October 7, 2010

Dear Fellow Investor:

In my last letter to you, dated April 23, I noted that, as of that date, the stock market had continued its impressive rebound from the profoundly depressed levels reached in early 2009 (“albeit at a more stately pace”), and that, given reasonable valuations and decent fundamentals, the trend was likely to continue “for the foreseeable future”. My letter had barely arrived in your mail box when we experienced one of the worst months of May on record, followed by an equally dispiriting June. By the end of June, the S&P 500 was down nearly eight per cent from where it started the year. So much for my prowess as a prognosticator!

Fortunately for you and for us, we do not invest your capital based on a particular opinion about the direction of the stock market. We seek excellent companies with sustainable competitive advantages available at prices that we believe will prove too low as time goes by. We then buy shares in these companies and hold them for long-term income and appreciation. No attempt is made to trade or “play” the market.

This approach has stood us in good stead so far in 2010. At the end of the third quarter, the S&P 500 had come back to some extent and stood a little more than two per cent higher than on December 31, 2009. Our accounts were uniformly better than that; for the most part, much better than that.

It may be worthwhile to note where we made our money and where we did not. The one word that comes to mind in the “what we did right” category is: INCOME! In a world in which returns on (supposedly) risk-free assets like money market funds, certificates of deposit, and Treasury securities is practically nil, blue chips like Coca Cola or McDonald’s, with dividend yields in excess of 4% (at the prices we paid for them), look pretty good. Thus, for example, one of the worst performing sectors in the S&P 500 year-to-date was energy. We have substantial investments in energy producing companies, but much of that is in master limited partnerships (MLPs), which feature high and tax-advantaged streams of income. Thanks to this latter characteristic, our MLPs now trade at prices at or above levels reached before the onset of the financial crisis in 2007-8, while even the best large oil companies bump along near the bottoms reached in early 2009. And, by the way, we continue to collect the income from those investments, the “rent,” an attractive return in its own right.

The word that comes to mind when I think of what did NOT work so far this year is: GROWTH! In a world of generally sluggish economic activity, growth is scarce, and, in a decidedly cranky stock market, the price for being wrong on growth is high. Even apparently easy decisions—people going back to school to improve their training when jobs are hard to find, increased crop yields to help feed a hungry world, getting in the way of some of the hundreds of billions of dollars appropriated for the government’s economic stimulus plan—have not worked out. Fortunately, the size of our commitments to those areas never became very large.

So we continue to look for investments that offer income, that is, current yield, as a component of investment return. To a certain extent this leads us back to the "credit basket" portion of our portfolios, about which I have written in prior missives. Earlier this year we began scaling back on the "credit basket" as a recovering global economy presented us with the threat of future inflation, the mortal enemy of the fixed income investor. But the factors that tanked the market this spring, i.e., multiple indications that economic growth is in fact *de*celerating, make it unlikely that we face a torrent of inflation any time soon. Therefore we reactivated the "credit basket" as a way to take advantage of high market rates of return as distinct from historically and artificially low official rates. But we are keeping a close eye on the "credit basket" as we have no desire to hold a slew of long bonds if and when inflation heats up.

The smallest of our baskets, the "cyclical basket", has become a little smaller yet, as tepid global economic conditions make a bet on improving demand less safe. We sold some of our less promising positions. Nevertheless, we still like manufacturing companies, particularly if they meet our paramount criterion of a sustainable competitive advantage.

In contrast we have held and added to our investments in the "commodity basket". From the defensive perspective, we view hard assets as a hedge against the depredations of heavily indebted governments against their own currencies; from the offensive perspective, these investments give us a chance to participate in the growth (there's that word!) of developing economies, especially in Asia and Latin America.

Finally, we are most interested in what I have termed the "quality basket", companies that are world-class leaders in their respective industries, companies evincing long and consistent records of high profitability, growth in earnings per share, sustainable competitive advantages, balance sheet strength, and outstanding management—in short, the usual Weybosset Research type of investment. The "quality basket" inhibited our progress in 2009, but has helped us very much so far in 2010; I am convinced that will continue to be the case.

Our portfolios then are characterized by: 1) quality; and 2) diversification; with an eye toward 3) income. But, ever mindful that we are operating in a dangerous environment, the greatest of these is quality.

Thank you for your continued support and for the privilege of working for you. As ever, if you have any questions or comments, don't be shy, get in touch with us. We welcome the opportunity to further discuss with you the *interesting* times in which we live.

Yours very truly,

Fla Lewis III
Principal