

# Cascade Investment Commentary

*The reason that stock market levels have become an issue of public discussion by the Federal Reserve is that massive speculation has driven capital into industries with unproven business models, and much of this unprecedented capital has come from unsophisticated investors. To the extent that it is coming from foreign investors, it affects national as well as world capital markets, currency and foreign exchange levels, which ultimately dictates the terms of trade worldwide. The investment behavior patterns of many recent investors is not well understood. Thus, should the market trends of the past four years continue unabated for another two years or so, we are uncertain that the Federal Reserve System has the assets necessary to maintain monetary stability without serious disruption to the nations economic expansion should a sudden exogenous event quickly erode investor confidence.*

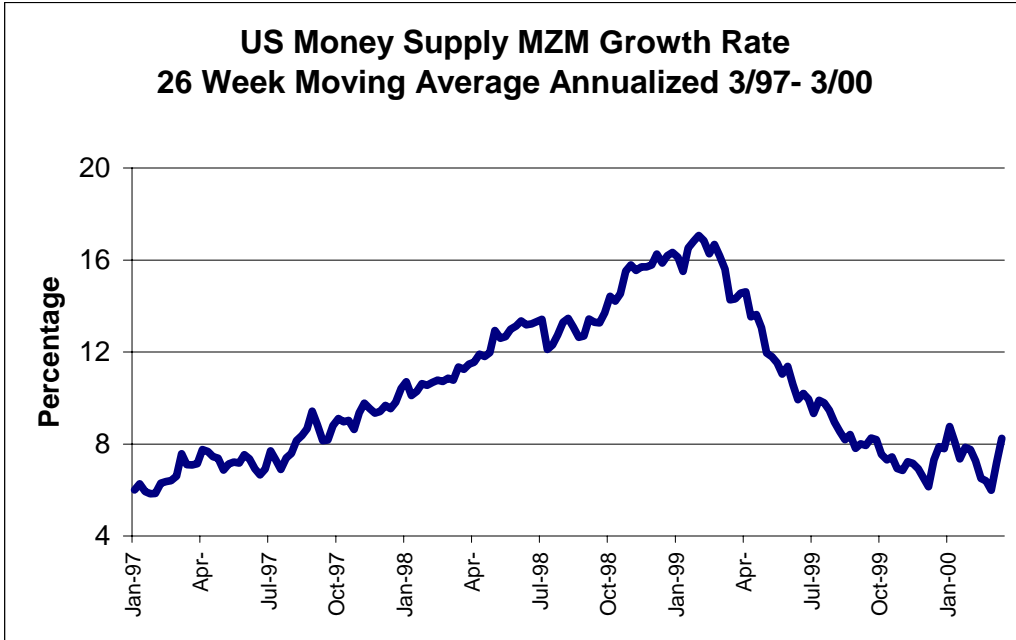
At the end of last year, we wrote about momentum, liquidity and interest rates. To this group we are adding leverage as a main topic of conversation.

It is no secret that Americans have fallen in love with the stock market, and this love affair is spreading worldwide. Rising asset prices have given the largest American generation unprecedented comfort about their financial future, and led the nation to a level of confidence never seen before. Why would the Chairman of the Federal Reserve Board try so hard for so long with public statements intended to lower this confidence? We believe that the answer lies in the Fed's perception of public attitude as much as with their "vigilant watch for inflation".

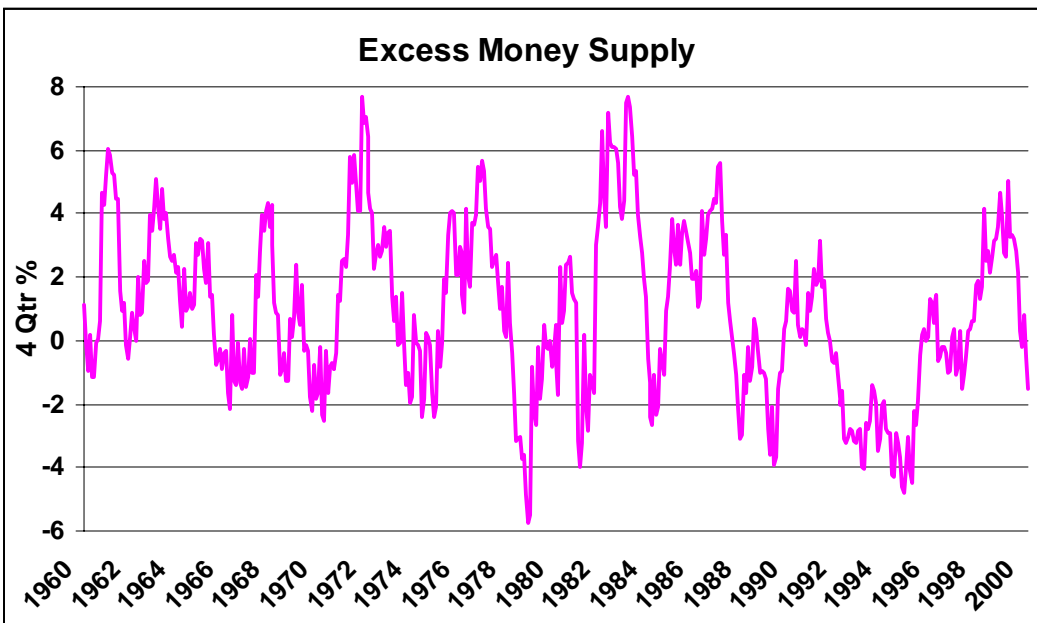
Just what is the public attitude that so concerns the Fed? We at Cascade are fundamental analysts not psychologists, but everywhere around us in our daily lives the love affair with stocks and the mania for "new economy" stocks is in evidence.

## **After The Flood**

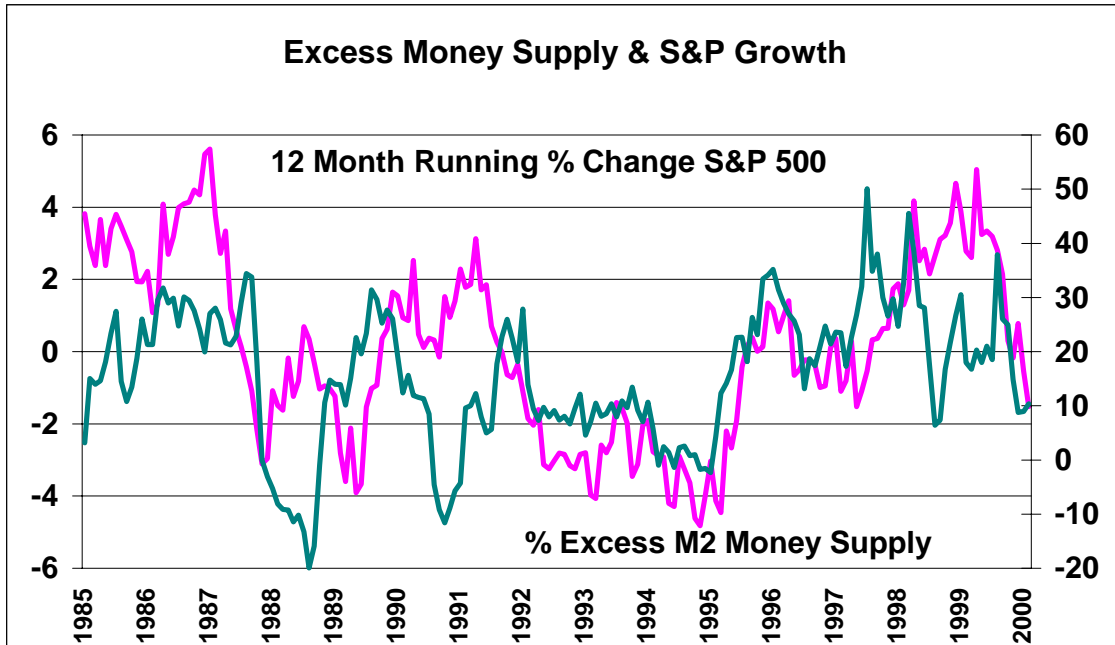
The greatest non-event of the change of the millennium was the prospect of widespread financial failures due to software problems. To insure that no major or even minor financial firm would fail, the U.S. Federal and most European authorities went to extreme length to insure an orderly transition. That included an unprecedented and coordinated injection of liquidity into financial markets. The rhetoric and obsession with Y2K hit the full flood stage in early 1999, as well as the maximum point of excess liquidity. Below is a recent history of MZM (money with zero maturity and can be spent immediately). Note the fall to levels approaching the GNP growth level steadily after January 1999. This is the fuel underneath the financial asset rocket, and every G7 country except Japan is gradually draining it from their system.



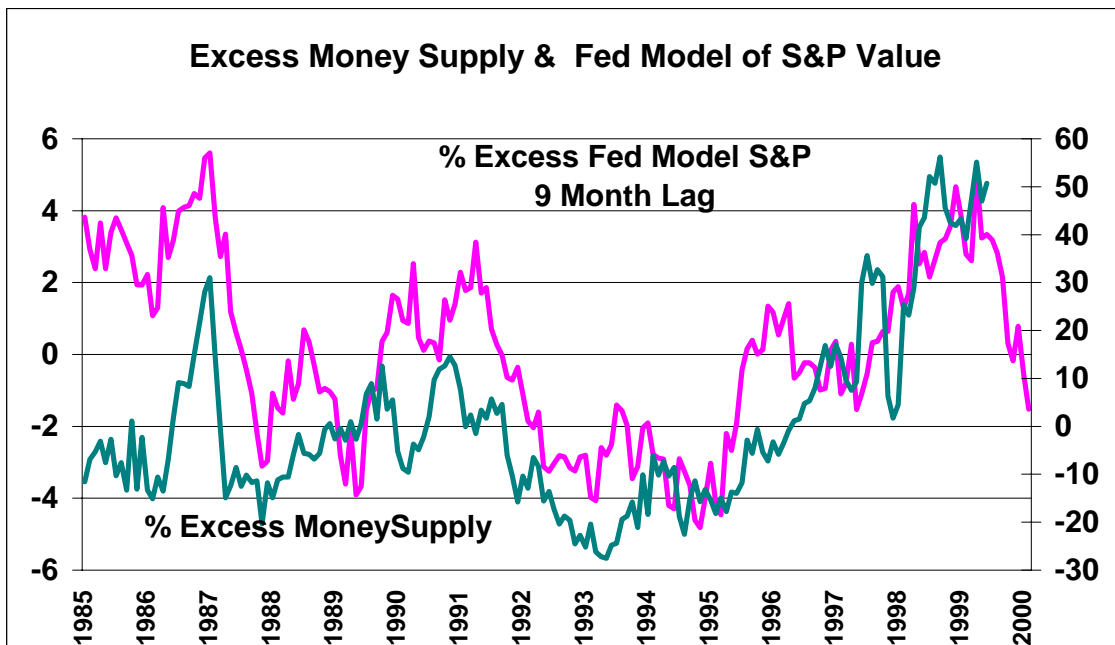
As this created liquidity was far in excess of what was needed to sustain economic growth, the surplus funds were invested in liquid assets: bonds and equities. One manner to view excess funds is to take the Real GDP growth rate and subtract the growth rate of money supply M2. Below we chart the 12-month moving average of Real GDP less 12 month moving average of M2. We call this **Excess Money Supply**. Generally excess money supply finds its way into financial markets, with varying lag times.



Below is picture of the Excess Money Supply plotted with the running 12-month change in the S&P 500 Index without any lag time. The correlation is high but not perfect.



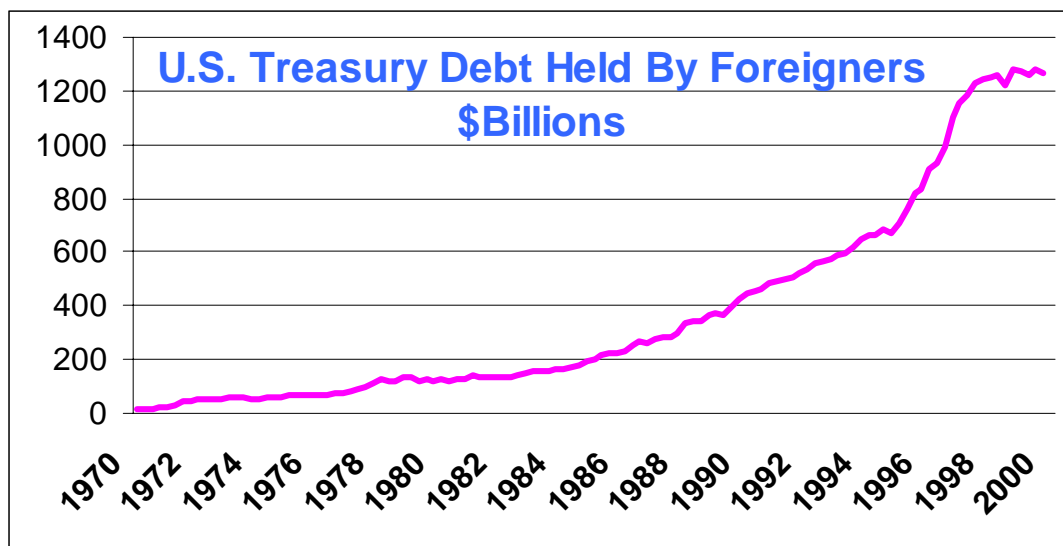
We know that the Federal Reserve keeps a model of fair value that compares the earnings yield of the S&P 500 (1/Dividend Yield) to the yield on the 10 year Treasury Note. That model gives a general idea of “fair value”. Below we show the Excess Money Supply to the Fed Model of Fair Value with excess M2 leading by 9 months.



With money supply liquidity coming down to levels more reasonable to GDP growth, the logical question is where is all of the money coming from to support stock prices? First you might notice that as the client of a value manager, not all stock prices have been supported. The “new economy” has dominated equity markets for the past year, not just producing spectacular gains in the internet hardware, biotech, chip manufacturers and dot.coms but also sucking the life out of every other sector. The more serious problem, and (we think) the chief concern of the Federal Reserve is household borrowing to play on Wall Street and to maintain lifestyle.

It is little observed that America is borrowing much of its consumption. Last year we spent 103.5% of our earnings, and the difference was loaned to us by the overseas producers of oil, automobiles, food, clothing, etc. who wanted to sell into our markets so badly that they would take excess dollars beyond their need to purchase our goods and services. At the end of the quarter, that excess was running at the rate of \$400 billion per year.

Tied with Alexander Hamilton, as the best bond salesman of all time is Robert Rubin during his tenure at Treasury. He managed to convince foreign central banks to buy over \$600 billion of U.S. Treasuries with their excess dollars. The chart below shows that either central bank’s have enough Treasuries or proves that his successor (Larry Summers) never went through a Wall Street sales training class.



We believe that an increasing number of trade imbalance dollars are finding their way into our equity markets, and are not necessarily destined to stay here forever. If so, their repatriation to their natural home (Japan, France, China etc.) will put substantial pressure on the Fed to maintain currency stability. Up until now, we have had a policy of maintaining higher real interest rates than our trading partners to keep foreign deposits money here. But as economic recovery

proceeds in Asia and Europe, their domestic demand for savings will increase and money may well leave.

### **Well Calculated Risk**

In October 1997, William Sharpe, the Nobel Laureate (developer of the concept of Beta and the Sharpe Ratio), gave a speech called "Financial Planning in Fantasyland", at UC Davis. He poked fun at the software being used by the financial planning community because he felt that simple computer programs were being used to give Americans a false sense of security about their retirement years. He stated that most of the computer models in use made just one assumption about the financial future, and ignored most of the risk. "An investor sees that he doesn't have enough money for retirement," he said. "Then he makes a couple of mouse clicks to increase the weight of stocks in the portfolio and presto! The shortfall disappears. What he finds out only later is that he's added a lot more risk to his portfolio to close the gap."

The American appetite for equity risk has skyrocketed in the past four years. The asset allocation to equities has never been higher at the individual level, and how individuals manage the coming fluctuation in values is yet to be determined. Barron's magazine wrote in mid March of 207 internet companies (out of 371 listed) with at market value of \$1.3 trillion. They estimated that 51 will run out of cash in the next 12 months if they continue to lose cash at the current rate reported. The common theme in all these companies is the profit-boosting impact of equity options. When the market price is going up, cash flow isn't a constraint because replenishing the capital is easy. It has been preposterously proposed that the "new economy" companies are not affected by rising rates because they are typically debt free. This is only true as long as there is a strong public market for new shares of their stock.

To illustrate: When an employee exercises an option, he or she is immediately taxed on the benefit (the difference between the grant price and the selling price). That is a real benefit to the employee, and should be taxed. If the company had paid that benefit directly to the employee, the company would have been entitled to a deduction. We know that the company didn't pay that benefit, but in an accounting non sequitur, U.S. companies are allowed to deduct from their earnings the taxable gain that their employees got from the option's exercise. When companies grant an option they don't have to count it as an expense, but when the option is exercised, the employee pays the tax and the company gets to deduct their employees' tax cost from their taxable income.

Consider the accounting of the two most loved and admired companies in the U.S. at the end of the Quarter: Microsoft and Cisco Systems. Microsoft got a tax refund of \$3.1 billion in FY 1999 to reflect the tax paid by its employees on their exercised options. With the corporate tax rate at 35%, Microsoft would have had to spend about \$9 billion in wages to get a tax refund of \$3.1 billion. Microsoft

spent nothing. In fact, its employees paid \$1.3 billion to exercise their options. Microsoft's FY 1999 after-tax earnings totaled \$7.8 billion. As an aside, Microsoft offers put protection to fund managers, by selling warrants to buy back its own stock at lower prices. Because Microsoft has been steadily rising in price, these warrants have expired worthless and the company counts the proceeds as earnings. In FY 1999 warrant proceeds were \$700 million. Thus if the price of Microsoft actually falls for an extended period of time, \$3.1 billion in tax refunds, \$1.3 billion from option proceeds and \$700 million from selling put warrants might be in jeopardy.

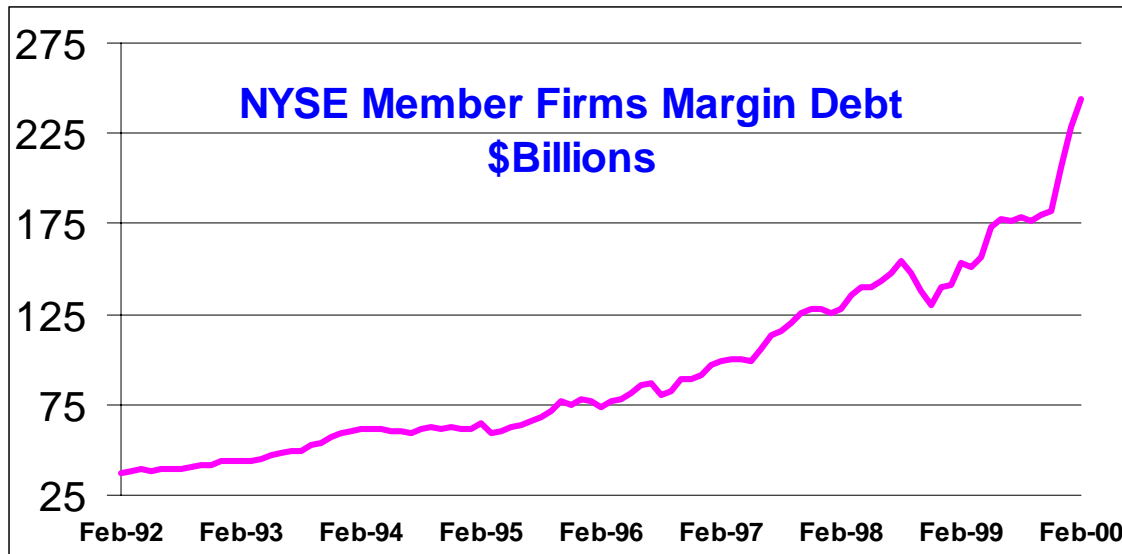
At Cisco Systems, at this writing the most valuable company on earth, reported earnings of \$2.1 billion. The cost of options grants amounted to \$498 million while the tax benefit from the options exercised amounted to \$837 million. In total, well over half of its reported after-tax profits would disappear in a prolonged bear market.

We dwell on this at length only because the Vanguard 500 (an S&P 500 index fund) is now the largest mutual fund in the nation, and is allocating approximately 10% of all new funds to three companies: CSCO, MSFT and GE. The nation's (now scarce) resource of personal savings is being allocated at the margin by momentum players who care nothing about fundamental analysis. Passive investing does nothing to sort the sound business models from the failures. In earlier times, when the public had not yet assumed the role of venture capitalist, such a function was carried out by commercial banks and very sophisticated investors who knew their industry well and kept a tight reign on capital spending. Now this is done only in hindsight after the models have failed. The now blind source of capital is funding many dubious business models at the expense of all credit users. We believe that this is indeed the proper concern of the Federal Reserve.

While it is reported that there is little wage inflation, the anecdotal stories of talented professionals going to work for startup companies to be paid in options are legion. While this may not be a permanent misallocation of resources, it clearly points out the allure of a rising stock market and capital gains tax over "earned income".

As long as the party continues on Wall Street however, everyone seems content. The "wealth effect" is widely discussed, and despite the Fed's open desire to dampen it, continues to fuel personal consumption. We have mentioned before that Americans continue to withdraw equity from their homes to purchase stock. While no nation was ever terminally harmed by such fads as uranium mining stocks, baseball cards, collectable Barbie Dolls or even contemporary art, the demand for "new economy" stocks surpasses anything we have seen since our careers began in the early 1960's. NYSE margin debt is rapidly approaching the net capital of member firms, and has become almost half the size of the Federal Reserve assets.

Bob Rubin, speaking in February to the London School of Economics said, “since returning to New York, I have been struck by the pervading assumption that all will always be well in the financial market.” “Investors would do well to consider increasing risks”. “The idea that the new technologies can erase business cycles is a myth. New technologies are of profound importance, but they are not the first new technologies of significance. Auto’s, electricity, railroads, and medicine led earlier productivity booms and none of them, separately or together produced one way prosperity”.



We at Cascade are not so much concerned by the mania as by the leverage. It is our view that the policy of the Federal Reserve is not necessarily destroy the value of stocks, but to change the attitude of the American people towards speculation. Building meaningful products, implementing productivity innovations, working hard and saving a significant portion of ones income has been the best past means of accumulating wealth. The history of day trading on margin in “new economy” stocks has as yet an unwritten final chapter.

Geoffrey W. Cutler

April 6, 2000