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Investing In Opportunity Storms

John Rutledge, 12.02.05, 9:00 AM ET

Wallace F. Forbes, president of the Forbes Investors Advisory Institute, recently hosted a financial roundtable discussion with a handful of the best-informed and most respected authorities in the professional investment community. They presented and informally discussed their views on economic and investment matters, which were then shared with subscribers to Forbes Growth Investor and Special Situation Survey. Presented today is the outlook of John Rutledge, founder and chairman of Rutledge Capital. Look for other market viewpoints In coming days from the current crop of roundtable participants, followed by a discussion of key investment themes.

Rutledge:

Years ago, I started an economic advisory business, which led to my work writing the economic plan in the Reagan White House. I advised CEOs on corporate restructurings in the 1980s. I learned about leveraged buyouts and invested in 30 of them. I have raised and invested two private equity funds and manage public equities using a global top-down approach executed with exchange traded funds. In addition to appearing weekly on *Forbes on Fox,* I am president of the Mundell International University Business School in Beijing, and I spend a fair amount of time in that part of the world.

Many years ago, one of my CEO clients asked if it was better to do turnarounds, that is buy under-managed assets and improve them, or to buy good quality assets and grow them. My answer is you should do what you're good at doing. We don't all have the same skills. I am a terrible operator, but from time to time, I get a long-term investment theme right. So I stick with what I know, which means long-term value-driven propositions. The framework that I work from is pretty simple. There's only one law in physics that works over and over and over again. It's the first law of thermodynamics. Basically, it says that if you hold together a hot mug of coffee and a cold glass of water, their temperature differential will disappear over time. The same is true with pressure. You see that on the weather map. When high and low pressure systems come into contact, the result is wind, lightning, thunder and hurricanes. So actions in the world are all driven by some sort of energy differential.

But you don't always know when or how fast things will happen. If the TV weather man says that a high pressure system and a low pressure system are butting up against each other, you know something's going to happen, but you don't know if it's going to happen in five minutes or in five hours. However, you know that what he's telling you will have no value at all in three weeks, because once today's differentials have disappeared, they do not help us to know what the next differential will be.

The point is that all these energy differentials are temporary. The same is true in economics. Price differentials create subsequent changes in prices. In fact, the very definition of a market is a place where prices are driven together. In the investment business, we count on that same law expressed in terms of differential returns on capital adjusted for all sorts of things that matter to investors such as taxes or risk. Although we're not sure what risk is, or how to measure it, we do know that it's important. So if you can identify a return differential, just as with pressure differentials in tectonic plates or volcanoes, you know something is going to blow up. Investors sell the low return and buy the high return. This drives the prices apart and the returns together. If you act quickly enough, you capture the higher yield plus the free ride on the price increase that happens as investors arbitrage away the yield differential.

I like to look at the things that create energy differentials in asset markets. Typically, these are policy changes or formerly closed systems that are being opened up by technology changes. If you have a divider in a washtub with water on just one side, when you drive a hole through the divider, the water will equalize on both sides of the washtub. In the same way, if you link the U.S. and Asia with fiber-optic cables, the two sets of prices and wages will be driven together by investors and by capital movements. That's really what's happening around the world today.

One storm system of interest to me today is the change in the dividend tax rate from three years ago. That has created $1.5 trillion in market value. It's a bunker-buster story because when you change the tax rate, you create an initial gap in the returns of dividend bearing and nondividend bearing assets. That gap is arbitraged away, and you get price movements and value movements. We've seen most of that part already. The second phase occurs when the companies that were left out of the favorable price action change their corporate policies to emphasize dividends over capital gains, to pay down debt and to issue taxable preferred shares. All of this takes time to do, but is potentially ten times more valuable than the initial price pop. So this dividend story has a lot of legs and will last a long time. So one of the positions I carry today is abnormally heavy dividend payers and potential payers, that is, companies that have lots of free cash flows but don't yet pay a dividend. Japanese companies are one example; they are starting to produce free cash flow and are facing shareholder pressure to raise dividends. I think Japan's going to become a dividend growth market over time.

A second storm system is tech/telecom. We've had a telecom law in the U.S. for ten years that essentially means that if you do the capital spending to build a network, you do not have property rights over the resulting assets, and you can't set the prices either. Therefore, no one in their right mind has built new networks, and investment spending has collapsed. High-speed telecom in the U.S. is an embarrassment, relative to what's going on in Korea, China, Japan, Taiwan, Singapore and India. The White House is completely deaf to this issue. They have no interest in it whatsoever. Congress, however, has had pressure from small-business owners in their local districts. They want something done about this because small businesses cannot compete with Asian companies with high-speed telecom access. So Congress is taking the lead and is rewriting the telecom laws. I visited with two Senators last week who are doing this. I'll see two more next week. The best bill outstanding was written by Sen. John Ensign of Nevada. It's a highly deregulatory bill. When Ensign's bill came out, telecom equipment shares jumped $22 billion in two days. I'd keep a close eye on this. I have a long position in the telecom equipment companies, which are a large share of the tech exchange-traded fund. I also have long positions in some of the telecom service companies that will be able to acquire property rights over this stuff.

Japan is an interesting story, because it stopped interest-rate targeting on March 19, 2001 and started to take more decisive action to end real estate deflation. The real interest rate in Japan was about 1,000 basis points measured properly using real asset prices for the 1990s. The real estate markets have now largely healed, and I think Japan is turning around in a pretty serious way. Prime Minister Koizumi's reforms help, but the essence is that the market has been liquefied again.

We all know what's happened to energy prices lately. It will require about $750 billion in capital expenditures in the Persian Gulf just to accomplish the required increase in oil production to cover global growth for the next ten years. That $750 billion requires returns that are attractive to guys like us. That will happen only if there is an army in Iraq. This army is not going to leave Iraq for a long time.

China privatized 1,000 oil companies this past year. These are not small companies. I met with one a couple of weeks ago that has $12 billion in assets. These companies are raising money to explore for oil and gas in western China, build LNG facilities and build integrated refineries.

They're shutting down the coal mines in the south because the air is dirty and the miners die. That puts more pressure on the oil and gas industry. There is a huge amount of capital spending happening there. Furthermore, I spoke with the fellow who will be the next president of China who indicated that the government's focus will be IT spending. They have to do this because if the amount of oil consumed to produce a dollar of GDP remains constant, over the next 20 years China will have to consume all of the world's oil production. That's not going to happen. So they have to reduce oil per dollar of GDP big time. They will do this by shifting resources away from heavy industry and toward information technology, which is why they're spending so much money on fiber optics and other fast communications networks and on education.

Because China's legal and accounting systems are still weak, I believe the best way to invest in China is through third countries. Korea produces most of the technology China is using right now. As for investing in coal, gas, LNG [liquified natural gas] and the like, I'd go through Australia and New Zealand. I also like the top-down asset allocation work, which is well tailored for ETFs. There's the **iShares MSCI Pacific ex-Japan**, which gives you exposure to Australia, New Zealand, Singapore and Hong Kong. Australia and New Zealand sell China coal and gas. Hong Kong and Singapore help them tap the capital markets. If you want exposure to Japan, you can add that in separately with the **iShares MSCI Japan Index**.

Finally, I'm very disappointed from what's coming out of the Administration. They're deviating from their own principles. Add in the fear that started with Sept. 11, 2001 and the recent hurricanes, and you have a public extremely sensitive to risk. The politicians are using this as a political tool. For example, they are making more out of the bird flu risk than is justified because the White House needs to look like it has a commanding presence. It's one way to erase the Katrina debacle. Katrina diverts our attention from the real issue, which is the need to find a long-term solution to energy problems. In order to produce wealth, we need to find a way to shift from dinosaur energy to human energy by improving education. They're going to do it in Asia, and we have to get busy doing it, too. We have to work on both conservation and development. It's all about technology and IT.

These are areas where I have some chips on the table. Each one of these thunderstorms is a six- to 12-month story.