The Equus Report

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CREATIVE DESTRUCTION

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"Capitalism exists in a state of ferment marked by spurts of innovation destroying established enterprises and yielding new ones."[1]

In his book, Capitalism, Socialism and Democracy (first published in 1942), Joseph Schumpeter argued that Capitalism exists in a state of ferment, dubbed "Creative Destruction," with spurts of innovation destroying established enterprises and yielding new ones. But just thinking about all of the 'destruction' last year, with

1. The World Trade Center
2. The Recession
3. Enron
4. California's Energy Crisis, and
5. The Telecom Meltdown

makes one's heads spin. It was awful. In fact, you could almost feel this great sigh of relief – rather than celebration – when New Year's Eve finally rolled around. We were happy to see it end and to close this chapter in history.

Only it isn't that easy. Life goes on and, in order to move forward, what we really need to do is ask ourselves: What will *this* year's headlines be? "Rising consumer debt leads to increased bankruptcies"?[2] "Record unemployment leads to Depression"?[3] Or something more positive: "Product innovations spur renewed demand, investment and capital expenditure"?[4] As Trinity asks in "The Matrix": "It's the question that drives you, Neo. What is the question?"

[1] "Schumpeter probably was right all along," says Michael Powell, "but it's only now, at Moore's Law speed, that you can actually observe it." Far less accepted is his ***second*** message: that entrepreneurs will disappear as innovation becomes mechanized in corporate labs – as it has today in Japan – and that ultimately the very success of capitalism will lead to socialism. Frank Rose, Wired Magazine, March 2002.

[2] "Key Macro Credit Indicators Continue Stable/Improving Trends," ABN AMRO Inc., January 30,2002. "The consumer debt burden for Q3 '01 surprisingly declined to 13.81% of disposable income, after peaking at 14.22% in 2001 and hasn't been at this level since 4Q99." Note: We're not yet out of the woods. Some of this debt was rolled into home mortgages via the largest refinance boom in history and the peak U.S. bankruptcy period typically occurs in March and April…

[3] "U.S. Companies Fired 1 Million Workers in 2001," Bloomberg News, December 26, 2001. "The U.S. unemployment rate rose to 5.7% in November from 4% in 2000."

[4] "The State of Silicon Valley, Inc." by Anthony Perkins, RED HERRING, February 2002. "Just as the bust we are going through is historically consistent (been here before), so too will be the next chapter which will usher in an age of innovation that will make even the inventions of the microprocessor and PC look tiny in comparison. Many great companies, like Disney (1923), HP (1938), and Cisco Systems (1990) were started during recessions."

In general, we are guided by rear-view mirror thinking and by the vistas behind us because that's what is foremost in our minds. Drawing comparisons with the past helps us feel that we have a roadmap for dealing with what lies ahead. But, when looking to the past, I have learned that conditions are almost never exactly the same.

Certainly, we must *start* by acknowledging things as they are. Polls show that CEO confidence is not yet on a recovery path – that their confidence has been shaken; they lack "visibility"; and they believe that improved trends will occur during "the second half".[5] At the same time, in a December survey of 375 manufacturers, "59% said they expect business to improve from July to December 2002; one in three said they see business picking up in the first half; and 19% said they were 'optimistic'".[6] Since it is a company's CEO who ultimately decides whether to hire or fire – and to increase or decrease capital spending – things probably will get off to a slow start. My contention is that the recovery, *when* it occurs, will be led by an up-tick in capital spending, just as its downturn led us into recession.

Next, lets' say that -- after last year's massive cost cutting layoffs -- the economy *has* bottomed and we start to see early signs of stabilization, as Mr. Greenspan suggested in his January 30 statement to the Federal Open Market Committee.[7] The question is: "Will early strength be the product of short-lived inventory rebuilding, quickly followed by the U.S. slipping back into a recession?" And if the US, why not the rest of the world, since our economies are now so closely tied together? This is one of "10 Surprises" Byron Wien, Chief Strategist at Morgan Stanley, thinks might occur.[8] Personally, I am not so pessimistic. But I do have several concerns, which I will closely monitor -- including interest rates being as low as they are. Last November, I listed this as a *positive* because it made things like buying a home or car more affordable.

[5] "Best Ideas for 2002," Goldman Sachs, January 4, 2002.

[6] "U.S. Manufacturers See Rebound in Second Half," Bloomberg News, December 11, 2001. Note: NAPM is changing its name this year to "the Institute for Supply Management" because "purchasing professionals are becoming more responsible for a supply of goods and services."

[7] "U.S. Federal Open Market Committee Statement," Bloomberg News, January 30, 2002. "Signs that weakness in demand is abating and economic activity is beginning to firm have become more prevalent. With the forces restraining the economy starting to diminish and with the long-term prospects for productivity growth remaining favorable and monetary policy accommodative, the outlook for economic recovery has become promising."

[8] "The 10 Surprises of 2002," Byron Wien, Morgan Stanley, January 7, 2002.

And it still IS a positive. But, with Fed Funds at a forty-year low of 1.75%, rates seem like they're about as low as they can go and there's not much more the Fed can do.[9] So maybe the government agrees on a reasonable stimulus package and government spending picking up where Greenspan leaves off. At some point, the ensuing Budget Deficit[10] will have to be paid and, once the economy does begin to grow again, interest rates will rise, which could be negative for both stocks *and* bonds.[11] The same goes for oil and gas. Clearly the substantial drop in prices last year provided support for consumer spending,[12] but that support will most likely diminish as prices stabilize and, at some point, begin to rise again (which, by the way, argues for us beginning to make some sort of energy bet).

Then there's productivity. Improved productivity has allowed companies to better compensate employees.[13] But some of those gains in "productivity" were simply a result of headcount falling faster than sales, and profit margins are still under pressure as companies find themselves unable to raise prices.

9 "Fed Saw Eleventh Cut as 'Insurance', December Minutes Show," Bloomberg News, January 31, 2002.

10 "U.S. Budget Heads for $21 Billion Deficit, CBO Says," Bloomberg News, January 23, 2002. "The U.S. will run a deficit of about $21 billion in the fiscal year that began October 1, the Congressional Budget Office estimates, as a slowing economy, tax cuts and a war on terrorism end a string of four consecutive surpluses. That deficit will narrow to $14 billion in 2003, with surpluses likely in succeeding years".

11 "Mr. Buffett on the Stock Market," Carol Loomis, FORTUNE, November 22, 1999. In a rare public interview, Mr. Buffett explained his opinions about the long-term future of stocks, including the following excerpt:

"From December 31, 1964 through December 31, 1981, the Dow Jones Industrial Average went from 874.12 to 875.00. Now I'm known as a long-term investor and a patient guy, but that is not my idea of a big move. And yet, during that same 17 years, the GDP of the U.S. almost quintupled, rising by 370%. To understand why (in spite of this fact) the Dow went exactly nowhere, we need first to look at one of the important variables that affect investment results: interest rates. These act on financial valuations the way gravity acts on matter. The higher the rate, the greater the downward pull. That's because the rates of return that investors need from any kind of investment are directly tied to the risk-free rate that they can earn from government securities. So, if the government rate rises, the prices of all other investments must adjust downward, to a level that brings their expected rates of return into line. Conversely, if government interest rates fall, the move pushes the prices of all other investments upward. The basic proposition is this: what an investor should pay today for a dollar to be received tomorrow can only be determined by first looking at the risk-free rate. In the 1964-1981 period, there was a tremendous increase in the rates on long-term government bonds, which moved from just over 4% at year-end 1964 to more than 15% by late 1981."

12 "Saudi Minister al-Naimi says oil market in "crisis," Bloomberg News, November 15, 2001. "Lower energy costs will help revive the world economy, where 2.2 percent growth rate is the lowest in eight years. A 10 Euro ($8.80) drop in oil prices is equal to an 800-euro tax cut for an average European household.

13 U.S. Manufacturers See Rebound in Second Half 2002," Bloomberg News, December 11, 2001. "Worries about labor costs have also increased at U.S. businesses as manufacturers expect to pay their workers about 2.3 percent more on average next year."

Also, there is a point when you get about as much as you can out of every worker anyway.[14] Hence, we may face continued profit erosion unless demand and top-line growth begin to improve *soon*.

Clearly healthcare (drug stocks in particular) will face the continued threat of price controls now being initiated by states like Florida and Michigan.[15] And the White House is beginning to suggest they might be open to reducing Medicare reimbursement if the states and Congress don't do something first. So, while healthcare remains an incredible long-term growth opportunity that deserves continued investment over time, the aforementioned threats will likely diminish near- term appreciation until we get more clarity on the issue.

The drama at Enron is only beginning. But it has already inspired a search into the reporting practices of any company with an asterisk in its financial statements – anything that would indicate a complicated accounting issue, from revenue-recognition policies at software companies, to the consolidated pro-forma and EBITDA reporting of leveraged or more acquisitive companies like Tyco.

Finally, there's the growing problem that some companies with aging workforces may soon face from defined-benefit pension liabilities. In years past, some of these companies actually included pension credits as part of their reported earnings based on returns exceeding expectations.[16] Some of these companies, over the years, have continued to ratchet up their annual return-expectations and, if their current 9%-10% returns don't materialize, the charges they would be forced to take could easily wipe out pre-tax earnings.

[14] "Adults in U.S. Are Sleeping Less and Working More, Poll Finds," Bloomberg News, March 27, 2001. "More than one third of residents said they are working 50 hours or more a week, and one in five adults is so sleepy during the day it interferes with daily activities at least a few days a week."

[15] "U.S. Health Spending Reached $1.3 Trillion in 2000," Bloomberg News, January 8, 2002. "U.S. health spending rose almost 7 percent in 2000 to $1.3 trillion, the fastest acceleration in 12 years and the second consecutive year that health spending grew faster than gross domestic product. Hospital care accounted for most of the dollar increase, rising 5.1 percent to $412 billion. But spending on drugs also rose 17 percent compared to a 19 percent increase in 1999 and remain the largest single component of out-of-pocket spending as employers become less inclined to offer generous but increasingly expensive insurance benefits."

[16] "Warren Buffet on the Stock Market," Carol Loomis, FORTUNE, December 10, 2001. "Last year, according to Goldman Sachs, 35 companies in the S&P500 got more than 10% of their earning s from pension credits even as, in many cases, the value of their pension investments shrank. I invite you to ask the CFO of a company having a large defined-benefit pension fund what adjustment would need to be made to the company's earnings if its pension assumption was lowered to 6.5%"

As for two of my favorite themes – "Convergence" and "Globalization" – I have focused on these for nearly a decade because I believe their ramifications will continue long into the *next* decade. The problem is that their ultimate impact might be different than I first thought. Until recently, convergence and globalization have been drivers of innovation, economies of scale and ongoing investment. Now, there is a massive shift to *outsource* and to focus on narrower core competencies. Companies from Merck to AT&T are unbundling the vertical models they've painstakingly built over years in an effort to "unleash shareholder value" and improve the earnings potential of captive subsidiaries. Also, we no longer live in a world where the US has a monopoly on the fastest growing areas of innovation, be it healthcare, technology or otherwise. **Things truly have gone global and, with the widespread use of the internet, new ideas will spread at the speed of light. Suddenly we're on the verge of an even playing field and the implications are immense**. Companies like Intel will no longer enjoy years of competitive advantage when it comes to something like processor speed. And, as a result, the economic (thus investment) cycle will get shorter and shorter and the markets more and more volatile to the point where I'm beginning to think that success will only come to those who are either very short-term (i.e. "Traders") or very long-term in nature. In the short term, it seems that one must play both sides of the fence, i.e. long *and* short, hence the recent outbreak and popularity of Hedge Funds and the way in which Wall Street is making these strategies available, not only to institutions, but to the public at large.[17]

I worry if, by the time Wall Street gets around to securitizing any new strategy (from Venture Capital; to Collateralized Mortgage Obligations; to the widespread use of derivatives), those strategies' potential return may already have begun to diminish. In other words, while making these products available to the public is *theoretically* an attempt to let more people participate and to "level the playing field," it often ends up being little more than an exit strategy for early investors, i.e. the "Smart Money." And, finally, if everyone's flocking to hedge funds, what will their ultimate impact be on the markets? The purpose of hedging is to *reduce* or *eliminate* risk as measured by beta, and to profit instead from the arbitrage in spreads. Won't those spreads just get narrower as more people get in on the action?

[17] "Hedge Funds Go Wide," Lewis Braham, BUSINESSWEEK, January 21, 2002. "With investors still reeling from the ravages of the recent bear market, the sponsors of these products expect them to be popular. After all, the average hedge fund eked out a 3.2% return last year using strategies such as short-selling and merger arbitrage, compared with the nearly 12% loss of the S&P500. But now that the recent bear market's worst days appear to be over, these funds are probably not a good investment. Over the long term they have lagged the S&P500."

Because that's one of the ways that **Supply and Demand** works: the more people want something, the less the Markets (or a given Manager) needs to offer as enticement.

There are questions. But in the end, it's the Consumer and a growing population ("**Demographics**") that ultimately drive markets.[18] If companies make a product that consumers really want (whether a Sony PlayStation or an SUV), people will line up to buy.[19] But they'll also be paying more attention to value, as shown by the widely divergent fortunes of companies like WalMart and the Gap last December.[20]

Retailers who had the right stuff at the right price did well. And, when it comes to spending, the same holds true for corporations: give companies something compelling that makes an impact on their business -- *and* that has a clear Return on Investment – and they will beat a path to it.

Given the above, when it comes to equity selection in the year ahead, I will continue to focus on the following three categories that, at this time, seem most likely to benefit from a slow, drawn-out recovery, with lots of ups and downs and attention-grabbing headlines along the way:

1. **Economically sensitive** companies whose earnings are most leveraged to an eventual recovery.
2. **Turnarounds** that have already begun to demonstrate a return to growth and profitability regardless of the economy; and
3. **Small- and Mid-cap**, best-in-breed companies that are focused, have faster growth rates than their larger brethren, and can stand out in comparison.

[18] "U.S. Population Growth Surpasses 1950s Baby Boom Era," Bloomberg News, April 2, 2001. "U.S. population growth in the decade between 1990 and 2000 surpassed the post-World War II baby boom, making it the largest 10-year population increase in the U.S. history, fueled by both an increase in births and immigration. U.S. population rose 13.2% to 281.4 million people from 248.7 million in 1990."

[19] "Wave Theory: The Ripple in Technology Spending," BARRON'S, January 19, 2002. "No question, the most innovative products in technology right now target the consumer, rather than businesses. To really succeed, however, tech companies need robust corporate spending – and another cycle is coming. Slowly, as the economy improves, and the last excesses are wrung out of the late 1990s spending glut, the cycle will begin anew. And as this next wave builds, investors who position themselves carefully are likely in for a profitable, if sometimes treacherous, ride. A November survey of more than 1,000 technology professionals, conducted by Gartner and Soundview, found technology budgets are expected to grow 1.5% in 2002. Forrester Research, offering a higher estimate, sees 2% growth; and Giga Information Group sees 4% growth."

[20] "Evening Market/Wrap," Rob Black, 2020 Insight, January 10, 2002. "WalMart reported an 8.2% increase in same store sales in December. Comparable-store sales for Pier 1 rose 18%; for Costco, 13%; Intimate Brands, 2.6%; while the Gap reported December sales falling 11%, as (to a lesser degree) they did at Kmart and May Department Stores."

In concluding this year's Outlook, I would like to borrow again from a recent, Warren Buffett interview by inviting you to, please, re-read his comments in Footnote #11 on page 4 of this report, which serves like a short course in "**Investing 101**." Next, in "Common Stocks as Long-Term Investments," Edgar Lawrence Smith (who studied security price movements in the 56 years ended 1922) asked: "Why do stocks typically outperform bonds?" The reason (as noted Economist, John Maynard Keynes explained in a 1925 review of the book) is that "well-managed industrial companies do not distribute to shareholders the whole of their earned profits. They retain a part of their profits and put them back in the business. Thus, there is an element of compound interest operation in favor of a sound industrial investment." In other words, over time, stocks outperform bonds in part because good businesses retain earnings that are used to generate *more* earnings (and dividends) and it is these *future* earnings and income that we are paying for today. We are "laying out money now to get more money back in the future" which, my friends, is what ***investing*** is – with the *caveat* that the companies in which we invest must be profitable *and* they must be more profitable each year than they were the year before. Again, in order for stocks to go up, either interest rates must fall; Price-Earnings Ratios expand; or profitability increase, year after year, over time. And as profitability increases – all else being equal – so will the value of our holdings.

Along the way, our sense of perspective will be challenged, almost on a daily basis, and as Charles Darwin used to do when running into something that contradicted a cherished conclusion, we must write down our new findings (within 30 minutes, he said). Otherwise, our minds will "work to reject the discordant information, much as the body rejects transplants. Man's natural inclination is to cling to his beliefs, particularly if they are reinforced by recent experience." This, again, is the pitfall of rear-view mirror thinking and what we call "Recency Bias." We look to the past for what has worked before, but the world is no longer the same – or, as one billboard in San Francisco reads, "Shift Happens." And it is happening at a faster and faster rate.

In fact, one could say that "Change is the New Normal."[22] Ever since the start of the Industrial Revolution, the goal of companies has been to grow and to become more efficient while investing in infrastructure that reduced variability – which works fine when things are stable. But, in turbulent times, when everything is in flux and the world is rearranging itself – while we may quibble about Cause and Effect – few people have any idea what's causing the change at the time; how it will affect them; or what to do about it.

[21] "Warren Buffet on the Stock Market," Carol Loomis, FORTUNE, December 10, 2001.

[22] "Survival Is Not Enough: Zooming, Evolution, and the Future of Your Company," by Seth Godin, Free Press, first edition January 8, 2002.

In times like these, "policy" and "routine" become hindrances and companies must recognize there are more competitors than market leaders. Leaders (if they want to remain leaders) must ***embrace the chaos and confusion*** and the concept of "Creative Destruction" in which upstarts thrive; where agility is the name of the game; and recreate themselves, over and over, before someone else does it to or for them.

This is the world in which we now live and all of us, in our respective ways, must be affected by it in the way we think. As a Portfolio Manager, I see it as an evolutionary process in which I want to constantly consider new tools and approaches that supplement my own investment style – from the use of options; to long and short; to shorter, trading horizons. Some I will do myself; some I will outsource to specialists. The bottom line is that we need all the pieces if we want to succeed.

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