WEDGE WATCH

A newsletter published quarterly by WEDGE Capital Management L.L.P. • October 2006

Pushing the Limits?

"No noble thing can be done without risks."
–Michel de Montaigne, French Renaissance essayist and statesman (1533-1592)

Third Quarter 2006 Financial Statistics

DJIA: 11679.07

S&P 500: 1335.85

90-Day T-Bill: 4.87%

30-Yr. T-Bond: 4.76%

It has been said that if you *"court disaster long enough; it will accept your proposal."* Sadly, for legendary wildlife crusader Steve Irwin, who was better known to his legion of fans as television's 'The Crocodile Hunter,' this truism turned to grim reality early last month in shallow waters of Australia's *Great Barrier Reef*. There, while filming an underwater documentary, a startling and fatal stab wound from a large stingray barb improbably took his life. The irrepressible and seemingly fearless Aussie had long stared danger brazenly in the face, enthusiastically squaring off (nearly eyeball to eyeball) with deadly crocodiles, venomous snakes, poisonous spiders and others of the world's most dangerous predators, tempting fate time and again to the delight and horror of audiences worldwide. To anyone who had the good fortune to see him in action, it was immediately obvious that this modern day Noah had a natural flair for the ultra-dramatic, especially in front of a camera or crowd. However, just beneath the surface of his daredevil persona was, by most accounts, the heart and soul of a zealously devoted wildlife expert and conservationist, deeply versed in the behavioral tendencies and nuances of the earth's most dangerous creatures.

Irwin, who was reportedly wrestling small crocodiles by the age of 9, was introduced to the *ways of the wild* years earlier under the watchful eye of his father, an adventure-seeking herpetologist and zoo owner who led young Steve on frequent snake-catching trips into the Outback. Not surprisingly, given his upbringing, the famed 'Croc Hunter' was quite cognizant of, and well-adapted to, the risks involved in his perpetual crusade to excite and educate the masses about the wonders of the world's most exotic wildlife. Nevertheless, it would not have come as a total surprise if Irwin had met his demise or been seriously injured by what he often referred to as a "cranky croc." However, the idea that something as typically benign and docile as a stingray would abruptly end his life came as a stunning shock.

It is debatable whether or not Steve Irwin ultimately ***pushed the limits*** too far. Although he was known to acknowledge the risks of putting himself in harm's way, there are probably those who believe he underestimated the danger lurking in plain sight that fateful September morning. After all, Irwin, who was an expert diver, had safely swum in close proximity to stingrays many times in years past. One thing we do know, however, is that the only way Irwin, a hand waving and highly animated 21st-century Tarzan, could have consciously reduced his risk of bodily harm was to do what those closest to him knew he emphatically could not or would not do, *stand passively outside the arena*. Its lure was just too irresistible, the innate passion for his life mission too compelling.

In the rough and tumble world of Wall Street, investors face risks far less lethal than those confronted by Mr. Irwin. However, financial risk (i.e., risk of permanent loss of capital) and volatility risk, whether one likes it or not, are constant companions of the equity holder. Although astute investors know, or certainly should by now, that there is *no free lunch*, the concept of risk and risk assumption continues to

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Limits?

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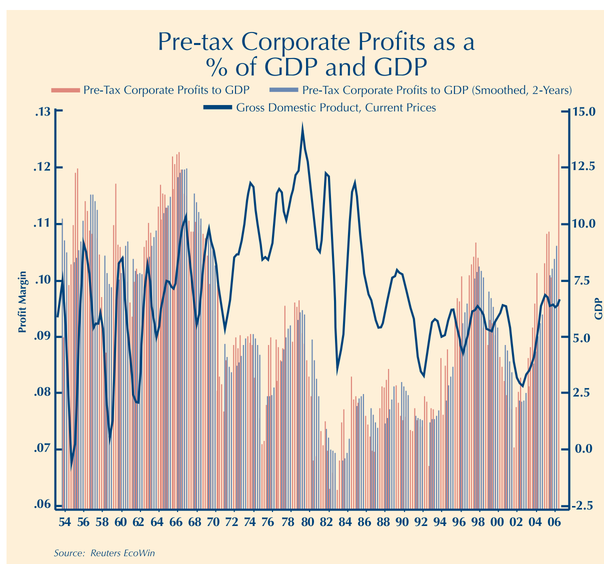
be misconstrued by many investors. In that regard, there is likely no better example of this upside down thinking than Wall Street's *episodic* history of boom/bust, which provides graphic and compelling evidence that the base human emotions of *fear and greed*, especially *greed*, continue to shrewdly seduce investors to ***push the limits***. For example, it is in reaching for returns by throwing caution to the wind and disregarding valuation levels (i.e., chasing high flyers) that investors often get into trouble. In today's market, amongst a myriad of ever-evolving risks, obvious and otherwise, investors are confronted with one particular risk that *could* potentially expose the equity market as being more richly valued than is currently presumed.

Chart 1 *provides a graphic depiction of the most commonly articulated bear case for U.S. corporate profitability*. As can be seen in *red*, pre-tax corporate profit margins as a percentage of GDP have reached levels not seen in forty years. (The same data in *blue* has been smoothed over two years.) This rare and lofty level is giving many professional investors considerable pause. Given the natural proclivity of value investors to lean on mean-reversion tendencies, it would not surprise us if the majority are skeptical that margins can expand from here (either from a cyclical or structural perspective). In other words, the apparent consensus is that "this is about as good as it gets."

Chart 1



As dyed-in-the-wool value investors, we have great respect for the philosophy of *consciously avoiding upside extremes* and have, to a large degree, *premised the success of our firm and our clients' financial fortunes on the persistency of* ***mean reversion***. In fact, by design, we often reference (and redundantly so) this powerful force in both our written and oral communiqués with clients, prospects and consultants. It is, we believe, a subject of *paramount importance*. However, *despite the proven mean reverting tendencies of equity valuations, it may not be as clear that corporate profit margins exhibit the same tendency*.

A key conundrum facing equity investors today is whether or not the U.S. economy is likely to recess at some point over the next 6 to 12 months. Are we late in the economic cycle or is the slowdown that appears to be emerging, vis-à-vis the unwinding of the housing bubble, just *the pause that refreshes*? As always, there are no easy answers. The crux of these questions, however, generally revolves around investors' desire to surmise whether or not corporate profitability can sustain its current lofty levels or, following a normal slowdown-induced margin contraction, elevate to even higher plateaus (during the next cyclical upturn).

Louis Gave and Steve Vannelli, of *GaveKal Research*, recently published two excellent research reports: *The Invisible Hand's Impressive Work* and *The Myth of Reverting Margins* which attempt to answer the latter question above, and to prove, contrary to popular belief, that 1) U.S. margins are not at all-time highs, and 2) margins do not revert to a mean. With their permission, what follows is a liberally excerpted and paraphrased synopsis of their research, along with our own editorial commentary and observations regarding their relatively unconventional but thought-provoking work.

Sir John Templeton, one of the most storied investors of the 20th century, once offered the sage advice that *"history never repeats itself, but it often rhymes."* Most likely he was referring to the inherent constancy of human nature and the persistent mean-reverting tendencies of financial markets. In the case of domestic profit margins (as a percentage of GDP), "they have historically reverted back to the mean from their cyclical peaks, as one would expect" since abnormally high profitability inevitably attracts increased competition and investment. "Otherwise, given the laws of compounding, profits would eventually end up being larger than GDP. *However, the mean to which they revert may be much higher than some expect.*

Indeed, *while profits as a percentage of GDP cannot increase forever, a structural upward shift in corporate profitability may be evolving*." In the examples that follow, we will attempt to provide clarity regarding some of the key underlying dynamics driving this (apparent) secular trend.

"Financial markets are a kind of time machine that allows selling investors to compress the future into the present, and buying investors to stretch the present into the future."
–Peter L. Bernstein, author of "Against the Gods: The Remarkable Story of Risk."

"In the U.S., an investment environment increasingly defined by the growing prevalence of shareholder activism and by the impact of ever-improving techniques of modern management (i.e., global outsourcing, lean manufacturing), many companies have become more judicious with their capital spending" (though post 9/11 risk aversion has likely been a factor as well). Relative to history, in fact, "incremental returns on capital deployed are being much more highly scrutinized; hence business units not earning their keep are being shuttered, spun off or sold to other investors. In other words, **in the U.S., what matters most are profits and returns on invested capital**. Employment, which is secondary, only comes as a natural consequence of the companies' profit seeking activities."

"In the case of China," the world's fastest growing emerging market of size, "thanks to a low cost-of-capital and a very low cost-of-labor, companies, especially manufacturers, have sprouted at an unprecedented pace. Because returns on invested capital are a distant consideration there" (via, to a large degree, the government's self-interested desire to subsidize, at nearly any price, the employment of the growing hordes flocking to the cities), "*many sectors are now in overcapacity*; and yet capital spending continues unabated. For example, China has over 300 auto producers (despite the fact that ten would likely suffice) and more than 3000 ball bearing manufacturers;" eye popping numbers which make little sense from a pure supply/demand perspective. **"So, in China, unlike the U.S., what matters most," at least for now, " is employment. Profits, on the other hand, appear to be a secondary consideration."**

Against this backdrop, "where trade barriers are dissipating and new emerging markets are opening up, China and the U.S. have increased their dialogue, especially regarding trade. As a result, it should come as no big surprise, that just as we saw a widening of the U.S. account deficit, *we also witnessed an explosion in the profitability of U.S. corporations*. Going forward, as trade between the two economic giants continues to grow, equity holders" (who have an obvious vested interest) "should ask themselves which of these two countries will capture the profitability of these trade flows? Will it be leading U.S. companies like Wal-Mart or rapidly emerging Chinese goods manufacturers?" Although both sides should clearly benefit, *we would lay odds that the lion's share of the profits ultimately find their way to places like Bentonville, Arkansas*.

Assuming we are in the ballpark regarding the magnitude of the China-related gains that ultimately accrue to U.S.-based multinationals like Wal-Mart, another important question comes to mind: "If Wal-Mart's foreign profits, as a percentage of total revenues, grow over time, should their *total profits* (domestic and foreign) relative to domestic GDP ultimately revert to the mean? In a "closed economy," the answer would most likely be "yes." However, few economies in the world today could be characterized as truly "closed economies;" instead, companies are increasingly global, and thus their *total profits* should probably be compared to global GDP, instead of domestic GDP. So, in the case of Wal-Mart, *maybe* the company's domestic earnings as a percentage of U.S. GDP are approaching their limits, however, the same, most likely, cannot be said of their total profits relative to foreign and U.S. GDP combined. **In other words, domestic profits will probably tend to revert to the mean on a national basis; total profits, however, may be in the early stages of secular ascent."**

Chart 2, which provides additional food for thought on the subject at hand, depicts, like **Chart 1**, the history of pre-tax profit margins relative to domestic GDP. However, there are two key differences: 1) personal consumption expenditures (dark blue line) are used in lieu of nominal GDP, and 2) the data on pre-tax corporate profitability as a percentage of GDP (blue) has been smoothed over *five years* instead of two. This change was done to deemphasize short-term fluctuations and to better depict a longer term trend.

The interpretations of these two charts (see next page), per *GaveKal Research*, are quite profound, if true, and suggest relatively surprising and somewhat

Chart 2

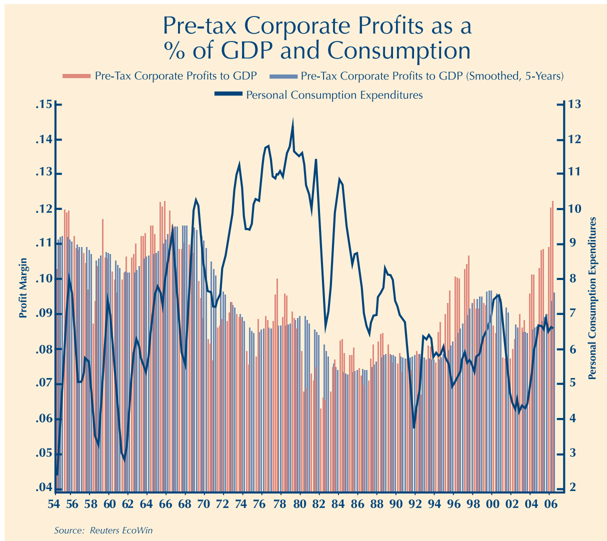
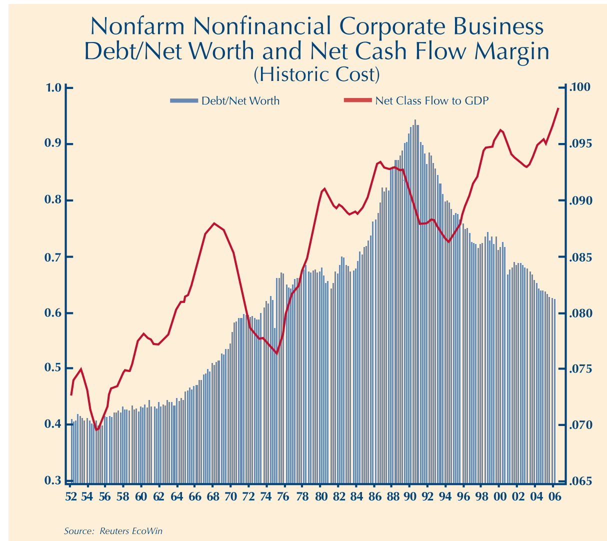


Chart 3



counterintuitive conclusions about margins and mean reversion:

1) Despite the recent surge in profitability, the five-year smoothing effect ***shows that profits are not at record highs,*** with margins, instead, nearly two percent below smoothed profits in the late-1960s.

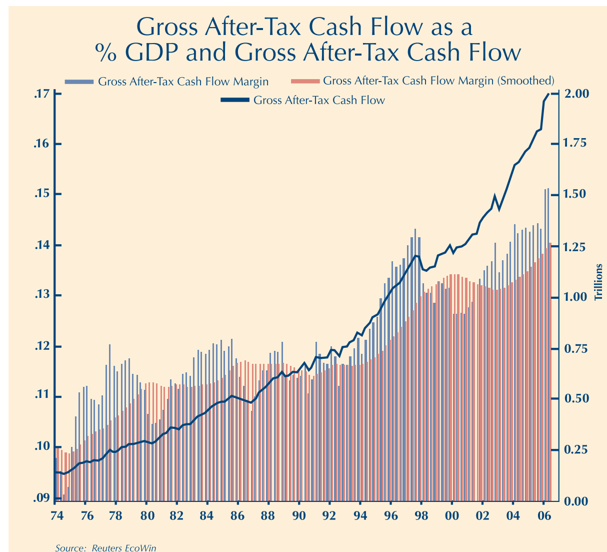
2) In addition, margins appear to bear little relationship to the level of GDP or consumption growth. In fact, as the economy accelerated from the mid-1960's to the early 1980's, margins plunged. Similarly, as the economy slowed from the early 1980's to the present, margins accelerated.

3) **The smoothed data depicted in the graphs suggests that it is debatable whether margins are a mean reverting data series.** Margins tend to demonstrate more of a trending tendency than a mean reverting tendency. After all, a mean is a reference point around which data oscillates. Per the data depicted in the graphs, there does not appear to be much of a central tendency evident, nor is there much in the way of rhythmic movements around that central tendency.

Notwithstanding these thought-provoking observations, experienced readers may still be skeptical as they, like us, have learned the hard way to be wary of investment arguments that declare *this time is different*. With that in mind, let's shift our attention to something considerably less esoteric.

"All good businesspeople" (and investors for that matter) "know that everything begins and ends with cash flow (i.e., cash is king). Whereas reported earnings are not necessarily an accurate representation of the health of a business, cash flow data is much more straightforward and difficult to manipulate. **It is, therefore, cash flow and cash-flow margins (their levels and sustainability), not profit margins that matter most." Chart 3** shows the trend in U.S. cash-flow margins (as a % of GDP) over the past 50 plus years while also graphically depicting the current state of corporate balance sheets. **Chart 4**, which looks at cash flow from a somewhat different perspective, shows gross after-tax cash flow (before distributed profits such as dividends) on an absolute basis and relative to GDP.

Chart 4



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Individually and collectively, again per *GaveKal*, these two charts drive home important and highly relevant messages for the *long-term investor*:

1) Despite bouts of cyclicality, **U.S. cash flow and cash flow margins have been in a secular uptrend for over 30 and 50 years respectively** (which likely explains the performance of broad-based stock indices over the same time frame). *No mean reverting tendencies apparent here.*

2) Until the early 1990's, rising margins were accompanied by rising leverage. **Since then, however, margins have continued to march higher while leverage has receded.**

3) Given this backdrop, it would appear **there is scope for companies to rediscover the virtues of leverage in magnifying future returns (hence the surge in private equity transactions and share buyback announcements over the past year)**.

The multi-decade trends just highlighted are difficult to ignore, and clearly the management teams of the world's leading companies are taking notice. With cash-flows now at record levels, and balance sheets brimming with cash ($2 trillion at last count), share repurchase activity has accelerated to dramatically higher levels. More specifically, according to Birinyi Associates, buyback announcements during the first eight months of 2006 reached a staggering $507 billion, up 88% from the record set in the prior year. Impressively, however, "companies are still funding increased capital spending and R&D investments" (from operating cash flow) in their never-ending quest to enhance and/or gain durable competitive advantage. So, barring a severe and protracted recession, which is obviously a risk, and assuming that corporate financial discipline is maintained, "*U.S. companies should have little dependence on outside shareholder capital in the years ahead;* ***enhancing the scarcity value of their shares*** *with the passage of time.*"

More specifically, we believe *the lead beneficiaries of this dynamic will be the* ***mega-caps****, which have been discarded by investors in recent years and yet appear best positioned to exploit the rapidly emerging global opportunity*.

Despite the positive backdrop just articulated, however, there are **risks**, some potentially material, lurking both in and out of the shadows. One need look no further than Connecticut hedge fund *Amaranth Advisors*, which reportedly lost $4.6 billion, or roughly half its assets, in one single week last month on *highly leveraged and highly concentrated* bets on natural gas. Fortunately for us and our clients, leverage (i.e., margin) is not part of the investment equation here at *WEDGE*. To the contrary, we are *long-term investors* focused on patiently compounding returns over extended multi-year time horizons. That said, we are quite cognizant that domestic profit margins *may* be **pushing their limits** for this cycle and that the likelihood of a recession has grown. However, despite these risks, *it is the longer term structural story of globalization, technological innovation and the slow but inevitable spread of capitalism that we believe may be the most important takeaways for the long-term investor*.

History has shown, time and again, that **ingenuity and profit motive are powerful forces not to be underestimated**. If there is money to be made, you can bet that profit hungry managements will, like the late Steve Irwin did in his passionate quest to "save the animals," relentlessly **push the limits** in red hot pursuit. As the old saying goes, "records were made to be broken" and who better to set the pace and step up to the challenge than American business, the world's most passionate proponents and practitioners of global capitalism. Stay tuned.

Index	09/30/06 Price	3rd Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	11679.07	4.7%	9.0%
S&P 500	1335.85	5.2	7.0
Value Line Composite	426.41	0.8	3.4
American Exchange Comp.	1906.86	-1.1	8.4
NASDAQ Composite	2258.43	4.0	2.4

**Does not include dividend income.*

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Fixed Income

Volatility Redux

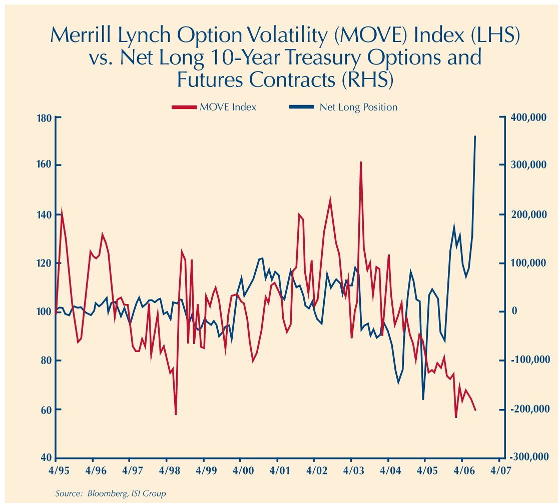
Two quarters ago, we noted the rather dramatic decline in **volatility** in the debt and equity markets over the past few years. Our concern, at the time, was that these periods of abnormally low volatility have not lasted very long, and many times have ended in a rather "volatile" fashion. We revisit this topic once again because **we believe changes in interest rate volatility will be an outsized driver of relative fixed income returns over the next 12 to 24 months**. Anecdotally, we are seeing evidence that investors are boldly stepping up to assume additional risk by betting more aggressively on the direction of interest rates in this low volatility environment. Could it be that this seeming contradiction is not a coincidence?

To be sure, it could very well be that interest rate volatility is moving into a new, lower secular pattern. The global integration of economies, capital markets and information flow may have combined with the advent of new financial instruments and risk management techniques to reduce volatility. However, we are highly skeptical this will persist indefinitely.

Merrill Lynch's "MOVE" index (which is shown on the left side of **Chart 5**), a weighted average measure of the implied options volatility of Treasury securities across the yield curve, helps graphically illustrate our point. **It is interesting to note that this measure has declined sharply and consistently since its peak in July 2003. In fact, this measure came close to setting an all-time monthly low last month! *We see this as evidence of an extreme and very crowded "consensus" that interest rate volatility will remain low for some time.*** Our expectation, however, is that interest rate volatility is more likely to *increase* going forward.

Just as interest rate volatility appears to be near record lows, it is interesting to note that the speculative net-long position for 10-year Treasury

Chart 5



bond futures and options traded on the Chicago Board of Trade **appears to be at a record high** (right side of **Chart 5**). *This is an extremely large bet that interest rates will decline*. We must acknowledge, however, that some of this exposure could indicate that participants with huge mortgage positions have hedged their duration against an unexpected fall in interest rates. Any significant decline in rates, of course, could lead to a surge in mortgage refinancing activity.

It is difficult to say whether these measures, ***currently at extremes***, reflect anything more than mere coincidence. Perhaps they are related in the sense that persistently low-volatility serves to encourage risk taking. Whatever the explanation, **we view it as an excellent opportunity to add value in our client accounts**. As such, we have been proactively positioning client portfolios to take advantage of an eventual *reversion-to-the-mean* of interest rate volatility. More specifically, we have added to several corporate "put" bonds while also increasing our exposure to well-structured, mortgage-backed securities that should outperform in a more volatile interest rate environment.

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