

The Long & Short of It

Rough Seas

"Choppy" seems to be the best way to describe the investment markets during the first quarter of 2007. Stocks turned in mixed results, again with smaller companies generally outperforming larger companies. Interest rates finished in March about where they were at year-end. What stands out is the significant volatility experienced in getting there, with most measures of volatility rising and falling dramatically during the quarter.

The Volatility Index (VIX), which measures the implied volatility of the S&P 100 stock index, has been declining, generally, since August 2002. Except for one brief moment in June of 2006, it has remained below 20 since May 2004. The VIX remained near 10 for most of January and February, quickly rose to well over 20 in early March, and then fell back to the low teens by the end of the quarter. During that same time period, stocks rose, fell abruptly, and then recovered. Bonds fell, rose abruptly, and then fell again. The U.S. dollar rose in January, and then fell for February and March.

The volatility seemed to reflect investor concerns over an expansion that feels long in the tooth; one that is vulnerable to potential disruption from numerous sources such as the housing sector, the weak dollar, and problems in the Chinese economy, which turned out to be rumors. Offsetting these worries was the continuation of merger and acquisition activities of well-capitalized companies and private equity funds that are flush with cash.

Broker Solicitations as a Leading Contrarian Indicator

We offer this anecdote as an example of how flush with cash private equity managers are and how popular private equity has become. At Robinson & Wilkes, we do all of our own research. We believe that it is best for all of the ideas to be internally generated so we can learn from our own mistakes instead of being confounded by the mistakes of others. It is also necessary in order to have both consistency of process and results for our clients.

As a result, the brokers we work with know not to call or fax us with recommendations on what we should consider for investment. Within the last year, we approached one particular institutional brokerage firm about using them for clearing equity trades. We do this regularly as part of a process to make sure our clients are getting the most favorable pricing and execution on brokerage and custodial services. In this case, having explained our business model to them, we were unable to reach an agreement. We believe this was because they were unwilling to match or beat the low charges of our existing brokers.

In March of 2007, a brokerage firm solicited us, not for our general trading business, as is usually the case, but simply to see if we were interested in one particular investment. This is the first time we can recall this happening.

Which brokerage firm was it? It was the same one with whom we were unable to reach an agreement last year. What were they offering that would drive them so far down the list as to solicit a non-client? It was their latest private equity offering. With that kind of effort going on to

bring cash to the private equity market, it is no wonder private equity managers have so much money to spend. It is also likely they have more cash to spend than wise investments to make.

With that kind of money available for deployment, one can understand why the market stabilized and recovered so quickly after the sharp drop caused by the late February rumor that China would soon impose new, larger capital gains taxes. One has to wonder how long private equity and hedge funds will remain the hot spot. The current strong consensus and resulting zeal by brokers and consultants frequently precedes a peak in popularity of a particular investment approach.

Topics of Interest

While valuations on large cap stocks remain attractive (and their small cap brethren less so), we feel very optimistic about the prospective performance of the investment opportunities we are finding. The housing and retail mortgage business is worth discussing, though, as it will likely have some material impact on the economy and the investment community. Having looked at the data, we do not believe that the sub-prime problems will explode into a housing collapse that drives a large consumer driven recession and a stock market crash. Nor are we in the other camp maintaining that the whole story is a bit overblown and that we have already seen the worst of it.

Commercial real estate should largely avoid the interest rate reset problems, but the retail housing market, overall, will be affected. The problem is broader than just the sub-prime area so heavily covered by the media. In 2004, when the federal-funds rate was at 1%, prime quality mortgage refinancing volume peaked. The most popular product was the 3/1 adjustable rate mortgage, where the rate is fixed for three years, and then resets once each year after that. Those mortgages will reset this year to rates that are 1% to 2% higher, increasing monthly payments for some borrowers by 20% to 50%. The sub-prime market peaked in 2005, when the most popular product was a two-year-fixed, 28-year floating rate mortgage. Those mortgages will also reset this year to higher benchmarks.

Anyone having to refinance will be met not only with higher base rates, but also with stricter lending standards (higher collateral value and down payment requirements, etc.) as well as wider spreads over the benchmark rates, as lenders are now demanding a greater premium for taking risk than they were in 2005. Rates for these homeowners will increase several percent, forcing many into bankruptcy or to quick sales, which of course will affect home prices negatively. The lowest rates in 2004 occurred in late March and in the early fall. In 2005, they occurred in January and June. These will be the months this year when the resets will be the most painful.

By late fall, we should have seen the worst of the rate adjustments. How long it will take to see the impact of those resets on the economy is most uncertain. One good thing is that the Federal Reserve has plenty of room to drop rates, which could ease payment burdens on many, and even re-stimulate demand for homes. By the fall, the Federal Reserve should have to add the slowing economy to its list of concerns, which at this moment primarily consists of protecting the economy against rising inflation. We believe that the Fed will likely have to drop rates sooner than expected. The Fed may even get a little relief from inflation pressures, though that never lasts very long. If so, we will see the yield curve return to a non-inverted position, which is fine for investors. It also means that the dollar will likely see increased downward pressure against other currencies, likely dropping to lows not seen in recent history.

So, potential themes for 2007 are firm prices on high quality bonds, a weak dollar, strong precious metals, and a move by investors toward less risky investments. In addition, increased volatility in the stock market is likely as it attempts to adjust to lower earnings (bad news), lower interest rates (good news), and the impact on company valuations resulting from their mix of domestic versus foreign sales and productive properties.

Staying the Course

For our part, we stay with high quality investments as much as possible. We know that, as a result, our investments will lag somewhat during bullish periods when it pays to take on greater risk, as it has over the last four years. Those periods are typically a bit painful, and at times quite exasperating. However, knowing that the investment approach remains consistent and has outperformed over the long run, adding value relative to the stock market mostly during periods of stock market decline, is a great benefit to derive in return.

Although the overall quarter was not so rewarding, February's correction brought a brief re-assessment of risk by investors. It was reassuring to see that, consistent with the above-described profile of our investment returns, the correction was very good for the relative performance of our clients' equity holdings. We feel we are positioned for more rational and prudent assessment of risk by investors, and that we will see more of this behavior over the balance of 2007.

Contrarian Value Equity Composite Portfolio Top 10 Holdings as of 3-31-07

Company Name	Percent of Portfolio
Electronic Data Systems Corp.	5.9%
Marsh & McLennan Companies, Inc.	5.1
American International Group, Inc.	5.0
ConocoPhillips Oil Company	4.9
Verizon Communications	4.6
BB & T Corporation	4.6
Coca-Cola Company	4.4
Gannett Company	4.3
The Home Depot, Inc.	3.9
Pfizer, Inc.	3.8

Contrarian Value Equity Composite Portfolio Fundamentals as of 3-31-07

	R&W Equity Composite	S&P 500
Number of holdings	31	500
Wtd. Avg. Mkt. Cap. (\$B)	83.9	99.9
Price/Earnings Ratio	15.1	17.6
Price/Book Ratio	2.7	3.4
Price/Cash Flow	7.8	9.1
Dividend Yield	2.5%	1.8%
Return on Equity	18.5%	23.6%

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