The Long & Short of It

Quarterly Newsletter
First Quarter 2009

Two Steps Back, One Step Forward

The bitter disappointment of 2008 was followed by the bitter disappointment of January and February 2009. At RVM, we are unable to recall feeling as emotionally distressed about the state of investments as we did during the last week of February and first week of March. With pessimism so deep and pervasive, surely most investors capable of parting with their stock holdings must have capitulated by that time. The low in early March will mark "A Bottom," though no one can know with certainty if it will mark "The Bottom." The ensuing rally in March felt very nice, but was unable to retrace the year-to-date decline. Having lost 8% in January and 11% in February, the 9% return in March left the S&P 500 down almost 11% for the quarter. In an unusual divergence, the Russell Value Index, heavy in financial sector stocks, fell almost 17%, significantly more than the broader market. Finance has led the decline; it will likely lead the recovery.

For many companies, their common stock is at least as attractively priced as it was at the bear market bottom in 1974. The extreme pessimism and sharp decline of the last several months are unsustainable. Yet, market bottoms typically are tested before moving fully to the bull market phase. In addition, we have yet to see a significant improvement in bank officer lending standards, a statistic that usually begins to improve before the market bottoms and definitely must improve before any permanent bull market can take hold. Certainly the government is attempting to do its part to renew growth.

In a nice bit of research by Jim Grant in his April 3, 2009 issue of *Grant's Interest Rate Observer*, measure was taken of our government's stimulus response to the last 13 recessions (i.e. back to 1929). It is a bit of math of which all Americans should be aware. His measurement was one that combined fiscal stimulus (change in the federal budget deficit as a percentage of GDP) and monetary stimulus (cumulative change in the Federal Reserve's balance sheet as a percentage of GDP). The largest stimulus preceding the current slowdown was that of the Great Depression, coming in at 8.3% of GDP. The other 11 averaged 2.7% of GDP. This time around our government will be providing an estimated fiscal stimulus equal to 11.9% of GDP and monetary stimulus of 18% of GDP. This adds up to an eye-popping combined stimulus of 29.9% of GDP.

The Great Crush-Session

With such a response, we know this recession will be different from both the Great Depression and prior downturns. For some much needed levity, we suggest a name for this economic moment: "The Great Crescession." It works for several reasons, beginning with the obvious linking of the terms "credit" and "recession." It also sounds a bit like "Crush," a word useful in describing much of what happened over the last year. Most importantly, it is derived from the Latin *crescere,* which means "to grow," something our government has done in nearly every post-Keynesian economic contraction, and will do yet again during this crescession. *Crescere* is also the root for the English word "crescendo," something toward which many feel we are headed.

Interestingly, a Spanish dictionary reveals that the neuter conjugation of "crecer" can mean, "To augment the extrinsic value of money." In the case of the 2008-2009 global crescession, this dictionary is most assuredly referring to real money, i.e. gold, as most paper currencies could end up emasculated. Further, in the reflexive conjugation, "crecer" means "To grow bolder, to acquire greater confidence; to get conceited, to have an exaggerated sense of one's importance." Clearly "reflexive" describes the responses offered up by so many very confident politicians intending to remedy the crescession using any means possible.

In order to make the term truly useful, especially for the government, our new word needs a formal definition. A crescession is ***"a severe, credit driven economic contraction through which the government and the public debt are the only things that grow."***

Tea Party Anyone?

Another bit of growth worthy of note is that of the number of pages in the CCH Standard Federal Tax Reporter, which records tax law, regulations, and related materials. According to the <u>Wall Street Journal</u>, this reference has grown from 26,300 pages in 1984 to 70,320 pages today. The University of Michigan estimates that the time and money individuals spend on tax compliance now adds up to $90 billion per year. So each year, roughly, individuals spend the equivalent of the market capitalization of the Coca Cola Company on tax preparation. If cash spent by businesses is included, the amount rises above $200 billion. Barron's cites the IRS estimate that individuals and businesses spend 7.6 billion man-hours complying with federal taxes. Moreover, none of these estimates include government expenditures on tax collection and/or the time spent by government employees on income tax administration.

Keeping the Big Picture in Mind

There is enough change and uncertainty to go around these days. In business school, it is taught that risk has to be compensated. A riskier investment, all things being equal, will carry a lower price. The uncertainties of today's environment have a lot to do with the low prices found for most investments. At some point the prospect for more change will begin to decline and investors will begin to take risks again. The bottom line for investors is that valuations on most common stocks are currently compelling to a degree not frequently seen throughout history. That alone should make it a good time to be a buyer of stocks. The high degree of pessimism found in early March was another reason to be a buyer of stocks. Future declines, especially at moments when pessimism feels oppressive, should again provide opportunities to add to holdings of stocks. However, strong balance sheets are likely to remain of utmost importance in the equity valuation process.

Finally, governments around the world are actively inflating their economies out of this deflationary moment. Eventually they will succeed or enough time will pass that the problems will be digested. Economic growth, and inflation, will resume. The two-pronged government stimulus mentioned earlier, combined with the inventory reductions seen in the first quarter of 2009, may lead to growth sooner than many expect. Somewhere along the way, succeed or not, the economic cycle will work from ebb to flow and valuations will normalize. A side effect could be that precious metals may continue to perform well.

It is during periods such as these that we are very happy to have strong internal research centered on our database of company specific financial statement and market data going back to 1969. Many investment professionals today who do not have access to such data (or want to sell a new product) will claim that the past tells us nothing about where we are today. We hue more closely to the old cliché that "The more things change the more they stay the same." Economic cycles are named "cycles" for good reason. More importantly, discounting future cash flows is conducted in much the same way today as it was since money was first lent at interest in ancient times. Moreover, the same methods described in Irving Fisher's 1930 book, The Theory of Interest, and John Burr Williams's 1938 text, The Theory of Investment Value, are still used to value stocks today.

Contrarian Value Equity Composite
Portfolio Fundamentals
as of 3-31-09

	RVM Equity Composite	S&P 500
Number of holdings	31	500
Wtd. Avg. Mkt. Cap. ($B)	38.8	69.2
Price/Earnings Ratio	15.8	14.5
Price/Book Ratio	1.6	3.3
Price/Cash Flow	7.0	6.7
Dividend Yield	3.6%	2.9%
Return on Equity	20.4%	7.8%

Our research shows that valuations such as these have taken place before for most companies that we follow, albeit rarely. Typically, investors only read about moments such as these, as well as fortunes that were made by those stalwarts unshaken by the turmoil. Our research tells us that, at these levels, we should be very optimistic about the long-term prospects for client portfolios and the opportunities before us. We have to admit that this is difficult to do while having access to a media outlet. Nonetheless, this is the position we will take. The companies in our client portfolios are higher quality and more attractively valued than at any time in the last 17 years. In our view, these stocks are as attractively positioned as they would have been near the bottom in 1974. The return to civilization will surely be a bumpy road. We suggest it may be well worth the trip.

Robinson Value Management, Ltd. (RVM) is an independent investment management firm, not affiliated with any parent organization. Founded in 1997, Robinson Value Management, Ltd. is registered with the SEC and serves both individual and institutional clients. The name was changed to Robinson Value Management, Ltd. from Robinson & Wilkes, Ltd. on December 31, 2008.