

## "We are Shocked, Simply Shocked"

There are two ways in which one can approach the Enron circus these days. One is to get completely absorbed in it, which produces behavior like reading 238 page documents (The Powers Report – riveting!) and surreptitiously listening to the C-Span hearings over the Internet with headphones on while outwardly pretending to be “on a conference call.” The other is to completely and utterly ignore it as yet another, albeit particularly egregious, example of how certain parts of corporate America engage in financial statement manipulation and how much of the investing world is content to swallow it whole.

Taking the latter tack, what we have, in other words, is nothing terribly new. Throwing \$70 billion down the drain should be patty cakes for a world that absorbed some \$4 trillion in dot-com bubble popping. Financial fraud is as old as the urban huckster offering the new-to-town rube “one for a dime, two for a quarter” and the history of mankind is filled with all sorts of delicious and painful frauds. These episodes are typically followed by large-scale collective hand-wringing, a series of impassioned yet dubious legislative moves by the authorities, and, for brief periods, man’s baser instinct toward greed and the lure of a quick buck is shelved.... temporarily.

This scenario appears to be playing out perfectly, judging by the absolute nonsense spewing forth from C-Span. There is no group more ill-suited to address complicated financial issues than Congress and it is one of life’s sure things that whatever emanates from this circus under the title of “reform” is bound to be counter-productive toward the

production of wealth. To be fair, there are some obvious and appropriate changes in terms of equality between the rank and file and “senior management” as it relates to pension issues, but on the whole most proposals floating around Congress and the Op-Ed pages of most newspapers border on the inane and irrelevant.



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Under this heading we would highlight any give-back of crucial safeguards against fatuous securities litigation by legal parasites who are anxiously awaiting the opportunity to shift their focus away from bankrupting companies who may have once flown the corporate jet over an asbestos-making factory to pursuing lawsuits over any company whose stock has fallen more than 15% over the past 12 months. We would also stand firm against any rule mandating the offering of investment advice to employees. (I’ll even go back to law school if this passes.) Can anyone in their right minds suggest

that between the armies of securities salespeople, the viral explosion of financial media designed to offer “advice” 24 hours a day and the internet, there is one employed (or otherwise) American who cannot find an outlet to seek financial advice? Good advice is an entirely different matter (insert ad for RCB here) but the reality is that like most people who have been burned investing money throughout history, the newly impoverished, ex-Enron employees did not lack advice, they simply chose to ignore it: DON’T PUT ALL YOUR EGGS IN ONE BASKET is not some MBA concept that can only be understood by Andy Fastow progeny.

Like chocolate, Survivor VII reruns, and free refills, many people just can’t help themselves if there is a chance to strut

like a peacock and yell “SHOW ME THE MONEY” when they see the Joneses appearing to make it big. Enron was simply the latest manifestation. With the benefit of a Houstonian on staff, we can attest to an overall atmosphere of multi-year whining at Enron over the rank and file’s ability to get *more* stock, just as otherwise decent citizens prostrated themselves in the late 1990s to get IPO allocations. Annoyingly led by California’s elected officials and Senator “If Anyone Should Know Better It Should Be An Ex-Goldman Sachs Partner” Jon Corzine, the reform movement will be the latest unsuccessful effort documented over thousands of years of history to demonstrate that there is not a law in the world that can stop people from being their own worst enemies.

What is significant, though, is that for the first time the elephant in the room is finally being identified as an elephant. The manipulation of financial statements designed to mislead investors is not a cute and fluffy version of the beloved family pet that occasionally stains the rug; it is fraud. Thanks to some extremely courageous work by former SEC Chairman Levitt, over 700 companies have been forced to restate financial results over the past 4 years. Some of this is simple and semi-legitimate re-negotiation on how far to push the interpretation of accounting guidelines, which by necessity are that - guidelines. The practical process of producing financial statements in a large multi-line, multinational company is a tortuous one involving the consolidation of “estimates” with a bewildering complexity of guesstimates of the future that wind their way up a long financial chain and finally make their way into the annual report, which makes sausage manufacturing look appetizing.

But an unforgiving chunk of these restatements is simply fraud. According to an article in the December issue of CFO Magazine, the SEC has brought lawsuits against 80 companies and 54 CFOs for financial fraud and has had another 250 companies under scrutiny since September 1998, and this was before Enron was sandblasted into our national consciousness. Nineteen CFOs are in jail or waiting sentencing. (We’re not picking on CFOs, we just happened to pick up CFO, not CEO magazine.)

How negative you think all this will be depends upon your view of life. Is the invisible hand of the markets guided by the “lead steers” who ignore a lot of this nonsense and focus rationally on cash flow and cash returns and therefore think this is all about nothing? In other words, if you were looking at life through this lens, and remained somewhat of a virgin in regard to the earnings manipulation game, and therefore did not buy over-inflated pieces of junk before, you would not be affected by their collapse and could go about your merry way picking through the pieces of securities unfairly affected by the bug that is going around. The problem is that “the other guys” have a heck of a lot more money than we and like-minded folks do, and, as seen in the 1990s, an awful lot of money thrown at an awful lot of nonsense can go a long way for a long time. It then follows that the New Era of

Post-Enron Financial Puritanism can go on for an irrationally long time.

The practical implications are three-fold. Your friendly neighborhood corporate auditor is now armed to the teeth and motivated by the real possibility of jail time if he does not perform his professional duty, which means that, on the margin, reported earnings in the intermediate future are likely to be “understated” to something approaching actual, making a near mockery of what people think corporate America is earning. The second negative is that it follows that long-term projected growth rates for many companies are also overstated. The “consensus” long-term growth rate for the 967 stocks in the Russell 1000 averages out to 17%... still. Our guesstimate is that it’s not even half that. Lastly, have people been so burned that they will implicitly demand a higher risk premium to attend the equity party the next go-round? These are the three key issues in valuation work: capitalizing the present, projecting the future value of growth and then discounting it back to today, and it’s easy to argue that all three are negative. The Graham/Buffett School suggests that the market in the short run is a voting machine but in the long run it is a weighing machine, and, therefore, if we buy value correctly, we will be rewarded no matter what the other guys are doing. We hope the long run is not as cold and lonely as it conceptually could be.

All this simply backs up our conviction that the “correction” of the 1990s bubble probably has some way to go and eking out a high single-digit return for the next few years would be a wonderful accomplishment. As a concentrated manager we don’t need “lots” of ideas so we are content with picking through periodic wreckage to buy things like Dow Chemical, which has been unduly tarnished with the Al Qaeda of Finance, asbestos. The chemical business is ordinarily not the preferred place to allocate capital as it tends to be a lousy business complete with low returns on capital and an emotional commitment to endlessly re-investing in your core business just when the getting is getting good. But occasionally, the price becomes so attractive that you are more than compensated for additional business risk and that is the case with Dow (and Celanese, which is a recent addition to our small-cap portfolios on a similar theme).

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