INVESTMENT COMMENTARY NO. 182
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Investigating the Persistence of the Market's Rise

1. *Indeed, it was a black Monday*

If things had gone according to the predictions of one of Switzerland's largest newspapers and the orchestrated commentaries of our electronic media, on Monday, August 18, 1997 the stock market would have crashed. Forewarned by a weekly that appears on Sundays and seconded yet again by the early morning radio news, the concerned reader of the apocalyptic stories had to be prepared for the worst. But alas the crash did not occur. The previous Friday's slide on Wall Street (a loss of 247 points on the Dow Jones Index, representing a 3.1% drop) was followed by no more than one or two percent declines in Europe. Since then, movements of this kind have recurred, but in both directions. The markets are apparently in the process of testing whether certain (high) stock valuations are justified. In this commentary, our focus will be on the criteria which comprise this test. But first, a few thoughts on the failed attempt to bring about a crash.

Was it just a breeze rustling the leaves, or did one of the major papers simply see an opportunity to increase its circulation and benefit its close associates in the monopoly electronic media industry? Maybe. But there is probably something more, and something more disturbing, behind it. After all, the assault launched on public opinion required the coordinated effort of similarly disposed entities for its success and it took a direction that was quite symptomatic of the psychological state of our country. The attraction to anything negative has taken on near-masochistic dimensions. This is particularly evident in how the Holocaust issue has been handled. It is one thing to allow a new generation of history students to evaluate recently revealed occurrences through the somewhat removed lens of those who have not been personally involved. But it is quite another thing to take every opportunity to pour oil on the flames (as, for example, with the shoddy pseudo-historical documentary being co-produced with the BBC); such actions can no longer be justified with rational arguments. Is it fin de siècle mood? Signs of over-satiation? Mean spiritedness born of small town boredom?

Whatever the origin of this national psychological state, the desire for a crash might emerge also from different thought categories. It is apparent in this country, and in other parts of Europe as well, that many people -- in particular intellectuals -- are struggling with the concept of capitalism. Given that the view of labor and capital as system-dependently separated economic factors has been relentlessly advanced for over a hundred years, it is understandably difficult to accept the notion that both labor and capital can easily flow from the same source. What has long been taken for granted in the U.S. is only starting to poke and prod its way into our consciousness: Through pension funds, investment funds, derivatives, and even direct investments, much larger segments of the population are holding an ever increasing number of stocks. Today, stocks represent approximately 20% of the average Swiss pension fund's holdings. It is estimated that within the next ten years this figure will rise to 25 to 30%. Given the continued growth of the retirement security sector, considerable amounts of new capital will therefore continue to flow into the stock market -- as a result, demand will largely be taken care of from this source alone. Ten percent of the total Swiss pension fund wealth (at today's level) represents approximately 40 billion Swiss Francs; the total capitalization of the Swiss markets, meanwhile, is about 800 billion ...

The man in the street as a direct or indirect shareholder: It is a nightmare vision for anyone who still maintains the belief that capital is by definition bad and labor necessarily occupies the moral high-ground. And even worse for those who live by this maxim are all the functionaries and bureaucrats who ultimately do nothing other than protect "the workers" from "the capitalists", and make a good living doing it. How can labor unions hope to push through excessive wage demands when their own members are shareholders? Nothing would suit these groups better than a veritable and sustained market collapse: "We've been warning you all along, all that is the Devil's work, now come back to the care-taker state!"

So August 18, 1997 was indeed a Black Monday -- for Swiss journalism; it revealed the machinations of a highly organized cartel. And from a political standpoint it was a bright red Monday.

2. *Who has anything against cabdrivers and liftboys owning stocks?*

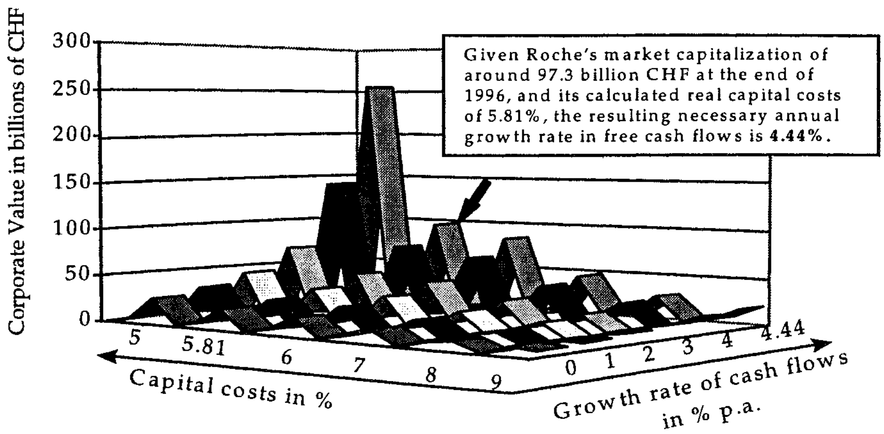
Admittedly, there are other circles in which a crash is desired as well. For one, and this is nothing new, there are all those analysts and advisors who, because of earlier fears, had only limited exposure during the recent months to the stock market performance and are anxious to finally be proved right. Increasingly, however, the management of major companies can be found criticizing the "excesses" of the markets as well; they have reached the limits of the pleasure they can derive from seeing their stocks rise. After all, every one Franc climb in the value of a company's stock represents that much of an increase in the performance expectations for the company.

We have repeatedly pointed out the "agency problem", or the diverging interests of shareholders and the management. This theory holds that management is only interested in higher stock values to the extent that they yield increased bonus payments. Beyond that, higher rates and a better return on shareholder equity are burdensome since they require pushing employees -- including managers -- to increase productivity.

It would thus be unfair to attribute the interest in a crash solely to the labor unions and the hopelessly-outdated leftists. There are deep-seeded instinctual reactions that are provoked by booming markets because they come coupled with further demands for increased productivity. In these cases one generally argues either that gains on the market are "easy money" or that current stock values no longer have anything to do with the state of the real economy; the only possible explanation is that it is all psychological, whatever that means. These arguments betray a fundamental mistrust of one of the critical phenomena associated with the recent structural transformation, the increase in the attractiveness of equity and the growing number of those who recognize their potential opportunities.

Often, situations like the one we have today are referred to as "cabdriver" or "liftboy" boom. When these people enter the market, so conventional wisdom goes, it is high time to realize gains and to turn to other investment opportunities. What an unfair and discriminatory image this is! It embodies the flip-side of the view that labor and capital are necessarily from separate economic orders. Why on earth should cabdrivers and liftboys, of all people, be discouraged from buying and

The value of Roche in relation to interest rates (capital costs) and the growth rate of cash flows [1)]



To compare, the growth rate of the historic operating cash flows for Roche over the last four years averaged 12%.

The study of Nestlé and SBC produced the following results:

Value of Nestlé (Mill.CHF.)		Real capital cost in % (WACC)				
		4	**5**	6	7	8
Real annual growth rate of cash flows in %	0	16'252	7'182	1'135	-3'184	-6'423
	1	27'248	13'485	5'202	-340	-4'313
	2	48'504	23'544	10'996	3'419	-1'668
	3	110'657	42'928	20'209	8'755	1'813
	3.4	193'241	**57'259**	25'749	11'629	3'565
	4		99'482	37'909	17'205	6'734

Value of SBC (Mill.CHF.)		Real capital cost in % (WACC)				
		5	6	**6.4**	7	8
Real annual growth rate of cash flows in %	0	15'740	13'117	12'219	11'243	9'838
	1	18'475	15'740	13'714	12'477	10'753
	2	22'838	19'675	15'767	14'107	11'900
	3	31'248	21'392	18'852	16'422	13'411
	3.2	34'210	22'587	**19'733**	17'055	13'801
	4	55'784	29'071	24'217	20'089	15'546

The growth rates of the historic operating cash flows over the last four years for Nestlé and SBC came to 6.4% p.a. and 11.5% p.a. respectively. The growth rate of the historic free cash flow cannot be included in the analysis because the free cash flows were occasionally negative.

[1)] The weighted capital cost level is calculated as follows:

$$WACC = K_{FK}(1 - T)\left(\frac{FK}{FK + EK}\right) + \left[r_f + \left(E\left[r_m\right] - r_f\right) \times Beta\right]\left(\frac{EK}{FK + EK}\right),$$

with:

K_{FK} - Interest on outside capital

T - marginal tax rate

r_f - riskfree revenues

$\left(E\left[r_m\right] - r_f\right)$ - risk premium for stock portfolio

Beta - systematic risk of shareholder capital owning stock? In our opinion, it is high time we get away from the class and categorical thinking about markets and recognize that open financial markets are accessible to everybody. Furthermore, it should be acknowledged that more and more people are taking advantage of this access. Today, if cabdrivers buy stock it is by no means necessarily a "late cycle" signal. It may be quite the opposite.

3. *Corrections as the norm*

This said, it is clearly not our contention that the markets will simply continue to climb indefinitely. Markets, by definition, experience continuous price changes. Markets are price setting mechanisms. The seller seeks to achieve a price that he considers adequate, while the buyer attempts not to pay too much. What is "adequate" or "too much" is determined through a comparison with alternatives and is thus never absolute. The price of a lettuce in the market square in St. Gallen is determined by the lettuce price in the supermarket and the corner store as well as by the prices for cucumbers, tomatoes, and other alternatives to lettuce. For stocks the alternatives are not cucumbers or tomatoes, but rather the stocks of other comparable companies or investments in other financial instruments (fixed interest, commodities, real estate) or currencies. A stock's value, its price, is determined relative to these other alternatives.

Given the extremely large number of alternatives -- alternatives which can be purchased or sold easily from almost any location around the globe -- it is clear that there will be regular shifts in the valuations of stocks. Trial and error is the principle behind the continual up and down. And sometimes an entire market will simply realize that, with respect to price expectations, it has reached the upper limit of what is reasonable. This situation will then produce a small, or possibly even larger, correction.

For stocks, a +/- 15% range of fluctuation in price is not at all uncommon and thus should not frighten the investor. Long-term and in the middle the investor will be rewarded for assuming the fluctuation risk. What we are currently observing in the markets is the intellectual and psychological processing of the consequences of the structural transformation. There is no question that this transformation has yielded higher valuations. However, how much of this additional value is already included in the current market levels and to what extent these valuations continue to be justified by corporate performance remain open questions. The efforts to answer them are reflected in the current increased volatility of the market. What follows is an attempt to identify a couple of milestones in this price-setting process.

4. *The contextual factors remain positive*

Nervous, or even justified, fears about a stock market crash that goes beyond the normal fluctuation range would only be warranted if there were substantial changes in the factors shaping the investment climate; in that case one would expect significant shifts in the relative attractiveness of existing investment alternatives. We have spelled out these factors on many occasions, and overall they remain positive:

- Setting aside for the moment the specific situation of certain countries on the Pacific, economic growth remains either persistently/robust (USA and UK) or persistently/weak (continental Europe and Japan). Where there are advances, these are always tied to increases in productivity, with more output per work-hour or per unit of invested capital. In comparison to the past, labor has become less of a scarce resource. Under these circumstances, a consumption boom is nowhere to be found.

- Despite a relatively generous supply of money from the central banks, there has been no inflation. Productivity increases are constantly blunting the impact of the inevitable capacity constraints, while global economic competitiveness has squelched any efforts to drive up prices.

At the same time, the European banking system is absorbing a portion of the available money so as to keep the creation of credit within narrow limits.

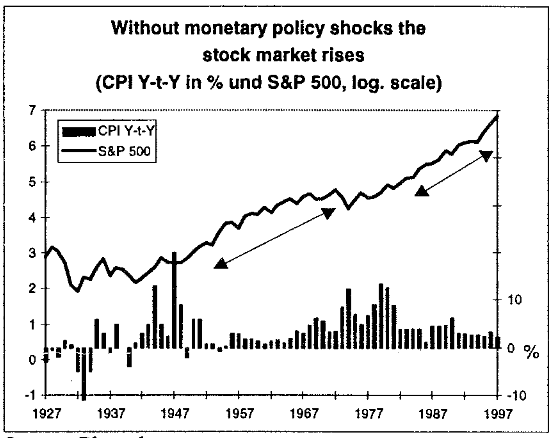
- The interest rate situation remains generally relaxed, despite marked declines in Europe and Japan. Thanks to the restrained economy and lower inflation rates, nowhere is their a foundation for inflation. And because the real interest rate level is not actually all that low -- given the historically low rate of inflation -- a drastic increase in interest rates is even less likely.

- Through productivity increases and the implementation of significant restructuring measures, the profit situation of corporations has significantly and sustainably improved. Those companies which are underperforming in terms of returns are more quickly identified by the market and are pressured with the threat of a takeover. In a word, the economy has become more permeable; the cartel of low-yielding dinosaurs is in the throes of extinction.

- At the moment, there is no region of the world from which to expect the emergence of a serious political or military threat. Where battles *are* being waged, or new potential conflicts *are* emerging, the impact is contained regionally. Aside from the USA, no country is currently in a position to announce its strategic interests and also realize them.

- Admittedly there are unknowns, and we locate the majority of them in the largest scheme of the last few years, the monetary unification of Europe. It is not that we have anything against the idea of European integration in principle. We simply cannot overcome our scepticism of the idea that monetary union is the best way to rid Europe of all the political and economic divergences among its member nations. Should it not be the other way around: First solve the problems, then create the union as a crowning achievement? We think the current weakness of the German Mark reflects a kind of pricing process for the future Euro.

All in all, however, the contextual factors detailed here do not paint a threatening picture. There is nothing that signals a need to make strategic decisions in preparation for a long-term turnaround in the market trend; there are no signs, for instance, that would suggest one should be moving away from stocks and into raw materials, real estate, or short-term money market investments.



Source: Bloomberg

If one looks at the very long-term development of contextual factors over the course of this century (see the above graph), two periods emerge which are characterized by few shocks: the period after WWII until about 1960 and the period since 1985. These shock-free (i.e. low inflation) periods coincide with periods of high growth on the stock markets. By contrast, the years of the Depression and the inflationary years of the 1970's were clearly periods in which shareholders were at a significant and sustained disadvantage. Why? - We now want to look in detail at the implications of possibly having interest rates remain low over a longer period of time.

5. *About the value of future cash flows*

One explanatory model for the valuations of an asset involves projecting its future cash flows and then determining their present value. The future costs of the money required

For an investment advisor, success depends on being able to locate those managements that have recognized this paradigm shift and are in a position to put it into practice. As long as a large enough number of financial analysts and investors remain attached to the patterns associated with high discount rates and continue to favor companies that are optimizing short-term yields, the adept investor will be able find undervalued, longer-term oriented, enterprises and realize excess returns. Our list of recommended Swiss companies was assembled with this idea in mind.

7. *It depends on the state of property rights*

We need, however, to return briefly to the problem of uncertainty factors associated with returns anticipated in the more distant future. We have addressed the risk of inflation and shown that it directly impacts the interest rate used in discounting. Inflation is one form, an especially subtle form, of depriving a person of his property; there is no fiscal police officer who marches up and confiscates the property, nor are there bandits hiding along the roadside. Nonetheless, the reduction in the value of money is a particularly dangerous form of property dispossession because it can lead an entire economy to mis-allocate resources. When, in response to high interest rates, the calculus of economic participants is too short-term oriented, there are potentially serious consequences for the population's standard of living. It would, for instance, be interesting to determine whether there is a positive association between long-term interest rates and the level of environmental problems. We strongly suspect there is one, precisely because the devaluation of money leads to short-term thinking and makes long-term consequences monetarily irrelevant.

But there are other, more explicit, forms of property dispossession ranging from excessive taxation, to various confiscatory corruption mechanisms, to the brute force we are familiar with from various parts of the world. Without making too much of the issue, we simply want to point out that given what we know about the present value of future revenues it is quite conceivable that future decisions about what will be produced and where in the world it will be produced will not be determined solely by labor-cost per unit; it will also matter where a company believes it is least likely to be dispossessed of its property. The predictability of state action, which Hayek advocated (in: Law, Legislation, and Liberty) as a means to increase societal well being, gains renewed respect in this light.

8. *In conclusion, a little empirical evidence*

At this point, the interested investor is likely asking whether these insights are actually useful for something. Since the question is a legitimate one, we posed it to ourselves and subjected a couple of prominent Swiss stocks to the discounting test. That means we assumed that the market capitalization of the specified companies reflected the present value of their future cash flows. Then using their annual reports we calculated their real capital costs (the exact formula for the calculation is in the footnote on the page after next). Finally, we determined the minimum rate of future cash flow growth that would be necessary to justify the given market capitalization.

The results are, in our opinion, very interesting, even though our findings are somewhat constrained by the fact that data access issues forced us to base our analysis on end of 1996 figures. Since then, the large gains in the stock market have increased the firms' market capitalization and thereby further increased the expectation pressure for future cash flow development. Nonetheless, with all due caution we believe we can conclude that according to this evaluation model, and assuming a continuing decline in capital costs, no excessive cash flow projections would be necessary to justify the admittedly significant upward movement in the stocks' prices.

The reader may want to draw his or her own picture of the relationships between present value/market capitalization, capital costs, and cash flow development. At our end, we are wagering that an appropriate emphasis on sustainability will be rewarded in the world of tomorrow. We are formulating our investment strategy and choosing our investments accordingly.

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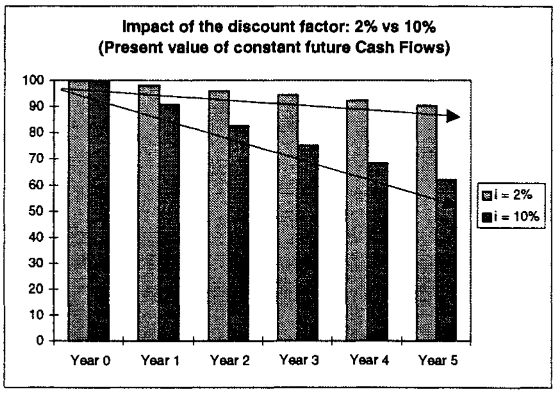
for the asset must be included in the calculus as well: This cost represents the rate at which expected future revenues are discounted. Of course, several uncertainty factors are of consequence. One cannot be entirely certain about the level of projected cash flows given that they are to be earned in the future. And one cannot know how stable the value of money will be into the future. It is possible to estimate the future value of money based on the interest rate curve, but nothing that lies in the future is certain.

Ultimately, the discounting process is fundamentally tied to the interest rate that is applied. How far into the future are anticipated earnings still relevant? The following graph shows the enormous differences in the weighting of the yield in the +5 year when the discount rate is varied. The lower the interest rate, the more relevant are the yields in the more distant future. Put differently, the lower the interest rates, the longer the relevant time horizon.



Source:

of this finding cannot be overestimated. After all, the entire financial industry, to the extent that it is not simply backward looking, is engaged in anticipating a company's earnings for the current and perhaps the coming year. There are very pragmatic reasons for this: A good analyst is expected to provide concrete numbers and he can only deliver these if he relies on past performance figures and uses them to make short-term projections. The belief in tangible numbers is, one might say, unshakable. Taking a short-term view also had an economic justification as long as future interest rates remained high, or at least uncertain, as a result of shifts in monetary policy (as was the case during the Seventies and early Eighties). It would have been senseless to even think about revenues to be generated in the fifth, sixth, and later years.

However, if we are in a phase of sustained low interest rates -- and there is plenty of evidence to suggest that we are -- then we need to change our initial assumptions. Thinking about the long-term earnings prospects of a company becomes unavoidable. It is evident that an increasing number of "soft" factors now come into play and that we can no longer rely as heavily on the pseudo-specificity of elegant quantitative presentations; the further into the future something is located the less certain it is. The job of financial analyst has to change. There is now greater demand for long-term economic vision and less demand for technical bookkeeping skills. One wonders who will survive this paradigm shift.

6. *The return of the "soft" factors*

The structural transformation of the last several years has swept through companies with a steel bristled broom. Without meaning to do "McKinsey" any injustice, the company's name is associated with a restructuring mentality which seeks to eliminate everything that is not directly related to the generation of money. No doubt, many poorly performing corporate dinosaurs were in need of just this kind of treatment. And yet a certain unsettling feeling remains after each of these restructuring efforts: Are we not engaged in a large scale dismantling of long-term earnings potential? For instance, when the major banks subject both their private and commercial clients to yet another round of corporate streamlining are they not sacrificing their long-term oriented client relationships?

As long as high discount rates essentially made long-term oriented thinking economically irrelevant, restructuring efforts of the type described were justified. Indeed, restructuring was rewarded by the markets; the company that laid off workers received praise in the form of higher stock prices. But again this will only be the case as long as high discount rates give decisive weight to short-term thinking.

What is true for the financial analysts and their evaluation models is even more true for the corporations themselves: When the foreseeable future contains few monetary-political shocks, meaning that a more stable and lower interest rate situation is likely to prevail, corporate management's relevant time horizon is extended. The cash flows of years five, six, and beyond must be given increased consideration. Eliminating short-term cost factors becomes relatively less important than protecting and nurturing long-term corporate values.

In other words, in light of the new low inflation circumstances a paradigm shift should start to become visible; there should be evidence of a move away from short-term profit maximization and toward a focus on the long-term sustainability of returns. Efforts at ensuring sustainability should be rewarded with higher stock valuations. Within this paradigm, sustainability becomes a very important orientation point for any post-structural transformation investment strategy.

- It should, for instance, now be worth more to have a product line in hand that is built on a foundation of substantial research and marketing and has long-term viability, than to achieve high turnover of a product that is nearing the end of its life-cycle.
- The stock market should reward companies which make circumspect and strategic efforts to increase the size, skill, and sense of belonging of their workforces.
- Companies which take into consideration that environmental damages done today may return as major burdens in the future should see this foresight rewarded with relatively higher stock values.
- It should pay for an enterprise to pursue an equity strategy that is conscious of the scarcity of the facor "money", but which is also oriented toward the risks that the company typically has to cary.

Admittedly, the admonition to give greater consideration to "soft" factors seems to get dangerously close to walking the old soft shoe. The decades-long burden on shareholder value created by so-called "higher virtues" and "collective interests" was what originally created the need for a major restructuring of the economy -- a restructuring which was fundamentally about getting rid of the excess layers of fat and the comfortable complacency. But what is at stake now is very different: The objective is to find a path away from short-term maximization and toward the optimization of long-term corporate earnings. This would also put an end to the academic and often polemical discussion about shareholder value.

The Piece of Cake Parable
(From Kraemer/Trenkler, Dictionary of Popular Misconceptions, Frankfurt a.M., 1996)

The person looking to lose weight can essentially choose one of two strategies: He can avoid consuming any additional calories by fasting; or he can get his body to handle more calories by exercising and building up muscle mass. Even at rest, this muscle mass requires so much energy to sustain it that there is no need to fast.

The one strategy is oriented toward the short-term. A person who passes on a piece of cake does not add any anything to his or her love handles. The second strategy is longer-term. It takes time to build up muscle mass -- not one, but a whole series of hiking trips. Given the large number of people who, despite ongoing abstinence from cake consumption, continue to suffer from being overweight, one has to conclude that the short-term strategy wins out more frequently but also fails more regularly.

It appears to us that in the context of the structural transformation, too often the prescribed remedy has been fasting rather than hiking.