

“A decade ago, there was no snap journalism, no minute-by-minute web-based reporting. Today, every form of reporting is compressed. Technology has not sped up writers; it has sped up how quickly we see what they have written. Speed is valuable but so is waiting. Will easily distracted modern readers value perspective enough to wait for it?”

Frank Partnoy, author of The Match King
Financial Times, October 1, 2011

Dear Friends,

Markets are people. People are emotional and, therefore, often irrational -- failing to distinguish between *information* and *perspective*. Information moves at breathtaking speed. Perspective is gained slowly and carefully. Information is plentiful and cheap. Perspective is rare and valuable. Traders and speculators react to information. Investors rely on perspective – especially in times like these.

The Equity Market and Our Investment Strategy

In our New Year letter to clients (January 3, 2011) we noted that *“In Europe, they riot in the streets. In America, we have our riots in the financial markets.”* The stock market has been rioting for the past few months. The Standard & Poors 500 Index fell more than 14% in the third quarter; posting a year-to-date total ‘return’ of -8.7%.

As usual, our clients’ portfolios have incurred only modest declines. In fact, several of our largest holdings (Abbott Laboratories, Automatic Data Processing, Coca-Cola, Exxon-Mobil, Hershey, Intel, Johnson & Johnson, and Procter & Gamble) have provided *positive* year-to-date returns despite the market environment – demonstrating, again, the benefit of an investment approach (*perspective*) grounded in bottom-up company analysis. In this report we review Automatic Data Processing; a company whose common stock continues to provide solid returns despite top-down unemployment data (*information*) that implies a difficult economic environment for ADP’s payroll processing business.

Market riots are rarely triggered by a single factor. At the start of this year we cited *“a few of the key risks which may disturb investors in 2011.”* These included: (1) rising long term interest rates, (2) slower growth of corporate profits, (3) an economic slowdown across Southeast Asia, particularly in China, and (4) continuing government debt problems across Europe. We concluded: *“The uncertainty surrounding each of these issues is likely to be resolved over the next year – possibly with significant adverse consequences for the stock market in the short term. Therefore, 2011 may end up being a mirror image of 2010; i.e. a positive fundamental economic backdrop and excess financial liquidity (provided by the Fed) supporting equities early in the year with fundamental and political uncertainties re-emerging later in 2011.”*

Except for the assumption regarding interest rates, our expectations have, unfortunately, been fulfilled. This is why we began the year with substantial cash reserves (10-15% or more) in most of our clients’ accounts. Although the decline in share prices is unsettling, it also provides a significant opportunity for genuine long term investors. Therefore, over the last few months we have put cash reserves back to work. Recognizing that market prices often go to extremes, and that the bottom (for individual stocks and for the market in general) is impossible to predict, we have invested gradually. For most clients we still have cash reserves of 5-10% -- enough to take advantage of more opportunities if the riot continues.

The Economy

In our last report (June 30, 2011) we reviewed the multi-decade transformation of American households from high savings and low debt to negligible savings and excessive debt. This deterioration of personal balance sheets is the principle reason why the economic recovery remains sluggish, fragile and vulnerable to external shocks -- like the European government debt and banking crisis. The imperative for households to now reduce their debts and increase their savings also explains why the economy has not responded vigorously to traditional monetary policy stimulus.

The financial crisis of 2008, which occurred in the midst of a recession that had been underway for more than nine months, triggered an abrupt plunge in private sector demand for goods and services. Government spending was increased with the intent of sustaining production, employment and income -- thereby accommodating debt reduction across the private sector. In short, *public debt has increased so that private debt may be reduced*. At the same time that government spending increased, tax revenues declined because of rising unemployment and falling profits. The sharp increase in the federal deficit (on top of the cost of bailing out banks, insurers and automakers) produced a significant rise in government debt relative to the size of our economy. This is the economic reality that guides *our* perspective.

As discussed in our last report, a sluggish economic recovery is consistent with the findings of Reinhart and Rogoff in their landmark analysis of financial crises: *This Time Is Different*. Still, many investors do not yet understand that (a) the financial crisis of 2008 was rooted in a consumption and credit bubble more than 40 years in the making, and (b) household deleveraging is a *secular* dynamic. Many have confused the consequences of deleveraging with short term *cyclical* issues -- interpreting the anemic GDP growth of the first two quarters of 2011 (0.4% and 1.3%, respectively) as an indication the economy is as vulnerable today as it was in September 2008. This analogy is misguided. Consider:

1. By August 2008 the Index of Leading Economic Indicators (LEI) had *declined* in 8 of the 12 previous months. In August 2011 the LEI *increased* for the 3rd consecutive month and the 11th time in 12 months.
2. The four-week average of unemployment claims is one of the most reliable leading indicators. In October 2008 the four-week average was 475,000 and *rising*. Today, the average is 414,000 and *stable*.
3. In the first nine months of 2008 the U.S. economy *lost* 760,000 jobs – more than 84,000 per month. In the first nine months of 2011 the U.S. economy has *gained* jobs every month. The Bureau of Labor Statistics reports that the economy has *gained* 1,074,000 jobs (120,000/month) since the start of 2011. Private sector job gains have been even stronger. The ADP National Employment Report, a survey of approximately 500,000 businesses (i.e. excluding government workers) reports an increase of 1,251,000 jobs (139,000/month) over the last nine months. Still, this pace of job creation is not sufficient to lower the national unemployment rate, which has been *stable* at 9.1%.
4. In the middle of 2008 pretax corporate profits were already *falling* at an annual rate of almost 15%. At mid-year 2011 corporate profits were *rising* at an annual rate of 8.5%.
5. In the middle of 2008 the price of oil was \$147/barrel and *rising*. Today the price of oil is approximately \$80/barrel and *stable*.
6. In the Fall of 2008 the U.S. economy experienced a liquidity *crisis* – an abrupt *shortage* of cash and credit. In the Fall of 2011 there is *excess* liquidity throughout the economy; corporations, banks and households are all accumulating and hoarding cash.
7. In 2008 the savings rate was nearly 0% and household balance sheets were *deteriorating*. Today the savings rate is above 5% and household finances are *improving*.

In summary: the recovery may be weak, but the U.S. is not currently in recession and overall economic fundamentals are significantly better today than three years ago. Indeed, it is difficult to argue that the economy is in recession when employment is increasing. Nevertheless, slower growth outside the U.S., particularly in developing countries like China, may still have adverse consequences for the domestic economy over the next year.

There is, of course, one important similarity between circumstances today and three years ago. In 2008 the balance sheets of U.S. financial institutions were stuffed with illiquid, overvalued and highly leveraged investments tied to home mortgages (i.e. toxic securities). Today, the European financial system is stuffed with government bonds of highly-indebted countries whose ability to pay interest and principle on-time is greatly in doubt. *The stock market is rioting not just because the global economy is weak, but also because of the fear and uncertainty stemming from a web of complex issues, like the European crisis, and the failure of politicians to inspire confidence in their ability to resolve these issues.*

Endowed with *information*, but lacking *perspective*, most politicians, in America and in Europe, have retreated to the comfort of their ideologies. For example, those on one side of the political spectrum blame America's excessive public debt on tax cuts for the rich. Those on the other side blame excessive government spending -- both before and after the financial crisis. Civil debates about sensible policies, grounded in economic reality, are rare. Dubious economic theories are popular. Fact: there is no empirical evidence to support the notion that cutting government spending in the short term will create jobs. Fact: there is strong empirical evidence that tax increases are, indeed, harmful to job creation.

Still, there may be a silver lining surrounding America's seemingly dysfunctional political process. European leaders have consistently underestimated the magnitude of their debt crisis and its consequences for their banking system and their economies. For more than a year they have adopted incremental measures; delaying the difficult political decisions needed to reassure financial markets that the debt problems of smaller countries (Greece, Portugal, Ireland) would not infect the larger economies (Spain, Italy). In contrast, both Democrats and Republicans in America have embraced the government debt issue. Unfortunately, both parties are advocating different tactics within the same flawed strategy being pursued in Europe – austerity. Raising taxes and cutting spending are both austerity measures.

Austerity can be good for a family's budget. Many politicians and voters believe austerity is also good for the country. *However, the finances of the nation are not the same as the finances of a family. For highly developed and highly indebted countries the correct strategy is growth – not austerity.* Unless and until politicians fully embrace *this* perspective, and adopt policies which balance short term support for the economy with long term fiscal discipline, the economic recovery will remain sluggish, fragile and vulnerable.

Fortunately, there is one institution whose perspective is grounded in economic reality: the U.S. Federal Reserve. Although there has been some disagreement among the Federal Open Market Committee (FOMC), Fed Chairman Ben Bernanke has continued the central bank's support for the economy and the financial markets with aggressive and creative policies. The Fed has made three important announcements in the last two month. (1) On August 9 the FOMC committed to keeping short term interest rates near 0% for at least two more years. (2) On September 21 the FOMC announced it would purchase \$400 billion of Treasury securities with remaining maturities of 6 to 30 years and sell an equal amount of securities with remaining maturities of 3 years or less. (3) Also on September 21 the Fed announced that it would make additional purchases of mortgage-backed securities.

The Fed's latest moves are aimed at (a) keeping interest rates at historically low levels, and (b) providing direct support for the mortgage and housing markets much as the Fed did during the first round of quantitative easing between March 2009 and March 2010. By keeping interest rates at low levels *the Fed is making investors an offer they cannot refuse*. The negligible return on risk-free U.S. Treasury bonds will eventually drive investors into higher yielding corporate bonds, mortgage securities *and common stocks* -- lowering the cost of capital for businesses and the cost of borrowing for households. Whether or not these strategies will lift the pace of the recovery, or insulate the U.S. economy from the European crisis, will depend on the willingness of companies and consumers to borrow in the era of deleveraging.

Automatic Data Processing (47.15)

Automatic Data has all the hallmarks of the companies and businesses we like to invest in: (1) essential value-added services which make the buyer more efficient and competitive; (2) high recurring demand/revenue; (3) a large and fragmented global market; (4) a dominant market share with enduring competitive advantages; (5) low capital expenditure requirements; and (6) senior managers who treat shareholders like partners. Very few companies have a business model to rival ADP. Not surprising, the stability and resilience of ADP's business is reflected in a share price which is far less volatile than the market averages.

	Annual Price Change (excludes dividends)				
	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011 ytd</u>
Automatic Data Processing	0.7%	-11.7%	8.9%	8.1%	1.9%
S&P 500	3.5	-38.5	23.5	12.8	-10.0
Dow Jones Industrial Average	6.4	-33.8	18.8	11.0	-5.7

ADP's senior management, lead by Gary Butler, President and CEO, and Chris Reidy, ADP's Chief Financial Officer, reviewed the company's results and strategies for the investment community on May 5. Since assuming the CEO position in 2006 Mr. Butler has aspired to an earnings per share (EPS) growth rate of 15%. Investors have been doubtful given ADP's growth rates of 11% and 5% over the last five and ten years, respectively. However, Mr. Reidy provided an analysis of revenues and profits for the last several years excluding the impact of divestitures, tax settlements, and one-time gains and expenses. The result: an EPS growth rate of 16% from 2005 through 2010. We believe a 12% growth rate is achievable over the next several years – despite the sluggish recovery of the U.S. labor market.

The company's Employer Services (ES) unit provides payroll processing, tax filing, human resource management, and employee benefit services at prices well below the cost that an employer would incur in-house. Only the very largest companies, which spread the costs of payroll processing over many thousands of employees, can justify the costs of in-house alternatives. Yet, outsourcing to ADP still makes sense even for very large employers -- particularly if their workforce is scattered across the globe. Consequently, more than 90% of ADP's annual revenue is recurring; generating highly predictable and reliable streams of profits and cash flow.

ADP also requires modest incremental capital investments in order accommodate additional clients and their employees. For example, over the last several years the company's annual capital expenditures have been consistently less than 15% of net income. Thus, ADP converts most of its profits into free cash flow. Under Mr. Butler the company has routinely returned most or all of its cash flow to shareholders. In fact, in fiscal year 2011 (June) the company reported after-tax profits over \$1.2 billion and returned \$1.4 billion to shareholders through dividends and share repurchases. The company also made nine acquisitions at a total cost of \$775 million in fiscal 2011. Still, ADP's total debt is just \$34 million. Needless to say, ADP is one of the "growth bonds" (companies with a very long history of consistent dividend growth) that dominate our clients' portfolios. ADP has increased its dividend every year for 36 consecutive years.

In its financial reporting, ADP separates the revenue and profits of its Professional Employer Organization (PEO) from the Employer Services unit. The PEO business provides many of the same services as ES (payroll, tax filing, benefits administration, etc.), but through a co-employment relationship with more than 5,000 small and medium sized businesses. In other words, ADP is the human resources and benefits administration office for these employers. Thus, as shown below, ADP generates 85% of its revenue (and about 88% of profits) from services to employers and employees.

	Total Revenue fiscal 2011 (\$ million)	Share of Total
Employer Services		
Operating Revenue	\$6,311	64%
Interest on Funds Held for Clients	540	5%
PEO Revenue	1,534	16%
Dealer Services Revenue	<u>1,495</u>	15%
Total Company	\$9,880	

Dealer Services is a distinctly different business; providing management systems to over 25,000 retailers of cars, trucks, motorcycles, RV's and heavy machinery. Although the Dealer business is commonly associated with automobile dealerships, and is widely assumed to be dependent on new car sales, the business actually provides software, hardware and services to help these retailers manage all aspects of their operations.

Importantly, ADP generates a significant share of revenue and profits from "*Interest on Funds Held for Clients.*" These are the funds paid by employers to satisfy federal and state unemployment insurance liabilities. Although held only temporarily, the funds are a permanent "float" that ADP manages for "safety, liquidity, and diversification." Interest earned on these funds is an important source of compensation for ADP. Also, these investment profits are earned at no cost to the client -- another reason why ADP is able to offer its services at prices lower than the cost of in-house alternatives. At the end of fiscal 2011 ADP held more than \$25 billion of clients' funds -- far and away the biggest item on the company's balance sheet. Given the magnitude of this responsibility, it is essential that ADP maintain the highest possible credit rating. Thus, ADP is one of only four remaining U.S. companies whose debt is rated Triple-A (the others being Exxon-Mobil, Johnson & Johnson, and Microsoft).

As noted above, analysts and investors often assume that ADP is hostage to broader trends in the labor market. Consequently, one of the metrics that ADP management tracks and reports, "pays-per-control," receives a disproportionate share of analysts' attention. Pays-per-control is the number of employees on the payrolls of ADP's clients. It is similar to the "same-store-sales" metric tracked by retailers. Although pays-per-control is an important measure of the company's short term progress, it has far less impact on the company's results than two other key drivers of revenue: (1) new business sales and (2) client retention.

In fiscal 2011 ADP generated \$1.1 billion in new business sales. This is the incremental annualized revenue expected from new clients plus the purchases of additional services by existing clients. Relative to total revenue of \$9.9 billion, this represents an increase of 11% in the year ahead -- far greater than the 1-2% improvement in pays-per-control implied by the national employment data discussed above. Meanwhile, a retention rate just over 91% implies that ADP could lose close to 9% of current revenue. Thus, generating new sales and improving client retention are critical. Also, sales to new clients are typically less profitable in the first year due to installation costs. The most profitable sources of revenue are additional "beyond payroll" services to existing customers. Consequently, improving retention has important implications for both revenue and profit margins.

With these dynamics in mind, ADP invested aggressively in new products, sales force expansion and client service during the recession of 2008-2009. These investments have begun to pay off. After posting flat EPS in 2010, ADP's per share profits increased 6% in fiscal 2011 -- including a 14% gain in the fourth quarter. Also in the June quarter, total revenue of Employer Services increased 9%, revenue for higher-value "beyond payroll" services increased 13%, and PEO revenue rose 20%. Finally, pays per control increased 2.6% -- remarkable progress in the current labor market and suggesting that ADP is gaining market share among smaller employers.

When Gary Butler assumed the CEO position five years ago, he quickly moved to sharpen the company's focus on its core ES business -- divesting the Brokerage Services Group via a spin-off to shareholders as Broadridge Financial. Other smaller divestitures followed. ADP has since made more than 20 acquisitions; mostly smaller companies which add unique products to the company's offering. ADP is able to accelerate the growth of these acquired companies by pushing their products and services through the largest direct sales force in the industry. Mr. Butler is also a strong advocate of returning cash to shareholders. Total shares outstanding have been reduced by 15% over the last five years and the annual dividend more than doubled. Finally, although Mr. Butler has endorsed the Dealer Services business on several occasions, we believe this operation could be sold or spun-off to shareholders at some point in the future. If such a transaction would increase total shareholder value, we have no doubt that Mr. Butler will consider it.

ADP has been a major holding in our clients' portfolios for ten years. With a dividend yield over 3%, and a double-digit long term growth rate, ADP should provide investors with superior returns over the next several years. Finally, we believe other investors are assuming only a single-digit growth rate for the company. If our 12% growth rate assumption is achieved, then investors are likely to once again place a significant premium valuation on ADP's common shares.