January 27, 2011

Dear Fellow Investor,

Happy New Year!

I am pleased to report that 2010 was a fine year for stock market investors, with the S&P 500 returning about 15%, and an even better year for the vast majority of Weybosset Research & Management portfolios.

As I mentioned in my last letter to you, the word that comes to mind when we think about what worked for us last year is, INCOME. The financial disaster of late 2008 and early 2009 wreaked havoc on nearly every asset class, including fixed income securities (non-U.S. Treasury bonds and virtually all preferred stocks), or securities that often act like bonds, i.e., income-oriented investments such as master limited partnerships (MLPs), real estate investment trusts (REITs), or common stocks featuring high dividend yields as a component of total return. The flight from these types of investments was so acute that by the end of 2008, credit spreads, the difference between what the most credit-worthy borrowers, i.e., the U.S. Government, paid to borrow and what all other borrowers paid, had blown out to levels not seen since the nadir of the Great Depression in 1932. Even though recovery from the trough of the Depression took years, with many fits and starts along the way, credit spreads tightened quickly and dramatically after 1932.

We reasoned that a similar thing was likely to happen in 2009 and 2010, and invested accordingly. Two major benefits accrued to us: 1) we locked in very high current returns on perfectly good securities; and 2) as spreads tightened—as the lofty premium paid by non-governmental borrowers diminished— prices of the underlying securities increased, in some cases spectacularly. Put another way, after panicked investors caught their breath, they noticed they were essentially being paid nothing on their CDs, money market funds, and Treasury bills, their "risk-free" investments. They also noticed that they could earn substantially more by purchasing corporate bonds, preferred stocks, MLPs, REITs, and the like, without taking on a lot of additional risk. The "search for yield" was on, very much to our advantage as we already owned the high-yielding securities.

Perhaps the best of a good bunch in what we came to refer to as our "credit basket" (and which also did duty in the "commodity basket") are the MLPs in which we invested. On the one hand they behave like fixed income investments in that they provide a steady and (hopefully) dependable stream of income, while on the other hand the sources of that income stream are commodity-based. In an inflationary environment, which can easily arise as our government prints a vast number of dollars in an effort to refloat the economy, the best things to own are hard assets such as commodities, because historically they have held their own as the value of the dollar decreased. Conversely, in a deflationary environment, which again can easily arise when high levels of private and public debt prove unsupportable, a steady stream of income is the desired asset as other assets lose value relative to the dollar. MLPs give us the best of both worlds, protection from fire (inflation) and protection from ice (deflation). And, thanks to the fact that they were available at rock-bottom prices for the last few years, they have appreciated mightily.

I take this occasion to sing the praises of MLPs because, despite their highly attractive investment attributes, everybody hates them at least once a year, and that is when one has to deal with the dread Form K-1 at tax time. Admittedly K-1s are a real pain in the neck, but it is this very complication that tends to keep large institutional investors away from MLPs, which in turn allowed us to invest at shockingly low prices. (By the way, I am informed that certain sophisticated institutional investors, the Harvard University endowment, for example, have decided that MLPs are attractive enough to warrant hiring entire accounting staffs to deal with the bookkeeping complications.) So this year when the K-1s roll in (invariably late), just remember how much money we've made with MLPs. If you or your tax advisor has trouble dealing with them, give us a call. We have been MLP investors since the late 1980s and have learned some useful tricks we'd be happy to share.

One last point with regard to MLPs: Prices have moved way up and are now as high as they were in the summer of 2007, before the financial disaster and collapse in MLP share prices. For the reasons cited above, and for others as well, we consider our MLPs excellent investments, but I doubt we will see the kinds of returns from them in the next two years that we have seen in the past two years.

Where might we make our money in 2011 and beyond? This letter will mark at least the seventh or eighth time I've pounded the table on U.S. blue chip stocks. Their prices have gone nowhere for more than ten years now, while earnings, dividends, and book values have advanced steadily. As a result, valuations are near historic lows, and business prospects—due to strong balance sheets, strong cash flows, and industry leadership on a global scale—have rarely been better. In 2009, our heavy and growing ownership of The Blues inhibited our progress to a degree, but in 2010 that trend began to change.

Berkshire-Hathaway, in many accounts our largest single investment, is a good example. In 2009 the S&P 500 was up more than 26%, but Berkshire less than 3%. In 2010, however, the market was up about 15%, but Berkshire popped a pleasing 22%. Likewise in 2010 the markets began to appreciate the fact that, whatever the economic outlook, people all around the world were eating more hamburgers and drinking more Cokes. If this trend continues, we have a pleasant future ahead of us. There is plenty of room for appreciation in our blue chips. If the trend does not continue, at least we have investments in rock-solid companies paying us good and growing dividends. We could do worse!

And, of course, we will continue our search for odd-ball (but profitable) special situations, such as, say, a chain of membership club warehouses in the Caribbean and

Central America, or a company with a corner on the radiation dosimetry market in North America and increasingly in Europe and Japan, or a partnership devoted to burying dead people.

I noted that we have had success capitalizing on the blow-out in credit spreads that occurred during the 2008-09 meltdown. Spreads have now returned to levels last seen before the bankruptcy of Lehman Brothers, which is to say, wide, but not outrageously wide. Therefore expect us to be less active in the fixed income markets.

We continue to look for ways to take advantage of the growth of the developing world, especially in commodity-based situations, and within commodities, especially energy. As ever, the focus will be on the highest-quality investments available at the best possible prices. Over time the market pays a premium for quality, as well it should. Our goal, now, in the past, and forevermore, is to acquire quality at a discount then patiently await the advent of the premium.

You should be hearing from Karin or Jeannine or me in the near future to arrange a discussion of your portfolio, your needs and our plans. But you don’t have to wait for the phone to ring or for the e-mail box to go *boink*. Ring us up or send us a message and let’s get together.

Thank you and I remain,

Fla Lewis III
Principal