

The Long & Short of It

Quarterly Newsletter
Fourth Quarter 2012

In 2012, we discussed hedging against the impact of increased government debt and regulation and the implications of the fiscal cliff. The motivation behind our approach to investing is the need to be a prudent investor in today's environment. As the structure of our county's balance sheet and the management of that balance sheet change, the actions that qualify as prudent must change as well.

Dear Prudence

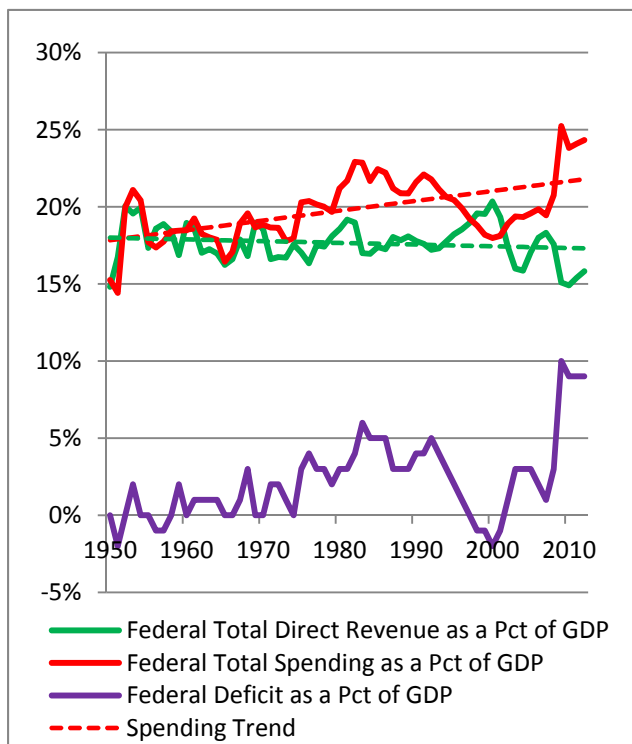
In the familiar Beatles tune, the lyrics entreat us to "Look around round round" and to "open up your eyes." Interestingly, the word's Latin root "*prudencia*" is merely a contraction for *Providentia*, the Roman goddess of foresight. Today, the word prudence seems to have become synonymous with caution. Perhaps a more accurate definition of the word would be the ability to govern and discipline oneself by the use of reason. Since we are referencing the Romans, it would be good to put its meaning in terms of the battle, thus prudence requires one to use foresight in choosing which fights to pick. As investors this translates into knowing which risks to take.

Traditionally, for cautious souls, the U.S. Treasury bond has been an easy path to prudence, offering decent returns, backed by Uncle Sam's wallet, and denominated in the world's reserve currency. Yet, after a 30 year bull market in bonds, interest rates ranging from 0%-3%, the federal debt looming ever larger, and a profligate Congress that appears unable to stem its debt accumulating ways, sitting where it has always been safe may be imprudent. In what we can foresee, U.S. Treasuries may be used for short term purposes, but "buy and hold" is dead. As quickly as markets fluctuate these days and as numb as the country has become to large amounts of debt, to seek prudence, investors must be nimble.

That Holiday Spirit

The stage was set for the fourth quarter investment markets in September with the promise of massive bond buying (money printing) by both the European Central Bank (September 6) and the Federal Reserve (September 13). Overall, the fourth quarter of 2012 was not easy for investors. The stock market, as measured by the S&P 500 was down as much as 6% in mid-November. As Thanksgiving approached, with holiday spirit in full swing, the politicians promised a deal, thus avoiding being labeled "Mr. Grinch". The Whos in Whoville (investors) soon followed with their own merry making, producing an 8% rally. However, the party was over before it began as December came to a close, the market began to sell off, ending the quarter down about one half of a percent.

At Robinson Value Management, we understand that the process of being prudent, of knowing which risks to take, is more important today in our current environment than it was in the go-go years of the bull market.





With floating exchange rates and the gold standard long ago abandoned, government spending has been set free through the mechanisms of borrowing and money printing. Currently buying its own bonds at a rate of over \$1 trillion per year, the U.S. federal government is financing about 80% of its annual deficit. The deficit amounts to over 35% of annual federal government spending, nearly one quarter of all economic activity in the United States or approximately 8% of the gross domestic product. If the government's ability to borrow in excess of the growth rate of the economy and population of the United States were removed, which one day it will be, then GDP would be somewhere around 6-8% below today's levels. It would seem prudent to assert that a slowing economy, accelerated money printing, or a combination of the two, are in our future. Moreover, reason seems to suggest that exposure to gold, specifically gold miners, should provide a counterbalance to the economic headwinds facing investors.

Gold: The Barbarous Relic and Its Role in the Prudent Portfolio

In 1924, John Maynard Keynes advocated for floating exchange rates, writing that "In truth, the gold standard is already a barbarous relic." Our federal debt, combined with continued expansion of regulation and our aging population leave no visible engine for significant improvements in real economic growth in the near future. There will be plenty of drivers of price weakness that the Fed will want to mitigate through money printing, and they are already printing at unprecedented levels. At one time, the Swiss Franc was the last currency on earth backed by the gold standard. Today's policy is to print as many Francs as needed to keep them from appreciating. The other holdout for stable currency, Japan, elected new leadership late last year that is promising to "Weaken the Japanese Yen and to strengthen Japan." With Japan and Switzerland officially joining the rest of the industrialized world in the accelerating competition to see who can print the most money, other countries will face great pressures to take the same steps.

With the advent of exchange traded funds (ETFs) that invest in gold bullion, investors have largely abandoned gold mining stocks to obtain more direct exposure to the precious metal. The poor performance of stocks in the mining sector in the recent past is now causing investor-led pressure on company managements to prioritize stock performance. Moreover, increasing domestic energy supplies—specifically more crude oil and natural gas—should bring the cost of production down for gold mining companies. Energy costs constitute a huge portion of mining company total expenses. A reduction in these costs relative to gold would help mining companies to be more profitable. Indeed, in a slowing economy, hard assets that are used for productive purposes, like steel, silver or energy, may tend to underperform gold, as they are sensitive to nominal economic activity. Gold cares less about the economy slowing, and actually may prefer it, as the slowing will be followed by even more money printing. Finally, as measured by the Philadelphia Stock Exchange Gold and Silver Index (XAU), in federal election years from 1984 to 2008 gold mining stocks lost an average of over 15%. During post federal election years, gold mining stocks gained over 20%. It should be a good time to be bullish gold and its producers--perhaps even the barbarous relic.

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