

WEDGE WATCH

A newsletter published quarterly by WEDGE Capital Management L.L.P. • October 2005

An Uncommon Distinction

"A prudent question is one-half of wisdom."

–Sir Francis Bacon, English philosopher, courtier and statesman (1561-1626)

*"Listed on the various stock exchanges of the nation today are not just a few, but scores of companies in which it would have been possible to invest, say, \$10,000 somewhere between twenty-five and fifty years ago and today have this purchase represent anywhere from \$250,000 to several times this amount. In other words, within the lifetime of most investors and within the period in which their parents could have acted for nearly all of them, there were available scores of opportunities to lay the groundwork for substantial fortunes for oneself or one's children. These opportunities did not require purchasing on a particular day at the bottom of a great panic. The shares of these companies were available year after year at prices that were to make this kind of profit possible. **What was required was the ability to distinguish these relatively few companies with outstanding investment possibilities from the much greater number whose future would vary all the way from the moderately successful to the complete failure.**"*

Such was the perspective of famed investor Philip A. Fisher writing in the first chapter of his now-legendary 1958 treatise on investing, *Common Stocks and Uncommon Profits*. Mr. Fisher, who gained notoriety for his outsized success as a money manager as well as his remarkably long tenure in the investment business (74 years), understood, as well as anyone, the compounding power of a *successful and sustainable* business model in the world of common stocks. Although valuation remains the most crucial factor assessed by the disciplined value investor, it is this underlying business model dynamic, so coveted by Fisher, that we believe merits serious, if not equal, attention from investors.

In 1980, Michael E. Porter, a professor at the *Harvard Business School*, authored what has become, to many, the definitive text on the subject of competitive strategy. The persuasively articulated theories in Porter's book, *Competitive Strategy: Techniques for Analyzing Industries and Competitors*, formed the basis for a more formalized approach toward analyzing and developing competitive strategy, along with understanding its vital role in the corporate arena. As an outgrowth of his work, important strategic concepts such as "barriers to entry" and "sustainable competitive advantage" were injected into the mainstream consciousness of corporate executives, management consultants, and Wall Street analysts alike. Today, twenty-five years since the initial publication of Porter's work, his timeless concepts continue to resonate with business leaders and investors around the globe. However, the complexities of the concepts underpinning his theories lack sufficient clarity for some. In an effort to address this perceived shortcoming, Bruce C. Greenwald, the Robert Heilbrunn Professor of Finance and Asset Management at Columbia Business School, (along with Judd Kahn) have just released a new book, *Competition Demystified*, which attempts to modernize and simplify Porter's concepts of competitive strategy.

Third Quarter 2005 Financial Statistics

DJIA: 10568.70

S&P 500: 1228.81

90-Day T-Bill: 3.54%

30-Yr. T-Bond: 4.57%

Continued on inside...

Distinction

continued from front...

Greenwald and Kahn, like Porter, agree that five primary forces – 1) threat of new entrants, 2) bargaining power of suppliers, 3) bargaining power of buyers, 4) threat of substitutes, and 5) rivalry amongst existing firms – tend to govern/drive much of what transpires on the field of competition. However, unlike Porter they do not believe “that these forces are of equal importance.” From their perspective, “one of them is clearly much more important than the others. It is so dominant, in fact, that leaders seeking to develop and pursue winning strategies should begin by ignoring the others and focus only on it. **That force is ‘barriers to entry.’**”

The existence of formidable entry barriers, according to Greenwald and Kahn, makes it especially “difficult for new firms to enter the market or existing companies to expand.” They believe, “there are only two possibilities. Either the existing firms within the market are protected by barriers to entry (or to expansion), or they are not. **No other feature of the competitive landscape has as much influence on a company’s success as where it stands in regard to these barriers.**” In fact, barriers of that scale exert such power that they provide those companies so blessed with something of immeasurable value, especially if perpetuated over many years. That something is competitive advantage which, according to Greenwald and Kahn, is derived directly from such barriers. Therefore, if entry barriers are in place and defensible, those firms protected by such defenses will be able to do “what their potential rivals cannot,” such as price their products at a premium with no discernable impact on end-market demand. “Being able to do what rivals cannot is the definition of competitive advantage.”

In the investment realm, barriers to entry and competitive advantage are of paramount importance, especially to the patient long-term holder of stocks. The ideal situation for an investor is to find a mispriced/undervalued stock whose underlying business possesses distinct and defensible barriers to entry, which in turn provide that firm with a sustainable or durable competitive advantage. Why is this important? According to Greenwald and Kahn, the fact that the global competitive landscape is populated with so many “companies seeking profitable

opportunities for investment, the returns in an unprotected industry will be driven down to levels where there is no ‘economic profit,’ that is, no returns above the costs of invested capital.” Such a scenario is highly problematic for the company competing in an unprotected industry or business, but also for the holders of its common stock. Over time, economic profits (that is returns above the cost of capital) are what drive the intrinsic value of a firm, and hence its stock market capitalization as well. A 1999 *Fortune* magazine commentary by Warren Buffett sums it up best:

“The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors.”

In the world of investment research, the process of identifying companies possessing distinct barriers to entry and sustainable competitive advantage is, like many aspects of this business, a combination of art, science and experience (derived from “the school of hard knocks”). Given our intense focus here at WEDGE on finding stocks priced with an appropriate “margin-of-safety” (from a valuation perspective), an assessment of the strength of a company’s competitive position receives intense scrutiny as the underlying business model supporting the stock price has a distinct impact on the margin-of-safety equation over time. Although the evaluation process presents distinct intellectual and analytical challenges, via the increasingly fluid nature of the global competitive arena, a basic template can be formulated to help guide the evaluation process.

“You can observe a lot just by watching.”
– Yogi Berra, Hall of Fame catcher (1925-)

In Chapter 4 of *Competition Demystified*, Greenwald and Kahn outline the basic steps they believe are necessary to determine if a company possesses a competitive advantage and, if it does, to identify the sources of that advantage. Although the authors appear to target corporate executives/strategic planners as their primary audience, we believe the analytical process they advocate is of great value to investors as well. What follows is the three-step approach they propose, along with an elaboration and discussion of their suggested methodology:

- 1) *Identify the competitive landscape in which the firm operates. Which markets is it really in? Who are its competitors in each one?*
- 2) *Test for the existence of competitive advantages in each market. Do incumbent firms maintain stable market shares? Are they exceptionally profitable over a substantial period?*
- 3) *Identify the likely nature of any competitive advantage that may exist. Do the incumbents have proprietary technologies or captive customers? Are there economies of scale or regulatory hurdles from which they benefit?*

According to Greenwald and Kahn, “the first and most important step is to develop an industry map that shows the structure of competition in relevant markets. This map will identify the market segments that make up the industry as a whole and list the leading competitors within each one.” From our vantage point as investors, such industry mapping can provide important perspective on the overall competitive landscape in the industry and the relative standing of the company or companies we are evaluating.

The second step advocated by the authors “is to determine for each market segment whether it is protected by barriers to entry, or in other terms, whether some incumbent firms enjoy competitive advantages.” According to them, “there are two telltale signs of the existence of barriers to entry/competitive advantages:

Stability of market share among firms. *If companies regularly capture market share from each other, it is unlikely that any of them enjoys a position protected by competitive advantages. In contrast, if each firm can defend its share over time, then competitive advantages may be protecting their individual market positions.*

Stability in the relative market positions of firms is a related issue. The key indicator of this is the history of the dominant firm in the segment. If the leading company has maintained its position over a period of many years, that fact strongly suggests the existence of competitive advantages. If, on the other hand, it is impossible to single out a dominant firm, or if the firm at the top changes regularly, then no single company is likely to enjoy sustainable competitive advantages.

The history of entry and exit provides another clue. The more movement in and out, the more turbulent the ranking

of the companies that remain, and the longer the list of competitors, the less likely it is that there are barriers and competitive advantages. Where the list of names is short and stable, the chances are good that the incumbents are protected by barriers and benefit from competitive advantages.

Profitability of firms within the segment. *In a market without competitive advantage, entry should eliminate returns above a firm’s cost of capital. If the companies in a market maintain returns on capital that are substantially above what they have to pay to attract capital, the chances are strong that they benefit from competitive advantages/barriers to entry. These sustainable excess returns may be restricted to a single dominant firm, or they may be shared by a limited number of companies who all enjoy competitive advantages over smaller firms and potential entrants.”*

In terms of profitability, there are several ways to measure it. For example, profitability measures that allow for comparisons across industries “calculate returns either on equity or invested capital. “According to Greenwald & Kahn, “after-tax returns on invested capital averaging more than 15 to 25 percent – which would equate to a 23 to 38 percent pretax return with tax rates of 35 percent – over a decade or more are clear evidence of the presence of competitive advantages. A return on capital in the range of 6 to 8 percent after tax generally indicates their absence.”

“When the analysis of market share stability and profitability are consistent with one another,” the authors suggest, **“the case for the existence of competitive advantage is robust.** *For example, Enron reported only a 6 percent return on capital for the year 2000 – its most profitable year – and it needed the help of accounting manipulations to do even that. This result by itself should have cast doubt on its claim to competitive advantages in trading markets for new commodities like broadband and old ones like energy. The history of the trading operations of established Wall Street firms, in which changing relative market positions are the rule, makes the case against competitive advantage for Enron even stronger.”*

“If market share stability and profitability indicate the existence of competitive advantages, the third step,” according to Greenwald and Kahn, “is to identify the likely source of these advantages. Do the dominant firms in the industry benefit from proprietary technologies or other cost advantages? Do they have captive customers, thanks to customer habit formation, switching costs, or search costs? Are there significant

economies of scale in the firm's operations, combined with at least some degree of customer captivity? Or, if none of these conditions seems present, do the incumbent firms profit from government intervention, such as licenses, subsidies, regulations, or some other special dispensation?"

These questions targeted at *"identifying the likely source of a firm's competitive advantage"* serve *"as a check,"* according to the authors, *"to confirm the findings from the data on market share stability and profitability."* From their perspective, *"even when market share is stable and profitability is high, a close look at the business may fail to spot any clearly identifiable cost, customer captivity, or economies of scale advantages. The likely explanation of this discrepancy is either that the market share and profitability figures are temporary, or that they are the consequence of good management – operational effectiveness – that can be emulated by any sufficiently focused entrant. Identifying the sources of competitive advantages should help predict their likely sustainability."*

The process of accurately identifying those companies possessing distinct and defensible barriers to entry and sustainable competitive advantage is, as we've intimated, an inexact science. With that in mind, Greenwald and Kahn make a point to reference real world company-specific anecdotes in an effort to add clarity and transparency to the process of assessing strategic positioning. More specifically, they cite one of the best-selling management books of 2001, *Good to Great*, which studied companies making the transition from ordinary to outstanding performance. According to the book's author, Jim Collins, a former faculty member at Stanford's Graduate School of Business and noted expert on what distinguishes "the best from the rest" in the world of business, *"almost all the firms that flourished began the change by adopting a simple and clear strategic focus."* He uses as examples, amongst others: Kimberly-Clark, which sold its paper mill to concentrate on marketing paper products; Walgreen, which focused on simple, basic retail businesses in well-defined geographic markets; Wells Fargo, which concentrated on basic banking in the western U.S.; and Gillette, which focused on razor technology and shaving products. It is important to note, however, that although these companies (and a number of others highlighted by Collins) had experienced measurable success by means of a

distinct and concentrated strategic focus, several of them (i.e., Circuit City) subsequently faltered (post-publication) as they moved away from their historic core competencies.

In assessing the underlying reasons for the ensuing shortfalls experienced by those select *Good to Great* companies, Greenwald and Kahn conclude that *"the subsequent experience of some of these companies underscores the indispensable role of management attention. Where great performances have deteriorated, there appears to be some important dissipation of management focus."* It is this loss of focus that we believe can make **all the difference** as the competitive arena (as well as the stock market) is brutally unforgiving to those that lose their way.

For the majority of companies, sustainable competitive advantage will remain a relatively elusive concept (though a worthy ambition). For a select few, it is an **uncommon distinction**. In that regard, the following lyrics from *"Dust in the Wind,"* the classic 1977 acoustic melody made famous by rock band *Kansas*, serve as an important caveat to both the investor and the corporate executive/strategist charged with assessing and/or pursuing strategic competitive advantage in a world where change, a fundamental constant, is accelerating:

*Nothing lasts forever but the earth and sky.
It slips away, and all your money,
won't another minute buy.
Dust in the wind, all we are is dust in the wind.*

From a fiduciary perspective here at *WEDGE*, it remains imperative that our research team proactively and vigilantly survey the investment landscape for overt and even nuanced shifts in management focus or priorities. The early recognition of wandering and/or dissipating strategic and/or operational focus can help us and our clients avoid much of the pain associated with the subsequent deterioration in fundamentals and stock price performance that often follows.

continued on outside flap...



continued from inside flap...

Index	09/30/05 Price	3rd Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	10568.70	2.9%	-2.0%
S&P 500	1228.81	3.1	1.4
Value Line Composite	409.73	3.7	1.3
American Exchange Comp.	1736.89	12.5	21.1
NASDAQ Composite	2151.69	4.6	-1.1

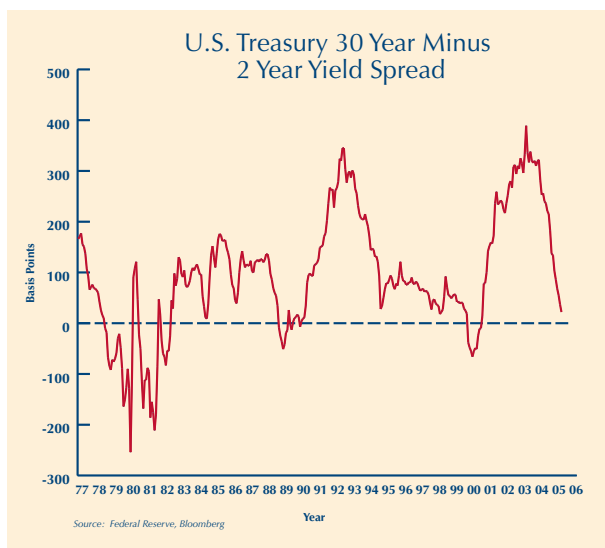
*Does not include dividend income.

Fixed Income

The Shape of Things to Come?

Almost two years ago, we noted that the extraordinary steepness in the yield curve provided an outstanding investment opportunity for fixed income investors. Since then, the yield curve has flattened dramatically, as measured by the yield spread between the 30-year and 2-year Treasury (**Chart 1**). As a result, employing a “barbelled” maturity strategy has worked quite well. However, the incremental value of such a strategy going forward is increasingly in question, in our opinion.

Chart 1



Although we believe the Fed will likely raise the Fed funds rate at least two or three more times, it is certainly closer to the end of its tightening cycle than the beginning. As a result, when the Fed eventually pauses or ceases raising rates, upward pressure on short-term rates will likely lessen. In addition, some recent economic anecdotes seem to indicate a slowdown in growth may have already been occurring before the impact of Hurricanes Katrina and Rita. Even if not true, the follow-on economic disruptions of the storms and the resulting incremental pressure from already-higher energy prices will most likely restrain economic growth in the months ahead.

While the scenario just articulated could lead to further yield curve flattening if longer rates decline as a result, we believe the markets may begin to “look past” any near term economic weakness. The primary rationale for this view is that most disasters only temporarily disrupt economic activity, while clean up and rebuilding efforts contribute to subsequent growth. At this point, the Federal Government seems more than willing to “spend what it takes” to rebuild the Gulf Coast region, which indicates to us that deficit reduction is no longer a priority. So, if monetary policy becomes less restrictive and fiscal policy becomes more stimulative, investors may begin to demand higher yields on longer-term Treasuries. In this

continued on back cover...



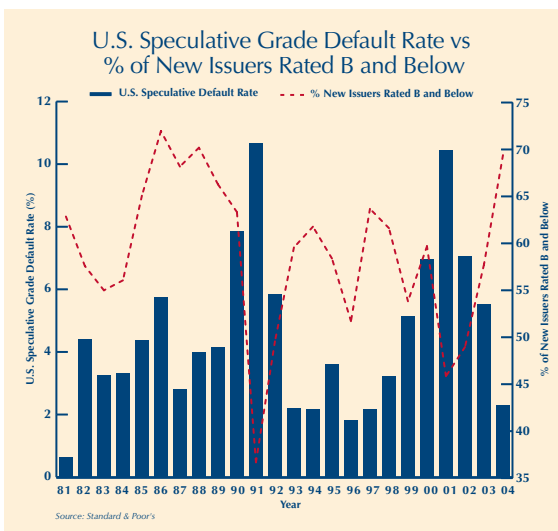
continued from outside flap...

scenario, the yield curve could steepen and, in anticipation of that, we have chosen to employ a more neutral yield curve posture at this time.

Late last year, we surveyed the backdrop of the high-yield market and concluded that valuations were quite full and that recent issuance was experiencing a marked decline in credit quality. We also concluded that default rates would most likely rise over the next several years as a result of this diminished issuance quality. In revisiting the sector today, we continue to find evidence that the credit quality of new issuance is diminishing, which we believe supports our previous conclusion that defaults are likely to increase significantly over the next few years.

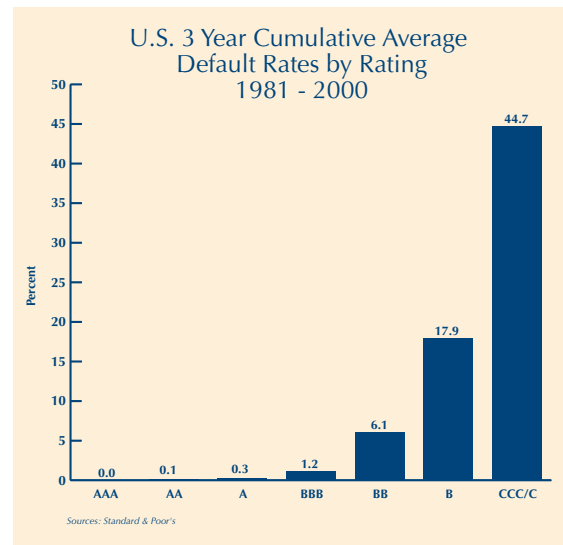
Chart 2 shows the U.S. speculative-grade default rate plotted against the percent of new speculative-grade issuers rated B and below. Note that the percent of new issuers generally tends to “lead” the default rate, that is, this ratio tends to peak or trough several years before the rate of default. Intuitively, this makes sense – if defaults are relatively high, the ability of new, lower-rated companies to access the high-yield market is limited. If default rates are low (similar to the current environment), the ability of these companies to place bond deals is typically much less restrained.

Chart 2



Historically, issuers rated B and below tend to default at a much greater frequency than higher-rated entities. **Chart 3** shows the average three-year cumulative default rate by rating category from 1981-2000. **Note that not only do B and below rated companies default more frequently, the magnitude of their defaults is far greater than that of the next higher-rated category.**

Chart 3



Given all the data just presented, what does the high-yield market have to do with our view regarding the investment grade corporate bond market? With current valuations across the rating spectrum quite full, by historic standards, we are very interested in identifying anything that may cause a change in perceived risk and, therefore, a widening of debt spreads. In a recent speech on monetary policy, Federal Reserve Chairman Alan Greenspan pointed to such a potential “change dynamic” by stating that, “*Our forecasts and hence policy are becoming increasingly driven by asset price changes*” cautioning that “*history has not dealt kindly with the aftermath of protracted periods of low risk premiums,*” such as we’ve experienced over the past couple of years. Taking all these things into consideration, **we remain comfortable with our higher quality positioning in client portfolios.**

