Star-Telegram.com

Posted on Mon, Oct. 25, 2004

What deficit?

Outdated thinking prevents economists from seeing U.S. margin surplus in trade

By Cecil Johnson
Special to the Star -Telegram

Forget America's balance-of-trade deficits; the margin of profit over the cost of goods is the truest measure of trade, writes hedge-fund manager and former Wall Street analyst Andy Kessler in his latest book, *Running Money.*

Kessler, author of the bestseller *Wall Street Meat: Jack Grubman, Frank Quattrone, Mary Meeker, Henry Blodget and me,* acknowledges that his view on the trade deficits runs counter to that of most economists. But he maintains that economists are massaging the wrong data.

"Government statistics measure absolute numbers, hard goods in and money flow out. The 10,000-pound gorilla in the room is the stock market. Economists miss the most important statistic, profitability. That's all the stock market cares about, yet economists are shockingly silent on this statistic. Are they just stupid? Nah, they've just never run money," Kessler writes.

Most economists today, Kessler says, are products of industrial-age thinking, which they bring to government statistics. Those statistics, Kessler writes, do not adequately account for the fact that the United States is a huge exporter of such intellectual property as software, microprocessor and network architecture, semiconductors, optical and cellphone components and databases that can be licensed to others to build end products.

Kessler points out that the entire architecture of a chip that has generated $1 billion in sales can be e-mailed legally to, for example, the Taiwan Semiconductor Manufacturing Co. without ringing up a cash register or a Commerce Department statistician taking note of the export. That chip and other licensed intellectual property along with cheap labor and other low-cost-margin components are used to make laptops and DVD players.

A Toshiba laptop, Kessler writes, may contain a $300 Intel chip, which yields $250 profit for Intel and a $50 version of Windows, which yields a $49.95 margin for Microsoft. It may be sold in the United States for $1,000, but the maker and every other supplier involved will be lucky to make a combined $50 in profit off it.

Despite the net trade deficit of $650, the United States clears $300, while the rest of world gets only $50.

"Which economic system would you invest in? Yeah, me too," Kessler writes.

He admits to paradoxes in his position and goes to great lengths to try to resolve them. Some economists, of course, might suggest that he does not succeed. But Kessler says the actions of Wall Street and of foreign investors bear out his position.

He points out that capital "sloshes around the globe to seek its highest return" and that before long, the dollars that we ship out to pay for our laptops and DVD players and Mercedeses eventually return home.

"Economists may insist we are running a trade deficit, but in reality, we are running a margin surplus. In a world where money crosses borders faster than J-Lo goes through boyfriends, profits are all that matter. The margin of profit over cost of goods and services is the only true measure of trade. I will gladly trade you an idea I make $1 profit on for five widgets that you only make a nickel on," Kessler writes.

His reflections on U.S. trade deficits flow out of his experience running, with Fred Kittler, a relatively small but successful hedge fund and his comparative studies of the phenomenon of scaling during the Industrial Revolution and the new era, where intellectual property is the driving force.

He is encouraged in that intellectual pursuit by a mysterious Mr. Zed, a Swiss investor who provided Kessler with a major chunk of the capital to give his and Kittler's hedge fund a rolling start.

In his study of the Industrial Revolution, commencing with the invention of the steam engine, Kessler discerns how every improvement and enhancement of it generated economies of scale: lowered production costs for associated industries and businesses, drove down prices and increased wealth and employment.

When Kessler tells Mr. Zed how turbine engines and the Suez Canal drove transportation costs lower and lower, the Swiss gentleman tells him to forget about all that as well as about investing in ships, railroads, electric utilities, textile companies and automobile makers.

"The Industrial Revolution is dead."

Kessler insists that there are lessons to be learned from it. Mr. Zed responds: "Of course, you didn't waste your time. But don't think like an industrialist. Silicon Valley isn't an industry, it's a giant design shop, as far as I can tell."

Kessler, who has lived in the Silicon Valley area since 1993, devotes most of the rest of the book to rounding out a theory of wealth based on his study of the new information economy and his dealings with the companies involved in that industry and the people who invest in them.

A book about hedge funds, which require an investment of at least $1 million, might not attract a wide audience. But this book is studded with so much wit and so many interesting profiles, historical observations and thought-provoking ideas that it is worth anyone's investment in the time to read it.

Running Money: Hedge Fund Honchos, Monster Markets and My Hunt for the Big Score

By Andy Kessler

HarperBusiness 320 pages

$24.95

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