

THE LONG AND SHORT OF IT

QUARTERLY NEWSLETTER FROM
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2003 was a good year for equity investors. Hopes of stability and recovery have been replacing the pessimism created by the busted market bubble, the recession, and 9/11. These hopes have been rewarded by indications of honest economic growth. Nevertheless, concerns remain that the recovery is tax-cut induced and thus temporary. From our perspective, with an accommodative Federal Reserve, the eventual return to economic growth was never the issue. The relevant questions were how long and deep the 2000 recession would go (accommodative policies helped to make it less painful) and how sustainable the recovery will be (which is yet to be seen).

Generally, 2003's best performing stocks were the flaky little companies (heavily leveraged with little or no earnings) that had fallen the hardest since the market peak. Perhaps they surprised investors by surviving the recession. Certainly, these companies do a better job marketing their own stock to investors than they do marketing their products to consumers.

Enough time has now elapsed since the extreme capital-spending boom of the 1990's for some of the capital goods created during that period to be fully depreciated. The majority of the fully depreciated goods created in the 1990's are those with the shortest life expectancy; typically technology related items. Thus a pick-up in spending in this area is expected and should continue. Demand for the longer-lived assets is naturally slower to grow but likely to materialize should the recovery be sustained. We do not believe another capital spending boom is in the offing, but the stocks of many of these companies are priced as if a new boom is imminent.

More than excessive bullishness, we believe that the high valuations now seen in small- and mid-cap companies are reflective of the growing consensus (the latest "conventional wisdom") that the traditional classes of equity, especially domestic, large-cap equities, are not the place to be. Small-cap equities have been outperforming for 4.8 years now. The popularity of small-caps has created a momentum in those issues that cannot be sustained in the long run. According to Merrill Lynch's chief small-cap strategist, Satya Pradhuman, the average small cap cycle, going back to the 1930's, lasts 5.7 years. We anticipate that when investors begin to anticipate an increase in interest rates by the Federal Reserve, the winning ways of small cap stocks will come to an end. We are mindful, though, that conventional wisdom can prolong a trend beyond its normally

Percent Return of Composites vs. Benchmarks for Various Time Periods

As of December 31, 2003

Return Periods	1 Year	3 Year	5 Year	Since Inception 12/31/97
Portfolio / Benchmark(s)				
		-----Annualized / Cumulative*-----		
Equity Composite (gross of fee)	26.3	4.9 / 15.3	6.1 / 34.3	7.7 / 55.9
Equity Composite (net of fee)	25.6	4.1 / 12.9	5.4 / 29.9	6.9 / 49.6
<i>S&P BARRA Value Index</i>	31.5	-2.8 / -8.1	1.9 / 9.9	3.9 / 26.0
<i>S&P 500 Index</i>	28.6	-4.1 / -11.8	-0.6 / -3.0	3.8 / 24.7
Balanced Composite (gross of fee)	16.1	5.2 / 16.5	6.1 / 34.7	7.1 / 50.5
Balanced Composite (net of fee)	15.2	4.4 / 13.7	5.3 / 29.2	6.2 / 43.2
<i>60% S&P BARRA Value / 40% SSB 1-5 Year Gov't./Corp. Index</i>	20.0	1.6 / 5.0	4.2 / 22.9	5.5 / 38.1

* Supplemental Information

sustainable period (As with the “new economy” thinking). Are we near the end of the current trend, or will conventional wisdom carry it on? We do not know, but we do know that one benefit of unsustainable trends in favor of one class of equities is that other classes become more attractively priced. Large-caps are now more attractively priced than usual, and are likely to become more attractively priced as the trend continues. We intend to take advantage of this anomaly for your profit as we did in 1999 when the old economy was not good enough for Wall Street’s money.

Opinions vary widely (as they usually do) about valuation levels today. At one end are the seemingly ever bearish who believe that bear markets only end when price-to-earnings ratios go below 8 (they reached a bottom of 19 in October 2002) and dividend yields reach 4.0% to 5.0% (they peaked at 2.2% in October 2002). At the other end are the ebullient such as Arthur Laffer, the original supply side economist, who believes we are already at a price-to-earnings ratio in the low single digits when earnings are measured correctly.

Our proprietary research indicated that the average large-cap stock was 40% over-priced in early 2000. In late 2002, the same research was indicating that companies were 35% under-priced. Now, the numbers come in at 10% below fair value. We have no reason to argue. The market has fluctuated around our calculation of fair value for decades. We have great confidence in the accuracy of our numbers as well as the robust nature of the analysis. The 30 names we own, of course, are seen as even more attractively priced against their fundamentals. Yet, we also recognize that accurate valuations tell you very little about where prices may go in the short run.

Valuation based on a long-term view does not seem to matter much in the short run. Investor sentiment is fickle and always focused on the latest news and trends, which are difficult to anticipate. In fact our approach recognizes this difficulty, finding it more advantageous to respond to unusual events after the market has over-reacted to them, than to attempt to predict them with any regularity.

In other words, the market is mostly efficient, most of the time, usually getting it mostly right. On the other hand there are the valuations we call “non-sequiturs,” i.e. the pricing of an asset that implies a reality that just does not make sense. One example is Cisco with a market capitalization greater than General Electric in early 2000. Cisco’s sales, assets, cash flow and earnings, respectively, were only 15%, 7%, 27%, and 19% of GE’s. It did not make sense that people would ever spend that much money on the types of products Cisco sells or would be capable of selling in the next five years.

During the 1990’s, the stock market recorded some of the lowest volatility in history as it laid the foundation for the great bubble. After this period of unusual stable growth, the markets have shown that averages are made out of extremes by taking investors through some of the widest gyrations (think Elvis) ever. The favor of investors has shifted dramatically among and between the different investment styles, market caps and credit qualities over the last six years. Examples include the moves into growth stocks, and then back to value stocks; the moves into large-cap stocks, and then back to small-cap stocks; and the moves into high quality stocks, and then back into low quality stocks. To us, the direction of each move made sense, but the magnitude of each move did not.

In large measure these aberrant moves appear to be over, with the latest trend among the investing cognoscenti being a move away from the traditional styles of equity investment. It seems to be common knowledge among most “In the business” that traditional stocks will never offer attractive returns again. Their solution is to move funds to alternative investments such as hedge funds, REITS, and international and private equity, all of which seem to be the rage these days.

Anytime something becomes “All the Rage,” (think tulips, junk bonds, and dot-coms), and especially when it comes at the expense of a sector considered to be dead money (the old

economy in the late 1990's and traditional equities today), we see the beginnings of an opportunity in the making. In fact, the whole alternative investment argument sounds like the old economy argument applied more broadly to all high quality, large stocks. The assertion that the greatest engine of growth over the last 100 years has finished its reign and will now lag behind feels like another non-sequitor. It may take a little time before the movement gets over-done and peaks, but it will happen. We will be positioned. We will be ready.

Of interest to those believing America's largest and strongest companies will survive and prosper, the S&P 500 stock index saw its most significant collective rise in dividend payouts in more than two decades. Twenty-one of the S&P 500 companies initiated dividends last year, and 247 increased their dividends. The increase in the total number of dividend payers was the first in 23 years. We have always been partial to solid dividend payers, so we are happy to have more companies with this variable working in your favor. According to Standard & Poor's, from 1926 through 2003 the dividend component of the S&P 500 represented 42% of the index's total return. Also, between 1980 and 2003, the collective average annual return of dividend paying stocks was 1.9% greater than that of the non-payers. And they have accomplished this superior performance while being more stable than their lower yielding brethren. The recent tax rate cut on dividends makes the advantage of these securities even greater.

One interesting quote from the material we covered over the last quarter came from Stephen Roach, chief economist at Morgan Stanley, arguing that a lasting economic recovery cannot be built on an increasingly indebted consumer. In a New York Times article dated January 11, 2004, he stated that "The 90's taught people to spend not just out of their paychecks but also out of their assets." The author Gretchen Morgenson, then added, "First, the stock market, then their homes." Leverage has grown dramatically of late, which is unusual. Typically debt rises during bad times and falls in recoveries. The party must be paid for at some point. Perhaps some of the payment has already been extracted through the weak dollar in 2003. It is likely that debt levels will become a greater problem over the next business cycle.

Determining that a stock is affordably priced is perhaps the easiest part of a true value-oriented approach to investing. Once a company is struggling and its price has dropped, the multiples of price to long-term fundamentals are easier to evaluate than discerning whether the company will eventually be freed of its current problems, much less what condition it will be in at that time. Most problems faced by companies can be overcome in some way over the long run. The real challenges are in evaluating how long it will take to overcome the problems, and determining whether the company is financially strong enough to survive until that time. The latter is more closely tied to credit analysis than equity analysis, and it is something most investors never begin to address. Some investors review a company's credit rating in assessing the level of risk involved, but rarely do they do more. As value-oriented investors, we put significant effort into overcoming these challenges and yes, we do rely on honest and full public disclosure on the part of companies and their executives. In the vast majority of cases, this is sufficient.

We take great delight in hearing or reading the words of some of the few remaining truly value-oriented investors. One of these is a small-cap, distressed company investor named Marty Whitman. In a Barron's article dated November 10, 2003, he explained why the value-oriented approach is not the same as Graham and Dodd once you get beyond the surface. Since his phrasing cannot be improved upon, we quote for you his reply to the question of what he has against Graham and Dodd.

"Everyone talks about Graham and Dodd. Nobody's read them. Graham and Dodd don't say what everybody says they say. For one thing, they knew zip about credit analysis...
...Second, Graham and Dodd very much emphasized all the conventional stuff: the macro picture, the importance of dividends, the past earnings record. One of the last worthwhile editions of Graham and Dodd's Securities analysis was in 1962. After the Securities Act

amendments of 1964, there was a fantastic disclosure explosion. So much so, that outsiders can know an awful lot about a lot of companies, a lot of securities, just by reading the public record.

That kind of stuff was not available to Graham and Dodd. What they provided were really great caveats to follow if you didn't know much about a company because when they originally wrote Securities Analysis – in the 'Thirties – there was no way of knowing a lot about companies. But the public record got so good and no scholars picked up on their original research because they all went for this efficient-market nonsense, which is predicated on the thesis no one can know anything because the market knows everything. Do you know how many efficient-market theorists it takes to change a light bulb? None. The market will take care of it!"

Delightful. Insightful. As value-oriented, somewhat contrarian investors, we are not chasing after the low quality names that have become so popular over the last year. We expect to under perform during large rallies, such as the current rally, but we also expect to out-perform over the full market cycle, and to remain well ahead of appropriate market indices over the long run. Just for perspective, in spite of its 50% rise in 2003, the NASDAQ Composite index still has a 56.2% loss since the market peak in March 2000. As the clients who have been with us since the market peak in March 2000 know, our composite return for the same time period is positive.

Over the long run, valuation matters. Our approach calls for consistent and unwavering dedication to the purchase of industry leaders with clean balance sheets. We purchase them when their prices linger around historically low multiples because they are out of favor or neglected due to a challenge we believe can be overcome. As the economy continues through its normal cycles, it is our hope that our investors remember past cycles and not be drawn to the bright light of the latest "New Thing." We hope they will remember to be a little contrary and to stick with the disciplines that have rewarded investors over the long haul.

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The Equity Composite assets as of December 31, 2003, were \$10.7 million, which represented 26% of the firm's total assets. The Balanced Composite assets as of December 31, 2003, were \$24.3 million, which represented 60% of the firm's total assets. Non-fee-paying accounts are excluded from the composites, and represent 3% of the firm's total assets. Returns are calculated in U.S. dollars.

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