The Long and Short of It

Quarterly Newsletter from

Robinson & Wilkes, Ltd.

Third Quarter, 2006

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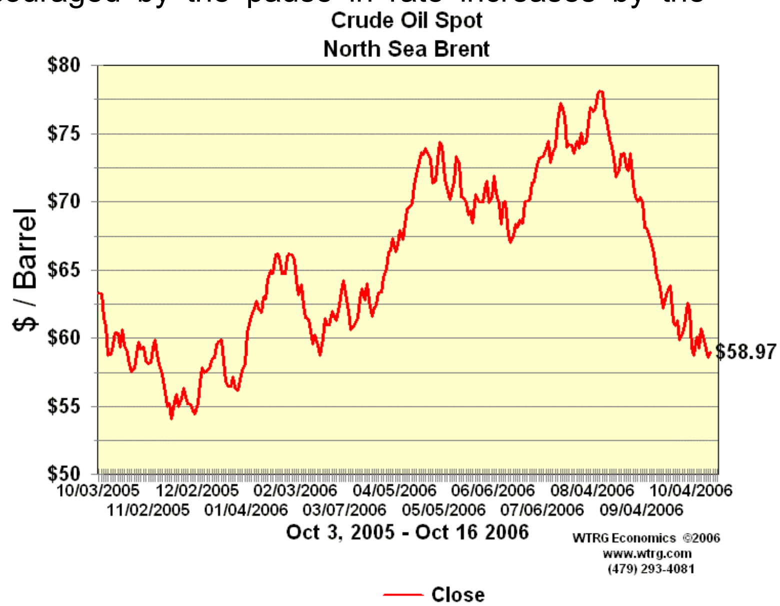
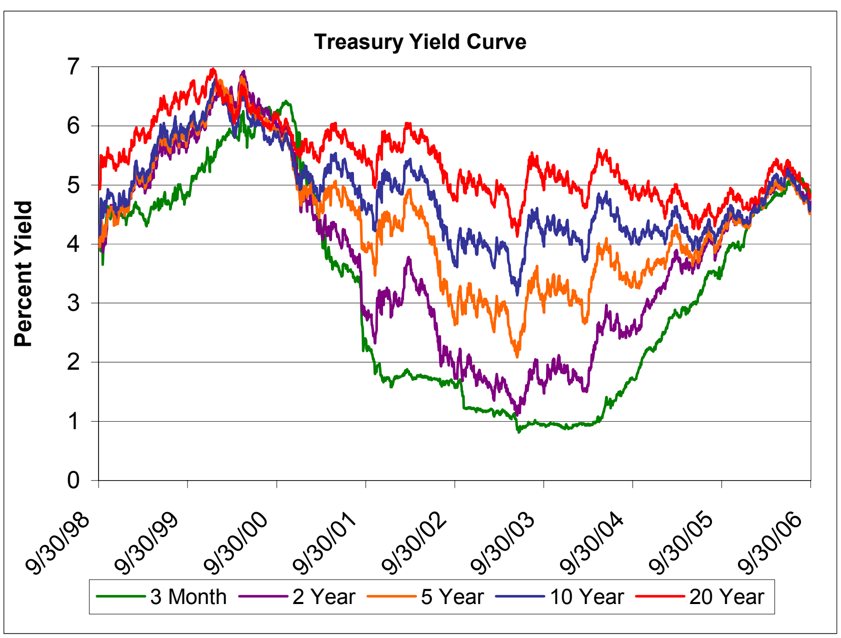
During the third quarter, stocks and bonds turned in healthy, positive returns despite significant macroeconomic uncertainty. After seeing stocks drop during the second quarter, investors were apparently encouraged by the pause in rate increases by the Federal Reserve, as well as the decline in commodity prices which eased inflationary pricing pressures. Of particular note was the drop in the price of crude oil from nearly $78 per barrel to approximately $60 per barrel by quarter end.



These and other events mitigated investors' inflationary fears, which led to a decline in intermediate-term and long-term interest rates. This has resulted in an inverted yield curve (short-term interest rates above long-term interest rates), suggesting that investors expect the economy to slow in the near future.



Typically, an inverted yield curve is accompanied by a decline in stocks as the economic slow down arrives, followed by a recovery in stocks as the Federal Reserve drops interest rates to stimulate the economy. Although it is tempting to make an effort at timing the market at times such as these, the pattern seems to be just unreliable enough to keep investors from making any easy money.

Our approach is to be aware of these macroeconomic issues and to do our best to take advantage of them, while keeping the major focus of our efforts on the fundamentals and the pricing of each of the companies we follow. We realize that the economic cycle will eventually re-cycle, and an investment in a good firm at a great price will provide a solid return over the long run, despite the imperfections in one's ability to perfectly time the economic cycle or a particular stocks response to it.

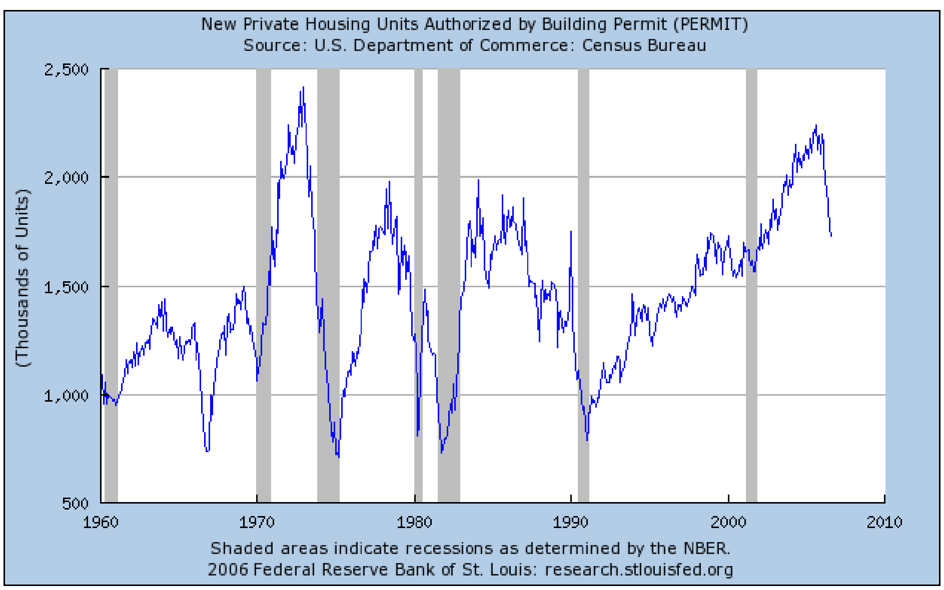
Contrarian Value Equity Composite Portfolio Top 10 Holdings
as of 9-30-06

Company Name	Percent of Portfolio
Electronic Data Systems Corp.	5.2%
American International Group, Inc.	4.8
Marsh & McLennan Companies, Inc.	4.7
BB & T Corporation	4.5
Verizon Communications	4.4
St. Paul Travelers Companies	4.3
Gannett Company	4.3
ConocoPhillips Oil Company	4.2
The Home Depot, Inc.	3.7
JP Morgan Chase & Co.	3.2

During the quarter, hedge funds created some real pain for investors for the first time since they became so prevalent. Amaranth Advisors reportedly lost $6 billion, or half of their fund's value, on bad bets in the natural gas market. Any time a particular behavior becomes very popular among the investing public, large losses seem to soon follow.

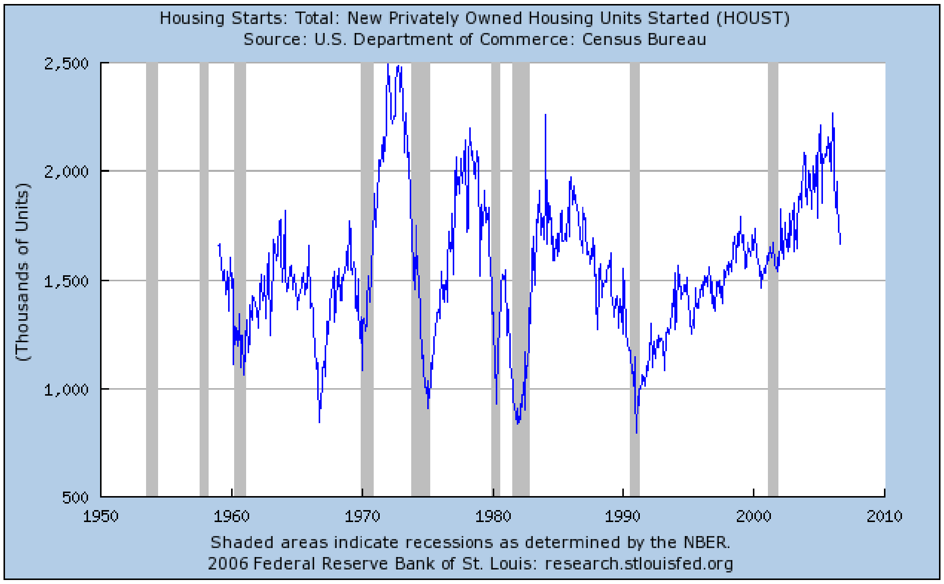
Hedge fund advocates deny that can happen, as hedge fund holdings flow through to the final investment. Although their logic may seem sound, one must remember that the telltale signal for most bubbles is when investors begin to believe that, "This time it's different."

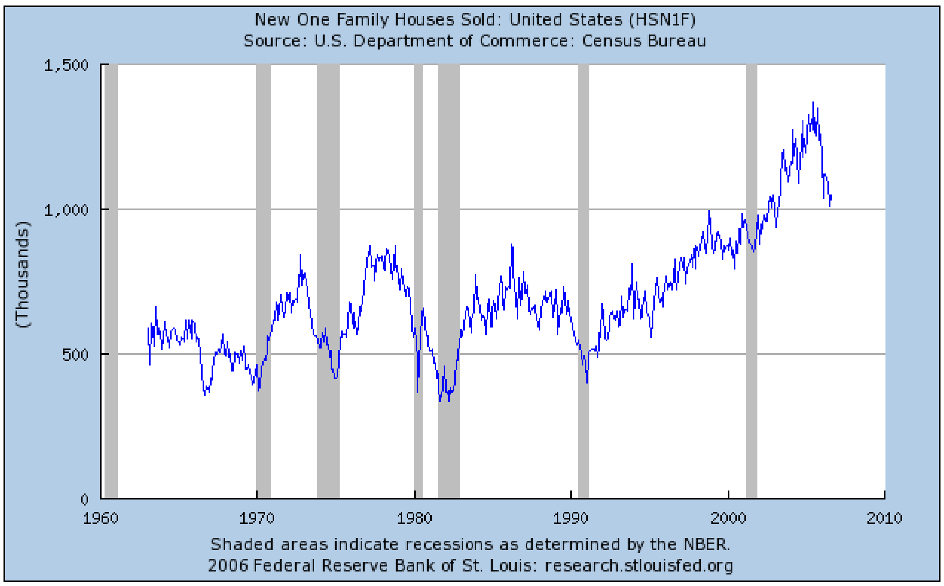
While hedge funds cannot have their prices "bought up" because they must price based on the underlying investments, there remains the risk of many hedge funds pursuing one area of investment (like recent buying in the oil sector). If this were to happen, it remains likely that the old pattern of bubble and burst could reoccur. Perhaps the hedge fund bubble will burst differently, with a series of events such as Amaranth, as opposed to a single industry-wide event, leading to a decline in their popularity. We will bet on history repeating itself in some form.



The loss of $6 billion by Amaranth is similar in magnitude to the $4.5 billion lost in 1998 by Long-Term Capital Management (a funny name for a firm that was in business for a total of four years). Most investors only see the largest failures such as Amaranth and

Long-Term Capital Management. In looking below the headlines, we found, a recent study discloses that, from inception to liquidation, the average hedge fund stays in business for 5.6 years. As for Amaranth, the founders chose the name because, in ancient Greece, the amaranth flower was a symbol of immortality. It was a flower that never died or faded. So much for finding meaning in a name.





The moribund nature of the housing market began to surface more significantly this quarter. There were significant slowdowns in permits, housing starts and new home sales. This may suggest that recession is ahead. But mortgage rates remain very low and most other measures of economic activity (i.e. rising industrial production, durable goods, factory orders, and personal income, along with a low unemployment rate and inventory-to-sales ratio) indicate robust economic activity.

Although most declines in housing are accompanied by a recession, some are not. Therefore, we continue watching the housing market. A continued decline in housing would portend a looming recession. On the other hand, stabilization at these lower rates of growth would be ideal for the hoped for “soft landing.”

We will also continue watching other measures of economic activity, like those listed above, for any significant slowing. Keep in mind, that the stock market’s strong performance denies any impending recession (it usually drops several months before a recession). Moreover, short-term interest rates now have plenty of room to drop if the Fed needs to stimulate the economy.

Finally, over the long run, cycles matter much less and valuations matter most. Currently, valuations remain attractive for many of the large domestic companies we follow.

During the early stages of a bull market (after the bear market lows have been put in) small capitalization companies and risky or heavily leveraged companies tend to do quite well for a period of time. As an economic expansion ages, the small and risky companies become more fully–priced, and investors typically begin to seek larger, higher quality, more defensive companies that will perform better if the economy slows. These are the types of companies in which we invest and it is our perception that this stage of the market cycle has been reached.

The small cap and higher risk stocks, which have done so well over the last few years, have become over-priced. Investors seem to be starting the process of returning to the tried and true names that, today, have quite reasonable valuations. Hopefully this will lead to a period of excess returns for our very patient investors.

Contrarian Value Equity Composite Portfolio
Fundamentals
as of 9-30-06

	R&W Equity Composite	S&P 500
Number of holdings	31	500
Wtd. Avg. Mkt. Cap. ($B)	69.9	95.7
Price/Earnings Ratio	15.5	18.2
Price/Book Ratio	2.7	3.5
Price/Cash Flow	7.8	9.3
Dividend Yield	2.4%	1.8%
Return on Equity	19.2%	22.1%

We are grateful to our exceptional clients for the trust they have placed in us. We remain deeply loyal to the process, as it has performed well for over thirty years. We continue to see our process perform in ways that are consistent with its long-term record of success; i.e. lagging in bull markets (especially when there are no significant corrections, as during the last three years), outperforming in bear markets, and outperforming over full market cycles.

The process can be emotionally difficult, especially during lagging periods. Yet over the long run, perseverance historically yields good, solid returns with the added benefit of somewhat reduced volatility.