

JULY 2002

Irrational Pessimism

The list goes on...Worldcom, Enron and ImClone. The investment public is rightfully aghast at American corporate governance. In this newsletter, we will try to explain how we got to this place in America and why we cannot join in the current pessimism.

First, let's examine some wide swings in the capitalist pendulum over the last four decades. In the 1960's and 1970's, too many large corporations were run like they were a cross between a country club and an amoebae. Blob-like conglomerates such as International Telephone & Telegraph simultaneously operated in diverse industries including hotels, auto parts and forest management. Corporate management and their boards were often comprised of "good old boys," where social climbing and cross-board directorships were typical.

During the "prehistoric times" of the 60's and 70's, financial incentives of corporate leaders were not necessarily aligned with the price of the underlying shares in their companies. Let's repeat that... corporate management in the old days didn't really care too much about their company's stock price. Not surprisingly then, the Dow Jones Industrial Average hovered between 700 and 1,100 from 1967 until the early 1980's. That was also a time when America was not competitive globally.

Things began to change in the 1980's when aggressive Wall Street-types combined their knowledge of discounted cash flow analysis with emerging court cases regarding management's responsibility to maximize, or improve, shareholder value. These

so-called "corporate raiders" began the process of taking on the sleepy, entrenched old boy network.

Realizing that big companies were worth far more than the valuations reflected in their current stock prices, corporate raiders quietly accumulated modest chunks of a company's stock at, say, \$20 per share. They would then threaten to take over the company. In many cases the raiders never made good on the takeover scheme, and simply sold their block of shares back to the company at \$40 or \$50 per share. Called "greenmail" back then, this process allowed shrewd operators to prosper while management kept their jobs. Unfortunately for ordinary shareholders, the company's stock price dropped well below the greenmail price following these transactions because substantial amounts of cash were used to keep the raiders away.

The era of sleepy managements and boards of directors ended in 1988 when a fellow named Henry Kravis took over RJR Nabisco. To illustrate the largesse at RJR before the takeover, it was apparently common for a corporate spouse to call on the RJR fleet of jets to fly across the country to pick up her prized poodles. When RJR was taken over, prior management was booted out and the era of "maximizing shareholder value" really began.

After takeovers became popular, large public corporations realized that no executive team was safe unless they managed the company for strategic growth. Managements decided, "Hey, if we don't manage this operation well, someone will acquire the company and fire us." With that attitude, the capitalist revolution of the 80's and 90's was under way. Jack Welch's management style demonstrates this best as he caused General Electric to identify core strengths, exit businesses where they were not Number 1 or Number 2, and to market themselves globally.

Corporate board directors joined in. They drew management's attention toward the maximization of shareholder value with offers of stock options tied to stock price performance. Can you feel the pendulum beginning to swing?

Well, it worked. With incentives now aligned, corporate management focused intensely on their stock price. General Electric, for example, increased their revenues from \$40 billion in 1992 to over \$70 billion. Their net earnings are now \$16 billion! General Electric's stock price was \$7.00 in 1992 and currently the shares are worth over \$25.00. Similar cases were repeated throughout America as our Gross Domestic Product (GDP) grew from just over \$6 trillion in 1992 to over \$10 trillion now (and still growing). Managements got rich and the number of workers grew by over 30 million to 151 million.

With invigorated strategic focus and growing corporate profits as underpinnings, the Dow Jones Industrial Average altogether added trillions of dollars of market value in the 1980's and 1990's. The shareholder-sensitive movement of the last twenty years contributed to making America the dominant world power. American manufacturing is second to none and gone are the days of our manufacturing technologies being inferior to Japan's.

As pendulums will do, they swing too far in either direction. Most recently, corporate management's share price incentives have been seriously abused. Whereas Jack Welch earned an eyebrow raising (but legitimate by baseball standards) few hundred million while growing General Electric's market capitalization by over \$200 billion, some unscrupulous managements simply traded in the truth

for money. They took advantage of the system. While one may debate whether some Chief Executive Officers are paid too much, no one defends the criminal element that apparently crept into Worldcom, Enron, etc. It is a shame and we hope jail time awaits many.

Unfortunately, the trillions of dollars of wealth created has been defiled by one or two hundred billion of waste and theft. We are dismayed and disgusted by the behavior of some of corporate America. However, we do not think the problem is systemic and we would not want to return to the past. We are pleased that our investment focus on companies with reasonable debt levels, sound management, and business plans uncomplicated by excessive acquisitions, has allowed us to avoid the headline disasters. We believe that the ill-doers are being weeded out and that corporate governance will be much stronger going forward.

There is an old saying in the investment business that one should not fight the tape. In these times, that means don't fight a bear market. We were bearish on some sectors of the market a few years ago and would be so again, if we didn't find so much evidence to the contrary. Specifically, we would be bearish if...

1. There was not \$3.0 trillion in cash on the market's sidelines.
2. America was not at peace with Russia and China.
3. Al Qaeda wasn't a bunch of miscreants with good hiding places.
4. The few governments that give quiet support to our enemies treated their own people well.
5. Unemployment was high and if residential real estate prices were dropping (they are not).
6. GDP did not grow 6% last quarter!

The capitalist pendulum will swing back toward a reasonable center. The United States has created hundreds of large, well-managed and focused companies with global leadership and reach. Far more value has been created than thieves can destroy. Importantly, the current lack of confidence in the face of good economic data may be creating one of the best buying opportunities for the right stocks in history. Incidentally, General Electric trades at the same price today as it did four years ago, yet their earnings have since more

than doubled. Investors may soon be accused of irrational pessimism.

We have been much more active in the last five years insofar as additions and subtractions from our Buy List of thirty Blue Chip companies. To review a list of activity over recent years, visit our Web site, click on Newsletter and scroll down to the last page. Enjoy.

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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