MIRROR, MIRROR ON THE WALL

WHAT DOES THE ENRON SAGA SAY ABOUT US?

BY JOHN RUTLEDGE

Put the corner of this page down and back away slowly. I'm not actually going to write about Enron. The really interesting thing isn't the Enron story anyway; it's what it reveals about *us*, the way we process information, and the way we make investment decisions.

Why did we discover it when we did? Why didn't we know what was going on? Why are we so outraged? Why do we watch the C-SPAN witch trials when we know the inquisitors were on the payroll, too? How will it affect risk taking? How will it affect the stock market? And most important to us capitalists—how can we make money out of it?

We need to know how you and I stepped on the biggest banana peel in history, proving for all time that God *does* have a sense of humor.

Unlike economists, physicists are used to looking in the mirror. To them the observer is an integral part of the *system* being observed—the essence of Niels Bohr's Copenhagen Interpretation of quantum mechanics. According to Bohr, the answer to the famous question about a tree falling in the forest is simple: If nobody is there to see it, the tree doesn't even exist!

Mathematicians call these Complex Adaptive Systems. According to CAS theory, if you put several agents together—think of an agent as a person—even though you think you understand how each agent behaves *separately*, the resulting *system* is very likely to behave in a surprising, complex or chaotic manner.

So it is for economics and financial markets, too. In economics the observer—i.e., the investor—determines asset prices by setting both the risk-adjusted cost of capital and the expectations for future cash flows. These prices then feed back through credit markets, collateral values, and analyst and rating agency announcements to further influence asset prices. When all this goes wrong, as it did with Enron, apparent value can evaporate overnight.

Here are some questions that highlight our own role in the disaster.

Why did we discover Enron—its problems—when we did?

Here's the principal reason: The incredible 1981-2001 stock market rise, during which you could make money in the stock market with Valley Girl *("What-ever")* stock selection, is over. For 20 years interest rates went down and stock prices went up. During that extraordinary period caution was not rewarded. Statisticians call such an improbably long run of luck—flipping a coin and getting twenty heads in a row—a *race*. Wall Street calls it a bull market. Either way it encourages people to place big uninformed bets and keep their winnings in the game.

Cognitive science researchers such as

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William Calvin, author of *The Cerebral Code*, argue that our brains process information by extracting patterns from the observed world and projecting them into the future. Twenty heads in a row is a pattern few stock market investors were willing to bet against.

The tech bubble bust, credit crunch and recession of the past 18 months sobered people up. The California energy crunch gave them a scare. September 11 sealed the deal. It is no coincidence that Enron vaporized in the weeks just after 9/11, when investors' appetites for risk collapsed with the World Trade Center.

Why didn't we know what was going on?

Apparently Abe Lincoln was wrong—you can fool all the people for a long time. At least you can in the public markets.

Public market investors are like mushrooms; they live mostly in the dark. Ironically, the insider trading rules that are designed to protect outside investors have built barriers of silence around public companies. Public company managers—whether out of disdain for public shareholders or fear of running afoul of the SEC's complex rules regarding dissemination of material information—keep their cards close to their vests. They hire investor relations staff to keep investors and analysts at arm's length, and conduct discussions only in tightly controlled venues. They produce consolidated, i.e., unintelligible, financial statements.

As a further irony, the bigger the company, the harder it is for an investor to find out what is really going on.

Finally, Wall Street analysts are just too young. More than three-quarters of analysts lost their jobs during the bear market from 1968 to 1981. Everyone working on Wall Street today still has hair. They have not yet lived through a bear market. Not good.

Contrast this with companies owned by private-equity investors, who have access to every document and person in a company, who can ask any employee any question at any time, who take part in planning the company's future, and who can intervene when necessary. The owner of a corner drug store knows more about what's going on inside his business than public investors or stock market analysts will ever know about companies like Enron.

There are people who know what's going on in public companies, of course. Unfortunately, they are either the hired managers with salaries and one-way stock options, or investment bankers, lawyers and other hired guns working for fees. Until we find a way to make them put their own money at risk, we shouldn't be surprised at the shabby way shareholders get treated.

Why are we so outraged?

Man is an order-seeking creature. Unfortunately, the world is a disorderly place and getting more so, guaranteed by the monotonically increasing entropy dictated by the Second Law of Thermodynamics. We bridge this uncomfortable gap by wrapping ourselves in a cocoon of illusion that the world—*our* world, at least—is safe.

This sense of order was shattered when we watched hijacked airliners crash into the World Trade Center. It was further eroded when we learned we could not trust public-company financial statements, or the people who audit their books. We will do almost anything to restore our illusion of order so we can go about our business in comfort again. Throughout history, the standard way to accomplish this is to burn someone at the stake. Anyone will do.

Why do we watch the C-SPAN witch trials?

Yes, we are having witch trials. In America today we use politicians to conduct our exorcisms. We hold them on C-SPAN so everyone can watch.

History gives us many examples of frightened people behaving badly. It forms the basis for Shakespeare's *Othello*, for Voltaire's *Candide*, for Dickens's *Tale of Two Cities*, for Charles MacKay's *Popular Delusions and the Madness of Crowds*, and for Freud's treatise on mob psychology in Hitler's Germany. It gave us the Inquisition, the Ku Klux Klan and Joe McCarthy.

The mob is out for blood today, looking for bad guys under every balance sheet. After Enron and Arthur Andersen, the spotlight shifted to Tyco, Vivendi, Global Crossing and many others. They will not be satisfied until our illusion of order has been fully restored. Let's hope our cocoon heals quickly.

In today's charged atmosphere it makes little sense to be a director of a public company, and none at all to serve on its audit committee.

How will Enron affect risk taking?

Moonwalking is in, risk taking is out. This is especially true of the professionals, the banks and insurance companies, who take risk for a living. Banks have decided that looking after their wealthy clients' money is better business than taking credit risk. Insurance companies are backing away from liability coverage. Stock market investors have voted with their feet, moving into bonds and hedge funds, with the hope of less volatile—but still positive—returns.

Our willingness to take risks has always been one of the great strengths of American companies and the American economy. Risk aversion undermines capital investment, innovation, new business formation and growth.

How will it affect the stock market?

Stock market investors have built a liar's premium into the cost of capital. which they use to discount public companies' expected future cash flows. As a result, since November the stock market has followed the Enron story down like synchronized pair skaters. The Enron saga has also made stock prices extremely volatile and made the shares of even established companies with huge market capitalizations react violently to every bit of new information.

This is a harsh environment for investors who don't do their own homework, and belies a serious structural problem in the market. In recent years, investors have developed an unhealthy and excessive reliance on the work of rating agencies and sell-side securities analysts when making valuation judgments. Investors who are willing to take positions based upon independent judgments about intrinsic value play an important stabilizing market-maker role. As their numbers dwindle, whether due to indexing or increased reliance on a small group of third-party advisors, stock prices become more volatile. Essentially, the market is deprived of the normalizing benefits of the Central Limit Theorem, which says that the average behavior of a large number of independent events becomes more predictable as the number of events grows larger.

In a similar way, lenders, vendors and stock market investors have all developed an unhealthy dependence on the work of rating agencies. Automatic triggers have increasingly been built into contracts, which change input prices, interest rates, credit availability and other important business parameters. These triggers depend on the decisions of just a few people at only three rating agencies, rather than the average behavior of a large number of investors. The result is the increasingly chaotic price movements we have

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seen—Enron's own cliff dive most prominently.

Mathematicians know that systems with both delayed feedback mechanisms (reliance on outsiders for information) and nonlinearities (triggers) are unstable. They react to slight disturbances with chaotic swings. Both phenomena are clearly present in the markets today.

How can we make money out of this?

Fortunately, the dwindling number of value investors willing to bet on their own intrinsic value judgments also implies higher returns for the few who continue to play this important role. The people who do this are essentially *gleaners*, earning above-market returns by doing the work of collecting and processing information that has been overlooked by the great herd of investors. Many of them are organized as hedge funds, where the principals have their own money in the game and a piece of the profits.

A second way to profit from the market's abnormal risk aversion is to become an insurer yourself. That's what the airlines were doing when they announced they were forming a new insurance cooperative, selecting self-insurance over backward-looking market premiums. Look for a lot more self-insurance schemes and co-op financing arrangements to develop.

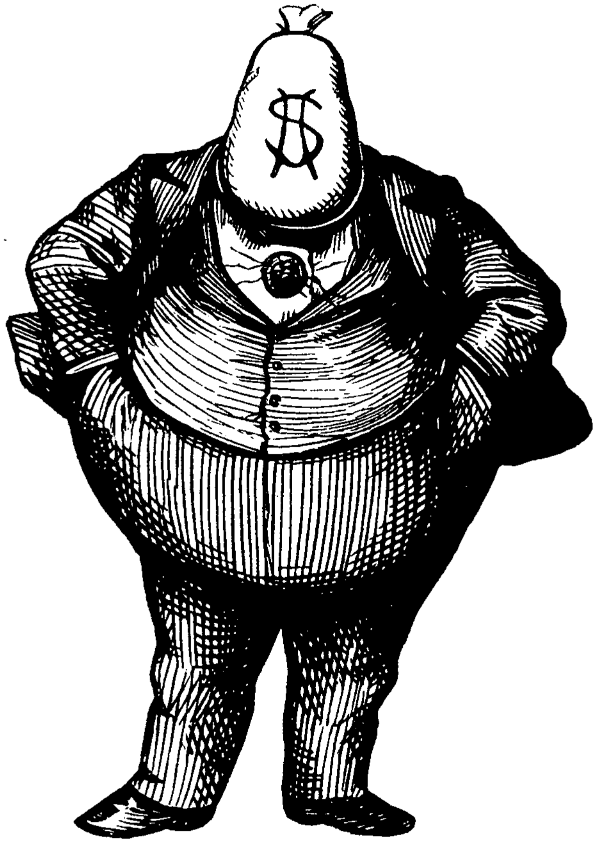
The higher risk premium investors are charging today does not affect all stocks equally. As the cost of capital increases, significant *duration* differentials among different industries and companies will lead to changes in their relative valuations. Growth companies, technology companies with back-loaded cash flow forecasts, and nondividend paying companies will be negatively affected relative to companies with steady free cash flow, simple technologies and steady dividends.

Duration is a concept many investors know from fixed-income analysis—the measure of how long you have to wait to get paid back. For equity investors, that means a time-weighted average of the present value of a company's projected future cash flows. Conventionally, duration is defined as the time it takes for you to receive *half* the present value of the future payments—dividends, interest or reinvested free cash—that make up the value of the security. But its real value is as a tool or proxy for investment analysts, because a 100-basis-point increase in the cost of capital reduces the prices of securities by a percentage roughly equal to their duration.

This has big implications. Equities necessarily have huge durations relative to bonds; after all, they have no redemption dates when principal will be repaid in full. Deborah Allen and Paul Davis of Rutledge Research, an independent research firm based at the College of William & Mary that makes intrinsic value estimates for U.S. stocks, estimate the duration of the S&P 400 Industrials today at just over 26, based on consensus growth and profitability assumptions for the individual companies in the index. By comparison, at today's rates the duration of the 30-year Treasury bond is only about 15. The upshot: a confidence event—another Enron or a terrorist attack—that increases the cost of capital by 100 basis points will push stock prices down by 26 percent, nearly twice the effect (15 percent) on the long bond.

There are other implications, too. Small-cap stocks have longer durations than large-cap stocks—their cash flows are more back-loaded. Growth stocks have longer durations than value stocks for the same reason. This means, ironically, that although the Enron disease started in the utility sector, its worst damage will be felt by small-growth companies.

Investors willing to look in the mirror and understand our own weaknesses are better equipped to take advantage of times like these. For those who do their homework and make their own valuation judgments and risk assessments, this is a great time to place your bets.



ENRON AND ME

BY STEPHEN MOORE

These days, the ultimate status symbol in Washington is to have been on Enron's payroll. The beneficiaries list reads like a *Who's Who* of the Washington power structure. It includes Robert Rubin, Karl Rove, Larry Lindsey, Frank Luntz, Bill Kristol, Robert Zoellick, Peggy Noonan and, of course, three-quarters of the members of Congress. Former Christian Coalition director Ralph Reed's $300,000 in Enron consulting payments got him on the *Washington Post's* front-page. In all, over the past decade, Enron tossed around tens of millions of dollars from its political piggy bank.

Don't get me wrong, I'm not casting aspersions on the list of Enron luminaries—far from it. This article is motivated by jealousy, not rage.

Stephen Moore is president of The Club for Growth.