Echoes of a Century Ago

There has been much talk in investment circles recently of a "New Era" or a "New Paradigm". By this is meant a new economic and political model, which can be used to explain an economy and stock market which have contradicted many of the established rules of the past three decades. What the new model seeks to explain is an economy which can produce both strong and sustained growth with falling unemployment and falling inflation. In fact, almost deflation. The old model, of course, said that there was a trade-off between inflation and employment; lower inflation would mean a weaker economy and higher unemployment.

This New Era, however, is far from new. It is reminiscent of the period in Europe a century ago. The years between the end of the Franco-Prussian war in 1871 and the outbreak of World War I in 1914 have a striking resemblance to our current age. This forty-three year period was characterized by peace and stability in Europe, enormous technological innovation, democratic capitalism which helped bring the early fruits of the industrial revolution to society, low inflation and the creation of enormous wealth. Germany was at the epicenter of this period of uninterrupted economic growth. If you go to almost any German city and visit the *Rathaus* (city hall), the *Hauptbahnhof* (main train station) and the *Kunsthalle* (art museum), chances are that they were all built during these years. The grand houses in Germany's industrial cities were also built during this period. The Germans call this period—*die Gründerzeit*—the Founders' Era.

Die Gründerzeit in the U.S.

The U.S. is in the midst of its own "founders era". From 1981, when Ronald Reagan became president, through 1996, the U.S. economy has created over 45 million jobs, while Europe has lost jobs and watched unemployment climb into the double digits. In the decade of the 1980's alone, the American personal computer industry grew from virtually nothing to $100 billion, according to *The Economist*, who called this, "the largest legal increase of wealth in history". Fifteen years of dramatically lower taxes and falling inflation have combined with an increasingly competitive American industry and ever-rising global trade to account for much of these results. The remarkable U.S. economic growth has even turned a large annual government budget deficit into a projected surplus in 1998—without either the executive or the congressional branch of the government cutting spending in any meaningful way. Additionally, like the period a century ago in Europe, the absence of a major war (as well as the recent diminished nuclear threat due to the dismantling of the former Soviet Union and the collapse of the Berlin Wall) has brought real defense spending to its lowest levels since the days before Pearl Harbor. The fruits of several decades of venture capital investing and technological innovation are being harvested in the midst of a genuine technological revolution—in its own way every bit as dramatic as the industrial revolution at the end of the 19th century and the first part of the next. The widespread use of the personal computer, the Internet, and wireless communication has produced an information explosion which is just as revolutionary as the railroad, automobile, electrical power, and the telephone. Some have even compared the establishment of Internet with the invention of the printing press. Finally a decade of corporate restructuring in the U.S. combined with deregulation has taught companies how to compete here and abroad very effectively.

Wealth Creation in the U.S.

The creation of wealth in the past 15 years in the U.S. has been truly incredible. On the one hand, there are the super-rich, such as multi-billionaires Bill Gates or Warren Buffet, whose personal wealth was recently pegged at $38 billion and $22 billion respectively by *Forbes* magazine. On the other hand, there are the rest of us Americans (and our ancestors), some 99% of whom came to this country poor. Yet today, even the poorest have seen their living standards rise to levels that their grandparents would have found unimaginable. By now, all but 14% of Americans are above the poverty line (which the government sets at $15,700 cash income per family of four). Even for African-Americans, who have suffered the terrible injustice of slavery and have faced unequaled obstacles, America has brought success that neither Africa nor any other place has ever provided. The combined income of America's 32 million blacks alone is far larger than the GDP of all but ten nations in the world and nearly as large as that of all of Africa's 800 million people combined—$300 billion versus $389 billion, according to Michael Novak in his recent book, *The Fire of Invention*.

Against this background, one must ask: How will these macro-economic conditions in the U.S. and global economy impact individual industries and companies in the U.S.? Jeffrey M. Applegate, Chief Investment Strategist at Lehman Brothers, has written recently about some of the crucial differences between the New Era and some of the preceding decades. Applegate says that the 90's are not, in fact, a New Era in economic terms. He finds precedent as recently as the economic conditions of the 1950's and early 1960's as the table below demonstrates. Moreover, he indicates that while the New Era economics closely resembles that of the 1950's, profit margins in 1996 were 6.3%—still well below peak profit margins of 7.5% in 1950. According to Applegate, the economy is currently in a virtuous cycle—a sharp contrast with the period from 1966-1982:

	1950-1966, 1991-Present	1966-1982
Inflation	low	high
Revenue Growth	low	high
Pricing Power	little or none	significant
Labor Productivity	high	low
Operating/After Tax Profit Margins	strong	weak
Price/Earning Ratios	high	low
Stock Market	good	poor

Implications for the Stock Market

Given the performance of American industry and remarkable improvement in the economic and fiscal situation in the U.S. since 1981, it is not surprising that the last 16 years have seen the most powerful and long-lasting bull market in American history. The S&P 500 Index has produced annual average returns of nearly 20%. It is also not surprising that equity valuations are expensive. With various prominent stock market strategists calling for $50 in earnings for the S&P 500 Index in calendar 1998, the S&P 500 Index's valuation of 947 at the end of the third quarter reflected a market P/E of approximately 19. The Dow Jones Industrial Average, which closed on September 30 at 7945 had a P/E of 16.5 on forecasted 1998 earnings. During this century, the stock market has generally traded between ten and twenty times earnings, so that the market is clearly at the upper limits of its valuation. And given the environment, it should be.

Nonetheless, it has become increasingly hard to discover bargains in the U.S. stock market. What, then, is our strategy at Bradley, Foster & Sargent, Inc.? Do we recommend using the lower rates of taxes on capital gains that were recently enacted to gradually exit the stock market? Or do we continue to invest in those well managed, established growth companies where strong revenue growth exists (in spite of weak pricing power) and profit margins are improving? The first strategy is based upon a market timing strategy which we eschew except in times of extreme overvaluation, which we do not believe exists. The second strategy is one which we believe makes the most sense and which we continue to pursue.

This is perhaps a good moment to re-iterate our investment strategy: it is to utilize an approach of investing in high quality, established, large growth companies as well as those emerging and medium capitalization companies in which we have specific knowledge or insight that we can bring to bear. Additionally, we employ a risk-adverse strategy of purchasing stocks at prices reasonable enough to achieve highly competitive investment management performance. Finally, we execute this strategy without attempting to "time the market" and through the medium of a well diversified portfolio. Generally the companies we invest in have the following characteristics:

- Market capitalization over $500 million.
- Strong historical and projected growth in earnings, cash flow and dividends.
- High return on equity and substantial profit margins.
- Strong balance sheet with low debt levels.
- Consistent record of dividend increases (except in the high technology industry and other selected situations).
- Significant stock repurchase programs.

In executing this strategy since our inception, we have focused on those industries which are the beneficiaries of the trends toward globalization, consolidation in the U.S., capital spending and low inflation. These include strong weightings in computer hardware, Internet related, and computer software companies which can increase revenues in spite of weak pricing power. Additionally, we have overweighted strong consumer brand name and drug companies which have the financial strength to exploit the significant opportunities in Latin Americas, Eastern Europe, India and China. Another area of concentration has been the banking, insurance and REIT industries which are consolidating and are beneficiaries of low inflation. Naturally, there are, in addition, other well managed companies in attractive industries which fall outside these categories.

Risks

At the moment, we do not see inflation on the horizon in view of the excess global capacity of plant and equipment and the ever-lower barriers to free trade. Nor do we forecast weaker corporate earnings in 1998. We also do not see imbalances in the economic system such as excess inventory, overleveraged balance sheets, or excess speculation in the stock market, which might bring a recession in the U.S. in the near term. The potential risks that we do see are those which are political in nature and which, by definition, cannot be forecast. These would include such nightmares as North Korea attacking South Korea, China flexing its muscles militarily against Taiwan, the re-unification efforts of a Stalinist Russia re-conquering the former Soviet Union, and a war in the Middle East led by the Islamic militants. While each of these in its way could be extremely negative for the stock market, one cannot base an investment strategy on the probabilities of an unknowable political event.

Summary

In brief, we believe that the chances are reasonable that the U.S. stock market will continue its advance in the same pattern as during the last several years—periodic strong advances punctuated by abrupt and volatile sell-offs. While the S&P 500 Index (total return) was up over 27% during the first three quarters, there was a 10% correction in March and April and another 7% pull back in August. This kind of pattern should continue with the caveat that the stock market cannot have another 12 months of 20%+ increase without becoming seriously overvalued; its valuation is already near an all time high. This current level of valuation depends upon inflation continuing at less than 3% and strong earnings growth among major companies of at least 10%. If these fundamental pillars of the U.S. economy were to change for the worse, the stock market would likely see a major correction.

History has given us clear examples of periods, as at the end of the 19th century, when positive economic and political conditions have continued for many decades. Perhaps the *Gründerzeit* in the U.S., which is currently unfolding, is one of those periods. If so, we believe that the stock market is not caught up in the midst of "irrational exuberance", in the words last December of Federal Chairman, Alan Greenspan for whom we have great respect, but rather in the midst of a thoroughly rational exuberance of which investors are the beneficiary.

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