April 17, 2013

Dear Fellow Investor:

I write to you on Wednesday, just two days after the heinous terrorist attack in Boston. I am sure you join me in praying for speedy and complete recovery for the injured, eternal rest for the deceased, consolation for the families and friends of victims, and swift justice for the perpetrators.

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The most important news from the financial markets in the first quarter of 2013 was, of course, the attainment of new record highs by all of the major stock market indices in the United States. I am pleased to report that the portfolios for which we are responsible fully participated in the first quarter move; most did measurably better than the averages as some of the anomalous market action that plagued our year-end 2012 performance, especially in the master limited partnership (MLP) sector, reversed itself.

A word or two about the new highs. The Standard and Poor's 500 Index first reached approximately 1550 in March of 2000 and then again in October 2007. In real terms, i.e., adjusted for inflation, the S&P would have to be considerably higher, 16 to 38 per cent higher, depending to which prior peak you refer and what inflation rate you use in your calculation, to be equal to the 2000 or 2007 pinnacles. The 2013 record is then only a nominal high. Secondly, if you had reinvested your dividends—and you know we at Weybosset Research & Management LLC place high value on dividends—the 2007 peak would have exceeded the 2000 peak by a substantial margin, and you would have reached a new high sometime in the first half of last year. Recent headlines are perhaps not as sensational as they seem.

A new high for the stock market should come as no great surprise. Stock prices are, after all, ultimately tied to the fortunes of the underlying businesses, which in turn are tied to the prosperity of the overall economy. Both prosperity and profits have been steadily increasing in saw tooth fashion pretty much since the end of the Middle Ages. The "normal" direction of the stock market is up. As Warren Buffett put it in his most recent letter to Berkshire-Hathaway shareholders:

> *…Periodic setbacks will occur, yes, but investors… are in a game heavily stacked in their favor. (The Dow Jones Industrials advanced from 66 to 11,497 in the 20th Century, a staggering 17,320% increase that materialized despite four costly wars, a Great Depression and many recessions. And don't forget that shareholders received substantial dividends throughout the century as well.)*
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> *Since the basic game is so favorable, Charlie [Buffett's partner and Vice Chairman of Berkshire] and I believe it's a terrible mistake to try to dance in and out of it based on the turn of the tarot cards, the predictions of "experts," or the ebb and flow of business activity.* ***The risks of being out of the game are huge compared the risks of being in it.***

Perhaps surprisingly, investor reaction to the market's ascent is far from euphoric. Karin Coulter of our firm worked for mutual fund giant Putnam Investments back when Bill Clinton was president. She reports that when the Dow Jones Industrial Average crossed the 10,000 level, not long before the major peak in early 2000, funny hats were distributed to employees and champagne flowed freely on the trading floor. (And Karin traded bonds, not stocks!) A best-seller that year was titled *Dow at 36,000*.

When the averages went to new highs in the first quarter of this year, you could strain your ears mightily but never hear the sound of a champagne cork popping. Likewise Anthony Boeckh of Boeckh Investments in Toronto recently conducted a survey of business book titles. They included: *The Great Crash Ahead: Strategies for the World Turned Upside Down; The Aftershock Investor: A Crash Course in Staying Afloat in a Sinking Economy; The Real Crash: America's Coming Bankruptcy—How to Save Yourself and Your Country; The Long Descent; The Moron's Guide to Global Collapse;* and my favorite, *Never Buy Another Stock Again*. Quite a contrast with the first time the stock market reached these levels!

Here at Weybosset Research, the picture was no different. As the market reached new highs, I don't remember a single celebratory phone call. Most callers said something like, "Shouldn't we get out now while we can?" The American Association of Individual Investors (AAII) regularly surveys its clientele, individuals, sometimes referred to as "retail investors." Last week the AAII survey was the most bearish since the bottom of the market in 2009. Market highs are greeted with the same pessimism as market lows! Apparently sentiment among institutional investors is not much better. The day the S&P broke through its previous high, J.P. Morgan described its clients buying that day as, "reluctant bulls", i.e., they had no choice but to participate, but they did so holding their noses.

One significant contributor to the gloom is the twenty-four hour news cycle which plays out for us prominently on cable network news. Remember, TV news stations are not in business to help us with our investing; they are in business to sell advertising. And scaring viewers does exactly that. I am reminded of an interview in the early 1960s with the young Bob Dylan, who had just gotten the world's attention with a series of protest songs, including, "Blowin' in the Wind, "Masters of War" and "The Times They are A-changin'". When asked why he wrote so many protest songs, I expected Dylan to say something like, "Because there's so much injustice in the world," or, "We need to change our attitudes in a fundamental way"—both true statements! His response: *"Bad news sells."* In that vein, I am told (I myself rarely watch cable network news) that late last year a reputable outlet, Market Watch, regularly kept a ticking clock in the upper left hand corner of the screen, counting down the days, hours and minutes until we plunged off the "fiscal cliff." How do you think that made people feel about their portfolios?

I mentioned that I rarely watch cable network news. But I do keep in touch with the companies in which we are invested. In this connection I note that at two of our largest investees, the outlook is excellent. One, a conglomerate located in Omaha, is drowning in cash and the CEO says his "elephant gun is loaded and I'm looking for game," i.e., he's eager for large acquisitions. The other, which dominates the market for recycling wrecked cars in the U.S. and U.K., has recently opened for business in a number of foreign markets, Brazil, the Persian Gulf and Germany. Long-time Weybosset clients have already made multiples on their investment in this company. If it is able to duplicate on a global scale what it has accomplished in the U.S. and U.K., the story is just getting started. The picture is similar as I look down the list of our holdings, from purveyors of healthcare products, to high tech consultants, to railroad operators, to hamburger stands, to rendering (the practice of recycling animal carcasses) facilities and even the cemetery business. Things are going well and are likely to continue going well.

My point in contrasting excellent market performance with gloomy investor reaction is that this is not the kind of sentiment normally associated with market tops. Nowhere do we hear talk, as we did in 2000, of a "new age" in investing, or people quitting their jobs in order to stay home and day trade, much less predictions of "Dow at 36,000. "

And, despite the long-term record, investor wariness is not unfounded. The previous two times the S&P 500 reached 1550, disastrous bear markets followed, the "Tech Wreck" of 2000-2003, and the financial collapse of 2007-2009. Human nature is such that trauma makes a deeper impression than experiences of pleasure, so the memory of the huge bear markets of the last decade is seared into our brains. And it is not as if all is light and life out there. Global economic growth is tepid on a good day. Cyprus reminds us that the situation in Europe remains tenuous. Political paralysis continues to confound attempts to govern the United States. All these issues and more, Donald Rumsfeld's "unknown unknowns," are sure to cause the periodic correction in the market, sending us all reaching for the Tums.

But the breakout into record territory does indeed feel "real." Valuations are reasonable (S&P 500 earnings are more than 80% higher now than they were when the market first reached 1550), profits are healthy, liquidity is plentiful and, as noted above, sentiment is far from frothy. Some might counter that the economy, here and abroad, is, by the way, far from fabulous, with unemployment stubbornly high and growth frustratingly weak. But remember financial markets and the real economy do not necessarily move in tandem. Financial markets are "discounting mechanisms," that is, they move in accordance with what participants believe future economic conditions will look like. As perceptions improve, or *as the future looks less bad*, markets rise. That has been the case since March of 2009 when the S&P 500 went below 700.

So we are grateful for a good start to 2013, grateful but wary. And we are particularly grateful for your continued support, Fellow Investor. Please do not hesitate to contact us with any questions, comments or complaints. It would be a pleasure hearing from you.

Yours very truly,

Fla Lewis III
Principal