INVESTMENT LETTER

A PUBLICATION OF CALDWELL TRUST COMPANY

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MORE CHANGES

This month we think there is a need to add further comment to last month's Investment Letter. You may recall that we put forward in that Letter several pretty fundamental but powerful assertions suggesting the need for some investment re-emphasis due to elemental changes that appear to us to be altering the way investors must now respond.

The key points raised were: (1) that the impact on investments of having a second-rate educational system in America vis-s-vis the emerging economies of the world perhaps has become more than just of passing interest to partisan politicians; and (2) that a radical change in the overall marketplace due to the heavy use of and reliance upon risk-averting types of "non securities," *i.e.*, derivatives, by big investment management professionals, may be making it almost mandatory that investors no longer ignore its impact — suspiciously not always for the good.

Our fear is that like it or not, these changes, among others, have had and are having a strong influence that can only be problematical to the continuation of more traditional portfolio management methods and styles. As always, Caldwell Trust intends to, and must, respond accordingly without moving away from its primary obligations and responsibilities as fiduciaries charged first and foremost with protecting and enhancing client wealth.

That said, we have long known and discussed the financial reality of generally low stock prices, mainly for larger public companies, in that they are woefully undervalued when compared to valuations derived from each company's underlying financial condition, profitability, return rates on capital, and prospects ahead.

There is perhaps only one significant over-arching reason that this might be an invalid assertion. For many years during the high inflation days of the 70's and 80's, corporate return rates were constantly below levels necessary to compensate stock investors adequately for the devastating deterioration in the dollars they were investing. The consequence of that was that stocks were widely avoided, mainly by individuals rather than by large pensions and others that had no choice in the matter. This resulted in a long period of stock price stagnation.

Once burned, many investors are necessarily leery about allowing overall corporate return rates to fall to levels that are more in line with our present, more historically justified, low inflation rates. As a result, it is now fairly widespread that the managements of major companies are mandated to produce very high returns on invested capital lest they be replaced in a hurry nowadays. What is missing, in our view, is that company internal rates of return on capital at such high levels, while nice, are in fact well above levels justified by the equity risks that stockholders actually face today.

This is obviously a complex issue that is hard to deal with in a short Letter like ours. However, investors must at least intuitively sense that when today's fairly predictable corporate returns exceed rates that are justified in a non-inflationary environment, that at some point in time, an upward correction in share prices either must occur, or alternatively, profit return rates relative to invested capital in aggregate must decline rather significantly below current levels. We are unaware of any serious investment professional or economist who believes the latter is even a remote possibility in the stable monetary and fairly vigorous economic environment that exists today.

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If this is so, other reasons must now be camouflaging the very fundamental disconnect between price and value, as we allege. We have tried in past letters to come up with one or more of the reasons for this, and think we did actually identify some. Massive derivative usage is but one of the more flagrant, in that the rise in such usage seems to coincide pretty closely with the advent of a stock price stagnation about four years ago. This is a hard one to pin down, however, in that there are simply no reliable statistics that could possibly lead to some kind of reasonable analysis of the worldwide derivative impact.

What we do know is that the large pools of professionally managed capital (pensions, etc.) are now big users of derivative products, and for good and valid reasons—one of which is that the nature of the laws, rules, and customs that now govern pensions and the like are so locked in place that there is really little room for managers to get performance using traditional approaches.

Consultants to these large portfolios have now even added a new category to allowed investment sectors in order to seek to outperform the former buy and hold approach. They call this category, "enhancement," which allows managers the flexibility to use derivatives to capture short term profits by trading against positions held in their stock and bond sectors.

Another obvious reason is because these large portfolios now also own the vast majority of all publicly traded stocks, so no matter what they might wish to do, it is now virtually impossible for them to out-perform, absent some mechanism to move outside (*i.e.,* "enhance") traditional stock, bond, and real estate investment sectors. The good news for us more traditional investment managers is that evidence is beginning to surface that the heyday for derivative junkies may be close to over as it gets harder to capture small price changes once everyone is trying to do the same thing. Reported moves in recent weeks by consultants and managers of big portfolios back into stocks of major public companies reinforces that view.

While beyond explanation based purely upon rational evaluations of corporate financials, derivative usage appears to employ leverage so as to allow managers to seek to capture changes in prices to a minute degree. The enormous volume of derivative transactions now reported suggest, to us at least, that the old buy and hold investor is now paying a pretty heavy price due to the ability of these "non-securities" security transactions to take for themselves what historically flowed to the benefit of the actual owners of the real stock and bond securities themselves. Again, while this is an unprovable assertion that we are making, it is at least one plausible reason, if true, why we continue to see the historically wide undervaluation of equities, as is most certainly true today.

CONCLUSION: As CTC researches other moves in the direction of seeking more ways to capture value for its clients, including investing a portion of each portfolio in attractive and faster growing foreign countries and companies, make no mistake that it remains clear to us that overall equity risk is now at an all-time low, aggregate corporate returns are close to obscene relative to risk, and share prices generally remain well below levels warranted. Absent the world's finding a way and an ability to repeal things like the Law of Gravity, equities must eventually rise to levels that are justified by real profits and prospects. We intend to seek to be there for clients when stock prices finally begin to reflect that reality, as they always have in the past for the patient and strong of heart. The recent firming in stocks suggests, hopefully, that the long overdue upward adjustment in stock prices may finally be getting underway.

Roland/Kelly

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