

FEBRUARY 2002

Ring in the New Year by Wringing Out Excess

A third wave of common sense is washing over Wall Street. "Earnings based rationality" re-emerged a few years ago with the bursting of the Internet stock bubble. The second wave drubbed overvalued technology and telecommunication issues. Companies we expressed serious doubts about in past newsletters, like Global Crossing and Amazon, are either bankrupt or off some 80% from their highs. In our view, we have reached the final phase of rational adjustment...scrutiny of those companies run by unscrupulous people and/or those participating in the "numbers game".

By way of background, it is common business practice for public companies to take advantage of the "elasticity" in accounting principles. Accounting flexibility can be used to build earnings reserves during good times that may be reversed in difficult times. This process dampens volatility of reported earnings per share. Hundreds of accounting "dials" can be adjusted, including those related to revenue recognition, loan or accounts receivable reserves and interest rate assumptions on pension or other liabilities.

Enron is different in that we appear to have a case of criminals stealing money. Our guess is that the Enron gang became enamored by Internet bubble billionaires and just could not help grabbing something for nothing.

There is nothing new about "fraud". What is new is that Enron appeared to have had tacit approval from their accounting firm. The accounting firm appeared to have run what, in effect, were bribes

through their consulting fee agreements. In the old days, Enron would have had to give suitcases of cash to its accountants to get numbers fudged...in this day and age, however, they offered lucrative consulting contracts. Not only does the modern method save on suitcase expenses, the fact that the accountants were withholding taxes and F.I.C.A. on the bribes made the whole scheme credible.

Aside from those at Enron, there is no question that many good 'ol American companies have aggressively turned accounting dials over the past decade. Accounting standards are easiest to misuse when a company makes numerous acquisitions, generating enough paperwork that few know what is happening until a recession hits and creditors ask to be paid.

The good news is that Wall Street is in the process of purging itself of questionable practices, thus removing another impediment to renewed stock market strength. We expect that all financial report-

ing will be more reliable going forward. We also believe that other Enron, Tyco, WorldCom and or Global Crossings may be uncovered.

However, we do not think the Enron problem is pervasive. We believe that the accounting profession is strong, stopping far more abuse than it enables. We are reminded of a case in the late 70's when a young accountant auditing a major record company was conducting routine, due diligence by inspecting a warehouse. He noted a large stack of brand new record albums in the "damaged and return" pile. He brought some home, and found they played beautifully. Turns out that a major record retailer was buying counterfeit records and, rather than sell them through retail outlets, returned them for credit as "damaged". The criminals did not take time to scratch the near-perfect counterfeits before returning them. The point here is that despite current events, the accounting profession is diligent and recent publicity will allow accountants to do their jobs even better in the future.

Most individual company stock meltdowns occur with companies that have common characteristics, including loads of debt. The classic case is a group of "sharp" Wall Street types who acquire many mundane companies at high prices and expect the reward of an extraordinary stock price. It seems that all greedy and/or dishonest managers invariably "leverage" their schemes with debt.

We have always shied away from companies with heavy debt or who grow primarily by acquisition. We seek the upside opportunity associated with a company's inherent business model, as opposed to financial gamesmanship. Our fixed income portfolios are comprised of bonds rated "A" or better, thus helping to insulate against surprises.

Besides feeling sorry for the employees of ill-managed companies, we are glad that we are not tied to the indices and thus forced to buy Tyco and Enron as many money managers had to do. That philosophy sets us apart and we are proud of our record.

We believe a strong equity market may well follow this third wave of rationality. Interest rates are low, the economy is improving and the excesses of the Internet, technology and questionable accounting approaches will soon be history. As always, risks abound...areas such as Japan, Argentina and the credit markets are unsettled, but these too will likely be overcome by sustained global growth. We anticipate that when the \$2-\$3 trillion (yes, trillion!) in cash on the sidelines returns to the stock market, it will head straight for the 30-35 high-quality Blue Chip companies on our Buy List. These quality companies have exemplary management, low levels of debt and genuinely successful business plans.

Your comments and questions are always welcomed.

Important Disclosure: "It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities discussed in this newsletter."

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