October 26, 2012

I have a simple rule: I am fearful when others are greedy and greedy when others are fearful.
--Warren Buffett

Dear Fellow Investor:

If we were to take the Oracle of Omaha's advice to heart, we would all be feeling extraordinarily greedy right now. Despite the fact that at the end of the third quarter of this year the S&P 500 closed within less than ten per cent of the all-time high set in October of 2007, and having more than doubled off the bottom set in March 2009, there is almost no sign anywhere of enthusiasm for equities; quite the opposite, in fact.

One measure of equity aversion by the general public might be the flow of investor money *out* of equity mutual funds and *into* bond funds. There are various ways of measuring these flows, but the one that most struck me was provided by Strategas Research Partners: since 2006 through the end of September 2012, $536 billion left stock funds while $1.2 *trillion* went into bond funds. According to Merrill Lynch, last week was the biggest week ever for bond funds, with $9.4 billion going into bond funds—*in a single week!*

Now ask yourself what is implied by this mass migration. Bond rates tend to key off rates available in the largest, most liquid, and, from the point of view credit quality, safest market in the world, the market for U.S. Treasury securities. Today, as I write, a one-year Treasury note yields 0.18%, a five-year Treasury .77%, the ten-year note 1.77%, and the thirty-year bond 2.93%. I don't know about you, but those returns look paltry to me. They are considerably worse than paltry when inflation is taken into account. CPI inflation has averaged somewhere in the neighborhood of 2.5%-3.5% for the last several decades. None of the rates on Government bonds surpass reasonable expectations of inflation, so all these bond buyers today are in effect agreeing to take a *loss* in real terms, i.e., after inflation, on their investment. Should interest rates rise, and given the extraordinarily low level of rates now, the next big move in rates has to be up, losses on bonds will not be just after inflation, but in absolute terms as well.

Why would anyone enter into a transaction with the expectation of losing money? The answer can only be that the expected loss in owning bonds is less than the loss feared by owning another asset, say, stocks. This is not an irrational fear, given the tremendous volatility in the equity markets over the last ten or twelve years. But note that the operational word, the only word that explains the apparent contradiction, is *fear*—fear on a vast scale.

Rich Bernstein of Richard Bernstein Advisors provides a different perspective via his Wall Street Sentiment Indicator. It is a "…survey, originally crafted in 1986…a survey of Wall Street strategists' recommended equity allocation for a balanced fund. Extreme readings (i.e., one standard deviation

above or below the long-term norm) have historically been reliable sell and buy signals." The Wall Street Sentiment Indicator is a contrary indicator, that is to say, when Wall Street strategists are most bullish, a sell signal is flashed; when they are most bearish, a buy signal. Indeed throughout the biggest bull market in stocks in history, the 1980s and 1990s, Wall Street strategists on average counseled *against* overweighting stocks until the very end, 2000 and 2001. Wall Street strategists missed the biggest bull market in history and turned bullish just in time for the worst secular bear market in history, the one that began in the spring of 2000. How's that for expert advice?

Where does the Wall Street Sentiment Indicator stand today? *It has never been more bullish*. In other words, despite admirable performance and reasonable valuations, Wall Street strategists have never been more bearish, never more fearful of common stocks.

These observations correlate with personal anecdotal evidence. I sit on the investment committees of several institutional endowments, which I like because, among other things, participation allows me to see what is going on in the world of institutional investors, the so-called "big" money. No consultant—they all use consultants—has come to a single committee on which I sit recommending increased exposure to common stocks. The rage is "alternative investments," private equity, commodities and the like. To the extent that common stocks are involved, the recommendation is invariably to hedge exposure via "absolute return" strategies, or other hedged vehicles, typically offered by hedge funds for very high fees. Not surprisingly, the performance of these institutional endowments has lagged that of the S&P 500 by a large margin. Why not just buy some good stocks at prices that make sense and hold them for the long run? Too risky. In my experience fear pervades the world of big money, too.

Now just because I'm paranoid doesn't mean there isn't someone out to get me. There are huge risks in the global economy, and we would be irresponsible in the extreme if we acted on your behalf without taking those risks fully into account. For instance, some Weybosset Research clients have informed me that they are tired of hearing me rail against the disastrous fiscal position of the United States and the cowardice of elected officials when it comes to confronting the problem. Nevertheless that remains the number one issue that keeps me up at night.

On the other hand, some big issues have ameliorated considerably over the past twelve months. Europe has been nearly the only story dominating financial news for the past few years, but, from the point of view of the markets, it looks as though the worst is behind us. The bond market expresses its approval or disapproval of the way peripheral European nations (think Portugal, Italy, Ireland, Spain—Greece already is history) are handling their (huge) debts by the interest rate it demands in order to continue financing those debts. A calculation by Merrill Lynch shows that a simple average of the two-year yields on peripheral debt has fallen from 12.7% in mid-2011 to 2.7% today—basically back to pre-crisis levels. This is not to say that citizens of Portugal, Ireland, Italy and Spain will soon be out in the streets laughing and dancing; Europe is in for a prolonged period of economic and political difficulty. We as investors have to deal with this, but from the point of view of a global financial crisis, the coast is clearer now than it has been for a long time.

Likewise the world's second largest economy, China, is looking less scary than a year ago. Slow growth in North America and the lack of growth in Europe, two big markets for export-oriented China, have taken their toll, along with opaque and often corrupt financial and political systems.   But the average Chinese is a hard-working, ambitious, and resourceful soul, and his or her search for a better life proceeds unabated. Thus it appears that the slowdown in China will result in a "soft" landing, not the "hard" landing dreaded at the beginning of this year. (Here at Weybosset Research, we are no longer looking to sell China copper, iron or nickel for use in additional high-rise apartment buildings in Shanghai or another beautiful highway or another high-speed railroad line—we've made our money there. But we remain interested in selling toothpaste, refreshing beverages and good restaurant food to increasingly affluent Chinese consumers.)

Alas, political paralysis persists in our nation's capital, but into this issue we will soon have better visibility as voters voice their verdict in November. Hopefully the "fiscal cliff", a fearsome but nearly unanalyzable threat arising from past political failures to deal with Federal financial difficulties, will fade as an issue. And—God willing and the creek don't rise—after the elections perhaps politicians will be persuaded to pay attention to the formidable fiscal facts of life.

But despite persistent problems, I am reminded of a story told to me by a friend back when Bill Clinton was president. My friend worked in the development office of an institution of higher learning in Cambridge, Massachusetts. His job was to maintain cordial relations with that institution's major benefactors. (Given the identity of the institution, to be considered a major benefactor, one must be quite a contributor indeed!) He had gotten to know an elderly woman, and on one visit felt comfortable asking what the source was of her great wealth. "Live long enough and stay in the stock market," she replied.   Living long enough is up to you; we here at Weybosset Research and Management will keep you in the stock market.

One final note before I close: I have spent this epistle extolling common stocks. In doing so I do not wish to cast aspersions on the prospects of other assets. For instance, I began by puzzling over why anyone would sell his or her stock mutual fund to buy bonds, given the low rates of return available in the bond market. This is not to say that *all* bonds are overpriced; good opportunities most certainly exist, but one must be highly selective given the poor value in the overall bond market. Here at Weybosset Research, Karin Coulter has done an admirable job of ferreting out the occasional high-quality, mispriced fixed income instrument. Karin has beaten her benchmark by wide margins with great consistency. But the job is more difficult than it was only a few years ago.

As ever, thank you for your support. Please, please, please do not hesitate to get in touch with any and all questions, comments or concerns. And keep the faith!

Yours very truly,

Fla Lewis III
Principal