Mountains labor mightily and bring forth a ridiculous mouse!

April 21, 2015

Dear Fellow Investor:

The Latin poet Horace's rendition (in English translation) of an ancient Greek proverb sums up my take on the performance of the stock market in the first quarter of 2015. Volatility increased strikingly in the quarter from the norm of the past few years. For instance there were sixteen days in March in which the S&P 500 rose or fell a full percentage point or more—and in March there were only 22 trading days! Yet the S&P 500 finished the quarter barely four tenths of a point (0.44%) higher than it ended 2014 (0.95% with reinvested dividends). The accounts for which we are responsible gyrated in like fashion but ended very close to where they had begun the quarter.

To the extent that our investments encountered fundamental (as opposed to merely market price) difficulty in the quarter, and the end of last year as well, the problem can be summed up in one word: *commodities.*

The irony here is not lost on me. You may recall that in the wake of the financial disaster of 2008-9 (the "GFC", for "global financial crisis", as it has become known in professional investment jargon) we made significant investments in a wide variety of commodity-based securities. At the time (and continuing today), central banks all the way around the world were printing money at a frantic pace in an attempt to restore a heartbeat to a comatose global financial system. Ben Bernanke, the U.S. Federal Reserve chairman when GFC struck, earned the moniker "Helicopter Ben" by famously remarking that if necessary, he could drop money out of a helicopter. GFC delivered the necessity and Bernanke, together with his successor, Janet Yellen, and fellow central bankers elsewhere on the planet, delivered the money (though not by helicopter).

Our concern here at Weybosset Research & Management was that this promiscuous printing of paper specie would eventually result in rampant inflation. A good defense against inflation is ownership of "hard" assets, things you can touch and use in everyday life, things which should hold their value relative to the eroding value of inflated currency. Thus we invested in industrial commodities such as lead, copper, zinc, iron ore and manganese (sometimes plucked from the bottom of the ocean), timberland, gold and *North American* oil and gas reserves. But over time—and we are, after all, long-term investors—commodity prices have declined in real terms, i.e., after inflation, since at least 1800. We therefore regarded our commodity investments as hedges, insurance against possible currency debasement, but available to trade under the right circumstances.

And trade them we did, in each case profitably. The single exception, the only position we kept, is a U.S. oil and gas production partnership which hedges its production in the futures market, essentially selling today's and tomorrow's output at yesterday's prices, putatively protecting us from perturbations in petroleum prices. The hedges did the trick in the dark days of GFC, but, alas, the precipitousness and magnitude of the decline in the oil price in late 2014-early 2015 was such that the efficacy of the hedge book was simply overwhelmed. (The fact that the partnership was in the midst of a re-jiggering of its drilling properties, leaving nearly a quarter of production temporarily unhedged, did not help I might add).

So the steep drop in oil prices caught us with our pants down, though we thought our pants were up and tightly belted. (I know of no pundit who predicted the collapse). Sometimes hedges work, and sometimes they do not; I assure you, the lesson is not lost on us. At current prices we believe the partnership in question offers good value, so we're holding it and looking to add to our position as circumstances allow.

Another source of volatility in the markets in 2014 and the first part of 2015, and a likely cause of further instability this year, is the timing of so-called "liftoff", the Fed raising short-term interest rates for the first time since 2006 (!!). Here I defer to Gerry Curtis, formerly of Kidder, Peabody & Co. and Eaton Vance, currently commenting in *Views from the Sidelines*:

> If the Super Bowl is the most overhyped sporting event, the anticipation of the Federal Reserve raising the federal funds rate is probably the most overhyped financial event. The decision to save or spend by millions of businesses and individuals worldwide will determine any change in the interest rates. The Federal Reserve will respond to changes in unemployment, inflation, GDP and currency fluctuations. I doubt that a ¼% increase in the federal funds rate will influence the decisions of most companies and individuals. The Federal Reserve raised the federal funds rate by ¼% *seventeen times* between June 2004 and June 2006 without negating the financial crisis of 2008. I suggest that the securities markets over-respond to anticipated actions by the Federal Reserve. (*Views from the Sidelines* #149).

I suggest that neither you nor I lose any sleep over the re-normalization of interest rates. On balance it is a good thing, indicative that the U.S. economy is healing from the trauma of 2008-09. Unquestionably adjustments will need to be made, and the markets may labor mightily, but I agree with Gerry that in the end not much more than a ridiculous mouse is likely to be brought forth.

In a similar vein, the long melodrama between Greece and its creditors in the Eurozone finds its way into the headlines from time to time. Will Greece remain in the European Union? Will Greece default on its debt? I have no particular insight into this particular puzzle, but I do know that 1) the other so-called "peripheral" EU countries, Italy, Ireland, Spain and Portugal, are in far better financial condition than just a few years ago, so the danger of a contagion effect from Greek default is vastly reduced; and 2) according to Carmen Reinhart and Kenneth Rogoff in their landmark study of financial crises, *This Time is Different,* "From 1800 until well after World War II, Greece found itself virtually in continual default…". From 1800 until well after World War II, the global economy on balance grew and in some cases grew meaningfully, despite the "continual" bankruptcy of Greece. If Greece defaults again, I doubt that this time will be different.

I do not wish to convey a sense of complacency about the condition of or the outlook for the financial markets. I merely wish to note that volatility has picked up considerably and is likely to remain elevated. This is for a number of reasons. Regulators, for example, trying to avoid a repeat of the GFC, have mandated reduced risk for the big Wall Street banks. But this in turn means less participation in the markets for institutions that have traditionally acted as intermediaries and buffers against disorder. So-called high-frequency traders (HFTs) have become as much as forty per cent of daily stock market volume according to some studies. HFTs are not at all interested in the fundamentals of markets or individual securities, but seek to exploit price momentum for very short-term (as in milliseconds) gain. As a result, they exaggerate that momentum, both up and down. Last week British authorities arrested Navinder Sarao, an HFT who, working from his semi-detached home in a suburb of London, helped cause the May 6, 2010 “flash crash” in which at one point the Dow Jones Industrial Average plummeted 1000 points (!!). Yet nearly five years later, the Dow is more than seventy per cent higher than its close on the day of Sarao’s suspected shenanigans.

My point is that we should keep our eyes firmly fixed on fundamentals underlying the markets and, most importantly, fundamentals underlying the individual securities in which we are invested. The twenty-four-hour-a-day news cycle will provide plenty of distraction, plenty of noise, as it always has. But the overall situation is far better than it was only a few years ago, and with regard to our holdings, I doubt if we have ever held a stronger hand. All that is required is a little patience. Yes, market craziness will continue, and yes, I can be counted on to pick the occasional stinker; but you can be sure no effort will spared around here to insure that your trust in us brings forth considerably more than a ridiculous mouse.

Thank you for that trust.

Yours very truly,

Fla Lewis III
Principal