

THE LONG AND SHORT OF IT

QUARTERLY NEWSLETTER FROM
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For the broader economy, few significant new developments took place during the second quarter of 2006. The Fed continued its steady increases in the Fed Funds rate. The economy continued to show moderating growth without slipping into a recession. Housing broke from its fever pitch, but more so in certain parts of the country than others which continue to grow, though at a more sustainable pace.

The new Fed chief, Ben Bernanke, remained in a period of testing. His first year seems particularly difficult, given rising inflation coupled with a slowing economy and a somewhat inverted yield curve. Yet, there has been no true loss of confidence in him.

Historically, the stock market has not performed well for newly appointed Fed Chairmen. Greenspan, appointed on August 11, 1987, pushed through a half-point rate increase at his first Fed policy meeting. After just two months on the job, the stock market had dropped 33%, concluding its decline with what was called Black Monday, October 19, 1987. Many blamed Greenspan's credit tightening for the ensuing market decline. Before Greenspan, Paul Volker, appointed on August 6, 1979, oversaw a 17% drop in the market during February and March of 1980. During William Miller's brief term from March 8, 1978 to August 6, 1979, the market performed fairly well, but there was a 14% decline between September and November of 1978. Even Arthur Burns, appointed on February 1, 1970, was subjected to criticism for presiding over a 31% decline during April and May of 1970.

Of the eleven New Fed Chairmen since 1920 (as far back as we could easily find market data) only two - Young in 1927 and Eccles in 1934 - have not suffered through the stock market's testing of the Fed Chair. Eventually investors seem to realize that the job done will be sufficient in the end, the New Chairman obsession ends, and the market goes on about its business. Bernanke, like his predecessors will likely have to disappoint once before investors can gain the confidence that his actions will be sufficient over the long run.

In addition to obsessing over the Fed Chair, political posturing began its bull market as "public dignitaries" (whatever happened to public servants?) started preparations for the fall elections.

The other big concerns during the quarter seemed to be the increase in inflation (in May, the CPI rose 4.1% and the CPI less food and energy rose 2.4%) and concern about the eventual slowing in the growth rate of corporate earnings (discussed in our newsletter last quarter). These concerns led to a correction that, though modest, was the largest correction (about 8%) since the

Contrarian Value Equity Composite Portfolio Top 10 Holdings as of 6-30-06

Company Name	Percent of Portfolio
Electronic Data Systems Corp.	5.5%
ConocoPhillips Oil Company	5.1
Tribune Company	5.1
BB & T Corporation	5.0
St. Paul Travelers Companies	4.9
American International Group, Inc.	4.6
Verizon Communications	4.5
Abbott Labs	4.4
Gannett Company	4.4
Marsh & McLennan Companies, Inc.	3.9

bottom of the market in 2003. Yet, with a late quarter rally, there was not much damage done. As noted in our last newsletter, periods of poor performance from the market are frequently associated with mid-term election years, rising interest rates and inverted yield curves. With all of those still developing, it is hard to imagine that the worst is over.

During the quarter, there was a clear escalation of hostilities in the Middle East. Historically, during moments such as these, the ensuing market declines serve as buying opportunities. The exception to this was the 1973–74 War between Israel and several Arab nations (The Yom Kippur War), when numerous other economic factors combined with the oil embargo to create a dramatic increase in interest rates and a slow growth economy in the United States. The bear market that ensued eventually turned into a buying opportunity, but most would have liked to avoid the 35% drop required to get there. In this case, there certainly are reasons to be concerned about the escalation of violence. However, there are other differences between the economy of the early 1970's and ours today.

Contrarian Value Equity Composite Portfolio Fundamentals as of 6-30-06		
	R&W Equity Composite	S&P 500
Number of holdings	29	500
Wtd. Avg. Mkt. Cap. (\$B)	67.3	91.3
Price/Earnings Ratio	16.0	19.9
Price/Book Ratio	3.1	3.4
Price/Cash Flow	7.6	9.0
Dividend Yield	2.4%	1.9%
Return on Equity	18.5%	22.3%

We will continue to observe global and macro-level events, but being prepared and positioned for opportunities means following the valuations and detailed events of each individual investment. Although macro trends are interesting, our bottom-up approach discovers investment opportunities one at a time.

After several years of below-average returns for domestic large capitalization stocks, we are finding plenty of good, solid investment opportunities. The economy may get a little too hot, the Fed may raise rates one too many times or not enough, or the Middle East conflict may create a scare.

Yet, most of the companies we follow have been growing earnings at a significant rate for some time while falling further and further out of favor. These are companies that continue to build value over the long run so falling further out of favor is unlikely to continue much longer. Any broad market sell-off over the next several months should provide a very attractive point of entry for the next several years.

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