July 15,2019

Plus ça change, plus c'est la même chose.
[The more things change, the more they remain the same]

--Jean-Baptiste Alphonse Karr, 1849

Dear Fellow Investor:

I am pleased to report highly satisfactory results for our clients in the first half of 2019. (I hope you agree!) U.S. stocks, as measured by the Standard & Poor's 500 Index, advanced 17.36% (18.55% with reinvested dividends) in the January-June period and recently set new all-time highs (3,000 for the S&P, 27,000 for the Dow Jones Industrial Average). This is great news for us as we are heavily invested in U.S. common stocks.

The even greater news is that the accounts for which we are responsible exceeded the returns delivered by the averages so far this year, in many cases by a substantial margin. Most of our accounts increased in value by percentages in the low-to-mid 20s in the first half of 2019.

The path to superior returns, however, has by no means been a smooth one. I have written to you in the past—many times—that the markets in which we operate today are inherently more volatile than through most of my lifetime. A combination of the withdrawal of certain traditional volatility-dampeners—Wall Street firms' securities inventories, stock exchange specialists, etc.—the sheer size of global markets, and the increasing prevalence of never-touched-by-human-hands trading techniques have combined to greatly exaggerate the magnitude of otherwise normal market fluctuations.

Regarding the latter point, the increasing prevalence of never-touched-by-human-hands trading, a *Wall Street Journal* story from late last year informs us that fully 85% of daily volume comes from index funds or computer algorithms jockeying for pennies-per-share or fractions of pennies-per-share profits on every trade. (You have to make a *lot* of trades to make those pennies add up to a perceptible return, and you can be sure that the flash-trading crowd makes *lots* of trades.) In the realm, the now-dominant realm, of never-touched-by-human-hands "investing", no consideration is given for old-fashioned matters like value, fundamentals, or even a future beyond the close of today's market.

We believe this circumstance provides us at Weybosset Research & Management LLC with multiple excellent opportunities. That is because we are, and always have been, *long-term fundamental investors*. Our goal is to provide you with a portfolio of outstanding businesses, *bought at attractive prices*, which you can hold for a very long time, ideally forever. Successful execution of this approach can lead to results that are almost magical, as, for example, long-term owners of our wrecked-car company can attest. My colleague Justin Deutsch wrote to you about this in more detail last April ("Volatility is Your Friend"). I only want to add a loud AMEN to Justin's comments.

A recent example of our approach in action: this past month of May featured the rare instance of the stock market declining in six of seven weeks. But things seemed OK out there. We used the occasion to acquire the world leader in the manufacture of advanced composite materials for use in things like aircraft or wind turbine blades. Hexcel briefly traded at a substantial discount to its historical valuation, but long enough for us to establish a position.

The focus on *individual* businesses—as opposed to, say, stock market sectors or any attempt to discern the next move of the broad averages—together with our long-term orientation at times makes us feel a little lonely in a world of 24/7 news (most of it scary as hell), competitors who preach “asset allocation” (whether, for instance, you should switch out of U.S. equities and into emerging market debt for the next six months), and the natural human aversion to volatility. Perhaps while subjected to the din of informational “noise” out there, you have felt the same. (One long-time client told me years ago that golf had lost some allure because his partners on the green kept telling him he had “way too much money in stocks”. I wonder what they’re saying today.)

We at Weybosset Research find, on further contemplation, our loneliness exhilarating. As legendary investor John Templeton remarked decades ago, “If you want to have better performance than the crowd, you must do things differently from the crowd.”

I do not want you to think that while celebrating our success for the last six months, we have become intoxicated by success. We are fully aware that we live in a very dangerous world and that things can change suddenly. The current economic expansion is already the longest on record and the accompanying bull market in stocks is now more than ten years old. So, if nothing else, it looks like about time for trends to reverse. “If something can’t go on forever, it will stop,” Ben Stein famously observed, and this is certainly true for periods of economic growth and bull markets.

But the primary indicators to which we look, sentiment and valuation, are far from flashing as much as a yellow light at present.

Again, John Templeton: “Bull markets are born in pessimism, grow on skepticism, mature on optimism, and die on euphoria. The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell.” It seems to me that on Templeton’s continuum we are at worst at the growing-on-skepticism stage. When was the last time you heard glasses clinking in toast to the most recent record high on the stock market (and there have been many of them)? That’s probably because stocks are not widely enough owned to elicit widespread celebration.

Likewise, institutional investors such as pension funds or university endowments, keep missing their stated return targets even though stock market returns for the past ten years have been far in excess of any return target of which I am aware. These pension funds and endowments clearly do not own enough common stock. They prefer “private equity” (the amount of money dedicated to venture capital has tripled in the last ten years), hedge funds (well, they used to prefer hedge funds until returns became so abysmal that only the most resolute stick around to pay the exorbitant fees), and other exotica (crypto-currencies, anyone?).

The question of valuation is crucial, but more difficult to analyze. The stock market today trades on the high side of what has been normal for the past 90 or so years. Not crazy, à la 1929, 1969 or 1999, but a little high.

However, valuation does not exist in a vacuum. The value of any asset—an apartment building, a farm or a business—is a function of future cash flows discounted to present value by an appropriate interest rate. The lower the interest rate, the higher the current valuation and vice versa.

Interest rates are historically low, which would justify higher valuation than in the past. But interest rates are historically low because that's what central banks around the world have decided to do to fend off deflation and economic collapse. What happens when central banks allow rates to seek a "natural" level? And what is the "natural" level? We have had a little hint of what the answer might be here in the U.S. where the Fed has halted so-called "quantitative easing" and raised short rates a time or two to boot. I would have fully expected rates to ascend to something approaching their historical norm, say, 5% on the 10-year Treasury note. As I write, the 10-year Treasury yields 2.1%. The last time the 10-year rate was much above 3% was 2011, as Europe grappled with the near-demise of the Euro system and the rest of the world was still reeling in the aftermath of the 2008 disaster. Things have improved markedly since 2011, but the improvement is certainly not reflected in the price of money.

Warren Buffett once likened the effect of interest rates on investments to the effects of gravity—you can't see it, but its force is felt everywhere. Right now, the gravitational pull of rates on asset valuations is more like the moon than Jupiter. If rates remain at or near current levels, stocks are FAR from overvalued.

Fortunately, we at Weybosset Research do not have to spend much time scratching our heads wondering what the "right" level of interest rates might be in the future. When I was younger, taller, and dark-haired (and much thinner), I worked at a Wall Street bank called Kidder, Peabody and Co. There I was taught some heuristics, some rules of thumb, for buying different types of stocks: you pay 10, 11, 12 times current year estimated earnings for a financial company, 12-17 times for an industrial company, maybe 17-20 times for a really exciting growth story. (Never more than 20!) In those days, rates were more like 9%. We have no trouble in today's environment finding first-rate businesses selling at prices about equivalent to those found when interest rates, when the pull of gravity, was nearly 5 times higher than today.

We have plenty of room on valuation and plenty of room on sentiment, so our intention is to proceed as we have so far—*plus ça change*! We're lonely but we like it.

I am thankful for our performance on your behalf thus far in 2019, and profoundly grateful for your support in our endeavors. Please do not hesitate to get in touch however you prefer to get in touch—phone call, email, personal visit, message in a bottle—with any and all questions, comments or complaints. We are *always* glad to hear from you.

Yours very truly,

Fla Lewis III

Principal