January 12, 2012

Dear Fellow Investor:

In 2011, the S&P 500 finished the year where it started. (To be precise, it fell .0003 per cent.) But it was anything but a placid year in the stock market. Instead, there was extraordinary tumult throughout 2011, with a series of sharp rallies and brutal selloffs, the biggest of which sent the market down seventeen per cent in a couple of weeks. Even on a daily basis, stocks were startlingly volatile: the Dow Jones Industrial Average moved more than a hundred points on forty per cent of trading days, and there were more than sixty days on which the S&P Index moved about two per cent or more (which in 2005, for instance, it didn't do once). Ordinary investors, who have watched the value of their 401(k)s yo-yo seemingly at random, have been left feeling understandably dazed and confused as they head into the new year.

Traders and professional money managers don't seem to have any real clue about what's going to happen, either. You might think that volatility would allow people with superior information and market sense to get ahead. But last year money managers did a very poor job of playing the market. According to estimates made by Goldman Sachs, as of the last week in December seventy-two per cent of core large-cap mutual funds had underperformed their market indexes. The average stock-market mutual fund was down almost three per cent for the year. And hedge-fund managers, who are supposed to thrive on volatility, did even worse, with hedge funds that focus on stocks falling more than seven per cent. Strikingly, some of the biggest flops came from superstars: Bruce Berkowitz, whom Morningstar named…"money manager of the past decade," saw his flagship fund fall more than thirty per cent; the hedge-fund manager John Paulson, whose bet against mortgage-backed securities a few years ago has been called "the greatest trade ever," saw one of his funds drop nearly fifty per cent.

James Surowiecki, in his review of last year's stock market in the January 16, 2012 issue of *The New Yorker,* neglects to mention that the U.S. market, with all its treachery, was the BEST performing major market in the world in 2011; the MSCI World Index was down more than 8% last year, while all the big European indexes posted declines of more than 20%.

In light of all this, I regard our results in 2011 with satisfaction. (I hope you do, too!) The vast majority of equity portfolios managed by Weybosset Research & Management LLC registered increases solidly in the mid-single to low-double-digit per cent range. (The exceptions were relatively small accounts, IRAs and custodial accounts mostly, in which we hold shares of Berkshire-Hathaway in lieu of mutual funds. Berkshire has been a superb performer over time, but underperformed the market in 2011.) These results were achieved not because we found a better "trade" than John Paulson, or are better at ferreting out value than Bruce Berkowitz---Lord, no! We are tortoises, not hares. We stick with an investment discipline so ancient, so tried and true, that my father and grandfather would have been quite familiar and quite comfortable with it.

Speaking of my father and grandfather, Mr. Surowiecki did not mention another peculiarity of the market in 2011. The *level* of the S&P 500 was nearly unchanged versus year-end 2010, but with *reinvested dividends* the return was 2.1%, by far the best in the universe of major indices. In other words, if you, say, via an index fund, made any money at all in 2011, *it all came from dividends.* This is consistent with data going back to 1926. The data, compiled by Ibbotson Associates, shows that, apart from esoteric items like taxi cab medallions in New York City, the best performing asset class since 1926 has been common stocks, as *long as you include reinvested dividends*. According to Ibbotson, fully 40% of the return from stocks over time has come from dividends. I mention this in conjunction with my father and grandfather because, for them, a good dividend was a primary reason for buying a stock in the first place. Likewise, here at Weybosset Research, perusal of our performance in 2011 indicates that something like 40% of our returns came from dividends and distributions from our master limited partnerships.

But you almost never hear the word “dividends” among professional investors, perhaps because the pros tend to be in too big a hurry. 2011 was the fourth or fifth year in which portfolio turnover at the average mutual fund exceeded 100%. For many hedge funds, a long-term investment is lunch-time tomorrow. Apparently nobody sticks around long enough to collect a dividend--which is fine with us long-term investors as it leaves a prime source of return overlooked and ripe for exploitation.

But will dividends continue to be a prime source of return? I am convinced they will. You have heard me rail repeatedly at the depredations of heavily indebted countries and the dangers those debts pose to your financial health. (EVERYBODY’S financial health, actually.) One consequence of massive government debt is unnaturally low interest rates administered by central banks. Low rates are a way of punishing savers to the benefit of debtors, the biggest of whom are none other than the national governments of which central banks are a part. As investors contemplate near-zero rates of return on savings accounts, money market funds, CDs and the like, a dividend yield of nearly four per cent from a blue chip such as Johnson & Johnson (versus less than two per cent from a 10-year Treasury) looks mighty tempting. Indeed Strategas Partners, a New York research boutique, identifies nineteen companies whose credit ratings (as defined by the cost of insuring against default) are *better* than the U.S. Government’s and whose stocks yield *more* than 10-year Treasury bonds, dubbing them “The New Sovereigns.”

An added advantage of dividends in the current environment has to do with a side-effect of heavy government debt, which is that excessive debt tends to depress economic activity. Indeed economic activity can become so depressed for so long that prices begin to fall, i.e., deflation sets in. The most desirable asset in a deflationary environment is a steady and, above all, *dependable* stream of income as goods and services lose value relative to money. Traditionally, if you feared deflation, you bought long-term government bonds. But when the cause of deflation is in fact government debt, you might want to find some other source of income. How about McDonald’s? How about Coke? How about Johnson & Johnson? If you are a Weybosset Research client, you have substantial holdings in “The New Sovereigns.”

OK, 2011 went reasonably well for us, how does 2012 look? The correct answer, the true answer is, I have no idea; but we are preparing for more of the same. A number of issues were on investors' plates in the first half of 2011—earthquake, tsunami, nuclear melt-down in Japan, the threat of a double-dip recession and a dysfunctional Federal government in the U.S., debate over whether China faced a hard or soft economic landing, and sovereign debt woes in Europe. By the end of the year, it seemed that only one story mattered, and that was the slow-motion train wreck in Europe. Bad news would emanate from across the Atlantic and markets would plunge, good news or not-so-bad news (in fact there was little good news), and mighty rallies would ensue, producing the yo-yo effect Mr. Surowiecki describes in his article. We fully expect sovereign debt woes to remain on the front pages for the foreseeable future.

Fortunately, though sovereign debt crises are a big, very big, story, it is not the only story. In July of last year I wrote to you using the analogy of *A Tale of Two Cities*, the contemporaneity of the "best of times and the worst of times." Government debt crises in the developed world took the part of "the worst of times", while the good-to-excellent condition of much private enterprise here in the U.S. and economic health in the so-called developing world—by far the majority of mankind--constituted "the best of times." I vowed to avoid to the extent possible the former and concentrate on the latter. That approach stood us in good stead in 2011 and we intend to see that it does so again in the future.

So we remain cautiously optimistic, above all, cautious. We own only the highest quality securities and are very careful what we pay for them. We are more diversified than at any time in my career. We own natural resources, particularly energy reserves, as a hedge against inflation, and "New Sovereigns" as (among other things) deflation hedges. We own gold as a hedge against debased and debauched paper currencies.

Thank you for your support in 2011. We are fully cognizant of the confidence you have placed in us and are determined to earn it. If we haven't met with you recently, give Jeannine or Karin a call and let's get together to discuss how these and other issues may apply to you.

Yours very truly,

Fla Lewis III
Principal