

SKBA CAPITAL MANAGEMENT

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CUCKOO CLOCKS & BALD SPOTS:

THE SURPRISING PERSISTENCE OF INNOVATION & INDECISION

By Matthew Zuck

And time yet for a hundred indecisions,
And for a hundred visions and revisions,
Before the taking of a toast and tea.

In the room the women come and go
Talking of Michelangelo.

And indeed there will be time
To wonder, "Do I dare?" and, "Do I dare?"
Time to turn back and descend the stair,
With a bald spot in the middle of my hair—

*From The Love Song of J. Alfred Prufrock,
by TS Eliot*

We all sometimes worry about appearances, or chat idly and urgently about nothing. This is human nature. *The key is not to be frustrated by these biases, but learn to profit from them.*

As the War on Terrorism, War on Iraq, War on Afghanistan, War on Drugs, and other "wars" drag on, we realize there will be time to worry about gossip and appearances. The backdrop reminds one of Orson Welles as Harry Lyme in The Third Man:

"Italy for 30 years under the Borgias they had warfare, terror, murder, and bloodshed, but they produced Michelangelo, Leonardo da Vinci, and the Renaissance. In Switzerland they had brotherly love - they had 500 years of democracy and peace, and what did that produce? The cuckoo clock."

As a war criminal on the run, Lyme had a vested interest in romanticizing post-WWII Vienna – a grotesque perspective. Warfare presented opportunity for men like him. But Lyme also had a point -- *never underestimate human ingenuity in the face of adversity.*

When faced with a challenge, people and organizations often surprise themselves with their ability to adapt. This ability to adapt is part of the fundamental process that ends up manifesting itself as competition and mean reversion of economic profits. In the United States, this process of competition and mean reversion is more robust than in other parts of the world because we have fewer constraints on the flows of capital and labor.

Over time, Wall Street's "hundred visions and revisions" of earnings become noise. As this noise fades into the background, we expect the most likely surprise to be the extent to which businesses have adapted to their respective markets.

This is not to say that we expect a sustained economic boom, but that as a result of this persistently surprising adaptability, the resiliency of the economy is much greater than most thought possible.

As investors, an understanding of competitive forces and innovation results in our being less optimistic than most in a boom and less pessimistic than most in the bust. In a boom, we expect high returns to attract capital and competition, thus reducing the returns. In a bust, we expect innovation to produce surprising efficiencies and support returns.

While Wall Street looks for the \$0.01 in next quarter's earnings, at SKBA we will be trying to find the \$1.00's which companies are adapting to earn three to five years from now, but which are not in the price today.

In this sense, our goal is to constantly be out-of-step with today's gossip and appearances, or, in other words – to systematically find profit for our clients in the fear of bald spots and in the comfort of cuckoo clocks.

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