

CANADIAN NATIONAL RAILWAY

Long a part of North America's history of economic growth, railroads have been experiencing a renaissance of late. Industry consolidation and new technologies—such as GPS tracking, more efficient locomotives, and high capacity and double-stacked railcars—have made rail transportation more efficient than ever. While there are numerous economic factors for shippers to consider, when the average rail company can move a ton of freight more than 400 miles on a single gallon of fuel, the viability of rail transportation is undeniable. This efficiency is a very powerful long-term force. Further, given the long-term upward trend of energy prices and increased concern over fossil fuel emissions, rail transportation is likely to become even more popular. Established in 1919, Canadian National Railway (CNI) is still going strong. By using its unique collection of rail routes with unusual efficiency, CNI consistently bests its rail peers with its high-teens net profit margins and industry-leading returns on capital.

CNI's 20,000 miles of rails span coast to coast in Canada and extend southward through Chicago to the Gulf of Mexico, making it the only rail operator connecting all three NAFTA countries. This allows the company to benefit from trade within North America as well as between North America and the rest of the globe. CNI's mix of freight runs the gamut from autos and forest products to coal, fuels, grain, consumer products and more. The ability of competitors to create a similar network is severely limited by a number of factors, such as massive cost and the difficulty in acquiring rights of way. In short, it's clear that CNI's collection of assets represents a powerful competitive advantage.

Railroad companies must manage a myriad of costs, so efficient business operations are critical. In this area, CNI excels. A key operating metric in the industry is the ratio of expenses to revenue, known as the operating ratio, and CNI routinely beats the competition. Its 2008 operating ratio was 62.7%, versus an industry average of about 76.8%.

CNI's management team has successfully created a culture of efficiency. In addition to focusing on costs in general, they track key operating metrics such as car miles per day, engine velocity, daily track miles and terminal dwell time. CEO Hunter Harrison's team has also proven to be effective at strategic planning. They've demonstrated long-term vision through key investments in new technologies that provide real-time metrics across their entire system and through additions of rail lines such as Illinois Central, Wisconsin Central, B.C. Rail, and the recent acquisition of the EJ & E line. For example, control of the EJ & E line will reduce rail congestion around Chicago, a key bottleneck in the American rail system. CNI has also developed exclusive rail access to the important western

Canada port at Prince Rupert, which represents the shortest route to North America from Shanghai China. It may take years for the benefits of the EJ & E and Prince Rupert operations to be realized, but it's clear that CNI is laying the groundwork for greater volumes and increased efficiency. For CNI's shareholders, management has a solid history of paying out a meaningful portion of profits to shareholders in the form of dividends. In 2008, the company increased its dividend by 10%. In short, we believe CNI has the right management in place for continued success.

While we appreciate CNI's unmatched collection of assets and excellent execution, we understand that the underlying business is cyclical. That is, its short-term fortunes are largely tied to the economic ebb and flow of North American economic cycles. As of late, shipping volumes have declined significantly, due in part to the widely publicized drop in auto sales and problems with housing. So while we view CNI's long-term future as bright, investors need to appreciate the cyclical nature of its business.

Financial leverage is always a risk in capital intensive businesses. Nearly 40% of CNI's assets are financed with debt, which is fairly conservative for the rail industry. Importantly, in 2008 the company's operations earned over 10 times its cost of interest. This reflects a reasonable level of debt relative to operations, so we are not worried about CNI's ability to meet its debt commitments. Other, less quantifiable risks include those associated with operating a wide and complex logistics network, such as inclement weather, accidents, labor relations and possible regulatory changes.

CNI is an excellent example of what we look for in a business: a unique collection of assets that competitors can't easily match, an enviable position relative to powerful economic trends, and a management team focused on cost control, execution and shareholders. If investors can consistently harness powerful economic and management forces at a fair price, good long-term returns should follow.

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