

Impressions

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Delicious Irony

Irony is a qualification of subjectivity
Soren Kierkegaard

The supreme irony of business management is that it is far easier for an inadequate CEO to keep his job than it is for an inadequate subordinate... At too many companies the boss shoots the arrow of managerial performance and then hastily paints the bull's eye around the spot where it landed.

Warren Buffet.

Perhaps the best definition of irony is the incongruity between what might be expected and what actually occurs. In rhetoric it is casting a deliberate contrast between the apparent and revealed.

Irony is one of the most sublime uses of the English language often mistaken for argument. The question is why am I bringing this up in terms of an investment letter? For three reasons: first, to hammer home the idea that good intentions do not mean good results, second that the law of unintended consequences is still in effect and third that I was right about something.

A number of years ago I wrote a piece about the unholy alliance between the trial lawyers and the state attorneys general. The theory was that states were persons in equity in class action lawsuits alleging defective products because citizens of the states in-

jured by the allegedly defective product cost the states money.

The trial lawyers were running out of time and money to pursue the tobacco companies but the states had huge resources (your tax dollars). Secondly it allowed the states to get revenues without taxation.

The states eventually signed a master settlement agreement (MSA) with the tobacco companies. The money was supposed to be used to repay the states for health care costs, to promote antismoking programs, and provide money to cover future smoker's health care benefits.

MSA contained an overlooked irony. Its predicate was that to pay the annuity the tobacco companies had to stay in business and at the same levels of profitability they had always enjoyed. If the antismoking efforts were successful, state tobacco sales tax revenues would fall. So the states secretly needed people to continue to smoke. But if people continued to smoke the state health care costs would continue to rise, this is the very definition of irony. But it gets better.

Smoking in the United States is largely confined to a few Hollywood types who need to put something in their mouths other than their feet, and lower income earners. The real irony of the settlement is that on one hand the federal government and some of the state governments were subsidizing farmers who grew this socially and morally of-

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fensive product while on the other hand wanting their poorest citizens to keep smoking and if possible increase consumption.

The poor are most dependant on public healthcare and they are disproportionately smokers. So not only are the states engaging in a steeply regressive tax structure against the poorest citizens but they need to expose those people to additional health risks to support the settlements from the tobacco companies. I am getting a headache.

The late Jesse Unruh said that money is the mother's milk of politics. The states suddenly found themselves in a recessionary pinch, tax revenues down and fixed spending up equal budget deficit. The issuance of bonds could do real damage to the state's credit rating unless the bonds could be secured by something other than tax revenues.

So Wall Street steps into the breach. As you all know the purpose of the capital markets is to allow you to use money today that will be coming in the future. So a bond could be issued today backed by the funds coming from the settlement. So the irony continues; here is money destined for the poor to help them stop smoking, to repay health care costs, actually being spent to secure a borrowing which can be used for other purposes so the poor and dependant and the tax payers are exploited again.

Now comes the really wonderful part. While the number of tobacco cases declined the companies were still being found guilty of various offenses and finally it hit a wall. An Illinois state judge ruled that Phillip Morris was guilty of misrepresentation and hit them with a \$10.8 billion dollar fine. To appeal Morris would have to post of bond of 12.5 billion. It just so happened that this ruling occurred about the same time that Phillip Morris was due to pay its next installment of the settlement. MO as we call it, even

thought they have changed their name to Altaria Group, told the judge that if they had to post the bond, the company would be pushed into bankruptcy. Wailing and gnashing of teeth followed.

It seems that several states including hapless, feckless California had arranged to sell bonds backed by the current payment and future installments and those bond deals had to be shelved. The rating agencies (Wall Street's equivalency to Saddam Hussein) immediately downgraded MO's bonds and also those of Kraft, and all the previously issued tobacco muni bonds.

It all turns out well, temporarily because the state court worked out a deal to reduce the bond and MO did not file bankruptcy and made the scheduled payment.

So now I have spent two pages telling you the history of this deal so why is it important to you as an investor? The first reason is that investment has to be made on the grounds of hard reality not good intentions.

The antismoking gang's antismoking campaign has trampled on the rights of others to accomplish what they see as a higher social good. Remember tobacco is a legal product, not only legal but encouraged by the tax policy of the United States. So people are punished and denied civil rights in defense of other's civil rights (the right not to be exposed). This is a very dangerous slope, how far will the mechanism of the state go to prevent smoking exposure?

In the hysteria which developed over the evils of the tobacco companies the psychology behind the firms changed. While we all knew the effect of the MSA on cash flow what the market could not predict was the impact of people's psychology on the stocks and future jury awards. The states did not think through the concept of the imposition

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of a regressive tax on their citizens and the need for those citizens to smoke to accomplish the higher goal of getting them to stop smoking. This is counter intuitive thinking at its best. This is an example of why governments should never be in business.

Because they are elected officials the AG's did not take into account the natural inclination of other elected officials (state legislatures) to beat the ground for sources of revenue other than taxes. The AG's allowed the money to be received as general revenue of the state. Along comes a recession with already high tax rates, high levels of imbedded spending from the boom times, and a high political cost to cutting programs and employment and the covetous eyes of government falls on the golden goose. Hey, we are short of money, let's use the American system and borrow it and use the tobacco money for security. Suddenly the strident voices of anti smoking crowd are stilled by the overwhelming justification of the need for the money.

The MSA has killed the tobacco companies in the United States. The combination of anti smoking assaults, the negative health effects of smoking and increasing cost are pushing the pricing elasticity to the limit. Unless those who continue to smoke use more product there has to be a fall off in revenues. The only answer for the tobacco companies is to raise prices. While the elasticity of tobacco demand is high it is not infinite there is a level at which pricing will result in large drops in usage. When this happens what is going to support the tobacco bonds?

The counter argument is that the states are only pledging a small portion of the settlement. That is for now. It is as inevitable as the rain in Seattle that governments will not be satisfied at this level there will be contin-

ued pressure to use the money for bonding, and the voices of the American Lung Association and the other anti smoking groups are not loud enough or strong enough to stop the trend.

So far everyone is happy. The trial lawyers have won the cases and are now busily suing each other and the states over whether their fees should be obscene or merely grotesque. The AGs have suddenly become powerful, the anti smoking groups have gotten their campaign and pound of flesh, big tobacco has found an expensive way to limit liability for past acts. Guess who isn't going to be happy much longer?

The taxpayers of the states, because when the business denigrates enough the companies will not pay in full the bonds will be unsecured and the tax payers will have to foot the bill.

Watch out for good intentions and unintended consequences in litigation and cast a weather eye on the drug companies and insurance firms, they could be the next victims of this insanity.

Always be careful if a group of melodious voiced, wire rimmed glass wearing fanatics get together with their self satisfied smiles to ban something, usually the concept has not been well thought out and is based on pure emotion rather than good sense. Never buy an investment which bets on the outcome of litigation or government action. It is a bad bet on people who have no incentive to help you.

The Markets

People are always asking me what do I think about the markets, when will they get going again? There are times I think I should have a business card made up that lists me as a

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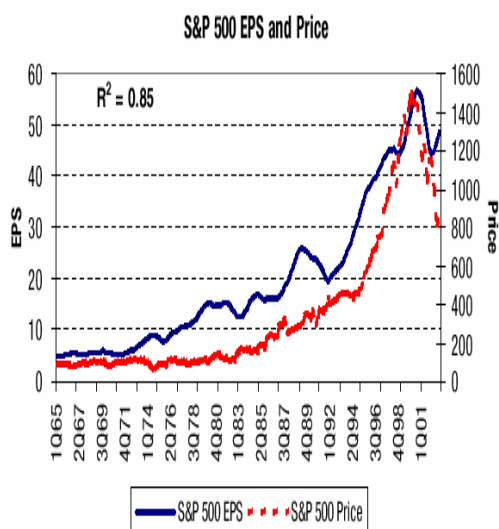
NY Life Insurance Agent, no one wants to talk to them!

With the exception of 1987 I have never seen a multi-year bull market that was not followed by a multi-year bear market so ten years bull cycle has been followed by the last three and the question on everyone's lips is it enough?

There is a widely accepted theory that the market would have to decline to Dow 5,000 to reach a point where the combination of dividend yield and valuation would be right to produce the long term investment return of the last 70 years. Good logic bad conclusion.

Things did not change that much in the last ten years, like President Clinton a good deal of it was illusionary but a few things did happen. The first was that there was tremendous spending on technology and communications and the potential productivity of that spending has yet to be felt. What will unleash the resident energy and make it kinetic? It will be software that integrates it all into one functioning mass. Sounds like the Holy Grail doesn't, it but it is coming.

Chart One



The internet is now moving to its third phase of development and with it comes tremendous possibilities for reduction in distribution and other fixed costs. In an environment of low inflation, low cost of capital and low pricing power, the reduction of costs and the increased turn over of assets are going to be critical to acceptable rates of return. So the technology of the internet has an opportunity to reignite earnings growth.

I have added a couple of charts that I think do a good job of stating the conundrum the markets find themselves in at the present.

This first chart shows the high correlation between the growth of company earnings and the prices of stocks. This is not just a "well duh!" comment. If the psychology of the market believes that earnings are going to grow slowly or at historic trends for a long period then the market participants will not award high or expanding price earnings multiples to the market. Most of the last bull market was due to expansion of PE multiples based on hope of expanding earnings. What happens if they do not grow?

Chart Two

Decade	Total Return	Price	S&P 500		
			Dividend	EPS	Price Perf. / EPS Growth
1900-1910	9.84%	5.47%	4.37%	5.60%	0.98
1910-1920	4.19%	-1.30%	5.50%	2.05%	(0.63)
1920-1930	14.97%	8.97%	6.00%	5.71%	1.57
1930-1940	-0.10%	-5.22%	5.12%	-4.31%	1.21
1940-1950	8.92%	2.96%	5.96%	8.08%	0.37
1950-1960	19.09%	13.46%	5.63%	3.83%	3.52
1960-1970	7.69%	4.36%	3.33%	5.43%	0.80
1970-1980	5.83%	1.59%	4.24%	9.82%	0.16
1980-1990	17.39%	12.48%	4.91%	5.42%	2.30
1990-2000	18.05%	15.18%	2.87%	7.20%	2.11
1995-2000	28.03%	25.70%	2.32%	9.79%	2.63

This second chart shows that in most periods dividends accounted for half of the total return on stocks. With the dividend paying stocks in the S&P 500 yielding 2.5% that

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would equate to a 5-6% return on the stock market.

What could change this is a prolonged sideways movement. Corporations having 'come to Jesus' meetings with their business models while repairing balance sheets, integrating technology and then generating lots of excess cash flow. Eventually this could lead to a catch up of the earnings/dividend stream to the prices. So there is no real need for a further huge downward move to adjust prices.

I am not saying don't worry be happy but I am saying that money can be made but you and I are going to work for every dollar.

Performance

For year as I write this the 500 index is up about 4.2% and most of that has come since the end of March. As I look over the account reports I see that we did not have a very good first quarter it was not horrible but it was not good.

It is my contention that the rally we are having is one of relief, recognition of some sectors doing well, professionally motivated by hedge funds and a counter trend rally in the over all bear trend. It just doesn't end this fast folks!

Television

If you are reading this and really wonder what is my thought process and what I look like when I get dressed up we were recently featured on a local television show call Entrepreneurs and Innovators. It available on the internet at www.scctv.net click the button for Entrepreneurs and Innovators and you will see my name under the archived shows. If you have a broadband connection you can watch it on your computer. It is an

hour but we are working on a shorter version.

Deflation

Just as we were going to press with this letter the Fed started using the D word. Not damned or darn or deficit but deflation. Deflation is the most dangerous of all economic beasts because it is so little understood and because we as Americans are so unprepared for its effects. To deal with deflation one has to turn thinking about investments on its head. You do not want to own leveraged real estate, or hard assets, you do not want to be heavily in debt, you have to get used to prices falling and the purchasing power of money increasing.

Like sin a little deflation does little harm but again like sin a little sin constantly engaged in over a long period does a lot of damage. A lot of deflation is really ugly in a credit driven economy like ours.

I will start working on the next letter which will discuss deflation in some detail.

Good Luck

Dennis Gibb