



The Power of Political Mandates

By Thomas E. Nugent

The technology bubble has burst, the power of the Wintel monopoly wanes and the struggle to find the new growth stocks of the 21st century founders. The inability to get a good stock market rally going can be attributed to a combination of Enronitis, the absence of a fiscal stimulus package and continued earnings' disappointments across the "growth stock" spectrum. Where will the next investment theme emerge that will lead to sustainable growth in revenues, earnings and stock prices? What event will set the stage for such a secular move in stock prices?

Astute market observers won't have to go too far to identify past relationships that have a high potential to produce successful stock investments. The driving force to beating the market in today's environment is neither a top down economic approach nor a bottom up stock picking approach. Without another enormous boost from a technology-like boom that gave us a bull market in the second half of the 1990s, the economy won't see four percent growth, so making a top down case for stock investing is difficult. On the other hand, a case for a bottom-up approach may be frustrated by the general unsustainability of trends in an extremely competitive economic environment. As a result, stock pickers will be challenged when it comes to the buying and selling within a small universe of growth stocks that go from under-valuation to overvaluation and back.

One option that makes sense in a difficult economic environment is theme investing—an approach that identifies a sector of the market that benefits from some external influence. This influence can have a variety of origins but has the power to benefit that one sector well above the market in general. One influence that has that ability in today's market environment is political mandates. A political mandate is a government decision that has broad and long lasting effects on industries either through a commitment to increase spending—a positive effect, or to increase regulation—a negative effect.

The political response to the September 11th terrorist attacks has dramatically changed the landscape for the defense sector. President Bush's reaction to the terrorist attacks—essentially to declare war on terrorism and single out an axis of evil—will have similar effects as did President Reagan's declaration that the Soviet Union was an evil empire.

In 1981, while I worked with Arthur Laffer, the well known supply-side economist, I came in contact with a major in the U.S. Air Force who was stationed at the Pentagon. In those days Laffer Associates, the economic consulting firm of Dr. Laffer, produced economic and market related research that was sold to the financial community. As a result of research conducted by this Air Force officer, the firm published a lengthy economic report entitled: "The Defense Industry."

The essential thesis of this report was that the U.S., under President Reagan's guidance, would fight a new cold war in a way that would ultimately bring about the collapse of the Soviet Union. The idea was that the U.S. would launch an enormous increase in defense spending that would force the Soviets to do the same to protect themselves against the possibility that the U.S. could defeat them in a conventional war. Reagan's idea was quite simple—the U.S. would force such a diversion of resources into defense that the balance of the Soviet economy would collapse as a result.

In 1981, this new political mandate provided an obvious investment opportunity: Invest in a broad range of defense stocks that would benefit from that political mandate. For the ensuing years up until the fall of the Berlin Wall, that investment strategy proved enormously profitable. When I look back on the stocks that Laffer Associates identified as major plays on that political mandate, it was easy to see that investing in the right theme proved unusually rewarding.

Today is no different than in 1981—with a slight difference—some of the players have changed. The U.S. commitment to eradicating terrorism is no different than President Reagan's unannounced intention of collapsing the evil empire. As long as terrorism remains a threat to world peace then the mandate for its eradication will dominate defense—either in the form of defense spending or in the form of spending on homeland security. So, for investors seeking long-term growth, the defense industry is one solid place to do your research.