Boy, do I have a smart son

BY JOHN RUTLEDGE

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LAST WEEK my son John called home from college. After a bit of small talk he got right down to business. "Dad, will my allowance stay the same next year or will it go up?"

I admitted that, with modest inflation, he could expect a modest increase. "Oh," he replied, "What is the average annual increase I should expect to receive over, say, the next five to seven years?"

"Actually, John, I was hoping that you would get a job some day and your allowance would stop altogether."

Ignoring my fatherly suggestion, John explained that he wanted to factor in the expected average increase in the hope that he might capitalize the expected income flow by going public. Goldman, Sachs was anxious to do the deal.

I am making all this up, of course. But only to make the point that college allowances are about the only stream of money that isn't going public these days. Portfolio managers, drinking from the firehose of mutual fund inflows, have been buying everything in sight, pushing valuations to levels that even Wall Street analysts are straining to rationalize.

Behind all this foolishness is a modicum of common sense. An aging population is hunting desperately to get its hands on streams of future income to finance its retirement years. That's why Coca-Cola today has a market capitalization of $142.3 billion. Where else can you find a business with dependable income that is almost certain to continue growing well into the future? But reliable streams of future income are getting harder and harder to find. The result has been impressive increases in stock and bond valuations and more and more creative efforts on Wall Street to package anything that generates future income.

Their latest creation is securitized intellectual capital. An example is the $55 million ten-year Bowie bond, with its 7.9% coupon to be serviced by the revenues from rock star David Bowie's music portfolio. There was also a $58 million Calvin Klein loan securitized by perfume royalties, giving a new twist to the term vaporware. On Wall Street today assets are out, famous is in.

The economic outlook suggests these trends will continue. Which is why I'm making private equity investments instead of peddling economic forecasts as I used to do. As income streams become scarcer, they get more expensive; i.e., security prices rise.

For investors this means that long-term interest rates will be lower than today's levels and that stocks will sell at multiples of earnings and book values even higher than today's levels. Companies that can promise growth will sell at even higher premiums than they do today. This means the current correction in the market is just that and not the beginning of a new bear market.

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As stock values continue to diverge from tangible book values, all investors will be forced to realize what intrinsic value investors have known all along, that stock prices have nothing to do with book values. The value of a company is determined by the present value of all the cash flow that investors expect to get paid during the life of the firm. That value, less the value of the company's debt, is what the company's equity is worth, regardless of the balance sheet.

In this intrinsic value market, the key risk that investors face is not volatility, it is buying an expected cash flow stream that fails to materialize because of competitive pressures or poor management. To properly evaluate those risks, investors will have to have a keen understanding of the companies they buy and the people who run them. This will require a sharp change of direction among security analysts, who have made a lot of money from macroeconomic trends since 1981. They will have to become experts in understanding businesses again and in evaluating human talents and motivations.

In this market, managers with a proven record of having the skill and the will to deliver sustainable, growing cash flows to investors will be highly prized. To know how a man is going to behave ten years in the future, there is no substitute for knowing him for ten years in the past.

So maybe my son John should take his allowance public after all. What more dependable source of cash flow than a solvent and indulgent parent?