

The Long & Short of It

Quarterly Newsletter

Fourth Quarter 2009

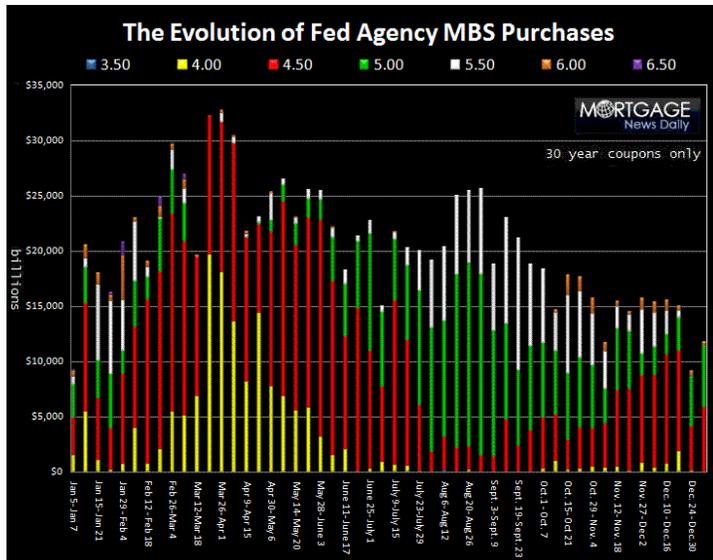
Thou Shalt Take Risk

In the wake of the tumultuous markets of the previous year, results for the fourth quarter of 2009 were so benign as to be a bit disconcerting. Domestic and international equities offered mid-single digit returns, while corporate bonds returned low single digits. Financial stocks lagged for the quarter with a slightly negative return while technology stocks led the way higher returning nearly 10%. Interestingly, the only area that experienced any significant pain during the quarter was the long maturity U.S. Treasury bond, which lost 7%.

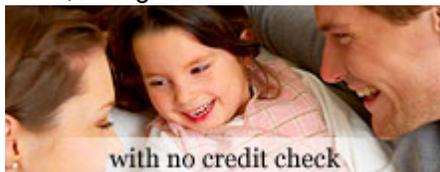
The results for the full year reflect more of the same. Short maturity Treasuries returned approximately 3%. Greater risk generally led to greater returns, as long as the underlying business survived the threat of bankruptcy. Following the flight to safety at year end 2008, long maturity Treasury bonds lost 17% in 2009. Between the massive stimulus package on top of the already massive federal budget, and the Federal Reserve's extraordinary efforts to add liquidity to the economy, the U. S. government did everything imaginable to support the prices of risky assets.

Don't Fight the Fed

The phrase is an old saw, though we had no idea how true it would become. Over the last year, while keeping Fed Funds near zero, the Federal Reserve has gone the extra mile purchasing \$1.1 trillion Agency Mortgage Backed Securities (MBS). The rate of acquisition has slowed, from around \$7 billion per day last March to around \$3 billion per day most recently, as it approaches the budgeted \$1.25 trillion. Most of the purchases are of instruments containing long-term, fixed rate mortgages from Fannie Mae, Freddie Mac and Ginnie Mae. In addition, since March 2009, the Federal Reserve has purchase over \$300 billion of long-term U.S. Treasury Bonds. In spite of this, housing prices still dropped by about 8% in 2009.



Yet, Federal Reserve policy is not the only thing supporting housing prices today. Today, with an FHA backed loan and a FICO credit score of as low as 580, one can borrow to purchase a home with only a 3.5% down payment. In 2009, first time home buyers could use the \$8,000 tax credit to meet the down payment requirement on a home valued as high as \$225,000. In addition, re-financing an FHA loan can be done without a credit check, as the picture from the FHA website advertises. In 2008, during the credit crisis, Congress raised the maximum FHA loan from \$362,790 to as high as \$729,750 for the most expensive housing markets. These artificially low mortgage rates created by the Fed's MBS purchase program and the low down payment/low credit score/tax credit for first time buyers continue to make home ownership attainable (a good thing), but with debt levels that home buyer can barely afford. Worse, with little-to-no down payment and an FHA buyout, the home mortgage industry





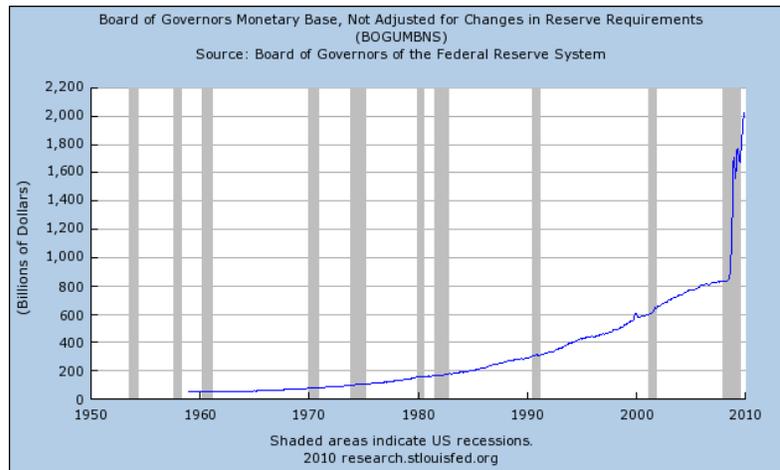
continues to facilitate owners walking away from their homes if the payments become difficult to make or if the loans go underwater. In fact, since the demise of the sub-prime markets, FHA insured loans have grown from 5-10% of the mortgage market to as much 25% toward the end of 2009.

If this is not enough, credit default swaps, the contracts (effectively insurance) used to protect against the default of MBS and other financial instruments, still do not have any capital requirements that might help to buffer against loss and encourage proper pricing. We understand that there are those who want to punish the perpetrators of the credit crisis, and that may need to wait until markets are more secure. However, the structures and instruments that helped to create these unsustainable circumstances could be dismantled or given proper regulatory oversight just a bit more quickly.

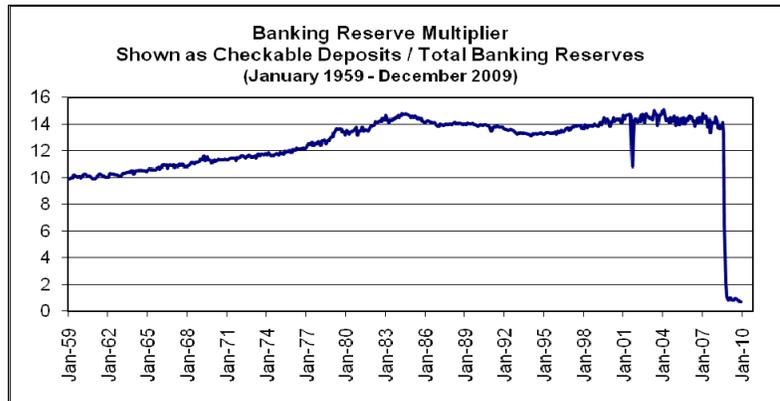
Dollar Doldrums / Fiat Currency Cascade

The Dollar Index closed the month with a 4.1% gain, but finished the year with a 4.1% loss. The dollar's doldrums this year helped prop up commodities prices and gave the CRB Commodity Index a 23.5% annual gain. But the small decline in the dollar does not go very far in explaining the 24% increase in the CRB Commodity Index. Money printing by central banks worldwide seems the more obvious culprit, with the strength in commodity prices being better understood as a broader decline in the value of paper currencies worldwide relative to hard assets.

The monetary base in the United States has ballooned by 150% in the last year. And while money supply has yet to show significant growth, the increase in the monetary base has led to a surge in Total Banking Reserves available for lending. Banks have to keep about eight to ten cents of each dollar of reserves on hand. Out of the 90% to 92% loaned out, much comes back as new deposits of which eight cents of each dollar again must be kept in reserves while the rest can be loaned out.



As a result, banks usually end up with checkable deposits that are a multiple of reserves that varies between 10 and 14 times. In the charts to the right, one can see that the explosion in reserves has not yet translated into an explosion in checkable deposits. As the banks begin to lend more aggressively, the Fed has indicated that they will remove the excess reserves from the banking system, presumably by selling the U.S. Treasury bonds and MBS securities that they have been buying for the last year. One has to wonder whether the Fed will have the acuity and the will to apply the brakes at just the right time and amount. The other question is whether or not the biggest buyer of these securities can become the biggest seller without creating new problems.



Source: St. Louis Federal Reserve (FRED)

Don't Fight Congress or the Treasury for That Matter

John Maynard Keynes (June 5, 1883 – April 21, 1946) was a British economist whose ideas have been a central influence on modern macroeconomics, both in theory and practice. He advocated interventionist government policy, by which governments would use fiscal and monetary policy to mitigate the adverse



effects of business cycles, economic recessions, and depressions. Although his theories were challenged by economists in the late 1900's, they are now widely embraced by the world's political class as justification for public sector expansion to avoid unattractive economic outcomes.

Keynes has been proven right that uncertainty and volatility in the business cycle add to investor uncertainty, creating a less-than-optimal environment for long-term economic growth. That a nation's best interests are served by promoting a stable environment which encourages optimal economic growth and the taking of reasonable risks; risks that might not be taken when the economic cycle is allowed to get too deep and unpredictable.

And while the government can accomplish some of these goals through monetary and fiscal policy, Keynes' theories are failing in their implementation over the long run primarily due to the fact that a government's drive to create public debt through fiscal stimulus during difficult times is much greater than its resolve to pay down debt through fiscal restraint during good times. Since the 1950's, governments that have adopted Keynesian principles have demonstrated with each economic cycle, a steady, usually creeping, occasionally lurching expansion in public debt in proportion to the national output. The result is a changing landscape for investors.

In the deep forgotten history of investing in the United States (with Wall Street this means anything further removed than the last 5 years), governmental activities were typically marginal considerations when seeking to evaluate the prospect for, or outcome of, any particular investment. Concepts discussed by investors during those times included such once-useful words as inventory levels, shifting consumer preferences, innovation, supply chain management, pricing power, and cost rationalization. Although we continue to consider such details at RVM, last year they were of limited use as the dominant variables effecting investment outcomes came from governmental activities. Rather than the normal business failures that should have taken place during such a downturn, the government used deep pockets to bring the near-dead back to life, thereby creating the biggest opportunities for investors in those very enterprises that should have disappeared or been absorbed into other successful and opportunistic companies. Having evolved from a prevailing wind into a trade wind over the last 20 years, in 2009 the government's influence became a gale force.

Sir Francis Beaufort (May 27, 1774 – December 17, 1857), an Irish-born British admiral, would have recognized the environmental shift and found a way to measure it. Through the late 1700's, naval officers made regular weather observations, but there was no standard scale for communicating sailing conditions. As a result, the terms were very subjective - one man's "stiff breeze" might be another's "soft breeze." In 1805, Beaufort published a scale carrying his name that succeeded in standardizing these measurements.

The initial scale of thirteen classes (zero to twelve) did not reference wind speed numbers but related qualitative wind conditions to the effects on the sails of a man of war, then the main ship of the Royal Navy, from "just sufficient to give steerage" to "that which no canvas sails could withstand." At zero, all his sails would be up; at six, half of his sails would have been taken down; and at twelve, all sails would be stowed away. At zero, the water is like glass; and at twelve, the air is filled with foam, the sea completely white, visibility is greatly reduced – there is widespread damage.

Over the last several years, and in particular 2009, investors have had to stow their sails in the face of reduced visibility and extensive economic damage. Some have launched their investment portfolios into the markets in the hope that the gale will carry them in the direction they want to go. Last year was a pleasant experience for most. Whether investor's sails were stowed or ripped by the gale, the storm happened to blow in a favorable direction. The greatest successes in 2009 were not so much sailing, as drifting with style. For those with funds to deploy, it is not investing but speculation. Similarly, for business managers, an unpredictable economy is challenging enough. But when the money flows and policies directed by political winds grow from being one of many considerations to being the elephant in the room, those investment decisions become speculative efforts to take advantage of the situation while it lasts rather than the pursuit of greater innovations and efficiencies. Keynes' government, with too many dollars flowing through too many programs, eventually becomes a cause of the very problem it set out to solve.



Economic theory holds that fiscal stimulus must become greater with each successive effort to produce the same effect. As the budgets grow, the government's portion of GDP becomes larger and the amount of revenues needed to service the debt increases, greater and greater stimulus is required in order to revive the economy. Looking at the credit crisis as a global event, the staggering size of the G-20's combined rescue package, totaling about \$12-trillion, was equal to a fifth of the entire world's annual economic output. As a result, the gross government debt-to-GDP ratios for advanced economies have risen from the high 70%'s in 2007 to about 100% in 2009. Estimates have them rising significantly again in 2010 and thereafter. The increase takes place so quickly because so much of what governments are spending must be borrowed. For example, in 2009 the United States borrowed to provide funds for 40% of federal outlays.

Because of the lack of grounding in practical reality, this will likely be Keynes' legacy. As debt-to-GDP ratios reach past 100%, ratings agencies will eventually find themselves pressured to drop credit ratings on sovereign debts. Perhaps we will begin the process of reducing the debt, one that will suppress growth for the better part of the next decade. Some say this has already begun, but so far the expansion of public debt is outpacing the decline in private debt. On the other hand, if confidence can be maintained and interest rates managed down to even lower levels, many countries may end up where Japan currently finds itself: with debt around 200% of GDP and tax revenues accounting for less than half of government spending (the rest is made up through borrowings and reserve depletions). 54% of Japan's tax revenues are currently used just to service the debt. If interest rates on Japanese public debt were to rise by 2%, the cost of debt service would surpass total tax revenues. Clearly Japan's deficit spending is supporting their GDP, so if Japan were to exercise some fiscal prudence, the 200% debt-to-GDP ratio would rise, quickly making matters worse.

At RVM we continue to invest client funds, relying on strong balance sheets and attractive valuations to minimize the risk of purchasing power loss while maximizing total return. As investors we know that valuation always matters most in the long-run. We are seeing many attractively priced high quality companies today, especially in the United States. Being a bit contrarian, we know that even our own sense of impending doom (see above) informs us that opportunities exist for those willing to do the work to find them.

RVM's Contrarian Value Equity Composite Portfolio Fundamentals as of 12-31-09		
	RVM Equity Composite	S&P 500
Number of holdings	32	500
Wtd. Avg. Mkt. Cap. (\$B)	68.5	83.5
Price/Earnings Ratio	16.1x	21.4x
Price/Book Ratio	3.3x	3.4x
Price/Cash Flow	14.3x	13.5x
Dividend Yield	2.7%	1.9%
Return on Equity	24.5%	5.4%

As for the current macro-economic challenges, we have all seen many names on the list of those potentially responsible for the creation of the mess. For the list of names to be considered to get out of the mess, we make our recommendation: Houdini.

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