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# FINDLAY PARK PARTNERS LLP

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## FINDLAY PARK AMERICAN FUND NEWSLETTER 27<sup>TH</sup> SEPTEMBER 2012

**Price of Dollar Shares: \$53.36**

**Price of Sterling Hedge Shares: £28.95**

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

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

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## Performance

Year-to-date the Fund is up 13.2% which compares with the S&P500 which is up 13.5% and the Russell 2000 up 11.9%. We have been able to roughly keep up with the indices this year which is a reflection of some quite good stock picking despite an average cash position in the low teens over this time period and also despite not having enough in housing-related stocks (more on this later). While in New York last week we were told by a contact who is on the board of a large fund manager that very few fund managers have outperformed this year. A factor is Apple which has contributed around 3.5% to the performance of the S&P500 alone, being up nearly 70% year to date.

To remind investors what we have said in recent newsletters: we are going through a very uncertain period from a macro perspective worldwide and no one really knows exactly what the outcome will be. In this environment we are just trying to be a sensible steward of our investors' capital, investing in a relatively conservative manner with a focus on high quality companies that generate significant excess cash flow and are able to enhance their growth through stock repurchases in the inevitable weak periods in the stock market when macro concerns are elevated.

## Economy and Stock Market

The third quarter has been characterised by continuing weakness in the world economy. The purchasing managers' indices in China, Europe and the US have all fallen below 50 and each area has its specific issues with a somewhat unclear outcome. Global growth has only averaged 2% during the middle quarters of the year, with a sharp contraction in global industrial production growth. **Despite this, the market has risen consistently since early June, about the time the robust unemployment numbers earlier in the year reversed and the profits outlook started deteriorating.** US Corporate profits have risen very sharply from around \$52 on the S&P 500 in early 2009 to around \$104 estimated for 2012. We have already had quite a few preannouncements for the third quarter results, almost all on the downside, particularly from the transportation sector, a key indicator of economic growth. The US economy is rather sensitive to the price of oil and the fall in this commodity in the

middle of the year should have led to a pick-up as we go through the second half of the year. Unfortunately tensions in the Middle East and more quantitative easing has resulted in a sharp rise in the oil price over recent months, putting further pressure on the economy.

As the year has progressed there has been more attention focussed on the fiscal cliff of over 4% of GDP, which hits at the beginning of 2013. This has been visible since earlier in the year and there are clear signs that corporations have cut back on spending in anticipation of the headwind if none of the issues are pushed out. Unfortunately the election has been fairly acrimonious, made worse by new legislation allowing almost unlimited spending by both candidates. We have all recently spent time with so-called Washington insiders and there are many different opinions on what will happen. There is no doubt that sense should prevail and a proper long-term budget solution should be worked out early next year, while some of the cliff is pushed out until a compromise is worked out.

The fact remains that the US has not really addressed some of the fiscal issues that Europe has tried to deal with, partially because there is a belief in the US that you need to grow out of your debt problems. On this topic we read a very interesting in-depth look at deleveraging from Ray Dalio of Bridgewater, one of the most successful macro hedge funds in the world. He looks at the Japanese example, America in the thirties and the UK after the war amongst others. Some have been ugly, causing great economic pain, social upheaval and sometimes wars, while others he describes as being quite beautiful, causing orderly adjustments. He describes the current US deleveraging as the 'beautiful' type with enough printing of money, debt monetisation to bring the nominal growth rate above the nominal interest rates, and the currency weakness to offset the deflationary forces. The best way for this to happen is for central banks to provide adequate liquidity and credit support, depending on different key entities' need for capital and for the central government to provide that too. This takes the form of the Central Bank lending against a wider range of collateral, both lower quality and longer maturity. This produces relief if done in the right amounts, and allows the deleveraging to occur with positive growth. The right amounts are those that a) neutralise what would otherwise be a deflationary credit market collapse, and b) get the nominal growth rate margin above the normal interest rate to tolerably spread out the deleveraging process. History has shown that those who have done it quickly and well, like the US in 2008/09 have derived much better results than those who did it late, like the US in 1930-1933. He believes the US has roughly got the current deleveraging right, with reflation and debt reduction through a mix of rising nominal incomes, default and debt repayment. During the ugly phase between June 2008 and March 2009 before the Fed

instituted its aggressive programme of quantitative easing to monetise the debts, incomes fell, total debt burdens rose from 340% of GDP to 370% and stocks lost almost half their value. He points out that debt burdens have now fallen below their starting level to around 335% (still pretty high), stocks have recovered all their losses, incomes have recovered, the credit markets have largely healed and private sector credit growth is beginning to improve. "Thus far, this deleveraging will win our award for the most beautiful deleveraging on record." He points out that debt levels have fallen 13% per year since early 2009 because of private sectors deleveraging while government borrowing has risen. Nominal growth has reduced the ratio while defaults contributed to a 6% reduction and repayments another 15%. The private sector has reduced its debt level by 37% of GDP. What is unclear is how Bernanke will reverse some of the stimulus to keep inflation under control longer term. This is a somewhat complicated subject but encouraging to read such an analysis by one of the most successful investors of the last 30 years.

### **US Housing & Mortgage Market**

One bright spot in the US economy has been the recovery in the housing market with some of the most depressed places recovering the fastest, mainly because of positive long-term demographics in those areas. The administration and the Fed realise that to get unemployment down much further you need to see a recovery in the housing market, and this will also cause a feel good factor with almost a third of households in negative equity. Mortgage availability is still very restricted, mainly because of the put-backs of older mortgages that Fannie Mae and Freddie Mac are sending back to the banks. The uncertainty around this has caused many large banks, such as the Bank of America, to severely cut back on mortgage originations. It seems the authorities really understand the issue here, and below we describe some of the details of the recent quantitative easing and policies the government is implementing to improve the housing market.

Recent policy announcements by the Federal Reserve (the "Fed") and the FHFA – the regulator of Fannie Mae and Freddie Mac ("Agencies") – represent a step-change in efforts to stimulate the US housing market and economy. The Fed has committed to buy \$40bn of Agency Mortgage-Backed Securities (MBS) per month until labour market conditions improve, in addition to the \$20-35bn they are currently reinvesting from their existing MBS holdings (accumulated during earlier QE efforts). The net result is that the Fed will be purchasing \$60-75bn in Agency MBS per month. For context, the entire US mortgage origination market averaged \$136bn in issuance per month in the first half of 2012

(and that includes private label and Ginnie Mae mortgages which are not targeted for purchase). The result has been a sharp drop in 30-year Fannie Mae MBS yields to 1.80% (chart below). This is the “secondary” market where Agency residential mortgages trade once they are securitised. Banks are currently originating 30-year fixed-rate Agency mortgages at 3.51% but the sharp drop in Agency MBS yields is likely to drive these rates lower in the future, improving housing affordability, driving another wave of mortgage refinancings and, potentially, driving residential home prices higher.<sup>1</sup>



Housing affordability is not the major impediment to the US mortgage market however – borrower eligibility and banks’ willingness to extend mortgage credit are more significant issues. Banks’ appetite for originating mortgages has been diminished by put-back claims related to mortgages and MBS they issued during the lax underwriting period between 2005 and 2008 – put-backs have cost the largest six banks \$23.2bn in the last 6 quarters alone. Most of these put-backs emanate from Fannie Mae and

<sup>1</sup> Some speculate that the yield decline seen in the Agency MBS market may not translate to lower 30yr Agency mortgage rates due to a lack of origination capacity at US banks, an oligopolistic market structure, and the rise in 10yr and 30yr Treasury yields post QE3

Freddie Mac which are in turn controlled by the US Government. Providing clarity with respect to mortgage put-backs is important to incentivise banks to underwrite mortgages. One of the reasons that the government's Home Affordable Refinancing Programme (HARP) version 2.0<sup>2</sup> was so successful is that it immunised banks from put-back risk. Version 1.0 of the HARP programme was announced by the Obama Administration in March 2009 with a goal to help 5m Americans who were underwater on their mortgage refinance (provided they were current on their mortgage payments). Most of these borrowers could not refinance otherwise due to a change in their credit scores during the recession. By August 31, 2011 only 894,000 HARP 1.0 refinancings had taken place as banks were reluctant to refinance mortgages without put-back protections and/or stringent underwriting criteria which greatly reduced the probability of a mortgage being put-back to them. In late 2011 the government launched HARP version 2.0 which contained several changes, the most important of which was rescinding mortgage put-back risk. HARP 2.0 has been a big success since its launch in November 2011 – members of Congress and the Fed have taken notice. There appears to be some movement on the put-back front outside of HARP 2.0. In September the FHFA released a new framework for mortgage put-backs with increased transparency and restrictions on put-backs in certain circumstances. These new policies only come into effect on January 1<sup>st</sup>, 2013 but the improved disclosure should aid the availability of mortgage credit. These recent policy actions by the Fed and the FHFA to resuscitate the market come during a period when residential housing is finally showing signs of life: nationwide home prices are up +1.2% YoY and +6.9% QoQ (according to the S&P/Case-Shiller index), housing starts are up +20% YoY, new home sales are up +21% YoY, existing home sales are up +10% and inventories are declining (existing home inventories are down -20% YTD and now represent 6.1 months' supply). Fears remain about the supply of seriously delinquent (90+ days past due) and foreclosed homes but these inventories are also down (30%) since the peak in January 2010.

## Portfolio

Overall we continue to have around 10% cash, down from the mid-teens earlier in the year, as the authorities seem to have brought out the big bazookas and it rarely pays to fight the Fed. Despite the current weakness in world growth you could paint a picture where by the middle of next year the US has addressed the fiscal cliff, the election is out of the way and US corporations, which have been

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<sup>2</sup> Home Affordability Refinance Programme 2.0 allows borrowers who are current on their mortgage payments refinance even if they have a loan-to-value (LTV) >125%

hording cash, begin to invest again while the housing market recovers further. The political handover in China will have been done, allowing more certainty for investment there, combined with potentially more fiscal or monetary stimulus. The other issue driving equities at a time of almost zero interest rates and an unattractive outlook longer term for bonds, is the ability to buy real assets at what seem to be reasonable valuations, giving one some inflation protection. Where else do you put your money? The recent rise in the S&P 500 has been driven by multiple expansion, not earnings growth, but over the previous 18 months the market had been relatively flat although earnings had grown significantly.

We just highlight again how low energy prices should be structurally good for the US economy over the next few years, with gas selling at about \$3 per MCF, well below levels elsewhere in the world. This has dragged down the price of coal very significantly, further reducing many energy costs throughout the economy, and also creating a much bigger export market as US coal is now very competitive on a global basis, both met and thermal.

There are people who think the world is heading for deflation and others who think it is heading for inflation - to us the outcome is somewhat unclear. However, we are trying to make sure that with each investment in the portfolio the companies have pricing power, decent returns on capital, and we have also been trying to find companies whose margins will benefit from less upward pressure on commodity prices. In the last year China consumed around 60% of the world's cement, around 40% of the world's copper and 55% of the world's iron ore. Its consumption of energy, particularly oil, is more in line with its share of world GDP at 10 or 11%. Also consumption of food is more in line with the figures for oil. It seems there's a good chance that some of the harder commodities might fall in price after ten years of rapid increases. Many companies have suffered from this raw material inflation and we are trying to focus on companies which have cut costs, adjusted to this environment and may now get some relief while being able to hang on to some pricing power. Interest rates are close to record lows and corporations are able to refinance debt at incredibly attractive short and longer-term rates. Many US companies are refinancing ten-year debt between 1 and 2% and even low grade credit companies are issuing long-term debt at what appear to be very attractive rates. Some of the great investments in the 1970s were companies that locked in very low nominal interest rates at the beginning of that period and with some leverage on the balance sheet were able to increase pricing at a time when inflation picked up, eroding the value of their debt. Some of these companies produced excellent leveraged equity returns in a relatively low-risk manner and many of our investments have similar characteristics.

Companies that have few hard assets and a high return on those benefit longer-term with inflation, but should also be good investments in any environment that we are likely to see for the moment. A record amount of our underlying companies are using their very strong free cash flow to buy back their stock at very reasonable valuations, particularly during periods of weakness in the market, significantly enhancing their longer-term compounded growth in earnings and free cash flow per share.

We have been somewhat frustrated by our inability to participate more fully in the housing market rebound, following house prices on average dropping 30% over the last six years and 50% in some of the higher growth southern States. After several false starts these stocks took off at the beginning of this year, and have always looked out of reach from a valuation perspective since but we have found some roundabout ways to participate in our usual manner. We have spent some time over the years studying the house builders but as a group we came to the conclusion that it is actually not a great business in the long run.

#### NVR

We have a small investment in NVR, which is a house builder based in the mid-Atlantic with a rather unique model of only optioning land and turning its housing inventory very quickly, which results in very high returns on capital while they have used their free cash flow to buy back more than 50% of the shares outstanding over the years. We purchased the holding a couple of years ago. Management spend their time running the business, rather than communicating with Wall Street. The area in which they operate around Washington and Virginia, which accounted for over 50% of their profits, was one of the few areas to hold up well during the downturn. As a result of this, all the other house builders moved into this area over the last 18 months, significantly increasing competition and putting pressure on the gross margin of NVR. This may have negatively biased our view on the house builders, but various members of the team visited a variety of house builders earlier in the year and just could not make the valuations work. You had to look out several years to get comfortable with many of these stocks from a valuation perspective, and what we thought was, there was going to be a slow, steady recovery in the housing market. What one never anticipates when an area has been out of favour for some time is how much companies are able to cut SG&A and leverage profitability when volume recovers. Inventories of homes have fallen very significantly. This is America and when there is a bargain, money is raised to buy assets cheaply. With sentiment now changing there is a lot of pent-up demand with a limited supply of home sites. The bottom line is that our bias against the business



resulted in us not buying any of the home builders. Other companies we looked at seemed to be too expensive relative to earnings over the next year or two. What we probably underestimated was the whole market cap of the housing-related space had shrunk to a very small amount. Every analyst we have seen over the last six months has said that all the questions they get asked by investors are around whether they have a reasonably priced stock which gives exposure to the upside in the housing market.

### Home Depot

Our biggest housing related holding is Home Depot, the home improvement retailer, which is gaining share from Lowe's in a duopoly and using free cash flow to shrink equity. We also highlighted Sherwin Williams in our June newsletter, which you will recall is a leading manufacturer and retailer of paints. Home Depot is the largest home improvement retailer in North America, its products range from basic materials to fitted kitchen and bathrooms. The company operates 2,200 stores predominately in the US and Canada. The stock was purchased earlier in the year following a meeting with the company in February and a number of follow up calls.

Home Depot has faced severe headwinds over the past 5 years due to the housing downturn. However, during this time the company managed to expand its operating margins from 6.1% in 2008 to 10.1% in 2011, despite sales being 12% lower. To understand how this was possible, one has to look at the history of Home Depot and its culture. Historically, Home Depot ran a very decentralised model, in which the individual store was king. Store employees were encouraged to focus on the customer and their needs, rather than corporate bureaucracy. It appeared that the company prior to the downturn was afraid to use a more centralized approach in case it lost the 'passion and enthusiasm of their store employees'. Plus in its defence, the company's store centric model had worked to date. However, as the housing downturn began to take hold in 2006, the company found it simply lacked the tools to manage inventory and remove costs from the system, and as a result operating margins collapsed from 11.2% in 2006 to 6.1% in 2009, on a 9.7% decrease in sales. To begin to remedy this situation, the company hired Walmart's head of supply in 2007. When he joined, Home Depot was using the same level of technology that Walmart was using in the eighties. However, despite the company's starting point in 2007 and a severe housing recession, the company has executed extremely well, resulting in solid margin expansion and free cash flow generation whilst investing heavily in its infrastructure. Home Depot fits firmly in 'the strong get stronger' theme of the portfolio.

At its recent analyst day in June, the company updated its 3 year business plan. It now targets EBIT margins to increase to 12% from 10% in 2012 and ROIC to increase to 24% from 15% by 2015. This appears fairly conservative given that the company is not relying on a top line recovery and its sales starting base is at 2005 levels. We feel this stock has numerous ways in which to win. Firstly, each 1% increase in sales would result in a \$0.10 lift to EPS. Also since they have slowed new store openings, the cash generated by the existing store base, is being used to buy back stock, whilst still investing heavily in IT initiatives to assist profitability and reduce working capital, further enhancing its ROIC profile.

We bought a small position in our old friend St. Joe, which owns a large portion of the panhandle of Florida. We purchased the shares at not too far above the valuation of the underlying timber with little value for the extensive entitled land portfolio and opening of a major new airport in the area. We also have a small holding in Vulcan Materials, an aggregates company where volumes have fallen 40% over recent years while pricing has remained steady. We have a position in the rails, which have good exposure to the housing market picking up, but it is a much lower base than it used to be. They are actually suffering from the low gas prices reducing coal shipments, and hence we only have a small weighting at the moment. Other companies that benefit from the housing market improving are the cable television companies, whose subscriber growth will be helped by new household formations in what is a relatively fixed asset. For many years we stayed away from US banks and only started dipping our toe in the water again late last year on individual banks. These companies benefit from sentiment picking up towards housing, which also helps a lot of their fee-related businesses and loan growth, which they need to offset declining net interest margins with such low interest rates. We also added to Rayonier a timber company who own over 2 million acres of forestry as timber prices are somewhat correlated to housing demand.

### CoreLogic

Earlier this year we purchased a holding in CoreLogic, the leading provider of residential property information and analytics to the US mortgage and realtor market. Around 40% of revenue is directly correlated to US mortgage volumes, while a further 20-30% would benefit in various ways from a healthier housing market. The company was spun off from First American Financial in 2010. We often

like to look at spin-offs as initially they tend to have less research coverage on Wall Street. During 2011, US mortgage transactions recorded a fourteen year low in activity. Meanwhile, the company divested and exited low-return lines of the business and hired a new CFO. The company has since been executing on a cost-cutting plan that would allow them to earn a respectable margin in a trough mortgage market with the ability to convert any upturn in mortgage volumes at high incremental profitability.

During a depressed period in the mortgage market, the business produced very impressive levels of free cash flow, allowing them to repurchase 10% of their shares outstanding last year and the same again this year. We purchased the stock earlier this year at 10x our estimate of 2012 free cash flow, an estimate that has risen significantly as an improvement in US mortgage market activity has unfolded this year. Even after a big upward move in the share price, the stock trades on 13.5x our estimate of 2013 free cash flow, with US mortgage volumes still 25% below their twenty-year average.

#### Stanley Black & Decker

Stanley Black and Decker is a diversified global industrial company, some 50% of revenues comes from selling their iconic Stanley, Black & Decker and DeWalt branded hand and power tools of which roughly 50% is sold within the US. The DeWalt brand is particularly popular with the professional user. They also sell door furniture, locks and taps that should all benefit from the housing recovery. The company believe that they are still some \$1.5-\$2b in sales lower than where they were at the peak of the housing market (or about 15-20% of total revenues). When we bought the stock over a year ago we felt that there was very little embedded in the valuation for an eventual housing recovery (which although we felt was inevitable the timing of which was much harder to predict) but we could still continue to see earnings growth as they benefited from the recent purchase of the Black & Decker business. Stanley is the brand leader in hand tools and Black & Decker had strong positions in the power tools business, so the combination seemed to make considerable sense. Black & Decker was relatively less well run and the Stanley management team have been able to extract an estimated \$450m in cost savings as they implement their business processes, additionally cross branding (i.e. using the DeWalt brand on a hand tool, something not previously done) has also been very successful. Valuation continues to be reasonably attractive and management seem to agree with us as they recently announced that they will be less focused on acquisitions over the next 12-18 months and increased their buyback authorisation to \$1.2b whilst also raising the dividend by 20%.

## Conclusion

We have reduced our cash position somewhat to just under 10% in response to action by central banks around the world trying to bring out their 'big bazookas' to help alleviate the weakness seen in the world economy over the middle two quarters of the year and the slowdown worldwide in industrial production. The macro environment remains somewhat uncertain in our view and we are concentrating on being a sensible steward of our investors' capital and cash is unlikely to fall any further than the self-imposed minimum 8% limit we have had over recent years. Since the summer the US economy has slowed markedly and the strong employment figures of earlier in the year have deteriorated since May. Many corporations are looking at the potential 4% fiscal cliff at the beginning of 2013 and have reigned in their investment intentions to see what happens. There have been several negative preannouncements so far for the third quarter results season with many in the transportation sector, which is a key barometer of the US economy. Profits growth is slowing down with only modest growth expected for the balance of the year and for next year. The exceptional operating leverage US companies experienced from 2009 through to the middle of this year is dissipating, with many companies at peak margins. As we have mentioned in previous newsletters, we are trying to focus on companies that still have good margin potential. Despite this rather more negative background the stock market has actually rallied around 13% since the beginning of June as investors anticipate an aggressive central bank reaction to slower growth and problems in the Eurozone. With cash yielding almost zero and longer-term government bonds looking like unappealing investments, there is money flowing into equities at the margin as there are not many other places to go.

One could paint a picture of the middle of 2013, where the fiscal cliff has been restored and a proper longer-term budget deficit programme been put in place, companies have under-spent on investments and there is a catch-up phase. The housing market is recovering strongly, helping consumer sentiment and spending with unemployment falling further. The new leaders will have been installed in China and hopefully will have tried to reaccelerate growth there, with Europe muddling through.

Most of the reduction in cash is due to interesting new investment ideas we have found, which are generally much harder to come by than in recent years, but with a team of ten senior fund managers and analysts constantly looking for opportunities we leave very few stones unturned. We will be pragmatic about our cash position and continue to be in the 8% to 15% range structurally.

<b>Annual Performance</b>	<b>Findlay Park \$ change</b>	<b>Russell 2000 change</b>	<b>S&amp;P 500 change</b>
<b>Inception to Year end 1998</b>	-0.40%	-8.49%	16.81%
<b>1999</b>	49.10%	19.62%	19.53%
<b>2000</b>	1.28%	-4.20%	-10.14%
<b>2001</b>	9.31%	1.03%	-13.04%
<b>2002</b>	-11.25%	-21.58%	-23.37%
<b>2003</b>	39.48%	45.37%	26.38%
<b>2004</b>	24.82%	17.26%	9.14%
<b>2005</b>	15.67%	3.09%	2.86%
<b>2006</b>	24.06%	17.00%	13.62%
<b>2007</b>	16.24%	-2.75%	3.53%
<b>2008</b>	-30.87%	-34.80%	-38.49%
<b>2009</b>	33.25%	25.22%	23.45%
<b>2010</b>	23.93%	26.28%	12.80%
<b>2011</b>	-2.54%	-5.67%	0.41%
<b>YTD</b>	13.19%	11.94%	13.48%
<b>Performance since inception</b>	433.60%	80.85%	36.21%
<b>Compounded Rate of Return from inception to 26 Sept 2012</b>	12.20%	4.16%	2.15%

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

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