RAILROAD WEEK IN REVIEW

December 21, 2018

“Investors focus on economic data in level terms, rather than the rate of change. But the market picks up on the subtle changes, and better or worse matters more than good or bad.” — Liz Ann Sonders, Chief Investment Strategist, Charles Schwab & Co, in Barron’s December 15, 2018

“Total household debt, driven by $9.1 trillion in mortgages, is now $837 billion higher than its previous peak in 2008, just as the last recession took hold. Such debt has risen steadily for more than four years and now sits more than 21 percent above a trough in 2013.” — Reuters, November, 2017

The Dow Theory is about the relationship between the Dow Jones Industrial Average (DJI) and the Dow Jones Transportation Average (DJT). When one of these averages climbs to a new high, then the other is expected to follow suit within a reasonable amount of time. If not, then the averages show "divergence" and the market is liable to reverse course. (The Dow Theory has its origins in the writings of Charles Dow -- founder of the Wall Street Journal and creator of the Dow Jones Industrial Average.)

In Dow's time, the two averages were the industrials and the railroads. The logic behind the theory is simple: Industrial companies manufactured the goods and the railroads shipped them. When one average recorded a new secondary or intermediate high, the other average was required to do the same in order for the signal to be considered valid.

Consider automobiles, for example. Rising wages, falling unemployment, reasonable interest rates, increasing values of residential real estate — among other factors — cause consumers to expect better days to come and they are comfortable looking for a new car. Demand goes up, more cars are built and sold, auto makers’ earnings and share prices go up.

But they can’t go up until the revenue starts coming in, and that can’t happen until cars are moving off the lot. That in turn requires getting cars from the places they’re made to the places they’re sold. The required transportation is paid for pretty much as it’s used, so the railroad earnings will go up before the auto builders’ earnings. Ergo transport stock price improvement presages auto builder stocks improvement, and an increase in rail share prices can predict share prices in other sectors, thus the Dow Theory.

Conversely, railroad share prices fall when revenue earnings drop, and revenue unit volume is a major factor. Revenues fall because there is less stuff being moved because less stuff is made because there is less demand for said stuff. The present downturn in share prices in general and the railroads’ in particular is The Railroad Bear Market. (Even though reported earnings are going up, they’re doing so largely on share buy-backs and cost-cutting. Intermodal is the fastest grower even as most merchandise commodities languish.)

The Reuters quote above bodes particularly ill for the consumer sector and its 70 percent share of GDP. Consumers are pulling in their horns and the rate of change volume of stuff on the move has dropped markedly. Railroad shares are getting hit — hard — and the adjacent table shows the rate of change of which Sonders speaks.

Railroad Bear Market

RR	Oct 1	Dec 17	Change
KSU	$123.00	$94.00	-23.6%
NSC	$184.00	$146.00	-20.7%
GWR	$93.00	$74.00	-20.4%
$DJT	11,494	9,471	-17.6%
CNI	$92.00	$76.00	-17.4%
CP	$216.00	$181.00	-16.2%
UNP	$164.00	$140.00	-14.6%
CSX	$75.00	$65.00	-13.3%
$DJI	26,986	23,490	-13.0%
$SPX	2,925	2,565	-12.3%
BRK/B	$216.00	$198.00	-8.3%

Not only are share prices heading down but they are heading down *fast*. The Dow Jones Transportation Index ($DJT) outperformed three names; four names plus the Berkshire BNSF proxy were down less than the Index.

Moreover, all the pure railroads were worse off than either the Dow Industrials ($DJI) or S&P ($SPX). Finally, nearly 60 percent of the S&P 500 companies are down more than 20 percent — worse off than most railroads.

So even though the RailTrends presenters two weeks ago were generally upbeat -- “excited to be in the railroad business” per Tony Hatch -- I do not share their enthusiasm, especially for the carload sector. That said, I do see the non-Class I railroad crowd increasingly valuable in creating customers with their local strengths. So the challenge is to get the Class Is to perform the road-hauls in accordance with what they've promised at RailTrends and in other venues.

Precision Scheduled Railroading is a term tossed liberally about at RailTrends and elsewhere. Yet a reader suggests that not everybody is using the term to mean precisely the same thing. And so it is that I opened my Hunter-autographed copy of *How We Work and Why — Running a Precision Railroad* to pull all the elements together and get everybody on the same page.

First, a little scene-setting. I first met Hunter when he and Gil Lamphere were running the Illinois Central as a scheduled railroad. Asked how it worked, he told me they scheduled everything — cars, locomotives, crews, trains, even track maintenance windows — to keep the railroad running the same way every day.

One result was that the IC was getting five turns a month on grain trains from the Midwest to the Gulf. I dined out on that for a few months until the next time we met. When I told him how well the story was being received in my rounds, he said, “Roy, you’re behind the times. We’re getting six.” Then he sent me his book and the rest is history. What follows is directly from the book.

There are five elements to running a precision railroad: Service, Cost Control, Asset Utilization, Safety, and People. These guiding principles do not change over time. They are constants in our planning and our operating decisions. They apply to everyone in the company, not just the people who run the trains.

Our business is serving our customers because without them, there wouldn't be any business. We make ***service*** *commitments to customers because it all comes down to doing what we say we will do. If we say we will deliver their goods on time and on damage-free, we'd better do just that or they'll take their business elsewhere.*

Cost control *is not to be confused with cost-cutting. Cost control means the right and tight management of all expenses — both short-term day-to-day operating expenses and long-term capital expenses. Cost-cutting as such too often means means reducing expense regardless of the consequences.*

An ***asset*** *isn't an asset until it's put to use. Until then, it's a liability. Assets have to earn their keep. An expensive asset that isn't being used to its utmost potential is just an expensive liability. That means we need to take a long hard look at what we have on hand and what we really require to run the business.*

Safety *is every employee's responsibility. Accidents and injuries take a huge toll in physical pain and emotional suffering. So no matter how you look at it, safety is good business. The more predictable the operation or process, the safer it is. When a processes becomes unpredictable, we become prey to uncertainty about what will happen and when.*

People *drive the trains that transport our customers' goods, maintain the tracks on which those trails run, answer the phones when customers call. They design, refine, and execute the plan — processes and procedures to manage the incredibly complex machinery of a modern railroad. In short, safety is built on the foundation of people. Without people none of this happens.*

There is no magic in any of this. It's simply adhering to the rules of Railroading 101. Yet over the last ten years I fear we've lost the focus on running trains to serve customers, paying more attention to the OR and shareholder returns. Precision Railroading done right will generate even better returns for customers, employees, and owners.

This is the final Week in Review for 2018. Thanks again for your continued patience and good humor. I'm looking forward to continuing the conversation in 2019.

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