Dear Fellow Investor:

2013 was a banner year for the U.S. stock market with the S&P 500 putting up its biggest return (32.39%) since the heady days of the second Clinton Administration (1997, to be precise) when the market was roaring and the term, "tech bubble" had not yet entered the general vocabulary. One commentator explained the move by saying that in 2013 the market adjusted to and priced in an environment in which the end of the world is not imminent. He means that investors concluded that a return to the days of high financial stress (or worse), the kind we endured in 2007-2009, is unlikely in the foreseeable future, and acted accordingly.

This is largely because certain macro threats, threats from the global economy and financial system, receded markedly in 2013. The European Union is less likely to disintegrate and wreak global havoc. Despite an utterly poisonous and dysfunctional milieu in Washington, the U.S. economy crawls doggedly ahead and the chance of a cataclysmic default by the U.S. Treasury is diminished. China, the third item on the macro worry list, remains an open question, but the chance of a growth slowdown there, which is certainly transpiring, morphing into an outright crash is not as great as feared a year ago. (Given China's debt levels, the opacity of its political system, the pervasiveness of corruption and significant imbalances in the economy, the situation in the world's second largest economy merits continued and close monitoring.)

And, crucially, as the big macro issues retreated, corporate profits remained robust, though growth in profits is frustratingly difficult to find. As a result, publicly traded American firms focused on "returning capital" to shareholders, i.e., buying back stock and raising dividends. In an era of "financial repression", an era in which governments around the world keep interest rates pretty close to zero in an attempt to stimulate economic activity and keep (enormous) government debt burdens serviceable, higher dividends and increased ownership via lower share counts of profitable enterprises is a combination appealing to investors.

Though the stock market went up dramatically in 2013, perhaps as important is what went down, or what did not go up much. For instance, market volatility hit its lowest level since at least 2006. Correlations, or the degree to which all securities move in the same direction and by the same magnitude, reached a post-crisis low. The latter implies that changes in individual securities prices were more a function of company-specific developments than, say, the likelihood that Italy will default on its debt. Things are getting back to normal (whatever that is)!

But from my point of view, the most significant change is the possibility that a thirty-two year bull market in bonds came to an end in 2013. Remember that bond prices move in the opposite direction of interest rates: rates down, bonds up; rates up, bonds down. Interest rates began an inexorable march upward at the end of the Second World War, finally peaking in 1981 at nearly 16% for the long-term Treasury bond. (Other interest rates tend to key off the relevant Treasury level.) Since then rates have worked their way downward in zig-zag fashion, finally getting to virtually zero on short rates currently, and only 1.65% on the ten-year Treasury note in 2012. Now when rates are zero or close to zero, the next big move in rates HAS to be up. How far and how fast remain to be seen.

Warren Buffett once remarked that interest rates are like gravity—you can't see them but their effects are felt everywhere. Using that analogy, the force of gravity is in the process of increasing. What are the effects on asset prices? Well, for stocks, we know that prices can rise regardless of the direction of interest rates. That was the case in the aftermath of World War II, which saw an enormous increase in share prices at the same time that rates were moving up, and in 2013 when a drop in bond prices of 2-5%, depending on which index you pick, was accompanied by an advance in stocks not seen since the days when Madonna was considered young, alluring and risqué. If rates are rising because economic activity is picking up and profits are increasing, stock market investors become enthused.

Bonds, not so good. Rising rates equal lower bond prices. Now, since 1981 the occasional spike in rates has not been a problem for bond investors, as the prevailing trend, the longer-term trend, was ever-lower rates. You could, for instance, buy a bond in 1993 and, six months or a year later, see your investment under water; but two-to-five years later, you were fine or well ahead of the game. Thus bonds became "safe" investments in the minds of investors, not just because of their superior place in the capital structure and the fact that a maturity date meant you'd have your capital back at a predictable moment in time, but because the wind was at your back trend-wise.

This was not always the case. I mentioned that after the Second World War, interest rates only moved in one direction, and that was up. When I first entered the securities business in late 1980 (!!), the gallows humor of the day was, "How do you get a million dollars out of the bond market?" "Start with two million!" If those days are coming back, many investors will be caught facing the wrong direction; their "safe" investments may not prove safe at all. (This, by the way, would not be the first time "safe" investments proved anything but safe!)

Michael Hartnett, the chief investment strategist at Merrill Lynch, and his team began talking in 2012 about a "Great Rotation," a movement by investors all around the world out of fixed income investments and into equities. Stunned and stung by the miserable bear markets of the decade 2000-2009, investors large and small fled stocks and huddled under the perceived safety of bonds, cash, or, in many institutional cases, turned their money over to managers of very expensive "hedged" investment products. The trouble is that bond rates are now too low to fulfill almost any return mandate—how many endowments or retirees make their plans assuming a 2-3% return?—and with interest rates rising, the return number is not 2%-3%, it is negative. I marveled to you in October of 2012 that investors, despite good valuation and good recent returns, had continued to liquidate stock funds and buy bond funds. That trend reversed in 2013 and Merrill's "Great Rotation" very well may be under way. Given the poor positioning of so many investors, large and small, the trend could carry the stock market MUCH higher.

A decade-long bull market in industrial commodities—think iron, copper, lead, that sort of thing—did not so much screech to a halt in 2013 as continue to peter out. The most dramatic expression of the end of the commodity "super cycle" was the collapse in gold prices early last year. Gold means a lot of things to different people; some are fans, some are not. (I am agnostic). But historically, gold prices have appreciated in periods when real interest rates, that is, the rate of interest minus the rate of inflation, were negative. Thus it is no historical anomaly that the price of gold peaked and then headed decisively south just as the *prospect* of higher rates appeared on the horizon.

Related to the end of the commodity boom was the dramatic underperformance of emerging market equities in 2013. In contrast to the outsize gains in developed economies markets—the S&P 500 had a huge year, but the champion was the Nikkei Dow, up nearly 57%--the Morgan Stanley Emerging Markets Index finished the year flat-to-down, depending on how you measure. The ten-ton gorilla in any consideration of emerging markets is, of course, China, where the Shanghai Composite *declined* by a high single-digit percentage and now stands not far above its 2008 low.

Here at Weybosset Research and Management we certainly got the asset allocation part of the puzzle right. We took profits (good profits) in most of our various commodity-related investments over the course of the last few years. (We still have positions in *North American* oil and gas and in trees.) Beginning with the onset of the financial crisis we had a substantial allocation to bonds or bond-like securities, which served us well and with little risk. But in recent years we either traded them or let them "runoff", i.e., mature, to the point that bonds were not a large portion of our typical account in 2013. As a result our returns for 2013 were in the low-to-mid 20% range—a good year by any measure, but far behind our benchmark, the S&P 500. The reason for the shortfall is, as I have explained previously, the fundamentally defensive nature of our portfolios. In a "hot" year like 2013, accounts loaded with blue chips, pipelines, and cemeteries were bound to trail a market led by the likes of Netflix and biotech companies. Merrill Lynch describes the typical outperforming stock in 2013 as "high beta [i.e., more volatile than average], low-quality". These attributes do NOT characterize our holdings.

But a conservative portfolio may not be such a bad thing to own in 2014 and beyond. The presence of ample liquidity—central banks around the world are keeping policy at the wide-open setting and are likely to keep it there for an "extended period"—together with the waning of past investment favorites such as bonds, commodities and emerging market equities could result in a situation in which developed market stocks find themselves the only game in town. Together with the relative underrepresentation of common stocks in individual and institutional portfolios, this could propel the market meaningfully higher. It could also result in mania-like psychology of the type that has ended in tears so often in the last ten or fifteen years. We think it prudent to enjoy the ride higher, but with due and increasing wariness.

Thank you, thank you, thank you, Fellow Investor, for your business and your support. And give us a call, shoot us an e-mail or arrange to drop by. We would love to hear from you.

Sincerely,

Fla Lewis III