"The Long and Short of It"

Quarterly Newsletter from
Robinson Wilkes, L.L.C.

Third Quarter, 1999

Our Turn
As you know, 1998 was a difficult year for value investors. The difficult market for value investors continued through the First Quarter of 1999. March of 1999 now appears to have been the peak in the momentum approach, as well as the bottom for value investors.

During the Second Quarter of 1999 the indices and benchmarks returned the following:

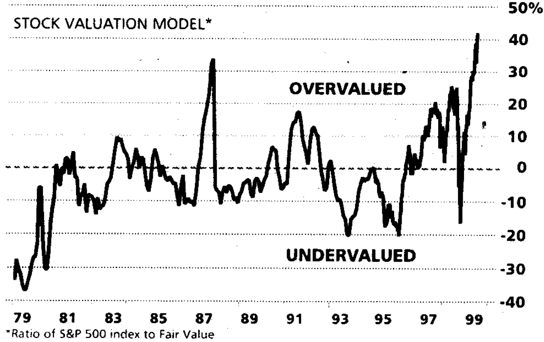
S&P 500 Index	6.71%
Dow Jones Industrial Average	12.11%
Russell Value Index	10.84%
Value Mutual Fund Average	9.04%
Russell Growth Index	3.81%
Growth Mutual Fund Average	7.07%

For Robinson Wilkes, L.L.C., the Second Quarter of 1999 was an example of how sticking to one's disciplines, even through the toughest of times, can pay off. During the Second Quarter our composite of equity accounts included about 20% in Treasuries and cash equivalents. Both were a drag on returns. Yet, our composite of equity accounts was able to turn in a solid performance for the quarter. We continue to hold somewhat large cash balances because of the difficulty we are having finding good businesses that are selling at attractive multiples.

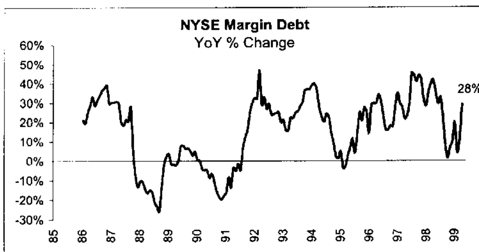
Our valuation models, which price each stock individually, indicate that the average stock is significantly overpriced. Out of the 220 companies we follow, there are only a handful that represent excellent values today. These companies are held at full positions in the equity portfolios we manage. Our portfolios also own approximately twelve companies that are attractively priced, but not compelling. These are held in smaller positions. The other companies we follow appear to have significant downside potential if optimistic earnings estimates are not met.

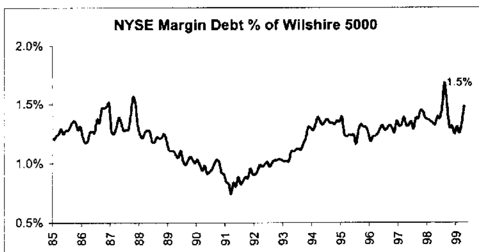
During the Quarter, there was plenty for the markets to worry about. Treasury Secretary Robert Rubin announced his retirement, the Federal Reserve raised interest rates, and the 30 year Treasury Bond yield increased to 6.14%, 31% higher than last year's low of 4.69%. Despite these worries, the Dow Jones Industrial Average temporarily moved beyond 11,000.

Still, not all is well on Wall Street. Dell's common stock was down about 10% for the Quarter and is now 33% off of its highs for the year. Many popular Internet stocks dropped more than 40% during the Quarter. Even Warren Buffet's Berkshire Hathaway closed down for the year as of June 30. The P/E ratio for the S&P 500 Index remains exceedingly high at 40.9 times the last 12 months' earnings. The dividend yield is down to 1.08%.



The June 21, 1999, edition of Barron's included a chart from Ed Yardini of Deutsche Bank. The chart plots stock market valuations based on the ratio of the S&P 500 Index to "fair value." To determine fair value, divide the consensus estimate for operating earnings of the S&P over the next twelve months by the yield on the 10-year Treasury bond. By this measure, the market is grossly overvalued. In fact, it is more overvalued than before the drop in 1987. However, there are many yardsticks used to measure the market. Not all agree with Mr. Yardini's.





Another number that has caught our attention is the current level of margin debt. As of the end of April, as depicted on the chart, NYSE Member Firm Margin Debt reached a new high of $182 Billion. More importantly, as a percent of the total capitalization of the market, margin debt is now the highest it has been since 1987, except for the peak reached last March when the broader market hit what remained the highest levels ever reached until the end of the Second Quarter. Our interpretation of this is merely that there is more "greed" than "fear" in the market. The end result will be a bigger and more explosive downside move - when it happens.

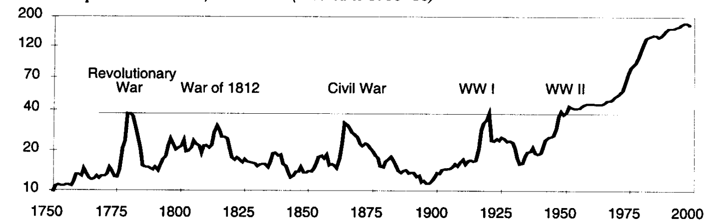
Also worthy of attention, the central banks are following an expansive policy of underwriting a global economic recovery, even if that means a pickup in inflation. The Federal Reserve seems to be steering policy based on global issues rather than domestic conditions. The Japanese are pumping money into their economy through fiscal programs. The European Central Bank cut rates just to help global economies. All of these actions moved the world away from the threshold of a meltdown in 1998. In

fact, some worry the policies were too expansive and that price inflation now looms imminent.
Yet we are still in a long term deflationary global environment from the point of view that 1) very few of the drivers needed to create growth are active, 2) there is excess productive capacity, which will become more excessive as capital frees up in Asia, and 3) productivity gains, which seem to be the only significant engine of growth in the economy, create additional downward pricing pressures. Excessive monetary expansion gets soaked up by the financial markets, leading to asset inflation, but secular price inflation continues to be mild to almost non-existent.

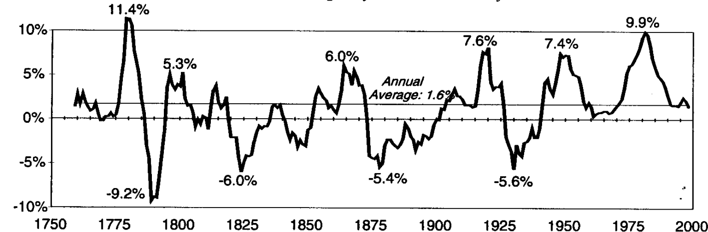
A big surprise on the downside remains more likely than rising inflation and higher interest rates. Once the expansive monetary policies of 1998 have had time to filter through the economy, the expansion is likely to slow again. A slowing economy creates an excellent environment for bonds and a mixed picture for equities as falling interest rates help to offset the impact of disappointing earnings.

Moderate Inflation is the long-term norm

Wholesale prices in the U.S., *1750-1998 (Indexed to 1750=10)*

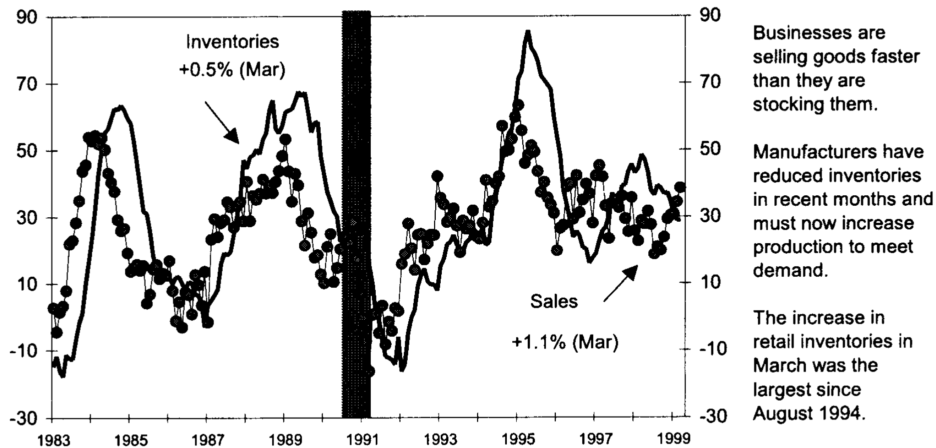


Wholesale prices in the U.S., *1750-1998 Rolling ten-year CAGR, annually*



Our view is that an ultimate recovery in the emerging economies will paradoxically lead to greater disinflation rather than higher inflation. As credit lines and capital are extended more freely, oil rigs, copper mines and shuttered plants will likely reopen and overproduce, resulting in a likely continued excess of supply over demand. This will probably be more noticeable in 2000 rather than this year, owing to this year's balancing out of the inventory correction process and Y2K inventory buildup.

Total Sales and Inventories
(Change from Year Ago Month)
(Billions of $)



In an economy that has successfully evolved from a high-fixed-cost industrial base to a high-variable-cost service/knowledge base, the direction of productivity and labor costs will dictate inflation pressures, not a temporary spike in commodity prices that resulted from an end to the inventory correction process.

Stock and bond prices have de-linked as they did in 1987 before the drop. It would not be surprising to see them re-link, with equities under-performing bonds for some period of time. Perhaps this is what the Second Half of 1999 will hold.

Despite all of this information, we do not invest based on where we think the stock market, interest rates or GDP ought to go. We focus on buying good businesses at great prices. We build a portfolio from the bottom up. A typical full position size is 5% of equity. To the extent we cannot find enough attractively priced companies, or the ones we own become overpriced, cash is our fallback position. One of the worst forms of speculation is holding overpriced merchandise. If one does not have to be fully invested, it is great to be able to sleep at night with some cash or Treasury bills in your portfolio.

Finally, the Internet stock bubble (which seems to have sprung a leak last Quarter) may face additional deflationary pressure in the future as the venture capitalists, insiders and other investors begin to exit their restricted stock holdings. This will result in an unremitting supply of Internet company stock for sale over the next year or two.

Equity Activity for the Second Quarter

On May 5, 1999, we established a position in **Robert Half International (RHI)**, the largest specialized provider of personnel in the fields of finance and accounting, administrative and clerical, paralegal, legal support, and information technology. RHI shares dropped significantly in response to a slowing in sales growth during the First Quarter, as well as the subsequent analyst downgrades. While sales growth did slow in RHI's core markets (financial and accounting), primarily due to a tight labor market, we

believe investors overreacted. Slowing sales growth did cause profit growth to slow somewhat, but profits still advanced by a respectable 23%, aided by effective cost cutting and a share-buyback program. Moreover, RHI's core business remains solid and expansion into new labor markets, like information technology and legal staffing, looks promising. Finally, in the highly fragmented staffing industry, RHI's dominant size positions it well for acquisitions, which will create additional growth and economies of scale.

We also exited **Consolidated Natural Gas (CNG)**, **Rohm & Haas (ROH)** and **Hubbell, Inc. 'B' (HUBB)** this Quarter. We exited the position in CNG after an acquisition battle between Dominion Resources and Columbia Energy Group drove CNG's stock price near its previous high. Believing the suitors had done their due diligence in valuing the company, we decided to take our profits and above market dividends from CNG and put them to work in more promising areas. We sold ROH after the stock's price increased 50%, significantly surpassing our price targets. Our exit from HUBB was more of a decision that HUBB, although a well-run, financially strong company, was not of sufficient size and does not command enough of a leadership position to meet the more demanding criteria we have adopted to be included in our companies for investment consideration.

Our remaining trades were either additions to or reductions of existing positions in companies we have reported on in prior newsletters. Our process dictates that when a company's stock reaches the lower end of our projected trading range, we will establish a small position. If the price of the stock gets cheaper relative to its fundamentals, and the story remains intact, we add on to the position. Sometimes this takes place because of a decline in price. Other times it is because of an improvement in the fundamentals that was not accompanied by an increase in price. Conversely, on the sell side, when a company's stock price reaches the high end of our projected trading range, we will cut back a portion of our position. If the price trades above the range that fundamentals would suggest, we will cut back further or exit the remaining position.

Applying these principles to several of our stocks, we bought a small position in **SCI Systems (SCI)** in March of 1998 at $36 and cut back somewhat in November at $41. We then added back on in April of this year when the price hit $27, and cut back again this month at $47. That gives our clients an 88% pretax profit in a stock that has increased 31% in value. **Nucor (NUE)** is a similar story. We established a position in January of 1999 at $47 and cut back somewhat in April at $56. We recently added to the position again at $47. **Mylan Labs. (MYL)** has been a bit more difficult. After its stock price dropped 15% in January of this year to $30, we bought an entry position (mentioned in last Quarter's letter). MYL then proceeded to drop to $23 in April, at which time we added to the position, bringing our average cost to $26.50. At the time we wrote this letter, the position had become profitable.

Contrast this "value" style of investing with the "growth" style that bets on a company continuing to grow at significant, and frequently increasing, rates of growth. The growth

style pays off big when projections are correct or there are positive surprises, but the cost is great when there are negative surprises. While growth has outperformed value the last few years, value has outperformed growth over the past 30 years about 60% of the time, and proved to be less risky. We believe the cycle is again beginning to turn in our favor as evidenced by our returns this last Quarter.

Taxing Issues

Hidden Taxes

Americans pay an average $2,462 annually per person in "hidden taxes," resulting in a total U.S. tax burden equal to 42% of annual personal consumption spending, according to a report released April 1 by the National Taxpayers Union Foundation. According to NTUF, Americans pay a total of $657.7 billion each year in taxes that are "not explicitly clear" to those who pay them, a figure nearly $20 billion higher than reported by NTUF a year earlier. Specific examples included gasoline, import, telephone, and travel taxes, along with licensing charges and the "so-called 'employer's share'" of Social Security and Medicare taxes.

Accounting and Your Investments

In "The Long and Short of It" last Quarter we relayed how pessimism surrounding **BMC Software, Inc. (BMCS)** centered in part around the restatement of BMCS's 1998 earnings due to the SEC's change in accounting rules for combining financial statements after corporate mergers and acquisitions. On April 21, 1999, the Financial Accounting Standards Board tentatively decided to eliminate the advantageous method of accounting for business mergers and acquisitions, the pooling of interests method, that has been used by marriage-minded U.S. companies for many years. The board also decided that only one method of business combinations accounting, the purchase method, should be used.

In pooling of interests accounting, the book values of the joined companies are simply added together. This leaves little change in the way assets are valued or earnings calculated even though the purchase price of the assets may have been well above the values listed on the balance sheet. The purchase method of accounting calls for the acquiring entity to recognize the fair market value of the assets of the acquired company, not the book value. It also creates an asset called "goodwill" which is the excess of the purchase price of the acquired company over the fair market value of its net assets.

Since amortization of goodwill creates an additional expense for a period of up to 40 years, the creation of goodwill creates a drag on earnings. Although the expense is a non-cash expense, the reduction in earnings for financial accounting purposes adversely affects a stock's price when earnings are used as a basis for valuing the company – which is almost always the case. Combining companies have been able to avoid the drag on earnings using the pooling of interests method of accounting, even though the true cost of the merger or acquisition is exactly the same. Only the method of accounting is different.

Over the next 18 months, while pooling of interests is still possible, there may be a rush of deals using that method of accounting. To the extent that companies use cash for these deals (instead of debt or their own company stock), liquidity will be provided to investors and thus the market.

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