January 21, 2016

Dear Fellow Investor:

Less than meets the eye

Statistically, 2015 looks like a fairly uneventful year. The S&P 500 was down a little bit (-.73%) or up a little bit (+1.38%) if reinvested dividends are taken into account. But these numbers mask a less sanguine reality. Fully 95% of the S&P 500's 2015 results were attributable to the ten largest companies in the index. (Remember the S&P 500 is a capitalization-weighted index—that is to say, the performance of the largest component of the index, Apple, Inc., is far more consequential than that of a smaller company, say, Clorox). The top ten companies in the index were up on average around 17% in 2015 while the rest of the index was *down* more than 5%. Within the top ten companies, results were heavily skewed toward the so-called FANG names—Facebook, Amazon, Netflix and Google. Absent FANG representation, the typical U.S. stock portfolio suffered a down year as the average S&P 500 stock was down between ten and fifty per cent in 2015.

We at Weybosset Research & Management LLC are not FANG owners. Will Facebook profits assuredly be higher in ten years than today? Will Facebook exist in ten years? Will Netflix dominate the TV sets of 2025 (if there are TV sets in 2025) or will it have been disintermediated by some as yet unknown entity, just as Netflix disintermediated the likes of Blockbuster Entertainment, the movie theaters or the television networks? Amazon trades at more than 300 times 2016 anticipated earnings. These are not our types of companies or stocks.

Results for the portfolios we manage were more in line with the broader market for 2015—our average account was down mid-single digits. Obviously we're not pleased with this result, but I would point out that we have gone six straight years without posting negative results; it may be that we were overdue a modest step back in an otherwise steady advance.

Two items dominated the negative narrative last year, the beginning of a regime of interest rate increases coming from the U.S. Federal Reserve and developments in China. With regard to the former, the fear is that the Fed has begun raising rates at a time when the global economy, while far from crumpling, is nevertheless flat as a board. The analogy proffered is 1937 when the Fed began raising rates before the U.S. had fully recovered from the shock of 1929-32 and the economy plunged back into depression.

China was the engine of global economic growth for much of this century as its 1.4 billion inhabitants demanded all kinds of commodities, from cement to copper to steel to oil to food, to facilitate one of the most remarkable marches from abject poverty to relative prosperity in the history of the planet. (Fun fact: between 2010 and 2014 China used more cement than did the United States in the entire 20th Century!). But even China can use only so many beautiful airports, excellent highways and tall buildings. (For years now, nearly half of China's GDP came from investment; the comparable figure for developed economies such as the U.S. or Europe is more like 20%). So China has begun a program of relying less on large infrastructure projects and more on domestic consumption, a la the U.S. or Europe.

This has not been an easy transition. One result has been a breath-taking collapse in commodity prices as Chinese demand cooled. The most obvious casualty is the price of oil. Oil peaked at $147 per barrel in 2008. The median prediction by Wall Street research departments for oil in 2015 was $100 per barrel, with the lowest estimate being $90; oil finished the year barely above $40. As I write, oil has gone below $30. Greatly increased supply due to the appearance on the scene of vast new reserves in North America, a result of the shale oil revolution, together with the resiliency of big producers such as Iraq and the re-entry of Iran into the global oil market, just as sluggish economies around the world tempered demand, has been cited as the prime reason for the breakdown in petroleum prices. While certainly true as far as it goes, it is also true that other commodities, from copper to iron ore to agricultural products seem to set new lows nearly every day. Oil has become a proxy for tepid global economic activity. (Fun fact: in 1965, gasoline cost 30 cents per gallon; at the end of 2015, adjusted for inflation, gas cost 26 cents).

Chinese authorities also decided that part of the transition to a more consumer-driven economy should include a functioning stock market so that vast pools of Chinese savings could be channeled into financing the economy rather than residing in Chinese mattresses. However, Chinese authorities, being heirs of Mao Tse-tung, also desire to *control* the stock market and have made some serious mistakes along the way. For instance, listed Chinese companies can suspend trading in their stocks at their own option. At one point last summer, only 19% of publicly traded companies were actually open for trading. You can get in but you can't get out—not good for confidence! In a similar vein, Chinese regulators introduced "circuit breakers," rules that would stop trading if markets decline more than a specified amount. The circuit breaker rules were soon jettisoned after it was discovered that the market could stay open less than half an hour before the circuit breakers were tripped. The result of these and other attempts to herd the cats that make up markets has been an utterly topsy-turvy stock market, alternating between rocket ship run-ups and heart-stopping plunges. Again, not good for confidence.

The obvious question is why should we as long-term investors care about the Fed or China? After all, the Fed is implicitly giving the U.S. economy a vote of confidence by raising rates, judging that the economy is sufficiently robust to tolerate a less suppressed price of money. And here at Weybosset Research we have very little exposure to China. We own no Chinese securities. We've sold all our commodity-producing companies. Yes, we do market toothpaste and beer in China (and the occasional diesel engine), but these businesses are doing well. And don't lower commodity prices act like a giant tax cut for the vast majority of consumers? Shouldn't markets be celebrating?

The answer lies in something I wrote to you about last April and that is the fact that markets are much thinner now than in the past. This is partially the unintended consequence of steps taken by regulators in the wake of the global financial crisis (GFC) of 2008. Regulators, 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. Then there are the high-frequency traders (HFTs) who now comprise as much as 40% of trading volume on a given day. 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. HFTs tend to exaggerate market momentum, both up and down.

Thinner markets mean that dislocations in, say, China or the high-yield bond market—under pressure due to the large number of junk-rated energy companies—reverberate much more widely and profoundly than would have been the case ten or fifteen years ago. The risk is that a rapidly retreating market degenerates into panic.

Something of this sort has set in since the first of the year. It appears that January 2016 will go down as the worst January since record keeping began in the 1920s. As I write, the S&P 500 has shed about 10% of its value since year-end 2015.

It is a little difficult for a student of the fundamentals to understand the stampede. While far from booming, the U.S. economy continues to chug along, with employment (finally) picking up, the housing market recovering from the disaster of 2007-2008 and automobile sales setting an all-time record in 2015. Consumer sentiment in the U.S. continues to improve. These are important matters as full-blown bear markets rarely develop in the absence of economic recession, and recession is nowhere on the horizon for the U.S.

Likewise bull markets usually end not with the profound pessimism ubiquitous among investors today, but with a kind of *it-can-only-go-up* euphoria. For example, Corbin Perception, an investor relations and advisory firm in Farmington CT, surveyed 73 investment managers globally representing more than $1.8 trillion in assets under management and found "an overwhelming 69% of respondents describing themselves as *neutral* to *bearish.*" And the survey was conducted *before* the current January meltdown! The American Association of Independent Investors polls mom-and-pop investors and its most recent review found only 18% expect stocks to rise (vs. 19% in 2008). This just is not the type of sentiment one finds at the top of bull markets. It is more typical of the bottom.

Nevertheless, the markets are very heavy, but I believe we at Weybosset Research are prepared. We've let cash levels in our accounts drift upward and they now stand at the highest level since 2008. We own no emerging markets securities, no commodity-producing companies or junk bonds. Our companies have proven records of consistent profitability, growth, competitive advantages in their respective industries, clean balance sheets and proven leadership. The share prices may be down, but the businesses are doing just fine, thank you. Our portfolios are constructed to weather any storm and I am confident we will weather this one. All we need is a deep breath and a little patience.

As ever, my thanks for your support and the confidence you have placed in us. We remain permanently available for any and all questions, comments, or complaints. We would enjoy hearing from you.

Sincerely,

Fla Lewis III
Principal