



ROBINSON & WILKES, LTD.

INVESTMENT MANAGEMENT

QUARTERLY NEWSLETTER

SECOND QUARTER 2008

The Long & Short of It

Though the second quarter of 2008 was difficult for investors, it was much less damaging than the first quarter. The average stock offered little to no return, with small-caps and mid-caps being slightly positive while large-caps returned mid-single digit losses. Year-to-date, domestic stocks have lost about 10%. Growth out-performed value by double-digit margins as financials, a staple for value managers, reached historically low price-to-book value levels before continuing to fall even lower. In fact, Morningstar reported that their average large-cap and mid-cap value funds had lost 21.9% and 24.1% over the last 12 months, respectively—a result significantly worse than that of growth-oriented funds. Just as the domestic stock market has declined about 18% from its 2007 highs, international stocks have fallen some 17%, led by Pacific/Asian stocks that have fallen about 30%—especially in China, which has given up around 50%.

When market bubbles deflate, as we have experienced in recent years, it can be quite dangerous. However, bubbles in any particular sector—whether in biotech, dot-coms, or even tulips—typically remain isolated, with a somewhat limited ability to affect the broader economy. A bubble in credit is a more serious matter, as its contraction will ripple throughout most sectors of the economy.

During the second quarter, concerns over the credit crunch spread from mortgage brokers and investment banks to a broad array of financial institutions. This created an increasingly gloomier outlook as the potential for an economy-wide credit contraction became more evident. Investors began to fear that sub-prime mortgage problems would lead to a drop in home prices, inducing less lending in banks, followed by contractions in investment, write-downs of commercial loans, credit cards, car loans, prime mortgage loans, drops in consumer sentiment and spending, etc. By the end of the quarter, contagion seemed unavoidable. However, a refreshing bullish indicator of extreme bearish sentiment was evidenced at the end of the second quarter, when short selling on the New York Stock Exchange had risen to 4.6% of total shares—the highest since at least 1931.

Faced with a severe credit contraction in 1929, the Federal Reserve Bank was the opposite of accommodating and allowed the money supply to shrink by 27% through 1933. During that time, economic output dropped by 29%. Recognizing this past mistake, the Fed has provided liquidity in 2007 and 2008 in order to avoid significant deflationary and recessionary pain. It has succeeded in preventing general prices from falling—perhaps a bit too well.

During the last round of significant inflation (1970's), demand was driven primarily by domestic forces (e.g. baby boomers buying their first houses and cars), factors that the Fed and other policymakers felt they could control somewhat. Today, the demand comes from abroad (emerging countries such as China and India), where the ability to slow demand for commodities used in the build-out of infrastructure is basically nonexistent.



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Thus, even a tighter monetary policy and a deep recession (which would likely heal many excesses created over the last 20 years) would still be accompanied by significant increases in prices of goods, due to demand from economies that cannot be effectively managed through domestic monetary policies. This would be very challenging.

This time around, something is different. Without a significant global economic slowdown, we should see continued price inflation no matter what monetary policy the U.S. follows. Furthermore, we are not the only nation inflating its currency. In fact, there is an evolving worldwide competition for countries to be the most competitive exporter by keeping their currencies weaker than that of other exporting countries. While United States Federal Reserve Bank assets increased by 3.1% over the last year, European Central Bank assets grew by more than 20%, Middle East central bank assets increased between 20-40%, and China's and India's grew 31% and 33%, respectively.

The acceleration in competitive devaluation, or "Beggars thy Neighbor" policies, poses a growing threat to the international currency system. Our subsequent concern has increased our interest in gold mining stocks—particularly in high-cost producers that do not hedge their reserves or production, thus offering optimal operational leverage for any increase in the price of gold.

At this time, there are more companies that look attractive for investment than at any time since 2002. Fortunately, some gold stocks meet our investment criteria of being industry leaders, having strong balance sheets, experiencing unfavorable sentiment, and selling at historically low multiples. One thing is clear: the process drives decisions that are frequently difficult to stomach, yet its performance has held up well over the long-run, especially during times of distress. We will remain dedicated and patient, focusing on avoiding permanent loss of capital while participating in the financial markets.

Contrarian Value Equity Composite Portfolio Fundamentals as of 6-30-08		
	R&W Equity Composite	S&P 500
Number of holdings	39	500
Wtd. Avg. Mkt. Cap. (\$B)	66.8	91.3
Price/Earnings Ratio	13.9	17.4
Price/Book Ratio	2.2	3.5
Price/Cash Flow	7.2	9.1
Dividend Yield	2.8%	2.2%
Return on Equity	17.9%	24.8%

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