January 16, 2013

Dear Fellow Investor:

After a basically flat year in 2011, 2012 was quite good for the stock market, with the S&P 500 Index returning 16%, despite widespread doom and gloom in the media. The equity accounts for which we are responsible trailed the S&P 500—our results were in the high-single to low-double digit range, similar but a little better than our returns in 2011 when the markets were flat. Clearly we are tortoises, not hares. That's fine with me, and I hope it is fine with you, too, as we both know who won *that* race.

The reasons for our shortfall are largely two-fold. First, I have emphasized in past epistles the essentially defensive nature of our portfolios. Thus, the main market leaders last year were the big money-center banks—Bank of America, for instance, more than doubled in 2012. We are leery of these names because, in an age of deleveraging, an age in which the scariest dangers arise from a surfeit of debt world-wide, ownership of the largest holders and purveyors of debt seems less than conservative. (That said, our portfolios are not *entirely* devoid of big banks: the largest shareholder of Bank of America is Berkshire-Hathaway Corp., which in turn is one of our largest holdings.)

(The temptation is to compare ourselves in 2012 to the blue-chip Dow Jones Industrial Average, as we own a lot of blue chips. The Dow returned about 7.26% in 2012. We definitely beat that index! )

The second reason for our shortfall, and the main reason for the magnitude of the miss, has to do with a seemingly random and certifiably irrational event that will almost certainly be rectified in our favor over time, but which penalized us markedly in the closing months of 2012. We are significant investors in master limited partnerships (MLPs). Via MLPs we own natural gas pipelines, substantial petroleum reserves in North America, and even a chain of cemeteries. In addition to these real assets, i.e., assets based on natural resources, MLPs provide us with a handsome and rising stream of income, tax-advantaged income to boot. Because of the complexities of their tax treatment, MLPs are owned primarily by wealthy individuals; the usual institutional investors, mutual funds, pension plans and endowments, are largely absent.

The day after the general election in November the entire MLP sector simply collapsed. Apparently the worry was that with Obama back in the White House and with more Democrats in Congress, the tax-favored status of MLPs was suddenly jeopardized by the party that ran (and won) on a soak-the-rich platform. Nowhere, nowhere at all, was there any proposal to change the tax treatment of MLPs—there simply is not enough money to be had for the government's coffers to make a change worth legislators' trouble. Nevertheless, down went the MLPs, and great was their fall. I am pleased to report that since New Year's MLPs have been coming back nicely. Our cemetery chain is up more than 20% off its low. Another lesson in why trying to predict and profit from short-term moves in the market is futile!

We entered 2012 with a trio of big-picture concerns confronting the markets. By the end of the year, depending on how you measure, two-and-a n-eighth to two-and –a-third of the issues were largely off the table, which goes a long way to explaining the good performance of the stock market last year.

Headlines since early 2010 have been dominated by the ongoing fiscal and financial crisis in Europe. Peripheral European nations, Portugal, Ireland, Italy, Greece and Spain, would come under the markets' microscope as investors feared one or the other of the "PIIGS" would fail to meet its financial obligations and default. Now sovereign default is hardly a new phenomenon. In a prior missive I mentioned Kenneth Rogoff and Carmen Reinhardt's landmark study, *This Time is Different,* which presents *eight hundred years* of financial crises going back to fourteenth century China and Medieval Europe. It turns out certain modern nations, Greece among them, have spent more time in default than not. The concern in recent years is that the financial distress of one or another peripheral European country would be transmitted to the rest of the world via the banking system. Spanish banks, for instance, own a lot of Spanish government debt. But to what extent is, say, Citigroup here in the U.S. entwined with vulnerable Spanish banks? If Citigroup is not entwined with Spanish banks, to what extent is Citigroup entwined with, say, French banks that in turn are involved with Spanish banks? And so on. The potential for repetition of the crisis of confidence that began with the collapse of Lehman Brothers in 2008 could not be dismissed.

Fortunately, but only after relentless pressure from the markets, the European Union in tandem with the European Central Bank made it clear that whatever steps were necessary to prevent such an outcome, an outcome that could have easily meant the demise of the European Union, would be taken. Markets began to calm down and by the end of the third quarter of last year spreads on peripheral European sovereign debt relative to the debt of Germany, a kind of thermometer for measuring the fever sweeping financial markets, had settled down to about where they were before the crisis. As I pointed out in my last letter to you, this does not mean a period of economic abundance lies ahead for Europe; there is still much to be done in the deleveraging process. But the potential for Europe's sovereign debt crises morphing into a global financial crisis is much reduced.

After the 2008 meltdown hamstrung Western and Japanese economic growth, the engine of global growth passed to the so-called developing economies, particularly China, which is now the second largest economy in the world. (Some say the day when China will overtake the United States as number one is not far off.) But China's prosperity has been based to a large extent on exporting to the developed world. When the U.S., Europe and Japan went soft, demand for China's exports also went soft, and the concern became, would the slowdown in China end with a "hard" or a "soft" landing? It appears that the latter is the case, with domestic demand from China's rapidly rising middle class taking up much of the slack created by the fall-off in demand from the West. As with Europe, plenty of questions remain, particularly concerning China's opaque and often corrupt financial system, but the threat to the rest of the world has diminished.

The third big issue for global markets resides right here in the United States, and it has to do with our chronic inability to address our own daunting fiscal challenge. The challenge is fairly simple: our government spends much more than it takes in, a problem that will only get worse by orders of magnitude as baby-boomers retire and avail themselves of various entitlement programs, Medicare, Medicaid and Social Security chief among them. The solution to the crisis is fairly obvious—revenues have to rise and spending has to fall, but how to make that happen is a matter on which politicians in Washington have repeatedly been unable to agree. When they failed yet again in the summer of 2011, lawmakers decided to blackmail themselves into SOME kind of resolution, and the result was the "fiscal cliff." The blackmail note stipulated a series of draconian tax increases and spending cuts that were to kick in automatically if no resolution had been reached by December 31, 2012. Congress averted at least part of the disaster by making permanent most of the Bush-era tax cuts and, yet again, punting on the spending side of the equation. This monumental break-through (I hope you detect some sarcasm here) was achieved not before December 31, but just before midnight January 1. A huge rally in the market ensued.

Preserving low tax rates for 98% of taxpayers is not exactly an act of political heroism. The hard part lies ahead: spending *must* be reduced or the fate of the PIIGS awaits our beloved land. But telling constituents that reduced benefits may be in the offing is not how politicians keep their jobs. Three different upcoming occasions could become the battleground over spending. The first is that, yet again, the United States has reached its legal borrowing limit. Congressional Republicans may demand spending cuts in exchange for increasing the debt limit. President Obama has said he will not even discuss the matter. The second is that Congress has not passed, and the president has not signed, a budget in years. Instead our government has been operating via a series of "continuing resolutions" whereby Congress authorizes the various departments to operate on the same budget they have been using since the last time Congress agreed to a budget. The latest continuing resolution expires in March, so the next continuing resolution could well not come about without a confrontation over spending. Finally, the "fiscal cliff" blackmail note provided for sizeable automatic spending cuts, known as "the sequester," which Congress in its wisdom kicked down the road until mid-February or early March.

I mention each of these occasions because any one of them or all could cause a riot in the markets. In general, as 2012 attests, policymakers have coped reasonably well with the macro challenges facing the markets. Chances are the trend will continue, and we will see a satisfactory resolution to our problems. But things could get hairy on their way to that resolution. (I am reminded of Winston Churchill's quip: "You can always count on the Americans to do the right thing—after they've tried everything else!")

So again I emphasize the defensive nature of our portfolios. We own only the highest quality securities, securities that have been selected precisely for their ability to ride out the roughest storm. If we encounter some rough water on our way to calmer seas, we are prepared. We enter 2013 optimistic but very cautious. But that's the way we enter every year!

Thank you, and Happy New Year,

Fla Lewis III