



Investing Environment



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"Never say about anything "I have lost it" but instead "I have given it back."

— Epictetus
Stoic Philosopher
55-135 A.D.

"The quality of a civilization is measured by the quality of its imagination."

— Victor Hugo
French Author
1802-1885

Epictetus was a leading figure in the Stoic school of philosophy, a line of thought that emphasized self-control and fortitude as a means of coping with the self-destructive emotions that can accompany untoward events in a person's life. John McCain is said to have taken comfort in stoic philosophy during his period of captivity as a prisoner during the Viet Nam War.

Stoic philosophy is the order of the day for the investor class. With massive downturns in worldwide equity markets, there has been a great deal of "giving back." The household wealth destruction that has accompanied the sell-off, estimated at \$7.1 trillion by the Federal Reserve, will have broad ripple effects throughout society.

Unlike past crises, however, the rich have experienced major wealth destruction. Unfortunately, the poor will suffer the most. Charities will find the fund raising environment difficult as many wealthy donors find themselves less so. In turn, it will become more difficult for charities to support their missions, thereby harming those most vulnerable in our society. In between the two extremes, wealth destruction

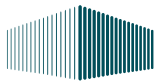
affects the lives of ordinary Americans in many ways, including:

- College will be unaffordable to some.
- Retirements will be delayed as 401ks and IRAs shrink.
- Health care costs, difficult to bear before the market collapse, will become crushing for some.
- State and local budgets will be under severe strain, possibly forcing cutbacks in services or tax hikes.
- Etc. (No need to belabor the obvious!).

Will New Phoenixes Arise?

If history is any counsel, this downturn will give rise to many new companies that will change the world and create new wealth. Among the historical precedents, in 1873 the Vienna Stock Exchange collapsed and triggered the "Long Depression." Yet concurrently, our nation was electrified, which triggered the Second Industrial Revolution spawning such diverse companies as General Electric, Eli Lilly, Coca Cola, IBM and many others.

During the Great Depression (1929-1939), the pattern was repeated as companies such as Hewlett Packard, Texas Instruments and United Technologies were founded. In 1957, a time of recession and rising Cold War tensions, Fairchild Semiconductor, the predecessor to Intel was founded and the computer age began. In 1974, a time of recession and gas lines, Microsoft was founded by a baby-faced young man named Bill Gates. In the early 1980s with interest rates at 20% and unemployment at 10%, biotechnology



leaders Amgen and Genzyme were founded. I could go on, but you get the message.

How is it possible that bad times spawn important new companies? There are several reasons:

- New companies, unburdened by legacy businesses and infrastructure, can capitalize on technological innovation to transform competitive landscapes.
- The business models of entrenched companies become stressed, constraining the ability of incumbents to respond to upstart competitors.
- Valuations are low, attracting risk capital.
- Entrepreneurs can hire first class people at a lower salary.
- Rents are lower.
- Fewer companies pursue commercialization of similar technologies, making them able to receive limited funding.

The Key is Innovation

One of America's great strengths is the ability of its citizens to formulate and commercialize new ideas. Economists have formalized the study of this phenomenon in a field known as "New Growth Theory," which was developed in the 1990s. New Growth Theory holds that ideas are the key engine of growth. But how does innovation happen? Several necessary conditions include:

- A legal, regulatory and taxation framework that encourages risk taking.
- Patient, long term focused capital to support entrepreneurs.
- An educated workforce that can perfect the intellectual property.
- A trained and motivated workforce to turn out "widgets."
- An environment in which companies that achieve some success can "go public" and access capital necessary to build a great company.

When framed as such, it is clear that the fabric of innovation in this country is fraying. The legal and regulatory environment is likely to become more stringent in the wake of the financial crisis. Taxes on capital gains will rise legislatively by year-end 2010. Our educational system faces major challenges. Patient capital is in short supply with government funding for

research being cut, corporate R&D focused more on the "D" than the "R" and venture capitalists, still chastened by the humiliation of the tech bubble, shortening their time horizons. For companies that are able to receive funding and achieve some commercial success, the Initial Public Offering (IPO) window has been slammed shut.

A holistic approach is needed to revive innovation. Set forth below are several ideas that I believe will enable America to regain its position as the innovation capital of the world. The proposals highlighted here deserve a more exhaustive treatment than space permits. My goal is to draw on the voices of many to construct a view we can use.

Need	Solution
<ul style="list-style-type: none"> • A legal, regulatory and tax environment supportive to innovation. 	<ul style="list-style-type: none"> • Eliminate capital gains tax on startups as proposed by President Obama. • Reform patent law to prevent frivolous patent infringement lawsuits. • Reform tort law to prevent frivolous malpractice suits.
<ul style="list-style-type: none"> • Sufficient long term focused capital is available to support entrepreneurs. 	<ul style="list-style-type: none"> • Make federal research and development tax cuts permanent. • Double federal funding of basic research over the next five years.
<ul style="list-style-type: none"> • A trained, well-educated workforce is available for startups. 	<ul style="list-style-type: none"> • Modify the H1B visa program to increase the number of permanent visas for highly skilled workers. • Modify primary and secondary funding to be at the student level, rather than the school level, forcing schools to compete for students. • Examine funding structure of community colleges as much innovation comes in the application of technology.

Need	Solution
<ul style="list-style-type: none"> To have the IPO window reopened. 	<ul style="list-style-type: none"> Reform Sarbanes Oxley.
<ul style="list-style-type: none"> A floor under the price of oil to facilitate the development of "green" innovation. 	<ul style="list-style-type: none"> Place a tax on the price of oil that is activated when the price per barrel falls within the \$40-\$50/barrel range.

America can and must recreate its innovation ecosystem. I believe the steps outlined in this paper would correct some of the weak spots in our system. But the problem of "short termism" is a difficult one. Please share your thoughts on this issue.



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Admittedly, the program outlined above will be difficult to implement. The most important precondition for this program to succeed is for all parties to lengthen their time horizons. Innovation can be messy and inefficient; it simply is not compatible with the predominate corporate and investor mindset of "What have you done for me lately?" The origins of the short time frame are unclear but may lie with Wall Street. Clients typically judge money managers by short term results. In turn, money managers pressure CEOs to turn out consistent quarterly earnings with the clear message that if they don't do so, the Board will find someone else who will. CEOs frequently respond in a predictable fashion by sacrificing the long term good of the company on the altar of the short term.'

'Over the trailing four year period ended Q3, 2008 the S&P 500 reported earnings of \$2.4 trillion. Over that same period stock buybacks plus dividends totaled \$2.6 trillion. Source: New York Times 12/15/08. That behavior by S&P 500 CEOs provides substantial evidence that large companies, in aggregate, are using free cash flow to serve short term purposes rather than investing in R&D, new product development and other long term focused activities. In turn money managers have shortened their time horizons with the average holding period of NYSE stock now 7 months.

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