

## Pulp Fictions

Few investors will ever match the long-term record of Peter Lynch at the Fidelity Magellan fund, not only in the money management, but in simple English as well. His maxim of “know what you own” is still one of the best distillations of investment wisdom ever.

Who doesn't know pulp and paper and the myriad useful products made therefrom? Firms such as Kimberly-Clark or Procter & Gamble have one of the greatest franchises in the world: Combine toilet paper and disposable diapers, and as REO Speedwagon would say, you can roll with the changes.

### If You Build It, They Will Ship

Pulp and paperboard long have been considered excellent coincident indicators of economic activity. If you make it, you have to ship it, and while the contents of a box change, the box itself remains pretty constant. The efficiency of producing these boxes has not improved much, as we can see from the Bureau of Labor Statistics' producer price index for converted paper and paperboard.

Efficient commodity markets are characterized by declining prices over time. While no reasonable person can expect Moore's Law to operate for cardboard boxes, we should expect their prices to decline as the Smurfit-Stones and Packaging Corporations of the world get better at what they do to halt the inroads of plastic and other packaging materials. This has not been the case for nearly two decades. Between the mid-1950s and mid-1980s, the PPI for paperboard rose more slowly than the general PPI. However, the cost of paperboard has risen more rapidly than other producer prices since 1983, and this signals a mature industry unable to improve significantly on its methods.

Premium of Converted Paper & Paperboard To PPI

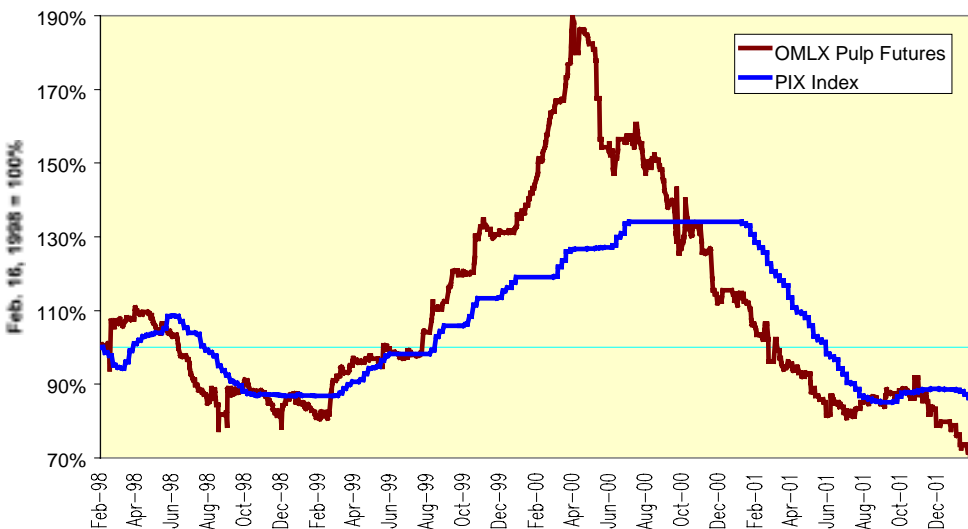


### Euro-Pulp: No Better Than Euro-Anything

What makes the inefficiency of the box makers – and I'm not referring to Dell or various combinations of Hewlett, Packard, Fiorina or Compaq here – so glaring over the past two years is how their raw material prices have plummeted, not only in the U.S. but in Europe as well.

If any of you have a strong opinion on the price of 24 tonnes of pulp, you can trade the futures in London on the Swedish OMLX Exchange. The nosedive these futures prices have taken recently is coincident with the global recession. The prices here and for the Finnish Option Exchange's (FOEX) PIX pulp index show no immediate sign of rebounding, which is consistent with a weaker economic picture in Europe than in the U.S.

European Exchange-Traded Pulp Prices



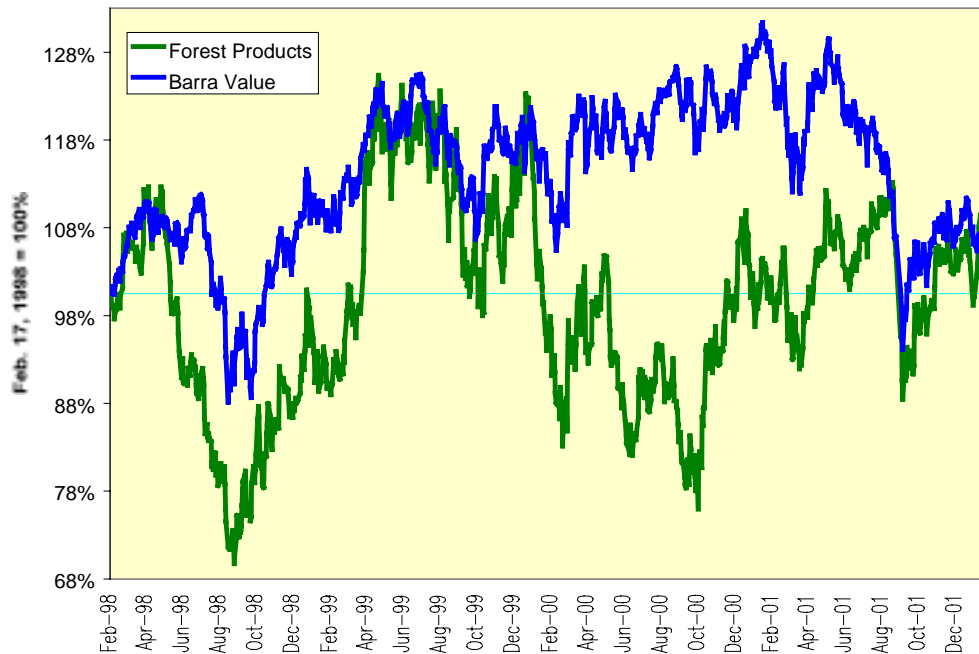
While there are no North American futures markets for pulp and paper, the European weakness is mirrored in the prices of U.S. newsprint. The FOEX index for this bulk commodity has lost 23% of its value since last June.

#### Urge To Merge Means Box Stocks Not Rocks

Students of industrial organization – and aren't we all? – should smell consolidation in the air whenever a mature industry is faced with declining efficiency. Mead and Westvaco merged recently to form MeadWestvaco. Upstream in the industry, at the forest management level, we see a pending takeover by Weyerhaeuser of Willamette Industries. Standard & Poor's celebrated the combination by downgrading Weyerhaeuser's credit rating to BBB, two ranks over non-investment status.

Perhaps due to an improving economic outlook and the continued disfavor in which technology and telecommunications stocks find themselves, or perhaps due to the prospect of further consolidation, the entire forest and paper products sector is performing well on a relative basis for the first time in years.

## Money Finally Grows On Trees



The 13-member Philadelphia Forest & Paper Products (FPP) index underperformed the broad market during the booming 1990s. Much of this underperformance was due to the strength of the dollar that accompanied most periods of strong economic growth (see "Paper Stocks Caught In Dollar Dilemma," August 1, 2000). While it might be easy to dismiss the rest of the performance gap as a function of the tech boom, the FPP even underperformed the S&P Barra Value Index during this period, as seen above.

Will the relative strength of the FPP continue, and will it get a currency kick? Given the opinion I've expressed that the dollar's strength is described best as the weakness of other major currencies, especially the euro, and that these currencies won't rebound until their economies do, it may be a tad premature to call an end to the dollar's strength. The U.S. is still ahead of the world in the economic recovery department. But, markets are discounting mechanisms, and the easiest profits go to those who are early.

If the index options on the FPP were more liquid, I'd suggest an intermarket call option spread of buying the FPP calls against a short position in SPX calls, but this trade is only for the brave. Instead, take a look at the charts of Abitibi-Consolidated, Bowater and Louisiana-Pacific within the index. And, on the pulp consumer side of the commodity equation, take a look at the aforementioned Kimberly-Clark. It's nothing to sneeze at.