

# ADDING VALUE

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**SUMMARY:**

Transforming ideas into action always presents challenges. During meetings that we attended throughout the fall, we were bombarded with ideas that are relevant to our investment practice and to your financial security. Since change is never easy, but is always a necessity, we thought you would enjoy hearing first hand observations from some dominant thinkers in the world today.

*ADDING VALUE is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.*

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## Fourth Quarter Investment Review and Outlook

Greg and I have recently completed a series of conferences lately in both New York City and Washington DC. These sessions were enriching intellectually and generated some great ideas. We thought you might enjoy a synopsis of the major speaker presentations, especially those where the speaker was also the author of a current best-selling book.

### Dr. Alan Greenspan – Former Chairman of the Federal Reserve

Dr. Greenspan gave the opening keynote address at the Schwab 2006 Impact Conference. Despite his retirement, his comments are still avidly followed by market participants. In person, without the media's interpretation, Dr. Greenspan's ability to cogently discuss the complex and chaotic financial interactions of world markets was impressive.

- He termed the domestic economy “not bad.” According to Greenspan, we have been in a slowing period, but he feels this is temporary: “The worst is behind us since profit margins are high and capital orders are potent.” He believes that we have a healthy diverse economy and we are making the transition from an unsustainable to a sustainable level of growth. Despite the recent weakness in housing, he believes the strength of the equity market should be offsetting to individual investors. Fourth quarter results in the domestic equity markets reinforced his positive statements.
- He had some firm convictions about federal entitlements. He asserts that the problem is not with Social Security because the number of recipients and the shortfall is well known. Medicare, however, is a very serious problem. Although we know the number of recipients, we have no clue as to the average payment amount. He expressed fear that the US government will continue to promise benefits it may not be able to deliver.
- Greenspan called exotic derivatives such as hedge funds, “pollination bees” and “very extraordinarily important” to a complex US economy. Their high rates of return help to stabilize the entire economic system and to offset the meager US savings rate. This was a surprising pronouncement because many other public figures have expressed a worry about the domino effect of a hedging strategy that could be cataclysmic to world markets, i.e. a repeat of the Long-Term Capital Management collapse.

- Dr. Greenspan also believes that the global economy is in good shape. However, he does worry about the concentration of income creating a widening gap between the have and the have-nots which could result in governments returning to protectionist practices. He commented that greater protectionist sentiment could be a mistake. In almost all instances in the past 20 years, those countries that open themselves up to competition – through trade and integration into the global capital markets – have benefited, and the rest have been left behind.

Dr. Greenspan was forthright, thoughtful, and very candid; he remains upbeat and sanguine about the state of the US economy.

**Dr. Steven Levitt – Author of *Freakonomics: A Rogue Economist Explores the Hidden Side of Everything***

Steven Levitt admits he is no Alan Greenspan. Instead, “he studies ridiculous things that no self-respecting economist wants to ask.” (He was maybe a little too self-deprecating since he received his B.A. from Harvard University and his Ph.D. in economics from MIT.) But in asking distinctive questions, frequently about cheating, corruption and crime, he told of how he has gained unique insights. For instance, he uses data to answer questions such as:

- Which is more dangerous, a gun or a swimming pool?
- Why do drug dealers live with their mothers?
- How does Roe vs. Wade affect violent crime?

While most people expected his book to be about business, instead it is a book about ideas. It is a book about asking unique questions to gain an incredible advantage. His book is very applicable to the investment business because it stresses the importance of doing your own fundamental analysis rather than accepting conventional wisdom. As many of our clients know, in our investment practice, we constantly strive to take the same set of data as everyone else and come to different conclusions. By thinking out-

side the box and not following conventional wisdom, we have been able to avoid many investment pitfalls. Dr. Levitt’s book provides intriguing food for the intellectually curious.

**Thomas L. Friedman – Author of *The World is Flat***

Friedman’s talk (and book) highlights the great changes taking place in our time - actually in the last five years - as lightening swift advances in technology and communication put people all over the world in touch as never before. He divided the global economic landscape into three periods: the Age of the Country, the Power of the Corporation and the Rise of the Individual. The first period of globalization started with Columbus in 1492 and continued through the 1800’s, the age when powerful countries colonized new worlds. The second period picked up in the middle of the 1800’s and lasted until 2000, where power resided with corporate growth. The third age, he posits, happened while we were sleeping and gave power to the individual. “The new, unique, exciting and terrifying thing about this third age of globalization is that it enables and empowers individuals to compete, communicate and collaborate with each other everywhere,” said Friedman.

Friedman identifies ten “flatteners” that launched this third age. The first three were the advance forces: the fall of the Berlin Wall, the launch of Netscape both as a browser technology and as an initial public offering, and a revolution in workflow. Friedman states: “the date August 9, 1995, was an important date in world history—that was the date of the Netscape IPO. There was the first easy browser that brought the Internet to life. And that IPO triggered the dot-com boom, which triggered the dot-com bubble which led to a crazy, absurd, outrageous investment of \$1 trillion in fiber-optic cable that made Bethesda and Bangalore and Beijing next-door neighbors.”

These three initial flatteners converged in the late 1990’s and that convergence created a platform from which six other flatteners sprung, in-

cluding outsourcing, off-shoring, uploading (Wikipedia), and informing (Google).

Then there are two business developments. In supply chain, Friedman identified Wal-Mart as able to manage business “down to the last atom of efficiency. When you pull an item off the shelf in a Wal-Mart, another one is made at a factory in China.” The inverse of that is what Friedman called in-sourcing and his poster child for this phenomenon is United Parcel Service.

The last of the ten flatteners are what Friedman calls the *steroids*: wireless technology, voice-over-Internet, and file sharing.

Friedman ties his arguments and thesis back together and states: “the iron rule of the third Age of Globalization is whatever can be done, will be done; the only question is whether it is going to be done by you or to you.”

This is a powerful book and it had an influence on us. Specifically, where applicable, we have added the Legg Mason Opportunity Fund, we have increased allocation to Thornburg Value Fund and Longleaf Partners Fund. It is our belief that these managers understand the third Age of Globalization better than most and are investing in companies best able to take advantage of the investment opportunities created by a flat world.

### **Dr. Ken Dychtwald – Author of *The Power Years***

Do you long for a life without work or pressure in which your days are spent baking for your grandchildren or playing golf? Well Dychtwald says to “forget about it.” The combination of increasing longevity; the uncertainty of external means of support from government, employers or family; and the need for people to take more responsibility for their own financial future is creating an extraordinary opportunity for reshaping conventional theories of retirement. Consider that with breakthroughs in medicine and biotechnology, living to 90 or 100 will become the commonplace. He says: “the boomers are the generation that changed majors in col-

lege and changed jobs. Twenty percent have changed religions and 50% have changed spouses. The idea of trying something new in retirement is not so far fetched.” The challenge is and will be—how to pay for it.

While Friedman detailed the exciting route of a high-speed train creating ten flatteners, Dychtwald more soberly introduced the concept of paying for retirement. His figures on longevity are startling. “Throughout 99% of human history the average life expectancy was less than 18 years. On the first day of the 20<sup>th</sup> century, life expectancy was 47 years and on the last day of that century it was 77 years,” he states in his book. If you have already made it to 65, your life expectancy is 83 years if you’re a man and 87 if you’re a woman. If you have above average income and take care of your health, add a few additional years.

The area of research that gives us the gray hair is how do we as investment advisors encourage our clients to save enough capital to allow for the financial wherewithal in these golden years. How do we balance “making a killing” in the stock market with stability and predictability. The whole idea of wealth accumulation and lifetime income becomes more important as longevity becomes a greater factor.

Dychtwald stated that the generation prior to the boomers wanted a financial planner who worked for a brand-name firm they could trust. What boomers want is someone who can help them visualize their future and then put the funding in place. As many of you know, we take this responsibility very seriously in our investment practice.

### **Sir Richard Branson – CEO of the Virgin Companies and author of *Screw It—Let’s Do It: Lessons in Life***

Sir Richard is the quintessential individualist. Starting from age 15 when he produced his first recording (because none of the existing studios would do it), he has never looked back. The full force of that relentless, but deceptively disciplined personality was evident on stage. His

advice: know your capabilities, hire people smarter than you to carry out your plans, pay handsomely, delegate responsibility, and believe in the impossible.

Branson, with a decidedly un-British attitude toward life and business, ended the presentation with a description of his latest entrepreneurial venture, Virgin Galactic. Now for the first time, the heavens are truly within reach of ordinary citizens. Like Sir Richard's previous transportation adventures, this one is being planned, designed, tested, and executed down to the last detail. Construction is progressing on a \$200 million spaceport in New Mexico with regular space travel to begin in 2009. The spaceship will carry six passengers and two pilots to an altitude of 60,000 feet on a carrier named *White Knight II (WKII)*. You can sign up now in the Neiman Marcus Christmas Catalog or just call Virgin Galactic directly. The company already has 200 passengers registered with 650,000 more on the waiting list. The yet-to-be-scheduled two and a half-hour jaunts to the atmosphere will cost \$200,000 (or 2 million Virgin Atlantic Flying Club points with no black out dates). It will be tough – 3gs on the 68 mile ascent, and 6gs on the way down.

## Space Tourism by the Numbers

Cost of a trip & stay on the International Space Station:	\$20 Million
Number of <i>WKII</i> tickets sold:	About 200
Weightless minutes on a <i>WKII</i> flight:	5
Cost per minute of weightlessness:	\$1,333
Volume of the human stomach:	About 1 quart

Source: Pearson, Aria and Adam Rogers. "Zero G, First Class." Wired December 2006: page 45.

Within hours of Sir Richard's presentation, I attended the RMU Pittsburgh Speaker's Series to listen to Captain Lovell's recount of the failed Apollo 13 mission. It is an interesting juxtaposition of the power of the individual and the failure of the NASA governmental bureaucracy. We do recognize that it is a new, ever-changing world where nothing is impossible.

So with all of these interesting ideas whirling in our heads, we end 2006 with satisfyingly robust performance and enter 2007 with a prayer that we continue to keep pace with new global developments.

Sincerely,

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