April 23, 2012

Dear Fellow Investor:

An old Wall Street adage goes something like, *the market will do whatever it needs to do to thwart the maximum number of investors*. That was certainly the case in the first quarter of 2012. After the *stürm und drang*, after the intense volatility of 2008-2011, and all the worry around the sovereign debt crises in Europe, the S&P 500 turned in its best first quarter since 1997, marching twelve per cent higher between December 30, 2011 and March 30, 2012. Moreover, unlike the violent moves of 2008-11, the market moved absent accustomed volatility; indeed, the ascent verged on peaceful. Nobody of whom I am aware expected: 1) significant appreciation despite the troubles confronting the markets last year; accomplished via 2) a gentle climb.

The reasons for the market action relate to the letter I sent you last October in which I likened the investment climate to the opening of Dickens's masterpiece, *A Tale of Two Cities.* The best of times and the worst of times in my analogy were the excellent condition of many U.S. publicly traded businesses, accompanied by low-to-reasonable valuations, on the one hand, and the deplorable state of government finances throughout the developed world on the other. In December of last year authorities in Europe instituted measures designed to take some of the pressure off European banks as "peripheral"—think Portugal, Italy, Ireland, Greece and Spain, the "PIIGS"—governments worked their way through daunting debt predicaments. For a while we heard no further bad news from the other side of the Atlantic, and up went the market. (It feels as if, in the absence of impending catastrophe from some overextended government, the market "wants" to go up.)

All of the accounts for which we are responsible posted positive results for the first quarter of 2012, but with nothing like the magnitude of the move for the S&P 500. Our results were mostly in the mid-single digit range rather than the low-teens appreciation delivered by the S&P 500. There are two reasons for this. The most important is that, as I have repeatedly emphasized, our portfolios are primarily defensive in construction, designed to protect your capital from the stress generated by the ongoing world debt crisis. Our portfolios did a good job maintaining their values during the wrenching declines of 2010 and 2011, but it is too much to expect them to also outperform in a certifiably "hot" market like we had in the first quarter of this year. As I will discuss below, I see no reason to abandon an essentially defensive investment stance because of a lone big quarter. If the price of defending the integrity of your equity is my looking a little foolish come April 2012, that's a price I'm willing to pay.

The second reason for our underperformance is that the move in the market was heavily concentrated in a small number of sectors, sectors in which we have little involvement. Mega cap banks, say, J.P. Morgan Chase, Citigroup, or Morgan Stanley, led the way. Bank of America Corp. common stock was

up more than 70% in the first quarter. These were the same entities that led the way *down* during the bear phases in 2010 and 2011 (not to mention 2008), as investors (rightly) worried about their exposure to big European banks, which in turn are heavily exposed to the debt of the PIIGS. When pressure came off the PIIGS, pressure came off the mega cap banks, and up they went.

Additional big contributors to the performance of the major market indices in the first quarter of 2012 were mega cap technology companies, mainly Apple, Inc., up more than 40% in the first quarter. Although the iPad I got for Christmas has revolutionized the way I do my business--I no longer schlep a big heavy briefcase up and down College Hill every day, and I am in touch via the Worldwide Web with the rest of the planet pretty much 24/7 (a decidedly mixed blessing)—I have never bought a share of Apple for myself or for you. What was I thinking? Peter Lynch's contention that technology stocks ought to come with a consumer warning label is deeply ingrained in your investment manager's mind.

But back to our adherence to an essentially defensive investment posture. I had the pleasure early last November of attending a lecture at Brown University given by Kenneth Rogoff, a professor of government and economics at Harvard. In 2009 Rogoff and Carmen Reinhart published *This Time It's Different—Eight Centuries of Financial Folly,* an exhaustive statistical study of financial crises such as banking failures, sovereign debt defaults, and hyperinflations going back to 13th century China and Medieval Europe. Rogoff and Reinhart's research reveals that sovereign debt crises of the kind we currently witness in Europe, and very likely could witness in Japan and here in the U.S., are nothing new at all. For instance, in 1815, in the wake of the Napoleonic Wars, nations representing no less than 15% of the world's income were in default on their debt. In 1941, following the Great Depression and the beginning of World War II, nations representing 40% (!!) of the world's income were in default. Greece, the bête noire of the recent turmoil in Europe, "from 1800 until well after World War II…found itself virtually continually in default, and Austria's record is in some ways even more stunning."

Banking collapses, of the type we endured in 2008, are more infrequent, but by no means rare. They tend to be followed by waves of sovereign defaults. Lo and behold, that pretty much describes the situation today. (I left the lecture feeling fairly good—the circumstances in which we are operating are by no means unusual. Investors survived and thrived in prior iterations of this scenario; we, too, can survive and thrive.)

Current data indicates, and history tends to confirm, that the kinds of market commotion witnessed for the past few years are likely to continue as far as the eye can see, because the problems causing them have yet to be resolved. The debt in question took decades to accumulate; it is not likely to return to reasonable levels quickly. And sure enough, not long after the close of the first quarter, the cost of insuring against default on Spanish bonds began to escalate inexorably, and once again markets are wobbling.

I think we'll stick with our defensive policy.

Well then, how is the defensive policy proceeding? Generally speaking, according to plan. On the one hand, we are not seeing the kinds of opportunities in the fixed income markets—random and usually small pieces of good-quality debt offering excellent yields and decent price appreciation—that we saw in 2008-11, so we have scaled back our activities in bonds. Putting money out for extended periods of time at today's paltry yields strikes me as the height of folly, all risk for precious little return. On the other hand, the reappearance of volatile and highly correlated moves in the equity markets, moves in which *all* securities, good, bad, and indifferent, go in the same direction, means some mighty fine babies are likely be tossed out with the bath water. We aim to catch a few of those babies.

Rising volatility also gives us a chance to sell some things at higher prices than might otherwise be available, at least on good days. So, for instance, I lacked the perspicacity to buy Bank of America common at half of book value, but we did buy some big bank debt late last year, and the recent "relief rally"—some call it "Europe's short vacation"—gave us the chance to sell for a nice and, I would maintain, low-risk total return .

One aspect of financial collapses as delineated in Rogoff and Reinhart's research is that economic activity in their wakes tends to be anemic. This time around, sluggishness in the developed world has spilled over into developing markets, retarding to some degree growth there. As a consequence we have reduced our exposure to industrial commodities. Market exuberance in the first quarter of this year allowed us to exit at favorable prices. At this point I would rather sell toothpaste or soft drinks to Chinese consumers than copper and steel for more high-rise buildings in Chonquing.

So we continue in our usual fashion, making adjustments as neccesary. We remain first and foremost cautious, but unopposed to picking up a five dollar bill if we find it lying on the sidewalk. We are mindful of the considerable risks that lurk out there and are determined to stay clear of them to the extent we can. We are also mindful of the confidence you have placed in us and renew our pledge to earn that confidence.

Thank you for your support!

Yours very truly,

Fla Lewis III
Principal