Rapport

Hats Off to Eliot Spitzer

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We live in interesting times – very interesting times! Why, only four short years ago the world was on cruise control. The stock markets about the globe were flying high. Trading values and volumes were going through the roof. In fact a few supposedly learned people were talking about the "new paradigm," whereby world economies could be expected to continue to prosper as never before. Very few amongst us seemed concerned about the need to wring the many excesses out of the system. The twin towers on Manhattan were standing tall and New York State's Attorney General had yet to be heard from!

SUCCESSFUL INVESTORS ARE WELL-INFORMED PEOPLE

Successful investors are curious and caring people. They want to know what is really going on. They have a propensity to read a lot about world affairs, the political and economic news, the comings and goings about the stock market. They watch CNBC, ROB TV and Wall Street Week, clip newspapers and tear business magazines apart.

My own sources include *The Globe and Mail*, the *National Post*, *BusinessWeek*, *Forbes*, *Investors Digest* and a raft of other magazines. I file these bits and pieces of information in preparation for writing my annual Off-the-Record Exchange of Constructive Ideas speech and papers on the various capital formation strategy and investor relation programme concerns that I believe need to be addressed. I look forward to doing so every day of the year.

On Saturday mornings I turn to the weekly stock trading tables to check how well my various common share and trust unit investments have been doing over the past thirteen weeks, vis-à-vis their respective peer group and the overall market. In this way I am able to quickly ascertain whether or not I am staying ahead of the curve, which investments are leading the way and which are trailing the parade; which to sell, which to buy and which to continue to hold on to. When in doubt, I always seek out a second opinion before I take any action. If the company in question happens to be one of Rapport's many corporate clients, I have to be particularly careful not to tread on the insider trading rules.

Why, just a few months ago a good friend and long-standing client asked me to comment on how best to put his company in play. Unbeknownst to him, he had put me in handcuffs, making it virtually impossible for me to sell the stock or buy more until the "for sale" information was made public. The good news is that the value of my investment subsequently shot up when the share exchange was announced. I have yet to sell out and do not plan to do so any time soon.

The whole point of this commentary is to suggest that successful investors make an effort to be well-informed about the big picture. They take great care when it comes to buying or selling a portfolio position, trying to keep trading costs to a minimum. They also have very long memories. It is highly unlikely that anyone of them would ever willingly buy shares in a company or units in a trust headed by anyone other than a proven CEO. They often know the person in question or of someone, such as a research analyst, who does.

They lean towards owning companies with a strong balance sheet, the ability to improve margins, and a commitment to growing the dividend and payout ratio over time. Those who stick to this sort of knitting usually do better in the long run than those who insist on trading in and out of highly volatile stocks. That is so because, when the market tanks from time to time, these stocks fare a whole lot better than most of the non-dividend-payers. In the last go around, most income trust unit prices actually rose in value, a measure lost on many of the institutional investors who have recently taken to blaming their stupidity on the lack of limited-liability provisions.

To give you a more precise measure, let us compare the performance of the relatively dividend-free Nasdaq versus the somewhat well-endowed, dividend-paying Standard & Poor's 500 stocks, from the time both indexes peaked in March 2000, up to the close of trading in 2003. The respective all-time index highs were 5,132 and 1,552. The October 2002 low closings were 1,114.1 and 776.8, off 78.3 and 49.9 percent respectively. Though the recovery in Nasdaq stocks as at December 31, 2003, has outdone the S&P 500 by a wide margin, at plus 79.8 versus 44.7 percent, if one had held on to these stocks for the duration, the S&P 500 was but 28 percent below its all-time high, the Nasdaq still 61 percent short of that mark.

Closer to home, the all-time record high for Canada's most actively traded and still most-covered stock, Nortel Networks Corp., was fully $123.75 per share in 2000. It subsequently fell to just $0.67 per share, before rebounding to the $12 level. Whereupon the CEO told everyone who would listen that business was picking up and that profitability was assured. In fact, $30 million in bonuses were paid to the top executives. Now the stock is back below $5.50 per share, and he has been fired. It is going to be a very long time before most of the investors can ever expect to get their money back. In the meantime, there is absolutely no return to speak of, as the company last paid a dividend back in 2001 and cannot be expected to do so again any time soon. Had it been fully committed to growing the payout, perhaps it would not have made so many foolish acquisitions. However, that is just conjecture at this point in time as far as the shareholders are concerned.

The maximum tax rate on dividends in the U.S. has recently been reduced from 35 to 15 percent, on par with the capital gains tax, thus removing any disadvantage for long-term investors. The equivalent rates in Canada are 36 and 26 percent. They are out of line and need to be adjusted downward in order for Canadian companies to remain competitive in the capital markets. If we fail to do so, investment in new plant and equipment will move to the U.S. or elsewhere, and we simply cannot afford to allow that to happen.

Given the reduction in the U.S. dividend tax rate, the S&P 500 stocks are expected to lead the way in 2004, and the stock-option-heavy Nasdaq companies would be wise to give in to the pressure coming from investors to have all forms of compensation expensed and dividend policies introduced, particularly if a company is well-to-do, as is the case with Microsoft. Though small enterprises may want to continue to reinvest all available cash flow, striving for an above-average growth rate, the sooner they get to paying the owners a regular dividend, the better their stocks will do looking two or three years down the road.

By the way, 370 of the S&P 500 stocks currently pay dividends, down from 435 just ten years ago, though up from the low of 351 in 2002. The total payout in 2003 was an all-time high of U.S.$160.6 billion, up from the previous-year record of U.S.$147.8 billion. Of note, 229 outfits increased their dividends by an average of 26 percent. At least fourteen doubled the rate, as did Microsoft. Thirty-three increased the payout more than once, and twenty-one paid dividends for the very first time, the biggest number to do so in twenty-four years. This upward trend can be expected to continue, which bodes very well for this major stock market benchmark.

THE MANDARINS NEED TO GET THEIR ACTS TOGETHER

At the moment, most well-healed investors feel that the auditors, lawyers, underwriters, research analysts, mutual fund managers and the securities commissions have lost their way. Although most of the evidence suggests that many have, it seems to be virtually impossible to get anyone from the various groupings to come clean and admit to the evil of their ways. Even when they have to pay a very hefty fine, these hypocrites are allowed to do so without ever having to say they are at fault or are sorry. Why, even a three-year-old would know better than to behave like that.

As a result, investors are going to remain suspicious for many more years to come. As far as they are concerned, the threat of lengthy jail sentences may be the only way to focus the culprits' attention on building longer-term shareholder wealth, rather than spending most of their time feathering their own nests. As a consequence, even the fairest CEOs are going to have to spend more of their day on the road getting the true story told. To leave it up to those with tarnished reputations will never do, for few investors will take them at their word. There have been too many shenanigans in the past to expect the longer-term investor to just fall into line.

Back in the roaring twenties, many unsavory types worked at and about the NYSE. In those days there were no real rules to abide by, and very few trustworthy stock promoters. Everyone, or so it seemed, was on the take, hoping to fleece the very next investor to appear at the door. Then along came President Franklin Delano Roosevelt with his New Deal. To everyone's amazement, in 1933 or 1934, he appointed the infamous Joseph Kennedy – JFK's father – a scoundrel who had practiced every trick in the trade, to head the brand new Securities and Exchange Commission. No other bureaucrat has made such an impression until recently, when Attorney General Eliot Spitzer came to power.

It is said that Joe Kennedy was looking to clear his name and build a political dynasty. Perhaps Eliot Spitzer is looking to become the next governor of New York. In any event, both are fine examples of people who can cut to the quick, outfoxing most misguided CEOs, investment bankers, research analysts, auditors, lawyers, and their like. It is very refreshing to watch the new man on the beat be so effective in sorting through the myriad of misdeeds, and calling the alleged offenders to task. Why the SEC had been so out of touch in this regard is anybody's guess. After all, you might have thought that it would have had a firm handle on the culprits long ago. Unfortunately, it still does not. It is all Eliot's way or the doorway these days!

THERE IS A BIG MESS TO CLEAN UP

Having charged Wall Street's mightiest investment banking firms with offering tainted research and underpricing hot IPOs, with spinning new issues, and forerunning client orders, it should come as no surprise that successful investors are fed up with these stuffed-shirts. When CEOs and directors are being charged with insider trading and over-generous compensation plans, fraudulent financial reporting and out-of-line expense accounts, you have to wonder where one has to go to find someone who really cares about the well-being of investors at large.

Now comes word about shameful market-timing and volume-trading practices in mutual funds, to the distinct advantage of the manager, a number of insiders and some special friends, and at the expense of tens of millions of ordinary folk hoping to make ends meet once they retire. You have to ask yourself whether or not all the charges could possibly be true. Unfortunately, most of them are. There is a big mess to clean up, and the sooner the authorities get to it, the better.

And what good are independent directors, outside auditors and lawyers, even investment bankers, if when push comes to shove all they do is quit. Just when the ordinary shareholder needs someone trustworthy to turn to, no such person can be found. It really is a very sad state of affairs.

Thank goodness for Eliot Spitzer. Without him we would really be lost, with nobody to turn to to protect our best interests. Rather than being offered a governorship, perhaps he should be beatified!

GOOD NEWS IS ON ITS WAY

Despite the aforementioned frenzy, there is light at the end of the tunnel. The crooks are being uncovered, their sins are being dealt with. Though not everything that should be done will come to pass, a lot will over the next number of years. Substantial fines will be levied, suspensions will be handed out, a number of the worst offenders will be jailed. The stock exchanges will wake up to reality. Merging the NYSE with the Nasdaq is a real possibility, and no one would have imagined that until recently. The ultimate answer to obvious conflict-of-interest and governance questions would be to have the new combined entity go public, as the TSX did, rather than remain a private club.

Research analysts will once again be set free and encouraged to come clean and be downright objective. As a result, CEOs will have to come to terms with the possibility that their company's stock could get a sell rating, rather than always be a good buy story. As it now stands, most research commentary emanating from the investment dealers is a joke, one of the real reasons why so few stockbrokers and underwriters ever commit their own money to the respective firm's investment recommendations.

Rather than pricing mutual funds only at 4 o'clock in the afternoon EDT, they will be quoted on an up-to-the-minute basis, just as stocks are. The practice of charging higher commissions to fund buyers to pay for soft dollar items, provided by the investment dealers at no cost to the fund managers, will no longer be tolerated. I am also quite certain that by the time Eliot Spitzer and his staff have completed their extensive investigation of the industry, many funds will be forced to merge as the fees paid to the managers shrink, sales

commissions drop, and portfolio turnover rates are reduced. Only in this way is it possible to improve upon the rather dismal after-tax returns to investors.

As such, my advice to all the securities commissions in Canada is this. Get your acts together as one. Pay particular attention to what Eliot Spitzer is up to and follow suit. Do not get carried away by the provisions of the Sarbanes-Oxley Act. In the opinion of astute investors it is not worth the paper it is written on. All it does is call for more red tape.

What investors are really hoping for is that a goodly number of the offenders will be jailed. Once a few of these soft-bellied types have been bullied about by a band of hard-core, tattooed inmates, perhaps the other buggers about town will be convinced that it is absolutely no fun being incarcerated. Bay Street might even sit up and pay close attention. They are certainly beginning to do so on Wall Street.

Who would have ever thought it possible that so many thugs, taking advantage of so many innocent investors, could get away with it for all these years? I say, hats off to Eliot Spitzer and his band of merry men and women who are steadfastly committed to setting things right.