Douglass Winthrop Advisors LLC
535 Fifth Avenue 22nd Floor
New York New York 10017

New York
Boston
Washington, D.C.

Telephone 212 557 7680
Telefax 212 557 7683
www.douglasswinthrop.com

Douglass Winthrop

July 6, 2015

Dear Client and Friends,

We are pleased to enclose our second quarter letter, including our commentary on the financial markets and, for our clients, your account statements for the quarter ended June 30, 2015.

Interesting times overseas…

Will they or won't they?

Investors around the world have been debating this question for months as they ponder the economic future of Greece and whether or not that nation will maintain its ties to the European community and its currency. Pundits and analysts have spent countless hours speculating about how this will unravel and which countries and companies will be impacted the most. Few financial stories have offered so many credible scenarios and so little clarity, even following the resounding "no" vote in the July 5 referendum.

On the other side of the world, China's stock markets have tumbled by more than 25% in recent weeks, prompting a torrent of questions: Is China about to slip into a recession? How will the government respond? Is this a buying opportunity in Red Chip stocks or just the first leg down in a prolonged bear market?

While our crystal ball is no clearer than any other when it comes to answering such questions, we see such times of turmoil and uncertainty as the breeding grounds for opportunity. Great companies distinguish themselves in the midst of turbulence, fortifying positions as weaker competitors struggle or fail. The stocks of such wonderful businesses can come under pressure as the pendulum of short-term market sentiment overshoots on the downside, giving long-term investors the chance to build positions at very reasonable prices.

…And steady in the States…

Compared to Europe and China, domestic financial headlines seem tame. Although this recovery has been tepid by historical standards, pocketbook issues weigh less heavily on most households today than at any point in the last few years. Our nation's payrolls have steadily increased, boosting income and consumer confidence. Confident consumers consume more, and in order to meet rising demand companies have to hire new workers, starting the virtuous cycle once again.

Yet for all the favorable economic news, corporate profits are barely growing. Granted, earnings this year have exceeded Wall Street's low expectations, but most companies have found it difficult to expand profit margins from their current all-time highs. Without the catalyst of rising earnings, the domestic stock market has meandered within a narrow trading range and enters the second half of 2015 at roughly the same level where it started the year.

While we do not indulge in the game of predicting the market's short-term twists and turns, we do weigh any number of fundamental factors to judge whether intermediate- to long-term returns are likely to be above or below historical averages. From where we sit, there is little chance that returns over the next 3-5 years will be as robust as they have been since the market bottomed in March 2009, and are unlikely to match the long-term historical average of 8%-9%. Valuations are one constraint. Although traditional measures like price/earnings ratios are within normal ranges, broader gauges such as the ratio of the market capitalization of all publicly traded stocks to U.S. gross domestic product (one of Warren Buffett's favorite yardsticks) is currently hovering around 125%, which is more than two standard deviations above its historical mean of 69%.

The Federal Reserve is likely to be another formidable barrier to superior investment returns. Fed watching has become a popular sport in the wake of its public comments suggesting that it will lift short-term rates at some indefinite point in the not-too-distant future. It will take years to judge whether the Fed gets the timing of that decision right. Some notable observers believe that they have already waited too long, fueling a speculative bubble evidenced by the eye-popping valuations recently accorded some private companies such as Uber. While we don't embrace that dire view, history tells us that equity returns tend to moderate once a period of monetary tightening begins, and the bond market is likely to struggle as well.

…Can still produce attractive opportunities

Regardless of the market's trajectory, we believe that a portfolio of 30 or so carefully selected companies that pass our five filters (wide-moat businesses with strong balance sheets, abundant free cash flow and opportunities to grow through re-investment, shareholder-oriented managers and reasonable valuations) will outperform. This quarter we identified Precision Castparts (PCP) as such a company. PCP's three divisions make complex metal components and products for the aerospace and industrial markets. These are high-margin businesses with loyal customers that rely upon PCP to produce parts that absolutely will not fail in use. An explosion at one of its manufacturing facilities, a temporary pause in purchases by one of its largest aerospace customers and weakness in its oil & gas turbine business have sparked a round of profit-taking, knocking PCP's stock price down by more than 15% this year after a long and stellar run (its total return from 2000 to 2014 ranked #7 among S&P 500 companies). We see these setbacks as temporary, and have started building positions in the stock.

We spend just as much time re-examining the prospects of our long-term portfolio holdings as we do searching for the next great idea. We ask ourselves whether we would want to buy the stock if we did not already own it, and try to make sure that the fundamental case that attracted us in the first place is still valid. We put Deere & Co. (DE) to such a test earlier this year.

The stock had lagged in 2014 as the agricultural cycle turned negative, crimping farm cash flows and leading analysts to slash their 2015-2016 profit forecasts. We determined that the company's managers are making the right moves to push through the lean part of the cycle without hampering future growth prospects, and the stock remains one of our firm's largest holdings.

Reminder: Vigilance required

Rarely does a week go by where there isn't some headline about a major cyber-security breach. This spring the U.S. Office of Personnel Management revealed that hackers had gained access to the personal data of as many as 18 million current and former government employees, a vivid reminder that every institution, big or small, financial or otherwise, is at risk of cyber-attack. As a consequence, many of these institutions are beefing up their security procedures, adding additional layers of identity verification to even the most trivial of interactions.

Douglass Winthrop is also taking additional precautions to prevent fraud. All wire transfer requests (except those subject to standing letters of authorization) are subject to additional documentation, acknowledgement by the portfolio manager and verbal confirmation by the client making the request. Such procedures may strike some as inconvenient, but we believe the reduction of risk is more than sufficient compensation.

Douglass Winthrop

Some closing comments

We are very pleased to welcome Olivia Le Blan to Douglass Winthrop Advisors. Olivia works primarily with Lea Highet to support our firm's wealth management offering, focusing on trust administration and estate planning.

We take our responsibility to our clients seriously, and we always put your interests first. We work hard to earn your trust every day, and appreciate the opportunity to serve you. We welcome your questions and comments, and wish you a safe and happy summer.

Sincerely,

Oak Strawbridge
Charles Crane
Robert Douglass
Lea Paine Highet CFP®
Charles Howard
Josh Huffard
Bryce O'Brien
Bowdy Train
Philip Warner
Grant Winthrop
Jay Winthrop