Investment Commentary No. 199

January 31st, 2000

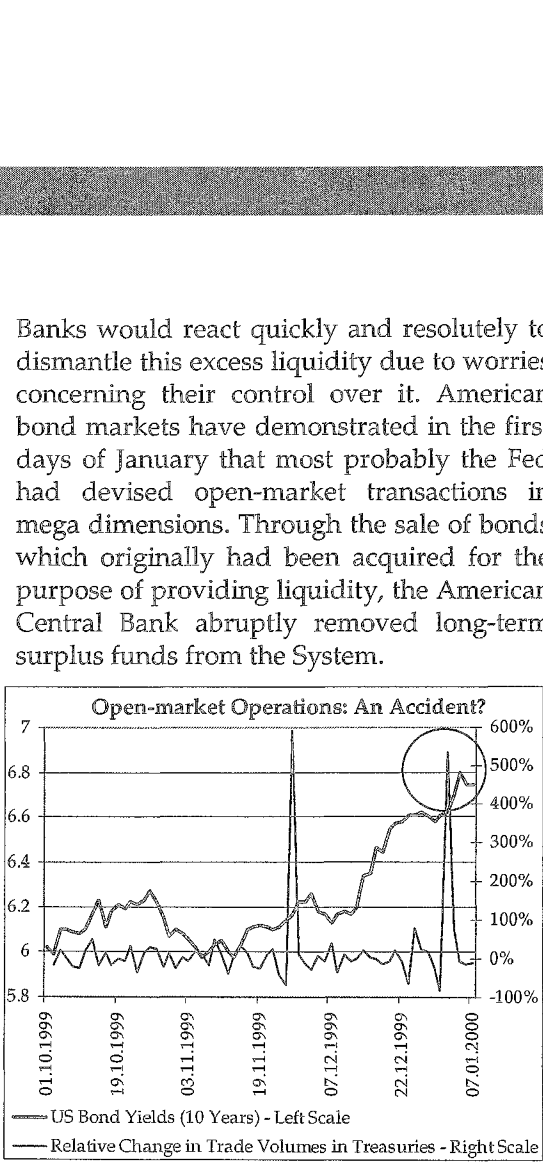
Searching for Values

1. Indeed, there was no Breather!

It can be a little annoying when predictions are literally fulfilled. We pointed out in December 1999 in view of the astounding share price increases, that the widely expected January rally might have already been anticipated. It became increasingly clearer that with respect to the envisioned Y2K problem, accumulated liquidity had already been invested in higher-yielding instruments in December. Anticipation of widespread economic events had a balancing effect on the course of the markets: that which has already demonstrated an increase, will no longer do so in the future.

But to begin the new year right off with a kind of systems catastrophe would again not necessarily have been needed for proof of this anticipation theory. What we have experienced during the first few days of the month of January in financial markets can respectfully be considered as a textbook example of the interplay between anticipation and general, though incorrect, market expectations. On the one side, the System – better said – the worldwide banking system, was to an extraordinary degree liquid. Everyone knew that the Central Banks had provided generously for liquidity. Hardly an end-of-the-month has passed accompanied by so few problems as the change from 1999 to 2000. Because the new millennium brought with it no nasty computer surprises, the general assumption held that the investing of this built-up excess liquidity would flood the financial markets and overwhelm them. This should have resulted in higher bond prices (respectively, lower yields) and higher share prices.

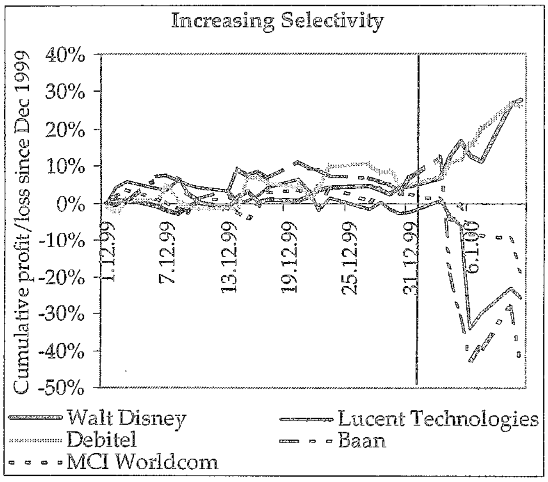
However, the share prices were already high in anticipation of this movement. And on the bond market side, too little emphasis was placed on the possibility that the Central Banks would react quickly and resolutely to dismantle this excess liquidity due to worries concerning their control over it. American bond markets have demonstrated in the first days of January that most probably the Fed had devised open-market transactions in mega dimensions. Through the sale of bonds which originally had been acquired for the purpose of providing liquidity, the American Central Bank abruptly removed long-term surplus funds from the System.



Source: Bloomberg;

One could say that this is completely in line with the current successful control of inflation of the USA. In the markets, however, it sounds differently. "Fear of high interest rates" is again casting its shadow; the belief that the Central Bank will find it necessary to bridle the booming economy with the effective damper of drastic interest rate increases is building. We see things differently. The increase in earnings since the beginning of the year can be traced back to the bond inventories which came in excess to the market from the Central Banking system as well as the world of banking (which it seems also held for liquidity reasons excessive amounts of bonds). The buyer side was not yet ready. A price drop, respectively, an increase in return, is actually very logical. In addition to this, as a result of the ever astonishing economy in America and in view of the now improved outlook in Europe, a certain tension is influencing the capital markets, although one cannot speak in any way of a real danger of inflation. Increased growth means a higher demand for money, visible for example in a few very ambitious issues. Therefore increasing interest rates cannot be a complete surprise.

That interest rates exert quite an influence on many other price structures in financial markets, and because obviously the shock of inflationary times still sits deep in the bones of all experienced market participants, it is in no way absurd that the stock markets themselves reflect that turmoil in such phases. The price fluctuations since the beginning of January have been very considerable. One could hit a vein of gold with one stock, and with another go down with the sinking ship.



Source: Bloomberg; :

are opposite poles of the same dimension. And it is just as obvious that a high measure of insecurity is involved in determining the worth of an enterprise. When, for example, a comparison is drawn between the two European manufacturers of corporate software, the Dutch Baan, and the German SAP, one can hardly maintain that (even in spite of some management difficulties) which should have evidently been worth 3.2 billion Euros before January 3rd, 2000, within a few days later was valued at the equivalent of only 1.6 billion. Conversely, one also wonders why the stock market capitalization of SAP should have climbed about 10 billion Euros to 66 billion Euros within the same time period.

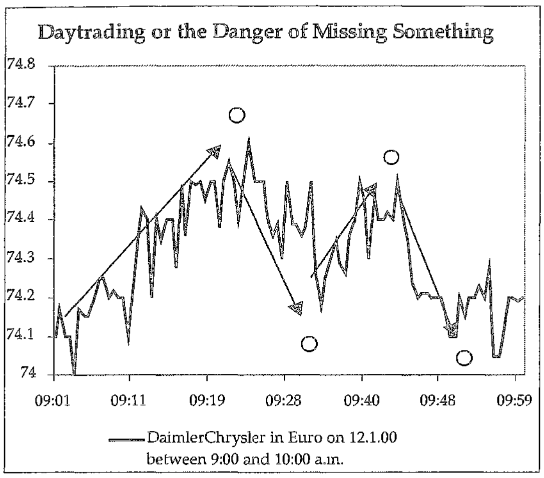
The markets are on the search. This enormous selectivity means nothing other than one is always looking for new insights in realms where no experience has yet been gathered, and which could lead to completely new discoveries and occasionally force brutal corrections. Constant trial and error is being applied to establish values. This is the burning topic this year, and perhaps for this decade, and therefore also of this first Investment Commentary of the New Year.

2. From Daytrading to Instant Trading

The falling information and transaction costs resulting from the direct access to the electronic communication systems available to the investor have definitely led to a mad rush in the markets. This hectic atmosphere can be measured by the statistical magnitude of volatility as well as the bandwidth of price fluctuations measures within a certain time span. Volatilities are still high in comparison to those of the past, even to those after the normalization in the wake of the financial crisis of 1998.

Certainly, professional investors are responsible for a portion of this hectic atmosphere; with an eye on the brief reporting intervals they have a tendency towards increased activity. Which institution, which high net-worth individual employs a portfolio manager to just sit there and do nothing? Frequently, directly or indirectly, transaction volumes are tied together to the compensation structures of these representatives – an unfortunate thing which stubbornly persists. Why? Because the majority of clients support the assumption that activism is to be preferred over passive observation. Above all, in the USA the proportion of such "professionally" managed assets has increased; this mad rush therefore does not appear to materialize out of thin air.

On the other side, a group of market participants has formed who are buying and selling financial instruments (shares, and above all options) in ever shorter and shorter intervals. The designation "Daytrading" is rather an understatement for this phenomenon. Within the shortest of time periods, purchases and sales are made over the Internet and other transaction platforms. These market oscillators presumably magnify the fluctuations in a considerable way. Empirical proof to support this theory is, however, not yet available. We know from other areas of knowledge, however, that short-term forecasts tend to extrapolation and that up and down movements cannot be cleanly reflected.



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One thing is sure; money will be lost with the chronological extrapoliation of any momentary trend. This is not tragic. The primary economic benefit for the Daytrader does not lie in monetary profit, but rather in the appeasement of his gambling addiction. In their function as speculators, Daytraders are bona fide risktakers and should not in principle bother us in any way. They belong to the financial system as rodents belong to the city sewers. Without them many a canal would soon become clogged; Daytraders see to it that the trial and error in the market place proceeds in a little bit faster pace now and then.

In our opinion we cannot avoid deciding for one or the other investment style. Daytrading is not limited just to some Yuppies in New York or London. Through the internet we are all, including those in the most remote of places, able to receive information about the latest Wall Street developments instantaneously, and we are all also in the position to take action immediately. Whether one makes use of this basic ability is another story.

In all respects, actually everything speaks in support of the superiority of calmness and long-term calculation. Statistical calculations have shown that already over a time horizon of 8 years, the probability of a loss has been reduced to insignificance for diversified share investments. While short-term fluctuations animate and devastate the Daytrader, they only cost the long-term oriented investor a smile. The orientation to long-term time horizons demands from all protagonists a high level of discipline; discipline is however only attainable and can only be maintained when a belief supports it that all will not collapse when the wind starts to blow.

3. The Demand for Endurance

Much ink has flowed on the subject "shareholder value" in recent years. It isn't worthwhile to come back to the ethically-embellished and often quite dishonest critique concerning the dangers of a "profit-only oriented corporate strategy." This position has been and will be much too often and too loudly advocated by persons who date from a time in which businesses had systematically destroyed shareholder value in order to fill the pockets of certain stakeholders and to acquire sinecures. It was certainly correct that in the framework of the great restructurizations of the nineties' businesses were thoroughly cleaned out with the hypocritical fug of "economic and social responsibility."

Simplified concepts and key figures were employed, which at first glance made sense, but with further examination showed hidden existential risks which most likely lay in the nature of things experiencing a revolutionary phase. So the critique of the one-sided orientation to Return on Equity is more than justified. With this phrase many a balance sheet and profit and loss statement have been (and will continue to be) jazzed up, silver bartered away, and absurd cost reduction measures pushed through. Such concepts are especially problematic when management bonuses are tied to maximizing such figures.

From an economic standpoint, this short-term profit oriented "shareholder-value-thinking," which actually it isn't, should be long gone. When we assume that the value of an enterprise is based on its future increased value, and when we further believe that the share price on average and long-term mirrors this future increased value, then the quality of this anticipated future value is of utmost importance. A part of this demanded quality influences the level of interest rates. The higher the interest rate, the less important are conditions far in the future. And to turn it around, distant future circumstances are considerably more important, the lower the interest rates. The discount formula repeats this connection, and it is also intuitively evident. How much am I prepared to pay today for an asset far in the distant future? Certainly less when money costs me more, and certainly more the less expensive the capital.

As we have explained in various ways, we should not assume that interest rates worldwide will soon return to a pattern similar to that of the seventies and early eighties. The bond markets and foreign exchanges have become too efficient to allow a Central Bank to follow inflationary financial policy. And technological advances have done their part to avert inflation-encouraging capacity bottlenecks by way of increased productivity.

If this assumption of continuing relatively lower interest rates is correct, then it is also clear that the perception of "shareholder value" must assume a much longer-term character. Quite simply, when interest rates are low, long-term increased value is worth more than when high interest rates prevail. What a company will do in five or ten years is relevant to the depicted interest rate scenario.

Should we proceed on the assumption, as outlined above, that the share price on average and long-term mirrors the value of future increased value, then this means also that for stock markets, circumstances occurring in the distant future are more relevant, the lower the interest rates are quoted. We predict that exactly because of this, financial analysis in the next few years will turn away from figures which are relevant short-term and will increasingly pay attention to longer-term aspects of corporate development.

4. How Does One Evaluate Soft Factors?

The great advantage of short-term shareholder value thinking is that one is able to deal with hard cold facts in the present time within a narrow time span, the momentary share price divided by the profits of the previous year. What a beautifully clear figure this price/earnings ratio is! And even when we dare to venture a little bit into the near future and, for example, make an estimate of this year's free cash-flows and relate this figure to the invested capital, we still move in a range of accuracy which allows for two decimal places.

However now, if circumstances lying in the distant future are distinctly more relevant, then we can no longer avoid considering the consequences of a company's long-term success. Certainly belonging to a company's long-term success, and most likely occupying first place is its economic success. To bet on a sickly and anaemic enterprise would be foolhardy. However, a radiant short-term earning power isn't everything. More frequently the burning question of potential is being asked.

For example, a currently favorable statistical situation still says nothing about how well the customers feel. Perhaps they have been offended by the cost reduction measures which have affected the service sectors. Even the most encouraging figures cannot reflect the morale which prevails among the staff. And the most attractive return on equity cannot give any information as to how loyal the management will act in the future. Perhaps exactly the opposite; the more attractive the present, the more potential has been compromised for the future. UBS's LTCM involvement was a typical example of a momentary lucrative strategy coupled with a well-disguised stress potential for the future.

Although the major problem in judging the lasting success of a business lies in a larger time horizon, the "softer" factors are constantly gaining more influence. Belonging to these "soft factors" are:

- A satisfactory long-term relationship with clients,
- An optimal personnel policy regarding education, career planning, salary structuring, and honouring company loyalty not only in the present, but also in the next 5 to 10 years,
- An investment policy in which the foregoing of present profit opportunities enhances future potential and,
- A participation program for management which guarantees a parallelism of incentives with the interests of the shareholders;
- An internal corporate climate in which virtues (albeit an old-fashioned word) such as decency, consideration and teamwork are respected, and likewise honoured. Everyone speaks of "knowledge management" these days, but what use is a high level of knowhow when that knowledge is not shared and cannot multiply within the company?
- An understanding that a company's right to exist stems essentially out of the interplay between individuals and groups,

and that a management culture does not systematically favour egoists and "elbowers." Profit-centre fetishism and exaggerated cost oriented thinking are lethal for a business culture long-term.

- A relationship with the nearer as well as more distant environments of the enterprise, which all in all appear to be acceptable and are not suppressed by negative external effects of a legitimate opposition.
- A financial strategy which keeps all the pleasures of leveraging in a balanced relationship between indebtedness and equity capital in view, so that potential crises can be effectively managed.

In other words, stable corporate development coincides quite extensively with demand as we have heard from economic ethical circles. If one wants to judge long-term success, then one cannot avoid asking "How does the company, how does the management keep up with *values*?" And as always in this area, it is so that not the pretty words (and models) which count, but rather actual behaviour.

Endurance is not freely available. The "soft factors" cost money short-term. These are investments in the distant future. And of course as economists we are able to see the increase of external strengths on that distant time horizon. Many a generous personnel policy has been exposed by well-trained employees who have quit their posts. The external effects aggravate the lives of corporate management as well as those who have discovered the value of the enterprise through its "hard" and "soft" factors. Nothing has changed the principle; the lower the interest rate, the more relevant the soft factors and the more decisive the external effects.

Out of pure economic reasons which have been derived from our long-term interest rate forecasts, we predict that in the coming years the study of business management, corporate consulting, management training and also financial analysis will be increasingly confronted with "soft" factors and, therefore, with the question of value. Endurance has received economic value. The implications of this observation cannot be overestimated in an economic as well as in a socio-political view.

5. And the Internet Bubble – Is there also "Value" Behind It?

The interested reader may wish to reproach the author of this Commentary for his pensiveness at the beginning of the new millennium. The author would prefer to descend from the heights of ethical quackery to address investment questions involving the real world. For example, he would like, if you don't mind, to address the question: what does the incredible boom in technology shares have to do with those opinions expressed on long-term corporate development? After all, the reader has the right to know whether or not he should purchase Internet shares. (Would the author please be so kind and save the rest for his Sunday sermon!)

No, not just yet. With these Internet shares all current valuation methods fail, because most of these companies, for the time being, are earning little to nothing at all. Together with dubious profit figures not even the sales numbers are correct. Potential is everything here. *Potential!* And we are not talking about today and tomorrow, but rather about 3, 4, 5 years from now. Especially in this sector the question of the endurance of a development has been asked, which has just really begun and with the merger AOL/Time Warner has brought forth the first far-reaching and economically relevant structural tremors.

Now actually, we cannot report much about values such as loyalty, sense of responsibility, and the like from the Internet sector. In demand are economic endurance and calculation. More casually said, in view of the colossal stock market capitalization of Internet shares, can one eventually earn money from this investment? These doubts are already justified if one thinks for example about the Internet provider, Yahoo!, which today has a capitalisation of about $95 billion, almost double the size of Philip Morris. Or Amazon.com with a capitalisation of a little over $20 billion, double the size of a Holderbank ($11 billion). In 1999, Philip Morris earned a profit of approximately $7 to $8 billion, Holderbank at least around $500 million, while Yahoo! can merely show earnings of $200 million and Amazon.com reports a loss of about $160 million.

If we merely look at the Internet as an advertising platform and as a medium for an electronically organized mail order business, then those doubts which arise in conjunction with earning money from this innovation are absolutely justified. The Internet allows margins to shrink to zero. Each individual consumer is in the position to pursue arrangements between providers with little effort. Micro-economically speaking, the Internet forces the price for goods in the direction of averaged costs and eliminates the economic profit for the supplier. That an operator of platforms and gateways in such a regime of systematic margin narrowing can earn more than a Philip Morris, a Nestlé or a DaimlerChrysler together is justifiably doubtable.

The key to understanding the enormous valuations lies in another consideration. The described possibilities of arbitrage between the various suppliers applies only to exchangeable goods. For *non-exchangeable goods* and especially for most of the services the exact opposite applies. The Internet allows in an almost ideal way client-individual price discrimination to be carried out. What does this mean?

In micro-economic theory, we differentiate between supply and demand. Where both curves meet there is a readiness on both sides for an exchange of services. The established price for a good is an equilibrium situation. Now "the offer" and "the demand" only exist in the theory of textbooks. The aggregation of individual user functions always yields an approach in practice only, with which one can perhaps live and somehow makes the deal possible, but is always sub-optimal. Because one individual buyer, due to his specific disposition and desires, is possibly be prepared to pay more for a specific service – with the aggregated balanced price one earns too little, respectively, the buyer consumes actually too much. When one offers another buyer a service for too high a price, in principle the buyer consumes too little. Price discrimination permits distinguishing between the one and the other buyer and the ability to offer goods to each individual at an optimal balanced price based on the differences between them. The result is a true economic profit, provided that the goods are not interchangeable.

Let us clarify these rather theoretically sounding considerations. The aggregated supply and demand curves can be compared to a train. It always departs at *one* specified time, the ticket costs exactly the same for everyone, whether the journey is an important business trip or whether one is on a senior citizen's excursion. The train travels at a constant speed, whether the passengers are in a hurry or whether they have all the time in the world. Price discrimination corresponds to the individualized private transportation. Each begins his travels at his own suitable time, drives as fast as he pleases, and fulfils his personal conception of comfort with the vehicle of his choice.

The merger of America Online and Time-Warner makes a lot of sense when examined from a price discrimination viewpoint, because the range offered by Time-Warner contains a multitude of non-interchangeable goods, namely services. To be able to view a film one has had to pay a uniform ticket price up to now. In the future, one can carry out client specific pricing, because the demanding client can make the disposition of his user-curve available in that he, for example, pays more for one film than for the others. Or that one can at least charge more for a new release than a rerun. For the time being one is limited to uniform tariffs for movie admissions.

One must not underestimate the potential of price discrimination in the service sector. What crumbles under margin pressure will, on the other hand, be strengthened again through individual pricing power. So viewed in this context, the profit projections standing behind the flagrantly high valuations of some Internet titles are really not illusionary. The Internet as a platform for client-specific services promises to be *very* profitable.

Also one can determine which points of view one could more or less develop for a solid lasting investment policy for Internet shares. One must concentrate on a combination which is focused in the service sector. Pure product-distributor-machinery-suppliers should be avoided. Thus viewed, the entry into the Internet makes little sense through the portals of department stores such as Wal-Mart or KidsRus, unless these supplier chains start to focus more on value-increasing services. Every success effort of real and original services in the direction of the Internet, for example Disney, should be rewarded with increasing share prices.

This subject has many further implications. The question has been raised of how the owners of famous and very marketable brand names should behave in view of the margin-destroying machinery of the Internet. Will they be able to keep their brands and to avoid arbitrage attacks? Or will the Internet destroy all that which has been built up through slow and tedious efforts (combined with many investments)?

6. Therefore Selectivity

Questions about questions, and most in areas where no valuable previous experience exists. It is no wonder therefore, that valuation differences arise as we have witnessed in the last few months and weeks. The questions and the (mostly temporary) answers are reflected in higher and lower share prices. The selectivity is more than justified. In view of the problem just mentioned regarding the optimal strategies for a brand name vis-à-vis the possibilities of the Internet, it would not be a big surprise if some very famous brand names are left by the wayside.

Questions about questions are also asked if one does not consider the results of the discussion concerning the valuation of long-term corporate outlooks. The valuation of soft factors leads necessarily also to soft, unclear consequences. Some time will pass before the markets with their army of financial analysts will have noticed that value-oriented management, has among other things, economic value.

Once again in these interesting as well as exciting times, we recommend a certain amount of patience, to enable one to live with these fluctuations. With sufficient diversification they may even be tolerable. It is foolish to imagine that even with our own selectivity, we will be right in every case. It is foolish to present the illusion that we are able to anticipate with skilful timing the next market movements. However, we absolutely believe that among all highly-valued stocks, here and there a candidate will be found which fulfils our criteria and demonstrates interesting potential.

KH, January 31st, 2000