

THE EITHER/OR INVESTOR

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The Either / Or Investor

*HOW TO SUCCEED IN GLOBAL INVESTING,
ONE DECISION AT A TIME*

Clark Winter

RANDOM HOUSE



NEW YORK

The Either/Or Investor is a commonsense guide to personal finance. In practical advice books, as in life, there are no guarantees, and readers are cautioned to rely on their own judgment about their individual circumstances and to act accordingly.

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To my wife and family
for their inspiration and support

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PART I

A CHANGING WORLD

Drivers, Passengers, and Roadkill

All successful investors have in their minds what the Germans call a *Weltanschauung*, a view of the world and the forces that contribute to shaping it. When I visit with clients and bankers, I bring my worldview with me, and my remarks are made within its context. I won't make the claim that my view is right and that others are wrong; it's just that without a lens through which to view events, it is extremely difficult to make decisions about investment opportunities. You see, it is possible for people to have different worldviews and still make money, but it is nearly impossible to make money consistently without a worldview.

A worldview must be wide, not narrow. If you think a set of prejudices constitutes a worldview, you are wrong. Things change. People change. Yesterday's struggling nations may be tomorrow's powerhouses, yesterday's allies may become tomorrow's enemies, and vice versa. If you are going to become a successful investor, you have to erase the phrase *It will never happen* from your lexicon. If you live long enough, the world will turn upside down, perhaps even a couple of times. Successful investing begins with learning about the world. That means picking up a couple of good newspapers, such as *The New York Times* or *The Washington Post* or the *Financial Times*, and reading them on a regular basis. Reading the world and national news along with some business news will make you better informed and give you information that will help you support your view of the world as it develops. You should also be reading magazines and journals such as *The Economist* and *Foreign Affairs*—again, not so that you can become an expert on the world, but so that when you do see an investment opportunity,

you will have frames of reference against which to measure it. (I should note that all of these newspapers and journals have their own world-views and biases, and you should be aware of them, but you are reading more for information than opinion. Most of the time, you won't even notice the biases in the news sections.)

Since I read these publications and subscribe to some very high-priced information services, when I get information, I take it in and organize it. I have noticed that most information can be put into a couple of major buckets that I am interested in at any given time, and every time I see a story that is even remotely related to one of the buckets, or themes, I cut it out and put it into a file. You don't have to do that. You can rely upon your memory, if it's good, or put a couple of articles aside, since you are not making investment decisions at the same level that I do. But since good investment decision making is ultimately backed up by facts and is not solely based upon opinions or hunches, any kind of system that allows you to lay your hands on the facts will help you. If you want to get really obsessive about this process, read *Off the Record: What Wall Street Doesn't Want You to Know*, by Craig Gordon, published in 2001. His San Francisco firm, Off-the-Record Research, does extremely detailed digging on companies for their Wall Street investment clients. His book explains how to emulate his methods, and, just as important, it explains the value of smart research in investment decision making. I don't do anything nearly as complex, but with just a worldview and a little information, I can make out pretty well.

As new evidence comes along, revisit the assumptions that you are making about how the world works and how and when you should invest. A change in facts should lead you to adjust your view from time to time—usually in small ways, but once in a while in a major way. What do we mean by *world*? For years, in many circles the phrase *the world* did not mean the entire planet and all of its people, but rather a narrow world within a world that took shape after World War II in a series of agreements on trade, monetary policy, and exchange rates. This smaller world and its rules did not govern the entire planet; rather, it governed only the signatories to the treaties that created it. For people who lived

within this rarefied, closed-off portion of the greater world, it was as if the political freedoms that went along with this world were coupled to economic freedoms that made companies and investors unremittingly optimistic. If you went to the larger world outside, you would feel the crushing weight of regulations and oppression that made investing all but impossible.

This smaller world was the world according to GATT, the General Agreement on Tariffs and Trade, which was signed by twenty-three nations in 1947. GATT, which eventually grew to 125 signatories before it was replaced by the World Trade Organization in 1995, helped to define the world economy and its rules of trade. For currencies and exchange rates, this small special world began with the Bretton Woods Agreements in 1944, while World War II was still raging. They created a system of fixed exchange rates backed by convertibility into gold. In 1971, the Bretton Woods system of fixed rates abruptly collapsed when the United States, pressured by France, decided that it would no longer repay dollars with gold. Since then, we have lived in a world of floating currencies. That change, from fixed to floating currencies, was the first great shock to the postwar worldview that had been constructed by America and its allies.

This smaller world was also the world governed by the Federal Reserve. After World War II, with Europe and Japan prostrate, the only thing holding the world together was the U.S. dollar and the willingness of Americans to spend. For members of the world of GATT and Bretton Woods, that willingness was embodied in the Marshall Plan, the World Bank, and the International Monetary Fund, institutions either wholly or largely funded by the United States. The Federal Reserve System, America's central bank, had come into being as the result of the destruction of one worldview and the start of a new one, which would prevail until the end of World War II. The Federal Reserve System was established in 1912 as a direct result of the Panic of 1907, a brief interlude that began exactly eighteen months after the San Francisco earthquake, when the United States literally ran out of money and had to import a boatload of borrowed gold from England to re-monetize its currency. The new central bank that emerged from that crisis decided to avoid the possibility

of parts of the country running out of money by breaking the United States into a dozen regions and issuing currency according to the needs of each region, as measured by commercial and bank activity and so forth. As time went on, the Fed's role evolved into using the money supply to regulate the economy and, later, using interest rates to regulate the money supply. When there was too much money in circulation, the Fed would raise rates to make borrowing for expansion more expensive and thus more difficult. When the economy cooled, the Fed would lower rates to make borrowing easier.

Why is this economic and institutional history important, even in abbreviated form? Because the influence of the U.S. Federal Reserve within the world that the United States and its allies and trading partners had created for itself in the wake of World War II became the thermostat for everyone within that world, raising and lowering the economic heat according to the needs of the U.S. economy. It was as if all of the participants had put on special blinders that allowed them not to see the rising populations of China, India, and the old Soviet bloc, which among them contained 60 percent of the world's people, most of whom were mired in poverty despite immense natural resources. While a number of thoughtful leaders made noises about bringing those areas into "our" world, most of us were content to ignore what was going on beyond our boundaries.

For companies and investors who lived inside "our" world, success meant learning how to interpret the actions of the Fed and relating those actions to the movements of interest rates and currencies and, indirectly, stocks and bonds. From the end of World War II until perhaps a decade ago, investment theory was directly tied to what the Federal Reserve did with interest rates. The Fed had become the de facto "driver" of our corner of the world, and countries, companies, and investors who learned how to put on yet another set of more subtle blinders, this time directed solely at the Fed and its behavior, became successful "passengers." That is, as long as they adjusted correctly to the Fed's dictates, they made money. When the Federal Reserve lowered interest rates, corporate passengers invested in their companies through capital spending and innovation, which led astute individual

investors to invest in stocks. When the Fed raised interest rates, individuals pulled their money out of the equity markets in favor of bonds and companies paid down their debts and used the time to prune corporate deadwood, in the form of unprofitable divisions, products that didn't sell, or, sometimes, employees.

The passengers to the Fed's drivers learned to distinguish what was important from what mattered less or not at all. If the Federal Reserve was the major driver inside our world, then Fed-watching, interpreting the comments of whoever was the Fed chairman, became critical to determining what investment decisions to make, both as individuals and as companies. For nearly sixty years, this worldview prevailed, bringing with it prosperity and order. But even as that world was approaching its zenith, the seeds of change had already been planted.

The Johnny Appleseed of global change was President Nixon. Though the judgment of history is still out on him, Nixon's 1972 visit to China and the changes that ultimately brought reformist Deng Xiaoping to power in 1978 set in motion the modern world as we know it. Nixon recognized the several billion people who were outside the existing global system, and he realized that if they could somehow be brought into it, American business would benefit. Nixon and Kissinger, his secretary of state, were pragmatists who believed that only trade and normalization, not democratic rhetoric, would change China.

While China began to go slowly but steadily down the path of reform, change was also beginning to take root in the Soviet Union. British prime minister Margaret Thatcher, acting on sound intelligence, finally figured out what nobody else in the West wanted to admit: that the USSR was nothing more than a tottering Potemkin village, a long-ailed state, albeit one with nuclear missiles. The trick was persuading the Soviets to accept that fact, and while President Reagan's famous "Mr. Gorbachev, tear down this wall" speech in June 1987 is credited with beginning the end of the Cold War, a closer reading of the full text of the speech reveals that the Soviets had also begun to take steps down the path of reform.

Since 1989, with the fall of the Berlin Wall, the end of the Soviet Union, the dissolution of the old Soviet empire, and the emergence of

several dozen states into the sunlight of freedom and economic liberalism, these states, with a wobble here and a currency crisis there, have slowly taken their place as actors on the world stage, and the flow of capital around the world has changed dramatically as a consequence. While the Fed was once at the monetary center of the world, now it is but one player among many. The European Central Bank has become a coequal player, and the People's Bank of China is also now a force to be reckoned with.

Under this circumstance, many companies that previously had been the passengers of Fed policies are now in serious danger of becoming global roadkill. Whole industries have shifted their economic centers. Steel, textiles, electronics, even energy, were once oriented in one direction, toward the large industrial and consumer markets of the West. Those may still be the best markets, but they are no longer the only markets, and increasingly, new consumers are dictating where goods go, how much they cost, how they are sold, and who will profit from their sale.

Industries that have not paid attention to similar shifts in the economy in the past have paid the ultimate price. In the 1950s and 1960s, when the textile industry was centered in New England and the phrase "American industry" meant factories in the Northeast and Midwest, the shift of textile mills to the South, with its cheaper labor, decimated entire town economies. Now, when factories and mills move, it is national economies that enter a prolonged slump. Europe, despite a well-trained workforce and steady product innovation, has seen its manufacturing lead usurped first by Japan, then by South Korea, and now by China. In the United States, a global lead in software has been, since the early 1990s, supplanted by talent in India, which in only a decade has moved up the innovation curve from updating legacy code to designing cutting-edge business solutions. Other industries on the cusp include aircraft, as Brazil aggressively enters the lower end of the passenger airline market, taking share from European firms like Fokker and Saab, with computers and perhaps even biotechnology to follow.

Companies in the developed West have tried to maintain profitability during this transformation through outsourcing, but that has been like

Lenin's old maxim about the capitalist who will sell you the rope with which you hang him. As new drivers continue to emerge—there appears to be an alliance among Russia, China, and Iran in the offing, which may well send us back to the days of the Cold War—nations and industries must remain alert to change and discover better ways to cope with it.

Beyond China, Russia, and the Eastern European states of the old Soviet empire, yet another new group of nations have also added their talents to the mix. These go by many names, but for purposes of convenience and definition, they are often called “emerging markets.” The largest of these is India, with more than a billion people; Brazil, which has gone from a nation in perennial economic peril to one of the sounder economies in the world on the strength of agricultural exports and a rising industrial base; Mexico, which has benefited greatly from the North American Free Trade Agreement (NAFTA); Turkey, the only truly modern Islamic state; Indonesia, another Muslim nation that is rich in oil and has thrown off decades of corrupt government; and South Africa, which has transformed itself from the appalling regime of apartheid to a multiracial, multicultural state rich in gold, coal, uranium, and diamonds, and with unlimited human potential. All of these nations have problems, to be sure, but they have emerged as drivers or potential drivers on the world stage and have helped to create a multipolar world that is a source of both opportunity and uncertainty for investors.

The very up-and-downness of some of these nations can be discouraging for investors, especially since we Americans seem to know little about geography and even less about world events. Even sophisticated investors are often loath to venture into unknown territory. The 2006 edition of the “World Wealth Report,” an annual publication of Merrill Lynch and Capgemini, a consulting firm, dryly notes that “despite a gradual shift over the past few years, North American high-net-worth individuals remained significantly invested in—and more narrowly focused on—domestic markets, with a heavy weighting of United States-centric investments.” Despite a falling dollar and dismal returns by U.S. stocks across the board, Americans kept their money at home.

Meanwhile, in 2005, investors outside the United States, who are more used to the vagaries of rising and falling markets, investment scandals, collapsing currencies, and political instability, were able to make gains ranging from a not-so-modest 16.7 percent on England's FTSE 100 index to a hefty 54 percent on the South Korean KOSPI index. Although emerging-market stocks have cooled off since mid-June 2006, it does not mean that great gains will not be made in the future. It will take slightly more discernment, the ability to separate those markets that rose because of speculation from those that rose because of sound profits and economies. My job is to teach you how to tell one from the other.

CHAPTER 1



THE DEVELOPED *versus* THE DEVELOPING WORLD WORLD

The developed world has people with money to spend. The developing world, meanwhile, has endless needs and a growing pool of savings. Which will be the better investment in the years ahead? The developed world has aging populations who will increasingly have to save for retirement and who will have to be parsimonious if they are going to have enough money to last their entire lives. Does that make them a bad investment? Not at all. Citizens of the developed world enjoy long life, and the willingness to spend money on health care treatments, leisure activities, and life experiences such as travel, hotels, and restaurants—all this makes for good investing in certain sectors. Just look at the cosmetic surgery market: at one time it was limited almost exclusively to older women. Women still account for most cosmetic procedures, but men are making up more of the total than they used to. In 2005, men underwent 13 percent of all procedures, according to the American Society for Aesthetic Plastic Surgery, up from 11.7 percent in 2002 and 9.7 percent in 1998. The total number of cosmetic procedures increased 18 percent in 2005, to 7.2 million. What's more, increasingly those procedures are being done by for-profit surgicenters connected not to hospitals but rather to hotel and spa chains, where patients can recover at their leisure, in pleasant surroundings. According to a July 2006 article in the *Los Angeles Times*, various companies are preparing to build as many as fifteen thousand of these stand-alone centers in the United States and Canada over the next ten years.

Over in the developing world, medicine of a different kind is an equally good bet. Health care budgets in many nations are rising rapidly,

and as countries pass out of the infectious-disease phase of health care, the budget is increasingly spent on the management of chronic illnesses, such as diabetes, hypertension, and heart disease, and on modern instrumentation, such as CT scanners and MRI devices. These are all made by a handful of U.S. and European firms, so as health care globalizes, opportunities for investors develop.

But health care is just one part of the puzzle. For years, public infrastructure spending in developed nations stagnated, while most of the action was in the developing world. No longer. The infrastructure of much of the United States and Europe is aging and obsolete and needs to be replaced: roads, dams, bridges, tunnels, even whole cities. The money for these projects comes from municipal financing, which, because of a rising interest rate environment, will result in higher rates on municipal bonds, which are generally tax-free, or, increasingly, through private equity deals that transfer ownership of public property to investors and take them off the tax rolls, allowing politicians to hold the line on raising taxes. Either way, there is sure to be a windfall for the manufacturers of the equipment that reshapes and rebuilds the infrastructure. Some of those companies will be American, but the steel is likely to come from China, Brazil, Korea, South Africa, or Mexico. The cement will come from an Italian, French, or Mexican company—a decade ago they bought up most of their American competitors—and the technology will just as likely come from a German or Japanese firm as an American one.

So is it the developing world or the developed? The answer depends upon the opportunity. If you had to pick between, say, a 30-year airport expansion bond paying 5 percent offered by a U.S. entity such as the Port Authority of New York and New Jersey, or a 30-year Mexican municipal bond from the state of Quintana Roo with a coupon of 7 percent, the answer would appear to be a no-brainer. The Mexican bond pays a higher interest rate, and at the same time the Mexican peso continues to appreciate against the dollar, giving you the possibility of earning 8 or 9 percent. But wait. The Port Authority has been paying off bonds successfully since 1921 and has never missed a payment even though it has no power to tax and must pay bondholders with the revenues it earns by managing bridges, tunnels, ports, and airports in and around New York and New

Jersey. The Mexican state of Quintana Roo, on the other hand, has no prior history of municipal borrowing, and while Mexico is currently in the midst of an economic upsurge, there are no guarantees that that will continue. Indeed, the disputed 2006 national election will ensure bitterness despite the outcome and may prejudice investors against Mexico for some time to come. So what you really have to decide is whether you are being adequately compensated for the risk you are taking whenever you make an investment.

There are bond-rating agencies that are supposed to help you answer that question, and you can go to your local public library and look up the Quintana Roo bond or get the rating from your broker or from the Internet. You can look at all three ratings—Fitch, Standard & Poor's, and Moodys—in a matter of seconds, and generally you will find that most of the rating agencies are in accord with one another. But don't be fooled. The agencies generally rate the risk for the bond only at the time of issue and depend upon the markets to reprice the bond thereafter, unless a *significant* piece of news forces them to rerate the bond. If, for example, Mexico's government were to turn sharply leftward, the rating agencies, fearing repudiation, might lower the bond's rating, even if Quintana Roo had remained scrupulous about making its interest payments.

Generally, you will notice that investors who commit to globalizing their portfolios are a cautious lot. Brazil's economy is roaring ahead, to be sure, but even though Brazil's Bovespa index has more than tripled over the past five years, Brazilian stocks still have low P/E ratios compared to U.S. stocks. In other words, they are undervalued by American standards, often by half or more, even though the companies are turning in double-digit growth rates. Why? It is because investors look at Brazil and see a long history of booms followed by significant declines. Fiscal discipline seems to take hold in Brazil for a few years and then vanish again like Brigadoon, not to reappear for another generation. Enough investors have been burned in the past by investing in Brazil that many remain skeptical about just how long the current honeymoon will last, and it is hard to fault them. Brazil's current president, Luis Inácio da Silva, known as "Lula," is a former leftist trade unionist who courageously took the step of adopting middle-of-the-road economic policies just at the time when

China's commodity-dependent economy was moving into high gear. The combination of sound fiscal management and booming exports has driven Brazil's chronic inflation down to near normal levels, has added billions of dollars to the nation's foreign exchange reserves, and has raised the living standards of Brazil's growing urban population. But you have to ask yourself how much longer such a "virtuous cycle" can prevail.

That's what assessing risk is all about. When you see a confluence of events, good or bad, you have to ask two questions. The first is "How long can this continue?" and the second is, to borrow from Cole Porter, "Is it the good turtle soup or merely the mock?" When you are seeking opportunity, you are attempting to make sense out of uncertainty, to make comprehensible the bits of information you have that don't seem to fit into a pattern. In the intelligence business, there is a saying that before you can connect the dots, you have to know what a dot is. Not all information will fit into an investment thesis, and sometimes, no matter what you do, you won't be able to make sense of what you are looking at.

That was before Google. One of the tricks I use is to take two or three words and type them together into Google and see what comes up, and then take another two or three related to the same subject, and then begin trying various combinations. What happens is fascinating. Let's take *Lula*, *economic reform*, and *China*, put them into the Google window, and hit the SEARCH button. As early as February 2003, right after Lula took office, evidence began to turn up on the Web that he was going to attempt to move Brazil down the path of economic reform at the same time that he was going to court China. By October of that year, the two nations had already signed the first of a series of trade agreements. Since China's economy was growing fiercely and Lula was not about to do anything stupid with Brazil's economy, there were already enough signals emerging that Brazil might be a good bet. But back in 1994, long before Lula's arrival, the U.S. Department of Commerce conducted a study that identified Brazil as a "big emerging market," a nation that, if it could get its economic and fiscal house in order, had the potential to become a major trading partner with the United States. In other words, the signs that the Brazilian economy was, as Soros put it, "a waterfall you could put your

bucket under” began to emerge more than a decade ago. The most opportunistic investors might have jumped in and invested then and been burned by a major currency crisis in 1998 and 1999, which was caused, ironically, by too much foreign investment (in the year before Brazil’s monetary meltdown, foreign currency inflows, chasing inflation-fueled interest rates, jumped 140 percent). Naturally, global investors who had been burned in the currency crisis were intensely skeptical that Brazil would get its economic house in order when Lula took over in 2002, especially since he had run on a fairly left-wing platform, which always gives capitalist investors in the West the heebie-jeebies, so little capital flowed back in as the Brazilian economy began to recover. But a handful of smart investors spotted a strong opportunity here, a waterfall, and placed their buckets appropriately. All through 2003, 2004, and 2005, you could have made handsome returns by investing in Brazil, until the Bovespa took a break in late June 2006. As it turned out, Brazil was the real turtle soup.

Which brings us back to the first question: how long can this continue? Ask yourself this question: what has changed since the Brazilian economy took off? Inflation is down, not up. Interest rates continue to drop. The nation’s foreign exchange reserves, now at \$57 billion, appear to signal a healthy economy. Brazil has paid off its \$15 billion debt to the International Monetary Fund, and commodity prices remain strong. Coffee is up so much that Starbucks has had to raise its prices. Brazil’s investment in sugar cane for ethanol has put a floor under formerly sagging sugar prices, and it is now the largest meat producer in the world. That’s the upside of Brazil. The downside is that Lula’s government has been plagued by charges of corruption, which led to the resignation of his finance minister. Party discipline is breaking down, as Brazil’s poor, who have not benefited nearly as much from economic reform as promised, are growing restive. Worst of all, there is simply too much foreign portfolio investment, at least \$100 billion, almost twice as much as a year earlier. Whenever there’s too much money on one side of an investment and not enough on the other, there is a stronger than even chance that the investment’s value will fall. It is a simple illustration of supply and demand.

Too many sellers will emerge at the first sign of trouble, and not nearly enough buyers.

What is true for developing nations such as Brazil is equally true for developed nations like the United States. For a long time, Americans watched interest rate changes by the Federal Reserve and bet on the general direction of stocks and bonds from there. When interest rates began to rise, stocks generally would fall, and vice versa. But the U.S. economy has become more interwoven with the global economy, so it is harder to discern the circumstances that will combine to push or pull the equity markets. That has caused investors to be flooded with information, which leads to overload, which can lead to indecision. How do you cope with too much information? Make yourself a balance sheet that contains four categories: *politics, economics, the environment, and exogenous factors*.

POLITICS

Political factors, for instance, might include the willingness of an administration to rein in spending. The current Bush administration has shown no such discipline, and in fact, because Republicans dominated both the executive branch and Congress for most of the past few years, there was no counterforce to keep them from passing whatever tax-cutting or deficit-enlarging legislation they wanted. If Democrats had been in power, the situation would have been exactly the same. Now that a counterbalance between the White House and Congress has been restored, the tendency by the party in power to run amok to the detriment of taxpayers and consumers may be dampened.

Other political factors include *how* the party in control of the White House exercises power. Are they imperious, or are they relatively open? Again, this is not a Republican versus Democrat issue. Each side has behaved badly when it had the reins of power, and it is discouraging to investors whenever that happens. Both sides have attempted at one time or another to force the Fed to make decisions about interest rates motivated by politics, which is always to the detriment of investor decision making.

ECONOMICS

Is GDP growing at a good clip? Are corporate profits rising or falling? What about job creation, consumer debt levels, and consumer savings? How is the housing market doing? All these are economic influences on your decision making. So, too, are trade balances, foreign exchange reserves, the money supply, and the cost of energy.

THE ENVIRONMENT

By environmental factors, I don't mean the physical environment literally, although that can come into play if a natural disaster causes a lot of destruction. Aside from the property losses, such disasters can suck resources from one part of the country to another and create imbalances that can stress the economy. That's why GDP dropped half a point after Hurricane Katrina. But other "environmental" factors are the quantitative versus qualitative data and the mood of the nation. Consumer confidence is an environmental measure, not an economic one, because it is an attempt to measure the zeitgeist of the country, not the true state of economic well-being. Presidential popularity is another environmental factor. When it is low, as it has been for the last couple of years, ordinary people are uncertain about how well their nation will be led when crisis erupts. And as we know, when people are uncertain, they don't invest.

EXOGENOUS FACTORS

Finally, exogenous factors are that portion of the chart labeled *visible yet incomprehensible*. They are factors or bits of information we see but don't know how to evaluate. If they are large enough, we can make some guesses. When severe acute respiratory syndrome (SARS) burst on the world scene in February 2003, no one knew if it was going to be a small but containable disease or a global pandemic. By the time the last death was reported two months later, much of Asia's economic life had shut down, and the region's GDP growth had lost half a percentage point for

six months. The repeated warnings by the World Health Organization that avian flu might have even more dire consequences makes that one of those exogenous events that you have to account for when you are considering your risk profile. Here's another: when Indonesia was hit by a destructive tsunami on December 28, 2004, that nation's stock market went down but a blip. Why? While the world was shocked by the huge loss of life in Indonesia, the Indonesians weren't. They have been hit by epic natural disasters for generations and are somewhat fatalistic about such events when they happen. Much more worrisome for investors, though, is the tsunami's aftermath. Banda Aceh, the province most affected by the destruction, has veered sharply to the religious right and has adopted *sharia*, Islamic law, which is very conservative, especially regarding the treatment of women. Indonesia is the largest Islamic nation in the world, and should the rest of the state follow Banda Aceh, that development would not be good for investors in Indonesia's booming economy.

Okay. Let's quickly review. First, whether you are investing in the developing world or the developed, you need good information, acquired early, to determine whether or not you should even consider making an investment. Second, you need to be able to assess how long the confluence of events that you have spotted is likely to exist. The longer it does, the greater the chances that if you get in relatively early, you will do extremely well, and that if you get in a bit later, there will still be enough time for you to earn a decent return. Third, you have to determine whether what you are seeing is a real change in direction or merely the appearance of one, a mirage that could evaporate in an instant, along with your investment. Do those things, and you can begin to answer the *developed versus developing* binary.

CHAPTER 2

THE RULE *versus* THE RULE OF POWER OF LAW

Having just spent some time looking at the developed world versus the developing world, I'd like to look at a different facet of that binary: the rule of power versus the rule of law. Looking at these two is meant to answer the following question: can I invest safely in a country where the deck is seemingly stacked against me? In nations such as Russia, China, Egypt, Saudi Arabia, and Indonesia, as well as many other emerging markets, the rule of law is weak and the rule of individual power is strong. As my friend Ian Bremmer, president of the Eurasia Group, a New York–based international relations consultancy, once described Russia, “Putin is a strong president, but there is no strong presidency in Russia.” In other words, the rule of law is weak and altogether too much power is concentrated in the handful of people with whom Putin surrounds himself. In the old Soviet Union, when the Communist Party was the dominant institution, the nation was a kleptocracy, a state where officials used their power to steal from the citizens. Russia today has exhibited many of those same traits, particularly with the confiscation of Yukos Oil, the jailing of the company's president, and the assassination of opposition political figures and journalists.

I do not mean to pick on Russia. It is just one example of a nation that still suffers from weak laws when it comes to protecting property rights and investments. Even when laws appear strong, the judicial systems behind them may be too weak or arbitrary to guarantee that an investor's rights will be upheld in a dispute. Some nations even make distinctions between local shareholders and foreign holders when it comes to rights, so that a

foreign investor could wind up at the end of the line in a claims dispute. How can a country where such behavior exists still attract investment?

It goes back to the question of how you assess risk and the direction of reform. Let's go back to Russia for a moment. There are many astute investors who believe that Russia, after seventy-five years under Communist rule, has nowhere to go but up. It is rich in energy, and because of its geography, Russia has the ability to become an effective bridge between Europe and Asia. But except for a period of less than a decade before World War I, Russia has had no experience with the rule of law, and it is struggling to define its legal system. President Putin takes strong umbrage at the idea that he is backsliding toward a Soviet-style government ruled in secret by a small handful of meretricious people, and he points to falling inflation, a strengthening currency, and rising wages as proof that he is going in the right direction. That has yet to be proved conclusively, and Russia's strong showing has been offset by rising AIDS, a shrinking population beset by alcoholism, aging, and worker absenteeism, and chronic violence and drug use among its youth. Also, thanks to Russia's far northern climate, the energy inputs required for everything from heating apartments to exploring for energy are far higher than for any other developed or developing nation, which puts Russia at a substantial disadvantage on world markets. Given the long tradition in Russia of distrusting the common man, the nation gives the appearance of reverting to its old Soviet model, even if it is not.

Despite rising investor doubts and a chorus of criticism of its behavior regarding the seizure of Yukos, the July 2006 initial public offering in London of Rosneft, a Russian oil company, raised some \$15 billion, proving that certain foreign investors were willing to take a chance on Russia. Overwhelmingly, these investors were large energy companies looking to cement ties with Rosneft so that they might gain a future share of Russia's oil. Individual investors and even institutional investors were notably absent. Why? The political risks were simply too great for most.

So does this mean that when you see a nation with investing potential but weak rule of law, you should stay away? Not necessarily. There are two things that you have to know about investing when the rule of law is weak. The first is that if you see a market about which you are pessimistic

rising, *open your mind* to find the reason. The second is that once you find the reason, start looking for a mechanism that allows you to invest with some prospect of getting your money out.

What do I mean by “open your mind” in this case? Don’t reject a market simply because you don’t like the politics or the players or the country or its philosophy. If you are willing to do a little digging, you will generally find a sound reason why a market is rising. (You might still balk at investing for moral reasons, perhaps not investing in the Sudan because of the killings in Darfur. But that doesn’t mean that other investors will be as squeamish. Where there is opportunity, somebody will take it.) For example, the post-9/11 crash of U.S. securities convinced people in many emerging markets that they needed to do something with their money besides park it in the United States. Many of them began looking at their own home markets and discovered that politics or the local economy had changed or that they were able to import back to their home states not only their capital but also knowledge and connections that they had acquired in their own years abroad. Smart Russians, Brazilians, Mexicans, Saudis, Kuwaitis, Egyptians, and citizens of many other countries began bringing their money home and, because of family connections and local knowledge, started to invest their money in rising industries, entrepreneurial ventures, and real estate. Between 2000 and 2002, this flood of repatriated capital became the foundation for much of the subsequent emerging-market boom that leveled off in mid-2006. Much of that boom took place in nations that were advancing along the path of reform, but some of the hottest markets were in nations like Saudi Arabia and Kuwait, where social and political reform have until recently been unthinkable. What made those markets hot was that the people who were repatriating their capital knew something you didn’t. Their local knowledge gave them the confidence to invest, and because they were part of the inner circle, they had a reasonable expectation that *they* would be treated fairly.

Your job is to take advantage of that change in market dynamics by finding someone who will make it *his* mission to figure out how to lay off part of the risk that you see in order to attract *your* money, as your money entering his market will cause it to rise at an even faster rate. In the case

of many emerging markets, this means country-based mutual funds or exchange-traded funds. In country-based mutual funds, the fund manager has made some sort of arrangement with the national stock market and local securities commission so that foreign capital can be invested and held in the country. Many of these funds, especially in emerging markets, maintain a high degree of liquidity and have holding periods, in which only a small percentage of the stock that the fund owns can be redeemed at any point in time. These mechanisms prevent capital flight in case things go wrong with the country's economy. National securities commissions reason that if foreign investors are going to profit from gains in their economy, they ought to share some of the pain when the economy does not do as well. At the same time, they want some insurance against unexpected capital flight if there is too large a buildup of foreign investment through a particular fund.

If all this seems like a lot of trouble, it is because Americans have been conditioned by more than seventy years of securities law and enforcement to believe that they can get a reasonably fair shake when they invest. We have a long history of legal intervention in the stock markets, going back to the Great Depression, which followed the first great period of popular stock ownership in the United States. When stock market manipulation wiped out many investors in the late 1920s, the U.S. government stepped in and formed the Securities and Exchange Commission, whose primary responsibility was to create fairness in the marketplace. Since then, the SEC has written many new rules, yet from time to time there are scandals that shake the faith of investors in American markets. In addition to the SEC, other bodies, such as the Financial and Accounting Standards (FASB) Board, have emerged to write rules about corporate behavior and accounting transparency, yet periodically companies will push the envelope on rules and suddenly find themselves the subject of a Justice Department investigation or even, occasionally, the subject of prosecution. This goes both for companies that issue shares and for the brokerages and financial institutions that buy and sell them.

American adherence to the rule of law may seem cumbersome. But just as physical standards are necessary to ensure that you are getting both the quality and the quantity you pay for—the origin of uniform

weights and measures more than five thousand years ago in early historic India is considered the foundation of modern civilization, because it allowed different cultures to trade goods according to a standardized and agreed-upon system, and the substitution of money for physical goods occurred not long after that—legal and accounting standards are equally necessary to ensure that when you buy a security or make an investment, you also get what you paid for. The representations that a company or municipal authority makes when it issues securities are supposed to disclose fully all risks so that you can make a comparative evaluation of all the choices available to you as an investor. If a company or other issuer doesn't do that, it's like tilting the machine in pinball. You might win for a while, but invariably, the machine will eventually cancel your game. If a company lures in investors with false information, as, for example, Enron did, its stock may prosper for a time, but eventually, the investors are going to get burned.

As Americans have invested abroad and as foreigners have gained experience in investing in the United States, the American system of financial transparency has spread abroad. Some emerging-market nations, such as India, where investors were burned by repeated stock market settlement scandals in the late 1980s, have installed investment settlement and monitoring software on electronic exchanges that is now equal or superior to any system in the United States. Other nations and regions, such as the European Union, have substantially beefed up their accounting and disclosure laws after investors were rocked by accounting scandals involving companies such as the Italian dairy giant Parmalat, the Dutch supermarket company Ahold, and the Belgian supermarket company Food Lion, among others.

This brings us to another one of those aspects of decision making that you must embrace: if an investment sounds too good to be true, it almost always is. When you are evaluating an investment opportunity, figure out whether the reward and the risk are commensurate. If someone tells you that you can get a 15 percent return with little or no risk of losing your money, can that be believed? Well, as we have seen in the past few years, it has been true for a number of emerging markets. But that is because of a confluence of events that may not repeat for a generation—or may

come again within a few months. The investing landscape constantly shifts, and you have to learn how to read it. What appears to be a waterfall right now might dry up in just a few months or a few years, so you have to watch the flow into the bucket as well as the future of the waterfall above. Move on before the flow turns into a trickle or dries up altogether.

A nation might look as if it is under the rule of law and yet not be. When you are making an investment, you are investing in the future potential of a company, an industry, and even a nation, and having that potential be thwarted by the law is as bad as having it thwarted by a powerful dictator or coterie of leaders. In order for a company or a nation to grow, there must always be room for competition. So when France will not allow an American company to take over a French firm, that is as bad for investors as China's poorly defined shareholder laws, which make direct investment there such a risky proposition, or, for that matter, as when American political considerations get in the way of, say, a Chinese takeover of a U.S. oil company. When Latin American nations pass "national patrimony" laws that protect certain segments of the economy, they discourage capital investment. Not only do they deny investors the opportunity to make money, but worse, they often condemn a nation like Mexico, which protects its oil industry, to do without desperately needed development. Whenever you read about a nation blocking competition, it is, at the very least, a cautionary flag that should make you think twice before you invest.

Let's review. First, keep an open mind when you invest. Just because you don't like a country's politics or a company's business doesn't mean you can't earn a good return on an investment. I'm not opposed to social investing: if you really hate the tobacco companies, by all means don't invest in them. If you think that Saudi Arabia is a dangerous place, by all means put your money someplace else. But if you are going for the best returns year in and year out, you are going to find that ethics is a one-way street lined with money. Don't ever invest in anything illegal, but otherwise, learn to look at all opportunities neutrally and equally, with a mixture of knowledge, skepticism, and a healthy worldview.

Second, learn to lay off risk. If an investment is risky, there is always some iteration of it that can be created that has a lower return but far less

risk, such as investing in a basket of equities with an option on the national currency, so that if the currency rises and the basket stagnates, you can still come out ahead, or if the basket rises and the currency stagnates, you get the same result. Your job is to find that proper combination of risk and reward that makes you comfortable, that does not put your capital in jeopardy, and that ensures that you will get a good payoff on the upside and leave you minimally harmed if things go wrong. I am a strong believer in protection. When you go to Las Vegas to play blackjack, the house offers you “insurance” whenever the dealer has an ace showing. If you would insure your bet at the gambling table, why would you possibly go, as the Asians put it, “naked long,” which is their expression for what we call “buy and hold”? If you forgo a little of the upside, there is a much greater chance that you will come away with enough to make your forays abroad worthwhile.

The third takeaway is “Follow the money.” You can’t possibly be an expert on every opportunity, but somewhere there is an expert of some kind, so learn to follow monetary flows. If you see a market begin to rise, find out why. Newspapers, the Internet, and scholarly journals will provide you with more than enough information to help you decide whether a potential investment has legs. If it does, put your bucket under it.

Finally, not all decision making is about following the moment; sometimes it’s about seeing developing trends. You don’t want to waste your time with ideas and investments that will fall apart after a couple of weeks. You want to be in long enough to get a solid return without having to spend so much time micromanaging your decision that you worry yourself sick. Remember, your own time is valuable.