

WEDGE WATCH

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The Way of the Future

“The empires of the future are the empires of the mind.”
– Sir Winston Churchill (1874-1965)

“Small opportunities are often the beginning of great enterprises.”
– Demosthenes, Greek orator and politician (384-332 BC)

Early last month, to the delight of many, Steve Fossett, the former options trader turned globe-trotting aviation daredevil, successfully completed the first solo, non-stop flight around the world (without refueling). Fossett, who was also the first person to circle the globe solo in a hot air balloon (in 2002), is the latest member of a highly exclusive fraternity that traces its roots back to the early years of the 20th century, when two bicycle-builder brothers from Dayton, Ohio fired the proverbial *shot heard around the world* (from a wind-swept beach at *Kitty Hawk*). Other daring visionaries and thrill seekers would soon follow, eager to test the limits of their spirits and imaginations. From Charles Lindbergh, one of the earliest aviation pioneers, who piloted the *Spirit of St. Louis* and gained international acclaim by completing the world's first non-stop transatlantic flight in 1927, to Amelia Earhart, the brave, record-setting female aviator who at age 40 tragically disappeared somewhere over the South Pacific while attempting to be the first woman to fly around the world, to Howard Hughes, the go-for-broke adventurer, aviator and entrepreneur (profiled in the recent film *The Aviator*), whose bold ambition and imagination inspired a generation of dreamers to *reach for the stars*. It has been said that **where imagination goes, invention follows** and certainly these four iconic American heroes sowed potent seeds of influence and invention that helped spawn vibrant and life changing new industries that even today continue to rev the engines of global commerce.

Throughout the 20th century, from the early days of American industrialization to the advent of the personal computer, man has been captivated by the infinite promise of the future. This, of course, is not surprising, as the world has seen and experienced more change in the past 100 years than at any time in the history of mankind. In the years and decades ahead, as technology relentlessly extends its increasingly pervasive reach, the pace of change will likely continue to accelerate. As investors, we can learn much from the study of history, both in terms of the ebbs and flows of market psychology and in terms of how fundamental trends, competitive industry dynamics, and individual company business models have evolved. However, *it is the future (and how it unfolds from an economic perspective) that will dictate, at the margin, the relative success or failure of individual companies and the ultimate returns generated by their respective stock prices*. Although many other factors, such as cost competitiveness and product differentiation, will also govern these outcomes, a very fundamental and basic *underpinning* of business may drive the ultimate tale of the tape going forward.

First Quarter 2005 Financial Statistics

DJIA: 10503.76

S&P 500: 1180.59

90-Day T-Bill: 2.77%

30-Yr. T-Bond: 4.75%

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Future

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Global distribution reach, although much touted over the years, appears to now be on the cusp of a difference-making impact that could drive growth and profitability (for those companies properly positioned) well into the 21st century. Coming off 2004, a year when *China* gained a new level of respect in the minds of investors, vis-à-vis the dramatic impact Chinese demand had on the price of basic commodities such as copper and oil, other signs are beginning to point toward a broader and more *secular* end-market view. In other words, **the emerging markets may now be nearing a critical mass inflection point that will inordinately benefit the forward-looking multinational corporation** that has proactively built out its global distribution reach and infrastructure.

Several weeks ago, *General Electric* (GE), the world's largest industrial company, issued its 2004 annual report and, although the release was unremarkable in and of itself, we found a particular aspect of CEO Jeff Immelt's *shareholder letter* of great interest. Mr. Immelt, who is establishing a strong reputation as a long-term strategic thinker, made a very definitive and bold prediction about where GE anticipates its most attractive future growth opportunities will reside: **"We believe 60% of our growth will come from developing countries in the next decade versus about 20% for the past 10 years."** Elaborating further, the *Wall Street Journal* stated that "GE expects its revenue from outside the U.S. to hit \$82 billion by 2007, up 17% from its estimated \$70 billion this year. In 2004, revenue from developing countries grew by 37% to \$21 billion, including \$3.8 billion from *China* and more than \$1 billion from *India*. As a point of comparison, GE's total 2004 revenues were just over \$152 billion." In terms of specific country forecasts, Immelt believes that *India*, the world's second most populous country, is now on the cusp of a long growth cycle, after disappointing for many years. In addition, he estimates that by 2024, *China* will be the world's largest consumer and consumer-finance market, as well as the largest producer and consumer of electricity. If these

forecasts ultimately prove valid, the implications could have profound significance for both individual companies and their shareholders.

In late 2003, the Global Economics research team at *Goldman Sachs* issued an in-depth report highlighting the importance of thinking about the developing world and its potential long-term impact on the investment landscape (***Dreaming with the BRIC's: The Path to 2050***). The report concluded that *"over the next several decades, the growth generated by the large developing countries, particularly Brazil, Russia, India and China (BRIC's), currently the world's four largest developing countries, could become a much larger force in the world economy than it has been—and much larger than many investors may imagine."* Using the latest demographic projections (at the time) and a *conservatively constructed model* of capital accumulation and productivity growth, the authors mapped out GDP growth, income per capita and currency movements in the BRIC's economies through 2050. **The results of their analysis (which are selectively summarized below) are quite startling.**

Economic Size

- 1) In less than 40 years, the BRIC's economies together could be larger than the G6 in U.S. dollar terms (see **Chart 1**). By 2025, they could account for over half the size of the G6. At the time the report was published (October 2003), they were worth less than 15%.
- 2) In U.S. dollar terms, *China* could overtake *Germany* by the end of 2007, *Japan* by 2015 and the U.S. by 2039. *India*, which, according to the U.N., is projected to become the world's most populous country by 2035, could see its economy grow to become larger than all but the U.S. and *China* in 30 years.
- 3) Of the current G6 (U.S., *Japan*, *Germany*, *France*, *Italy* and the U.K.) only the U.S. and *Japan* may be among the six largest economies in U.S. dollar terms in 2050.

Incomes and Demographics

- 1) Despite much faster growth, individuals in the BRIC's are still likely to be poorer on average than individuals in the G6 economies by
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2050. In the case of *China*, its per capita income could be similar to where the developed economies are now (about U.S. \$30,000 per capita). From our perspective at WEDGE, **this would seem to imply a very long tail to the growth in the BRIC's economies, even beyond mid-century.**

Global Demand Patterns

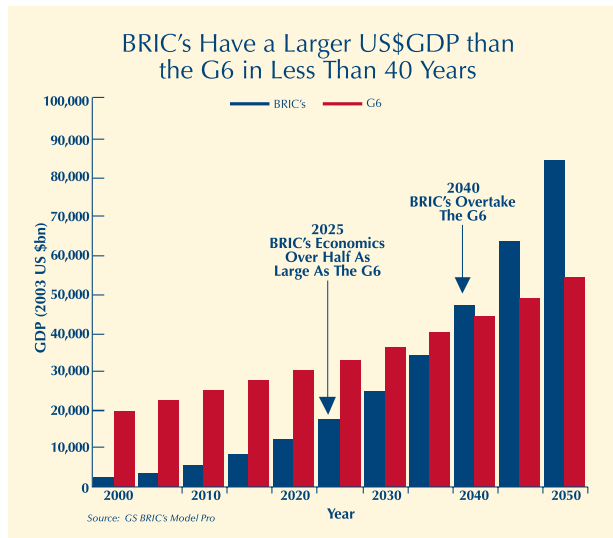
1) As early as 2009, the annual increase in U.S. dollar spending from the BRIC's could be greater than that from the G6, and more than twice as much in dollar terms as it was when the report was released (October 2003). By 2025, the annual increase in U.S. dollar spending from the BRIC's could be twice that of the G6, and four times higher by 2050.

Although the authors of the *Goldman* report rightfully acknowledge that their projections may seem dramatic (they assume that the BRIC's will maintain growth-supportive policies going forward), and that "the further out one looks, the more uncertain things become," they make a point to highlight that it was "only 50 years ago that *Japan* and *Germany* were still struggling to emerge from (post-WWII) reconstruction." In addition, the authors remind readers that "merely thirty years ago, *Korea* was just starting to emerge from its position as a low income nation while *China*, a perennial Third World and communist-run country, has seen its relative importance in the world economy increase substantially over the past decade." Going forward, given the revolutionary technological changes that have evolved in recent years, "the ready availability of state-of-the-art technological capabilities may allow these developing countries to more quickly close the gap with developed country techniques (i.e., manufacturing, etc.)"

Despite the obvious challenges of getting from here to there, the *Goldman* researchers believe the prospects of the BRIC's ascendancy are worth taking seriously and we tend to concur (although we acknowledge the multitude of risks to their forecast). As they point out, **"if these countries do come anywhere close to meeting our projections, the implications for the pattern of growth and economic activity could be very large indeed,"** not to mention, again from the WEDGE perspective, the relatively profound implications

such results may have for investors in the years and decades ahead. The report goes on to state that *"parts of the story—the opportunities in China for example—are relatively well understood. However, many other parts—such as the potential for India and the other markets and the interplay of aging in the developed economies with growth in the developing ones—may not be."*

Chart 1



As long-term investors with a global view, how might we at WEDGE capitalize on this apparent global growth opportunity? As we've highlighted in the past, our *quantitative disciplines* focus first and foremost on valuation as a primary factor input, and rightfully so. A *margin-of-safety* approach to individual stock *risk/reward assessment* is absolutely critical to stock picking success in the *value realm* (along with, of course, a careful evaluation of individual company financials, both in terms of earnings power and balance sheet integrity). Beyond that, however, more qualitative judgments must be made via an objective appraisal of the respective company's competitive positioning (both in terms of product differentiation and distribution reach). From an analytical perspective, this is where the apparent long-term growth opportunity in the emerging markets comes into play.

"If you don't know where you are going, you will wind up somewhere else."

—Yogi Berra, Hall of Fame catcher (1925-)

As we survey the investment landscape today, an interesting and eye-opening nuance of immediate

relevance to the prior *BRIC's* discussion is now garnering heightened attention from our analytical team here at *WEDGE*. **Large cap stocks, which are decidedly *out-of-vogue* relative to their smaller cap peers (more on this later), appear to offer far more leverage to the growth potential outside of North America, given their decidedly larger mix of revenues from international markets.** According to a recent *Lehman Brothers* report, “large cap companies, which benefit most from lower labor costs around the world, also garner the highest percentage of revenue outside the U.S., including the faster growing developing markets” (see **Chart 2**). Looking forward, this relatively sizable differential could imply better growth potential for large cap companies over the long-term (especially if the developing markets experience the above-average growth we anticipate over time).

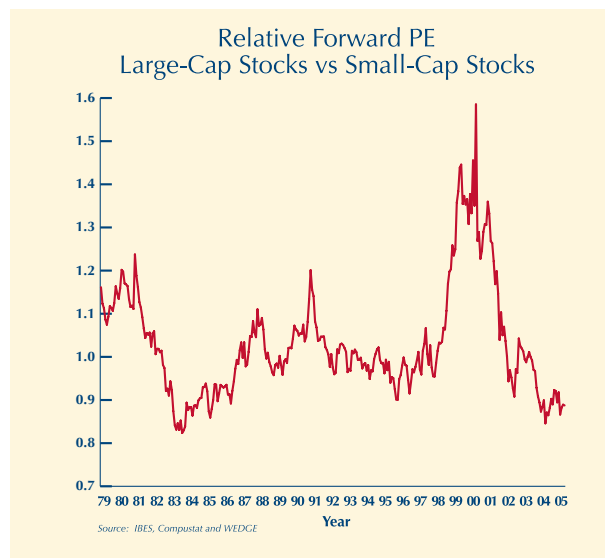
Chart 2

Sector	S&P 500 Foreign Revenue Share of Total	S&P SmallCap 600 Foreign Revenue Share of Total
Cons. Disc.	27.1%	5.4%
Consumer Staples	25.9%	18.2%
Energy	50.9%	27.6%
Financials	13.9%	0.5%
Health Care	21.9%	19.4%
Industrials	28.7%	21.5%
IT	53.0%	56.4%
Materials	49.9%	54.6%
Telecom	4.6%	0.7%
Utilities	7.6%	0.0%
	31.8%	15.8%

Source: Lehman Brothers and FactSet

Adding additional intrigue to the emerging investment case for large cap stocks (multinationals in particular), is the quite profound relative valuation differential that is apparent when comparing a broad-based large cap composite to a comparable universe of small cap stocks (see **Chart 3**). **Although the timing of a shift back in favor of large caps is difficult to predict, it would appear to be only a matter of time before investor sentiment makes a decided move in that direction (as mean reversion kicks in).** In addition, we believe it is important to note that the fifty largest capitalization stocks in the S&P 500 index trade near the low end of their 25 year relative P/E range versus the other 450 stocks in that same index.

Chart 3



If history is a guide, the large cap multinational stock of today, could very well be a prime beneficiary of global growth going forward. A research study recently highlighted in *Barron's*, which was directed by Jeremy Siegel, the well-known finance professor at the University of Pennsylvania's Wharton School, highlights this potential. According to his work, the best performing stocks in the S&P 500, since the inception of that index in 1957 (through year-end 2003), were predominately household name multinationals such as *Altria (Philip Morris)*, *Abbott Labs*, *Bristol-Myers*, *Pfizer*, *Coke*, *Merck*, *PepsiCo* and *Colgate Palmolive*. Other stocks of a similar multinational ilk, such as *Exxon Mobil*, *Royal Dutch Petroleum*, *GE* and *IBM* also outperformed the index over that time frame. These companies, whose stocks generated low double-digit per annum total returns (1957-2003), demonstrated an impressive and remarkable ability to navigate an ever evolving global landscape or as *Barron's* observed, were “undeterred by the sweeping changes in American industry.”

Will *past be prologue* for the stocks of today's multinationals with true global reach? Only time will tell. However, given the evidence we've just laid out, we are inclined to deem the odds favorable, especially in the context of *risk/reward* probabilities (i.e., more upside potential than downside risk). As stock pickers, we believe an excellent way to uncover significant long-term

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opportunities is to identify a widely-held misperception (i.e., out-of-favor large cap multinationals) in tandem with an emerging, yet underappreciated, macro-trend that appears to possess powerful secular upside potential (i.e., the long-term growth potential of the world's largest developing economies—BRIC's). The aviation pioneers highlighted in the opening paragraph are great examples of how *decisive action, bold vision* and *constancy of purpose* can lead to *uncommon*

success. In the investment world, those same attributes are indispensable as well. As we peer out over the distant horizon, contemplating an ever-changing global competitive landscape, we are reminded of the final scene of *The Aviator*, where the enigmatic Howard Hughes is seen staring into a mirror obsessively repeating the following words: ***“The way of the future, the way of the future, the way of the future*”** Stay tuned. This could get very interesting.

Index	03/31/05 Price	1st Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	10503.76	-2.6%	-2.6%
S&P 500	1180.59	-2.6	-2.6
Value Line Composite	387.10	-4.3	-4.3
American Exchange Comp.	1459.70	1.8	1.8
NASDAQ Composite	1999.23	-8.1	-8.1

**Does not include dividend income.*

Fixed Income

Winds of Change or a Temporary Gust?

During the last few quarters, we have noted the narrow yield spread environment that exists in the credit markets. To employ a weather metaphor, the credit markets have enjoyed an almost perfect climate, with the gentle breezes of ample Fed-supplied liquidity, a recovering economy, and balance sheet-focused managements combining to nudge yield spreads ever tighter. However, like the weather, conditions can change suddenly in the capital markets, confounding even seasoned forecasters. For example, the recent negative earnings announcement by *General Motors* (GM) shocked most market participants, which caused a quick re-evaluation of risk premiums in not only GM's bonds but in higher risk segments of the credit markets as well. As far more than passive observers of bond market machinations, this chain of events leads us to an obvious question: **Are GM's troubles a precursor to a climate change for the credit markets or do they represent a mere**

temporary wind gust in an otherwise pleasant forecast?

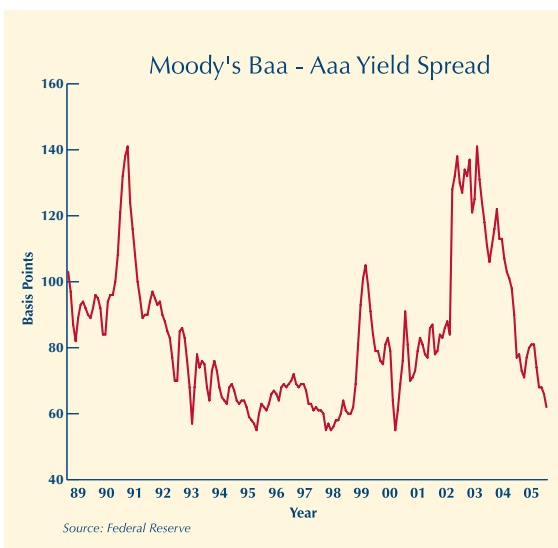
We need to examine a little history and compare it to prevailing conditions before we can begin to answer this question. **Chart 4** shows the recent spread differentials between Moody's Baa and Aaa corporate bond yields. Note that this spread appears to be rapidly approaching the lowest (narrowest) levels it has seen historically. In addition, once this spread has fallen below 60 basis points, it has not subsequently drifted meaningfully lower and, when it has, it has rarely remained below 60 for long. As a result, **with the current Baa/Aaa spread level at a very narrow 62 basis points, we believe that we are near the lows in quality spreads, and that the likelihood of Baa's continuing to narrow relative to Aaa's is fairly low.**

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Chart 4

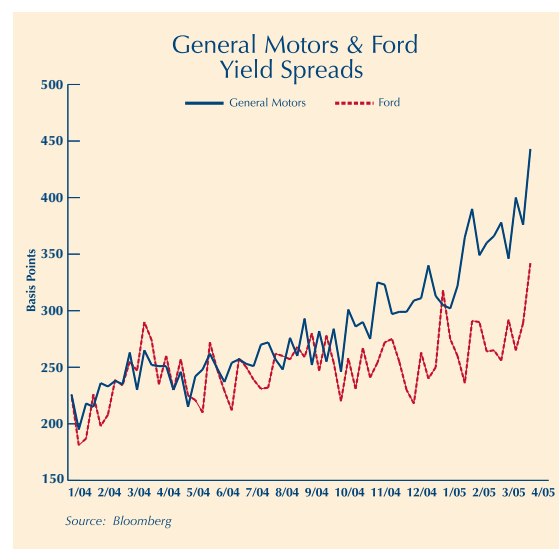


Despite this conclusion, the over-arching question regarding the go-forward climate for credit markets remains. In that regard, we do believe it's fair to say that merely because quality spreads are relatively low does not mean they can't remain there (or drift lower) over time. **However, if we re-examine the "gentle breezes" that brought us to narrow spread levels, we find that the wind direction may have shifted.** First and foremost, the Fed is now removing, albeit slowly, the lush liquidity it had so generously provided. In addition, although the economy still seems to be growing nicely, rising interest rates, increasingly onerous raw material costs, and materially elevated oil prices could begin to present formidable headwinds over time. In addition, as we have highlighted in the past, company managements have recently begun to shift their focus away from balance sheet repair to rewarding shareholders (through higher dividends and increased share repurchase). **All of these things considered, it could very well be that the credit markets are now beginning to feel the impact of these anticipatory winds of change.**

A fair criticism of our GM analysis would be that the market had, for the most part, already adjusted risk premiums on GM's (as well as

Ford's) bonds given the industry's well-known challenges, while most other spreads continued to narrow. In fact, as **Chart 5** shows, spreads on GM and Ford bonds had widened steadily for more than a year. But it can also be argued that given the relatively weakened state of these two U.S. auto manufacturers, it stands to reason that they would be the first to feel the negative effects of an unfavorable shift in the economic winds that we outlined earlier. Further, even though GM and Ford spreads were already trading at junk-like levels prior to GM's earnings warning, the magnitude of the shock was enough to drive spreads sharply wider. Anecdotally, the GM news also caused several Asian bond issues to be postponed (in what could be described as an early stage, albeit relatively minor, domino effect in the global bond markets). This suggests to us that **market participants may now be in the process of reevaluating all credit risk premiums.**

Chart 5



In summary, while we still do not envision a major credit spread widening scenario in the short run, we believe that GM's troubles represent something more than a temporary wind gust for the credit markets. As a result, we remain comfortable with our more conservative posture toward credit quality in client portfolios.

