Fording The Rocks In The Regulatory River

Dr. John Rutledge, A Jack-Of-All-Financial-Trades, Talks To FON About Swimming Upstream

During the week, Dr. John Rutledge is the chairman of **Rutledge Capital**, a private-equity investment firm that has invested more than $150 million in middle-market manufacturing, distribution and service companies. "My day job is owning and growing companies. I've been called a capital doctor, and I've been asked to figure out how to take care of capital, how to make it grow and how to make it valuable," he says. "Capital is the thing that makes us rich."

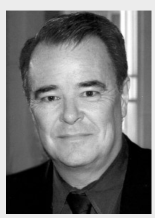
His weekend job as a mathematician finds Dr. Rutledge studying such things as chaos theory and complex systems. This combination apparently has held him in good stead as he lectures several times a week on global economics, financial markets, investment strategies, the impact of technology on the economy, and strategies for owning and growing the value of a business.

Dr. Rutledge's career includes several stints with the government, and he now is advising the Bush White House on both the dividend tax cut and rebuilding Iraq. His most recent foray into the telecom industry was an appearance on a teleconference discussing a study released by the **New Millennium Research Council** (*FON*, Sept. 22, p. 1), where he voiced some strong opinions regarding moving the industry forwards and the creation of capital. His ideas were so thought-provoking that *Fiber Optics News* called him in Maui to talk about economic theories, regulation and the role of politics in the next generation of telecom investing.

FON: With tech stocks showing improvement on Wall Street, is the end of the slump near?

Rutledge: The wild card question is the FCC. It thinks it's fine, but it's fly-in-the-amber fine. Nothing's happening, and nothing is going to. It's political paralysis.

As a writer, I love ironies. The most delicious irony of the whole thing is that the most potentially dynamic, creative, productive industry and the most competitive advantage the United States has is in the hands of a completely frozen organization. The politics between the members of the FCC have just stopped all forward motion. I heard one commissioner say, 'Well, that's okay because the market is so dynamic that it will just move around us like a river moves around a rock.' But that's not good. When a river moves around a rock or the air blows over an airplane wing, it creates pools of chaos both before and after. The clash between the energy of the industry and the stasis of the regulators is not good at all.



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– Dr. John Rutledge, chairman, Rutledge Capital

FON: Are you a believer that all things are cyclical, and that things will be getting better next year because that's what history has taught us?

Rutledge: Cycles happen. From 1981 until today, inflation and cost-of-living clauses in labor contracts have disappeared. Inflation has been replaced by deflation, and investors systematically have become worried about their future income. The 1996 Telecom Act created a host of business for the CLECs and it boosted such businesses as cable. Because future income was so scarce, those companies like CLECs and cable companies that could promise a 20-percent return were winning the beauty contests in the securities markets. So 75 percent of all of the financing done in the late Nineties was related to telecom, cable and infrastructure investment.

Then came the summer of 2000, when the Federal Reserve and the Treasury saw the revenue projections fall, and they were frightened. The banks then were forced by the Fed to cut back on their investments. Bank regulators, who made bank lending impossible to get, triggered the tech bust. The great irony was that although the hit squads were sent out to force the banks to quit making technology loans, the banks couldn't get their money back because it already was in the ground.

Banks are making record profits now, and they've written off nearly all of their bad loans. But they need to know that if they invest a dollar, they'll get two dollars back. This is the part of the cycle that isn't going away through natural healing, because of the politics.

FON: So who is the most intractable: the carriers, the regulators or the financial types?

Rutledge: The regulators are stuck with 1.5 feet in the past and a half a foot in the future. They are so focused on who will be the winners and losers or in cutting up the pie that they aren't paying attention to what needs to happen next. Their interpretation of the 1996 Telecom Act is to provide consumers with the lowest prices for things they already know about, like landlines and long distance.

This is exactly like rent controls in New York. The politicians decided they could get some political benefit out of forcing landlords to reduce prices; the result of that was the return on owning a building went down to nothing, and the landlords don't build more buildings and they don't fix the ones that already are there. Pretty soon, you end up with the rent-controlled housing stock in New York wearing out. That's the implication of regulators' view of competition.

FON: What indicators do you use when you prognosticate about the future of the telecom economy?

Rutledge: Looking back 10 years, I would judge the success or failure of a regulator based on how much new capital got put in the ground to create new facilities to offer new services to people. No capital spending means the regulators are flunking. Looking forward, you hear a lot of talk about capital spending on new technology but so far, investment only is being made by the Bells.

FON: So what is needed to turn skeptics into optimists?

Rutledge: Part of the story says the banks are getting healthier and, sooner or later whether they want to or not, they're going to have to begin to lend money again. This year, we have half a recovery, meaning the gross domestic product is going up but no one has jobs. Next year, you would expect more capital spending and more growth.

The thing to watch out for is the third irony: technology – and broadband in particular – work the economy by taking the time out of work. It makes you able to do more work in a day, a week or a year, and that means productivity goes up. If my productivity goes up 6 percent, but my customers' demand only goes up 3 percent, that means I have 3 percent of stuff left over. I either can *not* produce it, meaning I would have to fire 3 percent of my staff, or I would have to scrap it. The job of creating enough demand to sell all the product lies in the hands of the Federal Reserve, and it hasn't done its job.

A year from now in November, we're going to have a decent (but no cigars) recovery. Employment won't be materially better than it is now. Capital spending will be a little stronger. If the FCC gets religion and clarifies its rules at least on broadband (which really means the fiber-optics side of the ledger), I think you could have a massive increase in capital spending. It would require the White House to take a lot more interest in what's happening at the FCC that it has done to date.

FON: So, bottom line, recovery depends more on the FCC than it does on investors?

Rutledge: There are people who are making investment plans for broadband rollout and for fiber to the home. You have to see a long way into the future to get paid back. We need some clarity from regulatory policies.

The FCC has the ability to overturn what the last set of commissioners did; there is no ability to bind anything. It needs to make a decision one way or another and, once a decision is made, it cannot be overturned by the next guy. It matters a lot less what the rules are for the future than whether they stay where they are. You can plan a business around almost any set of rocks that are in the river, but you can't do it if they keep moving around on you.

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