The Long and Short of It

Quarterly Newsletter from

Robinson & Wilkes, Ltd.

Second Quarter, 2002

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Fraud Takes a Bite

The announcement of accounting fraud at WorldCom was, and still is, extremely painful and disturbing. Like every investment we have made, we relied on the accuracy of audited financial statements and other SEC filings. These filings and other information publicly released by companies are the basis for our research. In the end we rely on the assurances of those people who prepare and certify a company's financial statements. If that information is wrong, our judgements will be flawed.

Without the fraud (with accurate reporting of expenses), our process would have avoided investments in WorldCom. We are now discovering the extent to which the company went to create the appearance of transparency with respect to its purported capital expenditures. For example, each quarter the company met previous year's guidance for capital expenditures and WorldCom gave detailed breakdowns of capital expenditures during each of its regular analyst calls.

We hold out little hope of being able to identify corporate fraud among our holdings prior to its announcement. The fraud of companies like Rite Aid and Waste Management has taken money from us before. Cendant's fraud also hurt us, though we were able to recover from it. In spite of fraud, which no one can anticipate reliably, our approach to investing has managed to outperform over the long run.

Destroying a very large corporation with a successful franchise and a strong brand is extremely difficult. All publicly traded companies are subject to a vast array of checks and balances. Can you imagine, for example, being the chief executive of McDonald's, and being told your job is to destroy the company without the board, staff, shareholders, creditors or regulators finding out in advance? It would be difficult.

Yet it is possible to hide fraud from those involved in the checks and balances. Obviously, it is also difficult for someone who is not part of the checks and balances to discern what insiders have worked so hard to hide.

Still, we are doing all we can to discern the advance indicators of fraud. One means we are pursuing is an improvement of in our analysis of corporate debt and other financial leverage. When debt loads grow, corporate executives often find sustaining profit growth a tremendous challenge. This seems to be when management is most inclined to stretch the truth.

Our investment approach calls for us to perform the equity valuation analysis internally – something we feel we do quite well. We use outside sources to assist with the analysis from a creditor's perspective. We only establish a position in a company when its price has dropped to attractive multiples. Such drops are usually due to new challenges the company faces. It is one thing to know that a company will appear cheaply priced if it survives its current challenge. It is quite another to have confidence it will survive that challenge with its current fundamentals basically intact. That is where analysis of the credit is most useful.

Since 1997, several of our companies ran into debt troubles, but only two, Rite-Aid and Waste Management, became so encumbered as to justify exiting the position due to concerns that they would not survive. We have used Value Line, Standard & Poor's and Moody's to help us with debt analysis, but have found that their changes always come after the price of the stock fully reflected the concerns of the ratings agencies. It is as if the price drop calls to their attention the need for review. Perhaps the major ratings agencies apparent conflict of interest – the fact that they are paid by the issuers they cover – contributes to their untimeliness. In any event, we have found an alternative that will serve to enhance our credit analysis significantly.

After much investigation, we are now utilizing the Egan-Jones Ratings Company. We believe it will make a significant difference in our ability to see credit related problems on a more timely basis. Over the life of the company, Egan-Jones has impressively revised its ratings, on average, eight months ahead of the major ratings agencies. It also publishes detailed reports describing the facts that have led to the downgrade. Its timeliness, combined with our now slightly higher standard for what is acceptable to purchase and hold, should lead to improved performance. Surely it will help our portfolios avoid material exposure to truly distressed holdings.

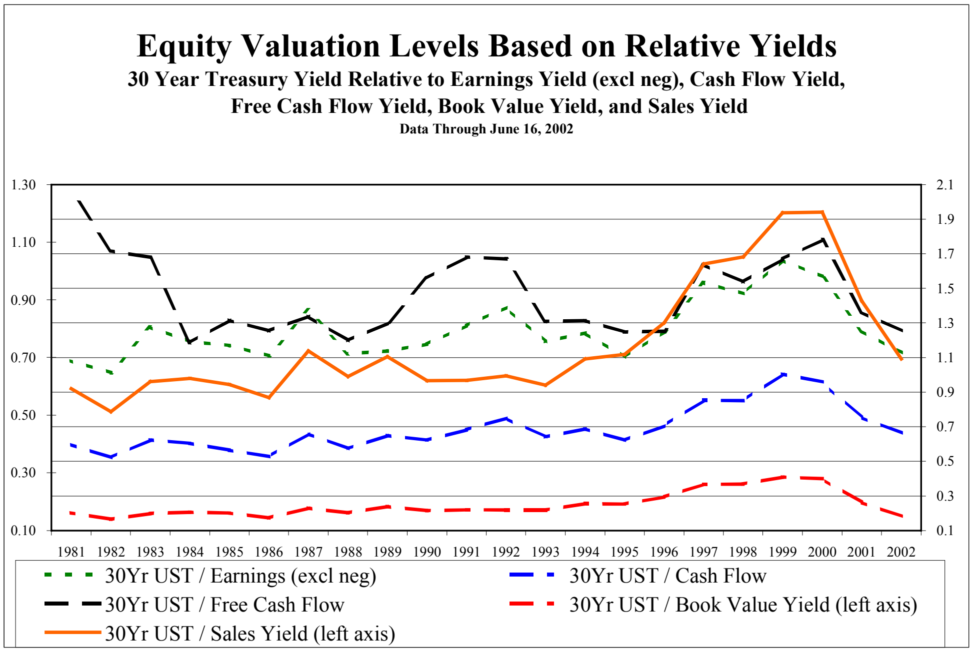
Valuation the Key

Market prices are determined by three factors: valuations, fear, and greed. Unfortunately, fear and greed can rule the day in the short run. This is currently the case, as the shenanigans of several corporate executives have become the exclusive focus of our powerful media and thus investors. Fortunately, valuation always matters most in the long run.

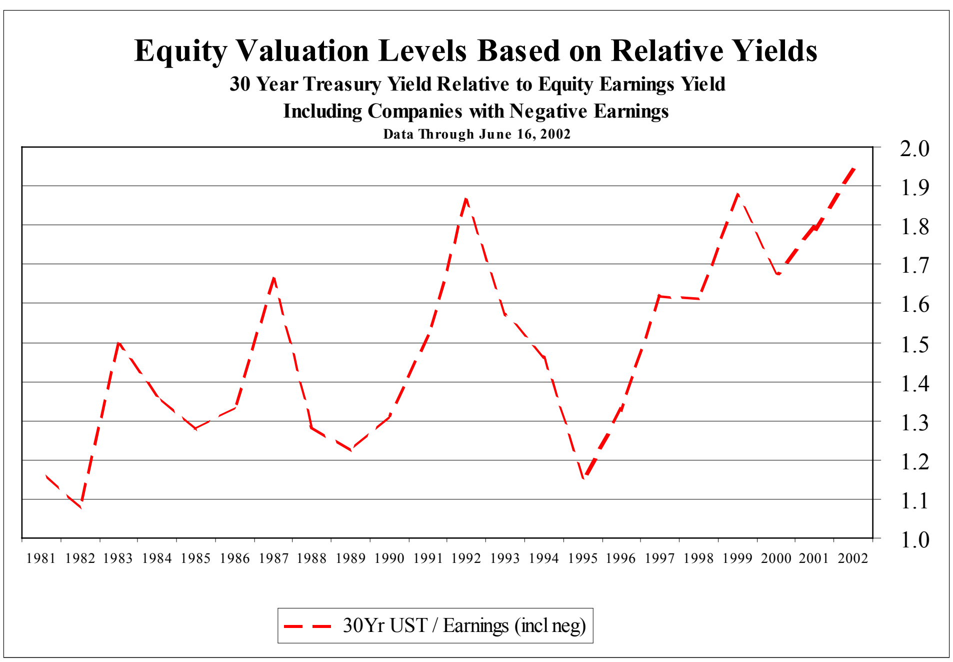
During the bubble of 1998-1999, greed won out over valuation, while fear was nearly non-existent. Our research showed the 200 companies we follow to be priced 40% over fair value at one point in early 2000. At that point the S&P 500 Index was at about 1525 and we estimated its fair value to be just under 1100. During the second half of 2000 and 2001, valuation won the day. By the third quarter of 2001, we found the companies we follow to be fairly priced. Today, with the S&P 500 hovering around 900, our individual company fundamental research indicates that large capitalization companies are nearly as far *below* fair value (30%) as they were *above* fair value in March of 2000. It is our view that current prices offer attractive opportunities for the long-term investor. That could not be said in 1999, 2000, or 2001.

Although this research is based on company-by-company math, in looking at what equities in the S&P 500 yield relative to the U. S. Treasury bond, one can see the dramatic drop in valuations that has occurred since the market top in 1999 to 2000. The earnings/price ratio is the sum of the most recently available four quarters of income (before extraordinary items) divided by current company capitalization. It is the inverse of the P/E ratio and represents the amount of earnings that a dollar of stock will yield to its shareholder.

When this yield is compared to that of the U.S. Treasury bond, one finds a fairly consistent relationship exists over time, as people are free to invest in either equity or bonds as their perception of value changes. In the chart to the right, we have plotted the yield of the 30 year U. S. Treasury bond relative to the yield of earnings as well as other measures of fundamental value for the S&P 500 Index. Currently, cash flow yield, free cash flow yield, book value yield, sales yield, and earnings yield (excluding companies with negative earnings), when compared to the U. S. Treasury yield, all reflect stock prices that are fairly to attractively priced by historic standards.



Most interesting though is the fact that the earnings data included in the above chart excludes companies that have negative earnings over the last four reported quarters. S&P does report earnings on all companies even if they are losing money. But, it also publishes the number excluding negatives so analysts can remove the spurious effect of negative earnings from cyclical companies during a recession.



If we include the relative yield calculation for the S&P 500 P/E ratio that most people use, which includes all companies, we get a very different picture. It appears that there are some companies that are experiencing very negative earnings while their cash flow and other fundamentals are intact. These companies are primarily those supercyclical technology and telecommunications companies that over invested in productive plant and equipment during the capital goods boom of the late 1990's.

This is to say that, in general, stocks now fall between fairly priced and cheap by historic valuations, but there are two or three sectors that are loosing money fast on a net income basis because they over-invested in productive capital to prepare for revenue growth that never came. Until the excess productive capacity is diminished, or demand rises to make use of it, the companies in these sectors will suffer, and those with large debt loads may go into default. Their suffering is also likely to have some slowing effect on the overall economy, as there is some wealth effect when such a large portion of our economy goes from boom to bust.

No one knows how far prices will drop, or how long fear will rule over valuation. In the end, valuations will win out. Money that stays invested through this turmoil should have a happy story to tell in a few years. Along the same line of thinking, Value Line has had some valuable commentary that we agree with and want to share with you.

It takes courage to be a buyer at this time. Still, we note that it has been at such times of despair that bear markets often have ended and bull markets have begun. This is not to say that we are at such a point now, except to note that the economy is getting better; profits may soon be on the mend; momentum for needed accounting reform is building; and this country's latest efforts to calm tensions in the Middle East may yet bear fruit. Thus, a turn in market sentiment could be closer at hand than many now expect. - **The Value Line Investment Survey**, "Selection and Opinion", July 5, 2002

As history has shown us, excess euphoria can lift stocks to unrealistic heights for a time. On the other hand, when pessimism is at extreme levels, excesses will typically take place on the downside. We think the latter situation prevails now. In such times, patience is often the best approach. Bear markets come to an end, just as bull markets inevitably do. - **The Value Line Investment Survey**, "Selection and Opinion", July 12, 2002

During the boom of the 1690's, between Tulipmania and the South Sea Bubble, was a time known as the Projecting Age. During that decade, London's Exchange Alley began regular trading in joint-stock companies for the first time in England. One of our favorite quotes comes from Sir Richard Steele who at that time articulated what is perhaps the first contrarian theory of investment. He stated, **"Nothing could be more useful than to be well instructed in his hopes and fears; to be diffident when others exalt, and with secret joy buy when others think it in their interest to sell."**

When large price drops occur, it is very difficult to be a buyer. But valuations do matter in the long run. Historically, large drops are almost always followed by a large recovery over the next year or two. Below is a table made from data in Ibbotson Associates' "Stocks, Bonds, Bills and Inflation" describing annual returns (January to December) during down markets since 1926. Because we use annual returns as opposed to peak to trough, both the loss and recovery percentages are somewhat muted from what one would experience while living through it.

Sequential Years Down	Number of Occurrences	Average Loss	Average Gain Over One Year	Average Gain Over Two Years
1	11	-9.0%	+23.8%	+44.4%
2	1	-37.3%	+37.2%	+69.9%
3	1	-20.6%	+20.3%	+51.5%
4	1	-64.2%	+54.0%	+51.8%

As of July 16, 2002, we are in the third sequential year down with a cumulative loss of 36.7% since December 31, 2000. This table tells us that the returns of the last 3 years are very rare. It also tells us that when the market does find the bottom, we are likely to see solid returns over the following two years. Obviously, it does not indicate where or when the bottom will take place.

With the assistance of solid fundamental research indicating that fair value lies some thirty percent higher, we feel it is quite rational to be optimistic about the prospects for equities going forward. One reminder: This is the same research that was deemed “Out of touch with reality” and “Not hip to the New Economy” when it indicated the 40% overpricing in March of 2000.

Lies and Managed Earnings

Because attractive valuations drive our stock selection, we always end up equity holdings that Wall Street and the media are telling investors not to own. We would like to use this opportunity to address the issue of SEC investigations and accounting restatements. Recently, the number of listed firms being investigated by the SEC was reported to be 18. Of those, we own Xerox, Halliburton, Tyco, Duke, and Merck. Let’s look at some of these in detail.

Xerox had been under SEC investigation for several years due to questions about accounting for operations in Mexico. In particular, some leases of equipment were booked as sales, which accelerated revenue recognition.

The SEC found Xerox’s accounting for its operations in Mexico to be inappropriate and required revenues from those leases to be spread over the life of the leases. Xerox settled with the SEC, paid a ten million dollar fine, and restated the 6% of revenue that was affected over the five year period in question. The investigation is not only over, it has been settled. No investigation is ongoing, no other violations were found. In fact, to our benefit, the effect of the restatement is to move previously recorded revenue to future periods.

In the meantime, Xerox has arranged for a dramatic reduction of debt by exiting the consumer finance business. It is a cyclical company that, in a slow economy, is expected to earn five cents per share in the second quarter and thirty-five cents per share for the year. Cash flow for the year should be around $1.80 per share. While struggling to advance its position in color printing, it remains the dominant player in black and white and its market position is fairly stable. Xerox’s history of cash flow and book value multiples since 1970, adjusted for the current environment, indicate a fair valuation range between $15 and $25. Conservative analysis on current conditions leaves fair value at $13. It currently trades at $6.40.

While Xerox still has some hurdles to clear on the debt issues, there is every indication it will succeed. Our point, though, is that the investigation should no longer be an issue with Xerox. Yet when it announced the restatement, which was the last step in concluding the settlement, the stock dropped dramatically and Xerox remains on everyone's "bad" list as if there is a continuing inquiry.

Both Merck and Duke are being questioned about transactions that had no profit margin associated with them. Each side will argue strongly that its accounting method is correct. It will not matter who is right in the end, however, as none of the issues has anything to do with cash flow or earnings. We did not purchase the companies based on the revenues that supposedly were inflated. Any resulting restatement based on current issues will not affect valuation, and any fine involved will easily be paid as a one-time expense that will not affect the earning potential of the company.

One of the more commonly used multiples, though not the most indicative of the opportunities in these two companies, is the P/E ratio. Duke has a P/E of 9 and Merck has a P/E of 14. Both companies are trading at or below the multiples where bottoms are typically found. Because of the current interest rate environment, the relative yields of these companies are at levels not seen in 32 years.

The accounting issues at Halliburton also appear to be immaterial, but able to garner great attention and outrage because of Dick Cheney's involvement in the past. There is a great valuation story there.

While Tyco does have great valuations, like Xerox, it has some debt hurdles ahead. Our primary concern is that the investigation is not over for Tyco. It is really the only holding that remains a big concern for us and will be watched very carefully. We will be eager to exit the position if we see any deterioration in the business or even see another similarly attractive valuation opportunity.

The last quarter was difficult for our clients. It was difficult for us as well. It appears that it also was difficult for most, if not all, equity holders. We have had setbacks like WorldCom before. This will not be the last. We have had lagging quarters before and, though this was the first lagging quarter in the last eight, it will not be the last.

We remain dedicated to constantly trying to improve our thinking. We remain dedicated to the rational process that is value investing. We remain sure that value investing is at its best when it is somewhat contrarian. Going against the prevailing view has never been an easy position to maintain. It invariably puts our clients and us in a position of purchasing and holding what the press and Wall Street say is foolish to own. It also puts us in the enviable position of having a good solid long-term track record and holding up well overall during the course of this three-year bear market. Better times will come. We hope you can have a great summer.