Economic Update

Waiting for Eighty

March 1, 2012

A few times in each generation, a transformative company is born, one which not only revolutionizes industry as it has been done in the past, but often creates significant new wealth for its forward looking owners. Microsoft, Intel and Cisco Systems (known collectively by the moniker WinTelCo) are three examples that introduced computing and networking to the world some thirty years ago. Google, Apple, Amazon and Facebook have been the new players in town, revolutionizing the way the internet and communications are used, with far reaching impacts on industries as diverse as music, advertising and the personal computer.

At the turn of the century, the Ford's, Carnegie's, and Vanderbilt's embarked on similar paths that while different, nevertheless rhymed. Steel and oil gave rise to automobiles and railroads, with dramatic effect on mass production techniques, transportation networks, and subsequent uses for energy. JP Morgan and Andrew Mellon helped finance it all, giving birth to our nation's modern banking system.

I suspect that there were those who quibbled over the appropriate valuation to pay for a dollar of Ford's earnings in the early days of the automobile industry just as investors similarly questioned the wisdom of paying $85 for Google when it went public eight years ago. Only now do some believe Google is a good investment based on the merits of "value" alone, but in quibbling over +/- $20, such investors may have missed out on $525 in subsequent gains. In my experience, focusing on the appropriate valuation to pay for transformative companies alone would be the historical equivalent of negotiating the price of a haircut on the Titanic.

At the same time, I also witnessed vast sums of wealth accrue to early investors in the WintelCo complex only to watch it go down the drain when the environment changed. An initial investment of $10,000 in Cisco by one client was worth $11 million when the shares hit an all-time high of $80 twelve years ago. Since the tech bubble cratered, shares of Cisco have never recovered to those once lofty levels.

While the gains remain outstanding for the earliest of investors, a strategy of now "waiting for eighty" to sell has clearly been misguided. Cisco's shares have been stuck in a trading range of $10-$30 for the last twelve years and only recently did the company begin to pay a modest dividend.

Similar fortunes were also created during the industrialization of America over one hundred years ago. Euclid Avenue in Cleveland, Ohio, once known as Millionaire's Row, was in its day one of the wealthiest streets in America and home to John D. Rockefeller, the world's richest man. While Northeast Ohio remains a great place to

live and work, the one-time millionaires who once lived on Euclid Avenue would no longer recognize it. Transformation can be shocking in both directions.

For much of the past twelve years, the equity markets have hardly been known as a place to get rich as was the prevailing mood during the tech crazed 1990's and roaring 1920's. What has been the fastest way to a net worth of a million dollars over the past ten years? By starting with two million, or so the joke goes. While a handful of companies like Apple and Google have bucked the general market trend, being an equity investor hasn't been easy.

Apple Computer, along with a few other companies, has been particularly kind to investors in recent years, minting many new millionaires just as prior transformative businesses did before it. If you've been fortunate to participate in the wealth created by a company like Apple, a pressing question is always how much higher can it possibly go or when do I sell?

Thirteen years ago, when people asked that question about Cisco, I often replied that selling would be like trading Michael Jordan. Why ***ever*** trade a winner? With the benefit of hindsight, the pain of real experience, and lessons from history, I now realize that this flip response was both shortsighted and arrogant. As Michael Jordan ages, making his skills less valuable, LeBron James waits in his wings. Euclid Avenue fades from memory, ceding storied ground to newcomers in places like Palo Alto and Silicon Valley. The question is not whether the glory days will end, but when.

I've never met anyone who sold their positions in Cisco, Microsoft, or Intel precisely at the peak, even though there are many who have tried or still think they can. More wealth has likely been lost by the average guy attempting to avoid capital gains taxes at all costs or "waiting for eighty" than any single individual who maximized their profits by cashing out entirely and precisely at the peak. As mentioned earlier, there are also those who avoid investments in transformative companies altogether simply because they couldn't get their hands around the valuation question or more likely were unwilling to consider what the future might look like.

The Broadleaf approach seeks to strike a balance between the two extremes. We will participate in the wealth creation opportunities that transformative players afford but will also systematically prune our winners along the way. The strategy isn't intended to achieve maximum gains for clients, but is a tool for managing risk in the portfolio and to guard ourselves from becoming emotionally attached to our portfolio holdings. By occasionally paying ourselves a dividend from our successes, an added benefit is that we free up some capital to invest in what we hope will become tomorrow's class of winners.

And so it was that we pruned the Apple tree yesterday as the shares surged to new highs. The pruning move isn't a bet against Apple - it remains the largest single position in the portfolio – but it does represent our tacit acknowledgement that the good times won't last forever and that we won't possibly exit the position completely at precisely the right time.

Henry Ford, Cornelius Vanderbilt and John D. Rockefeller were the rock stars of their business generation, but eventually ceded the stage to rising stars like Bill

Gates, Steve Jobs, and perhaps Mark Zuckerberg today. For all his gifts, LeBron James is most certainly closer to retirement today than he was yesterday.

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Shifting gears to the markets in general, we believe a significant shift in investor psychology is underway after many years of prolonged and painful drought. Just as a stronger economy engenders hope about the future, it also has the benefit of smothering the noxious fumes of political division.

To be sure, issues in Europe have not been resolved and exogenous shocks like the Japanese earthquake, the Gulf oil spill, and a nuclear Iran are ever present realities. The biggest risk to the economy right now may be rising gas prices at the pump. At the same time, when gas prices were at similar levels last year, mortgage rates were higher, consumer confidence was much lower, and employment trends were moving in the wrong direction. Can the United States reassert its leadership in the global economy?

We believe it is and it can.

Roughly two years ago, we presented a point of view that America could experience a manufacturing renaissance, catalyzed by more aggressive moves by China to subject their currency to market forces rather than pegging it to the value of the U.S. dollar.

One thing we hadn't expected nor could we anticipate was the impact that new supplies of cheap natural gas might have on American industry. In recent months, several companies in the chemical, auto and textile industries have announced factory expansions in the United States on the basis of our cheap natural gas resources. For some, these represent the first new factories on U.S. soil in multiple generations. We suspect others will follow.

As methods of transporting our cheap natural gas in liquid form around the globe are financed into reality, we expect that the much higher overseas prices of the commodity will converge to our own, unleashing a new wave of global productivity, not too dissimilar from the impact that silicon has had in recent decades.

But for today, the advantage is uniquely our own.

Kindest Regards,

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