



ROBINSON & WILKES, LTD.

INVESTMENT MANAGEMENT

QUARTERLY NEWSLETTER

THIRD QUARTER 2008

The Long & Short of It

The Great Impression

Over the last several weeks, we have seen too frequently the comparisons between current economic conditions and the Great Depression. Clearly the 1930's made a lasting impression on Americans --it was the worst of times. There are indeed similarities between that era and now: credit contraction and a deflationary environment. Ben Bernanke, the current Federal Reserve Chairman, is known as an expert on the Great Depression. Call it destiny or Murphy's Law, but current events will surely test his expertise.

In any event, pessimism grew significantly during the third quarter of 2008, as prices declined for assets across the globe. Prices for commodities, real estate, stocks, and bonds declined substantially. Each decline required companies and individuals to reduce leverage via asset sales. So goes the de-leveraging cycle, with asset sales driving price declines, which in turn force more selling to shore up beleaguered balance sheets.

The differences between today and the Great Depression are often overlooked. Today's trials are, to date, quite small in comparison to those of the early 1930's. The difference in severity perhaps is primarily attributable to our current government's willingness to get involved, attempting to ease conditions. In 1929, the Federal Reserve raised interest rates, intending to make bank deposits more attractive. The resulting rate increase failed to entice depositors and brought lending to a virtual standstill. Compounding matters, the government eventually increased taxes and enacted protectionist trade policies. Although the market decline began late in 1929, it did not bottom until mid-1932.

Credit is scarce again and lending has become exceedingly difficult. However, unlike during the Great Depression, the current loan environment is not shackled by a restrictive Federal Reserve raising interest rates. While the Fed has been very slow, in our view, to use many of its standard monetary policy tools, at least it is beginning to make adjustments to the money supply in the appropriate direction. In the long run, most (academics, industry experts, policy makers, and citizens) accept that some inflation is far preferable to a second Great Depression. As a result, it seems nearly inevitable that the Fed will eventually provide too much liquidity for too long, making inflation the likely end result of this deflationary crisis.

Depression Era Returns

Recently, one of our clients stated that it took 25 years (1929 to 1954) for stocks to recover from the Great Depression. Using Ibbotson Associates statistical yearbook, *Stocks, Bonds, Bills, and Inflation*, we looked into the numbers to offer readers an insight into the experience of holding stocks during the Great Depression.

Using monthly data, the study evidenced that if one had invested \$1.00 in the S&P 500 on August 31, 1929, (just before the stock market crash), it would have taken 25 years (to November 30, 1954) before the price of stocks recovered to the original \$1.00. However, **total** return includes dividends, which become substantial during a bear market. In 1932 and 1933, the annual dividend on stocks yielded an average of about 8%. As stock prices bottomed, the dividend yields rose to

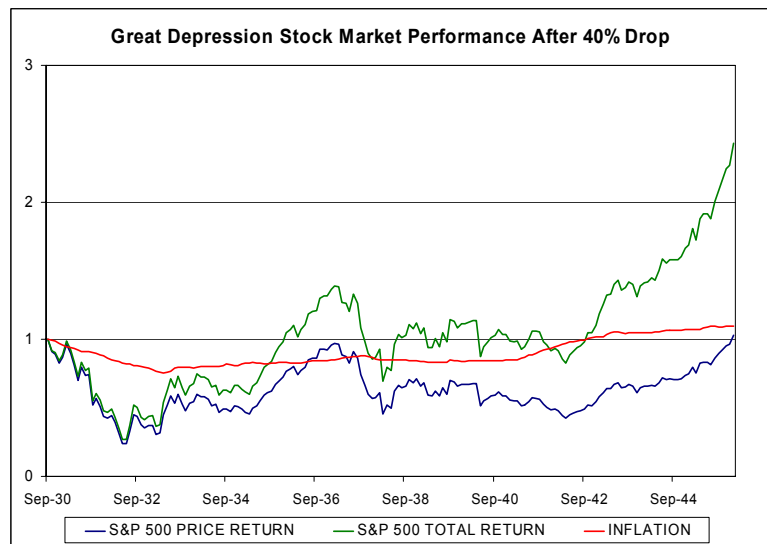
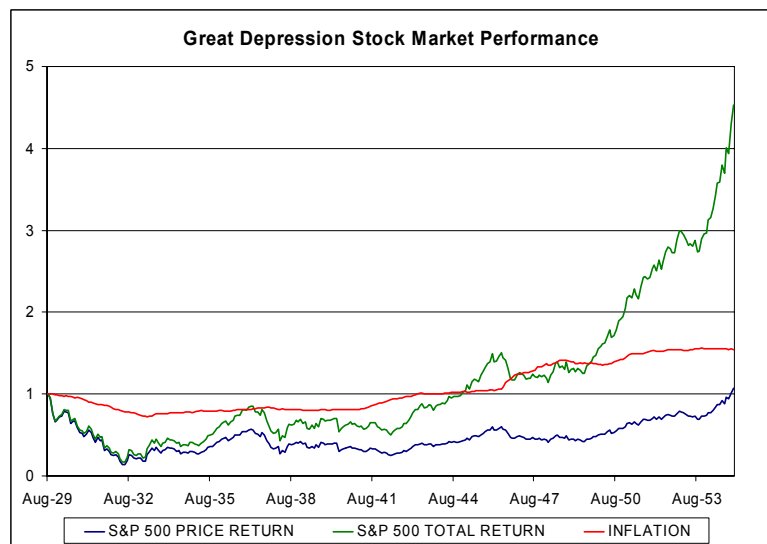
over 20%. Including dividends, index level performance would have grown the August 1929 investment of \$1.00 to \$4.30 by November 1954—not as bad as at first glance.

Using this total return approach, we find that breakeven actually came in December 1944, or 15 years after the top and some 10 years sooner than simple price recovery. Though \$1.00 invested in the S&P 500 Index, not counting dividends, would have dropped to as low as \$0.14 in 1932, and recovered to only \$0.43 by 1944, the significant return of dividends over the holding period was enough to make up the difference.

Now consider that the study of money and returns also involves the study of the purchasing power of a dollar, meaning we must adjust for inflation and deflation. With prices for products and services dropping as much as 27% between August 1929 and April 1933, people were able to buy the same amount of products and services with considerably less money.

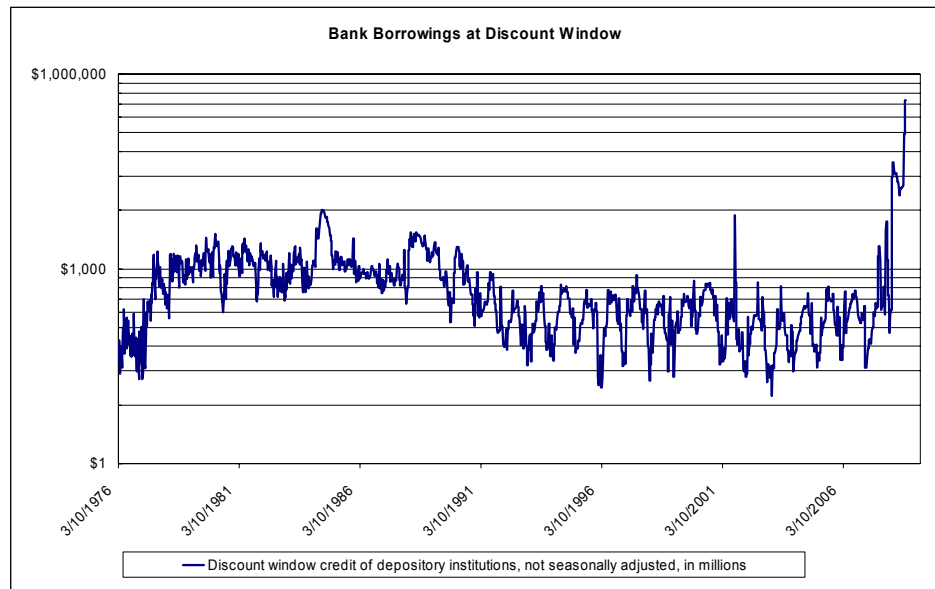
If we adjust for changes in the prices of goods and services, the same \$1.00 invested in stocks would have recovered its August 1929 purchasing power by November 1937. **Thus by including dividends and taking into account the effects of deflation we find that an investment in common stocks made its initial recovery of purchasing power by 1937, just 8 years after the market top of 1929.** A long time, yes, but not nearly the 25 years originally supposed.

Since the market has already dropped off some 40% from last year's peak, we also considered what might have been the outcome if one invested in stocks after the first 40% decline—rather than at the 1929 market peak—knowing one would lose at first and then recover. In the accompanying chart, one can get a feel for how long it took investors in common stocks to recover on price (15 1/4 years), total return (5 1/4 years), and purchasing power (less than 5 years).



Accommodation

Over the last year, the Fed has been somewhat accommodative with monetary policy. From mid-September to early October, the Federal Reserve has shifted its strategy, providing unprecedented and hitherto unimaginable liquidity. The Monetary Base, having grown at annual rates of around 0% - 2% thus far in the crisis, has now risen over 20% in the last month alone. The above chart, "Bank Borrowings at the Discount Window," illustrates the magnitude of the Fed's response.



The Discount Window is used by banks, usually on a short-term basis, to meet temporary shortages of liquidity caused by internal or external disruptions. In recent years, the discount rate has been approximately a percentage point above the federal funds rate. It has therefore been a relatively unimportant factor in the control of the money supply and only utilized in large measure during times of financial emergency. These borrowings have historically been kept to a minimum. In the aggregate, borrowings have ranged from \$11 million to \$8 billion since 1976, with an average of \$700 million.

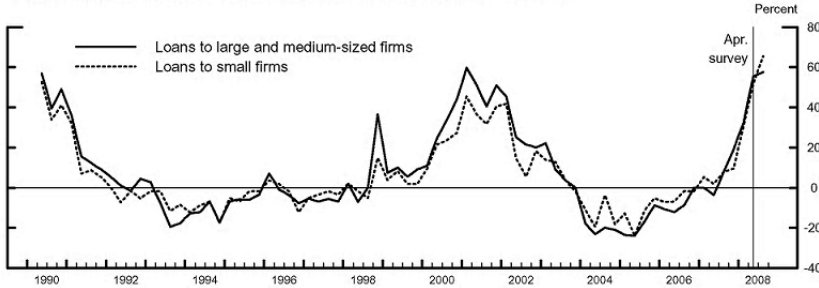
Recently, the Fed has dropped the rate from 1.00% above Fed Funds to 0.25% above. The term has also been increased from overnight to as much as 90 days. Banks are now taking full advantage of this offer, with the average amount borrowed having exploded from \$700 million to over \$400 billion (yes, with a "b") as of mid-October.

The above chart has a logarithmic scale and warrants careful examination. It reveals a greater than 500 fold increase in bank borrowings from the Fed's discount window. Impatient investors, and those receiving margin calls, have been unimpressed with the promises of greater liquidity. However, the provision of money at this scale should make a difference, although it should also raise concerns about an eventual impact on the dollar and interest rates.

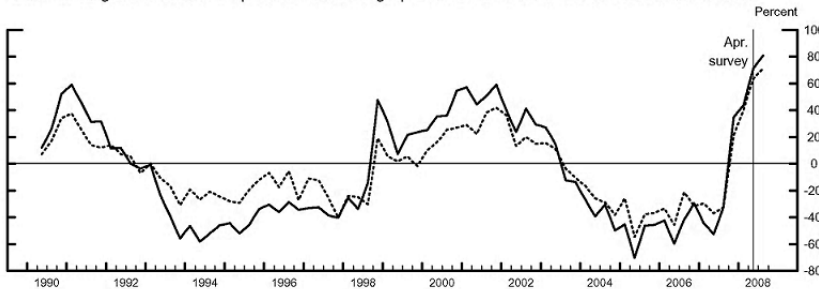
The Need for Lending

In this environment of extreme pessimism, we are able to find numerous attractively priced investment opportunities. Equity investors at this level may yet suffer, but will eventually be well-rewarded. Finding convincing evidence that the economy is again on the upswing will take more time.

Net Percentage of Domestic Respondents Tightening Standards for C&I Loans



Net Percentage of Domestic Respondents Increasing Spreads of Loan Rates over Banks' Costs of Funds



Source: The Federal Reserve Board

Banks have not been making new loans, as revealed in April 2008's Federal Reserve Board Loan Officer Survey (see top chart on left). This data does not reflect the tightening that has come due to the Lehman bankruptcy and September's credit market meltdown. As long as banks are tightening their lending standards, renewed growth will not be found. The next chart illustrates the spreads of loan rates over bank's cost of funds. These spreads have widened since this chart's creation. Until these spreads begin to narrow, they will indicate that banks have little confidence in borrowers' ability to service their loans.

Volatility creates opportunities which can be taken advantage of through incremental purchases of common equities of high quality, industry leading companies that are currently out-of-favor, down in price, and selling at low multiples relative to their fundamental measures of valuation.

We now adhere as tightly as ever to our value-oriented, somewhat contrarian methodology. Surely the degree of pessimism found in today's government inspired crisis of confidence must be the predecessor to solid returns. Wall Street, America, and most of the world is on sale.

Contrarian Value Equity Composite Portfolio Fundamentals as of 9-30-08

	R&W Equity Composite	S&P 500
Number of holdings	36	500
Wtd. Avg. Mkt. Cap. (\$B)	74.3	88.0
Price/Earnings Ratio	12.8	14.7
Price/Book Ratio	1.8	3.9
Price/Cash Flow	6.9	7.6
Dividend Yield	3.1%	2.5%
Return on Equity	15.9%	25.1%

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