GETTING PERSONAL: Investing The Old-Fashioned Way

By JANE J. KIM
A DOW JONES NEWSWIRES COLUMN

NEW YORK -- Instead of waiting to ride the next big tsunami, investors might want to play with the tinier waves instead.

A new investment theory suggests that higher returns will come from the smaller, more geographically dispersed opportunities, not from the "next big idea." For investors, that means a return to the basics. Those who have the fundamental analysis skills to identify assets with realizable cash flows are poised to find better opportunities than momentum investors.

"This market is more suited to PT boats than battleships," said **John Rutledge**, chairman of Rutledge Capital, a private equity investment firm in New Canaan, Conn., and a former economic adviser in the Reagan administration. Rutledge characterizes today's market as a "gleaner's market," named after the old-time practice of gathering the remnants of a crop from the field after harvest.

Over the past two decades, investors benefited from falling inflation and tax rates. But as balance sheets adjusted to those lower rates, the underlying macroeconomic forces that steered investors to financial assets and lifted stock prices in the process have largely subsided.

"We had a series of very large changes and have gotten used to the fact that there was a big story," Rutledge said. Today, "the fundamental changes are more varied and more modest than that."

Falling Inflation, Tax Rates

To understand the forces that drove security prices higher during past two decades, it's helpful to look at what inflation and tax rates were in 1981. At the time, inflation was running at 15% a year and the top federal marginal tax rate was 70%, Rutledge said. Investors, as a result, retreated to hard assets such as real estate, commodities and gold coins, and dumped financial assets, which had single-digit stock market multiples and 15% yields on Treasury securities.

As a result of economic and monetary policies, inflation and tax rates steadily declined from those initial levels, making the returns on securities more attractive, Rutledge said. In response, he said, Americans shifted roughly $11 trillion out of tangible assets into stocks and bonds over the past two decades. At the same time, falling interest rates and rising stock multiples reduced the after-tax cost of capital for American companies, resulting in increased investment and productivity growth.

But in recent years, those forces worked too well, and drove up prices excessively,

July 24, 2002 – Interview with John Rutledge

Rutledge said. Most of the market's gains in recent years came from rising valuations, not rising company performance.
"We had a feast in the investment markets...up until two years ago," Rutledge said.

Hedge Funds Poised To Outperform

Not only will investors benefit by returning to the old-fashioned skills of bottom-up, value-oriented security analysis, but they can also take advantage of local arbitrage opportunities by understanding how factors such as tax rates, regulatory policies, and legislative changes affect individual companies and specific regions.
Investing locally across diverse regions can also help investors diversify their portfolios more effectively.

"You're not making one big bet," Rutledge said. "You're making 10 to 20 bets on very different stories."

Hedge funds will be among the primary beneficiaries, he said. Unlike the larger, slower-moving mutual funds, hedge funds can take advantage of such arbitrage opportunities because they have the ability to sell short. Short-selling is generally considered a speculative way to place bearish bets.

Take, for example, the utility industry which has been battered by recent events. By identifying the good companies along with the bad, an investment manager can buy the good names and short the losers, Rutledge said.

And Germany is another region where investors might find merger arbitrage opportunities. As a result of a new tax structure enacted earlier this year, German companies will be allowed to dispose of their cross-shareholdings in other businesses without paying a capital gains tax. That's likely to spur a wave of restructuring, Rutledge said.

"It takes a lot of capital that had been locked up in low-return uses and frees it up to be redeployed," he said. As a result, it may pay to look for German companies whose shares are largely locked up in institutional cross-shareholding ownership that are cheaply priced, Rutledge noted. Or, wealthy investors could seek out hedge funds that target intra-European arbitrage opportunities, he added.

--By Jane J. Kim, Dow Jones Newswires; 201-938-4381; jane.kim@dowjones.com
Updated July 24, 2002 9:33 a.m. EDT