April 23, 2024

Dear Fellow Investor:

The bull market in stocks continued on its merry way for the first three months of 2024, with the major averages reaching all-time highs during the quarter. This is good news for Weybosset Research and Management clients as we are heavily invested in U.S. common stocks.

The S & P 500 was up 9.70% in the quarter. The accounts for which we are responsible were up in the mid-single digit range, also reaching new all-time highs (performance may vary for accounts that have recently come in).

The latest phase of the bull market has been labeled the “AI mania”, as speculation of how Artificial Intelligence will transform the modern world has captured investors’ imaginations. Most of the expected beneficiaries are the largest components of the S & P 500, such as Nvidia, Alphabet, Microsoft. As these companies grow and their share prices rise so does their weighting in the S & P 500.

The technology component of the S & P 500 is now at its **highest point in history**, surpassing even the dot.com era of the late 1990’s (!!). “Momentum investing”, people chasing prices as they go up and only because they go up without regard to fundamentals, has taken control of large swaths of the major indexes. This type of market usually does not end well for “momentum stocks”, as seen by the market action in the last few days. This is not our style of investing.

It is our practice to write to you after the conclusion of every fiscal quarter to give you an update on our progress on your behalf and commentary on the market. We are fortunate that over the years we have built a loyal client base that understands our investment philosophy of owning high quality businesses that can compound your money for decades.

Our job is to not only be rational and make hopefully smart decisions with your capital but also to inform, educate, and even “hold your hand” during inevitable difficult investing moments. For this quarterly update we decided to go right to the source to find out what things you, our fellow investors, **wonder** about.

With inflation where it is, the open border, wars, and everything else why hasn’t the market dropped 50%? I’m worried...

The twenty-four-hour-a-day news cycle provides plenty of distraction, plenty of noise, as it always has. But the overall situation is far better than it was only a few years ago, remember the pandemic?

For the last 100 years the markets have faced all sorts of challenges, from bubbles bursting, currency devaluations, bank failures, two world wars, malaria, aids, pandemics to name a few. Despite all these obstacles the market has risen 84% of the time.

The path to compounding wealth does not happen in a straight line. Sell offs are a natural product of markets. On average the market corrects 5-10% at least once a year. We don’t have to like them, but we do need to acknowledge their inevitability, so we shouldn't get flustered or panic when sell offs come.

To alleviate one's fears of a market drop we implore you to keep **adequate liquidity** (6months to 2 years' worth of living expenses in cash), so that you will always be prepared for the unexpected (job loss, health issues to name a few) and do not have to worry about "the market".

The combination of adequate liquidity and thinking of yourself as a business owner rather than a stock jockey should assuage one's fears in times of market stress. You might want to try turning the T.V. off and getting some fresh air for a while too.

Though the list of obstacles is horrific on a human level, with the loss of life and tragedies, these do not derail the ingenuity and the desire for millions of Americans to make their life better than it was the day before. Capitalism at its root can rebirth itself.

For the market to drop substantially, i.e. the great recession in 2008 (the market dropped 40%) *the entire US economy needs to go into a recession, this is a very rare occurrence*. Most often different sectors of the economy go into a recession at different times; what we call rolling recessions. Some sectors even benefit when the economy is in a recession, insulating the market from dropping 40%.

In the short term the market is a voting machine, taking its cues from the topic dujour where millions of people are trying to anticipate the market's every move and acting on their beliefs. In the long term the market is a weighing machine. The weighing machine is the part that matters.

The long-term and main driver of markets is earnings and profits (weighing machine).

If profits are anticipated to grow over the next year or two markets will rise, conversely if they are believed to be subtracting then markets will fall. In 2024 profits for the companies in the S & P 500 are anticipated to grow by 10%.

We at Weybosset preach (ad nauseum, some would say) that we do not look to trade the stock market, to divine the next BIG MOVE and capitalize on it, but to identify a handful of outstanding businesses in which we can invest (at reasonable prices) and hold for long-term (years, decades, generations) income and appreciation.

High quality securities do not always perform best in the short run; however, over the long haul, they have historically outperformed and beaten inflation. These businesses provide goods and services that are in demand. Affording them the ability to raise prices to beat inflation. A little bit of inflation, 1-3% per year is normal and just fine for consumers, companies, and markets to handle, that is where inflation is today.

During inflationary times business revenues and profits rise even though you, the consumer, must pay more for said goods. This may hurt your wallet as the purchasing power of your dollar decreases but it is good for businesses and their increasing stock prices (your portfolio).

The best way to combat inflation and to increase your purchasing power is to own US equities and US income producing equities. Our goal is, and always has been, to earn the best possible return for you consistent with the least possible risk, and regarding our holdings, I doubt if we have ever held a stronger hand especially in this inflationary period. All that is required is a little fortitude and patience.

What are your thoughts on AI (Artificial Intelligence)? Are we invested in AI?

We are very much believers in AI. Every decade or so a new technology comes along that marks a paradigm shift in the world: think electricity, the steam engine, trains, airplanes, the internet and now AI.

AI took the investing world by storm last spring with the release of an application called ChatGPT. Using high-powered semiconductor chips and software, computers can utilize large swaths of data to spit out answers to almost anything faster than one could imagine. The ability for computers to sift through all types of data and come up with solutions and answers to problems at warp speed is mind blowing. The first use cases of AI have shown up in the basics of answering questions, solving large problems, writing essays, creating images, and running call centers.

It is our belief that every company in every industry will have to reevaluate how they do business and how they can incorporate AI. AI will bring about extreme cases of winners and losers in the business world and stock market.

People often can't imagine the new jobs that will be created by new technologies. When we had major technological shifts in the past, working hours dropped because productivity went up: think the invention of the tractor. I have spoken to small companies who have incorporated AI and are already saving millions of dollars, increasing margins and increasing profits.

The intersection of new technology and investing in one is where it gets exciting. To date the largest technology companies in the world have been the ones investing billions and powering the AI movement. Nvidia, Alphabet, Microsoft, to name a few, have been the clear leaders in developing AI, investing and producing products.

From our perspective the beauty of AI is that you don't have to own just the company making the computer chips or the software. AI is part of the "Electrification of America", trillions of dollars over the next decade or two will be needed to make AI a part of everyone's daily lives.

Electrification and AI are major economic themes that Weybosset investors are invested in.

To run these computers and software massive amounts of testing, infrastructure, and energy will be needed. One data center (a data center is where all the computers are housed) will use 5-10x more electricity than a hospital!

We have investments in some of the largest American industrial and chip testing companies that will be building said infrastructure. Not only will AI create demand for the goods and services of these companies, but it will also create efficiency and productivity gains for **our entire portfolio of businesses**, making them more profitable. Increased profitability leads to higher share prices for our portfolio and more profits for you.

We believe that the world is at the beginning of the AI transformation. In the short run the market has most likely overpriced the market leaders and over emphasized the effects of Ai and conversely has **underpriced** the future growth and increased profitability that will come over the next decade or two for many other companies.

Describe your methodology for selecting stocks. Is there a particular order in your screening criteria, i.e., sector, historic p/e ratio revenue growth history/projections, cash flow, balance sheet?

Remember, at Weybosset Research & Management LLC we do not seek to trade stocks—to buy low, sell high, rinse, repeat, etc. Rather, we believe that first, the investor must have adequate liquidity, defined as access to enough cash to weather any unexpected financial storm, no matter how extreme; and secondly, the investor should own PRODUCTIVE ASSETS (as opposed to currency-denominated assets such as bank deposits or bonds) for long-term income and appreciation. Publicly traded common stocks afford us the ability to choose from thousands of businesses from all over the world doing almost any conceivable task. We seek to assemble a portfolio of businesses that we can own and enjoy for years, decades, or sometimes even generations.

What kind of businesses? I don't know about you, but since I have a choice, I prefer WONDERFUL businesses. What is a wonderful business? Warren Buffett (who ought to know) thinks a wonderful business is a business that, "...earns high returns on invested capital with the possibility of reinvesting at high returns..." So, my first criterion in evaluating a stock is the company's record of returns on invested capital (ROIC) and particularly return on equity (ROE) since I am the equity owner. If ROIC and ROE have been consistently high for years, you just might be looking at a wonderful business. I'm not much interested in ROEs below 15% because I don't have to be. (We avoid businesses with excessive debt, so ROIC and ROE should be close.)

If we have found a promising candidate, then what? This brings us to the trickiest part of the evaluation, the price at which a security trades. I am sure any two of us could sit down and produce a list of companies that consistently earn high returns on invested capital, consistently grow, produce opulent cash flows, sport gleaming balance sheets, and are well led; companies that meet Weybosset criteria, that is. But will we make any money from the investment? Return on investment is, of course, a function of what you pay for the investment, so we are incredibly careful about what we pay. Any asset, a farm, an apartment building, a dry-cleaning operation, will, over its lifetime, produce a given stream of income. An investor's return will depend on what he or she pays for that stream. An asset that produces $1 per year is a much better investment at $10 than $20 or $30. I am sure we all know people who bought some fantastic company but never made any money on the stock. Usually that is because the investor paid too much for the fantastic company.

Other criteria, such as balance sheet, growth opportunities, competitive profile, cash-generative ability, competency of management, are tested once we think we have a wonderful business selling at a price that makes sense. If the candidate passes all our tests, we buy it and own it, hopefully, forever. The result should be a portfolio of profitable, consistently growing, conservatively financed, well-managed businesses facing little competition. I sleep well at night knowing my capital is invested this way. (Remember, at Weybosset Research, clients and members of the firm are invested identically.) I hope you do, too.

What do you think about buying bonds? What about owning the S&P 500 index?

When I first started in the investment business ca. 1980, interest rates were extremely high, mid-to-high teens. Inflation was also extremely high but falling. Thus began a 40 plus-year bull market in bonds (remember, bond prices rise as interest rates fall, and vice versa) that ended with the extreme and entirely unprecedented phenomenon of negative interest rates—people paid the Bank of Switzerland, for instance, to hold their money for them (!!!). In recent years rates have headed back up. I do not think we will see negative rates again, and I certainly hope we do not see the economic circumstances that produced negative rates; but how far rates climb remains to be seen.

Bonds were always part of our portfolios from my earliest days in the investment business. At times, they became a significant part of our portfolios, especially if external events disrupted prices. Around the year 2000 we experienced a major bear market in stocks as the dot.com bubble burst. Junk bonds, which had financed the whole mania, were clobbered. We bought some and did very well but traded them out when they reached full value. Then again, in the Global Financial Crisis of 2007-2009 any asset NOT a U.S. Treasury security or a U.S. dollar saw its price fall through the floor. We were buying U.S. Government agency—Fannie Mae, Freddie Mac, Federal Farm Credit—obligations priced to yield in the vicinity of 18-21%. Couldn't pass on that yield!

But the problem with owning bonds in the current context is the lack of a satisfactory return in the face of considerable risk. Let us say you bought a bond today to yield 5%. If you are a taxpayer, that return could be halved after paying various governments, and inflation is running something like 3%. So, after the explicit payment of taxes and the hidden tax of inflation, there is nothing left in real terms of your 5%.

But you've undertaken considerable market risk—if rates continue to rise, the value of your bonds will fall, and if inflation persists, the value of your interest payments and the value of your principal at maturity erodes proportionately. Keep in mind that inflation compounds while most bonds pay simple interest. Not a great risk-reward profile, so we stay away. The cash reserves we recommend clients hold serve as an insurance policy against unexpected financial disaster and to buffer some of the volatility in the equity market. Note however that this policy is highly price dependent. If the variables change sufficiently, so will our policy.

The second question is easy. We LOVE the S&P 500 for a long-term investment. Though we prefer a curated portfolio of wonderful businesses, if one is uninclined or somehow unable to choose individual businesses, why not buy them all? In effect that's what an investment in an index fund represents. It's easy to do via a mutual fund or exchange-traded fund. Owning the S&P 500 Index might be thought of as a bet on American business in the broadest sense. I don't have any trouble making that bet.

As ever, many thanks for being our client. We pledge our very best on your behalf and hope you won't hesitate to call with any questions or concerns.

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performance of an index would incur fees and expenses which would reduce returns. Securities investing involves risk, including the potential for loss of principal. There is no assurance that any investment plan or strategy will be successful.