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Douglass Winthrop

April 6, 2015

Dear Clients and Friends,

We are pleased to enclose our first quarter letter, including our commentary on the financial markets, and, for our clients, your account statements for the quarter ended March 31, 2015.

We are excited to announce that Phil Warner has joined the firm in our New York office. Phil brings a wealth of experience in the investment advisory business having worked at Morgan Stanley, Neuberger Berman and Forstmann Leff. He is a graduate of Yale University and Harvard Business School. We welcome Phil's wisdom and good humor.

Please note that we recently filed our updated report on Form ADV. A copy of Part 2A, our brochure, is available upon request. The only material change noted since our last update in December 2014 relates to Phil's arrival.

Priced for (near) perfection…

The stock market delivered sub-par returns in the first quarter of 2015: including dividends, the Standard & Poor's 500 Index gained a little less than 1% in the period. We discuss a number of reasons why equities may have taken a breather below. Perhaps the most prominent to those of us who view the world through a value-oriented lens are the high multiples that stocks presently carry. Traditional measures such as price/earnings, price/book value and price/sales are all in the upper quartile of their historic ranges. A number of lesser known measures also appear stretched. For example, the market capitalization of all public companies in the U.S. is presently equal to 144% of our nation's GDP, the highest since 2000. Another measure, developed by Yale professor Robert Shiller, which compares prices to a trailing ten-year average of earnings, is in the upper decile of its 133 year series. While both of these unconventional yardsticks have their flaws, they reinforce our view that stocks in general are priced for near perfection.

…In a less than perfect world

The fundamental backdrop for stocks is far from perfect, however. Estimates for corporate profit growth have declined in recent months across all sectors, most sharply in industries tied to the plunging price of oil. Analysts believe that first quarter S&P earnings actually dropped several percent from the prior year, a stark contrast to the gains anticipated just a few weeks earlier. Chief among the culprits is the strong dollar, which now stands roughly 15% higher than a year ago against a basket of the world's leading currencies. Since more than 40% of S&P earnings are derived outside the U.S., the greenback's strength is a powerful headwind to the benchmark's bottom line.

The dollar's rise coincides with the growing divergence in monetary policy among the world's central banks. The Federal Reserve seems to be waffling on interest rates, dropping "patience" from its pronouncements but also expressing concerns about slow employment growth, stagnant wages and poor productivity gains. Despite the mixed signals, most pundits expect the Fed to lift short-term rates before year-end. Interestingly, the bond market seems to be focusing on the caveats: the yield on the 10 year Treasury bond was lower at the end of the quarter than it was at the beginning. As our Fed has laid the groundwork for tightening, the European Central Bank (ECB) has gone the other direction. The ECB has recently embarked on a U.S.-style campaign of quantitative easing, aggressively buying European government bonds with the aim of flooding the market with liquidity in an attempt to stimulate the continent's persistently sluggish economy. Early indications suggest that this policy is working: Europe's Purchasing Managers Index is signaling economic expansion, and many European stock markets enjoyed double-digit percentage gains in the first three months of the year.

A strong and unified Europe makes a better trade and economic partner for the United States. It could also temper the ambitions of an increasingly assertive Russia. Vladimir Putin seems intent on challenging the US and Europe on every front, exposing fault lines and weaknesses within the NATO Alliance. He remains popular at home despite a faltering economy and an increasingly autocratic government. Tough sanctions will be difficult to maintain indefinitely as they impede economic activity in both the EU and Russia. Angela Merkel is doing a good job of navigating this difficult situation but she is under a great deal of pressure from Germany's industrial powerhouses—the backbone of the EU's strongest economy—to take a softer line with Russia (perhaps in part because more than 35% of Germany's oil and gas arrives in Russian pipelines).

The Middle East remains a geopolitical hot spot as well. Israel's Benjamin Netanyahu stunned the world by renouncing his support of a two-state solution to the Palestinian question, upending fifty years of diplomacy. A proxy war between Saudi Arabia and Iran threatens to destabilize the entire region, and ISIS's reign of terror rages virtually unchecked.

Uncertainty leads to opportunity

Uncertainty is a constant in financial markets. The sources of uncertainty can seem a bit scarier at some times than at others. Current geopolitical risk appears higher than usual, as does the price volatility of various financial assets and commodities. The stock market as a whole does not seem priced with a margin of safety. It is tough to make sense of a world in which an investor gets paid less to lend money to Portugal than to the United States.

Uncertainty and risk, however, are the seeds and fertilizer of opportunity. As investors, we welcome them. Investor sentiment can change rapidly and sometimes will result in material changes to the price of a business even as the value of that business remains little changed. These temporary mood swings create opportunities for patient investors like us to acquire shares in great businesses that we can own for a long time (ideally forever). It was such price dislocations over the past 15 years that gave us the opportunity to build positions in stocks such as **Berkshire Hathaway**, **Nestlé** and **Brown Forman** that today constitute the ballast in the portfolios we manage. These are businesses that thrive regardless of the economic backdrop, providing safe harbor from stormy seas.

More recently we have taken advantage of short-term price declines to initiate positions in **Transdigm**, **Valeant Pharmaceuticals**, **Discovery Communications** and **Fastenal**. These companies exhibit the characteristics we look for: a wide economic moat, a focus on shareholder value, strong financials and solid prospects to grow the business thanks to ample reinvestment opportunities. Their business models are somewhat riskier, either due to greater leverage or cyclicality, but we think the potential returns on their stocks are commensurately greater over the next few years.

Let's take a closer look at **Discovery Communications**. Discovery is the leading global provider of non-fiction media, providing original and purchased content to over 2.6 billion cumulative viewers in more than 40 languages in over 220 countries worldwide. The company owns such networks as the *Discovery Channel, TLC, Animal Planet, The History Channel, The Oprah Winfrey Network* and many others. While its revenues come primarily from cable operators, the company is well positioned to provide its digital media to customers through other delivery mechanisms, particularly video streaming. The company's strong position in non-fiction content gives it a defensible moat. Discovery generates substantial free cash flow, and it has plenty of reinvestment opportunities for that cash, particularly in its international business where growth is strongest. We also expect additional investment in direct-to-consumer video streaming. The company has repurchased nearly half of its outstanding shares over the last four years, and its balance sheet is strong. Currency headwinds will negatively impact 2015 earnings from international operations, which account for about half of Discovery's revenues. As a result, Wall Street has soured on the stock, contributing to a 30% decline in the share price from recent highs. We are happy to take advantage of such *short-term* negative perceptions to buy into a great business at what we believe to be an attractive price for *long-term* appreciation.

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DWA Developments

Douglass Winthrop has grown rapidly in recent years. As of March 31, 2015 we manage more than $1.6 billion for approximately 400 clients. In recognition of this and in anticipation of further growth ahead, we are pleased to welcome Koren Howe and Alexandra Panetta to our team. Koren has worked with Phil Warner for 12 years, and we are thrilled to bring her extensive client service experience to our growing list of portfolio relationships. Alex adds to our administrative capabilities, and brings an infectious enthusiasm to our office.

At Douglass Winthrop Advisors we work hard to foster a culture of unwavering commitment to putting our clients' interests first. Our mission is to help our clients navigate uncertain times by utilizing sound portfolio management coupled with professional wealth management advice. We are grateful for the opportunity to engage in the meaningful work of earning and retaining your trust. Thank you for your ongoing confidence and support.

Sincerely,

Bowdy Train
Charles Crane
Robert R. Douglass, Jr.
Lea Paine Highet, CFP®

Charles T. Howard
Josh Huffard
Bryce O'Brien
Oak Strawbridge

Philip Warner
Grant F. Winthrop
Jay Winthrop