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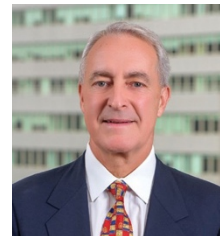
Thoughts for Investors



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"Obstacles are those frightful things you see when you take your eyes off your goal"

– Henry Ford

Great opportunities lie ahead for the New Year, the new century, and the new millennium. How long will it be before there will be a cure for cancer, a female president, a second superpower, water as a fuel source and the Eagles as Super Bowl Champions?

Whatever the future brings, the world's longest running democracy will play a major role in shaping the future. From a business perspective the question is always how to identify and take advantage of those opportunities.

A Historical Perspective

"The voyage of discovery is not in seeking new landscapes, but in having new eyes."

– Marcel Proust

I am currently reading Ron Chernow's book Titan about the life of John D. Rockefeller, Sr. Three major themes have emerged. The first is that throughout his life Rockefeller seized opportunities that no one, not even his business partners, were able to see. Wayne Gretzgy said you have to go "where the puck is going to be, not where it is now." Rockefeller developed the railroad tank car not the railroads. The railroads preferred shipping oil in 42-gallon wooden barrels on flatbed railcars because it was more profitable for them. In the end Rockefeller ended up "controlling" the railroads because he owned the tank cars. He leased the cars to the railroads, threatening to take them to a competitor if he didn't get favorable rail rates. He also built and owned the biggest oil & gas pipeline system. While the existing shippers preferred small schooners, Rockefeller built huge iron ore freighters for use on the Great Lakes. With these he was able to charge freight rates of 80 cents per ton as compared to his competitors $4.20 per ton.

The second theme is that of Rockefeller's great patience and persistence. After being taken advantage of in a business transaction he advised his employee "we will do nothing, but we shall not forget it." Under pressure he acted decisively while others waffled either out of fear, lack of conviction, or to protect profit margins in existing business. He dominated the iron ore industry, much to the detriment of Andrew Carnegie. He bought up all the stock of a company that owned the iron ore in the Mesabi Range at a time when that grade ore was not commercially viable. Eight years later, that $10 stock was worth $160 per share. He didn't care for JP Morgan but as one of Wall Street's largest financiers, Rockefeller was forced to do business with him. He looked for ways to lessen his dependence on JP Morgan. He financed Chase and eventually cut out JP Morgan's bank. What an irony that just recently these two banks have merged to form JP Morgan Chase & Co.

The third theme is that Rockefeller was able to accomplish much because of the paucity and ineffectual enforcement of governmental regulations, and the lack of financial liquidity. Many of today's business laws were enacted as a result of the success of the business "trusts" that Rockefeller and others set up for oil, sugar, and other commodities. With regard to financial liquidity, the Federal Reserve's active monetary policy has drastically reduced the number and severity of financial panics that used to routinely plague the market.

In this newsletter I would like to show how John D. Rockefeller, Sr. capitalized on the opportunities of his day and how these same insights apply to today's opportunities.

"Go where the puck is going to be"

Investors are sitting with nearly two trillion dollars in money market funds (as of this writing). Everyone is waiting for the "temperature" of the stock market to get better before making further investments. This is a dangerous maneuver for a long-term investor because the stock market is not a thermometer but a barometer. Yesterday's stock market told us what might happen to the economy today, therefore, today we should be investing based on what we believe the economy and company fundamentals will be in the future - after a Bush tax cut and more Fed rate reductions. If investors identify specific companies with large market opportunities, superior products and execution, barriers to entry into their business, and strong management then they have identified good investment opportunities that will sparkle when the sun does eventually come out.

Contrary to what you hear on CNBC, today is not the time to start getting defensive by investing in supermarket, food, or utility stocks. Unless you believe a company is going out of business, or their market has dried up, or you need to sell for tax reasons, an investor shouldn't sell simply because the stock price is down or an analyst has downgraded it. For years, Standard Oil stock was depressed due to the antitrust litigation. Devastating at the time, this event turned out to be the single greatest wealth creating factor for John D. Rockefeller Sr., or any investor that saw the opportunity. With all the various spin-offs, Rockefeller's net worth (not counting what he gave away) reached $900 million--or the equivalent of $13 billion in 1996.

Patience and Persistence

As an 18-year veteran of the investment business I have only become more convinced that patience and persistence are the cornerstones of investing. Rockefeller was known to wait years for an investment to produce a return, even with his own company. There were often ill feelings on the part of people whose companies he bought and who took payment in cash instead of Standard Oil stock, only to later watch the stock soar. Rockefeller routinely bought Standard Oil stock back from friends and employees if they panicked and wanted to sell. There were several instances where, in the heat of an argument and trying to call his bluff, people would sell their shares to him out of spite. He would always gladly buy and many a fortune (particularly among some railroad executives) was nipped in the bud. Even his brother William, at one point one of America's ten wealthiest men saw a gap grow between his and his brother's net worth because he periodically sold some of his stock. Contrast Rockefeller's patience with that of the PBHG Mid Cap Value mutual fund, anointed by S&P "our best 12-month mid-cap performer (with) a rousing 743% (turnover)." That's in one year! It is hard to understand how long-term success can come from such a short-term perspective.

Regulations and Liquidity

There are instances where the lack of regulation or the inability to enforce regulations assisted in the creation of Rockefeller's wealth. By the 1890's Rockefeller was earning $10 million a year, and that was before the establishment of an income tax. The Sherman Antitrust Act, authored by John Sherman, Ohio senator and brother of General William Tecumseh Sherman, was passed as a direct result of Rockefeller's creation of the oil "trust". For many years the law stood unenforced. Today many laws protecting competition are zealously enforced. In the 1930's laws affecting securities were enacted. In addition, the government took a more active role in providing liquidity to the financial markets. Before the government provided liquidity, such as during the Asian financial panic of 1998, Rockefeller used his great liquidity to further build his wealth. On one occasion he publicly pledged half of all he possessed to maintain the credit of the United States of America.

In summary, there are many similarities between the opportunities of Rockefeller's day and today's opportunities. The formation of an oil industry beginning with the pumping of oil from Sir Edwin Drake's well in Titusville, PA eventually led to the "gilded age" of the U.S. For our times the creation of the semiconductor has, I would argue, created another gilded age. The names Rockefeller, Morgan, Carnegie, Vanderbilt and McCormick have been replaced by Gates, Dell, Ellison, Walton, Buffett, and Welch.

"The empires of the future are the empires of the mind."

– Sir Winston Churchill

We may feel as if we are travelling in a sea filled with icebergs instead of opportunities. If that is the case I believe we are better off in a faster, more maneuverable boat than on a cumbersome, hard to maneuver ocean liner, even if the ocean liner appears more comfortable. It's much more difficult to maneuver General Motors around an iceberg than it is a Cisco Systems. In the past several years we've all benefited from "the rising tide that lifts all boats". Now, as Warren Buffett said, "when the tide goes out, we'll see who has been swimming naked".

In a recent Barron's article, Procter & Gamble's CIO, Steve David, remarked that with 110,000 employees spread over 70 countries, selling 300 brands in about 140 markets, "it was like the internet was made for us." The internet and technology is how old economy companies will stay connected to their customers, their suppliers, and even their own employees. The same article notes that Intel does about $2 billion in sales per month via the Internet, selling something to over 1000 companies – nearly all their customers. General Electric's website is now over 6 million pages of prices, products specifications, delivery information and employee communications, all with the required levels of privacy.

John D. Rockefeller Sr. often had the luxury of going home for lunch. Today with the internet it's "open for business" every hour somewhere around the world, and adjusted to 1996 dollars, John D. Rockefeller Sr. has moved from #1 to #2 all-time wealthiest American—behind William H. "Bill" Gates.

Great opportunities abound and this new millennium will certainly have its share. As in Rockefeller's (and later Gate's) time, the opportunities will only be recognized and exploited by a few people of vision. We will be among them.

"There is no security on this earth. There is only opportunity."

– Douglas MacArthur

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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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