How the mighty have fallen

In case you haven't been reading the newspapers or listening to the radio, the seventh-largest company in the United States — and considered by many to be one of the most innovative — has just been brought to its knees, if not to its final resting place.

ROB RIKOON

Real Money

Enron Corp., based in Houston, grew from being a distributor of natural gas and a utility company to become the world's largest trader of electricity and natural gas. The company also became a huge telecommunications firm, a paper and lumber trader, and one of the largest insurers in the United States. It had more than $100 billion in revenue last year. The collapse of Enron has caused, and will continue to cause, huge aftershocks in many of the nation's industrial sectors.

In this column, I would like to put the scope of the Enron disaster in nontechnical terms and then go down a partial list of who was duped by what looks to have been the biggest con since the tax shelters of the early Reagan years. How this catastrophe came to pass and what it means to individuals like you and me are questions that naturally come to mind. As you hear Enron being talked about, this should give you a context to develop your own opinion.

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Enron Corp. employed more than 21,000 people. Three-quarters of its employees kept all of their retirement savings in Enron stock, which went from a high of $90 per share last year to less than $1 last week. At its peak, Enron had a paper value of $67 billion, which stands now less than $1 billion, for a $66 billion loss of value in less that one year.

To help put this into perspective, the total claims for the World Trade Center terrorist attack should be approximately $20 billion. An additional $20 billion or so may cover the damage done to adjacent real estate,

Please see **RIKOON,** Page D-2

RIKOON

Continued from Page D-1

usiness operations, etc. The
oss to New York City's and
he U.S. economy at large is
ard to quantify, but let's use
n estimate of an additional
20 billion. This all adds up
o $60 billion, so it is likely
hat the economic magnitude
f Enron's collapse is similar
o the Sept. 11 tragedy.

The list of players who
ere drawn into the
idespread, tangled web of
nron's activities reads like a
Vho's Who of American
nance. The answer lies in
he inherent conflicts of
nterest present in this situa-
on. Two banks, J.P. Morgan-
hase and Citibank, came to
nron's aid within the last
onth to pledge $1.5 billion.
hevron-Texaco stood behind
ynergy, the short-lived
hite knight of Enron, to the
ne of $3.5 billion. Several
f the nation's largest mutu-
l-fund operators, including
lliance Capital and Janus,
ode Enron's stock all the
ay down into the tank.
here are, of course, many
ndividual investors and
nstitutional investors,
ncluding our own firm, as well as retirement plans and less well-known mutual funds who were drawn into the morass.

How could this happen? How could Arthur Anderson, with some of the smartest accounting minds in the country, or Standard and Poors, whose entire business mission is to look past superficial financial presentations in order to analyze the underlying strength of companies, be duped by Enron?

The firms that were charged with responsibility for overseeing the truthfulness of Enron's financial statements have been brought into the fray. Arthur Anderson, one of the world's largest accounting and consulting firms, overlooked, or perhaps as some people think, failed to look at basic accounting errors. It is easy to think that Anderson may have wanted to maintain its $52 million-per-year fee relationship with Enron. Arthur Anderson, also accused of looking the other way and having audit failures at Sunbeam Corp. and at Waste Management, may face prohibitions on taking new audit clients for a period of time. Some partners in the firm may be permanently barred from practicing the accounting trade for other public companies. These seem like mere slaps on the wrist, but to a firm like Arthur Anderson, they could herald a downward spiral for this huge accounting firm.

Intense lobbying on the part of Enron and its bankers brought pressure on the paid watchdogs, called rating agencies, at the worst possible moment. Standard and Poors, one of the best known of these rating agencies, and Moody's, a well-known bond-rating service, both failed to anticipate Enron's problems. As recently as late October, both firms gave Enron top grades on its financial report card.

The tragedy faced by Enron's own employees is among the worst. Those who put their faith and money into their own company by choosing Enron for stock retirement plans deserve the most sympathy. Under Enron's internal rules, these individuals had no choice but to keep their money in Enron stock until they reached a certain age, and this fall, when the news got really bad, they were not allowed to change their choice of investments. There will be many recriminations exchanged in the upcoming months and years, but it is clear that it was not just individual investors who were duped. Professionals who were supposed to have access to confidential and complete financial information failed to see the warning signs until it was too late.

For more on the collapse of Enron and its effect on the individual investor, see next week's Real Money column by Rob Rikoon in The New Mexican.

INSIDE

Classifieds D-3

Business

D

THE SANTA FE NEW MEXICAN

Tuesday

DECEMBER 18, 2001

www.santafenewmexican.com

There is more than one reason behind Enron's demise

Editor's note: *Because of space limitations, Rob Rikoon's column on the collapse of Enron Corp. was divided in half. The first portion appeared Dec. 11.*

The origins of Enron's disaster began in the movement to deregulate the American power industry. As supply and demand for electricity and natural gas were left to the free market, companies willing to take risk, like Enron, filled the void. Another major factor that allowed Enron to grow beyond its traditional roots as a gas-pipeline business was the lack of regulatory scrutiny on the rapid innovations being used by Enron, especially in the risk-management area. Enron was willing to assume a variety of risks, and in a magnitude that no one else could match. Enron gave its customers the feeling that their power, energy, telecommunications, and basic-materials costs would not be subject to the wild swings of the market, but would be protected by Enron managing these risks.

In order to perform on its promises, Enron created a vast and complicated structure of companies and private partnerships that lent money and took cross-ownership in each other. The purpose of these maneuvers was to present a far rosier picture of its business than

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Real Money

actually existed in order to propel its stock price higher. The truth is that Enron executives fell prey to avarice and ego. They were able to adhere to the strict letter of the law, but avoided the law's real intent of protecting investors.

The basic cause of Enron's decline and descent into bankruptcy was a widespread loss of confidence in the integrity of its management team. Enron obscured its true financial condition through purposefully complex transactions between the company and the private partnerships that it set up. Once that condition became public, Enron faced a fork in the road that many of us face in our personal lives.

The choice was between being honest and coming clean about mistakes and problems, or trying to hide behind legalese and accounting barriers. Unfortunately Enron, from its very top ranks down to mid-level executives, failed the integrity test. It first gave out minimal financial information and then, under pressure, Enron's leaders became defensive and denied having conflicts of interest. The company chose to hire lawyers and accountants instead of stepping forward in honesty and humility to regain the public's trust.

In businesses such as trading financial instruments, trust is the key component to be able to continue operating. Once Enron lost the trust of the energy-trading community — and then, only a few short weeks ago, the rating agencies — its ability to stay in business became severely curtailed. Rating agencies such as Standard and Poors were upbeat about Enron right up to early this November. But once Standard and Poors rated Enron as "junk," everyone knew that many of the loans Enron had taken would become due. Clearly Enron would then be unable to pay the loans off in such rapid succession as would be required.

Enron lied about how much debt it took on, lied about the nature of its reported profits and hid the truth of the enrichment of its own officers at the expense of shareholders and employees. It seems that there are very few things that Enron didn't lie about. While it is small consolation to shareholders and employees, company executives who made off with tens of millions of dollars over the last decade may end up in jail.

It is clear that investors can no longer rely on the rating agencies to do their homework for them. The question for stockholders, not just in Enron but in other corporate entities, is, 'What does all this mean?'

For starters, when important members of a business' management depart suddenly, without adequate explanation of their performance shortfall or giving their real views, it is a cause for concern. Often, the company and departing managers are being silenced by mutual gag orders. Therefore, the public has no information about what is really going on behind closed boardroom doors. This built-in wall that hides the inner workings of American businesses results in a huge disadvantage for shareholders. The hardest thing for anyone to do is to tell the truth. Full and immediate disclosure of financial problems, slipping market share, falling earnings or other similar issues ought to be encouraged as opposed to being discouraged. Unfortunately, the system works against these kinds of disclosures.

The reality is that much of this goes back to the tension between long-term financial health and short-term appearance. Our culture is, by and large, fixated on immediate investment returns. Most bonuses are based on quarterly or, at the most, yearly performance yardsticks. Therefore, the strong tendency inside business is to avoid telling the truth if the truth looks bad.

One way, as investors, to counter this inherent bias against the truth is to hold fast to the time-tested principle of diversification. We can keep our eyes open. News is readily available about companies, but the reasons and meaning behind the reported numbers are almost impossible to ascertain without digging deeper into the story. The advice we continue to give is to look for solid, long-term companies whose businesses are understandable and whose financial statements are straightforward.

In a world beset by uncertainties, taking on a lot of debt is inadvisable, both for personal and business success. A return to fundamental values, including integrity, clarity and simplicity, will go a long way towards making sure that your portfolio will not be the victim of the next Enron. When we can take this kind of occurrence in stride, other companies and opportunities will surely arise that are attractive to the prudent investor.

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