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Client Letter – September 30, 2012

We'd like to begin by announcing the exciting new addition of Elliott Savage to our firm. Elliott has over a decade of experience in managing portfolios. Prior to YCG, Elliott was a Senior Analyst who worked directly with the founding partner at Highside Capital Management, a multi-billion dollar long/short equity hedge fund located in Dallas, Texas. Elliott is incredibly brilliant and a natural fit to our investment philosophy; thus, we believe his addition will only serve to strengthen our investment team.

It may seem peculiar that over the past quarter, soft economic news was coupled with a strong rise in stock prices. The S&P 500 was up 6.35%, largely due to actions taken by central banks in the U.S. and Europe. Ben Bernanke announced that the Fed would initiate round three of quantitative easing (QE3) with no ending date, stating they would add to the program "if the outlook for the labor market does not improve substantially," or essentially, "QE…to infinity and beyond!" European Central Bank President Mario Draghi has echoed these comments, stating that the ECB would "Do whatever is necessary…" to provide liquidity and stimulate the Eurozone. Markets continue to crave growth through monetary stimulus even though neither of these latest actions addresses the underlying sovereign over-indebtedness issue. Nevertheless, these commitments convinced many to brush debt imbalance concerns under the rug and buy *risky* assets for fear of standing in front of a tidal wave of monetary stimulus and missing out on a rally when money sloshes around and drives up prices.

Our Concentrated Composite with Option Enhancement, comprised of many high quality companies, could not keep pace in this environment and appreciated by 2.79% over the quarter. Although many of our more boring, stable businesses tend to miss out on these short-lived rallies, we are confident that sticking with our strategy will produce favorable investment results over the long-term. Since our inception, the Concentrated Composite with Option Enhancement has produced 10.5% annualized returns versus 5.1% for the S&P 500.

Presidential Race and Econ 101 on Debt & Inflation

We've had some clients ask our views on the Presidential race and the effect it will have on stock prices. In the short-run, some pundits have suggested it's a win-win outcome. In other words, if Obama wins, then the economy is perceived to be recovering and good for stocks; and if Romney wins, he could put policies in place that will be favorable to business enterprise, job creation, and growth. They add that a Republican president could resolve the "fiscal cliff," which refers to the end of this year when the combination of automatic spending cuts and expiring tax breaks could siphon over $500 billion out of the economy next year. Thus, either outcome, they say, is thought to generate more demand for stocks in the short-run.

Of course, we're more concerned about the long-term, and, from this perspective, the real threat is the massive national debt and deficit. When you consider the numbers, it's clear we are on an unsustainable path. U.S. national debt, now over $16 trillion, exceeds GDP (gross domestic product – or the annual economic output of the country). In simple terms, not even speaking of current deficits, this means that GDP needs to grow faster than the interest rate the U.S. pays just to keep pace with the current debt level. If the budget were balanced, during a period of sub 2% interest rates, this appears manageable. But when you throw the primary deficit on top of these interest payments, our national debt is being added to by $1 trillion per year, which means that GDP needs to grow by 6% right now just to keep debt to GDP constant! Now, imagine if the government had to pay interest on that debt at pre-crisis rates from the 2007 period – interest costs would increase by about $500 billion, which would further widen the deficit to the point where GDP would need to grow by 9% per year to keep debt to GDP constant! At the current trajectory, it wouldn't be long before interest constitutes the largest piece of the budget and would send us into a fiscal crisis.

Some believe this concern is overblown, arguing we are in a new era of low interest rates. If true, this utopia would go against both theory and history. After studying centuries of data, the late Milton Friedman wrote, "I know…no example of a rapid increase in the quantity of money that was not accompanied by a roughly corresponding substantial inflation." (Money Mischief, 195). Given that we are in the middle of the largest monetary experiment of all time, with the monetary base having more than tripled in the past four years and the Fed, the ECB, and the Bank of England having conjured up money that amounts to 30% of the their markets' total equity capitalization, we find it hard to believe that "this time is different." Inflation is certainly low currently, possibly because banks are still tepid towards lending and consumers continue to deleverage, both of which reduce the money multiplier effect. In fact, we are currently experiencing for the first time in history a negative money multiplier. However, these circumstances will not persist indefinitely, and we question whether the Fed will be disciplined and agile enough to withdraw this excess liquidity when monetary velocity eventually increases.

This is not to say that we don't understand Ben Bernanke's point of view. The Fed has a dual mandate of 1. Keeping inflation in check, and 2. Growth. Since inflation has remained in check, as mentioned earlier, Bernanke has stated they will seek growth through monetary stimulus if the labor market remains weak. We're sure he feels further pressure because all of the government's other tools are used up. In an unleveraged economy, increasing government spending will provide a short term boost to growth and employment. However, since the United States is already so leveraged and is adding to that leverage every year through a big fiscal deficit, we can't provide any more fiscal stimulus. We could try and increase taxes to gain more firepower for fiscal stimulus, but history has shown that the taxes will reduce private spending and reduce savings and investments by more than the benefit we would get from increased capacity for fiscal stimulus. Thus, the only real alternative is to fund the increased government spending by creating money out of thin air, i.e., monetizing the debt. Monetization refers to converting something into cash, so debt monetization is the Fed creating new money by purchasing government bonds to fund the debt (quantitative easing).

The problem is this will inevitably lead to inflation at some point. If you think of money in terms of supply and demand, if the supply of money significantly increases, then prices drop. In other words, the dollar devalues and is unable to purchase the same quantity of goods, i.e., inflation. On the one hand, this will fortunately make past debt loads feel smaller (because those debts are priced in devaluing dollars), but on the other hand it will simply serve as another form of taxation without legislation as commodity prices and costs increase. This takes you back to the same problems of taxation hampering growth and employment. As alluded to earlier, it could also potentially lead to a spike in interest rates which could create an inflationary debt spiral scenario in which our fiscal deficit worsens because interest rate payments go up, we monetize the debt to fund these increases, the bond market responds by forcing our interest rates up even more, we monetize our debt, etc. Even if a low probability outcome, this is one that we should try and avoid at all costs due to the severe negative long-term economic consequences.

Overall, we see depending solely on monetary stimulus as the wrong prescription. Monetary stimulus is the prescription for a liquidity crisis, but our problem is not liquidity; our problem is too much debt. In our view, the best way one gets out of debt is by either living within ones means or by growing out of it. Obviously, monetary policy cannot control fiscal spending and budgeting, and the trouble of leaning on monetary policy for growth is that it only determines nominal gains, not real growth. Therefore, the missing prescription is for the branches of government that oversee fiscal policy to 1. Budget and 2. Set policies that encourage savings, investment and growth.

We do not know what fiscal policy will be over the next four years, but what seems clear is, of their dual mandate, the Fed is more focused on the labor market at the expense of allowing inflation to run rampant. For this reason, coupled with sky high valuations, we agree with Warren Buffett when he stated months ago that *bonds should come with a warning label*.

This is why we continue to focus our search on quality businesses trading at attractive valuations that will continue to produce strong cash flows even during turbulent times and have the ability to raise prices to maintain margins in an inflationary world. We found one such new investment this past quarter.

Aon – Risk “Arbitrage”

Last quarter we established a strong position in Aon (AON), the world’s largest insurance broker and human resource consultant/outsourcer. As a broker, Aon analyzes the insurance needs of corporations like Pepsi and Procter & Gamble and, using its virtually unrivaled global network of providers and database of transactions, matches these clients with the insurance companies that provide the best risk solutions at the lowest price.

Aon’s insurance brokerage business is excellent because, as a result of significant consolidation over the years, it is one of only two or three companies that have both the knowledge base and the network of insurance companies big enough to fulfill the needs of large global companies, resulting in pricing power and a sticky customer base. An additional benefit of Aon brokerage’s global scale, with two-thirds of revenues outside of the US and almost a third in emerging markets, is that the company should be able to grow revenues and profits for years to come as insurance needs in these areas continue to increase. In fact, because insurance premiums as a percentage of GDP stay relatively stable in developed markets and actually rise over time in underpenetrated emerging economies (with both experiencing some insurance pricing cyclicality in shorter time periods), a good way to think of Aon's brokerage business is as a toll collector with built-in price increases on global GDP. This "toll-taker with pricing power" characteristic makes Aon's brokerage business an excellent hedge against inflation since, as GDP rises in nominal terms, Aon's revenue and profits should rise even faster.

A further advantage of insurance brokerage is that it's mostly non-discretionary, leading to less cyclicality than the average business. Lastly, unlike insurance providers, which have to keep large cash reserves on their balance sheet to pay for claims, Aon takes no underwriting risk and its main costs are people and databases, resulting in very low capital requirements. This low capital intensity has allowed Aon to continue growing while, at the same time, paying back a lot of cash to shareholders in the form of dividends and share repurchases. CEO Greg Case is likely to continue this shareholder-friendly behavior, given that he owns $100 million of Aon stock and options personally.

Aon's second business is human resource consulting and outsourcing. This business assists commercial customers with ongoing human resource and compliance requirements in areas such as health and retirement benefits and talent retention and compensation. In addition, Aon consults on special human resource projects, which are most often driven by regulatory change, like the recent U.S. healthcare legislation. Until recently, Aon's consulting business was subscale, but the company's mid-2010 acquisition of Hewitt Associates solidified its position as one of a few global leaders of HR consulting, further strengthening Aon's competitive advantage. HR consulting has many of the same characteristics as insurance brokerage (low capital requirements, significant room for international growth, oligopolistic industry structure, etc.) and is complementary to insurance brokerage since, at many organizations, the same person is responsible for both risk and human resource solutions.

While Aon's stock is priced attractively relative to the current level of earnings, we think it's even more attractive when one considers that earnings actually understate the true level of cash flow that the business produces. As a result of accounting complexity from the Hewitt merger, free cash flow is substantially higher than earnings yet many investors still focus on earnings multiples. As free cash flow and earnings converge over time, the free cash flow multiple should expand.

Finally, not only are current earnings understated relative to cash flow, but we believe the company's current cash flow is actually at a cyclical low point, making the stock even cheaper. Insurance rates have declined for the last eight years, and insurance premiums to GDP are now at generationally low levels. When insurance rates turn and premiums rise, as they always eventually do, this revenue upside should provide a boost to earnings. Additionally, as part of Aon's role as a broker, Aon takes cash from its corporate customers and pays its insurance providers. While it only holds this cash for a very short time, Aon processes so many transactions that it always has a meaningful amount of customer cash on its balance sheet. Aon's customers allow it to invest this money at risk free rates, enabling Aon to earn an extra profit. Currently, the Fed is artificially holding rates at almost zero percent, preventing Aon from capitalizing on this "float," but if and when interest rates turn around, we anticipate another significant bump to earnings over time.

While this investment certainly doesn't meet the standard definition of risk arbitrage, we're sure you can see why the phrase came to mind as we wrote about Aon. We hope to make a profit from the business of risk for many years to come.

Concluding Remarks

As always, we are invested right alongside you. We encourage you to remain focused on a long investment horizon. Despite the global challenges, we sleep well at night owning a portfolio of what we believe to be predominantly high quality businesses trading at discounted prices. We will continue to diligently seek out the best risk-adjusted expected returns.

We thank you for your continued trust and loyalty.

Sincerely,

The YCG Team