July 13, 2012

Dear Fellow Investor:

I am no sports aficionado, but I can't help but wonder if Yogi Berra is the only professional athlete better known for what he said ("It ain't over til it's over", "When you get to the fork in the road, take it!", "Nobody goes there anymore, it's too crowded.") than for what he did. In thinking about the first half of 2012 from the investment perspective, the Berrism that comes to mind is, "It's déjà vu all over again!"

As in 2010 and 2011 the markets turned in strong first quarters, only to be confronted and confounded by the seemingly intractable problems that characterize the era in which we live, the era of global deleveraging. ("Deleveraging" is economist-speak for the process of working off accumulated debt.) The first quarter of this year was the strongest first quarter since Bill Clinton was president, but when the sovereign debt crisis in Europe yet again raised its ugly head, markets turned squishy. May was a particularly weak month. The big money-center banks that led the way up in the first quarter led the way down in the second quarter. On a year-to-date basis, the S&P 500 was up about 8.3% at the end of June.

Our accounts continue to trail the S&P 500 but not by as wide a margin as in the first quarter. All were solidly profitable, but year-to-date returns are in the low-to-mid single digits.

I am never glad to report underperformance, but, frankly, in this case I find it hard to worry much. A number of investments that have worked beautifully for us in the past, and will continue to do so, in my strong opinion, "corrected" in the first half of this year, i.e., saw their prices pull back in the normal course of market fluctuaton. So, for example, it was our good fortune to own the best performing stock in the Dow Jones Industrial Average in 2011, but it *declined* nearly 12% in the first half of this year, a result of, as far as I can ascertain, nothing much more than profit-taking. Likewise, one of our energy companies, after rising more than 65% in 2011 dropped by about 23% in the first half of 2012, the victim of 1) too fast an ascent in 2011 (we sold some last year in response) and 2) concerns over falling oil and gas prices as global economic growth turned anemic, partially due to the European crisis. Nevertheless the shares trade today at a level more than double what we paid about two years ago. All the way around the world, people continue to enjoy hamburgers at prices they can afford, and, I'm convinced, large reserves of *North American* oil and gas are and will continue to be valuable assets. I'm in favor of keeping our hamburger chain and our oil and gas partnership, though they retarded our progress in the first half of 2012.

Another factor that slowed us down in a rising market is higher-than-average cash holdings. Putting this cash to work has been the subject of much labor on our part, and weak market conditions are very much our friend in this endeavor. (The high degree of volatility makes the task tricky, however.)

What kinds of investments would we like to make with this cash? More importantly, what kind of investments do we *not* want to make? The answer to the second question is, nothing heroic. I have emphasized to you in the past that our investment stance is primarily defensive in light of the high degree of risk embedded in the macro environment. Thus we are not looking to buy, say, bombed-out European banks or Greek bonds, even though there are bound to be opportunities there, or fast-growing Chinese internet companies, though I'm sure there are opportunities there as well. We are sticking with the usual Weybosset criteria: enterprises with consistently high returns on invested capital, consistent growth, barriers to competition, solid finances, and talented leadership, and we want them at prices demonstrably too low. That said, where to look?

In an era characterized by deleveraging, particularly deleveraging by sovereign governments, two characteristics fundamental to almost any investment plan are in short supply, income and growth.

In an attempt to keep flagging economies pumped up, central banks keep official interest rates low, very low, in many cases close to zero, hoping to stimulate demand for credit, and, who knows, maybe, on a good day, economic activity as well. Since interest rates in the private sector tend to key off of official rates, interest rates across the board come down, and because official rates are so low, they come down a lot. (Weybosset clients enjoyed substantial benefits over the past few years as market-based rates moved toward official rates, known in investment argot as "spreads narrowing"). As a result, traditional sources of income, say, government bonds and notes, bank certificates of deposit, or money market instruments, offer returns that are inadequate by almost any measure. In turn other high-grade rates sources, investment grade corporate bonds or municipal bonds for instance, eventually become paltry. The incentive, then, is to look for yield to riskier investments, say, junk bonds. Unfortunately, to quote Warren Buffett, junk bonds, "…too often live up to their name." The challenge is to find good sources of income without buying junk.

We have enjoyed success in this endeavor at Weybosset Research, though the task gets more difficult as spreads continue to come in and as official rates remain suppressed. Increasingly we find ourselves looking off the beaten track, at cemeteries, forests, or the occasional corporate merger-related financing vehicle. With a substantial part of our portfolios dedicated to income-producing investments, we should enjoy reasonable returns even if the markets do not appreciate and just sit there for a prolonged period. We should also have a cushion when markets head down in one of their periodic and habitual swooning spells.

High levels of debt also act as a depressant on economic growth. In their landmark study of financial crises going back nearly eight hundred years, *This Time It's Different,* Kenneth Rogoff and Carmen Reinhart (whom I cited in my last letter to you) theorize that when government debt approaches about 90% of GDP, subsequent economic growth, for years at a time, is sluggish at best. In the developed world, the key debt levels were breached long ago, and, sure enough, Europe has relapsed into recession, the U.S. is struggling with the most anemic economic recovery since the Second World War, and Japan has enjoyed almost no growth *in more than twenty years.* If Rogoff and Reinhart are right, this is likely to be the case for the foreseeable future. So-called developing nations, which endured their own deleveraging cycles in the late 20th and early 21st centuries, offer better opportunities, but, the world being a highly interconnected place, they cannot remain entirely unaffected by torpor in developed nations.

The problem then for the investor is that he or she cannot look to the overall economic environment for growth; growth there is either snail-paced or nonexistent. Like the search for yield, we look in increasingly idiosyncratic places. So, for example, thanks to advances in agricultural productivity and other innovations, such as distribution and packaging, food is a much smaller proportion of Americans' budgets today than in 1970. Of that highly reduced proportion, according to the Food and Drug Administration nearly 44% is spent on dining out (!!). As consumers around the world improve their lot and emulate the American paradigm of the good life, more and more people go out to eat more and more often. Now if we could only figure out a way to make money investing in restaurants or *some indispensable vendor* to restaurants…

In a similar vein, thanks to a revolution in recovery techniques, North America is increasingly swimming in cheap energy, especially natural gas and gas liquids. North America also has the world's best infrastructure for processing and moving that energy around, together with a well-trained flexible work force. These are ingredients for which global manufacturers yearn, so what if we could find a service or product central to a revival of manufacturing in the U.S., Canada and Mexico?

The best investment, of course, is one that combines the attributes described above, that is, stable and *growing* income over time, with decent growth prospects. Our U.S. blue chip stocks fit this bill admirably, and we are glad to hold what we own and add more blue chips as opportunities arise.

So we think Yogi Berra has it right, that it is indeed déjà vu all over again, and that conditions that prevailed for the last several years will prevail for the foreseeable future. Under these circumstances growth and income will remain scarce. But we have had success ferreting them out for the last few years and I think we stand a good chance of sustaining success. The ever-present danger is that the economy tips too far one way or the other, either into deflation and economic depression, or rampant inflation as an unintended consequence of government attempts to assuage the pain of deleveraging. We guard against these threats by owning only the highest-quality securities—too much debt will never get one of our investees!—and by owning much in the way of real assets, energy especially, to hedge against debased and debauched currency. The challenges of investing in a world of financial repression are significant, but we have done alright so far, and I aim to see that we meet the challenge going forward.

Thank you for your support and stay in touch!

Yours very truly,

Fla Lewis III
Principal