



Bradley, Foster & Sargent, Inc.

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The Global Spread of Capitalism

There are two powerful arguments in favor of capitalism over its historical alternatives:
(1) capitalism better helps the poor to escape from poverty than any other system and
(2) capitalism is a necessary condition for the success of democracy.

Michael Novak, *Business as a Calling*, 1996

David Richards, the highly respected former money manager at Primecap Management and Capital Research & Management, did an excellent job of putting the global economy in perspective in an interview in the August 26th edition of *Barron's*. His view is that the global stock markets are not in a short term bubble which is about to burst. He maintains that the real estate bubble in the U.S. over the past 4-5 years was very different than what is happening in the global equity markets. He is quoted in the article as follows: "The whole world has adopted the notion that market-economy-oriented policies are correct. In other words, there is a theology of capitalism that is sweeping the world, to borrow a phrase from [Marxist] British historian Eric Hobsbawm. There are 3.5 billion people from Eastern Europe to the Pacific and from the Indian Ocean to the Arctic that were living under socialism or communism, where it was not possible to trade and not possible for entrepreneurs to get rich – and they have been transformed."

His statement focuses on the essence of what is happening across the planet. Communist nations, like the Soviet Union, China and Vietnam, as well as socialist nations such as India, have embraced free-market-capitalism and its principles in varying degrees over the past decade, and the pace of adoption of these ideas has even accelerated recently. In doing our own research on this theme, we came up with the following list of nations which have embraced capitalism in one form or another since the fall of the Berlin Wall in 1989:

<u>Nation/Region</u>	<u>Population (millions)</u>
China	1,300
India	1,200
Russia	143
Vietnam	87
Ukraine	46
Other former countries of the U.S.S.R.	135
Poland	38
Romania	21
Other Eastern European countries	<u>78</u>
Total:	3.048 billion

Source: United Nations Department of Economic and Social Affairs – Population Division, 2006

While our total is less than Richard's estimate of 3.5 billion people, there are other smaller nations in Asia and Africa which have chosen capitalism, which we have not included above. The key

point is that there has been a sea change in the global spread of capitalism, which is leading to significantly higher economic growth around the world.

David Richards made several other points in the interview which are worth repeating. India and China get most of the headlines now with their remarkable GDP growth trajectories of 8% and 9% respectively, but there are in fact dozens of less well known, newly capitalist countries such as Estonia and Turkey growing at 5-7% annually. Thus, global economic growth is not a bubble dependent on one developing country's GDP growth but is a sustained event of major proportions, playing itself out on many continents. In addition to the inherent economic benefits of adopting the capitalist model, another factor in this remarkable growth is the dramatic decline in the "cost of communications and computation," according to Richards, because of the Internet and fiber optic communication. You can manage a global business from the U.S. or the U.K., or from India or China. Lastly, Richards maintains that this economic transformation of more than half the nations in the world from an agrarian to an urban society will last 30 or more years. These observations, with which we agree, have significant investment implications which are addressed on the last page.

Intangible Capital

In 2006, the World Bank published a study which sought to assess how wealth is created. The study is called, "Where is the Wealth of Nations? Measuring Capital for the 21st Century." The study divided wealth into three categories: natural capital (pasture and cropland, forests, minerals, oil, gas and coal, etc.); produced or built capital (machinery, equipment and structures including urban land); and intangible capital residual. As a recent article by Ronald Bailey in *The Wall Street Journal* chronicled, the economists writing this study found that the majority of the world's wealth comes not from natural resources nor machinery and equipment but rather from intangible capital. And, according to the study, the key features of intangible capital are the following:

- Skills and know-how in the labor force
- Trust among people in the society
- Ability to work together for a common purpose
- Efficient judicial system
- Property rights
- Effective government
- Good school system

Source: World Bank, 2006

This groundbreaking study, which can be viewed in its entirety at the World Bank's website, tells us what we already intuitively know about national wealth creation over the past 200-300 years. How did Hong Kong, without land or other natural resources, become one of the wealthiest cities in the world in less than 50 years? It succeeded in creating a remarkable amount of wealth because of significant intangible capital which included the following key features: the creativity, skills and energy of its people; a good school system; the rule of British law; efficient courts; and minimal taxation which helped produce abundant savings (capital).

For thousands of years, wealth came primarily from the land and natural resources and to those who controlled it. Merchants, tradesmen and oceangoing traders also accumulated wealth, but the preponderance of wealth came from the land where the great majority of people worked. Commencing in the 18th century, savings began to be invested in factories and mills. The

concentration of such capital over a century produced a countervailing force – Marxism, whose proponents hold that wealth primarily comes from produced capital, and peoples everywhere need to gain control of the “means of production” to create wealth in an equitable manner. However, as well-known economist Robert Heilbroner wrote in the *New Yorker* (Jan. 23, 1989), “Less than seventy-five years after it officially began, the contest is over: capitalism has won. The Soviet Union, China and Eastern Europe have given us the clearest possible proof that capitalism organizes the material affairs of humankind more satisfactorily than socialism.” Now, in the World Bank’s study, economists suggest that “intangible capital” is responsible for creating 58% of a nation’s wealth in low-income countries, while natural capital and produced capital account for 26% and 16% of wealth respectively. There are numerous examples of countries which show how this phenomenon has worked including Japan, South Korea, Ireland, Singapore, and Estonia. In each case, these countries had modest natural resources, no oil and gas reserves, and unsophisticated technology and manufacturing resources. But they had social capital in abundance.

Democratic Capitalism

In 1982, when Michael Novak published *The Spirit of Democratic Capitalism*, the term democratic capitalism was not in common use. It is now. His book appeared first internationally in an underground edition in Poland in 1986 and has been translated into more than a dozen languages. Senator Patrick Moynihan commented that this book was one of those rare books that actually changed the way things are. It had a major impact in Latin America countries, where some in the political class were leaning towards “liberation theology,” and also in Eastern Europe in the 1980’s and 1990’s. Democratic capitalism requires a nation to go well beyond the features described above of “intangible capital.” Novak says that democratic capitalism is a tripartite system: economic, moral and political. It is possible to create wealth in a country with much “intangible capital” – even one that shuns democracy and the rule of law and remains authoritarian or communist. This is the case of China, Russia and Vietnam today.

This is an important distinction – both for those living in the country and for foreign investors. A country that nurtures market-oriented policies, has a good school system, and encourages its people to develop technological skills and know-how, but is not democratic, is a potentially unstable country. Institutionalized checks and balances to thwart concentrations of power and a process for peaceful conflict resolution are critical factors in the make-up of a nation. Without them, investors should proceed very cautiously. Other critical factors are the rule of law, property rights, trust among others in society (not just family), the absence of pervasive corruption, and low taxes.

In *The Spirit of Democratic Capitalism*, which some believe is the best book on this subject since Adam Smith’s *An Inquiry into the Nature and Causes of the Wealth of Nations* written in 1776, Novak explains how a nation with a democratic capitalist system is like a three-legged stool. One of its legs represents economic freedom – a rational exchange of value between buyer and seller by mutual consent and to mutual advantage at prices determined by the market. This is the genius of self-interest and how it works to the benefit of all. The second leg of the stool represents political liberty which includes the freedom to move freely throughout one’s country, to work wherever one wants, the rule of law, property rights, electoral democracy through the ballot box, and the peaceful resolution of conflict. The third leg is the moral-cultural order without which the other two legs cannot stand. Novak quotes the 18th century French philosopher Montesquieu, who quipped that the English excel in three things: piety, commerce, and liberty. This is, in fact, the essence of democratic capitalism, and one need only look at Britain’s former colonies to see how British values and institutions have endured. Novak writes unequivocally: “The moral-cultural system is

the chief dynamic force behind the rise both of a democratic political system and of a liberal economic system. Neglect of it bodes ill.”

Investment Implications in the Global Spread of Capitalism

Billions of people in dozens of countries are making the journey out of poverty as their nations have embraced the theology of capitalism. What does this mean for the U.S. investor? From a macro perspective, it means that global GDP growth will continue at its torrid pace of 4-5% annually for the foreseeable future – despite the economic slowdown in the U.S. The mess in the sub-prime mortgage market and the weak U.S. consumer sector (caused by high energy prices and a slowing housing market) will have little effect on the economic growth in the BRIC countries (Brazil, Russia, India and China). The GDP of the BRIC nations represent 12% of global GDP, using official exchange rates, and 26% of global GDP, calculated at purchasing price parity. The dozens of smaller countries in Eastern Europe and Asia which are also growing at 5%+ will help strengthen the U.S. economy. For the companies in the S&P 500 Index, international sales now represent approximately 50% of total sales. With this pace of global economic growth, it is likely that there will continue to be upward pressure on the prices of commodities, energy and other scarce resources. This also means that higher oil and gas prices are probably here to stay and that the global capital spending boom will cause prices of materials needed in construction and building infrastructure to trend higher.

At Bradley, Foster & Sargent, Inc., we are very positive on large, high-quality international firms that can use their global presence and management experience, technical skills, strong brands, cash flow and strong balance sheets to benefit from this dramatic global expansion in capitalism. Examples include consumer staples companies such as Procter & Gamble, PepsiCo and Coca-Cola (which are also plays on potable water), and Nestle. In the infrastructure sector, this could include companies such as General Electric, United Technologies and Caterpillar. In technology, the stocks of the leading firms such as Cisco, EMC, Intel, Hewlett Packard, SAP and Microsoft are making a comeback from the 2000-2002 bear market. One would also not want to neglect the large multinational energy, oil service and basic materials companies which have the financial power and technical expertise to develop natural resources and bring them to market. Unlike the peak of the U.S. bull market in 1999 when these stocks were grossly overvalued, most of these stocks are selling at relatively modest valuations – with P/E ratios on forward operating earnings generally between 15 and 20. A corollary approach is to invest in international equity mutual funds, ETFs, and closed-end funds targeted at the stock markets of specific countries and regions. While this approach has potentially high rewards, the risks are commensurate, as many of the fastest growing countries have stock markets without significant liquidity, which can cause dramatic declines in stock prices on negative events. In general, we advise caution when investing in stocks of firms in countries without democracy, property rights, and the rule of law. As our clients are aware, we emphasize quality when investing, and this is even more important when investing internationally. We also seek to moderate risk (political, economic, and currency) when investing internationally but still aim to generate excellent returns. There will be many opportunities to take advantage of the spread of capitalism globally, and we at Bradley, Foster & Sargent, Inc. intend to exploit some of these opportunities for our clients with a sustained and long-term investment approach.

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Investment Management

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