First Quarter Letter 2013

PERSPECTIVE

Recent headlines suggest that the economy's health is improving, with housing starts springing back, higher corporate profits and auto sales tracking the best year since 2007. One could infer that the stock market is a proxy for the health of the economy. In reality, there have been plenty of divergences between the stock market and the economy. Over time, through business cycles and bull and bear markets, economic output and stock performance have plotted no particularly meaningful relationship. In fact, since the 1900s the two best decades for Gross Domestic Product (GDP) growth were among the worst returns for stocks.

Stock market moves can be exaggerated and jump ahead of economic fundamentals. One market driver is earnings, particularly when they surprise investors on the upside. Another driver is market psychology, in particular the so called "bandwagon effect." People tend to get more excited and buy stocks when the market is up and expensive. Conversely, they get more anxious to sell when the market is down and cheaper. This cause and effect has been pointed out in many studies. These swings in market psychology can create waves of under- and overvaluation.

The current market has risen against the backdrop of the Federal Reserve's aggressive bond buying and record low interest rates. This has created some distortions incenting yield-oriented investors to buy stocks. At some juncture, the Fed will reverse course by selling assets and raising interest rates. That move, in turn, will provide investors with other yield options beyond stocks, potentially driving down share prices. In addition, unemployment remains a shade under 8% and wage rates are suppressed … allowing companies a window to keep labor costs down and pass on more profits to shareholders. Improving employment could put upward pressure on wages and subsequently downward pressure on earnings.

Daily headlines and market gyrations and distortions can impact the confidence of even the most seasoned investors. In place of trying to time the market or forecast policy and macro-economic events, our investment decisions are governed by long-term value requiring patience and discipline. We must remain disciplined because our buy and sell actions often run contrary to the direction of the market. Our trading decisions are based on the stock's price relative to our appraisal of value.

We must remain patient because it usually takes time for the market to separate and distinguish underlying long-term value from temporary, short-term issues. Remember that as value investors, by definition, we are buying businesses that are currently out of favor.
Successful investing requires an understanding of the role of psychology in influencing the

market and distinguishing it from real economic value. Seth Klarman, a well-known value investor, once said: “If you can remember that stocks aren’t pieces of paper that gyrate all the time – they are fractional interests in businesses – it all makes sense.” Our focus remains on the economic value of our companies while taking advantage of emotionally driven momentum that may periodically over- or underprice these holdings.

COMPANY COMMENTS

Comments follow regarding common stocks of interest to clients with stock portfolios managed by Delta Asset Management. This commentary is not a recommendation to purchase or sell but is a summary of Delta’s review during the quarter.

Sysco Corporation { SYY }

Based in Houston and founded in 1969, Sysco is the largest food service marketing and distribution company in North America. Sysco’s major customers include independent restaurants as well as schools, colleges, hotels, hospitals and other food service outlets. The company distributes more than 400,000 products, including approximately 40,000 Sysco-branded items; and it holds about a 17.5% market share (twice its largest competitor) of the $200 billion-plus food service market in the U.S. and Canada.

Each year, the food giant ships 21.5 million tons of produce, meats, prepared meals and other food-related products to over 400,000 customers. No single Sysco customer makes up more than 10% of revenues. To efficiently supply such a large customer base requires a complex web of software, databases, scanning systems and robotics. To meet this need, Sysco has software that calculates how much each pallet can accommodate and how it should be arranged, based on the weight of its items, its location and its destination. It targets full-service independent restaurant operators, and the company has nearly a 30% market share among this group. Sysco focuses on independent restaurants because of a relatively high degree of pricing power versus chains, which can bargain for greater discounts. Historically, Sysco has been able to pass along inflation adjustments without significant delays.

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Key drivers in the industry include prompt and accurate delivery of orders, competitive pricing, close contact with customers and the ability to provide a full array of products and services to assist clients in their food service operations. Profit margins in the industry are tight and largely depend on high volume. The industry is fragmented with over 3,000 domestic food distributors, in addition to more than 15,000 specialty distributors.

Sysco has the largest marketing and sales organization within the food service industry, which is a key differentiator. The company specializes in assessing business operations and providing a range of ancillary services providing customers with menu planning advice, food safety training, inventory control, product usage and labor scheduling reports. These services are appreciated by operators who typically lack the resources or sophistication to replicate them. In addition, these services also establish a level of trust and dependence and give Sysco valuable information relating to extensions of customer credit and accounts receivable management.

As acquisition opportunities become harder and growth has slowed, a new area of focus for the company has been supply chain efficiencies. Growing largely through acquisitions, Sysco has retained a decentralized, entrepreneurial culture that gives wide autonomy to the individual distribution centers. Sysco's Business Transformation Project represents a multi-year commitment to standardize operating systems among the company's distribution centers.

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The project is intended to consolidate procurement, increase sales productivity, improve customer service and streamline the order fulfillment process. Delays and additional costs have plagued the implementation, although recent conversions to the new system have gone more smoothly. When fully implemented, the cost savings provided by the new system should enable Sysco to pursue larger, national accounts and improve profit margins.

Assuming a successful implementation of the new operating system, we believe the company should be able to expand its industry leadership position by exploiting its scale and cost advantages over its competitors. Sysco can fund and implement large efficiency projects that competitors cannot match. We estimate that Sysco will be able to grow revenues long term at a low single digit rate versus an industry growth rate that is flat to marginally positive. We believe the company should be able to produce operating margins averaging in the mid-single digits, with those margins trending higher over time after the implementation of the new operating system. Using these assumptions, our stock valuation model indicates Sysco's current stock price offers a long-term annual average rate of return at just above 10%.

Computer Sciences Corp { CSC }

Computer Sciences Corp is a leading provider of business process outsourcing and information technology (IT) systems consulting. The company's global delivery capability, deep talent pool and long tenure with clients position it to serve more than 2,500 organizations worldwide. CSC focuses on long-term relationships that generate stable and recurring revenue. Client retention is above 80% as the company specializes in complex engagements requiring industry-specific solutions and depth of knowledge.

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Over the years, CSC has benefited from an outsourcing trend in IT for many companies that has reduced costs and in many cases improved service levels. As new technologies are introduced and IT budgets come under pressure, companies turn to service providers such as CSC to meet more of their needs. Outsourcing allows companies to reduce costs, avoid large capital commitments and rapidly deploy new technology.

CSC's most well-positioned asset is its North American Public Sector (NPS) division, which serves the Department of Defense and other federal agencies and departments. Contracting with the federal government on sensitive projects requires a high degree of security clearance, competency and the ability to navigate the labyrinth of governmental contracting and accounting standards. Traditionally, only a few domestic providers have been able to meet these hurdles, although recently the competition has increased. This segment may be challenged in the near-term due to impending reductions in defense and government spending.

In recent years, CSC was slow to adapt to industry changes in IT services. As the industry shifted to smaller, specialized contracts, CSC continued to pursue high-risk, high-cost mega deals. However, these deals became commoditized and serviced by low-cost providers. The company also suffered from a weak contract bidding process and oversight, which hurt profitability. Though wage differentials have diminished considerably, the IT consulting / outsourcing industry continues to be challenged by the growth and increasing sophistication of sizable, low-cost firms from India.

CSC's new management team, led by CEO Mike Lawrie, has moved quickly and methodically to put in place a strategic plan to improve the company's revenue and profit growth. The company is cutting costs and improving efficiency, rationalizing and standardizing its service offerings and instituting an accountability-oriented management system. Subsequently, company profitability has improved.

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To drive more profitable growth, CSC is increasing its large employee base in low-cost regions and utilizing those employees more efficiently. The company is moving up the value chain into better growth services with higher profit margins. CSC is also expanding its sales roles in higher-value, industry-specific solutions. The company's consulting and outsourcing businesses are positioned to capitalize on growth sectors, such as healthcare, chemicals and security with demonstrated industry expertise. In addition, CSC is building out its next-generation offerings, such as cloud computing and cyber-security services. These offerings are in early stages with many vying for relevance, but we believe CSC has a good initial position in the industry.

Overall, with mature industry and competitive characteristics, we expect growth to be modest during our forecast period. However, we believe management changes will lead to a more efficient CSC and result in higher profitability and free cash flow. Based on these assumptions, our valuation model indicates a long-term, average annual return of 9.5%.

Microsoft *Microsoft Corp. { MSFT }*

Microsoft is the world's largest developer of software products and services. The company's products include Windows operating systems for personal computers, servers, phones, server applications, Office business solution applications, video games and its online search offering: Bing. Microsoft is an early contributor to cloud-based solutions that provides customers with software, services and content over the Internet. In addition, Microsoft designs and sells hardware, including the Xbox 360 entertainment and gaming console and assorted PC hardware products.

The new Office application – Office 365 – is available as a subscription model, perfectly suited for a cloud future. The subscription can automatically renew each year and constantly updates year round.

In the past, Microsoft's legacy products, such as Windows and Office, gave the company high profit margins and cash flow to reinvest in non-core businesses. The migration of consumers away from the PC to mobile devices and the development of open source software applications threaten to erode the dominance of Microsoft's core operating system and Windows applications. Google has established itself as the leading online search player and has used its position to branch out into direct competition with Microsoft with its Chrome Internet browser and operating system software. On the mobile operating system front, Apple's iPhone operating system and Google's Android platform have become the market leaders.

Microsoft has attempted to protect its legacy businesses, while at the same time compete in a number of other product categories, including a search engine, PC hardware, music device player and gaming console businesses. This multiple product strategy has proven difficult and has left Microsoft in a position of being unfocused and late to market with new products. Meanwhile, consumers are moving to more and more computing on-the-go, using tablets and smartphones where Microsoft is not as strong.

Microsoft is an early contributor to cloud-based solutions that provides customers with software, services and content over the Internet.

To its credit, Microsoft continues to innovate, especially in its core businesses. The real question is how durable are its major franchises: Windows and Office. Both have varying degrees of durability, although Windows is the most vulnerable due to the rise in mobile devices. Office appears to have the greatest longevity and even some growth potential by mixing local and cloud applications. The new Office application – Office 365 – is available as a subscription model, perfectly suited for a cloud future. The subscription can automatically renew each year and constantly updates year round. Every time a user opens the program, they will be running the latest version. Documents will be saved to Microsoft's SkyDrive storage system by default, so documents and personal setting are remotely accessible.

Microsoft must continue to innovate as its core businesses mature and decline. Much of Microsoft's investments (Bing, Xbox, Zune) have been outside of the company's core; though we don't doubt the company's ability to invest its way to a viable business, the amount of capital committed in these efforts makes a compensatory return more challenging.

Collectively, these issues have framed our long-term assumptions. In the absence of a breakthrough product, Microsoft's revenue growth potential is constrained by the declining nature of the Windows franchise. Our assumption is that the company will be able to grow its revenues in the very low single digits on an annual percentage basis. Due to the anticipated decline in revenue in the company's most important core franchise, as well as changes in the delivery mode (cloud) for other core franchises, we assume that its profit margin also moderates over the long term while profitability will remain robust. Assuming that the current management remains in place, we anticipate that Microsoft will continue to develop and acquire a wide range of technologies and products – some of which will be outside of its core – and will experience relatively lower long-term returns on capital. Even with these assumptions, our valuation model indicates that at its present stock price, Microsoft still offers a potential 12% annual rate of return.

BD *Becton, Dickinson and Company { BDX }*

Becton is one of the leading medical device companies supplying a diversified mix of basic and sophisticated products throughout the world. Almost half of Becton's sales are in what are called sharps, which consists of safety needles, hypodermic needles, syringes, pen needles, catheters and related equipment, while the remainder is in diagnostic and research instruments. More than 60% of sales are in foreign markets.

The company maintains the largest market share of sharps worldwide, based on the quality of its products, innovation, worldwide service capability and lower cost. Becton has innovated in sharps for 100 years and continues to push the technology forward. The company's last major innovation has been in the field of safety devices, which reduces the potential for healthcare worker needle accidents. These products are now required in most U.S. hospitals and have fully penetrated the U.S. market. However, expansion opportunities remain in foreign markets due to a slower adoption of safety guidelines in Europe and the need to minimize the spread of infectious diseases in developing countries. We expect this business will continue to generate strong free cash flow, which management has a history of deploying wisely.

Almost half of Becton's sales are in what are called sharps, which consists of safety needles, hypodermic needles, syringes, pen needles, catheters and related equipment; Becton has the largest market share of sharps worldwide.

Becton's other businesses are more technology-oriented and have large market shares. The primary products are diagnostic testing instruments for disease detection and cellular analysis instruments for pharmaceutical and biotech research. Both product categories have related equipment and supplies businesses that are sizeable in their own right. Becton has historically innovated vigorously or acquired new technologies in these businesses, which is essential to maintaining its competitive position. Diagnostics is the most likely growth driver for Becton, due to an increase in successful treatments if diseases and infections are detected early. Becton is in the forefront of these trends with many instruments and tests in the marketplace along with a strong research and acquisition program in place.

Becton faces a number of challenges, including the weak economic environment, which has led to fewer patient visits to hospitals and reduced medical research budgets. Further, hospital buying groups are consolidating to increase their purchasing power with suppliers. Longer term, the major risk to Becton is the commoditization of sharps, which Becton continues to combat through innovations such as safety-engineered devices and ultra-thin pen needles. In addition, Becton faces growing competition from medical product manufacturers with sizeable research budgets, particularly in fast-growing segments. In the healthcare industry, there is always the risk that competitors create more innovative products to replace existing ones, which can result in a disruption in the market.

New U.S. healthcare legislation will impact Becton. Although the company will be subject to the new medical device tax, – the tax is 2.3% of medical device sales – it will be manageable for Becton and should be offset by various cost take-out measures. Becton likely will experience pricing pressure from healthcare providers in their efforts toward cost containment. At the same time, we believe unit growth in medical products may be enhanced due to the inclusion of additional insured individuals. Healthcare reform will not impact Becton's foreign business, most of which already operate under nationalized healthcare systems.

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We feel confident assuming a higher growth rate for Becton's more innovative businesses, such as diagnostics, and a more modest growth rate in its maturing sharps business. The population of the world is growing and in major industrialized nations it is aging, which implies that medical equipment will be in strong demand. Based on these assumptions, our stock valuation model indicates Becton's current stock price offers a long-term average annual rate of return of approximately 8.5%.

L'ORÉAL *L'Oreal { LRLCY }*

Founded in France in 1909, L'Oreal is a leading manufacturer in the world cosmetics market. The company has excellent market share positions in most regions of the globe – with a presence in 130 countries on five continents – and across all price points from mass-market to luxury. The breadth of L'Oreal's brand portfolio and geographic reach gives it sustainable competitive advantages. The company's success over many years is attributable to the development of premium products, global branding and a number of product innovations geared to targeted regions.

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Over recent years, L'Oreal's expansion had been driven by organic growth. A key driver of growth has been the impressive amount spent on advertising and promotion: 30% of sales versus the 25% on average for the sector. By concentrating its resources on a limited number of brands, the company can launch new products on the back of a firmly established identity. The marked increase in advertising and promotional costs over the past few years and their maintenance at a high level has been made possible by a considerable reduction in purchasing and administrative costs.

Organic growth is also driven by a healthy investment in research and development. The company has 19 research and 16 evaluation centers and filed 613 patents in 2011. Fifteen percent of sales are derived from new products.

The development of emerging economies across the world has presented L'Oreal with renewed opportunities for growth. European and North American markets are mature with established competitors and high penetration. In contrast, the company is seeing growth in newer markets where the middle class is emerging and eager for high quality cosmetic products. L'Oreal is targeting to more than double its customer base from 1.2 billion to 2.5 billion over the next 10-15 years by focusing on product categories that are popular in emerging markets.

China remains a major area of growth in emerging markets and now represents 7% of sales; it is L'Oreal's third largest market globally. L'Oreal is the No. 2 cosmetic company in China, with leading positions in skin care, make-up and colorings.
It only recently launched its hair care products, which comprise 25% of the Chinese market. These new category introductions may lead L'Oreal to becoming China's leading cosmetics player over the next few years.

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The company maintains worldwide pricing for its products, so profit margins in emerging economies are comparable to those produced in developed ones. A sustainable competitive advantage is the company's ability to cover all price points with a range of brands. L'Oreal can establish a presence in an emerging economy by introducing lower price point brands without damaging the later introduction of its higher-priced premium brands.

We believe L'Oreal can continue to grow its revenues despite its exposure to mature North American and European markets due to growth potential in emerging markets. Profit margins are likely to be constrained by competitive pressures as well as possible inflationary cost increases in the developed economies. These should be offset by cost efficiency measures in marketing and supply sourcing as L'Oreal consolidates the operational aspects of its disparate business entities. We believe L'Oreal will be able to maintain long-term operating profit margins in the middle teens and earn a return on assets in the low teens.

NATIONAL INSTRUMENTS *National Instruments Corp. { NATI }*

National Instruments Corp. is the leader in virtual measurement and automation instruments that use a personal computer for computation, which has proven a disruptive technology to makers of traditional instruments. Virtual instruments are used in a wide range of industries measuring and controlling electrical signals, temperature, pressure, speed flow, volume and vibration. National Instruments services over 35,000 customers. No single customer comprises more than 6% of revenue, and no single industry represents more than 15% of revenue.

The key to the company's market position is LabVIEW, a flexible, easy-to-use graphical programming language that is the leading software application in the measurement and automation space.

National's integrated hardware and software approach for measurement and control systems is more adaptable to technological change and can be defined entirely by the customer. The key to the company's market position is LabVIEW, a flexible, easy-to-use graphical programming language that is the leading software application in the measurement and automation space. Released in 1986, customers use LabVIEW to create an application that is unique to their particular needs using National's low cost virtual instruments. Taught in over 7,000 universities around the world, LabVIEW has a strong position in academia. The substantial installed base of LabVIEW and its exposure to engineering students (future clients) give National Instruments a formidable and seemingly sustainable competitive advantage.

The company is highly focused on organic growth and takes a long-term view toward investing in research and development (R&D). Almost a third of the company's employees work in R&D. The company continues to increase R&D investment even in downturns. In the past five years, the number of R&D professionals is up 40%. This R&D focus leads to multiple advanced new products every year, which is meaningful given that the average time from idea inception to profits in test and measurement is five to six years. The lead time to market and significant R&D investment necessitates careful management of the new product pipeline. National Instruments creates a road map on new product development by tracking new applications of LabVIEW, reducing the risk of its R&D allocations.

As the capability of personal computing has increased, National's virtual instruments have been able to penetrate more applications. Traditional hardware instrumentation employed by competitors is characterized by higher prices, closed architecture and limited programmability. National's offerings provide users with ease of use, customization, faster time to market and a lower cost. The company's success and market disruption has attracted competitive offerings (Agilent) validating its approach. Agilent recently introduced its own line of PXI hardware, a standard National Instruments pioneered. Additionally, National's test solutions have increasingly appealed to the R&D test market, which is larger and typically less volatile but has traditionally been dominated by competitors.

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Industrial and embedded applications, which previously were out of reach of virtual instruments, will be a key driver for future growth. The estimated addressable market for industrial / embedded solutions is $40 billion, of which National currently services $1.5 billion. National's virtual and modular instrumentation is well-suited and pre-positioned to take advantage of this growing market by capitalizing on lower costs and providing greater flexibility to the end user.

National’s software-centric approach to virtual and modular instrumentation has resulted in differentiated technology, a large installed base with switching costs and high barriers to entry, and consistent gross margins in the mid 70% range. Free cash flow generation gives National the flexibility to drive organic growth through new and innovative products and applications and expand its market share. In addition, management’s significant stock ownership (25%) promotes a long-term view and shareholder-focused stewardship.

Our valuation anticipates long-term revenue growth of approximately 11% and operating margins of 13%. National Instruments is on the cusp of realizing benefits of investments made over the last 10 years to expand and deepen its addressable market. Based on the current stock price, our analysis indicates National Instrument’s long-term average annual rate of return is approximately 7%.

Dated: April 5, 2013