Client Newsletter

SKBA CAPITAL MANAGEMENT

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The Growth and Value Debate – made easy!

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A Tale of Two Eras

The year is 1998. The rate of inflation is falling toward 1.5% and the economy is booming – nothing could be more "perfect" for most of corporate America and for stock investors. Well, almost everyone. Commodity-based companies are in the dumps.

Oil is nearing $10 a barrel and the respected Economist magazine predicts $5 as the next level. Natural gas troughs below $2.00 an MCF, gold drops below $250 an ounce, copper is selling below $2,000 per ton (less than 90 cents per lb) and the CRB (Commodity Research Bureau) is bouncing along at 20-year lows. During this high-growth, low-inflation period, a rapidly dwindling number of investors remain convinced that demand from an unprecedented global economic boom will likely bring about an increase in raw material prices. In 1998, many companies that operate in such lines of business are generating losses, cutting their dividends, and declaring bankruptcy. (Not until 2003 is Wilbur Ross able to assemble multiple bankrupt steel companies, repackaging them to form International Steel Group into a successful IPO and sell the company to Mittal shortly thereafter-but that's yet to come.) In 1998, "old economy" stocks, many of which would generate substantial profits under more normal raw material prices, are summarily discarded by the investing masses. Philips Petroleum, Phelps Dodge, Nucor, and US Steel are all well run firms with substantial market shares in their respective businesses and geographies. Yet the common perception is that they are no longer relevant. Growth investors are nowhere to be found.

Rather, in the years 1998 and 1999, growth managers believe we have entered a New Era of rapid growth and rapid price appreciation. (We have entered an era in which profits are a hindrance to security analysis and valuation predictions.) The four stalwarts of the stock market include Microsoft, Intel, Dell, and Oracle with combined market capitalizations in excess of $1 trillion. Five of the ten largest companies globally by market capitalization operate in technology and telecommunications. Microsoft has successfully won the "Browser War" over Netscape and is now the largest company by market capitalization (displacing Exxon, WalMart and General Electric). While valuations are somewhat rich for fundamental investors' palates, the sustainability of their businesses is well within the reaches of logic (of the day). All four companies are industry leaders in market share as well as profit generation. Their valuation multiples reflect their ability to generate "monopoly profits/rents" from their technological innovation. From the value investor's perspective, all four are superb companies whose expectations, nevertheless, seem to be more than adequately reflected in the prices of their shares.

In even higher orbit, more recent leaders of the New Era include Yahoo, Amazon, Ebay, AOL and Cisco Systems. These profitable companies are valued at levels generally considered outside the realm of any reason; they, nevertheless, appear to exhibit successful business models. The remaining New Era companies, too many to mention and the majority of which have since disappeared – not merged or acquired, simply disappeared - neither have nor ever anticipate generating profits. In addition, their business models are quite opaque. This, however, is the inherent beauty of the New Era – the less defined the business model, the less the ability to question its potential. And potential is what the new investment metrics are founded upon.

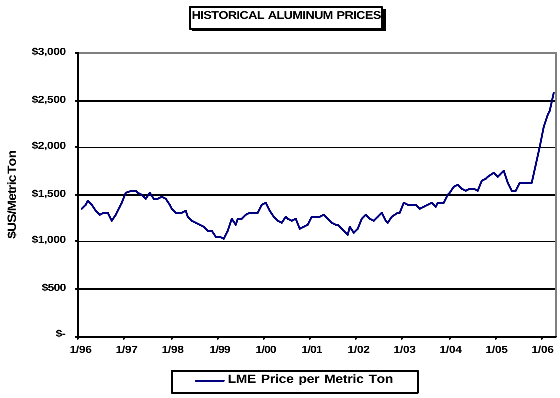
Much has been written about the technology bubble of the late 1990s, the likes of which we will not likely experience for a few generations, or until Gen Xers lose whatever credibility they have left. This bubble was unique not only due to the companies' lack of earnings, but due to a lack of revenues as well. While eyeballs and clicks were many, revenues remained mostly elusive.

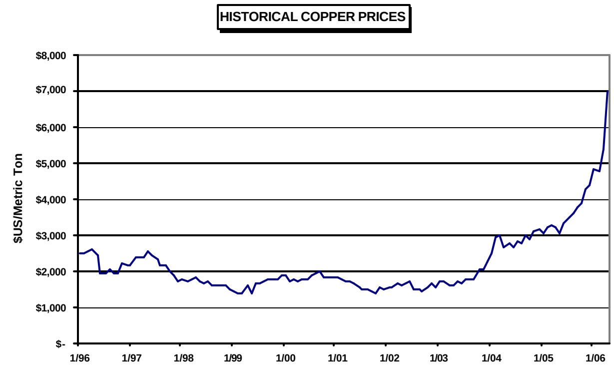
Out With the New, In With the Old

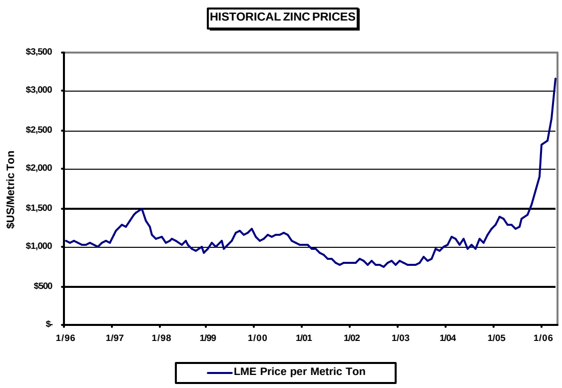
Fast forward to 2006. The world economy and corporate profits are booming, and somehow, most arguments, and markets, are "backward" – literally in commodity futures markets! In addition, the benign inflation rate of the 1990s has doubled. Copper just hit $8,600 a metric ton, or $4.00 an ounce (though futures selling at $1,500/ton lower may possibly be indicating a top). Zinc, nickel and gold are all reaching or surpassing their decades-old highs. Similarly, oil has flirted with $75 a barrel and estimates of $100 no longer seem out of reach (to many market seers). Exxon is, for the first time in years, the largest company by market capitalization, having displaced Microsoft and General Electric. Four of the largest ten companies globally by market capitalization operate in the oil patch. Natural gas has come back down to nearly $7 an MBTU from a $14 peak last summer following the hurricane season in the Gulf of Mexico. (To us, the natural gas market seems reasonably priced considering the long-term supply-demand fundamentals.) This decade is beginning to look like the 1970s in which hard assets increased due to geopolitical tensions, oil embargoes, an unsuccessful war effort, an impeached president, and higher inflation.

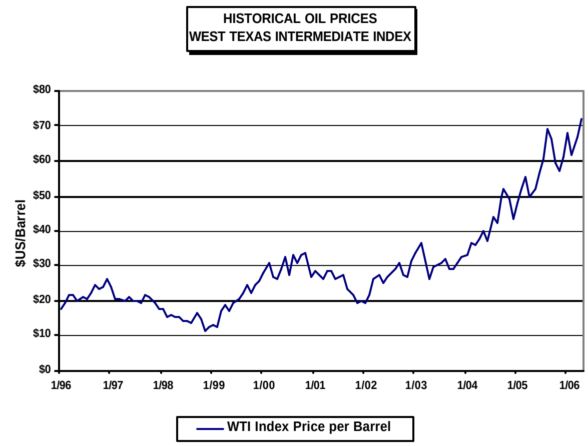
Today, Nucor, US Steel, Phelps Dodge, and ConocoPhilips are all earning record levels of profits. In 2005, Phelps Dodge and Nucor generated ten times the level of profits of four years prior. As in 1998, these companies remain well run. Growth investors shunned all of these companies back then while value investors gravitated towards them. Today, conversely, we stubbornly find ourselves in the camp that believes recent profits are far above normal. Profits are coming from spikes in spot and futures markets for most base metals. If these commodity prices continue on this unabated track, we are destined to experience global corporate profit shortfalls (if not a recession) as firms will be unable to pass on such drastic cost increases. We do not see these prices as sustainable, however, and are not as worried about economic growth as we are that many mining companies are earning unsustainable profits. Neither are we implying that today's commodities markets are akin to the technology bubble of the late 1990s, profits being an important differentiator. Our main observation is that speculative fervor is alive and well in certain well-defined markets. While we have no insight as to how long this will last (having long ago learned that we are not particularly adept at market timing), we would caution that current price levels do not seem to accurately reflect long-term equilibrium prices. This area is, nevertheless, the one in which growth investors are presently gravitating to en masse.

The four charts below graph commodities over the last ten years. Following nearly two decades of trend-less or declining price trends, commodity prices, particularly for metals, have surged to above the last peaks experienced in 1980.









What of the New Era constituents in 2006? Steve Ballmer, Microsoft's CEO, is about to make his first appearance at a Wall Street sell-side conference in six years, a clear sign that the company's message is not getting across. Investors are pushing for the company to repurchase up to $60 billion in its shares, representing 25% of the company's market capitalization. The company's shares are trading at the same level as in 1998 while sales, cash flows and profits have doubled. The perception is that no amount of additional spending will prevent Google from eroding its market position. If past is precedent, however, Microsoft has successfully thwarted competitive efforts to displace it in certain markets (Netscape and RealNetworks among others). Investors pushing for change at Microsoft and others have strong proclivities to value disciplines, and value managers have rarely been offered so many opportunities to buy supposed "growth" stocks at "value" prices! Similarly, Dell's shares are at the same levels as in 1998 while revenues, earnings and cash flows have tripled. While Microsoft, Dell, Intel, and Oracle have lost over half of their combined market value since the 2000 peak, their combined revenues have increased almost threefold. Similar dynamics are presently playing themselves out with many high-technology companies including Intel, Applied Materials and Cisco. Yet growth managers have abandoned them in droves.

Nokia and Hewlett Packard, two companies currently held in client portfolios, were recently selling at levels not reflective of their long-term fundamentals. While their near-term earnings were under pressure, their ability to return to more profitable levels remained mostly intact. While Microsoft, Dell, Intel, Applied Materials and Cisco have and always will be under competitive pressure, their market leadership has generally remained intact. Some have maintained market leadership through acquisition while others have achieved it through superior execution.

The resounding point to be noted is that we see little difference between growth and value with the exception of the price one is willing to pay for a business. Growth rates impact the short-term but tend to revert back to normal over time. We are witnessing this today as many technology companies expect to grow revenues in the mid-to-high single digits (a far cry from the New Era). Six to eight years ago, we were struggling to justify valuations on most technology companies. On the other hand, copper, steel, gold, and energy companies were selling at huge discounts to any normal operating profit metric. Today, we maintain exposure to the energy sector given the compelling long-term supply demand dynamics. However, since we feel that certain raw material prices are probably above normal, we are tempering our exposure.

Conversely, many sectors, technology and healthcare being prime examples, are very attractively priced. We currently find ourselves owning and seriously considering more technology investments than we have in years. As markets approach their six-year highs, the universe of securities attractive to us has not diminished; it just so happens that, once again, it is filled with companies that have been discarded by growth investors. This has enabled our exposure to increase in sectors historically limited to the purview of growth investors. We currently own Nokia, Intel, Hewlett Packard, and Sun Microsystems and are becoming intrigued by Microsoft and Dell. And while we would be happy holding onto these for years to come, we realize that most of their valuations will at some point increase to levels above our fair value estimates. If and when they do, there is a high likelihood that 2006's growth investors will have once again abandoned superb oil, gas and copper companies.

We look forward to revisiting this topic in 2014.
