

This month, we embark on a different kind of Chartbook... one where we explore some issues that may have considerable impact on the way we evaluate the macro-economy in the near-future. The primary issue for discussion is the role of what we call corporate capitalism in our society – not capitalism, per se, but the over-homogenization of products with an emphasis on the extreme reduction of all possible costs, often to achieve short-term financial goals. Most importantly, we offer some concerns that could have a negative impact on global interconnectedness in the coming years.

Disclaimer --

At Cornerstone, we are capitalists and devout believers in the power of free trade. We have surveyed alternate economic systems, and believe that capitalism is the most fair among them even though we do not think it is perfect.

There will be more winners than losers in trade. Yet, the power of comparative advantage allows each region or nation to collectively benefit by focusing on what it best produces. Those benefits include lower costs for goods and services, which make them more widely available to consumers.

While we implicitly believe in capitalism and free trade, we are also becoming pragmatists. And, we feel that the past decade has been a period of irresponsible management of the institution of capitalism. We believe the United States should be better stewards of this system and serve as an example of the fairness of capitalism to other nations.

Flaws in corporate capitalism

When we mention what we believe to be the failures of corporate capitalism, there are several issues linked to one another that could be considered symptoms of a greater problem. The problem is, in essence, a shorter-term profit maximization culture engendered in companies both large and small all over the United States. Some of the fall-out includes the following:

Constant Up-selling – What has become of our society when a visit to a trusted health care professional becomes an effort to sell on behalf of the provider? Need an example? One of our clients (not an especially wealthy individual) had an ophthalmologist provide cataract surgery, and she paid with cash. During a follow-up visit, there was the offer of another surgery to provide bi-focal lenses within each of her eyes. Now, our client had never expressed interest in this product or service, and it was a moderately expensive procedure. She was, instead, a “mark” with what were assumed to be deep pockets and no skepticism.

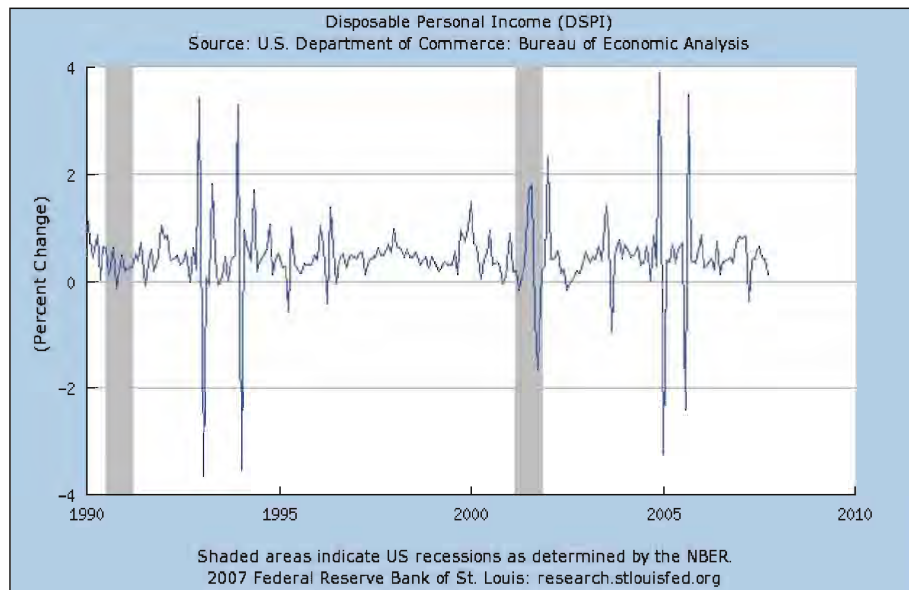
Need another example? Try going to a cosmetic dentist for a routine cleaning. The end result of this issue is a lack of trust by consumers, especially when “service” by a provider is solely offered for the opportunity to up-sell.

Price sensitivity / homogenization – For some time, we have viewed the competitive landscape as one where a product or service provider must choose between being a large quantity / mass-production / low-price model OR a low quantity / high service / higher price model. At Cornerstone, we call this phenomenon the “barbell” often using Tiffany and Walmart as the extremes of the spectrum.

While we have no problem with this model itself, it seems that in many industries far too many participants have attempted to stake out the mass-production end of the spectrum. Simultaneously, the majority of consumers seem to have become so price conscious (due to the competition on the low-price side of the “barbell”) that many are unwilling to pay a slightly higher price for the service level required to operate at the higher-priced end.

Due, in part, to higher skepticism from consumers and the irresponsibility of providers, many cannot compete in the higher cost / higher quality spectrum. This fuels increased price sensitivity in consumers which further influences this cycle which can limit revenue.

Costs of employment – If a provider cannot charge the higher prices necessary to compensate individuals for a higher quality good or higher service experience, this can cap wages. We have certainly seen this in recent years as real wage growth over the past has stagnated, especially when the income figure provided includes hefty bonuses paid to Wall Street.



Also, a disproportionately high percent of corporate earnings are accruing to shareholders rather than to employees as demonstrated in the chart below; as believers in reversion to the mean, we think this trend is likely to change. However, we would prefer that change be voluntary rather than disruptive.



Where are the stewards? – Recently, I read an article about the original role envisioned for the MBA degree. It was to be offered by a small number of forward-thinking institutions, and those who earned the degree were to be trained to be stewards of the resources entrusted to them.

Fast forward about fifty years... there are hundreds of institutions offering the MBA, and the primary mantra being taught is “increase shareholder value.” As investment analysts, we believe this is a worthy goal. But, something long-term has been lost when other stakeholders are excluded from the process. This is not mentioned as a “touchy-feely” fringe issue to make us feel better, but rather a way to consider how to make an entity better for the long-term. If you have happy employees, it is reflected in lower training costs and their service towards clients. If you have happy clients, you receive more referrals. The cycle continues...

Yet, we operate in an environment where employees are considered dispensable and many relationships with other stakeholders are adversarial. Corporate boards are insulated from shareholders and stakeholders; they are often figureheads with close social relationships to management. As a result, executive compensation is determined by a number of people whose salaries are or were disproportionately high relative to the vast majority of the citizens in this country.

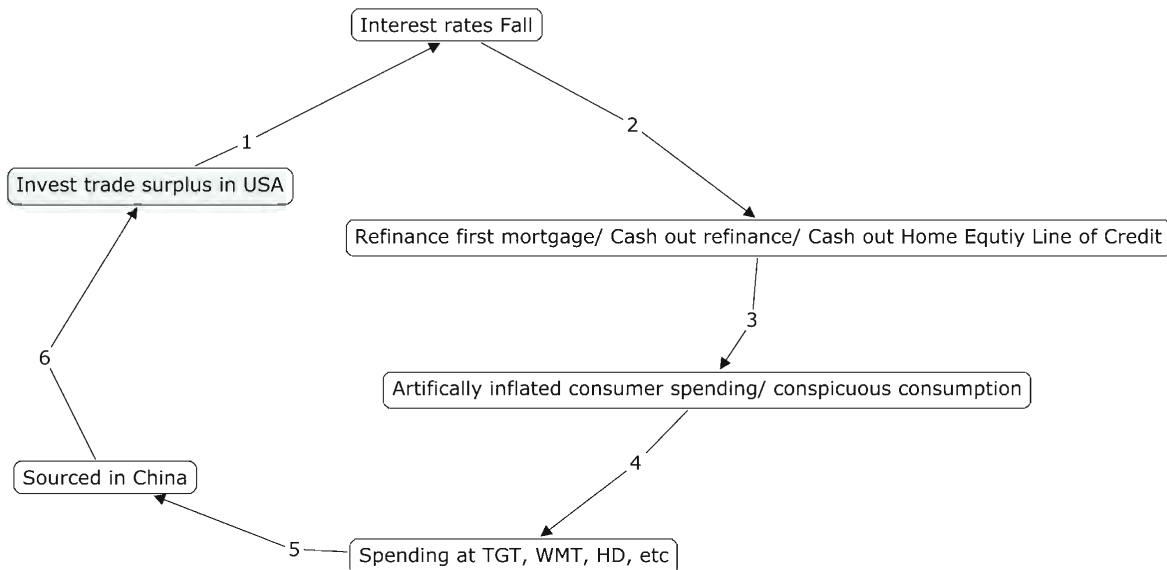
What can exacerbate this issue in the near-term?

Conspicuous consumption - Having mentioned some of the issues we feel have arisen from poor stewardship of the capitalist system, there are also some decisions made by consumers which are exacerbating these issues. The primary concern is the concept of conspicuous consumption – your reputation or standing in society used to be determined partially by your profession and partially by the integrity you demonstrated in your day-to-day dealings. Now, it seems that your standing is partially determined by the goods that you have.

Purchasing and consuming goods is not necessarily a bad thing, but it’s the excessiveness of this consumption that concerns us. Simultaneously, between technological change and the globalization of the marketplace, many goods have become less expensive over recent years. However, while there has been disinflation in the items we **want** (think, DVD player, I-pod,

clothing, home entertainment theatres), there has been tremendous inflation in the things we *need* to become a more productive society (health care and education).

Trade surplus cycle - This continued purchase of goods in an effort to consume more has led to a cycle of co-dependence between the US and the Asian nations that produce our trinkets.



Since wages for the average worker were not increasing significantly in real terms and investment account balances had declined, the way consumers felt as if they were not “losing ground” was to use their home as an ATM. Home prices had increased disproportionately to other asset classes as interest rates were cut, and the equity in one’s home was viewed as available for consumption. With this money, we purchased primarily low-value goods created overseas, and these foreign nations purchased our debt -- which kept our interest rates low, which kept our home prices high, which ensured the cycle would continue for the short-term. But, what happens when this cycle ends (as it appears is about to happen)?

Weaker US dollar – Historically, the US dollar has been the world’s reserve currency - meaning we were the safe harbor for investors from all nations. This additional external demand for dollars allowed for lower interest rates which provided additional liquidity in an already efficient system. However, the US has made a number of decisions that have weakened this position of strength, including increasing our national debt. This, combined with the belief of the market that any errors in judgment will be forgiven by printing money, has resulted in a lower valuation for the US dollar on world markets.

A weaker dollar can have a number of impacts on consumers in our global economy. The most important of which is the potential for increased inflation as we import more goods from overseas (and their currencies remain stable relative to our decline). The reason this impacts our corporate capitalism argument is that higher inflation in a competitive consumption environment can lead to additional price sensitivity from buyers as their real wages stagnate.

Why we care...

As mentioned at the beginning of this discussion, we are believers in capitalism and free trade and feel that history has borne out they are the most effective means of enhancing the standards of living for people around the world. The issues we see cause us concern because the response to them will not be increased freedoms and fewer capital controls. Instead, it will likely be economic populism and anti-globalism. These we feel are significant threats to the prosperity of a number of people around the world. In the same way that individual companies are often improper targets for societal angst, a reduction in entrepreneurial and trade freedoms would likely not offer the long-term benefits that are the objectives of their proponents.

Where does that leave us?

First, let's address this question from the perspective of the United States as a whole. Even though the dollar is being de-valued by decisions both by individuals and the government (through fiscal and monetary policy), our country does have some tremendous advantages. Our workforce is technologically skilled (and is currently about the cheapest in the English-speaking world) and highly mobile. In the US, if you can't find a job in your area, you move to an area where there is employment opportunity. In addition, our culture fosters an entrepreneurial spirit that allows individuals to take risk with a manageable downside. We strive to be a meritocracy, and if someone has the will and the acumen to achieve a goal, they are not constrained by where they went to school or what their last name is. Finally, the US offers reasonably low taxes or other encumbrances to starting or adding to a business.

From a bigger picture perspective, we hope that individuals and companies within the US move to a more "altruistic capital" model and do so voluntarily – perhaps because of an enlightened policy but also because this is the model that will benefit the business and its owners (including stockholders) most in the long-term. This concept might include some of the following:

- offering higher wages for a firm's valuable employees, especially relative to the increases that have been offered to corporate executives over the past few years
- providing a mentoring environment to those employees who show the potential to be around for a longer period of time
- enhancing relationships with suppliers and being willing to pay higher amounts for a difference in quality or service
- considering the longer-term of the entity and not sacrificing those long-term goals for slightly lower operating expenses in the near-term

Conclusion

Again, our concern is associated with a short-term thinking we believe has been fostered by a goal of reaching nearer-term goals without concern for the long-term. The changes we recommend are both altruistic and consistent with what will likely benefit entities in the long-run. And, most importantly, they could protect the system of capitalism and the goals of free trade which we believe are the most effective systems for the allocation of capital and resources.