

With Charles J. Hess of Inferential Focus

By Brooke Southall

Most chief executives are whip smart, but they can't always see the forest through the trees.

That is why Charles J. Hess, 55 — who can see the big picture — and the company he founded, Inferential Focus, are paid big bucks, an annual fee of between \$40,000 and "hundreds of thousands."

He has spent 25 years creating research based on the careful reading of hundreds of newspaper and magazine articles. This approach helped him alert clients to the financial meltdown later known as the "Asian Flu," the realities of terrorism and the pricing shifts in the oil industry.

Such insights have won New York-based Inferential Focus a following among decision-makers at financial giants such as American International Group Inc., Citigroup Inc. and Goldman Sachs Group Inc., all of New York, as well as Fidelity Investments of Boston. Mr. Hess also counts many smaller financial advisers as clients.

"In working with [Mr. Hess] over many, many years, I would say his gift is his ability to see the order in what appears to be chaos," said Kevin J. Bannon, chief investment officer of The Bank of New York Co. Inc.

Q. What is your edge in gathering useful intelligence for investors?

A. The method actually goes back to low-tech ways of getting information. I think there's a big change in the investment business that's impacting a lot of our clients. Getting some intelligence or a bit of information before the competition and being able to move on that — it's been effectively weeded out of the environment. So we do what people have done for a long, long time and that is try to get information you can rely on, and for us, those are events, and put those together in such a way that you get a picture of what is developing before it's well recognized.

Q. So what is an "event"?

A. An event is something like, Russia announces that they're going to do military exercises with the Chinese for the first time since 1958 this summer.

Another event might be, within the same context, that India changes their parliamentary restrictions and allows their oil minister to negotiate with Iran without restrictions. Those are two events, for example. And we try to accumulate a lot of little observations and put them in the right configuration to get us a picture of what's developing.

Q. How do you identify these events, and how do you determine which ones merit attention?

A. We read 353 journals and newspapers and, in a very disciplined way, we extract all of the opinions, all the commentary from the writers.

Every couple of weeks, we'll get together, the six of us who do the reading, and we'll have a stack of five or six inches of paper among us. We'll eliminate almost all of it and maybe come out with something to comment on.

Q. How do your reports differ from those of your competitors?

A. A lot of research organizations ask people things, and they respond to the responses. So they'll do polls, they'll do surveys, they'll go to corporate management, ask them what's going on, what their earnings projects are, and work off

SnapShot

Charles J. Hess, 55, president of Inferential Focus in New York since 1980

Education: bachelor of arts degree in political science from the University of Rochester (N.Y.), 1973

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of that. That, to us, is processed information.

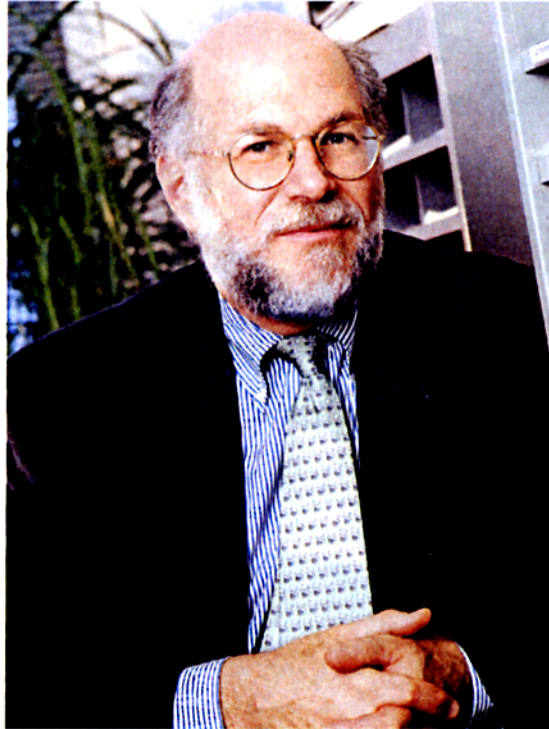
So we go back to the raw information, which is something that we can rely on. Actions speak louder than words.

Q. Then I guess you face the irony of having to turn around and process information. So how do financial companies use your expertise, and of what does it consist?

A. They use it to recognize a new situation. I was alluding to something we've written about recently, the very aggressive actions on the part of China, Russia and India getting together and creating what we call a "triumvirate." That's typically not what a China expert, what an India expert, what a Russia expert or a management investment strategist would be talking about. So we try to see out in the world what's occurring early and then migrate it to what it means for investors, for corporations, for the government. Those are our three basic client groups. We bring them whatever we find.

They don't tell us, 'we're interested in natural gas; go tell us what you know about natural gas.' We just discover what we discover.

Q. What have been some of your good discoveries in the past that have defined your success?



A. It's a long list. We started the firm in 1980, so it goes back a long way. Some of the most notable ones [include] the Asian flu, which surprised the financial markets in 1997 and 1998. We really had been warning about that for six months before Thailand devalued, and then we helped clients manage it as it progressed.

Q. Any more recent than that?

A. We saw something we called "World War III." And in September 2000, a year before 9/11, we wrote about the terrorist threat that we inferred was out there, that was not being recognized by the intelligence organizations. And with that, World War III to us was the dangers of permeable borders. Terrorism, physical incursion on borders was an obvious one, but it included everything from the record industry, the audio industry, not being able to protect their copyright borders of their records. So World War III became a very big context.

What that created, which became very important just as a timing issue for the investment world, was fear. As this developed, and of course as 9/11 occurred, the reality of borders not being able to be protected created an increase in fear, which we tracked through the end of 2002 and suggested — actually coming into 2003 — that the fear

had peaked.

With that decline in fear, what we suggested was risk premiums collapse, the stock market in fact does a lot better, earnings do a lot better. The beginning of 2003 for investors was an important time to be invested, when there was a lot of fear out there.

Q. When I spoke to you two years ago, you predicted that the housing boom would continue. You were right. But I understand that your view has shifted and evolved to encompass global implications. What's changed?

A. Speculators, or they're called "investors" by the realtors, are able to use new instruments — interest-only mortgages, 100%-plus financing in some cases. The Realtors Association says [that] last year 23% of all purchases of homes were by investors. That's a new variable.

Q. But you say that housing depreciation might be the least of our worries?

A. The real important part of the housing industry was the effect on the economy.

Some figures will say \$660 billion was pulled directly out of the home in home equity loans and cash-out refinancing. Money literally came out of the increased equity value of the home in the last two-and-a-half

years, a significant amount. That, we think, explains the anomaly of consumer spending right through very low growth in their income.

We think that, in fact, real estate is actually driving the economy. And we're suggesting to clients that it's not only key to our economy but key to foreign economies.

Let me just draw a couple of implications. Housing stock would obviously be hit if housing started declining. But the less apparent implications are things like basic materials and basic industries in China slowing down. Because we think the link is now very firm between the housing market and the U.S. economy, which still is the major economy for China, even though they're trying to diversify.

Q. Who are your customers?

A. They range from very large, like Citigroup and Bank of America [Corp.], to smaller companies like — I just met with a client up in San Rafael, [Calif.] called Eastbourne [Capital Management LLC]. They manage about \$2 billion for, in some cases, some small high-net-worth managers, investment advisers. There's one up in South Burlington, Vt., Paul Financial Services Inc. [with \$50 million under management] that we work with. It's another money manager. It ranges from the biggest to the smallest.

Q. So are you finding a growing market for the types of intelligence that you sell?

A. I think there's an inflection point toward recognizing that they need to do something differently than they've done for the past 50 years or so, which is basically rely on processed information. You see it in a marketplace, where hedge funds are taking greater risks because they can't get the performance that they expected or that the clients expected. And that's partly because of the efficiency of the market. They're not getting the advance warnings that they could play as easily.

Q. Can you share any concrete investing themes based on events you observe?

A. It's not, per se, the oil prices. It's really the shipping of oil. Turkey has changed the rules for ships going through the Bosphorus and Dardanelle straits. And that's something that's started to spread, and it's related to security, and not just terrorism, but just security in shipping. And so they changed the rule that mandated that all hazardous materials be shipped only during daylight hours. They spread the distance between the ships that go through the straits. What had been a 12-day round-trip from the Mediterranean to the Black Sea is now up to 44 days.

That's not going to go away if oil prices go down. So we'll need more ships, and the time to ship is going to be longer, so the costs will go up for the shippers. But it's good for the shipbuilders. And again, whether we go down to \$35 or \$30 a barrel, that security issue is not going to go away with lower prices.