to that space.

APPENDIX B:

Associate Research Analysts:

Anant Ahuja, MD
Anant is an Associate Research Analyst at East Coast. He is a recent graduate of Columbia Business School's Executive MBA program where he was the recipient of the MDPE 1984 Harry Taback Memorial Scholarship. Anant is a boarded internal medicine physician and earned his MD from New York Medical College and BS summa cum laude from North Carolina State University. He has prior experience as a healthcare analyst for a long/short hedge fund and did consulting equity research for ThinkEquity Partners during his medical training. Anant speaks fluent Hindi.

Kyle D'Silva, CFA
Kyle is an Associate Research Analyst at East Coast. He is currently enrolled in the Master of Business Administration degree program at The Richard Ivey School of Business where he is also President of the Ivey MBA Student Association. Prior to graduate school, Kyle earned his Honors Bachelor of Business Administration degree from Wilfrid Laurier University, his CFA designation, and worked as a Desk Analyst in Hedge Fund Sales & Trading at Blackmont Capital.

Denislav Ivanov
Denislav is an Associate Research Analyst at East Coast. He is currently enrolled in the Master of Business Administration program at the Boston College Carroll School of Management with a specialization in Asset Management. Denislav graduated from the University of Maine, Orono with a BS in Business Administration in 2006. Upon graduation, Denislav worked for Citigroup as a fund accountant and was in charge of implementing new financial software within the company. In 2008, Denislav received a MS in Finance degree from Boston College and served as a portfolio manager for the Boston College Endowment Fund.

Eric Jung
Eric is an Associate Research Analyst at East Coast. He is currently enrolled in the final year of undergraduate program at Boston College Carroll School of Management with concentrations in finance and accounting. In 2009, Eric worked as a Finance Initiative Intern for the UN Environmental Programme at Eco-Frontier, located in Seoul, Korea

Brett Paulsrud
Brett is an Associate Research Analyst at East Coast. He is currently enrolled in the Master of Business Administration program at the Boston College Carroll School of Management, with a specialization in Asset Management and Corporate Finance. Brett earned a BS in Justice Studies from Arizona State University. Prior to pursuing his MBA, he worked in the Real Estate industry generating closed transactions in excess of $60MM.

EAST COAST
ASSET MANAGEMENT

To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – Chief Investment Officer, Co-Founder

Date: October 12, 2010

Re: Third Quarter 2010 Update - "Joys of Compounding – Revisited"

Market Summary[1]:

	S&P 500	**MSCI AC World Index**	**MSCI Emerging Markets**	**MSCI EAFE Index**	**Barclays Aggregate Bond Index**	**Gold – $/Troy Oz.**	**Crude Oil**
Price 09-30-10	1041.20	305.16	407.14	1561.01	1565.60	$1,308.35	$79.97
YTD	3.89%	4.08%	10.75%	1.60%	7.82%	19.27%	0.77%
3rd Quarter 2010	11.29%	14.47%	18.03%	16.57%	2.16%	5.32%	5.74%
2009	26.47%	35.17%	78.51%	32.36%	6.37%	24.36%	77.94%
From March 6th, 2009 Lows	72.60%	82.71%	128.92%	78.90%	14.11%	39.28%	75.68%

For clients and interested parties, we will be forwarding our performance review and portfolio positioning under separate cover for confidentiality purposes.

Volatility continues to rule the market as indices fluctuate due to uncertainty that clouds the economic crystal ball. History proves the best prices for compounding capital are produced during periods where the future looks most opaque. The third quarter of 2010 was such a quarter as global equity indices produced strong double digit positive returns. Market participants looking for the "all clear" sign as impetus to dip their toe back into equity investments have missed nearly an 83% return from global equities as measured by the MSCI All Country World Index.

We expect equity markets to continue to climb a wall of worry from these favorable valuations. The myopia presently inflicting the consensus is as acute as can be remembered. Long term investors are a rare species and we do not remember a time where the delta between equity and bond/cash expected returns has been so great. The irony is that what investors deem as risk assets (equities) are what we conclude to be the most conservative and those thought by the consensus to be most conservative are in our calculation the most risky areas to invest, bonds and cash.

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast strategy will not seek to replicate the performance of these or any other indices.

As of this writing the world's three largest economies (United States, European Union, and Japan) represent 61 % of World GDP, and are printing historic amounts of money to remedy the post bubble prognosis. With megaphone in hand, central bankers in the developed world have made their intention loud and clear - use quantitative easing[2], fabricating money "ex nihilo" (out of nothing), to stimulate the economy and devalue future debts. This scenario proves extremely tenuous for those with accumulated wealth. We have been writing about this situation since early 2009 and have been preparing our clients to mitigate the effects of this public confiscation of their future purchasing power.

Praemonitus praemunitus! Forewarned is forearmed - knowledge of imminent danger can prepare us to overcome it. To that point, we are reminded of Sancho's sage advice to the carefree and adventurous Don Quixote, "forewarned, forearmed; a man loses nothing by standing on his guard. I know, by experience, I have enemies visible and invisible, and I cannot tell when nor where, nor in what shape they may attack me." We have a heightened awareness of the tail risks that exist today and while we see opportunities to compound capital, a margin of safety in portfolio holdings is warranted.

Top Five Macro Views:

Most of our day to day research is spent on the merit of individual investment ideas however we find it constructive to define and rank our "top five macro and micro views" on a weekly basis. The purpose of this exercise is to layer a macro framework on our fundamental bottom up process. This helps us determine if our portfolio positioning is in harmony or in contrast with major tail risk events of concern. We also want a spot check to verify that our portfolio positioning and individual return estimates are congruent with our asset class expected return estimates. With respect to the micro view, we compile a list of tail wind opportunities that exist for a collection of businesses with favorable industry dynamics (example: global smart phone proliferation, cloud computing, etc). For the purpose of this letter we have included the table below which highlights our "top five **macro** views."

	Macro Views – Top Five	**Description**
1.	High-quality valuation anomaly	• Own great businesses at reasonable prices – it is that simple! • Historic buying opportunity to own compounding franchises. • Strong get Stronger: Strong competitively entrenched businesses are thriving as they have generational opportunities to take share, consolidate smaller players, issue low cost debt, and buy back shares at reasonable valuations. • Double digit expected IRR's. • Pricing power/inflation protection: Owning a fractional interest in high quality global franchises with pricing power

[2] Do not allow central bank jargon to obscure the truth. Banks may create pithy expressions such as 'asset purchases',' monetary stimulus', 'quantitative easing', and 'open market purchases of financial assets' but in the end the reality is they are creating money out of thin air.

		will provide the greatest protection against future inflation risks.
2.	Inflation-Reflation Continuum/Inflation Inflection Point	• The elephant in the room – printing presses! • Developed World QE: Developed world central banks armed with printing presses, sovereign debt inherited from credit/debt bubble, high unemployment, and low GDP growth will use quantitative easing techniques (QE2) to debase future value of debts. • Targeting above trend CPI: Fed comfortable with above trend inflation – recent Bernanke testimony. True inflation will not be reflected in CPI due to 40% rents – see housing bubble below. • Inflection point: we believe an inflection point could occur without warning when the potential inflation genie is let out of the bottle. Everything is fine until it is not fine. Contrast to deflationary consensus that exists today.
3.	Bond Bubble	• 10 Year US Treasury at 2.44%. • Credit spreads at pre-crisis razor thin levels. • Printing presses globally working at a furious pace. • Very few places to hide – no margin of safety across the entire fixed-income complex. • 29 years of falling yields has lulled investors into complacency. • Major correction on the horizon. We expect a peak to trough correction of 28%+ for 7 year maturity and longer bond indices - Barclays Aggregate Index.
4.	US Housing Bubble – Act 2	• Keep your eye on month's supply! • Monthly supply of housing inventory has again spiked to 12 months after being abated by stimulus programs and banks releasing inventory. We want to see levels return to 5.5 months supply before the picture improves for financial institutions with housing exposure. Risk reward in our mind is not asymmetric for housing exposed investments. • Housing inventory will keep rents low and thus government tabulated CPI low as rents are 40% of the calculation.
5.	Deflation – short-term bias	• Deflation bias is a clear and present danger and we are not ignoring the facts; consumer deleveraging and elevated unemployment will drive less spending and crimp GDP growth for the foreseeable future. We are sizing our long equity exposures accordingly - weighing long term compounding opportunities against short-term downside volatility. • We view inflation as the elephant in the room and deflation as the hyena. The hyena is present, pesky, and tenacious but it should not distract us from the 4 ton mammal.

Joys of Compounding – Revisited:

We felt it would be timely to revisit the ultimate goals and roadmap of the investing process given the heightened level of scrutiny regarding macroeconomic and misperceived binary outcomes.

Investing is simply maximizing the rate of compounding for as long as capital can be employed net of fees and taxes. What strikes us as strange is how little we hear about compounding with regard to investing. We find the short-term perspective affecting the collective market psyche is focused on direction and immediate results that often limit the ability to truly accomplish outstanding rates of compound.

There is no better live experiment on the power of compounding than Warren Buffett. I spent the last few beach days of late August reading and then re-reading early Buffett Partnership Ltd. (BPL) letters written between 1957 and 1970. Immediately after working for his mentor Benjamin Graham in 1956, Buffett opened a partnership to manage other people's money including his own savings of $174,000 which at last count has compounded to a net worth of $47 Billion. Buffett closed the partnership in 1970 and gave his early clients the option of maintaining their share of a wholly owned subsidiary, Berkshire Hathaway, which BPL in those latter years controlled. The rest is history.

Two things stood out for me in those early letters; the first was the emphasis Buffett made on teaching the exponential importance of compound returns and the second was how he thought about the investment categories that would allow him to earn these types of above market/excess returns over time.

Buffett's Lessons on Compounding:

Beginning in January 1963 at the age of 32, Buffett penned three annual letters entitled "The Joys of Compounding." For the interest of our reader we have included excerpts of the letters in Appendix B. In those three annual letters, Buffett used examples of lollapalooza investments of historical context and compared those to what a sound investment program at conservative rates would have produced. The investment examples used were; Isabella's $30,000 underwriting of Columbus's voyage to find the new world, Francis I of France's 4,000 ecu ($20,000) purchase of Leonardo da Vinci's Mona Lisa, and Peter Minuit's $24 investment to purchase the island of Manhattan.

We have brought those examples up to date using 2010 estimates in the table below.

Investor	**Investment**	**Cost**	**2010 Estimated Value of Investment**	**Joys of Compounding @ 6.5%**
Queen Isabella	Columbus's trip to find the New World in 1492	$30,000	$31 Trillion[3]	$4.4 Quintillion
Francis 1	Mona Lisa in 1540	4,000 ecu = $20,000	$713 Million[4]	$98 Quadrillion
Peter Minuit	Manhattan Island in 1626	$24	$214 Billion[5]	$763 Billion

The above table shows the powerful effects of compounding as espoused by Buffett. If each of these individuals had invested their capital in an investment program and earned a 6.5% rate of compounded return, the present sum would be as extraordinary or in some cases considerably more stratospheric than these incredible investments, thus illustrating why "compound interest" is often described as the 8th wonder of the world.

Below is an excerpt from Buffett's 1965 letter where he includes a table to illustrate how an investor might fare at different rates of return over a more reasonable time horizon.

> "Some of you may view your investment policies on a shorter term basis. For your convenience, we include our usual table indicating the gains from compounding $1,000,000 at various rates:

		4%		**8%**		**12%**		**16%**
10 Years		$1,480,244		$2,158,925		$3,105,848		$4,411,435
20 Years		$2,191,123		$4,660,957		$9,646,293		$19,460,760
30 Years		$3,243,398		$10,062,656		$29,959,922		$85,849,877

> This table indicates the financial advantages of:
> (1) A long life
> (2) A high compound rate
> (3) A combination of both (especially recommended by this author)
>
> To be observed are the enormous benefits produced by relatively small gains in the annual earnings rate. This explains our attitude which while hopeful of achieving a

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3 This would be too difficult to place a value on so for the purposes of this exercise we'll use 2x revenue. Therefore we could use 2x US GDP of $14Trillion and 2x Canadian GDP of $1.5 Trillion equaling $31 Trillion.

4 *Guinness World Records* lists the *Mona Lisa* as having the highest insurance value for any painting in history. On December 14, 1962 it was assessed at US$100 million prior to the painting touring the United States for several months. Taking inflation into account, the 1962 value would be approximately US$713 million in 2010.

5 Another perhaps fanciful estimate: the area of Manhattan is 621,688,320 square feet and we use a healthy average price per buildable square foot of $345.

> striking margin of superiority over average investment results, nevertheless, regards every percentage point of investment return above average as having real meaning."

And from the 1963 letter, "even though we are shooting for more, we feel that a few percentage points advantage over the Dow is a very worthwhile achievement. It can mean a lot of dollars over a decade or two."

I thought East Coast might humbly add one more recent example to Buffett's "Joys of Compounding" canon. Growing up in Massachusetts you are generally born into the legacy, or for some time the lunacy, of being a Boston Red Sox fan. Up until recently that included a long stretch of being plagued by the "Curse of the Bambino" the 86-year curse broken in 2004 with a World Series victory against the St. Louis Cardinals.

On January 3, 1920, then Red Sox owner and theatrical producer Harry Frazee sold Babe Ruth for $125,000 to the New York Yankees and used the proceeds to finance a production of the Broadway musical "No, No, Nanette".

Not only was this a horrible deal for Red Sox fans, we have it from unreliable sources that his theatrical investment produced a complete loss of his $125,000 investment. We thought it would be interesting to see if Mr. Frazee invested his proceeds more effectively, perhaps the blunder would have at least been financially mitigated.

Investor	Investment	Cost	2010 Value of Investment	Joys of Compounding	Interest Rate
Harry Frazee	Broadway musical	$125,000	$0	$36 Million	6.5%
				$127 Million	8%
				$3.3 Billion	12%
				$79 Billion	16%

Investing the $125,000 in 1920 and allowing it to compound to present day would have produced a staggering windfall for Frazee's heirs. If for example he left the assets in a Charitable Foundation[6] where by an investment program was able to compound the capital at a healthy rate, say 12%, this initial $125,000 investment would have produced a present sum of $3.3 Billion. To further this fantasy, had the curse not been broken in 2004, Frazee's heirs could have used their sizable inheritance to make things right for Red Sox Nation. The foundation would have had enough assets to fund the $660mm purchase of the Red Sox from the Yawkey Family in 2002, been able to invest in a full roster of all-star players and refurbish historic Fenway Park, with $1.5 Billion left over to support local Boston charitable endeavors.

Our goal as investment stewards is to understand the true power of compounding and allow this force to work for our clients while meeting liquidity needs. Investing with a margin of safety through a sound value investing approach also serves to mitigate permanent losses of capital as well as protects assets during periods of downside volatility. Buffett's written words at the age of

[6] Assuming no 5% mandatory spend rate for the purposes of this Alice in Wonderland experiment.

32 foreshadowed his life study on the power of compounding. We believe his success in accumulating an exorbitant sum of wealth owes as much to the genius of his perspective as it is does to his investment prowess. It is our conclusion that true genius passes through knowledge and arrives at simplicity. We observe that most investors do not think with this end in mind and suffer from short-sightedness.

Buffett Investment Categories:

The second take away from these early letters was how Buffett thought about accomplishing his goals of compounding. He broke down his investment ideas into three broad categories; "generals", "workouts", and "control."

"Generals" consist of undervalued securities where Buffett had nothing to say about corporate policies and no timetable as to when the undervaluation may correct. Buffett remarked in 1965 that "over the years, this has been our largest category of investment, and more money has been made here than in either of the other categories."

The second category consisted of "workouts" - securities whose financial results depend on a corporate action rather than supply and demand factors created by buyers and sellers of securities.

The final category was "control"- situations where Buffett would either control the company or take a very large position and attempt to influence policies of the company. With this final category Buffett admitted investment should be measured on the basis of several years. It is with this final category that Buffett became particularly adept thus closing the partnership to own more of these types of investments with Berkshire Hathaway as the holding company.

Why might this be insightful and what intelligence can we garner from Buffett's early investment process? With his goal of increasing compound levels he rightly developed investment behaviors to not only source ideas but to have a way to frame the prospective investment's attributes and time horizon. His Generals and Controls were what we refer to as "time horizon arbitrage" investments. These are situations where he would value the business, buy at a meaningful discount to its intrinsic value and then allow the gap to close corresponding to healthy internal rates of return – IRR's. Workouts have a shorter time horizon and are similar to the strategy that special situation investors employ today. To capture his goals of compounding capital he would link a number of healthy shorter-term IRR opportunities together adding to his annualized return.

East Coast Investment Categories:

While to date we have not played in the area of "control" situations we have had a similar framework, organizing our portfolio investments into three categories. This also serves as the foundation from which we source prospective investment ideas. The three investment categories at East Coast are; "compounders", "transformations", and "workouts[7]."

The table below highlights the characteristics and attributes of each category:

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[7] While we have used the term General Value for some time we have decided to give tribute to early Buffett influences and recently changed the name to "Workouts" which better aligns with our research objective in this category.

	Compounders	**Transformations**	**Workouts**
Description	• Buy strong businesses whose intrinsic value is growing at a healthy rate and purchase the business at a reasonable price. • Invest with talented investment teams reinvesting cash flows or float.	• Invest in businesses where the economics are improving. • Post industry consolidation: sweet spot of this category where pricing power dynamics create exponential free cash flow growth.	• Opportunistic situations where a structural, observable catalyst is in place to unlock value.
Competitive Moat	Competitively entrenched market leaders. Very high barriers to entry. Low cost producers and structural advantages.	Industries historically seen as competitive but oligopolistic advantages emerge. This becomes visible post consolidation.	Average to above average competitive advantages.
Return on Invested Capital (ROIC) Rate & Direction	High and maintaining/improving ROIC.	Hockey stick effect as pricing drives increment positive changes in ROIC.	Average to improving ROIC.
Balance sheet	Very little debt. Opportunities to lever up at low rates to buy back stock.	Above average debt with high rates of repayment driving incremental free cash flow.	Dependent on capital structure. Often capital structure is source of value enhancing catalyst.
Sourcing Categories	High ROIC-high earnings yield businesses, duopolies/oligopolies, free cash flow yielders.	Industry consolidation/capacity reductions, industry screens, trade journals, channel checks.	Spinoffs, merger arbitrage, CEO change, credit screens, SEC filings, ECAM mean reversion models.
Time Horizon	Medium-Long Term	Medium-Long Term	Short-Medium Term
Investment Edge	Analytical, information, and <u>time horizon.</u>	Analytical, information and <u>time horizon.</u>	Analytical and information.

Sourcing portfolio ideas into these three categories help us frame the opportunity in a way to determine our investment edge and also drives a targeted checklist as we give due diligence to the idea.

Historically, as managers of individual and foundation wealth, most of our excess return has been driven from the first two categories; compounders and transformations. We expect this to continue; currently these two categories represent 80% of our portfolio. When we have completed the necessary analytical work and arrive at what we believe to be a mis-priced opportunity, the real advantage or edge in these two categories will be driven by a time horizon advantage. If there is a free lunch on Wall Street, we feel it is the time horizon perspective. Compounders and transformations are incredibly powerful and they will drive the lion share of our return in the future.

Workouts are a space heavily travelled by the hedge fund community. They fit perfectly into the mindset of an institutionally aligned hedge fund industry where there is more emphasis on monthly and quarterly performance numbers, especially after a difficult 2008. Consultants armed with a need to appear proactive have incentives to proactively deselect an underperforming manager. This institutional imperative is as alive and well just as it has been in the pension and mutual fund sectors for many years. Workouts give the manager a safety zone as they can invest with a perceived catalyst over a defined short-time horizon corresponding with their need to perform. There is also financial incentive for the investment team in the form of annual performance fees. When performance fees are not earned or when water marks are high these underperforming companies will see talent flee for literal higher ground. While we feel a structural mispricing may surface in the "workout" area, we don't anticipate this space to be a major source of truly outstanding investment ideas. However, we feel it can deliver a multitude of singles and doubles which ultimately improves our batting average – compounded returns. We expect on average 20 – 30% of our portfolio to be made up of ideas sourced into this category.

Organizational Updates:

Managing Director/Principal – Michael Kozak, CFP®, JD: East Coast is pleased to welcome Mr. Michael Kozak to the firm as its fifth partner. Finding like-minded partners is an integral part of our growth strategy and Michael is a strong complement to our team of seasoned-professionals, bringing over ten years of experience working with affluent individuals and families. He is an attorney who is licensed to practice law in Massachusetts and before the U.S. Tax Court. Michael also holds the CFP® designation.

In addition to his extensive experience in the areas of financial and tax planning, Michael is particularly interested in the area of fiduciary liability and frequently writes on how law firms, CPA firms, foundations and endowments can promote best practices to enhance the level of protection they provide for those accounts that they either oversee or serve as trustee.

A graduate of Boston University School of Law and the University of Massachusetts at Amherst, Michael has been featured on CNBC and has been quoted in many national publications.

Managing Director – Donald S. Thorn: We could not be more pleased to also welcome Donald Thorn to our team. Don brings a great depth of institutional investment experience and an extensive international background to East Coast. Most recently, Don oversaw numerous aspects of a global investment platform as a Director with Octagon Asset Management, an investment advisor focused on credit opportunities in Latin America. Previously, Don was a Vice President with Merrill Lynch, where he was responsible for international middle market sales and served as a key member of the firm's Japanese equity and global capital markets divisions. Don began his career in the wealth management division of the U.S. Trust Company of New York.

Don earned his MBA with concentration in Finance and International Business from the Ross School of Business at the University of Michigan.

Associate Research Analysts: While we bid farewell to a talented group of summer Associate Research Analysts, we are pleased to welcome three new individuals to our ranks. Our new recruits have been hard at work since early September. We are also fortunate to have Anant Ahuja, MD staying on board until the end of the year. As a noted in earlier letters, East Coast partners with MBA Programs at Columbia University, the Ivey School at the University of Western Ontario, and with our long standing partner, Boston College. We have worked closely with the Executive Directors of these schools, particularly those engaged in Investing Curriculums and if applicable their Value Investing Programs. We had an impressive number of applicants for our fall openings and in turn we are very pleased with the quality, experience, and intelligence of those invited to join our team. We encourage you to review their bios in Appendix A and hope you may have an opportunity to meet Anant Ahuja, MD, Chad Landrum, CFA, Genna Sankin and Noah Snyder upon a visit to our Boston or Essex offices.

We continue to manage your capital with the utmost prudence and look forward to meeting and talking with you soon. We greatly value your support and trust.

"Simplicity is the final achievement. After one has played a vast quantity of notes and more notes, it is simplicity that emerges as the crowning reward of art."

Frederic Chopin (1810 – 1849)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
Chief Investment Officer, Co-Founder

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APPENDIX A:

Associate Research Analysts:

Anant Ahuja, MD
Anant is an Associate Research Analyst at East Coast. He is a recent graduate of Columbia Business School's Executive MBA program where he was the recipient of the MDPE 1984 Harry Taback Memorial Scholarship. Anant is a boarded internal medicine physician and earned his MD from New York Medical College and BS summa cum laude from North Carolina State University. He has prior experience as a healthcare analyst for a long/short hedge fund and did consulting equity research for ThinkEquity Partners during his medical training. Anant speaks fluent Hindi.

Chad Landrum, CFA
Chad is an Associate Research Analyst at East Coast. He is a Columbia Business School class of 2012 MBA candidate where he is a recipient of the Fredericks Family Scholarship and an AVP in Columbia Investment Management Association (CIMA). Chad brings over 5 years of experience in high-yield and distressed debt buyside research to the East Coast team. Before beginning his MBA, Chad worked as a distressed debt analyst, covering various corporate restructuring situations and making investment recommendations through the capital structure. Before working in the distressed group at 40|86, Chad covered various industries as a high-yield analyst. Chad received his BA in finance at Ball State University.

Genna Sankin
Genna is an Associate Research Analyst at East Coast. She graduated with two Masters degrees from Columbia University in May 2010. Genna earned an MBA from Columbia Business School and a Masters of International Affairs from the School of International and Public Affairs. She has worked at bulge bracket banks in Investment Banking and in International Trade Finance, and also has experience with emerging market investments in China and Africa. Prior to returning to school, Genna worked in the large cap acquisition division of the United States Department of Defense. She began her career in Washington, DC as an investigative journalism researcher in the defense and oil industries. Genna earned a BA from Tufts University Cum Laude with High Thesis Honors.

Noah Snyder
Noah is an Associate Research Analyst at East Coast. He is a 2012 MBA candidate at Columbia Business School where he is Associate Vice President of the Investment Ideas Club within Columbia's Investment Management Association (CIMA). Noah has enjoyed several years of fundamental equity analysis experience including over one year of raising and independently managing equity portfolios for high net worth individuals. At Columbia, Noah has assembled an investment team of colleagues with diversified buy-side experience to help manage these high net worth portfolios. Previously, Noah spent two years at Arlon Opportunities Investors, a New York-based long/short hedge fund focused on food, consumer, retail, and other commodity exposed equities with a strong emphasis on cyclicals. Noah received his BA in Finance from the University of Illinois at Urbana-Champaign.

APPENDIX B:

The Joys of Compounding:

January 18, 1963 – Buffett age 32

"I have it from unreliable sources that the cost of the voyage Isabella originally underwrote for Columbus was approximately $30,000. This has been considered at least a moderately successful utilization of venture capital. Without attempting to evaluate the psychic income derived from finding a new hemisphere, it must be pointed out that even had squatter's rights prevailed, the whole deal was not exactly another IBM. Figured very roughly, the $30,000 invested at 4% compounded annually would have amounted to something like $2,000,000,000,000 (that's $2 trillion for those of you who are not government statisticians) by 1962. Historical apologists for the Indians of Manhattan may find refuge in similar calculations. Such fanciful geometric progressions illustrate the value of either living a long time, or compounding your money at a decent rate. I have nothing particularly helpful to say on the former point.

The above table[8] indicates the compounded value of $1,000,000 at 4%, 8% 12, and 16% for 10, 20 and 30 years. It is always startling to see how relatively small differences in rates add up to very significant sums over a period of years. That is why, even though we are shooting for more, we feel that a few percentage points advantage over the Dow is a very worthwhile achievement. It can mean a lot of dollars over a decade or two."

January 18, 1964 – Buffett age 33

"Now to the pulse-quickening portion of our essay. Last year, in order to drive home the point on compounding, I took a pot shot at Queen Isabella and her financial advisors. You will remember they were euchred into such an obviously low-compound situation as the discovery of a new hemisphere.

Since the whole subject of compounding has such a crass ring to it, I will attempt to introduce a little class into this discussion by turning to the art world. Francis I of France paid 4,000 ecus in 1540 for Leonardo da Vinci's Mona Lisa. On the off chance that a few of you have not kept track of the fluctuations of the ecu 4,000 converted out to about $20,000. If Francis had kept his feet on the ground and he (and his trustees) had been able to find a 6% after-tax investment, the estate now would be worth something over $1,000,000,000,000,000. That's $1 quadrillion or over 3,000 times the present national debt, all from 6%. I trust this will end all discussion in our household about any purchase of paintings qualifying as an investment. However, as I pointed out last year, there are other morals to be drawn here. One is the wisdom of living a long time. The other impressive factor is the swing produced by relatively small changes in the rate of compound. Above are shown the gains from $1,000,000 compounded at various rates.

It is obvious that a variation of merely a few percentage points has an enormous effect on the success of a compounding (investment) program. It is also obvious that this effect

[8] The referenced compounding table in this appendix is included on page 5 of this letter.

mushrooms as the period lengthens. If, over a meaningful period of time, Buffett Partnership can achieve an edge of even a modest number of percentage points over the major investment media, its function will be fulfilled."

January 18, 1965 – Buffett age 34

"Our last two excursions into the mythology of financial expertise have revealed that purportedly shrewd investments by Isabella (backing the voyage of Columbus) and Francis I (original purchase of Mona Lisa) bordered on fiscal lunacy. Apologists for these parties have presented an array of sentimental trivia. Through it all, our compounding tables have not been dented by attack. Nevertheless, one criticism has stung a bit. The charge has been made that this column has acquired a negative tone with only the financial incompetents of history receiving comment. We have been challenged to record on these pages a story of financial perspicacity which will be a bench mark of brilliance down through the ages.

One story stands out. This, of course, is the saga of trading acumen etched into history by the Manhattan Indians when they unloaded their island to that notorious spendthrift, Peter Minuit in 1626. My understanding is that they received $24 net. For this, Minuit received 22.3 square miles which works out to about 621,688,320 square feet. While on the basis of comparable sales, it is difficult to arrive at a precise appraisal, a $20 per square foot estimate seems reasonable giving a current land value for the island of $12,433,766,400 ($12 1/2 billion). To the novice, perhaps this sounds like a decent deal. However, the Indians have only had to achieve a 6 1/2% return (The tribal mutual fund representative would have promised them this.) to obtain the last laugh on Minuit. At 6 1/2%, $24 becomes $42,105,772,800 ($42 billion) in 338 years, and if they just managed to squeeze out an extra half point to get to 7%, the present value becomes $205 billion. So much for that. Some of you may view your investment policies on a shorter term basis. For your convenience, we include our usual table indicating the gains from compounding $1,000,000 at various rates.

This table indicates the financial advantages of:
(1) A long life (in the erudite vocabulary of the financial sophisticate this is referred to as the Methusalah Technique)
(2) A high compound rate
(3) A combination of both (especially recommended by this author)

To be observed are the enormous benefits produced by relatively small gains in the annual earnings rate. This explains our attitude which while hopeful of achieving a striking margin of superiority over average investment results, nevertheless, regards every percentage point of investment return above average as having real meaning."

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To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – Chief Investment Officer, Co-Founder

Date: January 10, 2011

Re: Fourth Quarter 2010 Update – "A Unified Theory of Investing"

Market Summary[1]:

	S&P 500	**MSCI AC World Index**	**MSCI Emerging Markets**	**MSCI EAFE Index**	**Barclays Aggregate Bond Index**	**Gold – $/Troy Oz.**	**Crude Oil**
Price 12-31-10	1257.64	330.64	1151.38	1658.30	1641.10	$1,420.78	$91.38
2010	15.06%	12.67%	19.04%	8.38%	7.00%	29.52%	15.15%
4th Quarter 2010	10.76%	8.73%	7.37%	6.67%	-1.38%	8.59%	14.27%
2009	26.47%	35.17%	78.51%	32.36%	6.37%	24.36%	77.94%
From March 6th, 2009 Lows	91.17%	98.87%	146.50%	90.84%	12.54%	51.25%	100.75%

For clients and interested parties, we will be forwarding our performance review and portfolio positioning under separate cover for confidentiality purposes.

Equity markets delivered strong calendar year gains of +15% for the S&P 500 and +13% for the MSCI All Country World Index. The MSCI Emerging Market Index logged a 19% return with MSCI EAFE lagging behind, as developed Europe weighed on the index, with a total return of 8%. Gold continued its upward trajectory with a 30% return in 2010.

While a year is a short interval to measure any type of success, we are pleased with how the portfolio is responding in the current environment. We believe our capital allocation decisions have performed favorably in absolute and relative terms. Interestingly enough, a heightened importance of "margin of safety" and in this case, protecting the purchasing power of our client's accumulated wealth was a strong advocating factor that confirmed our decision to continue to allocate capital to perceived "risk" assets.

That being said, we are not satisfied to rest on the laurels of this recovery. Greater than normal volatility is expected as global macro concerns and political posturing weigh on the emotions of the short-term investor. The actions that have guided us through this environment continue; sift

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast strategy will not seek to replicate the performance of these or any other indices.

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through the essential facts and "invert"[2] our conclusions to determine if we can refute preconceived notions on portfolio positioning. A rational process and value philosophy are at the core of our investment management plan. We have a heightened focus on "what can go wrong" versus "what can go right", however, we feel opportunities to compound exist and are quite compelling. We continue to favor equity investments and purchase fractional interests in quality businesses at reasonable prices. We have targeted businesses with pricing power which give a low cost option on inflation mitigation. In the appendix we revisit our "Top Five Macro Views" that give insight into the broader opportunities represented in the portfolio today and the areas we are seeking to avoid. During the 4th quarter this exercise identified a new Macro Theme[3] which will be subsequently discussed.

Credit Bubble Epilogue – "Force Majeure"

Over Thanksgiving weekend, my ten year old daughter and her best friend were playing with their American Girl dolls. This piqued my interest as dolls have not been part of their play dates for over a year. Their attention had appeared to move on to technology based activities like Wii and iPods. I was intrigued by their creative story lines as they imagined they were moms and the dolls were their children. Upon my asking what prompted the renewed interest in dolls, my daughter replied "Daddy, we are playing out their epilogue now that they are all grown up."

After being amused and registering a mental note to commend her teacher on a job well done, it struck me that "epilogue"[4] was the word that defined the thought experiment[5] I was working through to conceptualize the post Credit Bubble world.

Here is a synopsis of the Credit Bubble drama/tragedy. Beginning/Incentive Moment: Borrowers binge on credit available through ever increasing housing and asset prices fueled by a prolonged period of low interest rates and lack of appropriate financial regulations of banks and credit agencies. Middle/Climax: Prices and financial engineering prove unsustainable, bubble pops leading to an unprecedented lack of liquidity with overnight lending markets ceasing to function properly - foreclosures, write-downs, and financial institutions failures ensue. Central banks step in at the precipice of a global financial meltdown by providing a flood of liquidity and transferring toxic assets to their balance sheet. Falling action/Denouement: Central bank efforts, while not perfect in hindsight, prevent a great depression scenario. Markets rebound, confidence slowly recovers, job losses wane, and economic growth improves.

The Epilogue is just now being written. The fate of the cast of characters is being revealed. Actors in a leading role are developed central banks (US, Europe, Japan), borrowers/consumers, financial institutions/lenders, and investors with accumulated wealth. Actors in a supporting role are emerging market central banks, China, Brazil and to a lesser extent India, and Russia.

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[2] A reference to the extraordinary German Mathematician Carl Gustav Jacob Jacobi's maxim "invert, always invert," expressing his belief (and ours) that the solution of many hard problem can be clarified by re-expressing them in inverse form.

[3] Most of our day to day research is spent on the merit of individual investment ideas. However, it is constructive to define and rank our "top five macro and micro views." The purpose of this exercise is to layer a macro framework on our fundamental bottom up process. This helps us determine if our portfolio positioning is in harmony or in contrast with major tail risk events of concern. We also want a spot check to verify that our portfolio positioning and individual return estimates are congruent with our asset class expected return estimates.

[4] The final chapter at the end of a story that often serves to reveal the characters' fate.

[5] Einstein tribute will reveal greater significance in next section: A Unified Theory of Investing.

The critical element of the Epilogue will be driven by the forced actions of the developed central banks (US, Europe, Japan) and how they affect the remainder of the cast of characters. The debt from the binging did not go away; the lion share was transferred to sovereign balance sheets and the rest continues to constrain consumers and borrowers. The former creates debt and interest rate coverage constraints for central banks. The latter is what deflationists are rightly concerned about. Consumers who are underemployed and overleveraged are forced to ratchet back spending. Banks are not anxious to lend as they continue to absorb and fear losses, this propagates a self fulfilling downward spiral. Bernanke knows this better than anyone given his experience studying the Great Depression and Japan. European central bankers understand this after seeing the negative effects of Ireland austerity measures. Japan has lived it for the last 20 years.

The solution that is most palatable to the leading actors is "force majeure[6]." We use this term to describe the decision of the central banks to quantitatively ease their money supply, affectionately known as QE and now QE2. Due to the consequences explained above, central banks feel it justifies an extraordinary solution to correct imbalances. QE or the printing of money will accomplish the desired result of devaluing the future value of debts and initiate an illusion of wealth which will help provide a tailwind for job and economic growth. On December 6th Federal Reserve Chairman Ben Bernanke gave an Oscar worthy performance on 60 Minutes outlining the importance of this decision.

Financial institutions/lenders are also advocates of the QE approach as it helps stabilize losses still percolating from their housing exposure. Our best supporting actor nominee is the emerging central banks. They have and will continue to scold the developed world for currency manipulation and devaluing their currency reserves. The reality is they have a supporting role with their primary goal being to prevent social unrest and thus maximize employment. This means keeping currencies pegged to the dollar which continues to allow products to be sold at relatively attractive prices.

What are our thoughts? With investing it makes more sense to front the essential facts rationally than to act quixotically towards an ideal. QE is a win-win in the eyes of central banks and in the eyes of the majority of the populace of the developed world. Printing money is potentially win-lose for investors with accumulated wealth.[7] While it serves to mitigate deflation risk, which is a very dangerous path, it guarantees a course toward destruction of purchasing power. Our portfolio is positioned to mitigate inflation risk and maximize "real" rates of return from these levels.

[6] Force Majeure (French for "superior force") is a common clause in contracts that essentially frees both parties from liability or obligation when an extraordinary event or circumstance beyond the control of the parties, such as a war, strike, riot, crime, or an event described by the legal term "act of God" (such as flooding, earthquake, or volcanic eruption), prevents one or both parties from fulfilling their obligations under the contract.

[7] Note Open Letter to Ben Bernanke on November 15th signed by a number of influential individuals with significant accumulated wealth at risk. Their incentives are aligned differently than the 325mm other Americans who are, in aggregate, underemployed and over-leveraged.

A Unified Theory of Investing

At the age of 26, Albert Einstein published four articles which would contribute to the foundation of modern physics and change views on space, time and matter. In the years from 1918 to his death in 1955 Einstein spent the majority of his time in search of a unified theory of physics – a theory of everything. A pursuit of a final theory, a system of interlocking equations that describe all that can be learned from the forces of the physical universe. While his efforts fell short, the search continues.[8]

Edward O. Wilson in his book Consilience[9] commented on the dream of a final theory. "The theory will be beautiful. Beautiful because it will be elegant, expressing the possibility of unending complexity with minimal laws, and symmetric, because it will hold invariant through all space and time. And inevitable, meaning once stated no part can be changed without invalidating the whole. All surviving sub-theories can be fitted into it permanently."

Is there a Unified Theory of Investing? Is there a law that would express an infinite number of investment choices across countless different securities into a simple relative equation? A theory that would allow an investor, just like a biologist or physicist, to use the process of reduction and synthesis through levels of organization to solve investment puzzles?

I believe one exists and it has in fact been the foundation of analysis for the most intelligent investors throughout history. The reason the theory gets so little attention is because it is so obvious. As with universal laws that have come before such as Newton's Law of Gravity or Darwin's Theory of Evolution/Natural Selection, they appear self evident once identified. In the case of investing, it is both the complexity of the market place and the emotions associated with allocating financial resources that serve to obscure this law.

We propose that the Unified Theory of Investing is Internal Rate of Return (IRR). And since an important theory deserves a memorable equation we propose:

$$JoC = IRR$$

Where *JoC* is "Joys of Compounding" and "*IRR*" signifies internal rate of return.

"Joys of Compounding", highlighted in our last quarterly letter, pays tribute to three early Buffett Partnership letters where Warren Buffett, at the age of 31, referenced examples of the power of compound interest[10]. This foreshadowed a real life experiment on compounding capital that has never been and may never be replicated[11]. Internal Rate of Return (IRR) is the annualized

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[8] Modern day physicists working on variations of Supersymmetry String Theory and to what is now called M-theory could fulfill this objective in our lifetime.

[9] Consilience is one of the most written-in and earmarked books I own. I believe Edward O. Wilson to be one of the greatest thinkers/synthesizers of our generation. Consilience was originally recommended to shareholders by Charlie Munger at the Wesco annual meeting.

[10] It is really no surprise that compound interest is often referred to as the 8th Wonder of the Ancient World. Together with the Pyramids of Giza they would share the honor of being the only two that are still standing.

[11] Where the total eclipse on May 29th, 1919 proved Einstein's Theory of Special Relativity which was necessary to prove to the world that space is curved, we have been witness to Buffett's investing example - evidence that a unified theory of investing based on compounding/IRR investing is credible.

effective compounded return rate. IRR is the unified numerical quantity that can be used to compare and contrast an infinitesimal number of investment options.

An investment could be a fractional interest in a business (stock), a debt security (bond), commercial real estate, farmland in Nebraska, a project a business would underwrite, or any opportunity where one places funds with the hope of a profit. Any investment has an expected annualized effective compound return rate from the price you pay over a determined number of years[12]. Assuming the analyst has calculated the IRR correctly, an investor should allocate capital to those investments with the highest expected compound rates of return.[13] Just like a shopper walking the aisles of a grocery store, the investor shops for opportunities by the IRR that is intrinsic to the potential investment at the price quoted.

This concept is not obvious because the investment business feeds off complexity and chaos. Walk through the Financial District of any city and gaze up at the fruits of their labor. Complexity and chaos sell product. Most investors live in Maslow's[14] basement engaged in a tug-of-war between fear and envy. Both emotional poles are great for business. Helpers on Wall Street are eager to serve as purveyors to the needs of the crowd. Today the crowd is shouting "Give me yield and reduce my volatility". The insurance companies respond "we have annuities here!," the broker-dealer community opens one side of their coat and responds "we have separately managed accounts – how about five of them – diversity, diversity!" the other side of the coat opens "or perhaps you would like some alternative investments or better yet I have closed end funds trading at a discount."

Let's return to the edge of chaos.[15] Compounding capital is the penultimate goal of investing and IRR, more specifically a portfolio of IRR's are the universal units that collectively drive compound returns. The philosophy and process of the investor is what gives credibility to their estimate, solves the puzzle and unlocks the truth. The truth revealed is the compound rate of return based on a specific offer price and a defined time period. I do not believe there is one absolute way to determine an expected rate of return, however what I am proposing is that IRR is the universal law and universal unit of compounding. If it is in fact the universal unit of compounding the number one objective of the successful investor is IRR discovery.

East Coast Process on IRR Discovery:

At East Coast, the discovery process is at the core of everything we do. The objective of all research is to arrive at an IRR estimate. We come at the world from two directions; bottom up fundamental analysis of mispriced investments and global macro top down considerations.

[12] At East Coast we use 5 year estimates on our equity holdings comprising our "compounder" and "transformation" categories. With regard to "work-outs," the time horizon is determined by the category of mispricing (arbitrage, spinoff, restructuring, etc). Credit has a finite life determined by the maturity or our defined length of holding period.

[13] A customized investment policy statement should address liquidity needs and risk tolerance to determine how much capital can be deployed in an investment strategy focused on compounding capital.

[14] Maslow's hierarchy of needs is a theory of psychology, proposed by Abraham Maslow in his 1943 paper A Theory of Human Motivation. It is our belief that Maslow's pyramid is one of the most powerful models to understand human motivation and incentives.

[15] Edge of Chaos is a paradigm of Complexity Theory that states that the system that will evolve the most rapidly must fall between order and loosely connected parts that can be easily altered either singly or in small groups. Unofficial headquarters of Complexity Theory is the Santa Fe Institute in New Mexico.

- Sourcing Mispriced Investments: The greatest challenges in ascertaining an accurate IRR estimate are time, quality information, and resources. We only want to work on ideas that have a high probability of being mispriced and thus have considerable merit. We source from ten advantaged categories that have a history of producing mispriced investments. These ten sources fill ideas into one of three categories; compounders, transformations, and workouts. Each category has a unique thesis template that drives our best understanding of what we need to accomplish in our due diligence phase. The end result is the IRR estimate. We maintain daily IRR estimates on portfolio holdings, pipeline ideas, and estimates on an East Coast universe of businesses previously reviewed.

- Global Macro: Our primary global macro activities are the following: 1. Estimating a 5 year IRR estimate on each asset class[16], global sector, and US sector, 2. Identifying and ranking our top five macro and micro themes[17], and 3. Evaluating our consensus versus edge top ten[18].

- Portfolio Construction: All holdings in the portfolio, our pipeline, and the universe are competing for capital. We compare IRR estimates from investment specific work to our global macro work, looking at macro and micro themes to ascertain where tail risks exist or where tail winds reside. We evaluate where the consensus lives to determine if we are on the edge of the crowd or smack dab in the middle of it. We look to invert our thought processes to see if we missed key elements when seen from an alternative perspective. The portfolio is rank ordered weekly by three tiers[19] which help us segment the portfolio for where additional capital is more deserving or where capital should be harvested due to fleeting IRR's (profit realization) or a waning conviction in our thesis.

A unified unit of compounding gives our team a single objective and common language. *What is the IRR and tell me how you got there? It is that simple*! If the research is lacking or information incomplete, the puzzle is not solved and it is the analyst/portfolio manager's job to do more work or pass. As Warren Buffett remarked at the 1998 Berkshire Hathaway annual meeting "I call investing the greatest business in the world because you never have to swing. You stand at the plate; the pitcher throws you General Motors at 47! U.S. Steel at 39! and nobody calls a strike on you. There's no penalty except opportunity lost. All day you wait for the pitch you like; then when the fielders are asleep, you step up and hit it."

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[16] Our objective on top down IRR discovery is similar to the work GMO performs with their 7 year forecasts. It is my opinion that the genius of GMO resides in their asset allocation models driven by IRR estimates. The 7 year forecast is astoundingly accurate and they have nearly $100bl of assets under management that would agree. While enjoyable to read Jeremy Grantham's musings, the brilliance of GMO is how they have harnessed the universal law of IRR investing.

[17] See 3Q 2010 Quarterly Letter and Appendix.

[18] See 2Q 2010 Quarterly Letter.

[19] Tier One names are portfolio holdings with the most merit – most attractive IRR and our highest confidence, Tier Two names are attractive and we are still adding to, Tier Three names are not deserving of new capital due to IRR realization or waning conviction.

Edge: Infinite Refinement, Perspective and Synthesis (IPS)

This past quarter, I was fortunate enough to meet with Seth Klarman of the Baupost Group. I consider Seth to be one of the greatest investors of our time and Baupost a model firm. The topic we discussed at greatest length was the importance for any successful investment firm to have a definable edge. For many years I believed an edge consisted of having an advantage by out-analyzing, gathering a better information mosaic, and/or having a longer time horizon perspective than competitors. While those descriptions still have merit they failed to get at the core of an advantaged process and philosophy. As we thought more about the concept of an edge, if in fact we have or will continue to have one, it resides in the following: a process of infinite refinement, our perspective (IRR, time horizon and analytical), and synthesis.

With regard to ***infinite refinement,*** I was introduced to a valuable concept early in my career. My father handed me a book shortly after college graduation with the simple instruction "read this, it is one of the greatest books you'll ever read but do not ask me to explain why, just trust me." The book was Shibumi written by Trevanian and originally published in 1978. On the surface, a fictional spy novel that took place circa 1920 – 1970 in Japan and in the Basque country of Spain. However, within the fictional story a number of philosophical underpinnings are weaved into the storyline. There was one concept described which continues to capture my curiosity and in turn is the investment mission of our entire process.

The concept is the Japanese word and ideal called Shibumi. On page 77 Trevanian does an eloquent job of putting the concept to words:

> "*Shibumi*, sir?" Nicholai knew the word, but only as it applied to gardens or architecture, where it connoted an understated beauty. "How are you using the term, sir?"
>
> "Oh, vaguely. And incorrectly, I suspect. A blundering attempt to describe an ineffable quality. As you know, *shibumi* has to do with great refinement underlying commonplace appearances. It is a statement so correct that it does not have to be bold, so poignant it does not have to be pretty, so true it does not have to be real. *Shibumi* is understanding, rather than knowledge. Eloquent silence. In demeanor, it is modesty without pudency. In art, where the spirit of *shibumi* takes the form of *sabi*, it is elegant simplicity, articulate brevity. In philosophy, where *shibumi* emerges as *wabi*, it is spiritual tranquility that is not passive; it is being without the angst of becoming. And in the personality of a man, it is . . . how does one say it? Authority without domination? Something like that."
>
> Nicholai's imagination was galvanized by the concept of *shibumi*. No other ideal had ever touched him so. "How does one achieve this *shibumi*, sir?" "One does not achieve it, one . . . discovers it." "Meaning that one must learn a great deal to arrive at *shibumi*?"
>
> "Meaning, rather, that one must pass through knowledge and arrive at simplicity."[20]

[20] This quote has been displayed prominently on the top of the dashboard of East Coast's research database since our inception.

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We firmly believe the difference between good and great is the process of "infinite refinement." Einstein purportedly said there were five ascending levels of intellect: "Smart, Intelligent, Brilliant, Genius, Simple." With great humility we try to live in the latter. However, to get there you have to go through the discovery phases of knowledge. The heuristic of Occam's razor that guides scientists toward the law of parsimony to create theories that remove nonessential information is how we think through an investment before capital is deployed.

One of the most satisfying elements of the process is when we have gathered sufficient information, translated it to knowledge, and deliberately narrowed down the thesis to data points that define the investment idea. Of course the most satisfying outcome is to have our position established and the subsequent delight of Mr. Market agreeing with our thesis.

Perspective is the lens with which you see the world. We touched on this in our last letter stating that time horizon is truly one of the few investing free lunches. If we can elevate and educate our investors to understand the merits of an opportunity the reward is often "space and time". A perspective on IRR, as mentioned above, is the universal language for compounding. A perspective on the analytical process is to arrive at the critical data points and measure them effectively.

On the subject of *Synthesis*, Edward O. Wilson aptly writes "we are drowning in information and starving for wisdom." Information has been commoditized by the internet. The greatest success will be won by those who can synthesize information. Putting the right information together at the right time, viewing it critically, and making a rational choice, will be the most important differentiator moving forward.

The world has gone tribal. Everyone is a specialist hailing from a particular port that defines their identity. The investment business is acutely affected by this. At a recent Pan European Equity Conference in London, where I was one of only a few Americans in attendance, my fellow attendees had a difficult time placing me into a typical style box when I exclaimed I was an "all cap global generalist."[21] We strongly believe a research process that unifies knowledge from all disciplines within and outside of investing, harnessing consilient models, has enormous advantages.

Charlie Munger, who has been Warren Buffett's partner at Berkshire Hathaway since nearly the beginning, is one of the best synthesizers and thinkers in the world. The pilgrimage to hear Charlie speak "unplugged" at the Wesco meeting in Pasadena, CA every year is not to be missed. His knowledge and reading is so broad, from physics to philosophy, and the "mental models" he uses to assimilate information defines genius. Warren Buffett does a great job articulating his brilliance, "Charlie has the 'the best 30-second mind in the world. He goes from A to Z in one move. He sees the essence of everything before you even finish the sentence"

Infinite refinement, perspective and synthesis will be the rational tools that equip our journey through knowledge, simplicity toward compounding.

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[21] I would have exclaimed "all cap global rationalist" but I respect the etiquette of our industry's tribal rituals. Our universe of European equities continues to show improving IRR metrics due to volatility in the region so we have been brushing up on those businesses in earnest.

Organizational Updates:

Managing Director – Jeffrey Soulard, CPA/PFS, MST, CFP®: Attracting and retaining best-in-class professionals for both our investment team and our wealth management team is an important business objective. We could not be more pleased to welcome Jeff to our Wealth Management and Client Service team. Jeff brings over 10 years of tax and financial planning experience for high net worth individuals, families and business owners to the firm. Jeff began his career at Arthur Andersen where he held the title of Senior Tax Accountant, he later joined State Street Global Advisors as a Principal in their Estate and Financial Planning Group. Jeff received his Bachelor of Science in Accounting and Master of Science in Taxation from Bentley College. He also earned a Graduate Certificate in Personal Financial Planning from Bentley. Jeff received a bronze medal for his performance on the November 1998 Uniform CPA Examination and holds Certified Financial Planner (CFP®) and Personal Financial Specialist designations.

Jeff is a member of the American Institute of Certified Public Accountants, the Massachusetts Society of Certified Public Accountants, and the Financial Planning Association. He serves as a Chairman of the Essex Finance Committee and as Treasurer of the Essex Shipbuilders Athletic Association. Jeff has been quoted in several national publications on topics including tax and financial planning for high net worth individuals, families and business owners.

Associate Research Analysts: We welcome Ryan Coyle and Jenny Yu to our team. Our new recruits joined us in late Fall 2010 and will be with us until Spring of 2011. As a noted in earlier letters, East Coast partners with the Value Investing/Investment Management curriculums within the MBA Programs at Columbia University, the Ivey School at the University of Western Ontario, and Boston College. We have included Ryan and Jenny's Bios in Appendix B.

We continue to manage your capital with the utmost prudence and look forward to meeting and talking with you soon. We greatly value your support and trust.

"Men have sought to make a world from their own conception and to draw from their own minds all the material which they employed, but if, instead of doing so, they had consulted experience and observation, they would have the facts and not opinions to reason about, and might have ultimately arrived at the knowledge of the laws which govern the material world."

Sir Francis Bacon (1561 – 1626)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
Chief Investment Officer, Co-Founder

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APPENDIX A:

	Macro Views – Top Five	Description
1.	High-quality valuation anomaly	• Own great businesses at reasonable prices – it is that simple! Double digit expected IRR's. • Historic buying opportunity to own compounding franchises. • Strong get Stronger: Strong competitively entrenched businesses are thriving as they have generational opportunities to take share, consolidate smaller players, issue low cost debt, and buy back shares at reasonable valuations. • Pricing power/inflation protection: Owning a fractional interest in high quality global franchises with pricing power will provide the greatest protection against future inflation risks.
2.	Bond Bubble	• 10 Year US Treasury at 3.39%. • Credit spreads at pre-crisis razor thin levels. • Printing presses globally working at a furious pace. • Very few places to hide – no margin of safety across the entire fixed-income complex. 29 years of falling yields has created complacency. • Major correction on the horizon. We expect a peak to trough correction of 28%+ for 7 year maturity and longer bond indices - Barclays Aggregate Index.
3.	Credit Bubble Epilogue – Force Majeure	• Defined on page 2 - 3 of this letter.
4.	Deflation – short-term bias	• Deflation bias is a clear and present danger and we are not ignoring the facts; consumer deleveraging and elevated unemployment will drive less spending and crimp GDP growth for the foreseeable future. We are sizing our long equity exposures accordingly - weighing long term compounding opportunities against short-term downside volatility. • We view inflation as the elephant in the room and deflation as the hyena. The hyena is present, pesky, and tenacious but it should not distract us from the 4 ton mammal.
5.	US Housing Bubble – Act 2	• Keep your eye on month's supply! • Monthly supply of housing inventory has again spiked to 12 months after being abated by stimulus programs and banks releasing inventory. We want to see levels return to 5.5 months supply before the picture improves for financial institutions with housing exposure. Risk reward in our mind is not asymmetric for housing exposed investments.

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APPENDIX B:

Ryan Coyle

Ryan is an Associate Research Analyst at East Coast and he is a 2011 MBA candidate at Columbia Business School. Prior to enrolling at Columbia, Ryan spent four years as a senior analyst covering the consumer universe at Stadia Capital, a long-short hedge fund in New York that was subsequently acquired by FrontPoint Partners (the alternative investments division of Morgan Stanley Investment Management). Ryan began his career as an analyst in Media & Telecommunications investment banking at Bank of America. He earned his undergraduate degrees in Economics and History from Yale University. Ryan is a CFA Level III Candidate.

Yan (Jenny) Hu

Jenny is an Associate Research Analyst at East Coast and she is a 2011 MBA candidate at Columbia Business School. Prior to enrolling at Columbia, Jenny worked for the China Investment Corporation in the Tactical Investing Department (TID) as a research intern analyst. Prior to CIC, Jenny worked as analyst for KEW Capital China a Private Equity Fund and earlier as a consultant for Deloitte. Jenny earned her undergraduate degrees – in Economics and Journalism from Peking University. Jenny speaks native Mandarin and is a CFA level III candidate.

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To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – Chief Investment Officer, Co-Founder

Date: April 7, 2011

Re: First Quarter 2011 Update – A Nuthatch Concept™

Market Summary[1]:

	S&P 500	MSCI AC World Index	MSCI Emerging Markets	MSCI EAFE Index	Barclays Aggregate Bond Index	Gold – $/Troy Oz.	Crude Oil
Price 03-31-11	1325.83	343.64	1170.87	1702.55	1648.03	$1,432.30	$106.72
Q1 2011	5.92%	4.42%	1.95%	3.50%	0.45%	0.81%	16.79%
2010	15.06%	12.67%	19.04%	8.38%	7.00%	29.52%	15.15%
2009	26.47%	35.17%	78.51%	32.36%	6.37%	24.36%	77.94%
From March 6th, 2009 Lows	102.48%	107.87%	151.30%	97.53%	14.38%	52.48%	134.45%

First and foremost, our hearts go out to those in Japan affected by the tsunami and the related radiation threats. In addition to that catastrophe we have been following heightened political tensions and unrest in the Middle East and North Africa. Clearly, the past quarter has not been one of calm but rather calamity.

As stewards of your capital, we are evaluating opportunities that often surface when pessimism, fear and uncertainty are high. We feel secure with our portfolio, how it is behaving in absolute and relative terms in this environment and how we think it will perform under potential, stressful scenarios.

Equity markets delivered favorable total returns during the quarter registering gains of 5.92% for the S&P 500 and 4.42% for the MSCI All Country World Index. International benchmarks lagged behind domestic benchmarks as events escalated overseas. The MSCI Emerging Market Index logged a 1.95% return and the MSCI EAFE a 3.50% return. Commodity price pressure surfaced in force across the board. Crude oil leaped 16.79% during the quarter.

Our primary *investment* objective is to strive to achieve superior long-term capital growth with minimized risk of loss. We conclude that the attribution of our success historically has been and we feel will continue to be through studying and sourcing undervalued or mispriced investments.

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, MSCI Europe Asia Far East (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices.

We have also learned that a global macro perspective is a necessary overlay to limit tail risks and help expose the portfolio to secular tailwinds. In this light, we have given further thought to the polarity of forces at work in the macro environment. In the following section we share how our thoughts on this subject have evolved.

Global Macro *Tao* – "Yin Yang"

When we stop and listen to the cacophony of the marketplace the noise appears most deafening around uncertain macro and geopolitical outcomes. The consensus appears to be exaggerating the magnitude and swiftness of potential outcomes. It's during these times that it makes sense to elevate one's perspective. We believe there is a historical sea change underway whereby there are paths of considerable risk and conversely paths of great opportunity. Let me explain the "what" and the "why" – the "wu" and the "wei."

In Chinese philosophy "yin" and "yang" are complementary opposites that interact within a greater whole as part of a dynamic system. Yin yang is used to describe how polar or seemingly contrary forces are interconnected and interdependent, and how they give rise to each other. When defining yin and yang it is common to describe in terms of sunlight moving over a mountain. Yin literally means "shady place" and yang means "sunny place." As the sun moves across the sky, yin and yang gradually trade places with each other, revealing what was obscured and obscuring what was revealed.

One could argue that the world has been out of balance for some time. Only 25% of the world's population lives in the developed world, yet this group has been consuming 75% of output (GDP). This multigenerational yang phase led by the US, Europe, and Japan culminated in a leveraged induced bubble which imploded in 2008. The contrary force was the emerging countries, led by China, India, and Brazil which provided the inexpensive human capital and natural resources to serve the developed world's appetite. China, India and Brazil make up approximately 40% of the world's population.

Today we are witness to a seismic shift as the actors in these roles change places. Within our global dynamic system, a rising yang is represented by emerging countries and the waning yin has transitioned to the developed world. Westerners often confuse yin and yang with good and bad. That is inaccurate and this change should also not be interpreted as positive or negative for either party. It is a natural progression and there will be investment implications to consider as rebalancing occurs. We will need a rational and thoughtful process to anticipate risks and the opportunities that will materialize. It seems logical that we may need to invert our own developed world perspectives to ask the right questions and synthesize constructive answers.

The developed world appears not to have processed this paradigm shift and the emerging countries are not just aware; the process of change is culturally indoctrinated, particularly in China. The I Ching is one of the oldest of the Chinese classic texts and its philosophy is not only intrinsic to the Chinese culture, it is also seen by the Chinese as being the "universe in miniature." The principal message centers on the dynamic balance of opposites, the evolution of events as a process, and acceptance of the inevitability of change.

While investors have priced in imminent dramatic change, our differentiated view is with regard to the timing and structure of the prospective transformation. We anticipate a deliberate and prolonged rebalancing with China leading the emerging country *yang* cycle. Investors should anticipate the Chinese to follow a Taoist "wu wei" approach. This is defined as action that does not involve struggle or excessive effort - the paradox of action without action.

The *consumer* will be the driver of change and rebalancing. With the Middle East uprisings, one can observe just how interconnected the world is and more importantly the human desire to live a better life. We should not underestimate the power of the interconnectedness of technology and its effect on the aspiring emerging market consumer. Many of the imbalances that exist today in trade, currency reserves, and resource distribution will slowly solve themselves.[2] The newly minted *yang* consumer is and will be the linchpin.

At East Coast we are keenly focused on what businesses earn the right to sell goods and services as demand patterns evolve globally. We believe our biggest opportunity will come from the *consumer* force that will change over the years and decades to come. Simply put, we want to own global businesses that have a *localized* advantage. In the following section of the letter I describe what it means to be a local champion - a Nuthatch Concept™.

Below is a list of outcomes where we see reason to mitigate risk and position for opportunity:

1) Developed countries continue to exercise "force majeure[3]" and print money to debase the value of their debts. Unemployment continues to be a focal point of the developed world. Quantitative easing appears to be the medicine to quell further job losses. A US election cycle will incent the Federal Reserve and our Administration to err on the side of more stimulus.
2) Emerging countries play their hand deliberately and allow for their consumer populations to grow and rebalance mismatches versus sudden shocks that could drive social unrest.
3) Inflation will be heightened globally and accumulated wealth is at risk of losing purchasing power. Limit fixed-dollar investments.
4) We believe global equities will perform better than expected as investors seek an alternative reserve currency as paper currencies and bonds lose value.
5) High quality businesses that can raise prices and whose products have localized advantages with a growing emerging market consumer will thrive. We conclude that high quality businesses also represent the most attractive valuations from today's prices.
6) Interest rates continue to move higher to calibrate for real purchasing power erosion. Rates have already moved 100 basis points and upward pressure will continue.
7) We expect weakness in the developed world currencies (USD, Euro, and Yen) versus emerging country currencies which serves to increase attractiveness of developed world exports and helps bridge imbalances.

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[2] Chen Deming, China's Minister of Commerce, recently expressed his optimism on Chinese consumer demand in the high-end segment with the following comments: "In a few years, we will replace Japan as the No. 1 (luxury good importer); this is not surprising as China has a population of 1.3 billion people, which is 10 times that of Japan." According to McKinsey, sales of luxury items in China may more than double within five years to 180 billion Yuan ($27 billion) in 2015. CLSA forecasts that demand for luxury goods and travel from China will account for 44% of global sales by 2020, up from 15% currently.
[3] Referenced in our Q42010 Letter – "A Unified Theory of Investing."

A Nuthatch Concept™[4]

In the last two quarterly letters I highlighted "compounding" as our overarching goal and described how we think about "expected return". More specifically how IRR is the common and universal language we use to evaluate investment opportunities. This quarter I want to highlight the compounder category of the three investment categories we define: compounders, transformations, and workouts.

The compounder category has historically made up a disproportionate number of our portfolio positions, and for good reason. With the current opportunity set that exists to own "high quality" businesses, compounders represent more than two-thirds of our portfolio. A compounder is a competitively advantaged business that earns superior returns on invested capital. As cash earnings are reinvested back into the business, the value of the business grows year after year compounding our investment. If we buy at a discount to what we believe the business is worth, we will benefit twofold: by the growth of the intrinsic value and the market correction for the discount. There are two key variables when we evaluate a compounder: the competitive advantage of the business and the discrepancy between intrinsic value and quoted price. Competitive advantage can be fluid and fleeting, thus having a deliberate way to qualify this attribute is critical to success in this category.

Competitive advantage is very similar to evolution by natural selection.

In 1836 Charles Darwin returned from his voyage to the Galapagos Islands with fifteen passerine birds which have since become known as Darwin's finches. When he compared the finches to known species he noticed important differences. He found variances in the size and shape of their beaks due to adaptations for different food sources. Over the next three years, Darwin would conceive his theory of natural selection, ultimately proving to be the unified theory of the Life Sciences[5].

Natural selection is the process by which traits become more or less common in population due to consistent effects upon the survival and reproduction of their bearers. It is the key mechanism in evolution. Not only does this occur within a population of organisms, it also occurs in a population of businesses. Businesses that evolve have advantages that have allowed them to survive and thrive over their competition. In looking for a business that can compound its intrinsic value, we need to be aware of what drives competitive advantage and how that advantage changes over time based on the environment. Identifying these advantages correctly will determine the compounding effects of owning the equity of Apple Computer versus that of Polaroid Corporation.

Following Darwin's lead, I did not have to look further than my own bird feeder to reinforce these concepts. At our home in the White Mountains, where the weekend mornings lend themselves to bird watching, there are predominantly two species of birds competing for food at the feeder: the black-capped chickadee and the red-breasted nuthatch.

[4] TM - Trademark of East Coast Asset Management, Inc. - Federal Registration pending.
[5] Biologists in possession of this universal truth can trace key understandings and discoveries to "natural selection" principles. Last quarter we discussed how IRR (expected rate of return) is the universal truth that allows us to compare and contrast all investment opportunities. IRR discovery is our unified theory of investing.

The black-capped chickadee is a universally "cute" agreeable bird. They arrive in flocks and without much focus playfully swoop in and out in bouncy flight, feeding and singing. After the food source is gone they move on looking for the next meal or wait around in hopes of a refill. As I started to think about competitive strategy, the chickadee reminded me of the average corporation with an agreeable CEO. Just like the average corporation, chickadees compete with a large number of like competitors for the same food source. They expend considerable resources competing and playing for a small, often times cyclical, return. The return on their invested capital (energy and time) is average at best. They compete aggressively in one region and then move on to the next region without unique advantages, looking for food without any particular focus. The average corporation focused on growth for growth's sake often squanders away advantages that might exist in a region or product territory and is left to earn returns that either meet or fail to exceed the cost of capital they are employing on behalf of shareholders.

The nuthatch, in contrast, immediately garnered my respect because it has unique competitive advantages. The nuthatch is equivalent to a great business. For starters, nuthatches can do something that no other species of bird can do; they can walk down a tree head first[6]. Over time the species evolved to grow extra long toes with sharp toenails allowing it to cling to a tree with one foot and brace itself with the other. As in investing, where perspective is everything, the nuthatch has a unique perspective. Most creepers and woodpeckers find food by walking up a tree; by walking down head first, nuthatches are able to find bugs and store food that the other birds can't see. Not only is this an impressive Darwinist feat but it's also a Jacobian one at that. Carl Gustave Jacob Jacobi's maxim, "invert, always invert," expressing his belief that solutions to hard problems can be clarified by re-expressing them in the inverse could not be more notably illustrated here.

Not only does the nuthatch have a keen eye on competitive advantage with proprietary bipedal technology, how they compete is an even more striking and instructive analogy of how great businesses employ competitive strategy.

Nuthatches mate for life and one pair of nuthatches will settle and defend a territory year round. In some areas where the territories are small you may see pairs overlap on the edge of their region but it is quite rare. Nuthatches are not migrants and live their entire lives in the same area as they were hatched[7]. They will join loose flocks of chickadees, titmice, woodpeckers, and creepers as it affords them the protection of the flock without competing for food. They are the enforcer and leader at the feeder and will clear out other birds when they fly in to obtain food. After they eat a sufficient amount, they will then proceed to take additional food to a tree, walk down the tree, and store food from a competitor's sight. Not only are their actions of thrift impressive, even their nasal song "yank, yank, yank, yank" declares Yankee ingenuity. While they are fiercely competitive they welcome and honor allies. We have experienced this firsthand as we have had nuthatches feed from our hand[8] when trust is earned. This investor is always appreciative of a "bird in hand" – a certain advantage versus the mere potential of a greater one.

[6] A business that can do something their competitors cannot do has a supreme advantage. These advantages can be due to proprietary technology, patents, government entitlement and more commonly due to scale and supply advantages.
[7] This sounds very familiar to one particularly enlightened investor from Omaha, Nebraska.
[8] See picture of resident ECAM nuthatch resting on my hand in the White Mountains of New Hampshire.

What the nuthatch understands is that the most important attribute of a competitive advantage is to be a **LOCAL CHAMPION**[9]**.** Consider the phenomenal compounding success of Wal-Mart, Walgreens, or Wells Fargo. All these businesses first became competitively entrenched in a clearly circumscribed region. Only after consolidating their position in that region did they consider further expansion. Local competitive advantages also relate to a particular product space. Microsoft dominated operating systems for IBM's personal computers before it became a force in applications. Colgate-Palmolive dominates toothpaste globally. Competitive advantages that lead to market dominance are often bounded – either geographic or product specific.

The first groundbreaking book on competition was written by Michael Porter in 1980 called *"Competitive Strategy"*. While this book was a giant leap at how economic actors are motivated and interact, the book *"Competition Demystified"* by Bruce Greenwald and Judd Kahn offered a radically simpler approach. We feel Greenwald and Kahn's ideas correctly align greater emphasis on <u>barriers to entry</u> and the three related advantages any business would have: supply advantages, demand advantages, and economies of scale.

Greenwald and Kahn's insights on competitive advantage galvanized and refined my own mental models on competition, particularly the importance of geographic and product space <u>local</u> advantages. I decided to re-read the best selling strategy book *"Good to Great"* by Jim Collins to test out these refined concepts on competition. As I went through each business example with a "hedgehog concept"[10], highlighted as case studies in the book, my models were reinforced in that all these examples were <u>local champions</u>.

*A tenacious **<u>nuthatch</u>** strolls by and tips his striped cap to Darwin's finches and walks confidently head first down the tree toward the curled up nervous hedgehog and exclaims, "yank, yank, yank, yank, you are in my territory and I plan on being vigilant in defending it."*

East Coast is interested in compounding capital. Is there corroborating evidence that investing in local champions can drive superior investment returns besides just taking our word for it? I will share two model investors who have implemented these concepts better than anyone for decades.

The first well known example is the Warren Buffett/Charlie Munger team. The extraordinary record of Berkshire Hathaway has been on the shoulders of businesses that have localized competitive advantages including: Geico, See's Candy, Nebraska Furniture Mart, Borsheims, Coca Cola, and more recently Iscar Metals. Together with price, localization is the most discerning variable Warren and Charlie look for in purchasing a business.

The second example, perhaps lesser known to some, is the enviable record of compounding delivered by Steve Mandel of Lone Pine Capital. Steve was an analyst and portfolio manager at Tiger Management working with legendary investor Julian Robertson before the fund closed and Steve launched Lone Pine. In Steve's own words regarding what has worked for Lone Pine over

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[9] The term "Local Champions" was referenced in *"Competition Demystified"* by Bruce Greenwald and Judd Kahn. The word "local" is deservedly used 143 times in *"Competition Demystified"*.

[10] "Hedgehog concept" is derived from the story about the fox vs. the hedgehog. The fox, always quickly bounding forward to attack the hedgehog, is consistently met with the hedgehog's simple defense of rolling into a ball of spikes. Hedgehogs are not exciting; just very <u>consistent</u>. Collins uses this story to explain that most successful businesses have chosen to do one thing superior to their competition.

the years, "Our ability to identify businesses that have the market opportunity, product distinction, competitive advantage and management skill to grow earnings and cash flow for longer than is factored into consensus expectations has distinguished our investment effort over the years."

Misclassification is a common mistake in bird watching as a bird in flight or roost can be elusive. Classifying investments correctly can be equally challenging as businesses evolve. While I prefer to learn from other people's mistakes I wanted to share a blunder of my own where I misclassified a chickadee for a nuthatch. In the spirit of inversion, I often find more insight in what did not work[11] vs. what went well.

In May 2009 I attended J.P. Morgan's Global Technology, Media, and Telecom (TMT) Conference. On the final day of the conference John Chambers, CEO of Cisco Systems delivered a keynote speech.

After the 2008 equity market correction, Cisco Systems appeared to be a business with a Nuthatch Concept available at a reasonable price. We believed they had a localized product space advantage in routers and switches – the backbone of the internet. John Chambers is a dynamic CEO and on this morning he delivered a persuasive presentation. John did not perch himself on a podium but walked the room of 500 analysts making individual eye contact as he told Cisco's compelling story. Looking back, two moments of his speech should have alerted us to a fleeting competitive advantage. One is when he took his newly launched Cisco Flip camera off his belt and filmed the audience and the other when he announced 38 "adjacent" product categories they would be "investing aggressively" in to "get back to long term growth targets." The flock of analysts applauded in awe of his lofty objectives.

Had I focused my binoculars and consulted my North American bird field guide, I would have realized that Cisco was by no means a Nuthatch. What did that camera have to do with Cisco's core business? Why so much expansion? While dynamic, agreeable, and associating well in flocks of analysts, this CEO was competing for food in multiple territories without a competitive advantage. He had no unique ability to walk headfirst down a tree. Cisco Systems was a black-capped chickadee.

While shareholders participated in a spirited rally during the recovery of 2009, operationally Cisco has failed in meeting Wall Street's and their own expectations. As recently as this week, John Chambers was forced to issue a mea culpa admitting the company has lost its way and needs a major overhaul.

The Nuthatch Concept is a business with a durable competitive advantage; a business that can do something that its competitors cannot do - such as walk down a tree head first, and/or a business that is a local champion. Finding a business that has a Nuthatch Concept available for purchase at a reasonable price are the attributes we look for when accumulating a portfolio of *compounders*.

[11] One of the more brilliant speeches by Charlie Munger was to a graduating class of high school students in Los Angeles about "How to Live a Miserable Life."

Organizational Updates:

Christopher Begg - Adjunct Professor, Columbia Business School:
I have accepted a position as an Adjunct Professor at Columbia Business School teaching Security Analysis. My class will meet once a week on Wednesday nights for the summer semester. East Coast has worked closely with Columbia Business School over the last three years with our internship program. The Heilbrunn Center of Graham and Dodd Investing is the premier knowledge center for the practice and theory of investing. I am honored to be a part of the program that has included my hero, Benjamin Graham, who taught Security Analysis for nearly 30 years. Among Ben Graham's many successful investing students was Warren Buffett. The syllabus I have put together will look familiar to you as it aligns with the concepts and categorization we use at East Coast. I have included the link for your interest.

Headquarters –Essex, MA Office Space:
During the quarter we secured the remainder of our building at 16 Martin Street in Essex, MA which has and will continue to serve as our headquarters. We completed our renovations/build out and we have been able to breathe easier as we have doubled our square footage, adding extra offices, operations space, conference rooms, a kitchen, and storage space. We are fortunate that this location has been able to scale to our needs as a result of our growth over the last three years. This last addition of space will sufficiently meet the needs we anticipate over the coming years. We look forward to your next office visit to show you our new and improved space.

We continue to manage your capital with the utmost prudence and look forward to meeting and talking with you soon. We greatly value your support and trust.

> *"It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most adaptable to change."*
>
> Charles Darwin (1809 - 1882)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
Chief Investment Officer, Co-Founder

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To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – Chief Investment Officer, Co-Founder

Date: July 11, 2011

Re: Second Quarter 2011 Update – Finding Longitude – H4

Market Summary[1]

	S&P 500	**MSCI AC World Index**	**MSCI Emerging Markets**	**MSCI EAFE Index**	**Barclays Aggregate Bond Index**	**Gold – $/Troy Oz.**	**Crude Oil**
Price 6/30/2011	1320.64	341.82	1146.22	1708.08	1658.03	$1,500.35	$95.42
YTD	6.02%	4.96%	0.83%	5.37%	2.35%	5.60%	4.42%
Q2 2011	0.10%	0.42%	-1.10%	1.80%	2.37%	4.75%	-10.59%
2010	15.06%	12.67%	19.04%	8.38%	7.00%	29.52%	15.15%
2009	26.47%	35.17%	78.51%	32.36%	6.37%	24.36%	77.94%
From 3/6/09 Lows	102.69%	108.74%	148.53%	101.08%	15.21%	59.72%	109.62%

Equity markets delivered flat total returns during the quarter registering gains of 0.10% for the S&P 500 and 0.42% for the MSCI All Country World Index. International benchmarks were also anemic with the MSCI Emerging Markets down 1.1% and the MSCI EAFE up 1.8%. While gold moved 4.75% higher, some commodities including oil pulled back materially as the economy showed signs of weakening.

Headlines related to unemployment and pending stimulus expirations have unnerved investors this quarter. As a consequence, equity markets proved volatile with fears that the recovery has been held together by government fiscal and monetary stimulus and when removed the economy will once again spiral into a deep recession. While we have considered this outcome, the weight of the evidence continues to point to a more inflationary scenario. Binary outcomes, such as this, can often be solved through analyzing the source of the greatest incentives.

When Charlie Munger spoke about the Psychology of Human Misjudgment to Harvard Law School students he stated "I think I have been in the top 5% of my age cohort all my life in

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, MSCI Europe Asia Far East (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices.

understanding the power of incentives, and all my life I've underestimated it." We conclude that it is not economically or politically feasible to do anything but print money. A "do not fight the Fed" mantra is very instructive right now and it could even be expanded to "do not fight a Fed backed into a corner with no way out." The Fed's incentives lie squarely on preventing further job losses, leading this administration into the best chances of re-election, and resetting the bar through debt debasement of post credit bubble developed world liabilities.

We believe that the Fed's planned wealth effect is truly a wealth illusion effect. While asset prices may climb they will only rise alongside inflation. Printing money moves in a direction of solving the critical incentives that are "front of mind" with central banks. We do not see a strong incentive bias to the contrary that would lead us to believe we are going down a path of austerity measures. In this regard we have been and continue to operate with extreme care in protecting the purchasing power of our clients' wealth. Accumulated wealth is at greater risk of purchasing power loss than the principal loss of owning a high-quality, competitively entrenched, reasonably priced businesses.

Portfolio construction continues to be a balancing act. Weekly, we ask where the consensus is today and observe that most do not share our viewpoint. Winning by not losing in a world of heightened inflation is a completely different paradigm for investors with thirty years of reinforced biases to the contrary.

El Mirador – An Elevated Perspective

During a recent trip to New York City I learned that the New York Botanical Garden had opened an exhibition called *"Spanish Paradise – Gardens of the Alhambra."* I was intrigued having studied in the shadow of the Alhambra at the Universidad de Granada my junior year in college. With Manhattan temperatures nearing 100 degrees and a few hours to spare I headed to the Bronx to beat the heat and feed my curiosity.

The curator explained that Spanish garden architects often endowed their gardens with a *mirador,* the Spanish word for a place from which to experience an elevated view. The definition of the word *mirador* reminded me of my time in Spain. I remembered the feeling of going from the comfort zone of a Cape Cod summer to living with a Spanish family and being immediately forced to communicate in Spanish. I recalled the sardine-like experience of taking the city bus from my new suburban home to the center of Granada only to be quickly engulfed in the noise and congestion of a city pitched by the buzz of mopeds. My immersion into Spanish life delivered more of a culture shock than I anticipated. I decided after a few weeks of this routine that I needed a means of capturing back some personal space so I went to the neighborhood equivalent of a K-Mart and purchased an inexpensive mountain bike. This would become my transportation and my means of regaining some perspective.

During siesta and before afternoon class I would ride my bike to the hilltop town of Abaicin that is situated above the Alhambra. It is there that claims one of the most beautiful views in Granada and perhaps one of the most notable in the world - El Mirador de San Nicolas. Not only can you see the Alhambra in its entirety but you can also see the bustling city of Granada with the white-capped Sierra Nevada Mountains in the distance. It was from this elevated vantage point where I was able to appreciate my surroundings and experiences versus getting caught up in the emotional biases that were distorting my sense of reality.

I reserve this section of the letter for a similar purpose. The emotional ebb and flow of the market can give the impression that a baseline reality does not exist. While we focus much of our energy on bottom-up fundamental analysis, it is a necessity to elevate our perspective to a *mirador*. This is not only an essential part of our investment process, it is a means of sharing with our clients and interested parties where we are finding pockets of opportunity, what prices impute about expected return, and the tail risks we have identified that we need to mitigate or hedge.

From this perspective we surmise the following:

1) Force Majeure: Developed countries continue to exercise "force majeure[2]" and print money to debase the value of their debts. Unemployment continues to be a focal point of the developed world. Quantitative easing appears to be the medicine to quell further job losses. A US election cycle will incent the Federal Reserve and our administration to further enact stimulus measures to keep the status quo on unemployment and GDP. Anything more anemic would be politically intolerable.

2) Emerging Consumer Rebalances Imbalances: Emerging countries play their hand deliberately and allow for their consumer populations to rebalance mismatches versus sudden policy changes that could drive social unrest. Last quarter we discussed the cultural biases of China to not force change but to allow change to occur as part of normal rebalancing. The emerging consumer will be the change agent. Developed world currencies depreciate against emerging currencies.

3) Inflation and Interest Rates – A New Norm: Inflation will be heightened globally and accumulated wealth is at risk of losing purchasing power, therefore we will limit intermediate and long-term fixed-dollar investments. We expect a prolonged period of inflation which is the side effect of the medicine the developed world is administering to remedy the disease of debt that exists due to the credit bubble. Interest rates continue to move higher to calibrate for real purchasing power erosion. Rates have already moved 100 basis points and upward pressure will continue.

4) Global Equity Performance Continues to Climb a Wall of Worry: We believe global equities will perform better than expected as investors seek an alternative reserve currency as paper currencies and bonds lose value. Asset based inflation will also be a "full-moon" tide lifting most boats. Nominal returns will give the impression of wealth creation but real returns net of inflation adjustments will be more modest.

5) High Quality Global Equities – A "Mispriced[3]" Lunch: High quality businesses that can raise prices and whose products have localized advantages with growing emerging market consumers will thrive. We are finding a number of businesses trading at 6-10% free cash flow yields selling goods and services into growing markets.

[2] Referenced in our Q42010 Letter – "A Unified Theory of Investing."
[3] Not to directly offend the Modern Portfolio Theorists who contend no free lunches exist.

Finding Longitude – H4

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This quarter I want to share a concept with you that has more or less defied words for me throughout my investing career. While I have failed to articulate it effectively, I believe it to be, and it has been a primary objective of our research process. Great investors, defined by a long history of superior rates of compound returns, have been equipped with this ability. For years I have referred to this as "finding the critical data points" of the investment opportunity. It's the cornerstone of an investment thesis that will determine compounding success and our margin of safety. That description is forgettable, ambiguous, and falls short of describing the objective. In studying great investors equipped with the ability to sort through the complex to see the elementary, I observed they too also found this attribute beyond words. For success in anything: science, the arts, investing - one must arrive at simplicity. Investing success is a journey and investing genius is about determining your location from port to port along your "compounding" exploration. I submit to you an ideal to which we aspire with every investment opportunity we employ. At East Coast, we refer to this as Finding Longitude – which we symbolically endow as H4.

From the time the first boat set sail until the late 18th century, determining a way to find longitude at sea posed a big problem for sailors. Finding ones latitude proved quite straightforward using the sun and the stars. By looking up in the night sky and finding the big dipper and then following the right side of the cup, the first bright star one sees in the northern hemisphere is Polaris. You can then approximate the angle between the horizon and Polaris and arrive at a degree of latitude. At sea, where we do not have any fixed points west or east, finding longitude is not as easy and in fact over hundreds of years many lives and fortunes were lost as this unsolved puzzle vexed even the brightest minds. The concept of discovering the longitude became synonymous with attempting the impossible.

With no mechanism to find longitude, a captain would generally run north or south to the latitude of their port destination and then sail the parallel. This was the technique Columbus was using in 1492 to sail to Asia had not something got in his way. Long voyages were made even longer without longitude data and the extra time at sea often condemned the crew to disease. Oceangoing vessels would confine themselves to shipping lanes where collectively they would have the best chance of safe passage. These well-trafficked routes became a plundering ground for pirates and warships. In 1592 a squadron of six English men-of-war captured the Portuguese galleon *Madre de Deus* on its voyage back from India. The *Madre de Deus's* princely cargo included gold, silver and spices by the ton estimated at 500,000 pound sterling which was equal to half of the English Exchequer at that time.

In 1707 England lost four war ships and all 2,000 hands when their ships lost their longitude and found themselves on the rocks of the Scilly Isles. With so much lost to the problem of longitude, the need to find an answer was now of national importance. Shortly after this tragedy, the Parliament of England established a Board of Longitude and the famed Longitude Act of 1714 which would award a prize of 20,000 pound sterling for the most accurate solution and lesser awards for less precise solutions. As you can see from the table below, these prizes in today's dollars at different compounding rates were a rich reward. Parliament was certainly serious about finding a solution.

The Board of Longitude thought they would find the answer in the stars just as they had with latitude. Many members of the board were actually esteemed astronomers such as Sir Isaac Newton. However, little did they know the most accurate solution would be found in "time."

Board of Longitude – Prizes	Reward	2011 Value[4]	Joys of Compounding @ 6.5%
within 60 nautical miles	£ 10,000	£ 1.37mm	£ 1.3 Trillion
within 40 nautical miles	£ 15,000	£ 2.06mm	£ 2.0 Trillion
within 30 nautical miles	£ 20,000	£ 2.75mm	£ 2.7 Trillion

It was known for many years that a potential solution to longitude could be found by knowledge of the time and longitude of one's home port[5] versus the measured time at the ships current position. The earth takes 24 hours to revolve 360 degrees, one hour marks 1/24 of a revolution or 15 degrees and so each hour's time difference between the ship and starting point marks a progress of fifteen degrees of longitude to the east or west. Every day at sea, the navigator would reset his ship's clock to local noon when the sun reached its highest point in the sky; and then would consult the home port clock. Every hour's discrepancy between the two clocks translated into fifteen degrees of longitude.

The problem that plagued this solution was there was no device that could keep accurate time at sea. In 1714 when Sir Isaac Newton briefed the Board of Longitude he brought up the time solution and implied it was an improbable answer to the problem: "One method is by a watch to keep time exactly. But, by reason of the motion of the ship, the variation of heat and cold, wet and dry, and the difference of gravity in different latitudes, such a watch hath not yet been made."

A Yorkshire carpenter named John Harrison had something to say about that. As astronomers began mapping the heavens for an answer, John Harrison was honing his skills as a master craftsman of clocks. His revolutionary "gridiron" and "grasshopper escapement" inventions made his pendulum clocks among the most accurate clocks being made at that time. By 1727, Harrison had turned his attention toward the longitude prize and the unique challenge of marine timekeeping.

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[4] We used the UK Retail Price Index which implies a 1.67% annual compound inflation rate.

[5] This was made easy for a ship leaving the Thames River and the town of Greenwich, England at zero degrees Longitude – the prime meridian.

By 1735 John Harrison had completed his first marine timekeeper – Harrison's Number 1 which has since been known as H1. Weighing in at 75 pounds, the clock was ushered in with a hero's welcome at the Royal Society in London. As it was being prepared for a West Indies trial, Harrison, a perfectionist, listed the ways he planned on improving his device and asked the board not to reward him yet but to instead underwrite his efforts to build his next version, H2.

In 1742 Harrison presented H2 to the board with a comparable list of refinements and evolutions he would make to his next timekeeper. In similar fashion, he asked them to once again bypass the sea trial even though it was likely accurate enough for prize money. He wanted a stipend to underwrite his efforts to build his third sea clock. Harrison went back to his workshop and started H3 which he referred to as his "curious third machine."

It would take Harrison 19 years to build H3 with its 755 individual parts and revolutionary improvements, a bi-metallic strip to deal with varying temperatures and an antifriction device of caged ball bearings which is still used today in almost every machine with moving parts. Given the fact that ship clocks were kept in the Captain's quarters, H3's size was shipshape weighing in at a svelte 60 pounds and a more manageable 2 feet in length.

Harrison was still not satisfied. After working on building a pocket watch with a London clockmaker John Jeffries, he used that knowledge to build H4. In just two years, John Harrison completed H4. It looked nothing like his previous three timekeepers, but rather a like a large pocket watch 5.5 inches wide and weighing only 3 pounds.

Harrison expressed his pride saying "I think I may make bold to say, that there is neither any other Mechanical or Mathematical thing in the world that is more beautiful or curious in texture than this my watch or Timekeeper for the Longitude…and I heartily thank Almighty God that I have lived so long, as in some measure to complete it." Nearly 70 years old, Harrison's H4[6] would go on to win the award from the Board of Longitude and since has been memorialized as the <u>first marine chronometer</u> able to keep accurate time at sea. It was the key to solving the puzzle of finding longitude.

Finding Investment Longitude

When I read about the plight of "finding longitude" I immediately thought about the journey of the investor. Just as a sea captain was rewarded handsomely for delivering his cargo safely and efficiently, an investor can maximize his compounded rate of return by having a successful, repeatable process in a sea of investment opportunities. Knowing one's coordinates with accuracy is a critical attribute which will determine the absolute value of an investor's degree of success. Just as with the longitude prize, the reward is great.

I observe that most individual investors invest with their "portfolios on their sleeve" and are often driven off course by emotions, commonly fear and envy. This is the equivalent to being lost at sea with no idea of latitude or longitude. Most professional investors have a good idea how to

[6] Harrison's H4 and the three other Harrison brethren live at National Maritime Museum at the Royal Observatory in Greenwich. It is quite fitting that this is the site of the Prime Meridian that marks zero degrees longitude which runs directly through the observatory. At night a laser beam shoots out from the royal observatory nearly 10 miles directly over Essex, England. With our headquarters in Essex, MA we appreciate the symbolism.

find their latitude. With trusty investment tools, these investors run the parallels on well-travelled trade routes huddled together feeling safe in larger numbers. Their latitude coordinates are often marked by price to earnings multiples, next quarter's earnings per share estimates, management guidance, growth estimates, and ideally a cheery consensus. The professional investor's chance of excess returns is lost to the equivalent of piracy and capture when consensus expectations prove otherwise.

For investors that can determine their longitude at sea the rewards are exponential. Investors who know their latitude and longitude can travel a great circle[7] to their destination ultimately maximizing their IRR's and arriving at the joys of compounding. This perspective allows the navigator to travel with a margin of safety on less travelled passages that purposely avoid crowded trade routes. Knowing one's location also allows the navigator to avoid dangerous obstructions marked clearly on the equivalent of a navigational map, the investor's process, or engrained in the investor's "mental models."

John Harrison gave the world H4 – the first marine chronometer that could correctly determine longitude. <u>The investor's equivalent of H4 is the ability to infinitely refine a thesis to the critical data points</u>. This mastery of industry and company economics to arrive at investment baseline drivers is a rare skill set. There are two investors that intellectually summon H4 in every investment opportunity they employ.

The first investor is quite obvious, Warren Buffett. When you listen closely to Warren describing important drivers of a business he owns, what he is whispering is longitude coordinates. Warren has up to date datasets in his head that are critical to how businesses will perform. With these baseline assumptions he can determine how the business is operating, its long-term economics and the ability to decipher cyclical challenges versus operational missteps.

When Warren Buffett is talking about Burlington Northern, Coca Cola, Wells Fargo, or the economy as a whole, he will generally mention a dataset that is meaningful to the coordinates of that business or the specific economic example. Berkshire Hathaway owns many businesses in different industries yet Warren Buffett can quickly deduce each one with precision as to what are the key drivers or longitude that will allow that business to earn attractive returns on capital.

The second investor in possession of H4 insights is Glenn Greenberg. Greenberg, formerly of Chieftain Capital and most recently Brave Warrior, has an enviable record of compounding success and finding investment longitude.

I invited Glenn to speak at the Security Analysis course I am teaching this summer at Columbia Business School. In preparation for his visit, Glenn sent me a memo he asked me to share with my students. His memo included an Albert Einstein quote and five Value Line tear sheets of businesses he owns including excerpts of a recent earnings call transcript for each. The quote read:

"Not everything that counts can be counted, and not everything that can be counted counts."

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[7] The fastest route between two points when navigating the earth is not a straight line but a great circle.

Glenn's discussion was brilliant as he shared some examples how he thinks about a business and its long-term economics. Regarding management, he shared the CEO leadership attributes he looks for when investing in a business. Weaved throughout each example was his summary of each investment's longitude. It is in my opinion that this unique skill has been a key attribute of his superior investment record. His insights heralded H4 and I quote as follows.

> *"I've just found that it's very easy for me to zero in, after studying something for a few hours, the key make or break factor that makes it interesting. And that's with any of the investments that we have that you can boil it down to a fairly simple theory. And you're constantly looking for why that theory might be wrong. But the likelihood of it being, severely wrong is probably small."*

> *"I really felt that when I watched A Beautiful Mind about John Nash. In the movie, they showed Nash analyzing formulae and then it showed how it looked to him and it was like some things were really bold. And I understood exactly what he felt. I see a lot of times people are just totally caught up in the minutia and the details. A lot of the questions on earnings calls I listen to, people are getting into stuff that's not going to move things one-tenth of one percent. It's just not important and then people are really focused on it and they're missing the really important stuff."*

Glenn and Warren are exceptional investors because they have an advantaged way to circumvent the risky well-trafficked routes where investors fall prey to one another. In contrast, these great investors seek out passages that offer a greater margin of safety toward superior compounding realization. This skill set is available to anyone willing to do the work required and share a perspective that allows one to arrive at simplicity.

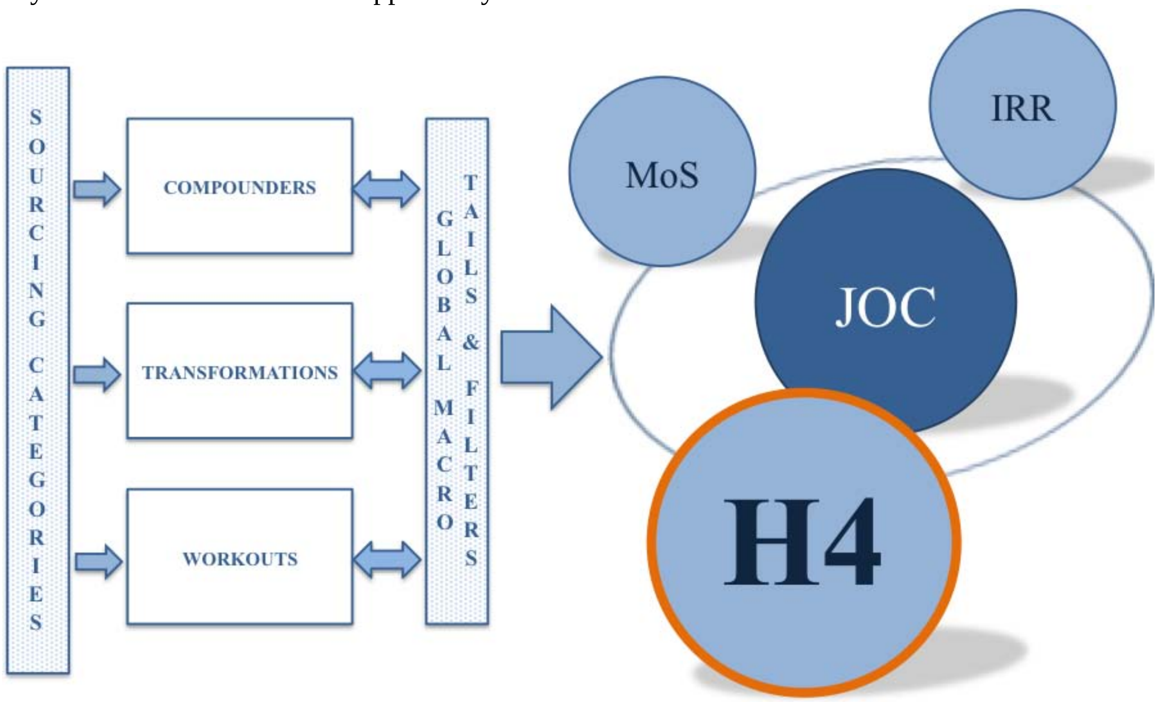
Knowing one's longitude becomes infinitely more important during time periods of inclement weather. Countless ships were decimated on shores and shoals when their visual position of longitude was obscured by storms. During the most recent 100-year storm that ravaged our financial system, it was those investors that were confident of their position that were not only able to survive but were also able to invest opportunistically when others were paralyzed with fear.

East Coast's Application of H4

We discussed investment edge[8] in our fourth quarter 2010 letter noting that if we have had or will continue to have an investment edge it will come down to three things: infinite refinement, perspective, and synthesis (IPS). Finding Longitude and possessing H4 insights is the product of employing IPS. When we have infinitely refined our thesis, when our perspective is contrary to consensus thinking, and we have garnered a variant insight through synthesizing information we have arrived at the essence of H4. We have thus arrived at what Glenn Greenberg referred to as the <u>emboldened insights that are at the core of the investment thesis</u>.

[8] East Coast Q42010 Letter – "A Unified Theory of Investing" – page 7 – "Edge: Infinite Refinement, Perspective and Synthesis (IPS)"

While there may be several ancillary objectives around this statement, we believe successful investing is compounding. In 1963 Warren Buffett wrote his early Buffett partnership letters on the attributes of compound returns and coined those semi-annual essays the "Joys of Compounding". We have referenced this title in a previous letter and refer to this objective symbolically as JOC[9]. In striving for this compounding goal we seek answers to three primary questions when analyzing an investment for inclusion into our investment portfolio: What is our expected compounded rate of return - *IRR*? What is our margin of safety - *MoS*? What are the key drivers of this investment opportunity– *H4*?



Our compounding universe is our portfolio. If we are to be successful in compounding capital at superior rates of return every investment in the portfolio must share these three attributes; it must have an attractive expected rate of return compared to other available opportunities - IRR, the absolute discount to intrinsic value and exposure to what might go wrong must leave us with a significant margin of safety - MoS, and finally we must be in possession of those critical data points that give us our command to either batten down the hatches and stay the course or when necessary abandon ship when the inevitable storm arrives - H4.

An investment opportunity will make it into our compounding universe, our portfolio, by going through the process we have illustrated above. We are seeking opportunities in the following three investment categories; compounders, transformations, and workouts. Last quarter we wrote about the compounder category in the letter titled "The Nuthatch Concept."[10] We harness approximately 15 sourcing categories that have proven to produce a steady stream of mispriced opportunities into these three categories. We compare this flow of ideas each week to see if they have the surface level MoS, IRR, and H4 attributes worthy of additional work. When ideas have

[9] East Coast Q32010 Letter – "Joys of Compounding - Revisited"
[10] East Coast Q12011Letter – "A Nuthatch Concept"

merit they are run initially through a "Phase 1" checklist and, if still attractive, ultimately a full thesis report.

Our "global macro" overlay is both a filter and a source of ideas. Any idea being researched for inclusion in the investment portfolio will be contrasted against our consensus versus edge[11] assumptions, our rank ordered global macro tail risks, and environmental, social, and governance tail risk filters. As a source of ideas, we maintain a rank-ordered micro theme list of industries experiencing tail winds and we maintain expected return data on asset classes and industries that can sometimes, more often in the extremes of over or undervalued climates, give us indications of value from a top-down perspective.

For those of you that like to solve puzzles, embedded in the illustration of H4 at the beginning of this section are six "value investing" references. I would enjoy hearing from you if you can solve all six.

Organizational Updates:

Gary Pomerantz, CFP – Senior Managing Director, Principal: We could not be more pleased to welcome Gary as a Senior Managing Director and Principal. Gary comes to East Coast from Lexington Wealth Management where he had a thriving practice, advising families for many years. His prior advisor roles were with Wingate Financial Group and TFC Financial Management. Gary also served as a Financial Planning Consultant at Harvard University. He continues to occupy a niche in advising the academic community of leading institutions. Gary graduated Phi Beta Kappa and magna cum laude with distinction from Boston University where he received dual degrees in Political Science and Journalism. Gary has earned the Certified Financial Planner™ designation.

John Slupski, CFP – Managing Director: We are also thrilled to announce the addition of John Slupski as a Managing Director. Prior to joining East Coast, John was Chief Investment Officer at Pegaesus Advisors, Inc and brings 12 years of highly personalized investment and financial planning experience to our team. John received his MBA with high honors from Boston University in 2001. He graduated from Boston University cum laude with distinction in 1990 with a BA in Political Science and a BS in Journalism. John has earned the Certified Financial Planner™ designation.

Jane Bolger, CFP – Director of Operations: The Director of Operations is the unsung hero of a successful investment group. Knowing this we took several years to find just the right person, as such we welcomed Jane Bolger to our team in June. She has spent the last 7 years at Cabot Money Management in leadership roles on their operations team where she worked closely for many years with our partner, Michael Kozak. We asked Jane to hit the ground sprinting and she has answered the call immeasurably. Jane is the friendly voice you may talk to when service matters arise.

[11] East Coast Q22010 Letter "Consensus versus Variant Perception"

Jack McManus, CFA – It is with sweet sorrow to report that we have retired an important number here at East Coast. Jack has been invaluable to our success as he wore just about every hat possible at our firm over the last three years. Jack, his wife and son have decided to move to be closer to family. We wish Jack the best and cannot thank him enough for his loyalty, professionalism, and lasting mark on our organization.

Associate Research Analysts: We welcome more "Mikes" to our ranks, Mike Xanthopoulos and Michael Keegan. Our new recruits joined us in May and will be with us until September of 2011. As noted in earlier letters, East Coast partners with the Value Investing/Investment Management curriculums within the MBA Programs at Columbia University, the Ivey School at the University of Western Ontario, and Boston College. We have included Mike and Mike's Bios in the Appendix.

We continue to manage your capital with the utmost prudence and look forward to meeting and talking with you soon. We greatly value your support and trust.

"I was like a boy playing on the sea-shore, and diverting myself now and then finding a smoother pebble or a prettier shell than ordinary, whilst the great ocean of truth lie undiscovered before me."

Sir Isaac Newton (1642 – 1727)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
Chief Investment Officer, Co-Founder

Appendix:

Associate Research Analysts:

Michael Keegan, Associate Research Analyst:

Michael is an Associate Research Analyst at East Coast. He is entering his second year in the full-time Master of Business Administration program at the Boston College Carroll School of Management. Mike earned a B.S. in Business Administration with majors in finance and marketing from Marquette University. Prior to graduate school, he worked as an Analyst for Aon Corp. in the Finance department and more recently as an Analyst for CB Richard Ellis in the Corporate Real Estate department. He is currently a Level 2 candidate for the CFA designation.

Michael Xanthopoulos, Associate Research Analyst

Michael is an Associate Research Analyst at East Coast focusing on alternative investments and equities. He is currently enrolled full-time in the Master of Business Administration program at the Boston College Carroll School of Management. Michael earned a B.A. in Economics and Business and a minor in English from Lafayette College. Prior to graduate school, he spent four years living in Washington, DC and working for Cambridge Associates, most recently as a Senior Hedge Fund Performance Analyst in the Arlington, VA office.

EAST COAST ASSET MANAGEMENT

To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO, Chief Investment Officer, and Co-Founder

Date: October 12, 2011

Re: Third Quarter 2011 Update – **"Testament of a Fisherman"**

I am honored to write this letter as we celebrate East Coast's third anniversary. I look around at our expanded team and see a determined group of seasoned professionals keenly focused on building the best investment management firm possible. While we are proud of our progress, the investment landscape and our clients' unique challenges are no less complex than they were when we launched in the midst of the 2008 financial crisis. With new puzzles to solve we charge ahead. Thank you for your trust, friendship, and the great responsibility you bestow on us to work on your behalf. This mandate gives us the privilege and fortitude to build a business that will allow us to meet our client's evolving objectives as well as make rational investment decisions in an ever-changing investment environment.

Market Summary[1]

	S&P 500	MSCI AC World Index	MSCI Emerging Markets	MSCI EAFE Index	Barclays Aggregate Bond Index	Gold – $/Troy Oz.	Crude Oil
Price 09/30/2011	1131.42	1104.06	880.43	1373.33	1658.03	$1,623.97	$79.20
YTD	-8.68%	-13.22%	-21.85%	-14.57%	6.47%	14.30%	-13.33%
Q3 2011	-13.87%	-17.32%	-22.49%	-18.92%	4.03%	8.24%	-17.00%
2010	15.06%	12.67%	19.04%	8.38%	7.00%	29.52%	15.15%

Equity markets reacted negatively to political and macro-economic instability in the third quarter. In the US we witnessed the debt ceiling debate and in Europe the survival of the European Union appears to be in jeopardy. The S&P 500 fell 13.87% during the third quarter and MSCI All Country World Index lost 17.32%. International benchmarks were even weaker with the MSCI Emerging Markets down 22.49% and the MSCI EAFE down 18.92%. While gold moved 8.24% higher, most commodities pulled back materially as the economy showed signs of weakening. We are very pleased with how our holdings have performed in this environment and as usual you will find your portfolio performance and positioning in your quarterly report.

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, MSCI Europe Asia Far East (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices.

Developed World Debt - Cardiac Arrest and Treatment Regimen

We live in a post credit bubble world. When the bubble popped in 2008, a meaningful percentage of the excess debt was transferred through bailouts and bankruptcies from over-leveraged businesses and individuals to government balance sheets. These sovereign central banks have further expanded their debt burdens through stimulus actions to help mitigate the inevitable slowdown as the world recalibrates to normal spending levels. We are in Phase 2 of this cycle where these sovereigns now must figure out how they can afford to pay off these debts. There are only three solutions to deal with this new reality: tax more, spend less, and/or "inflate away"[2] debt.

The sovereign debt issue is a developed world disease yet it is contagious given the fact that developed countries still consume nearly two-thirds of the world's output. The developed world is a very sick patient. Our elected officials, with differing viewpoints, are the doctors charged with the responsibility to administer the right cocktail of tax more, spend less, and inflation the patient should receive. This has and will continue to be a hotly contested political debate. The United States debt ceiling fiasco and ultimate credit downgrade was proof of just how ridiculous things can get. At least in the case of the United States, we have only one culture politicizing the right medicine. In Europe we have doctors from 17 different countries trying to arrive at a treatment regimen for a patient currently on life support.

The reality is the United States, Europe and Japan are in intensive care after a near fatal heart attack. While these three regions require a long term course of medicine around tax more and spend less, there will be life-saving procedures required to keep the patient alive during the expectant recurrence of other cardiac infarctions. The printing press is the crash cart, perhaps more aptly named "cash cart", which will revive these countries until they are well enough to leave the ICU to continue on their long-term meds of tax more and spend less.

We are fortunate that Bernanke understands this regimen better than most. Dr. Bernanke is a student of the Japan case study where the patient endured a decade long coma because CPR was administered when the defibrillator[3] paddles should have been used. Bernanke will continue to administer the appropriate medicine when it is politically acceptable, which usually means after a cardiac event. Today the "cash cart" has been wheeled over and the US is receiving some "inflate away" to restore effective rhythm. "Inflate away" has been around for hundreds of years and is typically evoked after a credit binge when countries have their own reserve currency. In these cases, it is the treatment with the greatest efficacy. Alternative treatments after a credit binge that rely only on austerity and tax increases can bring on a prolonged recession and at worst depression scenarios that are unpleasant and politically intolerable.

Dr. Bernanke will continue to use the "cash cart" when the United States goes into cardiac arrest and he will get creative so not to bore us with how he describes the "inflate away" medicine. He

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[2] As the government creates money out of thin air to pay its obligations it serves to reduce the purchasing power of those dollars. However, the debt for the most part is a fixed amount. Inflation is a good thing for debtors and a bad thing for creditors. Thus these actions are serving to "inflate away" the value of the debts.

[3] A defibrillator does not restart the heart. It *stops* a dysfunctional rhythm (e.g. pulseless tachycardia: beating too fast without effective pumping, or fibrillation: irregular beating without pumping) in the hope that the heart's intrinsic mechanisms will restore an effective rhythm.

might call it quantitative easing, this quarter he coined a new term naming the medicine a "twist" - a scheme to sell short bonds and buy long bonds. Just as we have a lot of brand names for ibuprofen like Advil or Motrin, don't be fooled by the names our Fed Chairman is prescribing as it is 100% pure "inflate away."

There has been a change in rhetoric that has shifted dynamically from austerity to jobs. A jobs focus is stretching across party lines and borders and we find this data point particularly important. A focus on jobs here in the United States and across the globe will drive the political fortitude to use the power and efficiency of money supply to remedy an ailing world. If you pick up a newspaper in any country you will see the social unrest due to a frustration over citizens seeking work. We see this today in our country with the Occupy Wall Street protests. We ask ourselves, if a jobs focus becomes the "elephant in the room", what political motivation will there be to use larger doses of the slower release medicine of tax more and spend less versus a more direct mainline infusion of "inflate away"?

We conclude that the remedy of the jobs dilemma will ultimately be housing. The credit binge put homes in the hands of people that could not afford them. Now we need time for household formations to sop up the excess inventory of homes created during the binge. When we see these levels equalize we will begin to see meaningful job growth which will bring overall unemployment down. Jobs that are directly and indirectly related to housing make up a large part of our economy. Housing is in a great depression scenario right now while the rest of the economy is recovering.

Our prognosis on the equity markets from these attractive valuations is quite bullish. However, we expect corrective periods to occur during this recovery like the one experienced in the third quarter. While we plan on taking full advantage of buying opportunities that occur during these episodes, we feel trying to time getting out of equities before every dip to be a futile, foolish, and truthfully, a nearly impossible activity.

In Europe, the patient is nearly flat lined with a very irregular heart beat; if the 17 countries of the European Union do not get together and administer life-saving coordinated money printing medicine, the EU will cease to exist. We have looked carefully at the various scenarios that could unfold and we have talked to experts on this topic. We conclude that key players such as Germany will eventually act appropriately to keep the EU intact through a large-scale bail out of the weaker EU constituents.

The inevitable "inflate away" remedy has many implications for long-term investors with accumulated wealth. The value of paper currencies will be worth far less in the future, just as the purchasing power equivalent of the dollar has lost 95% of its value since 1930. Investors should not feel overly secure in bonds and cash and should be looking to allocate capital to areas that can survive and thrive in an "inflate way" paradigm.

There is a very large disconnect between the prevailing emotional sentiment and truth. The vast majority of investors are tightly huddled in a consensus of uncertainty and fear. Fundamentals and merit appear in solitude at the edge of chaos. The questions of the majority are the same and the cacophony of the echo chamber deafening. We sadistically love these environments for the bargains they produce. We are in awe of the opportunities that exists in the world today for the investor who can raise their focal point beyond the myopic chaos of the here and now. Below I have summarized how we are constructing our portfolio to mitigate global macro risks and position for compounding opportunities.

Portfolio Construction – GO!

When I was younger my father introduced me to the game of GO. GO is an ancient board game played between two players that originated in China over 2000 years ago. Very simply the object of the game is to use stones to surround a larger portion of the board than the opponent. Placing stones close together usually helps them support each other and avoid capture, while placing stones far apart creates influence across more of the board. The strategy of the game stems from finding a balance between these conflicting interests. Players strive to serve both defensive and offensive purposes and choose between tactical urgency and strategic plans.

Dr. Henry Kissinger summed up the game with the following description “Chess has only two outcomes: draw and checkmate. The objective of the game is total victory or defeat – and the battle is conducted head-on, in the center of the board. The aim of GO is relative advantage; the game is played all over the board, and the objective is to increase one's options and reduce those of the adversary. The goal is less victory than persistent strategic progress.”

Portfolio construction for us should always resemble a GO board. We want to build offensive strategies toward our <u>long-term strategic compounding goals</u> in balance with the tactical urgency of the existing economic and political environment. Today we are finding great opportunities to own the equity of the some of the best businesses in the world at bargain prices. <u>We have continued to raise our equity exposures as prices fell during the quarter, making some mis-priced stocks even more attractive</u>. We feel our allocations will be rewarded handsomely and will in turn be the foundation of future returns. However, we still continue to operate with caution and with tactical urgency to protect our portfolio in the short-term through a focus on margin of safety and with adequate liquidity of cash, short-term bonds, and real assets. These options continue to serve as a source of funds if the market dislocation continues.

The inevitable “inflate away” central bank strategy being followed presents us with the long-term risk of purchasing power loss. The best way to counterbalance that offensive action on the GO board is by owning a healthy allocation of global, competitively entrenched businesses that have pricing power. Ownership of these businesses today at free cash flow yields ranging between 7 – 20% strikes us as a very common sense approach that maximizes our options. We do not view the outcome of our decision to own equities at these levels as potential for victory or defeat. We view the decision as an essential move which gives us the ability to gain strategic progress and a relative advantage over many of the large risks that exist in today’s investment environment, both seen and unseen.

While we have found adding to our existing businesses as the most intelligent use of our capital, we did add a select few new positions during the quarter. One new holding in our Core Portfolio has recently emerged from bankruptcy with a much improved balance sheet. It is in an industry which has been materially improved as capacity has been removed and a more rational shareholder mindset adopted. We bought this business at a free cash flow yield above 15% from current earnings. We look forward to sharing more about this holding in our personal meetings with you in the near future.

Consensus versus Edge: Schooling or Shoaling

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The concluding agenda item of our weekly investment meetings is to re-visit a list we call "where is the consensus - where is the edge?" This is where we elevate our thought process to the 30,000 foot level and take stock of where we believe the greatest amount of consensus thought (think concentric circle) is taking place and conversely identify what resides on the edge of that consensus thinking. Over time an investor following the crowd will be at best destined to mediocre returns and at the worst of times, in lemming-like fashion, will take the proverbial leap off the cliff and register a permanent loss of capital. The path toward generating truly exceptional long-term compounded returns is to have a differentiated view built on business-sense and harnessed through a repeatable investment process.

We embolden the following quote by Mark Twain in our weekly investment meeting notes that leads into this exercise: *"Whenever you find yourself on the side of the majority, it's time to pause and reflect."* The observation that continues to rank number one on our list over the last 6 quarters is the focus on global macro outcomes. I want to explore this topic and share with you how we are thinking about avoiding current global macro consensus risks and the importance of finding opportunity at the edge of the consensus.

One of the highlights of my summer is an annual fishing trip I take with one of my closest childhood friends. Our journey typically takes us to the "Canyons" 70 miles south east of Nantucket where the Atlantic Ocean, gulfstream and continental shelf meet and create an ideal environment for large migratory pelagic fish.

My friend is well aware of my tendency to get sea sick so he often gives me a job that captures my attention away from the rolling seas. On this recent trip, upon arriving at our fishing site he asked me climb to the top of the tuna tower to look for any signs of fish as the rest of the crew prepared bait, set out the outriggers, and prepared the rods. Beyond getting me out of the way of the more apt anglers, I was told to look for any indication of baitfish such as birds feeding. However, what my friend, the captain, really wanted to hear is confirmation that I have sighted a "bait ball."

A "bait ball" occurs when small schooling fish swarm in a tightly packed spherical formation as a last ditch defensive measure when threatened by predators. Bait balls are typically formed when a predator locates a fish school deep below the surface and uses tactics to force the school to the surface, herding it to a compact volume. The alarmed fish abandon their coordinated schooling movements and become chaotic. Their disciplined schooling strategies of uniform spacing and polarity degrade into frenetic attempts by each fish to survive. The movement, sound and smell of the bait ball actually attract more predators. Thus in their attempt to survive through safety in numbers and self-interest they are actually putting themselves at greater risk. Typically a feeding frenzy ensues as the predators attack the bait ball feeding off the weaker players, then allowing the ball to reform, only to continue their assault until the bait ball is decimated.

Many species, both fish and fowl, have adapted themselves to take full advantage of bait ball formations. Gannets attack from the air and can plummet from heights of 100 feet and enter the water at speeds of up to 50 miles per hour. Sailfish raise their sails to appear much larger to help herd and then slash the ball of school fish with their long bills. Thresher sharks use their elongated tails to stun the school and spinner sharks charge vertically while spinning on their axis.

The humpback whale uses a feeding technique called bubble net feeding which I find particularly interesting. Groups of whales swim in shrinking concentric circles blowing bubbles below a school of prey fish. Forage fish have a strong aversion to bubbles and can be contained within a bubble curtain. The humpback whales work together with some whales scaring up fish from below using vocalizing techniques and the leaders using the bubble net feeding technique to herd. Then as a synchronized group, whales will lunge-feed often swimming upward through the net, mouths agape, swallowing thousands of fish in one gulp.

Early this September as I perched myself on the top of the tuna tower, I began to think about how similar the actions of the school fish were to that of investors, particularly in light of the current chaotic investment environment. As I look across the investment horizon today I'm observing an impressive bait ball. The predators that are collaborating to create this bait ball are the many families that belong to the order "global macro fear and uncertainty". The schooling fish are being corralled into this bait ball through scare tactics which is then fueled by the modern array of news mediums. These herded investors are now worked into a frenzy of self-interest as they attempt to move their portfolios to the center of the bait ball and perceived safety.

Not only are investors being herded by the predator of global macro fear and uncertainty but they are also being curtained by the fear of bubbles. Just as bubble net feeding is an effective technique for humpback whales to scare school fish into a herd, it is also particularly effective for corralling investors away from common sense and truth. The tech bubble of 2000 and the credit bubble of 2008 are open wounds for many investors. Investors remark "I cannot live through another episode like that" and thus frenetically seek the center of the bait ball. Bubble net feeding continues to plague investors in a major way. Fear and uncertainty that it could happen again have paralyzed the vast majority of investors. We observe a complete disregard for what an investment is worth based on its own merit.

For me the most important ten investment words ever uttered came from Warren Buffett when he said *"investing is most intelligent when it is most business-like."* Today, business-like investing is looked upon as an ancient practice with very little merit. Even some of the most astute investors have joined the global macro circus looking for innovative ways to speculate on various macroeconomic outcomes. Beyond looking for tail-winds and tail-risks, we really don't think devoting a lot of our daily resources to macro-economic hunches is going to reward our investors over the long-term and we feel it would greatly limit our success. We are however putting our efforts into overdrive on uncovering some of the finest businesses in the world that given today's prices will deliver attractive compounding opportunities.

Schooling or Shoaling

Groups of fish that stay together for social reasons are said to be shoaling. If in addition the group is swimming in the same direction in a coordinated manner, they are said to be schooling. Genetically fish are endowed with a lateral-line and eyes on the side of their heads which maximizes their ability to swim in schools. Shoaling fish harness some of the protective measures of operating in a social group but act independently within the group. <u>Shoaling fish, for example, do not form bait balls</u>.

If one were to look back and examine what style of investing has maximized compound returns while mitigating risk, <u>value investing wins hands down</u>. Value investing is our shoaling group. We choose to swim independently within this group armed with an investment process that helps us vehemently avoid schooling. The timeless principles that guide this group may have been first articulated by Ben Graham but have been put into practice successfully by countless investors since, including the most well-known, Warren Buffett.

We are constantly learning as value investors. We feel our success is exponentially improved by our conversations with like-minded investors that choose to shoal collectively in this group. We learn from their success and sometimes from their mistakes. My connection with value investing was further strengthened this summer through teaching Security Analysis for the first time at Columbia Business School. I not only enjoyed the challenge of sharing investing principles and processes with some very intelligent students, but the classroom became an open forum with guest practitioners, invited CEOs, and students participating in thoughtful discussion.

The fact that value investing has had such a record of success without mass adoption is a constant mystery. Seth Klarman wrote about this in May 2008 when he concluded his eloquent introduction to the sixth edition of *Security Analysis* with these words.

> *"The real secret of investing is that there is no secret to investing. Every important aspect of value investing has been made available many times over, beginning in 1934 with the first edition of Security Analysis. That so many people fail to follow this timeless and almost foolproof approach enables those who adopt it to remain successful. The foibles of human nature that result in the mass pursuit of instant wealth and effortless gain seem certain to be with us forever. So long as people succumb to this aspect of their natures, value investing will remain, as it has been for 75 years, a sound and low-risk approach to successful long-term investing."*

We continue to observe the general proclivity for investors to school. Today these investors have formed a breathtaking bait ball that has historically produced very unsatisfactory outcomes. We feel we can maximize our chances of success by operating independently and intelligently within a shoaling group that has a history of safety and success.

Organizational Updates:

Jeff Berry – Managing Director: We are pleased to announce the addition of Jeff Berry as a Managing Director. Prior to joining East Coast, Jeff was a Managing Director at Seaward Management. Jeff will be leading the charge on some of the Business Development efforts here at East Coast. Jeff's previous positions have included marketing roles at State Street Bank and David L. Babson. I have personally known Jeff for years and we welcome his energy, experience, insights and good sense-of-humor to our team.

Lindsay Pollard – Operations Associate: We welcome Lindsay to our ranks. Lindsay will be working closely with our Director of Operations Jane Bolger in helping address many of the operational and service issues that arise for our clients. Lindsay spent her last five years at Harvard Business School as Assistant Director of Alumni Relations. Lindsay has quickly become an invaluable member of our team and we look forward to introducing you in person during your next office visit or by phone.

Associate Research Analysts: We welcome back Mike Xanthopoulos and Michael Keegan. Typically our summer internships end in September but we were so pleased with "The Mikes" contributions that we have asked them to stay on as they finish their final MBA year at Boston College. We are in the midst of interviewing candidates from Columbia Business School and Boston College for an additional associate analyst to join us this fall.

We continue to manage your capital with the utmost prudence and look forward to meeting and talking with you soon. We greatly value your support and trust.

> *"Testament of a Fisherman: I fish because I love to; because I love the environs where trout are found, which are invariably beautiful and I hate the <u>environs where crowds of people are found</u>, which are invariably ugly; because of all the television commercials, cocktail parties, and assorted social posturing I thus escape; because, in a world where most men seem to spend their lives doing things they hate, my fishing is at once an endless source of delight and an act of small rebellion; because trout do not lie or cheat and cannot be bought or bribed or impressed by power, but respond only to <u>quietude and humility and endless patience</u>…"*
>
> John Voelker (1903 – 1991)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder

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To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO, Chief Investment Officer, and Co-Founder

Date: January 12, 2012

Re: Fourth Quarter 2011 Update – **"Plain Truth – Embracing Certain Uncertainties"**

Market Summary[1]

	S&P 500	MSCI AC World Index	MSCI Emerging Markets	MSCI EAFE Index	Barclays Aggregate Bond Index	Gold – $/Troy Oz.	Crude Oil
Price 12/31/2011	1257.60	1182.59	916.39	1412.55	1682.87	$1,563.70	$98.83
2011	2.11%	-4.98%	-18.37%	-11.67%	7.69%	10.06%	8.15%
Q4 2011	11.82%	7.74%	4.44%	3.40%	1.15%	-3.71%	24.79%
2010	15.06%	12.67%	19.04%	8.38%	7.00%	29.52%	15.15%

On behalf of our entire team at East Coast, I want to extend to you and your family our sincere wishes for health and prosperity in the new year. Although we would love to start the year reporting that the equity market turbulence is behind us, we are expecting volatility to persist. Continued deleveraging of the global economic system coupled with heightened political inputs will fuel fear of the unknown. Our best absolute performance years have rarely been born out of a cheery consensus, thus this prognosis may not result in anemic returns. While an emotional "all clear" sign remains elusive for investors, we are finding the environment attractive for purchasing equity of competitively entrenched businesses.

We observe a general misclassification between uncertainty and risk. Looking forward, we also anticipate the general perception of "risk" versus" risk-free" assets will change. Central bank intervention to mitigate the effects of the inevitable deleveraging cycle will raise the cost of capital and compromise the value of paper currency. We expect this could be a disappointing realization for those seeking long-term shelter in cash and bonds. We will share some insight on these observations in this year-end letter.

Let's take a moment to review 2011. Equity markets rebounded in the fourth quarter, with the strongest returns in the US with an 11.8% recovery in the S&P 500 versus a more muted appreciation overseas with a 7.7% increase for the MSCI World Index. For the calendar year

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, MSCI Europe Asia Far East (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices.

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2011, the US was the only place to hide from the volatility brought on by Eurozone uncertainty. While the S&P 500 logged a positive 2.1% return for the calendar year, the foreign indices including MSCI World, MSCI EAFE, and MSCI Emerging Markets were in the red, giving up -4.9%, -11.6% and -18.3% respectively. The Barclays Aggregate Bond index registered a positive 7.6% calendar year return and gold moved 10% higher.

Attached with this letter, you will find your year-end portfolio summary including a detailed performance report.

Plain Truth – Embracing Certain Uncertainties:

The uncertainties that pervade the global economic landscape have many asking the same questions and voicing similar concerns. For every two steps forward out of this economic crisis there is inevitably one step backwards. We observe the psyche of market participants to be confused and frustrated. Investors want to know the truth. The illusion of prosperity created by a leveraged economic system has been exposed. The world is now rebalancing from the excess capacity brought on when credit was freely used by consumers, governments and corporations. Investors who were unprepared for the bubble that was forming feel duped, and citizens who are out of work or underemployed are angry and scared.

For this year-end update, I have highlighted the top seven areas where we are focusing our efforts. The list is portfolio and economic specific and includes change agents that we need to understand to extract opportunity or protect against tail risks. These broad views represent how and why we are allocating portfolio capital. The penultimate goal of our investing efforts, and I believe all investing, is to protect and compound capital (JOC)[2].

Toward this objective of compounding, we can succeed if we seek the truth in three areas when researching an investment. We need to determine the investment's internal rate of return (IRR)[3], understand our margin of safety (MoS), and synergize the critical data points that will drive the success of the investment (H4)[4]. If we are successful at determining these factors we can compare investments against one another and build a merit-based portfolio. An investment has merit when it has both an attractive expected rate of return (IRR) and a high confidence assessment garnered from the insights into MoS and H4. The following formula captures this objective: JOC = IRR * (MoS+H4).

In pursuit of truth, being intellectually honest about what we do not know or that which is unknowable are both critical to success. I find more people tackle this problem in reverse, pretending to know things that can't be known and in doing so build dangerous convictions based on false assumptions. Socrates' famous paradox, "the only true wisdom is to know that you know nothing," has always served as a reminder that we should constantly challenge our conclusions and more importantly those of the consensus.

[2] JOC = Joys of Compounding discussed in detail in "Joys of Compounding – Revisited."
[3] Internal Rate of Return (IRR) discussed in detail in "Unified Theory of Investing."
[4] H4 – finding the critical data points was discussed in detail in "Finding Longitude – H4."

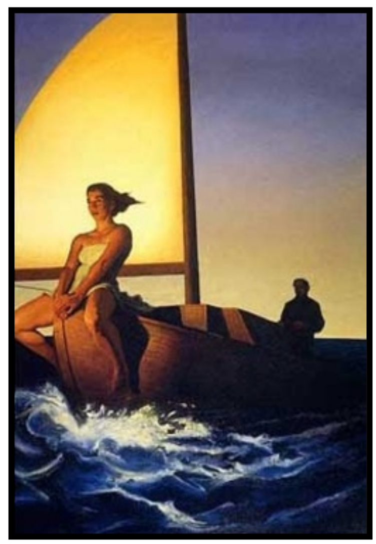
I find the Arts can be a guiding body of knowledge to study in pursuit of truth. Great artists have a keen ability to conceptualize nature and humanity. Ernest Hemingway wrote in his memoir, *A Moveable Feast*, that when he was having difficulty writing he would remind himself of the following: "All you have to do is write one true sentence. Write the truest sentence you know."

In the fine arts, paintings can be one of the greatest expressions of truth. Artists that have created enduring masterpieces refined their expressions to find the true essence of their subject; a still life, a portrait, or a landscape. Since human emotion contributes to mis-pricings, I believe the ability to synergize the truth of man-made systems gives the investor a true competitive advantage.

Below you will find a description of our seven broad views, and how we are expressing them in our portfolio today. To reinforce the fact that most of the uncertainty facing the world is the result of cycles of human nature, I have chosen a masterwork to demonstrate the timelessness of the topic. We feel an investor equipped with a process and philosophy to synergize truth will not be fooled by illusion and can move towards a goal of protecting and compounding wealth.

Broad Views:

1. Deleveraging - Embracing Certain Uncertainties – "*Certain Uncertainties*[5]" – C. Vincent:



By avoiding investments where the future is unknown, investors are paying a heavy price for perceived certainty. The investor's tool kit must be equipped to address a range of uncertain outcomes.

The survival behavior of fight or flight is not a positive attribute for investing. I believe people confuse the threat of danger with the fear of the unknown or simply uncertainty. Risk and uncertainty are two very different things. Uncertainty is the existence of more than one possible outcome. Measurement of uncertainty is giving probabilities to a range of those possible outcomes. Think probability distributions – the bell shaped curve for example.

Risk is the state of uncertainty where some of the possible outcomes have an undesirable result or a significant chance of loss. Thus, the measurement of risk is assigning odds and measuring the magnitude of loss based on probabilities.

There are uncertainties that exist in our portfolio that range from marginally positive to significantly positive outcomes. Based on multiple scenarios, some macro-economic and some specific to the investment, the expected returns will vary. We attempt to avoid those investments where there is even a slight probability of permanent loss of capital. We feel we can mitigate volatility, which we do not necessarily define as risk, by adhering to a value discipline and purchasing securities with a margin of safety. It is important to note that not all volatility is worth the return we would surrender to reduce it.

[5] Christian Vincent painted "Certain Uncertainties" in 1997.

As a result we are finding very compelling “certain uncertainties”. We are also finding, and avoiding vehemently, a number of investments where risk of permanent loss of capital is material and a risk of negative real-rate of returns are likely.

The global economic system is in a period of deleveraging. This deleveraging requires us to devise a playbook that will be different than one that may have been used over the last thirty years. While our fundamental cornerstones of compounding (ascertaining attractive IRR’s with confidence around MoS and H4) remain the same, the difference lies in how the economic system will work in light of the excessive debts accumulated during the credit binge.

I explained in last quarter’s letter that there will be a prolonged period where governments will need to cut spending, increase taxes and print money. The budget debate will be great political fodder for our election and higher taxes to the wealthy are likely imminent. However, the bulk of the block-and-tackling will be done by money creation here in the US, the Eurozone and in Japan. The inflationary effects of these activities will have negative consequences for long-term bonds and developed-world paper currencies.

We are favoring the positively skewed “certain uncertainties” of the equity of competitively entrenched global businesses which we define and discuss as compounders. We own and continue to buy these businesses at attractive IRRs. We also continue to find mis-pricings in the equity investments of our transformation and workout categories. For liquidity, we are using short-term bonds and a modest amount of cash. We continue to maintain a gold allocation which we have viewed as an attractive alternative to some of our fiat-currency money market assets.

This concept “uncertainty” was highlighted in Walter Isaacson’s biography of Steve Jobs. During the creation of the iPod Shuffle, Jobs told his engineers to get rid of the screen. When the engineers responded perplexed, Jobs predicted that users looking for a smaller device would not need to navigate, but rather if they were not in the mood for a particular song they’d simply skip ahead. Jobs was correct, and the Shuffle was another huge hit for Apple. The ads read “Embrace uncertainty.”

“I’m as proud of what we don’t do as I am of what we do.”

Steve Jobs – (1955-2011)

2. <u>A *"Fair Wind"* for Certain High Quality/Mis-Priced Equities</u> - *"Breezing Up*[6]*"* – W. Homer:

When we turn off of the global macro noise and look at the merit of the businesses we own and that are available for purchase, we are optimistic about the future. Our compounders, defined as businesses with very large moats that protect the favorable economics their position affords them, are attractive at current prices.

We have approximately two-thirds of our long-equity positions attributed to compounders. Representative holdings in this category are: Berkshire Hathaway, Becton Dickinson, Colgate Palmolive, Express Scripts, Google, Johnson and Johnson, Lab Corp, MasterCard, Nestle, and Transdigm.

Beyond attractive compounders, our equity portfolio is represented by a number of attractive mis-pricings in our transformation and workout category. Currently they account for about one-third of our long-equity portfolio. Representative holdings in these two categories are: DirectTV, Fairfax Financial, General Motors, National Oilwell Varco, Union Pacific, Waste Management, and Willis Group Holdings.

In Q4 2011 we added two new core positions to our portfolio. The first purchase was a basket of large-cap global technology companies which we are implementing through a sector level exchange traded fund (ETF). With this basket trading at less than 10x earnings we feel there will be a mean-reversion to a more appropriate valuation. Historically the competitive advantage in the technology industry, even for great businesses, can be fleeting so in this case we have chosen to diversify away some stock-specific risk by executing this opportunity by way of the ETF.

The second position purchased was a financial services company whose share price has been battered by weakness in the financial sector and current earnings disappointment. While the share price has come down in line with many banks, this institution has very little exposure to mortgage loans and housing weakness. They do however have a sustainable, competitive advantage in providing safe keeping for household wealth. Their earnings have been hurt significantly from this prolonged period of low interest rates where they cannot earn normal fees on money markets and interest spreads on bank deposits. They are growing client assets at a 4 – 5% rate as they continue to take share of the industry. We conclude there will be nearly $2 billion of incremental earnings power in the business when the Fed Funds rate normalizes. With trough operating income near $1 billion and the business available for purchase at $15 billion, we feel we are buying a growing business at close to a 20% normalized free cash flow yield.

"Look at nature, work independently, and solve your own problems."

Winslow Homer (1836 – 1910)

[6] This painting was painted just miles from our Essex office in Gloucester Harbor. Homer completed this to commemorate our centennial in 1876. This painting was a statement of optimism about the future of the United States as the young boy holding the tiller looks forward to the horizon, anchor on the bow, a brisk breeze filling the mainsail.

3. <u>Inflation and Interest Rates</u> - *"Perspicacity"* – R. Magritte:

When NASA set out to recruit astronauts in the mid-1960's, they wrote in their brochure that the quality they were most looking for was "perspicacity", which is defined as someone "who is able to quickly pick out, from among the thousands of things he sees, those that are significant, and to synthesize observations and develop and test working hypotheses."

Rene Descartes wrote in "Rules for the Direction of Natural Intelligence," "we should totally focus the vision of the natural intelligence on the smallest and easiest things, and we should dwell on them for a long time, so long, until we have become accustomed to intuiting the truth distinctly and perspicuously." Rene Magritte did an excellent job of visually explaining this quality in his self-portrait – he is looking at an egg but in turn painting a bird in flight.

I find these concepts helpful in thinking about the direction of inflation and interest rates. To provide perspective, the chart below highlights US CPI Inflation (orange) and the 10 Year US Treasury (green) over the last 50 years. In the deleveraging section we discussed how the printing presses would be a necessary tool to deal with developed world debts in a post-credit bubble environment. Most market participants are focused intently on the egg and painting the egg; the reality is that the market will require a higher cost of their capital in light of the amount of money that is being created.

We are finding value in businesses that will benefit when this trend reverses and are avoiding certain fixed income investments which would be negatively affected.

"Everything we see hides another thing, we always want to see what is hidden by what we see."

Rene Magritte – (1898-1967)

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4. Emerging Market Consumer -*"Impression, sunrise"* – C. Monet:

In the mid-1800's, photography was introduced to the mainstream world, instantly changing the unique and competitive advantage of the artist. Up to that point, the artist was the one charged with capturing an image; the most skillful could capture likenesses with awe-inspiring perfection. The camera was a game changer for the artist and a game changer to their competitive franchise.

Artists were forced to evolve and improve their techniques. They sought to capture a greater sense of reality that even photography could not capture. As a result, one of the great art movements in history was born – the impressionist movement. Claude Monet with his *"Impression, sunrise"* is said to be the first painting to emerge from this era. Artists painted "en plein air," capturing light, color and an impression of nature that had never before been done.

In our lifetime, we are and will experience another such watershed event in the world with the emergence of the emerging market consumer.

The interconnectedness of the world is self-reinforcing. Envy is a much more powerful force than greed. Human nature is said to covet that which it sees every day and with today's technology and social networking the world can see and covet prosperity at any time. This is a very powerful force and this power is now in the "hands of the people[7]".

Businesses with scale, product identity, and distribution into emerging markets will thrive. As an example one of our holdings, Colgate Palmolive, derives over 40% of their total sales from the emerging markets. Our holdings in Visa and MasterCard are poised to benefit as this emerging population is introduced to the benefit of debit/credit versus cash. Many of our high quality compounder businesses deserve the right to win business as this pipeline of greater and greater demand comes to market. This is the most certain way to play this uncertain consumer demand curve.

This "impression, sunrise" of the emerging market consumer is one of the most underappreciated change agents that will ultimately drive global economic growth over the decades to come, and help move the world economy beyond the deleveraging currently at hand. As the quote below suggests, when one studies the parts - the facts and the figures - the impression that emerges is often reality.

"When you go out to paint try to forget what object you have before you - a tree, a house, a field or whatever. Merely think, here is a little square of blue, here an oblong of pink, here a streak of yellow, and paint it just as it looks to you, the exact colour and shape, until it emerges as your own naive impression of the scene before you."

Claude Monet (1840 – 1926)

[7] This phrase was expressed in Henry David Thoreau's *Civil Disobedience* written in 1849. "After all, the practical reason why, when the power is once in the hands of the people, a majority are permitted…" The proliferation of smartphone technology into the hands of a large emerging market demographic will continue to be a driving force of change.

5. Eurozone Consequences - *"Abduction of Europa[8]"* – Rembrandt:

How can we be bullish on equities considering Europe? Are we being lured into complacency by a bullish delusion of what might transpire? Will the spillover effects drive the global economy back into a deep recession? We have carefully looked at the Eurozone situation and have solicited input from experts who specialize in the region. We have assigned probabilities and a range of outcomes to various scenarios. The distribution provides us with some insight into the range of uncertain outcomes and the probabilities of true risk.

As explained above, the global deleveraging process is acutely affecting the US, Eurozone, and Japan. The central bank solution to the debt burden for all three indebted regions will be austerity, taxing the wealthy and printing money. In the case of Europe there is an immediate need to print money to save the Eurozone. If they are unwilling to do so the worst case scenario may take place; the Eurozone could break apart. The different degrees of how much money they print will have scaled effects on the economic recovery and inflation. Too much and they release significant inflation, too little and we will see bank failures and sovereign defaults.

While a break-up of the Eurozone is a low probability outcome, it is also not zero. Even with some of these dire forecasts, we estimate that the most uncertain outcomes from these valuations give us a range of estimated returns between anemic single digit returns to healthy double digit returns over a multi-year holding period. When we stress test our own holdings, we do not see a major downside earnings revision or multiple adjustments from the businesses we own, particularly from current valuations.

We continue to monitor this situation closely and we have been looking carefully in the region for opportunities. We have added to some of our European-non bank holdings prudently. We will keep you updated on changes to our thought process as we digest more information during the first quarter.

> *"...Practice what you know, and it will help to make clear what now you do not know."*
>
> Rembrandt – (1606 - 1669)

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[8] Europe derives its name from the Greek goddess Europa. Rembrandt's depiction tells the story of how Zeus, enamored with Europa, decides he wants her for his wife. He transforms himself into a tame white bull and mixes in with her father's herd. As Europa and her attendants are gathering flowers, she is persuaded by the bull. She eventually joins him where he wades into the sea and swims to Crete where his true identity is revealed.

This irony is not lost on us when we think of the Eurozone and how some of their 17 constituents were deceived by the prosperity that leverage could bring. The bull has now revealed itself and they realize they have been abducted, swimming in debts they cannot escape, and facing the reality that economic consequences may be, among other things, their freedom. The future of the Eurozone rests now in the hands of a few politicians; where Europa eventually became the first queen of Crete, the various outcomes that will occur in Europe are less regal.

6. <u>Jobs and Housing</u> - *"Noon: Rest from Work (after Millet)"* – V. van Gogh:

We are ten months away from a US presidential election. President Obama took office just as the US economy was sailing into an economic perfect storm. Unemployment and underemployment has persisted, as it generally does when an economy deflates from a period of unsustainable leveraged growth.

The lion's share of the job losses have come out of the housing industry which directly and indirectly affects many people and businesses. We have and will continue to see job losses coming out of the banking industry as financial service companies continue to be dealt mortgage and earnings losses from the Fed administered zero percent interest rate regime.

Until we work off the excess capacity of homes, jobs will not return to these sectors. While the statistics are not perfect, we estimate there are 2.5 million surplus homes in this country. We have approximately 1 million new families that come into the market each year willing to buy these homes. We are currently building about 500,000 new homes each year, so we are sopping up approximately 500,000 homes which equates to about 4-5 years until we use up excess inventory. We have many bank-owned homes that will be foreclosed on and sold which we refer to as "shadow inventory." This is the skeleton in the closet for the banking industry.

For these reasons, we remain cautious on many financial institutions that have mortgage loan exposure. While banks and related businesses have favorable valuations, the uncertainty that exists around losses remains negatively skewed into the risk category.

We are hearing the beginning of some creative programs being initiated by the current administration to mitigate this reality. They believe if these programs can reduce housing inventory levels then possibly unemployment rates will drop and loan losses will improve.

James Carville hung a sign in Bill Clinton's Little Rock campaign headquarters that read "It's the economy, stupid" during President Clinton's 1992 successful bid to unseat George H.W. Bush. This election will be focused more on jobs rhetoric.

"Exaggerate the essential, leave the obvious vague."
Vincent van Gogh (1853 – 1890)

7. The "Sinnerman" versus The Protestor - *"Son of Man"* – R. Magritte:

Time Magazine's person of the year choice of the "The Protestor" was further evidence of just how impactful a year it has been for change. The individual has been empowered in the name of humanity.

Overseas we witnessed the Arab Spring and how civilians assisted by technology could band together and topple a dictator. Here in America the protestor is angry at the "faceless businessman" who pushed our financial system to the brink of collapse, blaming him for the joblessness that persists today.

During the leveraging of the economic system too many people, including corporate executives, politicians, regulators, and credit agencies, were lured to "bite into the forbidden apple." They envied the fruits of what others were enjoying just as Adam and Eve envied wisdom when they ate from the Tree of Knowledge.

The fact that many of these leaders were caught red handed with no consequence justifies protestor frustration. The sun is setting on the period where leverage, greed and envy led to mistakes. The sun is rising on a period where people learn to do more with less. We view the period ahead for our country and for the world as promising. We believe corporate and government leadership are being judged by their humanity, prudence, and virtue and not just on progress at the expense of others.

Charlie Chaplin was famous in silent films before he uttered words on screen. Those words were worth waiting for when he wrote and spoke the famous "Great Dictator Speech" in 1940. This excerpt of the speech captures the essence of the protestor's voice; "Greed has poisoned men's souls – has barricaded the world with hate; has goose-stepped us into misery… We have developed speed but we have shut ourselves in: machinery that gives abundance has left us in want… The misery that is now upon us is but the passing of greed, the bitterness of men who fear the way of human progress… Let us fight for a new world, a decent world that will give men a chance to work, that will give youth the future and old age security..."

We believe different themes and investment opportunities will emerge in an era of deleveraging. We will source businesses that will deserve the right to win in this paradigm- selling products and services that are in harmony with changing demand patterns. More importantly, we need to exit businesses not willing to adapt as their existence will be compromised.

"There are more valid facts and details in works of art than there are in history books."
Charlie Chaplin - (1889 - 1977)

Organizational Updates:

Laura Mok – Operations Associate: We welcome Laura to East Coast as an Operations Associate working closely with our Director of Operations Jane Bolger and Operations Associate Lindsay Pollard. Laura will help address many of the operational and service issues that arise for our clients. She has been working on special projects for East Coast and we have been so thrilled with her work that we invited her to become a permanent member of our team. Laura brings over 20 years of experience in the financial services industry. Laura is a graduate of Barnard College. Laura has quickly become an invaluable member of our team and we look forward to introducing you in person during your next office visit or by phone.

Associate Research Analyst: We welcomed Brian Degnan to our team this fall. Brian is a recent graduate of Columbia Business School and earned his Bachelors from MIT and JD from the University of Florida. Brian recently returned to Massachusetts with his family and we are lucky to have him working with us while he continues to pursue full-time analyst opportunities.

ECAM Award: We made an announcement prior to year-end that we awarded our 2011 ECAM Award to the "Horizons for Homeless Children" and "New England Center for Homeless Veterans." We look forward to assisting these charities with their mission in the year ahead.

We continue to manage your capital with the utmost prudence and look forward to meeting and talking with you soon. We greatly value your support and trust.

"I am progressing very slowly, for nature reveals herself to me in very complex forms; and the progress needed is incessant."

Paul Cezanne – (1839-1906)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder

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To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO, Chief Investment Officer, and Co-Founder

Date: April 24, 2012

Re: First Quarter 2012 Update – **A Focus on Mispricings**

Market Summary[1]

	S&P 500	**MSCI AC World Index**	**MSCI Emerging Markets**	**MSCI EAFE Index**	**Barclays Aggregate Bond Index**	**Gold – $/Troy Oz.**	**Crude Oil**
Price 03/31/2012	1408.47	1312.01	1041.45	1553.46	1685.22	$1,668.35	$103.02
Q1 2012	12.58%	11.72%	13.99%	10.99%	0.14%	6.69%	4.24%
2011	2.11%	-4.98%	-18.37%	-11.67%	7.69%	10.06%	8.15%
2010	15.06%	12.67%	19.04%	8.38%	7.00%	29.52%	15.15%

We hope you are enjoying a productive and healthy start to 2012. In this quarterly letter you will find an update on our portfolio, general market observations and an investment process segment focusing on mispricings. The conclusion of the letter outlines some notable organizational updates. As is our standard practice, client reporting, including performance and positioning, will be mailed to you under separate cover.

Global equity markets performed well in the first quarter of 2012 as the scale tipped in favor of fundamentals and valuation versus geopolitical uncertainty. The S&P 500 increased 12.5% and the MSCI World Index added 11.7% as the vast majority of global equity indices rebounded. As we close the first quarter, the S&P 500 and MSCI World Index have appreciated 30% and 23% respectively from October 2011 lows.

Strong performance was driven by diminished concerns over Euro zone risks combined with more evidence of a strengthening economy. We are cognizant that we're not completely out of the woods with regard to Euro zone risk. While long-term European Central Bank refinancing programs have helped some of the weaker European sovereigns refinance debt at reasonable rates, the success of austerity programs in Italy and Spain remains to be seen. We continue to

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, MSCI Europe Asia Far East (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices.

stress test our portfolio positions to determine if "certain uncertain"[2] outcomes could create permanent losses.

In March 2009 equity markets hit their post credit-bubble lows. Since then the S&P 500 has appreciated over 100% and the MSCI World Index over 80%. A meaningful long bias toward equity investments throughout this recovery has served us well. Our decision was driven by valuation and inflation mitigation. Great businesses were available for purchase at bargain prices. We also concluded that the ownership of competitively entrenched businesses with pricing power was a logical store of wealth as global central banks have had little choice but to print money to exit this credit crisis.

The search for asymmetric returns[3] has and always will be our mission. Our strategy remains simple: attempt to allocate capital to those investments that share the most attractive compounding merit coupled with our ability to quantify their margin of safety. The chance of gain means very little to us until we have attempted to rule out the probability of permanent loss.

Since early 2009, equities have been a clear merit winner and as such we have attempted to maintain an allocation in managed accounts at the high-end of our client's investment policy mandates. While the broad market mispricings that existed three years ago have closed some of the valuation gaps, opportunities remain. Not only are expected total returns favorable from current prices, but we also continue to conclude that owning a dominant business is the best way to mitigate many of the global macro risks.

Over the last three years, the saying that "a bull market must climb a wall of worry" has proven true. Times of fear and concern often correlate with attractive prices. However, this knowledge does not make investing into perceived short-term uncertainty less emotionally challenging. During these times we lean heavily on an investment process based on business sense that challenges us to invest with intelligence over an appropriate time horizon.

During this bull market, we have observed many bearish individuals investing in cash and bonds in an effort to weather a long, cold winter of discontent. They are now waking from their metabolic depression with depleted reserves and bewilderment. Not only was the winter not harsh, but they also slept through spring and early summer. We expect that headlines abroad will continue to keep many of these investors peering out of their caves as global monetary policy impoverishes savings.

The chart below helps to put the last five years in perspective. The trajectory of the market since March of 2009 has been upwards and to the right; however, we have had to live through periods where worry outweighed fundamentals. We have used these periods of dislocation to add new holdings to the portfolio. A better visual might be to equate the recovery to climbing a mountain, where there are a number of false summits that require a modest descent before the determined climber can continue her ascent toward the true summit.

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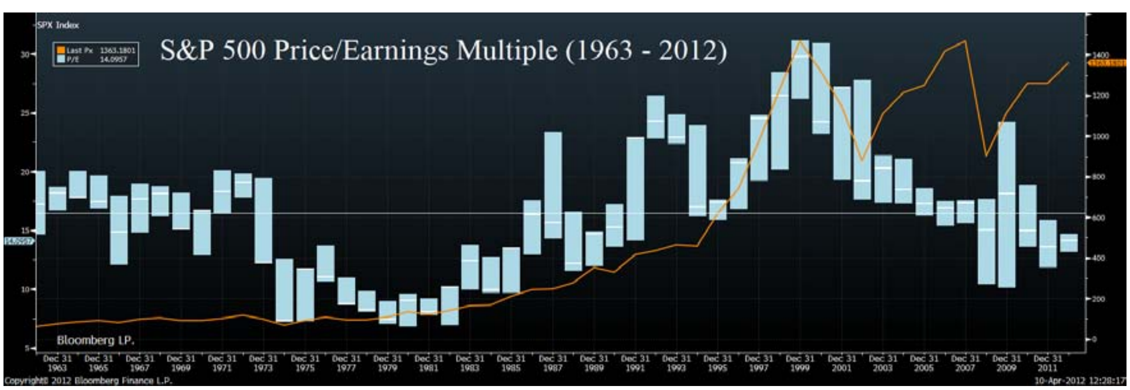
[2] The title of our 4Q 2011 letter "Embracing Certain Uncertainties" elaborates on risk vs. uncertainty.
[3] Asymmetric returns are those investments that offer a high probability of upside with a very low probability of downside.

Trying to understand the outcomes in Europe is like trying to play chess on three levels. While we understand the end-game, which is the ECB printing money to exit their regional debt crisis, in the short-term we can conjure up a lot of scenarios that may stress the investor's limited appetite for uncertainty. We intend to use these potential short-term corrections as buying opportunities. Any insight we have on likely short-term scenarios are nothing more than hunches and do not deserve action. Short-term market timing to avoid volatility has proven to be a futile effort. The opportunity cost would be too high if we were wrong, just as it has been for those hibernating bears.

We view investing as simply paying a price for a stream of future cash flows. We can earn very good returns if the price we pay equates to an attractive expected return on our investment. When we review the attractiveness of markets, we are also determining what we would need to pay today for those collective streams of cash flows/earnings. The chart below shows the historical P/E multiple of the S&P 500 from 1963 to present day. In aggregate, the market is reasonably priced at below 14 times 2012 projected earnings; inverting the multiple means that we are getting a 7.5% earnings yield. If we include an economic growth rate of 2 – 3% we arrive at expected equity returns in high single digits. We can augment this return by selecting a portfolio of businesses, (which we currently own), that are uniquely mispriced. I will talk more in depth about "mispricings" in the process section of this letter.



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We have not been shy in sharing our disdain for mid- to long-term fixed-income securities. While there is little insight into the timing of when interest rates may rise (potentially sharply), bond investments remain a "clear and present danger". Printing money is the global central bank's solution to diminish developed world debt. There will be an inflection point where capital market participants will demand a higher return for loaning money.

The chart below is a visual reminder of the current market situation and the biases that exist. We are witnessing a situation in the bond market where investor acceptance for low interest rates does not make logical sense, however we understand the psychological reasoning. As we saw with the housing bubble, everything can seem fine until it is not fine.

Individual investors are not the only ones participating in this folly. James Grant of Grant's Interest Rate Observer noted in his April 6th, 2012 newsletter that "for the first time in 12 years (reports the 2012 Milliman Pension Funding Study - a canvass of corporate America's 100 largest defined benefit plans), pension managers have earmarked more funds for fixed-income (41.4%) than equities (38.1%). Just five years ago, stocks got twice the allocation of bonds (60.3% vs. 29.3%)."

The unprecedented low yielding environment for asset classes has many institutions and individuals reaching for yield while taking on uncompensated risk. We are observing a flood of money embracing newly minted absolute-return strategies and alternative investments. While there are a number of very good practitioners employed in this space, when investor appetite exceeds supply many marginal players are willing to sell what the marketplace perceives it needs.

We also observe that thirty-one years of falling interest rates has been a tailwind for many products employing credit. Strategies that have relied on bonds as a source of stability and opportunity will face headwinds for a prolonged period of time. There are many examples in the marketplace of complex cocktails of bonds or derivatives of bonds that are renamed to something that sounds safe and prudent – the truth remains that the underlying returns for the majority of those credit investments are unattractive.

Apple – The Enviable Fruit

Envy is a much more powerful force than greed. Just as Eve envied the apple of knowledge, it seems everyone is envious over owning a slice of Apple, Inc. Many individuals and institutions have been clamoring to claim they own Apple shares - some mutual fund companies, fearful of near-term underperformance, have gone so far as to change their fund charters so that they can own more than their maximum individual security limit. Given the popularity of Apple we feel compelled to say a few words about how we view this company as an investment.

Apple is truly a great business and at East Coast we fully embrace their products not only at the office but also at home with our families. We look at their competitive advantage and view it as one of the most compelling in our investment universe.

From a valuation standpoint it does not appear overvalued using standard measures. Apple stock price (at the time of this letter) is at $620 a share and the company is worth $580 billion making it the largest company in the world based on market capitalization. The company has over $80 billion in near cash and equivalents and trades at a reasonable market valuation of 14 times 2012 earnings. If we subtract the cash, the stock trades at a reasonable 12 times earnings.

What is there not to like? A great company at a reasonable price! The question we ask of our prospective investments is - is it mispriced? And given the heightened focus on Apple why would it be mispriced? We are reminded of the quote by Mark Twain "whenever you find yourself on the side of the majority, it's time to pause and reflect." So when we are asked if we think Apple is a good investment, we must simply pause, reflect and answer truthfully that we do not know. The contrarian in us is skeptical.

We believe Apple's challenges going forward may come down to sheer size. At the market anticipated compounding rates, Apple would be worth nearly $1.1 trillion in five years and $2.3 trillion in ten years which is equivalent to France's entire annual GDP. The sheer size of Apple and the law of diminishing returns weakens our comfort level around margin of safety. We don't disagree with the quality of the business nor do we doubt that the valuation looks attractive. What we do struggle with is the ability to truly compound at an attractive rate based on size. Extraordinary innovation will be critical to their success and one of the most innovative things we will see this year is a dividend.

As with any investments that many feel compelled to own, we wonder if over time investors will come to the realization that they were guilty of the original sin, envy, or perhaps they will be the proud shareholders of a company equivalent to the 7th largest country in the world. In times like these we have the luxury to focus our time on opportunities where we feel we can gain a differentiated view and a higher conviction.

A Focus on Mispricings

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Compounding should be the overarching mission of investing activities for capital with a multiyear time horizon. Toward this mission, we look to allocate capital to the highest asymmetric expected return opportunities – those investments which share the highest internal rate of return[4] (IRR) and highest confidence around margin of safety.

While this stated mission is simple, in practice it proves challenging, as the universe of prospective investment ideas is infinite and an investment team's time is limited. The solution to this challenge can be found in understanding *where to look* for truly great opportunities and asking ourselves *why* these attractive returns are available.

We start with the premise that every investment has an inherent IRR based on the price set by the marketplace. With sufficient research we can arrive at a confidence level around an investment's margin of safety (MoS) coupled with our ability to synergize critical data points[5] (H4) that support the realization of our expected return. In an ideal world we would compare the two key inputs of IRR and confidence level across the investment universe and allocate capital accordingly. The merit of every investment idea could be explained by the following formula: compounding[6] merit is equal to the investment's IRR multiplied by our confidence level measured by percent. JoC= IRR * (MoS + H4).

In reality the two key inputs of IRR and confidence are obscured and out of focus until the appropriate lenses are applied. Further, it is the most attractive investments that will ultimately prove to be the most blurred upon initial inspection. Given that both our time and the number of truly great investments are limited, we need a way to select those candidates that have the greatest likelihood of being mispriced so we can apply our lens to see the reality. Mispricings occur when a stronger buying or selling force is applied to an investment than the corresponding supply.

Mispricing discovery *is* intelligent investing. We want to clarify that mispriced does not mean cheap – mispriced investments are not partial to any particular asset class nor are they partial to style boxes and growth rates.

If mispricings are the journey's end of our investment philosophy, then the investment process must serve as the guide to determine: (1) *where to look*, (2) *why is the investment misunderstood*, and (3) *what lens must be applied* to see the compounding and safety merit of the investment.

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[4] Internal Rate of Return (IRR) discussed in detail in "Unified Theory of Investing."
[5] H4 – finding the critical data points was discussed in detail in "Finding Longitude – H4."
[6] JOC = Joys of Compounding discussed in detail in "Joys of Compounding – Revisited."

Mispricings – Structural and Psychological

We believe there are two general kinds of mispricings - structural and psychological.

Structural mispricings exist when an event occurs that forces a large population of owners to sell without any change in the investment's intrinsic value. Examples of structurally induced selling would include: when an investment is deselected from an index, when a company is spun off from a larger parent company, or perhaps when a company's credit rating is reduced. These scenarios are just a few examples that produce a good flow of ideas into our workout category which we can then use to apply an appropriate lens.

Psychological mispricings are driven from collective investor psychology which induces broad selling or a lack of buying in an investment, asset class or group of securities. Psychological mispricings have produced some of our most compelling compounding opportunities. The study of how human beings perceive the world is a helpful tool to understand the psychological biases that produce mispricings.

More than half of our brain is used for processing sensory information with the majority of that processing being vision. Evolutionary psychologists have said that animals from fiddler crabs to humans use eyesight for collision avoidance, suggesting that vision is for directing action not providing knowledge[7]. We want to focus and apply a lens in the direction where there is a gap between the directed action of the marketplace and that of knowledge (truth).

Two universal visual impairments are myopia and hyperopia. Individuals, who suffer from myopia, or myopes, have difficulty seeing distant objects; hyperopes have difficulty focusing on near objects. These impairments can be used to describe the optical challenges that affect investors.

Hyperopes rely too heavily on their vision of distant objects and ignore short-term risks and headwinds that may destroy a business's competitive advantage. Sometimes there are events that have little to do with the operation of an individual business but can be systemic to the industry. In 2007/2008 we were witness to many good institutions trading at reasonable valuations permanently impaired by the hubris of our self-fulfilling housing and credit bubble. Hyperopia is also where you will find overvaluation when hopes and dreams bid up valuations beyond the near-term reality of their economics or a fleeting competitive advantage.

Our greatest source of mispricings occurs when myopic investors have difficulty focusing on the distant compounding merit of a great business (compounder category[8]) or the inflection point of a material change in an industry that is improving (transformation category). These collective myopes can see the near-term business or the business in 20/20 hindsight with ease but they have not given a fair price to the long-term economics of the business and its competitive advantage. Ralph Waldo Emerson aptly stated, "You cannot see the mountain near."

A bifocal lens is a useful way to describe the remedy we prescribe for mispriced opportunities where the investor population is suffering from an impaired ability to see into the distance and/or an impaired ability to focus on near-term risks.

[7] Kolb & Whishaw: *Fundamentals of Human Neuropsychology* (2003)
[8] Compounders were described in detail in "A Nuthatch Concept."

An example of the myopic mental model in practice is something we refer to as geographic myopia. Investors and analysts tend to focus more on what is near. The domestic business of a multinational company will receive an inordinate amount of scrutiny, which can obscure a thriving international business that has not been given proper credit in the overall valuation. Further mispricings can occur when a domestic business plateaus or is under competitive threat.

Our long-term investment in Colgate-Palmolive was discovered this way. Colgate analysts perennially give heightened scrutiny to the toothpaste competition in the US between Colgate and Proctor and Gamble's Crest. Market share for each tends to hover around 30%, and any modest change is of great interest to sell-side analysts. The fact is that only 15% of Colgate's revenues are derived from the US market. Their dominant market share in many emerging markets is often ignored, which has given us opportunity to build our position when others' visions are obscured.

In the first quarter of 2012, we added a new core equity position where the mispricing originates from geographic myopia. As is our standard practice with new positions, we have refrained from naming the investment in this quarterly letter but have included it in client reporting. The investment shares many of the attributes that we learned from our Colgate experience. This business has a strong US presence (65% of total revenue), and competes with two other formidable alternatives for delivering their services to the end customer. While they earn attractive returns on their capital employed in the domestic business, their growth has slowed and competition for the customer is fierce but rational.

What is not clear to the marketplace is that they have built a strong offering in Latin America (35% of total revenue), where the competition is years behind the ability to provide a similar solution and very little capital is being deployed to change that paradigm. The company grew the revenue of its Latin America business by 42% in 2011 and we expect compounded revenue growth in the mid-twenties over the next three years in this region. Management is generating more cash than needed to invest in the business and they have correctly decided to use excess cash to repurchase shares. They recently took advantage of the folly of the bond market (3% long-term debt) and as such accelerated their very large share-repurchase initiative. We hope the share price can stay low long enough so they can repurchase as many shares as possible at these prices, or better yet at lower prices.

Predictive Coding – The Focal Point of Psychological Mispricings

While age can bring experience to bear on investing, we find it can often be a detriment to the non-disciplined investor. Referencing Emerson again "People can only see what they are prepared to see." From birth through adulthood, humans take inventory of the world through their experiences and use these experiences to direct action. Cognitive scientists continue to embrace the belief that instead of gathering facts from the bottom-up for intelligent analysis, humans actually perceive the world from the top-down based on their drives and expectations.

Andy Clark, a Professor of Logic and Metaphysics at the University of Edinburgh, has written extensively on this subject and has used the term "predictive coding" to explain how the brain exploits prediction and anticipation in making sense of incoming signals and using them to guide perception, thought, and action. Clark explains:

> The basic idea is simple. It is that to perceive the world is to successfully predict our own sensory states. The brain uses stored knowledge about the structure of the world and the probabilities of one state or event following another to generate a prediction of what the current state is likely to be, given the previous one and this body of knowledge. Mismatches between the prediction and the received signal generate error signals that nuance the prediction or (in more extreme cases) drive learning and plasticity.
>
> We may contrast this with older models in which perception is a 'bottom-up' process, in which incoming information is progressively built (via some kind of evidence accumulation process, starting with simple features and working up) into a high-level model of the world. According to the predictive coding alternative, the reverse is the case. For the most part, we determine the low-level features by applying a cascade of predictions that begin at the very top; with our most general expectations about the nature and state of the world providing constraints on our successively more detailed (fine grain) predictions.

This inversion has profound implications. Clark continues:

> **The line between perception and cognition becomes blurred. What we perceive (or think we perceive) is heavily determined by what we know, and what we know (or think we know) is constantly conditioned on what we perceive (or think we perceive).** This turns out to offer a powerful window on various pathologies of thought and action, explaining the way hallucinations and false beliefs go hand-in-hand in schizophrenia, as well as other more familiar states such as 'confirmation bias' (our tendency to 'spot' confirming evidence more readily than disconfirming evidence). [9]

An illustration of this top-down thinking is the "hollow face illusion"[10], which illustrates the power of top-down influences on perception. As the mask spins, our expectation of a convex face trumps any visual clues that we are in fact seeing a concave mask. There are many such examples of optical illusions and how powerful expectations can shape our beliefs and thus our actions.

We believe that most investors approach the marketplace with a great deal of predictive coding. An investor's perception of equities may be framed by their recent experience after the credit bubble of 2008 and technology bubble of 2000 were exposed. Investors' predictive coding informs them that bonds and cash are safe. For some individual stocks, the negative perception remains even after a business has emerged from bankruptcy with a clean bill of health.

We find it is critical to have a process that allows us to strip away expectation. It is necessary to recognize that visions of the investment world are not innately clear and can actually worsen with age. Intelligent investing must be equipped to look for impairments and be equipped with the appropriate lenses to see the truth. T. S. Eliot shared this sentiment in *The Waste Land* when he wrote "we shall not cease from exploration, and the end of all our exploring, will be to arrive where we started and know the place for the first time."

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[9] "This Will Make You Smarter" Essay - Predictive Coding by Andy Clark edited by John Brockman.
[10] Hollow face illusion: http://www.youtube.com/watch?v=G_Qwp2GdB1M

Organizational Updates:

Office Space – Boston and New York City: In the first quarter we secured additional office space in Boston and New York City. These offices are open by appointment and have proved to be very helpful for client and investment meetings. We look forward to hosting you in our new office space either in Boston at the Prudential Tower, or on 34th Street in New York City across from the Macy's building. This summer I will resume teaching Security Analysis at Columbia Business School on Thursday nights. During the 10-week semester beginning on May 22nd, I will be working from the New York office Thursdays and Fridays. If you happen to be in the city, please plan a visit.

Associate Research Analysts: We welcomed Jason Cook and Luke Ferriter to our team this spring. Both Jason and Luke are finishing their MBA degrees at Boston College. Jason earned his B.A. from Harvard College and spent the majority of his pre-business school experience in investment banking. Luke earned his B.A. from Colby College and joined us from GMO where he was employed in research for five years.

We continue to manage your capital with the utmost prudence and look forward to meeting and talking with you soon. We greatly value your support and trust.

"Concentrate all your thoughts upon the work at hand. The sun's rays do not burn until brought to a focus."

Alexander Graham Bell – (1847-1922)

"Vision is the art of seeing what is invisible to others."

Jonathan Swift – (1667-1745)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder

To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO, Chief Investment Officer, and Co-Founder

Date: July 16, 2012

Re: Second Quarter 2012 Update – **The Beekeepers**

We hope you are having a wonderful summer. In our Q2 letter you will find an update on our portfolio and general market observations. Each quarter we highlight one component of our investment process - this quarter we discuss the "compounder" category, and specifically how we differentiate a great business from those of lesser quality. Included in this section is a representative example of a compounder business we recently added to our portfolio. As is our standard practice, client reporting, including performance and positioning, will be sent to you under separate cover.

Market Summary[1]

	S&P 500	**MSCI AC World Index**	**MSCI Emerging Markets**	**MSCI EAFE Index**	**Barclays Aggregate Bond Index**	**Gold – $/Troy Oz.**	**Crude Oil**
Price 06/30/2012	1362.16	1235.72	937.35	1553.46	1451.84	$1,597.40	$84.96
Q2 2012	-2.75%	-4.85%	-8.79%	-6.90%	1.97%	-4.25%	-17.53%
YTD	9.48%	6.30%	3.97%	3.30%	2.11%	2.16%	-14.03%
2011	2.11%	-4.98%	-18.37%	-11.67%	7.69%	10.06%	8.15%

Global equity markets ended the quarter better than expected given the volatility seen in May. The S&P 500 lost 2.7% for the second quarter and the MSCI World Index fell 4.8%. The U.S. equity markets continue to outperform foreign markets with a total return of 9.4% for the S&P 500 on a year-to-date basis versus 6.3% for the MSCI World Index, 4.0% for the MSCI Emerging Market index and 3.3% for the MSCI EAFE Index. Oil prices have fallen 14.0% for the year and gold has registered a modest positive return of 2.2%.

We continue to advocate for a healthy allocation to equity securities as we have since the first quarter of 2009. Our reasoning is simple – merit. If you divide the owner earnings of our portfolio of equities by the market price, we find that yield to be attractive. When we further

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, MSCI Europe Asia Far East (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices.

factor in market demand and pricing power attributes we believe our equity holdings have compelling inflation-adjusted expected total returns from these valuations.

We are not blind to the continued persistence of Eurozone uncertainty; however, we know that volatility and risk of permanent loss of capital are two very different things. We remain steadfastly focused on factors we can measure and price. To the degree that real risks do exist, we have attempted to reduce direct or indirect exposure. We feel confident that if we can withstand a bumpy ride in our equity investments, we will have travelled miles further toward our destination when we exit this current period of volatility. It is our experience that the lion's share of compounding success is born out of times when the investor psyche is not optimistic. This is clearly one of those times.

A Beekeepers Guide to Investing

The French beekeeper and author Abbé Warré opened his book *Beekeeping for All* with a clear definition of a beekeeper's mission. "Apiculture or beekeeping is the art of managing bees with the intention of getting the maximum return from this work with the minimum of expenditure. The production of honey is the main purpose of beekeeping, one that the beekeeper pursues before everything else, because this product is valuable and because it can be weighed and priced."

Intelligent investing shares a similar mission. Investment management is the process of allocating capital with the intention of getting the maximum compounded return with the minimum of expenditure (net of fees and taxes). Allocating capital to investments that produce an attractive stream of cash flows with the least probability of loss should be the main purpose of investing and one that the investment manager should pursue before everything else because the product is valuable and cash flow production can be weighed and priced.

The volatility of the current market is a reminder that an investment's cash flow is not always the focus of the marketplace in the short-term. The market tends to gyrate between extremes of fear and envy along a rhumb line of truth and intrinsic value. It is in these periods of extremes where the investor with an eye toward value can be successful.

Warren Buffett shared these sentiments in Berkshire Hathaway's 1987 annual report:

> In my opinion, investment success will not be produced by arcane formulae, computer programs or signals flashed by the price behavior of stocks and markets. Rather an investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behavior from the super-contagious emotions that ***swirl*** about the marketplace. In my own efforts to stay insulated, I have found it highly useful to keep Ben's Mr. Market concept firmly in mind.
>
> Following Ben's teachings, Charlie and I let our marketable equities tell us by their operating results - not by their daily, or even yearly, price quotations - whether our investments are successful. The market may ignore business success for a while, but eventually will confirm it. As Ben said: "In the short run, the market is a voting machine but in the long run it is a weighing machine." The speed at which a business's success is recognized, furthermore, is not that important as long as the company's intrinsic value is

> increasing at a satisfactory rate. In fact, delayed recognition can be an advantage: It may give us the chance to buy more of a good thing at a bargain price.

We could not agree more and operate with a similar intention. An investor who has a keen eye on operating results will be better prepared to know when the marketplace is in a phase of contagious emotional upheaval and in turn will be armed with truths to act intelligently.

A Beekeepers Guide to Swarm Management

Beekeeping and investing are two crafts that are regularly interrupted by swarming. With regard to bees, swarming is the means by which honey bee colonies reproduce. It occurs after an overpopulated hive causes diminished resources, prompting the queen bee to leave the colony with a large group of worker bees to find a new nest location. When the swarm emerges from a hive they will cluster about the queen and then send out twenty to fifty scout bees to find a suitable new nest location. An individual scout returning to the cluster will promote a new home through a waggle dance to indicate the direction and distance to others in the cluster. The more excited she is about her findings the more excitedly she dances. Several different sites may be promoted by different scouts as a popular location emerges from this decision making process. Swarming creates a vulnerable time in the life of honey bees as they are provisioned with only the nectar or honey they carry in their stomachs; they will starve if they do not find a new nectar store and home.

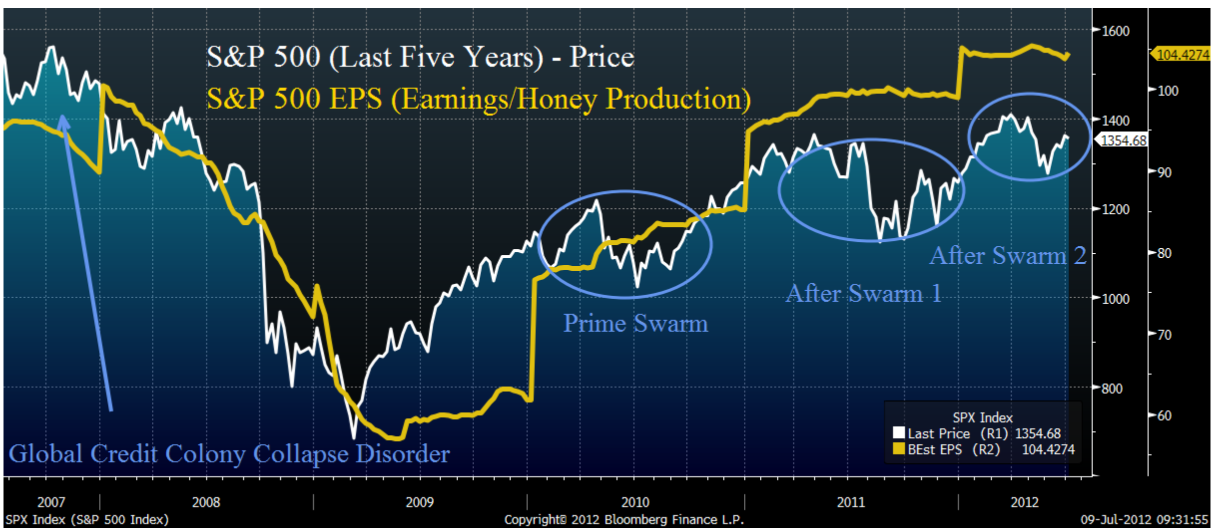
We observe that many investors appear to share similar behavior. Too much demand chasing too little supply will eventually drive prices to extremes, diminishing the resources or future returns for a particular asset class. We are witnessing this today with money markets and fixed-income securities where yields hover near all-time lows and the crowded hive has to swarm to find more resources. Despite the fact that a good nectar source is available in equities, many investor colonies have abandoned their focus on the cash flow (honey) production available in good businesses with pricing power. Darwinist genes of natural selection have genetically coded the colony to avoid certain death from equities like those experienced in the technology bubble of 2000 and the credit bubble of 2008.

Today, investors cluster about the safety of their queen: cash and bonds, while depleting nectar stores – accumulated wealth. Scout bees - stock brokers and investment “helpers” - have eagerly been dispatched to assist in selecting a permanent home that will yield more honey. Each scout bee arrives back to announce their findings; one by one their dances become more excited than the previous, as they proclaim a better home – more yield, less volatility, and absolute returns. The scout bees frenetically dance out the locations and merits of these prospective hive locations with their “copybook headings.” These locations appear to answer the demand of the cluster. However, upon a beekeeper’s inspection there is very little nectar flow (yield) and very little margin of safety against the colony’s natural predators (permanent capital loss and purchasing power erosion).

Where bears are a natural predator to the hive, a misconstrued bearish-bias is too often the largest predator of a portfolio’s compounding potential. Bearish investors frequently miss the compounding benefits of a business available at an attractive price that produces consistent and stable earnings. These bears prefer to forage aimlessly in search of an active hive and then clumsily take one big swipe for the immediate gratification of a paw full of honey only to be scared off by the cloud of bees that will emerge. Numerous bee stings incurred, the blemishes of an unpleasant exit and the search cost of finding the next hive will all be soon forgotten. What will remain is the memory of that temporary sweet taste of honey, and then the vicious cycle repeats itself with few, if any, lessons learned.

We feel it is important to differentiate between true principal impairment and swarming or volatility. The risks created from a pandemic spreading of credit based on a false assumption of indefinite rising asset prices were exposed in 2007. The global credit colony collapse disorder that followed represented the correction of the market to more normal assumptions. Disease infected our financial system, and that risk needed to be eradicated.

As the chart below illustrates, the global economy and companies have returned to the business of producing productive cash flows, or honey. Equity prices have responded favorably, albeit with periods of swarming - volatility. As with most historic credit bubbles, central bank intervention has been and will be necessary to mitigate the effects of the accumulated debt that has migrated from corporate and individual balance sheets and nested on government balance sheets. We have experienced three swarms over the last three years, which have all been countered by government stimulus to aid in debt reduction. As we have written before, a combination of money printing, cost cutting, and higher taxes will be necessary, all while attempting to maintain modest levels of economic growth and employment levels.



Beekeepers are keenly aware of the risks of swarming. An unattended hive can lose its entire honey-producing bee colony if the colony's resources become limited due to crowding. Bees also suffer from the biggest problem of most investors – the inability to sit in a room and do nothing. Beekeepers anticipate the spring swarm and can proactively take actions to mitigate negative effects.

An investor should adhere to a program of proper swarm management. Swarming is one of the greatest gifts to the value investor as it can produce an opportunity to pick up cash-producing businesses at bargain prices. Today we are experiencing yet another opportunity with the fear and uncertainty in Europe. The swarm hotlines are ringing off the hook as individuals see the frightening cloud of European honey bees obscuring blue skies. The learned beekeeper shows up on the scene to educate, and leaves with a profitable swarm to add to his apiary.

While we do not think too much about the seasonality of market opportunity, we can't help but notice three consecutive years of spring volatility. There is an old English poem that aptly states: "A swarm of bees in May is worth a load of hay; a swarm of bees in June is worth a silver spoon." Since we are long-term consumers of equity investments, we would prefer to restock our supply of equities when prices are low.

I was amused at the irony when I read the June 18th *New York Times* headline: "As Swarms Startle New York, Officer on Bee Beat Stays Busy." The article goes on to report that "a humming cluster the size of a watermelon bent a tree branch in front of Chase Bank." The swarms were due to a mild winter and the fact that a decade-long ban on raising bees was lifted in March 2010. Andrew Cote, the President of the New York City Beekeepers Association was quoted as saying; "It's up to beekeepers to practice swarm prevention techniques and regular hive maintenance. He added that many beekeepers were "poor stewards" for not regularly inspecting their hives and advocated stricter regulations. "But you can't regulate common sense," he added.

Beekeepers of Wisdom – Problem Solvers in a Knowledge-based Economy:

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"The more we progress the more we tend to progress. We advance not in arithmetical but in geometrical progression. We draw <u>compound interest on the whole capital of knowledge</u> and virtue which has been accumulated since the dawning of time. … Ten years now go further than a thousand then, not so much on account of our finer intellects as because the light we have shows us the way to more. … Now we walk briskly towards our unknown goal." [2] *Sir Arthur Conan Doyle*

The hierarchy of thinking can be broken down into four levels. The first level is data—simple facts and figures. The second is information. Information is data that has been gathered and organized and can be used as a reference tool. The third level is knowledge. This can be described as information that we have digested and now understand. The mind has collected information and put it into context and has arrived at the know-<u>how</u>.

The fourth and final level is wisdom. Wisdom is often indistinguishable from knowledge. Wisdom is the proper use of knowledge - the know-<u>why</u>. Wisdom is a deep understanding of universal truths – the realization of people, things, events or situations, resulting in the ability to apply perceptions, judgments and <u>actions</u> in keeping with this understanding. Wisdom is the

[2] Sir Arthur Conan Doyle was the inventor of my favorite childhood investigative researcher, Sherlock Holmes. Sherlock Holmes retires to Sussex England where he takes up beekeeping and writes his magnum opus on the "Practical Handbook of Bee Culture, with some Observations upon the Segregation of the Queen"

comprehension of what is true, coupled with the optimum judgment as to action. Knowledge can be described as doing things right, where wisdom is doing the right things.

The world is in the early innings of a tectonic paradigm shift toward a knowledge-based economy. Just as the developed world has transitioned in the past from an agricultural economy to an industrial economy to post-industrial/mass production economy, this transition will produce an irreversible shift in the global state of mind. With this change, some businesses will lead, evolve, and prosper and others will cease to exist. "In times of change, learners inherit the earth, while the learned find themselves beautifully equipped to deal with a world that no longer exists.[3]"

Phase One of the transition to a knowledge-based economy began with the build-out of the Internet. There were many new businesses that thrived selling the picks and shovels to this gold rush. After the network was built, a number of businesses prospered by putting information and content on the network. Both of these solutions have largely become commoditized. We now have a network of people and things and activities where information is readily available and data is being collected. We now have at our disposal an enormous new natural resource – this mountain of data that allows us to see and understand the world like never before. Yet, "where is wisdom we have lost in knowledge, where is the knowledge we have lost in information?[4]" Which businesses have and/or will have the knowledge and collective wisdom to answer this call?

Technology developments, demographics, and limited resources are three major disruptors that are driving this change. Where the Industrial Age emphasized the exchange of goods and services, a knowledge-based economy will emphasize the exchange of concepts. While we will still need goods and services, the shift that is emerging is one where the businesses that survive will have proprietary knowledge to more effectively deliver solutions through advanced logistical capabilities, networked advantages, and deep analytical know-why. The owners and purveyors of this wisdom will have an opportunity to thrive in a way that has not been seen before due to the world becoming more connected and integrated.

It is important to reemphasize that great is very different than good. While many *good* businesses do things right and produce compelling applications, we feel only a few great businesses have the scaled capability and know-why to do the right things. The greatest folly can arise from good businesses that fool themselves into thinking they are great and suffer from an illusion of knowledge. These actors march ahead under the auspices of conviction around a fleeting advantage and become victims of the inevitable unknowable. Wisdom exists beyond pride and lives in a world where humility and merit coexist.

Today we are stakeholders in a number of businesses that have built a deep level of deserved trust with their customers. This trust helps reduce the search cost for the consumer. Some of these businesses have the ability to solve complex logistical problems by serving as the trusted intermediary between a dispersed and fragmented supplier base with a fragmented customer base. It is of note that many of these businesses do not require a lot in the way of assets to run their businesses but have enormous intellectual property value in the mind of the consumer. We want to invest alongside businesses where this *economic goodwill* is greatest.

[3] Eric Hoffer.
[4] T.S. Eliot.

The Beekeepers – The Six Sides of Great:

Of our three categories of investments - compounders, transformations and workouts - compounders are most preferred. Compounders represent what we believe to be great businesses where the value of the business should improve over time. We seek to find these businesses when they are trading at a reasonable price. Compounders have produced - and we feel will continue to produce - the lion's share of our equity returns so I wanted to share with you how we define a great business, particularly in light of the fact that the words "high quality" are the moniker du jour for purveyors of investment products.

The mystery behind how honeybees create perfectly symmetrical hexagons in their honeycombs has long fascinated people since ancient times. Charles Darwin described the engineering of the bee honeycomb as being "perfect in economizing labor and wax." The hexagonal structure uses the least material to create a lattice of cells within a given volume. Hexagonal structures also provide the most efficient strength and are even angled at 13° to prevent honey from dripping out.

Just like honeycombs, great businesses or compounders are built to endure, employing the least amount of resources necessary to maximize the production of cash flows. Not only do bees support their own colonies, but they also serve society through pollination. This fact is fitting as great businesses have an enduring positive influence on society.

We conclude that a great business has six attributes, thus the hexagon is an appropriate shape to illustrate this description as each is equally important and interconnected . Each side is not independent but interdependent to create strength, efficiency, and endurance in the production of value to shareholders, employees and society.

Economics – The \e/

The \e/ or economics is the entrance and exit to the hexagon. Its place in the foundation of the hexagon is fitting as this is where due diligence begins for an investment. It is also where deteriorating economics will trigger a decision point for a sale of what was a compounding business. We are attracted to companies that have the capability to produce the greatest amount of owner earnings with the least amount of resources. The metric we use to measure this capability is the return on net tangible assets.

Competitive Advantage – A Nuthatch Concept

Competitive advantage is always top-of-mind and thus, fittingly, at the top of the hexagon. Of the six attributes of a great business, we will devote 90% of our intellectual horsepower to understanding if the competitive moat around the business is widening or narrowing. We wrote about this attribute in our Q1 2011 letter titled "A Nuthatch Concept[5]." We are looking for businesses that can do something their competitors cannot do and/or are a local champion in a product space or geography. It is important to note that the attributes that allow a business with superior economics to compound are rare. In fact, we believe most businesses that exist today will not be better five years from now. We assume that less than 20% will actually be better. It is one of *the most important pieces of wisdom* that we take into our compounder research.

Market Opportunity – bigger slice of growing pie

The top sides of our hexagon are the two key attributes that will affect the top-line revenue of our business – volume and price. Volume is driven by the end market demand for the products and services the business is selling. In general, we like businesses that are growing but growth is not always a prerequisite for a great businesses. If growth delivers favorable returns on the additional capital needed, then growing end market demand can be additive to the business economics. We feel having a differentiated yet rational view on end market demand and the sustainability of that demand can produce compelling results. The marketplace can suffer from myopia[6] at times, which can obscure the true opportunity that exists for a business's products and services.

Pricing Power – to the Nth power

Net incremental price increases over fixed costs produces exponential results. Intuitively 1 + 1 should equal 2 yet in the case of the operating leverage of pricing power, 1 +1 equates to the power of price. The ability to raise prices is integrally connected to the business' competitive advantage – a business with a Nuthatch Concept can help provide this Nth power. Pricing power becomes infinitely more important when your costs are rising, perhaps even sharply in an inflationary environment. While the world appears to have forgotten just how damaging inflation can be to wealth, we have not.

Capital Intensity – less is more

We prefer to own businesses that have favorable returns on their net tangible assets. We also prefer to own companies that do not need a lot of capital to maintain their competitive advantage or grow. Unlike today, capital in normal times is not free, and a business that requires capital will eventually need it at an inopportune time when capital may be expensive. A business that needs a lot of tangible assets to operate is hurt by inflation as they must spend the vast majority of their earnings just to maintain their volumes. Businesses that do not require a lot of tangible assets to operate will be least hurt by inflation.

Management – queenright

A hive is said to be "queenright" when a queen is in place and the hive is working at full capacity. We look for businesses that have effective leadership that are doing three things well;

1) operating the business effectively to maximize the long-term flow of owner earnings,

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[5] Q1 2011 East Coast Asset Management Investment Letter – A Nuthatch Concept – link.
[6] Q1 2012 East Coast Asset Management Investment Letter – A Focus on Mispricings – link.

2) allocating excess capital intelligently through timely share repurchases, dividends and accretive investment opportunities within its core competencies and
3) building a culture of excellence through vision, leadership and stewardship of the enterprise for stakeholders, employees and society.

A business that is queenright is drastically different than a business that is queenless[7]. We find queenless hives exist when the business is being run to maximize the income of overreaching management teams and not for the benefit of owners. We find queenless hives when there is a lack of management skill in both the operation of the business and more often with how they deploy excess earnings of the enterprise. And while less talked-about, we find queenless hives where the businesses culture is weak in the stewardship to its employees and to society. Today, a great business must be focused on more than profits; it must earn great returns on human and societal capital to be relevant and deserving of success.

Representative Idea: IBM

The year is 1951 and a confluence of events born from intense learning will lead to the creation of two of the greatest companies the world has ever seen. It has been six years since the end of World War II and the economy is slowly recovering thanks to a baby boom and a very accommodative Federal Reserve. A near zero-percent interest rate policy has been in effect to help mitigate the effect of debts accumulated during World War II and to maintain stability of the banking system. Year-over-year inflation spikes to 10% and the public is becoming worried about rampant inflation just as the government begins to make preparations for the Korean War. The Fed is induced to remove their 1% cap on interest rates and stocks go on to outperform bonds by 25% for the year.

At Columbia University, Ben Graham and David Dodd publish their third edition of *Security Analysis* just in time for Ben Graham to share these evolving insights with a group of new students in his Security Analysis class, one of whom is a young aspiring investor from Omaha named Warren Buffett. [8]

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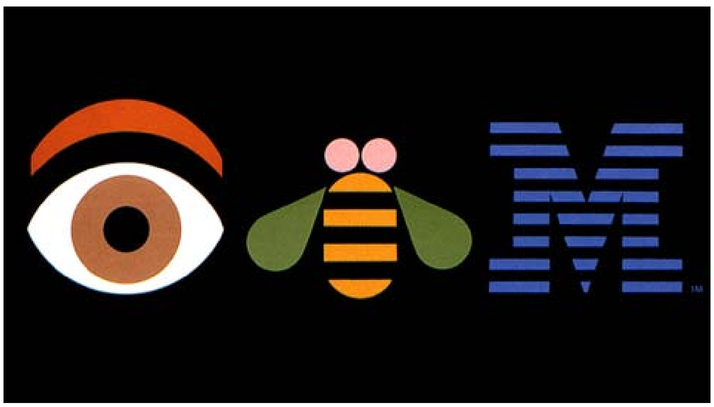
[7] Leo Tolstoy brilliantly described a queenless hive in his epic novel War and Peace. I found the entire description well suited to describe what we too often find in many businesses that do not pass this attribute of a great business and in its inversion describe those things which we value. The excerpt is available on our website – Tolstoy link.

[8] While value investing history is being made on campus in 1951, the 13th Columbia University president, General Dwight D. Eisenhower, heads to Europe to take on another day job as the first Supreme Commander of NATO. General Dwight D. Eisenhower returns to Columbia to make a successful run to become the 34th President of the United States in 1952 with the help and encouragement of his good friend Thomas Watson, Sr. President Eisenhower will move quickly early in his presidency to champion the formation of the Interstate Highway System which will serve to spur US economic growth for decades to come. Before the General would tackle the largest public works project since the pyramids in creating a national interconnected network that would reach 47,182 miles, one of his first acts as president was tackling a smaller thoroughfare. As a thank you to his esteemed supporters at Columbia, Eisenhower would secure the purchase of 116th street (adjacent to Ben Graham's classroom and the IBM research lab) between Broadway and Amsterdam for $1,000 where the *hexagonal* pavers of College Walk greet visitors to this day. The compounding benefits of both are extraordinary. Ike the value investor – I Like Ike!

Across campus in a research lab at Columbia, history is being made in another industry. Thomas Watson, Jr., in advance of taking over the reins as CEO of IBM from his father Thomas Watson Sr., checks in with fellow IBMers at their first research facility, Watson Scientific Computing Lab where a major breakthrough is underway. Soon IBM will unveil the first commercially successful general-purpose computer, the IBM 701 Defense Calculator, which Watson later recalled was "the machine that carried us into the electronics business."

Sixty-one years after those formidable days at Columbia, Warren Buffett's Berkshire Hathaway and Thomas Watson's IBM have become two of the ten largest businesses on the planet by market capitalization ($200 billion and $220 billion respectively). In 2011, Berkshire Hathaway made its first meaningful investment in IBM and has become the largest shareholder of IBM with an ownership stake of over $13 billion according to the most recent public filings.

Within the last quarter, we have added IBM to our core equity portfolios and I want to share some of the merits of this investment within the context of the six sides of a great business.



In a world that values solutions to complex problems from a trusted partner, IBM is in an advantaged position. [9]

While the culture and principles that were galvanized into the business over the last hundred years endure, their products and services have changed dramatically over its history in pursuit of helping their customers solve problems. If you have not followed IBM over the last decade, the company has been transforming itself yet again under the leadership of Chairman and former CEO Sam Palmisano. Sam has shared his "Smarter Planet" vision and wisdom with IBMers, strategic partners, and the world over the last ten years and has put those objectives into determined action with exceptional results. Where appropriate in this section, I have shared Sam's words from the numerous speeches he has given over the decade.

Economics – THINK \e/

IBM has averaged unlevered returns on net tangible assets over the last five years of greater than 20%. We see the measured annual improvement of this metric, from 15% to nearly 25%, as an economic affirmation that their go-to-market strategy, operating efficiency, and capital allocation policies are yielding incremental results. The business generated over $20 billion dollars of pre-tax owner earnings last year on revenues of $107 billion. In 2011, management repurchased $15 billion in stock and returned $3.5 billion in the form of dividends.

[9] The great thinker and graphic designer Paul Rand created many of the trademarks that exist today for IBM including this 1981 poster.

Competitive Advantage – Intellectual Know-why and A Culture of Innovation – R and D:

IBM is a local champion in the business of providing analytical software and service solutions to customers. They dominate their product space and win locally with customers by tailoring their solution geographically. Their durable competitive advantage exists in the sheer depth of their proprietary intellectual knowledge with which they can solve their customer's complex problems. The engine that drives these insights is a culture of innovation. Over the last 30 years, IBM has invested over $150 billion in research and development, producing over 75,000 patents. 2011 was the eleventh year in a row where IBM filed and won more patents with the US Patent Office than any other company, acquiring 6,180 in 2011 alone and investing over $6 billion. Most importantly, IBM has created a scaled system that has been able to convert research expenditures into development and profit.

> *We talk about R and D – and sometimes we forget the "and". They are different. As "Revolutions" reminds us, our industry depends on advances in basic science. Indeed, you could say that the fundamental purpose of the Information Technology industry is to create economic value from the discoveries of science. To innovate successfully for a decade or a generation – much less for a century – you have to be able to turn discovery into profits.*
>
> *For example, IBM is working with Rio de Janeiro and hundreds of other "smarter cities" around the world to build Integrated Operations Centers. These hubs pull together and analyze heterogeneous, often unstructured data from multiple sources, and they provide a whole new way of understanding and managing our cities.*
>
> *This is why innovation models matter. For the past couple of decades, we've seen one model based on serial launches, serial IPOs and "free agent nation." That has generated enormous vitality for Silicon Valley – but it may not serve to build lasting institutions or to support the basic science that those institutions are uniquely equipped to pursue.*

IBM's culture of innovation gives them the financial and human resources to pioneer new solutions to complex problems. IBM has designed a world-class system to maximize the benefits of the creative process – the process by which imagination leads to invention. IBM understands that truly great insights often come through a collaborative process – making connections both within and outside of the company. IBM's internal social network, fittingly called "Beehive," gives IBM researchers from around the world the ability to share research and ideas. IBM has also partnered with universities and outside research labs to gain unique perspectives to aid innovation. We feel IBM has the scale and intellectual know-why to be the trusted partner of choice for many businesses and government entities as we move forward in this knowledge-based economy.

Market Opportunity – Smarter Planet

IBM has targeted four key areas of market opportunity: the developing markets, cloud and smarter computing, business analytics and optimization, and smarter planets/smarter cities.

> *The world that has become pervasively instrumented, interconnected and intelligent, in which computation is being infused into things nobody would think of as a computer. This is the shift to what IBM calls a Smarter Planet. Let me give you some idea of its scope.*

> *We're all aware of the approximately two billion people now on the Internet. This number is growing rapidly in every part of the world, thanks to the explosion of mobile technology. But there are also upwards of a trillion interconnected and intelligent objects and organisms – what some call the Internet of Things.*
>
> *There are a billion transistors today for every human being on the planet. Intelligence is now embedded in the systems that enable services to be delivered, physical goods to be made and sold, everything from people and freight to oil, water and electrons to move and billions of people to work and live. All of this is generating vast stores of information. It is estimated that there will be 44 times as much data generated over the next decade, reaching 35 zettabytes in 2020. A zettabyte is a 1 followed by 21 zeroes. And thanks to advanced computation and analytics, we can now make sense of that data in something like real time. This enables very different kinds of insight, foresight and decision-making.*

Pricing Power – Make Me Smart Too

IBM has the ability to price its proprietary knowledge competitively and raise those prices according to the value they provide. In our research, the demand resonating from IBM's city contracts and analytic clients is one of "I saw what you did here can you do that for me?" Businesses and governments are demanding solutions to stay competitive and IBM is answering those challenges with complete solutions while their competition only has partial answers.

Management – Queenright at IBM

Sam Palmisano has been one of the most impressive CEOs we have encountered. His leadership and vision have been extraordinary and has put IBM on a promising course as it enters its next 100 years. His sense of humility and context of what leadership means is embedded in the IBM culture.

> *The truth is that I have always thought of myself not as a "captain of industry"… but as the temporary steward of a great enterprise. I came to work every day with the mindset that IBM would outlive me… and with a determination that I and my colleagues will pass on to future generations of IBMers… and to the world… a better IBM than the one we inherited. Better positioned in our industry… stronger financially… and more relevant to society.*

Ginni Rometti has recently taken over as CEO. She has been with the company since 1981, working with Sam Palmisano for over 31 years. We feel the transition of leadership has been effective. The shareholder orientation that has been in place should continue. Sam and Ginni have a strong shareholder orientation and have allocated the businesses' excess cash wisely. Over the last five years, management has made over $50 billion dollars in net share repurchases and paid out over $14 billion in dividends. We anticipate accretive share repurchase activities to continue as they have earmarked an additional $50 billion on their 2015 road map for share repurchase.

Capital Intensity – Intellectual Property versus PPE

We have previously written about inflation concerns. When we think of mitigating some of our exposure to this potential risk, our response is to own a great business with pricing power. We also prefer to own a business that only needs modest additional capital to maintain its competitive advantage or to engender growth. The fact that much of IBM's value is intellectual property, and not variable property (PPE), is an attribute we value.

Valuation – A Reasonable Price

A great business is not a great investment unless we can buy the business at a discount. A business, or any investment, is determined by the future cash inflows and outflows, discounted at an appropriate discount rate, which we anticipate to be delivered over the life of the investment.

Today, we believe there is still a stigma for many investors about IBM as many perceive it to be the business that prospered in the past and thus not relevant. IBM has evolved well beyond that, yet we believe the stock price has not fully reflected this reality. We feel IBM fulfills the following value proposition toward our compounding objective (JOC); a range of expected returns that are compelling (IRR), a measurable margin of safety (MoS), comprehension of the critical data points of what a "smarter planet" and thoughtful capital allocation strategy means to IBM (H4), and finally knowledge of why the perception of the marketplace may be mispricing IBM (M). The following formula is one that we look to satisfy in the valuation stage of any prospective investment opportunity. In the case of IBM we believe we have:

$$\mathbf{JOC = [IRR*(MoS+H4)]^{M}}$$

We continue to find this investment climate productive for adding businesses like IBM to our portfolio. If the current period of volatility persists, we believe it will only serve to bolster our long-term compounded returns if we can act intelligently with a prepared mind. We look forward to meeting and talking with you soon. We greatly value your support and trust.

> *"Those who have handled sciences have been either men of experiment or men of dogmas. The men of experiment are like the ant, they only collect and use; the reasoners resemble spiders, who make cobwebs out of their own substance. But <u>the bee takes a middle course: it gathers its material from the flowers of the garden and of the field, but transforms and digests it by a power of its own."</u>*

Francis Bacon (1561 – 1626)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder

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To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO, Chief Investment Officer, and Co-Founder

Date: January 22, 2013

Re: Fourth Quarter 2012 Update – **Seek Knowledge of Causes**

In our fourth quarter letter you will find an update on our portfolio and general market observations. Each quarter we highlight one component of our investment process – this quarter in the section titled *Seek Knowledge of Causes* we highlight our *transformation* investment category. As is our standard practice, client reporting, including performance and positioning, will be sent under separate cover.

Market Summary[1]

	S&P 500	MSCI AC World Index	MSCI Emerging Markets	MSCI EAFE Index	Barclays Aggregate Bond Index	Gold – $/Troy Oz.	Crude Oil
Price 12/31/2012	1,426.19	1,338.50	1,055.20	1,604.00	1,457.50	$1,677.75	$91.82
Q4 2012	-0.38%	2.68%	5.60%	6.63%	-0.02%	-5.46%	-0.40%
2012	16.00%	16.62%	18.47%	17.87%	3.76%	7.14%	-7.09%
2011	2.11%	-4.98%	-18.37%	-11.67%	7.69%	10.06%	8.15%

Bolstered by valuation and monetary policy tailwinds, equity investments performed well in 2012. The S&P 500 returned 16.00%, the MSCI World Index returned 16.62%, the MSCI Emerging Markets Index returned 18.47%, and the MSCI EAFE Index returned 17.87%. Fixed-income lagged, as the Barclays Aggregate Bond Index returned 3.76%. While we do not pretend to have any precise insights into what indices will return in the short-term, 2012 returns fell largely in-line with what the fundamentals warranted.

Equity markets sold off following the U.S. Presidential election as investors feared fiscal cliff implications, however, equity indices made up lost ground as those year-end discussions progressed. Returns have begun to favor the businesses we believe to be higher quality. Lower quality equities look more fully priced as they have been running at a faster clip since equity markets began to recover in 2009. While hares can have exciting starts, we will forever favor endurance.

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, the MSCI Europe Asia Far East Index (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices.

Inaugural Outlook:

"We have always understood that when times change, so must we; that fidelity to our founding principles requires new responses to new challenges..."

President Obama
Second Inaugural Address

Yesterday marked the fifty-seventh time the United States has sworn in a President[2]. The presidential inauguration has always marked a time when the country pauses, reflects, and honors a democracy that is far greater than any candidate or party.

As we open 2013, we also begin anew. We look to remove biases toward recent performance or macroeconomic events, and ask ourselves: what do the facts tell us about the merit of the universe of investment opportunities? We define merit as the return on our invested capital based on the timing and confidence of measured cash flows vs. the purchase price.

To this end, we are encouraged by the merit of our equity portfolio. We own and continue to find excellent businesses at reasonable prices, which we feel will translate into attractive compounded returns. During a time of extensive monetary stimulus, the low yielding intermediate-long term fixed-income security environment is a risky proposition. At some point yields may move sharply higher spurring a downside move in longer-term bonds that would catch many risk-averse investors unaware.

While our attention is focused on measureable market dynamics, we remain cognizant of geopolitical and economic concerns outside of our control. In this light, we will act accordingly if we observe risks that should be mitigated.

Portfolio Changes – ECAM Core Equity Strategy[3]:

In Q4 we added two new holdings to our portfolio. Both of our new holdings (and now our last three ideas) have been sourced from our transformation category, which will be discussed in the section titled "Transformations – Seek Knowledge of Causes." We also took advantage of market volatility caused by the election and fiscal cliff fears to increase our ownership of certain core positions as prices fell.

Additionally, we exited a business that we owned for less than a year at a modest profit. This investment was sourced from our workout category, and in hindsight we should have passed on the opportunity. While the business was sufficiently undervalued, its long-term competitive advantage had the potential to be inhibited by a change in government policy. We decided to exit the position as our work on new opportunities proved more compelling.

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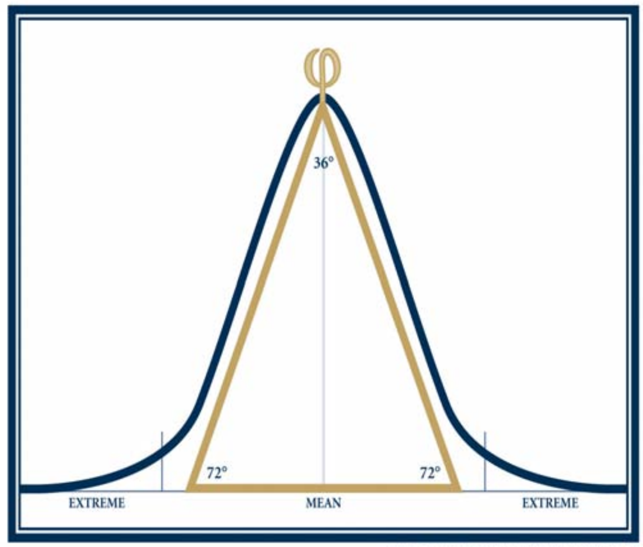
[2] President Obama took his second oath of office on January 21, 2013, to uphold the constitution, once again using the same bible used by President Abraham Lincoln in 1861, and the family bible of Martin Luther King Jr. To share another particularly appropriate quote from the inaugural address given some of the concepts discussed in this quarter's letter, "For history tells us that while these truths may be self-evident, they've never been self-executing."

[3] Disclosure: This letter is for informational purposes only. Past performance is not indicative of future results nor does it protect from future losses. ECAM only illustrates those investments that have been purchased by the firm in the past quarter for informational purposes. ECAM may not illustrate all trades of a prior quarter and will exclude those not relevant to a discussion in any particular quarter's letter.

A House Divided[4] – Compounding and State:

Four years ago the credit crisis enveloped the world and tested whether our financial system, conceived of freedom of enterprise and capital, could endure. The paramount objective became to preserve the system via a coordinated government response. We can look at the events that unfolded and declare, "*Thank God we have a government*[5]."

A majority ruled government of the people, for the people, and by the people can be represented by a bell-shaped curve. The mean is represented by the center of the curve and the edges of the curve (or tails) are represented by the extremes – a mean-extreme ratio[6]. We illustrate the idea with what we refer to as the *golden triangle of reason*. When viewed up close, a majority ruled government like ours often looks imperfect as the voices of the extremes capture the attention of the people and write the headlines. In contrast, when viewed from further away we observe that the majority is fully represented in a more perfectly proportioned union based on truth and reason; represented by the mean.



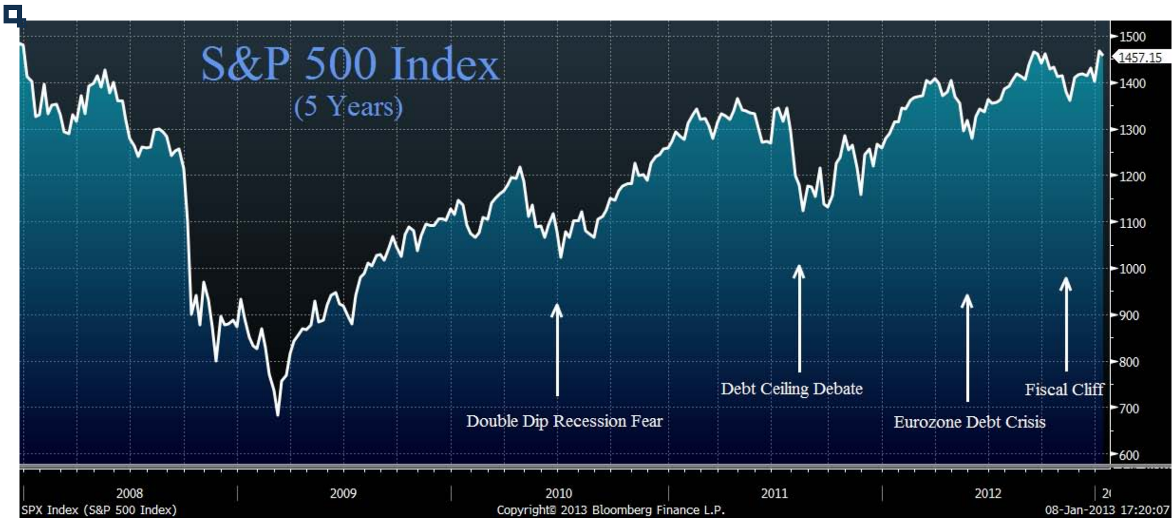
During turbulent times, contested debates and partisan gridlock often drown out the voices of reason, but ironically that is when our democracy is operating as it was designed. The merits of each extreme pull the mean, or the intelligence of the majority, to its rightful place. In fact, the system is working in this capacity right now as it corrects some of the missteps that led to, and that were inflicted by, the credit bubble. Thomas Jefferson explained these necessary course corrections in a letter to James Madison in 1816, "We shall have our follies without doubt. Some one or more of them will always be afloat. But ours will be the follies of enthusiasm … enthusiasm of the free and buoyant. Education and free discussion are the antidotes of both." *Thank God we have a government!*

The necessary government intervention to balance the credit fueled imbalances was significant and persists today. Investors who have been awaiting an all clear sign to be heralded find themselves at a loss. There has been one great battle to fight after another and there will be more to fight before we can declare any sense of victory. While the debt burden remains the same

[4] Abraham Lincoln's now celebrated "House Divided" speech was a brilliant address of reasoning on why the issue of abolishing slavery had to be resolved. The separation of investing decisions from government policy noise is a house that should remain divided.
[5] The phrase ***"thank God we have a government"*** was secretly etched into Abraham Lincoln's pocket watch by Jonathan Dillon while repairing the time piece on April 13, 1861. Dillon also etched for eternity the words "Fort Sumter was attacked by the rebels on the above date J Dillon April 13-1861 Washington." It is interesting to note that Lincoln would unknowingly be carrying the date April 13th, Thomas Jefferson's birthday, as he reasoned for self-evident truths of equality throughout the Civil War. Dillon's family would carry this generational secret until Smithsonian officials opened the watch for the first time and confirmed these etchings on March 10th, 2009.
[6] Euclid provided the first known written definition of the golden ratio, which he referred to as the "mean and extreme ratio."

enemy, the battlefields shift – double-dip recession, debt ceiling, Eurozone crisis, a tightly contested U.S. Presidential election, and most recently the fiscal cliff.

These challenges have been successful at distracting investor attention away from fundamental truths and reason, yet the best compounding opportunities will always be borne from environments like these. During these times, valuation is the most trustworthy guide to navigate the compounding journey and it will always remain the beacon of our investment philosophy. An investor who understands the *knowledge of causes* and finds emotional solace in valuation, and not in sentiment, is more apt to act with reason and participate in the joys of compounding. As I write this quarterly letter, the S&P 500 has climbed over 113 percent since the closing lows on March 3rd, 2009.



At East Coast we believe the financial markets are connected indefinitely over time; to the same idea of the *golden triangle of reason*. The mean-extreme ratio that serves as an invisible hand of reason for government also applies to the financial markets, as the actions of the majority guide prices toward true value over time. As misperceptions and emotional extremes play out in the marketplace, equity valuations overshoot in one direction or the other, thus creating environments of overvaluation or undervaluation. When this is observed on individual companies these mispricings become accentuated. This is a *very* fortunate reality for the value investor. An investor who is equipped with a process to identify where this *intrinsic value line* lies can make intelligent decisions when price and value diverge.

Transformations – Seek Knowledge of Causes[7]:

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I have never written at length about our transformation category.

Toward our mission of compounding capital it would be logical to assume that our compounder category sufficiently supplies the best opportunities for our overall investment objectives. We define compounders as businesses that have superior returns on tangible assets employed in the businesses, and we expect those returns to be sustained or improved over a five-year or longer time horizon. This investment universe is small, as we believe less than twenty percent of businesses that exist today will actually be better five years from now.

The truth is there are times when the market is efficient in extrapolating that which is working indefinitely into the future. Great businesses are often priced appropriately for their greatness; however, we do find the market less efficient in its ability to look around corners for businesses that are not yet great, but emerging toward greatness.

At East Coast, we call these investment opportunities *transformations*. In general, these businesses often have average or below-average economics, and we use the *six-sides of great framework*[8] to work through each idea, with the key difference being that we are focused on *seeking knowledge of causes* that will produce a meaningful inflection point of change on the economics of the businesses. *Transformations* have produced some of our most successful investments.

To finally give this category the justice it deserves, I have chosen to describe it by illustrating one of the more remarkable *emergence of greatness* stories in our nation's history. I will discuss three objects that are symbolic of the principles that facilitated Abraham Lincoln's transformation toward greatness, which culminated in seven years of exceptional leadership that changed the path of the Union from dissolution to compounding.

Lincoln's Gold Watch Fob – A "Euclidian" Triangle of Reason

The contents of Lincoln's pockets on the night he was assassinated were put into a box and given to his son Robert Lincoln. The contents remained in the Lincoln family until 1937 when Lincoln's granddaughter gifted them to the Library of Congress. The contents would sit in a Library of Congress closet safe until 1976 when the box was publically opened on Lincoln's

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[7] "*Causarum Cognitio*" or *Seek Knowledge of Causes* is the original name given to Raphael's famous 1510 fresco at the Vatican which has become known as *The School of Athens*. *The School of Athens* fresco is one of my favorite paintings and we have created a version of our own above for the purposes of this letter.

[8] The *six-sides of great framework* was highlighted in our Q2 2012 letter *The Beekeepers*.

birthday, February 12th. Inside the box was a lens polisher, a pocket knife, a linen handkerchief embroidered "A. Lincoln," a brown leather wallet with three sections titled "Notes, U.S. Currency, and R.R. Tickets," a $5 Confederate bill, nine newspaper clippings, two pairs of spectacles, and a gold watch fob.

Of all the objects, the gold watch fob seems the most curious. Yet, if one studies its geometric proportions[9] the watch fob calls forth Lincoln's numerous references to Euclid.

Euclid's *Elements*, which dates back to 300 BC, deduced an elaborate system of propositions that seemed both to accurately describe physical reality and to compose a flawlessly logical system of reasoning. In Lincoln's own words he recalls the Euclidean intellectual transformation he experienced while in his early forties and practicing law.

> *In the course of my law reading I constantly came upon the word "demonstrate." I thought at first that I understood its meaning, but soon became satisfied that I did not. I said to myself, What do I do when I demonstrate more than when I reason or prove? How does demonstration differ from any other proof? …*
>
> *At last I said,- Lincoln, you never can make a lawyer if you do not understand what demonstrate means; and I left my situation in Springfield, went home to my father's house, and stayed there till I could give any proposition in the six books of Euclid at sight. I then found out what demonstrate means, and went back to my law studies.*

Lincoln had the ability to demonstrate solutions to complex problems using a framework of logic linked back to self-evident truths. Listening carefully to the words of Lincoln's most celebrated works, one can hear the echoes of Euclid. I believe Lincoln's greatness emerged in 1858 when he began experimenting publically with this type of logic. This letter to Henry L. Pierce stands as an example of Lincoln's inflection point toward greatness.

> *Gentlemen, Your kind note inviting me to attend a Festival in Boston, on the 13th. Inst. in honor of the birth-day of Thomas Jefferson was duly received. My engagements are such that I cannot attend …*
>
> *But soberly, it is now no child's play to save the principles of Jefferson from total overthrow in this nation. One would start with great confidence that he could convince any sane child that the simpler propositions of Euclid are true; but, nevertheless, he would fail, utterly, with one who should deny the definitions and axioms. The principles of Jefferson are the definitions and axioms of free society …*
>
> *All honor to Jefferson – to the man who, in the concrete pressure of a struggle for national independence by a single people, had the coolness, forecast, and capacity to introduce into a merely revolutionary document, an abstract truth, applicable to all men and all times, and so to embalm it there, that to-day, and in all coming days, it shall be a*

[9] The triangle's shape is that of a golden triangle, an isosceles triangle in which the smaller side is in golden ratio with its adjacent side. Euclid's *Elements* provides the first known written definition of what is now called the golden ratio: "A straight line is said to have been *cut in extreme and mean ratio* when, as the whole line is to the greater segment, so is the greater to the less." Euclid explains a construction for cutting (sectioning) a line "in extreme and mean ratio" i.e. the golden ratio. Throughout *Elements*, several propositions (theorems in modern terminology) and their proofs employ the golden ratio.

rebuke and a stumbling-block to the very harbingers of re-appearing tyranny and oppression.

Lincoln continued to exhibit the keenest sense of Euclidian logic when the weight of preserving the Union fell squarely on his shoulders. Let the gold watch fob he carried represent the self-evident truths and principles of reason that formed the foundation of Lincoln's greatness.

Lincoln's art of reason was his ability to define his positions on a system of clear and inexorable logic. At East Coast, in a similar vein, every investment category must link back to our investment principles. Specifically, in our transformation category, we are *seeking knowledge of causes* that create a point of change, which then also meets the required philosophy we review for each investment. We have dedicated previous quarterly letters for each of our five core principles and we will continue to reinforce how those principles apply to our investment decisions. As perhaps Lincoln carried a watch fob to symbolize the art of reason, we carry the following investment principles that we believe to be self-evident truths:

1. Compounding is the ultimate objective (JOC)
2. Margin of Safety (MoS)
3. IRR is the Unified Theory of Investing (IRR)
4. H4 – Investment Longitude – knowledge of the critical data points (H4)
5. A Focus on Mispricings – knowledge of the reasons for mispricing (M)

The sum of these parts makes up the following equation that guides our principles of reason:

$$\mathbf{JOC = [IRR*(MoS+H4)]^{M}}$$

Q.E.D.[10]

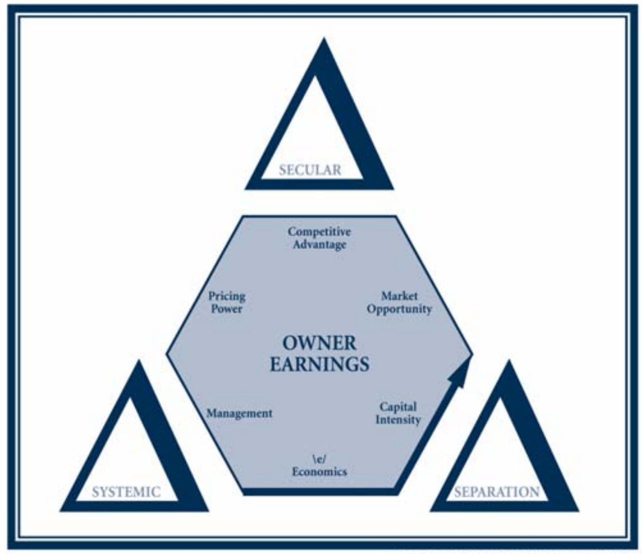
Watch Chain – Preserving the Union of Principles and Process

In 1862, while the Civil War was being fought, President Lincoln had the foresight to look beyond the immediacy of war and focus west. Lincoln recognized the importance of unifying the West with the East via railroad and economic development. On July 1, 1862, President Lincoln authorized extensive land grants in the Western United States and facilitated the issuance of thirty-year government bonds to the Union Pacific Railroad and Central Pacific Railroad companies to construct a transcontinental railroad. In 1863, the railroad delegation sent the President a gold watch chain[11] as a symbol of their appreciation for his leadership and confidence.

President Lincoln's gold watch chain symbolizes the process that he firmly connected to his principles of reason, or gold watch fob. Lincoln's acts as President were deliberate toward his goal of preserving the union and positioning the country to exponentially prosper.

[10] The phrase *quod erat demonstrandum* translates into "what was required to be proved." The phrase was used by many early Greek mathematicians, including Euclid and Archimedes.
[11] This particular watch chain shows plainly in several Lincoln photographs, looped through the second buttonhole from the top of the vest. The watch chain was gifted by the President's wife, Mary, to a cousin and eventually made its way into the collection of Oliver Barrett. President Lincoln's son Robert made numerous attempts to reclaim this chain and was negotiating a trade for manuscripts in possession of the Library of Congress but died before it was resolved.

Our investment process becomes considerably more important when we try to ascertain if a business is truly transforming and emerging toward greatness. Every business is either getting better or worse with change, and we feel the market tends to value businesses on a one-point perspective by inferring the status quo. This can lead to mispricings for those transformations that we identify prior to change agents being reflected on businesses' financial statements.



Evaluating change successfully can be a slippery slope, thus, we have created a process that has helped guide us. The three transformation categories that we have identified and have proven valuable are: Secular, Systemic, and Separation. The East Coast transformation tetractys[12] helps visualize this element of our investment process.

Secular:

A secular transformation is an opportunity to own a business, or sometimes multiple businesses, in an industry that we believe will see a prolonged positive inflection point in their business' economics. The cause of this inflection point most often occurs after an industry has consolidated and we anticipate a rational competitive environment to exist. We typically see revenue improvement, which is driven by either sustained volume gains and/or pricing power improvements. We look for opportunities where an industry's participants have meaningful fixed costs and excess capacity that can create an operating leverage lollapalooza effect on owner earnings. See our representative example on the railroad industry and our positions in Union Pacific (UNP), and Burlington Northern Santa Fe (BNSF) via Berkshire Hathaway (BRK.B).

Systemic:

A systemic transformation is when a business adopts a new companywide operational and cultural method that drives a permanent improvement in the operating economics of the business. Systemic transformations are not turnarounds, restructuring, or solely leadership changes. Systemic transformations occur when a new management team with an evolved system acquires a business with an average or inferior system. We also find these opportunities when successful operators set out to secure meaningful market share gains, both organically and strategically, through profitable acquisitions within an industry which they are or have a pathway to become scale advantaged. As they deploy an advantaged system over time, we are looking for a material and sustained inflection point in their returns on net tangible assets employed in the business. See our representative example on Colfax Corporation (CFX).

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[12] The Pythagoreans, who were great mathematicians and greatly influenced Western philosophy, held the tetractys to be their most sacred symbol. Their most solemn oath was "Nay! By him that gave our family the Tetractys, which holds the *fount and root of ever flowing nature* [*change*]."

Separation:

A separation transformation develops after a business has officially achieved its independence from a parent entity. The most common separations are spinoffs, demutualizations, and carve-outs. Often a declaration of independence is necessary to give freedom to a business that is not operating at its full potential while part of a larger organization. The most successful separations are prompted by the fact that these minority ownerships become too important to ignore. Once they are given their freedom, capital and human creativity is unleashed to productive use. The power of incentives is a major reason why this category continues to provide the best compounding opportunities of all three of our transformation categories. See our representative example on WABCO Corporation (WBC).

"Sum Book" – Time and Compounding

Logically, as we move from gold watch fob (principles) to gold watch chain (process), we should lastly arrive at the President's pocket watch. Perhaps President Lincoln's most notable pocket watch would be his George Chatterton Gold Watch, purchased from his Springfield, Illinois jeweler[13]. The pocket watch symbolizes the constant flux of change as we move forward through time connected to a chain or process and tethered to principles and self-evident truths.

However, I would argue there is another item of Lincoln's relics that does a better job of connecting the timelessness of the gold watch fob and gold watch chain to the idea of inevitable change. I think the crown jewel of all of Lincolnonia for those that appreciate *seeking knowledge of causes* comes from Lincoln's "sum book."

The earliest Lincoln manuscript comes from the pages of his "sum book" where, as a young student of approximately fifteen years old, he practiced arithmetic. A diligent student, Lincoln committed his most advanced problems, answers, and sometimes musings in a book which he sowed together the leaves[14], or pages. Its eleven separate surviving leaves constitute the only existing manuscripts of his childhood in his own hand. Roy Basler, who authored *Lincoln, Collected Works*, has numbered them from one to eleven and notes, "Little else survives to illuminate Lincoln's formative years."

Of the eleven leaves, numbers three and ten have the greatest significance, as they are objects that foreshadow Lincoln's emergence to greatness. In the third leaf Lincoln writes the following beneath his arithmetic calculations.

> *Abraham Lincoln, his hand and pen, <u>he will be good</u>, but God knows when. <u>Time, what an empty vapor 'tis,</u> And days, how swift they are! Swift as in Indians arrow, Fly on like a shooting star, the present moment, just, is here, then slides away in haste, That we can never say they're ours, But only say they're past.*

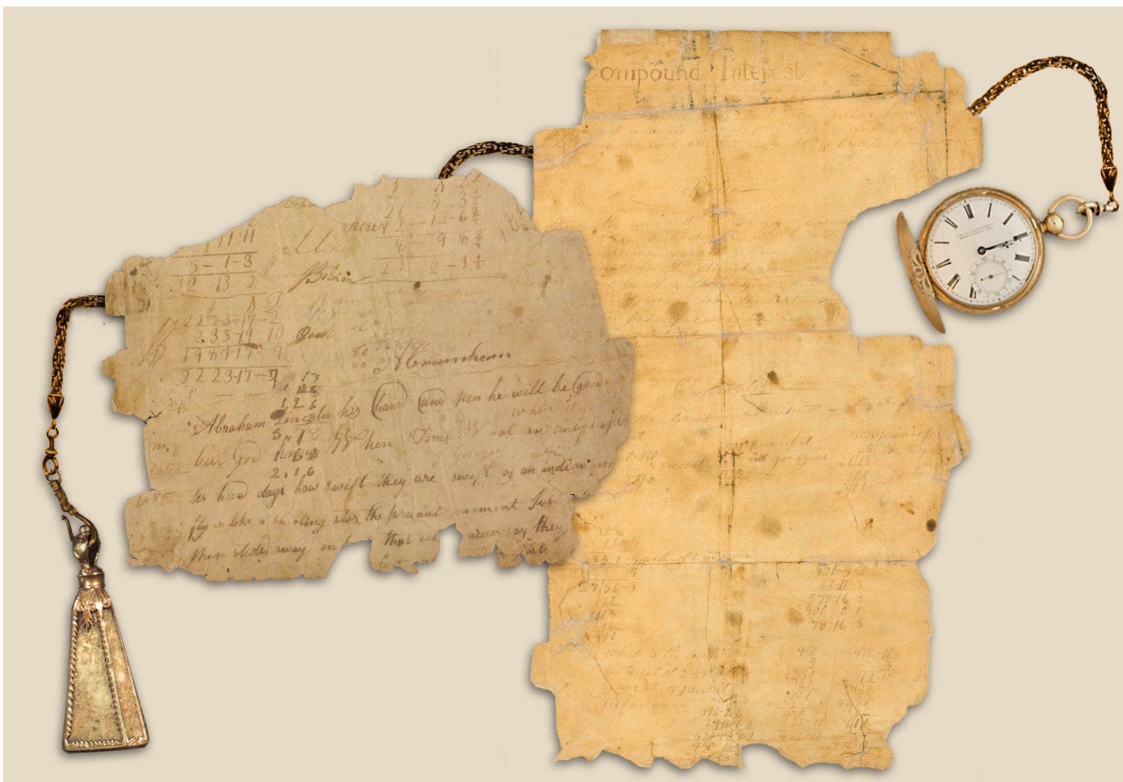
[13] The same jeweler President Lincoln employed to engrave the <u>thirteen</u> letters "Love is Eternal" on Mary Todd Lincoln's wedding ring. <u>Foreshadowing letters that I believe spell the legacy of his life</u>.

[14] After President Lincoln's death, his mother Sarah Bush Johnston Lincoln gave the "sum book" to William Herndon, Lincoln's law practice partner, as he was writing President Lincoln's biography.

Lincoln modestly foretells his emergence toward "good" if he is able to demonstrate his lessons. The words that follow are those of Isaac Watts and were most likely copied from a Lincoln family hymn book.

"Time, what an empty vapor 'tis" does a much better job at summarizing the essence of a transformation than a pocket watch. Time is fleeting. The inevitability of change is the constant. Circumstances and conditions are either waxing or waning but they are not staying the same. The art of reason is to understand the reality of change while connecting ourselves to a learned process that is grounded in self-evident truths that endure.

The tenth and perhaps most remarkable surviving leaf of Lincoln's "sum book" is where Lincoln copied for eternity his lessons on "Compound Interest." In his family's small log cabin in Indiana, Abraham Lincoln was fully engaged in the ***joys of compounding***.



Credits and Notes:[15]

[15] We created the illustration above to demonstrate the connection between the objects that are symbolic of the principles that facilitated Abraham Lincoln's transformation toward greatness.
"Sum Book" photo credit: Leaf # 3 – Private collection. Leaf #10 – Private collection, courtesy of Seth Kaller, Inc.
Watch Fob Photo Credit: Library of Congress. Pocket Watch Photo Credit: Smithsonian.

Transformation Representative Ideas: Secular, Systemic and Separation:

Representative Secular Idea: Railroads (UNP & BRK.B—BNSF)

> *"RAILROAD MAN DIES A HERO" reads the* October 10th, 1904, Post-Standard Syracuse headline. The article reports, *"Carrying out an oft-repeated declaration that he would never send one of his men where he would not go himself, Superintendent of Terminals ALEXANDER S. BEGG of the Grand Trunk Railway, was suffocated yesterday morning in the St. Clair tunnel extending from Port Huron, Mich., under the St. Clair river to Sarnia, Ont., into which he went with other railroad men to rescue from death by coal gas the crew of a freight train which had broken in two and become stalled.*

Railroads were a lifeline to the Civil War armies, and that is where my great-great grandfather Alexander Begg[16] began his railroad career, as a Union soldier. Railroads helped transform the outcome of the Civil War and were the critical tool by which the country reconstructed, unified and transformed the United States thereafter.

The rise, fall and rise again of the railroads provides several lessons on what drives success and failure in business as well as the importance of understanding change. The railroad industry touches on nearly all elements of both opportunity and constraint: regulation, deregulation, subsidies such as land grants, capital market financing, pricing power, operating excellence, overbuilding bubbles, and capital allocation (to name a few).

The railroad industry has been in a secular process of emerging toward greatness over the last seven years and we believe certain rails have a healthy track of improving economics ahead of them. We are shareholders of two railroads in this space: Burlington Northern Santa Fe (BNSF) via our ownership of Berkshire Hathaway (BRK.B), and Union Pacific (UNP).

While both are great railroads, the history of BNSF speaks to the principles we value in a business. These attributes were instilled early when empire builder and dominant founder of BNSF, James J. Hill, succeeded in building a lasting company when most other railroads' shortsighted tactics faltered or failed. His philosophy of heavy tonnages moved at low costs sounds familiar to retail strategies that are dominating today such as Amazon (AMZN) or Costco (COST). Hill understood that the best way to compete was to be the most efficient, and to that end he was meticulous about reducing every curve and grade of his railroad in order to operate at a lower cost than his competitors. As BNSF shareholders we are benefiting from his legacy[17] of infinite refinement and operational excellence.

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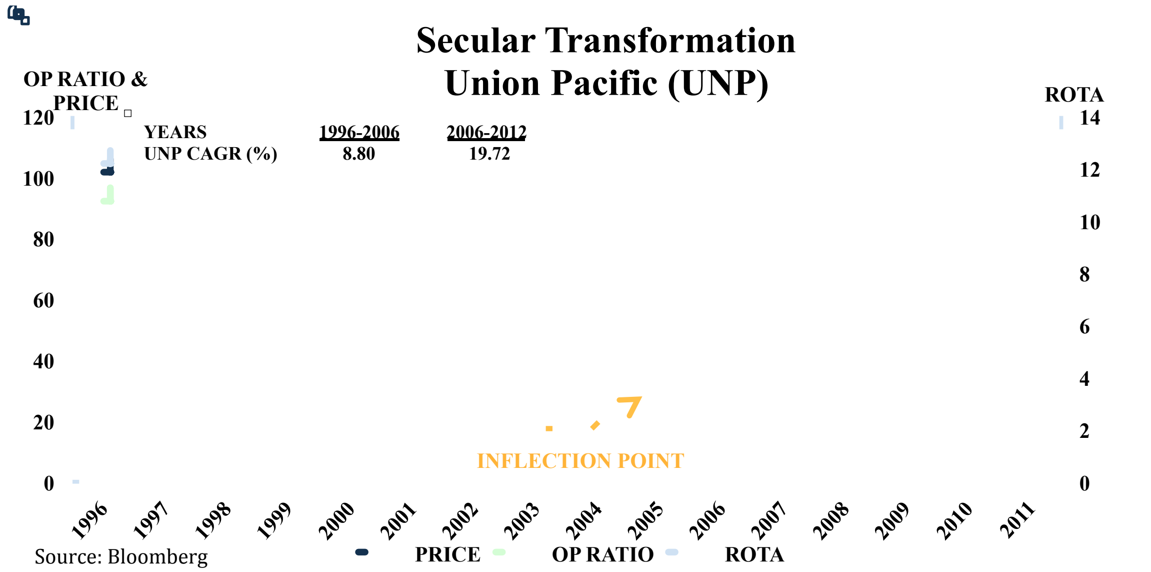
[16] A few years before he died that morning in the St. Clair Tunnel, my great-great grandfather presented my great-grandfather with his gold Waltham Pocket Watch and Watch Fob as he emerged into adulthood. This family relic has been handed down to the eldest son ever since.

[17] The New York Times typified James Hill's obituaries: "Greatness became him, and was a condition of his errand here. Whatever he had done, it had been greatly done. He trusted democracy perhaps more than it trusts itself. He believed in economic destiny. Giving much, he received much. We salute the memory of a great American." And the World's Work saluted him as the "foremost practical master of the large problems of progress of his time; the railroad-building genius who opened up the great northwestern wilderness." James J. Hill: Empire Builder of the Northwest by Michael P. Malone.



Union Pacific's (UNP) inflection point toward emergence of greatness began in 2004. Prior to this period, multi-decade-long competition from trucks running on a free interstate highway system, fueled by relatively inexpensive petroleum, competed effectively for cargo volume. As a proxy for the railroad transformation, the operating economics (ROTA) have improved from approximately 4% in 2004 to nearly 14% in 2011.

While the economics of the business improve, the market has rewarded the share price accordingly. For the ten-year period ending in 2006, UNP had a compounded annual growth rate of 8.9%, compared to a compounded annual growth rate of 19.72% for the following six years[18]. We believe we are in the middle innings of this transformation and expect to see both continued volume and operating efficiency gains over the decade, albeit with times of cyclical volatility. Three noteworthy tailwinds that are benefitting our railroad investments right now are: the accelerating U.S. oil and gas industry, improvements in the housing market, and historically low water levels on the Mississippi River, which are inhibiting barge[19] transport.

Representative Systemic Idea: Colfax Corporation (CFX)

In Q4 we purchased Colfax Corporation (CFX). To understand this systemic transformation is to understand a business we have not owned but long admired, Danaher Corporation (DHR). Danaher is one of the best-run businesses in the world and at the core of their success is the Danaher Business System – a system of lean manufacturing and continuous improvement that operates at a level of model efficiency. Danaher has been able to achieve superior returns on its net tangible assets for several decades, resulting in a thirty-two year annualized return of 20.95%, and thus falling into the East Coast compounder category.

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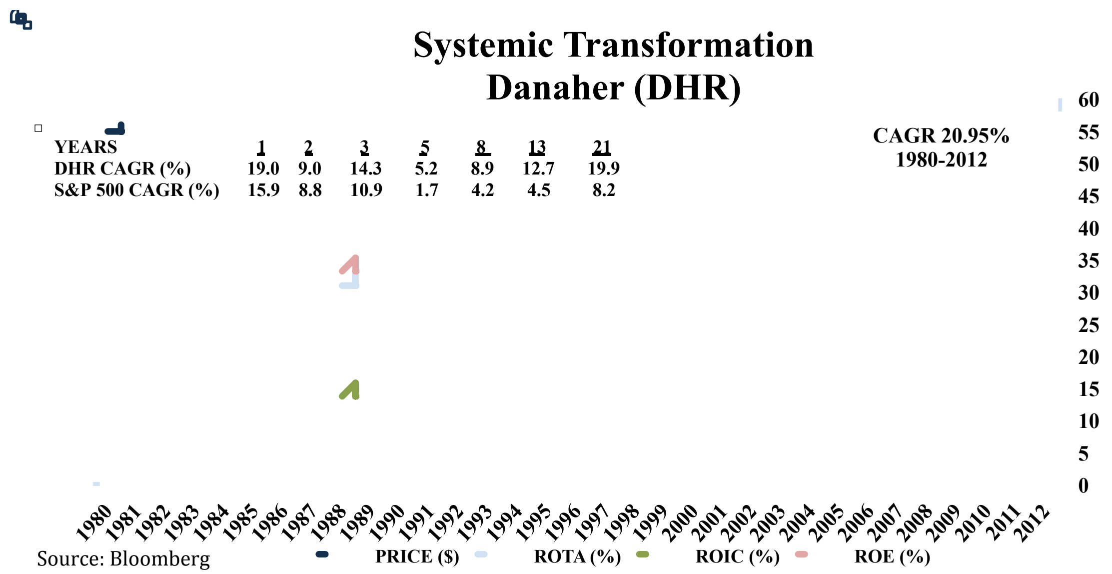
[18] Disclosure: Our discussion of UNP and BRK.B are for informational purposes only and are to assist in describing our secular transformation category pertaining to the railroad industry.

[19] On May 22, 1849, Abraham Lincoln received Patent No. 6469 for a device to lift boats over shoals, which he designed while working on flatboats on the Ohio River and Mississippi River. Lincoln is the only U.S. president to hold a patent.



Founded by Danaher co-founder Mitchell Rales, and run by former Danaher management, Colfax[20] is a leading player in gas & fluid handling, and welding products. The Colfax Business System is modeled after the business system that has guided Danaher for over thirty years. Last year, Colfax made a transformative acquisition that triggered our interest, as the Colfax Business System was unleashed on the underperforming businesses. As defined by our transformation category, the operating metrics of Colfax are below average, but as we progress through time we expect to see a meaningful inflection point in their economics toward Danaher levels.

Representative Separation Idea: WABCO Corporation (WBC)

In Q4 we purchased WABCO Corporation (WBC). WABCO was spun off from American Standard in July of 2007. While WABCO is years into its spinoff dynamics, we continue to find compelling separation attributes as well as some positive secular changes that we believe will reward shareholders over the coming years.

WABCO and its private German competitor Knorr-Bremse have a near duopoly in manufacturing braking and stability systems for heavy trucks. The heavy truck braking market is very different from the higher volume car braking market as there is a substantial amount of research and development accompanied by much lower volume. This model tends to favor a smaller number of competitors who are willing to make the necessary investments, and the businesses that are successful can earn attractive returns.

[20] The last order of business on the fateful day of April 14th, 1865, before President Lincoln left to attend a play at the Ford Theatre was a discussion with Schuyler Colfax. Congressman Colfax was leaving for California and Lincoln's last Presidential act was communicating the following message, "During the war, when we were adding a couple of million dollars every day to our national debt, I did not care about encouraging the increase in the volume of our precious metals. We had the country to save first. But now that the rebellion is overthrown and we know pretty nearly the amount of our national debt, the more gold and silver we mine makes the payment of that debt so much the easier." Lincoln said, "Tell the miners from me, that I shall promote their interests to the utmost of my ability; because their prosperity is the prosperity of the nation, and we shall prove in a very few years that we are indeed the treasury of the world." The realities of our post-credit bubble debt levels have required a similar message to be directed to the "miners" of our Central Bank.

There are two secular tailwinds that we feel made this investment timely: we have been producing substantially fewer trucks than the annual industry average due to economic headwinds, and we see greater safety standards accelerating demand over a prolonged period of time. As the market focused on perceived cyclicality and the European exposure of WABCO's business, we were able to achieve an entry price that we found attractive.

Firm Updates:

- ***ECAM Award***: At the end of each calendar year, each member of our team introduces a charity that they feel is most deserving of our annual award. The ECAM award is presented to the charity that garners the most votes from the ECAM team. Our 2012 ECAM Award goes to *Journeys of Hope,* which was introduced by our very talented Director of Operations, Jane Bolger. *Journeys of Hope's* mission is to assist homeless youth move from a homeless lifestyle to one of sustained shelter through a productive lifestyle.

We look forward to meeting and talking with you soon. We greatly value your support and trust.

"I have given up newspapers in exchange for Tacitus and Thucydides[21], for Newton and Euclid; and I find myself much the happier."

Thomas Jefferson (1743 – 1846)
Letter to James Madison

"He was great through his simplicity and was noble through his charity. Lincoln is a strong type of those who make for truth and justice, for brotherhood and freedom. Love is the foundation of his life. That is what makes him immortal and that is the quality of a giant."

Leo Tolstoy[22] (1828 – 1910)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder

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[21] Tacitus and Thucydides were considered the first historians to communicate history through *knowledge of the causes*. The founding fathers found these examples vital to understanding the follies of government. Jefferson wrote that the best way for people to combat the rise of tyranny is for them "to know ambition under all its **shapes**."
[22] Leo Tolstoy contributed to an article written for The World in 1909 for the centennial of Abraham Lincoln's birth. It is one of my favorite literary pieces of all time. I encourage you to read it here. *Tolstoy Holds Lincoln World's Greatest Hero* by Count S. Stakelberg.

EAST COAST
ASSET MANAGEMENT

To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO, Chief Investment Officer, and Co-Founder

Date: April 17, 2013

Re: First Quarter 2013 Update – **The Art of Fugue**

In our first quarter letter you will find an update on our portfolio and general market observations. Each quarter we highlight one component of our investment process. This quarter, in the section titled *Art of Fugue*, we will discuss how an opportunity moves through our investment process. This is the second of two parts, the first part being *Inventing a Flying Machine,* which we highlighted in our Q3 2012 letter. As is our standard practice, client reporting, including performance and positioning, will be sent under separate cover.

Market Summary[1]

	S&P 500	**MSCI AC World Index**	**MSCI Emerging Markets**	**MSCI EAFE Index**	**Barclays Aggregate Bond Index**	**Gold – $/Troy Oz.**	**Crude Oil**
Price 3/31/2013	1,569.19	1,434.62	1,032.62	1,674.60	1,842.14	$1,596.82	$97.23
Q1 2013	10.61%	7.90%	-1.92%	5.30%	-0.12%	-4.69%	5.89%
2012	16.00%	16.62%	18.47%	17.87%	4.22%	7.14%	-7.09%
2011	2.11%	-4.98%	-18.37%	-11.67%	7.84%	10.06%	8.15%

Valuation and monetary policy tailwinds continue to bolster healthy returns in equity markets, particularly in the U.S. For Q1 2013, the S&P 500 returned 10.61%, the MSCI World Index returned 7.90%, the MSCI Emerging Markets Index returned -1.92%, and the MSCI EAFE Index returned 5.30%. Fixed-income lagged, as the Barclays Aggregate Bond Index returned -0.12%. Equities have proven to be an attractive asset class based on their own merits. While valuations are not as appealing as they previously were, we think the absolute expected rates of return in equities continue to be compelling.

The relative attractiveness of businesses of greater quality to those of lesser quality came to performance fruition this past quarter. As we look to the horizon, we don't see as many economic clouds, although geopolitical clouds persist. Valuations and fundamentals will always be the drivers of long-term compounded returns. We will expand on our observations in the following section.

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, the MSCI Europe Asia Far East Index (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices.

Fourteen Conclusions[2] — Counterpoints to Consensus Views:

Equipping ourselves with a framework[3] of evolving mental models that can be used to make intelligent decisions is an objective of our learning experience. This section of our letter discusses market observations, and I have highlighted fourteen mental models that we find applicable to the current investment environment. We conclude that superior compounding results demand variant perceptions to consensus views. In this light, the following is a list of our counterpoints.

I. ***M**en with Hammers:* Abraham Maslow said, "I suppose it is tempting, if the only tool you have is a hammer, to treat everything as if it were a nail." Most investment professionals are only equipped with a hammer mandate in their specific style box or industry discipline. The dissonance of striking hammers yielding biased, narrow viewpoints is the music of the marketplace. The media further echoes this discordant symphony as headlines jingle for the fleeting attention of the mobile consumer's movable famine. While perverse incentives are not "new" news, the realization that the majority of the "experts" lack the ability to be opportunistic and are handcuffed to their hammers of trade is one of the most important insights we hold. When the breadth of tools in the tool kit is revealed and the true incentive systems are exposed, the songs they sing become clear.

II. ***A**symmetry:* According to leading astrophysicists, our multiverse has been inflating ever since it was born 13.72 billion years ago. We live in a world of extraordinary asymmetry where compounding is at the core of all hidden secrets of creation. "Up and to the right" is a powerful mental model to hold when we think about population growth, monetary inflation, global GDP, and the market capitalization of the universe of businesses. The Achilles heel of asymmetry in capital markets is the inevitable short-term periods of overvaluation and bubbles along the upward trajectory.

We are keenly aware of the tailwinds of asymmetry, and at the same time keep a realistic view of valuations. We seek asymmetry in every investment opportunity by measuring the polar attributes of our margin of safety with compounding return possibilities. Since the "big bang" of the credit bubble of 2008, we have been in a period of reflation. Inflation is not only eternal but will accelerate over the next decade. The sheer size of the indebtedness of the developed world, led by the U.S., Europe, and Japan, has one persistent outcome: the purchasing of long-term government bonds by their representative central banks. Just as an organist testing full volume, we expect central bankers to "pull out all the stops."

III. ***R**elativity:* Einstein's key principle of relativity tells us that all motion or rest is only in relation to other observed objects. Typing this letter I may not be moving in comparison to the earth, but I am travelling rapidly with respect to the sun. Investors are keenly

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[2] Pico della Mirandola wrote a document in 1486 titled the *Fourteen Conclusions after Pythagorean Mathematics*. The document arose out of his fascination with philosophizing through numbers (arithmetic, geometric, and harmonic).
[3] On mental models, I find it useful to think in terms of a hexagonal framework where each model is interconnected forming an infinite honeycomb pattern.

aware of their relative velocity versus their peers; there is no force more powerful in the marketplace than others making money when you are not. Fixed-income and cash investors look around today and see that while their velocity is slow, at least they are moving anemically relative to their peers. We expect the theory of relativity to create a behavioral shift toward equities and out of fixed-income when relativity triggers action.

IV. ***G****olden Triangle of Reason:* The consensus view would have you believe our government is dysfunctional. Last quarter we discussed our counterpoint that our democracy is in accord with how it was designed. The following is an excerpt from last quarter's letter, "A majority ruled government of the people, for the people, and by the people can be represented by a bell-shaped curve. The mean is represented by the center of the curve and the edges of the curve (or tails) are represented by the extremes – a mean-extreme ratio.[4] We refer to this as the *golden triangle of reason*. When viewed up close, a majority ruled government like ours often looks imperfect as the voices of the extremes capture the attention of the people and write the headlines. In contrast, when viewed from further away we observe that the majority is fully represented in a more perfectly proportioned union based on truth and reason, represented by the mean. During turbulent times, contested debates and partisan gridlock often drown out the voices of reason, but ironically that is when our democracy is operating as designed. The merits of each extreme pull the mean, or the intelligence of the majority, to its rightful place. In fact, the system is working in this capacity right now as it corrects some of the missteps that led to, and that were inflicted by, the credit bubble."

V. ***I****nvert:* The Jacobian maxim "invert, always invert" expresses the belief that solutions to complex problems can be unlocked by expressing them in inverse form. I would further add that inverting simple problems can be the most effective counterpoint in revealing truths from a variant perspective. Toward this end, we apply the use of inversion at East Coast to discuss valuations in the market place.

I have never understood why the financial world chooses to communicate in multiples instead of yields. A perspective on yield allows for comparison across all investment opportunities. While this is a simplistic point, it makes a large difference in perspective. The reciprocal of multiples to cash flow or earnings equates to a cash flow or earnings yield, as you can see from the table below.

Multiple Inversion = Yield

4x	6x	8x	10x	12x	14x	16x	18x
25.00%	16.67%	12.50%	10.00%	8.33%	7.14%	6.25%	5.56%
G	A	B	C	D	E	F	G

We are interested in the return (Earnings Before Interest and Taxes) on each business we purchase (Enterprise Value), or an EBIT/EV yield. Just like a pianist locates middle C on the center of a keyboard, a 10x multiple equates to a 10% yield, the equivalent to our middle C. In general, we want to buy businesses at or to the left of middle C, and sell businesses as they drift too far to the right. Buy bass, sell treble.

[4] Euclid provided the first known written definition of the golden ratio, which he referred to as the "mean and extreme ratio."

VI. ***N****othing:* In Lawrence Krauss' latest book, *A Universe from Nothing,* Krauss makes a compelling case for just how unstable "nothing" can be when it comes to both our quantum and cosmological universes. The investment universe is coming to terms with a similar reality regarding interest rates. The one thing harder for professional and individual investors to do rather than sit in a room and do nothing, is to sit in a room and earn nothing. We observe that many investors have convinced themselves to reach for a paltry yield while taking on a great deal of interest rate and/or credit risk.

VII. ***O****pposites:* Having already talked about asymmetry, we are equally in awe of the law of opposites and the mental model of symmetry. As investors, we prefer to be buying when the majority is selling, and selling when the majority is buying. Our enthusiasm is negatively correlated with the mood of the markets; we like the price of fear and uncertainty. As this recovery matures, we expect to see more and more buyers wade into the equity markets with rose-colored glasses, and we know the value we see and have seen over the last few years will wane. For every buyer there must be a seller, and we expect to be a source of supply for demand at higher prices. Opposites create harmony.

VIII. ***F****irst Causes:* When it comes to evaluating businesses and capital markets we want to arrive at the question of why. We may start with questions such as, "How much cash flow? How many assets on the balance sheet? How much do I have to pay?" But we complete our work by answering the question, "Why is this investment mispriced?" The title of last quarter's letter was *Seek Knowledge of Causes,* which was the original name of the *School of Athens* painting by Raphael. The great early philosophers understood the importance of understanding cause versus effect, which was illustrated in Raphael's painting. The search for the answer to why and harmony is a lost art.

IX. ***S****implicity:* Complexity sells. Purveyors of smoke and mirrors have created a profitable industry of putting layers of fees between investors' accumulated wealth and the building blocks of return – stocks, bonds, cash, and real estate. The workhorses asked to unsuccessfully pull bandwagons promising smooth, "absolute," and "hedged" returns with minimum volatility may not be an award-winning group, but it has never been a bad place to make a living. The stud pasture is full. We think it makes a great deal of sense to take a more direct line to compounded returns. We believe every investment building block has an inherent, obscured IRR, and our research attempts to decipher what that is. We simply want to build a portfolio with return attributes we can understand, a portfolio with merit and a margin of safety, while bypassing the croupiers in between. "Everything should be as simple as possible, but no simpler."[5]

X. ***A****rchitecture:* Vitruvian proportions. Palladian lines. Great architecture is about blending theory and practice, art and science. In my opinion, great architecture and great art imitate nature. The capital markets are a microcosm of nature and everything that is relevant to existence applies to successful compounding. We spend a great deal of time thinking about the architecture of our investment philosophy and our process.

[5] Albert Einstein.

XI. ***Flux:*** The "weeping philosopher," Heraclitus, is known for his insistence on ever-present change in the universe. Embracing change as a constant is not consensus wisdom, and perhaps as Heraclitus' sadness references, it is the stark reality of humanity. Human nature does a better job of taking experience and observations, and extrapolating them to infinity: great will remain great, good will remain good, and poor will remain poor. We attempt to counter human nature by embracing change as its own checkpoint in our investment process. Last quarter we discussed our transformation category and identified three areas where change has produced superior investment opportunities: secular, systemic, and separations. Furthermore, in our compounder category, we are emotionally equipped with the notion that less than twenty percent of businesses will actually have improved their business economics and competitive advantage ten years from now compared to today.

XII. ***Eternity:*** In my opinion, the best annual investment conference is the Columbia Student Investment Management Association (CSIMA) Conference,[6] held in February and organized by the faculty and students of the Heilbrunn Center of Graham and Dodd Investing at Columbia Business School. The highlight of this year's conference was a tribute honoring the 85th teaching anniversary of Columbia Business School professor Ben Graham, "The Father of Value Investing." Ben Graham is a hero of mine and he continues to have a positive influence on my behaviors as an investor. The tribute included filmed interviews from a number of his former students including Warren Buffett, Charles Brandes, Irving Khan, and others. A memory I found particularly interesting came from former student Marshall Weinberg. Mr. Weinberg shared that Ben Graham would begin the semester by writing the following phrase on the chalkboard: *sub specie aeternitatis*. The phrase is from philosopher Baruch Spinoza, and translates to: *in view of eternity*.[7] In a world where the consensus perspective is yesterday, today, and tomorrow, our counterpoint is a long-term view.

CSIMA, 2013

XIII. ***This Too Shall Pass:*** "It is said an Eastern monarch once charged his wise men to invent him a sentence, to be ever in view, and which should be true and appropriate in all times and situations. They presented him the words: 'And this, too, shall pass away.' How much it expresses! How chastening in the hour of pride! How consoling in the depths of affliction." Abraham Lincoln shared this story in a speech in September 1859.

In the first edition of Security Analysis, Ben Graham selected a similar Horace quote, "Many shall be restored that now are fallen and many shall fall that now are in honor."

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[6] At this year's CSIMA conference (pictured above), I had the opportunity to moderate the "Best Ideas" panel. We had a panel of great investors including: Jeremy Grantham, Jane Siebels, Thomas Russo, and Tim Hartch.

[7] I was particulary surprised when I learned of Ben Graham's way of opening his class, as I had included the same phrase in an illustration I had designed for our second quarter 2012 letter titled *The Beekeepers*, linked here.

Both pride and anguish are fleeting; it is truth that is infinite. This quarter was one of the stronger performance quarters we have had since our inception, as a number of our largest holdings had robust absolute returns, and the market seemed to agree with the notion that some of our newest additions were mispriced. However, we know that any brief sense of pride we have now may be replaced with brief moments of anguish in the future. Our objectives are much loftier. We recognize we know nothing about short-term movements of the markets, nor do we put too much emphasis on trying to understand them. If we have been short-term lucky lately, we know that this too shall pass.

XIV. ***Y****et:* The word "yet" as an adverb defines an action's persistence in time. It can define an action in the past, present, or future. "Yet" triggered my curiosity while reading *The Swerve* by Stephen Greenblatt. The Pulitzer Prize winning book tells the story of a book finder in 1417, who ultimately copies and saves, for eternity, Lucretious' epic poem *On the Nature of Things*. In the book Greenblatt includes an exchange between Cicero and his brother Quintus about Lucretius' use of the word "yet." I asked Mr. Greenblatt about his inclusion of this excerpt, as it clearly struck a chord with him, and this was his reply: "Thank you very much for your very kind and gratifying letter. I share your sense that in that little word 'yet' there is a whole history of the tension — evidently already felt in the ancient world — between the myth-making power of poetry and the demands of scientific or philosophical truth."

I believe that the myth-making power of poetry persists today. We observe that there remains a tension between the preponderance of stories to that of truth. This is great news for those that can synergize truth and solve puzzles. "Yet" is that space between consensus and counterpoint. We value the persistence of "yet."

Ben Graham opens chapter twenty in his book *The Intelligent Investor* with the concept that the secret of sound investment can be boiled down to three words. If you look at the first letter of each of the fourteen conclusions in counterpoint, the acrostic spells an identical message. We harmonically "venture the motto:"

M A R G I N O F S A F E T Y

Art of Fugue:[8]

In the third quarter of 2012, I wrote about our investing process in the letter titled *Inventing a Flying Machine*. I discussed the importance we place on pilot control (manager skill) and wing design (process) over what seems more common, an increase of horsepower (legions of analysts). The letter highlighted the concept of soaring, how we source lift or quality investment ideas, how we take each investment idea through an initial checklist, and how we categorize the magnitude of performance we expect from those ideas (thermals, ridge lift, and lee waves) to size the position appropriately.

This quarter I want to advance the investment process discussion beyond sourcing, checklists, and categorization, toward how an opportunity moves through the East Coast research and due diligence process, and eventually into our portfolio. Music theory can help us explain this process. To connect to our previous theme, this letter is the second part of the two part inventions of flight toward our objective of building a well-tempered investment process.

A fugue is a musical contrapuntal (counterpoint) composition technique in two or more voices founded upon a theme, announced in the first part in the tonic key, and subsequently imitated by all other parts in turn, according to certain general principles. "The name is derived from the Latin word *fuga*, a flight, from the idea that one part starts on its course alone, and that those which enter later are pursuing it."[9] Composing a fugue is equivalent to writing many songs that need to fit together harmoniously.

In the fugue genre, Johann Sebastian Bach "not only excelled peerlessly, but set new standards of technique, form, and performance."[10] Bach's place in history as a "fugue master" is indisputable. Beethoven referred to Bach as the "Progenitor [Father] of Harmony." Mozart, it is said, exclaimed after first hearing a Bach composition, "Now there is something one can learn from."

We agree.

Bach's reputation for fugue was well known in the final decade of his life. On May 7, 1747, at the request of King Frederick the Great of Prussia, Bach was invited to the join the King and his court musicians for the evening's private concert at the King's royal residence in Potsdam, Germany. King Frederick, who was an accomplished musician, asked if Bach would play a fugue on a theme the King had written. Bach executed the fugue with the royal theme flawlessly. The King then asked if he could hear Bach play a fugue in six obbligato[11] parts. While Bach was not able to fit the royal theme to the full harmony of six parts, he chose another theme and immediately executed the composition to the astonishment of those present.

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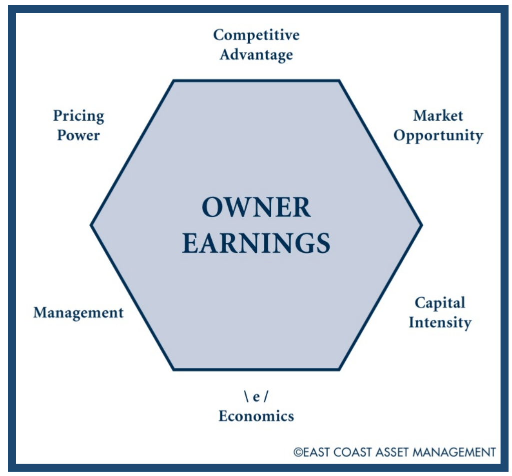
[8] The portrait, painted in 1746 by Elias Haussmann for The Mizler Society, is the only indisputably authentic image of Bach. In his hand in the original portrait was a puzzle canon for six simultaneous voices.
[9] *Fugue* by Ebenezer Prout, 1891.
[10] *Johann Sebastian Bach – The Learned Musican* by Chistoph Wolff, 2000.
[11] Obbligato: Not to be left out, indespensible, used of an accompaniment that is an integral part of a piece.

Interested in further impressing the King, Bach returned to his home in Leipzig, Germany, and composed one of the most treasured musical compositions of all time. Set to the King's royal theme, the composition would be known as *The Musical Offering*. *The Musical Offering* consists of two ricercars (or fugues – in three and six parts), ten canons, and a sonata. Bach's choice of the term "ricercar" (the older Italian word for fugue, which means "to search" or "research") as a heading was related to a Latin acrostic he designed to summarize the origin and character of the whole work: "Regis Iussu Cantio Et Reliqua Canonica Arte Resoluta" meaning "At the King's demand, the song [the fugue] and the remainder resolved with canonic art." The six-part ricercar was the six-part fugue the King asked Bach to resolve to his royal theme in Potsdam, now fully resolved.

A Musical Offering – Six-Part Ricercar:



A well-structured fugue is a helpful way to think about how an investment idea takes shape through our investment process. Once an investment idea is sourced, the idea is put through an initial checklist and if it has merit it will ultimately be categorized as a compounder, a transformation, or a workout. Next, the investment idea will go through two stages of due diligence – two individual fugues, both in six parts. In each six-part stage we always begin and resolve with our subject, or royal theme, which is a perspective on compounding. Throughout the process a compounding perspective helps give proportion and weight to the time horizon, expected return, and the purpose. With the subject or theme stated, we then introduce voices (economics, competitive advantage, pricing power, etc.) to see if we can solve for harmony. The first six-part stage is our *six-sides of great* framework,[12] which helps us establish the quality of the business.

If we can find sufficient harmony within the six parts, and return to the royal theme of compounding, an idea can graduate to the next level of research, or the second six-part stage of the investment process. We call this final level of research "M-Theory."

Research **I**nverts **C**onsensus **E**ternally **R**evealing **C**ounterpoints **A**symmetry & **R**eturn

Art of Fugue – M-Theory:

There has been no composer prior or since who has excelled at the theory and practice of counterpoint and fugue like Johann Sebastian Bach. Bach's composition, *The Art of Fugue*, was the apex of his excellence, his magnum opus. "The governing idea of the work is an exploration in depth of contrapuntal possibilities inherent in a single musical subject [theme]."[13]

The Art of Fugue consists of fourteen fugues whereby the final fugue, *Contrapuntal XIV*, is unfinished. It is said Bach was dictating a completion of this fugue after he lost his eyesight, but

[12] We detailed this process in our Q2 2012 letter titled *The Beekeepers*.
[13] *Johann Sebastian Bach – The Learned Musician* by Christoph Wolff, 2000.

it was left incomplete when he died. Each of the fourteen fugues utilizes a simple subject in D minor.

In the 1751 final printed edition of the composition, the various movements are roughly arranged by increasing order of the sophistication of contrapuntal devices. *Contrapunctus I* and *II* are simple, monothematic four-voice fugues on the main theme. *Contrapunctus III* and *IV* are simple, monothematic four-voice fugues on the inversion of the main theme. *Contrapunctus V – VII* are counter-fugues, in which a variation of the main subject is used in both regular and inverted form. Here, Bach introduces the technique of augmented (doubling all note lengths) and diminished versions of the main theme and its inversion. *Contrapunctus VIII – XI* are double and triple fugues, where Bach graduates the counterpoint of voices to that of subjects to stand ground in harmony with the main theme. *Contrapunctus XII* and *XIII* are mirror fugues, in which the complete score can be inverted without loss of harmony. The final, unfinished fugue, *Contrapunctus XIV*, which many believe Bach was seeking to resolve when he died, was to be a quadruple fugue – a four-subject fugue. The unresolved score shows that Bach had just introduced the third subject, which is based on the BACH motif, B♭ - A – C – B♮ ('H' in German letter notation).

Once an investment idea has been sourced, categorized, and taken through the *six-sides of great* framework, it arrives at the final stage of the investment process, or M-Theory. Just as in *The Art of Fugue*, the process is arranged by an increasing order of sophistication and contrapuntal devices. At the final movement of M-Theory, we are looking to resolve a four-subject fugue in six total voices on the simple main theme of compounding in D minor^{IRR}.

Four-voice fugue:
We begin M-Theory with a simple four-voice fugue on the compounding theme. We are looking to see if we are able to find initial harmony in four areas:

1. Does the investment have an attractive expected rate of return (IRR)?
2. Does the investment have a sufficient margin of safety (MoS)?
3. Do we understand the critical data points that will drive the success and intrinsic value of the business (H4 – Investment Longitude)?
4. Do we understand First Cause, or why the investment may be mispriced (M)?

We are looking for a simple harmony, under a general understanding of these four areas by stating our answers in a simple form, and by seeking further knowledge through inverting our assumptions. If we conclude that we hear harmony, we will listen more closely and move to the next stage.

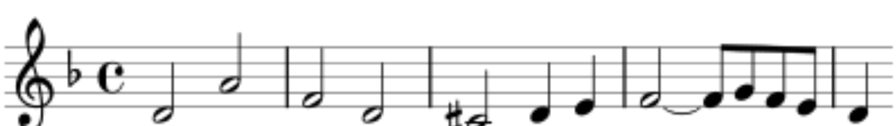
Four-voice counter-fugue:
As we better understand the business in terms of the four key voices, we then pair the voices against their counterpart, or counter-fugue. We are now looking for the potential return of the investment on a long-term compounded basis (IRR), and want to critically examine the counterpoint to understand our margin of safety (MoS). It is essential for us to study the concordant relationship between these polar objectives.

We then look to understand why the investment may be mispriced (M) with our insights into its counterpoint, the drivers of the business and ultimately the investment's success (H4 – Investment Longitude). It is useful to look at the positive, the investment's attributes (H4), against the negative, or why the consensus does not like the investment or what is misunderstood and has created the mispricing (M).

Double and triple fugues:
Again we use the technique of stating the general relationship and testing it under inversion. At this stage we begin to build out a range of possible outcomes in both augmented and diminished scenarios and assign reasonable probabilities to each path. The voices are now becoming more pronounced, and as our conviction grows around our knowledge the voices become subjects. We are now beginning to see the materialization of double and triple fugues. Often one or more of the voices will be more complex and will take time to resolve, or the voice may be dissonant and we then move on to a new investment idea altogether. Assuming we are beginning to hear double and triple fugues, and thus a harmonious relationship between the four voices paired in counter-fugue, the investment will continue to progress through M-Theory.

Mirror fugues – /e\ and N^{TH}:
The next stage can be thought of as a mirror fugue. We reintroduce the two most important voices in the six-part ricercar to our search for harmony in M-Theory. These two voices are the economics of the business (/e\) and the competitive advantage (N^{TH} – Nuthatch Concept). We now have a deeper understanding for the business and we want to blend these two voices into overall harmony, as these two insights will be critical for the long-term progression of the investment. /e\ and N^{TH} are the two key variables that we will check in with over the life of the investment to measure how they are holding up against the inevitable flux of the universe. These two also become paired and are viewed in general and in inverted form against one another. The measure of the attractiveness of the economics must be compared to how long or short the business will be able to earn those returns based on their long-term, sustainable competitive advantage. If harmony continues to resound, we arrive at the final fugue.

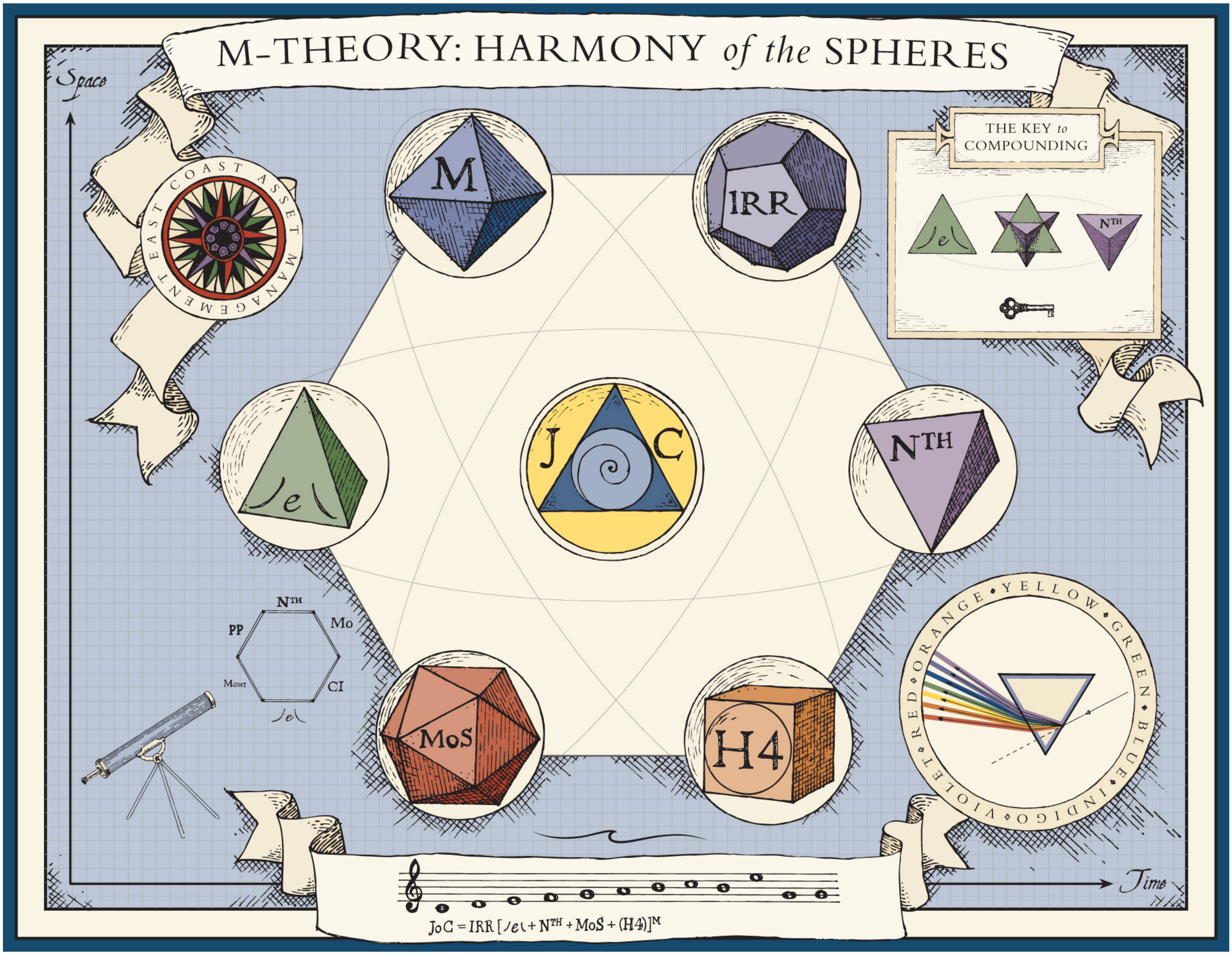
Six-part quadruple fugue:
At this final stage, we are looking to solve for harmony in a six-part quadruple fugue. If we have an investment of merit, we have solved for the harmonious contrapuntal relationship upon our simple compounding theme in the key of D minor^{IRR} between four central subjects: expected rate of return (IRR), margin of safety (MoS), investment longitude (H4), and mispricing (M). We have also harmonized the key contrapuntal voices of business economics (/e\) and competitive advantage (N^{TH}). Just as Bach never finished *Contrapuntal XIV*, this final stage in our process is never complete, even after the investment is purchased. We continue to solve for harmony in all six voices until we hear discordance among the key voices, at which point the investment is sold. With that in mind, our goal is to find harmony in a compounding opportunity that can produce an "endlessly rising"[14] fugue as intrinsic value keeps proper measure with valuation.



Theme in D minor – The Art of Fugue

[14] Bach's *Endlessly Rising Canon,* which is part of *The Musical Offering*, includes the technique for making modulation end in the same pitch, instead of an octave higher, often referred to as a Shepard scale. The scale creates the auditory illusion of a tone that continually ascends in pitch.

M-Theory – Harmony of the Spheres:



"Picture to yourself, if you can, a universe in which everything makes sense. A serene order over the earth around you, and the heavens above revolve in sublime harmony. Everything you can see and hear and know is an aspect of the ultimate truth: the noble simplicity of a geometric theorem, the predictability of the movements of the heavenly bodies, the harmonious beauty of a well-proportioned fugue – all are reflections of the essential perfection of the universe."[15]

[15] *The Music of the Spheres* by Jamie James, 1993.

M-Theory – Harmony of the Spheres (explained):

German mathematician, astronomer, and astrologer Johannes Kepler's "eureka" moment regarding planetary movement came when he was teaching basic geometry. He had drawn a circle, and within it an equilateral triangle, followed by another circle in the middle of the triangle with all sides touching. He realized the distance between the two spheres was identical to observations he had taken between the relative distances between planets. He went on to solve a number of his theorems based on how the planets rotated from the perspective of a solar observer, or someone looking out from the sun.

I have designed the *Harmony of the Spheres* illustration to provide a visual description of the final stage of our process, M-Theory,[16] described in *Art of Fugue*. In theoretical terms, I have found the concept of the *Harmony of the Spheres* to be a very useful way to connect all that was relevant at this stage. As Stephen Hawking once said, "I prefer to see things in terms of geometry."

We seek to look at our investment universe from the perspective of compounding (solar observer). You can see that the center of our universe is compounding (JoC), which I have symbolically referenced by the shape that Kepler was drawing in class. The central point of the shape and of the entire universe (center of the "o") is marked by a logarithmic spiral that most importantly indicates our search through nature for the golden mean – compounding.

Six spheres in the form of a hexagon surround the compounding objective, and the spheres further represent the elliptical counterpoint orbits as described in *Art of Fugue*. To geometrically evolve the illustration to the essence of counterpoint, I have chosen the five platonic solids to differentiate the key six parts.

Each platonic solid has a dual pair in nature, whereby the vertices of one correspond to the faces of the other. The dual of the dual is known as the original polyhedron. All the platonic solids are arranged in pairs except for the regular tetrahedron, which is self-dual. /e\ and NTH[17] are fittingly assigned these shapes just as they were discussed in the mirror fugues.[18]

Additionally, I have expanded the idea of illumination from the perspective of compounding to include the theory of light reflection and refraction that Sir Isaac Newton famously discovered. I have symbolically included Newton's prism experiment and have assigned the seven colors Newton discovered to the seven key shapes of our process. Just as Einstein's theory of relativity proved that light bends elliptically around objects of mass, the refracted light bends around the solar mass of compounding to the destination of each solid.

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[16] The leading theory of everything is called M-Theory, whereby the mathematical calculations only work if the universe operates in ten dimensions. Since we can see the three dimensions of space and the fourth dimension of time, there would be, in theory, six additional dimensions that we have "yet" to understand consciously.

[17] The Nuthatch Concept (NTH) is fittingly in inverted form. The nuthatch is a local champion who can do something its competitors cannot do – walk down a tree headfirst.

[18] As the /e\ (economics) and NTH (competitive advantage), the keys to compounding, graduate from the *six-sides of great* framework into the M-Theory spheres, they form a three-dimensional shape called a "stella octangula." In math, the number ***e***, known as Euler's number, is the base of the natural logarithm. It is the limit of $(1 + 1/n)^n$ as n approaches infinity, an expression that arises in the study of compound interest.

While this description looks celestial, the concept is appropriate for the large and small, cosmological and quantum. The theories of gravity and force are represented by the importance of the harmony of the paired elliptical patterns. The time scale on the horizontal axis complements the space scale on the vertical axis. Time is an absolutely critical element to the compounding equation.

Below the spheres, I have assigned each of the seven musical notes in C major scale to each of the seven parts and spheres of our investment process. I begin with C for compounding and I have represented each note as it plays out our formula for compounding. The full octave is fittingly completed in the note of C, "we shall not cease from exploration, and the end of all our exploring will be to arrive where we started and know the place for the first time."[19] As Bach had introduced his last name into the third subject in *The Art of Fugue*, the signature[20] I complete this illustration with has an appropriate resounding translated stretto (close): Mispricing (M), Economics (/e\), Margin of Safety (MoS), Margin of Safety (MoS).

Representative Idea – Consumer Retailer:

We purchased one new holding during the quarter, a leading specialty retailer of domestic merchandise and home furnishings.

Sourced & Categorized: We tend to look for compounding opportunities where there are clouds, or where we observe other soaring birds. The presence of clouds and discussions with our peers triggered our interest.

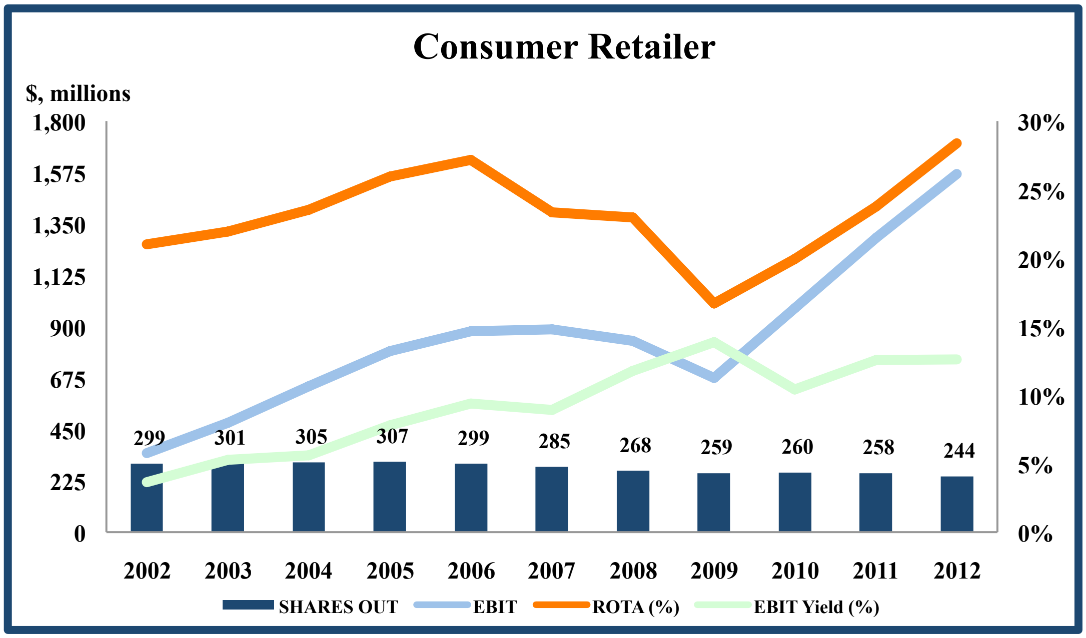
We categorized this business as a compounder with workout attributes. We prefer to think of the time horizon on our compounder investments well beyond five years, but the competitive advantage of any retailer has to be understood in the context of how consumer behavior and technology evolve. These variables could shorten our holding period (workout attribute).

Brief Summary – Six-sides of Great and M-Theory:

Economics (/e\): This business earns superior returns on net tangible assets of around 25%. We are impressed with how quickly operating earnings (EBIT) have recovered since the 2008/2009 financial crisis. In spite of a slow housing recovery, EBIT grew from $675 million in 2009 to $1.568 billion in 2012. Additionally, we expect pent up demand for housing transactions to be a tailwind for the business going forward.

Competitive Advantage (N^{TH}): Their core business has the largest industry market share and offers the widest assortment of products for their customers. They have a loyal customer base and a proven system of generating repeat store traffic through their couponing strategy. They have a number of new store concepts, two of which we think are very attractive.

[19] *The Wasteland* by T.S. Eliot, 1922.
[20] Begg.



IRR: As I write this letter, the business has an Enterprise Value (EV) of $13.6 billion and TTM EBIT of $1.6 billion, which equates to an 8.5x multiple, or properly inverted, an 11.8% yield. As new store concepts within the business evolve, the housing recovery takes hold, and management continues to repurchase shares, we arrive at a compelling range of IRR estimates.

Margin of Safety (MoS): Management has proven to be good stewards of capital, operating efficiently with no debt, and has approximately $785 million in cash and equivalents on the balance sheet.

Investment Longitude (H4): We find investment longitude in the owner-oriented managers that have run this business for decades. They repurchase shares when it is attractive to do so, and retain capital when it is advantageous to reinvest in the business. Management is efficient at cutting costs and making the right decisions when a part of the business is not operating at the required levels of return.

Mispricing (M): Many growth investors have exited the position for bluer skies. Two clouds that investors are concerned with are an e-commerce threat from Amazon, and consumers with smartphones using the store as a “showroom” to compare prices of retailers. This demands our continued attention, but fears and facts at this point are not the same.

$$\mathbf{JoC = IRR\ [/e\backslash + N^{TH} + MoS + (H4)]^{M}}$$

EAST COAST
ASSET MANAGEMENT

Firm Updates:

- ***Team additions*:** We have had no changes since the last quarter, but I am pleased to announce we are in the process of finalizing three new additions to our team. We will be making the formal announcements over the next few weeks and months.

We look forward to meeting and talking with you soon. We greatly value your support and trust.

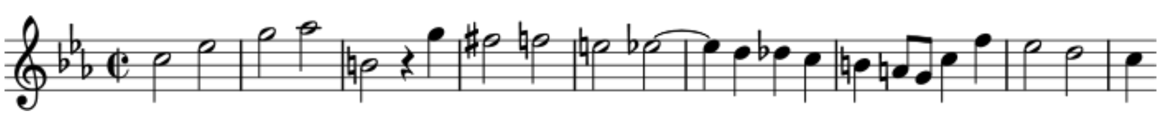
"I am more and more convinced of the truth that Nature is sure to act consistently, and with constant analogy in all her operations. From whence I conclude that the numbers by means of which the agreement of sounds affects our ears with delight, are the very same which please our eyes and mind. We shall therefore borrow all our rules for finishing of our proportions from the musicians, who are the greatest masters of this sort of numbers, and from those things wherein nature shows herself most excellent and complete."

Leon Battista Alberti (1404 – 1472)
Architect (Polymath)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder



The Royal Theme – The Musical Offering

On the Nature of Things:

When I wrote the first part of the two part inventions of our investment process, I concluded with a piece called *Inventing a "Learning" Machine*. This excerpt highlighted the love of learning told through the story of *Jonathan Livingston Seagull*, written by Richard Bach. The story illustrated how Jonathan reached out and tried to touch perfection in that which he loved to do – fly. I wanted to revisit the concept of perfection, nature, and joy of purpose.

This quarter I read Stephen Greenblatt's book *The Swerve*, which reintroduced me to a poem called *On the Nature of Things*, written around 55 B.C. by Lucretius. The poem, written in some 7,400 dactylic hexameters, is divided into six untitled books, and explores the concepts of observational truth and the meaning of life. Thomas Jefferson, who owned five copies in various translations, found some of the epicurean concepts so important that he included "pursuit of happiness" as a right of human nature in the Declaration of Independence. I could not agree more and found myself thinking about nature and what it was that created joy.

Is nature in its current state always beautiful and perfect, or is it art that can enhance nature? One of J.S. Bach's contemporaries at Leipzig University was a professor named J.A. Birnbaum, who wrote on the subject of art enhancing nature in defending Bach's music against a number of theorists during his last decade. The theorists argued that Bach's music was too complex and not naturally beautiful. Birnbaum's discussion elaborated on Bach's search into the depths of the techniques of counterpoint and harmony, which actually enhanced and beautified nature.

> *"Many things are delivered to us by nature in the most misshapen states, which however, acquire the most beautiful appearance when they have been formed by art. Thus art lends nature a beauty it lacks, and increases the beauty it possesses. Now, the greater the art is – that is, the more industriously and painstakingly it works at the improvement on nature – the more brilliantly shines the beauty thus brought into being… So through the investigation of art, one discovers, by virtue of the accompanying understanding of the artist, the traces of nature whereupon, she [nature] rushes – by step not by leap – towards perfection."*

I believe it is by the investigation of the nature of things that the musician, the portrait painter, the contrarian seagull named Jonathan, the learned investor with a compounding perspective, and the life-long student can step by step find perfection and true joy of purpose.

Finding joy in nature is the prelude. Finding intelligence through nature is the crescendo. Finding joy through purpose is a wonderful life, the magnum opus. We happen to find great joy in solving investment puzzles. Toward that purpose, at East Coast, we call the heart of our investment process…

"The Joys of Compounding."[21]

[21] Warren Buffett coined this term in the early Buffett Partnership letters in excerpts about compounding that were titled in this way. This title proved to be a prelude to what would be a magnum opus of compounding, whose music, like Bach, will be eternal.

EAST COAST

ASSET MANAGEMENT

2013 2nd QUARTER LETTER

"Although logos is common to all, most people live
as if they had a wisdom of their own."

"The way upward and the way downward are the same."

Heraclitus

Opening Quotes from *The Four Quartets* by T.S. Eliot – 1943

"Water is fluid, soft, and yielding.
But water will wear away rock, which is rigid and cannot yield.
As a rule, whatever is fluid, soft, and yielding will overcome
whatever is rigid and hard. This is another paradox: what is soft is strong."

Lao Tzu

EAST COAST

ASSET MANAGEMENT

To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO, Chief Investment Officer, and Co-Founder

Date: July 18, 2013

Re: Second Quarter 2013 Update – **Yielding to the Still Point**

In our second quarter letter you will find an update on our portfolio and general market observations. Each quarter we highlight one component of our investment process. This quarter, in the section titled *Yielding to the Still Point*, we will discuss some of the intangible attributes that we believe lead to intelligent investment decisions. As is our standard practice, client reporting, including performance and positioning, will be sent under separate cover.

Market Summary[1]

	S&P 500	MSCI AC World Index	MSCI Emerging Markets	MSCI EAFE Index	Barclays Aggregate Bond Index	Gold – $/Troy Oz.	Crude Oil
Price 6/30/2013	1,606.28	355.81	940.33	1,638.94	1,799.31	$1,234.57	$96.56
Q2 2013	2.92%	-0.22%	-7.77%	-0.77%	-2.33%	-22.69%	-0.69%
YTD	13.83%	6.39%	-9.52%	4.53%	-2.44%	-26.31%	5.16%
2012	16.00%	16.62%	18.47%	17.87%	4.22%	7.14%	-7.09%

The tailwinds of valuation and monetary policy continued to support strong returns in the U.S. equity market. For Q2 2013, the S&P 500 returned 2.92%. The emerging market indices were weak for the quarter as growth has slowed and social and economic unrest has heightened in China and Brazil. The MSCI World Index returned -0.22%, the MSCI Emerging Markets Index returned -7.77%, and the MSCI EAFE Index returned -0.77%. Fixed income also suffered, the Barclays Aggregate Bond Index returned -2.33%. The ten-year U.S. Treasury yield spiked nearly a full percentage point during the last few weeks as some economic indicators validated a stabilizing economy. While prices of equities move higher, we continue to feel our evolving portfolio of businesses offers attractive expected returns, and provides one of the few places to protect accumulated wealth against the loss of purchasing power.

A number of tailwinds present in our portfolio provide us with some comfort that our returns from today's prices should prove quite satisfactory. We will expand on our observations in the following sections.

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, the MSCI Europe Asia Far East Index (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices.

Yielding Fluidity:

When we founded the company nearly five years ago we chose to include a cresting wave in our logo. This choice carries a lot of meaning, yet we have not put words to its significance.

The most insightful book I have read on the teaching power of water and waves is *Sensitive Chaos*[2] by Theodor Schwenk. Some written words are timeless, and for that reason I continue to revisit this book.

> *Through wave movements, of whatever kind, water reveals its extremely impressionable nature. A stone in the stream, a gentle breeze blowing over the surface of a lake, the slightest thing will cause the water to respond immediately with a rhythmical movement. Two things are necessary for this rhythmical movement to come about: the water itself and some other activating force. The actual form of the wave is the result of the interaction of opposing forces, in interplay with one another. The wave is a newly formed third element between the polarities – for instance water and wind – and appears at the surface of contact. The water is like a sense organ, which becomes 'aware' of even the smallest impacts and immediately brings the contrasting forces to a moving rhythmical balance.*

The chemical make up of water is like our principles – they do not change. Yet, our investment process strives to be receptive and sensitive to truth with the ability to become "aware of even the smallest impacts," bringing contrasting forces together to make intelligent investment decisions. We have built a principled investment process that not only seeks continued improvement but also the ability to yield to the realities of a changing world. Like water, our basic make up is never compromised, however we do honor a process that can yield to fluidity.

Waves are an effective way for us to think about finding compounding opportunities. By applying our principles and our evolving process (water) to an activating force, such as a changing opportunity set (wind), we hope to create a third element: compounding success (waves).

> *When a wind begins to blow, the surface of the sea will at first become ruffled and then gradually bigger and bigger waves will form. The first ones with short wavelengths will have travelled a long way before the long wavelengths have formed. But even so the large waves will catch up and overtake the small ones because the long ones that have formed later have greater speed of propagation. As they move along an interesting sorting out takes place. The long waves, which have formed last, hurry forward at their greater speed, the shorter ones follow and the shortest, which are the oldest, come last of all. But the shortest will long have outrun their energy while the long ones still hurry on across great distances.*

In creating a third element, we are best served by looking for where long period waves (groundswell) are likely to form, rather than looking for short period wind swell which will not have the energy to travel long distances and are likely to be overtaken by long period waves.

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[2] First published in German in 1962 and translated into English in 1965. Commandant J.Y. Cousteau wrote a beautiful preface for the book when it was translated into French in 1963.

Looking for groundswell, we start our search by observing where the strongest winds are blowing – strong tailwinds that have a large expansive body of water ahead – to produce the waves of investment opportunities. When we look at our portfolio there are a number of tailwinds that we believe will have a compounding effect on our returns. Below we have highlighted five tailwinds that continue to inform our portfolio positioning.

I. ***Y**ield:* Sustained, strong winds of owner earnings, a long-term competitively entrenched fetch, together with operators who intelligently allocate cash flow will be the most important indicators of finding great compounding wave opportunities. We own and continue to replenish the portfolio with businesses that have attractive owner earning yields.[3] We have said before we are content to purchase businesses at ten percent or better owner earning yields and continue to be satisfied with the quality of opportunities that present themselves. Today's yields with modest growth rates reflect attractive IRR outcomes and continue to merit a healthy allocation to equity investments.

II. ***I**ndebtedness of the Developed World:* The developed world's post global credit crisis indebtedness persists. The best hope for the three largest central banks is to whittle away at this large debt through a course of prolonged debt debasement. The use of monetary stimulus to create modest inflation over a long period of time while attempting to achieve improved employment levels and modest GDP growth is a healthy political alternative to a policy relying only on tax receipts and spending cuts. The playbook central banks are following is to nominally grow out of world indebtedness; this means we are indirectly taxing savers who are not allocated to investments that will retain their purchasing power. For the last four years we have dedicated a portion of our quarterly letters to writing about this nominal tailwind. We have explained that equity markets will surprise to the upside as this strong, *albeit tapering,* secular tailwind is a force for creating a groundswell effect on nominal prices – especially prices of cash producing investments.

III. ***E**merging Market Demographics:* We have made a number of investments in companies whose geographic profiles are dramatically changing and will continue to do so over the next ten years and beyond. The emerging market consumer, buoyed by demographics of a large population with a growing middle class, is a very long secular tailwind of growth for certain regions. One of the mispricing themes in our portfolio is what we call geographic myopia. This is when a U.S. domiciled business is building a long-term, durable competitive advantage in a growing market, yet investors continue to value the business based only on the merits of its mature, U.S. business. We own a number of businesses where we believe geographic myopia affects valuations, allowing us to benefit.

IV. ***L**iquidity:* Over the last four years the world has shifted polarities from the low tide of illiquidity to the flood tide of liquidity. Corporate balance sheets are flush with cash as the world economy normalizes. Investors stare blankly at paltry yields in fixed assets that have provided a safe haven over the last thirty years. These investors, once burned twice shy, add equities back to their portfolio with an eyedropper as they cling and clutch to what they know – bonds and cash. We observe investors (including the brightest consultants guiding our largest institutions) with their water wings of fixed dollar investments and expensive "hedge" funds swimming dangerously close to the whirling vortex of higher rates. The ten-year U.S. treasury rate has moved up a full 100 basis

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[3] Earnings Before Interest and Taxes (EBIT)/Enterprise Value (EV)

points over the last few weeks, which in turn created a greater than ten percent price decline in many large fixed-income funds. *Yield to yield* – submit to the reality of expected returns. Strategic investment policy statements that currently guide the world's accumulated wealth were not written to sensitize to today's reality of expected returns and purchasing power risk disparity. Thirty years of falling fixed-income yields has desensitized the world to the realities of our *present* situation.

Higher interest rates, meaning a more normalized opportunity cost of investor capital, are not a bad thing. The ability to determine the *rhumbline* of normal and act intelligently when things go too far in either direction has served value investors well. Over a year ago we began making investments in a few financial services businesses whose earnings were well below normal. These businesses were trading at steep discounts to normal cash flows, which were not being earned on their customer's deposits, as the world extrapolated zero percent rates to infinity. If we managed money under a narrow mandate and were forced to wade near whirling vortices, perhaps we would convince ourselves into terms like "new" normal, but we purposely put no limits on our ability to act rationally, and are grateful to our clients and partners who give us the freedom to do so. Valuation and interest rates may ebb and flow, but normalcy in these waters has stood the test of time.

V. ***D**omestic Energy Capability:* I have always appreciated a line from the timeless book *Le Petit Prince*, by Antoine de Saint-Exupery, when the fox says to the little prince, "It is the time you have devoted to your rose that makes your rose so important." A confluence of events, including conflicts overseas to protect our energy interests and technology advancements to extract natural gas out of the ground, has changed the direction of energy investments in North America. U.S. energy capability, energy independence, and development in harmony with climate change initiatives are our country's rose and we will devote our time and resources accordingly. We believe we are at the new dawn[4] of a long secular tailwind in energy infrastructure spending and development. This will serve to benefit a number of companies that are attractively positioned as vital partners in both the service and infrastructure building sides of the industry. We have made three notable investments over the last five months in this space.

The tolling bell, Measures time not our time, rung by the unhurried
Groundswell, a time Older than the time of chronometers [H4], older
Than time counted by [the] anxious worried Lying awake, calculating the future,
Trying to unweave, unwind, unravel, And piece together the past and the future,
Between midnight and dawn, when the past is all deception,
The future futureless, before the morning watch,
When time stops and time is never ending;
And the groundswell, that is and was from the beginning, Clangs The bell.[5]

[4] New Dawn is my favorite rose varietal after my stepmother gave one to me when I moved into my first home. It remains my minds image of spring and this rose bush has subsequently taken over an entire fence line trellis.

[5] *The Four Quartets* by T.S. Eliot, 1943. This quote is from the chapter titled *Dry Salvages,* and is named after a rock cropping in Rockport, MA, very close to our office in Essex. T.S. Eliot grew up summering on Eastern Point in Gloucester and it has been written that sailing the Cape Ann waters as a young boy was imprinted on his memory.

The Joys of Compounding – The Six Dimensions of Joy:

It was nearly three years ago that I wrote the Third Quarter 2010 letter *The Joys of Compounding – Revisited*. That letter set forth a journey where I have used a section of these quarterly letters as a medium to explain an aspect of our philosophy and process. Toward our goal of compounding, I have shared components such as how we qualify an investment under our six-sides of great framework, how we source and categorize an investment, and last quarter I shared with you how we search for harmony among the hexagonal counterparts of our investment process through M-Theory. I have shared the system we have created to measure, evaluate, and ultimately attempt to make repeatable, intelligent investment decisions. To date, I have explained the tangible form of our beliefs and behaviors under the construct of the three dimensions of space and one dimension of time.

The fact is we view our investment effort as ten dimensional. The six dimensions that I have not committed to words are the *intangible* attributes. The intangible cannot be measured, yet it is the heart of, and leader of, our entire compounding journey. When I reflect on the extraordinary investment efforts of individuals who have allocated capital successfully over long periods of time, I would humbly suggest that the lion's share of their performance attribution could not be understood by a system or process alone. Instead, most of these extraordinary investment efforts came from insights and intuition that lead toward compounding success and away from permanent loss of capital. A great process may yield above average returns, but alone will not lead to a great long-term compounding record. What I want to attempt to discuss here is what I think those intangible attributes are, and why I believe the six dimensions I have yet to discuss have the potential to yield to the exceptional.

Last quarter I shared a story of Ben Graham opening his Security Analysis class at Columbia Business School by writing the following phrase on the chalkboard: *sub specie aeternitatis*. The phrase is from philosopher Baruch Spinoza, and translates to: *in view of eternity*. Professor Graham would go on to explain that any investor looking to be successful must have the proper psychological mind set. Eternity can be defined two ways: infinite or timeless. Graham and Spinoza were interested in the latter definition of eternity and believed that a truly enlightened state was the ability to see things with a view of timelessness. **In the plane of timelessness exists harmony, infinite presence to the reality and truth of the world, extraordinary insight, intuition, perspicacity, ceaseless coincidences, true joy, and clarity of thought**. Investing or not, this is the plane in which we want to envelope ourselves. This is the point, the ***still point***, we are looking to discover and ***yield*** to.

With this in mind, our goal is for each plane of our investment process to move us through a continuum of three hexagonal frameworks. As we have discussed, we begin with business assessment using the Six-sides of Great and then rise to the Harmony of the [investment] Spheres, or M-Theory. Now, we attempt to reach the highest plane: the Six Dimensions of Joy. The following are those six (intangible) dimensions:

Love:

I know what you are thinking, "What place does love have in the world of investing?" Perhaps nothing, unless you have *loftier objectives*, then the answer is "everything." I have not seen a better description of the keen insights that can be gained by a receptivity to love than in the beautifully written book *New Self, New World* by Philip Shepherd.

Love is a form of intelligence that liquefies the world… In fact, we might call love the supreme intelligence – it reveals the world to us as no other faculty can: it reveals the world in wholeness, it reveals the world in kinship, it reveals the world in ravishing specificity, and it reveals in the world a mindfulness that lives invisibly through all that is. In revealing the true and full relationship of things, and of us to the unbroken whole, love shows us, as physicist David Bohm put it, that "everything material is also mental and everything mental is also material. The separation of the two – matter and spirit – is an abstraction.[6]

The capacity to love and see the world as an "unbroken whole" is the entrance into our six-dimensions of joy. Keen insights in investing, as well as in life, come from being receptive, and perfect receptivity is made possible by the supreme intelligence of love. Love is about having complete freedom from envy, it lives in a realm of the absolute and not the relative, and believes in an abundance mentality and not scarcity. Love thrives for harmony and does not know discord, love senses the connectedness of all things, and love honors deserved trust. Perhaps in a subconscious realm there is truth to what George Washington Carver, the botanist and inventor born into slavery, said about the dialogue that love can open with the world around us. "All the flowers talk to me and so do hundreds of living things in the woods. I learn what I know by watching and loving everything… **If you love it enough, anything will talk to you**."

Curiosity:

While love is your supreme intelligence, curiosity is your greatest gift. There is not one attribute I value more in another human being than a deep, genuine curiosity. I believe great insights can evolve by searching the world with an honest "Why?" A childlike inquisitiveness can raise the consciousness (subconsciously) to the interconnections and relationships of all the moving parts of our lives to the harmony of the whole. **Curiosity opens the way for new insights** and is integrally connected to the other five dimensions.

Kaizen:

Kaizen is the Japanese word for "continuous improvement," which we often see associated with lean manufacturing processes and world-class businesses. In our quest for continuous improvement, we have adopted our own system of kaizen at East Coast. The concept of kaizen rests on the belief that there is no end game, no perfect answer, or solution, but simply countermeasures toward **a goal of infinite refinement**.

To us, the heart of kaizen is a life-long passion for learning set ablaze by curiosity and fueled by reading. Reading broadly and voraciously is the oxygen that breathes life into the six-dimensions. The more and more and more we read, the more interconnected the world becomes, the more we recognize patterns, the more we are able to "follow the threads."[7] As part of our process, we find reading source material to be the most important type of reading if the objective is to get as close to the truth as possible; summarized information is the great bane of the Internet, it disconnects the reader from the whole, as true insights are garnered in the subtle details. There are no short cuts to mental fitness. Much like compound interest, reading has compounding benefits.

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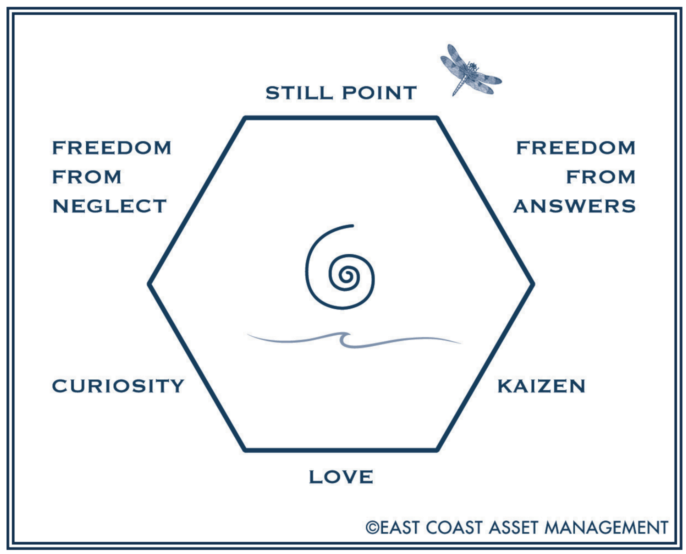
[6] *New Self, New World* by Philip Shepherd, 2010.

[7] We heard an investor we have a great deal of respect for use this term a few times in describing how he/she arrived at certain ideas where reading would introduce "threads" to follow.

Freedom from Neglect:

The greatest enemy of joy is neglect, which, if allowed to thrive, can lead one quickly away from insights, intelligence and interconnectedness. Neglect is the nagging feeling that someone or something demands your attention and pulls you from a state of the present. Neglect is not attending to the harmonious needs of that which is important such as ones health and family. The more things we have, the more people we invite into our lives, the more responsibilities and roles we steward, the more potential for neglect we weave into the fabric of our ***doing,*** which forces us out of our ***being***. I have learned that a pursuit of happiness is very different from a pursuit of joy, as the former is acquisitive, rewarding the self, and the latter belongs in a realm of a shared experience with that of the whole. The most rational way to free oneself from neglect is to attempt to **live simply and deliberately.**

Freedom from Answers:



Regrettably, one of the greatest fallacies of knowledge is knowledge. I believe one arrives at wisdom by coming to appreciate what is not known or unknowable. Sometimes the most intelligent, yet most difficult, words to say are "I don't know." A world constantly in flux means we live in a world where solutions and answers are fleeting. As soon as you whisper them, they are as soon negated. One of the greatest liberations in life that leads to a much deeper, *rooted* connection to timelessness and the whole, is to free oneself from the burden of arriving at answers. **What we seek is not answers, but harmony**[8] **with truth through humility**.[9] As Philip Shepherd wrote, "Self confessed ignorance is not a place of refuge; it is a place of encounter. It is a state of unknowing passivity that allows you be present with what is, and to feel it feeling you: the state of mutual awareness."

<u>Freedom from answers is not indecisiveness</u>, it is an awareness of the biases that lead to false convictions where one roots oneself into a position that is immovable. We are not always right, and humility has taught us to treat every capital allocation decision we make with the assumption that we are unaware of some unknowable piece of information. Even after we decide to make an investment, we set a course to discover what we missed. If the investment is intelligent then the compounding record will inform us that we made a good decision, a decision that works because it is in true harmony with the whole, but up and until that point we assume we are completely ignorant of some truth.

[8] In the final stage of our investment process we are searching for harmony among the key parts. When we find harmony we then make an affirmative decision (buy) and at the point we find discord among the key parts we disaffirm that decision (sell).
[9] *"The only wisdom we can hope to acquire is the wisdom of humility: humility is endless."* T.S. Eliot, 1943.

The Still Point:

I believe insight, intuition, intelligence, and an interconnection with the whole are magnified when they are discovered while yielding to the present. A hyper sense of reality embraces the grace of being and awakens the senses to the truth. Memory and hope are poor guides if your destination is reality. Thinking about the world in partitions of experience and expectation makes it difficult to assimilate with the world as a whole. **Yielding to the present means being receptive to the vulnerability of being changed by it**. While our timeless principles are foundational, allowing for a connection to the present is the only trustworthy guide to that which prepares the moveable feast – perspicacity.[10]

I have long admired the geometric spiral and like to think of it as an emblem of eternity. As we move though each side or dimension of our process, we move through the tangible dimensions toward the center of the spiral to the intangible, and eventually arrive at the very center – the here and now – **the still point**. In our search for 'what is' in our compounding journey, the still point is where we will discover truth. At the still point we yield to the present and discover our deepest harmony, sensitivity, intelligence, and joy – the joys of compounding.

At the still point of the turning world. Neither flesh nor fleshless;
Neither from nor towards; <u>at the still point, there the dance is,</u>
But neither arrest nor movement. And do not call it fixity,
Where past and future are gathered. Neither movement from nor towards,
Neither ascent nor decline. <u>Except for the point, the still point</u>.[11]

Yielding to the Still Point:

In late June, after I started writing this letter, I travelled to Quogue, NY, to attend a college reunion hosted by a close friend. I reconnected with my business school advisor who I had not seen in nearly twenty years. I was expressing gratitude for her help and stopped myself mid-sentence when I noticed her earrings were the geometric spirals, the emblems of eternity, which I had been thinking about with regards to this letter. I asked her about them and she told me that the spiral represented a symbol found engraved on the wall of a 5,000 year old prehistoric monument called "Newgrange" in her native Ireland. That is where my journey to Newgrange began, and I continue to be awe of what I have discovered.

Newgrange is a prehistoric monument located on a ridge above the River Boyne about 40 miles northwest of Dublin. In the year 1699, some Irish workmen, while digging up stones for a road repair found a very broad, flat, rudely carved stone placed at the bottom of a mount that they discovered to be a door to a cave. The early explorers crawled through the 62 foot passage and found a large chamber shaped like a three leaf clover with three recesses (left, right, and center) roofed by a soaring twenty-foot *hexagonal* stone vault. The right recess had a very large bowl, and both the exterior and interior stones were copiously engraved with geometrical looking designs. Archeologists soon realized that they had unearthed one of the great wonders of the world; a monument that dated back to 3,500 BC, older than the Giza Pyramids and Stonehenge.

It was not until an excavation in the 1960s that experts began to realize the true purpose of this building when they discovered a narrow transom called a "roof box" over the entrance to the

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[10] Perspicacity is a penetrating discernment – a clarity of vision or intellect which provides a deep understanding and insight. Perspicacity is the third element created by the forces of curiosity and learning.
[11] *The Four Quartets* by T.S. Eliot, 1943.

passage. The lead excavator, Michael O'Kelly, had heard rumors that during certain times of the year the sun would shine through the roof box and onto the back wall of the chamber. O'Kelly had a hunch that there was some purpose to this, tested his theory, and was proved correct in that the exact location of the building was positioned to allow the winter solstice, the midwinter's sunrise, to shine through the roof box, through the sixty-foot passage and onto the back wall of the chamber, which illuminated a *spiral* carving on the back of the center chamber.

The word *solstice* is derived from the Latin word *sol* (sun) and *sistere* (to stand still), because at the solstices, the Sun stands still in its declination, the seasonal movement of the Sun's path (as seen from Earth) comes to a stop before reversing direction. Solstice literally means, "still point."

An even more fascinating discovery was made when experts began to translate the meaning of the illuminated carvings and the bowl in the right recess. What they learned was that the Newgrangemen had a keen understanding of astronomy that they used for farming **and** for a spiritual connection with the universe. Experts believe that the bowl would fill through rain and dew formed on the rocks on a starry night and was used as a reflecting surface. An observer with his back to the right recess could not see out of the vault unless he looked at the water in the reflecting bowl. The spirals that were illuminated by the solstice and found etched on the numerous stones throughout the chamber signified the circumpolar rotation of the earth. If one were to look up in the sky and observe for a long period of time, they would see the stars rotate counterclockwise around the celestial northern point in the sky. Some experts have deciphered that these counter clockwise spirals represented *time* to the Newgrangemen, and time's march toward the inevitable. Of course, when an observer looked into the reflecting bowl the stars would rotate ***clockwise***.[12] Some experts conclude that the clockwise spiral was an emblem that meant the pausing or conquering of time, timelessness, and a connection with eternity.

Midwinter spring is its own season
Sempiternal though sodden towards sundown,
Suspended in time, between pole and tropic.
When the short day is brightest, with frost and fire,
The brief sun flames the ice, on pond and ditches,
In windless cold that is the heart's heat,
Reflecting in a watery mirror.[13]

Five thousand years before Ben Graham etched "in view of eternity" (translated) on his chalkboard, the Newgrangemen were honoring a similar message. The Newgrangemen attached special meaning to the still point of time, by honoring the winter solstice, the dawn of our calendar year, and by viewing the stars' clockwise rotation through reflection.

Dowth, Knowth, and Newgrange – The Journey to the Still Point:

While Newgrange is the most famous monument within the Neolithic Brú na Bóinne complex, there are comparable monuments alongside Newgrange known as Dowth and Knowth. Many similar stone carvings are found at all three of the monuments, yet, although similar, they

[12] The archeologists found many carvings of the letter "M" in the Newgrange chambers. It is believed the M signified the five bright stars that form the "W" called Cassiopeia, which resides in the Milky Way star fields. When the "W" of this constellation was viewed in the reflecting bowl it was viewed as an "M." It is believed the Newgrangemen honored the Milky Way as it signified their spiritual path to the next dimension. We appreciated the connection to our search for Mispricings. JoC = IRR [/e\+NTH+MoS+(H4)]^{M}

[13] *The Four Quartets* by T.S. Eliot, 1943.

represent an evolution of consciousness and intelligence for the Newgrangemen community. As they gained further perceptions into the workings of the world, they engineered and carved these insights into the newest monument as an emblem of their acquired wisdom.

Dowth was built first and means "darkness." Knowth was built second and means "knowledge." Newgrange was built third and has been referred to as the "house of light." The design of Dowth (darkness) was said to welcome darkness by way of letting in the setting sun. The east-west orientation of Knowth (knowledge) is perfectly situated to take the light in of the equinox, the day that is exactly half-day, half-night. And Newgrange, we learned, was oriented to welcome the solstice – the midwinter spring – the **new dawn**.

When I thought through these three Neolithic monuments and the significance of their names, I reflected on the journey one might take toward enlightenment through Dowth, Knowth, and Newgrange. As children, we are born with an innocence of perception and are infinitely present, yet void of world knowledge, and as we learn to adapt to the world around us we build up the "self." We move from being one with everyone around us to being one with our self, trying to understand the self and serve the self. Through all of this, we first arrive at Dowth, or darkness, as we allow the self to pull us inward and we disconnect with the whole.

As we experience life and struggle through Dowth, we ask "why" and "where" we fit into the world, and eventually evolve to the half awakened state of Knowth, or knowledge. Here we live in the infinite equinox between the self (darkness) and the whole (enlightened), we experience half-day and half-night, half questions and half answers. Heraclitus commented on this state when he wrote of those who "are as unaware of what they do when they are awake as they are asleep… though present they are absent." Finally, to arrive at Newgrange is to arrive at the still point, into a place of **presence**.

In Newgrange one of the stone engravings that was most curious to the experts was a three-dimensional, nine-rung ladder carved in the central chamber where the hexagonal vault climbed to the stars above. The ladder was clearly carved with two sections – three rungs below and six rungs above. The Newgrangemen, within their house of presence, the still point, had an idea of the nine rungs they needed to climb to conquer time and arrive at enlightenment, or **eternity**. At East Coast, we find the journey from Dowth to Knowth to Newgrange to be representative of a similar path we take when attempting to embrace the six intangible dimensions of our process. Though we begin in a state of darkness, and then evolve to a half awakened state of knowledge as we have half questions and half answers, we ultimately hope to exit the top of the framework of joy into a place of **presence and timelessness**.

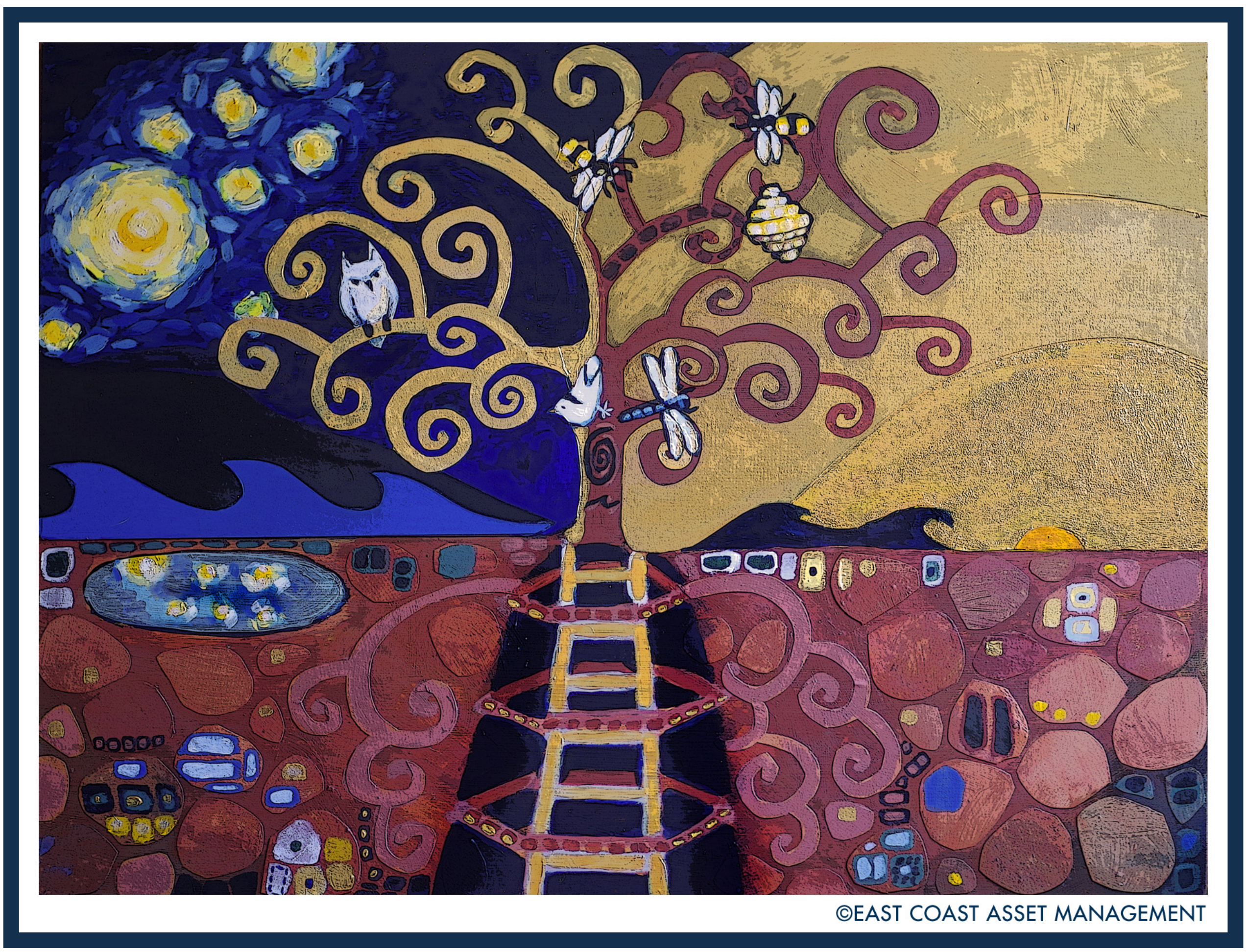
Our investment principles and process, our measured system, is confined to the three dimensions of space and one dimension of time, or the first section of the ladder. We believe we can elevate ourselves from confinement and find a truly differentiated insight that will lead to our best ideas by climbing the six additional dimensions or rungs. If we are successful at assimilating all ten dimensions of both the tangible and intangible, we may also arrive at the still point of insight and timelessness – seeing things the way Ben Graham encouraged, "in view of eternity." The nine rungs are fitting because as we climb all ten dimensions we will have removed the rung of time and arrived at timelessness. A rung that "measures time not our time, <u>rung by the unhurried groundswell, a time older than the time of chronometers</u>… when time stops and time is never ending; and the groundswell, that is and was from the beginning, clangs the bell."[14]

[14] *The Four Quartets* by T. S. Eliot, 1943.

When timelessness is valued as the tenth rung we can listen carefully for harmony of the whole – three dimensions of process rooted in the six-dimensions of sense. What investments have the greatest merit in a mindset where time ceases to exist? What is the one business you would want to own if you were forced to invest 100% or all of your family's wealth into it and you were not able to look at it for ten years? **This mindset of timelessness changes what risk you are willing to take**. These are the types of businesses we want to own.

By nourishing and improving our rooted awareness of the tangible and the intangible attributes, intuition, intelligence, and insights can branch out from the tree of life to compound and be reconciled among the stars. I believe building everything we do with eternity in mind is our highest calling, it is not only the key to our success, but also truly the way, the logos, the path toward true **joy**.

I said to my soul, be still, and wait without hope
For hope would be hope for the wrong thing; wait without love,
For love would be love of the wrong thing; there is yet faith
But the faith and the love and the hope are all in the waiting.
Wait without thought, for you are not ready for thought:
***So the darkness shall be the light, and the stillness the dancing*.**[15]



[15] *Ibid*. Camille Vicenti created the artwork above, entitled *The Dance*, for East Coast.

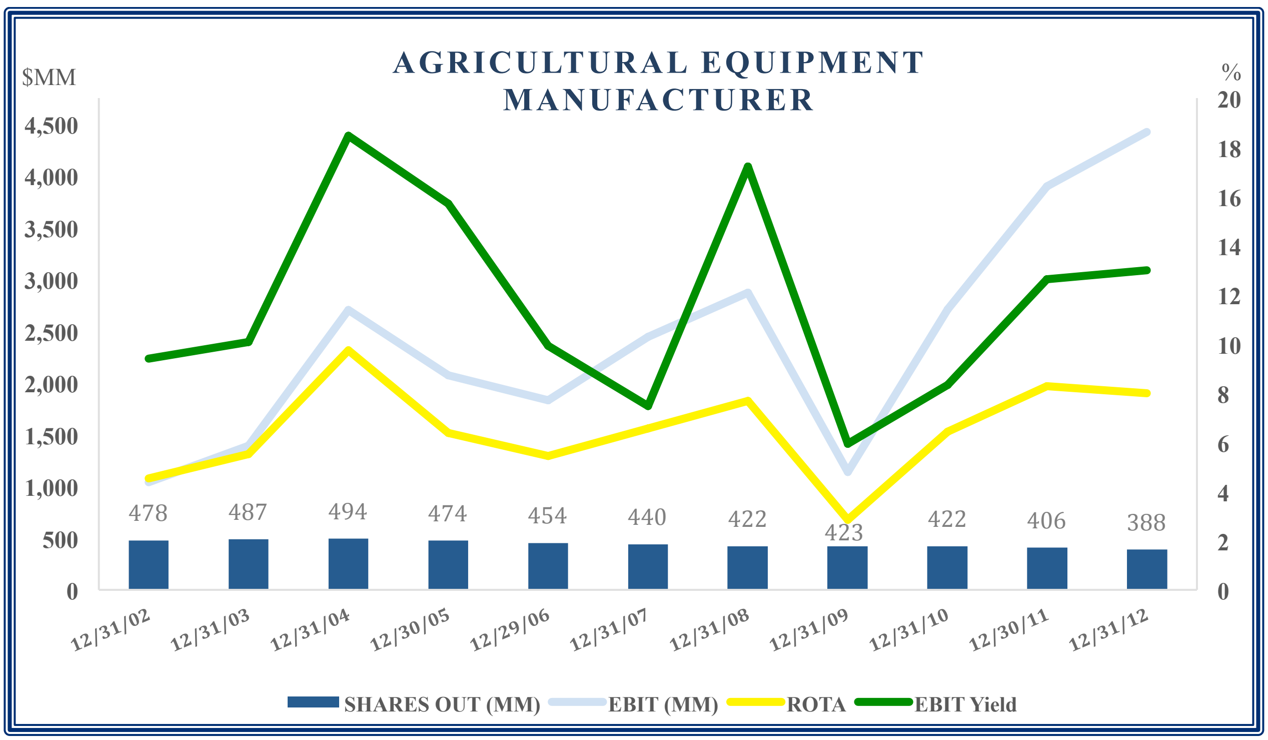
Representative Idea – Agricultural Equipment Manufacturer:

We made two new investments during the quarter, one of which was a leading agricultural equipment manufacturer that we will highlight as a representative idea.

Sourced & Categorized: A weekly part of our research process is to run multiple equity screens to source investments based upon parameters that we think show value and lead to intelligent discussions and further research. Most importantly our screens allow us to touch a lot of businesses on a weekly basis, and give us a barometer of what the market likes or does not like. From time-to-time, screened metrics will lead us to a name that we get excited about, as it did this quarter. We discovered this business utilizing a **simple** EBIT (earnings before interest and taxes) yield screen.

We categorize this business as a transformation. As noted in previous letters, transformations are businesses with average, or even below average, operating economics. Over time, we expect a meaningful change (inflection point) in operating economics through three different transformation categories: secular, systemic, or separation. This newly acquired business has systemic transformation attributes as they have evolved their operating systems and are extracting meaningful, sustainable, improvements in their operating metrics. We also see material secular transformational dynamics with strong tailwinds in agriculture, as the world exponentially demands more crops to meet a growing protein based diet.

Brief Summary – Six-sides of Great and M-Theory:



Economics (/e\): This business earns single-digit returns on net tangible assets, just below 9.0%. Removing the financing part of the business and long-term investments, the business earns a more attractive, but still quite average, 14.4% operating return on net tangible assets. Operating income has increased more than 4x from fiscal year 2009 as customers made purchases that were deferred during the credit crisis and subsequent slowdown. While we do not think we are at peak cyclical earnings, we assume that we might be, and even in our most bearish scenarios we are paying a fair price for a quality business.

Competitive Advantage (N^{TH}): The business has been around for almost two centuries; their core business has the largest industry market share worldwide and is one of the most well-known and respected brands in the United States. Loyal customers and a successful brand image that expands outside of its core business prove the brand's durability. The core competitive advantage resides in the company's established (and evolving) manufacturing and distribution capabilities that are far superior to its competitors.

IRR: The business has an Enterprise Value of $33 billion and TTM (trailing 12 month) EBIT of $4.8 billion, which equates to a 6.87x multiple or 14.5% EBIT yield. Even conservatively estimating benign growth in North America, coupled with a transformation in international growth, we arrive at an attractive IRR under quite bearish scenarios.

Margin of Safety (MoS): We are owners of this company at what we'd consider an extremely attractive multiple of roughly 7x EV/EBIT, meaning we are now owners of one of the most well-known brands in the world at an earnings yield of over 14%. Furthermore, management has generally proven to be good stewards of capital, and an opportunistic share repurchase plan appears to be accelerating, but time will tell just how enlightened management is going forward.

Investment Longitude (H4): We find investment longitude in the quality of the brand image and products, as well as the manufacturing and distribution capabilities of the business (the business has positioned itself to consistently deliver orders in one or two days, something customers require and competitors lack). This company's dealer network is extremely strong, allowing for the product's life cycle to extend multi-decade periods as used equipment can be traded in for new equipment or sold to a new client that can afford a lower price point.

Mispricing (M): The way we classify this mispricing is through a phrase used in the beginning of the letter: geographic myopia. We have owned a number of businesses where investors fail to see a change in the end market dynamics as the businesses evolve. In this case, investors focus on a mature U.S. business and ignore the runway of growth they have positioned themselves for in emerging markets and Eastern Europe. In five years we believe the business will have less than 50% of their revenues attributable to the U.S. business.

$$\mathbf{JoC = IRR\ [/e\backslash + N^{TH} + MoS + (H4)]^{M}}$$

Firm Updates:

- ***Team additions***: As we approach our five year anniversary this coming September, we coincidentally have the pleasure of announcing five new additions to the East Coast team. Bringing on team members is something we do with the greatest care for two reasons: each person impacts our culture, and we strive to run our business with the same level of efficiency that we look for in the businesses we invest with. These additions will allow us to move the bar a little higher on our client service and performance capabilities.

  Our five new team members span across the business units of East Coast:

David Lemons, CFA, joined us as a Senior Managing Director and Portfolio Manager. I have personally known Dave for over a decade and I could not be more excited to have Dave as a valuable addition to our investment team.

Ben Randlett, who has been with us for nearly a year in an internship capacity, has been hired as an Investment Analyst. Ben has become an invaluable member of our research team.

Don Hannan has joined us as a Managing Director and will serve in a Business Development role. A very close friend of the firm introduced us to Don and we are fortunate to have someone with his experience and integrity join our team.

Chris Bekel joined us as a Wealth Management Associate and is a fundamental contributor to our wealth management and client service efforts.

We also added a vital member to our Client Service team, Denise Burns. Denise will be working with Jane, Lindsay, and Laura.

We have included biographies in the appendix so that you can become more acquainted with Dave, Ben, Don, Chris and Denise.

We look forward to meeting and talking with you soon. We greatly value your support and trust.

Love is most nearly itself, When here and now cease to matter…
Here or there does not matter, <u>We must be still and still moving</u>
Into another intensity, For a further union, a deeper communion
Through the dark cold and the empty desolation,
The <u>wave</u> cry, the <u>wind</u> cry, the vast <u>waters</u>
Of the petrel and the porpoise.

<u>In my end is my beginning</u>.

T.S. Eliot (1888 – 1965)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder

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Appendix:

David W. Lemons, CFA

Prior to joining East Coast as a Senior Managing Director, David was the President and Co-Chief Investment Officer of Knott Asset Management (KAM) in Cambridge, MA. While at KAM, he managed the firm's global and multi-cap U.S. investment strategies, both with a strong value orientation, for institutional and individual clients. He had founded Vedette Asset Management, a boutique money management firm, in 2006 before merging it with Knott Asset Management in May 2011. From 2002 to 2005, David was Vice President and Chief Investment Officer at Foster, Dykema, Cabot & Co., a private wealth advisory firm in Boston. Before that, he served as Vice President and Investment Manager at Cambridge Trust Company. He also worked for over six years as an investment manager at Fidelity Investments in Boston, focusing on asset allocation strategies. He started his financial career in 1988 at Johnson & Higgins as a Business Analyst, eventually working with the Energy Group in New York covering oil and gas companies and alternative energy firms.

David graduated from Trinity College with a B.A. in History, studied Economics at the University of London/London School of Economics and is a CFA charterholder. He is also a member of the Boston Economic Club, the Cape Ann Investment Forum, and the Boston Security Analyst Society. David lives in Hamilton, MA, with his two children and where he has served on the Economic Development Committee for the town's Board of Selectmen and as Treasurer and Board member of Stoneridge Children's Montessori School.

Benjamin H. Randlett

Ben has been with East Coast since his senior year at Endicott College, as an intern, and joined the team full-time as an Investment Analyst in June, 2013. Ben works closely with our Chief Investment Officer and Co-Founder, Christopher M. Begg, on equity research. Prior to joining East Coast, Ben was a Summer Analyst at Cote Financial Management, a boutique wealth management firm in Wenham, MA. Before that, Ben worked for gammaSUPPLIES LLC., a medical equipment supplier to Global Fortune 500 pharmaceutical companies. Ben also spent four summers in his home state of Vermont as a Tennis Professional at the Basin Harbor Club on Lake Champlain.

Ben graduated cum laude from Endicott College with a B.S. in Business Administration and concentration in finance. While at Endicott, Ben was a member of the student-run Investment Committee, managing a portion of the school's endowment, was a member of the LIGHTHouse Leadership Society, and played for the Men's Tennis Team. Ben lives in Gloucester, MA, is pursuing his CFA designation, and is always up for a good game of tennis.

Donald J. Hannan, III

Donald J. Hannan III joined East Coast a Managing Director. Don brings over thirty years of business development experience to the team. Before joining East Coast, Don was a Business Development specialist at Saturn Asset Management, a venture capital firm. Prior to Don's time at Saturn, he was Director of Major Gifts and Planned Giving at the Constellation Center in Cambridge and The Boston Foundation for Sight.

Don also brings twenty years of experience in the field of business and corporate ethics. He helped establish the Center for Business Ethics at Trinity Church Wall Street. He also initiated a program at the DuPont Company with then CEO Edward Woolard and Herb Shapiro, who founded the Business Roundtable. Currently a Yale Fellow at Johnathan Edwards College, Don graduated with a Masters in Divinity from Yale in 1984. He served twenty years as an ordained minister in the Episcopal Church. During that time he worked with Desmond Tutu to facilitate an investment policy for international companies. He also served as Chairman of Board for Big Brothers/Big Sisters in Connecticut and on the Board of the American Red Cross.

Christopher J. Bekel

Chris joined East Coast as a Financial Planning Associate in May, 2013. Prior to joining East Coast, Chris served as Paraplanner at Boston Hill Advisors, a boutique financial planning and investment advisory firm. He worked alongside five financial advisors; specializing in the areas of cash flow and budgeting, investment analysis, retirement planning, tax planning, insurance needs, and business development.

Chris attended Bryant University where he graduated in May of 2012 with a B.S. in Business Administration with concentrations in Financial Services and Economics. Chris has his Series 65 license and is currently studying for the Certified Financial Planner™ designation.

Denise Burns

Prior to joining East Coast Asset Management as a Client Service Specialist, Denise worked for six years in multiple departments; Operations, Reception, Licensing and Commissions for Investors Capital Corporation. She went on to become a personal Assistant for one of the top Financial Advisors within the firm.

For twenty years prior to working in the investment world, Denise owned and operated a small business. She also worked for the court system for ten years in the Probation Department as a bookkeeper and a backup in the courtroom.

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2013 3rd QUARTER LETTER

A great matter is architecture, nor can everyone undertake it. He must be of the greatest ability, the keenest enthusiasm, the highest learning, the widest experience, and, above all, serious, of sound judgment and counsel, who would presume to call himself an architect. ***The greatest glory in the art of building is to have a good sense of what is appropriate****. For to build is a matter of necessity; to build conveniently is the product of both necessity and utility; but to build something praised by the magnificent, yet not rejected by the frugal, is the province only of an artist of experience, wisdom, and thorough deliberation.*

Moreover, to make something that appears to be convenient for use, and that can without doubt be afforded and built as projected, is the job not of the architect so much as the workman. ***But to preconceive and to determine in the mind and with judgment something that will be perfect and complete in its every part is the achievement of such a mind as we seek****. Through his intellect he must invent, through experience recognize, through judgment select, through deliberation compose, and through skill effect whatever he undertakes. I maintain that each is based on prudence and mature reflection. …*

Yet he should not be inarticulate, nor insensitive to the sound of harmony*; …* ***that he does not obstruct the light****; that he does not transgress the servitudes on rain dripping from the eaves, on watercourses, and on rights of way, except where there is provision; and that he has a sound knowledge of winds, their direction, and their names; still, I would not criticize him for being better educated. But he should forsake painting and mathematics no more than the poet should ignore tone and meter. Nor do I imagine a limited knowledge of them is enough. …*

Everything that Nature produces is regulated by the law of concinnitas, and her chief concern is that whatever she produces should be absolutely perfect. ***Without concinnitas this could hardly be achieved, for the critical sympathy of the parts would be lost****. …* ***Beauty is a sympathy and consonance of the parts within a body, according to definite number, outline, and position****, as dictated by concinnitas, the absolute and fundamental rule in Nature. This is the main object of the art of building and the source of her dignity, charm, authority and worth. …*

Look kindly on these studies, men of learning!

Leon Battista Alberti

On the Art of Building in Ten Books – 1452

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To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO, Chief Investment Officer, and Co-Founder

Date: October 23, 2013

Re: Third Quarter 2013 Update – **The Architecture of Reason**

In our third quarter letter you will find an update on our portfolio and general market observations. Each quarter we highlight one component of our investment process. This quarter, in the section titled *The Architecture of Reason*, I will discuss a framework of rational decision-making and how we attempt to apply it using our seventy-two-point investment checklist. As is our standard practice, client reporting, including performance and positioning will be sent under separate cover.

First and foremost, I am proud and honored to report that we celebrated our five-year anniversary at the close of the quarter. Being a part of building East Coast has been the highlight of my professional life. I am certainly biased, but I cannot imagine a better team that I could have the privilege to work with. As for our clients who have entrusted their capital with our stewardship, we will forever be grateful to you for your friendship, confidence and trust. Thank you for allowing us to be here today doing what we love to do.

Market Summary[1]

	S&P 500	**MSCI AC World Index**	**MSCI Emerging Markets**	**MSCI EAFE Index**	**Barclays Aggregate Bond Index**	**Gold – $/Troy Oz.**	**Crude Oil**
Price 09/30/2013	1,681.55	382.07	987.46	1,818.23	1,809.53	$1,328.94	$102.33
Q3 2013	5.24%	8.06%	5.87%	11.70%	0.57%	7.64%	5.98%
YTD	19.79%	14.96%	-4.22%	16.77%	-1.89%	-20.68%	11.45%
2012	16.00%	16.62%	18.47%	17.87%	4.22%	7.14%	-7.09%

Reasonable valuations and monetary policy tailwinds continued to trump political gamesmanship as equity markets logged favorable returns in the third quarter, extending robust year-to-date returns. For Q3 2013, the S&P 500 returned 5.2%. The developed international and emerging market indices came back to life toward the end of the quarter registering an 11.7% return for the MSCI EAFE Index and a 5.9% return for the MSCI Emerging Markets Index. Fixed income returns were flat as the Barclays Aggregate Bond Index returned 0.6%.

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, the MSCI Europe Asia Far East Index (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices.

As we find ourselves closer to fair value in many equity markets, we prepare ourselves for the likelihood of periods of greater volatility as extreme under-valuation elasticity has diminished.

As value investors we much prefer sowing to harvest, buying bargains that will create compounded value. Fair value is not the dreaded storm cloud that many claim, yet it is a time to be more disciplined, diligent, and deliberate. Today we are spending more time pruning where necessary, extending where we see continued merit, and overseeing our crop.

Man with a [Pythagorean] Hammer:

In 1966, American psychologist Abraham Maslow (1908-1970) popularized the phrase, "if all you have is a hammer, everything looks like a nail," in his book *The Psychology of Science*. More than ever we are observing a polarity in investment conclusions from a growing field of "experts," and I find Maslow's hammer to be one of the most important mental models to keep in mind when, as decision makers, we attempt to wade through the waves of "expert" opinions in search of truths. Here I want to expand the discussion of this mental model to the current environment.

As the legend goes, Greek philosopher Pythagoras (c. 500 BC) was walking by a blacksmith's forge when he heard the sound of anvils being hit by hammers. Hearing both pleasing and dissonant combinations of sounds, he walked over to the forge to investigate, and discovered that hammers' weight ratios caused these distinct sounds. The proportions of weights created consonance when the twelve pound hammer was stuck with the 6 pound hammer (2:1), when the twelve pound hammer was struck with the eight pound hammer (12:8 or 3:2), and when the twelve pound hammer was struck with the nine pound hammer (12:9 or 4:3). Pythagoras furthered these proportional insights with the length of strings, and named the ratios of his perfect consonances unison (1:1), octave (2:1), perfect fifth (3:2), and perfect fourth (4:3). Pythagorean tuning evolved as a system of musical tuning in which frequency ratios of all intervals were based on the ratio of 3:2, known as the perfect fifth. This was the ratio that was chosen as the *most* consonant and easy to tune by ear.

From Pythagoras and Maslow, I find harmonic consonance and dissonance a useful way to think about the investment universe. In music, the frequency of sound intervals is measured in hertz; in the investment universe we measure the frequency of investment opportunities in internal rate of return (IRR). Every investment opportunity is singing its particular pitch, and, as investors, if we can tune our ear to hear the harmony of the marketplace then we can allocate capital intelligently.

The challenge is that very few, if any, investors have the attribute of absolute pitch to harmonically sense the IRR frequencies of investments. As a result, investors often look to the manic-depressive conductor "Mr. Market" for direction to stay in tune. They are often left directionless as he moves back and forth from consonances and dissonances, building up the tension of the market's symphony. Investors move on and look to the "experts," professionals that have proven clairvoyant at times with their ability to harmonically sense IRR frequencies where others have not. Many of these professionals' last names are the brand names of the investment industry, and their music is considered gospel when they sing their foretelling missives. I spent a large part of my early career looking for this type of direction from the "experts."

The problem with this is that *most* investment experts are *men and women with Pythagorean hammers.* Each practitioner's singular hammer built their reputation and fortune when the marketplace was in harmony with their hammers' frequencies. These hammers may have been technology stocks in 1999, global macro strategies at the peak of housing bubble in 2007, distressed equity and credit investments in 2008, short-sellers in 2000 and 2008, or fixed-income investments over a period of thirty-one years of falling interest rates. With each golden hammer lofted above their heads, the media regularly parades out these virtuosos so we can hear their forecasts. I don't advocate ignoring these bright practitioners but it is important to note their hammer of trade. As a whole, investors need a better system to find harmony than looking for direction from "Mr. Market," narrow insights of sporadically harmonious virtuosos, or an allocation to a **diversified basket of noise**.

The tuning system we use applies a matrix of price and cash flow to assess the IRR frequency of investment considerations. We conclude that owning a great business at a reasonable price is the most consonant frequency of the marketplace – the perfect fifth. The other harmonic intervals would be cash (the perfect octave), or fixed-income (the perfect fourth). At times, the IRR frequencies of cash and bonds can be more concordant than owning equities. Today, in our opinion, is not one of those times. However, we believe having as many hammers available to us as possible makes a great deal of sense. We are not wedded to one ratio, rather we want to listen carefully to be in harmony with intelligent capital allocation based on IRR merit.

For the last four plus years the market has been in tune with our sweet spot, the perfect fifth, of what we love to own – great businesses. The market's beautifully harmonic tone in March of 2009 was equivalent to Stravinsky's *Rite of Spring* – absolutely stacked with perfect fifths. The wish list of many businesses we aspired to own at an attractive price was readily available. We favored the *most* attractive businesses for longer-term compounded returns at the expense of more favorable short-term bargains. We feel we have been rewarded, particularly this year, for a number of those quality decisions. Our employed hammer's perfect fifth ratio has and continues to be concordant.

As many of the businesses we own now trade at higher valuations, we now find ourselves in a *middling* period of fair value. We are not finding as many new businesses to purchase at a discount yet we remain content with the harmony of our portfolio in absolute terms and in *proportion* and *perspective* to other investment considerations, including the octave of cash and the extremely dissonant harmony of bonds. We will continue to overlay our matrix of price and cash flow on the entire universe and harmonize to the frequency of IRR as our primary input.

The most important attribute of an effective tuning system is the ability to see the parts in proportion to the whole, and the whole in proper ratio to all of the parts. To that end, I have thought a lot about the reasoning process, particularly one that can help arrive at this holistic perspective. I will discuss this framework in the next section, *The Architecture of Reason*.

> *Of all things, good sense is the most fairly distributed: everyone thinks he is so well supplied with it that even those who are the hardest to satisfy in every other respect never desire more of it than they already have.*

Rene Descartes (1596-1650)
Opening to the Discourse on the Method of Rightly Conducting the Reason,
And Seeking Truth in the Sciences

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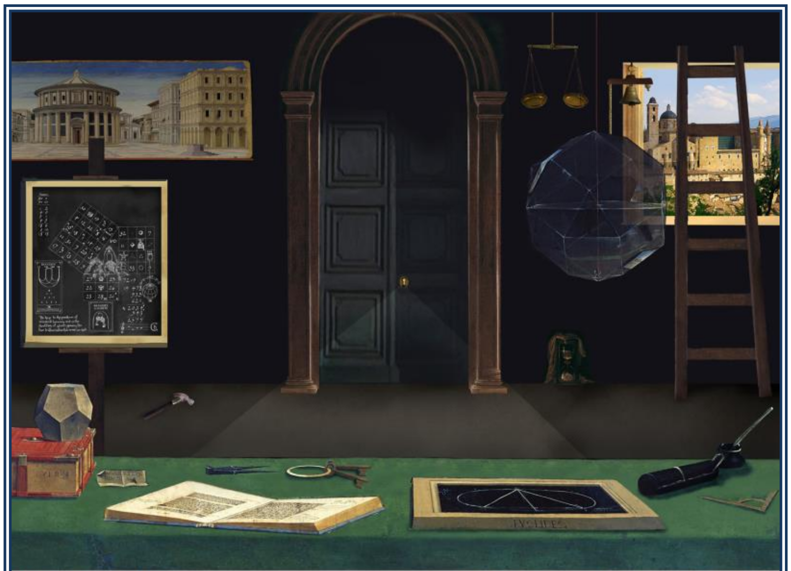


A Well-Lighted Place ©2013 EAST COAST ASSET MANAGEMENT, LLC

The Architecture of Reason:

Fra Luca Pacioli (1445-1517) was at the epicenter of the high Renaissance and the Enlightenment, he was a polymath among polymaths, a giant among giants. His personal mentors were the great architect Leon Battista Alberti (1404-1472), and the progenitor of perspective painting, Piero della Francesca (c. 1415-1492). Pacioli had become famous throughout Western Europe as a teacher, and most famously as an author of his book *Summa de [Everything about] Arithmetic, Geometry, Proportion and Proportionality*, published in 1494, which was a synthesis of mathematical knowledge at that time. The *Summa* included the first published treatise on bookkeeping, and to this day Pacioli is recognized as the father of accounting. Pacioli's soon to be famous book, *De Divina Proportione*, would be printed in Venice in June, 1509. It would also include brilliant illustrations by the ineffable left hand of Leonardo da Vinci (1452-1519).

On August 11th, 1508, at the Church of Saint Bartholomew in Venice, Pacioli approached the lectern[2] to deliver the most profound speech of his life. He looked out at five hundred of Europe's brightest minds, distinguished guests who had come to hear one of the great geniuses of their time discuss his learnings. He opened with these remarks[3]…

> ***Of all arduous and difficult things****, oh very reverend Lords, venerable Fathers, very eminent Doctors, distinguished Gentlemen, very intelligent students of whatsoever field of study, and you remaining very distinguished citizens,* ***the most difficult is proportion****.* …

Pacioli goes on to detail the importance proportion had: to the wisdom of the ancient philosophers, to physicians, astronomers, painters, sculptors, musicians, the liberal arts, grammar, law, government, and most of all to arithmeticians and geometers.

> ***This proportion is a boundless treasure for men****, and those who avail themselves of it become participants in the friendship* ***recommended by reason*** *of the gifts of discipline.* ***This I truly learned, and ungrudgingly I pass it on to others by most openly revealing its virtue****.*
>
> *Euclid, perceiving the necessary acceptance of proportions and proportionalities treated them most eloquently in this his fifth book* ***with the idea that a richer fruit of everything that he had said might be gathered****. The entire book is composed of definitions of these same proportions followed by thirty-four propositions after his manner of treatment.* ***And he made these impregnable to criticism****.*

---

[2] Most likely glancing up to Albrecht Dürer's alter piece *Feast of the Rosary* that he just completed for this church, which was a place of worship for Venice's German community.

[3] *No Royal Road – Luca Pacioli and his Times*: R. Emmitt Taylor – 1942.

> *Therefore, if any person desires to engage in any speculation no matter in what faculty, science, or art,* ***let him hurry to this fountain from which ever flow streams of living water****. And higher than the stars his genius shall be exalted. But the situation requires that we come to the text which thus begins: …*

In the words of Daniele Caetani, a learned contemporary of Pacioli, who concluded after reading Pacioli's treatise on proportion, *"**I rejoiced in a wondrous way to hear that our era was to have bestowed upon it a treasure so great, so rare, and so profound a secret**."*

I have long been intrigued by this time in history and after reading these words from one of the greatest thinkers and influencers of the era, I also felt like I had stumbled upon a great treasure.

The genius of the Enlightened period of the Renaissance was the incredible focus on finding truths through reason.

Reason is derived from the Latin word ratio. Derived from the word ratio is rational, meaning having the ability to reason. Proportion is a part considered in relation to the whole, or further said a harmonious relation of parts within a whole. We connect reasoning then to the knowledge of the harmonious relationship between the parts in the context of the whole, or proportion. **Pacioli's treasure of proportion is a gateway to perspective that opens the door to reason.**

It is human nature to rely on our senses to drive perception and guide our decision-making, however, our senses (unfortunately) deceive the application of reason. We do not measure and weigh the harmony of proportion but instead, instinctively, rely on what we hear, see, smell, feel, and taste. Rene Descartes (1596-1650) wrote extensively on the unreliability of the senses and covered these insights in depth in his magnum opus, *Discourse on the Method of Rightly Conducting the Reason and Seeking Truths in the Sciences* (1637). Descartes concludes,

"Thus what I thought I had seen with my eyes, I actually grasped solely with the faculty of judgment, which is in my mind."

Given we are **always** being informed by our senses, it is important to have an override framework so we can rely on **reason**, especially when making important decisions with profound outcomes (investment considerations).

While thinking about what this architecture of reasoning might look like, I was lucky enough to discover the insightful words of Marsilio Ficino (1433-1499), a beacon of reasoning and truth from the early Renaissance. Below is an excerpt from a letter he wrote in 1477 that encapsulated the thoughts that had been percolating in my mind on what this framework might look like.

> *…number, figures, and* ***reasons for movements*** *concern thought more than the exterior senses; by studying them, the soul detaches itself not only from corporeal appetite but also from the sense,* ***and is turned toward interior reflection****. Such is in effect the platonic order in the perception of these objects: arithmetic leads to geometry, geometry to stereometry, stereometry to astronomy, this last to music.*

While our *Architecture of Reason* framework applies to investment considerations, I think the basic concepts are relevant for any sort of decision-making. **To be clear, I am not presenting a new method of reasoning but merely reviving an old one**. Below I will discuss the framework we use and provide an example of how we apply the framework to our investment process.

<u>Arithmetic – Number, Weight, and Measure – One Dimensional</u>:

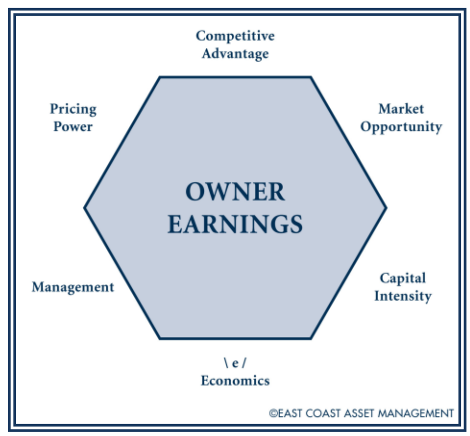
The Architecture of Reason begins with Arithmetic, or number, and thus an understanding of the parts in terms of weight and measure. This first part is one-dimensional, laying a mathematical foundation based on evidence and certitude.

1. **Wealth Creation Engine – The Number /e\ and Valuation {v}**: The first step in our work starts with the business's return on the tangible assets employed. We conclude that over time our compounded return will gravitate toward the business's earnings based on the assets required to run and maintain the business. We call this the wealth creation engine as it will provide the majority of the compounding horsepower. We also want to understand our initial operating income yield as measured by valuation (EBIT/Enterprise Value). Even if the business has a very attractive number /e\, we might pass if the investment has a low EBIT yield {v}. We typically look for 8% or better yields for later stage transformation or compounder investments.

"Measure what is measurable, and make measurable what is not so."[4]

<u>Geometry – Demonstrate – Two Dimensional Magnitudes at Rest</u>:

The next part of the framework is Geometry. This is where we begin to see the question at hand two dimensionally, often applying a shape to map out key components. Here we seek to outline truths that are "impregnable to criticism," and we begin to build if/and equations that can provide us a range of outcomes with proportioned probabilities.



2. **Six-Sides of Great - Hexagon:** If arithmetic passes, we will frame the investment using our six-sides of great *hexagonal* framework. We begin to take a closer look at competitive advantage, economics, market opportunity, price elasticity, capital intensity, and management's operational and allocation history. If applicable, we also use tetractys geometry to the three areas of transformations (secular, systemic, and separations). Seeing things in terms of geometry is enormously helpful.

"Let no one unversed in Geometry come under my roof."[5]

<u>Stereometry – Parts in Proportion to the Whole – Three Dimensional</u>:

The next step is Stereometry, which is a study of three dimensional shapes. At this part of the framework we want to evaluate the question at hand by assessing the parts in proportion to the whole. I have found a checklist to be a great tool here, as this is where the majority of due diligence takes place. **This step is at the heart of Pacioli's proportion and proportionality treatise**.

---

[4] Galileo Galilei (1564-1642).

[5] It is said this famous statement was written over the entrance of the Academy of Plato. Such requirements illustrated the great importance Plato gave to Mathematics, especially Geometry, as "God always geometrizes."

3. **Summa – 72 Point Checklist:** By now the investment opportunity has both qualitative and quantitative merit and thus we want to understand each part of the business in greater depth. We have created a 72-point checklist to assist in making sure we have looked at every aspect of the business and the investment. I will discuss in greater detail below how this checklist is formulated, and provide the first 24 points.

"The mathematicians seem to me to have arrived at true knowledge and it is not surprising that they rightly conceive the nature of each individual thing; for having reached true knowledge about the nature of the universe as a whole, they were bound to see in its true light the nature of the parts as well."[6]

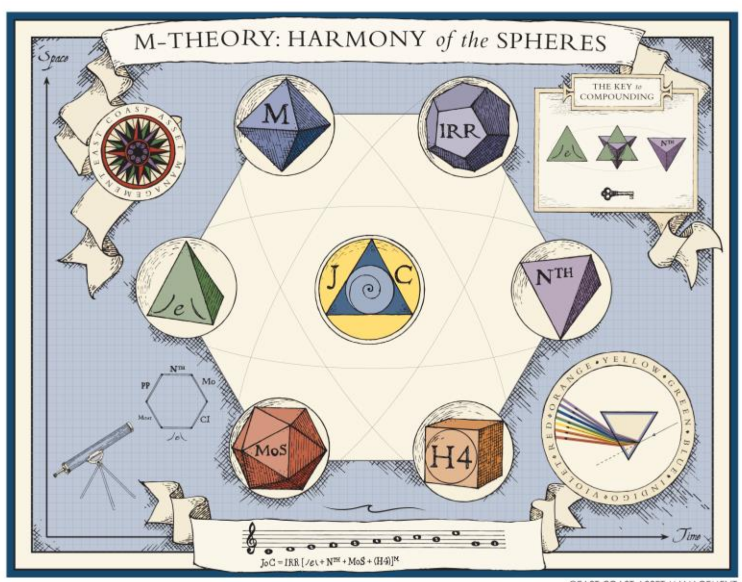
Astronomy – Evolution through Time – Three Dimensional Shapes in Motion:

We now move on to Astronomy, which we define as the study of three-dimensional bodies in motion. Nothing exists in a vacuum, so we must understand the direction, speed and motion of the truths we seek.

4. **The Vector – Business Evolution:** We address motion in our checklist and refer to it as the vector. What we are looking for in the vector will be different for compounders (compared to our two other investment categories: workouts and transformations) where we want attractive economics to be maintained or incrementally improved. This compares to transformations where we are looking for a true inflection point of the vector based on a number of tangible inputs that could be both company and/or industry specific.

"When things are in order, if the cause of the orderliness cannot be deduced from the ***motion*** *of the elements or from the composition of matter, it is quite possibly a cause possessing a mind."*[7]

Music – Harmony – The Whole Body in Relation to the Everything:



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We then arrive at Music, the knowledge of harmony. Are the parts concordant with the whole and is the whole concordant with the world at large? How does the business harmonize with its community, employees, competitors, shareholders and the environment?

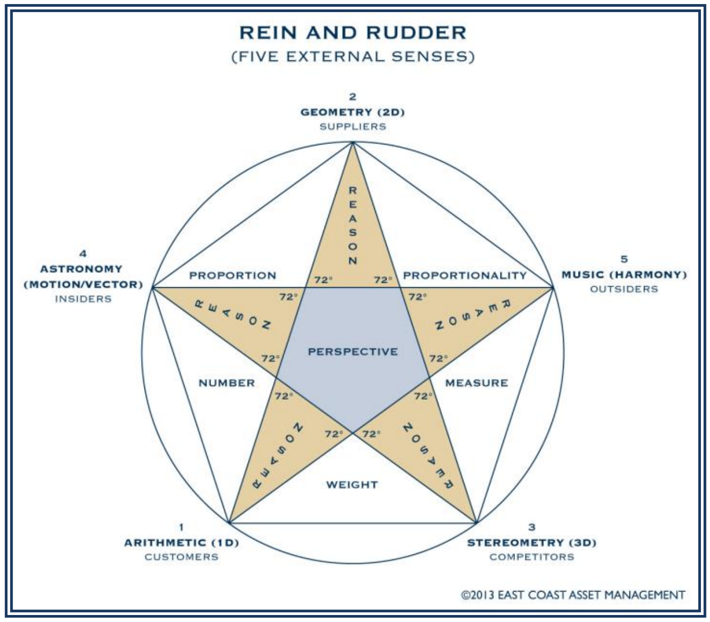
5. **M-Theory:** In our Q2 2013 letter I wrote about M-Theory using a harmony of the spheres framework. I detailed how we look for counterpoint harmony among the six key areas of the final stage of our investment process. A common metaphor referring to a great business is the width of its moat,

[6] Archytas the Pythagorean – Huffman, 2005. *The Authenticity of Archytas.*
[7] Johannes Kepler (1571-1630).

which is a useful way to assess the strength of its competitive advantage. While we want the business to have a defendable moat, we also want to see that they act harmoniously with the world. We refer to this state as the Ideal City. **We want the business to deserve to win because they have created a wonderful environment to thrive**. We want the business to think in terms of timelessness, with the decisions they make to benefit shareholders, employees, suppliers and their community. Winning should be measured by the merit of the whole business and its direct and indirect consequences.

"Music itself treats as a whole of nothing else but proportion and proportionality."[8]

I have invented the illustration here so that you can visually see this process. When we have connected our five areas of perception through the gateway of proportion, we detach ourselves from the potential delusion of our senses and find perspective. Through perspective we will have turned toward reflection and will surround ourselves by reason. Fittingly, you can see the pentagon in the interior (representing perspective) has been *inverted*. We have addressed the practical utility of the idea through the confidence of number, demonstration, shape, motion and harmony.



We apply this same pentagonal framework to the seventh point in our Competitive Advantage checklist **where we evaluate if a business's competitive advantage, or moat, is widening or shrinking**. We employ a value added research process of talking to sources in the following areas: customers, suppliers, competitors, insiders and outsiders. **We strive to build a holistic perspective of what would be anecdotal evidence in its partition**. We expect this process to yield incremental results as we continue to evolve this practice.

<u>Concinnitas – The Final Adornment of Reason – The Genius</u>:

The final part of the framework is assessing the **beauty** of the parts in relation to the whole. Leon Battista Alberti, who was Luca Pacioli's mentor, wrote eloquently on this subject, going so far to invent a word, "concinnitas," to assist in explaining beauty. I believe the meaning of this word best represents this final approach to our framework.

I am aware of the difficulties encountered in executing a work in such a manner that it marries practical convenience with dignity and grace, so that… their parts are imbued with a refined variety, ***in accordance with the demands of proportion and concinnitas****.*

…the three principal components of that whole theory [of beauty] into which we inquire are number, what we might call outline, and position. But arising from the composition and connection of these three is further quality in which beauty shines full face: our term is ***concinnitas****; which we say is nourished with every grace and splendor.* ***It is the task***

[8] Luca Pacioli – Introduction to the Summa – 1494.

> ***and aim of concinnitas to compose parts that are quite separate from each other by their nature, according to some precise rule, so that they correspond to one another in appearance****. … Neither in the whole body nor in its parts does concinnitas flourish as much as it does in nature herself; thus I might call it the spouse of the soul and of reason.*

I have always felt that great decisions should be beautiful. When ideas are rationalized correctly through proportion leading to perspective, our decision-making, or applied reason, should seem obvious, simple, and elegant no matter how complex our thinking began. Alberti's *concinnitas* is exactly the adornment we seek at the final stage of our framework.

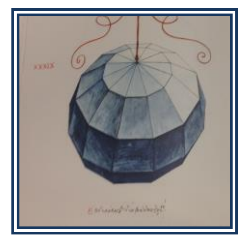
Luca Pacioli's friend, Leonardo da Vinci, said that the perspective was sometimes the *"daughter of the painting"* and other times the *"rein and rudder."* We will borrow from Master Leonardo and name our method for rightly conducting the reason: the Rein and Rudder.

> *About the nature of beauty, therefore, and the parts of which it consists, and about the number employed by our ancestors, and the arrangements of outline, enough has been said.*[9]

The Summa – Our Seventy-Two Point Check List

Fra Luca Pacioli in *De Divina Proportione*, Chapter 54, describes a seventy-two faced body, which in actuality was a miniature architectural treatise. Pacioli discusses the importance of geometric theory to architecture and asserts that architects employed the seventy-two faced polyhedron as a model for buildings, including among them the Pantheon in Rome. Leonardo de Vinci drew the illustration of the seventy-two faced body.[10]

> *Following this very fitting model, buildings are found designed and constructed in diverse areas, as is seen in the inestimable ancient temple the Pantheon.* ***This temple was designed with such diligent industry and attention to proportions that the light of one sole round aperture in its open ceiling is enough to render the entire interior splendid and bright****.*



The seventy-two faced body is the perfect shape to represent the reasoning we apply to investment ideas through our checklist. We have written our checklist in the construct of seeking truth through the rational measures articulated above in our *Architecture of Reason* framework. Toward our objective, each of the six components of our investment process is taken through a twelve-step checklist (three groups of two): economics (/e\) and competitive advantage (N^{th}), Valuation (IRR) and Margin of Safety (MoS), Mispricing (M) and Investment Longitude (H4).

The seventy-two shaped polyhedron is a fitting emblem of our checklist and compounding objective when we think of the Rule of 72. The Rule of 72 is a method to approximate how many years it would take to double an investment, simply by dividing 72 by an estimated compound interest rate. Luca Pacioli holds the first written reference to this rule in the *Summa de Artithmetica* – 1494.

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[9] Alberti.

[10] I would like to acknowledge and thank the Harvard College Library – Special Collections for providing me access to two copies of the Summa and their copy of De Divina Proportione (where this image is from).

Economics (/e\) and Competitive Advantage (N^{th}) – Checklist

Below I will highlight the headings of the first group of our checklist.

Economics (/e\) – Owner Mindset

1. **O**wner Earnings: cash flow is the lifeblood of the business
2. **W**ealth Creation Engine: what is the *number*? the operating metric
3. **N**umber Vector: what is the vector of the *number*?
4. **E**conomic "Goodwill": the only goodwill that counts
5. **R**eal vs. Nominal Profitability: the inflation test
6. **M**etrics: custom economic score card
7. **I**ntangibles and the Vanishing Point: demystify all intangible assets
8. **N**on-Economic Accounting Maneuvers: testing for disease
9. **D**ebt – proportion: is debt *proportional* to operating income?
10. **S**tatement of Cash Flows: management's "statement" – initial capital allocation test
11. **E**quity – Proportionality: $E = MC^2$ – is equity used in *proportionality* with its value?
12. **T**otal Other Obligations: Ideal City – harmony – company specific/community

Competitive Advantage (N^{th}) – N^{th} Advantage

1. **N**ovice Test: explain what the business does to a novice
2. **T**AM: total addressable market *by business unit*
3. **H**4 Industry: longitude/critical data points of the industry
4. **A**BC's: diagrams – an actual unit sold, the business model and competitive landscape
5. **D**egree of Timelessness: is it eternal?
6. **V**ariant Viewpoints: *CEO Parachute Test* – Company and Competitor
7. **A**dvantaged Moat: *The Five External Senses*
8. **N**uthatch Concept – Test 1 – Locality: are they a local champion?
9. **T**est 2 – Inversion: can they do something their competitors cannot do?
10. **A**ggregation of Owner Earnings – Ten Years Out: confidence of whole vs. the parts
11. **G**ating Factors: gating factors for industry and company success
12. **E**lasticity of Demand and Supply: pricing power – it [is] not but only a tiny knowledge of the eye

Representative Idea[11] – Global Supply Chain Leader:

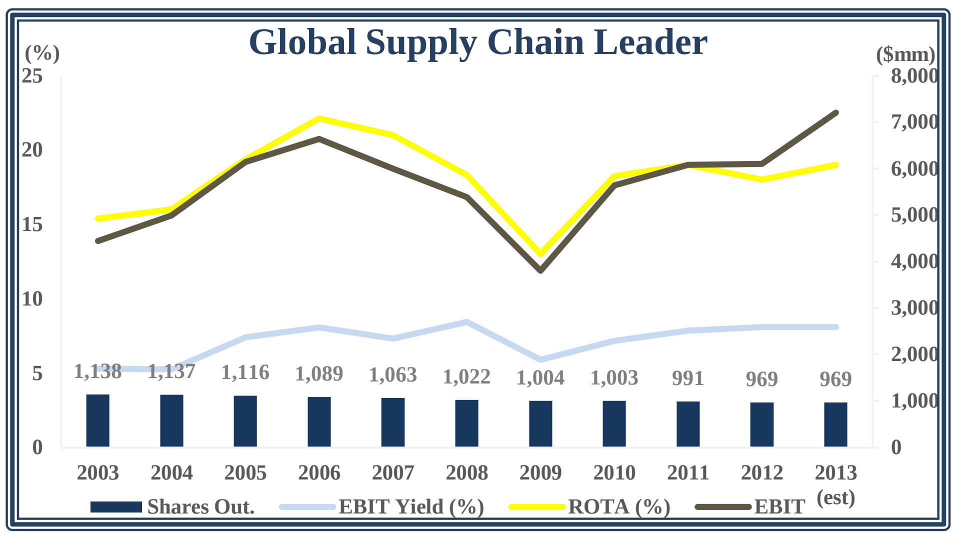
In the third quarter, we made three new investments and exited two long-term investments. One of our new purchases was a global supply chain leader that we will highlight as a representative idea.

Sourced & Categorized: The ability to buy and sell goods and services on the internet will continue to be one of the greatest game changers in the world economy. Competitive advantages are crumbling for a number of businesses, and some are being built anew with changing value propositions to serve e-commerce customers. While assessing this risk and opportunity, we kept coming back to businesses that fulfill the delivery component of these e-commerce purchases.

We categorize our new holding as a late inning transformation with greater compounder attributes. As noted in previous letters, transformations are businesses with average, or even below average, operating economics. Over time, we expect a meaningful change (inflection point) in operating economics through three different transformation categories: secular, systemic, or separation. This particular business is in the later stages of a systemic transformation and culture change toward a greater owner mindset, and is in the earlier stages of a secular tailwind of a continued share change of retail spending from "bricks to clicks."

Brief Summary – Six-Sides of Great and M-Theory:

Economics (/e\): We think this business earns attractive returns on assets employed in the business. Operating income has steadily improved since the credit crisis. We view the price elasticity of this business as favorable, yet we believe management will continue to operate with reason on price and not take short-term profits at the expense of long-term customer goodwill.



Competitive Advantage (N^TH): In the U.S. this business essentially competes in an oligopoly. The business owns a large and expensive infrastructure. The replacement cost and thus the expense to set up a business to compete effectively within this industry would cost nearly $20 billion before letting your first customer know you have arrived. We view this as an industry that operates best as a natural oligopoly, where the largest players can earn reasonable returns on capital.

11 Any discussion of investment or market performance is for illustration purposes only. Past performance of any investment or index is not indicative of future results and may lose value. As always, please discuss your own specific needs, risk tolerance and time horizon with your financial advisor. For complete disclosures, please see our disclosure brochure Form Part 2A and Part 2B.

IRR: The business has an Enterprise Value of approximately $90 billion and we anticipate they will earn approximately $7.2 billion of operating income in 2013, which equates to a 12x multiple or 8% EBIT yield. We would say this valuation is fair and we do not believe this qualifies as an extreme bargain, but we like the quality of the opportunity in proportion to our estimate of compounded return.

Margin of Safety (MoS): A combination of a solid competitive advantage coupled with a strong balance sheet gives us confidence. We believe the operating profit to be stable and in line with our views of the world economy, globalization and demographics, all of which play well with how this business serves customers.

Investment Longitude (H4): The critical data point comes down to the competitive dynamic (high replacement cost to compete) and the long-term secular tailwind by directly benefitting from increased online retail transactions. This type of H4 setup is similar in scope of the cash to credit/debit conversion we have seen with our credit card processor investments.

Mispricing (M): This business had a sizable charge in 2012, to remeasure and restructure their pension liability. If an investor was purely looking at 2012 or trailing twelve-month metrics in proportion to price, it might appear expensive. One must look at income from a normalized perspective to see the earnings power of this business. We also believe that there is an optical myopia, mispricing around time horizon – the long-term compounded opportunity here versus any near-term catalysts.

$$\mathbf{JoC = IRR\ [/e\backslash + N^{TH} + MoS + (H4)]^{M}}$$

We look forward to meeting and talking with you soon. We greatly value your support and trust.

"I know of no other qualities that contribute to the perfection of the mind; ***for as to the reason or sense****, inasmuch as it is that alone which constitutes us men, and distinguishes us from the brutes."*

Rene Descartes (1596 – 1650)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder

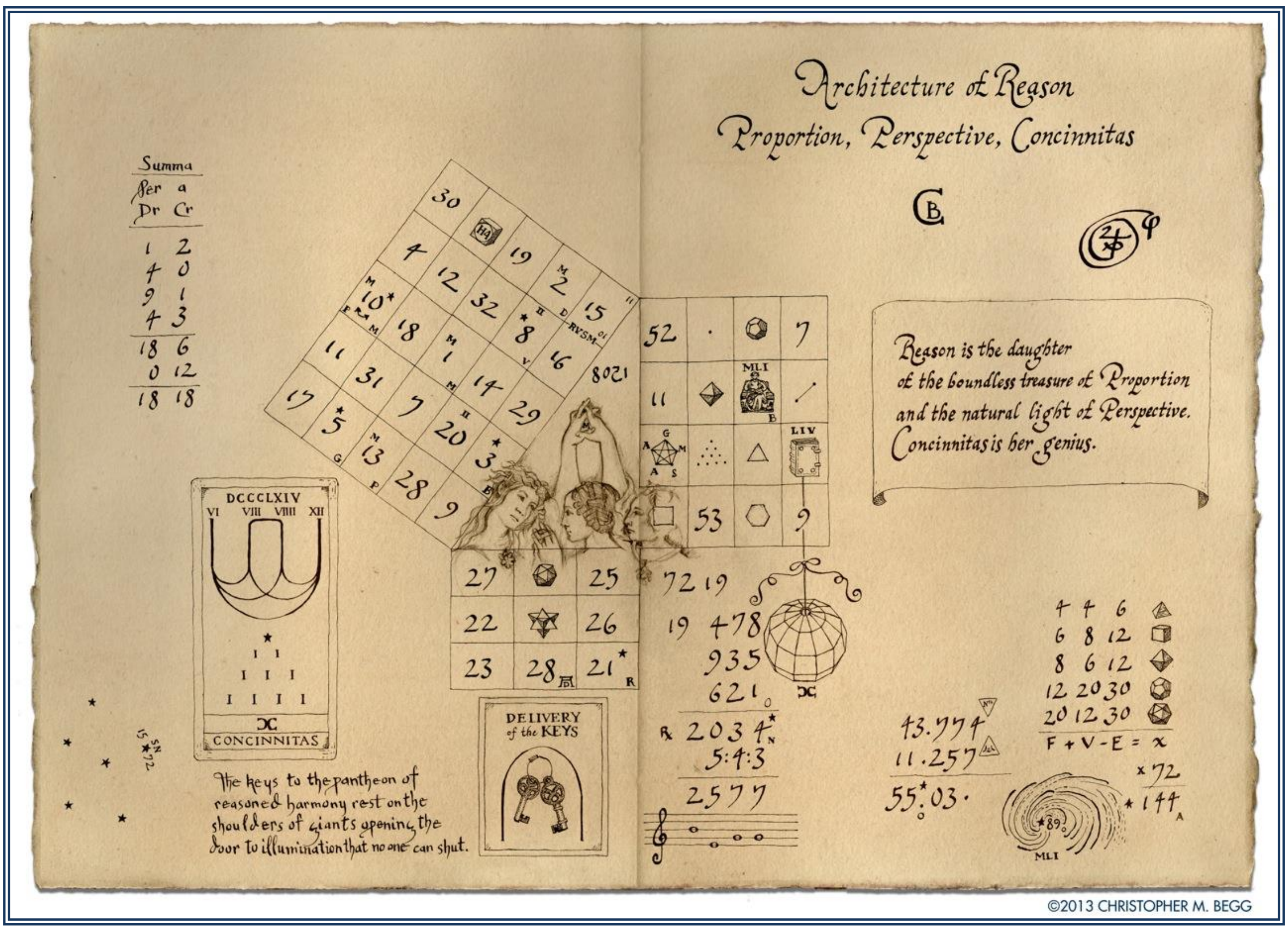
EAST COAST
ASSET MANAGEMENT

Appendix – Codex Reason:

The codex below captures my observations and notes on the *Architecture of Reason*, memorializing where possible the great thinkers and artists who left us a legacy of eternal treasures.

> *Those who call themselves architects, and have never seen even the cover of the excellent book by the worthy architect and great mathematician Vitruvius, who wrote about architecture with the highest learning of every structure – those who deviate from his teachings dig in water and build in sand.* ***They do not know the joy and gladness that Pythagoras had when he found the true proportion of the two straight lines adjacent to the right angle****. This angle is of such excellency that it can never be otherwise and the perfect geometers call it the "angle of justice"* ***because without a knowledge of it, it is not possible to recognize good from bad in any of our proportion****.*

Luca Pacioli (1445 – 1517)
Chapter 54, *De Divina Proportione*



EAST COAST

ASSET MANAGEMENT

2013 YEAREND LETTER

How he heard the ancient helmsman
Chant a song so wild and clear,
That the sailing sea-bird slowly
Poised upon the mast to hear,

Till his soul was full of longing,
And he cried, with impulse strong, –
"Helmsman! for the love of heaven,
Teach me, too, that wondrous song!"

"Wouldst thou," – so the helmsman answered,
"Learn the secret of the sea?
Only those who brave its dangers
Comprehend its mystery!"

In each sail that skims the horizon,
In each landward-blowing breeze,
I behold that stately galley,
Hear those mournful melodies;

Till my soul is full of longing
For the secret of the sea,
And the heart of the great ocean
Sends a thrilling pulse through me.

The Secret of the Sea

Henry Wadsworth Longfellow
The Seaside and the Fireside
Cambridge, Massachusetts – 1851

EAST COAST ASSET MANAGEMENT

To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO and Chief Investment Officer

Date: January 30, 2014

Re: Fourth Quarter 2013 Update – **Navigating Beyond the Pillars**

In our fourth quarter letter you will find our portfolio update and general market observations. Each quarter we highlight one component of our investment process. This quarter, in the section titled *Navigating Beyond the Pillars*, I will discuss some lessons we have borrowed from navigation and how we apply them to our process and the current investment environment. I will also continue the discussion from last quarter's letter on the investment checklist we employ. As is our standard practice, client reporting, including performance and positioning, will be sent under separate cover.

Market Summary[1]

	S&P 500	MSCI AC World Index	MSCI Emerging Markets	MSCI EAFE Index	Barclays Aggregate Bond Index	Gold – $/Troy Oz.	Crude Oil
Price 12/31/2013	1,848.36	408.55	1,002.69	1,915.60	1,807.06	1,205.65	98.42
Q4 2013	10.50%	7.44%	1.94%	5.79%	-0.14%	-9.28%	-3.82%
2013	32.38%	23.53%	-2.34%	23.57%	-2.02%	-28.04%	7.19%
2012	16.00%	16.62%	18.47%	17.87%	4.22%	7.14%	-7.09%

2013 was a very good year for equity markets in general and we were pleased with the performance of our portfolio of businesses. The S&P 500 returned 32.38% and the MSCI World Index logged a return of 23.53%. Emerging markets materially lagged the U.S. markets registering a -2.34% return for the MSCI Emerging Market Index as social tensions in Brazil, growth concerns in China, and continued challenges in developing economies combined to anchor returns. Interest rates inched higher throughout the year translating to negative fixed-income returns – the Barclays Aggregate Bond Index returned -2.02%.

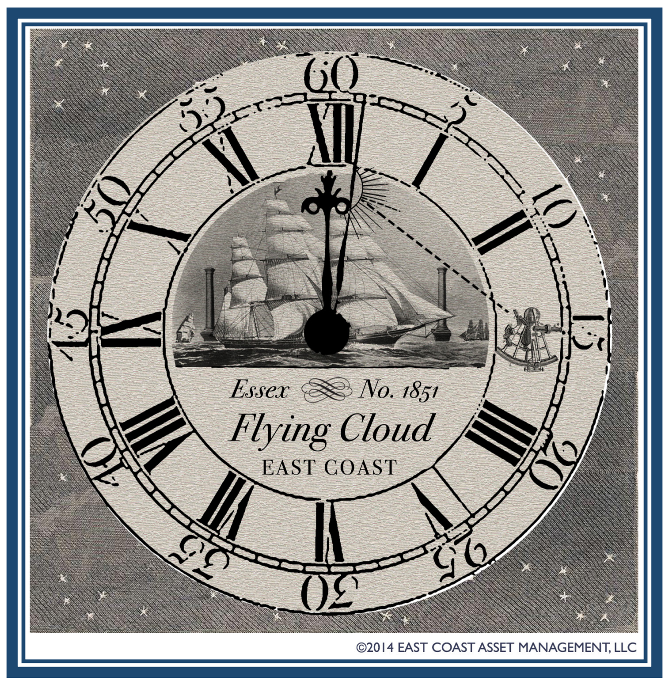
A ship's log entries include the date, the course steered, distance made good, wind directions, description and quantity of sails set aloft, approximate velocities, and remarks concerning important events. Quarterly letters, like a ship's log, act as a record – stating the conditions of the environment being encountered at a point in time and the resulting actions taken. These periodic updates provide a record of decision-making that can be used for learning.

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, the MSCI Europe Asia Far East Index (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices.

For the majority of our five-year history, our quarterly letters have reported an optimistic vantage point for a compounding passage. These updates have been echoing fair winds – attractive valuations, following seas – monetary stimulus, all sails set – nearly fully invested in equities, and distance made good – favorable absolute and relative annual and cumulative returns. We documented each squall (mostly government-related) and shared our reasoning behind our decision to remain under the full sail of equity investments through the volatility. As the market becomes more fully valued, the course we navigate will need to evolve to the changing opportunity set. While we believe our decisions have been in harmony with price action, we expect we will have more to write in future letters when our short-term performance appears discordant with the cheers or boos of the marketplace.

The favorable trade winds of undervaluation and economic stimulus will weaken as we settle into the belt of higher valuation in global equity markets. We prepare ourselves for potentially lower expected returns – calms – and likely heightened volatility – gales and squalls. **Today, more so than ever, we look beyond the pillars of the perceived, the comforts of the consensus, and the blindfolds of here and now and ask questions that might yield differentiated truths.** I will provide context to this objective below.

Navigating Beyond the Pillars:



The Flying Cloud – This skimmer of the seas, the largest American merchantman ever launched, commanded by Capt. Creesy, arrived in our port yesterday forenoon, after a passage of eighty-nine days from New York – ***the shortest time ever made****; surpassing the hitherto famed trip of the Surprise by seven days.* ***The Flying Cloud was built in Boston, and will stand, as long as she lasts, a monument of Yankee talent in the way of shipbuilding.*** *Her arrival in port yesterday morning created a considerable degree of excitement, and crowds rushed over to the North Beach to obtain a view of her. The antiquated hulks which, like huge washing-tubs, has been floating about the seas, sailing about as fast sideways as in any other direction, has been forced, by the rapid spirit of the trade with California, to give place to entirely new models of ships, graceful in their motions as a swan on a summer lake, and* ***fleet as the cloud which is blown by the gale.***

The Daily Alta Newspaper – San Francisco, California, September 1, 1851

The *Flying Cloud*, a tall ship built to deliver goods quickly from New York to San Francisco during the California gold rush, is arguably America's most famous clipper ship. The clipper ships were a **disruptive technology** capable of sustaining speeds in excess of twelve knots. In the 1850's a typical 16,000-mile voyage around Cape Horn to San Francisco would take 200 days. In 1851, on her maiden voyage, the *Flying Cloud* stunned the world when she set anchor in

San Francisco harbor after a passage from New York of only eighty-nine days, twenty-one hours. She stunned the world again in 1854 when she broke her own record with a passage of eighty-nine days, eight hours. The record the *Flying Cloud* set in 1854 stood for 136 years until 1989 when a modern yacht called *Thursday's Child* made the passage in eighty days, nineteen hours.

One of the most interesting aspects of the *Flying Cloud's* history was the exceptional ability of its navigator, Eleanor (Ellen) Creesy, the captain's wife. The captain, Josiah Perkins Creesy, and Ellen, when not at sea lived in Marblehead, Massachusetts, and together they made a remarkable team. Their record-breaking, maiden voyage was extraordinary, maintaining speeds that nearly reached what some called the limit of theoretical probability. Ahead of fashion, Ellen used the latest in scientific data and navigation techniques to guide the ship to the most favorable breeze and safest passage, techniques that many other ships ignored at their own peril.

Ellen was the first clipper navigator to circumvent Cape Horn using the research compiled by Lieutenant Matthew Fontaine Maury at the National Observatory in Washington (in *Explanations and Sailing Directions and Wind and Current Charts - 1850*). Maury and his staff culled through hundreds of naval ship logs confirming theories that trade winds shifted seasonally and the doldrums, areas of calm between the trade wind belts, differed in width depending on location. If navigators could plan their voyages with these factors, sailing passages between ports could be shortened in both miles and duration.

Maury's data was revolutionary, and by sharing his insights with merchant fleets, he had a meaningful impact on global trade. Maury continued to improve his work by providing research and compilations to ship captains if they provided him with their ships' logs. After the success of Ellen Creesy and others, few competent navigators sailed without Maury's body of work. Maury may not be a commonplace name for many, but his pioneering contribution to global navigation has been celebrated the world over, earning Maury the well-deserved nickname "Pathfinder of the Sea."

> *Perhaps it might be the first voyage of a young navigator to the given port, when his own personal experience of the winds to be expected, the currents to be encountered by the way, would it self be blank. If so, there would be the wind and current chart. It would spread out before him* ***the tracks of a thousand vessels that had preceded him*** *on the same voyage, wherever it might be, and that, too, at the same season of the year.* ***Such a chart, it was held, would show him not only the tracks of the vessels, but the experience also of each master as to the winds and currents by the way, the temperature of the ocean, and the variation of the needle****.*[2]

Navigating an Investment Course:

The story of the *Flying Cloud* parallels many concepts we value in investing. **While the disruptive technology of steam-power and enhanced navigation marked an end to the *Age of Sail*, investing has never sailed beyond its own veil of ambiguity**. Misinformation, investor emotion, and the ceaseless noise that collectively affect prices seem to be an eternal characteristic of the nature of investing.

There is a wealth of **investor ship logs** that chronicle what has worked, what has evolved, and the

[2] *Explanations and Sailing Directions*, Matthew Fontaine Maury, 1850.

mistakes made along the way. Ben Graham, the father of value investing, and his editions of *Security Analysis* (1934) and the *Intelligent Investor* (1949), like Maury's *Wind and Current Charts* (1850), presented investors with the pathways to navigate an uncertain investment sea. The value-investing practitioners have been aided by his wisdom and valuation concepts (such as margin of safety and "Mr. Market"), to augment their compounding potential by maximizing return (speed) and minimizing the potential of permanent loss of capital (ship and cargo).

Navigating Investment Variables, Trades and Doldrums:

We have attempted to create a process that harnesses and, through the test of time, evolves these insights. Much like clippers placing themselves in the best position to find fair wind, we attempt to sail from one belt of opportunity to the next, putting ourselves in the best position to sail swiftly, maximizing our return or speed. For clippers, that often meant avoiding the variable winds and calms as best they could, sailing longer distances in directions that were contrary to the perceived logic of following a direct course.

For East Coast, our maiden voyage began in September 2008, in the midst of a maelstrom. As the worst of the storm passed, skies cleared and we were left with an unprecedented time of great businesses trading at bargain prices. As we positioned our portfolio we were met with periods of variable winds of economic and government policy response unknowns – European debt crisis, U.S. debt ceiling debates, elections, etc. Through the variables (corrections of ten to twenty percent) we set a course toward the favorable trades produced by attractive valuation, effective government policy and an economic recovery.

"Trades" occur due to a high pressure in the North (Azores High) converging with low pressure near the equator (doldrums). They were named trades because of their vital importance to ships engaged in commerce. **Trade winds are also important to our investment objectives, they occur out of a period of high pressure of fear and uncertainty converging with a low pressure of poor expectations and low valuations.** For the last four years we have traveled quite a distance on trade winds. We remain under full sail and fully invested in a number of great businesses. However, we continue to make preparations for a period of lighter winds and calms as valuations continue to move higher. **So, how do we plan on navigating the doldrums?**

Maury wrote of the doldrums, "The calm belts of the sea, like the mountains on the land, they have their passes and their gaps." For the value investor, the doldrums are the belt of full valuations that exist when it becomes increasingly difficult to find mispriced businesses. This is where the IRR, our expectation for the speed of returns, diminishes for our portfolio holdings and for the universe of businesses that we would like to own. We think we improve our chances of not being becalmed in the doldrums by being vigilant about the opportunity for our investments. We are employing the following tactics:

- *Secular Tail Winds – Transformations:* We continue to shift more and more of the portfolio over to businesses where we think there is an **evolving secular tailwind for their end market, coupled with an inflection point in their economic returns** that are not being sufficiently valued into their share price (further discussed below – representative idea).
- *Iron Top Sails – Compounders:* Many of our compounder investments that enjoy high returns on their tangible assets (economic engine – iron top sails) are trading at fair valuations and continue to represent compelling expected returns. **When we find a truly**

exceptional business (the intrinsic and terminal value of the business grows every year) our gaze should look *plus ultra* (further beyond), as trading based on strict valuation assumptions would prove futile and significantly impair results. **Our search for timeless businesses is job one.**

- *Close Haul – Valuation Discipline:* The more we face *valuation headwinds* the more important it is to be valuation vigilant on businesses where the terminal value could deteriorate because of a fleeting competitive advantage. **The hardest thing to do in investing is not the decision to buy or sell but to sit idle even if that means allowing some build up of cash.** When share prices rise faster than intrinsic value, our expected returns fall. When IRRs fall below a threshold (net of taxes on gains) and there is a significant opportunity cost to own the business we will likely begin to sell the position.
- *Avoid Broad Reaches – Growth:* We have written before that we prefer to buy businesses with ten percent operating income yields or better. With moderate expected growth of yield and intelligent capital allocation we can earn attractive mid-teens or better IRRs. As valuations extend, it is easy to accept less *yield* now for more expectation of operating income *growth* in the future. **We find this a slippery slope as broadly overreaching for growth can inflict damage when the valuation tide inevitably ebbs.**

Maury's work not only calculated where to find the most favorable winds, he also carefully studied currents. The printing of money to make global debt burdens more palatable, albeit tapering, means the current is pushing our ship closer and closer to the perilous rocky shore. This means we need to take a more offshore course by owning investments that have some protection from the coastline, or those that allow us to keep a sufficient margin of safety. **Owning a business with pricing power is the only opportunity that we believe can help us run faster than inflationary currents.** Investors who have chosen to hug the shore with *disproportionate* cash and long-term bond allocations are on a very dangerous course as strong currents push their ships toward the rocky coast.

Maury would urge his readers to apply his sailing directions with common sense. He warned mariners not to chase wind or blindly follow his advice but to react as the weather and wind dictated. The sea, he said, was always revealing new mysteries. These warnings sound a lot like Ben Graham and we heed this advice to navigate with common sense and reason. We stand prepared to act accordingly as unforeseen information develops.

Take a Position Fix – Value a Business:

Finding your position in both the *Age of Sail* and in investing is no easy task, but it is one of the most important offices. Ellen Creesy consistently determined her position to find the most favorable currents and winds, minimizing time spent in the calms. Two of her most important tools were the chronometer, to determine her longitude, and the sextant, which determines latitude by measuring a celestial body's angle of elevation above the horizon.

Investing feels a lot like being at sea trying to fix ones position without modern navigational instruments. If we are constantly tracking our position we can triangulate where we are, like Ellen did, and determine where capital should be allocated and what our course should be. Where Ellen would "shoot the sun or a star" to find her latitude, **the equivalent for us is to value a business.** While that sounds obvious enough, it is only in recent years that I have realized just how important an exercise this is. The wise navigator always takes advantage of an opportunity to obtain an observation. Every bit of data serves as a piece in the puzzle of determining ones position. The more you do it the better you get, and you also begin to realize the businesses you can value and those you cannot.

The most enlightened investors I have met can look through the financials of a business and within minutes have a fairly accurate idea of the absolute and relative attractiveness of the investment. **A combination of the valuation (latitude) and the business's economic drivers (longitude) help us determine position.** As an investor-navigator we are trying to arrive at the internal rate of return expectation of the investment and compare that opportunity against others. Just as the navigator who can take advantage of every opportunity to establish a fix on their position, regardless if it's the sun, a star, a lighthouse, or dead reckoning, the intelligent investor persistently takes valuation and critical data-point fixes. With these insights the investor will always have a navigational advantage to best determine the economics of the sea of opportunities.

> *For myself, I am free to confess that, for many years, I commanded a ship, and, although never insensible to the beauties of nature upon the sea or land, I yet feel that**, until I took up your work, I had been traversing the ocean blindfolded**. **I did not think**; ... I feel that, aside from any pecuniary profit to myself from your labors, you have done me good as a man. **You have taught me to look above, around, and beneath me.***[3]
>
> William L. Phinney, Ship '*Gertrude,*' 1855

The *Flying Cloud* – Value Investment to World's Most Admired Business

Not only shipbuilders but the whole world was talking of the Flying Cloud. Her appearance in the world of commerce was a great historic event. No sooner was the Flying Cloud built than many ship owners wanted to buy her; among others the house of Grinnell, Minturn & Co. of the Swallow-Tail Line of Liverpool asked what we would take for her. I replied that I wanted $90,000 which meant a handsome profit. The answer came back immediately—

"We will take her!"

Memoirs of George F. Train, Jr., 1899

Francis S. Hathaway was a shipper and merchant operating from the New England seaside city of New Bedford, Massachusetts. Hathaway, who made his early fortune shipping and selling goods along China trade routes, quickly saw the opportunity in California and began investing accordingly. The *Flying Cloud* was his first major Californian investment, partnering with Grinnell, Minturn & Company, and John E. William in 1851 to purchase it from Enoch Train & Company.[4] Hathaway handpicked his close friend Josiah Perkins Creesy, and lobbied heavily to appoint Creesy to the highly coveted position of Captain. Hathaway's bet on the *Flying Cloud* and the Creesy captain-navigator partnership would be one of the most profitable and important decisions of his entire career. Hathaway not only owned the boat, but with his partner S. Griffith Morgan, he would also sell a great deal of goods in California shipped on the *Flying Cloud* through his partnership of Morgan, Hathaway and Co.

Not surprisingly, Hathaway ended up being one of the most successful merchants of the clipper era, and invested in four voyages of the *Flying Cloud*/Creesy team. Francis Hathaway died in

[3] *Sailing Directions*, Maury. Letter from "William L. Phinney, Ship '*Gertrude*.'

[4] Enoch Train would later lament that what then was the proudest moment of his career would end up being his largest regret, selling the *Flying Cloud*.

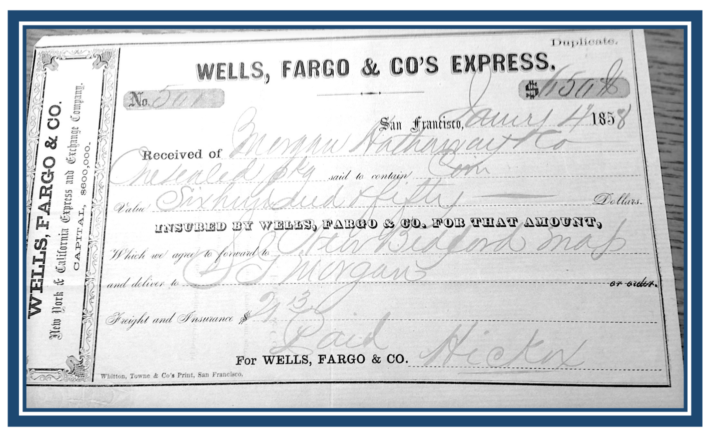
1869 with no direct heirs; his fortune was willed to his nephew Horatio Hathaway. Horatio would follow his family's footsteps in shipping and later founded the Hathaway Manufacturing Co. (Hathaway Mills) in 1888 in New Bedford. By 1917, Hathaway Mills would grow to 108,000 ring and mule spindles and 3,400 looms for the production of fine cotton goods. In 1955, Hathaway merged with Berkshire Fine Spinning Associates of Adams, Massachusetts, and became known as Berkshire Hathaway.[5]

In the spring of 1951 nearly 100 years to the day after Francis Hathaway and his partners said those fateful words, "I will take her!" a young Midwestern student named Warren Buffett enrolled in Ben Graham's Security Analysis class at Columbia Business School. Buffett would become acquainted with Berkshire Hathaway after working for Graham; he noticed that the business was trading at a steep discount to its working capital – a famous Graham "net-net." Warren Buffett would ultimately take control of the New Bedford based Berkshire Hathaway on May 10, 1965.

Sailing through the peaks and troughs of a difficult textile industry decline in the U.S., Berkshire Hathaway/Buffett would continue to buy better businesses. **Buffett, employing Ben Graham's timeless value principles, and through his and Co-Chairman Charlie Munger's navigation and resolution, would go on to paint the greatest economic masterpiece the world has ever known.** Berkshire Hathaway was the third largest business in the world by market capitalization as of December 31, 2013. Perhaps Berkshire Hathaway's history did not just begin in the New Bedford textile mills in 1888, but with the intelligent value investing of Francis Hathaway in the *Flying Cloud* and the helmsmanship of the Creesy team in 1851.

Flying Cloud/*Berkshire* – A Self-Fulfilling Prophesy of Investment and Insurance Excellence

While reading about the *Flying Cloud* I learned that Harvard Business School was gifted S. Griffith Morgan's (Francis Hathaway's partner) business records. My curiosity steered me to the Baker Library to go through some of the early correspondence and bills of lading of *Flying Cloud's* first four voyages. There, I found an early express check made out to Morgan Hathaway Company for $650 to be delivered to New Bedford by Wells Fargo & Co's Express. Henry Wells from Vermont, and William Fargo from New York, had founded American Express in 1850 and with the gold rush in California they quickly seized the opportunity and founded Wells Fargo and Co. in San Francisco in 1852. That express check receipt would foreshadow a noteworthy connection 161 years later as Berkshire Hathaway now owns $20 billion (9% of shares outstanding) of Wells Fargo and $11.5 billion (14% of shares outstanding) worth of American Express.


Duplicate.
WELLS, FARGO & CO'S EXPRESS.
No.
San Francisco, 1858
Received of
said to contain
Value Dollars.
INSURED BY WELLS, FARGO & CO. FOR THAT AMOUNT,
Which we agree to forward to
and deliver to or order.
Freight and Insurance $
For WELLS, FARGO & CO.
Whitton, Towne & Co's Print, San Francisco.
WELLS, FARGO & CO.
New York & California Express and Exchange Company.
CAPITAL, $600,000.

Berkshire Hathaway's evolution to a compounding machine flourished by building a world-class insurance business where insurance float could be invested intelligently. Warren Buffett often clarifies the importance of the insurance business when he refers positively to the CEO of

[5] The Providence, Rhode Island, based Chase Family and their history in bringing the Berkshire side of the name to prominence is equally important and interesting. Malcolm Chase would remain on the Berkshire board until 2007.

Berkshire Reinsurance Group, Ajit Jain: "If Charlie, I, and Ajit are ever in a sinking boat – and you can only save one of us – swim to Ajit." Ajit Jain has been an important part of fueling Berkshire's economic engine, preserving and growing investment float through underwriting profit. Ajit Jain, Warren Buffett and other investors/underwriters would appreciate the fact that the largest body of marine underwriters would take out an advertisement in the New York Times on February 8, 1855, honoring Captain Creesy for saving the *Flying Cloud* and its cargo on a passage back from China after running up on a reef under a *cloud of fog*. Instead of running her into a *sickly* port, which would have been very costly to the underwriters, Creesy had the boat bailed on a 24-hour shift for the remainder of the long voyage to home port.

> *"…as a skillful commander again became manifest, you seem also to have combined in yourself the talents of* ***a merchant as well as the shipmaster.*** *We also desire to record our testimonial in your favor, and to make known your example,* ***that the timid may be encouraged and the energetic sustained and strengthened in a similar course of conduct,*** *should they meet similar difficulties."*

This example may be an exception to Warren Buffett's general rule that, "Should you find yourself in a chronically leaking boat, energy devoted to changing vessels is likely to be more productive than energy devoted to patching leaks." **I continue to find *resolution* to be one of the greatest virtues.**

"Who is the greatest manager, really, Luque or Mike Gonzalez?" "I think they are equal."
"And the best fisherman is you."
"No. I know others better."
"Que Va," the boy said. "There are many good fishermen and some great ones. But there is only you."
"Thank you. You make me happy. I hope no fish will come along so great that he will prove us wrong."
"There is no such fish if you are still strong as you say."
"I may not be as strong as I think," the old man said.
"But I know many tricks and I have resolution."

The Old Man and the Sea, Hemingway (1951)

Our Investment Check List

Last quarter we wrote about our six-part investment checklist. Toward our objective of compounding capital, each of the six components of our investment process is taken through a twelve-step checklist: economics (/e\) and competitive advantage (N^{th}), valuation (IRR) and margin of safety (MoS), and mispricing (M) and investment longitude (H4). Last quarter we listed the checklists pertaining to economics (/e\) and competitive advantage (N^{th}). This quarter I will highlight the checklist for understanding the mispricing (M) of an investment and how we define Investment Longitude (H4).

Mispricings (M) are nearly always optical – a veil or a cloud obscures the truth (*a cloud without rain*). The mispricing (M) checklist seeks to see the optical truth through the veil or cloud and focus on the obscured business. The checklist also seeks to objectively understand what is driving the mispricing, and what might unlock value.

Familiar with clouds and sunshine, the storm and the calm, and all the phenomena which find expression in the physical geography of the sea, the ***right-minded mariner****, as he contemplates* ***"the cloud without rain,"*** *ceases to regard it as an empty thing; he perceives that it performs many important offices; he regards it as a great moderator of heat and cold — as a* ***"compensation"*** *in the atmospherical mechanism which makes the* ***performance of the grand machine perfect.***[6]

Investment Longitude (H4) comes down to understanding the critical data points that drive the business and the investment. H4 is where we look carefully at helmsmanship, or leadership of the business. We want to objectively understand what drives the leadership, culture, incentives, and their history of navigation and capital allocation.

Mispricings (M) – Flying Clouds

1. **Framework:** categorize opportunity; compounder, transformation, workout
2. **Lift Magnitude:** lee, ridge, thermals. See Q3 2012 letter Inventing a Flying Machine
3. **Yellow Room[7]:** what is the veil of ambiguity? What are the [flying] clouds?
4. **Invert:** articulate short thesis – credible?
5. **Nocturne:** is business and industry in the twilight of existence – disruptive entrants?
6. **Gating Factors to Close Mispricing:** beyond catalysts – simple answers
7. **Clear skies:** what was in place during fair skies that is different today?
8. **Long-term demographics:** headwind or tailwind?
9. **Optical Truth:** what lens is required to view the opportunity – myopia?
10. **Unclear Structural Impediments:** any perverse structural incentives?
11. **Discordance with ESG:** environmental, social, governance – risk present?
12. **Sentiments:** five external senses on business and valuation. See Q3 2013

Investment Longitude (H4) – Helmsmanship

1. **H4 Company:** longitude/critical data points of the business and industry
2. **Execution Excellence:** operating efficiency of the management team – culture
3. **Locate Position:** where is business and where is it going?
4. **Management incentives:** carrot and stick, over-reaching, vested ownership?
5. **Sextant/Ship Log:** what navigation tools are used, frequency, accuracy?
6. **Management Oversight – Board:** vantage point of board, vested interest?
7. **Allocation of Capital:** history, opportunistic, intelligent, open to being educated?
8. **Navigation Rules:** industry rules of engagement, perverse incentives, rational?
9. **Shipshape:** scale 1 to 10 on quality of business – now and three years out?
10. **Headwinds:** top five of business and industry independently
11. **Iron Topsail:** what is the economic engine?
12. **Principles:** what are the business principles and how are they communicated?

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[6] *Explanations and Sailing Directions*, Matthey Fontaine Maury, 1850.

[7] *The Yellow Room* (the former cloak room) at the Isabella Stewart Gardner Museum in Boston has two of my favorite James Abbott McNeill Whistler paintings. Whistler was the father of Tonalism. The Tonalist artists painted what they saw (optical truth) and sensed in nature (often through a veil) instead of trying to draw the perfection of what their mind deduced reality was supposed to look like.

Representative Idea[8] – European Cable Business:

In the fourth quarter, we made two new investments and exited two long-term investments. One of our new purchases was a European cable business that we will highlight as a representative idea.

The Opportunity: We have noted in this and previous letters that two sourcing categories that can present us with fruitful ideas are clouds and soaring birds. Soaring birds are most often what we call owner-operators who have a history of intelligent allocation of capital. Soaring birds can also be investing peers who we believe to have a proven pattern of thoughtful investing that overlap with (but mostly improve upon) how we think about value creation. We sourced this investment initially by talking to an investor I have known for nearly twenty years. We knew the business had a helmsman who was one of the most intelligent owner-operators we have studied. We soon realized, given his previous astute investments, that his recent action in consolidating the European cable business was something we wanted to understand better.

We categorize our new holding as a middle inning transformation. As noted in previous letters, transformations are businesses with average, or even below average, operating economics. Over time, we expect a meaningful change (inflection point) in operating economics through three different transformation categories: secular, systemic, or separation. This particular business is in a systemic transformation as the European cable business has been underpricing their product offerings relative to other developed markets.

We believe our experiences studying the railroad industry provide valuable lessons in the attractiveness of this business as the economics evolve:

- Attractive incremental returns
- Decent pricing power
- A predictable earnings stream that allows for financial leverage
- High degree of regulation creating a barrier to competition
- Technology improving operating returns
- The terminal value of the business growing each year, which gives us greater confidence in our return expectations.

When we see these business dynamics present themselves it becomes a question as to whether the price is compelling enough to make the investment. Ambiguity nearly always hides evolving transformations, as has been the case for the railroads, as the market does not see around corners well (something we wrote about in Q4 2012). We find the price we paid as attractive, but that being said, we would welcome some type of squall to stir up fears and give us a chance to buy more of the business at a lower price.

Acknowledgment: The book the *Flying Cloud* by David W. Shaw was sent to me by a good friend and exceptional long distance sailor. David Shaw's beautifully written account of this story was the spark that ignited an enjoyable maritime journey touching the classics, history, art, and poetry.

[8] Any discussion of investment or market performance is for illustration purposes only. Past performance of any investment or index is not indicative of future results and may lose value. As always, please discuss your own specific needs, risk tolerance and time horizon with your financial advisor. For complete disclosures, please see our disclosure brochure Form Part 2A and Part 2B. With respect to Berkshire Hathaway and Wells Fargo, East Coast does own each of these investments for clients. They are presented in this piece as part of the overall discussion with regard to Berkshire Hathaway's history and not as a suggestion that they are a suitable investment for investors outside of the context used here or to indicate any type of investment performance with respect to these two businesses.

Firm Updates:

- Team Additions:

  - **John Shepherd** joined us as a Managing Director and Principal to expand our client service team and to serve as a member of our executive team. John will be responsible for Business Development with our institutional clients. John comes to us most recently from Lateef Investment Management located in the Bay Area of California. We are pleased that John and his family have relocated to neighboring Manchester, Massachusetts, and we look forward to introducing you to John the next time you are in Essex.

  - **Michael Connolly** joined us as a Managing Director and Principal to build relationships with individuals and organizations in the philanthropic community. Michael has served as both Executive Director and Director of a series of non-profit organizations in Aspen, Colorado, and Wilmington, Delaware. Michael has also served as an advisor to a charitable foundation since 1991 and is a private investor in closely held businesses. He and his family live in Aspen, Colorado, but Michael will be a frequent presence here in Essex.

- ECAM Award:

  - We are pleased to announce that ***Big Brothers Big Sisters of Massachusetts Bay*** and ***Disabled Veterans National Foundation*** have been selected as recipients of the fourth annual ECAM Award. The ECAM Award is given to a charity whose mission is deliberate, simple and relevant to where our support can translate to compounding benefits.

We look forward to meeting and talking with you soon. We greatly value your support and trust.

We have been told in the foregoing pages how the winds blow and the currents flow in all parts of the ocean. These control the mariner in his course; and to know how to steer his ship on this or that voyage so as always to make the most of them, ***is the perfection of navigation.***

Matthew Fontaine Maury (1806 – 1873)
Master Navigator

On behalf of the firm,

Chris

Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder

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David Casper Friedrich, *Monk By The Sea*, 1808. Alte Nationalgalerie, Berlin, Germany.

Appendix – Evolving the Learning Machine – Beyond the Pillars:

One of the oldest, if not the greatest, literary works in the Western canon is the Odyssey by Homer. An epic tale of Odysseus trying to make his way home from the battlefields of Troy after his heroism in the Trojan War chronicled in the Iliad. Odysseus faces one seemingly impossible challenge after another. His pathway home is often referred to as the wanderings as he grows wiser with each error in judgment. With resolution, humility, and help from the seafaring and shipbuilding Phaeacians, he finally makes his way back home.

In Homer's time it was said that *nothing* existed beyond the navigational *Pillars of Hercules* and ships were urged never to travel beyond that point or risk certain death. It is human nature to seek protection, **huddle around the known,** and gain comfort in belonging. Through this we build walls of perceptions modeled after the consensus, but not necessarily truth. **The equivalent of traversing the ocean blindfolded without thought.** No great learning can occur without overcoming this human burden. I believe navigating beyond the pillars of the known is where true progress and insights are made. If we can unravel the shrouds of perceptions that we have constructed for comfort, and sense the optical truths anew, perhaps then we can truly learn and, maybe, even evolve.

wander beyond the pillars

an old moon wanes, a new moon rises
behold the awe, a boundless sea
infinite wonder, self's smallness heightens
nature wraps it's cloak, I am *nobody*

frenzied flock forewarns poseidon's wrath
foundless fears, flying-dark clouds, restless sea
lead me soaring-bird beyond defeat
"heed west winds, artisans, humility"

wandrous journey turns and twists
shadowy gates ivory disguised as horn
lash my curiosity to mast, ah sweet sirens
mark my sparkled-eyed star, rose-veiled morn

betwixt, besieged, becalmed- I have resolution
weave thy daily shroud, unravel by night
at the end of this long trick, home port awaits
end to doubt, envy, Time, birth to light

Christopher M. Begg
Prelude: Wanderings – Requiem: Resolution
Essex, Massachusetts - 2014

James McNeill Whistler, *Nocturne in Silver and Blue: Lagoon, Venice*, 1879. Museum of Fine Arts. Boston, Massachusetts.

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2014 1st QUARTER LETTER

Resistless rolls the illimitable sphere,
And one great circle forms the unmeasured year.
–Roll on, YE STARS! exult in youthful prime,
Mark with bright curves the printless steps of Time;

Near and more near your beamy cars approach,
And lessening orbs on lessening orbs encroach; –
Flowers of the sky! ***ye too to age must yield,***
Frail as your silken sisters of the field!

Star after star from Heaven's high arch shall rush,
Suns sink on suns, and systems systems crush,
Headlong, extinct, to one dark centre fall,
And Death and Night and Chaos mingle all!

–Till o'er the wreck*, emerging from the storm,*
Immortal NATURE lifts her ***changeful*** *form,*
Mounts from her funeral pyre on wings of flame,
And soars and shines, another and the same.

"Lo! on each SEED within its slender rind
Life's ***golden threads*** *in endless circles wind;*
Maze within maze the ***lucid webs*** *are roll'd,*
And, as they burst, the living flame unfold.

Grain within grain successive harvests dwell,
And ***boundless forests*** *slumber in a shell. …*
Incumbent Spring her beamy plumes expands
O'er restless oceans, and impatient lands,

With genial lustres warms the mighty ball,
And the GREAT SEED ***evolves,*** *disclosing ALL;*
LIFE buds or breathes from Indus to the Poles,
And the vast surface kindles, as it rolls!

Erasmus Darwin
The Economy of Vegetation – 1791
(Grandfather of Charles Darwin)

To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO and Chief Investment Officer

Date: April 22, 2014

Re: First Quarter 2014 Update – **The Economy of Evolution**

In our first quarter letter you will find our portfolio update and general market observations. Each quarter we highlight one component of our investment process. This quarter, in the section titled *The Economy of Evolution*, I will discuss business evolution and how some businesses are more fit for adaptation than others. I will illustrate a theme and new position in the portfolio that serves as a tangible example of the discussed concepts. As is our standard practice, client reporting, including performance and positioning, will be sent under separate cover.

Market Summary[1]

	S&P 500	MSCI AC World Index	MSCI Emerging Markets	MSCI EAFE Index	Barclays Aggregate Bond Index	Gold – $/Troy Oz.	Crude Oil
Price 03/31/14	1,872.34	411.02	994.65	1,915.69	1,840.37	1,284.01	$101.58
Q1 2014	1.81%	1.22%	-0.53%	0.84%	1.84%	6.50%	3.21%
2013	32.38%	23.53%	-2.34%	23.57%	-2.02%	-28.04%	7.19%
2012	16.00%	16.62%	18.47%	17.87%	4.22%	7.14%	-7.09%

After a year where we saw the S&P 500 return 32.38% and the MSCI World Index log a return of 23.53%, a rather lackluster start to 2014 seems like a reasonable outcome with 1.81% and 1.41% returns, respectively. There has been plenty of geopolitical noise from Russia to keep investors' attention away from fundamentals and more tuned into these important human-interest stories.

I echoed a similar message in our yearend letter when I noted we were finding the overall market fairly valued. Fair value does not have us searching for an exit strategy as we view our portfolio of businesses as attractive on an absolute and relative basis. We feel many of these investments have a unique mispricing and/or secular market opportunity that should provide a margin of safety and compounding tailwinds as time evolves. Many of our businesses have been actively repurchasing shares, thus we continue to be rewarded with a larger per share ownership of future cash flows from this capital allocation. While new positions have proven more elusive due to higher valuations, we continue to use the inevitable whims of the marketplace to own more of our existing positions – businesses we know well, and are interested in knowing even better.

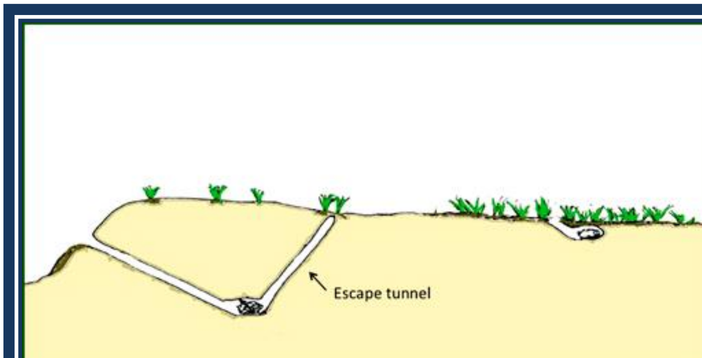
[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, the MSCI Europe Asia Far East Index (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices.

Praise of Folly:

An investment is worth the present value of all future cash flows produced over its lifetime. One would think a rational investor would then base decisions on estimating the stream of cash flows and assess confidence in a range of probabilities of their receipt. The truth is, **an overemphasis on the superficial and on the temporary is the eternal preoccupation of the marketplace.** Human nature often appears to react less with reason and more with a genetic inherited code that drives behaviors – fight or flight. Folly ensues as human nature weighs and measures inputs that then drive evolutionary instincts. I believe these behavioral responses can be modified if one is self-aware when foolish predispositions surface. Proper temperament is one of the most important attributes of the investor – breathing in reason before instinct.

With this type of behavioral observation in mind, the science of evolutionary biology has long fascinated me, particularly as it relates to why and how certain species make genetic modifications to maximize their fitness – food, safety, and compounding. I've previously written about how bees evolved their hexagonal honeycombs to maximize storage, how the nuthatch adapted its claws to be the only bird to walk down a tree headfirst, and recently have been reading how octopuses have evolved their mysterious camouflage traits. A creature's phenotype is the collection of its traits, from its body shape to its behavior, while its *extended* phenotype[2] is the stamp it makes upon its environment, such as beaver dams, beehives, bird nests, spider webs and mouse burrows. None of these attributes have specific genes, but genes clearly influence their construction. **The *extended* phenotype of the investor is their portfolio and their record of protecting and compounding capital.**

Three weeks ago I attended a lecture at Harvard titled *From Darwin to DNA: The Genetic Basis of Animal Behavior* hosted by evolutionary biologist Dr. Hopi Hoekstra.[3] Dr. Hoekstra and her team have been attempting to unlock one of biology's most elusive secrets: the genes that control behavior. In a basement lab at Harvard, they have been studying the burrowing behavior of two species of mice: oldfield mice (Peromyscus polionotus), which dig a long entrance tunnel to a nest as well as an escape tunnel, and deer mice (P. maniculatus), which dig a short simple tunnel to a nest.



Oldfield mice build complex burrows with a long entrance tunnel, nest chamber and a secondary tunnel that radiates up towards the soil surface but doesn't penetrate it. By contrast, its sister species, the deer mouse, typically build a simple burrows that lack an escape tunnel.
Adapted from Dawson et al. 1988
Credit to Hillery Metz, Harvard University

Dr. Hoekstra illustrated the behavioral difference in the two species by playing a time lapsed video of their burrowing habits over a twelve hour period. The oldfield mice pair worked tirelessly for twelve full hours digging a very long tunnel to a nest and a subsequent, long exit tunnel. Conversely, the deer mice mostly played, the video showing them frequently running up to the glass wall and literally doing back flips. Then, at the end of the video, you see the deer mice dig a short tunnel to a nest and fall asleep. Through her research,

[2] Richard Dawkins coined "*extended* phenotype."

[3] Dr. Hopi Hoekstra's parents are from the Netherlands and, before she caught the biology bug while attending University of California at Berkley, she aspired to become an ambassador to Holland. Hopi is a nickname that her Dutch grandmother gave her and means "little bundle."

Dr. Hoekstra has now learned, from cross breeding, the identification of the gene regions that drive this digging behavior – a huge breakthrough. They found that there are three gene regions underlying tunnel length, located on chromosomes one, two, and twenty, and one region, located on chromosome five, which determined whether escape tunnels were made.

At some point in the oldfield mouse genetic history, a persistent predatory threat (likely snakes) caused them to drive their behaviors to build exit tunnels. Dr. Hoekstra believes the oldfield mice genetic behavior of digging complex tunnels and exits may be tied to the same genes that drive addiction. There is some early hope that what they learn might help better understand, and further treat, addiction in humans.

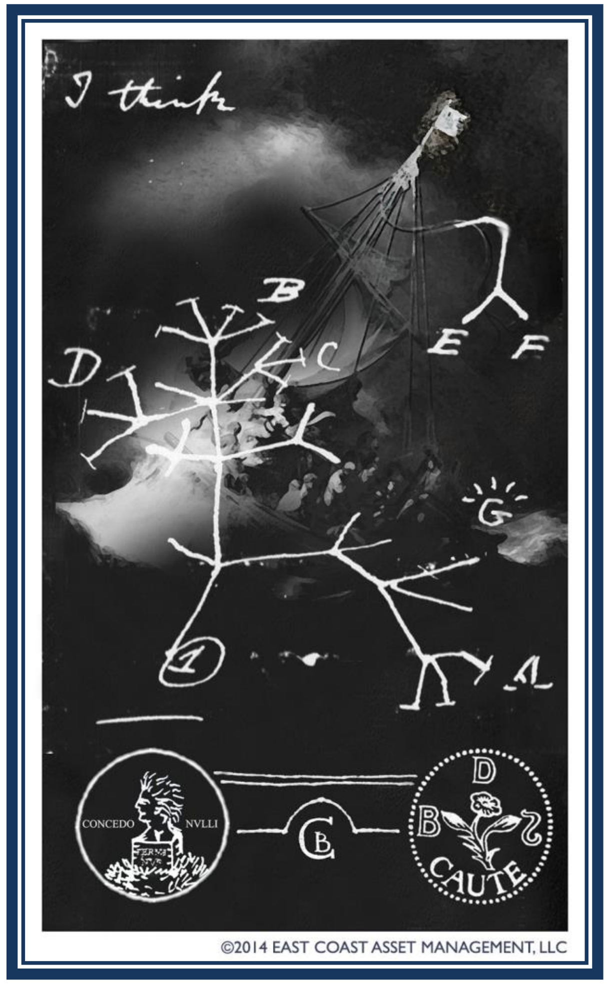
The burrowing phenotype of oldfield mice is very similar in concept to behaviors we observe in some intelligent value investors – they work tirelessly at digging deep, not nearly content with nesting at a surface level of insight. They value a margin of safety by thinking about their ability to survive in the event of a predatory threat. The *extended* phenotype of the oldfield mouse and the intelligent investor illustrates a model of breadth and depth. I believe that a bridge between learning breadth and significant depth of insight can connect one to enlightened, differentiated truths.

The incentives of the one, two, and twenty fee regions of the investment industry have driven an increasing number of investors to purchase securities, do a series of public backflips announcing their activist strategy and/or short positions, then burrow into their short tunnel – a fitting representation of their incentives and time horizons. Some of these investors have been caught short without an exit strategy – a deer mouse in the headlights. I find the majority of noise in the investment industry comes from a focus on deals, catalysts, upgrades, downgrades, human-interest stories, politics, and more recently these "activist" strategies. **It is wonderfully short-term.** The oldfield mouse approach requires work where the rewards are not immediate, not as flashy as backflips, and admittedly not nearly as satisfying to the *vanitas* and ego, but our plight is *addiction* – to digging and margin of safety.

… for since the Stoics define wisdom to be conducted by reason, and folly nothing else but the being hurried by passion, lest our life should otherwise have been too dull and inactive, that creator, who out of clay first tempered and made us up, put into the composition of our humanity more than a pound of passions to an ounce of reason.

Erasmus of Rotterdam – *Praise of Folly* – 1511

The Economy of Evolution:



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> *I have stated, that in the thirteen species of ground-finches [in the Galapagos Islands], a nearly perfect gradation may be traced, from a beak extraordinarily thick, to one so fine, that it may be compared to that of a warbler. (First Edition – 1839)*
>
> *Seeing this gradation and diversity of structure in one small, intimately related group of birds, one might really fancy that from an original paucity of birds in this archipelago, one species had been taken and modified for different ends. (Second Edition – 1845)*
>
> Charles Darwin
> Voyage of the HMS Beagle – 1839, 1845

While in the Galapagos Islands, Charles Darwin's insights into finch beak gradation (of birds native to the islands) were incremental, possibly pivotal, to his theory of natural selection. Darwin's prediction proved true, as certain finches lived or died depending on which species' beak structure was best adapted for the most abundant food supply.

Investors and businesses share the same dilemma – the economics of evolution is the ability to survive and thrive by adapting to a changing environment. A business sustains its life through a steady diet (earnings) and safety (sustainable competitive advantages). An investor searches for food in the building blocks of return (investment specific IRR) that offer ample supply of *asymmetric* compounding opportunities (margin of safety).

I think one of the greater follies of human nature is a belief that everything that exists today will exist in a similar capacity in the future. I call this the *theory of extrapolation* and it is a comfortable way for humans to cope with an unknown future. This human tendency to be held captive, chained to a specific, immovable feedbox, does not stand a chance against the historical record of continuous change. Pride of convictions, vanities and pleasurably eating apples from a tree of yesterday's knowledge are traits that have, through time, propagated the fall of man. This folly is often rooted in incentives, as the German proverb reminds us, "*Whose bread [thistle] I eat, his song I sing*." The finch in the human, the human in the finch.

A tree of life vantage point can provide an evolved perspective. In 1837, Charles Darwin advanced his thoughts on the adaptation of species and extinction using a tree of life metaphor in his sketch of an evolutionary tree in his first notebook on *Transmutation of Species*. Looking at the world through a lens of adaptation can expand ones vantage point – for example, as it pertains to the economy of business, is the business likely or unlikely to advance given new and different predatory threats and changing food sources?

Darwin's Wedge:

In an 1856 manuscript of *On the Origin of Species*, Darwin compared nature "to a surface covered with ten thousand sharp wedges . . . representing different species, all packed closely together and all driven in by incessant blows." Sometimes a wedge, a new species, driven deeply into this imaginary surface, would force out others, affecting species across "many lines of direction." This metaphor is an effective way to describe the interconnectivity of species and the importance of external impacts. Charles Darwin was influenced by his reading of Malthus' prediction on population growth and how limited resources would lead to an eventual catastrophe. He used the hammering of wedges image as a metaphor to emphasize that there was limited space for organisms to adapt, and that their ability to do so depended not upon absolutes but upon niches.

Just like with species, businesses and investors face "Darwinian wedges." These wedges can be subtly hammered in over time, or they can be more extreme, forcing immediate extinction of certain businesses. Wedges come in all forms: government regulation, a disruptive competitor, or environmental impact, to name a few.

Three Darwinian wedges we are following today are:

1. The Amazon Effect: Amazon is one of the greatest predators to brick and mortar retail commerce. The incessant hammering blow of a market share focus versus profit is, and continues to prove, a virtuous cycle. Just like the Wal-Mart effect on many small businesses, extinction is inevitable for those that cannot adapt to their changing food source.

2. Climate Change: The science seems overwhelmingly in support of a need to reduce the world's global carbon footprint. There are many businesses and industries that will continue to help this effort toward emissions reduction, and there are emitting industries whose extinction seems inevitable.

3. Gas Evolution: Through advances in technology (horizontal and deep water drilling) the world has found a relatively clean energy source that can help significantly reduce carbon emissions and meet a growing world energy demand. To move natural gas we will need to re-plumb the world's gas and oil supply chain – liquefaction, gasification, transportation, storage, as well as adapt geographically to where it makes economic sense to refine and store these energy assets.

Descent of Business:

An investor I respect shared a conversation with me that he had with Charlie Munger, who asked him, "What percent of businesses will be better ten years from now than they are today?" This investor's answer was 15%. Charlie replied, "I would have said 20%, but you are right."

The *invaluable* lesson is that most businesses fail to adapt. What made most businesses successful is likely not the *exact same system* that will drive their success into the future. While altruistic principles are forever static, systems often get crushed under the weight of change. For some large businesses, they also may face the law of large numbers, where it becomes increasingly more difficult to drive the level of change to have compounding benefits.

Star after star from Heaven's high arch shall rush,
Suns sink on suns, and systems systems crush,
Headlong, extinct, to one dark centre fall,
And Death and Night and Chaos mingle all!

As stated earlier, a business is worth the present value of future cash flows over the life of the business. To put this statement into practice and perspective, an investor would estimate cash flows out five to ten years, discount those cash flows by some rate, and then assign a multiple to the last year's cash flow to determine terminal value, which is also discounted. **After summing the cash flows and terminal value, a five-year discounted cash flow (DCF) calculation might attribute 75% of the intrinsic value of the investment to the terminal value.** An investor calculating a ten-year DCF could still be relying on over 50% of the fair value calculation to come from terminal value. One can visualize these streams of cash flows through time by the size of their effect on the intrinsic value calculation, including this disproportionately sized *orb* in that later, terminal value period deserving a disproportionate amount of attention.

Near and more near your beamy cars approach,
And lessening orbs on lessening orbs encroach; –
Flowers of the sky! ***ye too to age must yield,***
Frail as your silken sisters of the field!

So, one important adaptation to our own process is asking that *golden* question: will the business' terminal value be better five or ten years from now[4]? If we think yes, then our confidence must be grounded, otherwise we are *not* swimming in the rarified gene pool of those 15% of businesses that are improving over time.

The great rationalist and humanist philosopher, Erasmus of Rotterdam (1466 – 1536, Charles Darwin's grandfather was named after this great thinker), whose most celebrated work is *Praise of Folly* (1511), had a medal struck in his honor. Erasmus helped design the medal, and on the front he used an image painted by his good friend, celebrated Dutch painter Hans Holbein the Younger (c. 1497 – 1543), and on the back an emblem of the Greek God Terminus, who presided over boundaries, stoic on a pillar. On the left, in Greek, is the instruction, "*Keep in mind the end of a long life*." On the right, in Latin, is the stark reminder, "*Death is the ultimate boundary of things*." On either side of the head of Terminus are the words "*concedo nulli*," meaning, "*I yield to no one*." Erasmus wore a signet ring with this message to remind him of how life is fleeting and to live it fully with integrity. *I think* this is a fitting emblem to the importance of thinking about a business' terminal value.

The *terminal* value of a business will yield to no one. We continue to adapt our own processes to improve our probability of getting the terminal value assessment correct, as it *yields* compounding benefits. How can we bridge *terminus* with something enduring – Spinozian eternity – timelessness?

[4] For *compounders* we are asking this question over a ten-year window and for *transformations* we are asking this question over a five-year window. We measure improvement by the economics (return on the tangible assets the business employs) and the business' durable competitive advantage.

<u>Eternity and Calamity – The Bridge</u>:

As an acknowledgment to Ben Graham, I opened my Security Analysis class at Columbia Business School last semester with the same words Ben used to open his class. Ben opened with a statement on what he had learned to be one of the most important traits that would lead to success in investing. "*You must have the proper psychological attitude and no one says it better than Spinoza.* ***Spinoza said you must look at things in the aspect of eternity*****.**"

Spinoza defined eternity as outside of time – **timelessness.** Spinoza (1632 – 1677), one of the most beloved rationalist/humanist philosophers, who like Erasmus was Dutch, wrote the majority of his work in the Dutch Republic of The Hague, most of which was published posthumously.

In the Preface to the First Edition of Security Analysis, Ben Graham expanded on this concept:

> *The chief problem of this work has been one of perspective* ***– to blend the divergent experiences of the recent and the remoter past into a synthesis which will stand the test of the ever enigmatic future.*** *While we were writing, we had to combat a widespread conviction that financial debacle was to be the permanent order; as we publish, we already see resurgent the age-old frailty of the investor – that his money burns a hold in his pocket. ... For what we call fixed-value investments can be soundly chosen only if they are approached – in the Spinozian phrase –* ***"from the viewpoint of calamity."*** *In dealing with other types of security commitments we have striven throughout to guard the student against overemphasis upon the superficial and temporary. Twenty years of varied experience in Wall Street have taught the senior author that this overemphasis is at once the delusion and the nemesis of the world of finance.*

Ben Graham, in his unique way, identified the folly of the shortsighted investor's focus on the temporal and the superficial at the expense of the viewpoint that can be tested against an ever-enigmatic future. His Spinozian vantage point was from a perspective of eternity and calamity – timelessness and a worst-case scenario to arrive at a margin of safety.

Spinoza, like Erasmus, also wore a signet ring, which he used to sign important documents. The emblem he chose to identify himself with was a rose with the word "*Caute*" written under the rose, and his initials above. *Caute* is the Latin word for caution. Ben Graham's motto of "*margin of safety*" and Spinoza's "*Caute"* share a similar message.

*–**Till o'er the wreck,** emerging from the storm,*
*Immortal NATURE lifts her **changeful** form,*
Mounts from her funeral pyre on wings of flame,
And soars and shines, another and the same.

Allegory of Evolution and Extinction:

The difference between good art and great art is that great art is eternal. Its beauty provides a window by which we can see through time. *I think* great paintings can serve as puzzles to be solved to understand the truths around us. Johannes Vermeer's *View of Delft* is just one of those paintings. This is a painting I feel I know by heart. While it was painted of a place in time, it represents a place that exists outside of time, and its lessons are based on principles of old giving way to new. It represents that brilliant, elusive space between – where reality strikes the light of truth.

There are seven locations in the *View of Delft* that share a story of evolution and extinction. I have applied these *seven windows* into the past and present to two of the most important challenges the world is adapting to today, limited resources and climate change, and the investment opportunities we believe will be relevant as the world evolves to a changing energy food source. I have layered Darwin's 1837 sketch of the Tree of Life, *ABCD*, representing the past and present, with my own adaptation, *EFG*, representing the evolutionary bridge from old to new.

Vermeer painted this southern view of Delft on a spring morning in May of 1661. Geographically, Delft is a city connected by a seven-mile stretch of river to the port of Rotterdam to the southeast. As the gull soars, six miles to the northwest is The Hague. This was painted when the City of Delft was emerging from a tragedy that happened six years earlier on October 12, 1654, when the storage depot holding the town's gunpowder supply exploded and destroyed twenty five percent of the town. You can feel the dark cloud moving toward us in the painting, while the blue skies beyond represent the town healing from this tragedy. The triangle harbor in the painting is called the Kolk, and this is where trade and transport would enter and exit the Delft.

A. **Darwin's Wedge** – Climate Change – *Herring Busses*:

- *1661 – Global Cooling:* By 1661, humankind reached approximately 550 million. This figure was slowed by plagues brought on by what scholars called a Little Ice Age (LIA). However, the Dutch benefitted by this global cooling as fish stocks moved southward into the North Sea and away from the coast of Norway, where the herring fishery industry had been centered. As the fisheries came under the control of the Dutch, it created a *wedge* of industry and prosperity. The herring busses (fishing vessels) in the *View of Delft* were a technological breakthrough and increased productivity primarily with nets, rigging and processing facilities. The herring catch gave the Dutch a stake that they could invest in other ventures, especially shipping and maritime trade. **Vermeer's two herring busses represent a window into the Darwinian *wedge* of climate change that would change the world history of commerce and industry indefinitely.**

- *2014 – Global Warming:* Humankind has now reached 7.1 billion people. I think even Malthus would be surprised to hear we have not reached a catastrophe as he had predicted, yet the world must struggle with limited resources and with its impact on the environment. **I would argue that evolution is not just about survival of the fittest, but that genetic fitness favors altruism.** I observe a groundswell of altruism, especially from the younger generation, to change behaviors. There is a very large opportunity for businesses that can enable meaningful, rational improvements that make economic sense and that are scalable. This *will* happen for the generational greater good.

B. **Extinction** – *Old Church, Parrot Brewery*:

- 1661 – *Beer, Genever, Maritime Dominance:* If one were to travel from the Kolk under the bridge into the painting and city, you would either travel up the old canal to the Old Church (left side of bridge) or up the new canal to the New Church (right side). The larger tower next to the Old Church was the tower for the Parrot Brewery – Delft's major industry for over a century. In the beginning of the 17th century there were 115 breweries in Delft, but by 1661 there were only three. Two wedges created the downfall of the beer industry in Delft; consolidation drove out less efficient players but, more importantly, with prosperity there was a shift in consumer demand to the newly invented spirit Genever (the predecessor to Gin). Major distilleries were built six miles south of Delft in Schiedam given its close location to the import of its feedstock and the export of its finished product. The Nolet Family, and now Diageo, benefit from this history with their global leading brand KetelOne, rooted in this change agent.

- *2014 – Carbon Emitters:* What businesses will cease to exist ten years from now because of the global warming *wedge*? Through altruism, carbon tax, or innovation, change will happen and to those technologies and solutions that exist today that are not as efficient or are not as economically viable, they will be the Delft breweries of our generation. Matt Rose, the Executive Chairman of Burlington Northern Santa Fe (BNSF), the second largest freight railroad in North America, was recently asked at a Bloomberg Energy Conference what the number one agenda item in his inbox was. His answer came immediately: "*LNG, it is a big idea. It lowers the cost base for BNSF, means more tons to the railroad from trucks, and cleaner emissions profile. It will be the biggest transformation we have had since we moved from coal to diesel*." Once government policy is set, the groundswell of investment by the global transportation network could be monumental. So what does that mean? Extinction may be the outcome for those businesses that continue to operate from the perspective of the Old Canal.

C. **Time Horizon of a Darwinian Wedge** – Generational – *Schiedam Gate & Clock Tower*:

- *<u>1661 – Dutch Golden Age</u>:* The Schiedam gate building had two clocks, one facing the city side, the other facing the outside, to which a mechanized bell tower was connected. Horse drawn tow barges departed according to the schedule and the tolling of the Schiedam bell tower. Just as it is half past 7am in the *View of Delft*, the sun was also just rising on the Dutch Golden Age. A climatic wedge drove what has been called the Dutch miracle – an early expertise in fishing and investment that led to a first mover advantage in global trade and shipping that built the foremost maritime and economic power in the world. **One of the catalysts for this flowering of trade was a supply of cheap energy from windmills and from peat, easily transported by canal to the cities.** The invention of the sawmill enabled the construction of ships for worldwide trading and for military defense. One lesson to be learned from this era is just how prolonged a Darwinian wedge can last – 200 years.

- *<u>2014 – Gas Evolution</u>:* I believe the sun is also rising on a transformation toward a greater and more efficient use of natural gas as a leading energy source. The United States is uniquely positioned to benefit from this, as a large amount of gas trapped in shale deposits has been unlocked. There is also an increasing amount of gas being discovered around the world, often in locations where the existing transportation and processing infrastructure is lacking. The world is oil centric and our supply chain is oriented toward moving liquid oil – we will need to re-plumb some of this supply chain to get gas in a form that can be moved and stored in a safe and efficient way. I believe our Oil and Gas industry will morph over time to a Gas and Oil industry, as the supply chain enables more stability for producers and clarity for consumers to make the investments to shift to a new energy feedstock (Rail, Truck, Power Generation, Auto, Shipping, Chemical).

D. **Transmutation of Species** – *VOC Storage Warehouse*:

- *<u>1661 – Dutch East India Company (VOC)</u>:* The long roofline on the left side of the *View of Delft* is the warehouse of the Dutch East India Company, which was chartered in 1602 when the Netherlands granted VOC a 21-year monopoly to carry out trade in Asia. The VOC is often considered the first multinational corporation in the world and it was the first company to issue stock. Between 1602 and 1796, the VOC would send a million Europeans on 4,785 ships to Asia, netting 2.5 million tons of Asian trade goods while the rest of Europe would net less than one-fifth the tonnage. The VOC had six chambers (centers of operations) in the Netherlands and one of them was located in the Delft.

- *2014 – Natural Gas Production:* First mover advantage (as seen with the VOC early investors) can pay off handsomely, yet it can also be quite speculative. The history of booms and busts as a new industry expends capital to capture a market is littered with failures. In the Natural Gas production industry we have a number of good businesses with proven reserves and low cost production. This is not an area we have chosen to become experts in as we feel it is outside of our circle of competence. In many industries, such as 3D printing and other disruptive technologies, there is a fair amount of speculation into which business will be able to both innovate and endure. We don't think it necessarily advantageous to pick the winners at the root of an industry (production), or in the branches (consumption). We have found more success finding those businesses positioned in the trunk of the tree – enabling and connecting two very large fragmented groups of suppliers and customers. We have always preferred, and will likely eternally prefer, this middle space.

E. **Evolution Part 1** – Enablers Emerge – *New Church*:

- 1661 – Enablers to VOC: In the *View of Delft* as we move up from Kolk and out of the shadows we see the sunlit New Church. In 1661, the VOC was the most profitable, dominant company in the world. As a result, new businesses emerged to serve their needs, and one in particular was storage and related services. The goods that these traders were taking to the Netherlands (mainly coffee, tea and spices) had to be weighed, sorted, stored and redistributed within the Netherlands and beyond. A storage business, which has become one of the world's largest terminal storage operators and which I describe in this letter as a representative idea, originated to serve the VOC in this capacity, facilitating the rapid growth of the Dutch economy.

- *2014 – Enablers to Gas Evolution:* In that middle space between the production and consumption of this evolving and transforming energy source sits the vital supply chain. In the early days of this evolution we see a lot of players enter the space as entrepreneurs. A number of these new facilitator businesses were created to serve regional or local needs, to supply parts that wear out on the drilling site, to transport product and to provide storage. These businesses are not necessarily operating to maximize return on invested capital as much as they are born from an immediate need to serve demand. We find this is also not a time to enter into new investments, as the return to shareholders is spotty as some businesses use up free cash to just maintain the business – sometimes at lower and lower margins as competition and cycles create pricing constraints.

F. **Evolution Part 2** – Enablers Consolidate – Toll Gate – *Rotterdam Gate*:

- *1661 – VOC peak and Supply Chain Consolidation:* As more and more shipping competition flooded trade routes, the margins for the VOC deteriorated, yet their very large investment to maintain their vast business interest only increased. The very poor employee safety record made it harder for them to maintain a high quality workforce. While investors did very well in the expansion phase, the investment return flat-lined for nearly a century as returns were little better than government bonds until it ultimately went bankrupt.

The Rotterdam Gate served as a Toll Gate for anyone entering or exiting the City of Delft. We love finding businesses that naturally serve as a Toll Gate. The middle space between production and consumption often enjoys a natural oligopoly as owners realize that competing on price is a zero-sum game as many businesses are maintaining the same infrastructures to serve the same customer. Thus, consolidation drives scale into the industry and there is an inflection point of profitability following most consolidation periods. This is what we call a Secular Transformation, and we seek these out as part of our process, even if a Darwinian wedge is not driving them. In 1661, the winners that developed were those that built scale in the barge transport, storage, and supplied this growing maritime service industry.

- *2014 – Gas Evolution - Toll Gates:* As natural gas production has ramped up over the last few decades, we have seen a number of natural Toll Gates emerge. These gates have benefited from a process of consolidation and are now uniquely positioned to benefit given increased demand for their services. One business we own is located in The Hague, and serves as the Global Leader in the Front End Engineering and Design (FEED) of the plumbing that will be required to build out our global gas supply chain. While this business specializes in FEED, they are by no way chained to one immovable FEED-box, having evolved from building bridges to making the first storage tanks to hold petrochemicals, as well as inventing the first floating roof tank. Another Toll Bridge we own and admire is the global leader in parts distribution to the energy sector. It is interesting to note that Royal Dutch, which operates out of The Hague, launched Prelude FLNG in December 2013, the largest hull ever to float to facilitate deep water drilling and LNG production at sea. An amazing undertaking. We are currently looking at the shipping facilitators in this industry.

G. **The Lighted Reflection of Truth** – *Proust's Little Patch of Yellow Wall*:

- Marcel Proust (1871 – 1922) was helpful in bringing the interest of Vermeer and specifically the *View of Delft* to a larger audience when his character Bergotte, in his most prominent work *In Search of Lost Time,* visits a Dutch art exhibit and, while examining a detail of Vermeer's *View of Delft*, falls ill and dies.

> *At last he came to the Vermeer which he remembered as more striking, more different from anything else he knew … and, finally, the precious substance of the tiny patch of yellow wall. His dizziness increased; he fixed his gaze, like a child upon a yellow butterfly that it wants to catch, on the precious little patch of wall.*

What makes the *little patch of yellow wall* so refined and beautiful is that it is hiding in plain sight. Vermeer painted the light coming out of the dark clouds hitting the New Church, then paints the light so brilliantly washing over the sloping roof with its *solitary* window (which Proust refers to as a wall) and takes something so ordinary and makes it extraordinary and eternal. Proust once wrote that genius is in the power to reflect and not in the intrinsic quality of the scene. *I think* truth persists on the edge of that reflective threshold, beyond the mind's eye of reality, where being and beauty are indistinguishable. The humor and gratitude of the illusion solved, elusion found.

Great investments are often not obvious, and those that are obvious are often priced for their perfection. **Yet through following a few *golden threads* we hope that we will arrive at *a little patch of yellow wall*, so skillfully wedged into a much larger work of art, so integral to its workings.** Who would have been so foolish as to pick our little, 400-year old storage business to have adapted and evolved while the all-powerful VOC would wither and die in bankruptcy? Who and where are the *little patches of yellow walls* that are better prepared for evolution today, and which businesses will share a fate similar to the VOC? Puzzles to be eternally solved despite the burdens of our humanness and folly.

> *… to live once again beneath sway of those unknown laws which we obeyed because we bore their precepts in our hearts, not knowing whose hand had traced them there – those laws to which every profound work of the intellect brings us nearer and which are invisible only – if then! – to fools. (Proust)*

Representative Idea – Global Terminal Storage Operator:

In the first quarter, we made no new investments – we did, however, proportionately size a number of core positions based on their evolving business and valuation merit.

A business we began purchasing in the fourth quarter of last year, and continue to build our position in, is among the world's largest independent tank storage providers, operating 79 terminals with a capacity of 30 million cubic meters, strategically located in ports across 29 countries. This business specializes in providing conditioned storage facilities for bulk liquids including: liquid chemicals, gasses, and oil products. This business originated in 1616 to provide storage solutions to customers involved in the Dutch *Maritime* Golden Age (VOC).

The Opportunity: The wedges of climate change and gas evolution have been incessantly hammered into the world energy paradigm, and the world is increasingly adapting to this reality. For some countries, such as the United States, an ample, economically advantaged supply is now at hand.

We categorize our new holding as a transformation. As noted in previous letters, transformations are businesses with average, or even below average, operating economics. Over time, we expect a meaningful change (inflection point) in operating economics through three different transformation categories: secular, systemic, or separation. This particular business is in a secular transformation as the global supply chain for energy evolves. Below are a few of the critical data points that we believe bode well for the business and for our timing on the investment:

- *Global Growing Imbalances*: Growing imbalances between geographic areas of resource production (supply) and industrial activity (demand) are increasing the value proposition for supply chain enablers that focus on providing efficient and safe transportation and storage. As distances between supply and demand grow, larger ships are being utilized for transport. These vessels demand more advanced technology at the port for on and off loading, and can only operate in certain locations with the deepest ports. These limitations favor our Toll Gate idea.
- *Olefins*: The chemical industry, specifically olefins, is radically evolving as more and more production is being moved to the United States. Natural gas, the feedstock for production, can be as much as 80% of operating cost for chemical manufacturers. The United States is geographically advantaged for chemical production – olefins are now increasingly exported from the United States to locations where they are then used in manufacturing: Asia and Western Europe. The storage and transport supply chain will be *incrementally* more important.
- *LNG*: Liquefied natural gas storage provides a potentially very long-term growth opportunity for this company. The infrastructure build out necessary to move LNG around the world is gaining momentum, and this company continues to be asked to play a trusted role in the supply chain. One of this business' larger projects is an LNG terminal in Rotterdam that offers Europe an important alternative to Russian natural gas. Given my earlier comments on Toll Bridges, it is interesting to note that this facility is named GATE – which is an acronym for: Gas Access To Europe.
- *Clouds*: The European segments (ARA and EMEA) of this business are facing a challenging environment due to reasons that we believe are not long-term in nature and can be remedied through time. We have always found these time horizon mis-pricings fruitful when we are comfortable with the longer-term picture. Some of these challenges are masking quite positive developments of their growth platforms where checks continue to prove encouraging. Persistent clouds for the European business may serve to further weaken the share price in the short-term. We are hopeful that we may have the opportunity to add at even more attractive prices.

Firm Updates:

- After adding a number of new professionals to our team last quarter, we have no new hires this quarter.

We look forward to meeting and talking with you soon. We greatly value your support and trust.

The final cause of all these wedgings is to sort out proper structure and adapt to change.

Charles Darwin (1809 – 1882)
Notebook D on the Economy of Nature

On behalf of the firm,

Chris

Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder

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Appendix: The Human in the Finch

In January, I visited the Frick Museum in New York City with an hour to spare between meetings in mid-town. When I arrived there was a line formed, and I asked the woman in front of me if there was an event going on at the museum. She informed me that there was a special Dutch collection currently on loan from the Mauritshuis House Museum in The Hague. She said the collection included a couple of Vermeer's works, including *A Girl with a Pearl Earing*, but then added that she had come to see Carel Fabritus' *Goldfinch*. As it turns out, many of the visitors that morning were there to see the *Goldfinch* after having read Donna Tartt's bestselling, Pulitzer Prize winning, book *Goldfinch*. Tartt's novel is a coming-of-age story about self-discovery and the beauty in life and art, with the Goldfinch having a central role in the plot. Carel Fabritius died in the Delft explosion of 1654 and with him nearly all his art perished except for a few pieces (including the brilliant *Goldfinch*). Fabritius was the student of Rembrandt, and the teacher of Vermeer.

Inspired by many things I read over the quarter in thinking about the economics of evolution and the Dutch Golden Age, I designed[5] this image to convey a similar message beyond the narrative – an allegory; of evolution, of humanity and eternity, of real and ideal, of time fleeting and time everlasting, of finite and infinite, of knowing and the unknowable, of folly and supreme intelligence, of vanity and grace, of lost, stolen, and hidden lines of beauty, of fateful objects and the fateless bridges of discovery, and of the still point where all of this balances. A window through time, as if someone was peering into the solitary, eternal window on the *Little Patch of Yellow Wall* in Vermeer's *View of Delft*.[6]

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[5] Front-end engineering and design (FEED) work only. Artist: Camille Vicente.

[6] In no particular order I have incorporated the following objects of art and curiosity into the image: Rembrandt's *The Storm on the Sea of Galilee* (stolen – Isabella Stewart Gardner Museum - ISM) – 1633, Carel Fabritus' *Goldfinch* – 1654 (adapted), Charles Darwin's Tree of Life Sketch – 1837, VOC monogram at the Castle at the Cape of Good Hope – 1669, *Portland Vase* – Josiah Wedgewood Design #12 gifted to Sarah Wedgewood-Darwin – Humanity Scene – 1790, Original Artist Unknown *Portland Vase* – Eternity Scene – AD 25, Semper Augustus Record Selling Tulip Bulb – 1637, Plato's Dodecahedron – Fifth Element – The Universe – 350 BC, Gutenberg Bible – Lenox Copy – 1450, Thomas Malthus – *Principle on Population* – 1798, Pieter Claesz – *Vanitas* – 1625, Gu – Chinese Vessel from Shang Dynasty – 1500 BC (stolen – ISM), Vincent van Gogh's *Poppy Flowers* – 1887 (stolen – Cairo, Egypt), Proust's Yellow Butterfly – 1920, Erasmus of Rotterdam's *Terminus Medal* – 1528, Spinoza's Signet Ring – 1656, *Map of Delft* – Joan Blaeu – 1649.

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2014 2nd QUARTER LETTER

Honor that which is greatest in the world – that on whose business all things are employed and by whom they are governed. And honor what is greatest in yourself: the part that shares its nature with that power. *(Meditations 5.21)*

Practice even what seems impossible. The left hand is useless at almost everything, for lack of practice. But it guides the reins better than the right. From practice. *(12.6)*

What injures the hive injures the bee. *(6.54)*

Everything is interwoven, and the web is holy; none of its parts are unconnected. They are composed harmoniously, and together – they compose the world. *(7.9)*

Apply them constantly, to everything that happens: Physics, Ethics, Logic. *(8.13)*

Marcus Aurelius
Meditations – A.D. 121 – 180
(Translated by Gregory Hays)

**Twelve selections throughout the letter*

EAST COAST

ASSET MANAGEMENT

To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO and Chief Investment Officer

Date: July 30, 2014

Re: Second Quarter 2014 Update – **Horse in Motion**

In our second quarter letter you will find our portfolio update and general market observations. Each quarter we highlight one component of our investment process. This quarter, in the section titled *Horse in Motion*, I will discuss the value of an ownership mindset and how it plays an integral part in a compounding triumvirate with a good business and an effective operator. As is our standard practice, client reporting, including performance and positioning, will be sent under separate cover.

Market Summary[1]

	S&P 500	MSCI AC World Index	MSCI Emerging Markets	MSCI EAFE Index	Barclays Aggregate Bond Index	Gold – $/Troy Oz.	Crude Oil
Price 06/30/14	1,960.23	428.75	1,050.78	1,972.12	1,878.00	1,327.32	105.37
Q2 2014	5.23%	5.23%	6.71%	4.32%	2.04%	3.37%	3.73%
YTD	7.13%	6.53%	6.14%	5.24%	3.93%	10.09%	7.06%
2013	32.38%	23.53%	-2.34%	23.57%	-2.02%	-28.04%	7.19%

An improving economy, reasonable valuations, and low interest rates continue to produce a favorable environment for the owners of equity investments. While year-to-date benchmark returns have continued on an upward trajectory, there has been a greater variance in returns across industries and companies. Due to more attractive valuations we have increased our per-share ownership in a handful of our businesses. We continue to look at businesses that have reached full valuation as sources of capital.

We expect persistent geopolitical uncertainty to test the nerve of investors as we move towards year-end. We do not view this continued unrest as a reason to change our long-term investment strategy of attempting to own some of the best businesses at reasonable valuations. We find solace in measuring knowable business fundamentals and price, which provide the foundation of return expectations and risk. Our objective of investing with a margin of safety and a long-term view of compounding will always be our rein and rudder.

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, the MSCI Europe Asia Far East Index (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices.

The (Pari-mutuel) Stock Market:

Twenty years ago this past May I began my investing career. In April of that same year, Charlie Munger, who together with Warren Buffett has provided the greatest influence on my investment philosophy, delivered what I believe to be one of the most insightful investment talks of all time. Speaking to business school students at the University of Southern California, he loosely titled his talk "*The Art of Stock Picking as a Subdivision of the Art of Worldly Wisdom*." Like many timeless works, the lessons of twenty years ago continue to apply to today's investment environment.

The lecture highlights a number of mental models that can be used to make rational decisions and then discusses a few mental models that apply to investing. Personally, I have found one of the most important insights to be the lens by which a rational investor should view the stock market:

> *The model I like—to sort of simplify the notion of what goes on in a market for common stocks—is the pari-mutuel system at the racetrack. If you stop to think about it, a pari-mutuel system is a market. Everybody goes there and bets and the odds change based on what's bet. That's what happens in the stock market. Any damn fool can see that a horse carrying a light weight with a wonderful win rate and a good post position etc., etc. is way more likely to win than a horse with a terrible record and extra weight and so on and so on. But if you look at the odds, the bad horse pays 100 to 1, whereas the good horse pays 3 to 2. …*

The market is based on the collective *perceptions* of the participants. As bets are made in the marketplace, odds change. When the market participants perceive good business results, the potential payoff or expected return diminishes, and when the market participants do not perceive favorable results, the potential payoff or expected return improves dramatically (if the business proves otherwise). The market for stocks and horses in this pari-mutual pool is quite efficient in tallying up these perceptions and then changing the odds (prices). **However, perceptions and reality are very different.** When the races are run and as companies are operated, the truths are revealed and we can see, with hindsight, which odds were mispriced. While perceptions do a decent job in the pari-mutuel marketplaces in assessing correct odds to winners and losers in **aggregate,** the system is perfectly imperfect and thus **specific** mispricings systematically occur. Our process is built around attempting to find these mispricings – asymmetric investment opportunities.

> *I used to play poker when I was young with a guy who made a substantial living doing nothing but bet harness races… now, harness racing is a relatively inefficient market. You don't have the depth of intelligence betting on harness races that you do on regular races. What my poker pal would do was to think about harness races as his main profession. And he would bet only occasionally when he saw some mispriced bet available. And by doing that… he made a substantial living…*

Infrequent betting is the one consistent characteristic of people who have beaten the pari-mutuel system. Human tendency, especially with professional investors, is to attempt to know all about everything. We agree with Charlie and Warren that it is more intelligent to work hard and sift the world for that *rare,* mispriced bet.

> *And yet, in investment management, practically nobody operates that way… a huge majority of people have some other crazy construct in their heads. And instead of waiting for a near cinch and loading up, they apparently ascribe to the theory that if they work a little harder or hire more business school students, they'll come to know everything about everything all the time. To me, that's totally insane. The way to win is to work, work, work, work and hope to have a few insights…*

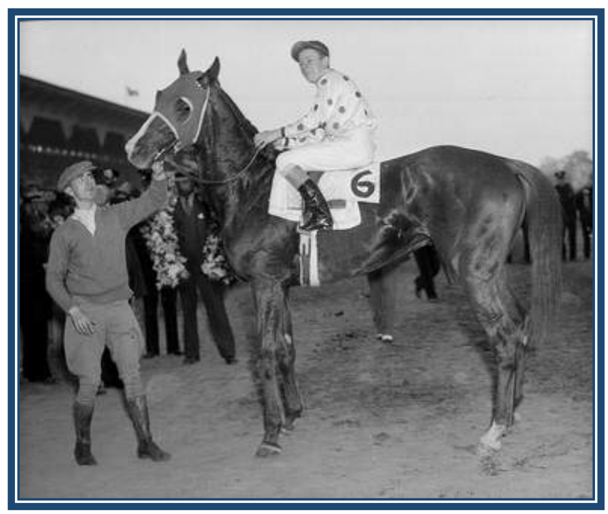
This year we have not found many *new* mispriced opportunities. We have, however, found opportunities within our existing portfolio. Our most important insights have come from learning about existing core holdings, and when afforded with downside volatility, we were able to add to these holdings at more attractive prices. Our one new holding is a business we have studied for some time and already owned as a small part of its much larger parent company. Fortunately, this company's management team also saw that this business was mispriced and spun off the business in May. We took the opportunity to make this business a full portfolio position. I will highlight this holding as a representative idea later in the letter.

During this quarter the world was once again captivated by the Triple Crown[2] and California Chrome's near winning campaign. Since it has been thirty-eight years since a Triple Crown winner, many believe the perfect triumvirate *aptitude* of horse, jockey, and owner/trainer might never coexist with the *endurance* necessary to attain this coveted achievement.

Aptitude and endurance are at the heart of a successful compounding journey. Our *level* of compounding success will be determined by:

1. The ability to identify the *right mix* of business (horse), operator (jockey), and owner mindset that will drive each investment's per share economic returns,
2. The insight to determine when the market is giving a *mispriced* opportunity that will deliver extraordinary returns, coupled with a margin of safety, and,
3. The fortitude to act with patience in constructing a *focused* portfolio with the knowledge that quality asymmetric opportunities are rare.

A compounding Triple Crown consists of winning all three races: business (exceptional), price (asymmetric), and focus (fewer quality bets) over an enduring time horizon.



Triple Crown Winner, *Omaha* - 1935

[2] There have been eleven Triple Crown winners and we await the twelfth. A convergence of value investing and Triple Crown history occurred in June of 1935 when Omaha won the third Triple Crown. Omaha was an unlikely winner as he had won only one of nine races leading up to the Kentucky Derby. Two young boys from Omaha, Nebraska, and their families were likely swept up in that national attention for their town's namesake pride. Charlie Munger was eleven years old and Warren Buffett was not quite five. Ben Graham had just published his first edition of *Security Analysis* while practicing on Wall Street and teaching at Columbia Business School. The market had finally begun to recover after the Great Depression and the Dow Jones Industrial Average closed at $114 the day before Omaha won on June 8, 1935 (DJIA today is at $17,084). Like Omaha, this trifecta of perhaps unlikely winners (Graham, Munger, Buffett), rose to become immortals of the American [business] turf.

Horse in Motion:

The colt, sir! He cried. The colt! Before comes another man to look, I should buy him!
'You? You? Buy Him' … 'and what are your plans for the colt?'
'I drive him.'
'You expect both speed and stamina?'
'How could it else? He is deep made in his heart place.' …
'I would have to sell the mare too. The mare with colt-at-heel.'
'My mind is made up sir!' William Rysdyk said with resolute look in his eye. 'Only one question I could want to ask.' Mister Seely waited.
'The money it grows slow. With the wages of ten dollars a month from you and six dollars from Mister Townsend, how long time I got to pay?'
'As long as you like, Rysdyk,' Mister Seely said kindly. It hurt to take the money at all. But he had set his price. I'm glad the two will be with you,' he added.
Slowly Mister Seely turned and walked into the house and he watched his hired man ride out of the lane with a colt skittering along at heel. For a long time he stood there until the three creatures smalled and were lost to view.

One Man's Horse by Marguerite Henry – 1950

In 1851, William Rysdyk, a farm hand in Sugar Loaf, Orange County, New York bought the colt he had cared for since birth (along with his mother) for $125. He bought them from his boss, Mr. Jonus Seely, and named the colt Hambletonian. **The story of Rysdyk's Hambletonian illustrates the powerful mental model of an owner mindset.**

> *With two creatures dependent on him, William Rysdyk's work had a new strength and purpose. Sleeves rolled, he faced each season like a giant refreshed – splitting logs, hauling, plowing, as if he were made of iron. And each month the money-till in the teapot was opened and silver dollars tucked inside. Soon the debt would be repaid.*
>
> *It was a September day, and without any more thought, without any planning, he entered Hambletonian, now two years old, in the Orange County Fair. When it came William Rysdyk's turn to show his colt, the judges shouted, Make way! … Lead rein in hand, William Rysdyk ran up and down showing his colt at the trot. He forgot he was at the Fair. He forgot everything in the rhythm of his colt's trot. Side by side they went, man and horse, evenly matched, not wanting to whoa, Not either of them. …*
>
> *The crowd stunned as the blue ribbon and the five-dollar premium went to William Rysdyk.*

Rysdyk and Hambletonian caused quite a sensation and many envious horsemen were quick to remark that he would never be a trotter, only a show horse. The issue was settled in 1852 at Long Island's Union Course. Hambletonian and champion competitor Abdallah Chief were hitched to skeleton wagons with their owners driving to settle the debate. The Chief went first with a mile time of two minutes and fifty-five and half seconds. Then it came time for Rysdyk and Hambletonian:

Go! It came like a knifeblade sharpened on the wind. The colt and the watch clicked off in unison. And suddenly William Rysdyk knew the watch was his opponent. ... The seconds were ticking themselves off. ***Time was his match.*** *One twenty-three at the half!* ***William Rysdyk felt pride rising with the wind.*** *His colt was speed, harnessed speed. The horse and Time were flying together, beat for beat, second for second.*

Now the brush down the stretch! William Rysdyk straining, pushing forward, sitting bird-light in the seat, long to trot alongside the colt, yoked to him, ***somehow worthy of him.*** *... Two minutes, forty-eight and half seconds as they crossed the finish line. Hambletonian had won! His time was better than the Chief's! Seven seconds better.*

In the days and years that followed, many horsemen approached Rysdyk trying to buy Hambletonian and he simply replied, **"There's nobody who could buy him."** Yet, many of those same horsemen brought their mares to Hambletonian to be bred and thus improve their trotting stock, including President Ulysses S. Grant. With each year Hambletonian's fame grew – 'Hero of Orange County! King of Sires!' the crowd often yelled at fairs. The Hambletonian breed became the standard and thus the foundation sire for harness racing horses – the Standardbred breed was born.

The mile times of Hambletonian's sons and grandsons kept getting faster and faster; his son Dexter became a household word for speed, winning forty-seven out of fifty-one races, reducing the world record to 2:17. His grandsons kicked up their heels, setting new marks with 2:08 for Maud S. and 2:07 for Peter the Great. **The line strengthened as it lengthened.**

Between 1851 and 1875, Hambletonian produced over 1,335 foals and the lineage of most North American Standardbred horses can be traced to him. Rysdyk's $125 investment would return cash dividends, for decades to come, of at least $500 for each breeding opportunity. **The horse, owner and driver formed an exceptional compounding triumvirate.**

Year on Year William Rysdyk drove him into the county fair grounds where the stallion would win best stallion in his class. He won blue ribbons, silver cups and sterling silver tea sets. Of course William Rysdyk had no more use for silver cups and silver tea sets than for water in his hat, but accepted them all as custodian for Hambletonian. And often on moon-bright nights he would steal out to the barn with lye ashes and rag to polish them. 'Foolish eh?' he would chortle as he rubbed. ***'Yah, foolish but not caring. In some other world maybe his thirst gets gentler and out of tea cups he drinks.'***

In time William Rysdyk's beard turned white, and white hairs grew around Hambletonian's muzzle. ***And still the horse was above price.*** *As the man and the stallion grew old together they looked upon each other with their hearts as well as their eyes.*

The legacy of Hambletonian continues to this day. Held in August, the first race of harness racing's triple crown is called the Hambletonian. Horse racing may be the *sport of kings*, but harness racing belongs to the American people. 'To England the Thoroughbred, to France the Percheron, to America the Trotter.' America owes her trotting breed to a bearded countryman who saw greatness in an awkward colt. Nearly all trotters today owe their pure gait and pluck to the blood of Rysdyk's Hambletonian.

Owner Mindset:

Extraordinary outcomes are often seeded in a freedom of will and aligned incentives that are best represented in the pride of ownership. Rysdyk's story is an example of how a hired hand with a dream and will to succeed partnered with a horse and created an enduring legacy.

Early in my investing career it was clear that there were distinct binary tribes that would define your investing style. The first differentiator was that you were either value or growth, the second was you were either top-down or bottom-up. I obeyed these tribal rituals and would confidently state I was a bottom-up value investor. Among the bottom-up value pride, a third categorization would be asked. Do you bet on the horse or the jockey? In other words, was the business horsepower more important or the management skill that would lead the business?

My tribal bonds quickly weakened with experience as I realized that I was all of those designations. I wanted to own a great business (horse), run by capable and ethical operators (jockey), earning excellent, sustainable economics with a strong balance sheet (bottom-up), benefitting from secular industry tailwinds in harmony with macro and micro economic truths (top-down), with excellent growing market opportunities (growth), and finally trading at a discount to its intrinsic value (value).

I further realized that even the horse or jockey debate was far from a binary decision as it ignored a critical element – *the owner*. The mental model of ownership plays a greater role in our analysis as our process evolves. It may have started with the simple question, "does management act like owners?" Now we are increasingly interested in the details of the incentives that drive ownership behavior and exploring if the ownership culture spans finite time horizons or perhaps reaches the ideal – **a pervasive system of ownership that exists outside of time horizons.**

Standardbred:

The second mental model that is illustrated by Rysdyk's Hambletonian is one of *standardization*. Hambletonian is considered the foundation sire of the trotting breed and from whom nearly all Standardbreds descend. The name "Standardbred" was first used in 1879 because, to be registered, every trotting horse had to be able to trot a mile within the "standard" of two minutes and thirty seconds.

Standardization is a powerful model to understand when you are looking at the *endurance* of a business. We are constantly seeking Standardbred businesses that, like Hambletonian, create a standard to which everything that follows must pay homage. **We love these types of competitive advantages because they can be generational.** Standardization is what allows for scaled growth – virtuous cycles of exponential compounded growth. When Bill Gates created the Microsoft operating system he created a standard by which programmers could write software.

John D. Rockefeller's Standard Oil was originally created to standardize best business practices of refining, transportation, and delivery of the oil that was being drilled by independent contractors. His standards were the genesis of the most valuable business in the world that still exists today in component parts.

We find some of our most valuable investment sourcing work is to contemplate where these Standardbred opportunities might exist. In 1994, Charlie Munger called these Standardbred opportunities "surfing":

Then there's another model from microeconomics which I find very interesting. When technology moves as fast as it does in a civilization like ours, you get a phenomenon which I call competitive destruction. ***You know, you have the finest buggy whip factory and all of a sudden in comes this little horseless carriage.*** *And before too many years go by, your buggy whip business is dead. You either get into a different business or you're dead—you're destroyed. It happens again and again and again.*

And when these new businesses come in, there are huge advantages for the early birds. And when you're an early bird, there's a model that I call "surfing" – when a surfer gets up and catches the wave and just stays there, he can go a long, long time. But if he gets off the wave, he becomes mired in shallows...

But people get long runs when they're right on the edge of the wave whether it's Microsoft or Intel or all kinds of people, including National Cash Register in the early days.

The cash register was one of the great contributions to civilization. It's a wonderful story. Patterson was a small retail merchant who didn't make any money. One day, somebody sold him a crude cash register that he put into his retail operation. And it instantly changed from losing money to earning a profit because it made it so much harder for the employees to steal... But Patterson, having the kind of mind that he did, didn't think, "Oh, good for my retail business." He thought, "I'm going into the cash register business." And, of course, he created National Cash Register.

And he "surfed." He got the best distribution system, the biggest collection of patents and the best of everything. He was a fanatic about everything important as the technology developed. I have in my files an early National Cash Register Company report in which Patterson described his methods and objectives. And a well-educated orangutan could see that buying into partnership with Patterson in those early days, given his notions about the cash register business, was a total 100% cinch.

And, of course, that's exactly what an investor should be looking for. In a long life, you can expect to profit heavily from at least a few of those opportunities if you develop the wisdom and will to seize them.

These Standardbred opportunities can have very long tails and thus we continue to scour the world for evidence of their characteristics. We further believe Standardbred opportunities can give us something enduring that will provide a firm foothold in a changing world.

Some things are rushing into existence, others out of it. Some of what now exists is already gone. Change and flux constantly remake the world, just as the incessant progression of time remakes eternity. We find ourselves in a river. Which of the things around us should we value when none of them can offer a firm foothold? (6.15)

Timelessness of an Owner Mindset:

The simplicity, transparency and meritocracy of an owner mindset are clear reasons why this model is so powerful. However, I believe there is also a more dominant force at work in terms of the *perception of time* that drives exponential results.

Leland Stanford, the former Governor of California and founder of Stanford University, owned and bred trotting horses. He was a student of the science of what made one trotting horse faster than another and owned over eight hundred horses at one time at his famous Palo Alto Stock Farm. One of the great debates among the trotting horsemen of his time was the minority belief (which Stanford backed) that there was a moment during a horse's gait where there was unsuspended motion. Stanford decided to hire the then landscape photographer Eadweard Muybridge to prove his position and settle a wager.

In 1872, and subsequently in 1878, Muybridge successfully photographed trotting horses airborne at the trot. **The images were revolutionary in that it was the first time anyone was able to still motion.** Muybridge is often credited as the man who stopped time. His early work would revolutionize photography and lead to motion pictures.

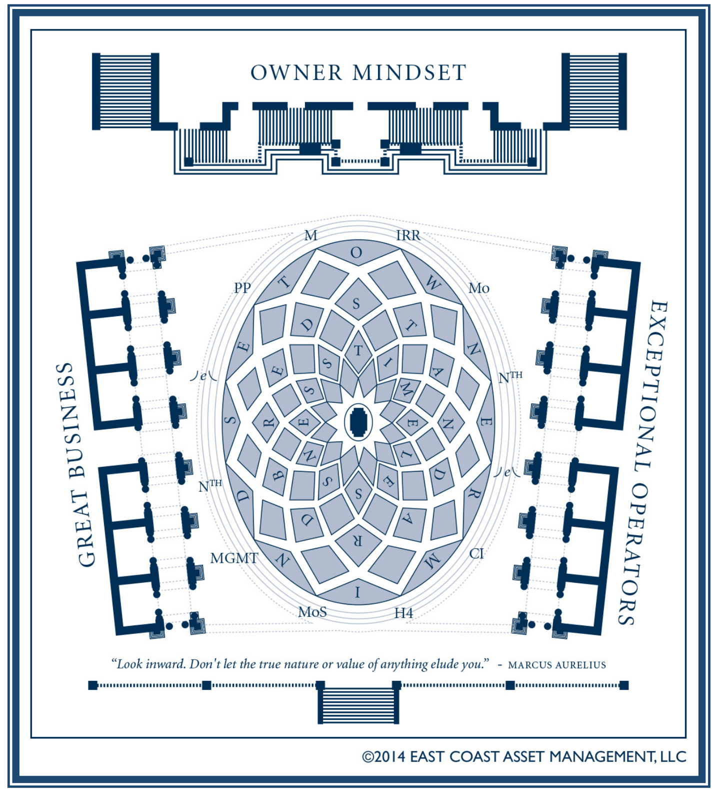
I often find that businesses view the *perception of time* in two ways. There are those that twist and turn to the limitations of time, and those that do not. **Timelessness is the most enlightened mental model of them all.** As investors we might have the rare great fortune to find businesses that **still time,** work outside of it, and *harness* time for its positive attributes – compounding benefits to stakeholders.

Owners see with their hearts as well as their eyes. Owners operate with an abundance mentality and understand the limits of a "not enough for anyone else" mindset of zero-sum scarcity. Owners view success as not about how much they can reap today, but in terms of a cumulative bounty beyond the here, now and self. Owners don't break the will of their employees with carrot and stick, but set simple, transparent standards driven by freedom and meritocracy to encourage continuous improvement. Sleeves rolled, there is no job beneath the owner. Owners build trust, give before getting, and care less about short-term winners and losers because they don't have an end game. Winning is a byproduct of striving for excellence. Owners listen keenly, are receptive to inspiration, and through their deeds they inspire others. Owners are life-long students and view teaching others as their legacy. Owners view themselves as stewards – conservators for future generations. **Owners operate outside of time in a realm of the infinite, where their craft is the journey; the journey their joy.**

> *Be like a vine that produces grapes without looking for anything in return. A horse at the end of the race. A dog when the hunt is over. A bee with its honey stored. And a human being after helping others.* (5.6)

Compounding Triumvirate:

We find the most productive investments have three key attributes: a great business that earns long term superior economics, ethical operators running the business and an ownership culture that is pervasive. Our most important work is to find where this compounding triumvirate exists and to curate an ever-growing intelligence about these businesses. It's not our first objective to seek out bargains but to first seek out high quality compounding businesses and then determine at what price does the business triumvirate make investment sense – an asymmetry of attractive expected returns and a significant margin of safety.



I have written in the past about the two hexagonal lenses each opportunity progresses through: first looking at the quality of the business, "six sides of great," and second looking at the attractiveness of the investment through "M-Theory." As the due diligence process evolves, the final impression is **first business, then price.** For our compounder and transformation opportunities, we want to ask ourselves: if we bought this business, in its entirety, could we put *blinders* on for five or ten years and feel secure in our investment? Our level of comfort is simplified to the three key factors of business (horse), operational excellence (jockey), and the timelessness of an owner mindset (owner/trainer).

> *Side by side they went, man and horse, evenly matched, not wanting to whoa, not either of them. … Now the brush down the stretch! William Rysdyk straining, pushing forward, sitting bird-light in the seat,* ***long to trot alongside the colt, yoked to him, somehow worthy of him.***

The story behind 3G Capital is one of the greatest examples of this compounding triumvirate *in motion*. The Brazilian trio that founded 3G is Jorge Paulo Lemann, Marcel Telles and Beto Sicupira. They came from modest beginnings but have since acquired Anheuser-Busch, Burger King and Heinz, among other successful businesses. During the quarter I read Cristiane Correa's book *Dream Big*, which chronicles the 3G story with a foreword written by former 3G consultant, Jim Collins. We believe the team at 3G to be a model of how a good business, operational excellence, and an ownership mindset can create a *lollapalooza* compounding effect.

> *In the intervening two decades, I have learned much from them. Here in the preface, I would like to share the top 10 lessons I have gleaned from watching, teaching, and learning from their journey.*
>
> 1. Invest Always – And Above All – In People
> 2. Sustain Momentum with a Big Dream
> 3. Create Meritocratic Ownership Culture with Aligned Incentives

4. You Can Export a Great Culture Across Widely Divergent Industries and Geographies
5. Focus on Creating Something Great, Not on "Managing Money"
6. Simplicity has Genius and Magic in It
7. It's Okay To Be A Fanatic
8. Discipline and Calm, Not Speed, Is the Key to Success in a Time of Potential Crisis
9. A Strong and Disciplined Board of Directors can be a Powerful Strategic Asset
10. Seek Mentors and Teachers, and Connect them Together

> *Having studied the development of some of the most extraordinary business stories of all time, and the entrepreneurs and leaders who built them, I can say definitively that this story – rising from such humble beginnings to global prominence – is one of which Brazilians should be immensely proud. ... Best of all, the story is not yet done. As these fanatics* [owners] *never stop asking, no matter how much they've achieved: What's next?*
>
> Jim Collins, Boulder, Colorado, USA, January 4, 2013

Too many CEOs run their businesses as if it were a *sport of kings* – where to the victor go the spoils. Ironically, the 3G triumvirate is the king of beers, burgers, and ketchup yet they choose to wear no crown, but share proportionately with and as owners. **Uneasy should lie the head that wears the entitled crown of an iconic brand.** There is a far better crown called merit, a crown it is that seldom kings enjoy.

> *Good fortune is what you make for yourself. Good fortune: good character, good intentions, and good actions. (5.37)*

Representative Idea – Worldwide Distributor – Energy and Industrials:

In the second quarter, our portfolio activity was quite modest. We did, however, have the opportunity to purchase one "new" business. One of our existing holdings spun out a business that we have long admired and we made that a full investment in the portfolio.

This business is a world-leading distributor focusing on energy supplies. Two key characteristics are present in this business that have long been an incremental part of our process: the attractive mispricing dynamics that often occur with *spinoffs* and the exceptional economics that can arise from a competitively entrenched and optimized *hour-glass supply chain*.

The Opportunity: We categorize our new holding as a transformation. As noted in previous letters, transformations are businesses with average, or even below average, operating economics. Over time, we expect a meaningful change (inflection point) in operating economics through three different transformation categories: secular, systemic, or separation. This particular business is experiencing the separation dynamics that exist when a business is spun off, which releases a number of catalysts that can drive meaningful near-term change, as incentives and freedoms are unleashed. We also observe attractive secular transformation dynamics as the global supply chain for energy evolves, building a larger market for the supplies they distribute. We believe over the next five years the business will become significantly larger and more profitable by the following levers:

- *Acquisition and Integration Advantages*: Senior management left the larger parent company to join the spun off company with a proven history of growing a business intelligently through acquisitions. New ERP-SAP system provides the company with an advantage in integration versus competitors during this runway of growth.
- *Margin Improvement*: Business margins are below normalized levels due to ERP installation costs and integration of former acquisitions.
- *Private Label – Gross Margin Improvement*: As with other hour-glass supply chain leaders that have been successful at selling private label products with higher gross margins to customers, we see an opportunity in meaningful incremental returns.
- *Growing End Markets:* We see a very strong growing end market for their products due to the following dynamics: U.S. and international oil rig activity and horizontal drilling trends equate to more parts needed, tar sands require a lot more infrastructure, the build out of LNG facilities and the current age of existing infrastructure.
- *Mispricing*: Spinoffs are often misunderstood as institutional holders with defined market cap mandates and index funds with set constituents are required to sell off the position that they inherited. As more coverage and knowledge of a newly independent business is understood, it can provide an inflection point of revaluation of the enterprise.

Firm Updates:

- *Summer Internships*: We welcome James Crockett, Patrick Hendrickson and we welcome back Olivia Cabral as part of our summer internship program. Jimmy is completing his MBA at Boston College. Patrick is an undergraduate at Bryant University and Olivia is an undergraduate at the University of Virginia.

We look forward to meeting and talking with you soon. We greatly value your support and trust.

> *If anyone can refute me – show me I'm making a mistake or looking at things from the wrong perspective I'll gladly change.* ***It's the truth I'm after,*** *and the truth never harmed anyone. What harms us is to persist in self-deceit and ignorance. (6.21)*

Marcus Aurelius
Meditations – A.D. 121 – 180
(Translated by Gregory Hays)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder

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Appendix: *The Horse in Motion and The Anatomy of Time*

In the spring of 1838, photography pioneer Louis Daguerre captured the first human to ever be photographed on the Boulevard du Temple in Paris. While the boulevard that morning was bustling with horse carriages and people going about their business, they are obscured in Daguerre's image as the earliest photography required ten plus minute exposure times, so any movement was lost in a blur. That day, the only motionless beings were a bootblack and his customer having his shoe shined, both of whom just happened to be stilled for the exposure.

Years later, Eadweard Muybridge would awe the world when he was able to inadvertently stop time in his motion studies and for the first time suspend motion. **I find these contrasting early images of motion blurred and motion stopped to be a useful reminder of where greatness is lost and where greatness is found.** The ability to still time, infinite presence, everything slows, the owner and his horse, the annihilation of the fourth dimension. Athletes, scientists, and philosophers eternally explore this place of infinite potential. *Zen*, *Logos*, *Zone* and *Flow* are all names attempting to label the ineffable. A place of limitless creativity and unity with the whole. A place where nothing remains unconnected. The illustration above is a narrative on the anatomy of time – time stolen – time stilled – chronicled through *the horse in motion*.

If you've seen the present then you've seen everything – as it's been since the beginning, as it will be forever. The same substance, the same form. All of it. (6.37)

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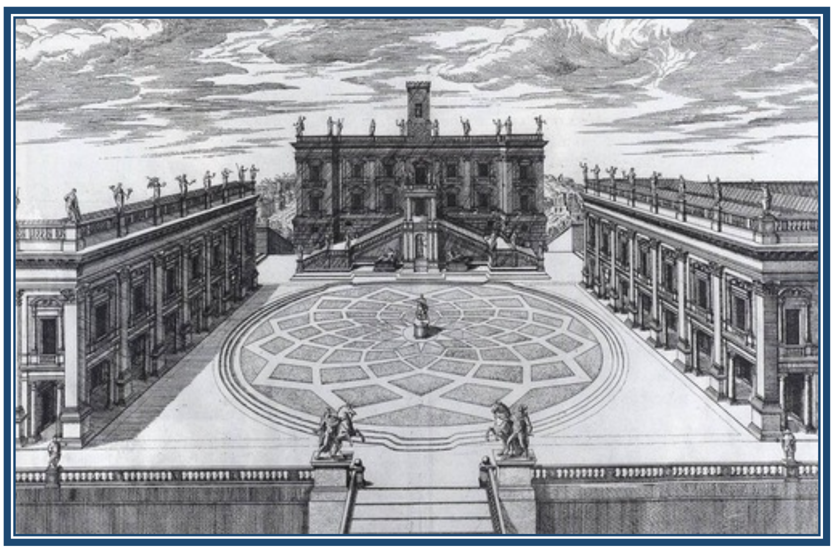
In homage to Marcus Aurelius – chase the timeless present with every dendrite of your being. Just not justified. Merit begets merit – be deserving. Extraordinary outcomes are not the result of extraordinary intelligence but extraordinary curiosity – stay with problems longer than most. Be a diligent student. Unsuspended motion – soar. No matter what anyone says or does, my task is to be blue, not picasso-blue but kandinsky-blue, the eternal blue of the ocean, sapphire, my color undiminished. Time is your match. **In the maelstrom of motion – be still.**

> *I saw him for the last time a few years ago, on a wet winter night, in the company of a stray Dalmatian. I was returning by taxi to my hotel after one of the most disastrous evenings in my entire life. The next morning I was leaving Rome for the States. ... The traffic moved with the speed one wishes for one's funeral. At the foot of the Capitol I asked the driver to stop, paid, and got out of the car. . . . Presently I discovered I was not alone: a middle-sized Dalmatian appeared out of nowhere and quietly sat down a couple of feet away. Its sudden presence was so oddly comforting that momentarily I felt like offering it one of my cigarettes . . . For a while we both stared at the horseman's statue . . . . And suddenly – presumably because of the rain and the rhythmic pattern of Michelangelo's pilasters and arches – all got blurred, and against that blur, the shining statue, devoid of any geometry, seemed to be moving. Not at great speed, and not out of his place, but enough for the Dalmatian to leave my side and follow the bronze progress.*

Joseph Brodsky, *Homage to Marcus Aurelius* – 1995



Michelangelo Design of *Capitoline Hill*, Rome
Etching by Etienne Dupérac – 1568

The Horse in Motion Artwork credit – Artist Camille Vicente[3]

[3] The illustration includes the following objects of art and curiosity in order as they appear in the 12 sections of the grid: grid 2, 4, 7, 12 – Eadweard Muybridge *The Horse in Motion* – Abe Edgington – Trotter –- 1878, grid 1 – the Statue of Marcus Aurelius – Capitoline Hill Rome – original now in Senatorial Building to the right of the replica in the piazza – 175 CE, grid 3 – *The Just Judges* panel (panel stolen 1934 and remains missing) from *The Ghent Altar Piece* – Jan van Eyck – Ghent, Belgium –- 1430, grid 5 – photograph by Louis Daguerre on the *Boulevard du Temple* – Paris, France - 1838, grid 6 – *Frightened Horse by a Storm* by Delacroix - 1824, grid 8 – *Horse* by Van Gogh (his only horse artwork) - 1886, grid 9 - *Horse* by Duchamp - 1914, grid 11 – *Tower of Blue Horses* by Franz Marc – 1913 (stolen 1945 and remains missing).

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2014 3rd QUARTER LETTER

The clearest way into the Universe is through a forest wilderness.

John Muir (1838 – 1914)
The Unpublished Journals of John Muir – 1938

The redwoods, once seen, leave a mark or create a vision that stays with you always. No one has ever successfully painted or photographed a redwood tree. The feeling they produce is not transferable. From them comes silence and awe. It's not only their unbelievable stature, nor the color, which seems to shift and vary under your eyes, no, they are not like any trees we know, they are ambassadors from another time.

John Steinbeck (1902 – 1968)
Travels with Charlie – 1962

Let us cultivate our garden [grove].

Voltaire (1694 – 1778)
Candide: or, The Optimist – 1762

This is their temple, vaulted high,
And here we pause with reverent eye,
With silent tongue and awe-struck soul;
For here we sense life's proper goal.
To be like these, straight, true and fine,
To make our world, like theirs, a shrine;
Sink down, O traveler, on your knees,
God stands before you in these trees.

Joseph B. Strauss (1870 – 1938)
The Redwoods

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To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO and Chief Investment Officer

Date: November 10, 2014

Re: Third Quarter 2014 Update – **Grove of Titans**

In our third quarter letter you will find our portfolio update and general market observations. Each quarter we highlight one component of our investment process. This quarter, in the section titled *Grove of Titans*, I will discuss the attributes of what we think constitutes an *enduring* business. As is our standard practice, client reporting, including performance and positioning, has been sent under separate cover.

Market Summary[1]

	S&P 500	**MSCI AC World Index**	**MSCI Emerging Markets**	**MSCI EAFE Index**	**Barclays Aggregate Bond Index**	**Gold – $/Troy Oz.**	**Crude Oil**
Price 09/30/14	1,972.29	416.85	1,005.33	1,846.08	1,881.11	1,208.16	91.16
Q3 2014	1.13%	-2.16%	-3.38%	-5.74%	0.17%	-8.98%	-13.49%
YTD	8.34%	4.22%	2.56%	-0.79%	4.10%	0.21%	-7.38%
2013	32.38%	23.53%	-2.34%	23.57%	-2.02%	-28.04%	7.19%

Over the past two months, volatility has returned to the equity markets. A six-year recovery of equity prices has many investors questioning the viability of an appreciating stock market. Projecting market expectations through a rearview mirror is a limiting strategy. Instead, we think harnessing business specific valuation and margin of safety tools are the only forward looking methods that deserve merit. In these terms, we believe our portfolio of quality businesses at today's valuations is an attractive and intelligent place to allocate capital.

Loss aversion is a deeply embedded human trait; thus it's only normal to feel uncomfortable when market prices move lower. While volatility can cause uneasiness, we feel that it often creates the possibility for improved expected returns by increasing per share ownership through direct purchases and company share buybacks. We think short-term volatility should often be viewed as an opportunity to the long-term investor who seeks enduring businesses at reasonable prices.

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[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, the MSCI Europe Asia Far East Index (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices. Past performance does not guarantee future results. The discussions in this letter are for information purposes only. Please consult with your investment advisor before making any investment decisions. For complete disclosures about East Coast Asset Management LLC visit our website or consult our Form ADV and Form ADV Part 2A.

Price and value are two contrasting sides of the same coin. The *value* of any investment is simply the present value of all future cash flows. News and related media spawn noise that create an environment where *price* overshoots *value* and they become disconnected, crisscrossing each other along a trajectory. The increasingly short-term nature of investors only serves to bolster our belief that employing a long-term business approach is a winning strategy through time.

Dialectical Materialism – The Unified Theory of Reasoning:

The quest for a theory explaining how the universe works has captured the imaginations of some the world's most enlightened thinkers. Einstein spent the final thirty years of his life attempting to find a grand unifying principle that would explain the universe both theoretically and mathematically.

In absence of a mathematical principle that unifies the laws of the universe, I do believe there exists a theoretical unifying principle that – when applied to certain questions – can produce an answer that aligns with how things work. This principle is called Dialectical Materialism or Dialectics for short. Dialectics is a method of reasoning that I interpret to have three foundational insights:

1. **Cycle of Life**: Everything is either coming into existence or fading out of existence. As early as 99BC, Lucretius captured this idea in these words, *"Nature repairs one thing from another and allows nothing to be born without the aid of another's death."* In the forest ecosystem, the forest floor recycles the fallen organic matter of trees to produce new growth. In business, lack of continuous evolution in light of the reality of change, bureaucracy, size and misaligned interests create an environment where disruptive entrants recycle the fallen business's organic matter to produce new, emerging businesses. Dialectics reveals the transitory character of everything and the uninterrupted process of becoming and of passing away. Human nature causes us to see things in their static *form* versus the reality of all things being in motion.

   Thus, the sum of things is ever being reviewed, and mortals live dependent one upon another. Some nations increase, others diminish, and in a short space the generations of living creatures are changed and like runners pass on the torch of life.

   Lucretius – (99BC – 55BC)

2. **Form versus Essence**: Dialectics employs understanding something via its essence, not just a fixed definition, or form. For ordinary understanding there is no difference between the appearance of a thing and its essence, but for dialectics the *form* and *essence* of something can be quite contradictory. I believe this to be one of the most important competitive advantages of reason. In investing for example, most market participants are keenly focused on the *form* of price and are too often ignorant of the *essence* of intrinsic value.

   The role of the artist, like that of the scholar, consists of seizing current truths often repeated to him, but which will take on new meaning for him … when he has grasped their deepest significance. If aviators had to explain to us the research which led to their leaving earth and rising in the air, they would merely confirm very elementary principles of physics neglected by less successful inventors.

   Henri Matisse (1869 – 1954)

3. **Unity of Opposites**: Dialectics is the reflection of the *motion* of reality and how opposites assert themselves in nature. It is by the continual conflict of opposites and their final passage into one another – or into higher forms – that determines the cycle of life and the nature of how things are. Seeing things from the perspective of "form" forces one to compartmentalize and categorize with a label. Dialectics seeks to see things holistically and, through seeing the whole, one can see that in reality one opposition gives way to its contrary. The essence of everything can be found in its binary nature where the principle of opposing forces, or *reciprocity*, is one of the most powerful fundamental laws of the universe. **This is why *inverting* vexing questions to arrive at workable answers can be so effective.**

> *If you are acquainted with the principal, what do you care for a myriad of instances and applications?*
>
> Henry David Thoreau (1817 – 1862)

Reasoning by Invariant Strategies:

I recently invited Peter D. Kaufman, CEO of Glenair, Board Member of the Daily Journal, and Editor of *Poor Charlie's Almanac*, to come speak to the Security Analysis class I teach at Columbia Business School. Peter Kaufman is an exceptional business operator and is also one of the great multidisciplinary thinkers of our time. On the topic of multidisciplinary learning and rational decision-making, Peter shared the approach he uses, which he refers to as his "three-bucket" framework, to arrive at universal principles that have high utility. Peter shared:

> *Every statistician knows that a large, relevant sample size is their best friend. What are the three largest, most relevant sample sizes for identifying universal principals? Bucket number one is inorganic systems, which are 13.7 billion years in size. It's all the laws of math and physics, the entire physical universe. Bucket number two is organic systems, 3.5 billion years of biology on Earth. And bucket number three is human history, you can pick your own number, I picked 20,000 years of recorded human behavior. Those are the three largest sample sizes we can access and the most relevant.*

Peter then walked the class through how *compounding* and the law of *reciprocity* can be applied to these data sets and therefore applied to reason. A light immediately went on. Applying questions to these three large data sets simplified and strengthened how I was organizing and applying mental models. Kaufman's approach provides a framework of general laws that have **stood the test of time** – invariant, unchanging lenses that we can use to focus and arrive at workable answers. A multidisciplinary framework helps shift the human paradigm to one of an empathetic perspective, as if we were looking from the outside in. Just as I began this letter with the three foundational insights of Dialectical Materialism, we want to be constantly searching for these types of *invariant* strategies that can serve us in rational decision-making.

> *Everything about which I thought or read was made to bear directly upon what I had seen and was likely to see. I feel sure it was this training, which has enabled me to do whatever I have done in science. My mind seems to have become a kind of machine for grinding general laws out of large collections of facts.*
>
> Charles Darwin (1809 – 1882)

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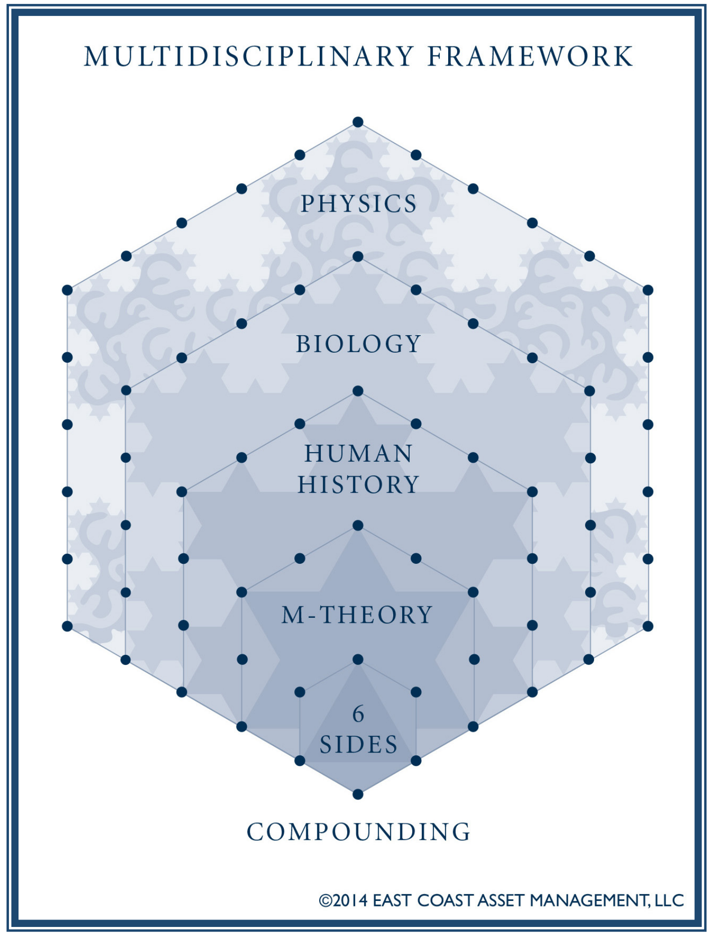
Peter Kaufman shared a quote by Joseph Tussman on the importance of aligning with general principles – *"What the pupil must learn, if he learns anything at all, is that the world will do most of the work for you, provided you cooperate with it by identifying how it really works and aligning with those realities. If we do not let the world teach us, it teaches us a lesson."* A foundational principle that aligns with the world and is applicable across the geological time scale of human, organic, and inorganic history is *compounding*. Compounding is one of the most powerful forces in the universe. **In fact it is the only power law that exists with a variable in its exponent.** The power law of compounding cannot only be applied to investing but it can even, and more importantly, be applied to continued learning. Compounding knowledge through a multidisciplinary framework is an individual's greatest *enduring* advantage.



The illustration to the right outlines how I have applied this framework of reasoning. Readers of our quarterly letters will recognize that the first two hexagons are the two lenses every investment is taken through – the lens of the business (Six Sides of Great) and the lens of the investment (M-Theory). The final three hexagons, or lenses, as described above, observe a thesis's alignment with the invariant strategies that we can curate from human, biological, and physical history. In this letter I will put this framework into practice as we apply the question of business endurance to biology – Coastal Redwoods.

The illustration for this framework is based on the sixth hexagonal number, 66. When a hexagonal number is plotted, it creates this cornered hexagon geometry – the sixth hexagonal number creates five hexagons born from a single point. The single point represents general laws and foundational principles.

> *66 is the path of a people in flight, refugees from dust and shrinking land, from the thunder of tractors and shrinking ownership, from the desert's slow northward invasion, from the twisting winds that howl up out of Texas, from the floods that bring no richness to the land and steal what little richness is there. From all of these the people are in flight, and they come into 66 from the tributary side roads [of compartmentalized knowledge), from the wagon tracks and the rutted country roads [of ingrained thinking]. 66 is the mother road, the road of flight.*

John Steinbeck (1902 – 1968)
Grapes of Wrath

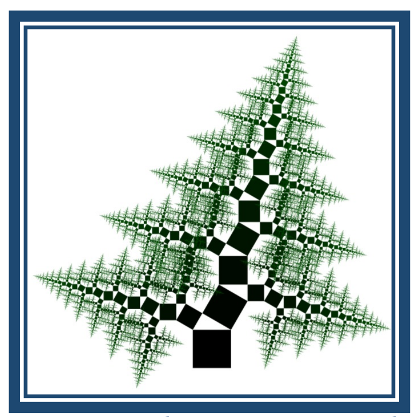
Seeing the Forest and the Trees:

One of the most limiting biases for individuals attempting to make sense of complex systems is that they are a part of the systems. When you are part of the system it becomes increasingly difficult to **see the forest for the trees.** Each individual tree's uniqueness and complexity can lead to confusion and ambiguity. The key is to attempt to step outside of the system and see the forest and trees for the *essence* of what they are. How can we find these groves or *islands of simplicity* in an infinitely complex world?

Jason Zweig of the *Wall Street Journal* asked Charlie Munger to describe a key attribute of Berkshire Hathaway's evolution over the years. His response: *"There isn't one novel thought in all of how Berkshire is run. It's all about what [Mr. Munger's friend] Peter [Kaufman] calls 'exploiting unrecognized simplicities."* Peter Kaufman was sitting with Charlie during this interview after the recent Daily Journal annual meeting. The entire quote that Charlie was referencing was one that Peter attributes to a 28 year old writer for *Sports Illustrated* named Andy Benoit, who wrote these words to describe the essence of a particular quarterback's genius: *"Most geniuses—especially those who lead others—prosper not by deconstructing intricate complexities but by exploiting unrecognized simplicities."* This quote captures the essence of genius and can serve as a roadmap to the *Grove of Titans*.

Finding unrecognized simplicities requires one to step outside the forest, outside of the human system to see and measure holistically without biases. I've found geometry to be the most effective way to think about and measure an infinitely complex world – a world one can simplify and illuminate with two geometric tools: Euclidean and Fractal.

> *To appreciate the nature of fractals, recall Galileo's splendid 1632 manifesto: [Philosophy] is written in the language of mathematics, and its characters are triangles, circles, and other geometric figures, without which … one is wandering about in a dark labyrinth. Observe that circles, ellipses, and parabolas are very smooth shapes and that a triangle has a small number of points of irregularity. These shapes were my love when I was a young man, but are very rare in the wild. Galileo was absolutely right to assert that in science those shapes are necessary. But they have turned out not to be sufficient, "merely" because most of the world is of great roughness and infinite complexity. However, the infinite sea of complexity includes two islands of simplicity: one of Euclidean simplicity and a second of relative simplicity in which roughness is present but is the same at all scales.*
>
> Benoit B. Mandelbrot (1924 – 2010) – *The Fractalist*



Pythagorean Tree - Fractal

Decision-making that arrives from Euclidian thought can be solved using simple tools, as if we were measuring a circle, triangle or square. These simplicities are often hiding in plain sight but, while the answers can be quite obvious, they may not seem that way to participants within the system. In our system of investing, the failure to recognize what is hiding in plain sight is often due to neglect, fear or lack of focus, and often leads to a mispricing. A rich area of Euclidean sourcing is when we find a business with high returns on tangible assets, with a sustainable competitive "moat," trading at a reasonable price due to the market's lack of focus on the business's economics. These mispricings are often time horizon mismatches between a short-term consensus and a longer-term view. In our opinion, Euclidean decision-making is preferred. **However, in the world of investing, mispricings tend to look more fractal in the wild.**

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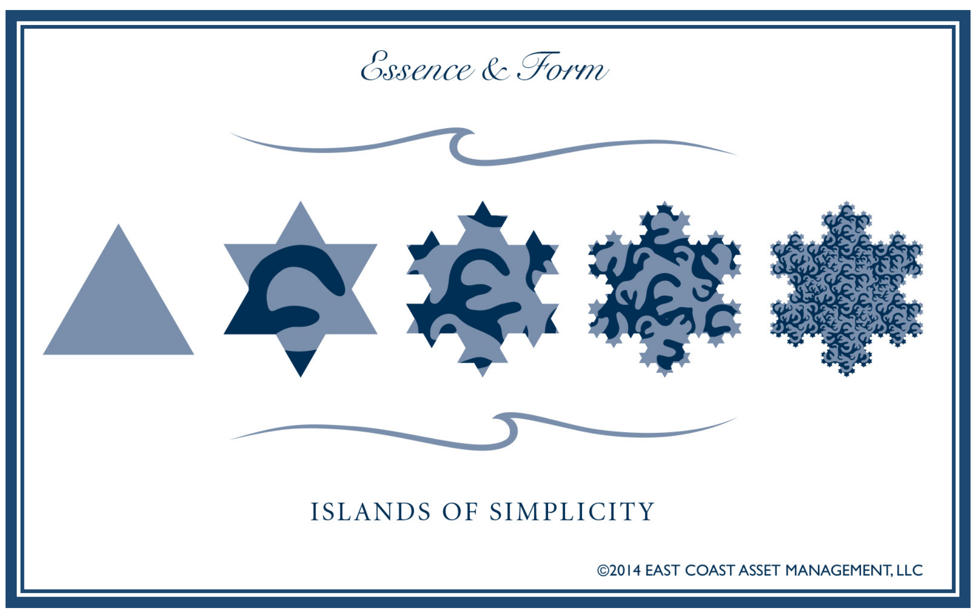
Fractal Geometry is the ability to measure roughness and complex patterns that repeat in nature. Benoit Mandelbrot coined this term and this type of physics helped make sense of the rest of the world, which appeared infinitely complex and immeasurable. Mandelbrot and other Fractalists came to the conclusion that they could, for example, mathematically measure the roughness and complexity of the bark of a redwood tree, a cloud, or the irregular geography of a coastline. What the Fractalists further concluded was that there was *self-similarity* within some of these patterns of roughness that could be measured. **To multidisciplinary decision-makers trying to make sense of complex systems, this is an effective way to think about perceiving simplicities when the questions or problems are optically rough or obscured.** When we view certain complexities, at a proper perspective, what we find is a beautiful pattern of repeating self-similarity. A few great value investors are quite skilled at recognizing these patterns and have a process for sourcing these self-similar fractals. Once someone points them out they seem so obvious, but for most participants they hide in plain sight, "fractally" camouflaged.

Examples of where we find self-similar fractal patterns are in companies that are transforming (systemic, separations, and secular), businesses or industries that have a short-term cloud over them that obscures truths, and/or situations where there is a large constituency of shareholders selling for uneconomic reasons. In both Euclidean and Fractal terms we are looking for situations that are *misunderstood* and where there is an *unrecognized simplicity* hiding in plain sight.

In the illustration[2] to the right I have demonstrated (using simple successive rules) the evolution from an equilateral Euclidian triangle toward Fractal geometry. We progressively arrive at the Koch Snowflake, which is an interesting fractal shape because we can continue our simple successive rule (of dividing each side of a triangle in three parts and bumping out the middle) into infinity. The shape and area of the hexagon remain the same, yet the perimeter is infinite. **This expresses the universal idea that within a bounded system (niche or circle/hexagon of confidence) we can produce boundless outcomes. Infinite wonders leap from persistent, incremental progress eternally repeated.**



[2] You will also note that the interior of our hexagons shows another simple rule repeated. Applied are the iterations of a plane-filling curve (Peano) to show how knowledge can compound and be plane filling with a domain (hexagon) of confidence. The plane filling shape begins with the stylized *E* and its *unity of opposites* – denoting *essence*, *everlasting*, and *eternal* and fills the plane through simple rules repeated without end.

Artist Credit: Camille O. Vicente

Grove of Titans –
Coastal Redwoods as a Model of the
Enduring Business:

The *Grove of Titans* is home to the largest ecosystem of redwood trees that has been discovered to date. Long hidden in plain sight off a popular hiking trail in Jedediah Smith Redwoods State Park, the Grove boasts the Lost Monarch, the largest coastal redwood on earth. The Lost Monarch and the nine other Titans that surround her have stood and observed nearly two thousand years of geological time: the rise and fall of Rome, the discovery of America, two World Wars, industrial and technological revolutions and the growth of the population on Earth from 200 million to 7 billion. The Grove of Titans was discovered in 1998 by explorers Dr. Steve Sillett and Michael Taylor. A handful of others have found the Grove since then, but none have revealed its location, even though hikers walk by it every day. The hikers are unable to see the *Grove of Titans* for the density of the trees before them.

The Coastal Redwood tree is not only the tallest living organism on the planet but, as a forest, it is the oldest living ecosystem on Earth. Some of the Coastal Redwood trees have been around since Lucretius wrote *On the Nature of Things* in 99 BC. What is it about the *nature of things* that endow the Coastal Redwood with near immortality that we can apply to recognizable traits that would *sustain* greatness in businesses? And for business operators, what traits can we borrow to cultivate our businesses from a garden of greatness to a *Grove of Titans*?

A tree can be thought of as in the business of selling oxygen. For a tree to produce oxygen there is a simple formula that a tree engages in with nature's counterparties, called photosynthesis. A tree needs six molecules of carbon dioxide (CO_2 = cost of goods sold) and six molecules of water (H_2O = salaries and operating expenses). It, then engages in a transaction with the light energy of the sun (photosynthesis = a customer order), which then produces six molecules of oxygen (O_2 = the final product for delivery) and sugar ($C_6H_{12}O_6$ = profits). The sugar, or profits, is stored as cellulose, which is what allows the tree to grow (mass = intrinsic value).

While all trees have the capability to produce oxygen, only one tree has unlocked the capability to grow to rarified heights, grow more mass than any living organism on the planet and sustain life for thousands of years. Using the Coastal Redwood as a model, I have compiled six lessons from this monarch of biology that align with what allows a great business to be truly everlasting.

<u>I. Culture – Hexaploidal DNA of the Organization</u>

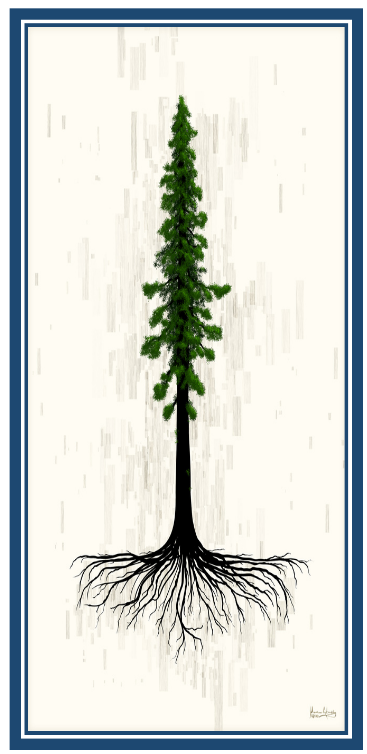
Just as all trees produce oxygen, a business's product differentiation is not an enduring moat. If the differentiation has any merit, it will eventually be *copied* and advantages will soon be frittered away. Xerox, Kodak, BlackBerry and countless other businesses once held product dominance and fell to this fate. **The only moat that is not fleeting, and conversely the only moat that is truly enduring, is *culture*.**

And they asked me how I did it; and I gave 'em the Scripture text,
"You keep your light so shining a little in front o' the next!"
They copied all they could follow, but they couldn't copy my mind,
And I left 'em sweating and stealing a year and a half behind.

Rudyard Kipling (1865 – 1936)
Excerpt from *The Mary Gloster*

Evolutionary biologists attribute the DNA[3] (hexaploidal – sets of six totaling 66) of the Coastal Redwood as the phylogenetic competitive advantage that drives its ability to endure through time, as it has an exponential amount of genetic coding to adapt to an ever-changing ecosystem to evolve and survive.

The culture, or DNA, of any organization is defined by the unique manner in which it adapts to change, which can be measured by how effectively the business works with its constituent counterparties. When viewing the business from an external perspective, I believe there are six key counterparties that every business is responsible for: suppliers, customers, employees, owners, stewards and society. Collectively these six counterparties makes up the organization's ecosystem. An enduring business must be *hexaploidal* with its counterparties, meaning it must create a win-win relationship with each counterparty over time. Business endurance is sum multiplicative – if a business scores a zero with any one of its counterparties over time, it introduces a disease that will eventually limit its growth and its likelihood of survival.



1. Employees – *The Leaves*: Enduring businesses honor their employees in exceptional, authentic ways. The leaves of the tree perform the most important function. They accomplish interacting with all of the tree's counterparties and this is vital. Nature honors this function by giving them the greatest glory of beauty, height, color and stature. **Enduring businesses turn the organizational chart upside down – *invert always invert.*** Everlasting businesses know that the environment of trust and loyalty they engender with employees is of supreme importance.

2. Suppliers – *The Roots*: Enduring businesses think about their suppliers as partners. The Coastal Redwood's ability to grow to heights higher than the Statue of Liberty is directly related to its strong, collaborative foundation in its roots. A Coastal Redwood's roots provide the important function of foundational strength and feeding the tree with its critical needs of nutrients to survive and prosper. A winning relationship with suppliers is one of the most overlooked areas for business sustainability. Most businesses nickel and dime their suppliers to extract short-term profits. Enduring businesses know that their supplier base is truly the base of the organization's strength. In some Titans I have studied, a few suppliers feel so well respected and valued by the *enduring* business that they are content to have them as their only customer. Mutual collaboration and trust create a leaping emergent effect.

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[3] The current working hypothesis of evolutionary biologists is that the Coastal Redwood genus (*Sequoia Sempervirens* – Everlasting Redwood) emerged in the Jurassic period when two existing species, the Sequoia and Dawn Redwood, hybridized and created a new species. This branch off in the *tree of life* is even more unique as both of these ancestor species, like humans and most conifers, have sets of two chromosomes in their DNA (46 in humans). The leaping emergent effect when the Coastal Redwood hybridized is that the species became polyploidal – more than sets of two. In fact the Coastal Redwood became *hexaploidal* – sets of six chromosomes that total 66.

3. Stewards – *The Trunk of the Tree*: The leaders of enduring businesses are not just effective operators and intelligent capital allocators, but they think of themselves as stewards of the enduring enterprise. **They want to leave the business in better shape for the leadership that follows.** The trunk of the tree has an important job as it sets the tone of the whole tree – controlling the speed at which water and nutrients must be transported, employing resources to fight disease, and allocating resources into cellulose to foster growth. The trunk of the Coastal Redwood operates the essential long pipes, the xylem, between our aforementioned counterparties of suppliers and employees.

   Stewards of enduring businesses operate the businesses to last through time. They do this by persistent incremental progress repeated without end, continual improvement of processes and systems and by persistent innovation through research and development, sowing seeds for the future. These investments may be at the expense of short-term profits for a longer-term reward. If they starve the future of these nutrients the organizations will not endure. Wall Street celebrates when companies eke out small incremental profits at the expense of investments in marketing and research and development. Thus many business leaders are easily persuaded and motivated to ignore this critical counterparty.[4]

4. Customers – *The Light*: The Coastal Redwood's DNA, or *culture of excellence,* figured out something quite important in its evolution. Trees need to synthesize sugar from sunlight to survive and thrive, so they genetically modified themselves to assure unequaled access to this source by growing higher than any other species on Earth. In our model of what makes an enduring business, this is quite fitting as the businesses that can altruistically grow closest to the customer's needs and desires are the ones that will deserve unequaled access to their demand. All of us can look back as consumers where we felt completely served by a business because they listened to our needs and wants humanely and delivered a product or service that surpassed our expectations.

   The light [customer] is a messenger, carrying a story about the form [essence] of the object [objective].

   William L. Bragg
   1915 Nobel Prize for invention of X-ray Crystallography[5]

5. Owners – *The Mass of the Tree*: The Coastal Redwood astutely takes its excess profits or sugars and reinvests, creating cellulose that gives these Titans their extraordinary mass – height and width. Enduring businesses take great care in how they allocate the resources of the business to grow the per share value proportionally to all owners. Great businesses often grow intrinsic value at exceptional rates as they gain a larger percentage of the revenues of their market by organic growth. Last quarter, I wrote about the importance of an owner mindset in the letter *Horse in Motion*.

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[4] An enduring business culture with stewards in place asks the question: "What is the one thing our competitors do not want us to do?" And answer consistently with – "Let's do that!" Berkshire Hathaway's Geico Insurance is a prime example. If you are in a region where they operate, look at how they blanket every billboard and advertisement opportunity for the benefit of long-term gain. How many public insurance companies would spend nearly all of their earnings to gain a very large reward for the future leaders and owners of their business? That is why Titans are a rare breed, breathing rarified air.

[5] X-ray crystallography has been associated with twenty-nine Nobel Prizes including the discovery of the double helix structure of DNA. Many of these discoveries were harnessed by the culture of the Cavendish Laboratory – a model of what it takes to build an enduring enterprise.

6. Society – The *External Ecosystem*: If you were to ascend the canopy of a Coastal Redwood, you would find a unique ecosystem where the Marbled Murrelet, the Northern Spotted Owl, and countless other species who make their homes only in these old growth forests. Coastal Redwoods are also one of the greatest consumers of the excessive *carbon* we create on our planet. Any business is only allowed to endure because it is sum additive to both the community and the environment – collectively its external ecosystem. Lose-win, win-lose, and lose-lose systems with the community and the environment are models destined for failure. Great enduring businesses celebrate and share their success with society and society will then honor and celebrate what fruits they enjoy from their success. **The general law of *reciprocity* in practice.**

II. Thrive on Adversity – *Fires and Floods*:

Earlier in this letter I shared the model of dialectical materialism as a living reality of life. Everything is either coming in or fading out of existence. Every one hundred years a flood or fire has been the bane of existence for trees through time; complete forests are wiped out and growth begins anew. The hexaploidal survival instincts embedded in the DNA of Coastal Redwoods is keen to this truth and has adapted to not just resist dialectal materialism's greatest weapon, but to thrive through it; the most remarkable characteristic of this species is how their bark evolved to grow very thick and fire resistant. When the fires come to the forest through natural or human means, scientists have shown that the species is not only unharmed, but the fire clears the forest floor of competing species and these Titans gain more share of the forest. The same event occurs during floods, as their root structure is highly resistant to the rot and disease that can infect most other species.

Organizations that endure look at time scales that are beyond immediate. They look at the fire and flood time scales and not only anticipate and prepare for these circumstances, but they also welcome this reality. They are keenly aware of the downside of financial, operational and reputational leverage. Prepared for flood and fire, it is in the inevitable economic cycles, similar to the one we experienced in 2008, that they thrive. In these periods, enduring businesses reinforce partnerships with suppliers by helping them. They reinforce trust with employees by resisting lay offs, even it if means short-term profit impairment. In fact, most enduring businesses go into the marketplace and look for great talent to add to their team. They lead through example to the benefit of society.

III. Seams and Edges – *Fog – Where there is mystery there is margin*:

The Coastal Redwood does not thrive in every environment and location. The Coastal Redwoods occupy a narrow strip of land approximately 470 miles in length and between 5 - 47 miles in width along the Pacific coast of North America. They usually grow in the mountains where there is significant precipitation in the form of *fog* from the nearby ocean. Coalescence of coastal fog accounts for a considerable part of the trees' water needs.

Great businesses become great because they occupy a niche that they can serve over a long period of time, operating with care and doing such an exceptional job that they gain a larger and larger share of that niche. Competitors will exit or fail because the towering, altruistic Titan above starves them of the light of the customer. This niche is often in an area at the seams and edges of big competitive markets for goods and services. The Titans dominate this niche where they can earn extraordinary profits because the customer is willing to pay a fair price for an exceptional product. These niches are often obscured in a fog of mystery because a few businesses dominate the domain, or to compete against entrenched players would be near impossible. One of the most important business sayings I have ever heard is fitting to describe these niche opportunities for operator and investor– "where there is mystery [fog], there is margin."

> *All services, professional as truly as other services, obey the law of supply and demand. There is always a large supply of poor work in all walks of life and for that sort of service a limited demand. There is always a small, a very limited supply of good workmanship and a correspondingly great demand for it. And it always commands high compensation and that, too, of various desirable kinds. Every step a man takes in capacity to work, and to do better work will bring him into a higher plane of action — a plane in which there will be fewer competitors, greater demand, and higher rewards. The life of such a man will be a pyramid, which rises higher step by step, with ever narrowing competition, until it reaches the summit of excellence, influence, and success, where a man stands at the head of his profession.*

Dr. Martin B. Anderson
Teacher/Mentor to Frederick Taylor Gates – University of Rochester
Chapters of My Life (1928) - Memoir of Frederick Taylor Gates
Trusted Advisor to John D. Rockefeller, Sr.

IV. Evolution – *Persistent Incremental Progress Eternally Repeated*:

Compounding, evolution, and human and business success are only made possible by persistent, incremental progress, repeated without end. The Coastal Redwood, with the help of an evolved cultural hexaploidal DNA, doggedly progresses incrementally every day, every year, some over the last two millennia. Always getting better, flood and fire prepared, quenched by drinking in the fog of uncertainty in the niche they dominate, leaning toward a shifting angle of the sun, growing deeper roots through evolving geology. The Coastal Redwood also importantly controls growth. Most trees grow too fast reaching for the sun. *Overreaching* is one of most common causes of death in trees as it creates an air pocket in the trees' pipes, xylem, which is why trees will often rot from the inside out.

Enduring businesses avoid this fate by employing resolute incremental growth. The stewards of these enduring businesses know that most business failures are the direct result of overreaching. Instead of incremental progress, they overreach in an effort to 'get theirs now.' Quite often, that unnecessary "extra" decays the organization from the inside out. If you study business failure, you can point to overreaching as the single biggest cause of dialectical materialism in business. We see it every day in the marketplace, in how management rewards themselves with options, and in how management teams follow inferior mergers and acquisitions strategies. How often do we see mergers and acquisitions work well in biology? It is a biologically flawed objective, so why should it work seamlessly in business? It is a short-cut strategy to produce growth that often creates that same embolism that will eventually rot the decent business as they try to merge contrasting DNAs. There are evolved business systems that can integrate mergers and acquisitions well, but they are outliers.

V. Limits and Enduring Societal Value – *Cathedral Rings and Fairy Rings*:

While Coastal Redwoods are nearly excluded from the saying that "trees do not grow to the sky," they are not immune from the laws of physics. Size and age eventually can prove limiting, even for redwoods. If you walk in the Grove of Titans, and in other redwood forests, you will notice that many of the large redwoods grow in circular rings. The rings are referred to as cathedral rings or fairy rings and are formed after a large Coastal Redwood has been felled and eventually dies. The immortal nature of the Coastal Redwood genus is that new growth will asexually spring from the old monarch's root system around the trunk of the decaying tree.

Enduring businesses often find it necessary, at times, to divide in order to thrive. John D. Rockefeller's Standard Oil Company is a living example of a cathedral ring in business. When the government found it necessary to break up Standard Oil in 1911, it created 33 "Baby Standards" that would evolve over time. Exxon Mobil, Chevron, and other sprouts born from Standard Oil represent the largest immortal case study on business that exists in human history. Chernow's biography, aptly titled *Titan*, is in my opinion the best biography ever written that documents the history of how Rockefeller conducted his affairs. Charlie Munger recently commented on John D. Rockefeller Sr. and *Titan* at the Daily Journal meeting.

> *Question: You mentioned recently that you enjoyed Ron Chernow's book on John D. Rockefeller, Sr.*
>
> *Munger: Oh, hugely. If any of you haven't read that book, you should read it. That's a wonderful biography. [Titan, by Ron Chernow] It shows how high grade that man was as a business partner. He may have been tough on competitors, but as a partner, he was one of the most admirable people who have ever lived. And as a philanthropist — you can actually chart what his philanthropy has accomplished — some of the most remarkable things in the whole history of philanthropy.*

What Titans of enduring businesses do with the wealth they create is of meaningful importance to society. Just as Standard Oil's cathedral ring thrives today, as Charlie references above, John Sr. created another ring of philanthropy that has not been equaled *yet* in human history. With the intelligent insight of his most trusted advisor Frederick T. Gates and his son John D. Rockefeller Jr., created a Fairy Ring[6] of philanthropies that have done unprecedented compounded good for

[6] A fitting memorial to the good works of John D. Rockefeller and the Rockefeller Family can be found artistically in the Union Church of Pocantico Hills. Just as the Grove of Titans has nine Coastal Redwoods surrounding the Lost Monarch, the Union Church has the last work of the master Henri Matisse, a stained-glass rose window surrounded by nine Marc Chagall stained-glass windows, which includes his masterpiece – *The Good Samaritan* in memory of John D. Rockefeller Jr.

society. Today we are witness to an equally unprecedented philanthropic force in the form and essence of The Gates Foundation, endowed by Bill and Melinda Gates and Warren Buffett.

VI. Freedom – *Organizations in Flight*:

The essence of everything eternal lies in its freedom. Freedom is written in the signature of all things. If we carefully ponder the physical universe, the biological, and human history, freedom is this untenable force in motion that is at the essence of which we see in form. The Coastal Redwoods seek freedom, which assures them unblocked access to sunlight.

If freedom is the *essence* to that which endures, how does one assure the *enduring* benefits that freedom bestows? My answer is that it can be found in *altruistic* meritocracy. The only path toward freedom is to rightly deserve. The best, most deserving product provides the freedom of price. The most enlightened win-win system with all counterparties assures the freedom to celebrate success. Altruistic meritocracy is not a business model of survival of the fittest but a model that looks to engender freedom by having a win-win relationship with all counterparties. The meritocracy that is most deserving of freedom over time in both business and in human history has three important attributes: deeply fluent literacy with the terrain in which it operates, delayed gratification instead of a focus on short-term reward, and an elevated purpose where life's reward is not finite, time stamped and compartmentalized, but rather holistic of a well-examined life. Liberty enlightening the world!

Firm Updates:

- *Research Analyst/Trader*: We welcome Daniel McQueen to East Coast in the role of Research Analyst and Trader. Dan recently graduated with honors from Bentley University. Dan was captain of the varsity golf team at Bentley and at the time of joining us he had a 'plus one' handicap. While we expect his handicap to increase, we have already seen the same work ethic and determination to succeed in his role at East Coast. We are lucky to have Dan on our team.

We look forward to meeting and talking with you soon. We greatly value your support and trust.

When we try to pick out anything by itself, we find it hitched to everything else in the Universe.

John Muir (1838 – 1914)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder

EAST COAST
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Autumn's Morning Light Through *La Rosace*
Photo Credit: Christopher M. Begg

Appendix: A Titan's Last Puzzle

In the last decade of his life, the artistic *Titan* Henri Matisse turned almost exclusively to cut paper as his medium and scissors his chief implement. He created what became known as "cut-outs." His "cut-outs" would be used in paintings, prints, tile murals, and stained-glass windows. The *Matisse Cut-Outs* exhibition just arrived this month at the Museum of Modern Art (MoMA) from the Tate Modern in London, where its summer exhibition set attendance records.

In 1954, Henry Matisse was commissioned by the Rockefeller Family to create a stained-glass rose window in memory of Abby Aldrich Rockefeller, the wife of John D. Rockefeller Jr., in the family's Union Church, Pocantico Hills, Tarrytown, New York. Abby Aldrich Rockefeller was a founding member of MoMA, and great admirer and collector of Matisse's art.

Matisse's final puzzle and last creation, known as *La Rosace*, began with a request to create an original stained-glass work within the restraints of the pre-existing framework – twenty-five lights that varied in size. This complexity perfectly suited the simplicity of Matisse's "cut-out" technique, the process he used to create the maquette for the window. Although Matisse was confined to a wheel chair, he still managed to find infinite freedoms through his work. "*When I am doing the cut-outs, you cannot imagine to what degree the sensation of flight which comes to me, helps me better to adjust my hand as it guides the path of my scissors.*" "Cut-outs" allowed Matisse to transcend the form of a painted outline with filled-in color and move directly to essence. *"Cutting into color reminds me of a sculptors direct carving."*

Due to his failing health, Matisse was unable to travel from France to New York to see the church. Instead, he was sent a full-sized architectural drawing of the framework, including time and light studies, which were hung in his studio bedroom. Henri Matisse solved this design in the final days of his life, as he died November 3rd, 1954, just days after writing to the family. Matisse reported that he "*had been able to complete, I think happily, ... the newness and the absorbing aspect of this work for me was to express myself in a well defined space, fragmented, and equally small as that contained in the woodwork of the rose window."*

I felt compelled to visit the Union Church at Pocantico Hills recently to see *La Rosace*. Through my visit, I learned that Nelson Rockefeller eventually decided to plant a *conifer tree* behind the church in front of Matisse's window. Rockefeller insisted on this in order to prevent the sun from shining too powerfully through the window, thus ensuring that it gave "the *kind of light* originally planned by Matisse." When the tree matured its branches could be seen swaying through the glass, adding a third dimension of motion to the window and casting beautiful shadows, an intersection between nature and art that Matisse might well have appreciated.

La Rosace is often overlooked in the Matisse canon due to the nature of the commission and the medium being *misunderstood*. In my opinion, it is Henri Matisse's most profound work of genius. *La Rosace*, like the Koch snowflake, expresses the universal idea that within a bounded area one can produce boundless outcomes. *La Rosace* portrays in its austerity how the natural light of persistent, incremental progress eternally repeated can produce infinite abundance and wonder. Matisse, through his artistic medium, searched for *essence*, *freedom*, and *simplicity* and from what he discovered earned *immortality*. Titans – ambassadors from another time.

EAST COAST

ASSET MANAGEMENT

2014 YEAR-END LETTER

“Let There Be Light.”

“The Gods Send Thread For The Web Begun.”

“Thine Own Reproach Alone Do Fear."

“All Is Well Since All Grows Better.”

Andrew Carnegie (1835 – 1919)
Carved into the walls of Carnegie’s personal library-study – New York City

For his bounty,
There was no winter in ’t, an autumn ’twas
That grew the more by reaping. His delights
Were dolphinlike; they showed his back above
The element they lived in. In his livery
Walked crowns and crownets. Realms and islands were
As plates dropped from his pocket.

William Shakespeare (1564 – 1616)
Anthony and Cleopatra

Ye see yon birkie ca'd a lord,
Wha struts, an' stares, an' a' that;
Tho' hundreds worship at his word,
He's but a coof for a' that.
For a' that, an' a' that,
His ribband, star, an' a' that,
The man o' independent mind
He looks an' laughs at a' that.

Then let us pray that come it may,
(As come it will for a' that,)
That Sense and Worth, o'er a' the earth,
Shall bear the gree, an' a' that.
For a' that, an' a' that,
It's comin yet for a' that
That man to man, the world o'er,
Shall brithers be for a' that.

Robert Burns (1759 – 1796)
A Man's A Man For A' That

EAST COAST
ASSET MANAGEMENT

To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO and Chief Investment Officer

Date: February 20, 2015

Re: Fourth Quarter 2014 Update – **"All Is Well Since All Grows Better"**

In our fourth quarter letter you will find our portfolio update and general market observations. Each quarter we highlight one component of our investment process. This quarter, in the section titled *All Is Well Since All Grows Better*, I will highlight twenty-four lessons I have learned from Andrew Carnegie. As is our standard practice, client reporting, including performance and positioning, has been sent under separate cover.

Market Summary[1]

	S&P 500	MSCI AC World Index	MSCI Emerging Markets	MSCI EAFE Index	Barclays Aggregate Bond Index	Gold – $/Troy Oz.	Crude Oil
Price 12/31/2014	2,058.90	417.12	956.31	1,774.89	1,914.87	1,184.86	53.27
Q4 2014	4.93%	0.55%	-4.55%	-3.45%	1.79%	-1.93%	-41.56%
2014	13.68%	4.80%	-1.94%	-4.20%	5.97%	-1.72%	-45.87%
2013	32.38%	23.53%	-2.34%	23.57%	-2.02%	-28.04%	7.19%

In 2014, U.S. equity markets were one of the few bright spots across global asset classes. The S&P 500 returned 13.7%, yet global indices fell well behind, with the MSCI All Country World Index registering a meager 4.8% return, the MSCI EAFE Index (a proxy for developed international markets) returning -4.2%, and the MSCI Emerging Market Index returning -1.9%.

Within U.S. Equity Markets, attractive returns on a sector basis also fell into a narrow range, with several Large Cap technology and healthcare stocks contributing to a large share of the attribution of the S&P 500's return. Oil prices falling from a 2014 high of $107, to a January 2015 low of $44, have weighed heavily on energy stocks and businesses where the perception of sustained lower oil prices could materially affect end market demand and therefore, earnings.

We feel we made measured progress last year on our goal of preserving and growing capital. In our opinion, the key to unlocking superior *long-term* compounded returns is to find a way to amplify returns without increasing risk. Any asset class or strategy can have its moment in the

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, the MSCI Europe Asia Far East Index (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices. Past performance does not guarantee future results. The discussions in this letter are for information purposes only. Please consult with your investment advisor before making any investment decisions. For complete disclosures about East Coast Asset Management LLC visit our website or consult our Form ADV and Form ADV Part 2A.

sun, yet as time passes we learn what risks were employed to achieve those periods of outperformance. We have always valued an approach that favors endurance. Toward this end we believe that a winning strategy is owning quality businesses that grow their intrinsic values over a long period of time, fueled by superior returns on assets employed, a protective moat against competitors and an enduring culture. Furthermore, we feel that owning businesses that will improve their advantages and market position when the inevitable tide ebbs gives us the margin of safety we require.

TO A LEMMING,
ON TURNING HER UP IN *NATURE'S RHYME*:

The lemming might be one of the most misunderstood creatures on our planet. There is a long propagated myth that the species commits mass suicide during migration by *instinctively* following its leaders to a certain death. Disney fueled this myth in the 1958 Academy Award winning documentary *White Wilderness,* which staged footage of a mass cliff-jumping migration. The same myth was used in the Apple Computer 1985 Super Bowl commercial "Lemmings" that showed businessmen marching off a cliff to their own demise to the Snow White song "Hi Ho."

Lemmings have been a popular metaphor for those that blindly follow popular opinion with disastrous consequences. In the world of investing, the much-maligned lemming can be equated to the naïve investor eternally walking off a market cliff.

While the lemmings' mass suicide is a myth, the population of lemmings is much like other species that exhibit periodic booms and busts. Lemmings are actually solitary creatures by nature, meeting to mate and then going their separate ways. When food is plentiful, they have a high reproductive rate and can breed rapidly, which leads to population "irruptions." These irruptions in turn increase the population of one of their main predators, the Snowy Owl. The female Snowy Owl will only breed if her food source is sufficient, often that food source consists of lemmings. The boom in the Snowy Owl population will then create a "bust" in the lemming population. This boom and bust behavior carries its effects across the ecosystem.[2]

We can summarize *subconscious* drivers of the sentient species on our planet into four categories[3]: self-preservation, hierarchy, territorialism and ritualism. The most powerful of these drivers is self-preservation. **All sentient creatures seek abundance and fear scarcity.** The fear of scarcity is the leading influence behind the behaviors of lemmings, Snowy Owls, and even humans as it is the unconscious evolutionary power that preserves and propagates the species. All sentient creatures have a core instinct to not just survive but *grow better*.

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[2] In New England we are currently enjoying the fruits of lemming irruptions. Snowy Owls are territorial, so mature adults will force the juvenile Snowy Owls south out of occupied territory. This is why over the last two years there are many Snowy Owl sightings on our fields and beaches, far south of their Arctic tundra breeding grounds. I have been corresponding with Norman Smith of the Mass Audubon who has helped relocate over one hundred Snowy Owls from the flight paths of Logan Airport in Boston.

[3] The categorization and understanding of the four core human instincts is attributable to Peter D. Kaufman, Editor of *Poor Charlie's Almanac* and CEO of Glenair, Inc.

The awareness of the *Law of Scarcity* can be of great utility to an investor. It can provide protection while also presenting an opportunity to seek an advantage based on the rhythmic behaviors of the collective *human* subconscious. The biggest mistake market participants make is to believe that the supply and demand of markets is driven by *rational* conscious behavior. Just like the lemming and the Snowy Owl, the *Law of Scarcity* has embedded traits that lead to *pricing* booms and busts.

Today, the production of oil and gas in areas where it was not previously viable has created a boom in oil supply. What typically follows a boom in production or supply is a corresponding change in price, which adjusts the supply to the realities of demand. This supply and demand interaction looks very irrational, just like the behavior of our lemmings and Snowy Owls. Today's oil prices are a case in point: ample supply of oil and gas driven from North American production, a temporary slowdown in emerging market demand and a strong dollar have helped push prices *off the cliff* from $120 to $44 a barrel. **While these price swings appear erratic, when viewed through the lens of history and biological reasoning, they are actually quite normal.** The clarity of hindsight shows that the price of any commodity tends to mean revert toward the marginal cost of production. This serves as its rhumb line just as lemmings and Snowy Owls will correct their own supply and demand through time.

The *Law of Scarcity* has existed for 3.5 billion years and will likely exist until the end of time. This invariant feature of complex systems can be harnessed to the investor's advantage if one can view it for what it is. **The investor and operator of a business who can patiently prepare for booms and busts, floods and ebbs, irruptions and panics, can make rational, opportunistic decisions when most are unprepared.**

There have been 47 economic recessions in the U.S. since 1790 and there will likely be an equal amount over the next two hundred years. The investor who operates off of flood time-tables, deeply fluent on the importance of having operational and financial flexibility, stands ready to not just survive but thrive in the next downturn. Many of the great fortunes that have been accumulated through time were often born from the preparedness and flexibility in dealing with the inevitable price dislocations that occur when tides ebb – Rockefeller, Carnegie, Frick, James J. Hill, Schlumberger, Vanderbilt, Munger and Buffett to name just a few.

The ploughman-poet Robert Burns reminds us, in his celebrated work *To A Mouse,* of the irrational behavior of our poor earth born companions. The "best laid schemes of mice and men" often go awry and can leave the unprepared with nothing but grief and pain in pursuit of promised joy. With elation of the irruptive up-cycle a long lost memory, the fellow mortal looks backward at those prospects drearily obscuring the present and a future that they cannot see, I suppose in fear.

Wee, sleekit, cow'rin, tim'rous beastie,
O, what a ***panic's*** *in thy breastie! ...*

I'm truly sorry man's dominion
Has broken Nature's social union,
An' justifies that ill opinion
Which makes thee startle
At me, thy poor, earth born companion
An' fellow mortal!. ...

But Mousie, thou art no thy lane,
In proving foresight may be vain:
The best-laid schemes o' mice an' men
Gang aft agley, [Go often awry]
An' lea'e us nought but grief an' pain,
For promis'd joy!

Still thou are blest, compared wi' me!
The present only toucheth thee:
But och! I backward cast my e'e,
On prospects drear!
An' forward, tho' I canna see,
I guess an' fear!

Robert Burns – (1759 – 1796)
To a Mouse, on Turning Her Up in Her Nest with the Plough

"All is Well Since All Grows Better" – Twenty-Four Lessons I Learned From Andrew Carnegie:

Andrew Carnegie was born in 1835 to a poor weaver. At the time of his death in 1919 he had built America's steel industry and amassed the largest store of wealth the world had known to that point. Prior to his death, Carnegie gave the majority of his wealth back to mankind by establishing various institutions and building 2,509 libraries. I feel Carnegie was not just heroic for his business acumen but also a worthy hero for how he understood and embraced humanity. An exceptional leader with a head as well as a heart and whose legacy will endure.

One of the first books I read when I began my professional life was *Think and Grow Rich* by Napoleon Hill. The title caught my attention, thinking that it might provide secrets to professional achievement. The book was based on interviews of Andrew Carnegie conducted by Napoleon Hill. At the time it was very much lost on me who Andrew Carnegie was and the experiences that led to his success. Like many other young, ambitious graduates, I was in a hurry, so a *furnished* list of proven techniques was very appealing.

The saying that "education is wasted on the young" rings quite true with my own experience. Too much of my early education, just like the way I approached Hill's *Think and Grow Rich*, was spent finding the fastest way to the finish line. **While I often found answers, they lacked a true understanding of the principles, the process and the illustrations of the practical experience that led to them.**

Since my initial reading of Napoleon Hill's book I have revisited the life of Andrew Carnegie. By reading biographies, his autobiography, personal correspondence, studying his heroes and his heroes' heroes, I truly began to appreciate the greatness of the business and philanthropic titan that was Carnegie. I have not encountered a greater collection of wisdom in any individual and I have since endeavored to commit his experiences to memory. For this year-end letter I wanted to share a number of those lessons that have been imprinted on my mind for the purpose of applying their utility when life rhymes. The quotes are all Andrew Carnegie's voice unless otherwise noted.

1. There *is* For Honest Poverty – *A Man's a Man for a' That:*

> *The hours hung heavily upon me and in the work itself I took no pleasure; but the cloud had a silver lining, as it gave me the feeling that I was doing something for my world—our family. I have made millions since, but none of those millions gave me such happiness as my first week's earnings. I was now a helper of the family, a breadwinner, and no longer a total charge upon my parents. …*
>
> *It is not the rich man's son that the young struggler for advancement has to fear in the race of life, nor his nephew, nor his cousin. Let him look out for the "dark horse" in the boy who begins by sweeping out the office.*

The desire to improve one's lot in life from that of modest beginnings toward independence has proved a winning advantage for many. This objective of freedom and ambition for oneself and for one's family, created America. How does one keep a team, a business, or a family motivated and maintain that burning desire which gives light to creativity, exponential productivity and economy? Team size (see Dunbar Rule[4]), evolved incentive systems and wealth distribution all need to be carefully and proactively crafted to benefit from *honest poverty*, or be sure the "dark horses" will stampede right by complacent indulgence. **"The honest man, tho' e'er sae poor, Is king o' men for a' that."**

2. Worthy of Pride and Promotion – *The Cotter's Saturday Night:*

> *The incident in my messenger life, which at once lifted me to the seventh heaven, occurred one Saturday evening when Colonel Glass was paying the boys their month's wages. We stood in a row before the counter, and Mr. Glass paid each one in turn. I was at the head and reached out my hand for the first eleven and a quarter dollars as they were pushed out by Mr. Glass. To my surprise he pushed them past me and paid the next boy. I thought it was a mistake, for I had heretofore been paid first, but it followed in turn with each of the other boys. My heart began to sink within me. Disgrace seemed coming. What had I done or not done? I was about to be told that there was no more work for me. I was to disgrace the family. That was the keenest pang of all. When all had been paid and the boys were gone, Mr. Glass took me behind the counter and said that I was worth more than the other boys, and he had resolved to pay me thirteen and a half dollars a month.*
>
> *My head swam; I doubted whether I had heard him correctly. He counted out the money. I don't know whether I thanked him; I don't believe I did. I took it and made one bound for the door and scarcely stopped until I got home. I remember distinctly running or rather bounding from end to end of the bridge across the Allegheny River—inside on the wagon track because the foot-walk was too narrow. It was Saturday night. I handed over to mother, who was the treasurer of the family, the eleven dollars and a quarter and said nothing about the remaining two dollars and a quarter in my pocket—worth more to me then than all the millions I have made since.*
>
> *On Sunday morning with Father, Mother and Tom at breakfast, I produced the extra two dollars and a quarter. The surprise was great and it took some moments for them to grasp the situation, but it soon dawned upon them.* ***Then Father's glance of loving pride and Mother's blazing eye soon wet with tears, told their feeling. It was their boy's first triumph and proof positive that he was worthy of promotion.*** *No subsequent success, or recognition of any kind, ever thrilled me as this did. I cannot even imagine one that could. Here was heaven upon earth. My whole world was moved to tears of joy.*

Seeking the pride of loved ones can amplify human achievement beyond the limiting objectives of one's self. This *altruistic* pride, free of rank and ego, is at the heart of many stories of human achievement. Holding oneself accountable to someone and something greater than oneself is one

[4] Dunbar Rule – Dunbar's number is a suggested cognitive limit to the number of people with whom one can maintain stable social relationships. "It is suggested that the number of neocortical neurons limits the organism's information-processing capacity and that this then limits the number of relationships that an individual can monitor simultaneously. When a group's size exceeds this limit, it becomes unstable and begins to fragment. This then places an upper limit on the size of groups which any given species can maintain as cohesive social units through time." R.I.M. Dunbar, *Journal of Human Evolution*, June 1992.

of the great force multipliers of each human journey. Never underestimate the importance of the powerful, *altruistic* qualities of pride.

3. Heroes and Mentors, Emulate and Evolve:

> *The Head, Wallace and Bruce*
>
> *It gave me a pang to find when I reached America that there was any other country which pretended to have anything to be proud of. What was a country without Wallace, Bruce, and Burns? I find in the untraveled Scotsman of to-day something still of this feeling.*
>
> *The Heart, Burns and Shakespeare*
>
> *Thenceforth there was nothing for me but Shakespeare.* ***I seemed to be able to memorize him almost without effort. Never before had I realized what magic lay in words****. The rhythm and the melody all seemed to find a resting-place in me, to melt into a solid mass which lay ready to come at call.*
>
> *But the one perennial literary character in Carnegie's early training was Burns. It is impossible to exaggerate the influence of the national poet on this particular worshipper.* ***The adult Carnegie's reading ultimately reached a considerable range, but his studies as a man discovered few truths that his favourite poet did not forecast.*** *He could quote lines from Burns that even seemed to anticipate Darwin.*[5]

Warren Buffett has often said in talks to students, "If you tell me your heroes, I can tell you how you are going to turn out in life." Carnegie, at a young age, would ask himself, "What would Wallace do? How would Shakespeare and Burns capture the sentiment of this moment?" Seeking answers I've started to ask myself, "What would Carnegie do at this moment? How would he lead his business concerns through a period of dislocation?" Having deep fluency of great heroes is a huge advantage, so that when the rhymes and melodies of life occur you will have a solid mass of available insight.

4. Organizing Labor – "*Studying Men, Their Manners, and Their Ways*[6]"

> *One of the chief enjoyments of my childhood was the keeping of pigeons and rabbits. …* ***My first business venture was securing my companions' services for a season as an employer, the compensation being that the young rabbits, when such came, should be named after them****. … My conscience reproves me to-day, looking back, when I think of the hard bargain I drove with my young playmates, many of whom were content to gather dandelions and clover for a whole season with me, conditioned upon this unique reward—the poorest return ever made to labor. Alas! What else had I to offer them! Not a penny.*
>
> *I treasure the remembrance of this plan as the earliest evidence of organizing power upon the development of which my material success in life has hung—a success not to be attributed to what I have known or done myself, but to the faculty of knowing and choosing others who did know better than myself. Precious knowledge this for any man to*

[5] *The Life of Andrew Carnegie* by Burton J. Hendrick – 1932.
[6] Robert Burns wrote these words in a letter to Thomas Orr, which paid homage to Alexander Pope's similar words used in a witty version of Chaucer's *Merchant's Tale*.

> *possess.* ***I did not understand steam machinery, but I tried to understand that much more complicated piece of mechanism—man.***

At the core of Carnegie's many attributes was a keen understanding of that most complicated mechanism – man. Carnegie carefully cultivated lessons on what motivated human actions. Many of his most intelligent business decisions (that are more fully discussed in the lessons below) have root in his understanding of subconscious and conscious decision-making. He understood the four core subconscious instincts of human beings: self-preservation, hierarchy, territorialism, and ritualism, and aligned himself and his businesses with these behaviors.

5. The Value of a Name – *What's in a Name? – Rank and Endorsement:*

Rank – Naming Rights:

One of the valuable threads woven through Carnegie's life was his keen understanding of the value hierarchy put on a name. Perhaps he stumbled on this idea in "Tom Sawyer" fashion when he compensated young boys with the naming rights of rabbits, but the value he received later for bestowing naming rights were much greater. **Carnegie received infinite worth by bypassing the human instinct for the applause of rank.** In his business he advanced his objectives in his Steel Works, by naming them after the president of the Pennsylvania Railroad, John Edgar Thomson. In his acts of benevolence, rarely did he stipulate that any of his gifts be named after him. The 2,509 libraries that he built were to be called Free Public Libraries.

> *"The rank is but the guinea's stamp,*
> *The man's the gowd for a' that."*
> *Robert Burns – A Man's a Man for a That*

Endorsement:

> *Mr. Drexel said he would like me to explain how I had been able to steer clear of these unfortunate troubles. I answered: by strict adherence to what I believed to be my duty never to put my name to anything which I knew I could not pay at maturity; or, to recall the familiar saying of a Western friend, never to go in where you couldn't wade. This water was altogether too deep for me. Regard for this rule has kept not only myself but my partners out of trouble. Indeed, we had gone so far in our partnership agreement as to prevent ourselves from endorsing or committing ourselves in any way beyond trifling sums, except for the firm. This I also gave as a reason why I could not endorse. ...*
>
> *The lesson was not lost. The sound rule in business is that you may give money freely when you have a surplus, but your name never—neither as endorser nor as member of a corporation with individual liability. A trifling investment of a few thousand dollars, a mere trifle—yes, but a trifle possessed of deadly explosive power.*

This lesson has infinite importance as success compounds. A reputation built over a century can be destroyed in seconds when honor and integrity are put at risk. This intention is often not malice but rather it happens from complacency with regards to lending one's name and assistance when times are good. Carnegie steered clear of many situations that proved to be the destruction of his competitors, friends, and even his mentor, President of the Pennsylvania Railroad Thomas A. Scott, by extending ones name through "the best laid schemes of mice and men" that went awry.

6. The Value of Good Will – *Going the Extra Mile:*

> *The habit [of going the extra mile] aids one in developing and maintaining the right "mental attitude toward others, thereby serving as an effective means of gaining friendly cooperation. It helps one to profit by the law of contrast, since obviously a majority of the people follow the exact opposite of this principle, by doing just as little work as they can get by with; and that is about all they are getting; just getting by. It creates a continuous market for one's services. Moreover, it insures on a choice of jobs and working conditions, at the top of the scale of wages or other forms of compensation. It attracts opportunities, which are not available to those who render as little service as possible, and thereby serves as an effective medium for self-promotion for wage earning to business ownership. Under some circumstances it enables one to become indispensible in his job, thereby paving the way for him to name his compensation.*[7]

Every step in Carnegie's career from working as a bobbin boy, to working in a telegraph office (where he was one of three people in the country who could take down a message by sound alone), to becoming Superintendent of the Pennsylvania Railroad, demonstrated a deliberate intention of doing more than what was asked. Each practical advantage that Carnegie lists above for personal achievement can be applied to a business and how that business treats each of their counterparties: customers, employees, owners, suppliers, the leaders stewarding the enterprise, and the community.

7. Dime Messages – *Cooperation – Unite and Lead:*

> *One great excitement of this life was the extra charge of ten cents, which we were permitted to collect for messages [as a telegram messenger] delivered beyond a certain limit. These "dime messages," as might be expected, were anxiously watched, and quarrels arose among us as to the right of delivery. In some cases it was alleged boys had now and then taken a dime message out of turn. This was the only cause of serious trouble among us. By way of settlement I proposed that we should "pool" these messages and divide the cash equally at the end of each week. I was appointed treasurer. Peace and good-humor reigned ever afterwards. This pooling of extra earnings not being intended to create artificial prices was really coöperation. It was my first essay in financial organization.*

I was under the false impression that to reach the success that Carnegie achieved was to employ the method of many other titans – "divide and conquer." I was surprised to learn just how important cooperation was toward his ends. Under full inspection, his strategy was that of "unify and lead."

> *If you want to go quickly go alone, if you want go far go together.*
> African Proverb

Today, you will find similar ingredients at work at Berkshire Hathaway where great businesses are communed for operational excellence and excess earnings are allocated intelligently. John Malone, Chairman of Liberty Media, keenly understands the benefits of cooperation, demonstrated by his comment at the November 19, 2014 Liberty Media investor day, "You don't have to consolidate the ownership to benefit from scale. Cooperation amongst players is an important ingredient to scale."

8. Definiteness of Purpose – *Investing Deliberately:*

> *Personal Memo – St. Nicholas Hotel, New York, December, 1868: Man must have an idol—the amassing of wealth is one of the worst species of idolatry—no idol more*

[7] *The Wisdom of Andrew Carnegie as told to Napoleon Hill*.

> *debasing than the worship of money.* ***Whatever I engage in I must push inordinately****; therefore should I be careful to choose that life which will be the most elevating in its character. To continue much longer overwhelmed by business cares and with most of my thoughts wholly upon the way to make more money in the shortest time, must degrade me beyond hope of permanent recovery. I will resign business at thirty-five, but during the ensuing two years I wish to spend the afternoons in receiving instruction and in reading systematically.*

"Whatever I engage in I must push inordinately." This truly sums up what differentiated Carnegie's accomplishments from even the most exceptional man or woman. When he set his mind to something, he had a definite purpose. **He approached everything with the very idea that you will only receive from something that which you were willing to expend.** We have all experienced the serendipity that occurs when we are keenly focused on something and how we become more tuned in to instances that were missed under a prior consciousness – a definitiveness of purpose is one of the factors that lie behind *exceptional* personal and collective achievements.

9. I've Got the Flash! – *Tapping into Infinite Intelligence:*

> *This was the celebrated T.T. Woodruff, the inventor of that now indispensable adjunct of civilization—the sleeping-car. Its importance* ***flashed*** *upon me. I asked him if he would come to Altoona if I sent for him, and I promised to lay the matter before Mr. Scott at once upon my return. I could not get that sleeping-car idea out of my mind, and was most anxious to return to Altoona that I might press my views upon Mr. Scott. When I did so, he thought I was taking time by the forelock, but was quite receptive and said I might telegraph for the patentee. He came and contracted to place two of his cars upon the line as soon as they could be built. After this Mr. Woodruff, greatly to my surprise, asked me if I would not join him in the new enterprise and offered me an eighth interest in the venture.*

Knowledge compounds. Both the conscious and subconscious mind gain experience throughout one's life. Carnegie, when presented with an idea, would often say, "I've got the flash," or he would say, "I didn't get the flash," when an idea did not connect harmoniously with his subconscious. Some might call that "flash" intuition. Intuition can be a flimsy mechanism with respect to decision-making, however, tapping into the infinite intelligence of the subconscious mind can be a huge advantage. Great, fast decision makers have an uncanny ability to take new information and change the solution almost immediately. "The gods send thread for the web begun."[8]

10. The Abbey Bell – *Getting the Culture Right*

One of the most touching sentiments Andrew Carnegie shared in his autobiography was describing the memory of the curfew bell that rang from the Abbey next to his home in Dunfermline, Scotland.

> *During my first fourteen years of absence my thought was almost daily, as it was that morning, "When shall I see you again?" Few days passed in which I did not see in my mind's eye the talismanic letters on the Abbey tower—"King Robert The Bruce." All my recollections of childhood, all I knew of fairyland, clustered around the old Abbey and its*

[8] Carnegie found this line in the *Scottish American* newspaper – 1903.

curfew bell, which tolled at eight o'clock every evening and was the signal for me to run to bed before it stopped. ...

By that curfew bell I had been laid in my little couch to sleep the sleep of childish innocence. Father and Mother, sometimes the one, sometimes the other, had told me as they bent lovingly over me night after night, what that bell said as it tolled. ***Many good words has that bell spoken to me through their translations.*** *No wrong thing did I do through the day which that voice from all I knew of heaven and the great Father there did not tell me kindly about ere I sank to sleep, speaking the words so plainly that I knew that the power that moved it had seen all and was not angry, never angry, never, but so very, very sorry. Nor is that bell dumb to me today when I hear its voice.*

The Abbey Bell is about getting the air right to prosper. The tolling bell is a metaphor of the environment of forgiveness, of unconditional love, support, understanding, trust, and loyalty where individual and organizational endeavors can be amplified. Last quarter I wrote about how the most important ingredient of an enduring business is culture. The *Abbey Bell* is about getting the culture right.

11. PIPER Mindset – *Persistent Incremental Progress Eternally Repeated:*

She [Mrs. Carnegie] heard and saw the pipers in all their glory and begged there should be one at our home—a piper to walk around and waken us in the morning and also to play us in to dinner. American as she is to the core, and Connecticut Puritan at that, she declared that if condemned to live upon a lonely island and allowed to choose only one musical instrument, it would be the pipes. The piper was secured quickly enough. ... We took our piper with us when we returned to New York.

I highlighted last quarter that Peter Kaufman, Editor of *Poor Charlie's Almanac* and CEO of Glenair, presented an important insight during a talk to our Security Analysis class last fall. Peter shared his belief that there is one principle that explains the progress of inorganic (physical universe - compounding), organic (biology - evolution) and human systems (human achievement). He concluded the answer was *Dogged Incremental Progress Over A Long Period of Time*. With the goal of refining this enlightened concept to a memorable acronym I arrived at: Persistent Incremental Progress Eternally Repeated – shortened to the acronym PIPER. It is a fitting illustration that one of the most exceptional examples of human achievement would begin and end his day by the sound of a piper. If I were asked what was the secret of Carnegie's success, I'd answer – persistent incremental progress eternally repeated, PIPER.

12. Bridge Builder – *Quality and An Owner's Mindset – "An Honest Brig"*:

The Keystone Bridge Works have always been a source of satisfaction to me. Almost every concern that had undertaken to erect iron bridges in America had failed. Many of the structures themselves had fallen and some of the worst railway disasters in America had been caused in that way. Some of the bridges had given way under wind pressure but nothing has ever happened to a Keystone bridge, and some of them have stood where the wind was not tempered. There has been no luck about it. We used only the best material and enough of it, making our own iron and later our own steel. We were our own severest inspectors, and would build a safe structure or none at all. ... We were as proud of our bridges as Carlyle was of the bridge his father built across the Annan. ***"An honest brig," as the great son rightly said.***

> ***I have never known a concern to make a decided success that did not do good, honest work, and even in these days of the fiercest competition, when everything would seem to be matter of price, there lies still at the root of great business success the very much more important factor of quality.*** *... I was very much pleased to hear a remark, made by one of the prominent bankers who visited the Edgar Thomson Works during a Bankers Convention held at Pittsburgh. He was one of a party of some hundreds of delegates, and after they had passed through the works he said to our manager:* ***"Somebody appears to belong to these works."***
>
> ***He put his finger there upon one of the secrets of success. They did belong to somebody.*** *The president of an important manufacturing work once boasted to me that their men had chased away the first inspector who had ventured to appear among them, and that they had never been troubled with another since. This was said as a matter of sincere congratulation, but I thought to myself: "This concern will never stand the strain of competition; it is bound to fail when hard times come." The result proved the correctness of my belief****. The surest foundation of a manufacturing concern is quality. After that, and a long way after, comes cost.***

Bridge building was Andrew Carnegie's first entrepreneurial venture. Carnegie saw a world of wooden bridges after the Civil War that were in desperate need of being converted to iron. *I saw that it would never do to depend further upon wooden bridges for permanent railway structures. An important bridge on the Pennsylvania Railroad had recently burned and the traffic had been obstructed for eight days. Iron was the thing.* Carnegie, with his skill of assessing human talent, picked two of the most experienced men in the art of bridge building and asked them if they would be interested in joining his venture.

> *Now, do thy speedy utmost, Meg,*
> *And win the key-stane o' the brig;*
> *There at them thou thy tail may toss,*
> *A running stream they dare na cross.*
> *But ere the key-stane she could make,*
> *The fient a tail she had to shake!*
> Robert Burns – *Tam o' Shanter*

Most of the practical experience Carnegie applied to steel was learned on the job at Keystone. As he indicated above, he learned the importance of *quality* as the most important goal of a manufacturing concern and the importance of running a business with an *owner's mindset* where everyone knows that "someone belongs to these works."

13. Ebb Tides – *Panics – Sowing the Seeds for the Eventual Harvest:*

> *It was not, however, all smooth sailing with our iron business. Years of panic came at intervals. We had passed safely through the fall in values following the war, when iron from nine cents per pound dropped to three. Many failures occurred and our financial manager had his time fully occupied in providing funds to meet emergencies.* ***Among many wrecks our firm stood with credit unimpaired.***

Panics are inevitable. There have been 47 economics recessions in the United States since 1791. The Panics of 1857, 1873, 1884, 1893, 1907, 1929, 1934, 1973, 1981 and 2008 were the most severe and yet most productive to those that were financially and mentally prepared to act. I opened this letter with a discussion of the lemming/Snowy Owl relationship to show how biological creatures are driven by core instincts that drive the cycle of scarcity and abundance. Carnegie understood this keenly and made the bulk of his fortune by being able to not only survive but also thrive when these economic tides ebbed. If you know that tides ebb, you remain financially and operationally prepared. Most businesses and individuals do not operate that way and thus are forced to make decisions that forfeit their ownership and control during these periods of distress.

14. Seeking to Earn the Approbation of Great Men and Women – *Velocity of Learning*:

> *Few men have wished to know another man more strongly than I to know Herbert Spencer, for seldom has one been more deeply indebted than I to him and to Darwin.*

One of the themes in Carnegie's practical experience was how he formed great friendships with those he most admired. He sought friendships with the greatest minds of literature, science, and leaders of nations. He surrounded himself with greatness and he challenged himself to be worthy of their respect beyond his business achievements. He formed profound friendships with Herbert Spencer, Mark Twain, John Morley, Prime Minister William Gladstone, and Matthew Arnold. These intellectual friendships were very important to how he continued to evolve and learn. This is a proactive objective – seeking out the best minds by being important and of great value to them. It is interesting to note that Darwin also listed this in his autobiography as an important objective.

15. Compensation of Labor – *Sliding Scale – The Gloucester Fishing Fleet Model*

A Gloucester fishing fleet, starting for the Grand Banks, seemed to have discovered the secret of business success. From Carnegie's Presidential Address to the British Iron and Steel Institute he explains, "I never see a fishing fleet sail without pleasure, thinking it is based upon the form which is to prevail generally. Not a man on the boat is paid fixed wages. **Each gets his share of the profits.** That seems to me the ideal. … A crew of employees versus a crew of partners would be in the race."

Carnegie's genius understood the importance of having each of the heads of his departments "interested." "A man who is a partner is fixed for life. It is a steady thing."

> *Of all my services rendered to labor the introduction of the sliding scale is chief. It is the solution of the capital and labor problem, because it really makes them partners—alike in prosperity and adversity.*
>
> *It is for the interest of the employer that his men shall make good earnings and have steady work. The sliding scale enables the company to meet the market;* ***and sometimes to take orders and keep the works running****, which is the main thing for the working-men. High wages are well enough, but they are not to be compared with steady employment. The Edgar Thomson Mills are, in my opinion, the ideal works in respect to the relations of capital and labor.*
>
> *It was a sliding scale based on the price of the product. Such a scale really makes capital and labor partners, sharing prosperous and disastrous times together. Of course it has a minimum, so that the men are always sure of living wages.*

With the Gloucester Fishing Fleets just miles from our offices in Essex, I have witnessed the simplicity he saw in this model. I have found that having key personnel "interested" can do more to augment productivity than any other improvement.

16. Bessemer Process[9] – *Never Stop Looking Around Corners – Transformative Technology*:

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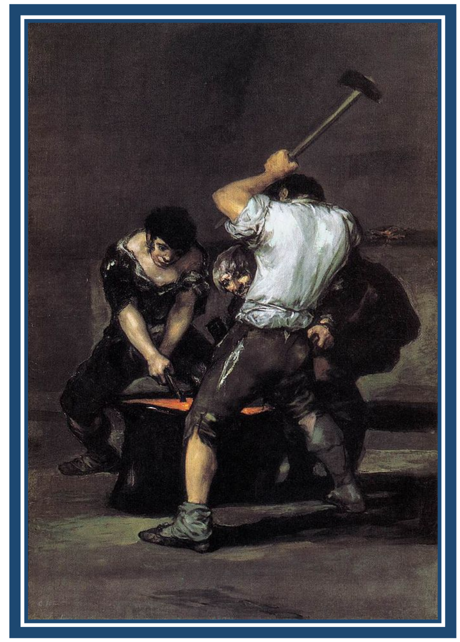
[9] "The Bessemer process revolutionized steel manufacturing by decreasing its cost, from £40 per long ton to £6-7 per long ton, along with greatly increasing the scale and speed of production of this vital raw material. The process also decreased the labor requirements for steel making. Prior to its introduction, steel was far too expensive to make bridges



The Forge by Francisco Goya – 1817
Frick Collection – New York City

> *I had not failed to notice the growth of the Bessemer process. If this proved successful I knew that iron was destined to give place to steel; that the Iron Age would pass away and the Steel Age take its place. ...*
>
> *The question of a substitute for iron rails upon the Pennsylvania Railroad and other leading lines had become a very serious one. Upon certain curves at Pittsburgh, on the road connecting the Pennsylvania with the Fort Wayne, I had seen new iron rails placed every six weeks or two months. ... there was nothing to be compared with the solid steel article which the Bessemer process produced.*

Many a fortune has been lost through pioneering. However change is inevitable so a leader must be on the front lines *touching the medium* of his business so he can interpret inflection points and know when to take action. Carnegie saw early on how revolutionary the Bessemer process would be as steel would eventually overtake iron. It was many years before he felt comfortable enough to enter, but after due diligence and adequate pioneering, he invested with great confidence. The Bessemer process installed at Braddock would be one of the inflection points of Carnegie's dominance in the global steel industry.

17. Reciprocation – *Like Draws to Like*:

> ***Working-men always do reciprocate kindly feeling. If we truly care for others we need not be anxious about their feelings for us. Like draws to like.***
>
> *Slight attentions or a kind word to the humble often bring back reward as great as it is unlooked for.* ***No kind action is ever lost.*** *Even to this day I occasionally meet men whom I had forgotten, who recall some trifling attention I have been able to pay them, especially when in charge at Washington of government railways and telegraphs during the Civil War, when I could pass people within the lines—a father helped to reach a wounded or sick son at the front, or enabled to bring home his remains, or some similar service****. I am indebted to these trifles for some of the happiest attentions and the most pleasing incidents of my life.*** *And there is this about such actions: they are disinterested, and the reward is sweet in proportion to the humbleness of the individual whom you have obliged. ... How true Wordsworth's lines:*
>
> *"That best portion of a good man's life—*
> *His little, nameless, unremembered acts*
> *Of kindness and of love."*

This is a simple but profound lesson. However you desire to be treated, you must first treat people that way to have it returned. It also is true that for any negative action you take, you can plan on receiving that behavior in return. To receive trust you must give trust, to get love you must be willing to give love, if you want to be heard you must listen. Carnegie profoundly understood the *Law of Reciprocation*.

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or the framework for buildings and thus wrought iron had been used throughout the Industrial Revolution. After the introduction of the Bessemer process, steel and wrought iron became similarly priced, and some users, primarily railroads, turned to steel." Thomas J. Misa, *A Nation of Steel: The Making of Modern America*, *1865-1925*

18. Memorization – *Wood-Notes Wild:*

> *My power to memorize must have been greatly strengthened by the mode of teaching adopted by my uncle.* ***I cannot name a more important means of benefiting young people than encouraging them to commit favorite pieces to memory and recite them often.*** *Anything which pleased me I could learn with a rapidity which surprised partial friends. I could memorize anything whether it pleased me or not, but if it did not impress me strongly it passed away in a few hours. ...*
>
> *The first penny I ever earned or ever received from any person beyond the family circle was one from my school-teacher, Mr. Martin, for repeating before the school Burns's poem, "Man was made to Mourn." In writing this I am reminded that in later years, dining with Mr. John Morley in London, the conversation turned upon the life of Wordsworth, and Mr. Morley said he had been searching his Burns for the poem to "Old Age," so much extolled by him, which he had not been able to find under that title. I had the pleasure of repeating part of it to him. He promptly handed me a second penny.*

Carnegie believed the ability to commit words and figures to memory was an important advantage. Memorization was a habit that Carnegie honed from a young age and it allowed him to formulate great insights that have survived the test of time. I am a believer that great works of art endure because they have touched something so true that they are eternal. The ability to carry those lessons into a boardroom or a drawing room among friends was a key to Carnegie's success.

> *Or sweetest Shakespeare, Fancy's Child*
> ***Warble his native wood-notes wild****.*
> *And ever against eating cares,*
> *Lap me in soft Lydian airs,*
> *Married to immortal verse,*
> *Such as the meeting soul may pierce.*
> **John Milton** – *L'Allegro* – 1645

19. Heed Life's Trifles – Upon Such *"Do The Best Gifts of the Gods Often Hang":*

> *Upon such trifles do the most momentous consequences hang. A word, a look, an accent, may affect the destiny not only of individuals, but of nations. He is a bold man who calls anything a trifle. Who was it who, being advised to disregard trifles, said he always would if any one could tell him what a trifle was?* ***The young should remember that upon trifles the best gifts of the gods often hang.***

Carnegie was very observant, very few details escaped him – his personal correspondence through life marked a keen sense of presence and curiosity. When we are paying attention, great opportunities often present themselves. He would refer to these events as trifles; *where upon the best gifts of the gods often hang*. From my own experiences, if you remain open minded and are willing to pay attention, some of the most rewarding situations often present themselves.

20. Velocity and Running Full – "*All is Well Since All Grows Better":*

> *These visits to Europe were also of great service in a commercial sense.* ***One has to get out of the swirl of the great Republic to form a just estimate of the velocity with which it spins.*** *I felt that a manufacturing concern like ours could scarcely develop fast enough for the wants of the American people, but abroad nothing seemed to be going forward. If we excepted a few of the capitals of Europe, everything on the Continent seemed to be almost at a standstill, while the Republic represented throughout its entire extent such a scene as there must have been at the Tower of Babel, as pictured in the story-books—*

Andrew Carnegie at Skibo Castle
With his Scotch Rough Collie – Laddie – 1914

> *hundreds rushing to and fro, each more active than his neighbor, and all engaged in constructing the mighty edifice. …*
>
> *When I, along with three or four of my boon companions, was in this stage of doubt about theology, including the supernatural element, and indeed the whole scheme of salvation through vicarious atonement and all the fabric built upon it, I came fortunately upon Darwin's and Spencer's works "The Data of Ethics," "First Principles," "Social Statics," "The Descent of Man." Reaching the pages which explain how man has absorbed such mental foods as were favorable to him, retaining what was salutary, rejecting what was deleterious, I remember that light came as in a flood and all was clear. Not only had I got rid of theology and the supernatural, but I had found the truth of evolution.* ***"All is well since all grows better" became my motto, my true source of comfort. Man was not created with an instinct for his own degradation, but from the lower he had risen to the higher forms. Nor is there any conceivable end to his march to perfection. His face is turned to the light; he stands in the sun and looks upward.***

Carnegie's personal mantra, "all is well since all grows better," which he discovered through his scientific explorations of evolution, was the basis of how he thought about wealth accumulation and distribution. The *march to perfection* in both business and evolution comes down to progress or motion. Toward the objective of motion, nature gives an exponential advantage to velocity rather than mass.[10] **One of the most interesting insights I gained from Carnegie was a conscious focus on velocity, and that maintaining velocity is not always about profit and margins.**

Carnegie stated, ***"It may be accepted as an axiom that a manufacturing concern in a growing country like ours begins to decay when it stops extending."*** The key to maximizing velocity for a manufacturing concern is to maintain full employment, and to keep "running full" through the down cycles so that you do not have to retool and rehire when up cycles return. This belief was not supported by many of Carnegie's partners and competitors. In 1876 Carnegie wrote to his superintendent at Braddock, "You know my views, fill the works at a small margin of profit—get our rails upon the leading lines next year. The year after take my word for it, you will make profit enough. Don't be greedy, 'small profits and large sales' in golden letters above your desk is respectfully recommended."

21. Concentrated Efforts – *Putting your Eggs in One Basket:*

> *The small shops put up originally for the Keystone Bridge Company had been leased for other purposes and ten acres of ground had been secured in Lawrenceville on which new and extensive shops were erected. Repeated additions to the Union Iron Mills had made them the leading mills in the United States for all sorts of structural shapes. Business was promising and all the surplus earnings I was making in other fields were required to expand the iron business. I had become interested, with my friends of the Pennsylvania*

[10] Kinetic Energy (the energy an object possesses due to its motion) = ½ Mass * Velocity^2.

> *Railroad Company, in building some railways in the Western States, but gradually withdrew from all such enterprises and made up my mind to go entirely contrary to the adage not to put all one's eggs in one basket.* ***I determined that the proper policy was "to put all good eggs in one basket and then watch that basket."***
>
> ***I believe the true road to preeminent success in any line is to make yourself master in that line.*** *I have no faith in the policy of scattering one's resources, and in my experience I have rarely if ever met a man who achieved preeminence in money-making—certainly never one in manufacturing—who was interested in many concerns.* ***The men who have succeeded are men who have chosen one line and stuck to it.*** *It is surprising how few men appreciate the enormous dividends derivable from investment in their own business.*

We have long written about the value of concentration and we employ this principle daily when evaluating our portfolio. There are only limited resources and ideas available, so we believe, as Carnegie did, that committing all of our resources to those best ideas will provide us with results that will prove satisfactory compared to spreading our time and money thin.

> *Concentrate your energy, your thoughts, and your capital.*
> Andrew Carnegie

22. Scientific Proof – *Proof – Employ a Chemist and Verify Three-Dimensionally:*

> *What fools we had been! But then there was this consolation: we were not as great fools as our competitors. It was years after we had taken chemistry to guide us that it was said by the proprietors of some other furnaces that they could not afford to employ a chemist. Had they known the truth then, they would have known that they could not afford to be without one. Looking back it seems pardonable to record that we were the first to employ a chemist at blast furnaces—something our competitors pronounced extravagant.*

Learning by his mistakes, Carnegie quickly realized the importance of dealing with facts (versus blind trust or faith) where resources could advance the unknowable to knowable. One of his biggest mistakes was when he purchased a field of iron stone based on tests at the periphery of the field. Those test showed that the field had the ideal makeup of iron ore for steel making. "*We were misled … They promised well at the edges of the mines, where the action of the weather for ages had washed away impurities and enriched the ore, but when we penetrated a small distance they proved too 'lean' to work.*" Going forward, when Carnegie tested a field he made sure to take extensive three-dimension grid testing across the entire landscape. The idea of "trust but verify" became one of the hallmarks of his *modus operandi* as he ran his business concerns. He relied on proven facts and figures to weigh his decisions.

23. Margin of Safety versus Pioneering – *Scotch Caution*

> *Up to this time I had the reputation in business of being a bold, fearless, and perhaps a somewhat reckless young man. Our operations had been extensive, our growth rapid and, although still young, I had been handling millions. My own career was thought by the elderly ones of Pittsburgh to have been rather more brilliant than substantial. I know of an experienced one who declared that if "Andrew Carnegie's brains did not carry him through his luck would." But I think nothing could be farther from the truth than the estimate thus suggested.* ***I am sure that any competent judge would be surprised to find how little I ever risked for myself or my partners****. When I did big things, some large*

corporation like the Pennsylvania Railroad Company was behind me and the responsible party. My supply of Scotch caution never has been small; but I was apparently something of a dare-devil now and then to the manufacturing fathers of Pittsburgh. They were old and I was young, which made all the difference. …

Among many wrecks our firm stood with credit unimpaired.

Carnegie employed a "Scotch Caution" margin of safety in everything he did. He did not succeed because of the great risks he took; he accumulated a fortune because he was able to survive and thrive when others were losing. Many of the great investors and business operators that leave enduring legacies have succeeded because they have also found this solution. Carnegie prided himself on that fact that he did not believe in pioneering. He would venture into an opportunity only after the risks of losing were minimized and he would often go in with customer orders already in place. He knew the greatest margin of safety was to be the *low cost producer*, thus he *pushed inordinately* to drive down costs per unit. He understood that cooperation and community were important to ensure harmony and he would seek out harmonious solutions at the expense of the fatal flaws that core human instincts often initiate.

> *You will pluck from the nettle danger, the flower safety.*
> William Shakespeare

24. An Abundance vs. Scarcity Mentality – *Laird of Pittencrieff – "Sweetness and Light"*

Pittencrieff Glen is the most soul-satisfying public gift I ever made, or ever can make. It is poetic justice that the grandson of Thomas Morrison, radical leader in his day, nephew of Bailie Morrison, his son and successor, and above all son of my sainted father and my most heroic mother, should arise and dispossess the lairds, should become the agent for conveying the Glen and Park to the people of Dunfermline forever. It is a true romance, which no air-castle can quite equal or fiction conceive. The hand of destiny seems to hover over it, and I hear something whispering: ***"Not altogether in vain have you lived—not altogether in vain."*** *This is the crowning mercy of my career! I set it apart from all my other public gifts. Truly the whirligig of time brings in some strange revenges.*

Carnegie (like many Scotsmen) thought Pittencrieff Glen was the most sacred spot on earth. The glen was adjacent to the Abbey and Palace, and across the street from Carnegie's childhood home. Pittencrieff includes King Malcolm's tower and the St. Margaret's Shrine that marks the birthplace of Scottish freedom. The glen had never been public and when Carnegie was a boy his family was not allowed on the grounds due to a long lasting feud between the owners, the Carnegie family, and Dunfermline community. In 1903, Carnegie bought the glen, which he then gifted to the community for public use along with an endowment. In the bequeathed trust document Carnegie writes that the funds are to be used "in attempts to bring into the monotonous lives of the toiling masses of Dunfermline more sweetness and light." **The core human instincts that favor scarcity close the gates only to be reopened by an abundance mentality.** An abundance mentality will give back tenfold when one is aligned with its power.

Epilogue:

Last quarter I wrote in the appendix that I had visited the Matisse *La Rosace* stained glass at the Union Church in Sleepy Hollow, New York. Upon leaving, the docents suggested I make a stop at the Sleepy Hollow Cemetery. When I arrived, I took a map of the cemetery with the names and locations of the notable interred. I recognized the name Andrew Carnegie on the sheet so I walked up the hill to find his grave. It took some time to find given the very small discrete markings in the midst of mausoleums. There were two small headstones for Andrew and his wife Louise Whitfield Carnegie and a larger Celtic pillar behind with beautiful Celtic carvings (I later learned the stone was from Skibo, Carnegie's home in Scotland, and the carvings represented the symbol for *eternity*). Interestingly, many coins had been placed on top of his simple gravestone. I fumbled in my pockets to find a coin but I came up empty. I looked around the grounds to find something to mark the cairn of my visit. I noticed an acorn and placed the single acorn amidst the abundance of coins.

This later proved ironic when I read Carnegie's autobiography. In speaking with pride of his early days of Keystone Bridge he wrote – "Large oaks from small acorns grow." The legacy of what Andrew Carnegie left to mankind by his benevolence and example have been valuable acorns for many that grow into thriving oaks. While mortal pride, rank, and matter fade out of existence, there are some imprints left behind that forever touch humanity, grow better and become immortal.

The leaves of the oak and the willow shall fade,
Be scattered around, and together be laid;
And the young and the old, and the low and the high,
Shall moulder to dust, and together shall lie. ...

'Tis the wink of an eye -- 'tis the draught of a breath--
From the blossom of health to the paleness of death,
From the gilded saloon to the bier and the shroud:--
Oh! why should the spirit of mortal be proud?

William Knox – (1789 – 1825)
Immortality

Artwork Note: I designed the Coat of Arms illustration to represent the enduring lessons of Andrew Carnegie. The following passage in Carnegie's autobiography provided the catalyst for the design:

I spoke again at Dunfermline, July 27, 1881, when my mother laid the foundation stone there of the first free library building I ever gave. My father was one of five weavers who founded the earliest library in the town by opening their own books to their neighbors. Dunfermline named the building I gave "Carnegie Library." The architect asked for my coat of arms. I informed him I had none, but suggested that above the door there might be carved a rising sun shedding its rays with the motto: "Let there be light." This he adopted.

Additional inspirations and symbols: Robert Burn's Coat of Arms of his own design (Woodlark, Wood-Notes Wild), Bridge with Keystone (Bridge over the Doon), City of Dunfermline Two-sided Burgh Seal (Malcolm's Tower and St. Margaret's Shrine located at Pittencrieff Glen), Robert Burn's *Twa Dogs* (Caesar and Luath), Braddock's Sash (1709 sprang sash given by General Braddock to George Washington upon his battlefield death – advantaged geographic site of *Edgar Thomson Steel Works*), Piper's Bagpipe (PIPER mindset), and Celtic Symbol of Eternity (carved on Andrew Carnegie's gravestone from Skibo Castle). Artist: Camille Vicenti.

Representative Idea – Agricultural Equipment Manufacturer:

We added materially to one of our existing investments during the quarter - a leading agricultural equipment manufacturer that we will highlight as a representative idea.

We continue to categorize this business as a transformation. As noted in previous letters, transformations are businesses with average, or even below average, operating economics. Over time, we expect a meaningful change (inflection point) in operating economics through three different transformation categories: secular, systemic or separation. This business has systemic transformation attributes as they have evolved their operating systems and are extracting meaningful, sustainable improvements in their operating metrics. We also see material secular transformational dynamics with strong tailwinds in agriculture.

> *Thus then to man the voice of Nature spake—*
> *"Go, from the creatures thy instructions take:*
> *Learn from the birds what food the thickets yield;*
> *Learn from the beasts the physic of the field;*
> *Thy arts of building from the bee receive;*
> ***Learn of the mole to plough**, the worm to weave;*
> Alexander Pope – *Essay on Man*

The business has been around for almost two centuries; their core business has the largest industry market share worldwide and is one of the most well-known and respected brands in the United States. Loyal customers and a successful brand image that expands outside of its core business prove the brand's durability. The core competitive advantage resides in the company's established (and evolving) manufacturing and distribution capabilities that are far superior to its competitors.

We feel this business continues to meet our requirements of improving economics, competitive advantage, margin of safety, an understanding of the critical data points, an insight into why we think its shares are mispriced and, most importantly, a valuation we deem attractive based on its future expected cash flows.

Firm Updates:

- ECAM Award: We are pleased to announce that ***Change is Simple*** has been selected as recipient of the fifth annual ECAM Award. ***Change is Simple*** is an impactful organization focused on educating young people on how they can be a force multiplier by protecting the environment through their own efforts. The ECAM Award is given annually to a charity whose mission is deliberate, simple and relevant to where our support can translate to compounding benefits.

We look forward to meeting and talking with you soon. We greatly value your support and trust.

Thou whom chance may hither lead.

Robert Burns (1694 – 1778)
Lines Written in Friars'-Carse Hermitage

On behalf of the firm,

Chris

Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder

EAST COAST
ASSET MANAGEMENT

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2015 1st QUARTER LETTER

... the sense of the symmetrical is an instinct which may be depended upon with an almost blindfold reliance. It is the poetical essence of the Universe — of the Universe which, in the supremeness of its symmetry, is but the most sublime of poems. ... He [Humanity] must have a care, however, lest, in pursuing too heedlessly the superficial symmetry of forms and motions, he leave out of sight the really essential symmetry of the principles which determine and control them.

Edgar Allan Poe (1809 – 1849)
Eureka

Pure mathematics is, in its way, the poetry of logical ideas.

Albert Einstein (1879 – 1955)
New York Times Letter to the Editor – 1935 – Honoring the Life of Emmy Noether

Philosophy is like trying to open a safe with a combination lock: each little adjustment of the dials seems to achieve nothing, only when everything is in place does the door open.

Ludwig Wittgenstein (1889 – 1951)

All things excellent are as difficult as they are rare.

Spinoza – (1835 – 1919)
Concluding line – *Ethics* – 1677
Referenced in Ch. 8 of *The Intelligent Investor* – 1949 – Benjamin Graham

EAST COAST

ASSET MANAGEMENT

To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO and Chief Investment Officer

Date: June 17, 2015

Re: First Quarter 2015 Update – Mr. Market Revisited

In our first quarter letter you will find our portfolio update and general market observations. Each quarter we highlight one component of our investment process. This quarter, in the section titled *Mr. Market Revisited*, I will discuss how symmetrical thinking can improve decision-making and how a palindromic mindset could be applied to Benjamin Graham's concept of Mr. Market. As is our standard practice, client reporting, including performance and positioning, has been sent under separate cover.

Market Summary[1]

	S&P 500	MSCI AC World Index	MSCI Emerging Markets	MSCI EAFE Index	Barclays Aggregate Bond Index	Gold – $/Troy Oz.	Crude Oil
Price 3/31/2015	2,067.89	424.76	974.57	1849.34	1945.63	1183.68	47.60
Q1 2015	0.95%	2.46%	2.22%	5.10%	1.61%	-0.10%	-10.64%
YTD	2.79%	4.27%	1.84%	7.44%	-0.10%	0.23%	12.58%
2014	13.68%	4.78%	-1.97%	-4.25%	5.97%	-1.72%	-45.87%

Investors rarely receive a plaintext message on what the future may hold for capital markets. In practice, it seems more like market information comes through as ciphered text, embedded in the noise of data are codes that, if deciphered, prove invaluable. While the deciphered messages are never perfectly clear, we are attempting to deduce a range of probable outcomes so we can intelligently allocate capital towards investments with merit.

Today the range of expected returns are not as attractive as they once were, yet the businesses we own represent compelling compounding attributes in both absolute and relative terms. Fixed-rate investments continue to prove enigmatic as the deflationary pressures of global deleveraging and technological productivity gains have kept interest rates at historic lows. A prolonged period of low and negative interest rates has perplexed even the most astute investor.

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, the MSCI Europe Asia Far East Index (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices. Past performance does not guarantee future results. The discussions in this letter are for information purposes only. Please consult with your investment advisor before making any investment decisions. For complete disclosures about East Coast Asset Management LLC visit our website or consult our Form ADV and Form ADV Part 2A.

THE PALINDROMIC MIND:

Curiosity is often the genesis of human achievement. The desire to solve for the unknown is deeply embedded in our DNA – the engine driving evolution. This observation is a likely explanation for why humans love detective stories, are obsessed with puzzles, and are captivated by unsolved mysteries and the hunt for hidden treasures. In mental and physical feats, the human drive to do what was thought impossible by breaking the "code" is a daily quest. Since we are solving puzzles from our first breath to our last, continuously improving one's ability to problem solve can have great utility.

I've always been interested in word puzzles. While reading the backstory about the code breakers of Bletchley Park, (whose efforts breaking the German Enigma and Lorenz ciphers helped shorten World War II by as much as two years and their story was brought to light recently in the movie *The Imitation Game)*, I was fascinated to learn that one of their diversions between deciphering codes was to create palindromes. A palindrome is a word, phrase, number[2] or other sequence[3] of characters that reads the same backward or forward. For those who enjoy solving puzzles, creating an intelligible palindrome phrase is an intellectual feat. The code breakers at Bletchley Park created some of the most famous palindromes that exist to this day. Peter Hilton, one of their top code breakers, constructed the 51-letter palindrome, "Doc note, I dissent. A fast never prevents a fatness. I diet on cod."

The more I thought about palindromes, the more the concept began to crystallize of just how valuable a *palindromic mind* is for decision-making. **Thinking both backward and forward is not a common human skill possessed in symmetry.** Looking backward we pull from our experiences and looking forward we are led emotionally by hopes, dreams and fears. **Thus our backward and forward-looking biases instinctively *skew* our decision-making, leading us away from the golden medium of rational decision-making.** Poor problem solving is often the result of how *skewed* information is processed and applied, not the lack of information. In a world populated by optimists and pessimists, how can we apply palindromic symmetry to enjoy the fruits of the realist?

> *An optimist will tell you the glass is half-full; the pessimist, half-empty; and the engineer* [realist] *will tell you the glass is twice the size it needs to be.*
>
> Anonymous

WHERE DO WE COME FROM[4] – LOOKING BACKWARD

Thinking backward is quite intuitive. Backward thinking involves looking for patterns, making links between unconnected events and forming theories to influence forward-looking decision-making. Backward thinking has a gravitational pull toward the experiential emotion in our past as well as giving more proportion to recent events.

[2] 2015 is the last binary palindrome year until 2047 and the most beautiful with a zero in center – 11111011111.

[3] Our DNA even forms a palindromic symmetrical sequence.

[4] Sub-headings influenced by Paul Gauguin's - *Where Do We Come From, What Are We, Where Are We Going.* 1897 – 1898 – Museum of Fine Arts, Boston, MA. Painting created in Tahiti. This painting and Gauguin's - Self-Portrait in *Tahiti Hat* in Musee D'orsay (mirror image of his famous *Manau Tupapau* in background) are his most famous works.

In my opinion, the biggest error in looking backward is not going back far enough to solve to laws and principles that are invariable, or unchanging through time. The three largest data sets, which I have previously written and credited Peter Kaufman for first enlightening me about, are:

1. The inorganic systems around us, which are 13.7 billion years in age and contain all the laws of physics and mathematics,
2. Organic systems, or all the biology on earth, which are 3.5 billion years in age and,
3. 20,000 years of recorded human history.

We can use these invariable laws and principles for intelligent decision-making.

WHERE ARE WE GOING – LOOKING FORWARD

Thinking forward employs a more mathematical process. The decision maker assesses variables collected in the backward-looking exercise and assigns weights and probabilities to arrive at an integrated forecast.

The pitfall with most forward-looking lenses, as with backward, is that they do not see beyond recent experiences. When we are focused on what just lies ahead, skewed by emotion, we lose the benefit of allowing the world to do the work for us. We do not harness the huge tailwind of laws and principles that have existed for billions of years. In my opinion, the proper time horizon is one that can look beyond the short-term and assess weights and probabilities based on what might be five or ten years out, and ideally even further. *It is not about ignoring the here and now, but engaging the qualities that can be sustainable and enduring*.

WHAT [WHERE] ARE WE – FINDING SYMMETRY

Symmetry is one of the most powerful principles that exists in the universe. I believe we can gain great insights by rightly applying the full time scale of both our backward and forward-looking lenses in symmetry, from beginning (alpha) to forever (omega). When we have arrived at true symmetry, we should be *more present, and thus more realistic,* about those decisions that are proportionately more certain than those that are less certain. Toward this end, I believe true wisdom is to understand where a range of probable outcomes is unsatisfactory and choose not to navigate in waters that are proportionately unknowable.

> *I am wiser than this man, for neither of us appears to know anything great and good; but he fancies he knows something, although he knows nothing; whereas I, as I do not know anything, so I do not fancy I do. In this trifling particular, then, I appear to be wiser than he, because I do not fancy I know what I do not know.*
>
> Socrates according to Diogenes Laertius

A palindromic mind seeks to give full weight to both backward and forward thinking, arriving holistically at the present. In a previous letter I referred to this present moment as "yielding to the still point." When I first wrote that piece, I did not fully appreciate thinking symmetrically and its subsequent benefits. **To truly yield to the still point is to first appreciate the whole completeness of the past with a full awareness of the proportionately uncertain future.** The idea of being present is a great bumper sticker mantra, but being present because you have applied a superintending, palindromic symmetry to the further past and further future can have extraordinary, practical utility. The aim is to yield to a comprehensive and realistic mindfulness of time and, ideally, timelessness.

> *At the still point of the turning world. Neither flesh nor fleshless;*
> *Neither from nor towards; at the still point, there the dance is,*
> *But neither arrest nor movement. And do not call it fixity,*
> *Where past and future are gathered. Neither movement from nor towards,*
> *Neither ascent nor decline. Except for the point, the still point,*
> *There would be no dance, and there is only the dance.*
>
> T. S. Eliot – *Four Quartets* – (1943)

There is no better example of the application of the superintending, palindromic mind than Warren Buffett and Charlie Munger. In Berkshire Hathaway's 2014 annual report, both Charlie and Warren independently shared what were some of the most important reasons for their success over the last fifty years and looked *symmetrically* at what they thought would bring Berkshire success fifty years forward. The return of Berkshire Hathaway over Buffett's tenure has been 1,826,163% compared to 11,196% for the S&P 500. The Buffett-Munger partnership is the best historical business example whereby applying symmetry of invariant laws and principles over a long period can lead to asymmetric extraordinary outcomes – *the joys of compounding*.

Mr. Market Revisited:

In 1949, Benjamin Graham introduced the parable of Mr. Market in Chapter 8 of the *Intelligent Investor*. The following two paragraphs were virtually all Graham ever wrote about Mr. Market, yet its importance endures.

> *Let us close this section with something in the nature of a parable. Imagine that in some private business you own a small share that cost you $1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or to sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.*
>
> *If you are a prudent investor or a sensible businessman, will you let Mr. Market's daily communication determine your view of the value of the $1,000 interest in the enterprise? Only in case you agree with him, or in case you want to trade with him. You may be happy to sell out to him when he quotes you a ridiculous high price, and equally happy to buy from him when his price is low. But the rest of the time you will be wiser to form your own ideas of the value of your holdings, based on full reports from the company about its operations and financial position.*

Warren Buffett wrote in the preface of the Fourth Edition of the Intelligent Investor, "I read the first edition of this book early in 1950, when I was nineteen. I thought then it was the best book about investing ever written. I still think it is…If you follow the behavioral and business principles that Graham advocates – and if you pay special attention to the invaluable advice in Chapters 8 and 20 – you will not get a poor result from your investments." Chapter 8 introduced the concept of Mr. Market and Chapter 20 introduced the concept of margin of safety.

I want to revisit Graham's definition of Mr. Market to see if we can expand on his metaphor for even greater benefit. The primary objective of the intelligent investor is to compound capital at the highest rate of return (IRR) while mitigating chance of loss by operating with a margin of safety (MoS). Once the intelligent investor has searched, measured and compared appropriate investments, they can allocate to those that are most deserving. **As Graham cogently suggests, Mr. Market is not there to guide us but to serve us.** Mr. Market will often offer to buy and sell at times that vary greatly from what the investment's fundamentals would suggest as reasonable. The astute investor paying close attention to value should act prudently and with confidence when deviations of price and value are in their favor.

In practice, taking advantage of Mr. Market is not always that simple. Mr. Market is the aggregate intelligence of the marketplace where hardworking, very intelligent investment professionals have financial incentives to make sure you are wrong. Thus, I think approaching Mr. Market as our antihero toward our mission of compounding may help improve our mindset. Mr. Market has many tricks that encourage the investor to take actions detrimental toward our objectives. I have compiled ten character attributes of Mr. Market that can help protect the investor. Each of the ten titles is followed by a palindromic phrase in italics to emphasize our objective of symmetry and lengthening our time perspective in our backward and forward decision-making.

1. IRRATIONAL – *Never Odd or Even*:

I believe *The Purloined Letter* by Edgar Allan Poe can serve as the perfect compendium to understand our foil character, Mr. Market. The unnamed narrator and character C. Auguste Dupin are asked to help solve a crime of a stolen letter. They know a certain Minister has stolen the letter, and are confident it has been hidden in his residence, but they need to find it in order to prove his guilt. Dupin deduces the letter's hiding place on a card-rack, located in plain sight, and somewhere detectives would fail to look. Dupin points out the fact they have not correctly measured the intellect of the criminal.

> *"The measures, then," he continued, "were good in their kind, and well executed; their defect lay in their being inapplicable to the case, and to the man. A certain set of highly ingenious resources are, with the Prefect, a sort of Procrustean bed, to which he forcibly adapts his designs. But he perpetually errs by being too deep or too shallow, for the matter in hand; and many a schoolboy is a better reasoner than he. I knew one about eight years of age, whose success at guessing in the game of 'even and odd' attracted universal admiration. This game is simple, and is played with marbles. One player holds in his hand a number of these toys, and demands of another whether that number is even or odd. If the guess is right, the guesser wins one; if wrong, he loses one. The boy to whom I allude won all the marbles of the school. Of course he had some principle of guessing; and this lay in mere observation and admeasurement of the astuteness of his opponents. …*

> *"And the identification," I said, "of the reasoner's intellect with that of his opponent, depends, if I understand you aright upon the accuracy with which the opponent's intellect is admeasured." "For its practical value it depends upon this," replied Dupin; and the Prefect and his cohort fail so frequently, first, by default of this identification, and, secondly, by ill-admeasurement, or rather through non-admeasurement, of the intellect with which they are engaged. They consider only their own ideas of ingenuity; and, in searching for anything hidden, advert only to the modes in which they would have hidden it. They are right in this much — that their own ingenuity is a faithful representative of that of the mass; but when the cunning of the individual felon is diverse in character from their own, the felon foils them, of course. This always happens when it is above their own, and very usually when it is below. They have no variation of principle in their investigations; at best, when urged by some unusual emergency — by some extraordinary reward — they extend or exaggerate their old modes of practice, without touching their principles.*

If Mr. Market is the collective intelligence of all market participants, then we must begin by acknowledging that the intellect of our rival is at times exceptional. I believe most analysts underestimate collective market intelligence and thus the best investments remain hidden from and misperceived by the typical professional investor. Professional investors look for hidden value by first considering their own ingenuity, and looking with no principal variation in their investigation.

Graham's concept of Mr. Market's irrational behavior can be a very important lesson. There are two definitions of irrational, the first being not logical or reasonable. The second definition is having an infinite and nonrecurring expansion when expressed as a decimal. For example the core of compounding - *e* - and the symbol of the circle - π. The point being that an irrational number is *never odd or even*.

Looking to the second definition, investors should remember that Mr. Market is never fully logical or illogical – never odd or even. I believe it is important to never set a fixed and unchangeable definition to what we can expect from the market's behavior. Mr. Market is always adapting his methods to foil the investor. **If market participants are collectively looking for value in one place, Mr. Market will hide *alpha* somewhere else.** When the collective intelligence of the market is most rational, in times absent of panic or euphoria, the best values may be hiding in plain sight, perhaps ignored because they appear too self-evident. Understanding value is the first step, yet even more important is to understand why the investment is mispriced by acknowledging the collective intelligence and mindset of the whole.

> *It is the eye of ignorance that assigns a fixed and unchangeable color to every object; beware of this stumbling block.*
>
> Paul Gauguin (1848 – 1903)

2. MATHEMETICAN AND POET – *Drab As A Fool, Aloof As A Bard:*

> *This functionary, however, has been thoroughly mystified; and the remote source of his defeat lies in the supposition that the Minister is a fool, because he has acquired renown as a poet. All fools are poets; this the Prefect feels; and he is merely guilty of a non distributio medii in thence inferring that all poets are fools." "But is this really the poet?" I asked. "There are two brothers, I know; and both have attained reputation in letters. The Minister I believe has written learnedly on the Differential Calculus.* ***He is a***

> ***mathematician, and no poet." "You are mistaken; I know him well; he is both.*** *As poet and mathematician, he would reason well; as mere mathematician, he could not have reasoned at all, and thus would have been at the mercy of the Prefect."*
>
> *The mathematics are the science of form and quantity; mathematical reasoning is merely logic applied to observation upon form and quantity. The great error lies in supposing that even the truths of what is called pure algebra, are abstract or general truths. And this error is so egregious that I am confounded at the universality with which it has been received. Mathematical axioms are not axioms of general truth.* ***What is true of relation — of form and quantity — is often grossly false in regard to morals, for example****.*

As we measure the intellect of Mr. Market it is important to appreciate that he is both a mathematician and a poet. Approaching Mr. Market simply by form and quantity (math and science) will produce limited results. Screening by math may share with the analyst what is statistically cheap, but it will never share with us what we are in search of – *what is truly mispriced?*

Finding mispricings requires the security analyst to identify *why* an investment might be misperceived (the poetical). This is where the attributes of the poet, a keen understanding of mortal, human behavior, should be considered. This is why mispricing represents one of the six critical areas we are trying to solve for with regard to every investment (M Theory). Unlocking the best candidates for compounding potential (IRR) and margin of safety (MoS) requires a combination of both the mathematical and the poetical. **We want to find investments that are mathematically logical and make sense as to why we think Mr. Market's poetical side has temporarily given us this opportunity to buy at a discount.**

3. VOTING VS. WEIGHING MACHINE – *Rise To Vote Sir!:*

Ben Graham advanced the idea that in the short term, Mr. Market is a voting machine and in the long term a weighing machine. Mr. Market's most coy maneuver, to foil your plans of superior compounded returns, is to encourage you to sell something of value for the perceived comfort of cash. Earnings releases, geopolitical events, change in political leadership, change in sector leadership, change in commodity prices, are just a few of the things that Mr. Market will throw at the investor as he asks the investor to *rise to vote* – take action – make a decision – make a trade – sell something of worth in exchange for something of less worth.

4. LOSS AVERSION FAVORS TIMING OVER CASH ON DELIVERY (COD) – *Doc Note I dissent, A Fast Never Prevents a Fatness. I Diet On Cod:*

One of the greatest tricks Mr. Market plays on the world is convincing the investor that there will be a better time to buy in the future. There will be a lower price if you wait, the price has moved too much already, the market is fairly priced, there are no bargains, margins are at all-time highs, economic growth is slowing, China is slowing, et cetera. Mr. Market will serve up countless reasons for you not to invest *now* as there will be a far better, "less risky" entry point in the future. Warren Buffett recently recounted that in his entire investment career the market has been in a fairly valued range about 80% of that time. While it is important to be aware of the 20% when we are at extremes, the majority of the time it is important to simply own cash-producing investments that are improving versus cash investments that pay little.

Before the ubiquitous use of credit for online and mail order purchases, there was the option of Cash on Delivery (COD). When I think of the ownership of a business we are basically counting cash as it is earned, which is typically when the product or service is delivered. Investing is simply the counting of all that cash and discounting that cash stream at an acceptable rate to determine what the investment is worth and buying that stream of cash at a discount to what it is worth. A steady diet of COD is the great secret of a long-term compounding record. The best fishing grounds for COD is owning great businesses with sustainable competitive moats that throw off a growing stream of cash earnings and do not require a lot of additional capital to engender that growth.

The Codfish: - Anonymous

The codfish lays ten thousand eggs,
The homely hen lays one.
The codfish never cackles
To tell you what she's done.
And so we scorn the codfish,
While the humble hen we prize,
Which only goes to show you
That it pays to advertise.

The strategy that Mr. Market would advocate, and that many investors employ, is a fasting approach where they only want to invest when *everything feels right*. Just as a fasting/binging diet does not produce a healthy human, nor prevents "a fatness," a similar strategy for investing can produce analysis paralysis, anchoring and inaction that will prove detrimental to long-term compounded returns.

These long-term cash-generating investments (COD) are often hiding in plain sight, devoid of catalysts, hiding behind a veil of some time horizon beyond now, shrouded in an enigma of delayed gratification. Our COD investments, while not cheap, trade at reasonable prices today, which we feel will reward us in growth of *intrinsic value* for years to come. Investors who prefer to pass on the entrée of cash producing investments of great businesses and save up their caloric intake for the desserts of distressed investments remain rightly stressed.

5. CIGAR-BUTTS AND CATALYSTS – *Cigar, Toss It In A Can It Is So Tragic:*

To limit the investor's long-term advantage, Mr. Market wants you to lower your gaze to the myopic depth perception of that which is close and tangible. Toward this objective Mr. Market loves to offer up the short-term appeal of cigar-butt investments and investments with perceived catalysts to those who share his impatience for immediate satisfaction. There is nothing Mr. Market knows better than the human condition's distaste for delayed gratification. In a world where we have evolved to immediate access of information at our fingertips, same day delivery, and instant gratification – long-term investment strategies are even less hip to the trend. Waiting around in investments that may work out wonderfully over years and decades is much less exciting than those that pay out quickly. The lion's share of the financial services industry is geared to incent and reward those who can unlock the elusive secret to short-term returns.

Cigar-butt and catalyst investing are short-term investment strategies that help meet this huge demand for short-term returns. The recent popularity of activist investing strategies is a *catalyst* case in point. When Buffett looked back over the first fifty years of Berkshire in this year's annual shareholder letter, he commented on his own evolution as an investor from buying cigar-butts, toward higher quality businesses. That change in Warren Buffett's perspective on time horizon evolved from short to long to forever, perhaps elevating toward the timeless.

> *I purchased BPL's first shares of Berkshire in December 1962, anticipating more closings and more repurchases. The stock was then selling for $7.50, a wide discount from per-share working capital of $10.25 and book value of $20.20. Buying the stock at that price was like picking up a discarded cigar-butt that had one puff remaining in it.*

> *Though the stub might be ugly and soggy, the puff would be free. Once that momentary pleasure was enjoyed, however, no more could be expected. …*
>
> *Charlie Straightens Me Out – My cigar-butt strategy worked very well while I was managing small sums. Indeed, the many dozens of free puffs I obtained in the 1950s made that decade by far the best of my life for both relative and absolute investment performance. Even then, however, I made a few exceptions to cigar-butts, the most important being GEICO. Thanks to a 1951 conversation I had with Lorimer Davidson, a wonderful man who later became CEO of the company, I learned that GEICO was a terrific business and promptly put 65% of my $9,800 net worth into its shares. Most of my gains in those early years, though, came from investments in mediocre companies that traded at bargain prices. Ben Graham had taught me that technique, and it worked. But a major weakness in this approach gradually became apparent: Cigar-butt investing was scalable only to a point. With large sums, it would never work well. In addition, though marginal businesses purchased at cheap prices may be attractive as short-term investments, they are the wrong foundation on which to build a large and enduring enterprise. … It took Charlie Munger to break my cigar-butt habits and set the course for building a business that could combine huge size with satisfactory profits.*

6. ANIMAL SPIRITS & ENVY – *Saw Tide Rose, So Red It Was:*

Mr. Market loves to exploit one of the greatest human weaknesses – envy. There is nothing more motivational to an uninformed investor than when the animal spirits are awakened by others profiting from short-term investments. No one has ever said it better than Keynes:

> *Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits—a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.*

The intelligent investor who sees not the green of envy when the tide rises but rather correctly calibrates the red of potential losses, has the proper mindset. The tides that rise can be general market valuation, sector euphoria or single security optimism, thus exciting the animal spirits to place valuations on businesses that are unreasonable based on future cash earnings. Mr. Market's most dangerous foil tactic is placing silly valuations on businesses, which encourages further speculations driving the tide so high that bubbles are formed.

7. PANIC & FEAR – *Won't I Panic In A Pit Now:*

At the opposite end of the spectrum is when the bubbles burst and tides recede followed by inevitable investor panic. After investors have suffered the damaging effects on their net worth, they are compelled to sell their ownership to Mr. Market at any price to stop the emotions of fear, loss and desperation.

The Tyger - William Blake (1757 – 1827)

Tyger, tyger, burning bright
In the forests of the night;
What immortal hand or eye
Could frame thy fearful symmetry?

8. UNPRINCIPLED MAN OF GENIUS – *Live On Time, Emit No Evil:*

Let it be emphasized that Mr. Market is an *unprincipled* man of genius. He is seeking to buy your interest at the lowest price and sell you shares at the highest possible price. Beyond ignoring his signals to act, there is a way to truly limit his damaging behavior. **The secret is to operate outside of his time scale.** If you can truly elevate your perspective above the short-term then you can actually communicate on wavelengths of fundamental long-term values. I believe this is the most powerful countermeasure to Mr. Market's damaging behaviors. The more I mature as an investor, the more I appreciate the absolute immeasurable competitive advantage time horizon has on Mr. Market. Beware is to truly be aware – by being aware of how valuable it is to live on your time and not Mr. Market's time, the investor can help ensure that he emits no evil.

> *A man will be imprisoned in a room with a door that's unlocked and opens inwards; as long as it does not occur to him to pull rather than push.*
>
> Ludwig Wittgenstein (1889 – 1951)

9. THIS TIME IS DIFFERENT – *Are We Not Drawn Onward, We Few, Drawn Onward To New Era:*

Another tool Mr. Market uses to the detriment of investor success is to convince the investor that "this time is different." Mr. Market cajoles you to believe that we are truly in a new era that requires different tools and a different way to see the world. Mr. Market will encourage you to change your perspective from cash flow and value to some new paradigm that may prove impossible or unsustainable. Every investor will consider the words "this time is different" at least a few times over their investment lifetime, most typically in the fear of panic and the euphoria of rising tides.

10. INVESTING IS A GAME – *Engage "Le Jeu" Que Je Le Gagne (Kick Off The "Game" So I Can Win It):*

All games have a conclusion where players win, lose, or draw. *Mr. Market approaches investing as a game where to win someone else must lose.* Mr. Market only wants to speculate in the purchase and sale of securities if he feels he is certain to profit immediately and persistently. A variant perception to viewing investing as a game is to view investing as a long-term ownership of a business, where you view yourself as a partner. The longer we feel our holding period in a business can be, the longer we feel we can benefit from not being played by the myopic game-driven exploits of Mr. Market.

Warren Buffett recently emphasized this very point in a comment he made after Kraft was purchased by 3G in a long-term strategic partnership with Berkshire Hathaway: "There is *no finish line* in either Berkshire's investments or 3G's investments."

Epilogue – Math and Poetry – Euler's Theorem and The Sator Square:

Back in March I visited the Yale University Art Gallery and saw a wonderful exhibit curated by Dan Rockmore called *The Concinnitas Project*. The exhibit immediately held my attention, borrowing from the word "concinnitas" from Renaissance architect and polymath Leon Battista Alberti to describe the *perfect symmetry of balance, outline and position*. The collection is ten framed aquatints produced from the contribution of ten chosen mathematicians and physicists in response to the prompt to transcribe what they believed to be the "most beautiful mathematical expression."

After reviewing the ten equations, I started to think over the following weeks what my response to the prompt might be. Maxwell's equations that form the foundation of electrodynamics, classical optics and electric circuits were a forerunner. With my mind on symmetry, I was also gravitating toward Noether's Theorem that a physical system behaves the same regardless of how it's oriented in space due to the symmetry of principles and laws, even though the physical system (output) itself may be asymmetric.

However, my personal selection for the most beautiful mathematical expression was one likely too obvious to be chosen by the experts – Euler's Identity. In countless physics and math polls Euler's Identity consistently wins "greatest equation ever." So I was surprised to find that this one was not already chosen and remained hiding in plain sight, perhaps too self-evident to the experts.

$$e^{i\pi} + 1 = 0$$

> *Like a Shakespearean sonnet that captures the very essence of love, or a painting that brings out the beauty of the human form that is far more than just skin deep, Euler's equation reaches down into the very depths of existence.*
>
> Keith Devlin – Stanford University Math Professor

To me, Euler's Identity is the most beautiful mathematical expression not only for its utility, which is beyond the scope of this piece, but also for what it connects. Three of the basic arithmetic functions occur exactly once: addition, multiplication, and exponentiation. The identity also links the five fundamental mathematical constants:

1. The number 0, the additive identity,
2. The number 1, the multiplicative identity,
3. The number π (3.1459…), which is ubiquitous in geometry and most importantly which governs the perfect *symmetry* and closure of a circle,
4. The number e (2.71828), the base of natural logarithms – foundation of exponential growth, compound interest, Moore's law, the engine of all things that grow, and
5. The number i, the imaginary unity of the complex numbers whose study leads to deeper insights into algebra and calculus and applies *rotation* to the formula.

When you put all of those numbers together in the above equation, what you get is *a perfectly solved puzzle* – not to some decimal but to an absolute perfect zero.

Toward our goal of compounding, Euler's Identity can serve as an important symbolic objective when its math is combined with poetry.

- Compounding (e - exponential) is the only power law which can be raised to the power of n in its exponent.
- If we can have a *holistic* superintending/palindromic perspective (π - pi) multiplied by curiosity and the imaginative (i - imaginative number) we can raise our compounding potential to the $i\pi$ power.
- $e^{i\pi}$ added to the first number (1) – the symbol for a fully symmetrical view backwards to our three big data sets (physical, biological, and human history).
- The equals sign represents the symmetric realistic present, our still point.
- The zero (0) is our future that is not defined as lacking in quantity but infinite. I like to think of zero as the reminder of the Socratic paradox, that what I know for certain about the future is that I know nothing. If we always conclude with that reminder we can be ever present to not skew forward with hope and optimism untethered.

SATOR SQUARE – "ROTAS OPERA TENET AREPO SATOR"

One of the oldest palindromes known to man is the Sator Square, which was found in the ruins of Pompeii (79 A.D.). The five words may be read top-to-bottom, bottom-to-top, left-to-right, and right-to-left.

While there are a number of theories of translations, the one that I think has the most merit is the boustrophedon reading (in alternating directions) common at the time. Sator (the sower), Opera (from opus – works), Tenet (mastery), Arepo (from arepus – by means of), Rotas (wheels).

A Sator Square in Oppéde, France

The sower works for mastery by turning the wheel.

Our most beautiful mathematical equation based on five-numbers combined with the oldest and most famous palindrome based on five-words share a universal connected message toward the secret of everything that prospers in the universe. Whether it is at the heart of everything that grows (physical universe - compounding), everything that evolves (biology - evolution), or human systems (human achievement), there is the same timeless message: persistent incremental progress eternally repeated (PIPER mindset) or as the oldest palindrome has it – the sower works for mastery by turning the wheel.

SATOR	OPERA	TENET	AREPO	ROTAS
THE SOWER	WORKS FOR	MASTERY	BY TURNING	THE WHEEL
PERSISTENT	INCREMENTAL	PROGRESS	ETERNALLY	REPEATED
0 =	1 +	e	i	π

Firm Updates:

- *Senior Equity Analyst – James Crockett*: We are pleased to announce the promotion of James Crockett to full-time Senior Equity Analyst. Jimmy has been with us for over a year as a Junior Equity Analyst while he finished his MBA at Boston College. Prior to going back to school, he worked as a Chemical Process Engineer at Bell Helicopter. He earned his undergraduate degree from the University of Michigan with a B.S.E. in Chemical Engineering. He has proven to be a valued member of the investment team.

We look forward to meeting and talking with you soon. We greatly value your support and trust.

> *"The desire to reach for the stars is ambitious. The desire to reach hearts is wise."*
>
> Maya Angelou (1928 – 2014)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder

Artwork Credit: Camille O. Vicente

APPENDIX:

THE CARD PLAYERS

Opta ardua pennis astra sequi.

Arcadia. At Aix-en-Provence, just after dark one blustery evening in the autumn of 1961, I was enjoying the twofold luxury of meditation and a meerschaum, in company with my friend Monsieur Benjamin Graham, in his little back library, or book-closet, at "La Champouse," No. 42 Avenue de Marseilles. For one hour at least we had maintained a reflective silence; while each, to any casual observer, might have seemed intently and exclusively occupied with the curling eddies of smoke that oppressed the atmosphere of the chamber.[5] For myself, however, I was mentally discussing certain topics which had formed matter for conversation between us at an earlier period of the evening; I mean the affair of the stolen Cezanne's recovered that morning only miles away, and G-'s favorite topic as of late, Euler's beautifully perfect theorem, which G- argues was discovered by Bernoulli. As he walked me through the mathematical proof, the eddies seemed to form Bernoullian, logarithmical spirals marching through time to the methodical, transcendental beats of π and e. The harmony and interconnectedness of the universe were curling before us, when we were interrupted by the *tattarrattat* on the door of the apartment and we admitted our old acquaintance, Monsieur D. Auguste Markét.

"Monsieur Graham has your retirement to the translations of Virgil and Homer made you forgetful of our appointment to play cards this evening? After last month's disappointing loss, I am eager to make myself whole."

"Negative, Monsier Markét, I continue to maintain the appropriate perspective on time. We have been expecting you. I sense your eagerness and impatience will prove again monetarily rewarding to me. Coincidentally, we have been discussing the news of the recovered stolen paintings, including Cezanne's *The Card Players* found hiding in plain sight in an abandoned car down the street."

"Yes G- I read about the recovery in this morning's paper. Silly thieves – what value is there in anything that cannot be readily sold at a moment's notice at a certain profit? Does this mean you will be waxing on again on the connection between Cezanne, Poussin, and Virgil? You impressed or should I say oppressed me during our last card game with your recitation of Champfleury's evocation of Cezanne's life work here in the Aix countryside – I am sensing a Cezanne Revisited monologue in honor of his recovered *magnum opus*."

"M- aha – insecurity cloaked in sarcasm, together with your other legion of oddities, I have become to rely on them for their consistency. I will indulge only for the sake of my more

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[5] The beginning of the first paragraph is purposefully the identical opening structure of Edgar Allan Poe's *The Purloined Letter* with word changes as appropriate to reflect the story.

thoughtful friend, Le Chevalier, before he takes his leave for the evening. Champfleury said of Cezanne in 1894 that "standing still for hours and hours, days and days in front of the same spectacle, struggling to understand it, to express it, – stubborn searching, concentrating in the fashion of those shepherds who, in the solitude of the meadows, have *discovered the beginnings of art*, *of mathematics, of astronomy, of poetry*… It is somewhat like, without method, the moving search of the Primitifs." My point was that Cezanne persistently and incrementally looked through form to seek out essence and truth that can only be found in the primitive nature of how things truly are. And contrastingly not what we are fooled into thinking by our perceptions. That is why that little picture, the most refined of the five versions of *The Card Players*, the version on loan from the Louvre and found in the abandoned car down the street, is so important. Cezanne, in that one picture and in the economy of every brush stroke and contemplated shape, encapsulated all that is essential from the beginning to the end of time in perfect infinite symmetry and depth of perception. In my opinion it is the most valuable painting the world has ever known and may ever know – born into existence by a simple shepherd seeking out those truths of Arcadia."

"Arcadia?" M- asked cynically.

"Yes, Arcadia – the *piper* Pan's home – a vision of pastoralism imagined by Virgil as an idyllic *vision of harmony with nature*. As if serving as an eternal signpost, Poussin's Arcadian shepherds point to the carved words – *Et in Arcadia ego* – I am also in Arcadia – what a lofty and worthy mortal objective. Enough on that subject for now. Speaking of the pipe, will you be needing a smoking pipe Monsieur Markét?"

"Monsieur Graham I am always in awe of your recollection of the primitive and superfluous. Arcadia is but a poet's attempt at the impossible – immortality. Soon enough, we are no more than a shepherd's shadow on an abandoned tomb. Can we focus again on the matter at hand – playing cards – the *releveler* medium of my previously purloined wealth? Engage le jeu que je le gagne! And no, non merci, I have a few puffs of a cigar left from an earlier smoke."

"Markét, might I be a fool I just may buy your cavalier demeanor yet I know your ambition to reach the stars knows no bounds. We just mostly diverge on how to get there and our amplitude of intention. Our definitions of winning are perfectly and symmetrically opposing."

As they dealt their first hand at an accompanying card table, M- struggling to light his weary stub of a cigar-butt and visibly unsettled by G-'s dealer choice of the game *Omaha* to light the evening's torch, I bundled up and excused myself from *The Card Players*.

EAST COAST

ASSET MANAGEMENT

2015 YEAR-END LETTER

I have just three things to teach: Patience, simplicity, and compassion.
These three are your greatest treasures.

Lao Tzu – Dao de Jing – 500 B.C.

Time and tide wait for no man.

Geoffrey Chaucer (1343 – 1400)

We have a light upon our house, and it gives hope to all who sail upon the stormy seas.
Do you know what it means to have a light burning atop your home?
It is safety, a place of refuge, seen by all as a signal that ye stand for something greater than this world, greater than us all.

James Michael Pratt
The Lighthouse Keeper

A ship in harbor is safe, but that is not what ships are built for.

John A. Shedd – (1859 – 1935)

It is better to light a candle than curse the darkness.

Eleanor Roosevelt (1884 – 1962)

EAST COAST
ASSET MANAGEMENT

To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO and Chief Investment Officer

Date: February 12, 2016

Re: 2015 Year-End Letter – Twin Lights

In our year-end letter, in the section titled *Twin Lights*, I will discuss how the beacons of *Distinction and Safety* shape our investment philosophy. As is our standard practice, our market overview and strategy update as well as client reporting, including performance and positioning, have been sent under separate cover.

Market Summary[1]

	S&P 500	**MSCI AC World Index**	**MSCI Emerging Markets**	**MSCI EAFE Index**	**Barclays Aggregate Bond Index**	**Gold – $/Troy Oz.**	**Crude Oil**
Price 12/31/2015	2,043.94	399.36	794.14	1,716.28	1925.40	1061.42	37.04
Q4 2015	7.03%	5.16%	0.68%	4.80%	-0.57%	-4.80%	-17.85%
2015	1.37%	-1.79%	-14.70%	-0.21%	0.55%	-10.41%	-30.47%
2014	13.68%	4.78%	-1.97%	-4.25%	5.97%	-1.72%	-45.87%

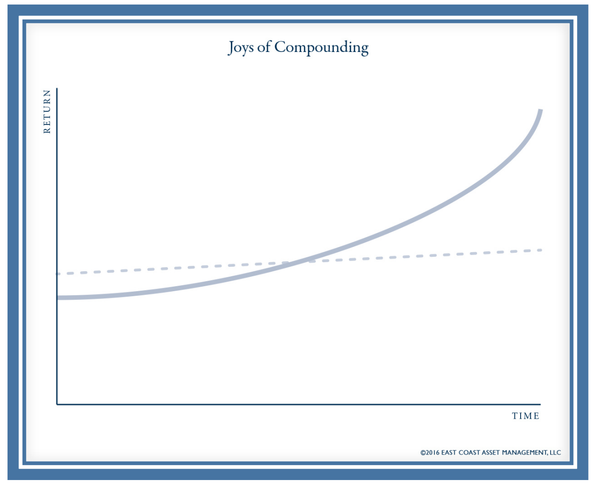
Military theorist Carl von Clausewitz wrote the widely influential book *On War*, which is often quoted for a commander's ability to reason strategically in the "fog of war." Clausewitz referred to a leader's ability to make rapid, highly consequential decisions with incomplete, dubious, and often erroneous information while experiencing high levels of fear, doubt, and excitement. On this topic he wrote, "*All action takes place, so to speak, in a kind of twilight, which like a fog or moonlight, often tends to make things seem grotesque and larger than they really are*."

Today we find ourselves in a "fog of war" where there is misinformation, fear, doubt and excitement swirling about nearly every global asset class and capital market. History reveals that *volatility* takes place in this kind of twilight where things seem larger, more devastating, and more grotesque than the likely truth of the situation. We believe distinguishing signal from noise, fact from fiction, sensible apprehensions from nonsensical unknowable concerns, and the myopic, frenetic short-term from the calm, collected, reasonable long-term is paramount to any *successful* investment strategy. The ability to derive these *distinctions* is what differentiates superior results from mediocrity.

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, the MSCI Europe Asia Far East Index (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices. Past performance does not guarantee future results. The discussions in this letter are for information purposes only. Please consult with your investment advisor before making any investment decisions. For complete disclosures about East Coast Asset Management LLC visit our website or consult our Form ADV and Form ADV Part 2A.

Toward this end, a focus on cash flows, moats, and valuations provides the long-term investor, who expects these tidal moments, with something tangible in a *fog* of panic. We believe that our per-share ownership of businesses in our portfolio have improved as certain companies have gained market share from distressed competitors and through opportunistically repurchasing shares. We are grateful to have clients and partners who allow us to look at these periods with a proper perspective and with the appropriate time horizon, as this is an essential ingredient if we are to attempt to achieve superior risk-adjusted compounded returns over the mid to long-term.

The Logarithmic Path:



T.S. Eliot opened his magnum opus the *Four Quartets* with an epigraph – a quote from the Stoic philosopher Heraclitus: "Although the *logos* is common to all, most live as though they had an individual wisdom of their own." The epigraph introduces the primary concern of the *Four Quartets*, the connection between the individual and the universal, the temporal and the eternal.

The secret of anything that *grows logarithmically* is the connection between the universal and the eternal in contrast with the individual and the temporal. In terms of growth we can conceptually think of two paths – the logarithmic path (upward sloping) and the linear path (dotted line). The etymology of logarithmic comes from the Greek root word *logos*, meaning the way or the path, and *rhythmic*, meaning number. Although the logarithmic path may be a *common* objective, most arrive on the linear path testing their *individual* wisdom.

The linear path is typically the path most people end up taking, where applying *individual wisdom* bears the burdens of biases, blind spots, and human instincts. The linear path is seductive as it advertises the *here and now* versus *waiting* for a future reward. The linear path is well travelled giving us the perceived sense of safety and community with the "in" crowd. What's more, the linear path generally starts out higher, where contrastingly the logarithmic path requires a prepayment period with an unknown, unquantifiable reward. Patience and delayed gratification were not useful instincts to our hunter-gatherer ancestors so they handed down very little DNA to assist in logarithmic ambitions. Planting seeds for future harvest is not intuitive. Perhaps that's why the rewards are so great for those that can crack the code [27-18-28].

Well-intentioned logarithmic pathfinders find themselves confined to the linear due to *intermittency* and *variability* of action toward intention. Many lives play out like the Greek tragedy of Sisyphus who was forced to push a boulder partially up a mountain only to see it roll back down to the bottom and start over again. The plight of the linear is pausing when things get too tough. Mediocrity is derived from the Latin word *medius*, meaning half, and *ocris*, rugged mountain. The linear path of *mediocrity* literally means – half way up the mountain. Staying on the logarithmic path is constant work and it requires habits that if not genetically embedded, need to be programmed into our being with *focus* and *frequency*. To enjoy the views from the top of the mountain by way of the compounding path requires sacrifice, delayed gratification, a long-term focus, and most of all a plan to fight off the foes of intermittency and variance when they rear their *idle* heads. Outliers find a way to clutch and cling to the *logos*.

Today's global equity markets are a case in point. There are so many temptations for an investor to take refuge and lower one's gaze to focus on the perceived reality of the manic depressive nature of *price*. The volatility of energy prices, China's hard landing, rising U.S. interest rates, the "what if" scenarios, and the terror of the bad actors in the geopolitical theater are just a few of the reasons to convince our human instincts to choose *mirages of safety* over a more intelligent, logical path that has been paved by reason and fundamentals.

Our stay-put behavior reflects our view that the stock market serves as a relocation center at which money is moved from the active to the patient.
Warren E. Buffett – 1991 Chairman's Letter

We are committed to a life-long study of the characteristics that should enable businesses to earn superior returns and sustain them over a long duration. Toward this end, we focus on expected per share cash flows that a business should generate over an appropriate time horizon. As the expected returns and our margin of safety are revealed with independent research, we can construct a portfolio around what we believe to be the most attractive risk-return businesses. We believe this path to be superior, intelligent, logical, and the most businesslike compared to other employed investment strategies. We only have to look to Warren Buffett and Charlie Munger to see just how rewarding the patient, logarithmic path can be.

Perhaps the logarithmic outcome is made possible by the collective aggregate of the linear. In the case of compounding, logarithmic paths and linear paths are not *opposing* forces but are *one* reality. Logarithmic success is born by the contrast of the linear crowd – a statistical force of nature driven by Pareto-like principles.

And the ragged rock in the restless waters, Waves wash over it, fogs conceal it; On a halcyon day it is merely a monument, In navigable weather it is always a seamark To lay a course by, but in the sombre season Or the sudden fury, is what it always was.
T.S. Eliot – *Four Quartets – Dry Salvages*

The misperception of risk, fueled by fear and envy, is often the reason investors abandon logarithmic paths. We have learned that risk is the *ragged rock* in *restless waters*. Waves wash over it and it's often concealed by fog when things are going well in calm, halcyon upward-sloping markets where *risk* is merely a monument, a seamark to lay a course by. Yet, in the sudden fury, *risk* is what it always was. We believe that business-like reason guided by the beacons of *Distinction* and *Safety* and the foghorn of a proper perspective of *Time* will allow us to stay on a logarithmic, compounding course. And as for risk, folly and hubris – we do not need the somber season or the sudden fury to remind us that the *ragged rock* is what it always was.

Twin Lights:

Gloucester Daily Times – February 24, 1919

Steamer George Washington bearing President Wilson and party returning from abroad and her destroyer escort might have come to grief on Thacher's Island yesterday afternoon at 3 o'clock while the craft and convoy were making for Boston, but fortunately the danger was discovered in time. The craft was coming nearly head-on in the snow squall which set in about that time when the danger was learned and the big liner stopped, sent full speed astern and anchored. …

When the Fog Lifted

The destroyer Paulding came close alongside and the heliographs got going. Then from over the starboard bow came the doleful, steady wail of a foghorn-dealing out its warning. Officers recorded the blasts by stopwatch, hoping to identify the station by its manner of blowing. Meanwhile Captain McCauley (USS George Washington) flashed a heliograph message to the Paulding to proceed cautiously and attempt to identify the signal. In a moment the destroyer got under way, splitting long trails of black smoke from her funnels, but she had hardly started when the wind shifted and drove the snow flurry off to the north, the fog lifted and one of the officers perched on the upper deck sang out:

"Thachers Island Dead Ahead!"

Through the dissolving mist the two lighthouses of the Cape Ann station became visible and the suspense was over. The Washington and her convoy had been headed toward shore just above Eastern Point Gloucester and still further north from Marblehead.

On that fateful day, President Woodrow Wilson was returning from the signing of the Treaty of Versailles in Paris. He directed Captain McCauley to redirect the convoy's destination from New York to Boston so he could make a speech to drum up support for his League of Nations agenda. The 722 foot USS George Washington was carrying over two thousand soldiers including the then Assistant Secretary of the Navy, Franklin D. Roosevelt and his wife Eleanor. It would be only 13 years later that FDR would become our 32nd President and be called upon to guide us through a Great Depression and World War II. Eleanor Roosevelt serving as "First Lady of the World" would go on to achieve historical progress in human rights.

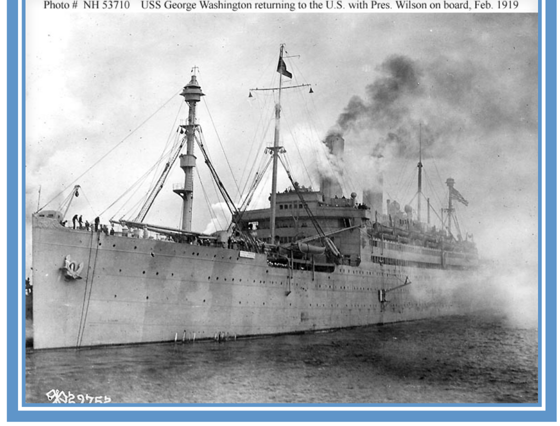


Photo # NH 53710 USS George Washington returning to the U.S. with Pres. Wilson on board, Feb. 1919

Maurice Babcock is one of the unsung heroes in our country's history. Acting as Thacher Island Third Assistant Keeper, Babcock saw a large ship heading for the island through a break in the fog. He incessantly blew the foghorn until he saw the ship shudder to a stop and turn away at the last minute before hitting the Londoner reef or the Dry Salvages reef just to the north. Babcock was unaware this was the USS George Washington and it wasn't until days later when a story appeared in the *Gloucester Daily Times* (referenced above) that Babcock read just how consequential his efforts were.

The Twin Lights had remained *hidden in plain sight* for my twenty years living on Cape Ann. Having grown up on Cape Cod with lighthouses scattered about, my conscious mind perhaps filtered what it had considered commonplace, as is typical of most blind spots in life. I have spent countless mornings admiring a sunrise casting light on the Twin Lights at our local surf break in Gloucester, yet I never knew their history. Why two? And why were they there to begin with? There was always this comfort and essence to their presence; the beauty of their symmetry and how nature would change around them throughout the seasons. They remained sentinels of my subconscious. The veil of ignorance was lifted this past summer when a friend, who has considered the island his refuge since he was a boy, invited my daughter and me to join him on his boat to explore the island and climb the towers.

The Twin Lights were built in 1771 after John Hancock, who had a large shipping business in the area, petitioned the Massachusetts government to build a lighthouse on the island. Once the American Revolution ended, President George Washington believed lighthouses were so important to trade that the ninth act of the newly formed Congress created the U.S. Lighthouse Establishment to build and maintain lighthouses along the East Coast. In 1792, Alexander Hamilton signed the actual appointment letter for the first lighthouse keeper at Cape Ann Light.

The Twin Lights were particularly important, as it was the first sight that ships arriving from Europe saw before working their way south to Boston Harbor. The island guarded the extremely dangerous Londoner reef that sits a half-mile off its southeastern shore and Dry Salvages reef just to the north. Several English wrecks occurred in this area, which was why the reef was named the Londoner. The Twin Lights are particularly noteworthy for two reasons:

1. <u>Distinction:</u> The reason two lighthouses were built on Thacher Island was so ships could determine which lighthouse it was before an intermittent light system was invented, called light characteristics, to mark distinction. Specifically it was important to distinguish between Portsmouth Light to the north and Boston Light to the south. Building Twin Lights was the best way **to mark a distinction without any shadow of a doubt**. The North-South alignment of the Twin Lights also serves as a range light to determine one's navigational heading. The Twin Lights are one of only eight Twin Lights ever built and today they remain the *only* ones still lit and in operation.

2. <u>Safety:</u> The Twin Lights were the first station built in the United States to mark **"a dangerous spot in the ocean"** as all other stations at the time simply marked harbor entrances.

The reason for the existence of Twin Light's, coupled with their steadfast duty of saving lives and assisting ships over the last 250 years, share two foundational principles we apply to our investment process: *Distinction and Safety*.

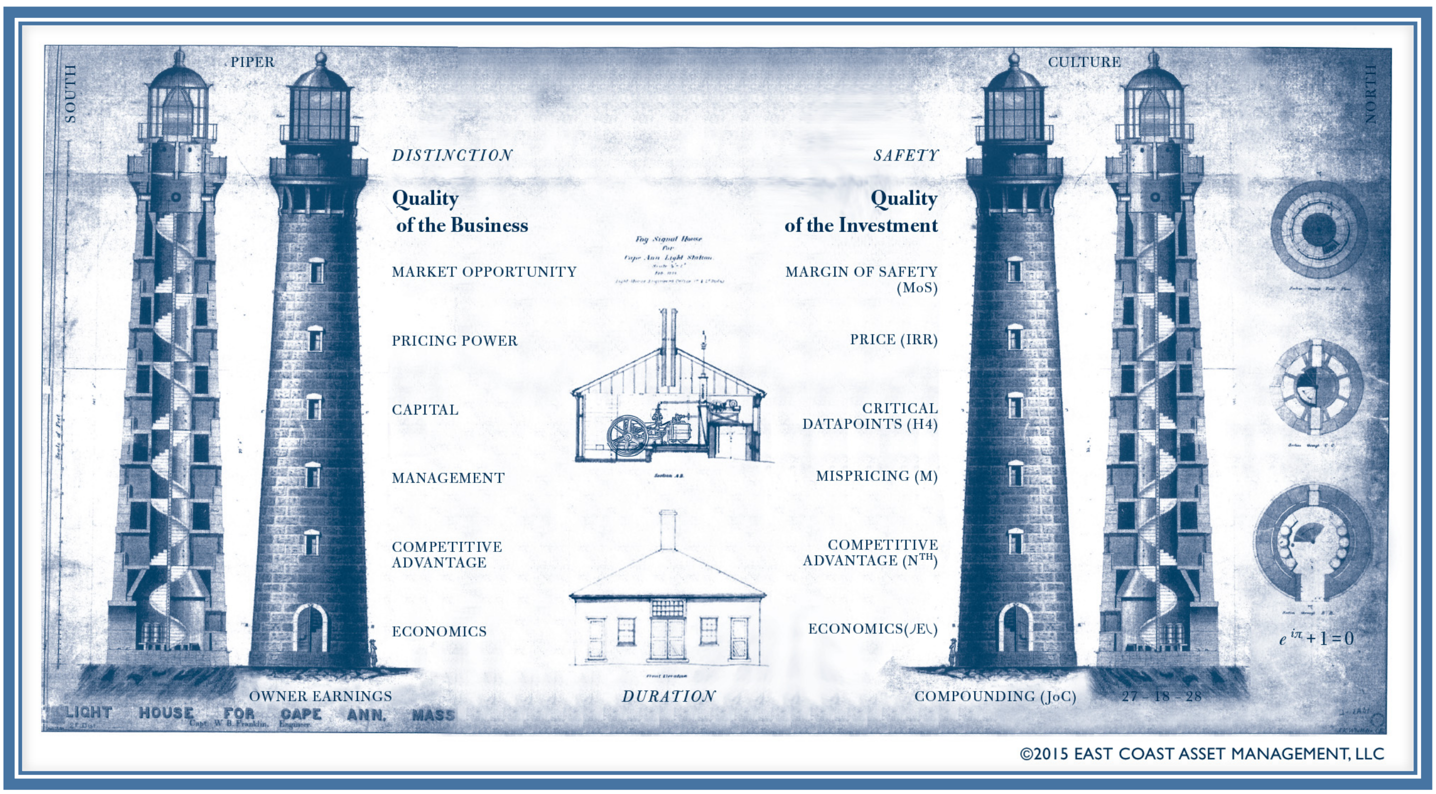
> *It is impossible to produce a superior performance unless you do something different from the majority.*
>
> Sir John Templeton (1912 – 2008)

I. BEACONS OF QUALITY – A "BLUEPRINT" FOR DISTINCTION AND SAFETY

Quality of the Business – *Distinction*

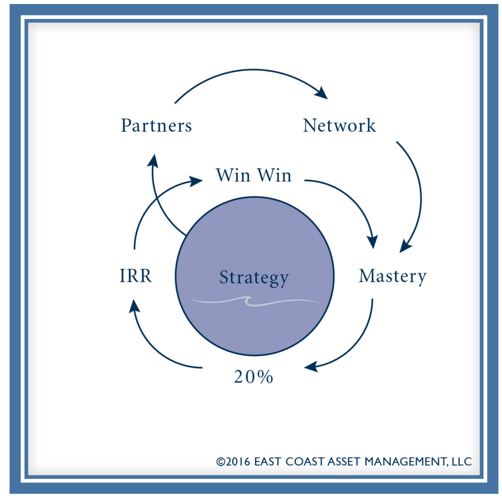
The first lens of our investment process begins with an assessment of the Quality of the Business. We have articulated our hexagonal approach to *Distinction* in previous quarterly letters and have referred to this element of our process as the "Six Sides of Great." Toward this end we are qualifying and quantifying a business's economics, competitive advantage, market opportunity, pricing power, capital (structure and allocation history), and management's operational capability. We are looking to determine what o*wner earnings* will look like over the next five to ten years with some confidence. Businesses are categorized as Compounders, Transformations and Workouts depending on their lifecycle and economics.

The beacon that lights the way for any business that passes our due diligence of *Distinction* lens is a **PIPER mindset.** Persistent Incremental Progress Eternally Repeated is at the heart of anything that grows and grows better over time. We are ideally looking for businesses where the terminal value will be materially better in five years or more.



PIPER Mindset – Twin Lights South – *Distinction*

Great businesses have a focused and far-reaching signal that is driven by a winning system and strategy. Every great business has a *flywheel* at work that is providing a steady state – non-intermittent power source producing abundant and amplified power. We attempt to identify a business's key drivers based on what flywheel effects are at work. We borrowed this idea from the actual back of the napkin flywheel that Jeff Bezos created when he launched Amazon. We have found this template a creative way to identify six critical areas of the business that will create *enduring* growth or help identify when there is a fatal flaw in the system. We have looked at East Coast's investment management principles under the same framework.



1. **Win-Win:** Our flywheel begins with the objective of a win-win mandate. We want our operations and the businesses we invest in to pass the "Win-Win Test" with all six counterparties: customers, employees, suppliers, stewards, shareholders, and the community. Win-Win is the only system that is sustainable over the long-term – any fatal flaw with any counterparty will inevitably self-correct. We believe by striving to eliminate Win-Lose, Lose-Win, and Lose-Lose situations we can go far in removing many of the blind spots that those unsustainable relationships nurture.

2. **Mastery:** We are seeking a level of Mastery in understanding the fundamental truths that enable a business to earn superior returns, with a healthy margin of safety over the longest duration possible. We prefer "one decision" (buy) to "three decision" (buy, sell, reallocate) investments, therefore the duration and sustainability of a business's advantages are important to us. We want to cultivate a level of creativity and imagination of how we curate and source the opportunities that meet our criteria.

3. **20%:** We believe Pareto's principle is one of nature's most prominent signatures. 20% of anything that is allowed to thrive owes its gratitude to the 80% that gives birth to its contrasting advantageous divergence. We believe it is likely that less than 20% of all businesses, worldwide, are actually going to be better five years from now. We are qualifying better as a widening moat and quantifying better as its return on tangible assets employed. This insight has taken greater essence for us as our process has evolved and is particularly important for focused investment strategies. This quality insight came out of the rhetorical question Warren Buffett has often asked – what percent of businesses will be better five years from now?

4. **IRR:** If we are successful in seeking Win-Win relationships, arriving at investment Mastery in our niche, and investing in a curated universe of businesses that are improving (20%), we increase our odds of earning superior compounded returns, without risking permanent loss of capital over a long duration.

5. **Partners:** Our desire is to work with clients and partners who share our appreciation of the logarithmic path – compounding of learning and capital. We believe our success will be directly correlated with whom we partner with to maintain a structure that can enable mutual success. Partners will lead to leaping emergent effects in both the joy of compounding and compounding of joy. We are interested in both so our business development efforts are limited to introductions by interested parties that we trust. We endeavor to deserve a call from potential clients and partners that share these ideals.

6. **Network:** A carefully cultivated network of investors and operators drives exponential benefits to the proceeding five ideals. This is one of the great sources of intellectual property we honor. This is also one of the areas in which we receive our greatest sources of joy in solving the puzzles with curious, intelligent, hardworking individuals.

In chess you might find a good move. Then you might find a better move. But take your time. ***Find the best move****.*

It is rarely a mysterious technique that drives us to the top, but rather a profound mastery of what may well be a basic skill set.

Josh Waitzkin – *The Art of Learning*

Quality of the Investment – *Safety*

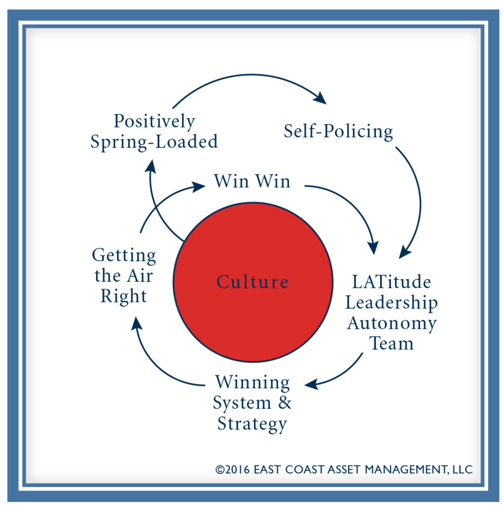
The second lens of our investment process takes a *quality business of distinction* through an assessment of the Quality of the Investment. We have written about our hexagonal approach to *Safety* and referred to this stage of our process as "M-Theory." Toward this end we are qualifying and quantifying the investment's merit by the following attributes: nature of its mispricing (M), critical data points that will drive the investment (H4), margin of safety (MoS), price and valuation (IRR), the duration and durability of competitive advantage (N^{th}) and economics (e). The foundational understanding where we are looking to arrive at is to determine the compounding merit of the investment – superior returns, asymmetric risk, and ideally a long-duration. We value the important truth that almost any advantage can be copied away eventually and that the only truly sustainable long-term competitive advantage lies in the *culture* of a business.

The beacon that lights the way for any investment that passes the due diligence of our *Safety* lens is **Culture**.

Quality tends to fan out like waves. *The Quality job he didn't think anyone was going to see is seen, and the person who sees it feels a little better because of it, and is likely to pass that feeling on to others, and in that way the Quality tends to keep on going.*

Robert M. Pirsig – *Zen and the Art of Motorcycle Maintenance*

Culture – Twin Lights North – *Safety*



We are keenly aware that the only, truly *durable* competitive advantage is Culture.

1. **Win-Win:** Win-win is as much safety as it is compassion. The sustainability of any organization ultimately rests on delivering a win-win partnership with counterparties. Any other relationship will eventually lead to a fatal flaw that will eventually be corrected. Be constant – Be Kind.

2. **LATitude:** The best, most thriving business cultures typically have a combination of three things: 1) a centralized leader who sets the tone of the organization, 2) a leader who gives responsibility and autonomy to their teams, individuals and often business units to carry out their vision, and 3) a leaping emergent effect driven by team dynamics. We see the effectiveness of this at Berkshire Hathaway, Transdigm, Constellation Software, and Glenair. The alternative is an approach of centralized control and micromanaging that,

while it can optimize cost and control, rarely aligns with human nature's innate desire for freedom.

> *A leader is best when people barely know he exists, when his work is done, his aim fulfilled, they will say:* ***we did it ourselves****.*
>
> Lao Tzu – *Dao de Jing*

3. **Winning System & Strategy:** Winning is just as important for employees as it is for the owners and operators of the business. Winning is essential to the culture of the organization. Not every human being is given the same opportunities at birth. For many employees working for a winning business may be one of their first opportunities to be part of something greater than themselves. Shared success and purpose amplify human achievement and the whole can accomplish things that were never thought possible.

> *The achievement in my life of which I am the most proud was turning that crew into a tight-knit, smoothly functioning team that boasted—accurately—that Benfold was the best damn ship in the Navy.*
>
> D. Michael Abrashoff,
> *It's Your Ship: Management Techniques from the Best Damn Ship in the Navy*

4. **Getting the Air Right:** A safe, secure environment where there is plenty of work is one of the most important elements of a great culture. Any species on this planet, when there is a feeling that resources are scarce, will hoard. Employees, when they feel the work is scarce or their job is at risk of being rationalized, will hoard work and hoard information so no one will know how to do their job. This culture of hoarding exists in many businesses that fail to understand the important psychology of scarcity and abundance. The goal is to create a homeostasis environment where workers can feel safe and thrive. This insight was recently imprinted again after a recent visit to see Peter Kaufman at Glenair – one of the best cultures and most exceptional CEOs in the world.

5. **Positively Spring-Loaded:** Every organization is subject to chaos. Uncertainties of economic cycles, disruptive technologies, and competition affect every company. The goal is to have a culture where the chaos can be confronted with a positive, united force. If all of the first four attributes of a great culture are in place, the business will have prepaid the system for positive outcomes. Cultures that are inferior when they face challenges will often spiral out of control because the system is negatively spring-loaded.

6. **Self-Policing:** Another virtuous effect of a great culture is that the work force and system participants will take great care to protect that which they value. They value their career, livelihood, and the joy and purpose of their job that they will monitor to make sure nothing stands in the way of hindering their happiness and autonomy.

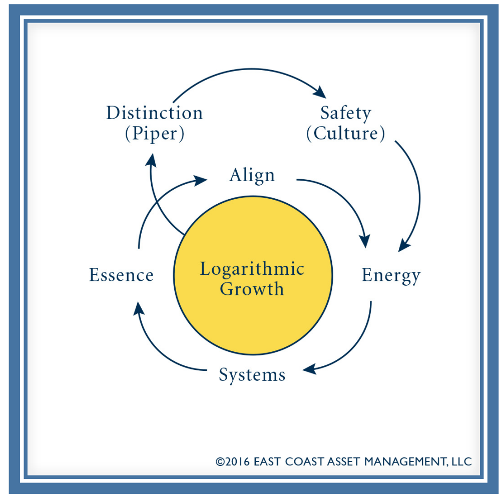
> *We trust that all of these intellectual and moral qualities will take deeper root in your lives, that they will* ***grow*** *through you and in you in all the days ahead, to enrich each one of you as a person, that most beautiful of God's creations****, and to add luminosity to your lives in a world that is often dark****.*
>
> Rev. Theodore Hesburgh (1917 – 2015)
> President – University of Notre Dame for 35 years

II. DISSIPATION DRIVEN ADAPTIVE ORGANIZATION – D^{2}AO

Organizational System – Foundational Structure of *Distinction and Safety*

The foundational structure that allows the Twin Lights of *Distinction* and *Safety* to follow a logarithmic path is an evolved and adaptable *organizational system*. The Second Law of Thermodynamics (Entropy) shows that energy is attracted to an organized framework that can harness that energy to do work and dissipate energy, which further compounds and replicates that organized entity. You only have to look to our DNA, the hexagonal atomic structure that creates a snowflake, or the hexaploidal DNA of a Coastal Redwood (3rd Quarter 2014 *Grove of Titans*), to see the system driven organization. **Nature aligns itself with an evolved structure and organization to fulfill its compounding mission.** When we observe the examples of outlier compounders, species, individuals and organizations from quantum to cosmos that have thrived we find the same six virtuous "flywheel" effects:

1. Align - An alignment with Nature's laws,
2. Energy - Harnessing an infinite and abundant energy source,
3. Systems - An evolved organizational system and structure,
4. Essence - An adaptable evolving growing entity,
5. Distinction (superior returns, PIPER mindset),
6. Safety (sustainability, culture).



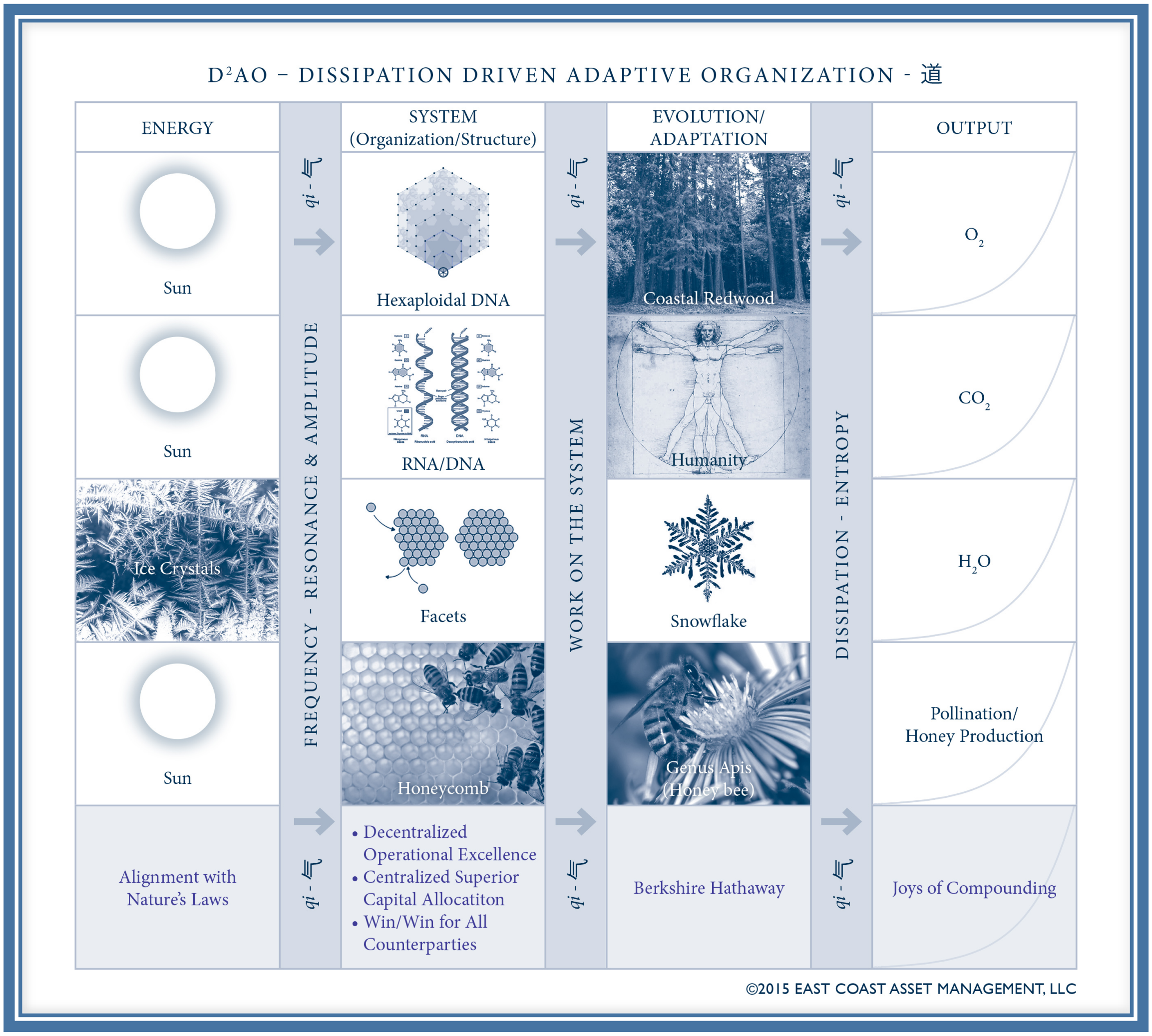
As this cycle propagates, the cycle becomes *virtuous* as energy *resonates* with those systems that have the capacity to dissipate greater amounts of energy.

Last quarter I visited with Jeremy England at MIT who has been working on a theory of evolution modeled after these very laws of physics, which he refers to as *Dissipation Driven Adaptive Organization*. I was intrigued as it makes sense that a physicist, with a fresh perspective and a much longer and universal data set (13.7 billion years), might shine the light a little brighter on the science of evolution.

Greater structural organization is another means by which *strongly driven systems* ramp up their ability to dissipate energy. A tree, for example, is much better at capturing and routing solar energy through its design than an unstructured heap of carbon atoms. England theorizes that under certain conditions, matter will spontaneously self-organize. This theory could account for the internal order of living things and of many inanimate structures as well. England noted that what, "Snowflakes, sand dunes and turbulent vortices all have in common that they are strikingly patterned structures that emerge in many-particle systems driven by some dissipative process."

> *Classical thermodynamics is the only physical theory of universal content which I am convinced will never be overthrown, within the framework of applicability of its basic concepts.*
>
> Albert Einstein (1879 – 1955)
>
> *The law that entropy always increases holds, I think, the supreme position among the laws of Nature.*
>
> Arthur Eddington (1882 – 1944)

The more businesses we study, the more we find that these insights apply perfectly to what determines an outlier organization. The common thread that connects our greatest investments over the longest durations has been one of greater structural organization leading to the ability to scale those businesses whereby greater and greater amounts of work are attracted to that system. Intuition might suggest that the great investments came from being early to a revolutionary product or an early entrant into a huge market opportunity. This has not proven to be the case. What we have found is that an evolved system that values persistent incremental progress eternally repeated (PIPER mindset) has delivered the greatest return, while taking the least amount of risk over the longest duration.



I will add that these are not novel ideas but have been the foundation of some of the greatest bodies of wisdom human history has written. The Stoic philosophers like Heraclitus and the Eastern Philosophy of Lao Tzu in the Dao de Jing have been sharing the wisdom of the *flow* of the universe, contrasting of high quality energy to low quality energy, and the compounding benefits of virtue since 500 B.C. We should appreciate the irony that the science that *lights the way* is finally catching up with art that *warms the heart*. These definitions of Art and Science will forever be the *essence* of the logarithmic path and thus the ***Twin Lights* of Truth**.

> *There are two kinds of truth: the truth that lights the way and the truth that warms the heart. The first of these is science, and the second is art. Neither is independent of the other or more important than the other. ... The truth of art keeps science from becoming inhuman, and the truth of science keeps art from becoming ridiculous.*
>
> Raymond Chandler (1888 – 1959)

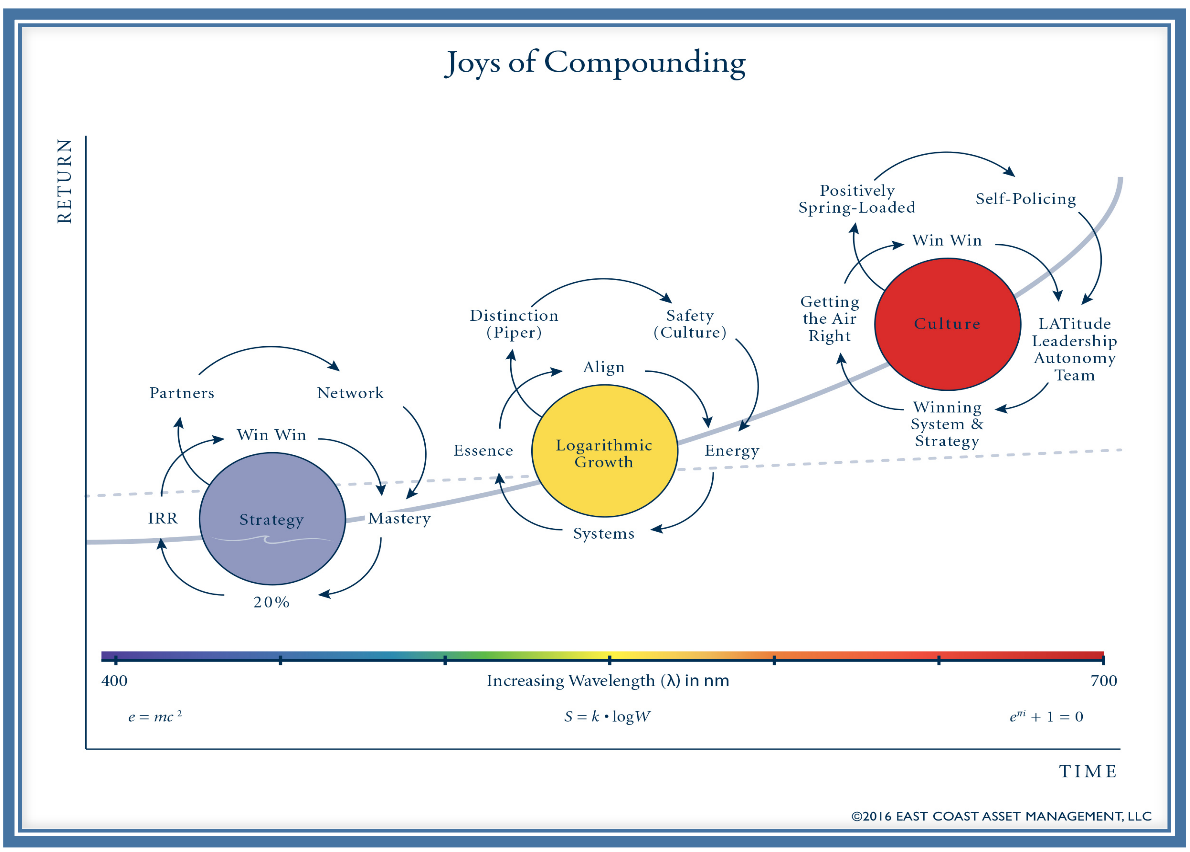
III: WHISTLE HOUSE – "FOG SIGNAL" – *TIME*

Joys of Compounding – The Logarithmic Path – *Distinction*

The French philosopher Claude Adrien Helvetius aptly said, "Truth is the torch that gleams through the fog without dispelling it." The beacons of *distinction* and *safety* can be often shrouded in the fog of a market's short-term focus. When the opportunities to own great businesses are most abundant will also be a time when there is no clear timing on when the fog will be dispelled. The foghorn that guides the intelligent investor is a proper focus on both the quality of the business and quality of the investment. In other words, finding the appropriate balance of both offense and defense. Looking at the symmetry of those two hallmarks will go far in gaining the confidence to administer **patience** and invest deliberately.

From our experience, the businesses that enjoy a logarithmic path are centered on a ***dissipation driven framework*** leading to *distinction* and *safety* buttressed by a ***winning system and strategy*** and a ***world-class culture*** that will allow the organization to amplify returns over an extended period of time. **Truly extraordinary businesses have all three of these "flywheel" masses of energy merged together creating a *gravitational wave*[2] that can be *surfed* for a long time.** These are the businesses that make up our ***20%*** and where we want to apply a Twin Lights process to identify and weigh the most attractive opportunities.

> *In a long life, you can expect to profit heavily from at least a few of those opportunities if you develop the wisdom and will to seize them. At any rate, "surfing" is a very powerful model.*
> Charlie Munger



[2] Congratulations to the LIGO team who announced this week the discovery of *gravitational waves*, ripples in space-time first anticipated by Albert Einstein a century ago. The LIGO discovery signals a new era in astronomy.

Dry Salvages – Timelessness – *Safety*

> *The Dry Salvages—presumably les trois sauvages—is a small group of rocks, with a beacon, off the N.E. coast of Cape Ann, Massachusetts. Salvages is pronounced to rhyme with assuages. Groaner: a whistling buoy.*
>
> T. S. Eliot – Opening to *Dry Salvages – Four Quartets*

Twin Lights were established to warn ships about the Dry Salvages and the Londoner Reef. T. S. Eliot grew up boating around the waters of Gloucester and named the third quartet after the Dry Salvages reef just off Thacher Island.

The *Four Quartets* is a journey from the temporal to the eternal. I have written on *timelessness* in the past. I continue to find that the most enlightened investors and operators seem to operate above time. They view things under the aspect of eternity. They can see farther and yet are completely present. A proper time horizon is one of the greatest competitive advantages that exist in investing. I began this letter with the words of Lao Tzu, so it is fitting to conclude with his timeless reminder that patience, simplicity, and compassion are our greatest treasures - signposts marking the *qualities* that lead us to and sustain us on the *logarithmic path*.

Firm Updates:

- *ECAM Award 2016*: We are pleased to announce that *Glimmer of Hope* has been selected as recipient of the sixth annual ECAM Award. Glimmer helps lift women and children out of extreme poverty in rural Ethiopia. Glimmer focuses on four areas of development: water, health, education, and microfinance and has spent more than a decade affecting millions of lives. The ECAM Award is given annually to a charity whose mission is deliberate, simple and relevant to where our support can translate to compounding benefits.

We look forward to meeting and talking with you soon. We greatly value your support and trust.

Between two waves of the sea.
Quick now, here, now, always—
A condition of complete simplicity
(Costing not less than everything)
And all shall be well and
All manner of thing shall be well

T.S. Eliot – Final Verses of *Four Quartets*

On behalf of the firm,

Chris

Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder

EAST COAST
ASSET MANAGEMENT