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Douglass Winthrop

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Dear Clients and Friends,

We are pleased to offer our third quarter letter, including our commentary on the financial markets and, for our clients, your account statements for the quarter ended September 30, 2014.

State of the World

We live in an increasingly complex world. It is a world with breathtaking changes in medicine, communication and global connectivity. Periods of rapid change are characterized by both extraordinary opportunity and increased risk. Advances in living standards and the benefits of greater cross cultural communication in a "flatter" world are necessarily accompanied by greater vulnerability associated with increased interdependence. Technological and cultural change challenge historically entrenched political systems, cultural norms and religious beliefs. The very things we take for granted inspire fear in those who feel their long held values, economic and political status, and very way of life are under assault. Cultures, societies and governments that see these challenges as existential threats may lash out in ways that seem incomprehensible to those of us who embrace the excitement and opportunity offered by a changing world.

Before 9/11 very few people recognized the extent to which extremists would attempt to defend their notions of cultural, political and religious norms by creating what we have come to think of as "Islamic terrorism." While Al-Qaeda itself may be significantly degraded as an organization, the rise of the self-proclaimed "Islamic State" and their recent well financed and barbaric sweep across Syria and Iraq, complete with a sophisticated social media campaign, can leave little doubt that this movement has great appeal to many disaffected by the world we now inhabit. At the same time the US determination to keep the peace in that region seems to have waned amid a sense that we have sacrificed too much of our blood, prestige and treasure for little gain in a place we don't understand well and which has become strategically less important to us as our dependence on oil from the region has substantially diminished. In the next 30-60 days from the time of this writing, US production of liquid petroleum will exceed that of Saudi Arabia.

On the European continent, a Russia which feels threatened by the increasingly powerful economic and cultural appeal of the West is led by a former KGB operative, Vladimir Putin, who seems intent on restoring the Soviet/Tsarist empire with himself as its autocratic leader. It is hard for us in the West to understand the wide political support Mr. Putin derives from a nostalgic sense of Russian nationalism. In the short run, the NATO alliance may be challenged to respond in unexpected ways. In the long run, however, we are confident the enduring appeal of Western cultural and economic norms will cause Russia and the West to deepen their already extensive integration.

Every day, we are seemingly bombarded by increasingly dire warnings of impending disaster: Ebola on our shores, cybercrime affecting our major financial institutions, a feckless and paralyzed government, among others. While we at Douglass Winthrop are mindful of these risks, we are also aware of the obligation to our clients to remain as objective as possible amid the drumbeat of sensational headlines. We must exercise discipline to avoid kneejerk reactions to the latest drama and to take a long term perspective. Anxiety is not an investment strategy. There are many great companies accomplishing amazing things all over the world. That will be true next week, next month and ten years from now. Our team works hard to determine which of these companies give our clients the best opportunity to preserve and grow their wealth in an increasingly complex and interdependent world.

State of the Markets

For all the dire news, the stock market has been surprisingly resilient and has continued its ascent in 2014. For the third quarter the S&P 500 gained 1.1%, and is up 8.4% year to date. This rise comes on the heels of a hugely positive performance in 2013 which saw the S&P 500 rise 32%. Equity investors who remained in stocks or invested in the early aftermath of the financial crisis have enjoyed a compound annual return in excess of 20%, more than twice the historical long-term rate of return on stocks.

Debt markets have also continued to show persistent strength with the Barclays U.S. Government/Credit Bond Index up 4.1% for the year and the yield on the 10-year Treasury now at 2.4%, quite low by historical standards. The average 30-year mortgage is 4.2% and central banks around the world continue to support a low interest rate environment. The US dollar is at a four-year high relative to the Euro, and the US remains the safe haven of choice for investors amid worries of a slowdown in China and stagnation in Europe. Inflation fears remain on the back burner for the time being.

Investors must now choose between investing in a more fully valued equity market, accepting historically low yields (and significant price risk) from bonds, or stoically enduring negative inflation-adjusted returns on cash balances. The good news for equities is that overall stock valuations continue to be reasonable, with the S&P 500 trading at 18x projected 2014 earnings and 16x next year's consensus earnings forecast. Although we think these estimates may prove somewhat optimistic, we see no alternatives that offer a better combination of liquidity, valuation and upside potential.

Investing in Risky Times

Risk is ever present in the investment world. It's the scope and magnitude of risks that vary over time. Although the US stock market is behaving nicely for the moment, now is not a time for complacency. Statistics show, however, that trying to time the stock market is a fool's game - being out of the market on just a low percentage of its best days dramatically reduces returns. Therefore, we remain committed, long-term investors through good times and tough patches. This strategy has the added benefit of keeping taxes low, an important consideration for almost all of our individual and family clients.

Accounting for the many and varied risks present today requires an investment process that focuses as much on preservation of capital as it does on appreciation potential. Good judgment is a critical element of this process, as is the consistency and integrity of the approach. This is why we rely heavily on the discipline of our five filters analysis as we scan the universe of opportunities for excellent long-term investments. Our five filters include: (1) durable/repeatable business models with high barriers to entry; (2) pristine financial condition, including strong free cash flow and a healthy balance sheet; (3) abundant reinvestment opportunities; (4) excellent leadership team that values all stakeholders; and, (5) non-challenging valuation. Ideally every company in our client portfolios possesses each of these characteristics. In reality it is tough to find companies that successfully combine all of them. When we find a company with these characteristics, it tends to stay in the portfolio for quite a long time. Consider **Brown-Forman**, the maker of Jack Daniels and other spirits, which has been mentioned in our letters many times - the stock has been a core portfolio holding for over 10 years.

Clients Come First

Our clients know that they have the attention of a seasoned, time-tested team working to further their objectives, and that their goals and ours are aligned - to grow capital in good times and to preserve it in tough periods. Every portfolio decision is undertaken with their best interest in mind, and each portfolio is tailored to a client's specific needs and risk tolerance. This responsiveness is not available from an index fund, large banks or other options where goal

alignment can be scant, if not non-existent. Additionally, Douglass Winthrop believes that our clients' wealth management objectives are best achieved when sound investment judgment is combined with strong strategic wealth planning advice. It is increasingly difficult to find firms which place equal importance on delivering both of these critical financial services to their customers. We take pride in this "whole client" approach to helping our many individual and family clients exercise stewardship over their assets.

We encourage you to visit us whenever you are in New York City or in the locations of our newest offices - Washington, DC and Boston. We take pride in our work, love what we do and enjoy sharing updates and insights. Many of you have provided wonderful nuggets of wisdom over the years, and we have learned much from this dialogue. Considering the main theme of risk in this letter, specifically cyber risk, we urge everyone to be extremely mindful of your personal financial security. We advise that you retain a paper copy of your most recent bank/brokerage/custody statements in a safe place.

Please let us know if we can be helpful in any way. We thank you for your support and friendship!

Sincerely yours,

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Charlie Crane

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Charlie Howard
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