October 19, 2018

"*I am still buying equities...Assuming you are holding them [long-term] wouldn't you want to own an interest in a variety of great businesses [producing a growing stream of earnings] than have a piece of paper paying you 3%?"*

--Warren Buffett, interview CNBC August 30, 2018

Dear Fellow Investor:

It is my practice to write to you after the conclusion of every fiscal quarter to give you an update on our progress on your behalf, commentary on the market and to keep you apprised of our plans here at Weybosset Research and Management LLC. Lately we've been changing things up a bit. Last quarter we sent you a book. (If you did not receive a copy of *Junk to Gold* by Copart Chairman and founder Willis Johnson, let us know and we'll get one to you ASAP.)

This quarter I've asked Tom Lamb to report to you. This is because we want to emphasize that though you hear from yours truly on a regular basis, there are in fact four of us here, each with his or her own perspective on what's going on in the wild world of investing. You might want to hear from somebody besides me. So, this quarter I'm handing the job off to Tom.

Take it away, Tom!

Since the end of the first quarter this year, where the S&P 500 ended down 1.2% from the end of 2017, we have seen the S&P 500 steadily increase to up 9.0% at the end of the third quarter.

At Weybosset Research and Management (WRM), we did not fare as well over that period, as generally, our accounts trailed the S&P 500's increase. While at the end of the second quarter we were slightly ahead of the index, in the third quarter, fears about failing trade agreements and expanding tariffs gripped the market and were reflected in the stock price performance of some of our most global companies.

The increase in the S&P 500 has coincided with a strengthening US economy which is in even better shape now than at the beginning of the year! Indeed, from our vantage point in October the second and third quarters of 2018 have seen a strengthening in economic conditions that were already robust when noted in the first quarter. GDP growth for the last two quarters in a row is running above 4% per annum and the level of unemployment is the lowest since the year 2000 and before that the mid-sixties. The pace of wage growth has *increased* and the ratio of unemployed people to job openings is the lowest, less than 1, in eighteen years! Consumer and small business confidence indices are at all-time highs which bodes well for more consumer spending and more hiring. The latest Purchasing Managers' Index (PMI) report shows expansion in 15 of 18 industries.

With the US economy showing such broad strength it is not surprising after-tax corporate profits are also at all-time highs, about $1.9 trillion annually, up almost 7% from a year ago and up 173% from their lowest point in 2008 in the Great Financial Recession. U.S. businesses, in general, are doing very well right now and this result, in part, has helped power public business valuations to current levels.

A common rule of thumb when referring to public business valuations in aggregate in the United States is to use the price to earnings (P/E) ratio of the S&P 500 index. Stated simply, this ratio represents the "price" of the index divided by the total earnings per share of all the companies in the index. Currently, companies making up the S&P 500 index are expected to earn about $161 per share in 2018 and $173 in 2019. At the index level (or collective "price" of all 500 companies) as of September 30 - $2,914 to be more precise - this amounts to about 18 times and 17 times 2018 and 2019 earnings, respectively.

For historical perspective, it should be noted, the 20-year average year-ahead P/E ratio for the S&P 500 is approximately 16 times. By this measure we don't view "the stock market" as being over-valued but, rather, fairly-valued or to put it another way, within a normal range. While some individual stock prices might suggest investors are irrationally exuberant – we can point to Amazon trading at 85x 2019 earnings, Netflix trading at 75x 2019 earnings, or Salesforce.com at 53x 2019 earnings and there are other examples to be sure - the vast majority of companies constituting the S&P 500 index have P/E ratios far lower than these such that the average for 2019 earnings is nearly 17x, as we mentioned.

So, as we survey the stock market we don't see broad overly bullish sentiment bringing in new buyers of equities willing to pay higher and higher prices. Perhaps potential new buyers have been attracted to crypto-currencies or cannabis stocks!

We will point out that in general, over time, client accounts – *your accounts* – have P/E ratios even lower than the market. This is because at WRM we invest in individual companies, not the market, and the price we <u>choose</u> to pay for each one of those companies is, *obviously*, a key element of our investment strategy. Our price sensitivity is the best defense against a misappraisal of a company's prospects and the best offense for producing higher returns. As such, we tend not to buy relatively high (compared to the market) P/E companies because the financial performance expectations embedded in that valuation represent a high hurdle to achievement - and where underachievement of expectations can result in a significantly less valuable company.

Our preference is to buy well-managed, profitable companies with growing earnings at a reasonable or - if we are lucky - a cheap price. Then, if the P/E ratio never changes, as earnings per share grow the share price will grow as well. And if we have judged a company's growth prospects correctly, over many years, through bull and bear markets, through economic expansions and contractions, the steady growth of earnings will create considerable value for investors.

Strength in the US and developed economies will continue to drive corporate earnings growth for some time into the future. While most economies around the world are growing, with a few notable exceptions (Argentina, Venezuela), there has been some softening in the *rate* of growth since earlier this year. Not so, however, in the United States where we are seeing full employment and rising wages as well as increases in raw materials and shipping costs. These cost increases are normal in an economy where the demand for goods and services is rising and productive capacity is tightening. The implementation of tariffs has also increased costs.

Inflation, which measures the general trend in prices of goods and services to final consumers, was 2.2% annualized in August up from last year's August measurement of 1.7% (using "core" Consumer Price Index, food and energy prices excluded). This rate of inflation is well within the range seen over the last 20 years, though higher than the past 10 years as the economy recovered from the recession of 2007-2009. Two percent inflation is targeted by the Federal Reserve (the Fed) because it is thought this level is where the economy can grow at its long-term rate while keeping inflation stable.

While inflation is now near desired levels what remains to be "normalized" are interest rates. As one of many policies to stimulate spending on goods and services and investment in productive assets during the recession, the federal funds rate was lowered to practically zero in late 2008 and kept at that level until late 2015. At that time the federal funds rate was raised to .25%-.50% (that is, one-quarter of a penny to one-half of a penny interest on $1 dollar of principle, for example) from 0%-.25% and inflation was running about 2.0% - a negative real interest rate of about 1.65%. In other words, if banks were keeping deposits at the Fed they would experience a loss of purchasing power far greater than the rate of interest paid on the deposits. So, lending those funds to creditworthy borrowers at a rate above the cost of funds and the rate of inflation was the way to prevent erosion of purchasing power, earn an appropriate return and fund spending on productive assets and goods and services.

Three years into the Fed interest rate normalization process and finally the federal funds rate, now at 2.00%-2.25%, is about even with inflation or "neutral". Normally, in an economy as strong as ours is now, the fed funds rate would be higher than inflation, or "positive". With attention to the incoming data, methodical timing, transparency and determination the Fed is raising rates to keep inflation in check and to achieve a positive fed funds rate so interest rate policy can be used effectively again should it be needed. Proceeding methodically, with an interest rate path laid out (3.25%-3.50% by end of 2019), is supposed to provide enough time and information for affected entities (just about everybody!) to make appropriate adjustments so these increases occur with the least disruption to markets and businesses as possible.

Businesses we invest in are making decisions with the upward direction of interest rates in mind. With solid balance sheets and ample cash flow neither their business plans nor, certainly, their solvency will be threatened. Leveraged, cash-consuming companies will not be so fortunate. We are confident, even when stock markets may be reacting poorly to events of the day, that our companies can meet the business challenges always confronting them and continue strengthening their competitive advantages.

As always, we appreciate your loyalty and your confidence in us. Please get in touch if you have any questions – we'd love to hear from you!

Yours very truly,

Tom Lamb
Securities Analyst