Sigma Summaries

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Enron - A Defining Moment

History is replete with tales of how once mighty corporate titans have fallen. Factors leading to their demise are varied but often include one or more of the following; inability to adapt to a changing competitive landscape, excessive debt, poor strategic decisions, and occasionally fraudulent behavior by insiders. What sets Enron's (ENE) failure apart from the pack may not only be the specific events that led to its collapse, but as important, the degree of outrage that is fanning throughout the investment and accounting community, the boardrooms of corporate America, and on Capitol Hill. In this month's Sigma Summary, we will summarize how this energy giant self-destructed and how this watershed event has and will continue to impact investment behavior.

In July of 1985, Houston Natural Gas merged with InterNorth to form Enron, making the Company one of the most dominant natural gas suppliers in the nation. Shortly thereafter, Enron saw its role not simply as a long haul transporter of natural gas but rather, as a service provider to its suppliers and end-users. Through the use of derivative securities and hedging strategies, and offering load management and logistical support, ENE established itself as a powerful force in the natural gas industry.

Simultaneously, as it was expanding both at home and abroad, Enron substantially increased its trading operations. Not only was the company a major market maker in natural gas derivatives, it also became a leader in trading other commodities. As a result, revenues and earnings skyrocketed. Enron scored another victory with the formation of EnronOnline, a first of its kind Internet-based trading platform that revolutionized the industry. By 2000, this service became the world's largest web-based eCommerce system. The extraordinary profitability of these operations more than offset weak results elsewhere. Ultimately, Enron began to dispose of many of its ancillary businesses, seeking to divert capital to its rapidly growing and highly profitable trading unit.

Enron's rapid demise in the last quarter of 2001 was triggered by Moody's downgrade of its debt shortly after the release of third quarter results. Although operating earnings appeared to be strong, the Company reported two billion-dollar write-offs against earnings. Initially, Wall Street was willing to ignore these extraordinary charges, but a downgrade in the Company's credit rating took on greater importance as analysts began to focus on ENE's off-balance sheet investments. With the debt downgrade, followed by the withdrawal of many of ENE's trading partners and a falling share price, it soon became clear that ENE was approaching insolvency. After a failed effort to sell itself to a smaller rival, bankruptcy protection became the only option.

ENE is now under attack on many fronts. These include SEC inquiries relating to conflicts of interest with off-balance sheet partnerships, accounting irregularities, a criminal investigation by the Justice Department, accusations that its auditors destroyed key internal documents, and indications that senior management and Enron's Board of Directors failed to act when internal probes of accounting irregularities were brought to light. The purpose of this report is not to assess blame or predict what ultimate charges will be brought forth. Rather, it is to assess the damage to the investment public and offer lessons that can be learned by recent events.

Investors have clearly been shaken by these events. The "irrational exuberance" in equity valuations in the late 1990's ultimately led to the peak in U.S. equity valuations in March of 2000. From that point forward, the market has been in a correction mode, seeking to find a valuation level from which it can form a base for eventual recovery. This period also has witnessed the lingering recession during 2001 and the terrorist attack on September 11. Surprisingly, the market staged a fourth quarter rally, seemingly confident that the war on terrorism was showing some signs of success, the economy was beginning to stabilize, and consumer confidence was returning to the market. Nevertheless, the unraveling of Enron has cast such a large cloud that the market is now again looking to re-establish its footing.

While the recent pullback in the market is indeed disappointing, there are some encouraging signs. Some argue that the Enron experience actually will make the financial markets stronger. Enron's loose practices brought to light much of the excess that was characteristic of corporate and investment behavior in the latter half of the last decade and it is widely believed that before a meaningful recovery can be staged, these excesses need to be exposed and purged. Perhaps 2002 is the year of reckoning. Management behavior is being closely monitored, accounting standards are already improving, investors are demanding more accountability, and the strongest entities not only will survive, but also will stand to prosper. While this experience has clearly left many investors with unsettled feelings, our conviction in the long-term viability of the equity market has not wavered.

Within Sigma, our behavior has been impacted as a result of recent events. For example, we are spending more time poring over financial statements and the fine print, trying to insure that we fully understand the risks of each company we own or are seeking to buy. This is not to suggest that we were not looking at financial statements before. However, the degree of scrutiny has risen decidedly.

Our portfolio construction is also being tweaked in light of the ENE experience and current market conditions. Our desire is to maintain a "model portfolio" of approximately 50 stocks, implying an average weight of 2% for each investment. While we have yet to achieve this target, we are actively expanding our universe of acceptable stocks that we would like to own, simply waiting for the right valuation before we initiate purchase. In controlling the weight for each of our investments, we can better manage the impact that any one stock can have on overall results.

We are also more comfortable having a healthy cash balance in our clients' portfolios when we cannot find suitable investments. While we don't claim to be market timers, cash as a percent of our equity mix is higher than normal, as we have recently sold stocks that no longer pass our quality screens, and we are patiently waiting for our growing list of buy candidates to meet our strict valuation criteria.

We were fortunate that ENE was not included in our model. However, we have had missteps with a small number of stocks over the past year where the market clearly punished investors for accounting concerns, too much debt, missing earnings estimates, etc. In some cases, the market may one day exonerate these stocks after the Enron cloud is lifted. Nevertheless, at this time we prefer to err on the side of caution. The market has spoken and investors are seeking asset rich, financially solid companies with understandable business models, strong management and impeccable accounting standards.

As investment advisors, it is imperative that we understand the market environment in which we operate. Moreover, we are committed to identifying premier companies, attempting to purchase them at attractive valuations. Our definition of what constitutes a Sigma stock has not changed. Characteristics that we seek include a diversified product line, strong management, solid financial structure, earnings visibility, attractive valuation and positive industry fundamentals, to name a few. What has changed is a tightening of our own standards, both in valuation as well as qualitative issues.

Our clients are seeking capital preservation first, capital appreciation second. Our goal is to provide a healthy balance of both, be it with cash, bonds or stocks. Enron has taught us valuable lessons; lessons that we believe make us wiser and stronger.

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