

The Long & Short of It

The fourth quarter of 2007 brought a difficult end to a difficult year. In the face of mortgage problems and a broad credit contraction, investment victories were few and carried narrow margins. One change worth noticing is that, for 2007, large cap stocks outperformed small cap stocks for the first time in six years.

Bear Market

At this point, it appears the bear has arrived. After 4½ years of a rising stock market with no significant correction, one could say we were due. Bear markets nearly always come in three phases. During the first phase, the leadership (best performing stocks) narrows, while the broader market begins a slow decline. Examples of leadership narrowing are the nifty-fifty in the early 1970's, the mega-cap and dot-com technology stocks in 1999, and the technology and agricultural stocks in 2007.

During the second phase, the leadership turns down dramatically, while the broader market stabilizes or even recovers somewhat. This is typically when the value and contrarian approaches turn in their best performances relative to the indices.

During the third phase of a bear market, everyone gets hurt. It does not end until, as they say, there is blood in the streets. The last year of this type was 2002. The Bull/Bear cycle of 2000 to 2002 provides the most clear, recent example of a bear market pattern. However, most bull and bear markets are orders of magnitude smaller than our most recent, in both price swing and time required to complete.

This time around, the broader market peaked in May of 2007. But the NASDAQ 100 did not peak until the last day of October 2007, when the broader market was already 7% off it highs. This period of time, from May to October of 2007, marks the first phase of this bear market. In 2007, as in 1999, the leadership came from the technology sector and was very narrow. While the S&P 500 stock index returned just over 5%, Apple and

Contrarian Value Equity Composite Portfolio Top 10 Holdings as of 12-31-07

Company Name	Percent of Portfolio
ConocoPhillips Oil Company	6.1%
Johnson & Johnson	5.0
Molex, Inc.	5.0
American International Group, Inc.	4.3
Electronic Data Systems Corp.	3.8
Barrick Gold Corp.	3.5
Pfizer, Inc.	3.4
Marsh & McLennan Companies, Inc.	3.2
BB & T Corporation	3.2
Alcoa Inc.	3.0

Google, already selling for stratospheric multiples at the beginning of the year, contributed about 25% of the total return of the S&P 500 stock index for 2007.

During the second phase of the current bear market, November 2007 to the present, the former leadership should drop rather steeply while the broader market resists participating in the downside as dramatically. In January 2008, we are seeing this begin to transpire. Unfortunately, much of the proceeds from sales of the "leading" stocks are not yet being reinvested into the broader market. Much of these proceeds are being used to pay down debt, as might be expected during a credit contraction.

Yet, the low multiple, large cap stocks are falling much more slowly than the high tech and agricultural leadership of 2007. We expect that the international stocks, so much in vogue over the last several years, will be the next shoe to drop, again creating more proceeds with which to pay off debt and move back into safer domestic large cap stocks.

More monetary accommodation is needed to slow the contraction, but it seems Fed Chairman Ben Bernanke wants to avoid the very thing that prior Fed Chairman Greenspan is being blamed for today – being too accommodative. So, instead of getting in front of the problem through one or two quick, large drops in the Fed Funds rate, Bernanke appears to be willing to wait until the slowdown is obvious enough to create consensus among critics who seek a more restrictive Fed. Whatever he is waiting for, his hesitancy to reduce the level of Fed Funds is reducing inflation and growth expectations dramatically, which is why U.S. Treasury rates continue to drop.

Financial Innovation and The Credit Cycle

Innovation is something spoken of frequently in the area of finance. One speaker recently credited financial innovation as the determinant of the variable "V" (velocity of money) in the macro-economic equation $M \cdot V = P \cdot Q$. This equation, taught in Economics 101, simply states that the money supply (M) times its velocity (V - the average frequency with which a unit of money is spent) produces a product that is the output of an economy, i.e. the price of goods (P) times the quantity of goods that changed hands (Q). Much has been said and written about how innovation in the financial markets drives the velocity of money, i.e. faster innovation creates faster economic growth. This sounds convincing to most, and for people in the field of investments and finance, almost noble. After all, how better to help the world be a better place than to consistently drive the world toward wealth creation through greater financial innovation?

Contrarian Value Equity Composite Portfolio Fundamentals as of 12-31-07

	R&W Equity Composite	S&P 500
Number of holdings	35	500
Wtd. Avg. Mkt. Cap. (\$B)	82.6	109.1
Price/Earnings Ratio	25.0	19.8
Price/Book Ratio	2.2	2.1
Price/Cash Flow	11.6	10.2
Dividend Yield	2.8%	2.0%
Return on Equity	16.1%	22.6%

While we subscribe to the use of the macro-economic equation, there remains some need for fine-tuning what is meant by the term financial innovation. First, one needs to separate financial innovation from monetary innovation, which does impact velocity. Improvements in money and its transfer mechanisms allow money to change hands faster. The advent of the debit card serves as an example of this concept.

Where financial innovation is concerned, financial instruments and the estimation of their values (investing) are almost completely defined by the process of discounting future cash flows. Innovation does not take place in the mathematical exercise of discounting future cash flows.

Discounting of cash flows is done today in the same fashion that it was by its inventor. It is simply a matter of determining the amount of future payments, when the payments happen and discounting those payments with an appropriate interest rate. Since innovation cannot apply to that process, "financial innovation" becomes a term primarily used to describe the many innovative ways Wall Street comes up with to parse and package cash flows. The attractive wrapping placed around these instruments seems in many ways intended to distract investors from actually reflecting on the potential cash flows and their discounted values.

Sadly, this type of innovation only creates cyclical improvements. It does not lead to dramatic real improvement over the long run. It merely aids in the creation of the credit cycle.

An American economist named Hyman Minsky, (1919 to 1996), described a model of asset bubbles driven by credit cycles, where economic and financial stability leads to a lowering of investors' risk aversion and a process of taking on leverage (i.e. debt). As it goes, economic growth becomes so stable that both borrowers and lenders become willing to accept greater levels of debt and interest payments relative to assets and income levels until the resulting increase in asset prices becomes unsustainable. The resulting instability forces a deleveraging, which eventually leads again to stability, which again leads to releveraging - thus the credit cycle.

Clearly, deleveraging is what is taking place now.

Opportunities Abound

With a 15% decline in the market completed at the time of the writing this newsletter, we do not see a great deal of downside remaining. The top of the market did not reach the valuation levels seen in many previous bull market runs. With the 15% drop, we are already approaching the levels seen in the bear market that ended in 2002. We are finding many companies selling at valuation multiples that are clearly attractive. Most large cap stocks purchased at these levels should be richly rewarding to their investors a few years hence. However, attractive valuations do not always immediately translate into



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market bottoms. Valuations can become quite illogical before the direction of the market changes. This time is likely to be no different.

Over the last five years, investment performance has come, at times with great ease, from every source except from the old standard, the very traditional asset class of domestic, large capitalization stocks. After all, there has been considerable pressure placed on investors and their advisors to get with it, move away from the old “has been” of traditional big domestic stocks, and participate in the latest new thing.

This type of pressure is not unusual in an economic expansion. What has been interesting in this go-round is the number of “new things”, each as compelling as the last, with each being accepted by most investors as clearly a more intelligent choice than staying in domestic large cap stocks. Investors have seen solid results during this period from micro-caps, small-caps, mid-caps, international, private equity, real estate and hedge funds. As these areas for investment have begun to unravel, capital has begun to return, though grudgingly, toward the old standard that had become an anathema to advisors set on helping their clients to participate in the latest thing.

As the credit cycle unwinds, the stock market will be volatile. Rising or falling, we expect investors will continue to shift equity holdings toward the safety of domestic, large cap stocks, especially the industry leaders with clean balance sheets. Given their already attractive multiples, any further sell-off must be met with growing optimism about the opportunities. We look forward to this and continue to embrace our prudent approach, especially after being so out of favor as it has been these last few years.

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