It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to heaven, we were all going direct the other way - in short, the period was so far like the present period, that some of its noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only.

July 14, 2011

Dear Fellow Investor:

The (justifiably) famous opening words of *A Tale of Two Cities* pretty well sums up the way I've been thinking about the investment environment lately.

Under the rubric "best of times," falls the condition of publicly-traded U.S. companies in general, and the ones owned by Weybosset Research & Management clients in particular. Business is good, cash flows are strong, dividends are secure and rising, balance sheets are healthy, prospects are bright and valuations are somewhere between reasonable and way too low. Indeed, despite a long list of bad financial and economic headlines, the Standard & Poor's 500 turned in a perfectly respectable performance in the first half of 2011, rising a little more than 5% since the end of 2010. (I am pleased to note that virtually all the equity portfolios for which we are responsible did better than the index in the first half of 2011; in some cases much better.)

Likewise, very big parts of the world, parts once known as the Third World, which throughout my lifetime and most of history were desperately poor, are beginning to enjoy the blessings prosperity. Supplying their needs, be it iron ore for steel for construction, airplanes for travel (number of visitors to Beijing in 2007: *200 million*!), a cool drink for refreshment, or toothpaste for oral hygiene, has been an important part of our strategy here at Weybosset Research & Management LLC.

On the other hand, financially speaking and from an altitude several thousand feet higher, if it is not "the worst of times," it is a close approximation thereof. The U.S. economy, having taken its biggest hit since the 1930s, is crawling, painfully, haltingly, incrementally back in the weakest recovery from a recession since the Second World War. Job creation has been especially disappointing.

But by far the biggest horror show lurks in the balance sheets of governments, state, local, and national, all across the developed world. Debt levels are simply too high and must come down one way or another. The process of unwinding that debt is not a pretty sight.

In Europe, Greece is all but done for and the question facing policy makers is how to distribute the pain, how to make the "restructuring" of Greek debt "orderly." There is considerable concern that Spain, Portugal, Ireland and perhaps Italy, much bigger players, will be next. The ramifications of sovereign default on European banks and from there to the global financial system could be severe.

The gross domestic product of Japan is about the same now as it was in 1990; there has been no economic growth in more than twenty years. Yet government debt is *triple* what it was twenty years ago. So far Japan has been able to finance its debt proliferation via an enormous pool of domestic savings. But as Japan's aging population retires, that pool of savings begins to shrink as retirees *dissave,* i.e., as they begin to spend savings to enjoy their golden years. Then what happens? We'll soon find out.

In the U.S., state and local governments are on the precipice and the predicament is not improved by poisonous partisan politics. The state government in Minnesota, for instance, has simply shut down, victim of fiscal strain and rancorous relations between the Democratic governor and the Republican legislature. Here in Rhode Island, poor little Central Falls, all of a mile square, is in receivership with almost no prospect of meeting its financial obligations. Most of those obligations are in the form of pension payments owed to retired city workers. In its wisdom, on behalf of its employees Central Falls years ago opted out of the Social Security system. If the city can't pay, on what will its aging former public servants live? In a similar vein, the unfunded pension liabilities of Rhode Island state and local governments are staggering. Central Falls and Rhode Island are not unique. Similar scenarios are playing out in local governments from sea to shining sea.

As I write, we are unwilling and grossed out witnesses to the sorry spectacle surrounding raising the debt ceiling of the United States government. Failure to do so could result in government default. The major credit rating agencies, Standard & Poor's and Moody's, have put U.S. Treasury debt on watch list with negative bias. In other words, securities backed by "the full faith and credit of the United States of America" could prove not so secure. The dependability of the U.S. dollar and U.S. Treasury obligations constitutes the backbone of the global financial system. Breaking that backbone could have incalculable consequences.

So far financial markets are not reacting in any meaningful way to the threat because they dismiss the whole performance as routine posturing prior to some sort of political deal. But the markets could be wrong. The game of chicken being played by our elected officials could end disastrously if reason does not prevail. That elected officials—Republican or Democrat-- would even contemplate such danger, would play with such fire, in the hope of political gain boggles the mind. Today our largest creditor, the People's Republic of China, issued a statement via its Foreign Ministry: "We hope the U.S. government adopts a responsible policy to ensure the interests of investors." Amen to that, ye heirs of Chairman Mao!

The source of all these far-flung fiscal problems, whether in Europe, Japan, Rhode Island or Washington, is the same. Governments have made financial promises to their various constituencies—employees, pensioners, sick people--that cannot possibly be fulfilled.

How different polities address this increasingly undeniable reality will define policy debate for years to come.

So what is a humble portfolio manager to do given this Tale of Two Cities—rising prosperity in a significant part of the world and commensurate fine business conditions on the one hand, and the prospect of collapsing government finances on the other?

Favor one over the other, obviously. To begin, we stay as far away as we can from the problem areas. We hold very little Treasury or municipal debt, no European sovereign debt, and avoid exposure to the financial sector to the extent possible. We progressively emphasize high-quality equity over debt. The companies in which we are invested are preponderantly self-financing, that is to say, they do not need access to the debt or equity markets to maintain their businesses. Whether our investees are headquartered in the U.S. or abroad—most are in the U.S.—their activities are heavily oriented globally, toward those parts of the world enjoying financial and economic health.

In fixed income portfolios maturities are generally kept short and we prefer high-quality corporate bonds over government paper for the same reasons we favor high-quality equity. We continue to add bonds not denominated in U.S. dollars, Euros or yen.

We have taken out some insurance in the form of gold, the "anti-currency." Likewise we own lots of hard assets, natural resources from bauxite deposits to copper mines to timberland, but mostly energy. These should prove preferable to "paper assets" such as bonds or financial companies or money market funds as cash-starved governments, intentionally or not, debase their own currencies. ("Financial repression" is the felicitous term sometimes used.)

But the "worst of times" actors are large and important and I would be less than candid if I assured you that there will be no bouts of volatility, some of them severe, as the public sector deleverages. But whatever storm arises, we are determined to emerge intact.

Thanks, as ever, for the trust you have invested in us. You can be sure we will remain vigilant as to the dangers out there and diligent as we seek ways to profit in these best of times and worst of times.

Yours very truly,

Fla Lewis III
Principal