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Douglass Winthrop

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Dear Clients and Friends,

We are pleased to enclose our first quarter letter, including our commentary on the financial markets and, for our clients, your account statements for the quarter ended March 31, 2017.

Presidential transitions, especially those when power passes from one party to another, are almost always chaotic but it is hard to recall a handoff as tumultuous as this one. The noise is catnip for short-term traders tempted to feast on every headline or tweet. For long-term investors like Douglass Winthrop, the focus remains on identifying great companies and purchasing their shares at valuations that offer superior potential returns over years, not a news cycle.

Animal spirits and the virtuous cycle

Since the beginning of 2017, investors have embraced a steady diet of stronger economic news, the key ingredient in the recipe for rising corporate earnings and higher stock prices. Domestically, recent jobs reports and surveys of consumer and business confidence have been positive. Increasing confidence is kindling animal spirits among executives across a broad range of industries. Capital goods orders have accelerated, a sign that companies are finally starting to spend more aggressively to meet future demand. We are heartened when companies reinvest in growing their business, as it is a clear sign that a virtuous cycle is in full swing: more capacity requires more workers; more jobs means higher consumer income; greater pay leads to increased consumption; stronger demand catalyzes further capacity additions, and so on.

Developed and developing economies around the globe also appear poised for expansion. In February, exports from South Korea rose by 20% compared to a year ago. Chinese exports increased by 11% over the same period. India's and Indonesia's GDP growth has been strong and steady. The price of oil has stabilized, helping commodity-driven economies.

A recovery that lifts profits around the globe benefits many of our portfolio companies that are either based outside the U.S. or that have significant international operations. In anticipation of accelerating earnings, investors bid up the prices of stocks around the globe in the first quarter: the MSCI World index, which includes international as well as U.S. equities, was up 6.4%, besting the 6.1% gain posted by the S&P 500, an index that includes only U.S. – domiciled companies.

But improvements may already be priced in

In our view, the primary risk today is over-enthusiasm. Telltale signs of froth are beginning to emerge. One of Warren Buffett's favorite valuation metrics--the total public market value of U.S. companies relative to GDP--currently stands at 130%, its highest level since 2000. The global market for initial public offerings is heating up. Margin debt levels reached a record high in March. Investors appear more worried about missing the last strides in the market's long bull run than they are about lofty valuations.

As usual, there are plenty of reasons for concern. Early missteps by the administration may delay or scuttle entirely some of its pro-growth initiatives, the expectations of which catalyzed job creation and capital projects. China is still burdened by high levels of debt, and tensions on the Korean peninsula are growing dangerous. Europe is facing a series of elections which could extend the populist themes that led to Brexit and may create serious existential risks for the Euro zone.

Such risks are ever present. It is wise to stay mindful of looming global threats that could shock markets into a correction. We do not forecast the market's direction, but we are finding fewer bargains these days, and many stocks appear fully priced. We look for pullbacks as potential opportunities to buy enduring businesses that will benefit our clients' portfolios for years to come.

We take our responsibility as stewards of our clients' assets seriously, and we have designed our investment process to respond to market dislocations when they occur. We strive to build resilient portfolios by focusing on companies with the following characteristics: sustainable advantages – or moats – which protect companies from competitors; pristine financials; ample reinvestment opportunities; valuations that afford appreciation potential with acceptable risk; and shareholder-oriented management teams that make sound decisions when allocating capital. Come what may, companies that possess these attributes will continue to prosper and reward patient shareholders over time.

In management we trust

In a dynamic environment, none of these attributes is more important than sound management. The primary job of a corporate leader is to employ capital in the best interest of shareholders. There are rarely obvious answers and judgment plays a key role amid shifting priorities and circumstances.

Managers have options when choosing what to do with their available capital. We prefer teams that put their cash towards furthering their own business. Investments that lead to new products, improve efficiency, generate demand by branding, or build capacity to meet future demand are noble uses of cash which should lead to virtuous cycles led by growing profits. When free cash flow exceeds the amount that can be profitably invested internally, executives can distinguish themselves by choosing to pay down debt, pay dividends, purchase another business, or buy back their company's shares, increasing each stockholder's percentage ownership.

MasterCard's management has produced excellent results for its shareholders by incorporating nearly all of these strategies. The team has made large investments in operational efficiencies and building scale in their payments networks, increasing operating margins from 20% in 2006 to 54.5% 2016. The resulting free cash flow has allowed MasterCard to raise its dividend every year and to repurchase 16% of its shares since 2010. Management has been cautious about making large acquisitions, recognizing that their position in the payments industry is sound and valuations for upstart payment companies have been prohibitively high. We remain enthusiastic about the company's prospects.

Another leadership team which shines within its industry is that of **Becton Dickinson**. This manufacturer of a broad array of medical products is constantly reinvesting to reduce costs and build scale. As a result, it has established a defensive moat despite the fact that nearly half of its business is in largely commoditized product categories. Becton's purchase of under-managed medical technology company CareFusion is an example of synergistic investment that is projected to generate elevated performance. Remaining free cash flow has been used to pay down debt amid rising rates and increase dividends at a 13.5% annualized rate over the last 10 years. While past performance never guarantees future results, such long histories of demonstrated management skill provide comfort.

Investing to serve you better

Like the companies we admire, Douglass Winthrop strives for constant improvement. The most important investments a firm like ours can make are in its people. To that end, we are pleased to announce two important additions to the Douglass Winthrop team. Associate Research Analyst Garrett Hayward joined the firm in February to support the investment committee. A Magna Cum Laude Duke Blue Devil and ACC Academic Honor Roll honoree, Garrett is already making thoughtful contributions to our investment process. In March, Meg Nestor joined our Client Relations team after 31 years at Fiduciary Trust. We are excited to have someone with Meg's experience join our firm. We would also like to congratulate Associate Olivia Le Blan who earned her CERTIFIED FINANCIAL PLANNER™ designation during the quarter, adding depth and expertise to our planning team led by Lea Highet.

We are confident that adding such capable members to our team and supporting professional development will lead to a better experience for our clients – the ultimate measure of our success. If you are already a client, we thank you. If not, we welcome the chance to discuss your investment needs and goals. To all, we welcome your comments and questions.

Sincerely,

Douglass Winthrop Advisors