REED CONNER BIRDWELL
INVESTMENT MANAGEMENT

INVESTMENT STRATEGY LETTER

Investment Management Since 1959 *Volume 41, Issue 1*

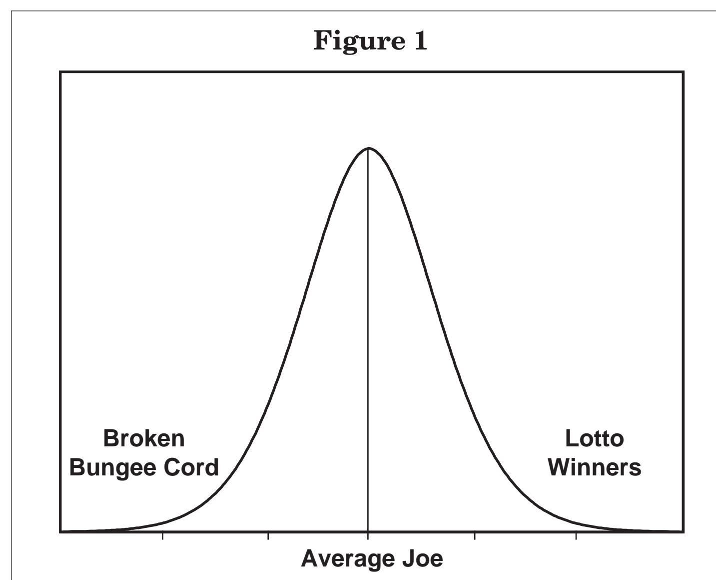
Where Do You Want To Be Today?

We pose this question at the risk of being sued by Microsoft for usage of its advertising slogan, a possibility less unlikely than one would ordinarily suppose given that Microsoft is undoubtedly itching for a victory somewhere in the legal system and we might seem like a pushover on surface.

Our answer starts with the following illustrations. The first (Figure 1), for all those not familiar with statistics, is the basic bell curve. This is a simple tool used to prove a statistical point. What statisticians have found is that if you collect enough data on a particular hypothesis or theory, most of the outcomes tend to group around an average, which is the midpoint of the curve. There are also some extraordinary outcomes on either side of the average, but their frequency tends to be rather small. Plot all these outcomes and you get something that looks like our rendering of the bell curve.

For hard facts, think of a craps table in a casino. If you roll the dice enough times and plot the outcomes, the seven will come out right in the middle of the bell curve as math dictates and the boxcars and snake eyes will be out on the respective tails as clearly possible outcomes, but outcomes with a much lower frequency than a seven.

Let's now apply the bell curve to life and investing. We believe that most of us (statistically speaking) would agree that most people are "average" in the sense that they have decent jobs, decent families, decent proficiency at some decent hobbies and generally decent lives by most standards. Flanking them would be $40 million Lotto winners on one hand and on the other those unfortunate souls whose fate it is to be hit by a bus. Again, both of the latter are possible outcomes in life, but the average Joe is neither as lucky or unlucky. Plot the lives of 280 million Americans and you'll come up with something that looks like a bell curve.

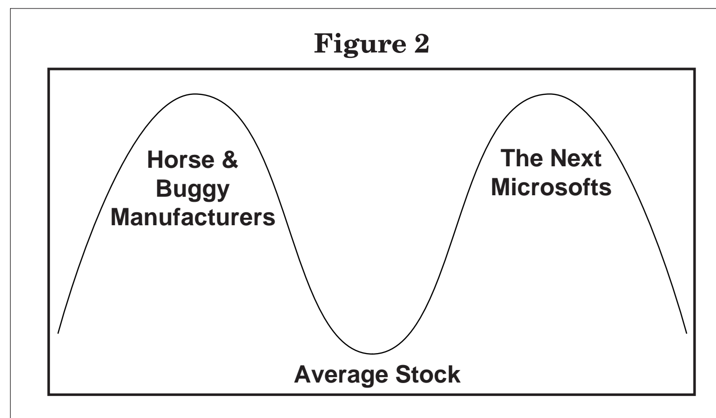


Our experience in investing is similar. Despite our best intentions every time we buy a stock, most of them tend to be "average" performers. We then have a handful of barn-burners that carry the day. Annoyingly, no matter how hard we work, we start with the same intentions for each stock and have yet to figure out how to bottle the "stuff" that makes the barn-burners. (We will keep you posted on our lab work.) Naturally, we then have our "dogs" on the other end of the spectrum. What we have found is that when we eliminate or sharply restrict the "kennel" on the left side of the curve where our disappointments lie, our performance tends to be excellent, defined in the increasingly smaller world where 20% plus is still considered decent. In our combined investment experience of more than 130 years, we have seen little to shake this hypothesis (which of course will play out in a bell-shaped curve.)

Figure 2 shows how Wall Street generally seems to view the bell curve. There is very little that is "average", since average does not fill the road-show meeting for the initial public offering nor does it gets salesmen's phone calls returned. What is hot is an inferno and what is not is ice. Under normal circumstances, which is a term that rarely applies to Wall Street at any particular point in time but defines itself over the equally proverbial long run, very few stocks turn out to be the next Microsoft and the hopes, dreams and

wallets tethered to the stocks on the right bulge of the Wall Street curve get painfully compressed. Conversely, the fortunes of many of those concentrated in the left bulge tend not to be as dire as Wall Street imagines and they move into the middle of the curve and some even to the far right. Thus, in a very fluid fashion, the Wall Street curve gets bent and twisted back into the statistical shape of Figure 1 through a process of reversion to the mean which we continue to maintain exists.

This brings us to today's otherworldly environment in which the distribution between the haves and the have-nots is clearly at its greatest spread in the 21st century, not to mention our old friend the 20th century, as demonstrated in Figure 3. In other words, there are large numbers of preposterously valued stocks, yet also huge swathes of the market where quite reasonable investments can be found and relatively little in the middle. To be slightly more precise, a quick statistical screen of stocks over $100 million in market capitalization producing a profit in the last twelve months identifies 1500 companies selling below 17 times current earnings, a light but not unreasonable definition of inexpensive and a number that includes one-half the companies in the defined universe. A cool 500 of these companies sell below ten times earnings. Another screen pulls up nearly 600 companies selling at 30 times earnings or more and, for fun, we found 129 companies (plus another seven that went public the week of this writing) that had less than $25 million in sales in the last fiscal quarter yet sported a market capitalization of $1 billion or more. This should remind you of the blind man and the elephant joke. Stumble into the right side of the curve and you were up 100% last year. Fall over the left side and you own a Rip Van Winkle portfolio.



So what does this mean, why is it still so, when is it going to change and how often are we going to have to listen to an ever more erudite version of the same tale that we have told for the past year?

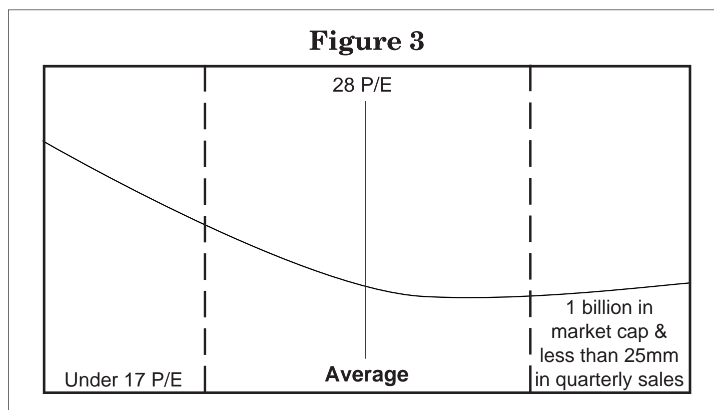
What this means is that, contrary to previous stated opinions, very clearly there has not been terrible carnage in the silly neighborhoods of the market which would vindicate even a modestly more traditional process of investing based upon careful analysis of fundamentals and a return to a world where 20% returns are something to be proud of, rather than a sign of relative mediocrity. What it also means is that there is an awful lot of money riding on the ability of 600 companies to pull some extraordinarily large rabbits out of their corporate hats to justify current valuations. For perspective, looking at the five years ending December 1998, (as the full set of 1999 numbers have yet to come in), we could only find 76 companies that produced 20% EPS growth in each of the past five years. Which means that things have REALLY changed, or there will be some unpleasantry ahead. While we can't put our fingers on the exact numbers, it is our very strongly felt intuitive sense that valuations tend to decline much more quickly than expectations of growth. What it also means is that there are plenty of investment opportunities among those stocks that are presently languishing, despite our misgivings about the current state of affairs on Wall Street.

These conditions continue to persist on Wall Street because...they continue to persist. According to some published figures we have seen $31 billion come out of what are commonly called "Value" funds in 1998 and $81 billion go into "Growth" funds. On the margin, money continues to chase what has worked, which makes it continue to work and so on, creating a most vicious and frustrating cycle if you are not getting even a meager allocation of over-hyped IPOs. In our own portfolios, we have seen the same results. A small group of stocks have gleefully progressed beyond what might have been our most fond hopes, and every partial sale of these positions has been a mistake...so far. On the other side, we have a fat group of stocks that congregate near unchanged or worse for no apparent fundamental reasons, other than sheer malign neglect.

"I don't do numbers" is a quote from one technology analyst in a major news publication. "We expect a flood of press releases from the company which should propel the shares higher" is the basis for a buy recommendation. This is dangerous talk in our opinion and goes together neatly with a general haphazardness and laziness, positions that many investors are adopting for the lure of easy money.

You cannot shake our belief that investing is investing is investing whether you are talking about building pyramids, putting up shopping centers, building and selling widgets, selling software or providing internet

services. A company has value when the present value of its expected cash flows in the future are discounted to the present day and that number is greater than zero. An attractive investment is one where you pay less than your estimate of these discounted cash flows. It matters not what kind of business generates the cash. To suggest otherwise is to take an enormous leap of faith into...what? An investment strategy where the entire value of the company turns over every 5 days? Where the frequency of press releases is more important than what they say?



So we expect another unusual year where the market indices again will fail to tell the story of what is happening underneath. It is our expectation that the action will go the other way and many stocks will have a perfectly decent year while the headlines seem a bit panicky. Famed investor Peter Lynch once said something to the effect that an investor who spends 20 minutes a year thinking about macroeconomic issues is wasting 15 minutes. On that note, the main event is once again the Federal Reserve, which in conjunction with some panicky bond traders, has finally created an inverted yield curve where short rates are higher than long-term rates. This has never been a favorable turn of events for stocks as it means the Fed is serious about tightening the noose.

Interestingly, Morningstar recently came out with a report in which they looked at a strategy of investing in the least popular mutual fund groups as defined by the largest cash outflows that year and compared it with the most popular fund as defined by incoming cash flows. They found that for the ensuing three years, a strategy of investing in the least popular funds outperformed investing in the most popular funds for 90% of the periods studied and beat the average mutual fund 80% of the time. So where do you want to be?

Corporate Venture Capital: The Latest Game?

On another topic, an awful lot of RCB's quality investment time is spent dutifully wading through quarterly earnings reports and, frankly, a lot of what we see is not good. What disturbs us is the laxity with which some companies report earnings, and just as disturbing is the increasing tendency of the investment community to accept the reported numbers on faith without looking at how they are produced. As long as the company "meets or beats" the expectations of the major analysts polled, all is well and we can move on to the next stock. As we have noted in the past, this has led to an increasingly sensitive dance as companies "guide" analysts and then manage to put a penny on top of that. The stock then goes up, preserving stock option values and analysts' jobs and reputations.

The latest boost to this process is the burgeoning amount of corporate venture capital that is increasingly dedicated to (You guessed it!) the Internet world. In the fourth quarter of 1999, 44% of Chase Manhattan's reported earnings came from Chase Partners, its private equity arm, while lending contributed 8%. Twenty percentage points of Microsoft's 30% earnings gain came from an increase in "investment income," representing returns from its $20 billion equity portfolio, which is conceptually growing by $1 billion a month in free cash flow. Delta reported a $596 million gain on the sale of its Priceline stake, versus $175 million from flying planes. Intel's blowout quarter also had a heavy dose of venture gains from its $6 billion portfolio...and the company said that these gains are "sustainable."

So the question for investors is, how do you value and account for these gains? Is there really such a thing as "sustainable" investment gains? (Yes, this is a question that is still worth asking!) How should companies account for these gains so that investors can make their own decisions as to how to appropriately distinguish core businesses from the gains business? These are significant questions for investors, since the numbers are becoming huge. For the first three quarters of 1999, venture capital by corporations totaled $15.4 billion, according to the National Venture Capital Association; a number that I am sure is getting bigger by the day. In the last three years, the number of companies with venture capital funds has tripled from 49 to 163, which again sounds understated. In just the past few weeks, Andersen Consulting revealed a $1 billion fund, Time Warner announced a $500 million fund and some of the "old guys" like KKR are getting into it. Even the CIA has announced a venture fund and started an office in Silicon Valley!

On one hand, it can be argued that this is a terrific thing. What has made this country the economic envy of the world can in many ways be traced to the entrepreneurism of its people and its capital. We have

a culture that tolerates mistakes, seemingly no matter how disastrous, and we have a marketplace that most of the time fluidly connects ideas with capital. Even enlightened big corporations are still big corporations and eventually get bogged down in layers of decision-making. Creating an autonomous entity can break free of the anchor that states "if it was not invented here it can't be any good." Despite the current logic of drug company mergers, it makes intuitive sense that a lot of real innovation and thinking outside the box happens in small groups, and companies need an outlet for this kind of thinking that may otherwise get strangled if tied up inside a bureaucracy. It can also be argued in many cases, particularly in the technology world, that it is easier to buy than to build and, therefore, taking stakes in a boatload of conceptually crazy ideas can yield some terrific results that would not occur under the main corporate roof.

That said, is this really a "sustainable" business that should get valued at the corporate valuation rate or are these really one-time gains that produce returns cyclically? When things are hot, which is the understatement of a lifetime in today's environment, returns are enormous. But when things are not so hot, which I still think is an outcome to which a rational investor should attach some level of probability , these returns evaporate...or worse yet, losses are realized as investments are written off. Naturally, in a corporate world where stock prices are high (in many cases), and pressure is intense to meet and beat already high expectations, the focus is clearly on getting while the getting is still good. We think it is absolutely incumbent upon company management to clearly report investing gains and let investors make their own decisions. Accounting rules are generally tilted toward this disclosure, reporting gains and losses "below the line," which means below the operating income line on an income statement. But this is clearly not happening in 100% of the cases. There have been numerous instances where a company reports great numbers on surface in their press release, and then when the 10-Q rolls out a few weeks later, it is revealed that part of the results came from a gain of some sort. This clearly distorts the picture of the volatility of the earnings of the underlying business. And since the highest multiples go to companies with a combination of the highest growth and the highest consistency, this starts to mean a lot.

There clearly is some inherent value in a corporate venture capital effort. GE, for example, has generated terrific returns from venture capital and other investing venues for over a decade. And who wouldn't like to have wired insiders at Cisco, Intel and Microsoft investing on their shareholders behalf? But we just can't shake our belief that these gains are cyclical and the getting is as good now as maybe it will EVER be. If everyone and their brother are starting venture capital efforts, isn't there a basic rule of economics that too much supply chasing deals will drive down returns as money gets thrown at lower and lower quality deals? And your younger brother is doing deals! The technology industry rag, The Industry Standard, recently reported that one Josh Newman, a junior at Yale, is in the midst of raising $10 million for a venture capital fund based on the idea of "why wait until I graduate"? The fund will finance college-based start-ups. This idea has some kernel of logic given how Dell, The Globe, Raging Bull and of course, the big Daddy of college start-ups, Microsoft, were founded. After all, the really smart guys are still the smart guys in college...and who are the people who really have the time and lack of responsibilities to sit in front of a computer with an endless supply of Domino's pizza and Coke cans for 20 hours a day -- college students. It is unclear at the current time whether the fund will focus strictly on those who are on a path to graduate or conversely will focus only on those efforts whose upside is so large that only an idiot would stay in college to finish.

Doesn't all this ring some modest bell that recalls what the corporate culture of Japan was like in the late 1980s: excessive corporate stock trading to boost profits to justify market prices that in retrospect turned out to be simply...silly? We know that it is a stretch to compare corporate day trading and dollar yen spreads to what is sometimes highly strategic corporate investing. And we are not suggesting that it is unintelligent for a company to have a venture capital fund for the reasons mentioned above. But what we are suggesting is that there is a fair amount of hubris involved in implying to the investment community that a venture capital arm of a corporation has somehow solved the investment riddle whose answer everyone is searching for and can now convert this knowledge into a predictable stream of cash flow. The investment community is equally smitten with itself if it buys off on this. In the overwhelming light of very recent history, it seem obvious that we are in an environment where outrageous gains can be produced seemingly from nothing more than a cocktail napkin business plan and some adventurous investment bankers. It is equally obvious (at least to us), that this will not always be the case, and the billions pouring into the venture capital business hasten its demise as a corporate strategy at what probably is a geometric progression.

Jeffrey Bronchick, CFA
Chief Investment Officer
Reed, Conner & Birdwell Investment Management
JBronchick@rcbinvest.com
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