

If a Tree Falls in the Forest...

The current environment highlights in a particularly painful fashion, the dilemma of the serious, long-term value investor. In order to acquire attractive businesses at appealing prices, we require some modest degree of randomized fear and unhappiness in the investor classes that create the opportunities that keep us in business.

However, there are some practical limits to the Buffett theorem that states: "We want the market to go down so we can buy more." The cyclicity of the economy can be absorbed and analyzed. We will gladly be overpaid to accept other investors' fear of owning the next WorldCom. We live and breathe to take someone's six-month problem in order to prosper over a three to five-year horizon. Pension and accounting issues? Bring them on. But we are unhappily resigned to the general reality that not much good is happening or will happen in our portfolios until there is some resolution of the Iraq situation.

To directly quote James Surowiecki, who writes about business and finance for The New Yorker: "Businesses and investors are grappling with an extreme version of a problem that was diagnosed in 1921 by the economist Frank Knight, who drew a distinction between risk and uncertainty. Risk, he argued, is something you can calculate – the probability of someone losing at roulette. Uncertainty, though, arises when the odds of success or failure are incalculable – the

probability of someone deciding to play roulette in the first place, and being pickpocketed on the way out of the casino. Weighing the consequences of war with Iraq, businesses and investors are dealing with uncertainty, not risk."

With the exception of perhaps Warren Buffett and Bill Gates, investment managers eventually run out of money to put to work in a declining market. This begets the old saying "The bottom is always 15% below where you bought your last share." We still have not changed our opinion that acquiring an otherwise decent business that is now on sale for 40% off a reasonable assessment of its value should be greeted with the same enthusiasm as a 40% off sale at Tiffany's and not as an excuse to begin a deep and prolonged depression that questions one's existence on this planet. Using the current geopolitical vernacular, the equity investor is living in a "target-rich" environment across nearly all market capitalization sectors. In other words and in our opinion, if you have a sufficient supply of Roloids, there are ample opportunities to make material amounts of money in a growing number of equities.

Speaking of Buffett, an investor should take nearly everything with a grain of salt, and in the case of the Chairman of one of our larger holdings, one should be prepared for a mouthful. Along with everything there is to respect about Buffett and his stewardship of Berkshire



Hathaway, there also comes a healthy streak of what is good for Warren should be good for everyone else. What is best for Warren and shareholders of Berkshire Hathaway are very large businesses that are willing to sell to Berkshire in a quietly negotiated, non-auction process whereby the price is somewhat or very much below the price that might be achieved if the animal spirits of an open auction are brought to the forefront. What is second best is if prices of the largest public traded securities reached truly dismal levels for a somewhat extended period of time which would enable someone with an investment portfolio pushing \$80 billion to take an appropriate sized position. Practically speaking, to take a 2% position in just his \$32 billion equity portfolio, Buffett has to buy \$640mm of stock and that starts to narrow down the prospective field of investment in a hurry as we count only 506 U.S. stocks that have a market capitalization of \$6 billion or more. (Assume 10% of the target's shares.) So when THE GREAT ONE pontificates in his latest annual letter to shareholders that "we still find very few (stocks) that even mildly interest us," there is precious little that is new in that statement. Since most investors have \$78 billion less to invest than Buffett, the opportunities to find values in this environment increase dramatically.

In accounts where we are not assigned asset allocation duties, we see plenty of inexpensive securities that admittedly seem to be getting more inexpensive by the day. Where we have asset allocation responsibilities, we are tethering ourselves to the pole of a 50% equity exposure, which we feel is a conservative balance between the mess of the world around us and the attractions presented daily in the markets. We are "leaning" toward a higher allocation save for a healthy respect for the plight of those who have striven for stardom and failed. As we have noted many times in the past, if we can avoid making grand pronouncements and bold moves with our clients' money, we will generally avoid making terrible mistakes and if we avoid making terrible mistakes, we are more than halfway home.

Investors seem again to be falling neatly into textbook behavioral finance mistakes. As an amorphous whole, they consistently do what they should have done three years ago. Three years ago was an ideal time to raise cash, short stocks, buy bonds, and position a portfolio in stocks with defensive characteristics. But is it now?

We argue "no" and use the example of the recent clamor to invest in "dividend paying stocks" which the Wall Street Journal adroitly noted have outperformed low and non-dividend paying stocks for the past three years. This

remains a near nonsensical notion and a desperately poor case of data-mining. What makes it all the more scary is that the editorial body that is perhaps the most public advocate of the inherently intelligent notion to eliminate the double taxation of dividends is relying on all the wrong reasons for why it makes sense! Their theory would suggest that a 5% zero coupon bond that will mature at par in 2005 is worth less than a 5% interest paying bond maturing in 2005, assuming both are purchased at the same yield to maturity.

They are obviously not alone in their misinterpretation of the seemingly mysterious ways of how corporate finance and the creation of economic value work. In fact, the Bush proposal is really most notable as a sneaky way to cut and index capital gains taxes by allowing investors to mark up their cost basis by a determination of "deemed dividends" which the rest of us have been calling "retained earnings." The determination of what will constitute worthy dividends and worthy retained earnings will result in a bonanza of eternal work for the accounting industry that has the capability of wiping out all the negative financial implications post the Arthur Andersen and Enron debacles. Contrary to the press which appeared when the Bush proposal was first announced, the changes may actually end up benefiting those who retain earnings rather than those who pay out dividends.

All else being equal, a thoughtful investor should be putting some of his or her fears and doubts aside and actually beginning to look for otherwise decent businesses that may be currently punished due to a consensual view that there is some specific lack of clarity in their near future or that possess an intelligent inclination not to pay a dividend, a combination which you might imagine is not being perceived today in a very favorable light. Put another way, "the hue and cry for dividends is actually a cry for help. It's an expression of fear and risk aversion. Even more than an end to the double taxation of dividend income, anxious investors today want sanctuary." Furthermore, "there is a considerable degree of twisted thinking and general acceptance of half truths about a number of aspects of common stock investments. However, whenever the significance and importance of dividends are considered, the confusion of the typical investor becomes little short of monumental."

As often seems the case when one can conceptually read hundreds of pages a day of the blur between fact, opinion and research, delineating the fine line between original thought and artful summation of others' versions of this fine line can produce a less than humble sense of one's own

intellectual grandeur. Within the context of being “on record” with what we feel were some very lucid and on-target comments in our last Strategy Letter in regard to the appropriate frame within which to consider dividends, before we get re-started on the current debate, we would like to tip two hats and refer readers to www.GrantsPub.com for a look at Jim Grant’s December 20th piece entitled “In Communion with Phil Fisher” from which we appropriated the first quote above and also to read (or hopefully re-read) the original source work, Common Stocks and Uncommon Profits by Phil Fisher, from which we stole the second quote. The latter is a classic and the former is simply another good piece by a guy who can think and write circles around almost anyone we know. (With no hint of self-parody, we note that erudition is unfortunately not a license to being right in an investment sense.)

Common Stocks and Uncommon Profits, was published in 1953. As we have noted many times in this space, things in the twenty-first century seem to be changing a lot, but the methods and abilities with which human beings process information do not seem to move an iota from the red line hovering dangerously close to silly. If a tree falls in the forest and we are not there to see or hear it fall does that mean the tree is not real and that it did not fall and in fact...is there a forest at all? That appears to be the suggestion logically derived from the clamor that “dividends are real” and therefore will calm investors’ fears that all the earnings being reported are not fake. None other than Mr. “Random Walk Down Wall Street” Burton Malkiel was recently quoted in the Wall Street Journal as stating that “in an environment where reported earnings are viewed with some degree of skepticism, cash dividends will provide a very strong signal to investors of true financial strength and the credibility of earnings reports.”

Anyone who has been paying even modest attention to the past decade, much less those who have studied the last 100 years of financial history should know that dividends do not always signal real profits, just as a share repurchase program that merely mops up egregious stock option issuance does not always signal that a stock is undervalued and GAAP earnings reports do not always paint the correct picture of economic earnings. Enron paid dividends and many companies have maintained abnormally high dividends in order to appease a certain class of investors. Companies are groups of people who fall prey to the same extraordinary popular delusions and the madness of crowds which afflict the rest of us. They are very adept at pandering to the perceived short-term desires of fickle and behaviorally unstable investors and are extremely capable

of paying out a dividend they can’t afford, just as they were capable of blowing mind-boggling sums of money on dot-com schemes or fruitless acquisitions.

We use the tree example because, in our small cap portfolio, we actually own a grossly undervalued company, Rayonier, whose management is literally cutting down trees, selling the wood, generating cash, paying taxes and reporting earnings and book value growth in order to demonstrate to investors that they really have an undervalued asset. In other words, they think that investors don’t understand what they have and what they are doing and therefore they “need” to do something to demonstrate the future earnings capacity that is possible when there really are high enough stumpage prices and/or a compelling argument for asset sales. While they are doing this on a relatively small scale and the shareholder value they are sending to the government through tax payments rather than internal compounding is not egregious, we see this kind of thinking all over corporate America and in the investment community itself. Given the unhappy state of affairs on both sides in terms of the economy and stock prices, there are precious few management teams who have the nerve to come out and announce they are going to beat their own drum and do what they think is right for long-term shareholder value creation rather than managing by an investor poll philosophy. (Please call us if you fit this bill!)

Practically speaking, we would rank the universe of available equity investments into 6 categories, from worst to best:

- 1) A fundamentally poor business as defined by return on capital - management doesn’t recognize it and they are constantly raising funds to pour into their eternal money-pit;
- 2) A decent business that retains excess cash flow in order to throw the money away year after year in any number of innovative ways, ranging from acquisitions and investments that do not return the bare minimum of a company’s cost of capital to outrageous executive pay plans and \$15,000 waste paper baskets;
- 3) A good business that generates excess cash flow but where management avoids investing in intelligent projects because they are beholden to an unsustainably high dividend to shareholders, eventually killing the core business;
- 4) A good business that retains excess cash flow and does nothing with it: “the hoarder;”

5) A company that generates free cash flow and invests some intelligently and returns some intelligently through well-timed share repurchase and/or dividends; and

6) A company that is in the period of life where it has ample opportunities to reinvest cash in its own businesses, does not pay out a dividend and thereby compounds return upon return for the investor.

In our view, an intelligent strategy is to avoid the 1s, patiently wait for the 5s and 6s to reach reasonable valuation points and carefully monitor 2 through 4 for signs of a change in management direction which would indicate a desire to become a 5 or 6. The presence or absence of a dividend, as you may deduce from the preceding comments, has little to do with the valuation of a specific security and is merely a corporate finance tool to be used by an intelligent management team to return cash to its owners when nothing more intelligent can be done with the money. In fact, we often look closely at companies that *cut* their dividends as a potential indication that management and the board finally recognized they were strait-jacketed by an historical anachronism and finally woke up to that fact. *A dividend does nothing to change the value of a firm.* What it really does is divide shareholders into groups: the most conservative who want all income and no risk; those who want some growth and some income; and those who want all growth and do not need income. On that basis, there is some benefit for the income needs of the taxable investors if and when something comes out of Washington, which should never mix with a breath-holding exercise.

Closing this chapter with a final “Phil-ism” and a promise not to discuss dividend theory again: “Perhaps the most peculiar aspect of this much-discussed subject of dividends is that those giving them the least consideration usually end up getting the best dividend return. Worthy of repetition here is that over a span of five to ten years, the best dividend results will come not from the high yield stocks but from those with a relatively low yield. So profitable are the results of the ventures opened up by exceptional managements that while they still continue the policy of paying out a low proportion of current earnings, the actual number of dollars paid out progressively exceeds what could have been obtained from high yield shares.”

This is the long-term attraction of equity investing: do you

want a static 3.8% yield or do you want a 1% yield growing at 11%? If one is selective, the math today is highly in the equity holder’s favor (more so everyday) and we would encourage clients, both actual and potential, to “lean against the wind” and take advantage of the opportunities currently presented. Or, as a recent headline in the Los Angeles Times postulated, an investor could adopt the following posture: “Dismayed by Bear Market, More are Throwing in Towel on Stocks.” Three years from now, what do you think you will wish you had been doing now?

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