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Trader Notes: April 11, 2008 **Doug Sandler, CFA**

Horizontal Diversification… That Dog don't Bark

A previous neighbor of mine owned a little sports car from the 70øs called an MG. It was a pretty car aesthetically and was a thrill to drive. Unfortunately, I rarely had the opportunity to see it or ride in it because it was always in the shop. The reason for the stroll down memory lane this morning has everything to do with General Electricøs (GE-N-$36.75) earnings report. From afar General Electric is a beautiful company to look at and for investors itøs a thrilling ride when their earnings engine is hitting on all cylindersí unfortunately, as was apparent today, those occasions do not happen as often as we like.

The justification for diversifying across business lines, or horizontal diversification, once the rage in the 80øs is becoming increasingly questioned. Companies like ITT (ITT-N-$56.59) that once lorded over an empire that included hotels, technology hardware and industrial equipment; have been embraced by the market only after they decided to undiversify and focus on what they do best. With liquid stock markets and low commission costs, investors no longer want a company to diversify its business lines for them, but prefer to diversify themselves. A horizontally diversified company forces an investor to make an ÷all or noneø choice regarding their investments. An investor cannot participate in the growth of GEøs exciting and fastest growing businesses (like infrastructure) without also committing capital to less attractive segments like financial services and media.

For holders of GE, like us (we have a below market exposure), it is probably too late to make an adjustment, given the fact that the stock is indicated down nearly 10% in pre-market trading. However, it is a reminder about being wary of other horizontally diversified companies. Horizontally diversified companies continue to exist in the market today. Diversified financials and multi-line retailers are two additional examples of business structures that should work in theory but rarely do. Like a TV/VCR/DVD combo, it sounds nice in theory, but is useless when one or more of the sub-components breaks.

Bottom Line: What sounds synergistic in theory rarely plays out in practice. We prefer to invest in industries through pure-play companies over their more diversified peers. We would rather buy a pure-play bank, insurance company, machinery company, etc. over a company that tries to do all things. While pure-plays may trade at a higher valuation, we believe the premium is justified for the greater flexibility they afford the investor.

Aside: While we are skeptical of horizontal diversification, we are more comfortable with vertical diversification. The large integrated oil companies, for example, have continually proven the value of owning and controlling the entire energy supply chain (from oil well to gas pump).

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