

Dear Friends,

The stock market has provided two consecutive years of strong returns. The two-year cumulative total return for the Standard & Poors 500 Index is more than 45%. *Because success often breeds complacency*, now is a particularly good time to note some of the major risks in the outlook for the economy and the financial markets.

Our new year letter, sent to all clients a few weeks ago, once again summarized the investment environment of the past year as well as our expectations and assumptions for the year ahead. Here are the key issues we cited in that letter as potential sources of risk and volatility for the financial markets in 2011.

- § *Rising long term interest rates* as the economy accelerates and the Federal Reserve concludes its purchases of longer term Treasury securities (QE2) at mid-year.
- § *Slower growth of corporate profits* as businesses begin to add workers at a faster pace.
- § *An economic slowdown across Southeast Asia, particularly in China*, as policy-makers raise interest rates in order to arrest accelerating inflation.
- § *A continuing debt crisis across Europe* where the bail-outs of Greece and Ireland have not fully resolved the problems of both governments (e.g. Portugal, Spain) and banks.

Over the past five months the stock market has pushed these issues and others (e.g. home foreclosures, state and local government finances) onto the back burners. Since the end of August, when the Federal Reserve signaled it would take additional measures to support the economy, the S&P 500 has risen 23%; demonstrating once again the power of excess liquidity to drive asset prices. However, the uncertainties listed above are likely to be resolved at some point in the year ahead -- possibly with adverse consequences for the financial markets. It is important to note that stock prices fell 16% last Spring after the Fed concluded its first program of quantitative easing. Without excess liquidity to support stock prices, investors became more nervous about the crisis in Greece, contagion through the banking system, and a double-dip recession. On a positive note, the risk of the latter has diminished significantly over the past few months.

On January 28 the Bureau of Economic Analysis reported that gross domestic product increased at a 3.2% annual rate in the fourth quarter -- a modest acceleration from the previous period. However, beneath the headline data was an indication that the U.S. economy has reached a turning point; real final sales (i.e. GDP excluding the change in inventories) rose 7.1% -- the fastest quarterly increase since 1984 and a dramatic acceleration from less than 1% in the two previous quarters. Some of this acceleration is due to pent-up demand. Still, the increase in long term interest rates over the last few months, with yields on ten year Treasury bonds rising from less than 2.5% to more than 3.5% (*despite the Fed's QE2 purchases*), is a strong indication that the transition from fragile recovery to self-sustaining expansion is (finally) at hand.

Nevertheless, it is impossible to ignore the cost of this economic recovery. Some combination of higher taxes and lower spending (particularly for the major entitlement programs, Social Security and Medicare) is needed to put U.S. Government finances back onto a sustainable path. There is great risk that short-sighted politicians will not deal with this challenge until another crisis, and a financial market riot, forces them to do so. Investors, like politicians, may remain complacent about this risk in the short term. However, eventually and without warning, this will become the issue which dominates all others in the financial markets. *Beware complacency.*

The New York Times Company (10.11)

On the surface The New York Times does not look like most companies in our clients' portfolios. Revenues and profit margins peaked eleven years ago. In 2009 the company was barely profitable and the dividend was eliminated. Needless to say, the stock has been a poor investment -- falling from \$53/share nine years ago to less than \$4 during the financial crisis. Even Warren Buffett, who made much of his fortune investing in The Washington Post for nearly 40 years, has ridiculed a business model which still uses young boys on bicycles to make early morning deliveries. Nevertheless, millions of people still rely on The New York Times for truthful and accurate reporting -- qualities which are increasingly rare now that the Internet allows everyone to pretend they are a journalist. Even many who disagree with the paper's editorial views are quick to acknowledge that they read The Times every day. Thus, despite its modest size (annual revenue of \$2.4 billion and stock market value of \$1.5 billion), The New York Times continues to exercise considerable influence over public opinion.

The company's flagship, The New York Times Media Group, accounts for 65% of total revenue. The New England Media Group (The Boston Globe and The Worcester Telegram & Gazette) represents 18%. The Regional Media Group, 14 small newspapers mostly in the Southeast, contributes 12%. Finally, the About Group, acquired in 2005, offers personally relevant information through specialized websites (About.com, ConsumerSearch.com, UCompareHealthCare.com, and Caloriecount.com). About is a small contributor to revenue (5%) but the Group demonstrates the attractive economics of on-line media; profit margins are over 45% and the business requires very low additional costs in order to reach more users. In 2010 About's *incremental profit margin* (the increase in profits divided by the increase in revenue) was almost 74%.

The economics of About have implications for the longer term profitability of the parent company. The New York Times is a company in transition -- from printed distribution to digital distribution of news and information. *As long as the company maintains its reputation for high quality journalism -- its most valuable asset -- we believe this transition will be successful and, over the long term, highly profitable.*

The traditional business model of newspapers has relied on a large subsidy from advertising. Because advertising is a discretionary expense, financial results for newspapers have been highly cyclical. For example, in 2001 The Times' revenues and profits fell 14% and 29%, respectively, amid a modest recession. Also, the migration of advertising spending to the Internet has lead many investors to conclude that newspapers are a dying business. As shown below, advertising revenue for The Times never fully recovered from the 2001 downturn. From 2007 through 2010 the company's News Media advertising revenue fell almost 40% to less than half the company's total revenue.

New York Times News Media Advertising Revenue (i.e. ex-About Group)

| | <u>2000</u> | <u>2001</u> | <u>2002</u> | <u>2003</u> | <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>2010</u> |
|--------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Ad-Rev. \$ Million | 2227 | 1874 | 1899 | 1994 | 2053 | 2097 | 2077 | 1940 | 1663 | 1221 | 1171 |
| % Total Co. Rev. | 64% | 62% | 62% | 62% | 65% | 65% | 63% | 61% | 57% | 50% | 49% |

The fundamental problem of the traditional advertising-subsidized business model is that consumers/readers have been trained to pay *prices* which are below the *cost* of gathering and distributing news as well as the *value* it provides. The industry itself compounded these misconceptions about price, cost and value several years ago when newspapers began offering their product on-line at no charge -- reinforcing consumers' views that news is free and that all news and information is equally true and accurate.

The New York Times will soon introduce a pay model for its on-line content -- providing a revenue stream which does not exist today. Currently, NYT.com is the most highly trafficked newspaper website (by far) with 32 million visitors per month in the U.S. and 45 million globally. The willingness of these readers to pay for on-line content is still uncertain, and the company may test several approaches before finding the right model. However, as shown below, total digital ad-revenue is now more than 26% of the company's total advertising revenue -- confirming that advertisers have already embraced the company's on-line offerings.

| | <u>2002</u> | <u>2003</u> | <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>2010</u> |
|---------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Print Advertising | 1848 | 1925 | 1958 | 1974 | 1921 | 1755 | 1462 | 1042 | 959 |
| % Change | | 4.2% | 1.7% | 0.8% | -2.7% | -8.6% | -16.7% | -28.8% | -7.9% |
| Digital Advertising | 51 | 69 | 95 | 123 | 156 | 185 | 201 | 179 | 212 |
| % Change | | 34.0% | 37.7% | 29.5% | 27.1% | 18.4% | 8.7% | -10.9% | 18.3% |
| About Group | -- | -- | -- | -- | 75 | 97 | 107 | 115 | 129 |
| Total Digital Advertising | | | | | 231 | 282 | 308 | 294 | 341 |
| % Total Co. Advertising | | | | | 10.8% | 13.9% | 17.4% | 22.0% | 26.3% |

This analysis of print versus digital advertising confirms that the latter is not immune to the business cycle. The company's digital ad-revenue (excluding About) fell almost 11% in 2009. Still, this decline was modest in the context of the worst recession in 80 years; reflecting the secular shift in advertising spending to the Internet. Also, in contrast to an ongoing decline in print advertising, the company's digital ad-revenue grew more than 18% in 2010. In fact, over the four quarters of 2010 the company's digital ad-revenue increased 11.2%, 19.8%, 21.6% and 20.3%. Because of these changing dynamics in advertising revenue, modest-but-steady growth in the company's other major revenue source, circulation, has been largely unnoticed.

| | <u>2000</u> | <u>2001</u> | <u>2002</u> | <u>2003</u> | <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>2010</u> |
|------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Circulation \$M | 737 | 760 | 825 | 886 | 884 | 874 | 889 | 890 | 910 | 936 | 931 |
| % Total Co. Rev. | 21% | 25% | 27% | 27% | 28% | 27% | 27% | 28% | 31% | 38% | 39% |

As shown below, circulation *revenue* for the flagship paper, The New York Times, has increased steadily over the last several years despite declining circulation *volume* for both the weekday and Sunday issues. The combination of declining volume and rising revenue indicates a steady increase in the price per issue. Indeed, we estimate the average price for an issue of The New York Times in 2009 was 32% higher than just four years earlier.

New York Times Newspaper Circulation Volume and Revenue

| | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>2010E</u> |
|----------------------------|-------------|-------------|-------------|-------------|-------------|--------------|
| Thousands of Copies: | | | | | | |
| Weekday | 1135.8 | 1103.6 | 1066.6 | 1033.8 | 959.2 | 877.0 |
| Sunday | 1684.7 | 1637.7 | 1529.7 | 1451.3 | 1405.2 | 1400.0 |
| Revenue (\$ million) | \$615.5 | \$637.1 | \$646.0 | \$668.1 | \$683.5 | \$683.7 |
| Price per Issue (estimate) | \$1.61 | \$1.71 | \$1.81 | \$1.94 | \$2.12 | \$2.27 |
| % Change | -- | 6.2% | 5.9% | 7.2% | 9.3% | 7.1% |

Because weekday and Sunday volume both declined about 16% from 2005 through 2009, the increase in price per issue is *not* due to a shift in favor of the higher price Sunday issue. Instead, the increase reflects management's deliberate strategy of raising prices and reducing less profitable circulation. Complete circulation data for 2010 is not yet available, but we estimate that the price per issue of The Times continued to increase at a high single digit rate. *This ability to raise prices, particularly in an economic environment of very low inflation, testifies to the strength of the company's brand as well as the loyalty of its readers. It also suggests that the forthcoming on-line pay model should be well-received.*

Other newspapers incurred even greater declines in advertising revenue during the recession – cutting deeply into their ability to gather and distribute news. The Times is now expanding into other major markets (e.g. Chicago, San Francisco, Texas) and positioning itself as a local paper by collaborating with local journalists and news organizations. Still, like its competitors, The Times was unable to reduce costs fast enough in 2008-2009 to keep pace with the decline of advertising. With its cash flow under pressure, the company borrowed \$250 million from companies controlled by Carlos Slim Helu (the wealthiest man in Mexico) at an interest rate of 14%. Mr. Slim also purchased 10 million of the company's Class A shares and secured warrants to purchase another 15.9 million shares at a price of \$6.36. Thus, Mr. Slim is now the company's largest shareholder with a 16% stake.

Still, members of the Ochs-Sulzberger family, descendants of Adolph S. Ochs (who purchased The Times in 1896), control the company through 90% ownership of the Class B shares. These shares are not publicly traded and they hold the right to elect 70% of the Board of Directors. Many investors object to such a dichotomy between economic interest and company control. We view the leadership of the Ochs-Sulzberger family as a guarantor of the company's journalistic standards and, thus, its competitive advantage.

In 2010 revenues fell 1.9%, but operating costs were cut more than 7%. Consequently, profits before interest, taxes and depreciation increased 42%. Higher interest costs reduced the improvement at the bottom line. Still, after tax profits rose from less than \$2 million in 2009 to just over \$100 million (\$0.74 per share) in 2010. Also, a sharp decline in capital spending, from \$380 million in 2007 to just \$35 million last year, has allowed the company to build cash and pay down debt. The company has the option to redeem the high cost loans from Mr. Slim in 2012 and is likely to do so given its improving cash flow and the proceeds from a recent bond offering: \$225 million at an interest rate of just 6.625%.

Finally, the company has a very valuable asset which is not relevant to its newspaper operations. The New York Times owns over 16% of New England Sports Ventures. NESV owns the Boston Red Sox, Fenway Park and approximately 80% of regional cable TV channel New England Sports Network (NESN). The investment in NESV is not liquid, but The Times sold a portion of its stake in 2010 at prices which suggest the total investment may be worth about \$200 million. The company has stated its intention to sell all its holdings of this non-strategic asset.

In summary, we have purchased shares of The New York Times for three key reasons.

- § *The New York Times newspaper is an iconic and enduring franchise whose high quality content endows the company with the ability to raise prices and gain market share at the same time.*
- § *The company is in the early stages of transition from print to digital distribution -- a substantially more profitable business model that will reach more readers and, therefore, enhance the value of the company as a platform for advertisers.*
- § *Strong cash flow and the sale of non-strategic assets will improve the company's balance sheet, reduce its high-cost debt, and augment the improvement in operating profits that is already underway.*

General Electric Company (20.14)

During the financial crisis two years ago GE's common stock traded at single digit prices. In a report written March 20, 2009, we noted that the share price at that time implied a price/earnings ratio of just 12x for GE's powerful infrastructure businesses and a residual market value of \$0 for everything else: financial services, NBC/Universal, appliances and lighting. As we stated in that report – "*Rarely in our experience have we seen such a dichotomy between market price and intrinsic value for one of the world's most dominant industrial companies.*" Less than two years later the share price has more than tripled. Still, GE remains an attractive investment.

GE's Chairman and Chief Executive, Jeff Immelt, made his annual presentation to investors in New York on December 14, 2010. It was the most optimistic assessment of the overall economic environment and GE's competitive position that Mr. Immelt has provided in the past three years.

In 2008-2009 GE endured a stunning collapse in its financial service business. Profits fell from \$12.4 billion in 2007 (55% of total company earnings) to \$7.8 billion in 2008 (43%) and just \$1.6 billion in 2009 (14%). This decline necessitated a \$3 billion investment from Berkshire Hathaway (the holding company of Warren Buffett) in late 2008, a cut in the company's dividend after 32 consecutive annual increases, and the loss of GE's triple-A credit rating. Although GE benefitted from several initiatives of the Federal Reserve during the financial crisis, the company never received a taxpayer-funded bailout from programs such as TARP.

Meanwhile, as shown below, profits from GE's infrastructure businesses accounted for less than 40% of total company profits as recently as 2006. While profits in financial services were collapsing, profits in the infrastructure businesses *increased* over 18% from 2007 to 2009 despite the worst economic environment since the Great Depression. Currently representing almost 70% of total profits, these businesses are the backbone of General Electric. The performance of these operations over the last few years reflects three key attributes: (1) GE's technical expertise in large scale manufacturing; (2) long lead times and large backlogs which allow for gradual and efficient changes in production; and (3) a majority of profits from aftermarket service agreements. In 2010 these businesses posted a profit decline of 2% -- largely due to a 21% increase in research and development to support an aggressive offering of new products over the next couple of years.

| | Infrastructure Segment Profits (\$ million) | | | | |
|-----------------|---|-------------|-------------|-------------|-------------|
| | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>2010</u> |
| Energy | 2,906 | 3,835 | 5,067 | 6,045 | 6,235 |
| Oil & Gas | 548 | 860 | 1,127 | 1,222 | 1,205 |
| Aviation | 2,802 | 3,222 | 3,684 | 3,923 | 3,304 |
| Healthcare | 3,142 | 3,056 | 2,851 | 2,420 | 2,741 |
| Transportation | 774 | 936 | 962 | 473 | 315 |
| Sub-Total | 10,172 | 11,909 | 13,691 | 14,083 | 13,800 |
| % Total Profits | 37% | 44% | 54% | 77% | 69% |

GE's earnings are now in a strong up-trend. Profits in financial services more than doubled in 2010 -- exceeding \$3 billion and lifting per share profits by 33% in the fourth quarter and 15% for the full year. The turnaround prompted the company to raise the quarterly dividend *twice* in the last six months -- a total increase of 40%. Despite the sharp recovery of the financial businesses, Mr. Immelt and his team are determined to keep these volatile and unpredictable operations from dominating the company in the future as they have in the past -- limiting their profit contribution to less than 40% and emphasizing areas in which GE's holds distinct competitive advantages; e.g., financing the sale of its own industrial products.

Finally, GE is in the process of reducing its ownership of NBC/Universal from 80% to less than 50% via a sale to Comcast. Therefore, even as the cyclical recovery of financial services continues, the highly profitable and more predictable infrastructure businesses will still account for a strong majority of GE's profits and cash flow. Given an improving cyclical outlook for several of these businesses (e.g. aircraft engines, gas turbines, locomotives), as well as GE's strong market shares and competitive advantages, *we believe the shift in profit contribution away from financial services and in favor of infrastructure will prompt other investors to place a higher valuation on GE's common shares over the next few years.*

(Note: In the final months of 2010 we increased our holdings of General Electric. For many clients we purchased the shares in October and November and then sold higher costs shares before year end in order to realize losses which offset gains from other sales and, therefore, reduced capital gains taxes.)