Peter Schiff on the Internet (2000/02) and Real Estate (2008/09)
http://archive.lewrockwell.com/schiff/schiff8.html

Issue 1 24 January 2000

Eight Investment Rules That Have Stood the Test of Time

Leithner & Co. adheres strictly to the traditional "value" approach to investment pioneered by in the 1930s by Professor Benjamin Graham of the Columbia University Business School. Although it has been practiced with enormous success since then by his colleagues and students, including Warren Buffett, value investing is distinctly unfashionable today.

It shouldn't be. Its cautious and constructively sceptical approach, emphasis on the analysis of financial statements and disdain for fads and fashions provides (I believe) a sound basis for investment in uncertain times.

And these are uncertain times. Most investors see naught but blue skies and calm seas ahead, and in some quarters – particularly Internet and other technology sectors – a gold-rush mentality has taken hold. At the same time, however, to a minority of investors the parallels between the Roaring Twenties and the past several years are too close for comfort. At all times, but perhaps particularly in frenetic times such as these, investors should take a step back, check their bearings and review sound principles which underlie the slow but steady accumulation of sustainable wealth.

It is therefore pleasing that Forbes published 8 Investing Rules That Have Stood the Test of Time in its 27 December 1999 edition. It is pleasing because, as acknowledged by Thomas Easton, the article's author, no fewer than seven of these eight rules are drawn from Ben Graham. It is also reassuring, since these rules (such as "Don't trust the market to value a stock properly"; "Don't think that it is easy to beat the market"; "You can't time the market"; "Base your expectations not on optimism but on arithmetic"; "Buy old public offerings, not new ones"; "Buy cold industries") lie at the heart of Leithner & Company's approach to investing.

Three Cheers for Ben Graham

It was a gutsy decision – and as it turned out, one of the most prescient market calls of the twentieth century. In June 1932, only weeks before the nadir of the Great Depression (as measured by Dow Jones Industrial Average), Forbes began a three-part series which made the case that unprecedented bargains existed on Wall Street. At that time, the shares of approximately one in three industrial companies could be bought at less than their per-share net working capital. Many companies, in effect, had $1.00 per share of cash in the bank (to say nothing of plant, equipment, goodwill, talented staff and experienced management); but shareholders, traumatised by the unprecedented severity of the economic slump and the fear of even worse times to come, were ignoring these assets and selling these shares for $0.75 or less. The articles' author, who had warned that buying many companies' shares in the euphoria of the late 1920s was more akin to speculating than investing, now stated that some companies' shares in the despondent early 1930s constituted rock-solid investments (indeed, not until the mid-1970s would shares be available at such attractive prices). The author reminded readers that investment is a matter of both price and value. In the '20s, overcome with greed, people were prepared to pay any price; and in the '30s, consumed with fear, they forgot about value. The articles' author? Professor Benjamin Graham.

Today, when Internet and technology stocks are selling at unprecedented multiples of their earnings, when many of these companies have no earnings and when many investors are convinced that nothing can go wrong, it is salutary to revisit a time when everything that could do wrong did go wrong. *Forbes*, in its 27 December 1999 edition, has republished these three classic articles by Ben Graham:

- Inflated Treasuries and Deflated StockholdersShould Rich Corporations Return Stockholders' Cash?
- Should Rich But Losing Corporations Be Liquidated?

[Please note, by March 25, 2001, these articles were no longer available on the Web.]

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Issue 2 Feb. 2000

Is Australia Really a Low-Inflation Country?

On 2 February the Reserve Bank of Australia increased the official cash rate, the rate of interest applied to funds lent between banks and other institutions, from 5.0% to 5.5%. It did so, according to the statement which accompanied its decision, partly because it detected incipient signs of inflation in the Australian economy. A vociferous band of critics, however, has discounted both actual and incipient inflation and contended that higher interest rates will harm businesses and consumers. Despite their differences, three key assumptions (which, it seems to me, have been completely overlooked coverage and discussion of interest rates) unite these disputants: first, Australia is a low-inflation country; second, disinflation and low interest rates underpin the robust growth which has been achieved in recent years; and third, the lower the rates of inflation and interest, the longer the current prosperity will prevail. Similar debates, conducted by similar coalitions of support and opposition, are being conducted in Britain, Canada and the U.S.

I dissent from both groups and these shared assumptions. To see why, and to understand the cautious and somewhat sceptical attitude which I take towards Australia's apparent prosperity, read the circular to shareholders dated 15 March.

Value Investing During the Internet Mania

The Internet is one of the greatest paradoxes of our times. It was originally conceived and built on a non-profit basis, and (thus far at least) few "Internet companies" have reported sustained profits from their operations. Yet hundreds of billions of dollars – and billions more with every passing week – are resting upon the conviction that the Internet will generate enormous returns to those entrepreneurs and their shareholders who can unleash its apparently limitless commercial potential. The resolution of this paradox clearly has tremendous implications for investors. Is the Internet an unprecedented bonanza? Has it been hyped into a bubble of speculative excess which must at some point burst? Should investors change their principles in response of its development?

Partially as a consequence of the intense focus upon the Internet and technology companies (and the associated spotlight upon telecommunications and media companies), value investing – the practice of buying established and profitable companies at prices less than their intrinsic value – has become distinctly unfashionable. Indeed, Warren Buffett, CEO of Berkshire Hathaway, Inc., self-made billionaire and the most prominent and successful value investor, has during the past several months been the subject of considerable adverse comment (a subject to which I will return in a subsequent newsletter).

I have thought long and hard about these issues over the past several months, and set out the results of my thinking in a six-part circular to shareholders. (An abridged version appeared in the *Australian Financial Review* on 13 January).

Part I defines e-infrastructure, e-business and e-commerce, and sets out some economic principles which appear to underlie them. Starting from first principles and reasoning deductively, it yields a startling conclusion: the economic fundamentals of e-business and e-commerce are far less favourable than e-entrepreneurs and their shareholders seem to believe.

Part II sketches some of the consequences of these economic fundamentals for Internet Service Providers (ISPs). Reasoning again from first principles, it shows how the conviction that the Internet will inevitably yield huge profits is attracting fierce competition; and this competition, in turn, is necessitating network diversification, joint ventures, mergers and "bundling" of network infrastructure and media content. Hence the AOL-Time Warner merger and the recent meteoric rise of News Limited shares.

Part III does the same for e-business and e-commerce ventures. It shows that, despite their generally-problematic fundamentals, the prospects of e-commerce and e-business firms need not necessarily be unfavourable. Indeed, of the new approaches to business made possible by the Internet, e-business "Infomediaries" have the potential to produce sustainable profits. They might also improve significantly the efficiency of "Old Economy" industries such as chemicals, transport and steel.

It was thought initially that the Internet would mainly be an e-commerce phenomenon, and that it would make money from its rapid dissemination of explicit information and sale of physical goods. It has long been fashionable to disparage the relevance of the knowledge of the particular circumstances of person, time and place. But it now appears that e-business, thanks to the recognition and use of implicit knowledge, may reorganise entire industries. The description of the (market) mechanism by which implicit knowledge can be disseminated is, according to Austrian School economists such as Friedrich von Hayek and Ludwig von Mises, the central task to which economics should be devoted. It is therefore apt that the Internet, a largely unintended consequence of advances in computing and telecommunications technology, is providing one such mechanism.

Part IV sets out the criteria which market participants are using to evaluate Internet and technology stocks. It shows that most investors appear to be either oblivious to or dismissive of the economic fundamentals of e-business, e-commerce and e-infrastructure. Nor has the great difficulty of assessing the intrinsic value of e-business and e-commerce firms deterred them. Quite the contrary: if anything, ignorance of these particulars has only increased and emboldened speculators' convictions about the Internet and the "New Economy." Today's market participants are thus treating the Internet and technology companies much like their forebears treated the communications innovations of yesteryear. Therein lie great dangers.

With this historical perspective in mind, Part V reviews the impact of technology upon consumers and businesses. Even a casual perusal of economic history demonstrates that technology affects businesses and their customers in significant ways. Equally clearly, improvements in communications, of which the Internet is the latest major innovation, have been occurring steadily since the mid-nineteenth century. It is therefore possible that the Internet's undoubted benefits will eventually diffuse so widely that, much like the telephone and fax machine, the 'Net becomes part of the basic commercial infrastructure which all enterprises must use in one way or another in order to remain in business. If so, then established companies which harness the opportunities provided by Internet and other technologies (as opposed to the developers of those technologies) may benefit most therefrom.

What, then, is the overarching message posed by the Internet for value investors such as Leithner & Co.? Part VI describes and justifies the approach that I am taking towards the Internet and 'Net-related phenomena.' Two points should be emphasised. First, I have no idea (nor, I believe, has anybody else any credible idea) how long Internet- and technology-inspired excesses will last. Nor do I know what will change the behaviour of the governments, lenders and speculators which are fuelling them. The fact that they are motivated by greed, fear and sheer folly is predictable; but the timing and sequence of these emotions are not. Hence the less the prudence with which others conduct their affairs, the greater the prudence with which we must conduct ours.

Second, the key to successful investing ultimately has nothing whatever to do with predicting the growth of a particular technology (Internet, biotech, pharmaceutical or whatever) or which company will emerge as its principal or most profitable provider. Still less has it anything to do with predicting how a particular technology is going to affect the economy or society at large. The keys to successful investing – as Benjamin Graham outlined them during the 1930s and as Warren Buffett, Walter Schloss and other value investors have practised them successfully since the 1950s – remain the estimation (using cautious and conservative assumptions) of individual companies' intrinsic value and the purchase of their securities when they are available at a discount to that value. The advent of Internet and other technologies do not affect – and still less do they upset – these principles.

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Issue 3 March

Mr Buffett Speaks

Berkshire Hathaway's 1999 Annual Report was released over the Internet on 11 March 2000. Berkshire's transmission of quality information to its owners, in my opinion, has long been a model of management's moral and legal accountability to shareholders. I strive to emulate its standard of communication and responsibility and therefore urge you to take a look at it.

The Chairman's Letter, which leads each year's report, is particularly worthy of attention. Like its predecessors, this year's Letter received has extensive media coverage (including a front-page article in *The Wall Street Journal*). As in previous years, however, most of this attention has focussed on Berkshire's short-term "performance." In contrast, the media have almost completely ignored the old-school ethics which permeate Berkshire's operations – and which, it seems to me, provide one of the two bases which underlie its unparalleled long-term results.

Frankness and Attribution of Responsibility

The Chairman's Letter is written personally by Warren Buffett – not by committees of lawyers, PR and media specialists or other intermediaries. (Berkshire employs few or no such staff; equally admirably, it appears to be a committee-free zone). Its most refreshing attributes thus include clarity, candour and sheer readability. During 1999, for example, the company's per-share book value increased by one-half of one per cent ($358m). Mr Buffett did not attempt to obfuscate or distract attention from this result. Quite the contrary, he focussed upon it and interpreted it unambiguously: "we had the worst absolute performance of my tenure and, compared to the [Standard & Poor's 500 Index], the worst relative performance as well." Perhaps because virtually none of them own a plurality of the shares of "their" companies, few if any corporate leaders assess their performance as bluntly and transparently honestly as Mr Buffett.

Further, no doubt was left about where the responsibility for this result lay: "evenInspector Clouseau could find last year's guilty party: your Chairman.... [M]y grade for 1999 is most assuredly a D. What hurt us during the year was the inferior performance of Berkshire's equity portfolio – and responsibility for that portfolio. is entirely mine." Executives are virtually always quick to claim bouquets. Few, however, are equally prepared to accept – and fewer still nominate themselves for – brickbats.

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Giving Credit Where Credit Is Due

Mr Buffett is not just quick to blame himself for Berkshire's very few shortcomings: he has long been equally eager to give credit to others for its many successes. This year's letter, like its predecessors, emphasises that Berkshire's outstanding long-term results owe much to the people who run its various businesses. The Chairman gave most of his operating managers an "A" not only because they delivered excellent results; more importantly, they conducted themselves with the highest standards of ethics. This year's letter devoted a page (with a subsection headed "A Managerial Story You Will Never Read Elsewhere") to praise the integrity of the head of one of Berkshire's subsidiaries. Mr Buffett concluded his tribute with the words "you can understand why the opportunity to partner with people like Bill Child causes me to tap dance to work every morning."

Similarly, this year's letter stated that "there are a number of people who deserve credit for [our success in the reinsurance business] over the years. Foremost is Ajit Jain. It's simply impossible to overstate Ajit's value to Berkshire...." Investors in Australian companies such as GIO Holdings Ltd, New Cap Reinsurance Ltd and Reinsurance Australia Ltd have in the past eighteen months developed a very keen appreciation of the skills required to assess reinsurance risk accurately and profitably.

Finally, "See's Candies deserves a special comment, given that it achieved a record operating margin of 24% last year. Since we bought See's for $25m in 1972, it has earned $857m pre-tax. Give the credit for this performance to Chuck Huggins.. Chuck gets better every year. When he took charge of See's at age 46, the company's pre-tax profit, expressed in millions, was about 10% of his age. Today he's 74, and the ratio has increased to 100%. Having discovered this mathematical relationship – let's call it Huggins' Law – [Berkshire Vice Chairman] Charlie [Munger] and I become giddy at the mere thought of Chuck's birthday."

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Cautious Optimism

Berkshire's extraordinary long-term results help to explain Mr Buffett's frankness and infectious enthusiasm. Since 1965, when he became its Chairman, its per-share book value has grown from $US19 to $US37,987. The company's net assets currently stand at $US57.8b – yes, that's almost fifty-nine billion American dollars. This implies a compound growth rate of 24.0% per annum over a thirty-five year period. This record has not been equalled – indeed, arguably it has not even been approached – by any other investor.

Given this stellar record, the positive tone of Berkshire's 1999 report is justifiable. Mr Buffett cautioned, however, that "equity investors currently seem wildly optimistic in their expectations of future returns." Moreover, given Berkshire's enormous size it is likely that the rate of growth in its intrinsic value over the next decade will exceed that of the Standard & Poor's Index by no more than modest amounts. In Buffett's words, "our optimism about Berkshire's performance is also tempered by the expectation – indeed, in our minds, the virtual certainty – that the S&P will do far less well in the next decade or two than it has done since 1982. A recent article in *Fortune* expressed my views as to why this is inevitable."

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The Technology Craze

In a recent series of circulars to Leithner & Co. shareholders, in which Benjamin Graham's and Warren Buffett's ideas figured prominently, I concluded that technology has revolutionised, is changing and will likely continue to transform the production, trade and consumption of goods and services. That is rather obvious. Less evidently, however, very few if any investors have the capacity – I certainly haven't – to predict with any useful degree of precision which technologies and companies will do the transforming, which will emerge as winners and losers, etc.

These two points are discussed in Berkshire's 1999 Annual Report. Mr Buffett reiterated that he lacks the expertise to evaluate new technologies and that consequently he is generally unwilling to purchase "technology stocks" (it is noteworthy, however, that Berkshire acquired a small stake in Microsoft Corp. last year). When Buffett and Munger cannot understand a company's operations to their satisfaction, and therefore cannot estimate its intrinsic value, they avoid its securities: "this explains. why we don't own stocks of tech companies, even though we share the general view that our society will be transformed by their products and services. Our problem – which we can't solve by studying up – is that we have no insights into which participants in the tech field possess a truly durable competitive advantage. Our lack of tech insights, we should add, does not distress us...."

Share Buybacks

Berkshire's 1999 Annual Report also canvassed two topics to which I have devoted some thought lately. The first, which I address in my 1 April 2000 circular to Leithner & Co. shareholders, is share buybacks and the circumstances under which companies should undertake them. (In the past six months two of the companies in Leithner & Co.'s portfolio have repurchased 7-8% of their shares.)

In this year's letter Mr Buffett indicated that he may consider a limited repurchase of Berkshire's shares. He wrote that "there is only one combination of facts that makes it advisable for a company to repurchase its shares: First, the company has available funds. and second, finds its stock selling in the market below its intrinsic value, conservatively calculated." (In the last fortnight, various writers in *The Wall Street Journal* have given very divergent estimates ($US45,000-$80,000 per share) of Berkshire's intrinsic value.)

Mr Buffett also wrote: "please be clear about one point. We will never make repurchases with the intention of stemming a decline in Berkshire's price. Rather, we will make them if and when we believe that they represent an attractive use of [its] money." Further, although share repurchases "are all the rage," they are "all too often made for an unstated and, in our view, ignoble reason: to pump or support the stock price." Hence many companies are "overpaying departing shareholders at the expense of those who stay. I can't help but feel that too often today's repurchases are dictated by management's desire to 'show confidence' or be in fashion rather than by a desire to enhance per-share value."

Executive Behaviour and Remuneration

Mr Buffett also noted in this year's letter that companies often repurchase their own shares in order to offset the options issued to their senior executives. The remuneration paid by companies in the form of grants of options over shares is the second topic to which I have devoted some thought lately. It is addressed in my 15 April 2000 circular to Leithner & Co. shareholders.

This subject matter has lately been in the news in Australia. John Hurst, in an article in the 20 March edition of *The Australian Financial Review*, ably expressed its crux.. In his words, "a new arrogance towards shareholders has crept into [Australian boardrooms]. It is typified by the reluctance of directors to take responsibility for blunders and to curb executive [remuneration] when companies are not performing." One of this country's largest listed companies provides a glaring example. Last year it recorded a $A424m net loss – in no small part because it bought a reinsurance business which has lost approximately $A1.2b. Earlier this year, however, its American CEO departed Australia with an $A13.2m handshake. Yet neither its Chairman nor its Board of Directors have accepted responsibility for – indeed, they have conducted little public discussion and explanation of – these events.

Further, as reported in *The AFR* on 1 March, this company's "top executives from around the world [have been assembled] to the Hyatt Regency at Coolum on Queensland's Sunshine Coast for a spot of golf, sun, surf and seafood, oh, and maybe a few sessions nutting out the strategy going forward to turn the ship around. That's right, as we speak at least 50 executives, including a complement from Britain, are at a management conference in the sun, a move we expect the punters, not to mention institutional investors, are likely to be just slightly miffed about."

Compare the deeds of this company's executives and the attitude which seems to underlie them to Buffett's and Munger's deeds (and those of their senior executives) and the old-school ethos which generates them. Also peruse Berkshire's Annual Reports between 1977 and 1999. In so doing you may come to two conclusions which are coalescing in my mind. The first is that Berkshire's outstanding long-term record is caused by, and not merely correlated with, its adherence to both old-school ethics and value investing. The second, a corollary of the first, is that the mediocre (by Berkshire's long-term standard) results displayed by most other companies can be attributed partly to the fact that, to greater or lesser extents, they apparently regard these two sets principles as quaint and passé.

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Issue 4 April 2000

I'm going to put two quotes on the screen and ask you if this was an honest mistake on the part of the White House, or if the speechwriters had no sense of history. The first quote is, "The economy is fundamentally sound." Herbert Hoover [uttered that memorable sentence in] 1929. And here is George W. Bush today, "The fundamentals of our economy are sound." Is this an honest mistake by White House speechwriters, who must know the difference or similarities in this case?

Brian Williams interviews historian Robert Dallek
CNBC's *The News with Brian Williams* (30 July 2002)

Mr President, I am put up here to speak a kindly word for the solvent and the damned; or, as the more advanced thinkers say, for the Rotten Rich.

H.L. Mencken to Franklin D. Roosevelt
The Gridiron Club, Washington (7 December 1934)

Janus Looks in the Mirror

The Dow Jones Industrial Average, "the Dow," is the most recognised and widely reported indicator of "performance" on the New York Stock Exchange. The Dow tracks changes in the aggregate price of 30 of the NYSE's most important and heavily-traded industrial stocks. Nasdaq, America's second-largest exchange, is an electronic market run by the National Association of Securities Dealers and consists disproportionately in "technology" companies. The Nasdaq Composite Index tracks the price movement of all stocks traded on the Nasdaq. The Standard & Poor's 500 is an index of 500 large stocks which are traded on the NYSE, Nasdaq and the American Stock Exchange (which is America's third most active market and is comprised largely of small- and mid-sized companies).

On Friday 14 April (the wee hours of Saturday 15 April in Australia) the Dow decreased 618 points (5.7%), from 10,924 to 10306; the Nasdaq Composite fell 355 (9.7%), from 3,676 to 3,321; and the S&P 500 dropped 84 (5.8%), from 1,441 to 1,357. In absolute (as opposed to percentage) terms these three decreases are collectively among the biggest ever recorded on a single day. For this reason, and also because changes in the All Ordinaries Index are roughly correlated with changes in its American counterparts, these events received extensive coverage in Australian tabloid newspapers over the weekend of 15-16 April and on Monday the 17th.

This coverage, alas, told us much more about Australian tabloid journalists and mass circulation newspapers than it did about the events in the U.S. which were purportedly being described and analysed. Two circulars to Leithner & Co. shareholders, the first dated 1 May 2000 and the second dated 15 May 2000, set out grounds for most value investors' sceptical and questioning attitude towards the mass media. (Indeed, I take at face value little of what I read about business, investments and finance in newspapers and magazines. I also accept without careful consideration even less of what I hear on radio and television – and run as fast as my legs can carry me from "tips" and the babble which pervades investment chat sites on the Internet). Events in Wall Street on 14 April provides a good case study which illustrates these circulars' points.

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The Misleading Atmosphere of Crisis

Australian newspaper reports of the day's events sought to convey a crisis-laden atmosphere which poses grave and imminent dangers to stock owners. Brisbane's *Sunday Mail* of 16 April, for example, under the front-page headline 'BLOODBATH' (set out in 4cm letters, the same size used to announce the fall of Singapore in 1942, JFK's assassination in 1963 and the prime minister's dismissal in 1975), stated that "Australian investors are expected to lose up to $18 billion [in] the aftershocks from Wall Street's most spectacular crash...." It added that "United States markets plummeted by a staggering $US1 trillion in just seven hours" and that "it was the largest sum of money ever lost in a single day." Feature articles emphasised that "massive plunges" in markets had occurred, that "indexes [had] suffered record-breaking falls" and that "most stocks were battered."

Similarly, the front page lead of Sydney's *Sunday Telegraph* repeated that "Wall St investors lost a staggering $US1 trillion ($A1.7 trillion) in just seven hours as the stock market suffered its biggest crash ever," and concluded that "trading on the Australian Stock Exchange is expected to be frantic tomorrow as equally terrified Australian investors try to get out of their high-tech holdings." Less hyperbolic – but not in all instances more insightful – coverage appeared on Monday the 17th in the broadsheet *Australian* and the specialist *Australian Financial Review*.

This tabloid coverage, considered as a whole, is misleading: indeed, several of its individual claims are patently false. When we observe tumult on the stock exchange (which, thanks to blanket media coverage, Americans, Australians, Britons and Canadians do virtually every day), we risk drawing erroneous conclusions. According to *The Wall Street Journal Interactive Edition*, approximately 1.2 billion shares changed hands on the NYSE on 14 April. But by my (admittedly crude) calculations there are approximately 240 billion shares registered on that exchange. In what was described as a selling frenzy, fewer than one-half of one percent of those shares actually changed hands. (Daily turnover of 1.2 billion shares on the NYSE, by the way, is not dramatically greater than that prevailing since the beginning of the year). As in New York, so too in London, Toronto and Sydney: from one day to the next, and from week to week and month to month, most investments stay invested.

Second, it is misleading to talk about "a rush to get out of the market." Tabloid and some broadsheet coverage gave the strong impression that trades conducted in Wall Street on 14 April consisted solely in one party – sellers. A moment's reflection, however, tells us that it takes two to tango: a transaction requires a buyer as well as a seller; and every stock which is sold must also be bought. Further, for every person who wishes to exchange a share of X Ltd for some amount of cash, there exists another person who is prepared to exchange that amount of cash for the share. And for every person who wishes to "exit the market" at some price there must also exist another who wishes to "enter the market" at that price. Indeed, at the end of a day's trading, regardless of the change in the Dow or other index, "the market" contains the same number of shares (ignoring new issues of shares and companies' repurchase of their own shares) that it did at the opening bell. At the close of trade, then, it has neither shrunk nor grown and the “exits” are perfectly matched by the “entries.”

It is therefore misleading to assert that on a particular date market participants “made” or “lost” a particular amount of money. This assertion misconceives the nature of market prices. Prices are ratios at which money is exchanged for titles, goods or services: they are neither arbiters nor indicators of intrinsic value. This assertion also confuses “paper” gains and losses and changes in sentiment on the one hand with commensurate increases and decreases in real wealth on the other. Finally, this assertion claims knowledge that one cannot easily possess, i.e., the prices at which those who told their shares in X Ltd on 14 April originally bought those shares. It is entirely possible – indeed., likely – that significant numbers of that day’s sellers did so at prices greater than their purchase price.

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The False Air of Certainty

Financial journalists,’ “market experts”’ and commentators’ analyses of the events on Wall Street on 14 April – like their analyses of financial markets on most other days – convey a false sense of certainty. A prominent syndicated columnist provides a good example. In his 16 April column, which appeared in both *The Sunday Mail* and*The Sunday Telegraph*, he stated categorically that “the good times are over. This is the bust in the crazy Internet and high-tech boom we were always going to have. Just in case the point has not been made crystal clear: the boom is over. Not postponed. Not interrupted by the ‘pause’ that refreshes. Bust. Well and truly shattered. What happened overnight on Wall Street [spells] the end of the unique combination of factors and forces that made the 1990s such a glorious decade....” In a separate article in *The Sunday Telegraph*, this columnist stated flatly that “most tech stocks are worthless.”

Statements such as these are thinly-disguised predictions; and the success rate of predictions about financial matters, as set out in my circular of 1 December 1999, is abysmally low. Moreover, financial journalists’, “market experts”’ and commentators’ explanations are *post hoc* and typically *ad hoc* attempts to summarise and rationalise very large numbers of actions undertaken by individual human beings. Each of these actions is complex and stems from different motivations; and considered as a whole, they are too complex for the human brain to grasp. Bloomberg columnist Caroline Baum hit the nail on the head: “to try and explain why markets do what they do on any given day is a Herculean effort. There are so many moving parts that it is almost impossible to quantify the short- and long-run shifts in the supply of and demand for a particular currency, commodity or financial instrument.” In short, there is no single, collective reason which prompts investors and speculators to buy and sell on any given day; and there is no collective “market mood” or psyche. Accordingly, we simply do not know what “the market” will do tomorrow, the next day, next week or next month. Anyone to possesses the pretence to this knowledge does not inform others; rather, he simply deludes himself.

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The Obsession with Prices and Projections

Finally, most financial journalists, "analysts" and commentators obsess about market indices and the prices of individual securities. With some exceptions, they also babble incessantly about revenue and profit projections, future developments in technology, interest rates and other macro phenomena. Their implicit definition of investment return is therefore the increase in a security's market price, and they usually take little or no interest in dividends and companies' actual (as opposed to projected) operations. Most importantly, very seldom if ever do they set out assumptions, evidence and patterns of reasoning which yield conclusions about a particular security's intrinsic value.

Instead, they offer "tips," prattle and mindlessness. These appeared in abundance over the weekend of 15-16 April. Among the gems: a *Sunday Telegraph* journalist (16 April) attributed to one expert – let us call him 'Expert X' to spare him embarrassment and the possibility that he has been badly misquoted – the view "that there is still potential for growth, even when an individual's stock price has risen substantially. 'A stock might have gone from $1 to $5, but then it could still go to $10.'" (This, not incidentally, is the same 'Expert X' whom the *Australian Financial Review* quoted earlier this month with the derisive and rhetorical question: "where would you rather be? In the Old Economy or the telecoms-Internet convergence"?). Barrie Dunstan, it seems to me, is far closer to the mark. As he stated in his *AFR*column on 17 April: "just because a stock has fallen from $10 to $5 doesn't make it good value if it never had any intrinsic value." Other "tips" offered by the gurus in*The Sunday Telegraph*:

- Open Telecommunications Ltd. Why? Because it "designs and builds networks and provides value-added services to telcos";

- Powerlan Ltd. Why? Because it "is a play on IT outsourcing in the Asia-Pacific Region";

- Energy Developments Ltd. Why? Because "there is a lot of upside in a new development, the company's solid waste-to-energy recycling facility. [and because] there is also blue sky in Energy Developments' credit holdings."

Austin Donnelly and Noel Whittaker constitute honourable exceptions to this generalisation. Ironically, their sensible contributions also appeared in *The Sunday Telegraph* and *The Sunday Mail*, respectively, on 16 April. Donnelly counselled caution (noting that further falls in the prices of overvalued securities are possible), suggested sensible criteria which investors might use to detect sound companies and emphasised the importance of dividend income in total investment return. And Whittaker reminded his readers to "be aware that when you own shares you own part of a business. Even if the shares in companies like [x, y and z] do fall tomorrow, the companies will still be open for business and making profits. People will still drink beer, do their banking and buy their groceries. There is nothing to be gained by dumping an interest in a good company because the market is having one of its normal slides." Whittaker also re-affirmed common sense when he stated that "if prices continue to fall next week, regard it not as a disaster but an opportunity to buy quality assets at 10% or 25% less than they were selling for a week ago."

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The Mass Media's Complicity

Wall Street's wobble on 14 April illustrated significant shortcomings (from a Graham-and-Buffett value investment perspective) in much – but by no means all – Australian tabloid coverage of financial matters. A key question is whether this coverage is a cause or a consequence of most Australians' apparently insatiable urge to speculate for the quick buck rather than invest for the long term. This coverage has reflected (and perhaps created) speculators' euphoria during recent years; and now, in the immediate wake of the wobble, it is reflecting (and perhaps helping to create) a misleading sense of crisis. More generally, many journalists' and mass media commentators' misconception of the nature of market prices, their confusion of "paper" gains and losses and changes in sentiment on the one hand with commensurate changes in real wealth on the other – and above all their pretence to knowledge which nobody can possess – has exacerbated the frequency and severity of Mr Market's) swings from mania to depression.

Further, Australian journalists' and commentators' false air of certainty tends to distract attention from the ambiguity (and hence the risk) which inheres in any investment operation. In recent years this unwarranted confidence has therefore lulled speculators into a dangerous sense of complacency with respect to the ease with which returns may be earned and an unduly optimistic expectation that large returns will be earned in the future. Finally, their obsession with "tips", market indices and the prices of individual securities, their unrelenting babble about projections, technological and other future developments – and their apparent unwillingness to set out assumptions, evidence and patterns of reasoning – has encouraged would-be investors to disparage and abandon careful research of financial statements and, in effect, become momentum speculators. If we wish to assign blame for the recent turmoil on financial markets, then we should take a good, long, hard look in the mirror. But the mass media, as either a cause or reflection of our partiality towards folly, is playing its part too.

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"The fault, dear Brutus, is not in our stars but in ourselves."

-- William Shakespeare's *Julius Caesar*

An Unheralded Facet of Risk

A recent pair of circulars to Leithner & Co. shareholders (The Mass Media and Value Investing, Part I and The Mass Media and Value Investing, Part II) set out the damage which market participants, aided and abetted by the mass media, can do to themselves. They showed that the media can reflect a herd mentality. One consequence of this mentality is that speculators who erroneously believe themselves to be investors either pay good money for poor businesses or pay too much for sound businesses (or both). By catering to their audience's proclivity towards greed, fear and folly, mass media reports increase the risk that speculators will incur substantial and permanent loss of capital.

Company executives and their legal, financial and management consultants can also contribute to the destruction of shareholders' equity. Like all other aspects of business, corporate mergers and acquisitions (M&As) are inherently risky propositions. The stark – but usually unuttered – reality is that many and perhaps most M&As fail to achieve what their highly-remunerated and jargon-spewing creators confidently claim that they will achieve. Disturbingly, corporate deal-makers are seldom in doubt but often in error. In Warren Buffett's words: "the sad fact is that most major acquisitions display an egregious imbalance: they are a bonanza for the shareholders of the acquiree; they increase the income and status of the acquirer's management; and they are a honeypot for the investment bankers and other professionals on both sides. But, alas, they usually reduce the wealth of the acquirer's shareholders, often to a substantial extent."

Hence my strong preference that the companies in which Leithner & Co. has invested are the ones being bought rather than the ones doing the buying. And notwithstanding the Ralph Review's incentives to do otherwise, if and when these companies receive a credible offer of merger or notice of takeover, I will generally sell our shares for cash in the open market (at prices which will usually be inflated beyond their intrinsic value by the confident buyer's generous offer) rather than swap them for the buyer's shares.

Two new circulars to shareholders, Corporate Mergers and Acquisitions: A Contrarian Case for Caution (I) and Corporate Mergers and Acquisitions: A Contrarian Case for Caution (II), dated 1 June and 15 June respectively, describe the considerable and growing risks posed by M&As – and, by extension, investment bankers, corporate lawyers and management consultants.

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Buffett and Munger Account to their Shareholders

Berkshire Hathaway, Inc. (BRK), a company oriented unflichingly towards the well-being of its shareholders (and which since the 1960s has arguably created more real wealth per share than any other company) held its Annual Meeting at Omaha, Nebraska on 29 April. In several respects its yearly gathering is unique. Most notably, it is one of the world's largest corporate AGMs. An estimated 15,000 shareholders, a majority of those on its register and hailing from across the U.S. and a range of countries including Australia, Britain and Canada, took the time and trouble to attend. Second, the meeting's formalities are concluded extremely quickly (normally within 10 minutes). Third, after the formalities' conclusion there ensues an informal question-and-answer session which lasts up to six hours. Asking the questions are BRK's shareholders – no queries from journalists, please, they'll be answered at a news conference after the meeting. Sitting alone on stage to underscore their responsibility and to answer questions are Berkshire's Chairman (Warren Buffett) and Vice-Chairman (Charles Munger). Fourth, and perhaps most admirably, Buffett and Munger respond clearly, completely and frankly to the questions which shareholders put to them.

Because Berkshire's executives are demonstrably among the world's ablest, the company's shareholders are a select – and, thanks to Messrs Buffett and Munger, wealthy – breed. (Omaha alone boasts more than 50 "Buffett Millionaires.") Not surprisingly, Berkshire's 2000 AGM was covered extensively by the American and international news media. (It is as disappointing as it is revealing, however, that *The Australian Financial Review* accorded it only a few sentences on 1 May and none on subsequent days). The coverage in outlets such as *The Wall Street Journal Interactive Edition* reflected Buffett's and Munger's formidable intelligence, wit and pithy turns of phrase.

Among the highlights of this year's Q&A:

- *The Internet:* Mr Buffett stated that he was unsure whether the Internet would pose more threats or opportunities to businesses. It will, however, "become an increasingly important issue on how it affects our businesses." The Internet would (through lower prices, greater choice and convenience) benefit consumers. At the same, time, however, because the Internet would erode profit margins more than it would facilitate corporate efficiency, it would prove to be a "net negative for capitalists. it will make American business, in aggregate, worth less than it otherwise would have been."

- *Sky-High Prices and Market Capitalisations:* Mr Buffett likened the current frenzy of speculation on Wall Street to the principle which underlies a chain letter. Early signers-on may make money, sometimes considerable amounts of it, but in the end larger numbers will lose even larger amounts. He and Mr Munger "have seen a lot of cases where valuations in the high side are unbelievable [and] don't see any great cases of dramatic undervaluation in this market." Mr Buffett noted that some companies which have a market capitalisation of $10 billion are not sufficiently creditworthy to borrow $200 million from a bank. Yet their individual owners could borrow 20 times that amount. This imbalance is "as extreme as anything that has happened – including the 20s." Mr Munger called it "the most extreme event in modern capitalism." Mr Buffett therefore warned that investors should reduce their expectations and feared that "looking back, you will see this as a period of enormous amounts of wealth being transferred." He added that he did not know how extensive this transfer would be, or whether it would affect particular sectors of financial markets, the entire market, parts of the real economy or the entire economy: "in five or ten years we'll know." In the long run and at all times, however, "valuation does count."

- *Day-Trading and Other Forms of Reckless Speculation*: at the press conference following the AGM, Mr Buffett said that many people today regard the stock market as a casino, and therefore that they speculate rather than invest. "It's assinine," he said of their capital allocation decisions. "They are influenced by rumour, what neighbours tell them and what they see on TV. They don't pay nearly enough attention as when they are buying a TV set."

- *Tech Stocks:* Mr Buffett repeated his oft-stated view that he is unable to estimate the intrinsic value of technology companies. "We have no religious belief that we don't buy into technology companies. But we've never found one where we think we know what the business will look like in 10 years."

- *Excessive Executive Remuneration:* Messrs Buffett and Munger criticised the extraordinary remuneration currently granted to many corporate executives. Mr Munger likened some corporate compensation schemes to "putting a rat colony in a granary." Both clearly believe that such practices serve shareholders poorly. They also indicated that some of the stock option plans proliferating on Wall Street pose significant risks to shareholders. This is because many of those receiving options "inherently know that they have a lottery ticket" – and may tend to behave accordingly.

- *Financial Advisors and Management Consultants:* at the press conference on the day after the AGM, Mr Buffett stated that serious investors should pay little heed to what they hear on television or read in the newspaper about either the stock market or specific companies. Further, financial advice "is basically not worth anything." Finally, he criticised management and other consultants, asking shareholders rhetorically if Andrew Carnegie would have asked an investment banker whether he (Carnegie) should purchase another steel mill.

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Links to More Information About This Year's Berkshire Hathaway Shindig

- The Community Television Foundation of South Florida Inc. produces the Nightly Business Report and Morning Business Report. NBR's Executive Editor, Linda O'Bryon, interviewed Mr Buffett on 29 April.

- Whitney Tilson, correspondent of The Motley Fool, compiled some usefulNotes from the meeting.

Summing Up

As the American actor James Stewart demonstrated in *It's a Wonderful Life*, it is indeed a wonderful life. But as the Bedford Falls Savings and Loan Association manager whom he portrayed knew very well, it is also an inherently uncertain life. Human action, we should always remind ourselves, has not just intended consequences, but also unintended and unforeseeable consequences ("each man's life touches so many other lives, and when he isn't around he leaves an awful hole.").

Yet many members of the general public, many businesses and their advisors and most governments continue to underrate this uncertainty. Some, indeed, display overconfidence bordering on hubris with respect to their ability to navigate through it; and a select few breezily dismiss the probability that their actions will have negative, harmful or unintended consequences. Therein lie both risks and rewards. As Mr Buffett concluded during Berkshire's AGM: "the ability [today] to monetise share holding ignorance has never been exceeded."

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Issue 6 June 2000

"Self-love, my liege, is not so vile a sin as self-neglecting."

Shakespeare's *Henry V*

This month's Newsletter emphasises the negative consequences which can occur – and, I believe, continue to occur – when participants in markets discount hard evidence, ignore elementary rules of logic and succumb to emotion and unwarranted optimism. In so doing, they neglect the very self-interest which their emotional and optimistic impulses sought to promote.

A Modern ESOPs Fable

In a recent circular to shareholders entitled Brickbrats to Share Options I described share options, the perverse incentives which they present to managers and the damage which they often do to companies' owners. Other things equal, Leithner & Co. therefore avoids businesses which issue options over shares to their managers or employees. Many businesses which use cash properly and systematically to recompense their staff – from the greying executive in the board room to the pimply teenager in the mail room – are nonetheless able to reward their shareholders commensurately for the risks which inhere in the investment of capital. Conversely, the more arbitrarily and lavishly companies remunerate their executives and other selected staff, i.e., the more they use options over shares, the more poorly they tend to reward their shareholders.

On 16 May 2000, a series of articles and an editorial in *The Australian Financial Review*discussed Employee Share Option Plans (ESOPs). One of the articles, a front-page lead, began with the sentence "the retreat in the share prices of technology stocks has hit many employee share schemes, leaving participants sitting on sizeable paper losses."

Warner reports that "some dot-com employees are learning the hard way that theirstock options are not only worthless, but can wind up costing them money. it's the new-economy dream gone horribly awry. What's happened is that some dot-com option-holders have had to pay more money in taxes than they could hope to make selling shares of their deflated stock in the public markets. This is the ugly fine print of the options culture. It's horribly arcane and it depends on what kind of stock options you have, but few people who signed up for an exciting job at a startup worried about such things."Australian and U.S. tax law, and the fine print of

Australian and American options contracts, clearly differ in a number of important respects. The concluding sentence of Warner's article, however, applies not just to its intended audience but also to Australian employees who participate in employee share option schemes and Australian investors who subsidise them. Hence a modern "ESOPs Fable" which is a by-product of the dot-com, IT and startups mania, which in turn derives from loose credit, blind optimism and naked greed: "when the market's going up, everyone thinks that they'll get options and be the next dot-com millionaire but I think there are going to be more [horror] stories like this."

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A New Book for Value Investors

Henry David Thoreau, a resident of Walden Pond, near Concord, New Hampshire, wrote in his diary "how many a man has dated a new era in his life from the reading of a book? The book exists for us perchance which will explain our miracles and reveal new ones." Two pessimistic books, each published in April, are probably not changing people's lives. Arguably, however, they describe and analyse something which is a matter of wonder and amazement; and judging from their sales and reviews, they seem to be catching people's attention.

The first book is *Valuing Wall Street: Protecting Wealth in Turbulent Markets* (McGraw-Hill Professional Publishing, ISBN 0071354611) by Andrew Smithers and Stephen Wright of the London financial consulting firm Smithers & Co. At the book's heart is the Q Ratio, devised by Nobel Laureate James Tobin in 1969, which tracks the ratio between the market value and net worth (i.e., physical and financial assets minus liabilities) of publicly-traded securities. Tobin designed Q as a measure of the cost of capital: the higher its value the lower the cost. Smithers & Co. use it differently, i.e., as a measure of the value of both an individual security and the overall market. To their (and Benjamin Graham's) thinking, if a company's stock is priced very high relative to its tangible net assets then it is probably overvalued; and the higher the average stock's ratio of price to book value, the dearer the market as a whole. On the basis of the value of Q, Smithers and Wright warn that overall equity prices in the U.S. are currently dearer than at any time in the twentieth century. Indeed, "since Q shows the stock market to be overvalued by more than twice, a fall of 50% to 60%, or more, is likely [and] could easily bring the Dow Jones Index to under 4,000."

Gene Epstein, writing in *Barron's Online* on 15 May 2000, made three important points with respect to this prediction. First, he noted that Smithers & Co. has been sounding this warning since 1996. Second, Q measures tangible assets but excludes intangible assets. Examples of intangible assets include the patent on Viagra, the copyright on Windows98, brand names like Coca-Cola, the masthead of *The Wall Street Journal* and trade secrets like Colonel Sanders' recipe for Kentucky Fried Chicken. Third, if these intangibles (whose value, alas, defies anything other than crude measurement) were included in the denominator of Q then its value would be lower and the inference about the valuation of individual stocks and the overall market "less drastic." The critical and unanswered question – how much less drastic?

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Another New Book for Value Investors

The second new book is *Irrational Exuberance* (Princeton University Press, ISBN 0691050627). Its author, Yale University economist Robert J. Shiller, is one of the leading scholars of behavioural finance (a field of study which combines psychology and economics). His book, the subject of a review in the 3 April edition of *Business Week* and the lead article of the 22 May 2000 edition of *Barron's Online*, attacks mantras ranging from the efficient market hypothesis to the stocks-beat-bonds-over-the-long-term hypothesis. It also suggests that no explanation – including the technology-driven New Economy and Baby Boomers' scramble to accumulate assets for retirement – accounts adequately for the high valuations prevailing today on Wall Street.

Shiller concludes that the behaviour of an "irrationally exuberant" (a phrase he used early in 1996 in a briefing note to Federal Reserve Chairman Alan Greenspan) herd has driven American financial markets to unsustainable heights. For each month between 1880 and early 2000, he calculated the stock market's price-earnings ratio. The figure has varied from 5.0 during the 1920-21 depression and the nadir of the Great Depression to 44.3 in January 2000. This latter figure dwarfs the previous record (32.6 set in September 1929) and in Shiller's view makes a "correction" inevitable. It is noteworthy that, stripped of their econometric embellishments, Shiller's logic and evidence parallel those of Charles Kindleberger, the University of Chicago's historically-inclined scholar of financial speculation and author of the classic *Manias, Panics and Crashes: A History of Financial Crises.*

Shiller notes that the correction which he is predicting need not be short and sharp, but rather can unfold over years or even decades. During the period 1901-21, for example, American equity markets gradually lost two-thirds of their real value and earned an average annual return of minus 0.2% per year. The years which followed the Great Crash were little better: from peak in 1929 to trough in 1932 the S&P 500 lost 80% of its value and from 1929 to 1949 returned an average of 0.4% per year. Finally, between 1966 and 1986 its return net of inflation averaged 1.9% per annum. If history is any guide (Shiller reckons that it is) then American investors should not expect more than modest real returns from their investments during the next ten or more years. (Warren Buffett, in a series of outstanding speeches edited by *Fortune* writer Carol Loomis in 1999, draws the same conclusion).

Gene Esptein has also criticised Shiller's methods and questions his conclusions. In the 8 May 2000 issue of *Barron's Online* he stated they discount the "big earnings surge of recent years," attenuate the denominator of the price-earnings ratio and thereby greatly exaggerate the level of the market's earnings multiple since the mid-1990s. Further, the 430-odd non-technology companies in the S&P 500 are selling for approximately 16 times earnings – a figure which only modestly exceeds their long-run historical average. (A rough parallel, it seems to me, currently exists in Australia: the same market which overvalues most high-profile 'blue chip' and 'tech' companies also undervalues a select number of low-profile medium and small firms).

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Australian Blue Chip and Tech 'Cover Stories'

I follow closely and take seriously the writings of James Grant, publisher of *Grant's Interest Rate Observer* and author of several outstanding books. In the preface to *The Trouble With Prosperity: A Contrarian's Tale of Boom, Bust and Speculation* Grant asked and answered (to my satisfaction, at least) what has probably been the key question posed by participants in financial markets during the past five-or-so years: "...have we, then, reached a new Garden of Eden? Categorically, no. I base this assertion on the tendency of people in markets to miscalculate – to invest too much and then too little – and to rationalise these errors with a macroeconomic cover story" (italics added).

Borrowing Grant's phrase, since the beginning of May a "cover story" about Telstra Corp. Ltd has been clearly discernible. This story, in the form of a spate of negative articles and media commentary, seemingly rationalises what in retrospect appears to be the error of participating in the Telstra 2 float (or, equivalently, of buying Telstra at prices prevailing during the past couple of years). A "Solution 6 cover story," which excuses speculators for paying up to $18.00 in January for a security which was quoted at less than $3.00 in May, has also been prominent during the past few weeks. And on 27-28 May *The Australian Financial Review* published what may the first instalment of a "News Corp. cover story" which will absolve many funds managers and investment institutions for paying up to $26.00 in April for the NCP scrip which they sold for $12.00 in December.

Why the cover stories? As detailed in a new circular to shareholders dated 1 July 2000, experts have preferred and continue to prefer implausibly optimistic to conservative assumptions, anecdotes rather than explicit reasoning and woolly words to hard numbers. In so doing they have miscalculated: as demonstrated in new circulars dated 15 July and 1 August, the use of very generous (to the companies concerned) assumptions, simple-yet-rigorous reasoning and information readily and continually available to the general public to yields the conclusion that the purchase at current prices of the shares of many of Australia's largest companies and seemingly safest 'blue-chip' securities does not provide what Benjamin Graham called a "margin of safety." Nor, even at their much-reduced prices, do the fallen market darlings of the tech sector.

The prevalence of cover stories may be a symptom that experts have neglected plausible assumptions, explicit reasoning and hard numbers, and that they now seek to distract attention from that neglect. (In President Harry Truman's words: "an expert is someone who doesn't want to learn anything new, because then he wouldn't be an expert").

Accordingly, it seems to me that brokers, financial analysts, planners, journalists and commentators should be studying not only Smithers' and Wright's *Valuing Wall Street* and Schiller's *Irrational Exuberance*: equally importantly, they should be pondering the implications of Shakespeare's *Henry V*.

New Circulars to Shareholders

- Australian 'Blue-Chip Cover Stories' (1 July 2000)
- 'Irrational Exuberance' in Australia: Part I (15 July 2000)
- 'Irrational Exuberance' in Australia: Part II (1 August 2000)

The Year Ahead

Leithner & Co. has avoided and continues to steer clear of 'blue chips' (which in most cases are overpriced) and tech companies (which in many cases are doomed to extinction). Its cash weighting is also high. At the same time, however, a small number of quality Australian financial assets have been and remain available at prices attractive to value investors. This stance, unconventional to many people, is particularly out-of-step with the distemper of the times. It seems to me, however, that it is both prudent and conservative. A circular to shareholders, to be dated 15 August 2000 and released early in the new financial year, will justify this position and thereby outline the gist of the Company's intended operations during the next twelve months.

Chris Leithner

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Issue 7 July 2000

The Best Value Investor You've Never Heard Of

From a modest and nondescript flat at Des Moines Iowa, Joseph Rosenfield, 96 years of age and friend of Warren Buffett for almost 40 years, has made fewer than a half-dozen major investments. For this and other reasons Mr Buffett calls him "a model of unconventional rationality." Going about his business quietly and modestly (and with assistance from Mr Buffett during the late 1960s and early 1970s), in little more than 30 years Mr Rosenfield has transformed an $11 million endowment into an investment juggernaut with a market value of approximately $1 billion. Grinnell College has 1,300 students, a 108-acre campus, a solid reputation in educational circles and – thanks to Mr Rosenfield – the largest endowment per student of any private liberal arts college in the U.S.

Grinnell's nest egg not only dwarfs those of top-ranked liberal arts schools such as Amherst and Vassar: it is also bigger than the endowment funds of major universities including Carnegie-Mellon and Georgetown. Yet very few people – including the students who have benefited so much from his actions – would recognise his name or face. Jason Zweig's article in the June 2000 issue of *Money*, "The Best Investor You've Never Heard Of," tells a story worth reading, an investment parable worth studying and an approach to ethics and life well worth emulating.

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Risk and Risk Control in an Era of Confidence (or Is It Greed?)

It seems to me that many market participants (whether as individuals or employees of investment institutions) are, notwithstanding the severe volatility encountered during April and May, continuing to discount hard evidence, ignore elementary rules of logic and succumb to emotion and unwarranted optimism. Some are doing so by equating hard facts, woolly hype and optimistic predictions; others are doing so by confusing quantitative dexterity with logical rigour. If so, then they under-estimate the risks which inhere in the allocation of investment capital. As Benjamin Graham wrote of Wall Street's frenzy during the late 1920s, "...there was nothing wrong with these ['New Economy'] ideas, except that it was almost impossible not to carry them too far. With encouragement from the past and a rosy prospect in the future, the buyers of 'growth stocks' were certain to lose their sense of proportion and pay excessive prices. For no clear-cut arithmetic sets a limit to the present value of a constantly increasing earning power. Such issues could become worth any value set upon them by an optimistic market."

John C. Bogle, founder and former chief executive of The Vanguard Group and currently the president of Vanguard's Bogle Financial Markets Research Center, stands apart from this crowd. The text of his speech, entitled "Risk and Risk Control in an Era of Confidence (or is it Greed?)" and delivered on 6 April 2000 to the New England Pension Consultants' Client Conference, Boston, Massachusetts, therefore deserves close study.Bogle's speech consists in three key premises. First, investing comprises four key elements: reward, risk, time and cost. One element, reward, is beyond the investor's control. In Bogle's words, "future stock market returns are completely unpredictable in the short-run and-unless we know more about the world 25-years from now then we do about the world today-may prove even less predictable over the long-run." Bogle believes that investors can control the other three primary determinants of investing and that they should focus on them.

Bogle's second premise is that (although we cannot control them) the rewards derived from any given investment is based upon the stream of earnings (if any) which that investment will generate in the future. "The purpose of any stock market, after all, is simply to provide liquidity for stocks in return for the promise of future cash flows, enabling investors to realise the present value of a future stream of income at any time."

Bogle's third premise is that "the sheer mathematics of the market – *even assuming the continuation of box-car growth rates that are by no means assured* – [seems currently] to defy reason. A recent analysis by Professor Jeremy Siegel (author of *Stocks for the Long-Run*) considered the nine large-cap companies that are currently priced at over 100 times 1999 earnings. Dr. Siegel accepted, for argument's sake, that the earnings of these companies would grow at their estimated average rate of 33% per year(!) over the coming decade-an even higher rate than I assumed earlier. Even so, for investors to earn a 15% annual return, they would have to sell at an average of 95 times their earnings five years from now, and 46½ times their earnings a decade hence. Based on his analysis of the Nifty-Fifty era of the early 1970s, he reports 'no stock that sold above a 50 p/e was able to match the S&P 500 over the next quarter-century.' His conclusion: 'Big-Cap Tech Stocks Are a Sucker Bet.'" In recent weeks, alas, a bet which more and more Australian investors are willingly undertaking.

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Australia's New Financial Year and the Case for Reasoned Scepticism

Like Warren Buffett, John Bogle believes that many of today's 'investments' are riskier propositions than their owners realise. He also believes that investors should reduce their expectations about future rewards – which, he hastens to remind us, are beyond the investor's direct control – to more realistic levels. Messrs Buffett and Bogle thereby echo an admonition uttered by Benjamin Graham during the 1930s: "We [Graham and his co-author, David Dodd] have been trying to point out that this concept of an indefinitely favourable future is dangerous, even if it is true; because even if it is true you can easily overvalue the security, since you make it worth anything you want it to be worth. Beyond this, it is particularly dangerous too, because sometimes your ideas of the future turn out to be wrong. Then you have paid an awful lot for a future that isn't there. Your position then is pretty bad." Mr Buffett re-iterated this fundamental point at Berkshire Hathaway's 1998 Annual Meeting: "investors making purchases in an overheated market need to recognise that it may often take an extended period for the value of even an outstanding company to catch up with the price they paid."

The beginning of Australia's financial year is an appropriate a time to set out plans and strategies. Two new circulars to shareholders, dated 15 August and 1 September, describe Leithner & Co.'s policy of "reasoned scepticism" (the opposite of Robert Shiller's evocative phrase "irrational exuberance") and how it proposes over the next year to address key investment risks.

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Issue 8 August 2000

Three Pointless Obsessions

Most market participants, including institutions, brokers, advisors and private investors, obsess about 'the economy,' its growth and the statistics such as Gross Domestic Product devised to measure its size and growth. Most agree that contraction and slow growth are bad, that rapid growth is also bad – lest it generate inflation and prompt the central bank to increase interest rates – and that moderate growth is good. Hence the attention paid and discussion devoted around the world to central banks' attempts to engineer 'soft landings' (reductions of GDP's rate of growth from the rapid to the moderate range) and 'recoveries' (increases of growth from the slow to the moderate range). And consequently the prominence accorded to attempts – much like those of the gizzard squeezers' endeavours to tell Roman Emperors when the Huns would attack – to forecast levels of and rates of change in GDP.

Yet 'the economy' is a virtually meaningless figure of speech; and a fixation upon GDP and other aggregate-level statistics distracts rather than informs investors. A recent article entitled *Does the Concept of an Economy Make Sense?* by Dr Frank Shostak, Chief Economist at Ord Minnett Jardine Fleming Futures, provides a salutary reminder of these key points.

'The economy' is a virtually meaningless phrase because economic transactions cannot be distinguished from the individuals and firms which undertake them. In Dr Shostak's words, "in the real world there is no such thing as national output. All wealth is produced by somebody and belongs to somebody. Goods and services are not produced in totality and supervised by one supremo." Because individuals have different preferences and their goals change over time, governments' ability to manipulate their transactions will be clumsy, their capacity to predict transactions' course will be crude – and their attempt to summarise the transactions of large numbers of entrepreneurs, producers and consumers, buyers and sellers and importers and exporters in terms of a single number, GDP, will obscure much that is important and illuminate surprisingly little that is relevant.

Accordingly, for value investors the relevant figures on which analyses are based are not the aggregate-level statistics such as GDP, employment, balance of payments, etc. which are assembled by the Australian Bureau of Statistics. Rather, the appropriate data are the company-level profit-and-loss statements (which, under new accounting standards, become statements of financial performance), balance sheets and statements of cash flow produced by companies' accountants and auditors.

Plus Ça Change

Investment institutions, brokers, advisors and private investors – not to mention many business people and homeowners – also tend to obsess about interest rates. This obsession takes the form of extensive discussion, prediction and speculation about their direction and level. On 2 August, in an announcement whose timing surprised some pundits, the Reserve Bank of Australia increased its official cash rate (i.e., the rate of interest charged to funds lent between banks and other institutions) by one-quarter of a percentage point.

This second obsession is also pointless. (Warren Buffett once famously remarked: "if Fed Chairman Alan Greenspan were to whisper to me what his monetary policy was going to be over the next two years, it wouldn't change one thing I do"). Obsession about interest rates is futile because the key question to ask about the price of credit relates not to its level and short-term direction but rather to its integrity. Artificially-low and stable terms of credit – 'easy money' – can introduce distortions into and mask deformations in the chains of transactions from the production of raw materials to the final consumption of particular goods and services. Hence value investors ignore the chatter and ask themselves whether today's prices of credit reasonably reflect people's valuation of time. Do these prices, in other words, convey plausible signals about the extent to which people are willing to forego consumption today and direct their savings into investments? Do they communicate reasonable expectations about these investments' ability to generate greater consumption tomorrow? Acting on these signals, would entrepreneurs and investors make remunerative and sustainable choices? Or would they be tempted to undertake 'malinvestments' which must eventually be liquidated?

In this context, the circular to shareholders entitled Is Australia Really a Low-Inflation Country? and dated 15 March 2000 remains relevant. The defining feature of credit-induced booms, it seems to me, is not that they are periods of when the pace of business activity is brisk. Rather, they are times when the artificially-low price of credit tempts entrepreneurs to squander precious capital on dud investments.

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Woolly Words, Hard Numbers and Tacit Speculation

On 27 July The Broken Hill Proprietary Co. Ltd released its preliminary financial statements for the 13-month period ended 30 June 2000. Befitting its position as one of Australia's largest listed companies, BHP's results have been the subject of extensive discussion and comment.

Two aspects of this discussion are noteworthy. The first is the profusion of soft words, the paucity of firm figures and historical perspective – and the virtual absence of hard logic. Obscured within the fog of words, for example, are the company's Earnings Per Share (E.P.S.) of approximately – depending upon one's assessment of 'abnormal' items – $1.05. On the one hand, E.P.S. have rebounded smartly from the record loss of $1.34 recorded in 1998-1999. Yet E.P.S. for the financial year just ended – which were derived from the largest profit (measured in absolute terms) in BHP's history – are virtually identical to those recorded in 1994-1995. BHP currently boasts a high (20%) return on shareholders' equity. But this impressive figure owes much to the fact that more than half of the company's per-share book value has been destroyed since 1997 (the smaller the number x by which one divides another number y, the bigger the resulting number z). Finally, BHP's unfranked dividend, $0.47 per share, is the lowest since 1994; and since 1991 dividends have increased at a compound rate of just 3% per annum.

The coverage of BHP's results did not emphasise these points. Nor did it underscore the laudable attempt of BHP's Chief Financial Officer to note the undoubted strengths but to downplay the blue-sky potential of its present operations. Hence the second aspect of journalists' coverage – its accentuation of possible upsides and attenuation of possible downsides. One commentator in *The Australian* crowed on 28 July: "if [Chief Executive Officer Paul] Anderson can keep it up – and there is every indication that he will – then BHP's share price will be re-rated to recognise the strength of its management." One journalist stated that "during the next five years, Mr Anderson aims to double BHP's share price to $40, and market capitalisation to around $60b, giving it the size and liquidity needed to win the backing of the world's largest institutional investors." Another of *The Australian*'s journalists quoted Mr Anderson: "if we can't get to $40 in the next few years, then we aren't doing our jobs."

Brave Assumptions and Hard Facts stand in the way of this objective. First, if the price of BHP shares is to double during the next five years, then either its E.P.S. must double, or the multiple which market participants attach to earnings must double, or some combination of the two must occur. Second, to assume that its earnings multiple will double is to assume that it will increase from approximately 20 (not far from the All Ordinaries' current average) to 40 (nose-bleed territory). Third, to assume that E.P.S. will double during the next five years is to believe that they will grow at a compound rate of

15% per annum during that interim. Fourth, to make that third assumption is to take for granted something which has not occurred in living memory (as *The Australian*'s otherwise-crowing commentator confided on 28 July: "apart from brief periods, BHP management has not had the confidence of [investment] institutions for two decades"). Fifth, it is worth recalling that upon his accession to the helm of Boral Ltd, its then-CEO, Mr Tony Berg, also prophesised (in response to baiting by journalists) that its share price would double. Five years later the price of its shares had not doubled – quite the contrary: it had decreased – and Mr Berg was no longer at the helm.

An increase of 100% in the price of BHP's shares during the next five years thus implies either that these already-ambitious (judging from the historical record) expectations about its operations will turn out to be conservative or that its share price will increase more quickly than its earnings. Over the long term (which is admittedly longer than five years), however, the intrinsic value of an asset cannot grow faster than the earnings which it generates. Accordingly, and as the circular dated 1 September shows, the juxtaposition by market participants of modest past results and exuberant expectations about the future is fraught with risk. (Another oft-quoted Buffettism: "Our conclusion is that, with few exceptions, when management with a reputation for brilliance tackles a business with a reputation for poor economics, it is the reputation of the business that remains intact.") If so, then a startling possibility stares us in the face: during the next five years Mr Anderson and a significant number of other 'blue chip' CEOs will innocently but nonetheless to a significant extent rely upon speculators – and the market price fluctuations on which they thrive – to do their jobs. (Perhaps that's one reason why Australian CEOs and speculators are beginning to exhibit American-style appetites for options over shares).

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'Risk Management' Leads Back to Graham and Dodd

This sobering point begs questions about the conventional definition of risk and the practice of 'risk management.' Most market participants have a third obsession: they define *investment risk* in terms of the short-term ups-and-downs of a security's market price. As a result, the practice of *investment risk management* is conventionally understood as an attempt to reduce within acceptable bounds the short-term variability – particularly in a downwards direction – of an investment portfolio's current market worth.

A small and reprobate minority, value investors in the Graham-and-Dodd mould, disregard both the conventional definition of investment risk and the standard practice of investment risk management. In Benjamin Graham's words, "basically price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. *At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies"* (italics added). The first of a series of new circulars to shareholders, dated 15 September, sets out assumptions which subsume this key conclusion. Considered as a whole, the circulars encapsulate Leithner & Co.'s conception of investment risk, practice of 'investment risk management' and disavowal of pointless obsessions.

Chris Leithner

Disclaimer

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Telstra and Mr Market

Telstra Corp. Ltd, Australia's second-largest listed company, is clearly a formidable enterprise. Despite a ratings downgrade earlier this year and the possibility of a further downgrade in the months ahead, it nonetheless retains one of corporate Australia's highest credit ratings. And at the end of August it reported the largest 12-month profit ($A3,700 million) in Australian corporate history.

Value investors in the Graham-and-Buffett mould seek to purchase sound assets – on the critical condition that they are available at a bargain price. In their search for value at a sensible price they bear in mind Benjamin Graham's motto that "you are neither right nor wrong because the crowd disagrees with you, [but] because your data and reasoning are right.... The right kind of investor [takes] added satisfaction from the thought that his operations are exactly opposite to those of the crowd."

With that attitude in mind, in a circular to shareholders dated 15 November 1999 and entitled Telstra: A Contrarian Case for Caution, I set out assumptions and reasoning which yielded the (at the time contrary) conclusion that the market price of Telstra's securities exceeded their value. I wrote that "if this contrarian case holds water then the conventional wisdom has recently encouraged 1.6 million Australians to undertake what will turn out to be a mediocre long-term investment." Since then the prices of Telstra's securities – like those of many of their American, British and other counterparts – have fallen significantly. Telstra presently hovers at an 18-month low (common stock) and an all-time low (IRs).

In response to this development, the attention and energy of Telstra's senior management, its major shareholder (the Commonwealth Parliament) and market participants seem presently to be focussed at least as much upon day-to-day fluctuations in the company's share price as they are upon its present and future operations. The 8 September cover story of *Business Review Weekly* fret about Telstra's share price. On 7 September *The Australian Financial Review* reported that management was considering the unusual step of releasing details about its first-quarter operations "to try to shore up its collapsing share price." AFR also reported that the "lacklustre share price is causing nervousness among government ministers, who are worried the small army of Telstra shareholders might react adversely to potentially large paper losses." One of its editorialists reported that both its Chairman and CEO met secretly in Parliament House on 6 September with the Finance Minister and Communications Minister. "And it's a sure bet that the meeting discussed the vexed issue of the company's share price and the looming date for shareholders to convert their instalment receipts into full shares." (Non-institutional investors paid $4.50 per IR in November 1999 and must pay a further $2.90 in November 2000 in order to convert it into a fully-paid common share).

The fall from grace of Telstra's share price also seems to be causing nervousness among minority shareholders. Robert Gottliebsen has written unequivocally of "the panic to get out of Telstra." According to Gottliebsen, "there is a crisis. if Telstra shares remain at their current level, then we will be looking at a huge public share loss spread around an unprecedented number of people. The political consequences will be massive." (*The Weekend Australian* 9-10 September).

Seemingly as a by-product of their obsession with the decrease of its share price, Mr Market and his hangers-on have become gloomy with respect to Telstra's current operations and outlook for the future. Recent headlines are unequivocal: 'Telstra Adrift in Sea of Doubt' (*The Australian* 29 August), 'Telstra Under Pressure' (*The Australian* 31 August), 'Investors Turn Torch on Telstra' (*The Australian* 7 September), 'Telstra Facing a Loss of Faith' (*The AFR* 6 September) and 'Telstra Alarm Bells Ringing' (*The AFR* 7 September). And for good measure, in an article entitled 'Telstra Is Bringing Us All Down', Alan Kohler stated that senior management's "strategic failure to deal with the digital revolution" has caused not just the fall of the prices of Telstra's securities: it has much to do with the recent decline to record lows of the $A vis-à-vis the Yen and $US (*The AFR Weekend Edition* 9-10 September). The implicit rule: Anything That Is The Matter Down Under is henceforth to be blamed upon the perceived shortcomings in Telstra's management.

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Graham Has Been Forgotten...

Two points – each of which is simple, fundamental and therefore publicly unutterable in finance and investment circles – emerge from the Telstra Share Price Saga. The first is that 'regression to the mean' or something akin to it occurs on financial markets.

Benjamin Graham premised his investment research and practice upon three axioms: a security's price and value can and often do diverge; they may sometimes diverge for uncomfortably long periods of time; but eventually they will converge towards one another. The considerable success of Graham-Newman Corp. owed much to the increase of the prices of sound-but-unfashionable securities, bought at depressed market prices, towards their intrinsic value. Conversely, if the price of company's securities are bid above their value by euphoric buyers, then – *even when the company's basic operations and prospects remain unchanged* – it is likely that, like Icarus, it will eventually fall from its rarified level. It is possible that 1.6m or more Australians are unwittingly experiencing this unpleasant reality. (For more on regression to the mean, see the circulars entitled Australian 'Blue-Chip Cover Stories' and The Mass Media and Value Investing).

"Analysts" cited in the Australian press (*The Courier-Mail* 2 September, *The Weekend Australian* 2-3 September) have tended to "advise" readers not to be swayed by day-to-day price movements and to retain their Telstra Instalment Receipts for the "long-term." Similarly, the Prime Minister, Mr Howard, told Melbourne Radio 3AW on 1 September that "I don't give a day-to-day commentary and I would simply make the observation that people should take the long view."

Taken at face value (and thus possibly unfairly), these analysts and advisors appear to be oblivious both to the basic distinction between price and value and to their tendency eventually to converge. Warren Buffett has described one consequence of this omission: "investors making purchases in an overheated market need to recognise that it may often take an extended period for the value of even an outstanding company to catch up with what they paid." Perhaps that is what the Prime Minister, together with many stockbrokers, funds managers, financial advisors and media commentators, mean when they continue to say – as they said at the time of the T2 float – that Telstra is a long-term investment. If they have paid a price which exceeds its value, then the owners of Telstra IRs may have to wait a long time – and in the process incur a significant opportunity cost – for their investment to generate its expected return.

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...and Kahneman and Tversky Have Never Been Learnt

On the other hand they might decide to cut their losses and sell. In this respect a second elementary, fundamental and (with one partial exception) unuttered point emerges from the Telstra saga: the "advice" tendered by these "analysts" appears to be oblivious to key findings – such as the aversion to loss, 'sunk cost fallacy,' 'endowment effect' and 'framing' – of behavioural finance. This fascinating field of study, also known as behavioural economics or the psychology of economic misjudgement, draws insights in approximately equal measure from both economics and psychology. As shown by its founders Daniel Kahneman, Richard Thaler and the late Amos Tversky, money, finance and investing figure prominently among those things which render individuals uncertain, anxious and confused. Indeed, research in this field helps to explain why many otherwise-sensible people repeatedly make retrospectively-foolish financial choices. This very point inspires *Why Smart People Make Big Money Mistakes and How to Correct Them: Lessons from the New Science of Behavioral Economics* (Simon & Schuster, 1999), an excellent book written for a general audience by Gary Belsky and Thomas Gilovich.

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Some Good Introductions to Behavioural Economics

Behavioural finance, it seems to me, is hardly a be-all-and-end-all. It is, however, an important tool with which to uncover and confront the biases which can impair one's financial decisions. Everyone knows that optical illusions distort the way we 'see.' Now scholars are discovering that cognitive illusions – sets of biases imbedded within the human mind – distort the way we think. Charles Munger, Vice-Chairman of Berkshire Hathaway, has stated that "I came to the psychology of human misjudgement almost against my will; I rejected it until I realised that my attitude was costing me a lot of money."

A short article by Scott Medintz entitled Reading Between the Lines provides an entrée to this field. Medintz writes that "the new science of behavioral finance can help investors understand why they make mistakes – and how to prevent the next one. Investing mistakes, like most things we do, have both immediate causes and more fundamental ones. Didn't do your homework on a stock that tanked soon after you bought it? Your more fundamental error may have been crediting previous lucky moves to skill, and thereby grossly over estimating your investing abilities. In fact, psychological factors lurk behind many, if not all, common investor slip-ups – so much so that a whole academic discipline called behavioral finance has developed to study them."

Whitney Tilson's article entitled The Danger of Investor Overconfidence on *The Motley Fool*'s website provides a concise (3pp) introductory overview of some of the field's major insights. The end of the article also contains useful links. Tilson notes correctly that investment decisions and performance can be affected more by emotions than intellect. Warren Buffett agrees: "success in investing doesn't correlate with IQ once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."

Undiscovered Managers, a money management firm based at Dallas, Texas, has put together a simple and concise Introduction to Behavioral Finance. Their Behavioural Finance Research Library contains academic research from leading scholars in the field. Of particular relevance are Terrence Odean's Boys Will Be Boys: Gender, Overconfidence and Common Stock Investment and Are Investors Reluctant to Realize Their Losses?

Finally, if you can spare 40 minutes, then the time spent listening to the audio interview conducted on 8 October 1999 (that's 10-8-99 on Wall Street Uncut's website) between Gary Belsky and Dave Allman will be time well-spent.

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Graham Has the Last Word

It seems to me that we have a psychological error and a cognitive misconception to thank for the angst presently being experienced by Telstra's owners. The psychological error derives from the overconfidence of investors, both institutional and individual; and the cognitive misconception stems ultimately from the conventional but mistaken conflation of investment risk and short-term price volatility. Circulars to shareholders entitled Reasoned Scepticism versus Irrational Exuberance outline the steps Leithner & Co. takes to combat overconfidence; and Value Investing, Risk and Risk Management set out its conception of investment risk and practice of 'investment risk management.'

In Graham's words "... the risk of paying too high a price for good quality stocks – which is a real one – is not the chief hazard confronting the average buyer of securities. Observation over many years has taught us that the chief losses to investors come from the purchase of lower than expected quality at times of favourable business conditions. thus it follows that most of the fair-weather investments, acquired at fair-weather prices, are destined to suffer disturbing price declines when the horizon clouds over – and often sooner than that." The owners of Telstra Instalment Receipts are hardly the only ones who might ponder those words.

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Issue 10 Oct 2000

Olympic Ecstasy and Currency Agony

Wonderful Olympic Games were staged in Australia's centre of culture and commerce. The pre-Games torch relay, which visited far-flung points across the continent, elicited great interest. Visitors, participants and officials marvelled at Australians' hospitality and eagerness to cheer athletes from all nations. The host country's participants distinguished themselves in myriad ways – conspicuously but not only in the medal tally – and thereby reinforced Australia's reputation as a young and virile nation (and, not incidentally, an eminently desirable destination for migrants). At the Games' close the organisers, facilities and supporting infrastructure were praised effusively.

To be sure, political and other controversies, some self-inflicted and others beyond the hosts' control, preceded and attended the Games. But nothing could distract attention from the central fact that Australians – organisers, volunteers and participants alike – outdid themselves. In a way that had seldom occurred before, the host country basked in plaudits, accolades and admiration from around the world. Indeed, more than one VIP reckoned that these Games were the best ever; and several journalists added only half in jest that they should be staged permanently in the Land of Oz. From many perspectives, then, the Melbourne Games of 1956 stand out as one of the finest episodes in modern Australian history.

The Melbourne Olympiad deserves to be regarded as the more successful of the two staged in Australia. This is because Melbourne 1956 possessed three attributes which Sydney 2000 most conspicuously lacked. First, the 1956 Games did not cost heaven and earth. They were preceded by neither billions of expenditure for opulent sporting and other infrastructure; nor hundreds of millions of extravagance for athletes and hangers-on; nor tens of millions for corporate élites to "network" and lavishly entertain one another. Second, as noted by Brian Toohey in *The Australian Financial Review*, the Melbourne Games were not followed by extraordinary outbursts of false premises, invalid logic, disingenuity and sheer babble with respect to their "meaning for Australia." Finally, and most symbolically, the timing of the 1956 Games did not coincide with falls to record lows of the purchasing power of the Australian currency vis-à-vis its American counterpart. If Melbourne 1956 characterised the restrained sobriety of its day, then Sydney 2000 epitomises the overextended distemper of ours.

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Exporters and Importers; Creditors and Debtors; Investors and Consumers

The impact of a change in the price of one currency with respect to others is not a straightforward matter. This is partly because it depends upon things which nobody can know (although a fair few seem to pretend that they do), i.e., how considerable the change will be and whether it will be ephemeral or enduring. Its impact is also less than clear-cut because it depends whether one is an importer or an exporter, and therefore upon the foreign currency which one must buy or sell in order to transact business; whether one is a debtor or a creditor, and therefore upon the currency which one is borrowing or lending; and whether one is a consumer or an investor, and therefore upon the currency with which one accumulates or fritters assets. Many Australians simultaneously wear several of these hats. They also wear them in assorted shapes and sizes and for different periods of time. It is likely, then, that the type and severity of the impact of the $A's fall will vary – perhaps considerably – from one individual and company to another.

That said, two points can be made. First, it is apparent that as individuals, Australians –

and, for that matter, Americans, Britons, Canadians and New Zealanders – have demonstrated repeatedly that they are capable of importing and consuming prodigious quantities of goods and services. Second, in recent years they have not, by and large, demonstrated the resolution required in order voluntarily to accumulate sufficient nest eggs to finance this high level of consumption. Accordingly – and thanks to the spendthrift habits developed during the second half of the twentieth century – despite the superficial appearance of wealth and prosperity their pockets (net of accumulated debt) are often surprisingly shallow. Without secure and well-paid employment, ongoing forbearance from creditors – and, in no small number of instances, the disposal of assets – few can support the habits of consumption which they increasingly regard as their birthright.

These points have an important consequence. To the extent that creditors ultimately prevail over debtors (citizens and their governments are a glaring exception), and to the extent that a bear market restores wealth to its patient and rightful owners, then the depreciation of the $A vis-à-vis the $US, if it is sustained, will pose challenges to consumers, importers and debtors. It may thereby present opportunities to creditors, exporters and investors. Indeed, irrespective of any change in exchange rates the gulf between psychological expectation and financial reality fostered by easy access to credit and celebration of debt is creating significant strains in many individual Australians' finances. There are signs (interest-cover ratios, gearing, comments by ratings agencies and other indicators of creditworthiness) that the quality of Australian corporate debt has also deteriorated during recent boom conditions.

These developments may create significant opportunities for individuals and companies who possess much cash, a bit of acumen and no debt. To borrow Warren Buffett's words, "when much of the rest of the investing world, burdened by debt, encounters some crisis forcing a panic, [they] are standing there with no debt and a loaded gun of cash ready to bag rare and fast-moving elephants," A new circular to shareholders, dated 1 December and entitled "Australia's Post-Olympic Reality Cheque," details the assumptions and reasoning from which this key conclusion is derived. It summarises Leithner & Co.'s proudly, irredeemably and appallingly 'un-Australian' attitude towards debt – and the country's leveraged condition and Brass Age.

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Two Interviews With James Grant

I owe these last two phrases to James Grant, publisher of *Grant's Interest Rate Observer*. I'm a great admirer of Grant's theoretical rigour, historical perspective, contemporary relevance, trenchant style and mordant but engaging wit. These virtues appear in abundance in his books *Money of the Mind: Borrowing and Lending in America from the Civil War to Michael Milken* and *Minding Mr Market: Ten Years on Wall Street With Grant's Interest Rates Observer.*

Good books transcend time and place. Although it was published in 1996 and its subject matter is mostly American, it seems to me that a careful reading of Grant's *The Trouble With Prosperity: A Contrarian's Tale of Boom, Bust and Speculation* tells us more about debt and credit, asset values, interest and exchange rates in Australia today than any Australian source, author or publication does. Grant speaks as fluently as he writes. So if you can't find the book or don't want to spare the time to read it, the transcript of an interview published in the Winter 1996 *Austrian Economics Newsletter* provides the next best thing. Further insight into Grant's sharp mind and turn of phrase appear in abundance in a 31-minute audio interview conducted with *Wall Street Uncut* on 28 January 2000. Happy reading and listening.

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Issue 11 Nov 2000

The Next Warren Buffett

As detailed in the past month in *The Wall Street Journal*, Mr Buffett's succession plans are a matter of growing public comment. *TWSJ* has speculated that Mr Lou Simpson, currently charged with the investments of Berkshire's GEICO insurance subsidiary, may eventually manage its parent company's billions of securities. Indeed, Mr Buffett wrote in Berkshire's 1995 annual report that "Lou takes the same conservative, concentrated approach to investments that we do.... His presence on the scene assures us that Berkshire would have an extraordinary professional immediately available to handle its investments if something were to happen to [Vice Chairman Charles Munger] and me." With a glowing testimonial from such an eminent investor, Mr Simpson's approach to the allocation and stewardship of capital is clearly of much more than passing interest. Hence a recent article worth reading is The Next Warren Buffett by James M. Clash (*Forbes* 11 October 2000).

Graham's Successors

Tweedy Brown Company LLC, established in 1920 and based in New York, has an enviable reputation among value investors. Its investment approach derives from Benjamin Graham (who, through his investment firm Graham-Newman Corp., was one of Tweedy's primary brokerage clients in the 1930's, 1940's and 1950's). It was through Graham that the original partners of Tweedy developed brokerage relationships with outstanding investors such as Walter Schloss and Warren Buffett; and it was from Graham-Newman Corp. that Tom Knapp joined Tweedy Brown in 1957, leading TB's conversion from broker to investor. Given the firm's pedigree, the views of its principals are well worth studying.

The Changing Face of Value Investing

What does it mean to be a contemporary value investor? Have value strategies evolved? Should a value investor own technology stocks? Much babble has been spoken and nonsense written about these topics. Several cuts above the run of the mill is The Changing Face of Value Investing by Susan Dziubinski. In it Morningstar CEO Don Phillips, Legg Mason's Bill Miller, Oakmark's Bill Nygren, and Davis Funds' Chris Davis discuss these questions. Chris Leithner's $0.02 worth: Bill Miller is particularly sharp and his words and thoughts well worth studying.

Two New Books for the Christmas Stocking

Robert G. Hagstrom, author of two well-received books about Warren Buffett's investment methods, has written a new book entitled *Latticework: The New Investing*. The book adopts a broad ("liberal arts") approach to the operation of markets and the understanding of investing. I don't yet have a copy, but according to a recent (20 October 2000) review in bizjournals.com, "this work was inspired, in part, by Charlie Munger, Vice Chair of Berkshire Hathaway. Mr. Munger believes that extraordinary investing and exceptional insight can only be achieved when people adopt multiple viewpoints that intersect in the form of a latticework. The book draws examples from biology, mathematics, physics, economics and psychology."

Mr Munger is also the subject of a recently-published (13 October 2000) biography by Janet Lowe. The book, entitled *Damn Right: Behind the Scenes With Berkshire Hathaway Billionaire Charlie Munger* has a forward by Warren E. Buffett. I haven't read it either, but a blurb states "Warren Buffett may be the household name, but Berkshire Hathaway Director and Vice Chairman Charles Munger is considered by many to be 'the brains behind Warren Buffett.' One of the investment world's most private figures, Munger is the man Buffett credits with teaching him the value of great franchises and the virtues of qualitative analysis. In his own quiet way, he has helped expand Berkshire's value (and his own personal fortune) to mammoth proportions. In fact, Berkshire Hathaway's stature as a model investment firm owes much to Munger's staunch advocacy of ethical business practices, his brutal honesty, and his fame for 'cutting through the bull.' Now, for the first time, *Damn Right! Behind the Scenes with Berkshire Hathaway Billionaire Charlie Munger* lets the public discover the tactics and techniques, the business philosophy and humor of this highly influential, yet little known, financial wizard."

Best Wishes to Joy

The readability and navigability (yes, it's a proper word – I checked) of Leithner & Co.'s web site owes nothing to me and everything to Joy Rhonda Williams of Artist Web Design – which I can recommend unreservedly for any and all web design services. Her impending emigration is a loss to Queensland and a gain to California's Silicon Valley. We are extremely fortunate, however, that Joy will continue to manage Leithner & Co.'s presence on the Internet from her new base Stateside. Many thanks, Joy, for your great and future service – and all best wishes for the bigger and better things which await you.

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Issue 12 & 13 Dec 2000 and Jan. 2001

Issue 14 Feb 2001

A Year to Remember

The end of one year and the beginning of the next is an appropriate time to reflect upon the outgoing year's events, twists and turns, triumphs, trials and tribulations. It is also a time to place them into a broader context, consider their causes and consequences and plan for the new year. Alan Abelson, writing in *Barron's Online* (4 December 2000), summarised the last year of the twentieth century in unambiguously dour terms: "as you're undoubtedly and possibly painfully aware, 2000 is already memorable in Wall Street as the year the air began to whoosh out of the monster stock-market bubble and, after many a frustrating try, the year the bears finally ate Goldilocks. In fact, unless such portents as mounting claims for unemployment insurance and the latest downbeat readings on business from the purchasing managers are completely misleading, 2000 will go down as the beginning of the end of the most salutary and long-lived economic boom to grace this nation (and probably any other)."

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A Mass Misallocation of Capital?

From the perspective of a value investor, it seems to me that 2000 was noteworthy in two respects. First, signs emerged that the latter half of the 1990s was a period during which staggering amounts of credit was created, misdirected – and in some instances squandered. Most notably, market participants allocated massive amounts of financial resources on very favourable terms towards entrepreneurs seeking to develop or commercialise 'New Economy' capital goods (i.e., computer, Internet and telecoms infrastructure; B2C, B2B, biological and other technologies; and other forms of intangible capital). In the past three years, for example, banks lent approximately $900 billion to the telecommunications sector alone; telecoms companies themselves raised further billions of equity; and the costs of '3G' licenses and other infrastructure will during the next several years maintain telecoms' hearty appetites for financial resources.

Notice, however, that what was never created cannot be destroyed. Accordingly, to the extent that this mass mobilisation of credit has not helped to create businesses which emit reliable streams of real earnings, wealth has neither disappeared nor been destroyed. Rather, unrealistic expectations (and in some instances millennial hubris), based upon soft credit rather than hard savings, are gradually being uncovered and belatedly corrected.

Three developments have made these 'malinvestments' (if, indeed, that is what they turn out to be) possible. Central banks such as the Reserve Bank of Australia, U.S. Federal Reserve, etc., have enabled if not promoted the creation of historically-unprecedented amounts of credit; technological innovations, most notably the advent of the Internet, have encouraged the formation of firms with voracious appetites for debt and equity; and exaggerated expectations about these businesses – abetted by a wilfully blind eye towards history – have whetted many market participants' appetites for risk. Signs of an unintended consequence of these patterns of behaviour – the production of quantities of 'New Economy' goods and services which exceeds consumers' demand – began to appear during 2000. The 'tech wrecks' of April and October-November, it seems to me, were belated, very partial and therefore incomplete recognitions that the New Economy will not fulfil the millennially-optimistic assumptions about profits which its boosters ascribe to it.

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The Appearance of Disquiet

Bearing this first point in mind, from the point of view of a value investor 2000 was noteworthy in a second respect. Market participants' behaviour gradually ceased to be characterised by euphoria and greed and in some instances began to be characterised by disquiet and fear. An editorial in *The New York Times* (2 December) entitled 'End of the Good Times' epitomised this sentiment. It stated that "the party may be over. It is not yet clear whether the present U.S. economic slowdown will ultimately lead to a recession or is simply the 'soft landing' that Alan Greenspan has been plotting so carefully. But either way it spells the end of the economic nirvana of recent years – that potent concoction of extremely robust growth, low inflation [sic] and low unemployment. The universal sense of awe at the magical new economy is giving way to a sense of unease."

The Times continued: "Bill Clinton owed much of his second-term political buoyancy to the same economic euphoria that turned Americans, at least in Alan Greenspan's view, into a nation of irrationally exuberant investors. Millions piled into the stock market to profit from the tech-driven revolution, and at times seemed to turn the hope that the new economy had transcended the restraints of the business cycle into a self-fulfilling prophesy. But that euphoria has chilled greatly. Alan Greenspan may yet pull off a soft landing for the economy, as he did in the mid-1990s, ensuring continued, although less robust, growth. But things have been hard for investors, particularly those who had grown accustomed to the idea that it pays to speculate."

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Three Virtues

During 2000, then, hares (i.e., recklessly exuberant speculators and short-termers) ceased to bask without interruption in glory; conversely, and almost imperceptibly, tortoises (i.e., cautious, studious and long-term custodians of capital) ceased to be regarded universally as objects of derision. Accompanying this shift, if it is actually occurring, is a portentous, historically well-understood but presently- unappreciated development. The British economist and investor, Lord Keynes, expressed its essence in The Applied Theory of Money (1930). "If enterprise is afoot, wealth accumulates whatever may be happening to thrift; and if enterprise is asleep, wealth decays whatever thrift may be doing." In certain quarters in Australia and New Zealand, and probably in other countries, enterprise is presently afoot and thrift wide awake. But not in the manner trumpeted relentlessly by boosters of the 'New Economy.' Quite the contrary: these two virtues are alive and well within a small number of well-managed and unheralded firms that are not New Economy market darlings and thus have not been lavished with financial resources on lenient terms.

It is the essential and irreplaceable role of the value investor to nurture these firms and promote these financial virtues; i.e., to ration capital, ensuring both that ethical, profitable and thrifty firms are backed with patient and long-term equity – and that firms which lack these attributes are denied it. In so doing value investors are a cornerstone of capitalism – not just because patience has its own intrinsic rewards, but also because the fruits of savings, combined with vigilance and the patient custodianship of capital, beget material abundance.

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Looking into 2001

As in the past, this stance is likely to remain a minority stance. Whatever they might think and whatever the denizens of Wall Street, Martin Place and the financial media might lead them to believe, it seems to me that the mentality of most of today's market participants continues to have much more in common with that of speculators than investors. This speculative mindset is characterised by an obsessive focus upon an asset's current market price and short-term changes therein ("performance"); a lack of genuine and dispassionate interest in the operations of the business and other fundamental factors which underlie the security being traded; and very optimistic expectations – bordering upon conviction – about the extent to which the market prices of 'their' assets can and will continue to increase.

One of the many unfortunate consequences of this speculative mindset – the definition of an asset's 'performance' in terms of the direction and magnitude of short-term changes in its price – reveals much that is trivial and obscures much that is relevant. This point is described and elaborated in a series of new circulars to shareholders, dated 1 and 15 January, entitled Value Investing and the (Mis)Measurement of Results.

On this subject of short-term price volatility Alan Abelson (*Barron's Online*, 4 December 2000) was also unambiguous: "what we've found most intriguing is that, until now, all this blood in the Street has evoked very little public outcry. We've experienced a kind of cruel and vast but silent mugging. Magazines like *Time* and*Newsweek* haven't done their usual heavy-breathing treatments, nor have most newspapers, including *The New York Times*, made a front-page fuss about the decline and fall of Nasdaq. Nor are the networks running their usual inane specials. Moreover, until quite recently, mutual-fund shareholders have placidly watched their wealth withering. No crowds gathering in front of fund headquarters and, more tellingly, no rush to redeem their holdings. There are several possible explanations for this rather astonishing diffidence on the part of the financially wounded and the absence of hysteria in the press, both the electronic version and the genuine item. The distraction of the election that never ends. The fact that most everyone who wants one still has a job and a relatively high comfort level. Whatever the cause or combination of causes, that we're in a bear market, and a vicious one, doesn't seem to have sunk in yet."

If Mr Abelson is correct, then 2001 will – in retrospect – be seen as a good year. Value investors, as custodians of capital, seek to buy quality financial assets at bargain prices. Leithner & Co. therefore likes gloom, doom, pessimism and despondency – not for their own sake but because they help to make good businesses available at sensible prices. Precisely because the Company is a net saver and therefore a net purchaser of financial assets, my preference for 2001 is that the quality of the investments we own (or seek to own) improves – but that the prices at which we are able to buy them decrease. Warren Buffett gets the last word: "Only those who will be sellers of equities in the near future should be happy at seeing stocks rise. Prospective purchasers should much prefer sinking prices."

A pleasant summer and prosperous 2001 to all,

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Analysts, Cheerleaders or Used Car Salesmen?

According to Glen Stevens, Assistant Governor of the Reserve Bank of Australia, many market professionals make forecasts "with a view to selling a product, or a piece of advice. Many forecasts made in the private sector are essentially of this variety. The forecaster has a story to tell in order to provide credibility to their employer's efforts to win business" (quoted in September 1999 by *Australian Financial Review* correspondent Stephen Koukoulas). Do brokers, analysts and the like have similar incentives? On 11 February the Nine Network's *Business Sunday* program broadcast a report, produced by CBS News of the U.S., which comes to the unpalatable conclusion that they often do. A full transcript of this excellent report is available on ninemsn.com's website. Several other recent articles draw attention to this festering issue. Bethany McLean (Does Wall Street Need a Reality Check?*Fortune* 5 February 2001), for example, notes that "some investing pros are declaring that the worst is over. Sounds great, but remember-they were positive last spring too. [and there] are strong reasons to be cautious right now. Wall Street firms make money by selling stocks, and it's probably naive to expect them to say that stocks are a bad business. Analysts' 'buys' are notoriously untrustworthy. And as for the strategists, these are the same people who have been saying 'buy' since the Nasdaq crossed 5,000. This is also the same crowd who argued that tech stocks were growing so quickly and had so little debt that they would be immune to rising interest rates. A highly paid Wall Street professional isn't going to say, 'I'm sorry, I missed it, I cost you millions, and now I don't know what's going to happen.' But the truth is, no one does know. And some market observers are concerned-in part precisely because the Street seems a little blithe about the current downturn."

A second article, The Price of Being Right by David Rynecki, also appeared in*Fortune* on 5 February 2001. It tells the story of Mike Mayo, an analyst who "thought he could change the ratings game on Wall Street. He thought he could be honest-and tell people to sell stocks that were headed for a meltdown. It cost him his job." Part three of the article states that "it is hardly a deep, dark secret that the ratings game on Wall Street is beset with serious conflicts. Once kept separate, by long-held convention, from the investment banking side of the business, brokerage houseanalysts now find themselves in the supporting role of assistant dealmakers. Researchers pull double duty as stock boosters, often serving as liaisons between the companies they cover and the investing public. It is, after all, a game about money. Piles of it."

Rynecki also notes that "even during the uncertain, recession-fearing, shoulder-twitching present, more than 70% of the 27,000 analyst recommendations tracked by First Call/Thomson Financial are buys or strong buys. That compares with a minuscule 1% for sell ratings of any kind. Among the ten largest investment banks(which do the vast majority of underwriting), the pattern is more pronounced. First Call identifies a total of 57 sells vs. 7,033 buys." In Australia, a recent study cited by*Business Sunday* stated that, of the 415 analysts' reports sampled, 18 (4.3%) were 'sells.'

Rynecki concludes that whilst "the rewards for positive coverage are well known--and remain an issue of continuing concern for the Securities and Exchange Commission – it has never been obvious (beyond the top-floor corridors of Wall Street) just how stark the penalties could be for being overtly negative. The Mike Mayo case is instructive for just that reason. If a top-rated, thoroughly respected analyst earning a seven-figure salary with a name-brand firm can take this kind of career hit, Wall Street's legions of lower-profile analysts have little hope of summoning the courage to shout 'Sell!' on a given stock or sector. The message to retail investors is sobering: If, in fact, stocks are headed for a disastrous slide, you won't hear it from the researchers paid to predict it."

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Bulls' and Bears' Etymology

"How did the word 'bear' come to apply to stocks? The most common answer is that, in 18th-century England, and perhaps earlier, stock traders who sold shares 'short' (betting against the market by selling shares they didn't yet own) were dubbed 'bearskin jobbers' after dealers know for selling bearskins they hadn't yet acquired. They became known simply as bears, and eventually the phrase applied in general to naysayers on the market, not just short-sellers. The origin on 'bull' is much less clear; some historians say it's because bull-and-bear baiting once was a popular sport, or because a bear tends to paw at, and pull down, its prey, while a bull charges forward and sends its prey flying upward." (E.S. Browning, *The Wall Street Journal*, 16 January 2001).

Corporations and Their Debts

Is Australia Really a Low-Inflation Country? (15 March 2000) stated that "the monetary expansion of recent years has sown the seeds of economic difficulties in the future."
And Letter No. 10 (October 2000) stated that "the gulf between psychological expectation and financial reality fostered by easy access to credit and celebration of debt is creating significant strains in many individual Australians' finances. There are also signs (interest-

cover ratios, gearing, comments by ratings agencies and other indicators of creditworthiness) that the quality of Australian corporate debt has deteriorated during recent boom conditions." Signs of economic difficulties have been reported more prominently during the past 2-3 months. One of these signs is the growing quantity and deteriorating quality of debt. The Extraordinary Edginess of Crowds (*The Economist* 11 January 2000) described the risks which various forms of corporate debt may presently pose to investors. It noted that "the derivatives markets are certainly showing signs of stress; and the market for credit derivatives, which has grown rapidly in the past couple of years, is exhibiting stress to an extreme degree. Which institutions are bearing the bulk of the risk in these contracts is not clear to the public, and it may not be clear even to the Fed. It is possible that banks have used financial engineering to take on risks that do not show on their balance sheets, which mostly look healthy. Credit quality has deteriorated rapidly in recent months, both for marketable debt and for bank loans. And it is expected to get a lot worse. Many banks, including Bank of America, which bid aggressively for loans, have warned investors of big losses on bad loans. The market for high-yield ('junk') corporate debt ground to a halt in December. Several well-known investment-grade companies, notably Xerox, have since seen their debt sink swiftly into the junk category, scaring investors who thought that 'investment grade' meant 'low risk.' The risk of California's electricity utilities going bankrupt has added to the market's jitters. Seemingly the safest of all securitised corporate lending is the market for commercial paper. But even that market has suffered an attack of investor nerves."

This debt-induced angst, according to *The Economist*, may explain why the U.S. Federal Reserve unexpectedly cut the funds and discount rates during the first week of January: It cited one analyst who reasoned that "nearly $600 billion of commercial paper would need to be refinanced during the first three weeks of January: a vast sum in such a short period. The rate cut may have been intended to help reduce the cost of this borrowing, and to ensure that less-healthy firms--already squeezed out of markets for longer-term corporate debt--were not shut out of short-term paper and, crucially, forced to turn to the banking sector."

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Corporate (Mis)finance

The 27 January 2000 edition of *The Economist*, which reviews the present state of corporate finance, expanded and elaborated these sombre themes. The Party's Overnotes that "a long corporate-borrowing binge" has occurred in the U.S., that risks to borrowers and lenders alike are growing apace and that lenders are getting wary of shouldering this risk. And Debt Trap! states that "the risk that everything on the economic front could go wrong this year remains real. It is most pronounced in America; and its most fearsome guise is as a debt trap. In simplified terms, the big worry is whether America might follow a similar road to that taken by Japan ten years ago: a burst bubble followed by a deep and prolonged recession, or even slump."

The Economist concludes that "there are enough eerie similarities between America today and Japan in 1989-90 to be worrying. The biggest is excessive debt. Too much debt was always at the heart of Japan's weakness. So it is alarming that America's boom has also been fuelled by massive borrowing by companies and households. Our survey of corporate finance in this week's issue explores how American firms' borrowing binge has left lenders exposed to some nasty risks. And, as if corporate debt is not alarming enough, consumer borrowing has been even more rampant. By borrowing against paper gains in share values, households have been able to shop until they dropped, not bothering to save."

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New Circular to Shareholders

A three-part circular to shareholders, entitled Interest Rates, Corporate Debt and the Business Cycle, explores these issues from the perspective of a value investor. Its crux is that I disclaim any ability to predict the future course of interest rates; nor do I know whether the business cycle will turn (or whether it has turned) downwards; and still less can I claim to know when, to what extent or by what process this reversal of fortune might occur. Yet I can and have structured Leithner & Co.'s portfolio in response to three possible risks and one possible opportunity.

The first risk is a misplaced obsession with rates of interest. The relevant question to ask about interest relates not to its level but to its integrity. Investors should ask whether time preferences – and changes therein – convey accurate information. Acting on them, would individuals make reasonable choices? Or would they undertake 'malinvestments'? The second risk is that the confidence (and in some quarters unshakeable conviction) in the ability of central banks to 'engineer soft landings' may be misplaced. The third is that the consequences of recent decreases in interest rates in Australia, Britain and Canada (the Reserve Bank of New Zealand is smarter in this respect), if maintained and extended, may be harmful rather than beneficial. For today's debt-burdened consumers and businesses, in other words, lower market rates of interest may do more harm than good – they merely delay the correction of the mistakes of recent years.

The possible opportunity, in Mr Buffett's words, is that "the best time to buy assets may be when it is hardest to raise money" (*Fortune* 23 October 1989). A good time to invest, in other words, is when others are unable or unwilling to invest. Leithner & Co. therefore likes credit crunches, if one is in the offing, not for their own sake but because they help to make good businesses available at sensible prices.

All best wishes for the remainder of the summer,

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Issue 15 Mar 2001

It's not at all clear that priming the pump like mad and slashing interest rates will quite do the trick against a downturn that's rooted in huge overcapacity brought on by a reckless capital-spending boom and a vastly overleveraged economy. None of us has been witness to the strange and more than a little unnerving sight of the Fed pushing on a string, but stick around and keep your eyes open.

As for the technical signs that lead these seers to the bullish path, we won't quarrel; they certainly know more about such things than we do. But we don't think all the indicators in the world are as important as the simple fact that we've had a market that has battened on at least five years of unbelievable, almost unimaginable excess, an excess it's going to take more than nine months and a partial wipeout of Nasdaq to get rid of. What's happened so far, we'd call a start. And, besides, what kind of a bear market would it be if it didn't devour some of its own?

Alan Abelson,
Up and Down Wall Street, *Barron's* 19 February 2001

The Value Machine

An excellent article by Carol Loomis, The Value Machine, featured in *Fortune*'s (19 February 2001) coverage of America's most admired companies. It reviews Berkshire Hathaway's recent activities and the principles which motivated those activities. For five consecutive years Berkshire has appeared on the Most Admired list; this year it sits in position number 7.

Part II of the article states that "Berkshire had a remarkable year in 2000, in ways largely unrecognized." As a result of eight acquisitions, its number of employees doubled and its revenues increased by $US13 billion to $30 billion; and as a result in 2001 Berkshire will be among the top 50 companies on the Fortune 500 list and its earnings may approach $US3 billion. Its recent acquisitions cost $US8 billion and were financed entirely with cash. Moreover, all of this cash was generated from Berkshire's operations: not a dollar, in other words, was borrowed. This ability to generate large amounts of cash rebounds hugely to Berkshire's advantage when the business horizon darkens. As Loomis notes, "2000 had a tightening financial character that gave Berkshire an edge in buying companies. The money available for purchases of companies got short as the year went on, with junk bonds tough to sell and big equity investors skittish. In fact, a New York investment banker visiting [Berkshire Chairman Warren E.] Buffett told him that he thought of Berkshire as the only investor in the country that could lay out $5 billion for an equity position."

This ability to generate cash, together with Mr Buffett's decisiveness, enables Berkshire to transact business very quickly. In a typical instance, the purchase of Johns Manville, negotiations were conducted and arrangements finalised within days. This plain-dealing, cash-on-the-barrelhead approach also enables Berkshire to attract and retain a disproportionate number of America's ablest executives. According to Loomis, after its incorporation into the Berkshire fold, JM CEO John Henry "met with Buffett in Omaha for about six hours. He went into the meeting, Henry says, thinking about plans he had to retire and ready to say 'I'm gone' if he got any clue that he couldn't work with Buffett. Instead, he says, he emerged from the meeting charged up: 'I came out totally committed to making this thing work. It's easy to see what happens with Buffett's companies. You end up saying you don't want to let this guy down.'"

Yet as Part III of the article notes, Mr Buffett neither sought to join the Fortune 500 nor possesses a grand plan for its acquisitions – "other than answering the phone." In Loomis' words, "the truth is, when it comes to creating value for investors, he doesn't see the world the way many chief executives do. He doesn't focus on his company's stock price; on a given day, he may not know where it stands. [And] he is not searching for synergy." To the managers of Berkshire's stable of businesses "Buffett promises independence and respect and then-barring some irreconcilable problem that just has to be dealt with-delivers on the commitment." In Mr Buffett's own words, "we don't have any MBAs running around telling these people what to do. And God knows I wouldn't know what to tell them."

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Mr Buffett's Letter to Shareholders

Still on the subject of Berkshire Hathaway: its 2000 Annual Report was released over the Internet on 10 March. Berkshire's transmission of quality information to its owners has long been a model of management's moral and legal accountability to shareholders. Mr Buffett – not a committee of lawyers, PR and media specialists or other intermediaries – writes the Chairman's Letter personally. (Berkshire employs few or no such staff; equally admirably, it appears to be a committee-free zone). Its most refreshing attributes thus include clarity, candour and sheer readability. Mr Buffett's Letter therefore repays careful study. Some of its highlights:

- *Operations and Results* Mr. Buffett said that Berkshire's net worth increased by $4 billion in 2000. Net profit more than doubled to $3.3 billion, or $2,185 per share, compared to $1.6 billion, or $1,025 per share, in 1999. (Mr. Buffett has called 1999 one of the company's worst years).

- *Buying Businesses With Cash* "We remain awash in liquid assets and are both eager and ready for even larger acquisitions. Try to control your excitement. [we] embraced the 21st century by entering such cutting-edge industries as brick, carpet, insulation and paint."

- *Berkshire's Portfolio of Assets* In 2000 Berkshire sold nearly all of its holdings of mortgage giants Fannie Mae and Freddie Mac. Mr Buffett did not elaborate the decision to shed the issues in an equity portfolio he described as "only mildly attractive." He added that whilst Berkshire owns shares of some "excellent businesses ... most of our holdings are fully priced and are unlikely to deliver more than moderate returns in the future." There were only modest other changes in Berkshire's other large equity stakes.

- *The Stock Market's Speculative Binge* "It was as if some virus, racing wildly among investment professionals as well as amateurs, induced hallucinations in which the values of stocks in certain sectors became decoupled from the values of businesses that underlay them." (Mr Buffett warned in last year's letter that investors' hopes for returns on tech stocks were "wildly optimistic" and that when their outlook returned to more realistic levels "the market adjustment is apt to be severe, particularly in sectors in which speculation has been concentrated.")

- *In Hindsight, Even the Best Make Mistakes* Perhaps because virtually none of them own a plurality of the shares of "their" companies, few if any corporate leaders assess their performance as bluntly and with such transparent honestly as Mr Buffett. His 2001 Letter pointed candidly to problems in various Berkshire-owned companies. He acknowledged, for example, that last year he wrongly predicted that "we would get our money's worth from stepped-up advertising" at Geico (a major insurer). He also stated that while most of Berkshire's manufacturing, retailing and service businesses "did reasonably well last year," the exception was its Dexter shoe unit. "Our attempt to keep the bulk of our production in domestic factories has cost us dearly [and] we face another very tough year in 2001. I clearly made a mistake in paying what I did for Dexter in 1993 [and] compounded that mistake in a huge way by using Berkshire shares in payment."

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Speculators Still Don't Get It

The cycle of boom and bust which has made its presence felt on markets for financial assets in the past few years – and may presently be unfolding in the markets for goods and services – can be explained partly in monetary terms (see the circular entitled Interest Rates, Corporate Debt and the Business Cycle). What remains unexplained, however, is the widespread confidence – in some places ebullience and in a few places unabashed conviction – which continues despite signs of bust to be placed in the New Economy and tech stocks. A new circular, The 'New Economy' and 'Tech' Stocks: Speculators Still Don't Get It, attempts such an explanation. It shows that although there are some individual exceptions, as a whole and as a rule the economic foundations of information, knowledge, It – and hence tech companies – are transitory and weak. Yet even in the wake of the tech wrecks of 2000, few recognise the grave risks which continue to inhere in the ownership of New Economy securities.

Taken as a pair, these two circulars' central conclusion is that the 'irrational exuberance' (as Robert Shiller has dubbed it) present in financial markets since the late 1990s has been a consequence of three things. The first is a conceptual confusion between savings and credit – and the deleterious consequences stemming from the diminution of savings and strong growth of credit. The second is a logical confusion between correlation and cause. The phenomenal rise of the Internet and the increase of economic activity since the mid-1990s are correlated (in the sense that they occurred at the same time), but the former did not cause the latter. Rather, both may be consequences of a common cause: the suppression of market rates of interest below their natural rate.

The third is the problematic economic status of knowledge, information and technology. If this central conclusion is correct, then we face a cruel irony. In Peter Hartcher's words (*The Australian Financial Review Weekend Edition*, 3-4 March 2001), "to turn a Silicon Valley favourite back on its originators, these guys just don't get it. The rise and fall of the Nasdaq, and of the U.S. economy itself, is part of an old paradigm – a paradigm that has prevailed since people stopped bartering and started using money. Easy money fuels a boom. And the easier the money and the longer the boom, the more likely that tons of liquidity will create a big run-up in the price of assets – and that will lead to a mania. Then, when the money starts to tighten, a savage retrenchment begins...."

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Issue 16, April 2001

The decisive common denominator between the Japanese downturn and the gathering U.S. slowdown is that they are both cycles of over-investment against a backdrop of booming credit growth; with the only major difference being that this time around much of the resulting excess capacity is invisible. History shows that such over-investment cycles nearly always end in. downturns. This is the message now being transmitted by the financial markets.

These points are made to counter those conventional thinkers who argue that comparisons between America today and Japan's deflating bubble economy then are 'off the wall.' Unfortunately, the comparisons are as *obvious as they are ominous. What the sceptics should note is that the people who regarded Japan as a bubble economy 10 or more years ago were considered off the wall. What everybody knows is usually not worth knowing; and almost everybody today still thinks they know that such comparisons between Japan and America are idiotic.*

In coming weeks and months it will [therefore] be interesting to watch the Fed chairman warning of 'irrational panic' in the U.S. stock market, just as he once warned against 'irrational exuberance' before succumbing to nouvelle nonsense. In fact the Fed's mistake in recent years was to ignore money and credit growth data and to be seduced by New Economy rhetoric. This was also the error made by the Bank of Japan in the late 1980s. [A recent Bank of Japan research report about that country's asset bubble during those years] notes that monetary tightening was delayed because of the then prevailing view 'that the statistical relationship between money supply and prices had become unstable.' Accordingly, the 'large increase in the money supply was not taken seriously.' This reads like a repeat of the current Greenspan line....

Christopher Wood,
The Asian Wall Street Journal (20 March 2001)

Nightmare on Easy Street

A recent article by Betsy Morris, Nightmare on Easy Street (*Fortune*, 2 April 2001), covers in an American context some of the points set out in Australia's Post-Olympic Reality Cheque. The article makes two good points. First, "there are very real reasons for people to be very nervous right now. They are going into this downturn more heavily indebted than ever. Too many people are perched precariously atop living standards supported by lines of credit and depreciating assets." Second, "stocks, real estate and 401(k)s are not cash flow. The same thing that happened to so many dot-coms during the recent gold rush happened to consumers too: they forgot about cash flow. People had assets. But now their assets are way down, and the liability is real. Their lifestyles require cash."At the same time, however, the article also repeats three sets of widely-held and dangerous fallacies:

- Fallacy #1: "Consumer confidence – and what it portends for spending – is the single biggest factor standing between a mere downturn and a full-blown recession. Fed Chairman Alan Greenspan has made no secret that he is paying close attention to consumer spending levels. Consumption accounts for about two-thirds of GDP. It has been the willingness of people to fork over not just $5 for a latte and a muffin at Starbucks but $50 for an afternoon of skateboarding at the Rampage Extreme Sports Park, $10,000 for a family ski vacation at Aspen, or $100,000 for a home renovation that has kept the economy so strong for so long."

- Fallacy #2: Right now, [home mortgage] refinancings and cash-outs are buoying the economy because they give consumers more cash to burn. [Indeed], the refinancing wave could very well turn out to be instrumental in forestalling a more severe economic downturn."

- Fallacy #3: "Stocks can have a major impact on the economy through the so-called wealth effect. As stocks rise and people feel richer, they're willing to spend more. Some economists have argued that the savings rate, defined as the gap between disposable income and expenditures, doesn't take into account money 'saved' through appreciating assets like houses and stocks, or the contributions companies make to employees' 401(k) plans. If assets appreciate, the thinking goes, there is less need for old-fashioned savings."

New Circulars

A new series of circulars to shareholders, dated 15 May and entitled GNP and Consumer Confidence in Australia: A Dissenting Argument, justifies the claim that these three statements are fallacious and harmful. It draws attention to a currently-unrecognised but stark gulf in economic thinking: classical and Austrian economists applaud private citizens' and businesses' resolve during times of economic adversity to increase savings, cut debt and reduce expenditure. Yet today's mainstream economists regard such behaviour as folly; and politicians, bureaucrats, central bankers and commentators discourage it. Hence a priority for Australian businessmen, investors, consumers and governments: to restore the logical correspondence between traditional business practice, sensible household budgeting, sound economic theory and prudent public policy.

A New Book Worth Reading

A new book by Thomas Sowell entitled *Basic Economics: A Citizen's Guide to the Economy* (Basic Books, 2000, ISBN: 046508138X) has been written in precisely this spirit. Sowell, the Rose and Milton Friedman Senior Fellow at the Hoover Institution, Stanford University, is an economist who has experience in the private sector, government and several universities. As detailed in his recent autobiography (*A Personal Odyssey*, The Free Press, 2000, ISBN: 0684864649), his experiences also include poverty during childhood and racial discrimination as an adult. His most influential scholarly work is *Knowledge and Decisions* (Basic Books, rev. ed. 1996, ISBN: 0465037380). He is also the author of *The Vision of the Anointed: Self-Congratulation As a Basis for Social Policy* (Basic Books, 1995, ISBN: 046508995X) and writes a columnsyndicated to more than 150 American newspapers.

Basic Economics: A Citizen's Guide to the Economy uses plain English and contains neither jargon nor graphs or equations. It is written for anyone who wants to acquire a working knowledge of the principles of applied economics. Most relevant to businessmen and investors are Chapters 2 (The Role of Prices), 5 (The Rise and Fall of Businesses), 6 (The Role of Profits – and Losses), 12 (Investment and Speculation) and 13 (Risk and Insurance).

Desperately Seeking Bottoms

"Wall Street is obsessed with bottoms. What it demonstrates is the inherent optimism of investors, especially so-called professionals (they're the ones who get paid for losing other people's money). It's rather a touching fetish, since it bespeaks an irrepressible optimism. For in contrast to such preoccupation with bottoms, interest in identifying a top when the market was in the clouds a scant year ago was not only minute but considered bad form. But in view of the mania for spotting a bottom currently in full rage in the Street, we feel. a little historical perspective [is in order. What such perspective reveals] is that we're a long way from where most bear markets – and all the truly vicious ones – have ended in the past. Or, to put it rudely, what we're viewing today bears as much resemblance to a traditional bear-market bottom as a bad bruise does to a blast wound. Let's change the imagery a bit: True bear markets like the one we're in don't end with stocks still greatly overpriced and everyone on the alert for the turn. They end with valuations almost as depressed as those relatively few investors still standing" (Alan Abelson, Up and Down Wall Street, *Barron's* 2 April 2001).

"A shrewd money manager whom we've known forever remarked to us over breakfast last week that the vast majority of economists and investment pros were in denial as to the real state of the economy. The truth, though, is evidently beginning to leak out and, who knows, one of these months it may even sneak into the sanctum sanctorum where the Fed does its very private gabbling and monetary dabbling. We're increasingly convinced, moreover, that this recession, which is the misbegotten issue of excess, will last longer and carry deeper than anticipated, especially by the folks who get paid to do the anticipating. We don't think that kind of recession is in the market. Which is why we don't think we're even close to a bottom" (Alan Abelson, Up and Down Wall Street, *Barron's* 9 April 2001).

All best wishes for a pleasant ANZAC Day holiday,