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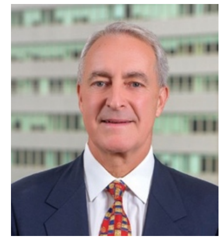
Thoughts for Investors



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Summer Newsletter

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The question that we have been asked most frequently this summer is about the stock market and its future direction. Could Allan Greenspan be correct about "irrational exuberance?" (About 2000 points ago). Certainly the stock market was anticipating continued good prospects for growth in earnings. Where would that growth come from? Productivity enhancements? Labor cost savings? Restructuring?

Our response is that we are confident, having seen firsthand the strength of American corporations internationally, and the amount of business yet to be done by developing countries.

Field Trip to Beantown

As many know, we are fans of the great investors such as John Templeton, Philip Fisher, Paul Cabot, Benjamin Graham, etc. Many new noteworthy investors also credit these individuals. Warren Buffett claims his success is 50%, Ben Graham and 50% Phil Fisher. George Soros also quotes Fisher.

I went to Boston to chat with several portfolio managers at Fidelity Investments. The purpose was to better understand Fidelity's investment process, and to hear their thoughts on the progress of the market. The most senior portfolio manager and vice-chairman of the firm is George Vanderheiden, a twenty-five-year Fidelity veteran and Peter Lynch's former boss. George outlined nine investment "guidelines" that draw heavily on the teachings of Templeton, Graham and Fisher. Summarized they are as follows:

1. Avoid the big loss by avoiding swinging for the fences.

2. Develop conviction. If it's down and you understand why you bought it, buy more.

"When everyone thinks alike, no one thinks much."

3. Great companies have great leaders. Invest with the person. Bill Gates at Microsoft, Andy Grove at Intel. Larry Ellison at Oracle.

4. Buy "pricing power", companies with an ability to raise prices.

5. Respect the force of government actions. For example, when the government got into the space race, Texas Instruments went up 17 times. Conversely, the government investigation of Columbia/HCA is currently weighing heavily on the company's stock.

6. Learn to live with uncertainty and failure.

7. Avoid investment bias. A good stock can be found anywhere. For example, when home building costs were skyrocketing in the 1970's, mobile home stocks did well yet some investors shied away because of their "unglamorous" nature.

8. Don't be frozen by inertia when events change. Take advantage of them.

9. Be patient. Stick with the winners. The best investments have been the slow ones. In 1919 Coca-Cola came public through JP Morgan and what 'is now SunTrust Bank in Atlanta. Both received 5000 shares as part of the underwriting fee. JP Morgan sold their stock after it tripled a few years later. Sun Trust still has theirs and it has grown to 48 million shares worth over $3 billion.

Other Fidelity managers concurred with George and together they offered several "themes" that we have woven together with our theories, and that will, we believe, continue to drive the market forward. The U.S. has the lowest wage rates of any developed country. Our $17 per hour compares very favorably to $24 per hour in Japan and $32 per hour in Germany. Keep in mind though, that since the fall of the Berlin Wall in 1989, 3 billion people have been added to the labor pool, most at $2 per hour in places such as Poland and $0.25 per hour in India and China. American companies have to be quick to take advantage of this low-cost labor.

These same new workers are also freer to trade. Airports like Heathrow and Gatwick, JFK and Newark, LAX, San Francisco, Chicago, Atlanta and even Philadelphia have become the new "Ellis Islands". When I travelled through Heathrow I noticed airlines of many unfamiliar countries. This free trade has also made capital more mobile. Owens-Coming moved a glass plant from Germany to Poland and has been making a profit selling glass even though it reduced the price from $400 per ton to $250 per ton.

The Hong Kong Miracle

More mobile capital has sometimes led to over investment, which, should not be confused with venture capital or investment in risky, young enterprises. Sir John Cowperthwaite, Hong Kong's financial secretary from 1961 to 1971, and some say its architect of prosperity, was very clear in his opposition to regulate or direct the movement of capital. A recent article about him in the Wall Street Journal Europe outlines his approach.

"In the long run, the aggregate of decisions of individual businessmen, exercising individual judgment in a free economy, even if often mistaken, is less likely to do harm than the centralized decisions of a government, and certainly the harm is likely to be counteracted faster."

"Simply put, money comes here and stays here because it can go if it wants to. Try to hedge it around with prohibitions and it would go and we could not stop it and no more would come .... Our only course is to ensure that the economic and political conditions here are such as to give every inducement to come and to stay."

The United States is the only country outside of Hong Kong where new enterprises are privately funded by individuals and businesses through an organized system called venture capital. Other countries fund new enterprises out of public funds. Again, Sir John Cowperthwaite's thoughts.

"It is precisely because Papa does not know best that I believe government should not presume to tell any businessman or industrialist what he should or should not do."

"I must confess my distaste for any proposal to use public funds for the support of selected, and thereby privileged, industrialist, the more particularly if this is to be based on bureaucratic views of what is good and what is bad by way of industrial development. An infant industry, if coddled, tends to remain an infant industry and never grows up or expands."

A thriving venture capital industry not only provides funding for new businesses but also for the reinvigoration of older businesses. The result is investment opportunity for individual investors such as ourselves.

The Key to Real Earnings Growth & Rising Stock Prices

Over investment can sometimes lead to problems. China's auto production has expanded so rapidly that there is a huge excess of unsold cars. Over investment in real estate in Kuala Lumpur has resulted in the construction of what is now the world's tallest twin buildings. Over investment leads to cutthroat competition, which leads to disinflation/deflation which leads to lower corporate earnings, which is bad for stocks.

There are two paths to real growth. The first is to have unit volume growth, i.e. to "sell more stuff'. Today one sees many companies whose earnings are rising (along with their stock price), but it is the result of financial "voodoo" such as asset sales and stock buybacks. Unfortunately their sales remain stagnant.

Unit volume growth (increased sales) occurs for two reasons, either the size of the market is growing or the company is gaining market share. A company gains market share because it has superior products and execution. The products have some technological advantage and may be upgradable and/or scalable.

The second path to real earnings growth is by raising prices. This is not always easy to do especially in today's environment, though companies that are constantly developing new products can get away with it.

Conclusions

It should come as no surprise that the two best industries at unit volume growth and pricing flexibility are technology and health care. Almost every corporation is dependent on technology to do business, do more business, save time, save money and sometimes even save lives.

Health care is obviously crucial to sustaining the workforce. It is estimated that currently 20 cents of every health care dollar gets spent on paperwork. Information technology products help that money get spent on real health care instead. And those three billion new workers and consumers from the developing countries? What will their demand for technology and health care be as they try to live better and grow their economies?

Calvin Coolidge said "the business of the American People is business." The United States has a tremendous higher education system which attracts smart people from around the world, a venture capital system for finding and nurturing startup businesses, a stable political environment, and a stock market system for allowing individuals to invest alongside people such as Bill Gates. The stock market will, we believe, continue to provide great investment opportunities for years to come.

Technology Seminar

Alex. Brown is hosting our eighteenth annual Technology Conference on October 13th-16th at the Renaissance Harborplace Hotel in Baltimore. We are in the process of mailing out the invitations now, and we look forward to seeing you there. There will be over 2000 attendees including over 200 leading technology companies presenting, followed by breakout sessions for in-depth discussion, along with several luncheon and evening events. Since this is a very popular event, please send in your responses as early as possible, since there is a limit to the number of attendees. If you have any questions, or you would like to invite a client or associate to join you at the conference, please feel free to give us a call.

AUDI PARTEM ALTERAM

Hear the Other Side

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If you would like to discuss the topic of this newsletter, or our team's approach to investing, please feel free to contact us by email at al.boris@alexbrown.com.

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