October 30, 2013

The market looks high, and it is high; but it's not as high as it looks.

--Benjamin Graham

Dear Fellow Investor:

Ben Graham (1894-1976), the father of modern security analysis, the father of value investing and mentor to a host of star investors, uttered these words in 1955 before a Senate panel interested in determining whether the bull market in stocks under way at the time might in some way threaten the economic expansion that was also under way at the time, whether the market was exhibiting what Alan Greenspan subsequently called, "irrational exuberance." Memories of the crash leading to the Great Depression were still vivid. As is so often the case with Graham, the words he spoke then are pertinent now.

The market is high again, higher than it has ever been. At the end of the quarter ended September 30, the Standard & Poor's 500 Index stood nearly 18% (17.91%, to be precise) above the level at the end of 2012. (The accounts for which we are responsible trailed the benchmark by a few percentage points, no surprise in a "hot" market given our portfolios' fundamentally defensive construction.) As I write, since the close of the third quarter the S&P has tacked on an additional 5.4%. (And the gap between the performance of our accounts and that of the index has narrowed as certain, ahem, *problems* affecting the share prices of some our investments have begun to straighten out.) It seems like every new day brings another new high. With the market going parabolic, are we setting ourselves up for a mighty fall?

The answer, the real answer, of course, is that I don't know. Nevertheless I doubt it. First of all, the new highs we are witnessing are only *nominal* highs. When adjusted for inflation, the level of the S&P 500 has not yet exceeded the high first set in 2000, and then equaled in 2007. The decade 2000-2009 was the worst on record, exceeding by a small margin even the disastrous decade of the 1930s. In January of 2010 I reported this dreary fact to you and commented that it is rare that a long period of bad performance in the stock market is followed by *another* long period of bad performance; usually the reverse is true. This has been the case since the unlamented (from the investment point of view) end of the first decade of this millennium. We have a lot of catching up to do.

Speaking of past epistles, a year ago I began my letter to you with a quote from Ben Graham's pupil, Warren Buffett: "I have a simple rule: I am fearful when others are greedy and greedy when others are fearful." I then cited a number of items that, despite good recent performance and decent valuation, indicated a high degree of fear among investors regarding the stock market. These indicators included movement by the general public out of equity funds and into bond funds, where returns were almost

certain to be disappointing; personal anecdotal evidence relating to conversations with Weybosset Research clients and in the board rooms of various institutional investors to which I was privy; and, my favorite, Richard Bernstein's Wall Street Sentiment Indicator. To refresh your memory, the Wall Street Sentiment Indicator is, "…a survey of Wall Street strategists' recommended equity allocation for a balanced fund. Extreme readings (i.e., one standard deviation above or below the long-term norm) have historically been reliable sell and buy signals." To further refresh your memory, the Wall Street Sentiment Indicator is a contrary indicator, that is, when Wall Street is most enthusiastic about stocks, the market is least likely to do well and vice versa. In the summer of 2012, the Wall Street Sentiment Indicator had never been more bullish, i.e., Wall Street strategists had never been more bearish about the future of the stock market.

None of these sentiment indicators have changed markedly, even though the market is more than 25% higher than when I wrote to you a year ago. When interest rates began climbing earlier this year and bonds began to lose value, the public indeed redeemed some of its bond fund holdings, but a commensurate flow into equity funds, if it happens, is just beginning. It appears that the proceeds of redemptions are largely sitting in cash. Our clients are no longer calling wanting to know if we should get out now while there's still time, but neither have I detected any signs of celebration out there. Institutional investors do not appear to have lost any of their enthusiasm for very expensive but on the whole poorly performing "hedged" strategies. And the Wall Street Sentiment Indicator, though no longer in record bullish territory, remains solidly positive. Fear is a hard feeling to shake.

Then there is the question of valuation. This is the kind of thing that, when it comes to the overall stock market, can be debated endlessly. What is the right measure to use? The ratio of price to earnings (P/E)? If so, which earnings, operating or reported? Shiller's P/E or regular old P/E? The ratio of price to book? Tobin's Q?

Fortunately for us (and hopefully for you), we at Weybosset Research & Management LLC spend little or no time pondering the valuation of the overall market. We spend *lots* of time thinking about the valuation of individual securities, especially the ones we own on your behalf or are considering owning on your behalf. In these cases I would say things in general are priced about right, neither outrageously high nor way too low. There are exceptions, of course. When one of our holdings gets stretched out valuation-wise, we sell some--not all, but some, as we like to stick with a great story. And certain of our investments are certifiably priced way too low, especially, these days, in the Master Limited Partnership (MLP) space. We are always happy to put extra cash to work when the price is right.

So from the point of view of valuation—not too hot, not too cold; sentiment—hardly frothy; or where we appear to be in the cycle, things look and feel OK. The most important item in the calculation, corporate profits, is also coming along satisfactorily. Given most investors' woeful underweighting in common stocks, and the paucity of plausible alternatives, these things combine to provide a strong tailwind. I am pleased to report that we at Weybosset Research & Management LLC are *not* underweight common stocks, and so am inclined to enjoy the ride.

One note of caution that I keep repeating to myself: human nature is such that we tend to take the recent past and extrapolate it indefinitely into the future. In a rising market, risks already taken are rewarded, encouraging us to take bigger risks, which in turn are rewarded, and so on, until, usually without warning, the inevitable day of reckoning arrives. I regard it as crucial that we at Weybosset Research & Management LLC do not give in to this temptation. We need more than ever to adhere to our discipline of holding only the best quality securities acquired at prices allowing for *a margin of safety*—Ben Graham's three most important words in investing. We pledge to keep our eyes on the ball on your behalf.

As ever, thank you for your support, and PLEASE do not hesitate to get in touch with us with any comments, complaints, or questions. We would love to hear from you.

Yours very truly,

Fla Lewis III
Principal

P.S. Since Ben Graham's testimony in front of the Senate Committee on Banking and Currency in 1955, the Dow Jones Industrial Average—the Standard & Poor's 500 had not yet been constituted—has risen more than *three thousand eight hundred percent,* not including generous dividends. We're in a good game!