Ruminations of

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A Question of When & What, Not If

Often, huge challenges lead to huge opportunities. The Contrary Investor has written for some time about the opportunity created by the challenges facing our country's aging water and wastewater infrastructure. In similar fashion the infrastructure that conveys a "substance" very nearly as important to life as water – electricity – is horribly outdated and poised to capture huge investment dollars.

The electricity grid in the U.S. wastes power and discourages the use of renewable sources of energy like solar and wind. The grid still relies on technology from the 1960s, says journalist Joel Achenbach, who wrote about the nation's electrical infrastructure in a fascinating article in July's *National Geographic* magazine. Achenbach points out that most people don't think about the way electricity from a power plant hundreds of miles away may be used to turn on a light bulb in their home.

"We've just become so accustomed to the electric power grid — it's like oxygen," he says. "But we can't take it for granted. Things go wrong, and suddenly 50 million people are without power, and then they notice the grid and they learn about the system behind the magic."

Achenbach's article examines how the aging power grid must change to keep up with 21st-century demands. Blackouts and brownouts, he writes, cost Americans an estimated $80 billion a year — and unless upgrades are made, the grid will continue to be "prone to failure."

Creating a smarter energy grid — one that allows information to go back and forth between consumer and energy producer — would provide information like who is using power when, and both consumers and energy providers would then be able to adjust accordingly, Achenbach explains.

"The goal — what people would like to do – is create a smart grid that's not just electricity going down a line, a wire that has no information coming back," he says. "If you think about it, those power lines that go to your house — they're not like broadband cable. There's no data going on that, and the power company typically does not know how much electricity I'm using unless they send a meter reader to come and look at a meter on the side of my house. So when are we going to bring this into the 21st century?"

"For traditional reasons, it remains kind of a local/state-regulated system," Achenbach says. "It's a little bit here, a little bit there. It gradually evolved. If you had to build it over again, you wouldn't build it this way necessarily. It's been 130 years in the making, and it's not going to suddenly be erased overnight."

An improved electric grid could potentially make electricity more reliable, more efficient, cleaner and perhaps even cheaper. But what would it cost to actually build it, and how much would it save? And where will the investment dollars flow (read "how can I profit?")?

The answer to the first two questions isn't simple. It's difficult to put a price tag on a new grid, and almost impossible to quantify the potential savings. The economic stimulus bill passed in February of 2009 includes $11 billion to upgrade the country's power grid, but that's just a down payment on a massive undertaking. That's because when it comes to electricity, not much has changed since Thomas Edison fired up the first commercial power grid in lower Manhattan on September 4, 1882. The fundamentals he pioneered are still the basis for an electricity grid in the U.S. that is almost 100 percent reliable. But in recent years, that grid has started showing weakness.

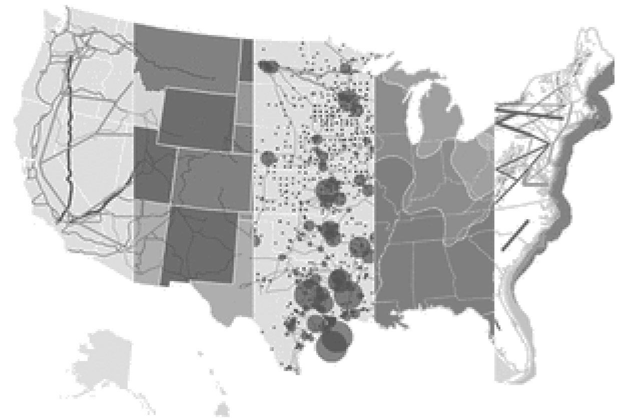
There aren't many estimates of what it would cost to modernize the grid, and the estimates that do exist can range from $100 billion to $2 trillion.

Part of the problem is that the grid isn't one coordinated entity — it's made up of dozens of little parts, which would be built and managed by different sectors of the energy industry. And people often disagree about which of those elements actually count as the electric grid. Is it just the power lines? The "smart" technology? The power sources? Each can add hundreds of billions of additional dollars to a total cost estimate. In its most basic form, the smart grid adds a computer cable to the electrical wire. With data points all along the system, computers can then manage the grid much faster and more efficiently than humans could.

There's also basic disagreement over what the grid ought to look like. How many miles of transmission lines are needed to access renewable energy sources, such as wind and solar? Where should those lines be, and what kind of terrain will they need to cross? And moreover, what are the goals — how much of the nation's energy will really come from renewable sources?

The cost can also vary depending on how long it takes to get the different components built. Public opposition and environmental concerns can add years to the building process and also carry the extra cost of litigation. A 90-mile transmission line recently built in West Virginia and Virginia, for example, was delayed more than a decade because of problems with the permitting process, costing the builders an extra $50 million.

Pretty much everyone agrees on one thing about the grid: It's not going to be cheap.



A Visualization of Our Current Power Grid

The American Society of Civil Engineers estimates that total needed investment in electric utilities could be as much as $1.5 trillion to $2 trillion by 2030. That would include money for energy generation (wind farms, solar farms, etc.) and all of the power lines to move the energy to your neighborhood.

To bring the numbers down to size, here's one that's a little more manageable: $250 — that's the amount it would cost to install a digital smart meter in your home or business, according to the Center for American Progress, a nonprofit think tank. Smart meters seem to be one of the first steps being taken in the arduous process of upgrading our power grid.

The smart meter can tell you how much energy you're using on a minute-by-minute basis, and it can give the utilities a better idea of their customers' needs. With about 140 million residential and small-business electricity customers in the country, that comes to a total of approximately $35 billion for smart meters alone. About 5 percent of roughly 140 million U.S. residential and commercial buildings currently use smart meters; 60 million to 80 million more could have them over the next five to seven years. In California, for example, over 10,000 smart meters are being installed every day.

President Obama initially wanted to use stimulus money to help install 40 million smart meters nationwide to help Americans save electricity and money (by the end of 2009, that number had dropped to 18 million, with $3.4 billion earmarked for meters). Even the Contrary Investor can do this arithmetic, and $3.4 billion is far short of the $35 billion needed. This is leading to utilities proposing surcharges and/or higher rates, which is predictably leading to consumer backlash.

In July, the town council of Fairfax, California, in the San Francisco Bay Area, unanimously approved an effort to stop Pacific Gas & Electric from installing smart meters, which relay detailed, timely data to utilities and consumers. Officials cited consumer concerns of inaccurate readings and complaints of sharply higher rates. Maryland's Public Service Commission in June denied Baltimore Gas & Electric's proposal for surcharges to cover an estimated $835 million to install smart digital meters for all residential and commercial customers.

In response, utilities and tech companies are stepping up efforts to educate consumers on smart grid benefits, similar to the conversion from analog to digital TV. As one industry analyst said, “three-fourths of consumers don’t even understand what a smart grid is.” And in some cases new rate plans that coincided with smart meters’ installation may have contributed to higher bills. All this notwithstanding, there are a host of firms seeking to cash in on this huge market opportunity.

Investors can look to industry giants like IBM, Cisco Systems, GE, Intel and others that sell software, network management tools and other products for smart grid systems. Another play might be the publicly-traded utility companies who will benefit from cost savings over the longer term. The Contrary Investor, however, is a high conviction, concentrated investor who prefers a more focused, “pure play” on this theme.

A stock we added to our portfolio recently is Itron Inc. (NASDAQ: ITRI). Itron makes smart meters, and they are selling a bunch of them. On July 12th, the company installed its one millionth smart meter for Southern California Edison. Interestingly, Itron also makes water meters that will address the replacement of our water and wastewater infrastructure mentioned at the beginning of this article.

The trade-off isn't between build this or don't build this. It's between build this or build something else.

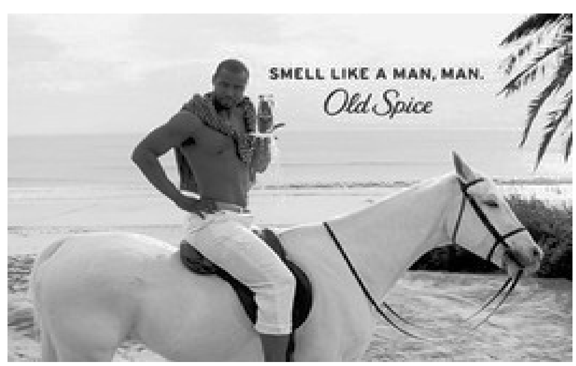
In other words, no matter the details on spending and saving, a major investment in an improved grid may be an unavoidable necessity — perhaps just part of the cost of doing business in America. It seems to be a matter of how one might want to play it!

- Alex Seagle

Clean Your Act Up!

The Contrary Investor recently saw an interview with New York Yankees’ pitching ace Andy Pettitte. Pettitte was announcing a major advertising gig he was undertaking for a men’s body wash product. Unilever’s Dove brand has actually hired three major league stars as pitchmen (along with Pettitte, slugger Albert Pujols and manager Joe Girardi), and these guys don’t come cheap! “What gives?,” the Contrary Investor asks.

The answer is that for the first time, sales of body wash have surpassed sales of regular bar soap in the U.S. The final push over the hump, apparently, was the development and marketing of body wash for men. Soap companies don't even advertise bar soap anymore, because body wash is so much more profitable. (the main ingredient is water). There are at present two big believers in the trend: Unilever (Dove brand), and Proctor and Gamble (Old Spice and Gillette).



Since mass-market body wash was introduced to women in a big way in the mid-1990s, sales have soared. For the year ending Jan. 24, U.S. sales of body wash hit $757 million in food, drug and other mass outlets, slipping past deodorant and non-deodorant bar soap sales of $751 million, according to Information Resources, a Chicago-based market research firm. The battle for men is just beginning.

The winner might be determined by who understands the nuances of the purchasing decision for body wash. Men may not care about shower-time routines. But women, who do the majority of household purchasing, will buy a "male" body wash for their main squeeze as a recession-era treat. Or perhaps each shopper will pick up a bottle for her guy so, come shower time, he'll keep his wet mitts off her products. P&G's Old Spice brand is clearly the most-focused on marketing to women (see past articles on "womenomics"), so therefore should come out of the starting gate first.

But Unilever has had great success selling its Axe body wash, sprays and fragrances to teens and college kids. For the middle-aged married types, they are instead promoting Dove Men + Care body wash, advertised during the Super Bowl.

In an investment environment that might favor safer, large cap consumer names, incremental profit gains will be important. The Contrary Investor (who by the way has never used body wash, with the exception of his stays at the Basin Harbor Club for the Contrary Opinion Forum, where there is no bar soap) was astonished by the size of the market — approaching $1 billion a year — as well as the profit margins on this stuff.

I happen to think a bar-soap guy is one who really smells like a man, man. But P&G and Unilever, eager to get guys to trade up from low-margin offerings, want to put a stop to low-maintenance personal-hygiene practices. It seems the only thing one can count on is that things will change!

- Alex Seagle

Time for a Vegemite Sandwich?

By and large, investors don't have a lot of exposure to arguably the best-performing equity market over both short and long time periods, and just who that market is might come as a surprise.

Dollar-based total returns of Australian shares have consistently outperformed developed equity markets across the globe. Through 1009, MSCI reports the Australian market soared 95% in 2009. No other market did better. The same holds for the trailing three years, with Australian stocks averaging annualized returns of 7.49%. Five-year annualized returns of 14.04% were bested fractionally only by Spain. Over the last decade, Australian stocks again led the way, averaging total returns of 13.99%.

In contrast, both the MSCI US and EAFE indexes pale miserably over the comparable period. Domestic 1-, 3-, 5-, and 10-year annualized returns were 23.93%, -5.27%, 0.74%, and -0.64%, respectively. Foreign market returns weren't much better: 43.57%, -

-3.79%, 5.38%, and 2.84%.

"Australia's economy has been broadly protected from the economic storm raging in the rest of the world," reports the Economist Intelligence Unit. While jobs have been disappearing at an alarming rate across many developed markets, Australia's unemployment rate of 5.7% has increased by only 1.5 percentage points over the past year and has remained flat since June. The EIU reports that house prices in Australia have barely budged from historic peaks in 2007. With virtually no subprime exposure and loan arrears remaining small, the country's banking system has held up well, having remained profitable throughout the financial crisis, enabling lenders to lend.

"Most important," notes the EIU, "the country's trading position with Asia, and especially China, is flourishing. China, where growth is booming again, is now Australia's largest trading partner. Exports of raw materials have grown from 20% of Australia's exports to more than 40% in the past decade."

The country is unique — a huge, mineral-rich, economically diverse land mass hosting a small population of just 22 million people that's complemented by well-capitalized banks. Four of the world's large AA-rated banks are Australian. The country enjoys a strong corporate governance and regulatory environment that support an efficient, established marketplace. Another compelling aspect of the country is its competitive standing globally. In its latest review of the quality of the business environment, the EIU ranked Australia seventh, six notches ahead of the U.S.

Despite all of the country's positives, most globally diversified investors have only limited exposure to Australia. Investors who have purchased the international index, EAFE, have been provided with only about 8% exposure to Australia. When relying on the MSCI All World Country Index, exposure falls to about 3.5%.

The Australian stock exchange is dominated by three sectors: Finance represents 27%, materials 23%, and consumer staples 14%. Within these groups, Australia has a number of industry leaders, many of which trade in the U.S.

BHP Billiton is the world's largest and most diversified resource company. It produces petroleum, aluminum, copper, gold, iron ore, coal, nickel and diamonds. Its earnings and stock price have been growing at a nearly 30% and 26% annual clip, respectively, over the past five years.

Macquarie Group is one of the world's most innovative investment banks. With a focus on infrastructure, the bank specializes in buying assets around the world and setting up specialized funds that eventually hold them. While shares got slammed by the banking crisis, they've rebounded close to their 52-week high. The reason is that the bank has been free of unusual provisions or write-downs. It hasn't been exposed to problem trading or poor credits. Macquarie's "risk policies are closely aligned with those of Goldman Sachs, which has provided added confidence in its management and risk policies.

These are just two examples of solid companies in Australia, both of which boast excellent dividends (a trait common to Aussie equities). Australia is not a panacea for market risk, but the rapid recovery of its equities and currency speak of Australia's underlying strength. With most market observers believing that emerging markets are going to be one of, if not the strongest sources of growth going forward, achieving this exposure through the security of a strong developed market may be the safest way ahead.

- Alex Seagle

Words to Consider

Knowledge speaks, but wisdom listens.

~ Jimi Hendrix

It is almost impossible to remember how tragic a place this world is when one is playing golf.

~ Robert Lynd

If you had to identify, in one word, the reason why the human race has not achieved, and never will achieve its full potential, that word would be 'meetings.'

~ Dave Barry

Economic advance is not the same thing as human progress.

~ John Clapham

Life forms illogical patterns. It is haphazard and full of beauties which I try to catch as they fly by, for who knows whether any of them will ever return?

~ Margot Fonteyn

I don't know where I'm going from here, but I promise it won't be boring.

~ David Bowie

I believe, along with many others, that you must first ask for what you want before you can have it.

~ Wally "Famous" Amos

Often undecided whether to desert a sinking ship for one that might not float, he would make up his mind to sit on the wharf for a day.

~ Lord Beaverbrook

You don't adjust. You just dominate.

~ Al Davis

I never learned from a man who agreed with me.

~ Robert Heinlein

A good newspaper is never nearly good enough, but a lousy newspaper is a joy forever.

~ Garrison Keillor

I guess you could write a good song if your heart hadn't been broken, but I don't know of anyone whose heart hasn't been broken.

~ Lucinda Williams

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