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THE AMAZING BRAIN

It seems a reiteration of the obvious that there is a lot of intellectual capital harnessed to analyze financial markets. This may be less obvious now than a few years ago, since anyone with half a brain wouldn't deem it worthy to sloth around for Wall Street's piddling dollars when hundreds of millions are so easily within reach via a dot-com IPO. But even taking out the bubble of the past two years, Wall Street has always attracted more than its share of IQ for the obvious Willie Sutton-like reasons.

We have learned the hard way that intelligence in the investment business is yet another asset class that falls to its knees at the altar of the gods of diminishing returns. Clearly you have to be able to dress yourself and successfully chew your own food, but once these goals have been achieved, the marginal advantage of each IQ point begins to diminish. Or else, taken to its logical conclusion, Bill Gates would have gone to Wall Street and made $70 billion and the Forbes list of the world's 400 wealthiest people would be made up of former Nobel Prize winners.

In a roundabout way this leads us to the main topic of this piece, in which we end up praising a competitor who at least on paper, seems to be "one of the smart guys." Recently, a few copies of the monthly Global Investment Review by the London-based Marathon Asset Management appeared upon our desk and facing facts...it was damn good (and they are far enough away to praise without competitive repurcussions.) What made/makes it good is the ice cold bracing nature of its analysis of just how silly some things have gotten both in the financial markets and the investment managers who practice within it. It is a slightly pathetic state of affairs today when this sort of critical and contrary opinion actually seems "fresh" in the often sickeningly sweet output of the Wall Street "buy" machine. And naturally, they write wonderfully about things we tend to agree with, making them, of course, honorary "smart guys."

What really attracted our attention was their recent analysis of "intellectual capital," which poses the questions: why is intellectual capital different than physical capital, how should it be valued and why it is immune to the laws of supply and demand that seem to govern everything else on this planet? We shall pick up the gauntlet they have thrown down by wondering out loud why there has been so little analysis of the subject. In what follows, we mix and match some of their ideas and questions with some of our own, having given them a boatload of credit at the start.

It has been postulated ad-nauseam that in the "New Economy," intellectual capital is the most precious of assets and traditional valuation measures are incapable of picking up on this value creation. The implication is also that the converse is true: physical assets like office buildings and nearly any other form of "plant and machinery" whose value can be measured, are diminishing in value...as anyone with a modicum of the aforementioned mental bandwidth should be able to

realize. The former is somewhat intuitively true, as clearly Coca Cola, Microsoft and many firms have intrinsic value that greatly exceeds a simplified notion of the replacement value of their tangible assets. In fact, a business really only has intrinsic value in excess of the value of tangible assets if it can generate returns on its investment (buildings, steel, computers, people, etc.) in excess of its cost of investment. This "spread" can be seen as intellectual capital of some sort. Clearly, a number of businesses have been run by people shrewd enough to build brands, technology positions, consistently productive research labs, imposingly large distribution systems or to attract and harness gifted and motivated employees working together to create a corporate gestalt whose value obviously exceeds the value of the bricks and mortar. And equally obviously, these are the kinds of businesses you want to buy at the right price. Somehow, this rather basic concept is being built into a new world order with bizarre implications for the investor.

Intellectual capital is obviously a tough thing to measure quantitatively, which makes it easy to create outlandish theories on how to overvalue it. In "the old days," say the early 1990s and before, intellectual capital was actually viewed with much suspicion. After all, "the assets walk out the door every night" was the reason for the historic cyclicality of the valuation of businesses like advertising, investment banks and investment management firms, consultancies etc. But as any long term follower of financial markets knows, nearly any argument can and will be turned on its head.

Despite a raft full of debatable assumptions, the Marathon folks attempted to quantify the premium being placed on intellectual capital, see if it makes sense and discuss the investment implications thereof. Assumption number one involves the capitalization of R&D expense into both the earnings stream and the capital base. While hardly novel, if you are a glutton for punishment and actually find accounting treatments and valuation analysis interesting, new economy theorists do make a persuasive case that their "capital spending" is R&D and by treating it as a one time expense under GAAP, it understates their earnings vis-a-vis a traditional economy company that gets to capitalize their factory spending and depreciate it over 20 to 40 years. So Cisco is only grossly overvalued rather than preposterously overvalued if you capitalize R&D spending and amortize it back into the income stream. To practically accomplish this, you have to make some assumptions as to the value of corporate R&D. Again, if you are a glutton for punishment, you can review all sorts of academic papers on the subject and come up with data clustering around a ten-year value for pharmaceutical R&D on the long end, and down to 3 to 5 years for more technology-related R&D, which not coincidentally coincides with new accounting rules that are forcing companies to amortize software spending over 3 to 5 years, an item that was previously expensed

Marathon's methodology, as shown below, is standard valuation analysis with a twist. With a reasonable discounted cash flow analysis, we can get somewhat close to the intrinsic value of existing assets and prospects. What is unknown, of course, is the future. What is the present value of all the new projects, presumed to be economically viable to be taken on by a company, that are currently still a smudge in someone's notebook? Marathon postulates that in a world where intellectual capital is supposedly king, the future value of a corporate entity should be directly related to R&D and in using Merck and Nortel as examples, they essentially divide the current R&D level by 10% (equal to a 10 year capitalization rate), creating a "book value" of intellectual capital. If you start with the enterprise value of the firm and subtract out the "knowable" value, you are left with a stab

at intellectual book capital. So at what price do the kings of intellectual capital sell in relation to this book capital? Marathon throws in the James Tobin Q factor, which is a rough measure of price to replacement value, and they conclude that Merck and Nortel sell at nearly 6 times their intellectual capital, making both patently overvalued by yet another measure.

as obvious as breathing that the tens of billions of dollars being thrown at every "me too" idea in technology will inevitably bring down returns to investors. And, while we don't have the time for it here, it will be noted in passing that the dearth of dollars currently be committed to more tangible industries will concurrently raise the expected returns from those assets.

	Merck	**Nortel**
Price	$75	$70
Shares Outstanding	2,300	2,754
Market Value (A)	$172,500	$192,780
Net Income Before Tax Adjusted R&D	$7,290	$3,725
Intrinsic Value (B)	$47,600	$24,300
Book Value Intellectual Capital	$21,000	$29,000
Market Value - Intellectual Capital (A-B)	$124,900	$168,480
Tobin's Q Ratio: Market to Book Value of Intellectual Cap.	5.9	5.8

**Source: Marathon Asset Management LTD.*
*** Figures are millions of dollars.*

It is easy and correct to conclude that this analysis is utterly dependent on a wide range of debatable inputs and therefore of questionable value, but in a way that is exactly the point when people try to justify outlandish valuations on the basis of the intellectual capital argument. If something is very difficult to measure, it can be subject to enormous variation as to the opinion of its value. And it follows that just as intellectual capital was bid up to nearly biblical proportions earlier this year, it is entirely possible for the opinion of its worth to swing the other way.

And if the drive to create "intellectual capital' is good, how much more is better? If Merck is worth $172 billion with $2.1 billion of R&D, would the stock double if Merck doubled R&D? This is unlikely, as nearly every pharmaceutical merger to date has proved. The laws of supply and demand and their corollary of diminishing returns are as valid in technology, software and R&D of nearly any kind as they are in the steel industry. While lacking the exact numbers offhand, it seems

Tossing aside interesting theoretical arguments for the moment, let's get back to the base of intellectual capital - people. Whether it's money management, advertising, technology, the current NY Yankees or even a government or two, history is written of times and places where groups of like-minded people are drawn together and sometimes inexplicably create genius. History also records the tremendous difficulty in maintaining that intellectual gestalt as throngs of "me-too" capital and people seek to emulate that brilliance. And to close the subject, how many articles do you have to read regarding employees deserting busted technology companies because their options are hopelessly gurgling under water to appreciate the very real chance that intellectual capital is a slippery and ephemeral concept whose value should be carefully and conservatively judged.

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

Jeff Bronchick, the Chief Investment Officer at Reed Conner & Birdwell and portfolio manager of the RCB Small Cap Fund, has been a contributing editor to www.TheStreet.com for several years. Commencing this month, he will no longer be "The Buysider" at TheStreet.com, but will be penning these and related thoughts on a weekly basis for www.GrantsInvestor.com. We believe that Grant's Investor is the most relevant and intelligent investment site for the serious investor and would recommend that you check out the site for yourself. As a "friend of RCB", we have asked Grant's to provide you with access to the premium information on the site. Go to the website and on the home page, type in the following code on the "invitation card" on the lower left: 107201424.

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To reach us at RCB:

Investment Management

Donn B. Conner, CFA, President	dconner@rcbinvest.com
James C. Reed, CFA, Executive Vice President	jreed@rcbinvest.com
James P. Birdwell, Jr., Executive Vice President	jbirdwell@rcbinvest.com
Jeffrey Bronchick, CFA, Chief Investment Officer	jbronchick@rcbinvest.com
Victor F. Hawley, CFA, Vice President	vhawley@rcbinvest.com
Thomas D. Kerr, CFA, Vice President	tkerr@rcbinvest.com

Business Development & Client Services

Daryl Ann Weber, Senior Vice President	dweber@rcbinvest.com
Michelle Gosom , Marketing Associate	mgosom@rcbinvest.com
Teresa Furbush, Marketing Assistant	tfurbush@rcbinvest.com

Trading & Administration

Daniele Beasley, Chief Administrative Officer & Compliance	dbeasley@rcbinvest.com
J. Fred Aguilera, Trader	faguilera@rcbinvest.com
Madge Alston, Portfolio Administration	malston@rcbinvest.com
Kimberly Charmaine, Director of Operations	kcharmaine@rcbinvest.com
Kimberly Sherwood, Office Admin./Portfolio Admin.	ksherwood@rcbinvest.com

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