



The Long & Short of It

The failure of many of our nation's foremost financial firms in the fall of 2008 caused a cascading credit crisis that reverberated worldwide in the fourth quarter. During the quarter, the S&P 500 declined by 21.9%. According to Morningstar, the average domestic stock fund lost 24.5% and the average international stock fund fell 23.1%. For the full year, the S&P 500 dropped by 37.0%, the average domestic stock fund fell 39.2%, and the average international stock fund declined 45.9%. Latin American stock funds led the way down, with losses of 59.8%.

There were few places to hide as investors demanded greater returns for the perceived greater risk, thus also driving down dramatically the prices of most bonds. The most obvious exception was U.S. Treasury bonds, which were purchased hand-over-fist in the largest flight to quality in decades. Over the course of the year, the average taxable bond fund lost 8.0%. Note that this is a total return figure, one that includes the positive impact of the bond's coupons. Worse yet, high yield bond funds lost 26.3%. The safe haven of U.S. Treasury bonds produced mid-single digit returns for short and intermediate maturities. Longer maturities returned between 20% and 30%. Currently yielding less than 3%, U.S. Treasury bonds now offer little, other than an over-stated perception of safety. When investors' appetite for risk and other asset classes resumes, the flight out of treasuries may be equally or even more dramatic than last year's rush into treasuries.

The business cycle, including such deflationary phases such as we are now experiencing, has long been a part of the successful American economy. The Keynesian notion of governments being able to stabilize the economic cycle has been guiding U.S. economic policies for some time now. It is a difficult balancing act between inflation and slow growth, but these efforts to eliminate the deflationary portion of the business cycle have encouraged the creation of asset price bubbles and the taking on of debt. The longer the periods of stability, the larger debt loads tend to become. Larger debt loads lead to larger contractions, such as the current one, with the result being that the government's balancing act becomes ever more precarious. Greater and greater inflation of the money supply and deficit spending is required to offset the deflationary/recessionary portion of the business cycle.

The U.S. government is now re-inflating more aggressively than at anytime since World War II. The government's latest thrust is the Federal Reserve's program to purchase \$500 billion of agency mortgage-backed securities. This program will begin in early January and will be funded through the creation of additional bank reserves (printing dollars). It must be completed, by the end of June 2009. It is clear that the government will persevere with re-inflating until it succeeds in avoiding the "great deflation," but likely at the expense of future inflation and a weaker dollar. Robinson Value Management's (RVM) client portfolios are already well positioned for such an outcome, and benefited nicely from exposure to gold mining stocks during the fourth quarter.

Asset bubbles over the last 30 years have always focused on a particular area of investment: junk bonds, biotech companies, dot-coms, and large cap stocks (or indexing). Over the last five years there has been less of an intentional emphasis on pursuing what is in fashion, than an outright avoidance of traditional asset classes, especially domestic, large cap stocks. As the real estate bubble grew, this dynamic led to mini-bubbles in most of the non-traditional asset classes, including small-cap stocks, international and emerging country stocks, hedge funds, and private equity. We do not believe any of these areas for investment will disappear, but we do see institutional investors becoming less enamored with alternative investments and structured finance, resulting in a significant return to traditional investment classes.

In the last several years, one error committed by numerous investors has been an excessive allocation to international investments. International investments historically have provided higher rates of growth and slightly higher returns than domestic investments. They have demonstrated attractive qualities for diversification due to low correlations with domestic assets during periods of stability. The benefits of international investments appear overstated for two reasons. First, the low correlations disappear during times of economic



crisis. As it did during last year, history shows that when our stock market experiences a serious decline, international stocks decline further. They make for great diversification until they are most needed for such, at which time they betray their investors. Secondly, domestic companies frequently have significant sales and even manufacturing operations outside of the United States. Coca Cola and Intel, for example, provide global diversification, as do many companies whose headquarters and stock listings based domestically. The 200 companies we follow most closely all trade on the New York or NASDAQ exchanges, obtain well over 40% of their sales from abroad, and nearly all are headquartered in the United States.

The need for currency diversification is also over-stated. Currencies can be quite volatile, but do not produce wealth or long-term expected returns like stocks, bonds, or cash. Also, history shows that the vulnerability of any local currency can be effectively hedged with precious metals. The key to effectively hedging currency risk is to employ significant operating leverage by buying shares of particular types of mining companies rather than owning the metal outright. This method eschews the use of debt and yet, through it, a significant hedge can be made with a relatively small investment.

Looking at the economy, we continue to have little desire or ability to prognosticate, as has remained the case since we began investing. We will leave that for the economists. We are, however, keenly aware that valuations for many of the stocks that we follow are more compelling than at any time since 1969, the year in which our company specific financial statement and price data begins. We also cannot make any predictions as to when a recovery for investments will arrive. Yet, barring some unforeseen external shock greater than has been seen in the last 100 years, we believe that late 2008 will be looked back on as one of the greatest buying opportunities of this century.

With the New Year, our firm has taken on a new name: Robinson Value Management, Ltd. The change in name brings little other change. As always we continue to focus on our value-oriented, somewhat contrarian research process. We continue to seek high quality investments that are temporarily under-priced and out of favor, emphasizing risk avoidance just slightly more than return enhancement. We remain ever mindful that the best way to make money is to avoid and minimize loss. While no one can predict inflation or deflation for the next year, we can work to identify industry leading companies that are less likely to be hard-hit by the economic turmoil because they are 1) attractively priced, 2) less reliant on the financial system, 3) do not rely on discretionary spending from consumers, and/or 4) have strong balance sheets.

We wish you all the best, in particular survival, in 2009.

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