

THE LONG AND SHORT OF IT

QUARTERLY NEWSLETTER FROM
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Much of what we saw in the first quarter of 2006 appeared to be very bad for stocks. Crude oil prices rose from the low 60's to high 60's. Gold rose from below \$520 an ounce to above \$580. Interest rates rose across the board. Short-term rates, i.e. Fed Funds, rose from about 4% to 5%, and long-term rates rose from 4.55% to 4.89%, leaving the yield curve slightly inverted (i.e. that short-term rates were higher than long-term rates) at quarter end. International tensions continued to mount, especially in Iraq and Iran. Most initiatives before Congress failed to make any progress. (Um, excuse me. We would include that in the good news for the quarter.)

Offsetting this very discouraging environment were corporate earnings, which continued to rise at a double-digit rate. The first quarter 2006 earnings reports are expected to mark the 14th sequential quarter of double-digit growth in annual reported earnings for the S&P 500. This beats the prior longest period of sequential quarterly double-digit growth, which ran from the fourth quarter of 1992 to the fourth quarter of 1995. The general media has little interest in reporting such favorable economic news absent a booming stock market; however, it clearly is worth appreciating.

One aspect of the support for the stock market this past quarter that does give us pause was the frequent use of the always-dangerous phrase, "It's different this time." In particular, many were referring to the historically reliable tendency for an inversion of the yield curve to be bearish for stocks, asserting that this time will be different. Perhaps that will be true in the short-run, as the yield curve did not become significantly inverted or stay that way very long. Just two weeks into this quarter, reports of strong economic growth have again pushed the long rates above the short rates. Should the Fed continue raising short-term rates, however, its policy of restraint will likely become effective and slow economic growth. The likely consequent decline in long-term interest rates could result in a more significant inversion of the yield curve and a drop in the stock market. You can see an extremely informative depiction of the relationship between treasury rates and the stock market in the "Free Chart" section of StockCharts.com, at <http://stockcharts.com/charts/YieldCurve.html>.

There are other concerns as well. Over the last few weeks, Iran moved to the front of the average investor's watch list. Meir Dagan, the head of Mossad, Israel's intelligence agency, told the Knesset, the Israeli parliament, last December that "Iran is one to two years away, at the latest, from having enriched uranium. From that point, the completion of their nuclear weapon is simply a technical matter." Last week, (four months later) Iran announced successful enrichment activities just before its

President Ahmadinejad (humorously pronounced “I’m a dinner jacket” by Mark Steyn) went beyond calling for the annihilation of Israel, to predicting Israel’s imminent demise. Although we stay away from macro-level analysis when trying to find cheap stocks, one cannot ignore the magnitude of what seems to be developing in the Middle East. The bottom line for the United States seems to be that Iran cannot become a nuclear-weapons state. The problem is that the Iranians believe that only by becoming a nuclear state can they defend themselves against the U.S. These irreconcilable policies point to several potential outcomes that would be perceived as bad for the market, at least in the short run. On the other hand, Iran may be content to put off any true confrontation over the issue until President Bush is out of office. It remains a subject that bears watching.

On a related topic, “It’s different this time” has been applied to the rising price of petroleum. It is true that our economy is less dependent on oil now than it was in the 70’s. As evidence of this, based on the dramatic increase in crude oil inventories over the last three years, one would expect crude prices to come down eventually. Nevertheless, oil company valuations are high enough to be inconsistent with this view. For our part, we feel it is impossible to successfully predict oil supply and demand, even in the short run, due to the possibility of another bad hurricane season (the Gulf remains quite warm) and/or political volatility and hostilities worldwide, or even the unexpected absence of such events.

Portfolio Top 10 Holdings <i>as of 3-31-06</i>	
Company Name	Percent of Portfolio
Electronic Data Systems Corp.	6.1%
American International Group, Inc.	5.1
JPMorgan Chase & Company	5.1
ConocoPhillips Oil Company	4.9
BB & T Corporation	4.6
Gannett Company	4.6
St. Paul Travelers Companies	4.5
Abbott Labs	4.2
Marsh & McLennan Companies, Inc.	4.2
Eastman Kodak Company	3.5

What we do know is that, over the long run, common stock valuations matter. We also know that opportunities lie in low priced stocks that are currently out of favor. Being out of favor is a condition that is usually the converse of what consensus indicates is the hot place to be. For example, if Google is popular, then the traditional media companies will be out of favor, providing Google investors a source of funds with which to buy Google. During the 2000 Bubble, large cap companies concluded a cycle where they had become excessively popular, and small-cap and mid-cap companies had become very cheap. As the Bubble burst, investors saw the attractive pricing (low multiples) of smaller companies and placed funds there, driving them to out-perform larger companies for several years.

As a result, over the last two years, smaller companies have become fully priced. So the arguments for why to own smaller companies have changed from “What great valuations we can find in smaller companies!” to “Small companies are best because you do not want to be in large companies.” For several years the popular consensus for attractive investments has been constantly rotating among small-caps, mid-caps, international, real estate, private equity, and even hedge funds. We have heard a

growing chorus of the pundits' mantra: "anything but traditional large-cap stocks." Reasons are varied, and seem as many as the stars, but include the likes of "Large publicly traded companies are over-regulated, unlike private equity firms," "They have too much in pension, health care, and other legacy costs to ever succeed again," and "There is too much analyst coverage for opportunities to exist in the large-caps," and "They just cannot perform as well." What good were the pundits (in particular analysts) when the large-cap stocks became so over-valued in 2000?

The current anti-domestic, anti-large company chorus sounds very similar to the "Bubble Logic" of avoiding old-economy companies, which was so very wrong in the late 1990's. We believe the driver for this type of thinking is more closely related to a short attention span and the desire to invest in something new, different, exciting, and most importantly, currently successful. People love a winner, even when it is over-priced. Our conclusion is that the large flows of funds to small-cap, mid-cap, real estate, international, hedge funds, and private equity are chasing performance or, at least, the perception that performance can be found in these areas of investment. In fact, the general pattern last quarter was the smaller the market cap, the better the performance.

It takes a lot of money to move a large-cap stock price, but relatively little to move the price of a small company, or even all the stocks in a small country. The source of funds for investment in all of the other investments mentioned has been the large-cap stocks. So much so that valuations in many of these other areas of investment have become unsustainably high, while large-caps have become exceedingly attractive. The flow has been so dramatic that small-cap and mid-cap managers, along with other non large-cap managers, are now complaining "They don't know what to do with all the money in their funds because there aren't enough promising small companies" (WSJ, 4/18/2006, C1).

The market may be mostly efficient, most of the time. But certainly there is the occasional "non-sequitor." The occasional conclusion that just cannot be right over the long run. Interestingly, any uniformly clear consensus frequently points to an opportunity in the converse. Large-caps should be a very good investment relative to small-caps over the next few years.

Newspaper, radio and traditional media companies continue to become more out of favor, trading at very attractive multiples and subject to regular predictions of their demise at the hands of Google and Yahoo. We continue to believe this consensus represents a significant buying opportunity. Radio and newspapers, as during the advent of television, will continue to succeed long into

Equity Composite Portfolio Fundamentals as of 3-31-06		
	R&W Equity Composite	S&P 500
Number of holdings	28	500
Weighted. Avg. Mkt. Cap. (\$B)	66.6	84.5
Price/Earnings Ratio	15.2	18.3
Price/Book Ratio	2.8	3.5
Price/Cash Flow	7.5	9.4
Dividend Yield	2.3%	1.9%
Return on Equity	18.2%	19.4%

the future. In addition, traditional media companies have the cash flow and branding value to be able to enter and compete successfully in the Internet space. Although it may take longer, mid-term election spending should boost this year's operating results somewhat, thus improving the performance of the sector late in the year.

Speaking of elections, get ready for the mid-term election mudslinging. If this newsletter is not enough to scare an investor, the rhetoric, spin, and lies coming from politicians ought to work. It is history's lesson that the stock market does not do so well during the late summer and early fall of mid-term election years. Although there are always reasons that any particular year can be different from the averages, we are aware of history and will do our best to prepare for such an outcome. On the brighter side, history also teaches us that the later fall and winter months are favorable for stocks, not to mention the long run that everyone knows about.

Despite historic patterns for the overall market, we are finding numerous industry leading companies, currently out of favor and attractively priced relative to their current fundamentals. With interest rates back above 5%, and an economic cycle that is getting long in the tooth, bonds are also approaching levels we consider to be very attractive. We continue to seek out such opportunities and to invest client funds in pursuit of excess risk adjusted returns.

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