October 13, 2011

Dear Fellow Investor:

In my last two letters I commented on the heavy macro problems confronting the markets—earthquake, tsunami, nuclear meltdown in Japan, a chronically sluggish U.S. economy characterized by seemingly intractable high unemployment, and a financial crisis in Europe that appears all but insoluble—and observed that nevertheless the markets were holding their own.

Well, that changed in dramatic fashion in the third quarter of this year, as the S&P 500 buckled under the cumulative weight of obstreperous policy and political problems, plunging nearly 14 per cent-- which looked pretty good compared to drops of more than 20% in China or more than 25% in France and Germany! At one point in August, the S&P 500 was down almost 20% from its high set in April, nearly qualifying for official bear market status.

I am reminded once again of how fortunate we are that neither your investments nor mine depend on a particular view of the markets, but rather on a discipline focused on acquiring high-quality securities at bargain prices.

Indeed as I surveyed our results at the end of September I pronounced myself for the most part satisfied. (I hope you are, too!) On a year-to-date basis, the S&P 500 index was down a little more than 10% (8.7% including reinvested dividends). None of the accounts for which we are responsible performed that poorly. The vast majority was roughly break-even for the year or up a few percentage points. (The sole exceptions were relatively small accounts, IRAs and custodial accounts mostly, in which we hold shares of Berkshire-Hathaway in lieu of mutual funds; Berkshire performed about in line or a little better than the market in the first nine months of this year.) I have repeatedly emphasized the defensive nature of our investment stance, and am encouraged that, at least so far, this has been the right approach.

Volatility picked up substantially in the third quarter, with large moves both up and down the norm rather than the exception. Correlations, that is, the degree to which *all* securities moved in the same direction on a given day, also reached a level not seen since the stock market crash of 1987. This latter development, the fact that EVERYTHING, good, bad, and indifferent, screams up and screams down at about the same rate should give us excellent opportunities going forward. We hold higher-than-normal cash positions in our accounts, and it is our intention to put this cash to work to your benefit as we identify babies—cute babies-- that have been thrown out with the bathwater.

A portfolio item that helped mightily in the first nine months of 2011 is our investment in gold, via the exchange traded fund known as GLD, which rose nearly 14% in the first

nine months of 2011. (If you are a new client of Weybosset Research & Management LLC, you may not have owned GLD until just recently.) I am in no sense a gold bug. In fact, as an old (or aging) value investor, gold is anathema: there are no cash flows associated with the asset, it has little or no intrinsic value; indeed it is mostly the object of speculation.

But it has become the vehicle by which investors express their lack of confidence in the fiat currency regime which has prevailed since Richard Nixon in effect took the U.S. and the rest of the world off the gold standard in the early 1970s. I have railed repeatedly against the depredations of heavily indebted governments against their own currencies, and in this regard, gold is the *anti-currency*. I look at is as a type of *insurance policy*, insurance against the mischief of those in government as they struggle with the highly unpleasant necessity of dealing with dogged debts. It is not my intention to leave GLD to my kids or grandkids, but only to hold it until the deleveraging crisis in the developed world passes.

There is another type of insurance policy to which I am attracted, and perhaps you will be attracted too, though it is not yet time to take out such a policy. It involves buying put options on the S&P 500 Index. If the index falls in price, the value of the put option should rise, the classic hedge. We would use these options to hedge against a BIG market decline, something of the magnitude of 2008, not the 15-20% drops that come along from time to time and are just part of the routine of the experienced investor.

Now the name of the game in insurance and hedging is to buy adequate protection at a reasonable price. In my thirty-plus years in the investment business, I have often checked the price of hedging at times when I have become worried about the overall market. Invariably, the price of the hedge made the transaction not worthwhile, so I passed.

The single exception was this past summer when the U.S. Congress faced the task of raising the nation's debt ceiling. The markets simply assumed something would be done, but the game of chicken being played in Washington over the issue had me genuinely concerned that the Treasury could wind up in default, potentially disastrous for the financial markets. At that time, I could hedge a portfolio against a BIG decline at a cost of about 1% of the assets of the portfolio. That struck me as a pretty reasonable price.

As events unfolded, we did not need such an insurance policy, but one can imagine a circumstance in which it would have come in handy. If you would like to give us the option (pardon the pun) to further hedge your portfolio, please contact Jeannine Bizier or Karin Coulter and we will get the necessary paperwork to you for your signature. Of course we would be happy to answer any and all questions regarding our hedging strategy. Again, we probably will never take out insurance against a big market decline, as our investment stance is already highly defensive, but we live in unusual times and it is nice to have any and all instruments at our disposal to protect the value of your investments.

One obvious question is, if you are so worried about the outlook, why not simply sell everything, or most everything, and go to cash and wait for the dangers to pass? (Some of our clients have in fact asked that we do just that.) The answer lies in the binary nature of possible outcomes. In July I wrote to you using the metaphor of "A Tale of Two Cities," in which I described the contrast between the health of corporate America and the emerging markets on the one hand, and the grim condition of government balance sheets in the developed world on the other. If European, Japanese and American governments can get their fiscal houses in order, the outlook is extremely bright. One way or another, these governments will get their houses in order—there is no alternative—but the process is proving difficult.

The second reason a move to all cash is unlikely to do us much good in a bad situation is the nature of the threat itself. When a government faces unsustainable debt, and the debt is owed in a currency which that same government prints, then the temptation to debase the currency, to resort to inflationary policies to deal with the problem, is nearly irresistible. High-quality equities are likely to do the best job of maintaining your purchasing power in an inflationary environment, better than cash.

It is important that you understand that I believe the outcome of the global deleveraging crisis will be favorable, and that we will benefit mightily. The more I look into the situation, the more encouraged I am. But the road from here to that bright future is not straight or smooth. Your investments—the highest-quality securities highly diversified--are designed to take us as smoothly as possible from here to there. But a little extra insurance might come in handy at some point.

So if extra insurance sounds like an option you might like to have, give us a call or e-mail or stop by, and we would be pleased to answer any and all questions and take care of the necessary paper work.

As long as I am on what is mainly a house-keeping topic, it has come to my attention that my habit of communicating with you via "snail mail" is *so* 1970s. If you would prefer that we send my quarterly letters via the Worldwide Web, give us a call or shoot us an e-mail and we will unburden your snail mailbox in accordance with your wishes.

As ever, many thanks for the confidence you have placed in us. It seems to me we are headed in the right direction, and it is our commitment to keep it that way.

Yours very truly,

Fla Lewis III
Principal