

MARKET CALLS

Theme Song: It Jihad To Be You

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In investing, there is nothing so powerful as a theme whose time has come. If you get the theme right you can make a lot of other mistakes. You can get your timing wrong. You can get your stock selection wrong. You just have to get the theme right, and all your sins will be washed away.

And, amazingly, it doesn't take a genius to get the theme right. Believe me, I know, because I'm no genius. And I got just about everything wrong when I put what I call the model **Jihad Portfolio** together on September 28. But I got the theme right, and it was obvious: **defense**.

As of yesterday's close, the Jihad Portfolio was up 21.24% over its life of a little more than two weeks. That's far better than the S&P 500, up only 3.47% for the same period -- and after yesterday's drubbing, it's pulled way ahead of the NASDAQ 100, too, which is up 12.53% for that period.

Here's a snap-shot of the Jihad Portfolio as it stood at yesterday's close.

Symbol	Name	Price	Cost	Weight
ABGX	ABGENIX INC	27.85	22.70	11.0%
ACAM	ACAMBIS PLC	36.35	22.76	13.2%
BA	BOEING CO	33.70	33.50	28.4%
BEAV	B.E. AEROSPACE	9.17	11.14	1.7%
BREL	BIORELIANCE	27.50	13.95	16.1%
CBST	CUBIST PHARM	36.81	33.00	9.1%
GILD	GILEAD SCI	59.88	56.60	8.4%
ICTS	ICTS INTL NV	7.26	9.78	1.5%
INVN	INVISION TECH	13.47	9.80	2.8%
MAGS	MAGAL SECURITY	10.99	9.10	2.4%
PLCM	POLYCOM INC	31.70	32.23	2.9%
VSNX	VISIONICS CORP	13.85	12.25	2.3%

It's all about themes. And over my twenty-five years of participating in markets, I've seen some great themes come and go. When I started in the late 1970s it was the gambling stocks, set on fire by the introduction of legal gaming in Atlantic City. In the later 1970s and early 1980s it was gold and natural resource stocks, ignited by the oil embargo and the hyperinflation of the dollar. In the mid and late 1980s it was takeover stocks, launched by deregulation of industry and the

introduction of high-yield bonds as a financing vehicle. And, of course, in the late 1990s it was Internet stocks.

The art of it, of course, is to buy into a theme reasonably soon after it first comes and get the heck out before it goes. Like a Roach Motel, it's easy enough to get in -- but getting out is the tricky part.

It's easy to get in because great themes are potentially evident to anyone who reads a newspaper. They are usually driven by some macroscopic political or technological shock that everyone knows about -- a sudden large-scale change in the normal order of things that arbitrarily redefines what it means to be a winner or a loser.

The September 11 terrorist attacks are a perfect example. Commentators started talking about defense stocks while the World Trade Center towers were still standing. It really *was* obvious that a whole new order to things was at hand. And when the markets re-opened, if the emergence of the defense theme wasn't obvious from reading the headlines, it was surely obvious from reading the tape. From the opening bell defense stocks rocketed while the rest of the market cratered.

Even though the emergence of a powerful new theme like this is obvious, there are still plenty of reasons why investors might not jump on the bandwagon. In this case, one powerful reason was that most investors were so scared or grief-stricken that they didn't want to think about stocks at all, and if they did, it was probably to figure out which of their bleeders to sell. So in one sense it was theoretically easy to pick the new winners from the new order of things post-September 11 -- but to do that, as a practical matter you had to force yourself to see beyond your shock, and beyond the losers on your books.

Another deterrent to jumping on a theme bandwagon is the particular curse of people like me who tend to over-think everything. When something is obvious, it's *too* obvious. And I'm much too sophisticated to do the obvious, right? Right. I'm so sophisticated I have to sit there for two weeks while the obvious gets so *painfully* obvious that even a sophisticated brain like mine has to acknowledge it. And, of course, by the time *that* happens I can delay even further by torturing myself about whether it is too late already. It took me two weeks to overcome my sophistication, and I left lots of money on the table.

So for whatever reason, chances are you aren't going to get into a theme on the first day. But let's say that, like me, you manage to overcome your losses and your sophistication and you finally get on board. If you've picked a truly powerful theme, that's okay -- it probably still has lots of room to run. Now the trick is to *let it run*.

Even the most powerfully rising tide is made up of hundreds of waves breaking on the beach, one at a time, and then each one pulling back before the next one rolls in. The risk is in focusing on the waves, not the tide -- and a great theme is a tide, not a wave. Every time there's a pullback in your theme stocks you'll want to sell because you'll be worried that it's all over. And every time there's another surge you'll want to sell, too, because you'll tell yourself that it just can't get any better.

But with great themes it *does* just keep getting better and better. With great themes you have to not only buy pullbacks, you have to buy rallies, too. *You just have to buy*. Because when the order of things is radically transformed, nobody ever expects the true scope of the transformation. You've managed to get in, and someday you'll have to get out. But *until* you get out, you have to *stay in*.

Certainly it's extraordinary that **Bioreliance**, one of the Jihad Portfolio stocks, a company that makes smallpox vaccine, has more than doubled since the portfolio bought it just two weeks ago. When they preannounced a blow-out quarter on Monday they were careful to say that they have no idea whether they will truly be a beneficiary of the war on terrorism. But if they *are*, this company that makes vaccine for a disease that theoretically doesn't even exist anymore could be a ten-bagger. Just in the right place at the right time. That's the power of themes.

They're not *all* going to be that good, but the rising theme tide lifts most theme boats. The closer to the theme, the more the lift. So it doesn't pay to get too clever: just stick to the theme!

For example, of the eleven stocks in the Jihad Portfolio, all but three are winners at this point, and the two losers are ones where I tried to get too clever. The three losers are **BE Aerospace**, **ICTS International**, and **Polycom** (which only joined the portfolio yesterday). BE makes cockpits and interiors for commercial jets, and ICTS provides airport services. Both have opportunities in a world at war with terrorism -- bullet-proof cockpits, enhanced airport security services, and so on -- but defense is a sideline at best for these companies, and their core businesses are badly hurt by the slowdown in air travel. I picked them precisely because they were dark horses, and their stocks hadn't run up after September 11 like the pure plays had. Next time I'm just going to keep it simple, stupid!

Polycom is new, and has yet to play out. It's not a "defense stock," but it is poised to take advantage of a world in which a war on terrorism is going on. They are the leading manufacturer of equipment for "telepresence" -- fancy word for conference calls and video-conferences. In a world where it's so much costlier and riskier to travel, Polycom's equipment will find a whole new market.

Now that we've talked about getting in and staying in, it's time to talk about *getting out*. Make no mistake about it, that's the hardest part. And it's the part where you can give back all your profits *or more* if you don't get it right. If the sudden collapse of the Internet theme in 2000 and the networking theme in 2001 didn't prove *that* to you in technicolor and 3D, you should most assuredly have your pulse checked by a professional as soon as possible.

There are no foolproof "when to sell" rules with themes, any more than there are with individual stocks. But I think I can give you two important principles to work with, based on my experience with themes in the past.

The first is: just as a theme emerges to begin with as the result a shock imposed by political or technological change, a theme can be ended by similar counter-shock. For example, the takeover boom of the 1980s was enabled by the rise of high yield bond financing pioneered by **Michael Milken** and **Drexel Burnam Lambert**. Milken and Drexel were driven out of business by criminal investigations, and the junk bond market was demonized by the media and politicians. With this source of financing impaired, the energy source behind the theme was removed -- and the theme collapsed in the "mini-crash" of October, 1989, when the leveraged buy-out of **United Airlines** fell through. Themes live by the news, and they die by the news. So follow the news.

The second is: even themes that are not terminated by adverse shocks eventually become fully exploited in the market. The conventional wisdom is that this is revealed by frenzied speculative activity by individual investors. But from what I've seen, themes often have a long way to run even after they've been heavily invested by individuals -- just remember how long and how far the Internet stock theme carried, well after it was thoroughly adopted by amateur investors.

I think the truth is that themes tend not to top out until *professional investors* get sucked in. And you see *that* happen most vividly in large corporate transactions, as stodgy companies who were left standing at the station when the theme-train pulled out finally decide to get on board. Consider: the Internet theme finally topped out within days of the announcement of the merger of **Time Warner** and **America Online**. And the defense theme will top out when some huge non-defense company pays an investment bank hundreds of millions of dollars in fees to pull off a mega-transaction (the press will call it a “blockbuster,” as always) to merge with or acquire a defense company.

So until that day arrives, don't be afraid to do the obvious. Just remember the party scene in **The Graduate** in which an obnoxious man intones to **Dustin Hoffman**: “I just want to say one word to you. Just one word... *plastics!*” Crude, but effective -- for the time, *that* was theme investing. Today, the best offense is some good defense stocks.