"The Long and Short of It"

Quarterly Newsletter from

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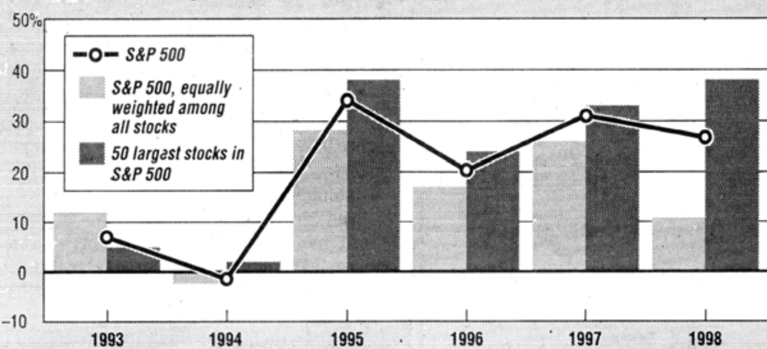
Fourth Quarter, 1998

During the Fourth Quarter of 1998 equities performed quite well with the S&P 500 Index, Dow Jones Industrial Average, and Russell 1000 Value Index returning just over 21%, 18%, and 16% respectively.

OF INDICES AND AVERAGES

Although most indices ended up in positive territory for the year, the majority of stocks were down in 1998. Losers on the year outpaced winners both on the Big Board and, more dramatically, on the NASDAQ, where 1,690 stocks were up and 3,351 fell. The Russell 2000, a popular benchmark of small stocks, was down 3.4% for the year. Although the average stock in the large capitalization S&P 500 Index gained less than 11% in 1998, the calculated return of the S&P 500 Stock Index was 26.7%.



According to data going back to 1958 on the S&P 500 and the S&P Industrials compiled by Minneapolis-based Leuthold Group, the differential has never been so large. Since 1958, the average stock in those two indices typically outperformed the indices themselves by three percentage points a year. Not in 40 years has so much of the stock market's advance been so concentrated in just a handful of stocks. Not even in the "Nifty-Fifty" days before the recession in 1973 and 1974.

Since the S&P 500 Index is capitalization-weighted, rather than an average, the largest companies like General Electric and Microsoft dominate the results of the index. In 1998, more than ever before, these companies outperformed the broader market. Another way of looking at the year, if one were to remove the 250 largest stocks from the Wilshire 5000 Index (which includes all stocks traded on the NYSE, AMEX, and NASDAQ), U.S. stocks would have ended the year in negative territory. Salomon Smith Barney estimates that the 50 largest companies collectively returned 38% in 1998.

The eight stocks that Wilshire Associates defines as mega-growth stocks returned 51.7% through late December. They include Microsoft, General Electric, Merck, Intel, Coca-Cola, Pfizer, Wal-Mart and Johnson & Johnson. The easy path suggests one buys stock in these companies, the clear winners, and holds them until rich beyond measure! However, beware that since 1958 the average company has outperformed the capitalization-weighted indices by about 3% per year.

S&P 500 winners

Company	1998 Gain*	% of S&P's Gain*
Microsoft	75 7/8	8.50
General Electric	29 7/8	4.43
Wal-Mart	42 1/2	4.32
Lucent	72 1/8	4.32
Cisco Systems	56 21/64	3.99
Intel	50 13/16	3.89
World Com	44	3.56
IBM	82 1/2	3.51
Dell Computer	53 9/16	3.09
Pfizer	50 1/16	2.98

S&P 500 sinners

Company	1998 Loss*	% drag on the S&P*
Schlumberger	−33 5/8	−0.83
Boeing	−16 7/8	−0.78
Cendant	−15 11/16	−0.61
Halliburton	−21 1/2	−0.43
Royal Dutch/Shell	−3 7/8	−0.38
Deere	−27	−0.30
Citigroup	−46 5/8	−0.30
Kellogg	−15 1/16	−0.28
Computer Associates	−10 7/8	−0.28
Disney	−2 9/16	−0.24

*Figures through 12/29/98

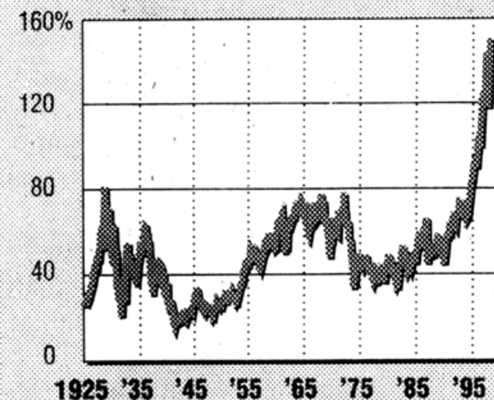
Source: Deutsche Bank Securities

Currently there are two primary reasons for large company growth. First, when investors expect a slowing economy, they rush to the large companies whose earnings seem a bit more secure. Second, the current popularity, and positive cash flow, of the index funds. In 1998, the largest portion of net inflows to stocks and bonds went to Index Funds. 12% of net inflows for the year went to Vanguard's S&P 500 Index Fund alone.

While we have difficulty buying companies like Microsoft, the year's biggest contributor to the S&P, at a price equal to 70 times earnings for the last twelve months, the same cannot be said of the Index Funds. The mission of these funds is to hold an exact replica of the index they follow. As a stock in the index goes up in price, a greater portion of any new flows of cash into the fund must be used to buy that particular company. That is, when cash is coming in, the higher the price of the company, the more they buy. However, when cash flows to Index Funds turn negative, the large companies will lead the way down.

Keep in mind that these stocks were already at large multiples when they began to gather their recent gains. In addition, stocks that outperform the broader market in one year typically give up much of that return over the next one to three years. Every year some sector of the economy, or group of stocks, comes into favor resulting in that group outperforming the indices. This year, the stocks that were in favor were the ones that determine the fate of the indices.

Perhaps it is sour grapes for us. Perhaps it is our risk aversion. This is the first year in the last four that we have underperformed the S&P 500 Index and we do not like that. But, rather than jumping on the bandwagon, we look to the fact that our investment approach has proved itself over generations. Consequently we remain true to our school. In fact we are embracing our methodologies more dearly than ever, as the temptation to change is as strong as we can remember and valuations on individual stocks are beyond anyone's memory.



Total market capitalization now tops $13 trillion and stands at an astounding 140% of the nations annual output of goods and services. At the peak in 1929, the comparable figure was only 81%. By that measure, another 16% increase in stock prices will leave our stock market twice as expensive as it was in 1929. It is not the time to be buying stocks at a premium.

TULIPS.COM

Leading the way over the last couple of months has been the Internet Sector. It was not considered a sector last year, but it now accounts for over 6% of the overall stock market, surpassing the 5% share held by the entire energy sector.

Amazon.com has grown to carry a market capitalization of over $40 billion, which makes it the fourth largest retailer in the United States when measured by its value in the stock market. The three largest are Wal-Mart, Home Depot, and Gap. They sell a lot more than books. The entire U.S. book market has only $20 billion in annual sales. In fact, we believe Amazon.com, along with many other “Internet Stocks,” should not be classified as such.

Amazon.com is a retailer of consumer non-durables and has to live within the same market size limitations as other retailers. Whether we buy a book by driving to the local store, calling the company over the phone, sending in a mail order from their catalogue, or logging on to their web site, a book store is still a book store.

A newspaper article in early December found 15 booksellers on the Internet, at least five of which had materially lower prices than Amazon.com. In addition, many of them are profitable, unlike Amazon.com. Yet this kind of math matters little to Amazon’s fans, who believe it will develop into an online retailing powerhouse. The way it is now priced, it has to be in the top three retailers by profitability or there are better places for them to invest their money.

As for Amazon.com or other companies doing well because they have a good web site, they have to compete with every other company that is also in their line of business (retailing or whatever). The barriers to entry for doing a business over the Internet are small and excess profits will draw innumerable competitors who will drive profits down.

From our perspective, the Internet is primarily a very efficient means of communication, following after newspaper, telephone, and television. It is certainly more important to our economy in the long run than tulips were during their day. Yet, true Internet companies are the ones who charge a fee for their subscribers to gain access to the Internet. America Online is one of these, but so are each of the Baby Bells, all the long distance providers, all of the cable companies, the dish companies, the newspapers, Mindspring.com, Internet Direct, Texas Networking, and innumerable other local and regional providers across the country.

“I may be technically driven, but valuation is still the chauffeur.”

Outside of the access providers (or portal sites) and other PC related companies, the companies that we feel offer the best reward/risk ratio will be established companies that can use the Internet to extend their franchise. In large measure this includes all content providers including news services, newspapers, and entertainment companies, like Disney and Time-Warner.

In many ways the strength of this sector reminds us of the oil boom in the 1970’s and the Biotechnology boom in the early 1900’s. The oil sector became 27% of the S&P 500 and has since declined to 5%. Out of the 35 largest biotechnology companies at the end of 1991, only 10 have surpassed the highs they set in 1991.

One primary difference between the previous two booms and the Internet is that oil and biotech had significant barriers to entry that could protect profitable firms from new competitors. If extraordinary profits exist on the Internet, very little capital is needed to compete. Proof of this is found in the vast number of recent Initial Public Offerings (IPOs). Too many new companies are going after the profits of the Internet.

In the Wall Street Journal, we found an interesting article about the attitudes of many Internet IPO executives. Many of these companies were initially offered at prices much lower than where they began trading on the exchange. For example, theglobe.com's stock was issued at $9 per share. It opened trading at $90 per share. It is now at $42. Since the issue price determines how much capital the company is able to raise, significant underpricing could be a problem for the company going public as well as the underwriter. Companies might think the investment bankers had put money into investor's pockets and left the company short of needed capital.

The response of most Internet company executives has been that this mismatch is not a problem because an IPO is also about getting a public persona. Having your stock pop on the first day gets you a mention in many different publications, even Sports Illustrated. The IPO is thus seen as a branding event; a way to launch the company's name. Had theglobe.com been issued at even $42 per share, with 3.1 million shares in the offering, the company would have had an extra $102,300,000 of capital with which to grow. That sounds like some pretty expensive advertising. We do not think theglobe.com got their money's worth.

The point of all this is that profit is perceived to be so easy, and the capital requirements (barriers to entry) so small, that mispricing is not an issue. To us, that spells trouble. It is reminiscent of autos in the early 1900's. Between 1900 and 1908, 485 companies entered the auto industry, but 262 companies had failed by the latter date. Also, the PC industry which was the darling of the 1982 to 1983 bull market. By February of 1984, a group of 24 major PC companies were, on average, 50% below their 52 week highs. Who were the leaders at the time? Michael Dell was still in high school. Compaq had just gone public in December, 1983. Gateway was yet a dream. The leaders were Apple, IBM, Atari, Commodore, Tandy, and Texas Instruments. Second tier included blockbusters such as Key Tronic, Lotus, Kaypro, Dysan, Tandon, Miniscribe, Verbatim, and others. Few of these companies have survived to today. It is a very good time to be very cautious.

It is easy to get caught up in the exuberance. Investor's Intelligence publishes a study of bullish consensus among advisors, which is the highest it has been in seven years. Will any act of exuberance be proven irrational? The answer, we're sure, is yes. The timing, unfortunately, is less certain.

Globally, economic troubles abound, leaving warning signs that global economic activity will slow. Notwithstanding current rates of inflation and global economic growth, central bankers around the world must perceive that something is amiss. There have been at least 66 central bank interest rate cuts worldwide since October 1, 1998. Domestically, Alan Greenspan and Bill Gates are putting on a party that many believe will last for years to come. We are doing our best to participate soberly, without exposing your capital to excessive risk.

This difficult environment for value managers will pass. We remain dedicated to a disciplined implementation of our clearly defined methodologies, which continue to bring solid returns to our clients while limiting their risk exposure.

HIGHLIGHTED HOLDINGS

This Quarter we are beginning a new reporting process and dropping an old one. The "Your Portfolio" section of our normal reports is being replaced with the following section in the Quarterly Letter where we will talk a bit about some of the major changes we have made to most portfolios. By not discussing every trade in every account, it leaves us more space and time to offer a bit more detail about larger positions, which will have the greatest impact on portfolio returns.

Cendant Corporation (CD) is a leading global provider of consumer services. The Company operates primarily in four segments: membership services (approximately 100 million members), travel (e.g. Ramada, Days Inn, Howard Johnson), real estate (e.g. Century 21, Coldwell Banker) and entertainment and educational software. The SEC asked CD to again restate its financial statements after CD had concluded its own investigation into its accounting irregularities and released its estimate of the earnings impact. Investors' extremely negative sentiment, resulting primarily from the SEC actions, continued to drive the

price of CD to even more attractive prices based on continuing very favorable fundamentals. In line with our investment process, we took this opportunity to add to our positions in CD. Activities indicating investors overreacted are (i) strengthened financial stability through sales of non-strategic businesses and excellent free cash flow being used to pay back debt and fund CD's $1 billion stock repurchase program, (ii) termination of the American Bankers acquisition, (iii) strong internal growth from core businesses, and (iv) strong demand for the services offered by CD's well recognized brand-name franchises. CD's CEO, Henry Silverman, has a long history of running a tight ship. We have confidence he will instill an appropriate ethic, which will make the most of CD's strong franchises.

HealthSouth Corporation (HRC) is the nation's largest provider of outpatient and rehabilitative healthcare services, including non-emergency surgery, physical therapy, sports medicine, and occupational therapy, with over 1,850 patient care locations in all 50 states and the District of Columbia. Health care stocks have been volatile recently due to the uncertain effects of new legislation and an evolving managed care industry. In particular, managed care operators are trying to use their market position to force health care providers to keep prices at relatively low levels. The market's reaction to publicity over United Health Care's attempt to renegotiate prices with HRC on the basis that HRC is too profitable was to reduce HRC's stock price to nearly all time lows relative to fundamental indicators of value, such as revenues and book value. As long as HRC's products are priced competitively and of sufficient quality, we do not believe HRC's profitability will be an effective basis for UNH to renegotiate contract prices. So far, HRC has held its own in the negotiations, and its volume of business continues to increase. Also, following the Clinton administration's efforts to modify healthcare delivery in the United States, the inflation rate on health care services has slowed dramatically. The resulting decline in the quality of care is beginning to get significant coverage in the media, to wit, President Clinton's "Patient's Bill of Rights." We do not feel that there will be significant reductions in the costs of healthcare delivery without an outcry from patients over the falling quality of care. HRC is a very well managed premium health care provider. HRC's long history of improving fundamentals, combined with expected increases in demand for health care services due to the aging of the baby boomers, causes us to believe HRC will prove to be a very solid long-term investment.

Thermo Instruments Systems (THI) manufactures and markets instruments used for elemental analysis and detection and measurement of toxic substances, nuclear radioactivity, and air pollution. Services include environmental studies, water resource management, nuclear contamination monitoring, and analyzing soil, air and water for hazardous wastes. An announced corporate restructuring, with resultant lack of acquisition activity, further reduced expected earnings and led to THI being priced even more attractively against all measures of fundamental value. In line with our investment process, we took this opportunity to add to our positions in THI. With weakened demand for analytical instruments, particularly from Asia, this is an opportune time to restructure, which is expected to create significant efficiencies for the company. Trading significantly below the market multiple of earnings, THI provides significant upside potential since the company normally trades about 1.5 times the market multiple.

Schlumberger Limited (SLB). 72% of SLB's sales are from Oilfield Services and 28% from Measurement and Systems. The decline in the oilfield services stocks has been extended by the continued weakness in oil prices. SLB stock has not been spared and, as a result, it is now priced even more attractively against almost all measures of fundamental value, especially price to earnings per share. SLB remains an investment grade company whose stock is supported by the deepwater and international contract drilling business, which is less sensitive to changes in oil prices. Further, Camco, a company with recognized expertise in well completion services, merged into SLB. The combination enhances SLB's ability to provide reservoir optimization solutions and positions the company to capitalize from the growing trend toward integrated service contracts. Management is in the process of cutting costs in response to the weakening business environment and should be in an excellent position to capitalize on the eventual improvement in the industry.

TAXING ISSUES

There is not much exciting to write about in the tax news this quarter. (Some would argue there never is anything exciting in the tax news.) So we will just report on two new developments that can have

significant consequences for those of you who are gifting, and one that enhances a technique for reducing income taxes on sales of appreciated assets and reducing those unnecessary estate taxes.

To File or not to File…

The IRS published proposed regulations interpreting the 1997 and 1988 amendments to sections 2001, 2504, and 6501 of the Internal Revenue Code. The amendments prohibit the IRS from revaluing adequately disclosed gifts after the running of the limitations period. Prior to these amendments, the IRS could let the limitations period run on a gift tax return and then increase the value of those gifts on the donor's later gift and estate tax returns, thereby subjecting the later gifts and estate assets to higher tax rates. The proposed regulations describe the information that must be provided on the gift tax return to meet the adequate disclosure requirement.

Unfortunately, the proposed regulations also make it clear that all gifts, even those within the $10,000 annual exclusion, must be reported if the IRS is to be prevented from revaluing them in a later computation of gift or estate tax. Practitioners are increasingly filing returns to report annual exclusion gifts if there is any potential valuation issue, and these regulations may accelerate that trend.

If you are giving cash or publicly traded stocks, the new rules have no practical effect since the values of cash and publicly traded stocks are easily and decisively determined. However, if you are giving undivided interests in real estate or interests in family owned businesses, whether in corporate or partnership form, the new rules create greater risks for those not reporting gifts within the annual exclusion. Taxpayers have traditionally given family members interests in assets such as family limited partnerships, believed to be worth less than $10,000, and not reported them because there is no requirement to report annual exclusion gifts. Now, even though there still is no reporting requirement for annual exclusion gifts, if you want to make sure the IRS does not challenge property values later, you must report them on a gift tax return. How is that for tax simplification?

Charity Begins at Home

The Internal Revenue Service released final regulations on December 10. 1998, allowing the use of a "flip" payout feature in charitable remainder unitrusts. The flip payout feature makes charitable remainder unitrusts even more appealing vehicles for disposing of highly appreciated assets. To understand this, a little background is necessary.

A charitable remainder trust, as defined in Section 664 of the Internal Revenue Code, must provide for the distribution of a specified payment, at least annually, to one or more persons. The payment period must be for the life or lives of the individual beneficiaries (all of whom must be living at the time the trust is created) or for a term of years, not in excess of 20 years. Upon the termination of the noncharitable interest or interests, the remainder must either be held in continuing trust for charitable purposes or be paid to or for the use of one or more charitable organizations. A qualified charitable remainder trust is exempt from income tax, and the grantor is entitled to charitable income, gift, and/or estate tax deductions based on the present value of the remainder interest ultimately passing to charity.

There are two types of charitable remainder trusts. A charitable remainder annuity trust is required to pay a sum certain annually to one or more beneficiaries, at least one of which is not a charity. The sum must be equal to at least 5% of the fair market value of the trust assets valued as of the date transferred to the trust. A charitable remainder unitrust is required to pay a fixed percentage of its net fair market value to one or more beneficiaries, at least one of which is not a charity. The fixed percentage must be equal to at least 5% of the net fair market value of the trust assets as valued annually. Thus, the amount paid by a unitrust fluctuates with the fair market value of the trust assets, whereas the annual payment from an annuity trust remains constant. In addition, a unitrust may provide for the payment of the lesser of the fixed percentage or the trust income (i.e., a "net income only" unitrust). In the case of a net income only unitrust, the unitrust may, but need not, provide that any amount by which the trust income falls short of the fixed percentage is to be paid out in subsequent years to the extent the trust's income exceeds the fixed percentage in such later years (i.e., a "make-up" provision).

A “flip” unitrust is a net income only or net income with make-up unitrust that flips to a straight unitrust payment at a specified time in the future. Under the regulations, the flip can occur upon the happening of a specified event such as the sale of unproductive property, or a marriage, divorce, death, or birth.

For many taxpayers, a contribution of low basis, appreciated, non-income producing property to a charitable remainder unitrust may be attractive, especially when there may be future income needs. Low yield assets such as closely held stock paying a marginal dividend are basically equivalent to non-income producing property.

As long as the property is not tangible personal property, the donor is assured a current charitable income tax deduction based on the property's full fair market value. Until the asset is sold, as long as the unitrust amount is greater than the income from the property, the donor or other designated income beneficiary keeps all the income from the asset. In addition, with use of the net income exception, the trust can distribute only income actually received and not be required to sell the asset to fund a straight unitrust amount.

The subsequent sale by the unitrust of the non-or low income producing assets, and reinvestment of the proceeds in income producing assets, allows the "unlocking" of income earning potential without adverse tax consequences. There are no adverse tax consequences because the assets can be sold by the charitable remainder trust free of tax and the entire sale proceeds reinvested to provide additional current income to the donor or other designated income beneficiary.

Charitable remainder trusts make great retirement vehicles because they can be set up for the donor without complying with ERISA rules. In addition, with the flip feature now blessed by the Internal Revenue Service, non- or low income producing assets can be put in the trust generating a current income tax deduction, and then sold when the donor is ready to retire. Payout to the donor is then the full unitrust amount and not limited by the actual income earned or the make-up limitation.

HUMOR

Finally, we thought we should conclude with some philosophy (humor); these were drawn from Scott Adams’ cartoon character “Dilbert:”

1) I can please only one person per day. Today is not your day. Tomorrow is not looking good either.
2) I love deadlines. I especially like the whooshing sound they make as they go flying by.
3) I’d explain it to you, but your brain would explode.
4) Someday you’ll look back on all this and plow into a parked car.
5) Tell me what you need and I’ll tell you how to get along without it.
6) Needing someone is like needing a parachute. If he isn’t there the first time that you need him, chances are you won’t be needing him again.
7) I don’t have an attitude problem. You have a perception problem.
8) I don’t suffer from stress. I am a carrier.
9) You are slower than a herd of turtles stampeding through peanut butter.