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Flying with Instruments... the Victor Kiam Test

Never is there a risk-free time to own stocks. War, recession, asset bubbles, deflation, oil prices, assassinations...disturbing current events are forever clouding the investment outlook. Even so, long-term investors prefer not to settle for the riskless returns of 90-day Treasury-Bill investments or Certificates of Deposit which currently pay 1%-2%. Instead, they are drawn to the stock market in search of better returns. In light of this, we want to discuss our methodical investment approach which is based upon quality, diversification and a strict valuation discipline. We will reiterate our belief that global economic growth will be strong and share with readers one of the many "tools" (the Victor Kiam Test) we use to preserve capital during perpetually turbulent times.

As we have documented in recent newsletters, we are confident that the global economy will grow at least as fast in the next 50 years as in the last. Gone are the unproductive days of fighting the Soviet Union whose annual military budget has dropped from over \$200 billion to about \$30 billion now. Gone as well are direct communist-based threats from China as people there now seek an improved standard of living, much as is witnessed in China's billion-person neighbor, India. The three countries just cited have a combined population of 2.4 billion that could easily generate incremental global GDP of \$2.0 trillion annually (\$1,000 in annual improved income multiplied by 2.0 billion people). Just as likely are much, much larger numbers in the coming years as the standard of living of the more than 6.4 billion inhabitants of the World continues to improve.

Having established our projection for continued global growth, how best for investors to participate? What we do when the outlook seems foggy, or even when not, is to focus on quality and check our valuation gauges carefully. We define "quality" stock investments as those in companies worth more than \$1.0 billion that operate in understandable, value-added industries with predictable regulatory environments. Moreover, we select companies with outstanding management reputations and corporate cultures. As a final test of quality, we only own companies with reasonable debt levels.

Often, we find a company that meets our criteria for quality, but fails tests for a reasonable valuation. This is where the "Victor Kiam Test" comes in. We last talked about this in our October 1996 newsletter. Although he passed away a few years ago, you may remember Victor Kiam as the man who "liked

the razor so much, he bought the whole company.” We think the same way when buying shares of a company’s stock. For example, if we are going to buy 100 shares of United Technologies, we ought to be just as willing to buy every share of that company at that price, or higher. While nothing more than a simplified merger and acquisition formula, the Victor Kiam Test is essential to our efforts to preserve capital.

To illustrate, let’s assume that an investor entrusts you with around \$130 billion to buy one or more companies outright, and you are wondering whether to buy every share of Cisco Systems or both United Technologies and United Parcel Service. All three pass our traditional quality screen. Let’s assume further that your investor demands an 8% annual cash return on investment. Incidentally, it would require \$134 billion to buy Cisco Systems, and roughly the same to buy both United Technologies (\$51.0 billion) and United Parcel Services (\$81.0 billion). Now look at the mathematics of your choices based upon these company’s underlying earnings:

*Important Disclosure to our corporate finance friends – We recognize fully

Victor Kiam Test*	Cisco Systems	United Technologies & United Parcel Service
① Cost to Buy Whole Company(s)	\$134 billion	\$132 billion
② Earnings (EBITDA) Generated by Company(s) Available to Pay Shareholder Returns	\$4.6 billion	\$10.7 billion
③ 8% Annual Cash Return on Investment (① x 8%)	\$10.7 billion	\$10.6 billion
④ Surplus or (Deficit) (② – ③)	(\$6.2 billion)	\$.1 billion

that many metrics are not factored into the table above such as capital spending, working capital needs, growth rate differences, etc., but still find straightforward presentations of obvious distortions a valuable exercise.

As shown, even though Cisco Systems is worth the same as the combined global business of United Technologies and United Parcel Services, the ability to produce an 8% cash return is woefully strained in Cisco’s case. As a footnote, the cost to buy all

of Cisco Systems prior to the bubble popping was \$500 billion, not the \$134 billion that the stock trades for today! Obviously, Cisco is not on our Buy List.

As a final thought, we encourage investors to remember that the capitalist forces which drive our mainstream media are such that the world’s bad news can appear to dwarf a much larger set of good news. Where, for example, is the media coverage of the fact that America and China recently agreed to increase flights between the two by 460% in the coming years; that Pakistan’s economy is growing nicely and royalty payments are being made from nuclear technology transfers?

Although investment performance can never be guaranteed, and skies will never be perfectly clear, we are convinced that global growth will continue and we will rely upon our investment instrument panel to guide investors to satisfactory returns.

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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