



Staying Out of Trouble

FOUNDERS CAPITAL MANAGEMENT
2011 ANNUAL REPORT

Investing for the Long Term. Every Day.



An innovative money management firm investing in publicly traded equities and fixed-income securities. A deep base in business management with a truly global perspective. A drive to identify true fundamental value. A commitment to buy carefully and hold for the long term. A passion to provide customized investment solutions tailored to each client's financial goals and risk tolerance.

This is Founders.

Founders Capital Management, LLC

2011 Annual Report:

“Staying Out of Trouble”

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PRINCIPALS' LETTER

From: Founders Capital Management

2011: Staying Out of Trouble

2011 was a schizophrenic year for the stock and fixed-income markets. After a lot of movement, the Standard & Poor's 500 finished the year at "up 2.1%"—not a great follow-on to 2010's 15.1% gain, and certainly nowhere near 2009's 26.5% leap. Of course, in total, we should be pleased with the gains of the past three years following 2008's swift decline—that is the year to overlook, when the S&P 500 lost 37%. Considering the past five years in retrospect: Although many are relieved to see the S&P 500 89% above its March 2009 low, \$1 invested in the S&P 500 at the beginning of 2007 is worth about 99¢ at the end of 2011, including reinvested dividends—a poor return.

We continue to hold the opinion that many investors—both professional and amateur—think the stock market remains a dreadful place. Last year, we pointed out the *massequity exodus*, when individuals removed a net \$55 billion from stocks in 2009 and 2010, opting to shift \$600 billion over to the fixed-income market during the same time frame. This year reflected more of the same: Morningstar reported that investors had removed some \$75 billion from U.S. stock funds through November, 2011.

Overall, extreme thoughts continue to unsettle the investment world, with one camp insisting, "The stock market now represents the best investment opportunity we have seen in decades," while the opposing camp persists on screaming, "Sell now, before the market revisits the previous lows!"

Investing today is an unnerving experience, and the line between investment and speculation is becoming more blurred. Many individuals are making large commitments to so-called undervalued assets with conviction, or chasing nouveau securities that they believe are destined to rise in price. Such individuals, who confuse investment with speculation while disregarding investment basics, end up like the schoolboy who gets caught acting out in class: After losing their money, they find themselves filling the blackboard with the sentence, "I will never do this again."

This year's letter is about one of the supreme gifts to humankind: A teacher. A great teacher cultivates an environment in which continuous learning takes place among students, while stressing the importance of becoming educated and staying out of trouble. Disciplined students—those that pay attention in class, keep their heads in the books, and allocate time effectively—obtain favorable results. Undisciplined students that fail to stay the course are guaranteed one thing: Disastrous results, and being "schooled." What it takes to succeed in school is an apt analogy for investing.

In our 2011 letter, we will discuss:

- Stretching for High Returns
- *Measuring Business Ability*—the “ables”
- Pronounced Ongoing Problems
- Big Challenges Ahead: The “State of the European Union” and the “State of Our Union”
- A Unified Solution

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Founders Capital Management is pleased to report that the underlying business value of our aggregate equity holdings continued to grow in 2011. The cumulative companies we own remain very profitable and continue to exploit attributes that give them a long-term competitive advantage. Even in this problematic economic environment, most of our companies continue to grow stronger as competitors fall by the wayside or go out of business.

Nevertheless, we have not changed our view, stated in previous letters: Although the overall markets have been successful in generating a “significant rebound rally” over the past few years, any longer-term gain is suspect due to lingering risks in the global financial system. We believe that the equity and fixed-income markets will continue to undergo a long-term “deleveraging” process brought about by financial institutions and governments that borrowed too much money, whether to enhance returns or to support their growing deficits. We wish we could say that the market volatility is over or that the market fall has seen its bottom—but as you know, we are not prognosticators. What we can say is that we anticipate random price movements in both the stock and fixed-income markets in the coming years—along with a high degree of unpredictability.

This leads us to our usual (slightly modified) statement, which we continue to evolve as market conditions change:

With today’s uncertain environment of prolonged low interest rates, opaque financial markets, volatile commodity prices, high amounts of consumer and government debt, a bloated trade deficit, large currency imbalances, and ongoing geopolitical issues—investors (including professionals) remain extremely cautious. At current prices, we believe selective equity securities to be fairly priced, while speculative equities and most fixed-income securities seem overvalued.

Naturally, we do not have a general view on the future direction of the stock and fixed-income markets. Most fixed-income securities rose considerably over the past few years and continued to rise this year. The current yields being offered on these securities, however, will not provide outsize returns going forward. In addition, we believe that speculative equities have reached extreme values and that the considerable rise in price of speculative equities and fixed-income holdings indicates an imbalance (perhaps extreme) between risk and return in these areas.

Stretching for High Returns

Treacherous conditions prevail, as aftershocks from the financial quake that unfolded in 2008 are likely to continue into the near future. The market thus remains a gut-wrenching environment for participants, who have not forgotten the sting of the major fall a few years ago. Nevertheless, both professional and amateur investors remain frustrated with the stagnant investment returns of the past 10 years. As a result, both groups are seeking higher returns, convincing themselves that this is possible in a low-return environment. Eventually, some of these investors start chasing returns with the belief that they are investing. This speculative behavior sets up a learning experience one would receive as they add risk, not returns.

In the current market, many professional and amateur investors appear to be putting the concept of “investing” aside and pursuing stocks that they perceive to have a tremendous future, or that are being purchased at higher prices by others—participating in the greater fool’s game. The “hot” companies that pundits are aggressively pushing today are social media and similar companies that have little revenue and profits—these businesses are

apparently the new place to put money. Everyone seems to want a piece of Facebook, Twitter, Groupon, Zynga, LinkedIn, Zillow, and Pandora. And Wall Street seems to be more than willing to fulfill the wishes of speculators, having brought LinkedIn, Zillow, Pandora, and Zynga to the public in 2010. Of course, everyone is waiting with bated breath for the big one: Facebook's pending IPO slated to take place in 2012, at a potential company valuation of \$100 billion.

The Face of a \$100 Billion Justification

Facebook has built a tremendous social networking ecosystem of 800 million active users, of which more than 50% log in on any given day. Considering this fact, the advertising revenue potential seems unlimited. Facebook's worldwide revenue was an estimated \$4.3 billion in 2011, with profit margins running in the 50% range. Extrapolating these figures into 2012: If Facebook doubles its revenues to more than \$8 billion, coupled with ever-increasing advertising fees, after-tax earnings should be around \$2.5 billion. Now, double this again in 2013, and we approach \$5 billion in net profits and a \$100 billion valuation.

Why are we not participating in the purchase of Facebook or comparable companies that have seemingly unlimited future potential? The problem lies in a total dependence on the future. To us, it makes little economic or business sense to purchase a portion of a company that does not have a *predictable* earnings stream, along with a *sustainable competitive advantage*. It is our opinion that the companies now being brought to the public lack both of these critical investment attributes. We have seen it many times before: The mania of investors purchasing something at any price, only to end with individuals being "schooled" in the not-so-fine art of speculation. We are reminded of the past manias described in *Delusions and the Madness of Crowds*—a 170-year-old book by Charles Mackay that reviews famous bubbles such as the Mississippi Scheme, South Sea Bubble, Tulipomania, and others. As evidenced by today's chase of newly minted stocks, the ongoing human desire to "get rich quick" is alive and well, especially among individuals seeking to gain back money they lost during the precipitous recent market decline.

Further Speculation Disguised as Investing

Rather than pursue newly minted IPOs, other professional investors are searching for "bargain investment opportunities." For example, certain money managers are investing in old-line retail companies for the so-called "hidden real estate opportunity." Basically, the concept is that the underlying real estate value of the retail store holdings owned by the company is worth more than the public valuation of these entities—even if the business is dead. Our opinion about these investments is no different than how we view the purchasing of speculative IPOs: Just as an investor in social media companies is fully dependent on the future, the acquirer of these dying retail entities is depending 100% on the firms monetizing their dormant real estate in the future. What this real estate can be turned into to produce positive cash returns after the retail business dies is uncertain—especially in a struggling economy that may persist for another decade. Again: It makes little economic or business sense to purchase a portion of a company that does not have a *predictable* earnings stream, along with a *sustainable competitive advantage*.

We are also witnessing investors guessing on the next big acquisition, hoping that the troubled company they purchase will shoot up in price when another company rushes in to acquire it at an outsize price. In addition, some investors are placing money into well-known financial institutions that are trading lower than their supposed liquidation value (a clue that the troubled assets and liabilities are known). Again, the problems lie in assessing the future value of these entities—which amounts to speculation.

All these cases illustrate individuals that are hoping that someday in the future, a princess will come along and kiss an investment frog that will turn into a handsome prince. In reality, many of these investment frogs are likely to stay frogs, and all the investors in these businesses will wind up with is lips with warts. Individuals attempting to chase these "great opportunities," or hoping that their investment prowess in substandard businesses will eventually turn these entities into cash-generating machines may end up waiting an investment lifetime. This approach is similar to buying a pond full of frogs with the hope that a lot of kisses will turn several into handsome princes. Unfortunately, investors in these cases usually get croaked, and most frogs end up being just what they are: Frogs.

"Never fool yourself, and remember that you are the easiest person to fool."

– Charlie Munger

With today's uncertain conditions, investors should concentrate on "what's important" and "why it's important" versus "when it's important" and "where it's important" and adjust their high-return expectations in a low-return environment—to "fair return expectations." It is our opinion that fair returns are available in this environment if one sticks with the investment basics.

Investment Basics (With an Expansion)

Last year, we discussed how intelligent investing involves choosing a few top-rate businesses that you understand, and purchasing an interest in these entities at a fair price. Although this sounds easy in theory, in practice the hard part of investing is identifying a few top-rate businesses and understanding them thoroughly enough to decipher a fair purchase price.

A quick review: To figure out a fair purchase price, a top-rated business can be viewed as a goose that lays an ever-increasing number of golden eggs. The job of the intelligent investor is twofold—to evaluate the goose's capability to continue producing golden eggs, and to have a predictable view of the number of eggs that goose will produce today, as well as many years out. Very few businesses on the planet, of course, fit the description of a rising golden-egg producer—so when an investor identifies one, it usually pays to purchase a meaningful amount of this goose. The objective to investing is to correctly figure out today's value of the golden eggs produced over the life of the goose—and then acquiring the goose at a discounted price. Principally, an intelligent investor tries to pick up \$1 of today's value for the price of 65 cents.

How should the investor react to the changing price of eggs? The intelligent investor does not take the view that it is necessary to constantly exchange one's golden eggs, or to place them in a number of baskets to avoid the risk of changing prices. In fact, intelligent investors intently watch over the *goose* rather than the eggs (or the fluctuating price of eggs). True risk to an intelligent investor is not represented by short-term fluctuations in the quotation price of eggs, or in the number of baskets one puts one's eggs into. Risk resides in a lack of clarity about the goose's ability to lay golden eggs far into the future. The more cloudy, the greater the hazard.

Obtaining clarity about the goose's future golden-egg output depends on the ability to ascertain the strength of what we refer to as the business "*ables*." The so-called business "*ables*" include:

- **defendable** businesses that are difficult for competitors to penetrate
- **sustainable** businesses that can be viewed many years out
- **predictable** businesses that have a high market share of consistently needed products that are integral to daily activity—leading to steady returns on capital and profitability
- **affordable** businesses that are selling at a desirable price that provide an investor a fair return over time

Unfortunately, *investing* in "*able*" businesses does not provide an opportunity to obtain riches quickly. This explains why these opportunities are not in vogue today and, in fact, are largely avoided by individuals seeking higher returns. Nonetheless, holding these *valuable* businesses over time can be financially rewarding.

Measuring Business Ability – the "ables"

In our opinion, pursuing a Masters of Business Administration (MBA) degree may be a key to understanding business, but it may not be enough for successful investing. What may prove more important is acquiring a "supplemental MBA": *Measuring Business Ability*. The curriculum for *Measuring Business Ability* involves two "*able*" courses: "Understanding Economic Value" and "Understanding Business Models."

Understanding Economic Value 101

Many investment students understand the importance of sales and profit growth, and how these factors can add value to a firm. But the more crucial component to value creation lies in how management allocates capital within a business. Investors should keep a sharp eye on earnings—especially those that are retained by a company—and how they are deployed to obtain future returns for business owners. Investors should not overlook the importance of management's ability to create economic value for shareholders.

Businesses earnings should not be viewed on an apples-to-apples basis due to variations in the capital intensity of one business compared to another. For example, when an automobile manufacturer reports \$1 of earnings, a large portion of these profits *must* be retained to enable the company to retool and/or build factories to produce new cars. This type of business thus places a heavy burden on retained earnings, requiring management to achieve an equal or better return on this freshly invested capital compared to prior returns on retained equity. If management fails to obtain a return on this reallocated equity that is equal to or better than what was achieved before, then economic value is destroyed. At this point, it may have been better to have distributed *all* earnings to shareholders. Of course, in many cases this is not possible. A capital-intensive manufacturer that opts to distribute all earnings to shareholders jeopardizes its economic standing in the industry or risks its financial well-being as the company is forced to borrow money to maintain its competitive position.

The restricted variety of earnings can be deemed to possess value, but must also carry a heavy financial weight. To illustrate, let's say that an unlevered business is able to obtain a return on both current and incremental invested capital of 12%. In today's market environment, when the return on a long-term taxable corporate bond is around 4%, the opportunity to obtain a favorable eight percentage point premium through a reinvestment of funds within our business would be deemed a "good deal." If long-term bonds spike from 4% to 8%, however, a reallocation of money into our business does not look as desirable. Taking this one step further: If the market encountered "Greek like" long-term bond yields of ~30%, the 12% business return would be deemed a bad deal. Shareholders would rightly request that management distribute all capital to owners to enable them to place these funds in securities with higher yields.

On the opposite side of the coin, let's look at an unlevered business that is able to achieve a strong 30% return on all employed capital. In this scenario, shareholders would likely request that management maintain all capital possible to cumulatively and exponentially increase returns—every \$1.00 retained would turn into almost \$14 in 10 years. This is an investment dream come true. However, businesses that generate returns of 30 cents on every \$1 of capital employed would find it very difficult to reinvest undistributed capital on a continual basis to achieve a return of 30% per annum. Thus, this excellent business would likely generate a large amount of unrestricted earnings that, in principle, should be distributed to shareholders through dividends and/or prudent share repurchases.

Principle and practice are, of course, two different circumstances. Many managers today are choosing to retain unrestricted earnings that should be distributed to shareholders. The reasons are many and range from plans to expand a business kingdom in the future to the desire to maintain financial comfort in a difficult economic environment. In either case, shareholders end up watching their capital accumulate on a corporate balance sheet—and the low-risk annualized returns attained on this dormant money is in many instances less than 1%. Our view is that unrestricted earnings lying dormant within a business should be retained by management if (*and only if*) there is an opportunity to allocate this capital to areas that will produce additional returns for shareholders above those opportunities commonly available to market participants. Otherwise, management should hand the money back to shareholders.

Our view is based primarily on the mixed track records of many public companies with regard to allocation of unrestricted shareholder capital. We have observed managers of businesses that display excellent economics find a way to allocate unrestricted earnings to projects and ventures with inferior returns. When excess capital builds on a company's balance sheet, many managers can't seem to help themselves. They eventually get silly and spend money on business opportunities that lie outside of their core competencies or—worse yet—overpay for acquisitions, convincing shareholders that diversifying capital among various enterprises will reduce reliance on a single business and concurrently lead to increased earnings. We recently witnessed a large snack-food and beverage company purchase a dairy operation (a business that generates dreadful returns on capital) with the rationale of expanding its international beverage distribution and pursuing drinkable yogurt. In another case, a growing, high-profit software technology company is sinking billions into low-return social media and mobile phone businesses. The CEOs of these companies respond with frustration to business analysts who question their strategies and flat stock prices, countering that their moves are necessary to meet increased earnings projections. These CEOs also point to the sustained high returns on capital produced by their conglomerates. The sustained high returns may be valid, but savvy investors recognize how the higher returns generated from a wonderful business temporarily mask the poor decision to allocate capital to low-return businesses. These alert investors understand that continuous poor capital-allocation decisions will lead to a loss of economic value for the conglomerate, and the high return on overall invested capital may not be

sustainable. Regrettably, these CEOs (who often have traditional MBAs) fail to comprehend that they are consistently taking profits produced from spectacular businesses and reallocating this capital to low-return, commodity-type businesses, with potentially devastating results.

We should point out that there are managers that are extremely adept at allocating capital and increasing economic value for shareholders. Their corporations exhibit consistent, mouth-watering returns on both equity and incremental invested capital. Several of the companies we own, including Kraft Foods and ConocoPhillips, have recently taken steps toward maximizing economic value for shareholders. In both cases, management decided to de-emphasize the conglomerate structure and to break up their companies into several entities. This action can unleash hidden value, as the core businesses receive greater focus and the reallocation of retained earnings receives a sharp eye by management that benefits shareholders.

A greater understanding of economic value by investors and managers can maximize value for all business stakeholders. The obvious next question is: How can investors recognize when managers are increasing economic value in a competitive business environment?

Understanding Business Models 201

One of the more difficult challenges a CEO faces is the expansion of a company's business domain. A CEO who manages a company with a 15% return on equity, and retains all earnings, will oversee the reallocation of 100% of the company's original equity over a five-year time frame. In light of this fact, a significant question investors must ask is: How are managers building the company to create long-term competitive advantage and expand the economic moat around their business castle (a Warren Buffett metaphor). An expansion of a company's business is highly correlated to its business model.

A step back: An MBA would likely define a business model as the business strategies and tactics executed by an organization to generate revenue and profits from its operation. The model includes the components and functions of the business—sales, marketing, operations, human resources, administration, R&D, finance, etc.—and how these functions interact to make money. Our MBA (*Measuring Business Ability*) definition is a little simpler: *A business model reflects how a business makes its money.*

Underlying this simple definition, however, is some complexity. We think that investors should focus on defining the *type* of business model a company uses to make money. We categorize well-defined business models and strategies into four broad areas:

1. Controlling the Middle
2. Segregation and Integration
3. Organic and Mechanistic
4. Purpose and Focus

Controlling the Middle

“Controlling the middle” in business is analogous to a key strategy to winning the game of chess. This chess strategy—which consists of tying pieces together to attack the central four squares of the board—gives the executing player control over the game. Controlling the center of the chess board is important because tactical skirmishes often take place around the center squares, from which pieces can access most of the board. This concept also applies to business.

A little history: Business have applied tying and play-to-the-middle strategies for centuries. Ben Franklin expanded his publishing business through special access to the postal service (he served as the postmaster of Philadelphia from 1737 to 1753 and as joint postmaster of the U.S. colonies from 1753 to 1774). At the time, newspaper publishers often served as postmasters, which helped them to gather and distribute news. Postmasters decided which newspapers could travel at no charge in the mail—or even be distributed through the mail at all. The postal service served as the “middle” between the publisher and the consumer, allowing Ben to deliver his newspaper to households as he constructed a profitable postal system throughout the colonies. The postmaster's control over this central delivery source ensured a scalable distribution source as well as circulation bragging rights to attract advertising—creating a large competitive advantage.

The most famous application of the “controlling the middle” business strategy was executed by John D. Rockefeller, who used this model to gain control over the oil industry. Rather than build his company, Standard Oil, through oil exploration or through retail outlets that sold kerosene and oil to consumers, Rockefeller decided to build and purchase oil refineries, which stood in the middle between oil exploration and production on one side, and the consumer on the other. Standard Oil, which had its roots in Cleveland, Ohio, competed fiercely in the refining business. During a six-week period in 1872, Standard Oil gobbled up 22 of 26 competitors in the Cleveland area. Of course, Standard Oil did not stop in Ohio, gradually combining most of the refiners in the U.S. until it controlled 90% of the daily capacity of the American petroleum industry by 1879. During this time, as Rockefeller gained control of the refining business, he set his sights on tying up the transportation of oil from areas of exploration to their refineries, and eventually to the consumer. Standard Oil set up exclusive cartel agreements with railroads and purchased various rail tank car manufacturers to form the Union Tank Car Company. Union Tank Car made the oil tankers that transported oil. By controlling and expanding the middle of the oil business system, Rockefeller eventually extended his reach into exploration and consumer sales. By 1911, Standard Oil’s monopoly was entrenched with approximately 65% market share, and the Supreme Court ruled that the company should be broken up into 34 different companies. (We own some of the original Standard Oil companies—Chevron and ConocoPhillips—along with Union Tank Car, which is part of The Marmon Group, which is majority-owned by Berkshire Hathaway.)

Controlling the middle is a powerful business model that can generate tremendous returns to a corporation and value to owners. Investors in companies that use this model must continuously evaluate the movement of the middle in a changing industry, potential anti-trust violations if the strategy is abused, and the company’s ability to anticipate and respond to market forces attempting to break its hold of the middle.

Segregation and Integration

In our view, the segregation and integration model echoes a flexible version of another business strategy—vertical and/or horizontal integration. To understand our thoughts on the segregation and integration business model, however, it is imperative that we comprehend its roots. Again, a little history:

Vertical Integration: Vertical integration takes place when a business owns/invests in its upstream suppliers and/or its downstream buyers. For example, a company engages in *backward vertical integration* when it controls subsidiaries that produce parts used in the production of its products. An automobile company may own a spring manufacturing business, a battery company, and a seat manufacturer. In theory, controlling these subsidiaries creates a stable supply of parts and provides consistency in quality. Conversely, a company engages in *forward vertical integration* when it owns/invests in distribution centers and retailers that sell its products to consumers.

Henry Ford—the pioneer of the assembly line—used a vertical integration approach effectively. While serving as head of the Ford Motor company during the early decades of the 1900s, Ford believed that the cost of manufacturing automobiles started from the second the raw materials were obtained up until the time that the finished product was sold to the customer. Based on this thinking, he set out to control every aspect of manufacturing a car. Henry Ford built a manufacturing complex near Dearborn, Michigan called the Rouge—a compound along the Rouge River that was a mile-and-a-half wide and more than a mile long. He consolidated Ford Motor’s entire business there in 1928. Touring the Rouge complex, a visitor could watch iron ore and coal unloaded from a Ford-owned railroad with 100 miles of track make its way into ovens to manufacture coke and steel. In another part of the facility, one could watch glass being made, car panels being stamped, and engines being assembled. At the end of the Rouge complex, a visitor could literally witness all the pieces coming together and watch the car be driven away. Vertical integration became the main business approach of Ford and of other automobile companies seeking to minimize costs by centralizing production.

Horizontal Integration: Horizontal integration takes place when companies that produce similar products or services decide to merge. The purpose of consolidating similar businesses can be obvious: The combined company has the ability to obtain economies of scale, leverage its position in the marketplace, and increase market share.

Horizontal integration usually takes place in industries that are fragmented or fast-changing. For example, many mergers and acquisitions have taken place within the media industry over the decades, with the development of conglomerates that control publishing, movies, television, and radio. Combining companies

has enabled several media enterprises to become a virtual tollgate between advertisers and consumers—in effect, they set the toll price.

There are plenty of success stories around vertical and horizontal integration, but investors should be aware of several issues that come with these models. For example, many companies pursuing these strategies end up with large and inflexible legacy businesses that are difficult to alter in a changing industry. The vertically integrated automobile company that owns a unionized tire manufacturer may find it difficult to compete if an independent tire manufacturer develops new patented tire technology or lowers labor costs through efficiencies. In addition, the imagined benefits of horizontal integration could prove elusive. In our times, a certain company that was primarily focused on manufacturing printers expanded into the computer hardware and software business with the strategy of developing sales synergies to increase market share of corporations. Unfortunately, these businesses have proven difficult to combine and manage, and the company has lost value.

In summary, a company that pursues a vertical or horizontal business model may forfeit future options that would position it to be flexible in a fast-paced business environment. This loss of optionality can lead to a deterioration in market position as the company gets cornered into a so-called concrete business structure. This stalemate can eventually lead to a destruction of long-term business value.

A more favorable strategy is what we call the “segregation and integration business model,” which freely mixes into the business structure the best opportunities available under both vertical and horizontal integration. Several companies have learned the special art of segregating and integrating business functions to master their industries.

A model story: In 1899, Asa Candler, the founder of Coca-Cola, was finding it difficult to quickly scale the company and its products. He wanted to deliver them throughout the U.S. without having to raise a vast sum of money (Coca-Cola did not go public until 1919). His solution was to sell the bottling rights for \$1.00, thinking the future profitability of the business was in soda fountains. Obviously, he was somewhat mistaken, but the 370 bottling franchisees that existed by 1910 invested vast sums of money into bottling and distributing Coke’s products throughout the U.S. This so-called “mistake” by Mr. Candler created tremendous scale for Coca-Cola. By developing a segregated system of bottlers, the company quickly covered the country with its products. Any competitor who hesitated to set up a similar business system during this short time frame was crushed. (There were more than 150 imitating competitors by 1916, which forced Coke to further differentiate itself by introducing and patenting the famous “hobble skirt” bottle that became an American icon.)

Only PepsiCo was able to develop a similar business system—and the industry literally became a duopoly. Once Coke learned the advantages of segregating its distribution system (and its capital-intensive nature) from its core business, the company repeated this concept elsewhere. Coke segregated and integrated various marketing functions between the company and bottlers—Coke manages large advertising campaigns, while bottlers focus on point-of-sale penetration within stores. The company also segregates and integrates financial and supply-chain functions. For example, Coke purchases all cans and bottles at the company level on behalf of its bottlers to maximize purchasing leverage, passing these supplies to bottlers to fill and distribute products. Recently, both Coke and PepsiCo have integrated their bottlers within the U.S. to gain greater control over the complexity of delivering many diverse beverage brands. Looking at the history of these two companies, we can see how the delicate balance established through the proper segregation and integration of business functions can create significant value—and is *very* difficult to duplicate. Mastering a “segregation and integration” business model can create a tremendous competitive advantage, and investors who notice a business successfully applying this model should take an interest in purchasing the business (at the right price).

Organic and Mechanistic

The typical MBA definition of a mechanistic business structure is an organization that is specialized, centralized, and standardized—think “bureaucracy.” An organic structure is the opposite: An organization that is non-specialized, decentralized, and non-standard. We believe a contemporary business model has emerged from these concepts.

In our view, a mechanistic business model is a traditional company that organizes all business activity under one roof—centralizing and standardizing business functions such as operations and marketing to gain full

control over the production and delivery of a product to the customer. A traditional appliance manufacturer is an example of this type of company.

On the other hand, an organic business model would be inherent in a “virtual” company, in which 80% or more of the business functions are outsourced and managed through a central headquarters. Virtual companies tend to be R&D and marketing entities.

A good example of a company that has set up an organic business model is Nike. Nike started off as an obscure track footwear company in the early 1970s and, over the next decade, emerged as a dominant company in track-and-field athletic footwear. By the end of 1982, every world track record, from the men’s 800 meter to the marathon, was held by individuals wearing the Nike Swoosh. Many believe Nike’s growth is attributable to its unique products, spanning running shoes in the 1970s to basketball and soccer shoes in the early 1980s. Yet these segments already had entrenched competitors at the time—Adidas, Puma, and Converse. The astute business student would ask, “What did Nike do differently from its competitors to become an industry powerhouse?”

Here’s the story: Phil Knight, a founder of Nike, was an avid runner. While he was at Stanford pursuing his MBA, he wrote a paper describing a plan for a Japanese athletic shoe company to challenge Adidas athletic shoe dominance in the U.S. After graduating, he decided to pursue his idea by enlisting a shoe manufacturer in Japan (Onitsuka) to designate Knight’s company, Blue Ribbon Sports, to become the exclusive distributor for Tiger running shoes in the western U.S. Over the next 10 years, Blue Ribbon Sports sold, distributed, and helped develop the Tiger brand of running shoes. After reaching \$2 million in sales in the early 1970s, Blue Ribbon Sports was consistently sales-rich but cash-poor. At this point, Onitsuka decided to leverage its relationship with Blue Ribbon Sports and delivered Phil Knight an ultimatum: Allow us to buy 51% of your company, or lose our contract. Blue Ribbon Sports elected to develop its own shoe—and Nike was born.

Although the “bootstrap” financial experience with Onitsuka was difficult for Phil Knight, his crucial arrangement to develop shoes and have them manufactured by third parties led to Nike’s eventual domination of the sports athletic footwear and apparel industry. Designing shoes and apparel sourced from low-cost manufacturers in the Far East became the cornerstone of Nike’s strategy. This approach allowed Nike to focus on research and development, outlining design specifications for various products, and quickly having them manufactured overseas in low-cost areas. In turn, Nike marketed its shoes through exclusive sponsorship contracts with famous athletes who endorsed its products. This built brand awareness and consumer demand, along with increased profit margins through premium pricing. Large competitors that remained mechanistic in handling all business functions, from manufacturing to sales and marketing, became inflexible compared to Nike, unable to “move on a dime” to develop various specifications of a product and quickly bring it to market at a low cost. Nike’s organic business approach—whereby the core company became an athletic R&D, marketing, and sales machine—was impossible for a mechanistic competitor to duplicate without essentially dismantling itself.

An organic business strategy requires minimal capital and leads to higher profit margins and cash flow. This model cannot be executed by all companies, however. A capital-intensive company that produces an extremely complex and integrated product would find it difficult to outsource most of its manufacturing to third parties. Boeing’s experience with the 787 aircraft provides a recent example of what can happen when a complex mechanistic company attempts to apply an organic business model.

In 2004, Boeing announced the launch of its new midsize, wide-body jetliner—the Dreamliner 787—and received more than 800 orders. The company had traditionally used a “build-to-print” mechanistic system, whereby Boeing engineers designed a plane and sent blueprints to suppliers to construct parts of the aircraft, with most of the assembly completed by Boeing. With the 787, however, Boeing decided to use an organic system of outsourcing design and manufacturing—allowing 15 companies in seven countries to design, engineer, and subassemble specific sections of the aircraft. Management anticipated that this organic process would require only 1,000 Boeing employees to “snap” the aircraft together in just three days, reducing final assembly time by 90%. Unfortunately, due to the complexity of assimilating thousands of parts that had been designed and completed from manufacturers all over the world, delivery of the first 787 was delayed for approximately three years, forcing Boeing to have to write off \$2.5 billion on three built but unsalable aircraft.

Ironically, Boeing was forced to implement a mechanistic approach in taking over a greater portion of the manufacturing and assembly process to ultimately deliver the first 787 aircraft in 2011.

Our view is that an organic business strategy can lead to a competitive advantage if agility is required in product development to respond to rapidly evolving consumer tastes. This model works well for more simple, fashionable products that undergo continuous change. Complex, integrated products that do not face continuous change require a mechanistic business model. As business analysts and investors, we are agnostic to either an organic or mechanistic model. But we do feel it is important to be aware of how a company is approaching product development and manufacturing in its industry as it attempts to build a competitive advantage.

Purpose and Focus

During their first year of an MBA program, students are usually introduced to Harvard Professor Michael Porter's model for industry analysis. Professor Porter's model outlines a framework of five forces of competition that impact industry. Analyzing these forces, a company can theoretically shape business strategy to gain a favorable competitive position within its industry:

1. Existing competitive rivalry between suppliers
2. Threat of new market entrants
3. Bargaining power of buyers
4. Bargaining power of suppliers
5. Threat of substitute products (including technology change)

A quick synopsis of this model:

1. When competitive rivalry is extremely intense (think airline industry), industry participants act in kamikaze fashion, fiercely competing for customer favor and, in the process, sabotaging any ability to obtain a profit.
2. Conversely, in the case of a monopoly, when competitive rivalry is absent, profitability can be very high because the sole business can dictate price. In this case, if there are low barriers to enter an industry (due to minimal capital requirements or little brand awareness), new market entrants will emerge until profits either normalize or become nonexistent. For example, if a particular type of restaurant is very successful in a town, similar restaurants may emerge until patronage to this type of eating establishment is normalized. In our example, if there are high barriers to entry due to zoning restrictions, competing restaurants are deterred, and profits can remain high because customer choice is limited.
3. If customers are able to walk into an establishment and leverage the salesperson through price negotiation, then the bargaining power of buyers is prevalent, and the business has minimal ability to obtain a large profit (a typical car dealership or furniture store may fall into this category). Since we do not have the option to negotiate price when purchasing a pack of gum, the bargaining power of the consumer in this case is low—allowing the manufacturer greater pricing flexibility to obtain a profit.
4. If the bargaining power of suppliers is very high, the business has little ability to purchase products at a large discount and, in turn, attain a large markup when selling to consumers. Cable companies provide an example of the bargaining power of suppliers. A local cable operator has very little competition, and networks seeking to have their channel viewed by subscribers to the cable company have little choice but to accept the cable company's price—otherwise, the cable company will not carry them.
5. The threat of substitute products can lower industry profits, especially in a commodity-type business. If a sugar substitute comes along that tastes exactly like the real thing but is cheaper or healthier for consumers, you would not want to be a sugar cane farmer.

In summary, a business analyst that reviews Professor Porter's model can identify an industry as unattractive if the combination of these forces drives down overall profitability. Conversely, an industry emerges as attractive if the combination of these forces produces minimal threat to competition, allowing participants to be profitable.

With this MBA background on analyzing competitive forces to guide business strategy development, a student seeking to measure business ability will ask, "What business actions need to be taken to blunt these competitive forces and deliver a business advantage? In essence, what can a company do to create competitive advantage?"

In our opinion, a business can find competitive purpose by focusing on four broad areas when competing in an industry:

1. Operational Excellence
2. Product/Service Differentiation and Innovation
3. Employee Development
4. Customer and Supplier Intimacy

When a company pursues *operational excellence*, it is not necessarily attempting to be the low-cost producer of a product. For the product they are manufacturing or for the service they are delivering, however, the company is attempting to excel in every part of its operation, including sourcing suppliers, manufacturing, distribution, etc. When a business executes a strategy focused on operational excellence, it embarks on a never-ending mission to become operationally better. This continuous improvement concept has brought about well-known business initiatives, such as Total Quality Management and Six-Sigma.

McDonald's is a company that built a competitive advantage through operational excellence. The company's founder, Ray Kroc, anchored his strategy on the operating system. His relentless focus on developing a standard and efficient operation led to a focused menu, integrated supplier relationships, and a strong environment for training and monitoring franchisees. Fred Turner, one of Ray Kroc's original managers, developed a 750-page manual in 1957 that outlined in detail how to grill hamburgers, fry potatoes, and make milkshakes. This extreme focus on operational excellence is an enormous factor in McDonald's ability to create a competitive advantage that is difficult to duplicate in the fast-food restaurant business, even today.

Product/service differentiation and innovation can also lead to a competitive advantage. A business that pursues this focus is continually seeking to offer a different and unmatched customer experience. Apple is a company that may immediately come to mind. Through Steve Jobs' tireless quest to deliver a different and unmatched technology experience, consumers have enjoyed products such as the iPod, iPhone, and iPad over the past five years. Gillette (owned by Procter & Gamble) also pursues the product differentiation and innovation strategy, continually upgrading the customer shaving experience by introducing ever more innovative razors that most consumers will trade up for.

A focus on *employee development* is often overlooked by companies that seek a competitive advantage. This may be due to an inability to obtain a measurable return on this investment, or to the transient nature of employees. Nevertheless, an emphasis on employee development can lead to a powerful long-term competitive advantage. Knowledge capital is the cornerstone of building value in most businesses today. Given this fact, businesses that can create an environment for sharing and building knowledge capital from one management generation to the next can develop a tremendous advantage. Building knowledge capital allows managers to share information and widen the unbreachable moat around their operating businesses. It also develops and reinforces a strong partnership culture within the organization that becomes difficult to duplicate.

General Electric's involvement in various businesses may morph over time, but the company's focus on developing its people never waivers—we consider GE a management machine. General Electric spends more than one billion dollars annually on employee training and development and has built a large competitive advantage over the past century through this focus. To cite an example: Each year, several students from our University of Connecticut Portfolio Management class are recruited into GE's Financial Management

Program. Through this development program, a talented graduate signs up for six-month rotations within GE's various business units over a two-year period, learning the company and its culture in the process. After their rotation is complete, they are placed in a management position that best suits their talent and the company's needs. These new recruits also have the opportunity for further development through participation in classes offered at the Jack Welch Leadership Development Center in Crotonville, New York.

Customer and supplier intimacy is an area in which many companies lose focus. A large business many times has a tendency to look inward due to its size and organizational complexity. Once an organization becomes insular in nature, however, it almost always leads to an erosion of its competitive position in the marketplace. A company that has a focus on customers and supplier intimacy is continuously communicating with these key components of its business and is able to evolve by meeting customer and supplier needs. In essence, they are always looking to embrace the customer and supplier, getting as close as possible to understand what they want, and to give it to them, with a focus that goes well beyond offering the lowest price.

IBM is a company that has built its business on a long-term, unique focus with customers and suppliers. IBM's roots date back to the latter part of the 1800s, many years before the advent of computers. The Computing Tabulating Recording Corporation (CTR), incorporated in 1911, was IBM's predecessor. CTR brought together four corporations, including the Bundy Manufacturing Company founded in 1889. The merged companies manufactured employee timekeeping systems, weighing scales, automatic meat slicers, coffee grinders, and punch-card equipment—nothing to do with computers.

When Thomas Watson, Sr. became president of CTR in 1915, he implemented a series of effective business changes: A high focus on customer service, along with an insistence on well-groomed, dark-suited salesmen. The sales force grew into a professional and knowledgeable arm of the company, trained to pay attention to customers and to meet their needs. Watson stressed the importance of listening to the customer, a lasting IBM principle that allowed the company to evolve from manufacturing tabulating machines to manufacturing typewriters and, eventually, to manufacturing computers.

Unfortunately, IBM became large and insular during the 1980s and early 1990s and lost customer focus. For some reason, the company became product-focused, and other technology companies such as Oracle, Microsoft, Intel, Digital Equipment Corporation, and Sun Microsystems invaded IBM's business base. IBM was on the precipice of going out of business until Lou Gerstner, an industry outsider from American Express and RJR Nabisco, was brought in to run the company. Mr. Gerstner accomplished an amazing turnaround that put IBM back into a technology leadership position that persists today. How did he do this without any technology experience? He refocused the company back on the customer. A long-lasting customer and supplier focus can create a tremendous competitive advantage by allowing a company to stay nimble, evolving by meeting customer and supplier needs.

Many companies attempt to use one or several of these models and strategies to develop a durable competitive advantage. When measuring business ability, we take into account that, in practice, these models are used in combination, in what we consider to be the art of building a sustainable business.

Pronounced Ongoing Problems

"Americans can always be counted on to do the right thing, after they have exhausted all other possibilities."

—Winston Churchill

After this year's financial debacle in Europe, Sir Winston may consider adding "Europeans" to the "Americans" portion of this statement.

The deteriorating financial condition among European nations including Greece, Spain, Italy, and France is highlighted in the news, contributing to investor unease. The European Union (EU) is now in a more difficult financial position than the U.S., and the European Central Bank will likely be forced to further back the debt of these sovereign debtors, given that their government bonds are held by banks throughout the European

continent. In other words, European banks are now undergoing stress similar to what U.S. banks experienced a few years ago due to the deteriorating value of local sovereign nation bonds held on their books—and the European banking crisis carries global financial consequences. Once again, we face a lack of confidence until governments come together to stem the financial crisis within the global banking system. In the eurozone, the process of bringing 17 EU states together to agree on a central financial solution, along with unified fiscal responsibility among its members, may be long and arduous.

How does this impact us? In today's global environment, we are all economically intertwined—whether through cross-investment, trade, or in financing our mutual economies. In other words, when a butterfly flaps its wings in Asia or Europe, we will feel the breeze in the U.S. According to the Federal Reserve, as the European financial crisis unfolded, cash held by U.S. banks surged 8.4% to a record \$981 billion during the week ended July 27, 2011. This is three times the amount banks had in July 2008, just prior to the collapse of Lehman Brothers that nearly froze bank-to-bank lending. It is quite possible that additional money will be deposited with U.S. banks in the upcoming months if investors lose further confidence in European banks. As a lack of confidence broadens in Europe, investors continue to move their money away from European banks amid concerns that the Greek debt crisis will spread to Spain, Italy, and beyond—France is next on the docket. Unfortunately, these European cash deposits are transient, and U.S. banks cannot rely on them to stick around for very long. With few opportunities to lend these funds out on a short-term basis, U.S. banks are exacerbating the problem by slapping fees on depositors to keep their financial returns from eroding.

On the other side of the coin, the U.S. was not without its challenges during 2011. We experienced a “debt ceiling” debacle, coupled with a rating downgrade on U.S. debt by Standard and Poor's. More than 45% of U.S. debt that has been downgraded is held by foreign entities, including China, Japan, Russia, etc. When the U.S. flaps its wings, it is also felt throughout the global financial system. These creditor nations are becoming increasingly nervous about their vast investment in U.S. Treasuries and would become very concerned if the value of their U.S. holdings severely deteriorated.

The global financial system is interconnected, and it is essential that we realize that global financial problems impact all investors, regardless of where they reside.

Big Challenges Ahead: The “State of the European Union” and the “State of Our Union”

When we look at Europe, it is beneficial to look at two zones—the economically strong northern European zone that contains countries such as Germany and France, and the weaker southern European zone that contains countries such as Portugal, Spain, Italy, and Greece. From the beginning of the European Union, the weak southern states have piggybacked on their stronger northern European friends through the shared single currency and shared central bank. Despite their united financial front, however, a common fiscal policy agreement was eluded. This EU bifurcation allowed weak countries to borrow funds to support their growing deficits without having to make any fiscal sacrifices. In the end, financially strapped countries such as Greece and Italy, which are highly reliant on public sector employment, have to either take austerity measures to maintain EU member support or eventually face withdrawal from the EU and watch their economies collapse—not a good scenario.

Northern Europe members (such as Germany) are highly resistant to using their stronger economies to bail out weak EU members that are reluctant to change their high-spending ways—and thus, the standoff. In the meantime, the bonds of southern European countries are becoming worth-*less* by the day, and much of their sovereign debt is held by northern European banks. Contagion now reigns over the eurozone, as depositors yank their funds out of local banks and head for the door—with a run on the banks ensuing. The situation has created a self-fulfilling prophecy: European bank stocks continue to collapse, while bond yields of southern European countries quickly rise. Germany is also not immune—the country recently encountered its worst 10-year bond auction in history.

The northern European countries are facing a dilemma—either bail out the southern states, or bail out their own banks that are heavily exposed to the debts of Portugal, Italy, Greece, and Spain. A bailout of Greece and

Portugal could be accomplished with the €440 billion European Financial Stability Facility (EFSF). A bailout of Spain (which represents approximately 10% of the eurozone) and Italy (which represents 15% of the eurozone) is not easily attainable under the current financial plan, however. In the meantime, the U.S. and European Central Bank are ensuring that plenty of dollars are provided to European banks that have lost their ability to borrow short-term cash from U.S. money-market funds. But the high-rated collateral that is necessary from the European banks to back these dollar loans through the European Central Bank is insufficient—making U.S. assistance more of a gesture than a reality. The European governments, in concert with the European Central Bank, will need to develop a coordinated financial bailout plan or face the consequence of an EU breakdown. (We believe a coordinated financial plan will be reluctantly accomplished.)

Many investors are frustrated over the lack of coordination in Europe and with the seeming inability of these countries to come to an agreement to ward off a potential financial collapse. These investors are concerned that Europe's financial problems will migrate to the U.S. This anxiety has merit, as the U.S. union may eventually face similar problems.

The U.S. Federal Reserve has greatly expanded the size of its balance sheet over the past three years. During this time frame, the Fed's balance sheet has grown more than threefold, from about \$900 billion to approximately \$2.8 trillion. Much of this advance was accomplished during the 2008 U.S. financial crisis. However, additional balance sheet expansion has occurred with ongoing quantitative easing—the term used to describe how a central bank monetizes debt through the purchase of government bonds and other securities. This action potentially adds tremendous amounts of money supply that could create further imbalance in the monetary system.

In addition to the large liability at the federal level, U.S. state and local governments are also mired in debt. A recent *Vanity Fair* article by Michael Lewis clarifies the situation at the state level:

“From 2002 to 2008, the states had piled up debts right alongside their citizens’: Their level of indebtedness, as a group, had almost doubled, and state spending had grown by two-thirds. In that time, they had also systematically underfunded their pension plans and other future liabilities by a total of nearly \$1.5 trillion. In response, perhaps, the pension money that they had set aside was invested in ever-riskier assets. In 1980, only 23% of state pension money had been invested in the stock market; by 2008, the number had risen to 60%. To top it off, these pension funds were pretty much all assuming that they could earn 8% on the money they had to invest, at a time when the Federal Reserve was promising to keep interest rates at zero. Toss in underfunded health-care plans, a reduction in federal dollars available to the states, and the depression in tax revenues caused by a soft economy, and you were looking at multi-trillion-dollar holes that could be dealt with in only one of two ways: Massive cutbacks in public services or a default—or both.”

As we can see, states are facing future problems that dwarf those of the past. Most states (and local governments) are dumbfounded when presented with the widening gap between their pension assets and an accurate assessment of the present value of their liabilities. In 2008, the 50 U.S. states had an estimated total obligation of \$3.35 trillion in pension benefits owed to current and retired employees. Unfortunately, assets to meet this liability total only \$2.35 trillion—a shortfall of \$1 trillion at the time, and estimated to be around \$1.5 trillion today. This shortfall sounds like a lot, but it actually may be more—much more. Changing the calculations used by the states to measure their pension obligations increases the shortfall significantly. One study found that if states were to lower their discount rates to calculate the present value of future liabilities to more realistic current levels, their underfunding would be \$3.2 trillion, as opposed to \$1.5 trillion. And, as pointed out in Michael Lewis' *Vanity Fair* article, most states have assumed unrealistic future annual returns of 8%+ on their pension portfolios. As a result, states are shifting their funds to high-risk alternative investments, such as hedge funds.

Many investors (including banks) are now flocking to purchase the debt of state and local governments, pointing out the fact that these securities have a historical near-zero chance of default. This seems like *déjà vu* all over again. Just a few years ago, pundits cited mortgage-related securities as “super-safe bets,” given their historical low default rate due to consistently rising house prices. Always be careful when you are told that the

past will dictate the future. In their analysis, experts forgot to evaluate a recent speculative rise in home prices, along with a decline in lending standards.

The ultimate economic problems in the EU and the U.S. are ironically similar: The money being borrowed by federal governments to backstop the vast amount of failing consumer, state, and local government debt will not be sustainable at current low rates. In addition, the generous entitlement programs supporting a large global population base cannot be continued without long-term negative financial consequences to future generations who will have to support this growing liability.

A Unified Solution

Both the European and U.S. central banks have the capacity to print money and become the lender of last resort to failing sovereign nations and states. Although, in concept, this individual cure seems rather easy, the end result is that printing money has negative long-term economic consequences if it cannot be removed from the financial system in a timely manner—inflation eventually takes hold. For example, it might seem that the European Central Bank could avert a short-term crisis by purchasing and/or restructuring Greek, Spanish, and Italian bonds to keep those nations afloat. If these nations do not curb their spending habits, however, continually supporting their growing debt would be akin to a bank raising the credit card limit for a consumer who is unable to make payments on his balance but continues on a rampant spending spree. When the consumer walks into the bank and requests a further credit limit increase to manage the ever-increasing interest payments and spending, the bank may have little choice but to accommodate the consumer if they wish to avoid a default on the loan. The bank would do well to strongly request the consumer curb his spending habits—with consequences for not doing so. As we can see, this is why spending reduction wrangling is an ongoing discussion between central banks and various governments around the world.

Other issues surface when an unlimited amount of money is created—notably, a loss of trust in paper currencies. A currency has two basic functions: It acts as a medium of exchange as well as a unit of account. If the currency is backed by a strong economy and managed responsibly, it is also a store of value. When central banks and governments intervene at an excessive level to manage and/or create money, however, the utility of currency comes into question. At this point, holders of the currency become uncertain about its role as a unit of account. In other words, investors begin to ask about future changes in price versus future changes in value—a distinct difference. They become consumed with the thought that their currency will be worth less tomorrow, and must be spent today.

The problem: The globalization of markets is here. We have interdependent economies throughout the world, but independent financial systems to support the global marketplace. We are highly skeptical about the ability of independent central banks around the world to coordinate their activities and to work interdependently, and in the best interest of a global economy.

Greatness is achieved not by building, but rebuilding. You need to tear down success to become better.

Ultimately, it is our opinion that industrialized nations need to move toward a global central bank solution by creating an entity that can work with local central banks and act as a lender of last resort. Imagine if independent central banks were represented through a unified global central bank that was chartered with the mission to manage global interest rates and currency flows, along with the ability to issue multicurrency bonds. This action would change the behavior of independent-minded central banks and lead to greater balances in trade and currency around the globe.

The global central bank could willingly purchase debt of issuing countries throughout the world, with agreed-upon fiscal discipline restrictions associated with the amount—and associated penalties. It is quite possible that the International Monetary Fund could eventually act in this manner. Strong independent countries are unlikely to give up the freedom of printing money, however, unless they are forced to. We will stay tuned as our financial system evolves, but until an interdependent global financial system is agreed upon and developed, we are likely to encounter volatile markets.

* * *

What is Founders Capital Management doing in this volatile investment environment?

At Founders Capital Management, our activity will remain deeply rooted in the time-tested principles of investment simplicity. We will seek investments in securities that we know and understand, and in assets whose intrinsic value we can fairly estimate. We will heed the advice of an investment teacher by staying disciplined—paying attention to the economy, keeping our head in Founder’s investments, and allocating money effectively to obtain a favorable result. To accomplish this, we are committed to:

- **Managing our portfolio in a way that avoids excessive trading**
- **Striving to identify developing risks**—even in areas that have not yet erupted
- **Investing for the long term**, and concentrating on the distinction between what is knowable and important as opposed to what is either knowable and unimportant, or important and unknowable
- **Holding to the conviction that emotional stability and thinking independently from the crowd eventually lead to success**, despite random price fluctuations in the market

MANAGEMENT'S DISCUSSION & BUSINESS UNIT REVIEW

Equity Holdings: 2011 Highlights

Our current portfolio represents a collection of great businesses that we believe are trading at better-than-fair prices and that continue to gain value every day. An investment teacher would say: “These companies are the apple of my eye.” Every morning, we go to work knowing that our basket of investment apples are the best of the bunch—Berkshire Hathaway, Coca-Cola, PepsiCo, Procter & Gamble, Microsoft, Johnson & Johnson, Medtronic, Disney, Chevron, and our other holdings continue to grow their aggregate earnings and strengthen their businesses independent of any short-term gyrations in their stock quotations.

Following is a summary of business highlights from our portfolio companies during 2011, along with our expectations for 2012.

CONSUMER GROUP

Our primary consumer holdings—Coca-Cola, PepsiCo, Procter & Gamble, and Kraft Foods—continue to grow their global franchises despite the economic challenges confronting world economies. These businesses performed well in 2011, and we expect our consumer group to produce satisfactory results in 2012.

What is the special business model that surrounds our specific consumer companies?

We have mentioned previously that a consistent purchase pattern among product categories creates an efficient revenue and profit stream. The daily worldwide consumption of Coca-Cola, PepsiCo, Procter & Gamble, and Kraft products enables these businesses to perform better than average in both deflationary and inflationary times. Consistent purchase patterns and high product turnover also allow these companies to use assets effectively. If a business needs to invest vast sums of money into property, physical plant, and equipment to produce consumer goods, a steady unit sales pattern leads to consistent production efficiency—maximizing the return on each dollar invested in the business. The art of making Tide, Crest, Oreos, or concentration syrup for Coca-Cola and PepsiCo products has not changed in decades—which means associated property, plant, and equipment last for years. During deflationary and inflationary times, these companies can “delay” large capital expenditures. This is very important, as these businesses can lower prices in a period of deflation, or raise prices with inflation—remaining highly profitable in either circumstance.

Second, the businesses that make up our special consumer group also have a balanced “push and pull” business system that is difficult to duplicate. When we go to the grocery store and shop for cola, potato chips, laundry detergent, and cheese, we are usually “pulled” to particular brands such as Coke, Frito-Lay, Tide, and Kraft Cheese. Each of these brands carries a special attribute that attracts a large share of consumers—a comfort in knowing that the product is of a certain consistency and quality. The emotional comfort that consumers associate with these brands is produced through repetitive advertising, promotion, and purchases. When a product achieves the special status of being labeled a brand, the ability for a business to “push” these goods to the consumer becomes much easier. For example, if a company knows the consumer desires its brands, it can more easily persuade retailers not only to offer their products but also to give preferential shelf space within easy view and reach of the customer.

In addition to brand appeal, these companies have incredible “brawn” in the consumer goods industry, largely through use of a “segregation and integration” business model. For example, Coca-Cola’s \$50+ billion supply-chain network, established between the company and its principally segregated bottling system, is one of the largest and most complex of any organization on earth. Some astounding statistics: Coke and its bottlers use 500,000 vehicles to distribute 2,400 beverage products through 16 million outlets every day (PepsiCo, Procter & Gamble, and Kraft share similar distribution strength). These juggernauts’ distribution components may be their most important hidden competitive advantage. When any of our consumer companies introduces a new product or makes an acquisition of a complementary brand, they can immediately put this merchandise through their tremendous distribution networks and introduce them throughout the world.

The above factors highlight the challenge of setting up a business system to compete against a Coca-Cola, PepsiCo, Procter & Gamble, or Kraft. Their business castles are surrounded by tremendous moats that make it difficult or nearly impossible to penetrate. Let's review each of these companies.

Coca-Cola

During 2011, Coca-Cola grew its overall volume at approximately 5%, led by the company's double-digit volume growth in China, India, and Central America. The company improved this year's per-share profits by more than 9%, selling 1.7 billion servings each day to customers throughout the globe. Coke continues its decades-long remarkable growth in the worldwide beverage market.

Many wonder if Coke will be able to replicate its historic 100-year growth in the next century. An investor looking at the worldwide per-capita consumption of the company's products might conclude, "Yes, the company has an equal opportunity to grow in the next 10 decades as it has in the past." The average person in North America consumes 394 eight-ounce servings of Coca-Cola products each year. Most would think that North America has the highest penetration of Coca-Cola products, but it is actually Mexico. This country consumes 675 eight-ounce servings per person. Now, let's compare this per-capita consumption of eight-ounce servings to China (34), India (11), and Russia (69). Given the population of these large countries and their relatively low per-capita consumption rates, we believe Coke represents a growth opportunity projecting many decades out. And the company continues its efforts to penetrate the next generation to ensure its growth in markets all over the world.

Recruiting teenagers to consume Coca-Cola products is a priority for the company. Coke is a major participant at teen-centric venues such as Live Nation concerts, cinemas, and American Idol. Believe it or not, Coke holds the leadership position on the social networking site, Facebook, with 33 million worldwide "likes" and "fans." The company attracts more than 9,000 new Facebook fans on a daily basis, and each week adds 81,000 admirers. Through this following, the company is learning how to harness the social network medium to communicate and stimulate young customers, day in and day out.

Coke is also continuing its quest for global growth in 2011, purchasing half of the equity of Aujan Industries, one of the largest independent beverage companies in the Middle East. Aujan holds a top-three position in still beverages in every country in which it operates and is one of the top 100 companies in Saudi Arabia. This \$980 million transaction will provide Saudi Arabia-based Aujan Industries an opportunity to accelerate the international growth of the Aujan brands. Conversely, this investment will give Coca-Cola Company a significant equity stake in one of the leading still beverage businesses in the Middle East, allowing the company to further strengthen the distribution of Coke's products in this growing region.

Coca-Cola also announced a \$2 billion investment in India over the next five years to capture a greater share of the Indian beverage market. This is on top of the more than \$2 billion Coke has invested in India since it re-entered the country in 1993. Given India's currently low per-capita consumption and massive population, this country is a strategic growth area for Coca-Cola in the future. Even today, India ranks among Coke's top 10 markets in volume globally and is the largest market in the company's Eurasia and Africa Group.

In summary, Coke represents a global growth story for both customers and shareholders. The company will produce approximately \$7.7 billion of cash for shareholders in 2011, up approximately 10% over 2010. Coke currently pays an annual dividend of \$1.88 per share, which represents approximately a 2.7% yield, and we think the company will increase its dividend in 2012—to around \$2.00 per share. Coca-Cola will also repurchase approximately \$3 billion of stock during the next year – providing shareholders a 4.75% "look-through" dividend. In 2012, we believe Coca-Cola will grow its per-share earnings slightly more than 8%, producing around \$4.15 per share. Coca-Cola will remain a long-term holding in our portfolio.

PepsiCo

In 2011, PepsiCo's accelerated growth slowed, with per-share earnings rising around 6.5%, from \$4.13 to \$4.40. Despite being a global business powerhouse that shares many of the same attributes as Coke, PepsiCo's business is split between two areas: Beverages and snack foods. Given its high exposure to snack foods, the company is subject to higher commodity input costs (grain, sugar, etc.) that can weigh on profit growth if these rising costs cannot be passed on to consumers through increased prices. Rising commodity costs the past few

years have been weighing on PepsiCo's profit growth. We expect the profit tide to eventually turn, and in the meantime, the company's broad portfolio of brands—including Pepsi, Gatorade, Tropicana, Lay's, Doritos, and Quaker Oats—continues to grow worldwide.

Some may argue that an individual should trim or eliminate holdings in PepsiCo given the company's acknowledgment about the short-term business challenges it is facing. Some investors may even point out that PepsiCo has lagged the S&P 500 Index during the past three years and is likely to lag in the near future. (These same experts forget that PepsiCo's share price grew more than 9% per year the previous five years, while the S&P 500 Index grew at 5.5% per year.)

This would be a perfect example of an investor asking the wrong questions—asking “when it's important” and “where it's important” versus “what's important” and “why it's important.” We think the real question is: “What has PepsiCo done to increase its intrinsic business value over a rolling five-year period compared to the S&P 500 Index, or a combination of businesses that represent the overall stock market?” At this point, an important distinction should probably be made between the facts of “price movement” versus “value movement.” It is our estimation that PepsiCo has increased its intrinsic business value at around 8% per year the past five years—based on an increase in PepsiCo's per-share profits and cash available to be distributed to owners from 2007 to 2011. The S&P 500 has increased its intrinsic business value at roughly 3.3% per year over the same time period—from \$82.54 to approximately \$97.50 earnings per one share of the S&P 500. The deterioration of the financial industry has likely led to a slower value gain within the S&P 500. The comparable price movement of PepsiCo and the S&P 500 Index (or any other large market basket index) during this five-year time frame should be of little consequence to an investor, and in fact represents a short investment period in our view.

The second question is: “Why will PepsiCo continue to increase its per-share intrinsic value far into the future?” To answer this, one needs to revisit the per-capita consumption of snacks and beverages, and PepsiCo's share of these products.

In the U.S., the per-capita consumption of snacks is about 8.5 kilos per person—that's the highest in the world. The next-closest country to the U.S is the UK, at five kilos. In Mexico, the per-capita consumption of snacks is at three kilos, and many emerging markets are at less than one kilo. The emerging markets have been growing at twice the rate of the average growth rate for snacks. The worldwide per-capita consumption of snacks—and PepsiCo's share—is likely to increase over the upcoming decades. Frito-Lay is a business juggernaut that has tremendous consumer pull and distribution push that provides business leverage and market penetration. Its “business moat” is well protected and keeps expanding. PepsiCo moves and sells more than \$30 billion of snacks around the globe and has the largest direct-store delivery system in the world through its snack business. The company touches millions of points of distribution every day, and its products are within an arm's reach of consumers. Cycle times on the snack products are short—around seven days from the time a potato comes out of the field to the time it's consumed—leading to production efficiency and consistent returns on capital. PepsiCo's share of the snack market is huge and growing: In Argentina, PepsiCo has more than 80% share. In markets such as Mexico and Turkey, PepsiCo's share of the market exceeds 70%. In the U.S. and Canada, PepsiCo has around a 65% share. In emerging markets such as Brazil, PepsiCo has a 50% share. PepsiCo holds a more than tenfold relative market share advantage compared to its nearest global competitor. Over the past five years, PepsiCo's global snack portfolio has grown volume at low single-digit rates—around 3% annually—and has grown revenue and profits consistently at around 8%. We do not see this trend slowing over the long term.

As for beverages: As the worldwide per-capita consumption of beverages keeps growing, PepsiCo's (and Coke's) share continues to increase. Globally, beverages are a huge market, with 460 billion cases growing at a compounded rate of 3% per year. The liquid refreshment beverage market is growing at a compounded rate of 5% and is expected to represent approximately 37% of the total beverage market in 2020. Liquid refreshment beverages currently represent only about 30% of the total beverage market, highlighting significant long-term upside for PepsiCo (and Coke), especially in developing and emerging economies. Liquid refreshment beverages continue to grab share from non-liquid refreshment beverages such as hot coffee, tea, and tap water (vs. bottled water) as economies develop around the world.

In 2011, PepsiCo continued to increase its return to shareholders, raising its annual dividend by more than 7.25%, from \$1.92 per share to \$2.06 per share. We expect PepsiCo to raise its dividend to approximately \$2.20 per share in 2012, which implies a yield of about 3.3% at the year-end stock price. In addition, we anticipate the company will repurchase approximately \$2.5 billion of stock in 2012. This action adds another 2.4% return to shareholders, reflecting a 5.7% “look-through” dividend. In 2012, we expect PepsiCo to grow its per-share earnings between 5% to 7%, producing around \$4.65 per share.

In summary, we like the long-term potential and economics of the beverage and snacks businesses and think there is a multi-decade opportunity for the dominant companies in this area. PepsiCo has a large position in these growing areas. Our assessment: Why sacrifice ownership in a great company for which the long-term future is known, for a short-term price movement that is largely unknown? PepsiCo will remain a long-term holding in our portfolio.

Procter & Gamble

We have a significant investment in one of the largest consumer companies in the world that sells more than three billion products to more than four billion customers every day. Procter & Gamble (P&G) sells leading brands such as Pampers, Tide, Ariel, Always, Pantene, Gillette, Bounty, Dawn, Gain, Charmin, Downy, Iams, Crest, Oral-B, Duracell, Olay, Head & Shoulders, Wella, Vicks, and Braun.

P&G’s worldwide net sales volume is expected to increase approximately 4% in 2011, with earnings per share growing 5%, from \$3.75 to \$3.92. As in the case of PepsiCo, rising commodity input costs are proving to be a headwind for P&G, leading to temporarily lower gross profit margins. We expect the company’s earnings drag due to higher commodities to decelerate as we go through 2012. In fact, more stable commodity prices may turn into a profit tailwind, since P&G has increased prices on many products to offset higher input costs. In response to the business challenges it is facing, P&G continues to concentrate on product innovation and productivity.

Innovation: P&G is rolling out its strong innovation pipeline that either extends or adds to its stable of worldwide brands. For example, P&G will launch a range of new products in 2012, highlighted by Tide PODS, which represents a convenient, environmentally friendly extension to the Tide detergent brand. P&G anticipates that the release of Tide PODS during February, 2012 will reinvigorate its laundry detergent business and generate up to \$2 billion in additional sales. In addition, during 2011, P&G announced an agreement with Teva, the world’s largest generic pharmaceutical company, to jointly develop and market over-the-counter drug products to consumers. P&G’s contribution to this venture is strong in-store knowledge with products such as Pepto-Bismol and NyQuil, coupled with an unprecedented distribution network.

Productivity: Coupled with its innovation, P&G continues to seek cost-cutting opportunities to offset the rising price of commodities. The company is in the midst of executing a plan to cut the number of manufacturing lines in half, from 300 to 150. P&G is also executing plans to combine smaller brands that are not achieving desired sales objectives, and to shed brands that are not related to the company’s core business—the sale of Pringles is one example.

With P&G’s eye on increasing economic value, we expect the company to earn approximately \$4.42 per share during calendar 2012 and to return a large portion of its \$12 billion in profits to shareholders in the form of share repurchases and dividends (dividends are expected to be more than \$5.7 billion, or \$2.10 per share—equal to a yield of approximately 3.1% at the year-end stock price). We remain excited about P&G’s global opportunities and will continue to commit capital to this company.

Kraft Foods

A few years ago, we allocated a significant amount of capital to Kraft Foods, the largest packaged food manufacturer in the U.S. and the second largest in the world, with annual sales near \$50 billion. Kraft Foods includes 11 brands that each generate more than \$1 billion in revenue, and approximately 70 brands with annual revenues exceeding \$100 million each. Most of these brands are familiar: Kraft Cheese, Oscar Mayer meats, Philadelphia cream cheese, Maxwell House coffee, Nabisco cookies and crackers, A1 Steak Sauce, Cool Whip, Miracle Whip, Jell-O, Kool-Aid, and Oreos.

During 2011, Kraft Foods announced a breakup plan to split into two separately traded companies by the end of 2012—a Global Snacks business and North American Grocery business. The Global Snacks company will include brands such as Oreo, Cadbury and Milka chocolates, Trident gum, and Tang powdered beverages. This business will have sales approaching \$32 billion, with developing markets representing 40% of the revenue. The Global Snacks company has high growth potential due to an opportunity to leverage an international product platform. What does this mean? Notice that the products placed in the global snacks company are “near-perfect” worldwide consumer products such as cookies and chewing gum—these products have worldwide appeal, can be produced on a global scale, do not spoil quickly, and are easily transferrable. These attributes allow Kraft to more easily distribute and penetrate hard-to-reach developing markets around the globe.

The North American Grocery company will include brands such as Oscar Mayer meats, Philadelphia Cream Cheese, Maxwell House coffee, Capri Sun beverages, Jell-O desserts, and Miracle Whip salad dressing. This business is expected to have sales of \$16 billion. The slower-growth North American Grocery company will focus on marketing, innovation, and efficient capital allocation. Although profit development in this company may not be as high as the Global Snacks company, the cash generation of this business allows for a generous return of capital to shareholders through dividends and share repurchases.

Kraft currently pays an annual dividend of \$1.16 per share, which represents approximately a 3.1% yield at the company’s year-end stock price. In 2012, we believe Kraft will grow its per-share earnings at an 11% clip, earning around \$2.53 per share. Again, this company fits the description of a business we want to own.

INDUSTRIAL GROUP

Our primary industrial and transportation holdings—United Technologies Corporation (UTC) and Lockheed Martin—were profitable in 2011, and we expect these businesses to produce good results in 2012.

Just as our consumer businesses use a “segregation and integration” business model, our so-called infrastructure businesses use a unique business model that provides them a competitive advantage. Both UTC and Lockheed Martin use what is referred to as a “razor blade” business model. This model comes from a strategy used by Gillette, which focuses on continual product innovation—announcing a newly improved razor every few years. When the new razor is announced, the company will sell the razor at cost, and subsequently make a high profit on the constant razor blades sold to the consumer as their blades wear out and replacements are needed. UTC and Lockheed Martin use a similar razor blade model. These companies are focused on product/service innovation and sell high-end infrastructure products that are extremely expensive to produce and have a slow replacement rate—attributes that normally would be detrimental to a business’s profitability. UTC and Lockheed will initially contract to sell their products at a low profit margin, and strike a long-term contract to service these products over their life span. For example, when UTC wins a contract for supplying elevators for the world’s tallest building, Burj Khalifa in Dubai, or when Lockheed Martin wins a defense contract to deliver aircraft such as the F-35 fighter jet, once these products are delivered, the associated high-profit-margin servicing contracts can continue for years (since it is highly unlikely that these costly items will be replaced any time soon), providing a predictable and long-term revenue annuity. A so-called razor blade business model can produce long-term value for shareholders as long as the company maintains a commitment to product/service innovation and ongoing product sales continue at a high profit margin.

United Technologies

United Technologies (UTC) has an extensive product portfolio that is well known in the commercial and defense market segments. UTC owns firms such as Otis elevators, Carrier air conditioners, Pratt & Whitney jet engines, Hamilton Sundstrand aerospace systems, and Sikorsky helicopters. Each of these UTC subsidiary companies has achieved leadership and powerful market entrenchment in their respective areas of expertise. UTC’s balanced exposure in aerospace and defense reduces revenue uncertainty and helps the firm ride out downturns in the economy. As we stated earlier, UTC derives much of its revenue from servicing agreements associated with the sale of its products—more than 40% of the company’s \$58 billion in revenues comes from aftermarket services. Plus, these services are always in high demand because UTC’s products are extremely expensive and are used in critical, heavy-wear applications (one cannot have elevators and jet engines failing).

In 2011, UTC agreed to purchase Goodrich Corporation for \$16.4 billion in cash— representing UTC’s largest-ever acquisition. Goodrich is a global supplier of systems and services to the aerospace and defense industry, primarily selling aircraft landing gears, wheels, and brakes. This \$8 billion business is a good fit with UTC and gives the company an opportunity to increase its market share of total content provided on leading commercial and military aircraft. The acquisition, scheduled to close in 2012, also complements UTC’s razor blade business model, offering significant long-term aftermarket sales that match UTC’s existing aerospace business. We expect UTC to produce approximately \$5.48 per share in earnings during 2011 and to increase per-share earnings to \$5.77 per share in 2012.

Lockheed Martin

Lockheed Martin is a \$45 billion global security and information technology (IT) company. The majority of Lockheed Martin's business is with the U.S. Department of Defense as well as U.S. federal government agencies. The company is the largest provider of IT services, systems integration, and training to the U.S. government and sells products and services to the governments of other countries as well.

We invested in Lockheed Martin for several reasons. First, the company is scheduled to deliver the F-35 fighter jet to the U.S. military in upcoming years. The F-35 is the single largest Department of Defense project. This planned stealth fighter will replace the aging fleet of Air Force F-16, Navy F/A-18, and Marines AV-8B aircraft. The F-35 program is expected to deliver more than 3,000 aircraft to eight countries around the world. In total, this project is worth up to \$1 trillion—encompassing \$300 billion in new equipment and \$700 billion in maintenance contracts. (Notice the large aftermarket sales that should power earnings growth for Lockheed Martin, despite pressure on the U.S. defense budget). Second, we think Lockheed Martin is positioned to widen its expertise in the promising information systems business. Increasingly, modern warfare depends on information systems to analyze potential threats and secure information assets. We believe that government funding in this area will continue to grow, and we anticipate Lockheed's \$9+ billion information systems revenue to increase concomitant with this increase in spending.

Lockheed Martin will produce approximately \$7.61 per share in earnings during 2011 and will distribute well over \$2.5 billion in reported earnings to shareholders through dividends and share buybacks. Incidentally, Lockheed Martin pays an annual dividend of \$4 per share, which represents an approximately 4.9% yield at the company’s year-end stock price. We believe this high payback, coupled with ongoing share repurchases, is owner-oriented. Our plan is to remain patient long-term investors in Lockheed Martin.

HEALTHCARE GROUP

Our primary healthcare holdings, Johnson & Johnson and Medtronic, achieved profitable growth during 2011, and we expect these medical businesses to grow their earnings throughout 2012.

The healthcare industry has become uncertain for investors due to healthcare reform legislation. On top of pending changes in the law, it has become difficult to predict the future of drug development. Pharmaceutical companies have little to show for their \$65+ billion in annual research and development, in addition to the fact that they must invest, on average, more than \$1.5 billion to bring a single successful drug to market. Needless to say, this area is disliked by investors now. However, we remain steadfast that owning the right healthcare companies that do not carry many of the typical risks associated with this sector can provide long-term rewards. Johnson & Johnson and Medtronic are two companies that fit our long-term investment criteria: Each company occupies product segments that are resilient under any economic condition or social reform, and each displays consistent purchasing patterns and strong loyalty from a growing customer base. It is our opinion that both companies are positioned to do well as the global population increases and ages in the coming decades—and we believe both are now selling at “better than fair prices.”

In our opinion, a successful business model in the healthcare segment looks somewhat different than those of other industries. A “controlling the middle” business model is very difficult to execute in the healthcare sector due to government intervention and the severe regulation surrounding this industry. Several companies have successfully executed a modified version of a play-to-the-middle strategy, however; companies such as Johnson & Johnson use a strategy that can be associated with the Chinese game of *wei qi* (way chee). The translation of *wei qi* is “a surrounding of pieces;” that game pivots on a strategy of positioning one’s pieces to

gain an incremental strategic advantage with every move. Unlike chess, where conquest becomes evident through the acquisition of an opponent's pieces and by controlling the middle of the board, victory is achieved in wei qi through an ongoing process of minimizing the strategic flexibility of one's opponent and maximizing one's own.

Johnson & Johnson

Johnson & Johnson (J&J) has executed a wei qi strategy over the decades, becoming the most diversified healthcare company in its sector, with more than 250 companies selling to every country in the world. Through constant acquisitions, and by incrementally maneuvering within the evolving healthcare industry, J&J has minimized the strategic flexibility of its competitors. For example, when we view a hospital operating room, we can see J&J products throughout—from surgical instruments to patient implants to wound care. Competitors that may compete in one area, such as surgical instruments, find it difficult to enter J&J's space due to J&J's product breadth, which encompasses every step of the surgical process.

J&J participates in three healthcare segments—Consumer, Pharmaceutical, and Medical Devices and Diagnostics—that constitute approximately 30% of the \$4 trillion global healthcare market. Although J&J is a very large company, its sales represent only about 5% of total sales in the sectors in which it competes—the other 95% represents future potential. In other words, like the game of wei qi, J&J has a long way to go before it approaches victory in the healthcare game. We expect J&J to continue the flexible strategy and diversified approach that has enabled the company to deliver an exceptionally consistent performance for decades, racking up more than 75 consecutive years of sales increases.

In 2011, Johnson and Johnson continued to broaden its position in the healthcare industry through strategic acquisitions. The company entered into a definitive agreement to acquire Synthes for \$21.3 billion. Synthes is a leading global medical device company that specializes in the development, manufacture, and marketing of instruments, implants, and biomaterials for the surgical fixation, correction, and regeneration of the human skeleton and its soft tissues. Upon completion of this transaction, Synthes will be combined with DePuy, J&J's orthopedic and neurological care company. The newly formed business will represent one of the largest medical devices and diagnostics companies in the world.

We also remain sanguine about J&J's pharmaceutical pipeline: Currently, J&J has more than 30 new products and line extensions set to be filed over the next five years. There are several blockbuster-potential products in this lineup that could each surpass revenue of \$1 billion by 2015, including Bapineuzumab, an experimental treatment for Alzheimer's disease that J&J is co-developing with Pfizer; Xarelto, an oral anticoagulant; and ZYTIGA, a treatment for prostate cancer. Another potential home-run product in J&J's pipeline is Telaprevir, a treatment for hepatitis C that may add \$500 million of revenue by 2015.

J&J will earn approximately \$4.97 per share in 2011 and should grow earnings at slightly above 5% in 2012, to \$5.23 per share. The company generates more than \$11.5 billion of owner earnings and will return cash to stockholders through continual share repurchases and more than \$6 billion of dividends (a 3.5% dividend yield at the year-end stock price). Given its current return to owners, along with its long-term growth potential, J&J remains a very attractive position in our portfolio.

Medtronic

We maintain a large position in Medtronic, the leader in implantable cardioverter defibrillators (ICDs) and other devices for managing out-of-step hearts. The company also continues to be a leader in devices that manage chronic diseases of the spine, pancreas, and brain. The stock price of Medtronic remains stagnant since our initial investment, reflecting the belief of many analysts that the company's core franchises in the cardiac rhythm management and spinal businesses have slowed down as patient volume has fallen off and managed care has begun to push back on reimbursement. Nevertheless, we remain excited about this long-term investment. Why?

Medtronic is also using a wei qi strategy to incrementally gain a favorable position among companies that create medical devices to manage chronic diseases. Medtronic's acquisition of Ardian provides a perfect example of how this company is constantly improving its place among competitors. Ardian's product is the Symplicity Catheter System, a radiofrequency (RF) ablation procedure for renal denervation (RDN) in patients

with treatment-resistant hypertension. RDN is a catheter-based procedure that uses low-power RF energy to deactivate the renal sympathetic nerves, which is believed to reduce hyperactivation of the sympathetic nervous system that is often the cause of chronic hypertension.

Hypertension is an epidemic, affecting nearly a billion people worldwide. The U.S. Centers for Disease Control and Prevention estimates that 56 million or more adults suffer from high blood pressure. Hypertension takes a tremendous toll on the healthcare system (approximately \$76 billion last year) and is a major contributor to heart disease, stroke, and renal disease. Although the use of antihypertensive meds has helped alleviate the problem, only 50% of U.S. patients are considered “well controlled.” This has led to a significant race to develop a device-based therapy, and renal denervation could be the solution. In addition to this procedure allowing patients to reduce or eliminate their need for lifelong antihypertensive medications, denervation may also be used to treat other conditions characterized by elevated sympathetic nerve activity such as heart failure, diabetes, and chronic kidney disease.

Medtronic estimates that more than 25 million people in the U.S. could be candidates for the procedure. It is our opinion that the product could be available for market by 2014 and may lead to more than \$1 billion in incremental sales.

We expect Medtronic to earn approximately \$3.45 per share in its fiscal year ending April, 2012 and to grow earnings 8% in the following year, to approximately \$3.73 per share. The company is also returning money to shareholders via a 97¢ per share dividend, yielding 2.5% at the year-end stock price. Given Medtronic’s current franchise strength and future market opportunity for devices that manage chronic diseases, we plan to hold this quality healthcare company in our portfolio over the long term.

TECHNOLOGY GROUP

Technology is considered to be a tough business for investors, largely due to its characteristic quick-paced changes. No sooner does one company dominate the technology landscape, than another one seems to knock it from its perch. For example, we have pointed out in the past that Xerox was the actual inventor of the personal computer, the graphic user interface (GUI) that led to Windows, and the popular mouse. When Xerox’s board deemed the PC and its associated software to be “something not worth pursuing,” Steve Jobs (Apple) copied and brought to market much of what was developed at the Xerox Palo Alto Research Center—and then Bill Gates (Microsoft) copied Apple. But, of these three technology companies, which two are the most valuable today? Microsoft and Apple.

When Microsoft and Apple first developed their respective operating systems, Apple chose to largely compete in the consumer area, and in a closed environment. The company offered its software only in conjunction with the purchase of its hardware—relying on a strategy of permanently locking in the consumer by “tying” its hardware and software products together. This tying strategy has been successful for Apple (just look at iTunes), and today consumers enjoy a ubiquitous user experience with Apple products.

Microsoft, on the other hand, took a different approach. Recognizing that the operating system was the middle component between the customer (especially businesses) and computer manufacturers, the company decided to license its operating system to all computer manufacturers. This strategy quickly created tremendous scale and leverage by which to sell consumers other software products—software applications through Microsoft’s Office.

While Steve Jobs and Apple pursued being a leading innovator of consumer products, Bill Gates and Microsoft were highly adept at applying a strategy to control the middle of the business board—a maneuver we referred to earlier as “playing to the middle.”

Executing a tying strategy and becoming an innovator of consumer products allowed Apple to develop into a prevailing force in the consumer technology business, while a play-to-the-middle strategy allowed Microsoft to achieve a dominant position in the business area. Of course, Microsoft’s large market share in the industry also attracted government scrutiny, eventually dampening the company’s competitive capability to control the center of the so-called technology business chessboard—the operating system for the PC.

The technology industry has moved beyond the PC over the past decade, however, and the operating system is no longer considered the “center,” or middle, of the computer chessboard. As a result, most business analysts have written off Microsoft as an investment, and the stock price has languished over the past 10 years, despite the company’s continued growth. We still don’t believe that Microsoft has lost its way. Microsoft’s management team understands that the middle of the computer chessboard is morphing from the operating system to “cloud computing”—creating the ultimate computer network. Let’s talk about Microsoft, our major technology company, and how it is adapting to a changing technology landscape.

Microsoft

Microsoft, our largest technology holding, had very good business results in 2011, and we expect the company’s growth to continue in 2012. The investment market is currently underappreciating the strides this technology powerhouse is making in the marketplace, especially in its forceful move into cloud computing.

Cloud computing basically involves the delivery of computing as a service instead of as a product. Using cloud computing, customers share resources, software, and information that are provided to personal computers and other devices as a metered service over the Internet. Cloud computing is analogous to an electric utility, whereby the power station delivers power to the electrical grid, and consumers draw down on that power as they need it—and are charged based on their usage. The infrastructure that supports cloud computing comprises large data centers (“server farms”) that are owned by companies such as Microsoft, Google, and Amazon.com. Obviously, cloud computing offers businesses an opportunity to reorganize their IT infrastructure and decrease their reliance on corporate servers—resulting in overall savings to their IT spending budgets.

In a recent global *Harvard Business Review* survey of 1,500 business and technology leaders, 85% stated that their organizations would be using cloud computing tools moderately to extensively over the next three years. This is more than double their current use. It is our opinion that decisions by companies to “move to the cloud” will be “all or nothing.” Cloud computing is a conduit that offers flexibility, scalability, and affordability to businesses (especially small- and medium-size businesses) that seek to improve computing efficiency and productivity.

Many think that cloud computing is a “commodity” business, with hundreds of competitors seeking to gain scale in this easy-entry business. We somewhat disagree—just look at the oil-refining business in the early part of the 20th century, or the utility business. These are industries in which scale and control of the middle has been important—and thus we believe Microsoft is positioned to emerge as a dominant player in this space. In fact, Microsoft has dedicated \$8 billion of this year’s R&D budget and 90% of its 40,000 engineers to cloud computing.

There are many examples of Microsoft’s move to the center of cloud computing, but the following two services provide good examples of how cloud computing complements traditional Microsoft products: Office 365 and Windows Intune.

Office 365 is a service that applies to most businesses and is a blockbuster for small businesses with 50 or fewer employees. This service allows a company to centrally manage email, calendar, and contact management through Microsoft Exchange Online. Office 365 does not replace traditional versions of Office but adds to its functionality. In fact, Microsoft’s current Office suite—Office 2010—remains the best-selling version of the Office product ever, with more than 100 million licenses sold over the past 18 months.

Windows Intune cloud service allows a company’s IT staff to remotely perform a number of security and management tasks including managing updates, helping to safeguard PCs from malware threats through endpoint protection, and inventory management. Using this service, company IT departments can be confident that employees will have access to necessary computing and remain productive from virtually anywhere through an Internet connection.

In the future, much of our traditional software will not be delivered in the traditional way. Microsoft’s strength in developing scalable business platforms such as the operating system should enable the company to expand its capabilities through cloud-based services. As this transition of the center of computing takes place, Microsoft will likely emerge a different company from what it is viewed to be today.

Microsoft will earn approximately \$2.77 per share in its fiscal year-end, June 2012, and should grow earnings at approximately 10% the following year, to approximately \$3.07 per share. The company will generate more than \$25 billion of owner earnings and will return this cash to stockholders through net share repurchases of \$10 billion and around \$6.7 billion of dividends (an approximate 7.6% look-through dividend yield at the year-end stock price). Given the current return to owners of this company, along with its optimistic future, Microsoft will remain a large position in our portfolio.

FINANCIAL SERVICES GROUP

Given today's financial services industry quagmire, we should spend some time reviewing this sector. The financial services industry represents a cluster of tough businesses, especially in the area of banking and insurance. The reason for the rough nature of these businesses is twofold: First, banking and insurance businesses are commodity-type businesses that possess little differentiation in either product or service. Customer choice is largely based on price and convenience over brand loyalty. In the case of a bank, when a lower-cost loan becomes available, the customer goes to this opportunity like a bee to honey. Likewise, in the insurance business, when one insurance company offers comparable coverage at a lower rate, customers flee in droves. This scenario, by itself, qualifies these businesses for the "hazardous material" category.

In addition, an evaluation of banking and insurance businesses requires multifaceted analysis. Both businesses achieve their profitability by borrowing customer money at a low rate of X and reinvesting this money to achieve a greater return of Y . Profits are generated by achieving a positive difference between (X) and (Y) —called the "spread," in industry parlance.

The investor looking at a bank or insurance company first needs to assess the cost of borrowing customer funds, as well as its so-called "stickiness" (how long money sticks around). The initial questions to ask are: "How are customer funds generated (i.e., what types of deposits or premiums)?" "What are the costs of these funds?" "How long will they be around?" Favorable answers to these questions allow a bank or insurance company to reinvest borrowed customer funds at a higher rate of interest to achieve a profit. On the liability side of this equation: If a bank promises too high an interest rate on customer deposits, or if an insurance company charges too low a premium for insurance coverage, the business can eventually get into trouble.

For the "money generating" side of the equation, a bank and/or insurance company enjoys the benefit of investing customer funds to achieve a higher rate of return. A bank may lend out money to other customers at higher rates than were borrowed, or—in the case of an insurance company—they can invest customer premiums at higher rates of return until policies need to be paid out. A few questions emerge regarding the placement of these assets: "Where are these funds invested?" "What is the expected length of time and return on the invested funds?" "What is the degree of certainty that the expected returns will be achieved?"

Believe it or not, these are the easy questions about the financial service industry's business activity that *must be answered* prior to an investment. In addition, layer this difficult assessment with the innovative ways financial institutions are now using to further enhance profitability. Banks that originally collected deposits and made loans now package their extended mortgage loans (along with auto and credit card loans) and sell them to the investment community—then take the money they receive from the sold loans and repeat the process. We have described this circular motion of money in our past letters—*securitization*. The process of securitization produces bank fees and supposedly transfers the loans from the bank's balance sheet to investors, spreading risk throughout the investment world.

Furthermore, many insurance companies no longer collect premiums through underwriting traditional insurance policies or invest their float in old-style securities. During the 2008 financial crisis, several insurance companies experienced extreme financial stress due to underwriting insurance policies that protected their customers against a deterioration in the value of mortgage-backed securities. When mortgage-backed securities tanked, these insurance companies owed more on these policies than the net worth of their companies. To make matters worse, many of these same insurance companies were leveraging their assets and investing the float from customer premiums in the same arcane securities—CMOs, CDOs, etc.—that became literally worthless.

Needless to say, the financial service industry's business model has become *very* complex. Despite the high level of complexity, professional money managers and individuals have recently flocked to invest in this sector due to the fact that many of these entities are once again trading "below tangible book value." For accounting aficionados, tangible book value is basically defined as liquidation value—selling off the tangible assets of a company, paying off the liabilities, and having money left over for distribution to shareholders. It is our opinion that tangible book value is *not* the primary figure to focus on when banks and insurance companies are encountering stressful conditions. Why?

Under traumatic conditions, an investor's principal focus should be on the financial industry's fundamental two-pronged challenge: The *ongoing ability* to obtain low-cost funds, and the ability to reinvest them to achieve *consistent* higher rates of return. As we described, the financial service industry profit model has been taken to extremes over the past decade and has led to kamikaze competitive behavior that has greatly impacted the value of the worldwide financial system. Global banks (and insurance companies) increased risk by overleveraging their customer funds and reinvesting this money in esoteric areas to achieve higher rates of return—magnifying profits from a widening "spread." As we are learning, this has not only occurred within U.S. financial institutions. European banks and insurance companies gathered and leveraged customer funds, investing them in sketchy sovereign debt obligations to achieve higher rates of return—all with the belief that European governments and the European Central Bank would collectively come to their rescue to guarantee the profits on the spread. Unfortunately, this has not happened, and the stickiness of customer deposits has now become elusive as individuals pull their money from several banks out of fear of default, despite the efforts of these banks to offer higher interest rates to lure customers. These same financial entities are watching the value of their investments fall by the day as European governments are reluctant to come together to bail out sovereign nations such as Greece at 100% on the euro. As a result of the two-pronged debacle, tangible book value, which is leveraged in some instances more than 20 times, is quickly and permanently dissipating.

We are now facing another global credit crisis as financial entities turn to the European Central Bank for support, given their unwillingness to sell their investments at a significant discount to satisfy customers' demand for their money. Without central bank support, a so-called run on the financial institution will take place, which naturally leads to *bank-ruptcy*. Not a good day. Many pundits are saying: "The European banking crisis is not going to spread to the U.S. We have righted our ways, and this is an opportunity to invest in high-quality U.S. financial institutions." We are skeptical about this statement. Although the U.S. financial landscape has improved during the past few years, we have watched several prominent U.S. banks and insurance companies increase their purchase of state and local government debt to maximize their profitability, believing that using low-cost customer funds to reinvest in these safe, higher-yielding securities is a good bet, because the U.S. government would eventually come to the rescue if state and local government bonds begin to fail en masse. We are not of the same opinion—just look at what is happening in Europe as financial institutions that purchased sovereign debt face a permanent haircut on this investment.

At Founders, banks and *most* insurance companies remain on our non-preferred investment list, and we will continue to avoid any investment in these organizations, as we have for the past six years. Our desire to avoid highly leveraged institutions in which the generation and placement of money cannot be reliably tracked will stay in place until such time that we can fully understand the cost and stickiness of deposits, as well as decipher with greater certainty the investments in which these funds have been placed.

With this said, we have a large investment in two insurance companies that are worth noting—Berkshire Hathaway and Fairfax Financial Holdings.

Berkshire Hathaway

Our largest financial services holding, Berkshire Hathaway, experienced slight growth in book value in 2011. This short-term tepid rise in shareholders' equity comes on the heels of a 13% increase in per-share book value during 2010. Even though Berkshire's per-share book value has now grown around 30% from the end of 2007, Berkshire's stock price is down approximately 20% in the same time frame. This is another instance in which we believe a disparity exists between a company's price and intrinsic value. Berkshire is now trading where many financial entities are trading right now—at around the company's liquidation value. It is our opinion, however, that Berkshire is worth more than its current stock price—although the company is facing a

challenging insurance environment. (Mr. Buffett agrees with our assumption about Berkshire's low valuation and recently announced a share repurchase program—we will explain this later in our highlight section.)

Our thoughts on Berkshire's value stem from the questions we highlighted earlier that an investor must answer prior to making a commitment to a financial entity. Berkshire has consistently produced a low cost of borrowed customer funds over the decades (less than zero) and, due to the nature of its insurance business, the float "sticks" within the company for many years—i.e., they get to maintain this money for a long time. Berkshire primarily generates its float by providing insurance directly to individuals (GEICO), as well as by providing other insurance companies coverage against very large catastrophic loss events such as hurricane or earthquake (this is called reinsurance).

On the "money generating" side of the equation, the long length of time Berkshire holds customer funds gives Mr. Buffett the benefit of investing float with a long-term horizon—to obtain a highly probable rate of return on this money. The funds are invested in understandable assets, and in many cases in wholly owned businesses that will remain a part of Berkshire indefinitely.

A few recent highlights on Berkshire's 2011 investment activity:

1. During 2011, Goldman Sachs Group, Inc. repurchased the \$5 billion of perpetual preferred stock issued to Berkshire Hathaway in a private offering during the financial crisis. Berkshire received proceeds of \$5.5 billion as part of this deal, based on the requirement that Goldman Sachs pay a 10% premium. Berkshire Hathaway's warrants to purchase \$5 billion of Goldman Sachs common stock with a strike price of \$115 per share remain in place—these warrants are exercisable at any time during the five-year term of this arrangement.

No sooner did Berkshire collect \$5.5 billion from Goldman Sachs than an announcement was made on August 25, 2011 that Bank of America had entered into an agreement with Berkshire Hathaway, whereby Berkshire agreed to purchase \$5 billion of Bank of America 6% Cumulative Perpetual Preferred Stock. As part of this transaction, Berkshire also received a warrant to purchase 700,000,000 shares of Bank of America, exercisable at Berkshire's option at any time for 10 years. The exercise price is around \$7.14 per share of Bank of America Common Stock.

What does all this mean? Berkshire is lending \$5 billion to Bank of America at an interest rate of 6% and has a 10-year option to purchase 700 million shares of Bank of America stock at a depressed price of \$7.14 per share.

2. General Electric, which sold \$3 billion of perpetual preferred stock to Berkshire Hathaway during the financial crisis, has officially stated in a regulatory filing that in October, 2011 the company called in the preferred stock with a perpetual dividend of 10%. The GE Preferred has been redeemed by GE at a price of \$110,000 per share (\$3.3 billion in aggregate)—the buyback provision required GE to pay Berkshire a 10% premium. Berkshire Hathaway's warrants to purchase \$3 billion of GE common stock with a strike price of \$22.25 per share at any time between now and 2013 will remain in place.
3. In September, 2011 Berkshire Hathaway completed the acquisition of Lubrizol for \$9.7 billion, including net debt. Lubrizol is the largest global supplier of lubricant additives and had sales of \$5.4 billion and earnings of \$732 million in 2010.
4. On September 26, 2011, Berkshire Hathaway's Board of Directors authorized the company to repurchase Class A and Class B shares of Berkshire at prices no higher than a 10% premium over the then-current book value of the shares. In the opinion of the Board and management, the underlying businesses of Berkshire are worth considerably more than this amount, though any such estimate is necessarily imprecise. Berkshire plans to use cash on hand to fund repurchases, and repurchases will not be made if they would reduce Berkshire's consolidated cash equivalent holdings below \$20 billion. Financial strength and redundant liquidity will always be of paramount importance at Berkshire.

Basically, Mr. Buffett is indirectly allocating excess capital to Berkshire shareholders via an indefinite stock repurchase program as long as Berkshire remains undervalued. We applaud this share-repurchase program. In fact, our hope is that the stock price remains low enough to enable Mr. Buffett to repurchase large amounts of Berkshire stock—increasing our per-share ownership of the company.

5. Throughout 2011, Mr. Buffett accumulated more than \$11 billion of stock in IBM. We cited IBM as a company that has built its business on a long-term, unique focus with customers and suppliers. The company incessantly communicates with these key components of its business and is able to evolve by consistently meeting customer and supplier needs.

In summary, Berkshire's business model pivots on making investments in and/or buying good companies at attractive valuations with low-cost funding. Mr. Buffett has been successful at buying businesses that generate very high levels of cash flow that accumulates over time—and then effectively reallocating this cash to ever-increasing opportunities. Mr. Buffett is clearly a very good investor, picking up \$1 of today's value for the price of 65¢. Given the current low valuation of Berkshire and Mr. Buffett's ongoing intelligent allocation of capital, we will continue to be enthusiastic holders of Berkshire Hathaway and look forward to watching the intrinsic value of this holding grow in upcoming years.

Fairfax Financial Holdings

Over the past few years, we have been raising our commitment to Fairfax Financial Holdings. The company was founded in 1985 by its present Chairman and Chief Executive Officer, V. Prem Watsa, and is headquartered in Toronto, Canada. Fairfax is in the insurance and reinsurance business and, like Berkshire Hathaway, operates on a decentralized basis. Fairfax subsidiary insurance companies provide a full range of property and casualty products, maintaining a diversified portfolio of risks across all classes of business, geographic regions, and types of insureds. Most importantly, autonomous management teams are focused on underwriting profitably in their respective markets.

Many consider Prem Watsa to be the “Warren Buffett of Canada,” though he would not characterize himself this way, and neither would we. Mr. Watsa stands on his own two feet, managing to increase Fairfax Financial Holdings' book value at a compounded rate of 24.7% per year in its first 25 years. Although these results are impressive, we had not invested in Fairfax previously due to our inability to fully answer key questions an investor must ask prior to making a commitment to any financial entity.

Prior to 2008, Fairfax Financial Holdings owned several insurance businesses and held significant stakes in a few other insurance companies. The significant stakes came about from Fairfax Financial Holdings raising capital through public offerings in two insurance subsidiaries in 2000 to 2002—Odyssey Re and Northbridge—to achieve greater financial flexibility. The investment track record in these entities was attractive after their IPOs, but (in our opinion) came with an offset: Fairfax's less-than-100% ownership in these insurance businesses contributed to some small restriction in the company's ability to *flexibly* govern the float associated with these publicly traded entities. Thus, we were not comfortable in our ability to ascertain the fully controllable long-term cost of this float, its ability to “stick” within the holding company, or the skill of the company to reinvest fully owned float on a long-term basis. What changed our view about this?

Fairfax made a planned wager in anticipation of a credit debacle, aggressively purchasing insurance against a severe market decline. Mr. Watsa had a desire to protect the company's net worth in case a financial crisis occurred. Of course, the financial earthquake erupted in 2008/2009, and Fairfax Financial Holdings made a lot of money. In a single year's period, Fairfax's common shareholders' equity increased from \$4.9 billion at December 31, 2008 to \$7.4 billion at December 31, 2009—an increase of \$2.5 billion (of which \$1 billion was new capital raised for the privatization of OdysseyRe). In the financial crisis years of 2008/2009, common shareholders' equity increased from \$4.1 billion to \$7.4 billion—an increase of \$3.3 billion—resulting in an increase in book value per common share of 61%. Now, this gets our full attention.

What interested us was Mr. Watsa's use of this money to fully privatize the public insurance companies in which Fairfax had a controlling interest, the purchase of other insurance businesses, and the company's expansion of insurance operations to China, Poland, and Brazil. As this was accomplished, we were able to more confidently answer the questions surrounding controllable float, its true cost to Fairfax, and its stickiness. We are keeping a watchful eye on how Fairfax reinvests this float to obtain long-term, consistent returns. Given its smaller size, it is still difficult (and early) for Mr. Watsa to purchase businesses outside of the insurance industry that could become a permanent part of Fairfax (similar to Berkshire). We are becoming more optimistic that this will take place, however. (Fairfax Financial Holdings' investment arm, Hamblin

Watsa Investment Council Ltd., has attained outstanding results over the past 15 years, achieving a 17.2% annual return on common stock investments versus an S&P 500 annual return of 6.8% over the same time frame.)

Like Berkshire and most financial companies, Fairfax Financial Holdings is currently trading slightly above the company's book value. As with Berkshire, however, it is our opinion that Fairfax Financial Holdings is worth more than its current stock price. We are excited about the addition of Fairfax to our portfolio, and we may further increase our commitment to this company over time.

RETAIL GROUP

Our major retail holdings—Home Depot and Walgreens—had a very good year in 2011 as retail purchases recovered after the recession. We have stated before that we are interested in large, industry-specific retailers that continue to gain economic value over the long term. We have previously described the retail areas in which we are invested as a couple of two-horse races—between Home Depot and Lowe's in the home improvement market, and between Walgreens and CVS in the retail pharmacy market. All four have gained ground in this difficult economic era and will likely gain further ground in upcoming years. We have not changed our view: It is virtually impossible for new competitors to gain a foothold in these specialized retail segments that require substantial infrastructure and real estate development.

Home Depot

Although home repair and remodeling continues to remain slow as a result of the recession and significant housing downturn, Home Depot's business performance is stellar. In previous letters, we pointed out that Home Depot was making great strides in improving the company during this difficult period, and the results of these initiatives are creating tremendous economic value for shareholders. Over the past few years, the company has rolled out a new distribution system, along with innovative information technology tools to exploit efficiencies in merchandising, store operations, and transportation.

Home Depot's Rapid Deployment Centers (RDCs) were at the epicenter of the company's plan to reduce its cost structure and improve sales. The RDCs provide Home Depot a more flexible flow of inventory throughout its extensive store network, along with better insight into inventory levels at the stores and within their supply chain. The results are now coming in: With the company's system transformation, Home Depot has improved the percentage of merchandise allocated automatically through central replenishment from 20% five years ago to ~85% today. The systems enhancements are creating opportunities for Home Depot to increase sales and profits through better in-stocks, improved assortment planning, and more customer interaction.

Home Depot continues to place greater emphasis on international growth as emerging economies continue to flourish. The company is learning to adapt to the Chinese market through its seven stores. In addition, we see Home Depot continuing to expand in Mexico and believe the company will be attracted to opportunities in Central and South America.

We expect Home Depot to earn approximately \$2.38 per share in 2011 and to increase its earnings more than 14% in 2012—to \$2.73 per share. The company will generate more than \$4 billion of owner earnings and will return this cash to stockholders through share repurchases of \$2.5 billion and approximately \$1.8 billion of dividends (a 6.5%+ look-through dividend yield at the year-end stock price). We are pleased with Home Depot's approach to its customers and shareholders—we will remain committed owners of Home Depot.

Walgreen Company

The Walgreen Company is one of the powerhouse retail firms that are emerging from the difficult economy amid changes in healthcare. The company's large store base offers consumers unmatched convenience, its brand name is one of the most recognized in the retail pharmacy business, and there is a Walgreens store within five miles of 70% of U.S. households. It is our opinion that it would be a near-impossible task for a startup competitor to match the Walgreen Company's convenience and brand pull with its customers. In the future, Walgreens will benefit from an aging population base in the U.S., continued growth in the pharmaceutical market, and an overall increase in healthcare spending—especially in patient healthcare maintenance.

The healthcare market landscape continues to change with the advent of reform, and Walgreens is positioning itself to be a leader in the new healthcare environment. Walgreens' plan is to evolve from a retail drugstore to a retail health and daily living destination. Company management envisions putting the Walgreen brand within an arm's length of everyone in America. As part of this vision, Walgreen acquired drugstore.com during 2011, which includes all websites and customer service and distribution center operations—a transaction valued at approximately \$409 million. The drugstore.com acquisition positions Walgreens as a multi-channel retailer that conveniently meets customer needs. It also provides Walgreens a unique opportunity to access more than three million online customers and add approximately 60,000 products to its online offerings. As an offset to this purchase, Walgreen also completed the sale of its pharmacy benefit management business—Walgreens Health Initiatives, Inc. (WHI)—to Catalyst Health Solutions, Inc. in a cash transaction of \$525 million.

Clearly, the Walgreens of the future is aiming to be much more than a typical retail pharmacy. We think the company's planned evolution to offer consumers a more integrated package of healthcare services will create significant value for shareholders.

In the meantime, we remain pleased with the continued positive results The Walgreen Company is achieving during a challenging retail economy. The company earned approximately \$2.64 per share in its fiscal year-end, August 2011, and should grow earnings at approximately 7% in calendar 2012, to approximately \$2.82 per share. The company will generate approximately \$2.5 billion of owner earnings and is expected to return cash to stockholders through share repurchases of \$1.7 billion and \$800 million of dividends (an 8.5%+ look-through dividend yield at the year-end stock price).

MEDIA GROUP

We have stated in the past that the media and communications industry represents a unique business due to its reliance on the ongoing development of infrastructure (internet, cable, etc.) as well as the necessity to create and distribute “great content” to customers. In no other business can a customer switch loyalty as quickly as in the media business. For this sole reason, it is important to choose media companies that have a special toehold in the marketplace. In this category, we have chosen the best media business in the industry—Disney.

Walt Disney Company

In 2011, Disney broke ground on its sixth theme park, located in mainland China. Located in Shanghai's eastern Pudong district, the amusement will be a Magic Kingdom-style theme park with characteristics tailored to the Shanghai area. The 963-acre park will cost approximately \$3.75 billion to build and represents one of the largest direct investments into the Chinese market. Once completed, this park is expected to draw 7.5 million visitors per year.

Disney's Studio Entertainment division continues to fire on all cylinders: *Pirates of the Caribbean, On Stranger Tides* produced more than \$1 billion in global sales, while initial global ticket sales from *Cars 2* exceeded sales of *Toy Story 3*. We continue to emphasize that Disney possesses an annuity-like attribute: Selling entertainment products that are in demand every day. Very few consumers will deny their children a Disney film, even during difficult times. Disney films are like an ever-producing goose that continuously lays golden eggs. Recently, Disney re-released *The Lion King* in 3D in theatres to correspond with a newly remastered DVD release. The marketing plan called for a two-week movie run leading up to the DVD release. The 3D *Lion King* box office performance was so strong, however—grossing more than \$100 million worldwide in a few weeks—that at the time of this writing, the movie was entering its fourth week in theaters. As a result of this success, Disney announced that it will re-release in 3D *Beauty and the Beast*, *Finding Nemo*, *Monsters Inc*, and *The Little Mermaid* over the next two years.

We remain confident in Disney's management team, led by President and CEO Bob Iger. We believe that Disney has stronger long-term growth prospects than most investors realize due to the company's highly competitive position within the media and entertainment industry. Disney's broad range of content and growing international presence allow the company to extend its reach throughout the world.

Disney earned \$2.54 per share in its fiscal year-end, October 2, 2011, and should grow earnings over 14% in the next year, to approximately \$2.91 per share. The company will generate more than \$4.0 billion of owner earnings and is expected to return a large portion of this cash to stockholders through share repurchases of \$3

billion and \$1.1 billion of dividends. Given the ever-increasing value this franchise is creating, we will remain excited long-term holders of Disney.

COMMODITIES GROUP

Our Commodity Holdings include Barrick Gold, Central Funds of Canada, Chevron, ConocoPhillips, and Royal Dutch Shell, along with smaller positions in several other oil companies. We originally invested in commodities seven years ago and have maintained our investment for two core reasons:

- Given the growing amount of debt throughout the world, we believed that the value of most currencies (including the U.S. dollar) would deteriorate over the long term and that central banks globally would have no choice but to eventually inflate away rising debt. Unfortunately, this assumption has proven correct, and thus we have not changed our view.

The European Union continues to come apart at the seams as countries such as Portugal, Italy, Greece, and Spain face mounting debt problems. The European Central Bank has no choice but to lend and, eventually, to print money to bail out these sovereign nations. We believe ongoing lax monetary policies will likely result in a continuing deterioration of global currencies. Over a long-term period during which global currencies such as the U.S. dollar continue to depreciate, gold and silver have risen to around \$1.565/oz. and \$28/oz., respectively.

- There continues to be a long-term growing imbalance between commodity supply and demand. For example, daily worldwide oil consumption is now at 89 million barrels of oil per day, exceeding pre-recession levels of approximately 86 million barrels of oil per day. It is our opinion that “safe” worldwide oil production capabilities are about equal to current demand. Demand for energy is increasing, however, as emerging economies grow at a rapid pace—putting pressure on oil prices that are flirting with \$100 per barrel.

Gold & Silver

We have stated previously that gold as an investment vehicle makes little to zero economic sense. The metal has no utility—all the gold produced from the beginning of time still exists. This metal is dug up from the ground, refined, and then placed in permanent storage—and individuals pay an ongoing fee for this privilege. From time to time, however, another aspect of this metal comes into consideration: Gold has no utility until it has utility.

Since the beginning of civilization, gold has been used as a form of currency. The metal’s disassociation as a form of currency occurred in the early 1970s, when the U.S dollar was taken off the gold standard, no longer officially backed via exchange for gold, but by the good faith of the U.S. government. Today, there is not a currency in the world that is backed by anything but the good faith of its issuer. Unfortunately, the good faith of all currency issuers is waning as governments mired in debt throughout the world have little choice but to print money and debase their paper currencies at a rapid pace. Otherwise, we would likely face a deflation scenario similar to that of the 1930s—something to avoid. The result of each debt debacle is different, however, and as citizens around the world begin to understand that their paper currency is slowly losing its utility, they are attempting to find new utility in the time-tested currencies of gold and silver.

In 2004, we decided to invest primarily in Barrick Gold Corporation, a gold and silver mining company. Barrick Gold Corporation has mines that span the globe and is the world’s largest gold producer, as well as a significant silver producer. This precious metals giant is targeted to increase annual production of gold by roughly 18% over the next five years, to nine million ounces. With the climbing prices of gold and silver, Barrick’s profits are soaring. Barrick is expected to earn \$4.85 per share in 2011, and at current gold prices should grow earnings at more than 20% in the upcoming year, to approximately \$5.90 per share. The company is expected to return a portion of its earnings to stockholders through a distribution of \$600 million in dividends.

We also have a sizeable investment in gold and silver bullion through our interest in Central Fund of Canada, a specialized investment holding company that purchases gold and silver in the open market and stores the

bullion in a bank vault. Central Fund's net assets at market value are approximately \$5 billion, represented by approximately 54% gold bullion and certificates, and 45% silver bullion and certificates—the remaining 1% is cash and other net assets.

Oil

We made our initial oil investment in Chevron, a leading international integrated oil and gas company with operations worldwide, in early 2005. At that time, we felt rather confident that an imbalance in worldwide oil supply and demand would push long-term oil prices higher, increasing profits of integrated oil companies. Since our initial allocation of capital to this sector, our confidence has been further bolstered by the lax monetary policies of global central banks. Therefore, during the market downturn, we increased our exposure to integrated oil companies through investments in businesses that we felt traded at significant discounts to their long-term values such as ConocoPhillips and other integrated oil companies. We now have a rather large investment in the energy sector and anticipate oil trading at more than \$90 a barrel.

Our combined oil holdings are gushing cash. The average dividend being paid by our integrated oil companies is greater than 3.5%—essentially, in this case we are being “paid” for our insurance against future inflation.

FIXED-INCOME INVESTMENTS

The Morningstar taxable bond index was up 5.9% in 2011. This positive result follows a 7.7% gain in 2010 and a 14% gain in 2009. The credit market has continued to rise in price, with investors aggressively purchasing fixed-income securities. As we stated at the beginning of this letter, investors have been so skittish about the stock market since the credit crisis that they have poured their savings into bond funds. At this point, investors are losing business perspective and chasing returns in the credit market, while remaining leery of the stock market. When evaluating the current fixed-income market, individuals would be better off taking a business approach to their investment in this area.

If individuals stepped back and looked at their fixed-income investments in a similar manner to an investment in a business, they would become somewhat skeptical about their future returns. Let's say that a business with zero debt is able to produce a steady 10% return on equity. If management elects to retain the annual earnings of this business, and plow this money back into the company, investors can expect to see their so-called equity bond double in a little more than seven years.

Now let's look at a bond in a similar business light. If you purchase a bond that produces a 10% coupon, and choose to retain the annual earnings from this bond and reinvest this money into the same bond at par, you will also double your money in a little more than seven years—producing a similar result to our business example.

After reviewing this example, it is our opinion that individuals purchasing bonds today are not taking a business perspective. For example, if we purchased a 30-year U.S. Treasury bond at a 3% yield, and chose to reinvest the coupon payments into these same bonds at par, it would take more than 23 years to double our money. If we presented our clients with a similar arrangement to invest in a business that produces a 3% return on equity and retains all the proceeds to repeat this poor return, our judgment would be questioned regardless of whether the business had assured survivability.

There are currently businesses that can be purchased near book value that produce a consistent 10% or more return on equity. But financial advisors adhering to “portfolio management theory” are placing a greater-than-average portion of their clients' assets in *unbusinesslike* opportunities.

We continue to emphasize several points that concern us about fixed-income instruments. Besides the poor returns being offered in this area, looming risks associated with this “secure investment vehicle” include the possibility of future rising interest rates and even greater chances of default. We remain concerned about the low long-term market interest rates, which may move upward as the Federal Reserve begins to struggle with maintaining a low interest rate environment, along with high liquidity in the market. The Federal Reserve could pull back on its goal to assist banks to recover losses and allow leveraged borrowers to refinance their debts. On the other side of the Federal Reserve coin: As incoming data show ongoing housing difficulties and rising mortgage default rates, we may experience a prolonged loosening of monetary policy, resulting in a

permanent increase to the money supply. If the Federal Reserve continues to put the “pedal to the metal” on quantitative easing (money printing), the market response is likely to be a rise in long-term interest rates as inflation threatens to take hold of the economy.

In 2011, we have had several tranches of municipal and corporate bonds come due. We have maintained a businesslike attitude toward our fixed-income investments, carefully allocating money to securities that offer a fair risk and return over the duration of their holding. We are avoiding speculative investment activity such as chasing returns and/or buying what we consider junk. We are maintaining our attitude of finding the best-yielding securities, understanding the risks we are taking with each individual fixed-income allocation.

In summary, we remain concerned about:

- **Unresolved long-term issues related to lax lending practices** by major banking institutions that have not yet worked through the system
- **The possibility of higher inflation** in the future due to an expanding money supply
- **Long-term rising commodity prices**

* * *

A FINAL THOUGHT

At Founders Capital Management, we believe that the best way to approach investments is with a businesslike view. Although there were (and will continue to be) challenges ahead, we will keep our focus on what’s in front of us—adhering to our value-based investment principles. We will fully understand what we are investing in and why, and we will maintain a view on the intrinsic value of our holdings. As such, we continue to invest in high-yielding stocks and bonds—and then watch the value of our investments grow.

In this age of ongoing high uncertainty, it is our opinion that to be successful at the investment game, it is important to focus on long-term business and economic considerations rather than short-term trading strategies. We will continue our effort to avoid making irrational decisions based on emotions—including fear of failing to meet desired returns for clients and being greedy when prudence should prevail.

We remain comfortable with our current businesses and the future worldwide prospects for each of our operating companies. We are also comfortable with our fixed-income investments and believe the returns are fair for the risks we are taking. We want to assure you that we continue to be mindful of the risks in today’s markets and will strive to allocate capital in a way that minimizes any long-term effects on the value of our holdings.

Thank you for the opportunity to serve you and for your continued trust. We look forward to working on your behalf during 2012.

* * *

The examples and descriptions of investments in this client letter do not represent all the investments purchased, sold, or recommended by Founders and instead represent:

- 1) *the 10 largest equity positions held by Founders’ clients;*
- 2) *the two largest equity positions in each industry group to which Founders has allocated capital; and*
- 3) *all equity positions that account for 3% or more of the total funds allocated by Founders to equity holdings.*

The performance of these investments was not a criterion in determining the representative list. It should not be assumed that the investments identified and discussed were or will be profitable.



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