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The Rationale of Hope...A Conversation with Jeb Terry

First the obvious. The bear case is conventional wisdom. We are living through a racking period of debt liquidation in a country that has lived beyond its means and allocated its cash flow abysmally. \$1 trillion blown up in Iraq, hundreds of billions of dollars sent overseas every year for oil that we burn, while the cash that we pay for oil funds our enemies. Then we round up whatever cash is left, plus whatever we can possibly borrow, and build houses we don't need and can't afford. These are all extremely low return investments. (Okay, there is a psychic return on home ownership!) Now combine all that with underfunded and corrupt pensions, runaway medical costs and associated unfunded future liabilities. Finally, we are witnessing a precipitous decline in basic civic virtue. Rather than carrying out the fiduciary duties that they have agreed to perform, countless corporate board members, executives, elected officials, trustees, etc., operate under the mantra, "First, I'm going to get mine."

According to its many critics, the Administration's response to the current financial crisis is "too little too late", or highly inflationary, or proof that we are now a communist country, or some combination of all three. It is all pretty bleak. It takes a true contrarian to see a way out of the mess we are in. For some time now, I have had a few theories on how we get out, beginning with American Exceptionalism – "When the going gets tough, the tough get going". Adam Rowe expressed the theory as follows:

"Problems of this scale are nothing new to America, nor, indeed is our tendency to despair before them. America's resiliency has never seemed inevitable to the generations that eventually summoned it. Before the Miracle at Philadelphia, the American Union seemed doomed to fail beneath an inadequate government no one was willing to change. Gloomy predictions that American exceptionalism has run its course, that prosperity, as Edward Gibbon once put it, has ripened the principle of decay, is a reoccurring American theme. These predictions usually signal that those national qualities that have served us well in the past, though sorely missed, are emerging once again..."

"Because we always have" is a strong though not completely satisfactory assurance that the United States will emerge from the current mess stronger than ever.

ENTER JEB TERRY

Jeb is an old friend with a lot of theories. As we talked, I realized that he was enumerating a few of the missing pieces to the bullish puzzle, prompting me to turn on the recorder. To follow is an edited version of our taped conversation.

Hybrid Vigor

SR: I had fun talking to your “petite” son, Jebby, a few weeks ago. He’s smart and enormous. Isn’t his size a reflection of one of your theories on our economic prospects?

JT: (Laughing) ... You have to understand that my “theory” is cocktail party talk and completely tongue-in-cheek. If anybody I don’t know sees this, please do not for a minute think that I’m some crazy amateur geneticist... And I don’t think of myself or anyone in my family as a cow. Anyway, my son is 6’6” and weighs approximately 320 pounds, whereas I’m not a small man but only 6’ 2” and my wife is 5’ 8”. So the question we often get is how did we have such a large offspring? To that, my answer is that he is the classic example of hybrid vigor.

Hybrid vigor is something that those in the cattle and horse breeding businesses would know. If you take a cross of two breeds, the first cross offspring exhibits positive traits of the parents. So that phenomenon is hybrid vigor. My wife is Yugoslav and I’m Scots-Irish, hence two unrelated gene pools combined and there you have it... hybrid vigor.

SR: So hybrid vigor has allowed Little Jebby to knock heads in the NFL for six years and get accepted at Wharton. That’s great stuff, but it also fits into your macro theories on the world.

JT: My wife’s parents came to the United States after WWII. Her dad spoke five languages and her mother spoke seven languages. They met and married as war refugees fleeing the Communists. After living in Italy and Paris, they came to Texas in 1952. Their story has been repeated millions of times. The United States has had the incredible advantage of introducing new genes and talents, experiences, and knowledge to the population, making the country as a whole a stronger and more vigorous population. By definition, those that come here in that fashion are the most aggressive and most success-seeking out of their “tribe” and that’s an enormous benefit we have. The value of the mobility of labor and capital cannot be overstated. The influx of talent and movement of people within the United States provides us with a continuing source of hybrid vigor in our economy and society.

Immigrants come from tribes. They bring the best of the tribal customs and adopt those things that are better in the society that they join. So, if one goes to Europe and traces one’s heritage to whichever part of the world you’re from, you’ll discover that that genealogy traces back to a village which traces back to a tribe where, for thousands of years, they married within the same “county”, if

you will. Large scale population movements triggered either by natural or economic calamity or war have launched periods of above average growth in the past and now should be no different.

SR: So, sociologically, biologically, and geographically, the population of the United States is uniquely suited to prevail in the modern world – is that fair?

JT: I think that's very fair. I think the missing ingredient when people measure aptitude tests and things of that nature is it's hard to measure adaptability or a tendency to innovate, and that's where the United States is strongest.

SR: And that, of course, is a function of our individual freedom. Where I think we're headed is building a fairly bullish case beginning with point one, which is that we have this sociological, geographical, and biological advantage just because we're the mixing ground. In fact, I've heard people talk about how amazing it is to go to the Olympics, and you go to the Russian village and they look like Russians, and you go to the Chinese village and they look Chinese, and then you go to the American village and it looks like everyone rolled into one.

JT: That's right. Something else to think about is the constant influence of different cultures that keeps us off-center a little bit. In other words, it's hard to stay in a rut when constantly introducing change.

Flow of Productivity: Moore's Law, Metcalfe's Law

SR: We get the best customs and values that come here – that's good – let's move on. We've already made the negative case. Is there a positive spin on the bearish case I described at the outset?

JT: Absolutely there is. People never fully understand that our economy is highly dynamic. I call that dynamic "flow". The part of the analysis that is very bearish, tends to be static and in a paradigm of scarcity. "There ain't goin' to be enough oil, or there ain't goin' to be enough capital, or corn" etc., etc. –

SR: Good news is always a surprise. But that isn't the point I want to lead you to. I just gave you the half-empty case. What is the half-full case?

JT: That is the point . . . it's not whether it is full or empty. It is self-correcting, thus is always filling. Back to the flow sense. If one said "We've over-levered on real estate" what we've missed is that what funded all that was trillions of dollars of free cash flow that is still there but will be directed elsewhere. Now it will be directed to more productivity enhancing endeavors. Somebody bought all that awful paper in search of a return. Now much of the \$9.4 trillion sitting cash in the U.S. will search for returns from new sources other than real estate.

SR: It is amazing that our economic system is still working at all after absorbing as much abuse as it has.

JT: That's right – but see, at its very essence, capital is something that is not finite. Capital grows. So if we think of our economy as a mix of people, productivity, and capital, we haven't changed the people part of it – the people part of it remains extremely positive and the productivity element is still generating a better livelihood for everyone - only now with more urgency. The capital part is both a derivative of and a boost to productivity. Even though we've vaporized a lot of capital in the context of mark to market valuation, that is a backward-looking concept. Looking forward we have ample seed capital and the financial infrastructure and intermediation technology to stimulate growth.

SR: And in fact technology creates time and space to think up even more useful things. Plus, I agree that there will be plenty of capital for the next big idea. Let's hope it is a good one. Isn't Moore's Law something that you frequently talk about? What is it, and how does it apply to our discussion?

JT: This is all part of the digitization of American culture and business – that we're benefiting from the powerful combination of two core laws – one being Moore's Law, expressed by Gordon Moore, a founder of Intel. He stated in the early sixties that in the context of developing microchips, every 18 months you would see the speed of the microchip double and it's costs drop by half.

SR: And that leads you to your paradigm of scarcity versus abundance.

JT: Yes. And so, as those prices drop, now all of a sudden people are applying more and more of those chips into more and more of those smart devices that are permeating our daily experiences. The second law that interacts dynamically with Moore's Law is Metcalfe's Law. Metcalfe is the guy who invented the Ethernet – he's alive today and lives in Boston. His notion is that the value of a network - think cell phones for example - is a derivative of the square of the number of nodes in that network.

SR: Okay, so what does that mean?

JT: If you had two cell phones, being only able to talk to each other, that would have a fairly low value. But each time you add a user, the value squares. So if you go to four to ten to today, something in the order of over four billion cell phones, all communicating with each other, the value of that network – the ability to transmit information over that network – expands exponentially. And that is why we see an explosion in the value of network – centric businesses who are simultaneously benefiting from Moore's Law. This means that the cost of delivering those services – computers, memory, all the hardware, continues to drop rapidly while performance gets better and faster.

SR: So you get Metcalfe's power of the network, and the power of Moore's Law at the same time.

JT: Those two elements together put productivity in hyper-drive – it's productivity on steroids.

The Paradigm of Abundance versus the Paradigm of Scarcity

SR: That's neat. That all flows into the paradigm of abundance, as opposed to the paradigm of scarcity, as I've heard you put it. What about your ghost town analogy?

JT: Borrowing from George Gilder...If you think about it, all ghost towns are what is left over from economies based on scarcity. If you had a town built around a gold mine and there's no more gold, there's no more reason for that town. But if you think of the great cities of the world, they're all about abundance – London, Paris, Hong Kong, and New York are not so much about the scarcity of goods, but the abundance and the ability to trade and engage in commerce and culture. So, those are centers of information and the ghost towns are centers of stuff, if you will. At the end of the day the ability to add sustainable value grows as the ability to communicate grows.

SR: So, in the United States, people are uniquely able to communicate freely?

JT: That is correct. The United States has an enormous advantage. Nowhere else in the world is there a fabric of roads, railroads and telecommunications capability as extensive and developed as the U.S. that allows resources to be allocated and efficiently utilized. No other place on the planet brings all this together as dynamically and powerfully as the United States.

SR: In August of 2007, I prematurely took to heart the economic / investment theory that David Richards had expressed in *Barron's*. The idea is that there is a new, even bigger industrial revolution taking place in countries like Brazil, Russia, China, India and Indonesia. 3.5 billion people are in the process of moving from farms to cities, creating a great business opportunity that would trump the problems that the financial nonsense our country was engaged in. In the long term the theory holds. But in the short term, the world nearly went broke. Meanwhile, the Americanized globalization opportunity is still out there and the power of communication, because of technology and networking, will accelerate the process if it gets started again. I might also add, that it offers the United States its best shot at digging our way out of the deep hole we are in. Realistically, I see it as the only way out. An important key to digging our way out, incidentally will be for investors, who have been particularly abused in this debacle, to demand accountability from corporate directors.

JT: In addition to the 3.5 billion people you just mentioned, consider that demographically, we're still in a sweet spot here in the United States. We've got the most highly educated workforce to ever walk upright on the planet engaged furiously in communicating with each other, and allocating their labor to those activities that give them the highest return – they're capable of getting on the internet, they're capable of finding where the jobs are and they go to those jobs or they create new ones. We have the most open and flexible system in the world.

Disruptive Technology

JT: Changing subjects for a moment, let's consider energy. There's a great book called *The Bottomless Well*, by Peter Huber. What I like most about the book is the concept conveyed by the title. The concept is that we've never had a "shortage of energy." The inexorable trend of any civilization is to always consume more and more energy because we want to avoid the use of our personal energy – you know, the sweat of our brow, our manual labor. At a price, multiple

alternative sources of energy become available. The thing we're struggling with now in the fossil fuel regime is that technological advancement is bringing down the price of alternative non-fossil fuel energy. That's a natural process – that's always ongoing. It's how oil disrupted the coal business and coal disrupted the wood business etc.. There always has been and will be ongoing downward pressure on the price of scarce resources, i.e. oil for example, as entrepreneurs develop technology to substitute abundance – think wind or solar power – for scarcity. It may take time but the outcome is assured.

SR: So, what about information and technology ?

JT: There's a continuous process of disruptive technologies challenging the status quo. Disruptive technology, as the term is used by Christensen, is an extension of the notion of creative destruction popularized by Joseph Schumpeter, the Viennese economist. Simply stated, his concept was that entrepreneurs are constantly out stirring the pot and finding new ways to create wealth. That stirring the pot process stimulates innovation – it is essential to the creation of new jobs and sustaining growth in the economy. It inevitably destroys old line businesses. The good news for the U.S. is we have lots of entrepreneurs. The willingness to disrupt the old and create the new is a core notion in the paradigm of abundance. Contrast for a moment our information based economy today versus the manufacturing and commodity based economy of the 1930's. Less than 10% of our workforce today is engaged in manufacturing or farming. Our recovery from the present recession will be faster than the 30's and it can happen with less capital as entrepreneurs leverage our store of intellectual capital. Think for example of our entrepreneurs such as Bill Gates at Microsoft sorting out that you can do something with software and create a massive company. By the way Microsoft was founded in 1975 as we were recovering from the then worst recession since the depression. Think also of Larry Page and Sergey Brin at Google who while at Stanford dreamed up the notion of a better search engine and created Google. Google also thrived during the tech crash and recession earlier this decade and went public in 2004. I believe the current recession will spawn an even bigger group of great entrepreneurial companies.

SR: So, as an investor, where does all this lead you?

America the Intermediator

JT: America is the world's great intermediary. We define the market for most of the world's goods, services and capital – we set the standards. In effect, we act as broker and principal in a manner that enables us to best combine talent, capital, and technology. That sets up economic growth. I believe that tremendous entrepreneurial growth lies before us and will be centered on technological innovation.

By way of example, if you have a company that owns a coal mine, the value of coal may go up and may go down with business cycles, but a ton of coal is always a ton of coal. In contrast, Google comes up with a search engine that is purely an intellectual enterprise that has created valuable services in markets that did not exist when it got started ten years ago. Another important point is that the Googles of the world can grow while producing capital instead of consuming capital.

SR: So, enough with the theory. How do we make money?

JT: Conventional wisdom today is that you add alpha (outperformance) through trading. Trading is a zero sum game. I believe that alpha comes from superior stock selection against a timely and valid, overarching, investment theme. The investment boom I see developing post the recent real estate bust will provide new funds with ample opportunities in healthcare, e-commerce and alternative and green energy. I do microcap technology companies. It is my conviction that you go after technology companies that are small, that are network centric in their business models, that harness Moore's Law and Metcalfe's Law. That means, they're going to have software. In today's world, there's a lot of chatter about cloud computing – software as a service – those things all make a ton of sense and I'm highly focused on those opportunities. The idea is to provide services in real time for customers over the internet as opposed to selling hardware and software for direct installation.

SR: Say that again. What about software?

JT: I want businesses that are going to harness this notion of cloud computing or software as a service. The companies' core value added is comprised of computing services delivered over the internet that help their customers do things better, faster and cheaper. The companies that I'm involved with are small and their stocks are too illiquid for me to talk about publically.

SR: So there we have it. If we are right on the incoming direction of the tide, your little boats and my big boats will all rise.

That does it. Thank you.

The End