April 19, 2011

Dear Fellow Investor:

An article in *The Wall Street Journal* a week or two ago proclaimed that the first quarter of 2011 was "the best first quarter for the stock market since 1997." This in spite of the fact that the markets were confronted with: 1) a triple disaster in Japan: earthquake, tsunami, nuclear meltdown; 2) revolution, civil war, and widespread civil unrest across the crucial energy-producing region of the Middle East and North Africa; 3) the possibility that when the Federal Reserve Bank in a few months ends its "QE2" program, designed to keep a lid on long-term interest rates, there will be no one on hand to buy the debt that gushes from the U.S. Treasury; 4) exploding food and oil prices; 5) continued high unemployment in the U.S.; 6) a housing market for which the description "moribund" would be kind; 7) a sovereign debt crisis in Europe that shows no sign of improvement—if anything, it looks worse now than a year ago when the S&P 500 began an 11% descent; and 8) speaking of sovereign debt crises, yesterday Standard & Poor's reaffirmed the AAA credit rating of the United States of America, but with, for the first time, a "negative outlook," warning potential buyers of Treasury debt that the credit-worthiness of our great land is deteriorating—as if they were not already aware!

Quite a list of negatives! Nevertheless the S&P 500 returned 5.92% in the January-March period, real testimony to the market's resiliency. Most of the accounts for which we are responsible did that well or a little better.

On the whole I am gratified by our mediocre-to-a-little-better-than-mediocre performance in the first quarter of this year inasmuch as one of the main drivers of our performance for the past two years, the collapse of the huge credit spreads that mushroomed during the panic of 2008, is largely spent. Spreads are about where they were prior to the bankruptcy of Lehman Brothers, which is to say, elevated, but not historically extreme. Thus we have been gradually transitioning from our "credit basket" of investments, which I have described in previous missives, to something that might more closely resemble traditional stock market investing. It is nice to see some of our new positions working for us faster than expected. Though patience is putatively a hallmark of our investment style, I relish instant or near-instant gratification as readily as the next fellow.

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I have spoken to you extensively, perhaps ad nauseam, about the danger, the very great danger, posed to your investments by our governments'--Federal, state, and local--foolish fiscal habits. The idea of spending no more than you take in, *sine qua non* in any family's planning, is evidently an alien concept to those responsible for our government's budget. This is true not only in the U.S., but throughout the developed world. Trouble in Europe or Japan, however, will seem as child's play in the financial markets if the United States runs into difficulty paying its debts.

It is not hard to understand why governments have so much trouble balancing their budgets. The heavy incentive for any elected official is to promise as much as possible to as many as possible in order to get elected, then, thanks to the availability of seemingly unlimited borrowing power, push the problem of paying for those benefits down the line to the next batch of public officials. (The contradiction between fiscal responsibility on the one hand and the exigencies of electoral politics on the other hand is one of the reasons, beginning more than two hundred years ago, that many thought democracy could never work. We will soon see whether the skeptics were right.)

At some point, of course, the limit is reached, and creditors will no longer extend credit, and instead demand repayment of existing debt. Bankruptcy is the process we have developed to deal in an orderly fashion with this endpoint. As someone once remarked (Ben Stein, I believe), "if something cannot go on forever, it will end." The U.S. Government's habit of borrowing and spending cannot go on forever.

So the question becomes, how will it end? Two possibilities present themselves: either we figure out and agree on a way to bring down our deficits and begin paying off our debts (as we did in the 1990s), or the markets force a solution. It is the latter outcome I dread—in comparison, the fourth quarter of 2008 would feel like a day at the beach-- and have been diligently working to protect you against in our work here at Weybosset Research & Management LLC. We have emphasized hard assets, non-dollar denominated sources of revenue via our equity and fixed income investments, and an avoidance of heavily indebted entities, especially Treasury and municipal paper. We have also devoted much of our efforts to trying to discern which of the two outcomes—we work out a solution to our fiscal problems or the markets force a solution—is likely to prevail.

I am pleased, and greatly relieved, to report that our research thus far points to a benign outcome. We scour the same media, newspapers, television, radio, etc., that you do, but we have also had occasion to confer from time to time with various Washington insiders, mostly senior members of Congress and certain veteran lobbyists and staff members. The insiders indicate that the main players in the drama fully understand what is at stake and are determined to avoid a crisis, even if it means giving up some political advantages, with a sobriety in stark contrast to the demagoguery and drive for short-term political advantage that accompanied the financial crisis in 2008. The problems we face are hardly insurmountable, but fixing them will require uncharacteristic political courage on the part of elected representatives. There is a growing chance that we may see some of that courage.

A perusal of the press shows fiscal issues front-and-center nationally and locally. The various parties to the debate contend with one another via competing proposals for reining in spending and enhancing revenues. Some are even getting down to specifics. Yesterday's warning from Standard & Poor's about the looming threat to the United States' credit rating paradoxically increases pressure on policy makers to come up with *something*. The process is bound to play itself out in the usual messy manner of democracies—lots of yelling and screaming, posturing, brinksmanship and bargaining—but if the issue remains on the front pages long enough, politicians will be forced to deliver a solution to our fiscal problems before the markets riot. The results could be extraordinarily positive for our investments.

Don't get me wrong—I wasn't born yesterday. There is no guarantee that free people are capable of governing themselves. They have the sovereign right and the power to ruin themselves financially and very well may do so. But early indications are that we will be alright, however unsightly the process.

Again, I wasn't born yesterday. Plenty of dangers lie ahead and much can go wrong in trying to get from here to there. We have not abandoned an essentially defensive investment stance. (Fortunately, as I have pointed out in prior epistles, in this market defense and offense are often the same.) But the sword of Damocles that has been hanging over our heads looks a little less threatening today than a few years ago.

We promise to keep a close eye on the situation and welcome any comments you may have. As ever, thank you for your business and the confidence you have placed in us. We take that confidence seriously and promise to spare no effort in earning your trust.

Yours very truly,

Fla Lewis III
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