

# THE LONG AND SHORT OF IT

QUARTERLY NEWSLETTER FROM  
**ROBINSON & WILKES, LTD.**  
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Consistent with history, and as discussed in our last quarterly letter, post election stock market activity produced a relief rally in the stock market. Also consistent with history, was the weakness early in the New Year, as Congress reconvened and uncertainties surrounding large legislative initiatives grew. The Fed continues to raise interest rates. The economy continues to sustain the current growth cycle, though the results are so mixed as to be unconvincing. The most recent declines in consumer credit and housing starts have also been seen before. Yet, in this rising rate environment, it would not be surprising to finally see housing and consumer spending slow somewhat.

Sentiment surveys show that a fear of a falling dollar continues to gain importance with investors. We remain impressed that a serious recession has, so far, been avoided. At the end of any long economic expansion like that of the United States in the 1990's, one expects to see considerably more correction in economic activity, more wringing out of excess, and generally more pain.

Accommodative monetary and fiscal policies and some impressive productivity gains have averted such a fate in the short-run, but the cost of those policies are visible in the dollar's recent weakness. Recessions typically eradicate economic imbalances. However, during the last recession this did not happen; in fact, most imbalances (debt, trade deficits, and productive capacity) actually increased.

European and Japanese policies have not been as accommodative as those of the United States. While their currencies are faring better, their economic growth rates are very low. In the United States, an effort to maintain the strength of the dollar through more restrictive monetary and fiscal policies over the last several years would have weakened the economic recovery during the post bubble years when the economy was quite vulnerable. One can well debate about how the policies may have been more wisely fine-tuned, but greater restrictiveness surely would have brought with it a significantly deeper recession.

One concept we like to keep in mind is that during inflationary periods, it is a race to see who gets rich quickest. During deflationary periods, the challenge is to avoid being the one who goes broke. During recent history, a period when secular economic forces were strongly deflationary, it seems reasonable to argue there was a choice to be made between ongoing recession with a strong dollar or reasonable economic growth and a weak dollar. The last three years have not been nearly as bad as they could have been.

In the fourth quarter of 2004, the market finally gave investors something small to cheer about. Results for the major diversified stock indices last year varied widely, ranging from 5.3% for the Dow Jones Industrial Average to as high as 23.3% for the S&P/Barra Small Cap Value Index. The S&P 500 Stock Index had a total return of 10.9% for the year, which is very close to its long-term average nominal return. With the CPI increasing at about 3.0% in 2004, the S&P 500's real return was 7.9%, approximately 1.0% better than the long-term average for stocks. Popular sectors for the year were Energy and Utilities, followed by Consumer Services and Industrials. Sectors dragging down performance for the year were Technology and Healthcare, followed by Media and Telecommunications. Small stocks continued to outperform large, though by smaller margins than in recent years. We continue to see opportunities increasing in large companies, while smaller companies are now priced significantly above what their long-term fundamentals would warrant.

<b>Equity Composite Portfolio Fundamentals as of 12-31-04</b>			
	R&W Equity Composite	BARRA Value	S&P 500
Number of holdings	31	322	500
Wtd. Avg. Mkt. Cap. (\$B)	66.1	62.6	92.0
Trailing P/E Ratio	18.7	18.3	20.7
Price/Book Ratio	2.9	2.1	3.0
Price/Cash Flow	8.8	9.1	12.0
Dividend Yield	2.3%	2.2%	1.9%
Return on Equity	18.8%	14.0%	19.6%

<b>Percent Return of Composites vs. Benchmarks for Various Time Periods As of December 31, 2004</b>					
Return Periods	4 <sup>th</sup> Qtr	1 Year	3 Year	5 Year	Since Inception 12/31/97
<i>Portfolio / Benchmark(s)</i>			-----Annualized / Cumulative*-----		
<b>Equity Composite (gross of fee)</b>	<b>7.2</b>	<b>10.2</b>	<b>0.7 / 2.0</b>	<b>6.9 / 39.6</b>	<b>8.1 / 71.9</b>
<b>Equity Composite (net of fee)</b>	<b>7.0</b>	<b>9.2</b>	<b>-0.2 / -0.7</b>	<b>6.0 / 33.5</b>	<b>7.1 / 61.5</b>
<i>S&amp;P BARRA Value Index</i>	9.9	16.3	6.5 / 20.8	2.5 / 13.2	5.6 / 46.3
<i>S&amp;P 500 Index</i>	9.2	10.9	3.6 / 11.7	-2.3 / -11.1	4.8 / 38.4
<b>Balanced Composite (gross of fee)</b>	<b>4.0</b>	<b>6.8</b>	<b>2.7 / 8.4</b>	<b>6.8 / 38.7</b>	<b>7.0 / 60.5</b>
<b>Balanced Composite (net of fee)</b>	<b>3.8</b>	<b>5.9</b>	<b>1.8 / 5.6</b>	<b>5.9 / 33.1</b>	<b>6.1 / 51.4</b>
<i>60% S&amp;P BARRA Value / 40% SSB 1-5 Year Government/Corporate Bond Index</i>	6.0	10.4	6.3 / 20.0	4.5 / 24.8	6.2 / 52.4

\* Supplemental Information

In one way, the 2004 market is somewhat similar to that of 1999. Both were years where investors, led by the popular press, became convinced that traditional large stocks were dead, or at least not the place where knowledgeable investors make money. Historically, the total return on large, dividend-paying U.S. companies has been exceptional, especially when measured relative to the risk or volatility of the returns. Investors have always been too quick to get bored with these reasonable results, and want to abandon the asset class altogether. The media helps in this endeavor, always needing something new and/or newsworthy to tout to its audience.

During the dot-com bubble, old economy stocks were declared to be dinosaurs. In 2004, the “traditional asset classes” were given a similar fate. Among these classes, stocks of large companies were the most vilified. Similar in popularity to the dot-coms of the late 1990’s were stocks from emerging countries, private equity, hedge funds, commodities and just about anything that could claim to be an “alternative investment,” i.e. non-traditional.

As noted in our last quarterly letter, the first two years of each presidential election cycle (post-election and mid-term years), on average, are not the best of times to be in stocks. Typically, when stocks turn in a sub-average performance, smaller stocks perform worse than large. So why not avoid stocks altogether? Because the alternatives are worse over the long run and they are currently excessively popular.

Cash yields are very low, mostly delivering safety and slow erosion through inflation. They could be a good safe haven if you have a long-term record of success in market timing. We have yet to meet the person who can do that with any consistency. Bonds have had a bull market for the last decade that rivals a bull market in stocks. They now seem potentially vulnerable to the improving economy and rising interest rates. Real estate, as an asset class (though it is closest to being able to compete with stocks over the long run), seems to have been too hot for too long. There are numerous investments with attractive fundamentals, but few of those investments are priced attractively. Only large cap stocks appear to be so cheap as to be considered at or below fair value.

We remain cognizant that, while there has always been some reason not to invest in equities of America’s best companies, these same companies have provided the best return/risk ratio for long-term investors. When many of these companies appear expensive, as in 2000, investors should not abandon the asset class, but recognize that they must always be discerning about which companies they are willing to own. Discernment requires knowledge of a company’s prospects and the ability to value those prospects. It also requires the will (or discipline) to sell what is popular and over-priced while buying what is attractively priced, even when Wall Street and the popular press reject it.

Recently, with the weakness in the dollar finally getting everyone’s attention, the media continues to promote the need for international investments. We have always strongly believed that investors should have international exposure. However, we do not see that the location of a company’s headquarters determines whether or not it provides international diversification. International diversification comes through investing in companies with sales that take place in foreign countries and productive assets that reside in foreign countries. Some experts suggest that to gain international exposure, as much as 40% of one’s wealth should be “invested” in foreign assets.

Most interestingly, many of the most successful publicly traded companies in the United States have significant international exposure. When measured by the percent of sales that come from foreign sources, these include General Electric (86%), Intel

(75%), Coca-Cola (69%), McDonald's (65%), and Hewlett-Packard (60%), and many others. At Robinson & Wilkes, 39% of the sales of companies we currently own, and 42% of sales of the 200 companies we follow closely, come from foreign sources.

In the past, diversification was enhanced greatly by owning stocks headquartered and traded on foreign exchanges. Today, the correlation of returns between our markets and foreign markets continues to increase. Historically the correlation has increased dramatically during periods of increased volatility (just when you need it to be low). This is to say that historically, when things go bad, they are bad for the whole world. This correlation has reduced the value of diversification based on headquarters or exchange (which was bound to happen anyway). However, the benefits of owning revenue streams and productive assets that take place abroad will continue. That is why our clients will continue to benefit from the growth of non-U.S. economies, while the stocks of the companies they own are traded on our own domestic exchanges.

In these quarterly letters, we frequently indulge in discussions of the state of, or prospects for, the economy and the market. We want to take this opportunity to inform our readers once again that, in spite of the supposed significance of such discussions, they have little to do with the ability to create good, solid investment returns. For those things, we look to an understanding of the wealth creating capacity of each company over the long run and the attractiveness of its current price. We do not have much regard for macro-economic issues that cannot be predicted, such as whether one feels comfortable with the 3.4% GDP growth estimate, due to feeling that 3.5% would be more practical, or if one *feels* like the market just has to go up or down from here. For our clients' portfolios and us, it is always about understanding the companies in which one invests.

We wish you a healthy and prosperous 2005, and invite any questions or comments you may have.

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Established in 1997, Robinson & Wilkes, Ltd. is an independent investment management firm that uses a value-oriented, somewhat contrarian approach to investing client assets primarily in domestic, large capitalization companies, U. S. Treasury obligations and high-grade domestic bonds.

The Equity Composite assets as of December 31, 2004, were \$14.4 million, which represented 26% of the firm's total assets. The Balanced Composite assets as of December 31, 2004, were \$33.0 million, which represented 60% of the firm's total assets. Non-fee-paying accounts are excluded from the composites, and represent 3% of the firm's total assets. Returns reflect reinvested dividends and are calculated in U.S. dollars.

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To receive a complete list and description of Robinson & Wilkes, Ltd.'s composites and/or a presentation that adheres to the AIMR-PPS standards, contact Amy Robinson at (210) 490-2545, email us at [contact@robinsonwilkes.com](mailto:contact@robinsonwilkes.com) or go to our web site at [www.robinsonwilkes.com](http://www.robinsonwilkes.com).