R&W

ROBINSON & WILKES, LTD.

INVESTMENT MANAGEMENT

QUARTERLY NEWSLETTER SECOND QUARTER 2007

The Long & Short of It

Rising Rates

Stocks moved higher in April and May, but retreated in June as the continuing trend of rising interest rates throughout the quarter finally became too painful for equity investors to ignore. The S&P 500 rose 6.24% during the quarter, while intermediate treasury bonds gave up as much in price as they produced in yield. The Lehman Brothers U.S. Aggregate Bond Index (a bond index with broader diversification) lost about 1.5%.

Although interest rates increased throughout the quarter, easy credit remained sufficiently plentiful to continue encouraging the private equity boom. Nevertheless, fear of tightening credit was one of the concerns causing June's decline in stocks. Many investors are focused on whether there will be enough credit available for the private equity boom to continue. The market reflects such widely held concerns. As usual, we are on the lookout for the type of problems that are less widely anticipated, and thus more capable of creating a meaningful negative surprise.

While rising interest rates should eventually slow the zeal for going private with lots of debt, we will not predict a collapse in private equity. However, we cannot help but be concerned about the growing leverage of these newly privatized companies. While publicly traded companies generally maintain fairly strong balance sheets and solid credit ratings, there is a quickly growing list of companies with balance sheets deeply leveraged as the company was taken private. Leveraged balance sheets work well in a growing economy, but can create significant problems in a slowing economy.

Contrarian Value Equity Composite Portfolio
Top 10 Holdings
as of 6-30-07

Company Name	Percent of Portfolio
Electronic Data Systems Corp.	5.6%
ConocoPhillips Oil Company	5.2
Marsh & McLennan Companies, Inc.	5.1
American International Group, Inc.	4.9
Verizon Communications	4.7
Coca-Cola Company	4.6
BB & T Corporation	4.3
Gannett Company	4.0
The Home Depot, Inc.	3.9
Pfizer, Inc.	3.6

Declining Consumption

A logical question, given that the non-US industrialized economies are beginning to see a new earnings expansion, is "What could cause a slowdown?" We say, "The American Consumer." We recognize that investors have erroneously anticipated a slowdown in domestic consumer spending for longer than most managers have been investing.

So, it is likely the American consumer must encounter a considerable headwind before willingly foregoing their conspicuous consumption. In this limited space, we offer two potentially significant headwinds.

Rising Energy Prices

The first impediment to the American consumer may come in the form of a renewed increase in energy prices. Crude oil and its derivatives are not as much a part of the economy as they were in the 1970's, and prices have yet to reach 1970's levels, in inflation adjusted dollars,. Yet, crude oil is now bumping up against old high prices, egged on by the very global expansion that has recently comforted investors. Significant new high prices for petroleum may begin to have an impact on the consumer that, for the most part, has been avoided thus far.

Contrarian Value Equity Composite Portfolio
Fundamentals
as of 6-30-07

	R&W Equity Composite	S&P 500
Number of holdings	32	500
Wtd. Avg. Mkt. Cap. ($B)	85.7	103.5
Price/Earnings Ratio	16.1	18.3
Price/Book Ratio	3.0	3.9
Price/Cash Flow	8.2	9.4
Dividend Yield	2.5%	1.8%
Return on Equity	18.4%	21.9%

A recovering non-US economy spurs demand for goods and increases inflationary pressures. Such pressures, combined with inflationary rising energy prices, support the Federal Reserve's current restrictive policy (high short term interest rates in the United States) to stem inflation. High interest rates provide another potential headwind for the American consumer for the reasons discussed below, i.e. rising mortgage payments and retreating lenders.

Rising Mortgage Payments

As we mentioned last quarter, mortgage rate resets are likely to peak by the late Fall of 2007. Yet, as noted recently by Jim Grant and his analyst, Dan Gertner, $1 trillion of subprime Residential Mortgage Backed Securities were issued during 2005 and 2006. Over $25 billion of these subprime ARM's will reset in each of the next 18 months.

With the rise in interest rates last quarter, ARM mortgage rates are resetting to higher levels not seen in four to seven years, depending on the term of the loan used to peg the rate. The impact is finally being recognized by the rating agencies, as evidenced by S&P and Moody's announced significant problems in mortgage instruments, including downgrade watches and downgrades.

An additional detail about the mortgage market worth noting is the recent normalization (de-inversion) of the inverted yield curve. Long-term interest rates are now above short maturity interest rates for the first time in about a year. This means that the relative attractiveness of longer maturities that has existed since short rates closed ranks with long rates has gone away. Now, if the short-term rates are high after a rate reset, then long-term rates will be even higher. Choosing to lock in a mortgage rate for the long-term now is even more painful for the American consumer.

Retreating Lenders

In addition, rising bank charge-offs for mortgage debt gone bad, and the resulting tightening of lending standards, makes it clear consumers will not be getting much help from their bankers, who have already extended more credit than might be considered prudent. Bankers are likely to demand greater spreads for lower quality credits, as well as greater security in the form of greater down payments, greater income coverage for mortgage payments, and greater collateral, though house prices have already dropped in many areas.

Private Debt Challenged

Should energy prices and mortgages slow American consumption, we expect the impact to be most evident on the recently privatized (and highly leveraged) companies. Standard procedure in going private is to saddle the acquired firm with 60% to 80% debt, and then hope to pay down the debt to more reasonable levels over a three- to five-year period. By comparison, the typical debt load carried by most publicly traded companies is in the range of 20% to 40%. Currently, the typical publicly traded company is carrying even less debt on the balance sheet, so a consumer slowdown would likely be much more painful for the recently privatized companies than for their public brethren.

In addition, the largest domestic companies, not so much targets of the private equity funds, typically have a greater portion of their revenues from non-US consumers. As a result, they will be less affected by a slowdown in domestic consumer spending. Smaller companies (many of which are newly private and leveraged) typically generate more of their sales from the domestic economy; so, again, they will be more vulnerable to slowing domestic consumption.

Lenders Retreat Further

If the holdings of private equity funds begin to have debt defaults due to a consumer recession, banks are likely to further tighten lending standards and the whole situation could become rather glum. Of course, the truly dire scenario is typically avoided as the Federal Reserve has the ability to lower rates – we hope Mr. Bernanke has easy access to his wallet, so he can quickly spread the cash liberally. We expect he is up to the challenge, though he may find that perfecting the timing of such changes to policy difficult.

Solid, Attractively Priced Companies Benefit from Flight to Safety

We have heard several comparisons recently between the amount of money chasing deals during the dot-com days and the current private equity boom. When the average investor finally tunes in to the opportunity of the latest boom, the boom usually begins to unravel. In this letter, we have commented on a few risks. There are always others that cannot be identified in advance. Even those identified are not easy to quantify and to translate into actionable investment recommendations.

At Robinson & Wilkes, client investments remain positioned, to the best of our ability, outside of the private equity and mortgage hotspots. We remain watchful for catalysts to risk events while continuing to seek value-oriented investment opportunities among that which is unloved on Wall Street. As you know, our approach is to stick with quality names and a tried and true approach, no matter how tempting the next popular new idea may sound.

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