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**NEW ECONOMY TRENDS: IMPLICATIONS FOR
INVESTMENT, ROTATION DYNAMICS, AND GROWING
STRUCTURAL INEQUALITIES**

by

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ABSTRACT

This paper examines the evolution of the structure of the United States economy in the post-World War Two period. It identifies the drivers of the “New Economy” and their impact on major industries and companies. Finally, implications of these trends on investor portfolios are examined, with guidelines for enhanced performance over the next decade.

INTRODUCTION

Economic performance in the United States in the 1990s was truly exceptional. Since March of 1991, the end of the mild recession, economic growth resulted in rising employment levels, a declining unemployment rate, expanded production of goods and services, and a major change in the bottom-line budgets at every government level (federal, state, and local).

Productivity of all economic resource groups, including both labor and capital, grew at an accelerated pace throughout this period. The computer revolution contributed significantly to this record, as the number of computers soared in both business and home locations. It took many years to reach the point where there were enough users to have an appreciable impact on the number and cost of transactions. Exactly when this threshold level was reached may be debated, but it is irrelevant. There can be no doubt that by the year 2000, the threshold had long been passed and the significant benefits of time and cost savings on all types of transactions, as a result of the e-revolution, were an established reality.

Competition expanded from regional and national levels to global proportions, also contributing to the reduction in the cost of doing business. Most importantly, competition is forcing these cost savings to be passed along to the customers (business as well as consumers).

There has also been an explosion of information made possible by new methods of communication. The result has been enhanced decision making and an increase in other efficient uses of economic resources.

THE DRIVERS OF THE “NEW ECONOMY”

There has been a great deal of argument, discussion, and disagreement about the term “New Economy.” Some people say there has simply been an evolving transition to new products and services, brought about by the computer and communication revolutions. Others suggest that changes now occurring throughout the economy are truly revolutionary in size and scope and will result in significantly different lives for most people in the near future.

We believe that, although change is inevitable, there has been an acceleration of it in the 1990s. Although data may show continued evolution of change in the last ten years, it is safe to say that over the last twenty years there have been revolutionary changes in the magnitude of adjustments to business and consumer life.

What have been some of the drivers of change in the 1990s? Here are just a few of many that could be identified:

1. In the United States, the “deregulation” movement, beginning with the airline industry and moving through financial services, etc., is an important change driver. It was in the late 1970s, under the administration of President Jimmy Carter, that the first movements away from regulation took hold. This movement has continued today. Deregulation results in increased competition, which lowers costs and contributes to rising consumption of the deregulated products and services.
2. The landmark ERISA legislation was passed during the administration of President Richard Nixon. It changed the face of investing for retirement, enhanced returns, expanded investor choice, and greatly expanded the supply of capital to the financial markets. The cost of capital was reduced for users, and expanded investments can now be made across the spectrum of industries.
3. The restructuring of corporate America gained new strength and momentum in the 1980s. Operational and financial enhancements to corporate efficiency spread throughout the U.S. industry, with benefits being passed along the distribution chain all the way to the consumer.

The hierarchy of corporate organization charts has been altered in this time frame. Layers of middle managers have disappeared, as a leaner, flatter structure has been created. This new structure is much more receptive to change, with a much quicker reaction time when adaptation is required.

4. As globalization has taken hold in industry after industry, the size of markets has grown exponentially. This has allowed global corporations to take greater advantage of economics of scale and scope in their business operations. The results are lower average and marginal costs and continuing downward pressure on prices, due to global competition.
5. The development of the Internet as a communications medium began in the Defense Department of the U.S. Government. This breakthrough has spilled over into the private sector and, in conjunction with revolutions in computer technology, has contributed to the cost containment policies and market expansion strategies of global business firms.

6. Very substantial government spending to support, fight, and finally win the Cold War during the 1980s set the stage for a massive refocusing and shifting of capital and labor resources to more peaceful commercial endeavors in the 1990s.

The forces identified above and the drivers of change in the world economy have had a profound impact on the fortunes of different industries and companies. Some of these characteristics of corporate transformation include the following:

1. *The changing scope and composition of mergers and acquisitions affecting industry and company structure.*

In the 1980s, there was a wave of merger activity that was based primarily on concepts that could be labeled “financial engineering.” In an environment of high inflation and high interest rates, the leveraged buyouts of the 1970s grew to enormous proportions in the early 1980s, capped off by the \$29 billion RJR Nabisco deal, structured by LBO specialists Kolberg, Kravis, and Roberts (KKR).

This event proved to be the end of the giant LBOs, because the interest charges on the massive debt loads (over 95 percent of total capital) proved impossible to support for more than short periods of time. If additional equity could not be acquired within a few years, even the strongest operating firms would be brought to their heels, financially speaking.

After a slowdown in Mergers and Acquisitions (M&A) activity in the late 1980s, the 1990s saw a pickup in activity, but with some major differences in emphasis, structure, strategy, and financing. The deals of the 1990s have been primarily business-based, in that the benefits of bringing two firms’ operations together were the driving force behind a transaction. Economies of scale and/or scope, expanded markets, and consolidation of overlapping activities have been prime movers of deals in the banking, paper, airline, chemicals, and pharmaceutical industries.

Financing of mergers in the 1990s also took on a very different “look” from the 1980s. Many more transactions used common stock, or even cash, as the currency of exchange, compared with the dominance of debt used in the previous decade. The general level of equity valuations in the 1990s was higher than almost any period since the 1960s, so the use of equity also resulted in enhanced financial strength for many firms in the M&A business.

In addition, the 1990s experienced an explosion of entrepreneurial activity in America, supported by expanded availability of venture capital for new companies with novel ideas and products. Perhaps the two industries that best exemplify these trends and that have participated in, and benefited from them the most, are biotech and Internet technology. Some have even taken the position

that there is now more venture capital available to new businesses than there are new businesses with viable plans!

- 2. Compensation packages have changed in many industries, especially within smaller companies.*

Workers will take options and incentives rather than "cash now"; they will share the risks in exchange for potential rewards. But while the boom times reinforce these trends, leveling off can cool them down!

- 3. Social Implications: Compromising salary for the sake of stock options in a speculative firm that may not grow significantly in an economic slowdown is a risk few workers can afford in the long term. Moreover, the sacrifice of leisure time based on the promise of instant wealth makes little sense if a slowdown undermines the prospects of quick growth.*

The average workweek of eighty hours in Silicon Valley leaves no down time for dates, family, or recreation. Without the incentive of fast wealth in a couple of years, workers may decide it is not worth the trade-off. If not, and the cultural habit of work over leisure (or living) continues, Joseph Schumpeter's concept of creative destruction descends from the level of technological development to that of personal deconstruction: human capital is sacrificed to the new economy. From a status quo of two-income, latchkey kid families, the United States could increasingly become a coupleless, childless workstation. Of course, the new economy provides a biotech solution: women can pick up sperm at sperm banks with the range of probable genetic characteristics they prefer. This, in turn, has sparked a side industry in elite colleges where men donate sperm to "the bank" for \$100 a shot. This "new economization" of family life is ultimately emotionally bankrupt and has troubling ethical implications in terms of genetic engineering.

The new knowledge economy has other disturbing ethical implications in terms of the growing gap between earnings and the social positions of the well educated and those less well educated. Despite the short-term incentive to drop out of school for the computer competent, for most people the payoff of having a college or post-graduate degree in terms of lifetime earnings has gone up considerably in the past decade. Those with the misfortune of being brought up in poor real estate areas with corresponding mediocre schools are handicapped from the outset. Moreover, globally, those in other countries without access to quality schooling or the Internet are significantly disadvantaged in the emerging new economy. While 58 percent of Americans have access to the Internet, only 28 percent of the Germans do, and developing countries are much further behind. Thus, the privatized, deregulated, high-tech, fast-moving American-dominated new economy model (what Thomas Friedman calls "the golden straightjacket") benefits well-positioned Americans the most and everyone else in the U.S. and the world to a much lesser extent, raising long-term equity concerns of major

proportions. For example, the inability to mimic Silicon Valley anywhere else despite valiant efforts, both within the U.S. and in other countries, implies that this may be a unique constellation of historical circumstances in one spot that may be as fragile and short-lived as it is unique (cf. David Kaplan's *The Silicon Boys and Their Valley of Dreams*).

Globalization has sped everything up and has prepared Americans for the fast more than for the slow. If things slow down, they may be less well equipped to handle the community ties, social obligations, leisure, and aesthetic pursuits that are normally the fruit of a hegemonial nation that starts to slow from its peak of power. Cultivation then becomes as important as competition, time as significant as money, and the grace of the slow as attractive as the latest technology of the fast. Just as there are rotations from old economy stocks to new economy stocks, and then back to old economy stocks in slower times economically, there may well be lifestyle rotations from the fast-track mobility of the e-technological world of work back to the old fashioned sense of roots, culture, and family--the slow traditions. The speed of new economic development may paradoxically serve to highlight the human importance of non-material social, cultural, and spiritual concerns. The "attention" economy can suddenly focus on old qualities as well as new quantities, content as well as means of delivery, and leisure as well as the power lunch (in which no one has time to eat). Just as the closest American presidential election in history, in 2000, redirected citizens' attention to the meaning of their political traditions, so an increased sense of stock market and economic uncertainty may lead Americans to dwell more upon the meaning of everyday life. Meanwhile, however, human beings must still make investment decisions based on the latest turbulent waves of "creative destruction."

Creative destruction was illustrated in 2000-2001 with the rise and meltdown of the dot-com Internet phenomenon. Although this decline in values and valuations made headlines, history suggests that we have seen similar patterns of equity prices in the past (the biotechs of the late 1980s, the nifty-fifty of the late 1960s, and, internationally, the real estate market in Japan in the 1980s and 1990s). At least in the U.S., these events have not had any permanent, negative effects on the underlying, long-term performance of U.S. economic activity.

Rotations of corporate and industry valuations can be characterized by shifting investment capital flows. Short-term volatility should not influence longer-term investment portfolio strategies followed by either individuals or institutions. In fact, they are quite likely to create significant buying opportunities, provided that the investment decision-maker understands and appreciates the sectoral shifts taking place at these critical junctures.

INVESTMENT IMPLICATIONS

There are a number of methods for measuring the changing structure of the American economy and the investment implications of these changes. Total assets of a firm, market capitalization (number of common shares outstanding times price per share), price-earnings ratios, and price-cash flow ratios are some of the more recognized indicators of corporate performance.

It is interesting, but not surprising, to note that very few firms are found in the top echelon of these categories over long periods of time. For example, in the early 1960s, General Motors, Ford Motor Company, General Electric, and Standard Oil of New Jersey (later renamed Exxon) were clearly the revenue giants. On a market cap basis only, IBM was clearly number one, with AT&T, and GM following close behind. Using price-earnings ratios, smaller firms (Polaroid, Xerox, Avon, American Home Products, Teledyne, and Litton Industries) were found at the top.

Moving to the 1970s, sales leaders were General Motors, Exxon, Ford, and Mobil. Using market capitalization, IBM, AT&T, Exxon, and GM led the field. By the end of the 1980s, revenue giants were still the likes of Exxon, General Motors, and Mobil. Market cap leaders were still Exxon, GE, IBM, and AT&T, but in the top ten, new names began to appear. Philip Morris, Merck, Bristol Myers, Coca Cola, and Wal-Mart showed how investors began to value the more rapidly growing sectors of the economy: pharmaceuticals and distant retailing.

In the 1990s, revenue giants did not change very much, with the exception of the rise of Wal-Mart. However, the market capitalization and P/E ratio expansion brought a number of new names to the tops of the lists, particularly in more rapidly growing industry groups such as health care, technology, and financial services. By decade's end, the likes of Microsoft, Intel, Dell, Nortel Networks, Cisco, IBM, AIG, Home Depot, Citigroup, Johnson & Johnson, Merck, and Pfizer joined Exxon-Mobil and General Electric as major companies whose market caps comfortably exceeded \$100 billion.

Where do we go at the beginning of the new millennium? Where will investors find the great companies with exceptional operational performance that will lead to above-average rates of return on their capital? Can individuals and/or institutions simply identify great companies and hold them indefinitely?

We favor a top-down approach to the investment challenges of the next decade. Industries most likely to generate above-average operating performance are health care, technology, financial services, and segments of retailing. Within these groups are many firms that specialize in segments of each industry. Different segments will grow at varying rates, so a fair amount of research will be

required to find the “jewels in the crown.” Products and/or services, operating efficiencies, and management expertise are critical components of these firms.

Timing of purchase and sale transactions will also contribute to enhanced investor portfolio performance. The best companies may not translate into the best investor returns if their shares are purchased at extremely high prices. The nature of equity markets is that, in short periods of time (up to 1-2 years), irrational exuberance and/or irrational negativism can have significant effects on stock prices. Successful investors must incorporate patience and prudence into their portfolio management activities. With enhanced timing of transaction decisions the long-run performance of a portfolio may be enhanced, to the benefit of its owner.

The equity markets in the U.S. are the most highly developed and efficient markets in which investors may participate. Most of the firms traded and headquartered in the U.S. have global operations that contribute to their growth opportunities as well as stability of operations. For even more diversification, the American Depositary Receipts (ADRs) of major corporations headquartered outside the U.S. may still be traded in the U.S., in U.S. dollars. Surely this universe, which currently exceeds 7,000 firms (on the NYSE and Nasdaq), should be diverse enough to meet the needs of even the largest of investment portfolios. While diversification may reduce the volatility of short-term portfolio performance, a more targeted and focused selection of company securities is likely to produce enhanced long-term performance. We recommend this approach and expect equity returns of at least 10 to 15 percent per year for well-managed portfolios in the next decade. Such financial stability, in turn, will be lease time for a more human focus upon the quality of life and leisure.

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