

## Foundation Resource Management Quarterly Commentary 3<sup>rd</sup> Quarter 2003

Although there was a slight pullback in the stock market in late September, most investors benefited from the second consecutive quarterly increase in stock prices. It seems that most stocks have performed reasonably well this year even though there are certain performance observations that we would highlight. Speculation, which ruled the day in the U.S. stock market four years ago, has begun to creep back into today's market valuations. This has resulted in a lack of new investment opportunities. We can assure you that our research effort is strong, but our discipline is stronger. We know that good long-term results require patience. We have targeted many investment prospects, but are being patient until they reach an attractive entry point. The good news is that your recent performance has been encouraging in spite of the renewed stock market speculation. We can only attribute this to stock selection, as most value indices have fallen behind most growth indices this year.

We have frankly been surprised by the short memories that stock investors have retained from the several years of speculation in the late 1990s. Technology stocks in general, and those that have poor fundamentals in particular, have led the field this year, as evidenced by the NASDAQ's nine-month return of 33.8%. It seems the worse the company, the better the stock performance this year. In general, companies with aggressive accounting, high leverage, and low profitability have done quite well. Ironically, most technology stocks have premium valuations although many have ten-year earnings growth rates that are below the 3.4% rate of the S&P 500.

Speculation has also returned in the form of margin debt. Margin debt (money borrowed to purchase stocks) has risen rapidly this year, particularly in NASDAQ stocks (See chart below).



Source: CrossCurrents

NASDAQ margin debt reached \$26 billion in July, a 32% increase for the month and a 412% increase this year. That tops the old record of \$21.4 billion in, you guessed it, March 2000. Total margin borrowing, which includes both the New York Stock Exchange and NASDAQ, hit \$174.4 billion in July, a 25% increase from the end of 2002. That total is the highest in two years, although it remains 42% below its peak in March of 2000.

Another surprise is the relative performance of dividend paying stocks so far this year. The tax rate on dividend income has been significantly reduced for most investors to 15%, the same rate as that on long-term capital gains. It was expected that the lower rate would make dividends more attractive to investors and provide corporations with a greater incentive to pay them. It also was anticipated that investors would sell stocks that paid little or no dividends and buy stocks with generous yields. This has not yet occurred. As you know, as value investors, we favor above-average dividend yielding stocks. We believe that dividend yields will be given more serious consideration by investors in the future for both tax reasons as well as issues regarding corporate governance, which we will discuss next.

### CORPORATE GOVERNANCE

Corporate governance issues dominate most of today's business newspapers and magazines. It is very easy to see how investors could grow pessimistic, even to the point of being cynical, about the state of business ethics in our country. We, on the other hand, are more optimistic, not less, as we witness the much-needed improvements to return our markets to a firm foundation of corporate stewardship. Clearly, not all companies should be painted with the same brush. Some companies, in our opinion, are singularly focused on the long-term well-being of shareholders. We believe we have invested in several of those companies on your behalf. However, we believe much work has and must be done to improve the stewardship of corporate America's assets for its shareholders.

Probably the best champion we know proposing broad improvement in corporate governance issues is the outspoken John Bogle, the now-retired founder and former CEO of the Vanguard Group. Mr. Bogle believes that there has been a "pathological mutation" in capitalism. He recognizes that the classic system – owners' capitalism – had been based on a dedication to serving the interest of the corporation's owners, maximizing the return on their capital investment. However, a new system developed – managers' capitalism - in which "the corporation came to be run to profit its managers, in complicity if not conspiracy with accountants and the managers of other corporations."

So who is at fault? Certainly, managements must take some responsibility. The disparity of compensation within corporate America is one piece of evidence. According to the Wall Street Journal, the average CEO's compensation in 1980 was 42 times the average worker. Today, that ratio is over 400 times. From 1988 to 2001, while the annual compensation of the average worker rose 60% - from \$16,700 to \$26,800 – the compensation of the average CEO rose 443% - from \$2,025,000 to \$11,000,000. It would be understandable if the increase in executive

compensation were justified by corporate achievement. However, the statistics do not justify this. From 1988 to 2001, annual operating earnings grew by 3.5%, less than the 5.5% annual growth in America's GDP for that period. That may actually overstate the situation. Reported earnings - earnings reduced by write-downs of bad corporate investments – averaged \$24.70 for the companies in the S&P 500 in 2001. This is barely above reported earnings of \$23.75 in 1988. Nevertheless, managements are not alone in the blame game.

Too many corporate directors failed to consider that their overriding responsibility was to represent the shareholder, not the management of the company on whose board they served. Warren Buffet describes the director's role in his 1993 annual report as follows, "Behave as if the corporation you serve had a single absentee owner, and do your best to further his long-term interests in all proper ways." This issue has become most obvious in the recent developments regarding the firing (resignation?) of Richard Grasso from the chairmanship of the New York Stock Exchange due to controversy over his outrageous compensation package. Often, management hires the consultant who recommends to the board of directors higher compensation for that same management, regardless of performance. After reading hundreds of proxy statements, we have yet to find a board of directors recommending that managements' compensation should be reduced to below median compensation in the industry peer group due to sub-par performance within the peer group.

Nevertheless, our industry, the investment management industry, deserves blame as well. The 100 largest managers of pension funds and mutual funds (we are not yet one of those) now represent the ownership of one-half of all U.S. equities. However, with all that power has come very little interest in corporate governance. Why? Because the overwhelming majority of mutual funds continues to engage, not in the process of long-term investing on the basis of intrinsic corporate values, but in the process of short-term speculation. Portfolio turnover is sky-high such that large institutional investors have become stock-renters, not shareowners. According to John Bogle, prior to 1966, it was a rare year when annual turnover exceeded 16%, an average holding period of six years. Today, mutual fund managers turn their portfolios over at an astonishing 110%, an average holding period of just eleven months. Bogle says, "Fund managers have turned what used to be a profession of stewardship into a business of salesmanship."

This brings us to the importance of dividends. Investing for income is a long-term strategy and investing for capital gains is a short-term strategy. According to Vanguard, the turnover of dividend-paying stocks is one-half the turnover of non-dividend paying stocks. Dividends are "real" in contrast to earnings per share, which can be easily manipulated. A return of dividends to their formerly high standing on the agenda of shareholders would considerably reduce today's high turnover and excessive speculation. We have stated in previous commentaries that there continues to be a shortage of income for savers and investors. In our opinion, good dividend paying stocks should receive more investor interest in the future.

## China-The World's Growth Engine

As we study different companies and industries during the course of our work, it has become obvious to us that China's rapid growth rate is providing the major area of economic expansion in the world. The country is probably the largest manufacturer in the world, despite the fact that its overall economy is considerably smaller than that of the U.S. The tremendous growth in China's economy and in the Chinese people's standard of living will be a major economic force in the world for decades to come. China's economic growth rate is frequently cited between 8%-10%. Ironically, like Japan, the country lacks many of the raw material inputs for manufacturing. For many years, we have had a larger than market weighting in stocks of companies representing commodities. Some of these investments have not been stellar performers thus far. As the world's economic growth and manufacturing base has rapidly shifted to China and other parts of Asia, we want to continue to be well positioned in assets that China is lacking. Some of these include copper, nickel, gold and oil.

### **Growth of Chinese Industrial Production**

#### **Year over Year Change 2002 vs. 2001**

Automobiles	36.6%
Electricity Generation Equipment	66.7%
Alternating-Current Motor	16.6%
Refrigerator	17.0%
Air Conditioner	30.4%
Mobile Telecommunication Equipment	38.8%
Micro Computer	47.1%
Electricity Generated	11.4%

**Source: International Business Daily**

In 2001, China passed the United States as the number one copper consuming country and expanded its lead in 2002. China's maintenance of a strategic reserve of copper ore makes it difficult to pinpoint precisely its supply and demand situation. The Chinese government has been an opportunistic buyer of copper ore when prices are low and less aggressive when prices are firm. Despite the existence of this strategic reserve, a huge supply requirement exists. China only ranks seventh in world copper ore production, or about 4.5% of the world's total, while its number one consumption standing puts it at about 16.75% of the world's total, according to International Business Daily. China makes up the difference by importing ore, refined copper and copper scrap. Their ore imports are large enough to make them the second largest smelter in the world, behind Chile, the world's largest copper producer.

### Chinese Copper Consumption 2002 vs. 2001

	Million Tons		%
	2001	2002	Change
China	2.2	2.5	13.6%
USA	2.212	2.364	6.9%
Japan	1.145	1.116	-2.5%
Germany	1.092	1.076	-1.5%
South Korea	0.849	0.918	8.2%
Italy	0.676	0.663	-2.0%
Taiwan	0.54	0.645	19.4%
France	0.538	0.541	0.6%
Mexico	0.419	0.375	-10.5%
Spain	0.299	0.316	5.7%
Global Total	15.075	14.928	4.2%

Source: International Business Daily

Nickel has been the strongest performer of the industrial metals group in the last couple of years. Again, China is providing the growth. China mines only about 4% of the world's annual nickel production, according to the U.S. Geological Survey. We were not able to find numbers for China specifically, but Asian consumption excluding Japan is cited by Inco (the western world's largest nickel producer) at 26% of the world's total. China is the biggest part of that. Nickel's primary use is in the production of stainless steel and is also used in many batteries. China's fledgling stainless steel industry is expected to drive a worldwide increase in demand for nickel at a minimum of a 5%-6% annual growth rate, with no meaningful nickel production capacity additions seen in the near future.

While China's domestic gold supply and demand are in much better balance (consumption of 200 tons per year versus production of 180 tons per year according to China Daily), as Chinese incomes rise, demand for gold is expected to rise. This is because the Chinese have a cultural tradition of putting a high percentage of their savings in gold, sometimes quoted as 30% or more. This is done in the form of jewelry, as well as the 99.99% pure form. There has also been some speculation that the Chinese government might use its vast stockpile of U.S. dollar reserves to buy gold.

Consistent with rising standards of living in China, energy consumption is increasing as well. According to the U.S. Department of Energy, China recently passed Japan as the number two oil-consuming nation in the world, despite that the domestic automobile industry there is really just in its infancy. According to China Daily, oil imports have now reached an annual figure of 80 million tons out of a total annual consumption of 230 million tons. Earlier projections did not have imports reaching 80 million tons until 2010. Imports have recently risen at an astounding 15% annual rate. China currently has no strategic reserve of oil, but is considering one, which would add to demand.